

 WHITEPAPERS

Is it time to rebalance your retirement portfolio?

In this whitepaper, we look at sequencing risk and the Australian market's present elevated valuations to ask whether there is merit in rebalancing portfolios towards domestic equity funds that can capture more of the upside and less of the downside.

If you are younger, and a long way from retirement, you have the luxury of being able to endure, survive and even prosper from bear markets - provided you follow the basic tenets of long-term investing, and aim to maintain or grow your purchasing power. Of course, and as an aside, if you focus on quality and value, you will be more inclined to stay the course than those who seek the fastest returns and inevitably suffer the deepest and most painful setbacks.

However, if you are approaching retirement or have just entered it, a much more serious consideration of risk is required.

By Roger Montgomery
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For retirees, regular withdrawals of capital may be needed where income is insufficient to meet lifestyle requirements. And in an environment of ultra-low rates, generating a sufficient income is challenging. With restricted income, many investors must decide between spending less or eroding capital to meet spending demands. And when an investor is required to make regular withdrawals, regardless of the market level, capital losses experienced early in retirement can be extremely deleterious.

Sequencing risk - which describes the pattern of returns, or the order in which they are received - looms large for retirees. And when I talk of risk here, I am not only referring to a permanent loss of capital but also volatility.

The impact of sequencing risk on retirement incomes is the opposite to that on dollar cost averaging, which can be employed to accumulate wealth. This is because dollar cost averaging involves *making* regular investments, while retirees in the pension phase are required to *take* regular payments from their investment portfolio.

Typical dollar cost averaging examples involve an investor investing a fixed sum of money at predetermined regular intervals - for example, \$20,000 every month. By fixing the dollar amount for every investment, a discipline is forced upon the investor; when share prices are low, more units are acquired, and when share prices are higher, fewer units are purchased. For the dollar cost averaging strategy, volatility becomes an investor's best friend. As a net purchaser of shares, lower prices can be anticipated with eagerness.

The opposite would be true for a retiree in pension phase, who is required to receive regular fixed dollar or percentage payments from their portfolio.¹

While sensible financial planning may involve the quarantining of some cash to fund more immediate spending needs from volatile assets, regular withdrawals are often ultimately required.

Table 1. Minimum pension payment factors – 2018/19 financial year

Age of Beneficiary	Percentage factor
Under 65	4%
65 to 74	5%
75 to 79	6%
80 to 84	7%
85 to 89	9%
90 to 94	11%
95 or more	14%

Source: *Superannuation Industry (Supervision) Act 1993 (Cth)*

¹ As we will see momentarily, there is a subtle difference between what transpires when the 'super pension payment' is set as a percentage rather than a fixed dollar amount.

An investor required to take fixed dollar withdrawals regularly from their portfolio would experience the opposite of that experienced by an investor whose pension payments are based on the dollar cost average. At lower prices, a retiree would be forced to sell more units simply because more units are required to meet their minimum pension payment. After those units are sold, the remaining portfolio is smaller and has fewer units, it becomes more difficult for the portfolio to recover to previous levels.

It is therefore essential to avoid large losses or the risk of large losses, especially early in the investment journey.

The environment: forgetting risk

As a tidal wave of the world's population enters retirement, a similar-sized avalanche of investing mistakes might be occurring. Just when retirees need their assets protected most, they are adopting unacceptable risks. And thanks to sequencing risk they are adversely, and potentially permanently, altering possible retirement plans.

If you remember the early 1990s and Paul Keating's recession "we had to have", you'll remember the aphorism 'cash is king'. Fast-forward nearly three decades and the pendulum of sentiment towards cash has most certainly swung to its opposite extreme. Today, cash earns less than 2 per cent per annum and nobody wants it.

The consequence of investors' cash 'allergy' has been the pursuit of higher returns and a migration into riskier assets such as property, profitless listed companies, private equity, venture capital and collectibles such as art, cars and even low-digit number plates. Even some junk bonds now have negative yields!²

At the time of writing, one of history's longest bull markets and most benign periods in terms of volatility has rendered the 'migration trade' both successful and confidence-building. But investors are forgetting two basic tenets of investing, and whenever these basics are rejected in the hope of better returns, the consequences are painful.

