CAREFULLY PREPARED BY

MONTGOMERY

BEST of the BEST

MAGAZINE

Investment Insights

DECEMBER 2024

MY PARENTS ARE CASH-STRAPPED, SO WHY DON'T THEY SELL THEIR HOUSE?

By Roger Montgomery

ARE WE FOLLOWING BUFFETT'S LEAD TOWARDS A MARKET CRASH?

By Roger Montgomery

THE TRUMP EFFECT ON SMALL CAP STOCKS

By Roger Montgomery

MARKET VOLATILITY AND THE UNBOTTLING OF 'TURNING POINTS'

By Roger Montgomery

Aura Core
Income Fund

Aura Core Income Fund Target Return

The Fund aims to achieve a target return currently equating to 7.85%-9.85% [1] per annum net of fees and costs.

The target return is 3.5%–5.5% per annum above the Reserve Bank of Australia (RBA) Cash Rate, net of fees and costs, through the economic cycle.

MINIMUM INVESTMENT $25,000

The Aura Core Income Fund aims to preserve capital and provide a stable monthly income through exposure to a diversified pool of Australian private debt assets, predominantly made up of small to medium enterprise (SME) loans.

FUND BENEFITS:

- Aims to deliver **stable monthly income.**
- Aims to **perform through the economic cycle. The Aura Private Credit team's track record has demonstrated that the SME loan asset class can deliver reliable income** to investors through disruptive market conditions. Returns are earned from interest generally charged at a floating rate above the RBA Cash Rate.
- **Low volatility** and little correlation to public markets.
- **Exposure to the private debt asset class** that individual retail investors cannot easily access on their own.
- **Access to the investment expertise** behind the highly successful Aura Private Credit Income Fund (available to wholesale clients only).
- **A diversified portfolio** of credit exposures across industries and geographies.

To learn more about the Aura Core Income Fund, please visit www.montinvest.com or call Rhodri Taylor directly on 02 8046 5000 to discuss the strategy.

[1] The Target Return is not guaranteed. The Fund's total return may rise, or fall based on, amongst other things, performance in the underlying loan assets and on movements in the RBA Cash Rate.

The Aura Core Income Fund (ARSN 658 462 652)(Fund) is issued by One Managed Investment Funds Limited (ACN 117 400 987 | AFSL 297042) (OMIFL) as responsible entity for the Fund. Aura Credit Holdings Pty Ltd (ACN 656 261 200) (ACH) is the investment manager of the Fund and operates as a Corporate Authorised Representative (CAR 1297296) of Aura Capital Pty Ltd (ACN 143 700 887 | AFSL 366230). You should obtain and carefully consider the Product Disclosure Statement (PDS) and Target Market Determination (TMD) for the Aura Core Income Fund before making any decision about whether to acquire or continue to hold an interest in the Fund. Applications for units in the Fund can only be made through a valid paper or online application form accompanying the PDS. The PDS, TMD, continuous disclosure notices and relevant application form may be obtained from www.oneinvestment.com.au/auracoreincomefund or from Montgomery.

BEST of the BEST

ISSUE 47: DECEMBER 2024

FROM THE EDITOR

Welcome to the final edition of ***Best of the Best*** for 2024. The year has ended exactly the way we predicted; a good year for equity investors. As long as disinflation and positive economic growth continue into 2025, you can expect 2025 to see more of the same, perhaps even better than 2024. I realise that's not the consensus view.

The chorus of commentators and investors that suggest the market is expensive and due for a correction is growing, but there are plenty of reasons to think the rally is only midway. The world is faring well, and in the U.S., whose stock market now accounts for 75 per cent of the MSCI World Index, earnings are growing, the U.S. economy is robust and corporate profit margins are healthy. While many point to the Shiller CAPE ratio as a sign of unbridled optimism, we have to remember the CAPE ratio uses a ten average earnings number, which includes Covid. In other words, the denominator in the calculation is depressed by an unusual (hopefully) one-off event.

The other point to remember is that company earnings growth is accelerating. For Q3 2024, 75 per cent of S&P 500 companies reported a positive earnings per share (EPS) surprise and 61 per cent of S&P 500 companies reported a positive revenue surprise. Meanwhile overall growth is 5.8 per cent, well above the 4.2 per cent consensus expected by analysts. At 5.8 per cent, the growth rate for the quarter marks the fifth straight quarter of year-over-year earnings growth for the index.

Meanwhile the positive from Trump's proposed tariffs is they may stoke faster economic growth in the U.S. if they support businesses to front-run them by ordering inventory ahead of their imposition. U.S. businesses may also sponsor workers ahead of restrictions on immigration, fuelling stronger employment data. And keep in mind Tariffs are a one-off change. After the change, inflation falls again (disinflation). Producing an extra couple of billion barrels of oil a day will also help lower inflation, and if this can coincide with accelerating GDP, equity markets should be content in 2025.

