ZANACORP

Special Market Update
Property Edition

June 2015

From the hallowed halls of the Australian Parliament, to the humblest of dinner tables in Australian suburbia, there is only one topic that currently occupies the centre of conversation …. the price of houses. It is nearly impossible to escape a client conversation or read a newspaper without the subject being raised. As a necessity of life, housing and accommodation is important to us all, but at what cost? Australian residential housing in Melbourne and Sydney now ranks amongst the most expensive on the planet. In time, we will learn if that title is justified or simply our belated home grown version of the same problem that sank the Western world in 2008/09.

Next Stop… The Twilight Zone

Return ON Capital vs Return OF Capital (Part 2)

In March 2015 we re-addressed the issue that investors today have compromised investment risk pursuing investment return. The single minded chase for yield has been so compelling, that just as in 2007, the pricing of risk has been relegated to just a dismissive afterthought.

Higher Yield Does Not Equal Higher Return

Investors today underestimate the risks of shifting asset classes (eg. from cash/term deposits to bonds, shares or property). The asset price rises of recent years, accompanying higher yield investments, has distracted investors to focus on income yield rather than total return.

In a low interest rate climate, retirees are understandably concerned with being unable to generate sufficient income to fund lifestyle. Meanwhile, property investors and speculators alike have profited from the compression of the differential between the cost of money (interest rates) and the return on money (yield). Risky investments now appear to be self-funding and risk free, so borrowing often heavily, also has the appearance of being simple and risk free.

In Australia, income tax and CGT concessions afforded to both shares and property have created a crowded space where retirees, investors and home buyers are being pitted against each other to buy the same assets, at ever increasing prices. It seems it will be this way forever.

To digress momentarily, your writer was born into a household where small business ran through our veins. My parents and my grandparents before them, each ran traditional green grocery businesses, after emigrating from Southern Italy both pre and post WWII.

As a youngster in the 1960's and 70's, my school holidays commonly demanded I rise, at 4am to assist with the daily labour intensive task of attending the produce markets and loading our truck with the farm fresh goods, to be later sold to our customers. In those formative years, I learned a fundamental lesson - *in the retail world, business profits were largely determined by how well (cheaply) we could buy the goods*. Since selling prices were set by market forces, the lower the price we paid our suppliers, the better would be our profits. In other words **buying at the right price was the secret to success.**

In a similar manner, but different context, successful investing demands buying assets at the right price in order to make a profit on sale. In today's world, **bonds, shares and property are either fully valued or over valued**. This makes investing and managing the risk of loss, an extremely hazardous task. It is for this reason we have cautioned clients not to aggressively chase yield within their investment portfolios. The current risk of investment loss is becoming **HIGH**.

When analysing an investment of any type, an astute investor will assess total returns considering the price paid, the income return and risk to capital. Often, **higher yield does not mean higher returns**.

Why Do Investors Underestimate Risk?

Although more complex, **investors generally err in extrapolating the most recent asset price patterns and performance into the future**. This leads them to pay too high a price for future income underestimating the risk that prices may fall, even if the income does not.

Globally, investors have yet again presented with the same market risk amnesia, typical of the pre GFC investment psychology, that led to so much financial trauma.

Current asset prices provide very little wiggle room for anything to go wrong in the economic/financial world. As we peruse the global landscape, **we see too much evidence of asset price distortions and economic imbalances to sustain the current asset price premiums** and low, risk adjusted discounts.

Excessive debt was the core of the GFC implosion. It should demand attention that some 8 years later, global debt is 20% higher than pre GFC levels.

More particularly, we should consider our own backyard, where **Australian HOUSEHOLD DEBT attributable exclusively to housing loans has grown from $743 billion in March 2006 to $1,423 billion* by March 2015**. That is a staggering 92% increase in debt in 9 years of at least **3.5 times the rate of increase** of GDP and/or average wages. Total Australian household debt for the 1st time in history now also exceeds Australia's total GDP.(* www.australiandebtclock.com.au)

It is a perverse world where in Europe, **LENDERS currently PAY BORROWERS**! While in the US a 5 year deposit yields 0.75% p.a. This will not last, and when it ends, it could get very messy for the whole world.

Gen X,Y (and Z) readers are asked to remember these years. It is likely your children and grandchildren will not believe it.

