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Premature talk of bubble trouble

Roger Montgomery

Amid the recent emergence of rising prices, all the talk of bubbles in stocks or in property is simply premature. We'll leave US Treasury bonds and the US Federal Reserve out of this discussion until the Postscript and focus on Australia for now.

That is not to say that prices will not decline. They may fall, but any drop from current levels would not be due to the presence of a bubble, nor evidence of it bursting.

But I do believe the first seeds of a bubble have germinated and it is also true that bubbles already exist in some individual stocks and sectors. It may be some time before a true bubble – one marked by contagion that is damaging to markets, investors and the broader economy – emerges, and it may be the case that no potentially damaging bubble develops at all.

Bubble definitions

To discuss both shares and property in the context of bubbles, it is first worthwhile to define them.

The Canadian and later 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 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 recently sold a block of five flats in Mosman, on Sydney's north shore, for $3.52 million 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 one 3-bedroom apartment, two 2-bedders and two 1-bedders. The gross rent was just $139,000 a year. The new buyer will have to subtract maintenance and other costs, fees to a property manager and tax before a net yield is available. If more than 50% of the purchase price was borrowed, you can be sure there will be no income return available.

John Galbraith 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.

Damaging and debt-driven

Back in 2010, I wrote in my blog:

"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*, former US Federal Reserve Chairman 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 as those that are debt-based, contagious and damaging when they burst, it may be prudent to apply the definitions to both the Australian stock and property markets.

In Australian stocks there are 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 that score 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 they are cheap or not.

If we put aside this test, we can rank 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. If we apply this test, we discover that at the time of writing just four of the top 100 companies show a discount to intrinsic value. If only four companies are cheap, it suggests 96 companies are expensive.

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

However, I should point to the existence of one of several 'mini bubbles' at the moment, although the impact will be quarantined by their microscopic size. Since mid-July 2013, the share prices of several small technology companies have been riding a wave of optimism, buoyed by digital communications 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 made a loss in 2013 of $4.1 million, then if 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 the companies SmartTrans, Mobile Embrace and Mint Wireless and you have exactly that 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 realised.

Property worries

When it comes to property, it appears a slightly different ingredient is emerging that could be more damaging if permitted to inflate further.

During the GFC, many homeowners, some of who are reading this article today, found themselves unable to offload their multimillion-dollar abodes. Even in exclusive and popular Mosman, entire streets where 'quietly' on the market. Properties purchased for $10 million to $15 million couldn't find buyers at $8 million. The impact was felt most acutely by those whose financial obligations were reliant on continuing bonuses that failed to repeat previous excesses. The wealthy, however, largely represented the boundary of the fallout.

Today matters are quite different. Low interest rates have served to encourage buyers in 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% with 100 per cent gearing, 70% in your super fund – have meant that many will overextend.

By way of example, Bloomberg finance reporter Narayanan Somasundaram wrote, in an article entitled, *Australians ride housing with pensions not so super:*

"Howard Kindler, 57, dipped into his pension to turn property investor, spending a third of his retirement savings and taking out a mortgage to buy a Melbourne apartment.

Disappointed with the returns of his retirement fund, Kindler is one of the million Australians who go it alone and manage their own pensions, known as self-managed superannuation funds or SMSFs that together hold A$500 billion ($US474 billion) in assets. Many are increasingly banking on surging home prices to provide a comfortable retirement, and like Kindler, are leveraging their investment, expecting higher returns."

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 assets."*

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, housing supply is one thing we don't have an excess of. When visiting New York and Florida in 2007, I was struck by the billboards that urged Americans to buy a house and get one free. And this was before the US economy went pear-shaped. Until 2007, low interest rates in the US led to a boom, not only in house prices, but also residential construction. 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 no longer able to support the mortgages that had been propping up house prices.

Germinating not bubbling

In Australia we don't have a bubble in stocks or property yet, but we do have a couple of the key ingredients that if left unchecked could help fuel a bubble.

In property the germinating ingredient is that everyone believes they can become rich, or safely retire, through buying property. Low interest rates and the fear of missing out may just encourage enough buyers to borrow too much, supporting house prices rising to elevated levels that prove temporary.

In stocks, there's no bubble in the broader market either, although there are examples in certain sub categories. However the overall market does appear expensive, given that just four companies in the top 100 reveal any hint of a discount to our estimate of intrinsic value.

Postscript: key policy shifts overseas?