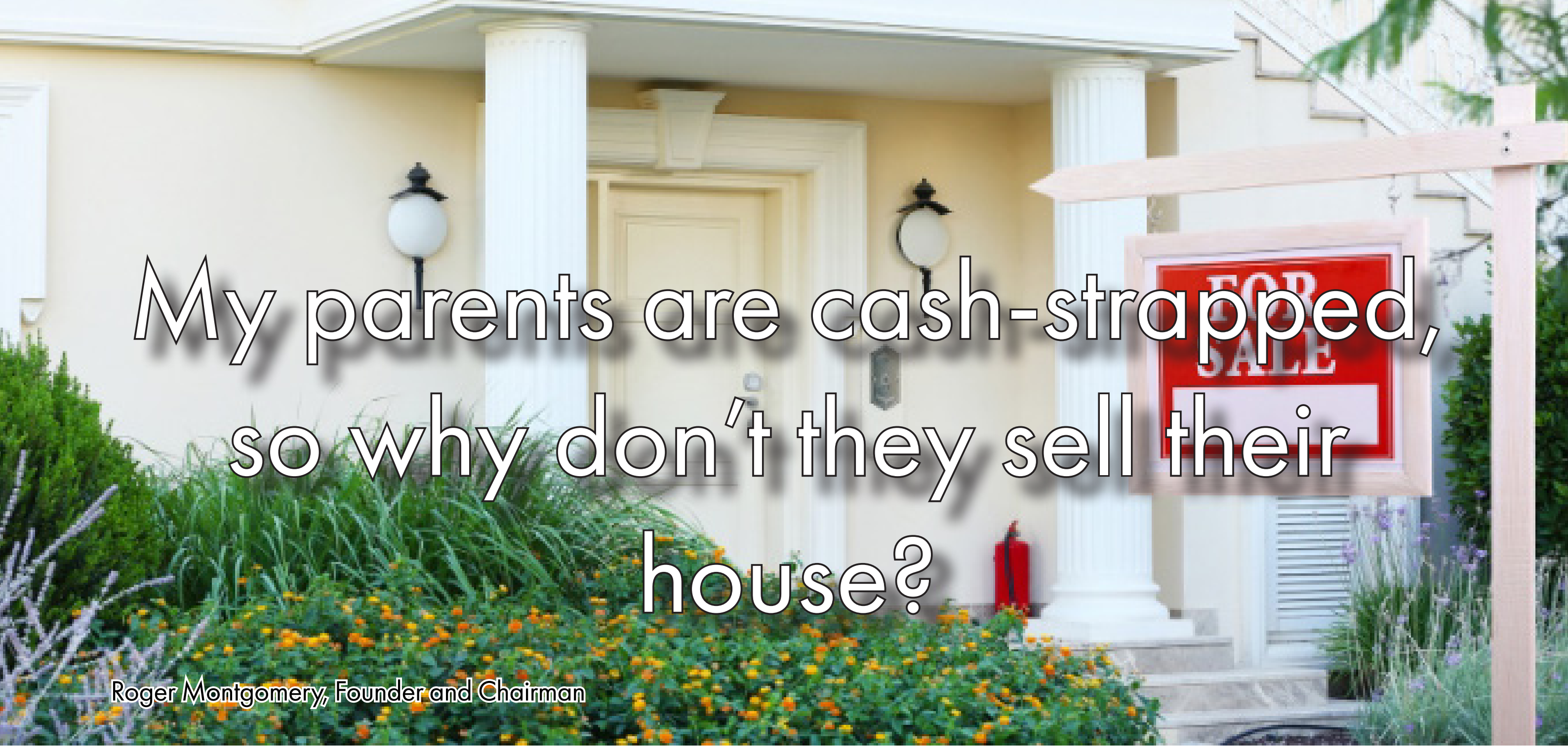
I remind investors we expected 2024 to be a good year for equities and it was. Provided the base ingredients remain – those being positive economic growth and disinflation, 2025 could be another memorably good year for equity investors. This may be especially true should the enthusiasm around Trump's policies turn into evidence of mild inflation and stronger economic growth.

I pray for a safe and peaceful Christmas and sincerely hope for a prosperous 2025.

Roger Montgomery

Founder and Chairman

TABLE OF CONTENTS



My parents are cash-strapped, so why don't they sell their house?

Roger Montgomery, Founder and Chairman

Roger explores the familiar question facing Gen Xers about why their cash-strapped parents don't sell the family home. He highlights the barriers to downsizing, while discussing strategies for retirees to access home equity and invest in private credit funds to generate attractive income, enhancing both lifestyle and financial security in retirement.

The question, 'my parents are cash-strapped, so why don't they sell their house?' is a familiar topic of discussion among us, Gen Xers, aged between 43 and 59 in 2024.

With many Gen Xers having done okay and some having done extremely well, those with respect for the start their parents gave them often feel guilty about not having the time to help out their parents more. And while it is important to acknowledge we make time for what's important to us (one of the most valuable realisations to dwell on), the conversation often then turns to what baby boomer parents can do for themselves. To the Gen Xers I say, your parents are adults and fully capable of making decisions about their finances, just as they did before you were born! Nevertheless, the adult kids often wonder why the large home their parents are living in isn't sold with some of the proceeds used to finance more 'joyful' pastimes.

There are several factors at play. For many parents, holding onto the family home and leaving it to their children is an act of love and provision. There are also practical considerations. Established relationships in the local community and proximity to familiar places and essential connections are crucial. Meanwhile, the frictional costs of selling and stamp duty on a new, smaller property are also deterrents. Even leaving the garden behind can be too heartbreaking for some to consider. Moreover, if a suitable downsizing option is unavailable locally, moving away to rebuild friendships and community is often the only, and usually undesirable and acceptable alternative.

What if my parents want to access more cash?

Selling the family home isn't the only way to release some cash. Some options release equity and permit continuity of lifestyle in the family home.

Knowing the proceeds can be invested to produce an attractive monthly income may help with the decision-making process and conversations.

Discussing the options

Retirement is often the time to enjoy the fruits of one's labor, but for many Australians, the reality is a stark contrast. Despite having significant wealth tied up in their homes, a considerable number of retirees find themselves with insufficient superannuation and savings to fund their desired lifestyle. This paradox raises a crucial question: How can retirees access the equity in their homes to secure a more comfortable and financially stable retirement?

The untapped potential of home equity

The family home has long been considered the Australian cornerstone of wealth. And for many, it is. The home provides shelter, security, emotional attachment, and as we explored earlier, a legacy to pass on to the next generation. However, there are limitations associated with this line of reasoning leading retirees to overlook the financial potential locked within their own home.