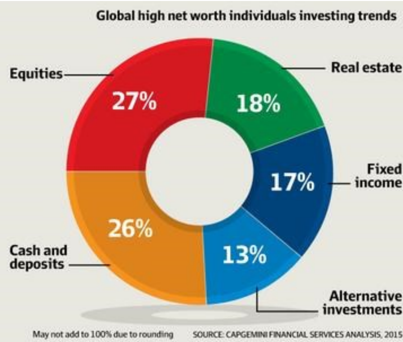
Diversification - Practised by the Wealthy & Wise

We often discuss the importance of diversification. At Zanacorp it is part of our creed. Presently, we are again in the process of de-risking all client portfolios by reducing exposures to growth assets. Since 2012, our average portfolio returns of 35% - 55% have amply rewarded our clients, and so we are again drawn to seek to preserve those gains rather than greedily chase even more at a time of elevated risk.

With so many investors either borrowing more money, overexposing themselves to a single asset class, like property, or increasing their risk with higher exposure to shares, we remain as disciplined and steadfast as possible to our **buy low sell high** philosophy to avoid capital loss.

It is insightful to us and hopefully our readers to study the 2015 asset allocation of high net worth investors in the US. Having enjoyed tremendous gains from both bonds, equities and alternative assets, it is interesting to note that **the US middle class wealthy (who most commonly pay for advice) continue to employ the basic discipline of in-**

vestment diversification to protect what they have. They regularly rebalance asset allocations to minimise investment risk and are averse to using leverage to chase returns. Just as we are.



Take a moment to look at the above asset allocation chart.

It begs the question, why people with far less income and/or assets, especially Australians, and at current high prices, consider that borrowing for shares, or more likely property, will be the recipe for their financial success. Is it the modest tax break? Or because everyone else is doing it? Do people even understand how long a 25 year loan is?

Excluding the family home, we expect many Australian Gen X'ers will have extremely growth oriented single asset class portfolios, quite vulnerable to investment risk. The mindless belief that employing the same strategies that made their asset rich baby boomer parents comfortable over the last 20 years, will deliver the same outcome to them in the next 20 years is flawed logic. As Australia leaves its golden age, we believe the next 5-10 years will debunk many current strategies.

Grexit – A Greek Tragedy

After a decade of sovereign deception by the Greek government, commencing in 2001 with their admission into the European Union (EU), we are approaching a climactic moment in history. The first of the EU Mediterranean refugees, Greece, looks likely to be thrown overboard to sink or swim alone. Their exit is now simply referred to as "Grexit".

Of itself, Greece is only 2% of EU GDP and potential debtor losses are manageable. Of greater concern is the risk that others may follow the same path, either forcibly or by necessity, and leave the great political/cultural experiment in tatters.

Germany has had enough of Greece, and newly elected Greek prime minister Alexis Tsipras, akin to Ned Kelly, has defied the creditor directed austerity measures imposed on his constituents. There appears to be no meeting of minds, with the left wing Greek government defying calls for asset sales and structural tax, labour and pension reform.

The escalated tension between all parties last week has spooked Greek citizens, leading to a massive withdrawal of Euro denominated funds from the bank system. And another nail is driven into the coffin of the Greek economy.

Why would Australian's care about the EU imbroglio? Well just quietly, the Australian banking system that has lent you or your children the small fortune to buy a house, borrows upwards of 40% of its funding from overseas. A disorderly EU would very easily disrupt bond markets and lead to increased risk premiums on debt. Interest rates could rise in Australia, beyond the control of the Reserve Bank or your personal bank. Oops, Australians are not supposed to know we rely on the goodwill of our creditors, or the housing thing may end up being a "penny bunger" with a really short wick.

More importantly is the fact that the EU is the biggest single importer of Chinese/Asian goods and services, our biggest trading partners and in whom we rely on to help us pay our creditors. Let's just say we believe resolution of the Eurozone challenges is in the best interests of the global financial system. Let us hope that Tsipras is no Oedipus Rex.

Getting Older, But Not Wiser

In 2014, a white paper entitled "Freedom & Choice in Pensions: A Behaviour Perspective" was released. It heralded seismic changes into the UK financial system and dawned a new age where consumers will be offered more direct control their retirement capital. Scary isn't it?