“The first tenet is: the higher the price you pay, the lower your return. The second is: when risk appears lowest, it is usually highest.”

² Source: Bloomberg 9 July 2019; there are now 14 junk-rated companies with euro-denominated bonds that have negative yields: Ardagh Packaging Finance plc/Ardagh Holdings USA Inc., Altice Luxembourg SA, Altice France SA, Axalta Coating Systems LLC, Constellium NV, Arena Luxembourg Finance Sarl, EC Finance Plc, Nexi Capital SpA, Nokia Corp., LSF10 Wolverine Investments SCA, Smurfit Kappa Acquisitions ULC, OI European Group BV, Becton Dickinson Euro Finance Sarl, WMG Acquisition Corp.

I have just reread a column I wrote recently for *The Australian* about the space-letting company WeWork. In 2018, WeWork lost its owners US\$1.7 billion. That's capital B, Billion! Then I read my columns about Uber prior to its initial public offering (IPO). Uber recorded a US\$3 billion operating loss in 2018.

In normal circumstances, if a company announced a loss of that quantum, with no immediate prospect of stemming it, its shares would plummet.

But at the time of writing, these two loss-makers had a combined estimated market capitalisation of US\$80 billion to US\$90 billion. That's roughly the same market capitalisation as the Commonwealth Bank, which generated US\$6.7 billion in profits in 2018, or Volkswagen (US\$14 billion in profits), Morgan Stanley (US\$8.5 billion), Christian Dior (US\$3 billion), Lockheed Martin (\$US5 billion) or Caterpillar (US\$6.1 billion).

Sure, these more established companies might not be growing their revenues as quickly, but they are making profits today and likely will be in years to come. As Uber and WeWork grow revenues, however, so do the losses required to generate those revenues.

Of course, the mathematics of present-valuing future cash flows shows that declining interest rates deliver a larger boost to the value of more distant dollars earned. But in order for those future dollars to have a present value at all, they must actually be produced. There appears to be no consideration of the risk that these 'businesses' might never produce a profit. I maintain that companies including Uber, Peloton, Tesla and a host of other unicorns comprise a list of businesses that will cease to exist, in their present form, in decades to come.

John Kenneth Galbraith, in his 1954 book, *The Great Crash 1929*, observed that when the fundamentals of a business, its income, or even its long-run worth are ignored and replaced with the blind pursuit of foundationless capital gains, a boom has morphed into a bubble.

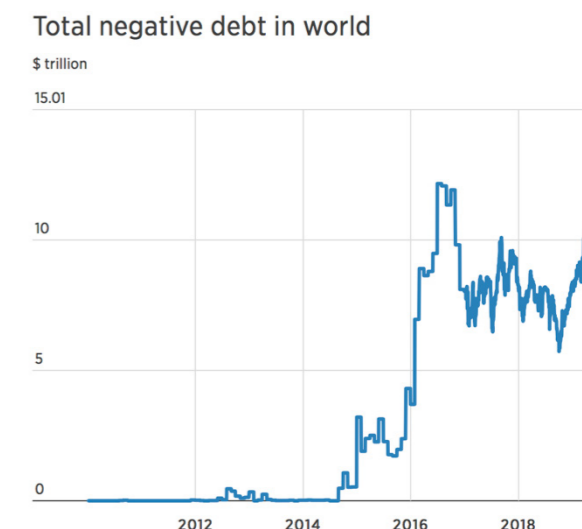
Investors nearing retirement can ill-afford to experience the large losses that typically follow such bubbles seen with these unicorns.

Interest rates are low

An astonishing 31 per cent of bonds in the world's most watched global bond index now have a negative yield. According to Deutsche Bank, that's more than US\$16.7 trillion and it is triple the value of negative-yield bonds in October 2018!

Amid global economic uncertainty, so desperate have investors become for a safe haven that they are willing to pay governments to borrow from them.

Figure 1. Total global negatively yielding debt



Source: Deutsche Bank

Investors and commentators are attributing the rout in interest rates to economic slowdowns, the China-U.S. trade war, the ageing of the global population and quantitative easing (QE).