Missing out on travel, or a nice wine, or that new local restaurant is unnecessary, when millions of dollars are available in the walls of the family home. Sure, as we age, we want less, but we don't have to go without. Gradually and sensibly drawing down and spending superannuation savings or other assets, such as the home, is a difficult but possibly rewarding bridge to cross. Additionally, the funds accessed can be invested and with the income used for lifestyle pursuits. In the latter case the capital need not diminish and long-term security remains uncompromised.

Barriers to accessing home equity

Several factors inhibit retirees from tapping into their home equity. Emotional attachments and the desire to leave a debt-free home to heirs are significant psychological barriers. Meanwhile, downsizing or accessing home equity is burdened by red tape and transactional costs, including stamp duty and legal fees. And the lack of suitable housing options in familiar neighborhoods can make the prospect of moving unappealing.

Obviously, the government could do something about this, and it would also help with anemic consumption (which current measures must rely upon immigration to boost). Relaxing and finetuning income and asset rules for the age pension and changing means testing and assessable asset rules for released home equity could alleviate some of these barriers.

The rise of private credit as a potentially lucrative investment and source of income

While retirees tackle the question of how to utilise their home equity, another financial trend is gaining momentum those same retirees need to be aware of: the burgeoning private credit market. Quality, growing businesses are demanding credit that banks are being regulated away from providing, fueling opportunities for investors seeking higher yields.

Private debt funds, such as the funds accessible through www.montinvest.com are offering returns ranging from eight per cent to 12 per cent, attracting self-funded retirees and high-net-worth individuals eager to enhance their income streams.

Since the global financial crisis (GFC), changes in bank capital adequacy regulations mean the supply of capital to quality businesses is declining versus the demand for it. That represents a compelling need for borrowers keen to secure capital, but also an opportunity for investors to reap an attractive premium from private corporate lending.

The Aura Private Credit Income Fund targets a return of nine to 12 per cent per annum from a broadly diversified portfolio of secured loans to businesses in Australia. The Fund is also working towards bridging the funding gap left by major banks by focusing on profitable businesses now forcibly ignored by traditional bank lenders. Importantly for investors, the Fund only finances businesses providing adequate security and/or generating comfortable levels of cashflow to service their debt.

Marrying home equity with private credit investment

It's not easy to decide to sell the family home or even some of it. Releasing equity from the family home means you will ultimately share the proceeds of any future market sale with someone else. But it also means earning an income, and possibly an attractive one, today. Remember, when equity is tied up in the family home, no income is being produced.

The convergence of the two major financial themes, thus presents a unique opportunity for retirees. By accessing the equity in their homes, retirees can invest in private credit funds, thereby generating higher income to support their retirement lifestyle. The strategy not only unlocks dormant wealth but also capitalises on the robust returns offered by the private credit market.

And you can continue to live in the family home surrounded by all that is comfortable and familiar.

As we predicted some years ago, more investors, advisers and commentators now see private credit as an essential asset class within portfolios, while economists and commentators see private credit as complementary to bank lending with an essential part to play in the economy.

Mitigating risks and ensuring alignment

Not all private credit funds are the same and investing in private credit is not without risks, such as liquidity and lower regulatory oversight compared to traditional banking. However, funds like the Aura Private Credit Income Fund are structured to mitigate these risks by applying stringent investment criteria and aligning interests between lenders and investors.

Retirement prosperity

The intersection of home equity access and private credit investment offers a potential transformation or retirement financial planning. Retirees can unlock the wealth in their homes to invest in high-yield opportunities, thereby enhancing their financial security and quality of life.

Changing the narrative around the family home from an untouchable asset to a strategic financial tool however is essential. With supportive policy changes and increased education on the benefits and methods of accessing home equity, retirees can embrace this new and powerful financial combination.

At the same time, where traditional income streams may fall short, leveraging home equity to participate in the private credit market could be the key to a more prosperous and fulfilling retirement. Retirees can enjoy a more flexible lifestyle and silence the whining of their Gen X kids!

This article was written on 9 October 2024. All prices and movements in prices are on this date.

Disclaimer

The Aura Private Credit Income Fund is an unregistered managed investment scheme for wholesale clients only and is issued under an Information Memorandum by Aura Funds Management Pty Ltd (ABN 96 607 158 814, Authorised Representative No. 1233893 of Aura Capital Pty Ltd AFSL No. 366 230, ABN 48 143 700 887)(Aura Group).

This information is for wholesale or sophisticated investors only and is provided by Montgomery Investment Management Pty Ltd (ABN 73 139 161 701, AFSL No. 354 564)(Montgomery) as the authorised distributor of the Fund.

An investment in the Fund must be through a valid online application form accompanying the Information Memorandum.

The information provided is general in nature and does not take into account your investment objectives, financial situation or particular needs. Before making an investment decision you should read the Information Memorandum and (if appropriate) seek professional advice from a licensed financial advisor to determine whether the investment is suitable for you.

Montgomery and Aura Credit Holdings Pty Ltd (ACN 656 261 200, CAR 1297296) (Aura Credit Holdings), who is the Investment Manager of the Fund do not guarantee the performance of the Fund, the repayment of any capital or any rate of return. Investing in any financial product is subject to investment risk including possible loss. Past performance is not a reliable indicator of future performance. Information in this report may be based on information provided by third parties that may not have been verified.

Aura Group has entered into a Distribution Partner Agreement (Distribution Agreement) with Montgomery to distribute the Fund to its client base. Montgomery may receive a share of the fees you pay as well as potential equity in Aura Credit Holdings.

Are we following Buffett's lead towards a market crash?