A key finding of the report discussed behavioural biases related to age, particularly amongst older people, the very group able to access their funds. The report described that **as people age, they increasingly make decisions that increase positive emotions and decrease negative emotions**. A form of "learning from experience".

Importantly, their behaviour manifests itself by way of:

i) Preferring fewer options when making decisions, and being more satisfied with their choice, given only a few options
ii) Focussing on one or two common characteristics between options, rather than trying to compare multiple, non comparable features
iii) Heightened aversion to loss

The paper also found reduced cognitive skills, wherein the ability to absorb and incorporate new knowledge within existing biases declines with age. In other words, **people tend to stick to what they know rather than explore new options**. Interestingly, many older respondents were acutely aware of their thought process and use the experience of family or friends to guide them and reinforce newer ideas.

Loss aversion, of course, is relatively easy to understand later in life driven by a fear of insecurity. But extreme loss aversion was identified as a serious dilemma, particularly where it **predictably leads to people outliving their capital and forfeiting their financial independence**, especially in a low rate environment.

All investors, young and old can draw some connection between themselves and the described behaviour. We should each be able to see the merit of conservative tendencies, but also recognise that diversification, even outside one's immediate comfort zone is important in retirement.

For our existing retirees/pre-retiree clients, we remind you that often, retirement capital needs to last well over 25 years. To accommodate both investor risk concerns (loss aversion) and growth needs, Zanacorp has developed a strong armoury of asset allocation strategies to generate above average market returns with below average market risk.

Although these strategies often involve considerable back office time and effort, we are exceptionally pleased with the strong outcomes we have achieved for clients who have been open to learn "new tricks", unlike their UK counterparts.

Residential Property - The Australian Safe Harbour

From our colonial origins, the Australian dream has been to own one's home. And why not? Home ownership demands savings discipline for 25 years, but in return offers financial security, privacy, enjoyment, self satisfaction and importantly peace of mind. Although these personal aspirations are universal, Australia is unique in developing social security and taxation laws designed to protect the sanctity of the home.

Driven by continuous post WWII immigration that has undoubtedly enriched our culture and our affluence, our expanding population has underpinned ever increasing land values, particularly near our capital cities. The combination of a resilient economy, migration, scarcity, favourable tax treatment **AND easy credit** has now led us into the biggest single dilemma of the 21st century - **HOUSING AFFORDABILITY**.

The Big Picture—Bubble or Not?

Recent months have seen an unrelenting flow of attention grabbing headlines from politicians, the RBA, bankers, property developers and naturally journalists, either declaring a property bubble exits or not. In a most complex segmented market, with many influences affecting both current and future prices, we feel it its unhelpful to generalise.

Each state has different characteristics and different conditions with inner city, outer suburbs, regional, growth corridors, freestanding/ duplex, apartments and 1/4 acre blocks, new and existing.

Our focus will be largely directed to Melbourne metropolitan housing prices and, to the extent conditions are similar, Sydney metropolitan.

Is there a housing bubble? We believe the answer is **NO**. Bubbles are very rare in history. In the last 70 years, there have been only 4. The most notable being the Japanese real estate/stock bubble of 1989, the Asian property bubble of 1997 incorporating Thailand, Philippines and Indonesia, the dot.com bubble of 2000 and of course, the GFC in 2008.

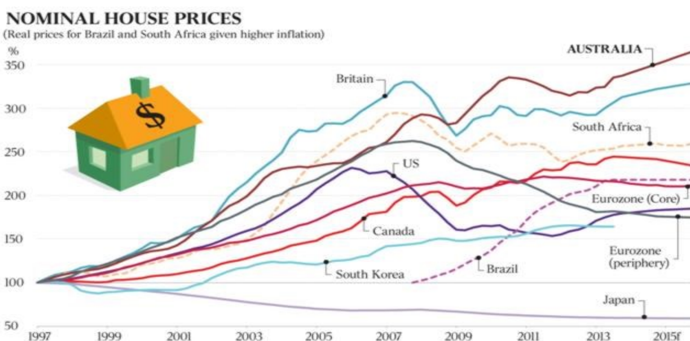
What we currently have in pockets of Melbourne and Sydney is a **full blown asset price boom.** Like all booms, it has lasted years longer than many, like ourselves, expected, or consider healthy. Prices are very high, but are far from forming a bubble. So let us avoid any talk resembling a mania or hysteria. "Irrational exuberance" may be more apt.