In reality, central banks have had to cut rates to keep people employed. But by cutting rates they set themselves a trap: they have incentivised businesses to invest in the technology that displaces labour or reduces the amount workers can earn. With fewer people employed and more earning less, central banks have to cut rates even further.

It's a phenomenon that is recognised by central banks including the Reserve Bank of Australia.

Demand for negatively yielding bonds is evidence that bond investors are concerned about the direction of economic growth. Meanwhile equity investors in the aforementioned unicorns have been euphoric, producing profitless prosperity, which itself is unsustainable.

“The combination of rising asset prices and deteriorating fundamentals is typically unsustainable. As Herb Stein once wryly observed, if something can't last forever, it must stop.”

Sequencing risk

All booms eventually end, some with a bang and others with a whimper. The ensuing bear markets typically remind investors of the importance of adhering to those basic investing tenets we referred to earlier.

As recently as the fourth quarter of 2018, investors were reminded of the reality of volatility and its potential impact on retirement plans. Please see Figure 2, showing the Q4 period as reported by Morningstar.

If you are retiring today, and receiving an annuity stream from your investments, the order of your returns will have a very significant bearing on your wealth. Indeed, sequencing risk can be a major obstacle to a retiree realising a fully funded retirement. And while almost all investors understand the impact of volatility on retirement savings, many underappreciate the greater concern called sequencing risk.

As the Financial Services Institute of Australasia (FINSIA) noted:

“With increasing numbers of baby boomers entering the 20–25 year conversion phase from retirement savings into retirement income, the sequence of returns risk is a current and significant challenge both for fund members (members of defined contribution superannuation funds in Australia) and policy makers.”

Figure 2. Stock market and fund manager returns late 2018



Source: Morningstar

Table 2. Exploring sequencing

Scenario A in Table 2 presents a hypothetical sequence of returns over the course of 30 years. Two and a half million dollars invested at the beginning of 2019 grows to \$15.6 million, with an average annual return of 6.3 per cent. Of course, we have assumed there's no tax to pay and all investment returns are reinvested.

The second sequence of returns, entitled Reversed Scenario, is the same series of returns as Scenario A in reverse order.

The first observation to make is that the order of returns does not change the outcome. Both scenarios produce the same \$15.6 million.

The outcome illustrated by Table 2 is not sufficiently realistic for a retiree who must withdraw a superannuation payment. The minimum pension payment or annuity must be received from one's investments and while we have not applied taxes, the following examples highlight the dramatically different outcomes when current Australian minimum pension payment factors are applied.

Age	Year	Scenario A		Reversed Scenario	
		Return	Investment	Return	Investment
65	2018		\$ 2,500,000		\$ 2,500,000
66	2019	9.9%	\$ 2,747,500	-17.5%	\$ 2,062,500
67	2020	25.9%	\$ 3,459,103	-11.3%	\$ 1,829,438
68	2021	17.6%	\$ 4,067,905	-4.6%	\$ 1,745,283
69	2022	6.6%	\$ 4,336,386	9.6%	\$ 1,912,831
70	2023	14.1%	\$ 4,947,817	-9.8%	\$ 1,725,373
71	2024	-19.7%	\$ 3,973,097	12.1%	\$ 1,934,143
72	2025	-1.8%	\$ 3,901,581	13.1%	\$ 2,187,516
73	2026	16.2%	\$ 4,533,637	18.4%	\$ 2,590,019
74	2027	8.6%	\$ 4,923,530	6.0%	\$ 2,745,420
75	2028	9.9%	\$ 5,410,959	-8.3%	\$ 2,517,550
76	2029	-0.3%	\$ 5,394,727	18.4%	\$ 2,980,780
77	2030	25.6%	\$ 6,775,777	7.2%	\$ 3,195,396
78	2031	15.9%	\$ 7,853,125	-3.7%	\$ 3,077,166
79	2032	23.6%	\$ 9,706,463	-1.0%	\$ 3,046,394
80	2033	16.9%	\$ 11,346,855	13.0%	\$ 3,442,426
81	2034	13.0%	\$ 12,821,946	16.9%	\$ 4,024,196
82	2035	-1.0%	\$ 12,693,726	23.6%	\$ 4,973,906
83	2036	-3.7%	\$ 12,224,059	15.9%	\$ 5,764,757
84	2037	7.2%	\$ 13,104,191	25.6%	\$ 7,240,535
85	2038	18.4%	\$ 15,515,362	-0.3%	\$ 7,218,813
86	2039	-8.3%	\$ 14,227,587	9.9%	\$ 7,933,476
87	2040	6.0%	\$ 15,081,242	8.6%	\$ 8,615,754
88	2041	18.4%	\$ 17,856,191	16.2%	\$ 10,011,507
89	2042	13.1%	\$ 20,195,352	-1.8%	\$ 9,831,299
90	2043	12.1%	\$ 22,638,989	-19.7%	\$ 7,894,533
91	2044	-9.8%	\$ 20,420,368	14.1%	\$ 9,007,663
92	2045	9.6%	\$ 22,380,724	6.6%	\$ 9,602,168
93	2046	-4.6%	\$ 21,351,210	17.6%	\$ 11,292,150
94	2047	-11.3%	\$ 18,938,523	25.9%	\$ 14,216,817
95	2048	-17.5%	\$ 15,624,282	9.9%	\$ 15,624,282