Roger Montgomery, Founder and Chairman

Roger challenges the idea that markets don't fall simply because they are high and emphasises the importance of focusing on quality growth companies. He advises investors to remain disciplined, view corrections as opportunities, and avoid being distracted by market indicators.

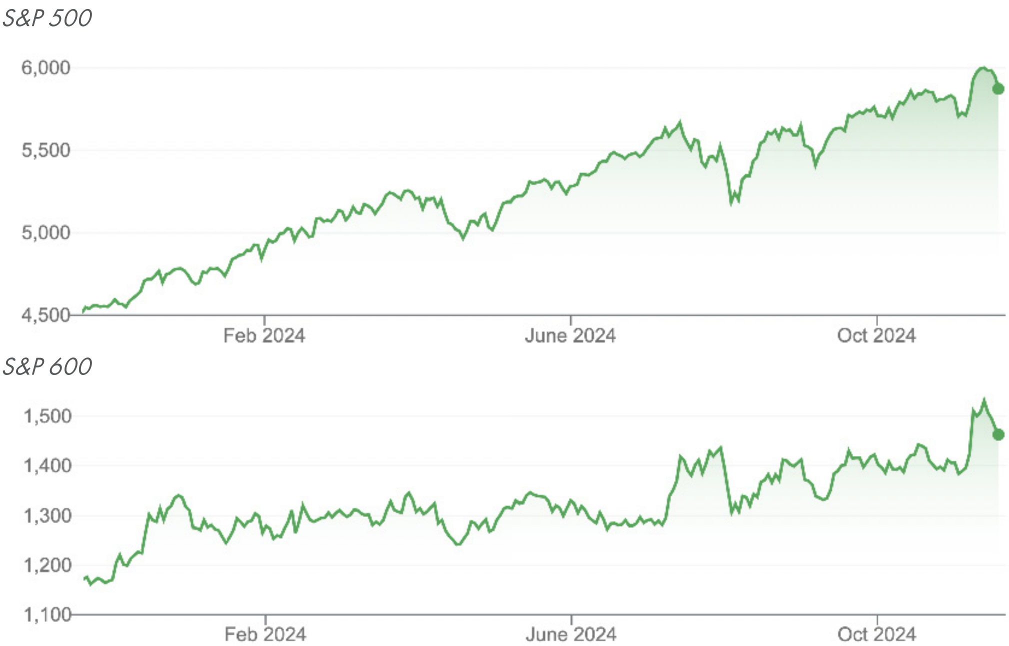
Every day, I am met with articles quoting commentators telling me that the market is high and, therefore, on the precipice of a correction. Let's get one thing straight – markets don't fall just because they are high. They can stay high and continue upwards for a long time. It is also a mistake to believe that a catalyst is required to cause the market to crash. Investors, to this day, debate the trigger for the 1987 crash.

So, markets don't fall just because they are high, but they can fall for no apparent reason.

The trick is not to try and make sense of it but to stick to the framework you have developed for investing. My framework for equity investing is 1) stick to quality quality and quality growth (the latter being organic rather than acquisitive) and 2) be aggressive when value slaps you in the face (note: value can take many shapes).

Right now, the market peers back at a very good rally. The S&P 500 is up 36 per cent in the last 12 months, the S&P SmallCap 600 Index is up 37.50 per cent over the same period, and the All Ordinaries is up 19 per cent.

Figure 1. S&P 500, S&P 600, 17 November 2023 – 15 November 2024



Source: Google.com

Of course, if you have been following this blog, reading my fortnightly articles in the Wealth section of *The Australian*, or spotted me fortnightly on Ausbiz or on ABC TV and radio, you would know I've said many times, that 2024 would be a good year for equities.

Here's just one example from a February 6, 2024 blog post entitled, [How to maximise Your Returns in 2024 and Beyond.]

And it has indeed been a good year for equities.

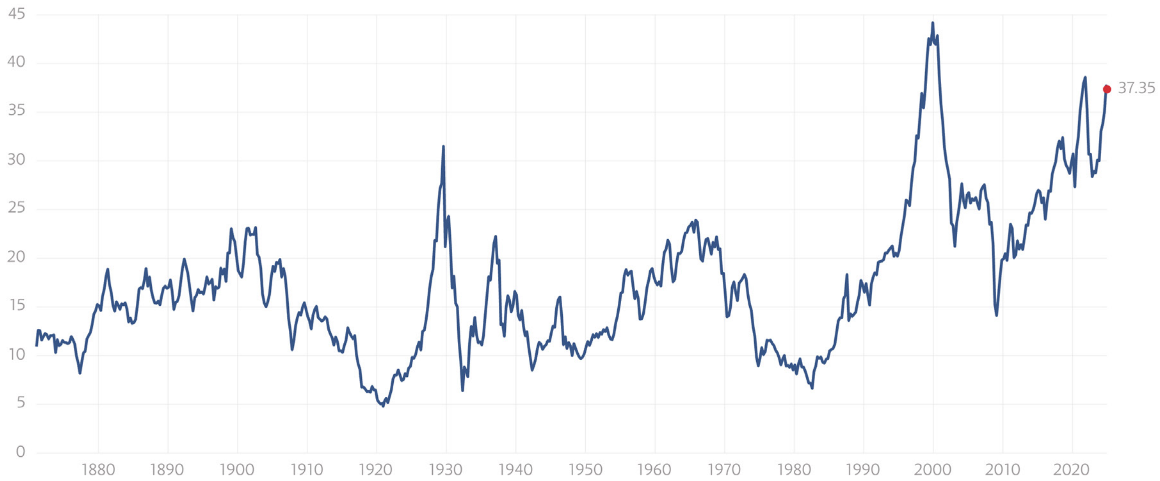
The reason for the optimism was twofold: 1) major Western economies would enjoy positive economic growth, and 2) disinflation would remain a feature. Why do those two things matter? Well, since about 1970, whenever the two coexisted, equities did well, especially the equities of innovative businesses with pricing power and whose ability to grow can be faster than the market currently predicts or can be sustained for longer than the market currently anticipates. When growth is quicker or can be sustained for longer than expected, the market tends to re-rate the company, and investors receive a boost from the expansion in the price-to-earnings (P/E) ratio, as well as the gains from the better-than-expected growth in earnings.