As we are on the subject of stocks and bubbles, it's worth adding a postscript that ties this discussion to developments in the deep dark corners of the US Federal Reserve.

One of the conversations occurring in the halls of global central banks — but not being reported in the Australian press — is whether the Fed is about to embark on a 'regime change', by which I mean a very serious shift in policy.

When European Central Bank President Mario Draghi infamously pronounced in just seven words, that the central bank would do "*whatever it takes to preserve the euro*," he signalled a massive regime shift at the central bank. And it worked.

When Japanese Prime Minister Shinzō Abe replaced both the Governor and the two Deputy Governors of the Bank of Japan and committed to setting ambitious targets for inflation by engaging in quantitative easing on a massive scale, he signalled to the world and its officials that to get something done, you really need to 'move the dial'.

The US is looking at this in the context of a study that found since January 2009, the New York Stock Exchange rose every week the Fed bought bonds and fell every week it didn't.

The idea of fuelling a bubble may be gaining momentum.

We all know that the US economist Janet Yellen is taking the Chair at the Fed, and she has said that targeting inflation will play second fiddle to ensuring healthy employment. And the US central bank is widely regarded as having been unsuccessful in its policy settings as they relate to unemployment.

Christina Romer, who was head of Obama's Council of Economic Advisers from January 2009 to September 2010 and a worldwide expert on the Great Depression, may replace Yellen as Vice Chair of the US Federal Reserve. Christina Romer aligns with Yellen in that she forcefully supports the idea that withdrawing stimulus too early threatens a 1937-type economic reversion, and she believes that economic growth can be improved by changes in expectations on growth, and that if the Fed turns its focus to targeting nominal GDP, it can achieve its aim.

In a speech entitled "*Monetary Policy in the Post-Crisis World: Lessons Learned and Strategies for the Future*" that she gave on 25 October 2013, Christina Romer said:

"A final way beliefs may be important involves expectations of growth. People's expectations about the future health of the economy have a powerful impact on their behavior today … If a central bank through its statements and actions can cause expectations of stronger growth, that can be a powerful tonic for the economy … ***for policymakers to really move the dial on expectations and push them firmly in the direction they want them to go — it takes a regime shift. Smaller, more nuanced moves are easily missed or misinterpreted by people in the economy.***

"Back in 2011, a number of economists, including me, argued that the Federal Reserve ought to adopt a new operating procedure for monetary policy: a target for the path of nominal GDP … Switching to this new target would have some important benefits. In the near term, it would be a regime shift. It would unquestionably shake up expectations. Since we are currently very far below a nominal GDP path based on normal growth and inflation from before the crisis, it would likely raise expectations of growth, and so help spur faster recovery …

"Today, I worry that guilt over letting asset prices reach the stratosphere in 2006 and 2007 has made some policymakers irrationally afraid of bubbles. ***As a result, they focus on the slim chance that another bubble may be brewing rather than on the problems we know we face*** *— like slow recovery, falling inflation, and hesitancy on the part of firms to borrow and invest."*

As I mentioned at the beginning of this article, we are not in a bubble … not yet, anyway.

Roger Montgomery is the Chief Investment Officer at The Montgomery Fund, and author of the bestseller, 'Value.able'.

Top 10 tips to find great small companies

Chris Stott

At Wilson Asset Management, our major focus is investing in well priced growth companies, which we usually find in the small and mid-cap industrial sectors for our three listed investment companies.

As discussed in previous articles, small cap companies outperform their large cap peers over the long term and are a great way of enhancing your portfolio's returns and providing added diversification. In the small cap sector there is an asymmetry of information. If you do the hard work, there is a higher probability you will get strong risk adjusted returns. We describe below some of the attributes we look for in identifying great small cap companies.

1. **Management.** Management is extremely important for all companies, particularly smaller ones. It can make or break a company. When we are investing in a company, we make sure we spend time with management so we can assess them. We look at their past performance. Do they have a detailed understanding of their business, particularly the financials? Do they have a clear vision for the company?

2. **Earnings Per Share growth.** I believe that movements in Earnings Per Share (EPS) have the best correlation to movements in share prices. It is important to find a company that has strong EPS growth. We look for companies that are growing at 15% to 20% per annum over the next two years.

3. **Free Cash Flow.** When you are looking at companies that are growing strongly, it is important to understand how they will fund growth. We look at the cash the company generates before amortisation and depreciation and after subtracting the dividend payment, capital expenditure and the change in working capital (change in working capital equals inventory plus debtors minus creditors times the percentage increase in sales in a 12 month period). It is important that cash flow is positive.