Table 3. Scenario A with pension payments

Table 3 follows the results of an investor whom commences retirement at 65 years of age with \$2.5 million (as per Table 2) and then experiences the sequence of returns as described by Scenario A.

The first observation to make is that at 95 years of age the investor has \$1.63 million remaining in their investment portfolio, not the \$15.6 million shown in Table 2. The reason for the difference is that a smaller amount of each year's gain is retained and compounded. This is because Australians are required to receive a minimum pension payment each year from their investment portfolio.

The second observation to make is that over the course of 30 years the investor has received \$9.2 million in pension payments (no taxes on balances or on income in this example).

As an aside, when sequencing risk is illustrated, the author will typically apply the withdrawal as a fixed dollar amount. Of course, doing this results in the same withdrawal irrespective of the size of the portfolio. The consequence is that the retiree who experiences negative returns early runs out of money completely and well before the retiree who does not experience large losses early.

In Australia, the minimum pension payment is a percentage of the portfolio rather than a fixed dollar amount. The result is that as the portfolio declines in value, a smaller payment is received. And the reverse is true when the portfolio rises in value.

Age	Year	Minimum Pension		Scenario A	
		Scenario A Return	payment factors	Scenario A Investment	Scenario A Pension Payment
65	2018				
66	2019	9.9%	5%	\$ 2,610,125	\$ 137,375
67	2020	25.9%	5%	\$3,155,641.13	\$ 164,307.37
68	2021	17.6%	5%	\$3,553,251.91	\$ 185,551.70
69	2022	6.6%	5%	\$3,610,103.94	\$ 189,388.33
70	2023	14.1%	5%	\$3,938,623.40	\$ 205,956.43
71	2024	-19.7%	5%	\$2,965,783.42	\$ 158,135.73
72	2025	-1.8%	5%	\$2,764,110.14	\$ 145,619.97
73	2026	16.2%	5%	\$3,073,690.48	\$ 160,594.80
74	2027	8.6%	5%	\$3,184,343.34	\$ 166,901.39
75	2028	9.9%	6%	\$3,308,532.73	\$ 209,975.60
76	2029	-0.3%	6%	\$3,100,095.17	\$ 197,916.43
77	2030	25.6%	6%	\$3,707,713.82	\$ 233,623.17
78	2031	15.9%	6%	\$4,074,777.49	\$ 257,834.42
79	2032	23.6%	6%	\$4,791,938.32	\$ 302,185.50
80	2033	16.9%	7%	\$5,266,340.22	\$ 392,124.31
81	2034	13.0%	7%	\$5,582,320.63	\$ 416,567.51
82	2035	-1.0%	7%	\$5,135,734.98	\$ 386,854.82
83	2036	-3.7%	7%	\$4,586,211.34	\$ 346,199.90
84	2037	7.2%	7%	\$4,595,383.76	\$ 344,149.30
85	2038	18.4%	9%	\$5,027,349.83	\$ 489,684.09
86	2039	-8.3%	9%	\$4,157,618.31	\$ 414,907.18
87	2040	6.0%	9%	\$4,032,889.76	\$ 396,636.79
88	2041	18.4%	9%	\$4,411,981.40	\$ 429,744.73
89	2042	13.1%	9%	\$4,592,872.64	\$ 449,095.59
90	2043	12.1%	11%	\$4,643,394.24	\$ 566,347.13
91	2044	-9.8%	11%	\$3,677,568.24	\$ 460,717.58
92	2045	9.6%	11%	\$3,626,082.28	\$ 443,367.63
93	2046	-4.6%	11%	\$3,060,413.45	\$ 380,521.07
94	2047	-11.3%	11%	\$2,377,941.25	\$ 298,604.54
95	2048	-17.5%	14%	\$1,628,889.75	\$ 274,652.21
Total Income					\$ 9,205,540