And the quality growers are indeed the companies that have done well in 2024.

But after a period of heady gains, some investors become nervous – I know I do.

Figure 2., plots the Shiller Cyclically Adjusted P/E (CAPE) Ratio and reveals the ratio is at a level it has only visited four times since 1871.

Figure 2. CAPE Shiller Ratio, 1987-2024



Source: Multpl.com

Before you go and sell all your equities, keep in mind that the CAPE ratio was last at this level in November 2021. You might have decided to sell stocks, then. If you had, you would have side-stepped a brief 24 per cent decline, but the market has since rallied almost 68 per cent, to now be 30 per cent higher than when the CAPE ratio was last at the current level.

The CAPE ratio is not great for predicting crashes. It has a half-decent track record in its prediction of future returns.

The higher the price you pay, the lower your returns

Robert Shiller's cyclically adjusted P/E CAPE ratio currently points to potentially muted returns, possibly around 0.5 per cent annually after inflation for the next ten years.

Meanwhile, Goldman Sachs and Vanguard have both forecast low returns for large-cap U.S. stocks over the next decade, with expectations hovering around 3-5 per cent annually. I don't know about you, but I have seen Vanguard and Goldman Sachs get their forecasts very wrong in the past – many times.

Perhaps more worthy of reflection are the moves by Warren Buffett, Todd Combs and Ted Weschler at Berkshire Hathaway (NYSE:BRK.B). Their cautionary actions – holding a US$325 billion cash reserve and paring down positions in key stocks like Apple (NASDAQ:AAPL) and Bank of America (NYSE:BAC) – might give pause to even the most enthusiastic investor.

Should the rest of us follow suit?

As I have noted previously, Buffett's massive cash position is not without precedent. Over his career, he's stockpiled cash before two of the market's most significant declines: in 1969, when he closed his first investment partnership citing "frothy" markets, and before the 2008 financial crisis, when he strategically waited to deploy his capital at more favourable valuations. Considering his track record, some investors see his current cash strategy as a potential signal that the market may be expensive and due for a pullback or correction.

But as I wrote back in August, in *The Australian*, "Sometimes it's correct to conclude a rising cash balance at Berkshire Hathaway reflects Buffett's nervousness about the market's heady levels but, thanks to the cash-generating nature of the businesses owned by Berkshire Hathaway as well as the limited opportunity to make meaningful acquisitions with such large amounts of cash being produced, the cash balance is frequently reaching a "record".

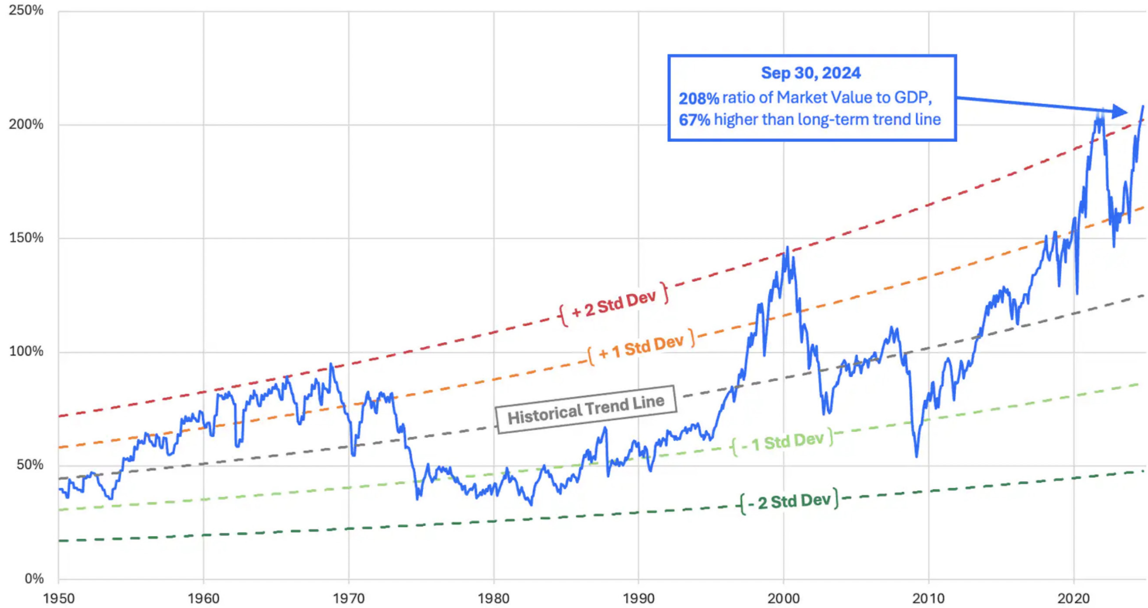
"Indeed, Berkshire's cash balance can reach new record levels quarterly. Clearly, Buffett isn't predicting a market crash each quarter."

Nonetheless, while cash at Berkshire Hathaway has been trending up for decades, it has recently accelerated, leading many more commentators to conclude Buffett and his management are forecasting a correction.

Another indicator many of these commentators rely on is the Buffett Indicator, which Buffett himself once described as "probably the best single measure of where valuations stand at any given moment." The Buffett Indicator is a ratio of all listed stocks to the size of the U.S. economy. Currently, with the market capitalisation of the U.S. Stock Market at US$61 trillion and annualised U.S. GDP at US$29 trillion, the ratio sits at 210 per cent.

