BIZCOMMUNITY

Seeking sanity in an upside-down world

By Adrian Saville

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We find ourselves in an environment in which there is more to be worried about than usual, including an escalation of the China-US trade war, fallout from a "no-deal" Brexit, and erratic or aggressive Fed policy decisions.

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Then, for good measure, we can add a dose of yield curve inversion in the US, a phenomenon that has been followed by a recession every time in the past 60 years — with only one exception in the late 1960s.

Altogether, this makes for a high-risk economic and political cocktail. Yet, notwithstanding this, markets have pushed into territory of crazy valuations and perverse investment activity.

Take Denmark’s Jyske Bank, which recently launched the world’s first negative interest rate mortgage – offering home loans at minus 0.5% a year on a ten-year mortgage. Negative interest rates effectively mean that a bank pays you to take their money. Over the life of the loan, you pay back less than you borrowed.

The insanity of “upside-down banking” had spread from bond markets where, recently, Germany sold the world's first 30-year bond offering a zero coupon. The German bond was issued on an effective yield of minus 0.2%, meaning investors are guaranteed to lose money on the thirty-year investment. In total, about half of all European government bonds have a negative yield, and globally there is $15trn in negative-yield debt.

Equity markets also have produced some astounding valuations, seen in profitless initial public offerings (IPOs). Loss-making Uber came to market at a share price of $45 in May, valuing it at $82bn, or seven times annual revenue. The global average for all businesses is less than two times revenue. Likewise, shared-space office company WeWork announced a September IPO at a $47bn valuation, more than 25 times annual revenue – a staggering sum for a company that isn't profitable and may never make money.

When valuations get carried away – whether bonds, equities, tech or tulips – it never ends well. Yet, investment decisions have become heavily distracted by breathless storytelling of new business models, disruptive technologies and quantitative easing, leading to lofty valuations.

To manage this risk and successfully navigate the current environment, we should remember that sound investment decisions are founded on a core principle of buying good assets at good prices. Importantly, the one doesn’t replace the other: paying a low price for a bad asset is a bad investment.

Utilising these criteria, the most loved destinations for investors with low risk appetites – cash and bonds – start to look risky. Negative interest rates are high risk. By contrast, precious metals – widely shunned for paying zero interest – might be a sensible bet. Consider that, at $1500/oz, the gold price has risen 26% over the past year, and silver almost 20%.

Emperor's clothes

In equities, new business models might also be wearing the emperor’s clothes. Uber came to market with the largest loss ever for an IPO. The share price is down 25% since listing, and there is a growing view that it may never produce a profit, potentially leaving the business worth substantially less than the $82bn price tag at IPO.

Indeed, with excessive valuation marked as a key risk, the most sought-after equity markets – which include the loved US, safe Switzerland and fast-growing India – might also prove dangerous. Using cashflow, revenue, earnings and balance sheet valuations, these three markets are trading at substantial premiums to the world average. By contrast, snubbed China, stalled South Africa and sleepy Japan are trading at discounts of between 20% and 30% to the global average.

This isn’t a case for throwing out US stocks in favour of Chinese stocks, or putting European bonds aside in favour of gold. But, with risk management as the foundation of investing, one of the primary risks that we can control is the price we pay for any asset. When the market is extremely optimistic, you need to be cautious; and when investors are pessimistic, that’s when to look hard: when buyers arrive, it’s too late to start looking, and when sellers arrive, it’s too late to start selling.

Sweeter ride?

Digging into the detail of these markets throws up potentially rich payload. Consider Apple and Xiaomi. Apple, the world’s second-largest company with a market value of $895bn and 12% of the smart phone market, is widely loved and admired. As a result, Apple trades at hefty multiples of 3.8 times sales, 18 times earnings and 10 times net asset value (NAV). By comparison, China’s Xiaomi, founded in 2010, holds 8% of the smart phone market, and is valued at 0.7 times sales, nine times earnings and three times NAV.

In the space of a few years, Xiaomi’s top-of-the range smartphones have caught up to Apple in performance yet retail at half the price. Indeed, the Chinese company is becoming increasingly known for its phenomenal value for money, pledging to earn no more than 5% profit on any of its hardware.

Perhaps in selling down Apple, investors would also be well-advised to sell loss-making Uber in exchange for South African-listed SuperGroup which is trading at seven times earnings, is below NAV (0.9 times), boasts a Level 1 BEE rating, has R3.5bn cash on its balance sheet against a market valuation of R10.2bn and earns half of its revenue outside of SA. Surely, this is a sweeter ride?

ABOUT THE AUTHOR

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