Table 4. Reversed Scenario with pension payments

Table 4 illustrates the impact of reversing the sequence of returns thereby imposing large losses on the portfolio early in retirement.

Perhaps surprisingly, the investor has a similarly sized investment of \$1.8 million at 95 years of age. Remember, the minimum pension payment is a percentage, which under the two scenarios offered, mutes the impact of withdrawals on the final balance. You might recall that when no withdrawal is made, both return sequences produced a \$15.6 million balance at 95 years of age. When minimum pension payments are withdrawn as a percentage, the ending balances are likewise similar.

The impact of a poor sequence of returns has to be experienced somewhere, and in the above examples it is experienced through income (pension payment). That is, the Scenario A pension payment aggregates to \$9.206 million over 30 years (or an average annual payment of \$306,851) while the Reversed Scenario pension payment aggregates to \$4.384 million over 30 years (or an average annual payment of \$146,130). This is a difference of \$4,821,451, or an average of \$160,715 in annual pension payments.

Early losses experienced by the portfolio under the Reversed Scenario never really recover. Under Scenario A, the portfolio peaks at a value of \$5.6 million in 2034, when the retiree is 81 years old. Of course, withdrawing a mandated percentage of a higher value portfolio will result in more income.

Under the Reversed Scenario, the portfolio never really recovers from those large early losses and its value peaks at \$2.5 million in 2041 when the retiree is 88 years of age. Under Scenario A the retiree has a portfolio that is valued at \$4.4 million at 88 years of age (2041). This is \$1.95 million more than under the Reversed Scenario and they are receiving almost twice as much income as the retiree under the Reversed Scenario.

Age	Year	Reversed Return	Reversed Scenario	Reversed Scenario Pension Payment
65	2018			
66	2019	-17.5%	\$ 1,959,375	\$ 103,125.0
67	2020	-11.3%	\$1,639,996.88	\$ 86,898.28
68	2021	-4.6%	\$1,482,557.18	\$ 78,227.85
69	2022	9.6%	\$1,550,754.81	\$ 81,244.13
70	2023	-9.8%	\$1,321,243.09	\$ 69,939.04
71	2024	12.1%	\$1,415,051.35	\$ 74,055.68
72	2025	13.1%	\$1,529,670.51	\$ 80,021.15
73	2026	18.4%	\$1,734,646.36	\$ 90,556.49
74	2027	6.0%	\$1,751,992.83	\$ 91,936.26
75	2028	-8.3%	\$1,501,457.85	\$ 96,394.65
76	2029	18.4%	\$1,687,638.63	\$ 106,663.57
77	2030	7.2%	\$1,707,890.29	\$ 108,548.92
78	2031	-3.7%	\$1,542,224.93	\$ 98,681.90
79	2032	-1.0%	\$1,434,269.19	\$ 91,608.16
80	2033	13.0%	\$1,520,325.34	\$ 113,450.69
81	2034	16.9%	\$1,670,837.54	\$ 124,408.22
82	2035	23.6%	\$1,948,196.58	\$ 144,560.86
83	2036	15.9%	\$2,121,586.07	\$ 158,057.19
84	2037	25.6%	\$2,516,201.08	\$ 186,529.85
85	2038	-0.3%	\$2,282,194.38	\$ 225,778.72
86	2039	9.9%	\$2,302,734.13	\$ 225,731.85
87	2040	8.6%	\$2,293,523.19	\$ 225,069.23
88	2041	16.2%	\$2,458,656.86	\$ 239,856.66
89	2042	-1.8%	\$2,193,121.92	\$ 217,296.09
90	2043	-19.7%	\$1,519,833.49	\$ 193,718.46
91	2044	14.1%	\$1,566,948.33	\$ 190,754.30
92	2045	6.6%	\$1,498,002.60	\$ 183,740.36
93	2046	17.6%	\$1,596,870.78	\$ 193,781.62
94	2047	25.9%	\$1,834,804.52	\$ 221,150.63
95	2048	9.9%	\$1,759,577.54	\$ 282,303.02
			Total Income	\$ 4,384,089