Figure 3., puts that circa 210 per cent into perspective.

Figure 3. The Buffet Indicator, 1950 – 30 September 2024



Source: Marketvaluation.com

Once again, it is easy to become nervous while examining these charts, but the Buffett Indicator exceeded its 2000 all-time-high in 2018, has pretty much remained high since then and yet, the S&P500 is up nearly 142 per cent since then.

Of course, there can be bumps along the way, but provided you are sticking to quality issues of companies growing as a result of innovation, you will do very well. And anyway, caution can take many forms.

Keep in mind that Berkshire Hathaway is unable to buy small-cap stocks and make any difference to its returns. It's just too big. Smaller investors, however, can profit where Buffett cannot. And, for what it's worth, while Vanguard thinks the S&P 500 may only produce very low single-digit returns for the next decade, they are more optimistic about small caps, predicting U.S. small-cap stocks could yield 5-7 per cent annually.

Patience, discipline and perspective

Eventually, one day, the stock market will crash again. You can bet on it. Trying to work out when by studying CAPE and Buffett indicator charts, however, is an unnecessary distraction from the task of identifying high-quality growth companies or the fund managers that invest in them. Stick to that, keep a little cash on the side as an option over lower prices, and in the long run, you'll do just fine.

Postscript

For what it's worth, I think the start of 2025 will be as good as 2024 was, but towards the end of 2025, some caution might be warranted.

Nobody can accurately predict what the market is going to do. That said, it is, if nothing else, a stimulating exercise to investigate what the catalysts, if any, could be for a correction.

Xi Jinping's promise to take back Taiwan

We already know an emboldened China intends to fulfil its imperial and geostrategic objectives through expansionist behaviour against Taiwan, and while military strategists believe the People's Liberation Army (PLA) will be ready by 2027, intelligence agencies have said that Xi has directed the People's Liberation Army to be prepared for a potential invasion of Taiwan by 2027.

Debt refinancing

A second possible catalyst is the refinancing of very large amounts of debt adopted during ultra-low and zero interest rates and the consequent demand on liquidity to do it. As Michael Howell of Crossborder Capital wrote in the *Financial Times* on October 17, 2024;

"If bull markets always climb a wall of worry, then financial crises often smash into a wall of debt. We are already walking into the foothills of another crisis. It is not just the growing size of the interest bill that matters, but more so the task of rolling over a pile of maturing debts. Next year, and particularly 2026, will prove challenging years for investors.

"Consider how, over the coming months, stock prices will not only have to defy growing investor doubts about growth and inflation, but by late 2025, they will have to scale a sizeable maturity wall of debts. This term describes the bunching in the refinancing of those debts mostly taken out a few years back when interest rates were at rock bottom. Similar refinancing tensions have helped trigger several past financial meltdowns such as the 1997-98 Asian crisis and the 2008-09 financial crisis."

History suggests investors should expect corrections. Indeed, they should look forward to them. For investors with longer horizons, cheaper prices, such as those presented by a crash should be seen as an opportunity to boost returns.

Remember, the lower the price you pay, the higher your returns.

This article was written on 19 November 2024. All prices and movements in prices are on this date.

The Trump effect on small cap stocks

Roger Montgomery, Founder and Chairman

Roger explains that Trump policies, such as tax cuts, deregulation, and domestic economic focus, favour small caps, predicting their continued strength into late-2025.

Since 2022, we have predicted that small cap stocks, especially those representing innovative businesses with pricing power, would do well in an environment of disinflation and positive economic growth.

Since the end of 2022, the U.S. Russell 2000 Index of small-cap stocks has risen 36 per cent, the U.S. S&P SmallCap 600 index is up 31 per cent, and the S&P/ASX Small Ordinaries index has risen 12 per cent.

Interestingly, most of the gains in the Russell 2000 Index (23 per cent) have been recorded since April this year, and the S&P SmallCap 600 is up 21 per cent over the same period. The bulk of the gains over the last two years have occurred in the last two or three quarters.

Given the disinflation/ positive gross domestic product (GDP) picture was no different before April and after April, we can put the acceleration down to something else. That something else may just be bets that a Trump election victory would be positive.

If so, why have U.S. small caps done well amid a Trump victory?

Answering that question may offer some insights into what happens next (for what it's worth, I believe the small caps rally, which commenced in 2022, should continue into 2025, and we should reappraise the situation towards the end of 2025.

Domestic focus: Small-cap companies often derive a significant portion of their revenue from domestic operations. The last Trump administration emphasised policies that stimulated domestic economic growth, such as infrastructure spending and tax reforms, benefiting these companies.

Tax cuts and jobs act of 2017: Trump last reduced the corporate tax rate from 35 per cent to 21 per cent. Small cap companies generally paid higher effective tax rates compared to larger, multinational corporations. The reduction in taxes disproportionately benefited smaller companies, improving their profitability.

Deregulation efforts: The last Trump administration pursued deregulation across various sectors, reducing compliance costs and operational burdens. Due to these policy changes, small businesses, which have fewer resources to manage regulatory complexities, found it easier to expand and invest.

Trade policies: The focus on renegotiating trade agreements and implementing tariffs affected multinational corporations more than domestically oriented small cap companies. Large-cap companies with extensive international operations faced uncertainties and potential losses, whereas small caps were relatively insulated.

Economic growth and consumer confidence: The period saw steady economic growth and high consumer confidence levels. Increased consumer spending boosted revenues for small businesses that rely heavily on domestic markets.

