The eighth wonder of the world and the Montgomery Small Companies Fund

Since inception in September 2019, the Montgomery Small Companies Fund has made an admirable start.

While small capitalisation companies generally involve more risk because of their lower liquidity, their greater sensitivity to managements' influence, and their greater sensitivity to economic conditions, they have proven over a long time horizon to be a rewarding asset class to allocate capital – preferably for patient investors who grasp the power of compounding.

Investing in low return asset classes, such as bank term deposits, can reduce anxiety, but it can also have higher long-term opportunity cost in terms of lower capital accumulation.

In this whitepaper, we look at the Montgomery Small Companies investment methodology which categorises the companies within their investment universe into four areas, and the differences in annual rates of return having a large impact on long-term results.

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The Montgomery Small Companies Fund (The Fund) invests in a portfolio of between 30 and 50 smaller and emerging companies which are listed on the Australian Securities Exchange (ASX) or New Zealand Exchange (NZX). The Fund was launched in September 2019 and in the period from inception to October 2020, it has delivered the original investors a return of 14.72 per cent, after all expenses.[1] This compares favourably with its benchmark, the S&P/ASX Small Ordinaries Accumulation Index (Benchmark), which was down 2.85 per cent over the same period, for out-performance of 17.57 per cent.

Relative to most asset classes – agriculture, commercial property, gold, government bonds and term deposits – shares have provided the best ungeared investment returns since the mid-1940s. And over the longer-term, the shares of small companies, according to Morgan Stanley Research, have generally done better than the shares of their larger counterparts. We believe this is because smaller companies offer the opportunity to focus on businesses that occupy profitable niches and have the opportunity to grow at a much faster rate.

We believe a key reason for this long-term out-performance is due to the fact smaller companies are often operated by dynamic founders or hand-selected successors who are focussed on building wealth for themselves and their fellow shareholders.

The second point to understand is the power of compounding – often referred to as the eighth wonder of the world. Albert Einstein famously said that compound interest is the most powerful force in the universe "he who understands it, earns it; he who doesn't, pays it." The table below illustrates this using four differing annual average return scenarios over four differing periods, assumes a starting point of $10,000 invested continually over the entire period and ignores any tax that may be payable (and will vary depending each investor's particular situation).

For instance, a 20-year old who invested $10,000 today, and earned an average annual return of 3 per cent for the next forty years would end up with $32,620. Had that same person received an average annual return of 12 per cent, they would have ended up with $930,510 after 40 years. While the difference in average annual return between 3 per cent and 12 per cent is four-fold, the difference in the amount in the kitty after forty years would be nearly 29-fold ($930,510 v $32,620).

Small differences in annual rates of return of various asset classes have a large impact on long-term results. While investing in low return asset classes, such as bank term deposits, can reduce anxiety through a reduction in volatility and avoiding shorter-term potential losses, it can have a higher long-term opportunity cost in terms of lower capital accumulation.

While stock returns have been very risky in the short term, they have generally not been as risky over long horizons as might be expected. A feature of shares is that they are accompanied by higher volatility than other asset classes – and the shares of small capitalisation companies have gone up and down more than the shares of large capitalisation companies – it is important to note US studies dating back to 1945 have demonstrated that Small Company Shares have delivered investors at least 2 per cent per annum more than Big Company Shares (on a pre-tax basis).

When evaluating the returns of Small Company Shares, we must consider the inherent "survivorship bias" that lies in the composition of small company indices. In Australia, this is the concept that the very best-performing small businesses are elevated from the Small Ordinaries Index into the S&P/ASX 100 as they continue to grow and prosper.

[1] *Past performance is not a reliable indicator of future performance*

Nominal Return/ Timeframe	**3%**	**6%**	**9%**	**12%**
10 years	$13,439	$17,908	$23,674	$31,058
20 years	$18,061	$32,071	$56,044	$96,463
30 years	$24,273	$57,435	$132,677	$299,599
40 years	$32,620	$102,857	$314,094	$930,510

Relatively recent examples of these once-small businesses include Afterpay Touch (ASX: APT), REA Group (ASX: REA) and Xero (ASX: XRO).

To make room for these small-cap success stories, the poorest performing Big Company constituents, which are often in structural decline or experiencing management issues, are relegated back down to the small company index. This phenomenon negatively distorts the historical performance of the small company index. Of course, investors are not bound by the same index regulations and can continue to own these businesses throughout the journey.