Mitigating risks

There are a number of ways investors can mitigate the risk of poor outcomes, and reputable financial planners are well qualified to advise on the very best approach. It may include quarantining some funds in the early years to meet near-term lifestyle requirements and allowing the bulk of the investment to ride through the volatility and recover.

At Montgomery, we put the preservation of capital at the top of our list of aims. Our literature is replete with references to protecting and preserving capital, as much as that is possible in the stock market.

Figure 2 demonstrates the benefit of aiming to preserve capital during periods of market volatility such as that experienced by investors in the fourth quarter of the 2018 calendar year. During this period, The Montgomery Fund and The Montgomery [Private] Fund (The Funds) performed as might be expected when an absence of value in the domestic market and the flexibility to hold cash allowed them to raise the level of cash in portfolios.

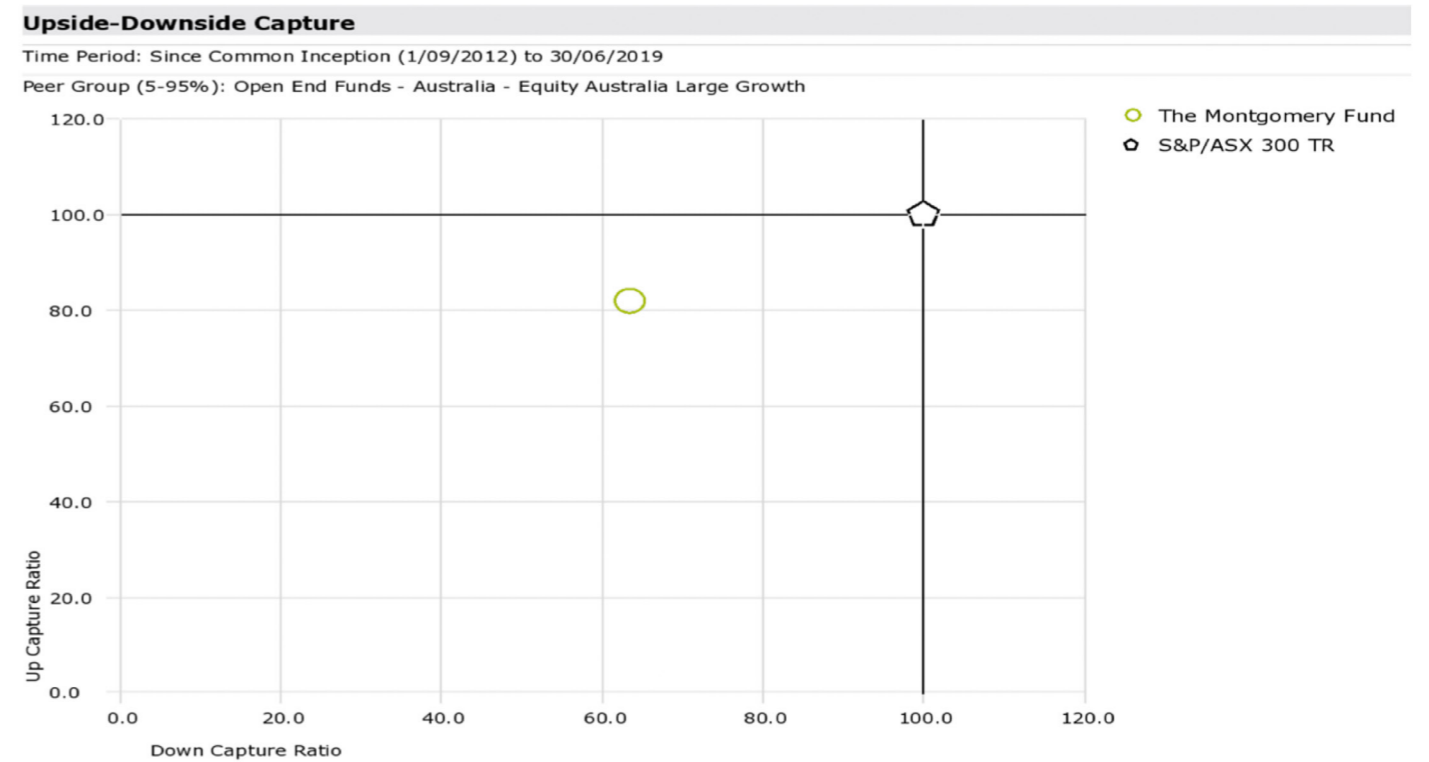
Montgomery seeks to preserve capital primarily by adjusting the cash weighting in the portfolio, using a repeatable framework that reflects the absence or presence of value in the market.

