Bubble Trouble? by Roger Montgomery

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Let me lay it on the line for you; amid solely on the emergence of rising prices, all the talk of bubbles is simply premature.

That it not to say that price will not decline. They may very well decline, but any decline from current levels is not because of the presence of a bubble, nor evidence of it bursting, in either Australian property or shares - we'll leave US T-bonds out of this discussion and focus on Australia.

Having said all of that, I do believe the first seeds of a bubble have germinated and it is also true that bubbles currently exist in some individual stocks and sectors but it may be some time before a true bubble - one whose contagion is damaging to markets, investors and the broader economy - emerges, and it may be the case that no potentially damaging bubble develops at all.

To discuss both shares and property in the context of bubbles it is worth first defining them.

The Canadian and U.S., economist and diplomat, John Kenneth Galbraith, in his book *The Great Crash* observed;

"…at some point in a boom all aspects of property ownership become irrelevant except the prospect for an early rise in price. Income from the property, or enjoyment of its use, or even its long-run worth is now academic. As in the case of the more repulsive Florida lots [in a mid-1920s Florida land boom], these usufructs may be non-existent or even negative. What is important is that tomorrow or next week, market values will rise-as they did yesterday or last week-and a profit can be realized…"

Stewart Robertson of Raine & Horne real estate in Mosman recently sold a block of five flats in Mosman, NSW for $3.52 million dollars on behalf of a couple who had purchased the property at the depths of the GFC in 2009 for $2.9 million. The block contained 1 three bedroom apartment, two 2-bedders and two 1-bedders. The gross rent was just $139,000. The new buyer will have to subtract the maintenance costs, the fees to a property manager and the tax before a net yield is available and if more than 50 per cent of the purchase price was borrowed at, say 5 per cent interest rates, you can be sure there is no income return available at all.

When John Galbraith said; “*these usufructs may be non existent of even negative*” he was referring to income, or the lack thereof, from vacant Florida swamp land but the reference is equally valid for the Mosman block of flats; at least some of the usufructs are marginal at best.

Back in 2010 I wrote “a bubble guaranteed to burst is debt fuelled asset inflation; buyers debt fund most or all of the purchase price of an asset whose cash flows are unable to support the interest and debt obligations. The bubbles to short are those where monthly repayments have to be made.”

And in his book *The Map and The Territory; Risk Human Nature and the Future of Forecasting*, Alan Greenspan goes further, distinguishing a bubble whose bursting causes widespread damage from one that doesn’t;

“The crashes of 1987 and 2000 had comparatively minimal negative effect on the economy. The severity of destruction caused by a bursting bubble is determined not by the type of asset that turns “toxic” but by the degree of leverage employed by the holders of those toxic assets. The latter condition dictates to what extent contagion becomes destablising. In short, debt leverage matters.”

With bubbles properly defined, it may be prudent to apply the definitions to both the Australian stock and property markets. Those in Singapore can simply apply the same logic to whatever companies and properties they like in their own investment universe. The wonderful thing about value investing is that it will be successful long-term in any market.

Here in Australia, stocks are showing a few signs of elevated prices. At Montgomery we first define companies according to a quality score; A1 companies have the lowest risk of catastrophe between now and the next reporting period. Companies with a C5 rating have the highest risk. We will only invest in companies who scores are A or B and 1 through 3. That means companies rated A4, A5, B4, B5 and C1, C2, C3, C4 or C5 at the time of possible acquisition will not find their way into The Montgomery Fund, irrespective of whether or not they are cheap or not. You can find out more about quality companies by buying my book *Value.able* **here**

If we put aside this test however we can rank all of the largest 100 Australian companies (we can rank every listed company in the world, see skaffold.com) by their discount and premium to our estimate of their intrinsic value.

Interestingly if we apply this test we discover that at the time of writing just four companies display any discount to intrinsic value. The four companies are Fortescue, JB Hi-Fi, Orica and Leightons. Now, before you run off and buy these companies, you should note that if only four companies are cheap, it suggests 96 companies are expensive.

Over the last three or four years, when I have observed this, the market has ceased rising and in fact, in most cases, the market has subsequently fallen by between 5 and 15 per cent. Once again, I am not predicting the commencement of a sell-off, nor the presence of a bubble, but it does seem that prices are not currently justified by valuations.

Having made this observation I should point to the existence of one of several 'mini' bubbles. Their bursting is, I believe, inevitable however the impact will be quarantined by their microscopic size. Since mid July, Mint Wireless (MNW), Smarttrans Holdings (SMA), and Mobile Embrace's (MBE) share prices have been riding a euphoric wave of optimism, buoyed by industry buzzwords such as 'cloud', 'mobile', 'payments' and 'online scale'. The share price trajectories have left us shaking our heads.

Suppose we offered you the opportunity to buy a diversified digital 'business' for $292 million. If, upon telling you that the business generated just $16.9 million in revenue and produced a loss in 2013 of $4.1 million, you didn't zip up your wallet and run you would arguably need your head read. Combine the current market capitalisation, revenue and profit for Smarttrans, Mobile Embrace and Mint Wireless and you have exactly the same scenario.

Paraphrasing Galbraith, all aspects of ownership have become irrelevant except the prospect for an early rise in price. Income from the businesses, or even their long-run worth is now academic. What has become important is that tomorrow or next week, market values will rise—as they did yesterday or last week—and a profit can be realized.

When it comes to property it appears a slightly different ingredient is emerging as the germinating input for a bubble in Australian property that could be much more damaging if permitted to inflate further.

During the GFC many Australian home owners, some of whom are reading this column today, found themselves unable to offload their multimillion dollar abodes. In upmarket suburbs like Mosman, entire streets where "quietly" on the market. Properties purchased for $10 million to $15 million before the financial crisis, couldn't find buyers at $7 million. The impact was felt most acutely by those whose financial obligations were reliant on continuing bonuses that failed to repeat previous excesses. That however represented the boundary of the fallout.

Today matters are different. Low interest rates have encouraged the broader market to acquire homes at every price point but low interest rates and generous borrowing terms - you can obtain a fixed rate mortgage for 4.8 per cent with 100 per cent gearing, 70 per cent in your super fund – have meant that it is inevitable many will overextend. Remember Alan Greenspan's observation; "The severity of destruction caused by a bursting bubble is determined not by the type of asset that turns "toxic" but by the degree of leverage employed by the holders of those toxic asets"

The Reserve bank noted back in September: "Property gearing in self-managed superannuation funds was one area identified where households could be starting to take some risk with their finances."

To be fair, supply is one thing we don't have an excess of. When I visited New York and Florida in 2007, I was struck by billboards that urged Amercians to buy one [a house] and get one free. And this was before it all went pear shaped. Up until 2007, low interest rates in the US led to a boom, not only in house prices, but also the construction of residential accommodation. A subsequent supply of excess stock combined with the rolling over of sub-prime loans from interest-free periods triggered a collapse as home owners were unable to support the mortgages that had been supporting house prices. So in Australia we don't have a bubble in stocks yet nor in property yet. We do have a couple of the key ingredients that if left unchecked could help fuel a bubble. In property the ingredient is that everyone believes they can become rich buying property. Low interest rates and the fear of missing oit may just encourage enough buyers to borrow too much supporting houses prices whose elevated levels prove temporary.

In stocks there's no bubble in the broader market either although there are examples in certain sub categories. The broader market does appear however to be expensive; just four companies in the top 100 reveal any hint of a discount to Skaffold's estimate of intrinsic value.