While small capitalisation companies generally involve more risk because of their lower liquidity, their greater sensitivity to management's influence and their greater sensitivity to economic conditions, they have proven over long periods of time to be a rewarding asset class in which to allocate capital – preferably for patient investors who grasp the power of compounding.

Elroy Dimson, Paul Marsh and Mike Staunton of the London Business School believe many developed world share markets have delivered a nominal return, accumulating for dividends, averaging nearly 10 per cent per annum since 1900 (at the pre-tax level).

This is supported by Professor Jeremy Siegel of the Wharton School of the University of Pennsylvania, who argued in his investment bestseller "Stocks for the Long Run" that stocks over the very long run have returned an average annual real 6.5 per cent to 7.0 per cent return (whilst annual inflation in many first world economies has averaged around 3.0 per cent). Known as Siegel's Constant, this has been surprisingly stable, as over the past 200 years the annual average real return on US shares has ranged between 4.9 per cent and 7.7 per cent, about 90 per cent of the time.

The point here is that if very long-term investors can earn an annualised 2 per cent more over a 40-year period, then a 14 per cent per annum versus a 12 per cent per annum return on a starting balance of $10,000 is a difference of $1,888,835 verses $930,510, or more than double.

The Montgomery Small Companies Fund

Gary Rollo and Dominic Rose, Portfolio Managers of the Montgomery Small Companies Fund, break down their audience of stocks into four categories. These are Structural Growth, Cyclicals, Resources and Stable Compounders. At the time of writing, The Fund's portfolio and Benchmark were structured as follows:

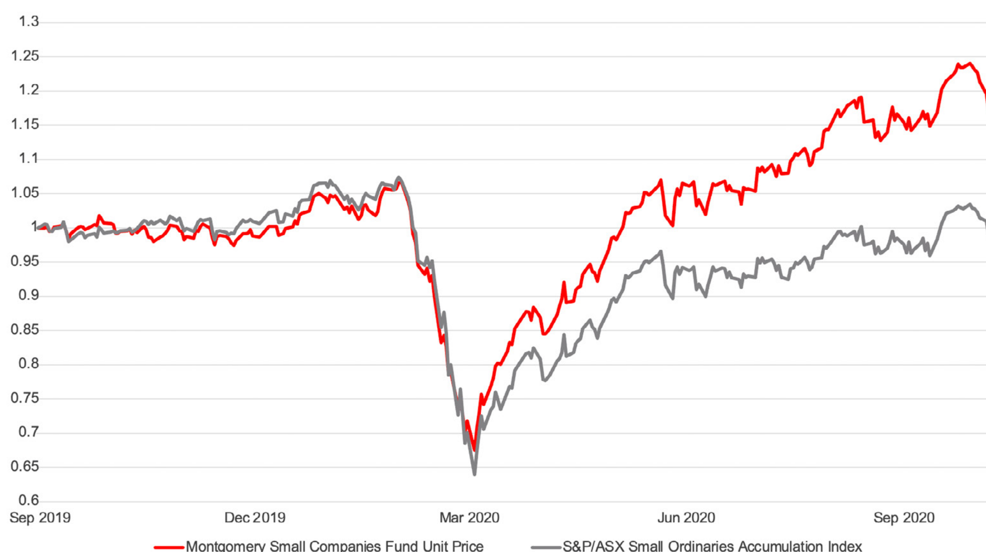
	The Fund Portfolio	**Benchmark**	**Difference between The Fund Portfolio and Benchmark**
Structural Growth	49.5%	30.7%	+18.8%
Cyclicals	20.5%	32.8%	-12.4%
Resources	12.0%	17.4%	-5.4%
Stable Compounders	12.1%	19.1%	-7.0%
Cash	6.0%	-	+6.0%

Readers will notice the strong over-weight position to the Structural Growth sector in The Fund (49.5 per cent versus 30.7 per cent Benchmark allocation). This has played a major role in The Fund's out-performance of the Benchmark – which became clear from the pandemic lows in March 2020 and is illustrated over.

Breaking down their entire investible universe into four distinct categories provides Gary and Dominic with a firm grasp of the Australian and New Zealand small company landscape. This segmenting allows them to clearly identify and target the themes they wish to exploit, as well as those themes not to participate in, achieved through an underweight allocation relative to the benchmark.