When Montgomery Investment Management was launched, our direct investors requested something that we thought might be impossible to deliver. They wanted to ‘go up with everyone else but not down with everyone else’.

As can be seen in Figure 3, since inception The Montgomery Fund has, on average, captured 81 per cent of the upside in any month that the market has risen, but only an average of 61 per cent of the downside in any month when the market has fallen.

This somewhat pleasing outcome is a function of focusing on quality, value and the ability to hold cash. When interest rates are low, cash is of course an anchor on returns. But there are benefits, especially for retirees.

Figure 3. Capturing upside not downside



Source: Morningstar

We illustrate the benefit to retirees of capturing 81 per cent upside and 61 per cent downside, as The Montgomery Fund has done since its inception.

In Figure 4 the red upper line represents the performance of a million dollars invested in the S&P/ASX 200 Accumulation Index (dividends reinvested) over the past 27 years – roughly a period of retirement for somebody in excellent health, retiring at age 65.

The performance depicted by the index, however, is not that experienced by a hypothetical Australian retiree required to make regular ‘super pension’ withdrawals over the same period.

The black line at the bottom illustrates the experience of a retiree who is 100 per cent exposed to the vagaries of the market and required to begin drawing 5 per cent a year from the age of 65, ratcheting up to 14 per cent annually once they reach 90 years of age. Their experience is a very different one. Their ending balance is \$1.85 million and super pension payments have amounted to \$10.1 million.

Being required to withdraw funds irrespective of market conditions dramatically changes the outcome for an investor exposed to 100 per cent of the upside and downside of the market.

An understanding of this dynamic confirms there is merit in aiming to preserve capital for investors simply by capturing less of the downside.

The grey line in Figure 4 represents the hypothetical picture for a retired investor who invested \$1 million at 65 years of age in a hypothetical fund that captured 81 per cent of the market’s upside movements and 61 per cent of its downside movements over the last 27 years.

As can be seen, a vast improvement over an index investment is achieved by investing in a fund that successfully preserves more of the capital on the downside. The retired fund investor ends the investment period with a portfolio valued at just over \$2.5 million and has received super pension payments of \$13.2 million. The active fund investor’s portfolio is worth 37 per cent more than that of the ‘index’ investor (\$2.55 million versus \$1.85 million) and they have generated 31 per cent more in pension payments to themselves (\$13.2 million versus \$10.1 million).

Conclusion

For retirees, especially those most in danger from sequencing risk, there is merit in investing with an active fund manager that continues a track record of capturing relatively more of the upside and less of the downside.

Sequencing risk can be managed a number of ways. Quarantining cash from volatile assets for immediate spending needs is one way of mitigating the risk. Another is having a fund manager that captures more of the upside than the downside.

This analysis also has implications for those contemplating index funds which, despite their low fees, may burden retired investors with 100 per cent upside and 100 per cent downside.

Markets cannot remain disengaged from earnings growth and the economy forever. Today, the spread between market prices and domestic fundamentals is as wide as it has ever been. This suggests now is an opportune time to reconsider an investor’s exposure to the market and consider rebalancing towards funds that might capture less of the downside.

Figure 4. Retirees benefit from 81 per cent upside and 61 per cent downside



Source: MIM

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