

THE PROPERTY REPORT

Bets Against Australia's Banks Rise

Anticipating a downturn in the housing market, hedge funds are shorting the country's lenders

By VERA SPROTEN

SYDNEY—Hedge funds looking for the next housing bubble think they have found it—in Australia—and they are wagering more than \$6 billion that the country's banks will feel the pain.

Australia's biggest banks are among the most profitable in the world, and investors have wrongly bet against Australia's property market. But the shorts think the housing market is closer to a downturn this time around, one that would add to the pain of rising bad debts and falling earnings.

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.—collectively have soared 50% this year to more than 9 billion Australian dollars (\$6.46 billion), the highest level since regulators began compiling data six years ago.

Sydney-based asset manager John Hempton and Jonathan Tepper, who runs U.S.-based hedge-fund consultancy Variant Perception, helped fuel the flurry of bets earlier this year after teaming up 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.

They said what they found was considerably worse than

what they expected: borrowers relying heavily on interest-only mortgages, a taxi driver living in an \$1.5 million home with lots of investment property, a strong belief that prices could only go up.

"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: short Australian banks.

Short sellers were emboldened earlier this month, when ANZ became the nation's first major lender to cut its dividend since the global financial crisis. The move came as its bad-debt charge more than doubled to \$5918 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 worth \$78.6 billion globally.

The proportion of earnings the "Big Four" banks return to shareholders, an average of 7%, according to EPFG, is among the highest in the world.

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



Customers use automated teller machines at an Australia & New Zealand Banking Group Ltd. branch in Melbourne.

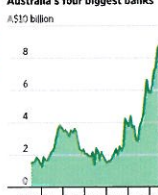
Expanding Shorts

Australian banks are among the world's most profitable... Return on equity of major global banks*



Note: A13 billion to US\$70 million. *Based on which company's first-half results for fiscal 2016. Source: EPFG, (RBC), (2015), (Westpac Global Advisors (short-selling beta), (Asia (performance))

...but an uncertain profit outlook has lured short sellers... Value of short bets on Australia's four biggest banks



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...who make money when share prices fall... Year-to-date stock performance, through May 20



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the risk of loan defaults from steelmakers to dairy farms. Banking analysts at Morgan Stanley, Goldman Sachs and UBS think further dividend cuts look inevitable.

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

Mr. Hempton, who runs

hedge fund Bronco Capital, is one of the few to admit openly that he is shorting Australian banks. He said those bets made up only 5% of the portfolio of his hedge fund, which has \$126 million in assets under management, according to data compiled by financial website Credio. He drew global attention last year for being a vocal short seller of Valeant Pharmaceuticals International Inc., whose stock collapsed on alleged accounting irregularities.

ties.

Many have failed to call correctly an end to a house-price boom, which has led to some of Australia's sleepest country towns becoming less affordable than New York City. The trade carries the nickname "widowmaker" because of the losses it has caused short sellers in the past. In 2010, Jeremy Grantham, co-founder of Boston-based hedge fund GMO and famous for predicting bubbles, found traction among

short sellers when he proclaimed Australia's property market was a bubble ready to burst. Instead, house prices continued to climb.

Mr. Grantham's experience underscores the high stakes involved. Investor's shorting Commonwealth Bank, the nation's largest lender, would have made a profit, as the stock has plunged as much as 18% since the start of the year. But the shares have started rebounding in recent days and if they continue to rise, short sellers are at risk of losses when they buy back the stock at a higher price and return it to the original investor.

The banks are benefiting from expectations that Australia's central bank may cut interest rates from a record low 1.75%. This has helped to allay concerns about 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 worth \$250 million. "Australia's major banks don't make good shorts."

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