4. **Valuation.** You can look at a company on a Price to Earnings (P/E) basis or a discount to asset basis. We try to find companies that are growing (EPS growth) at 1.5 to 2.0 times their P/E. Say the company is on a P/E of 10x and growing at 15% to 20% per annum. On other occasions, you may find companies that are trading at a discount to the value of their net assets. Obviously, it is important to understand the make-up of those assets. The discount to asset opportunities can provide low risk plays for patient investors.

5. **Operations.** Operations in a small company are paramount. Companies should have a tight cost focus and strong financial controls. Avoid firms trying to spread themselves too thinly across various products and services. Also, be wary of companies with a future tied to one particular event such as a major gold discovery, drug approval or a change in legislation, as these tend to be very high risk plays.

6. **Industry position.** Analysing the market or industry position is important in order to ascertain how feasible a company's long term strategy is given its operating environment. This is crucial as the strategy put forward by management must be realistic given the current business environment. Is the company operating in a new high growth sector or is it operating in a more mature stable low growth market?

   In the early stages of a new growth market, a lot of small companies can start up and perform well, as there is plenty of growth to go around.

At the other end of the spectrum (think retail), it can be very hard for small companies to break into mature markets, as there are usually a few dominant players with large market shares and significant financial fire power to counteract the threat of new entrants. You are trying to identify companies that are well positioned in growth industries.

7. **Patience.** Small cap stocks tend to be more volatile than their large cap cousins, but hanging in there can pay off for investors in the long run. This does not mean an investor should stick with a stock stoically until it has lost 99% of its value. Patience only applies if the company is continuing to execute its strategy in line with its stated timeframe. If the fundamental reasons that attracted you to the stock are still valid and the management is delivering on its strategic plan as stated, then be patient and filter out the background noise of the market. The market should recognise the results and the story in due course.

8. **Catalyst.** Before we invest in a company, we identify a catalyst that we believe will re-rate or drive its share price higher. The catalyst could be a positive earnings surprise, a management change, a structural change in the industry, the sale of a loss-making division or expansion into a new market. A catalyst could be anything that you believe will positively change the value of the company in the eyes of the market.

9. **Strong fundamentals.** A good small cap company should have a strong balance sheet. Although the dollar values involved might look minuscule compared to BHP Billiton, they are just as important. Companies with high cash levels and low to zero debt are something to look for. Also, watch out for intangible assets on the balance sheet such as goodwill and deferred revenue. These may have to be written down significantly at a future date.

   The cash flow statement is also a key document. In its purest form, it registers all the cash flowing in and out of the business over a period. Look for positive cash flow overall and especially positive cash flow from operations. Usually companies that have negative cash flow from operations don't survive.

   Good companies with strong businesses usually have straightforward accounts that are easy for the user to read and understand. A convoluted set of accounts can sometimes be a red flag indicating that the company is in trouble or trying to hide something.

10. **Liquidity.** For most investors in large cap stocks, this issue isn't a concern. However, at the smaller end of the market, investors need to keep in mind the size of the position they wish to accumulate in a company and the average daily trading volume in the stock.

    While the company in question might be a great one, you still want to be able exit at either a profit or a loss if the reason behind your investment fundamentally changes. Investors need to be aware that in very thinly traded stocks it may take days, weeks or even months to exit. Hence, the old saying, 'equity is forever'.

The above points are not foolproof but they should assist investors in making their decisions when searching for a small cap stock or two for their portfolio.

Chris Stott *is the chief investment officer at Wilson Asset Management.*

Would you invest in this emerging market?

Ashley Owen

Looking for an emerging market to invest in? How about this one:

- real GDP growing at rates of more than 7% a year for five decades, including three decades of growth above 10% a year. This is better than any other emerging market. China has had only three decades above 7% growth (in the 1980s, 1990s and 2000s); India and Brazil have had only one decade above 7% (India in the 2000s, Brazil in the 1970s)
- a stock market that has delivered market index returns of more than 40% a year in eight different years, including one year of 66% returns
- a very young population with a median age of just 22
- no welfare system, no labour laws, and virtually no domestic taxes or regulations.