No Bubble, But Still Trouble

Ignoring the semantics, property prices relative to income are at extremely elevated levels never before seen in Australia. The convergence of strong demand from migrants, home buyers, Asian investors and local investors has seen prices increase by 300%-400% in the last 15 years. Unfortunately, over the same timeframe, as interest rates have fallen to all time lows, **Australian per capital debt has also increased by 300%-400%** correlating closely with the price of properties.

Australians curiously assume our behaviour is no different from those of other countries, except that we are smarter at avoiding financial disasters. 25 years of continuous prosperity supports that proposition. However, the IMF does not share our self confidence and are undertaking an economic review. They are concerned about our level of individual property leverage and speculation. They worry about our over exposure to China, declining terms of trade and lower future income prospects following the mining investment boom. Ouch!

The following graphic puts Australian house prices into perspective. Australia, on average, has the highest prices in the world, even though we do not have anywhere near the highest income in the world. What makes up the difference you ask? **DEBT, DEBT and more DEBT**.



After two decades of almost uninterrupted falls in interest rates, Australians have more than **TRIPLED** household debt levels exclusively to invest in houses. **Both borrowers and lenders remain starry eyed**.

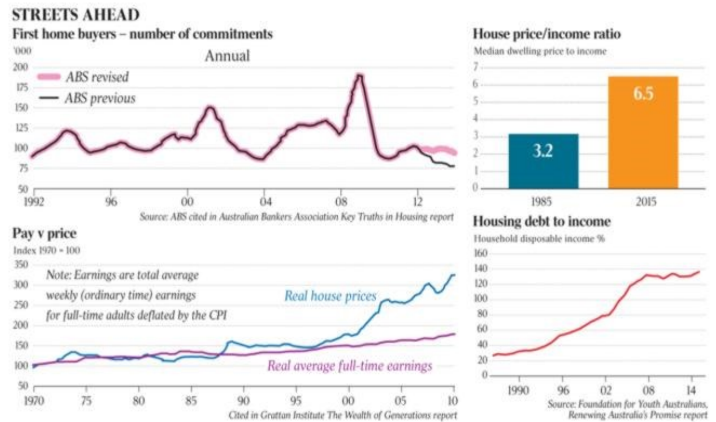
Many of you will be unaware of the extraordinary behaviour we commonly see amongst the "invulnerable" Gen X'ers aged between 35 and 50. This group has leveraged themselves to the eyeballs. Their experience of life has been nothing but one of a prosperous Australia. Hence their belief that debt increases wealth and the more you can borrow the better your chances to get ahead. Paying off existing home loans is no longer an impediment to borrow even more for a rental property.

The new generation of borrowers rarely seek independent holistic advice. They "plan" their financial future using internet based tools and calculators. They arrange their borrowings online or with brokers (peddlers of debt) to borrow as much as they can at the lowest cost.

There is very little emotion involved and no genuine intention to form a long term relationship with a lender. You know, the "old school" rationale that relationships are most valuable when things don't quite work out as planned. Gen X'ers believe that won't happen to them!

WOW! Now I really feel old, even though I am not.

Study and absorb this chart because this is what happens as a result:-



First home buyers are no longer engaged. Median house PE ratio has doubled to 6.5, but **in both Melbourne and Sydney is now OVER 8 times income**. Real prices no longer relate to earnings and household **debt has gone from 30% of income to over 140% of income. Nothing here is normal or sustainable,** yet it is what it is.

What about the Supply Shortage?

As booms grow over time, so does the need to rationalise reality by pointing to simple and obvious factors that best explain away complex, emotional and irrational behaviours. This one is no different.

3 years ago, **the mining boom that would last for decades** was rationalised by the greatest urbanisation of humans in history. The China story. Fat lot of good that has done for many of our now struggling or bankrupted miners and mining industry workers .

So it is with the current residential housing boom. **Today's mantra is "shortage of supply" is causing rising prices.** The cry is for less red tape, more land releases and the affordability problem will be solved.

Since we all know migration in recent years is strong, and all our kids want homes, the hypothesis that underpins the boom seems, well, logical. And buyers believe it. But is it true?

