Are we at the beginning of a long grind lower?

ROGER MONTGOMERY

With the high-momentum growth stocks falling in a heap — just as we warned they would — investors may be considering whether value has emerged.

Before jumping in however, it may be worth instead considering whether the circumstances that drove their share prices to giddy heights in the first place, and unjustified by realistic prospects, are likely to return.

It has been a tough road for value investors in the past couple of years. Berkshire Hathaway, run arguably by the world's wealthiest fund manager, Warren Buffett, now has more than $US125 billion ($174bn) in cash, representing just over a quarter of its market cap, and earning virtually no interest. When Buffett noted, at Berkshire's AGM back in March, that "an attractive price is a requirement that proved to be a barrier to virtually all deals we reviewed in 2017", I felt his frustration.

I can remember in 1999 and 2000 when Berkshire Hathaway had underperformed the Dow Jones by a massive 40 per cent and commentators and tech stock traders said he was "washed up", that he didn't understand the "new paradigm", and that he should retire. Then the tech bubble burst, Berkshire returned to outperformance and everyone said he was a genius. In reality, he hadn't changed anything that he was doing. He simply stuck to the tenets of value investing.

> Our position remains unchanged from a year ago — stay cautious

At Montgomery, we too are holding a large balance of cash and have been left behind by peers who were happy to "invest" in long shots simply because long shots were winning. As their gains accumulated over the last year or so, we looked more out of step.

But now the tables are turning, and our optimistic friends' accumulated outperformance is being rapidly unwound.

Stocks we have warned investors about in this column over the course of the year, such as Kogan and Afterpay, have at times been down 40 per cent and 70 per cent, respectively. That's a crash in anyone's language. Others I have warned about include WiseTech, Appen, a2 Milk, Xero, Altium and Pushpay.

And it may not be over just yet.

The job of an investor, as opposed to a share price speculator, is to purchase at a rational price, a part share of an easy to understand business, whose earnings are virtually certain to be materially higher in five, 10, or 15 years.

It's the "rational price" part that has been missing during the earlier rally of the above names.

The Shiller CAPE ratio, which compares the inflation-adjusted S&P 500 to 10-year average earnings, is about 30 — the highest since 1870 with exception of Tech Boom 1.0. The ratio isn't particularly good at predicting crashes however, so don't assume there's one coming. What it does very well is predict whether the next 10 years' average returns will be high or low. Whenever the ratio is below 15 times earnings, returns from investing in the S&P 500 over the subsequent decade have been very good. Whenever the ratio is very high, subsequent returns have been very low, even negative. Today, at about 33 times earnings, the CAPE Ratio is very, very high indeed.

It's worth keeping in mind that the current US economic recovery is the weakest since WWII and therefore many of the usual excesses requiring correcting have not been built in. However, the aforementioned credit binge, lax lending standards and plain nonsense in the prices of many growth stock hopefuls are elements of the sort of froth that can typically be identified ahead of past corrections.

A worthwhile way to think about whether current excesses exist, and whether they should be corrected, is to consider what low interest rates have forced investors to do. Punitive rates on cash — set by central banks — have caused investors to move much higher up the risk spectrum than they normally would. This is reflected in the record prices paid for non income-producing assets such as art, stamps and collectible cars as well as the willingness to fund loss-making start-ups, such as Uber for nine years, through private equity. So, while broad-based optimism isn't evident in the community, it is evident in asset prices, reflecting the abandonment of risk aversion.

Another way to examine the presence of optimism is with simple arithmetic. Greenlight Capital's David Einhorn, who has admittedly lost his investors about 25.7 per cent year to date, recently offered simple maths to highlight the absurdity some investors are willing to support in an attempt to beat cash rates; "The current market view is that profitless companies with 20-30 per cent top-line growth are worth 12-15 times revenues, while profitable companies that lack that level of opportunity are worth only five to eight times after-tax earnings. As an arithmetic exercise, if you pay 12 times revenues for a company that eventually makes a 10 per cent after-tax margin and trades at a 20 times P/E, the company has to sustain a 25 per cent growth rate for eight years for you to break even, and for 12 years for you to make an 8 per cent internal rate of return. If the company is increasing the share count by paying employees in stock, the math gets worse."