Where is this marvellous place to invest? Before answering, be aware that this country has also suffered many of the negatives often associated with emerging markets, including:

- bouts of run-away inflation above 20%, and deflation worse than minus 15% at times
- government debts, which at one time soared to more than 200% of GDP (worse than Japan now and more than double the levels in Greece and Portugal)
- current account deficits that ran at times at more than 30% of GDP (twice as bad as Portugal, Italy, Ireland, Greece and Spain – the PIIGS – today)
- default on its government debt, and a $40 billion (in today's dollars) restructuring of government debt (or debt equivalent of 100% of its GDP), where investors took a 'hair-cut' and lost more than 20% of their interest payments and had to wait up to 30 years to get back the principal on their loans
- suffered a (brief) military coup
- the ousting of democratically elected leaders by foreign rulers – twice
- as an ex-colony of a European military power, wiped out most of the native population in bloody battles, confiscated land and spread diseases.

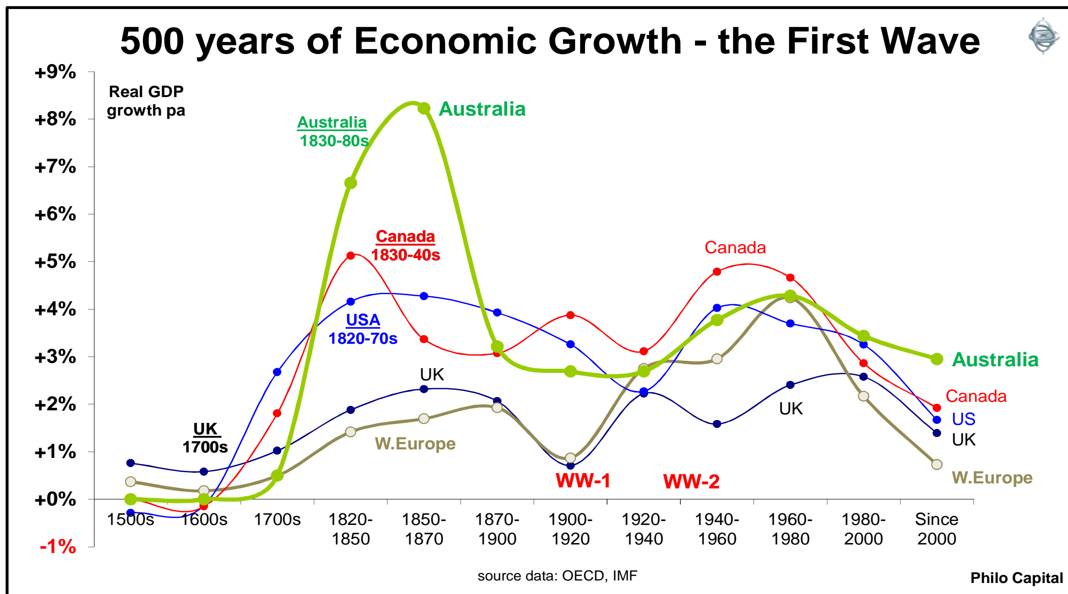
Where was this vibrant investment opportunity?

In short: a young, vibrant 'frontier-land' economy with few rules, plenty of adventure, abundant untapped resources, and ample opportunities to make fortunes quickly for canny investors.

Where was this great emerging market? Well, you're sitting in it!

Australia was the stand-out 'emerging market' of the 19th century. Its rapid growth spurt started with the success of wool exports to Britain in the 1820s and 1830s, then the gold rush from the early 1850s followed by minerals and property booms in the 1870s and 1880s. (New Zealand also enjoyed real GDP growth rates of more than 10% in the 1840s, 1850s and 1860s).

The following charts show five centuries of economic growth rates in various countries. The first chart shows the first great wave of industrialisation, which started in Britain and spread to the rest of Western Europe. The first wave of emerging markets were the British ex-colonies where the colonists overpowered the native inhabitants and cleared the land to produce agricultural exports for the markets back home - firstly the US, then Canada, Australia and New Zealand.