Regrettably, although migration is strong, current new housing stock is being built at the highest rate ever. Chances are, many of us live very close to the new so-called "medium density" developments of 20-60 homes on a 3 house block. A trip to either Melbourne or Sydney CBD will lead you to discover the tens of thousands of high rise apartments being built and the multitude of cranes, building new ones.

Statistically, we are building one home for every 1.5 people coming to our shores. Even though the last census average was 2.5 occupants. Huh? Yes it is a simple fact we are overbuilding just like the Chinese have overbuilt in China. The housing shortage is an urban myth.

So Who Is Buying All These Houses/Apartments?

Australia has become a country of landlords. Many will be aware offshore buying has exploded in the last 2 years. And they happily pay top dollar. Want to know why? It's not a secret, it is government policy.

The massive surge in Asian investment into our new apartments, propping up prices and employment is largely driven by the **Significant Investor Visa Program** (SIV). This permitted **over half of the $5m** required to obtain a visa, to be invested indirectly in residential real estate for 4 years to be eligible to apply for a permanent visa. Melbourne, for its world leading education sector and Sydney, for its finan-

cial hub, have been the two beneficiaries of the this program. Clearly, if you are rich enough, you can buy Australian citizenship!

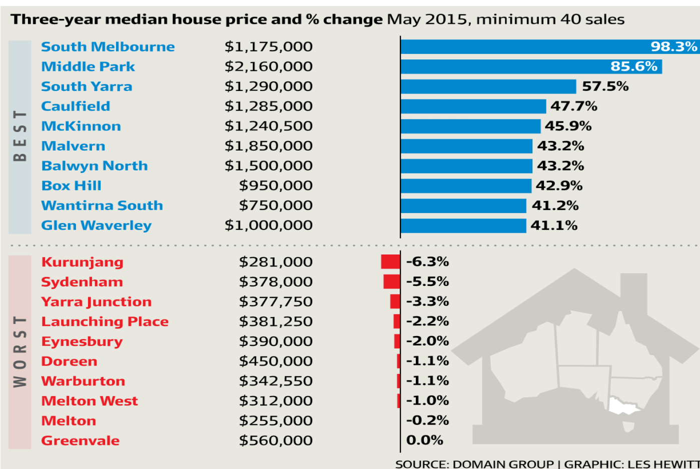
Material changes to the SIV program take effect from 1st July, 2015. **The new framework limits investment into residential real estate to $300,000.** This is a major change that will impact the building and sale of FUTURE developments. It has the potential to contribute to a glut of apartments on the market at the expiration of the 4 year investment criteria, as future Asian emigrants find more accommodating countries to go to. Any apartment investor unaware of this, really failed a most basic element of due diligence.

Investors, Tax and Falling Rents

In March 2015 we illustrated that over 50% of houses are now purchased by investors. The overwhelming number of local investors have purchased existing dwellings within 20kms of the CBD contributing little to the economy. Pursuing capital growth, taxpayers have funded both negative gearing and CGT breaks for little return. Although better framing our tax concessions to new dwellings would produce a better structural and economic return, that horse may already have bolted. The recent Asian fuelled apartment expansion has resulted in supply quickly catching up to demand in the areas people want to live in. The result is that residential rents are conspicuously falling and vacancy rates rising. With so many projects approved but yet to be built, in time, this construction boom appears destined to mimic every other.

Not All Winners are Grinners

One may be excused for thinking that every property investment over the last 3 years has been a magic potion for making money. Not so. Like all things in life, successful investment demands attention to detail. Whilst some sectors have boomed, many newer "growth corridors" have floundered, potentially leaving their owners, permanently in the property wilderness. Their bankers, though, are quite happy.