When investors are buying an asset whose net yield is below cash, they are receiving a lower return but taking on more risk. The risk-adjusted returns on cash start to look more attractive. Of course, rates have been so low for so long, nobody seems to believe the world could change. But changing it is, and the recent share price falls we have been warning about may be just the beginning of a long grind lower.

For that reason our position remains unchanged from a year ago. Stay cautious.

Roger Montgomery is founder and chief investment officer of the Montgomery Fund.

www.montinvest.com

Housing downturn not a collapse

JAMES KIRBY
WEALTH EDITOR

It's an unfortunate reality of both the property market and the media today that the extreme view gets most attention.

As they say, squeaky wheels get the grease and nine times out of 10 those squeakers are doomsayers.

Except once in a while the truth of the matter somehow breaks to the surface. Just now we are overloaded with bad news. On Thursday someone did the numbers for Sydney that showed prices were at their weakest since Bob Hawke was PM. Across most major cities similar stories are appearing.

Earlier this week the economist and veteran contributor to the Wealth section Don Stammer, a former chief economist at Deutsche Bank Australia, offered a column headed 'Housing isn't going bust'. That's the sort of headline that sinks a story fast in this age of shrill social media and measurable page views.

But a funny thing happened, the column that said property would drop — but not drop dramatically — managed to make it into the top 10 most-read pieces of the day. Stammer had revealed a hidden truth about our market and the facts were concerning but crucially they were not alarming; if anything they were a pointer for smart investors and ambitious homeowners who want to optimise their wealth at this time.

The success of Stammer's column has to be set against the immediate context in which it was presented: an apartment tower here is discounting sales, an attractive house there has failed to sell. For investors, the dispatches are a little more disturbing — investment property lending has slowed to a crawl. One-time favourites of the private investors such as childcare centres or petrol stations are failing to sell or bring in decent returns.

But Stammer stood back from all this with the experience you get from monitoring the market for more than half a century and he pointed out three facts:

- In the past 12 months the median house price has dropped about 4 per cent across Australia (Sydney is not *all* of Australia).
- Mortgage stress is roughly the same as it was a decade ago.
- Australians have been ahead on mortgage payments — prepayments equal 18 per cent of mortgages outstanding.

You might quickly argue that things are about to get worse ... and there is no doubt this housing downturn has further to go.

The experts tell us we could see another 5-10 per cent drop from this point: perhaps this is true, perhaps the reality will be somewhere in the middle. Either way, a slump should be modestly paced since the basics that underpin a strong market are still with us — low interest rates, low unemployment and a rising population.

The missing ingredient is finance. Banks are choking off credit to the wider market to the point that even Treasury secretary Phil Gaetjens has noted the effect of home loan applicants being turned away. Presenting a set of results that saw profits go backwards by 5 per cent on Wednesday, ANZ chief executive Shayne Elliott said home lending could halve from peak levels in the coming years.

Everyone has a view on property. The Reserve Bank is the most authoritative view and this is what it says about residential property: "Households in aggregate appear well placed to managed debt repayments: reliable and relatively timely indicators point to pockets of household financial stress but this is not widespread."

Those pockets of stress are eminently predictable — off-the-plan apartment developments, lower-grade housing developments. From a regional perspective the black spot is Perth, where the figures remain depressed. But Brisbane, which has been soft for two years, is seeing a change in tone where housing is showing signs of improvement and apartments, though still oversupplied, have sparked bargain-hunting.

On the ground we see clearance rates dropping to their lowest levels in years and behind the scenes there are other factors that you get when the market is very soft. There is evidence of sellers accepting 5 per cent deposits on home sales rather than the standard 10 per cent. At the corporate level there is evidence of discounting and initiatives such as rent-free periods, rental guarantees and all the other moves you might associate with a buyer's market.

It's a downturn, not a depression. One bright spot from the downturn in prices and the semi-freeze on bank lending is a break for first-home buyers and for parents willing to take out parental guarantees on mortgages their kids are stretching to achieve.