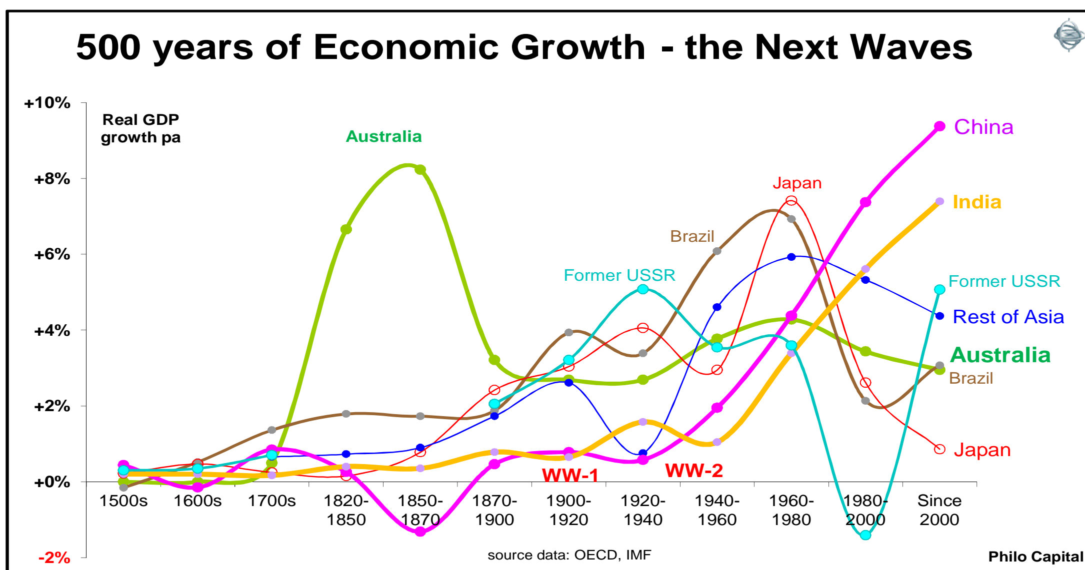


After World War II, Germany was the main emerging market in Europe and the reconstruction effort spread across western and northern Europe in one huge development area – financed largely by the US as a buffer against the Soviet threat in the Cold War. Canada, the US and even Britain also experienced relatively rapid growth in the post-war baby boom years.

Does the end of the period of explosive growth mean the end of great investment returns? As emerging markets mature, economic growth slows as the population ages, productivity gains give way to redistribution, and these trends are accompanied by increases in the size of government and rising levels of regulation, welfare, and taxes to pay for it all.

All emerging markets end their dream run, but this does not necessarily mean disaster for investors. In the case of Australia, economic growth slowed to a more stable 3%-4% during the 20th century, but the Australian stock market as a whole still delivered returns of an incredible 11% a year (or 7% after inflation) in the 20th century while economic growth slowed down.

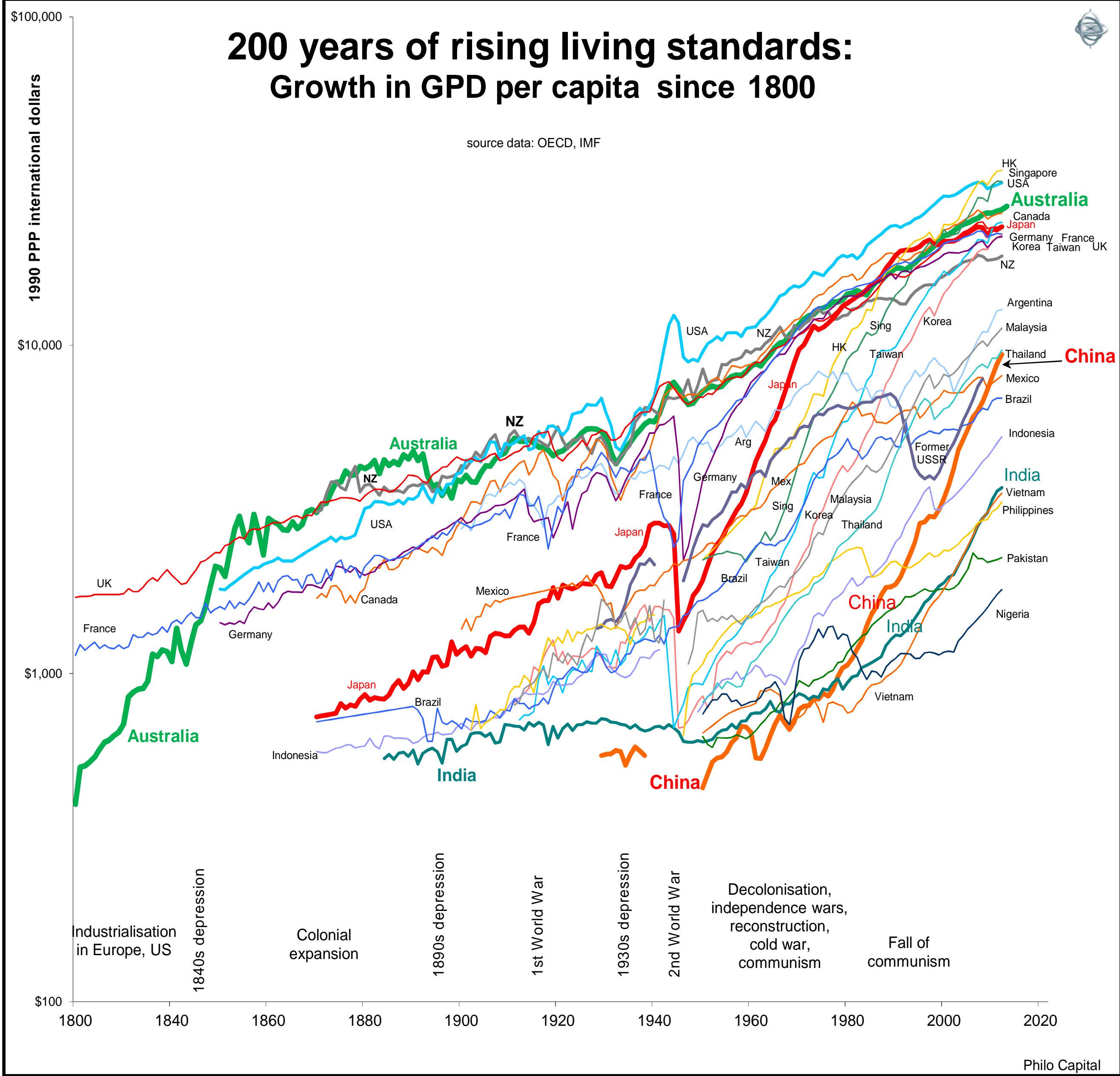
The second chart shows the growth paths of the next wave of emerging markets, and shows Australia's for comparison.



