Funds Bet Against Australia's Big Banks

BY VERA SPROTHEN

SYDNEY—Hedge funds are throwing their weight behind a notoriously risky trade that suggests Australia's biggest banks, among the most profitable in the world, might be headed for trouble.

Rising bad debts, falling earnings and fears of a property-market downturn have triggered a record number of "shorts" on Australian banks, which have long been stock-market darlings because of their high shareholder returns. Short sellers borrow shares from other investors and then sell them in the hope of buying the stock back at a lower price, turning a profit.

Short positions on the four largest Australian lenders—Commonwealth Bank of Australia, Australia & New Zealand Banking Group Ltd., Westpac Banking Corp. and National Australia Bank Ltd.—have collectively soared 50% this year to more than 9 billion Australian dollars (US$6.49 billion), the highest level since regulators began compiling data six years ago.

Earlier this year, Sydney-based asset manager John Hempton teamed up with Jonathan Tepper, who runs U.S.-based hedge-fund consultancy firm Variant Perception, for an undercover investigation of Australia's property market. Posing as a gay couple, they drove around Sydney, from glitzy beachside suburbs to the shabby city fringes, to probe potentially risky lending practices. What they found was considerably worse than what they had expected.

"We witnessed a mania in all its crazy excess," Mr. Tepper told clients. "Australia now has one of the biggest housing bubbles in history." Among the trades he recommended in anticipation of a major property-market downturn: shorting Australian

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banks.

The surge in hedge-fund short bets is at odds with the enthusiasm of ordinary investors saving for retirement, who favor Australian banking stocks because their dividends provide a steady income. The proportion of earnings the "Big Four" banks return to shareholders—an average of 78%, according to professional-services firm KPMG—is among the highest in the world.

It has also begun to unsettle mainstream asset managers such as State Street Global Advisors and Macquarie Group, which have warned clients that heavily shorted stocks typically underperform the market.

Short sellers were emboldened earlier this month when ANZ became the nation's first major lender to cut its dividend since the 2008 global financial crisis. The bank said bad-debt charges more than doubled to A$918 million in the six months through March, while net profits shrunk by a quarter.

"Short sellers are likely to deem Australian banks as mispriced based on dividend and earnings risks," said Nicholas Vidale, a Hong Kong-based portfolio manager at Man Group, a hedge fund managing assets valued at US$78.6 billion globally.

Credit-ratings firm Moody's Investors Service recently added to investor concerns, forecasting weakening bank earnings and sharply rising bad debts from record-low levels, as a global commodity-price rout increases the risk of loan defaults at companies from steelmakers to dairy farms. Banking analysts at Morgan Stanley, Goldman Sachs and UBS say they think further dividend cuts appear to be inevitable.

"One doesn't have to be overly negative to expect Australian bank earnings growth to stall. Dividends are likely to be higher than what the banks can sustain," said Mr. Vidale, who declined to comment on his specific trading positions.

Shorting Australia's major banks isn't a strategy most hedge funds would likely be eager to publicize. The trade carries the nickname "widow-maker" because of the losses it has caused short sellers in the past. Mr. Hempton is one of the few hedge-fund managers to acknowledge openly that he is shorting Australian banks—albeit in a small way. He said those bets made up only 5% of the portfolio of his hedge fund, Bronte Capital, which has A$126 million in assets under management, according to data compiled by financial website Credio.

Mr. Hempton wrote in a note to clients this month that he scours markets for potentially fraudulent or over-hyped businesses. Last year, he drew global attention for being a vocal short seller of Valeant Pharmaceuticals International Inc., whose stock has collapsed as the Canadian company deals with accounting and drug-pricing scandals.

Shorting the banks is a high-profile bet that risks defining those who make it, Mr. Hempton said in an interview. "This is a no-win situation for us because if we lose on it, everyone thinks we are stupid, and if we make money on it, everyone will look at the returns and ask why they are not larger," he said.

Many have failed to call correctly an end to an Australian housing-price boom that has led to some of the country's sleepiest towns becoming less affordable than New York. One investment manager's experience underscores the high stakes involved. In 2010, Jeremy Grantham, co-founder of Boston-based hedge fund GMO and famous for predicting bubbles, found traction among short sellers when he said Australia's property market was a bubble ready to burst. Instead, housing prices continued to climb.

This year, investors shorting Commonwealth Bank, the nation's largest lender, would have made a profit, as the stock has plunged as much as 18% since Jan. 1. However, the shares have started rebounding in recent days. If they continue to rise, short sellers would be at risk of losses when they buy back the stock and return it to the original investor at a higher price.

The banks are benefiting from expectations the Australian central bank will further cut its benchmark rate this year from a record-low 1.75%. This has helped to allay market concerns about intensifying mortgage distress among Australian households, which are among the most indebted in the world. Home loans account for the majority of Australian bank assets.

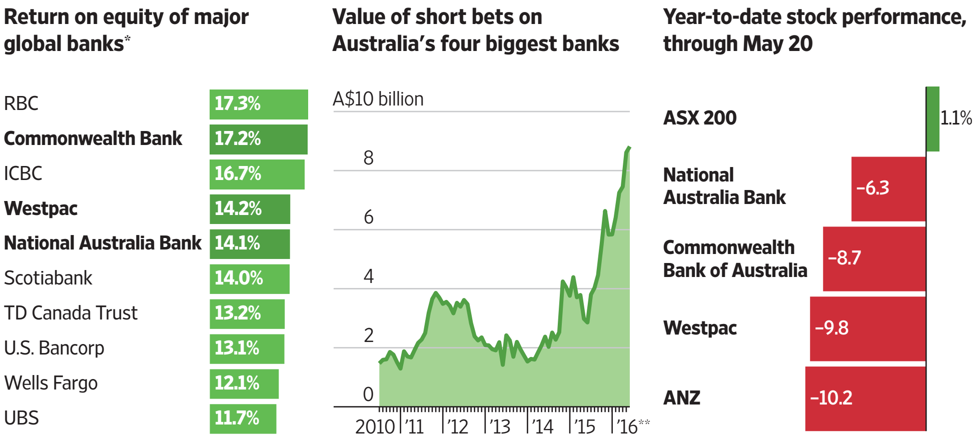
"It's a tough trade," said Andrew Macken, a fund manager at Montgomery Global Investment Management in Sydney, who helps manage assets valued at A$250 million. "Australia's major banks don't make good shorts. Even if their profit prospects may look weaker than in the past, they're still some of the most profitable in the world, competition is limited and they enjoy an implicit government guarantee."

Expanding Shorts

Australian banks are among the world's most profitable...

...but an uncertain profit outlook has lured short sellers...

...who make money when share prices fall.



Note: A$1 billion = US$730 million *Based on each company's first-half results for fiscal 2016 **As of May 13

Sources: KPMG (ROE); State Street Global Advisors (short-selling bets); Iress (performance)

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CORRECTIONS & AMPLIFICATIONS

Policy makers in Japan have tried to use stimulus measures to engineer a so-called virtuous cycle of private spending and investment. A Page One article Thursday about the country's economic growth incorrectly referred to it as a virtual cycle.

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