As active managers it is important to know the risks you are taking on, and the risks you are not taking on. Our view is that this approach boosts the potential to outperform the market while taking on as little relative risk as possible.

Absolute performance: Montgomery Small Companies Fund vs S&P/ASX Small Ordinaries Accumulation Index 20 September 2019 – 31 October 2020



Warning: Past absolute performance is not a reliable indicator of future performance

We define the Structural Growth sector as companies that we believe are positioned to benefit from favourable global megatrends over the medium term, which today include cloud deploying technology tools, data centres, digital payments, e-Commerce and medical technology.

In our view these structural tailwinds allow these types of businesses to potentially grow independent of the economic cycle – meaning their destiny is very much in their own hands. Selected Structural Growth companies in The Fund's portfolio include Appen (ASX: APX), City Chic (ASX: CCX), EML Payments (ASX: EML), Kogan.com (ASX: KGN), Marley Spoon (ASX: MMM), Megaport (ASX:MP1) and Tyro Payments (ASX: TYR). With the Reserve Bank signalling that interest rates in Australia could remain effectively nil for the next three years, we anticipate that investors in today's low-growth world will be far more willing to pay a premium for companies which they feel confident are capable of delivering strong growth over the coming years – namely those businesses that are able to expand their market share.

While these Structural Growth stocks have been one of the primary drivers of The Fund's strong performance to date, it is important to note that the portfolio isn't simply a 'one-trick' technology strategy or an 'all-out' growth fund. Rather, The Fund is a balanced, "all-weather portfolio" that includes notable exposures to various sectors and industries including Gold Miners (8.7 per cent), Real Estate Investment Trusts (REITs) (7.8 per cent), Mining Services (7.7 per cent) and Utilities/ Telecommunications Providers (4.4 per cent).

We believe that the balanced approach will help The Fund to perform irrespective of future market conditions. In recent weeks The Fund's Portfolio Managers have started to identify and pivot to the next developing investment themes.

Two key themes we have identified are:

(1) increasing exposure to the "dirty growth" stocks – those companies whose businesses models were severely impacted by the pandemic-enforced shutdown which we expect to naturally benefit from the continued reopening and recovery of the domestic economy – namely Webjet (ASX: WEB), Corporate Travel Management (ASX: CTD) and IDP Education (ASX: IEL); and

(2) the ever-increasing hunt for meaningful yield. As savers are crippled by the negligible cash rate, we are expecting that businesses with consistent and comparatively stable earnings streams will be highly sought after as investors look to rely on alternate sources of income. Examples of these are the historically high-yielding REITs within The Fund's portfolio, Ingenia Communities Group (ASX: INA), Centuria Capital Group (ASX: CNI) and National Storage REIT (ASX: NSR).

We believe this ability to make tactical decisions is the greatest benefit of investing in an actively managed portfolio (of 30-50 holdings). This flexibility allows us to invest more heavily in sectors and themes where we identify attractive opportunities, and veer away from those areas we identify as being more uncertain or possessing outsized risks.

With more than 14 years each of specialist small cap investing experience across both Australia and the United Kingdom, Gary Rollo and Dominic Rose have deep knowledge and existing relationships with management teams and stockbrokers which enable them to consistently assess the long-term opportunities and understand the inherent risks of these formative businesses.