Although recent growth in China and India looks rapid, this growth has been along similar lines to that of Australia and New Zealand in the 19th century. Rapid growth does not and will not last forever, as economies mature and living standards rise more slowly as they catch up.

The next chart shows the rises in living standards in various countries over the past two centuries. The lines represent GDP per capita in real dollars. The steepness of the upward sloping lines indicates the rate of growth.

We can see that the slope of the line for China in recent years has been no steeper than say Japan in the 1950s to the 1980s, or those of Hong Kong, Singapore, Taiwan or Korea in the 1970s-1980s or indeed Australia's curve in the first half of the 1900s.



After Australia's explosive growth in the first half of the 1900s, Australians enjoyed the highest living standards in the world for much of the second half of the 19th century (with New Zealand not far behind). Growth rates in the subsequent half century were not as rapid, but we were already on top of the table.

Australia was hit especially hard by the 1890s global depression, made worse by a severe drought here, then World War I, the 1930s depression and World War II. In the second half of the 20th century, our growth was supported by high levels of immigration, and a wave of free market reforms in the 1980s and 1990s that attracted high levels of investment.

The US has had the straightest path of all since the mid 19th century – aside from a dramatic drop in the 1930s depression and an equally dramatic spike in the World War II boom.

We can also see the collapse of the German and Japanese economies following World War II and their rapid re-emergence as the great emerging markets of the post-war reconstruction period.

The Asian tigers followed soon after – Hong Kong, Singapore, Taiwan and Korea had steep upward growth paths in 1960s and 1970s – following the Japanese lead. Living standards in Hong Kong and Singapore have now caught up with the old world countries, and they are now classified as developed markets.

The next breed of emerging markets appears as steep upward sloping paths on the right side of the chart. The growth paths of China, India, Vietnam, Indonesia, and the Philippines are as steep as those of Japan and Germany in the post-war era, but no steeper than Australia's path in the 19th century. The rises of Brazil and Mexico have not been as rapid, but they have taken place over longer periods.

The chart also highlights the fact that the 2008 financial crisis was a relatively minor hiccup in economic growth compared to the deep contractions in the 1930s. The 2008 crisis seemed a big deal because it is fresh in our memories, and because it has been so long since the last contraction, but it is hardly visible in the broad sweep of economic history.

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Real client experiences often differ from the headlines

Rick Cosier

In the financial and economic world, we use medians and averages to assess our position and make decisions about the future. Over the last month, some experiences with clients have led me to question which statistics are useful and which may be obscuring reality for many.