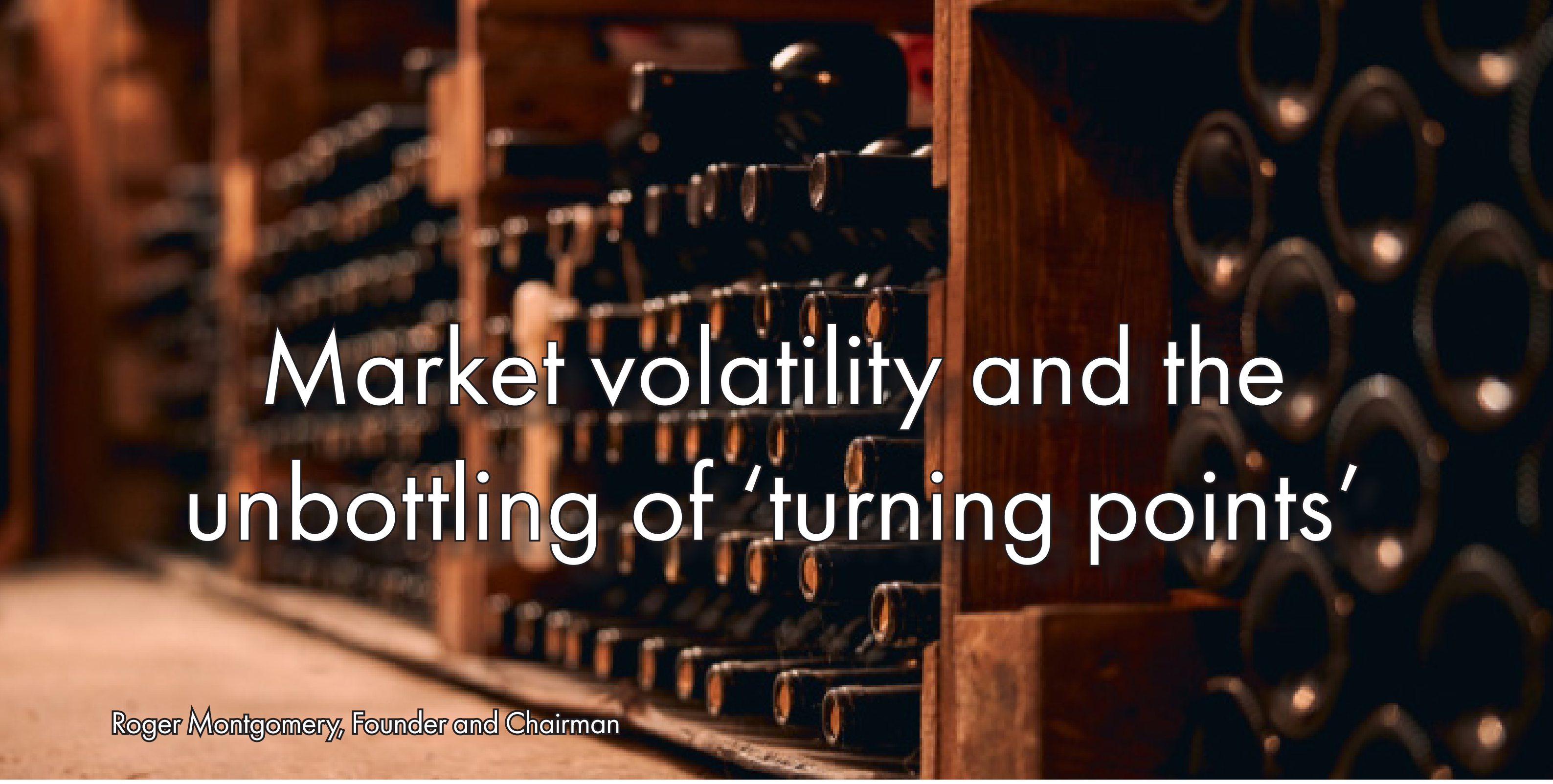
Stronger U.S. dollar: A stronger dollar can negatively impact multinational companies by making exports more expensive and reducing the value of overseas earnings. With limited international exposure, small-cap companies were less affected by currency fluctuations.

Infrastructure initiatives: Proposed investments in infrastructure projects promised potential contracts and growth opportunities for smaller companies in construction, manufacturing, and related industries.

Together, the first time around, these factors created an environment where small-cap stocks could outperform their larger counterparts. Under a second Trump term, many investors believe the same is in store, which is why the Russell 2000 Index was up five per cent the day after Trump's win. Of course, it's important to remember honeymoons never last and stock performance is influenced by a variety of factors, including global market conditions, geopolitical conflict, investor sentiment, and, most importantly, profit growth.

For now, and until late 2025 (and excepting a war with China), I believe small caps will do well.

This article was written on 12 November 2024. All prices and movements in prices are on this date.



Market volatility and the unbottling of 'turning points'

Roger Montgomery, Founder and Chairman

Roger explains how volatility often clusters around market turning points but argues that it's largely irrelevant for investors seeking steady income, particularly in retirement. Highlighting private credit funds as an alternative, he notes they can deliver equity-like returns with minimal volatility, preserving purchasing power without the stress of market fluctuations.

When I worked in derivatives trading in the early '90s, one of the accepted truths about market behaviour was that "volatility picks up around turning points".

It was, for example, wise to be alert to the possibility of a large move lower if volatility emerged after a long rally. And while it has been my experience that volatility does indeed cluster around major turning points, it's possible I only remember what I want to.

However, a quick analysis of the most volatile days in the S&P 500 since 1988 dispels any concerns about selective memory or unconscious bias. Of the 25 largest single-day up moves and the 25 largest daily down moves, almost all cluster around the major turning points in the market, such as the global financial crisis (GFC), COVID-19, the tech wreck of the early 2000s and the market lows in 1998, 2011, 2018, and most recently 2022.