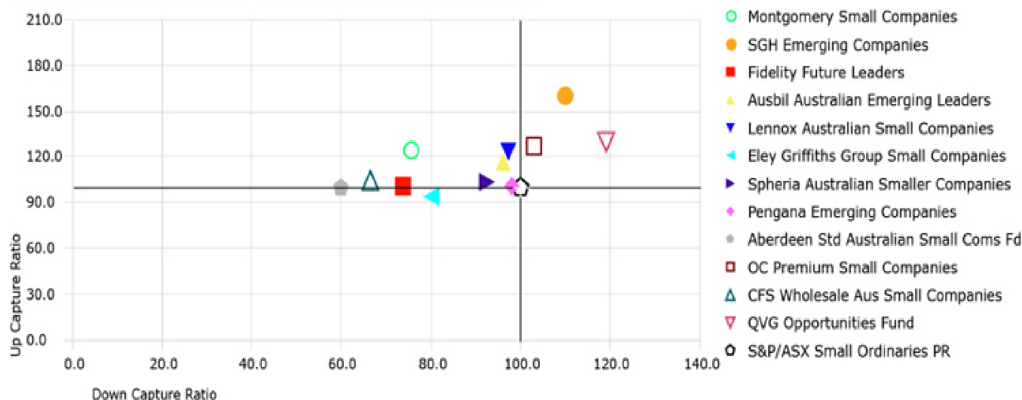
This active management, when executed successfully, can serve to magnify investors' gains and minimise downside. Looking at independent researcher Morningstar's Upside/Downside Capture analysis below, we can see that since its inception, the Montgomery Small Companies Fund has captured 124 per cent of its Benchmark's (the S&P/ASX Small Ordinaries Accumulation Index) upside in months in which the Benchmark has delivered a positive return and conversely captured 76 per cent of its downside, during months in which the Benchmark has declined. Having exhibited this stewardship through a period of significant market volatility (encompassing both the market's sell-off of February and March and its subsequent rally) in its first thirteen months since inception, we believe The Fund can continue to perform favourably irrespective of future market conditions. However, investors should be aware that past performance is not a reliable indicator of future performance.

Manager Analysis

Upside-Downside Capture

Time Period: Since Common Inception (1/10/2019) to 31/10/2020

Peer Group (5-95%): Open End Funds - Australia - Equity Australia Mid/Small Blend



Market Performance

Time Period: Since Common Inception (1/10/2019) to 31/10/2020

	Up Period Percent	Down Period Percent	Best Month	Worst Month	Best Quarter	Worst Quarter	Up Capture Ratio	Down Capture Ratio	R2
Montgomery Small Companies	53.85	46.15	17.99	-17.47	32.78	-21.12	124.05	75.70	97.24

Warning: Past absolute performance is not a reliable indicator of future performance

Over the next two financial years (Fiscal 2022 on Fiscal 2020), The Fund's portfolio, which currently comprises 48 stocks, has the following forecasts relative to the stocks which make up the Benchmark. The biggest differential is sales growth, which is forecast at 16.4 per cent per annum on average over the next two financial years for The Fund's portfolio, 2.4 times the 6.4 per cent per annum from the Benchmark.

Despite significantly stronger EBITDA growth (16.8 per cent per annum for The Fund versus 12.4 per cent per annum for the Benchmark) and EPS growth (31.4 per cent per annum for The Fund v 22.8 per cent per annum for the Benchmark), the valuation attributes using EV/ EBITDA and PE multiple forecasts for Fiscal 2022 are priced at only a small premium (7 per cent and 9 per cent, respectively) relative to the Benchmark. If these forecasts prove to be accurate, then The Fund's portfolio could be driven by the Structural Growth sector.

F'2022 on F'2020 (estimated annualised growth)	**The Fund Portfolio**	**Benchmark**	**Relative performance of The Fund Portfolio and Benchmark**
Sales	15.6%	6.4%	2.40X
EBITDA	16.8%	12.4%	1.35X
EPS	31.4%	22.8%	1.38X
DPS	11.9%	19.7%	0.60X
Valuation			
EV/EBITDA - F'2022	11.5X	10.8X	1.07X
PE - F'2022	18.2X	16.7X	1.09X
Yield -F'2022	1.7%	2.4%	0.71X
Risk			
Liquidity (1).	$9.7m	$6.4m	1.51X
3 Year rolling Std Dev.	3.2	3.1	1.03X

(1). Average daily turnover, per stock, based on the rolling three months trading.

Warning: The above forecasts are based upon assumptions which, although we consider them to be reasonably based, may not eventuate. If the assumptions upon which the above forecasts are made prove to be incorrect, then the forecasts will be inaccurate and consequently The Fund may not perform as expected. Future returns are not guaranteed.

If you would like to invest in the Montgomery Small Companies Fund you can find more information and request the Product Disclosure Statement via our website:
Download the Product Disclosure Statement

Investors are able to apply via an online application which can be accessed here:
Online Application Montgomery Small Companies Fund

Alternatively, if you would like to have a discussion, both David Buckland and Toby Roberts can be reached on (02) 8046 5000.

Do you want to get in contact with the team at Montgomery?

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Important Information

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