According to RP Data, the median price of homes across Sydney increased by an average of only 2.5% a year over the 10 years to July 2013. This figure is used to refute claims that we are in a housing boom. However, a client told me she had been offered $920,000 for her home in Petersham, in Sydney's inner west, just six months after being offered $850,000. Another client has just bought the house next door in the inner Sydney suburb of Alexandria for $800,000, two years after buying their similar home for $600,000. Clearly, 2.5% is not a good measure of what's going on in many parts of Sydney more recently.

An estimated two-thirds of households have no mortgage debt (half of these are renters) and of the third that do, most are well ahead in repayments. A client has just refinanced her home loan with her new partner. The property was purchased for $1.2 million using a loan of $800,000 with a 30 year term. It's a big loan, she told me, but they both earn substantial salaries and can comfortably service the repayments.

The problem is that these clients are 54 years of age. Does the bank expect them to work and maintain their high salaries till they are 84? The alleged safety valve that 'most people are well ahead in repayments' is nonsense if this sort of practice is widespread. Perhaps the bank expects the repayment will eventually come from superannuation proceeds or downsizing, or if necessary, the bank can repossess the property and hope to sell for more than the borrowed sum.

On Saturday, I asked a mortgage broker friend how many loans like this are being written. He told me that it was common, but he didn't seem too fazed by the practice. It appears that the average tenure of a home loan is only four years, so repayment of the loan is likely to end up as another bank's problem. Another broker said that banks are not supposed to write loans unless there is a clearly identifiable exit strategy whereby the mortgagee is not compelled to sell their house.

Unfortunately, cashing out super to pay off debt appears to be an acceptable exit strategy. A report published by CPA Australia in August 2013 identified that this was an all-too-common experience. Data from the Association of Superannuation Funds of Australia (ASFA) shows that the average superannuation balance for a male aged 65 to 69 is just $77,000, and for women it is only $55,000. If many of the households that have eliminated mortgage debt have done this by cashing out their super, then this statistic is hardly cause for comfort.

The *Australian Financial Review* had a front page article on 12 October 2013 claiming that there was a surge in baby boomer retirement. The implication is that with average net assets close to $700,000, boomers were happily exiting their jobs for a life of overseas travel and playing with the grand-children. Anecdotally, my experience is that for every boomer client who is smelling the roses, there are another four working for low pay in places like Coles and Bunnings. The CPA survey revealed that the average net wealth of retirees aged between 60 and 69 is $987,000. This statistic is being used to illustrate how wealthy we are, but $598,000 of this is tied up in property. It's not much good having a net worth of close to $1 million if most of it is the value of your home when you retire, and you face the prospect of creating sufficient money to live on for 25 years without employment income.

Moving on from property averages, let's look at the share market. The performance of the S&P/ASX200 is a weighted average of the returns from the top 200 companies listed on the Australian share market. The price index (ignoring dividends) is still about 30% lower than in 2007. Yes, you can study price/earnings ratios and come to the conclusion that the share market looks like reasonable value. But P/E ratios are usually based on future expectations that may not eventuate, and to say that the market is 30% below its 2007 level is disguising huge differences. Shares in CBA are trading at record highs, while the price of BHP Billiton has fallen by about 22% from its $48.70 peak in 2008. How much joy clients are receiving from the market depends on what they own.

I recently had a visit from my auditor for our annual check-up. "How are your clients doing," I asked. Given that unemployment had recently fallen to 5.6%, and business and consumer confidence was rising, I thought he would be quite positive. "Terrible," he said. "Most small business revenue is 40% to 50% down." He explained that the choices facing small business people are not good. Either they close down with debts they can't pay back, or they keep going in the hope that things will pick up. In the meantime, they pay themselves less and less, and they still have to pay minimum wages to their staff.

You only have to drive down Parramatta Road or Oxford Street in Sydney to see how small business is struggling. We also know that many people have given up looking for work, and the fall in the participation rate disguises underemployment. Many are working fewer hours than they would like or for less money. The unemployment rate is another questionable statistic we use to measure the strength of the economy, but we need to factor in these reality checks.

People approaching retirement should make sure that if things go wrong they have an exit strategy. It means making sure they can achieve short, medium and long term goals. It means diversification and risk management. It means that they cannot afford to be complacent. To quote Tim MacKay of Quantum Financial on using all your super to gear into property: "As long as property prices go up forever, interest rates stay low forever and you never lose your job, there is no risk with this strategy. Good luck with that."