Three-year median house price and % change May 2015, minimum 40 sales

	Suburb	Median price	% change
BEST	South Melbourne	$1,175,000	98.3%
	Middle Park	$2,160,000	85.6%
	South Yarra	$1,290,000	57.5%
	Caulfield	$1,285,000	47.7%
	McKinnon	$1,240,500	45.9%
	Malvern	$1,850,000	43.2%
	Balwyn North	$1,500,000	43.2%
	Box Hill	$950,000	42.9%
	Wantirna South	$750,000	41.2%
	Glen Waverley	$1,000,000	41.1%
WORST	Kurunjang	$281,000	-6.3%
	Sydenham	$378,000	-5.5%
	Yarra Junction	$377,750	-3.3%
	Launching Place	$381,250	-2.2%
	Eynesbury	$390,000	-2.0%
	Doreen	$450,000	-1.1%
	Warburton	$342,550	-1.1%
	Melton West	$312,000	-1.0%
	Melton	$255,000	-0.2%
	Greenvale	$560,000	0.0%

SOURCE: DOMAIN GROUP | GRAPHIC: LES HEWITT

The above chart shows the 3 year change in prices for Melbourne's best and worst suburbs. Many first home owners, buying in so called growth corridors, may have been better advised to rent than buy. The allure of the modest but free First Home Owner's Grant may have led them to an unwelcome destination. Just as it did in the 1980's boom.

So Where to From Here?

To young people under say 25—28, do not despair. Your day will come when over stretched Gen X'ers and income hungry baby boomers will release their property holdings. Our advice is to find a career you enjoy and will stick with for a long time. It will form the income base for you to pay off your future home. Home ownership demands sensible savings habits, so start early. Sure enjoy life, but don't wake up one morning realising you have no capital, as many 30 somethings' do.

How Long Will Current Conditions Last?

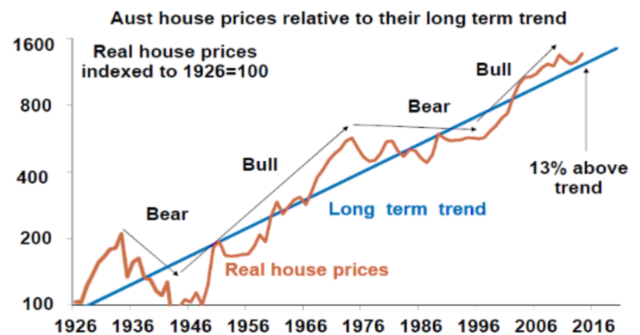
Without presuming we have any answers, we believe (hope) any property market correction will be relatively orderly. There are few signs that the current boom will end soon. As our economy weakens further, RBA interest rates are likely to fall, supporting the current paradigm.

We are also very mindful that powerful forces will be brought to bear to avoid a GFC style catastrophe—so don't expect one. The property sector plays a pivotal role in our economy and always will. It supports our financial sector, employment, retail spending and of course generates massive taxes for all levels of government. It is a golden goose.

As in the late 1980's, State Governments have become extremely dependant on stamp duty and land tax revenues. They would become very quickly insolvent if the goldilocks property sector were to be disturbed by father bear. Since this is well known, we feel the market would be steered to deflate rather than crash.

Our best guess leads us to consider a sharp rise in unemployment, or crash in global bonds or Chinese property (both real bubbles) as the greatest threats to disrupt the current status quo. Presently, neither of these appear imminent. So for now, the boom still has legs.

Ultimately, we are preparing for a protracted bear market in the property sector. It will rebalance itself to once again provide accommodation for people rather than dizzying price rises.



The graphic above, summarises all we have said. For prices to now mean-revert, they either need to fall by 10% - 20% or do nothing for 5—8 years. Neither option is a desirable prospect for those in debt.

If history has taught us anything, it is to expect the unexpected. **Many borrowers and investors will be confronted by a most unfamiliar future world**. A world where **icons considered unbreakable, shatter**.

Look, **that's the signpost up ahead, your Next stop, the Twilight Zone**.

MARKET FACTS	June 2015	June 2014	June 2013	June 2012	5 Yrs Ago 2010	7 Yrs Ago 2008	10 Yrs Ago 2005	15 Yrs Ago 2000
Australian All Ordinaries	5,451	5,382	4,775	4,135	4,325	5,333	4,229	3,258
Dow Jones (US)	17,619	16,826	14,909	12,880	9,774	11,350	10,374	10,447
FTSE 100 (UK)	6,521	6,743	6,215	5,571	4,917	5,626	5,109	6,313
Nikkei (Japan)	20,235	15,162	13,677	9,008	9,382	13,481	11,584	17,411
Hang Seng (Hong Kong)	26,250	23,191	20,803	19,441	20,129	22,102	14,201	16,156
Dax (Germany)	10,945	9,833	7,959	6,416	5,965	6,418	4,583	6,898

DISCLAIMER

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