Embracing market volatility and looking for opportunities

MY WAY
Dubliner Alva Devoy, a former molecular engineer, is the Australian managing director for the $US279 billion global investment manager, Fidelity International

HOLLIE ADAMS

Alva Devoy: 'Investors have been right to deploy their cash into higher yielding and returning assets'

You've been less bearish on markets than many commentators ... are you more or less comfortable with that position after the recent market setback?

Arguably, the anomaly has been the low levels of volatility we have seen since October 2017, when the Fed stopped rolling its balance sheet and went into run-off. Market volatility is to be expected during transition periods ... which is what this is. We are weaning markets off their drug of choice — low rates. And market volatility can be good for investors as it throws up opportunities for those actively seeking those opportunities.

What is the single biggest concern you see in global investment markets?

The levels of corporate debt and the concentration of that debt. This means more than ever that using active managers to screen out those companies that are now going to be very exposed to rising cost of debt makes sense.

Would you agree that if the markets go south the global economic system does not have the same capacity this time around to cut rates or launch QE programs?

The US and Australia are now roughly equal in terms of base rates which, while low, does reflect the lower inflation cycle we are seeing this time around. We have also seen that zero is not the lowest we can go; we have seen negative rates as in Europe.

So to me there is some fuel in the tank, but sensible central banks will be looking to refuel as fast as economic growth will allow them.

House prices are falling — in your home country, Ireland, they fell 40 per cent in the last downturn — is there any significance in the Irish story for Australian property investors?

Banks were lending at a ferocious pace at that time in the Irish market, in part because of the speed of appreciation of real assets — a developer would buy a piece of land with low-cost borrowings and within months it was appreciating rapidly, affording more equity against which to borrow again. So the supply of development (creating unsustainable employment growth) and housing supply jumped well in excess of the normal rate of demand.

This meant that not only were asset prices inflated due to the cheap cost of debt but the supply versus demand economics were out of synch.

The man on the street also became a developer in effect, borrowing against his home to buy investment properties because the economics made perfect sense (capital was cheap and easy to access) so long as house prices kept increasing. In contrast, Australia has its own central bank in the RBA, which rate sets as appropriate for this country.

> 'If you were putting new money to work right now, you would not be investing in companies that have run so hot'
>
> ALVA DEVOY
> MANAGING DIRECTOR
> FIDELITY INTERNATIONAL

Australian investors had too much cash for a long time. Is there a danger they do not have enough now?

Let's separate household wealth and cash from investing and cash.

From an investment perspective, investors have been right to deploy their cash into higher yielding and returning assets — if I can achieve a 7.5 per cent yield on Australian equities versus a 2.7 per cent term deposit against inflation at 2 per cent, then the sensible decision is to invest or the value of my cash will be eroded.

That said, entering into a period of higher volatility does call for a higher allocation to cash, in part because you want to have money to deploy when opportunities present themselves, along with cushioning to downside risk, especially for those who are retired.

You began your career armed with a PhD in molecular engineering. Was the qualification ever really useful? If so, in what way?

Absolutely, because it armed me with an ability to research in any field — that's the transferable skill. Also, to question conventional wisdom. This is the central tenant of success for a long-term investor. Put it this way, today information has little value; it's what you do with the information and the decisions that you make that are important. So I utilised those skills as an investor.

Entering the investment market you got started researching dotcoms — how do you rate valuations of major tech stocks today?

The FANGs, to a degree, deserved to re-rate as they were the companies enjoying huge growth rates, far outstripping other areas of the market.

However, the market is extrapolating the growth experienced by these firms far into the future and the flows via passive ETFs have perpetuated that cycle, as these passive ETFs are forced buyers of these large market cap stocks in indices.

So what happens when the environment shifts for even one company, such as increased regulation for Facebook or Amazon? I believe the pain will be felt more broadly. If you were putting new money to work right now, you would not be investing in companies that have run so hot.

Instead, you would be actively seeking out the next area of growth that is not so popular today; that might be as un-sexy as food and water!

What was your best investment?

My best has been Apple, which I started buying after I bought their first iPod in 2001 and which is still in my pension fund today.

And your worst?

The worst was an Irish biotech company called Elan. It was the market darling and early in my investment career. I rode the wave all the way up (and made my first house deposit on the way), but I fell in love with the company *and* believed all that management said, and so I rode that wave all the way down the other side.