Rick Cosier is a financial adviser at Healthy Finances Pty Ltd.

Index versus active – our readers reprise

Graham Hand

Last week's article on index versus active portfolio management drew many comments, including on the website, by email and by forwarding other articles to us. Here's a sample:

Robert Keavney, Former Chief Investment Strategist for Centric Wealth, and in 2001 described by Money Management as one of the Ten Most Influential People in Australian Financial Services.

Here's my view on the active vs passive debate. Efficient Market Theory (EMT) argues that the fact that most managers underperform the index is evidence that markets are efficient and that there is no such thing as superior skill.

However 'the market' largely consists of professional investors. The fact that the return produced by professionals, and amateurs for that matter, after fees and real world costs like stamp duty and brokerage will almost always under-perform the return before these real world costs (ie the index) is so unremarkable as to hardly be worthy of comment. And it should also be added that most index funds under-perform the index by the sum of their fees and costs, though their fees and therefore underperformance will generally be lower than for active funds. Of course, the average net of costs will be less than the average free of costs. How could it be otherwise?

Further, the average fund manager has no superior skill. This can be verified, in my view, by a brief conversation with most of them, quite apart from their lack of superior track record.

The above are strong arguments against investing in an average fund manager.

*However, the problem for EMT is that it must argue that no individual or fund manager can **ever** demonstrate superior skill. According to EMT, investing is unique among all human activities in that it is claimed to be impossible for anyone on any occasion for any single person to display superior skill. A single counter example is enough to disprove the theory in its pure form. Thus Buffet's outperformance has to be **completely** explained away as pure luck. Closer to home, the Platinum International Fund's almost quadrupling of the index return since its inception in 1995 has to be explained away without any reference to ability or hard word.*

At best the assertion that superior skill is impossible is unprovable. And the attempts to prove it do become intellectually contorted eg Fama/French acknowledgement that small caps and value stocks will outperform the broad index in the long run and that funds which invest in them can do likewise - which would seem to be an acknowledgement that outperformance is possible. But they

argue that this outperformance is a result of the market efficiently rewarding the higher risk of value and small cap stocks.

Another example of intellectually contorted arguments: according to EMT the price of every stock at every moment is always the correct price reflecting all the information available to the market. When you ask what meaning the word 'correct' has in this context, and how it is measured or verified, you are told that the correct price is the market price. So the market price is the correct price because the correct price is the market price. Nicely circular and thus devoid of content.

This discussion of EMT is, of course, quite separate from the question of whether most people will get a better return by investing in index funds. Few individuals have the ability to identify superior managers so most people in practise will do better to invest in index funds.

Two readers sent in recent articles on the subject. The first is from The Financial Times, with the reader commenting that "I had not thought of benchmarking problems this way, with a very good analogy." The second is from Reuters and Business Insider.

Predictable rump of index money won't last, Simon Evan-Cook. FT, 29 September 2013

"In April 1831, an accident occurred that forced the British army to change its procedures. The event was unforeseeable, though hindsight makes its causes – and its simple solution – seem obvious. A company of soldiers marched on to the Broughton Suspension Bridge, which began to vibrate in unison with their step. As more troops marched on, the vibrations became more pronounced. Rather than becoming alarmed, the soldiers enjoyed the swaying, even playfully exacerbating it. But as the first troops reached the far side, a bolt snapped, causing the bridge to collapse. Post-crash hindsight may demand that more investors break step, like the army does when crossing a bridge, to prevent disaster ... The risk stems from the widespread use of benchmarks which are synchronising investors' actions. This is most obvious in passive investing, whose perpetual growth is encouraged despite its unknown consequences."

Finally, it looks like picking stocks is a winning strategy, David Randall, Reuters, 4 November 2013.

"It's a good time to be a stock picker. Some 57 per cent of U.S. funds run by active managers are beating their benchmark indexes this year, according to fund-tracker Morningstar. That is the best overall performance for the industry since 2009 and well above the 37 per cent of funds that typically top the indexes.

Stock pickers are doing well in part because after more than four years of marching higher en masse, stocks have started to separate themselves into leaders and laggards. The lines of demarcation became more pronounced during the past few weeks as U.S. companies reported their recent quarterly results."

There are many useful comments following last week's article on the Cuffelinks website.

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