Volatility rises at intermediate market highs and lows due to a conflict between bullish and bearish investors. At new highs, optimists argue with the bears, who invariably describe the market as overvalued.

At or near market lows, pessimism clashes with value-seeking investors and those investors hopeful of a rebound.

Notably, current market activity can be described by its significant surge in volatility, suggesting major stock indices might be on the cusp of a turning point. This recent development is of immediate interest to investors and traders, and you might expect me to offer a prediction about what might happen in markets next.

While my prediction for equity returns for the remainder of the year and most of 2025 remains positive, the next point I'm about to make is likely not what you predicted.

The discussion about volatility is, and perhaps should be, completely irrelevant to a large number of investors, especially those nearing or in retirement. Why? Alternative funds now exist that offer returns commensurate with equity markets without much volatility. Some funds, like those Montgomery distributes, have delivered historical returns of almost 10 per cent per annum with zero volatility.

Financial experts tell us that as we grow older and wiser, we should aim to reshape our portfolio towards more income, along with less volatility and, therefore, less risk. Traditionally, reducing volatility meant reducing the exposure to those assets that offered the best potential growth. But rejecting growth at any age is a patently bad decision because it almost guarantees a loss of purchasing power.

Think of it this way: This weekend you will enjoy a bottle of Penfolds St Henri shiraz with friends. Back in the early '90s I was buying that wine – it was a claret back then – for $14.99 a bottle, a price I was happy to pay in my mid-20s.

Today, 30 years later, that same wine is $150 a bottle, representing inflation of 8 per cent per year. If you are celebrating your retirement at 65 this weekend with a bottle of St Henri, and you enjoy it so much that you hope to celebrate your 80th birthday in 15 years with a bottle of St Henri, you will require $474 to do it.

To maintain your "St Henri" purchasing power, you need your wealth to rise by at least the same amount as the price of that bottle of wine.

Of course, the example of a consumable I have shared is wine, but it can be any other item or items you consume today and want to continue to enjoy through retirement.

Typically, growth assets like shares are required to perform the task of "purchasing power preservation" because, given enough time, the market value of shares follows the performance of the underlying business.

If a business is generating a sustainable 15 per cent return on a shareholder's equity and that business pays 50 per cent of the return as a dividend, the market value of the shares should eventually track the increasing value of the company, which is rising at 7.5 per cent per year.

Of course, the share price won't rise by 7.5 per cent every year – more on that in a moment – but in theory, the market value over the long term should rise at an average rate that approximates the increase in the value of the underlying equity.

Notice the careful language. I said in the "long term", and "at an average rate". That's because, in the stock market, nothing goes up smoothly. We use phrases like "long-term" and "on average" because we know markets should reflect the value of an underlying business in the long run, but in the short term anything can happen and usually does.

And that's because, inevitably, there are setbacks. Sometimes, these setbacks have nothing to do with the company. For example, if U.S. inflation surges or China annexes Taiwan, investors will dash for cash and sell shares merely because they fear their shares might decline, even temporarily. Their fear-inspired actions turn that fear into a reality and the shares fall. At other times, share prices react due to idiosyncratic reasons, such as a company reducing its growth expectations.

As I mentioned a moment ago, in the long term it should all work out well, but in the short term, volatility is even more certain.

What if there were a way to grow your wealth at rates similar to those of the broad stock market without the associated volatility? What if there was the possibility of growth and income without the ever-present worry of a stock market collapse that wipes out this year's and maybe even next year's St Henri purchase?

Well, now there is and the growing allocation by advisers and individual investors to these private credit funds, such as those we have partnered with at Montgomery, reflects the realisation by a growing band of investors that lending to businesses can be as lucrative as providing the equity without the wild gyrations.

Who wouldn't want the 9.64 per cent annual returns, generating monthly cash income with no negative months, that investors in one of those funds have enjoyed over the past seven years? While historical returns are not a reliable guide to future returns, and risks do exist, what we do know is that in equities, one thing IS guaranteed: volatility.

This article was written on 2 October 2024. All prices and movements in prices are on this date.

IMPORTANT NOTICE

This document has been prepared by Montgomery Investment Management Pty Ltd (ABN 73 139 161 701) (AFSL 354 564) (Montgomery).

The information provided in this document does not take into account your investment objectives, financial situation or particular needs. You should consider your own investment objectives, financial situation and particular needs before acting upon any information provided and consider seeking advice from a financial advisor if necessary.

Future investment performance can vary from past performance. You should not base an investment decision simply on past performance. Past performance is not an indicator of future performance. Investment returns reviewed in this document are not guaranteed, and the value of an investment may rise or fall.

This document is based on information obtained from sources believed to be reliable as at the time of compilation. However, no warranty is made as to the accuracy, reliability or completeness of this information. Recipients should not regard this document as a substitute for the exercise of their own judgement or for seeking specific financial and investment advice. Any opinions expressed in this document are subject to change without notice and Montgomery is not under any obligation to update or keep current the information contained in this document.

To the maximum extent permitted by law, neither Montgomery, nor any of its related bodies corporate nor any of their respective directors, officers and agents accepts any liability or responsibility whatsoever for any direct or indirect loss or damage of any kind which may be suffered by any recipient through relying on anything contained in or omitted from this document or otherwise arising out of their use of all or any part of the information contained in this document.

Montgomery, its related bodies corporate, their directors and employees may have an interest in the securities/instruments mentioned in this document or may advise the issuers. This document is not an offer or a solicitation of an offer to any person to deal in any of the securities/instruments mentioned in this document.

For more information on investing with Montgomery, please call Rhodri Taylor on 02 8046 5000, or email rtaylor@montinvest.com.

MONTGOMERY