NEWSLETTER

February 2018

GATEWAY Financial

Introduction

Welcome to 2018! This is our first newsletter for the year and we take the opportunity to wish you all the very best for the coming 12 months. This newsletter includes a property and share market update, and we are releasing it at the same time as we are releasing our updated Guide to Negative Gearing, which you can access from our website.

Did You Know…The Dutch Tulip Bubble

If you have been hearing about Bitcoin and other crypto-currencies you will probably have heard people talking about investment bubbles. An investment 'bubble' is where the price of something rises in a way that cannot be explained by investment fundamentals. Crypto-currency has been nominated as a potential bubble because the prices rose very quickly (before falling even more quickly) even though it is not clear how anyone investing in them will make money - other than by finding somebody to buy them off them at an even higher price!

Historians see a link to 17th century Holland and what became known as 'Tulipmania.' Tulips arrived in Europe in the late 16th century. They were beautiful and radically different to flowers growing in Europe at the time and quickly became a luxury item. Tulips grow from bulbs, and as growers cultivated new forms of tulip, the bulbs became increasingly valuable. In an early precursor to our own GFC, markets developed in and around the trade in tulip bulbs. These markets were busy - individual bulbs were said to have been sold up to 10 times *a day*. Obviously, the people buying and then selling so quickly had no intention of planting the bulbs and making a profit from the flowers – they were banking on finding a 'bigger fool' to buy them later.

Prices skyrocketed – one person offered to swap 12 acres of land for a single bulb. Finally - and suddenly - people stopped buying. When buying slows, prices fall. When buying stops, no price exists at all. These tulips represented a kind of 'pass the parcel' game. People who bought and then sold while prices were rising did well. But the people left holding the parcel when demand stopped made a huge loss. At least they could plant some nice flowers.

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Property Market

The Christmas/New Year period is traditionally a quiet one for property markets. Unlike the sharemarket, where shares change hands on a daily basis, the relative infrequency of property sales makes for a much calmer and more planned market.

So in this property market review, we will look at some data from the last three months of 2017, rather than just the last month.

You may have heard the term 'auction clearance rates.' The term is self-explanatory: it is the percentage of properties taken to auction that subsequently sell at that auction. Many commentators use it to measure the 'heat' in the property market. Higher auction clearance rates indicate more buyers bidding at auction - and more buyers typically lead to rising property markets.

According to property data researcher CoreLogic, clearance rates across Australia fell in the last three months of 2017. This is despite the fact that the number of houses being taken to auction increased. This made for a twofold impact: more properties being auctioned, but fewer people wanting to buy them.

Prices are set by the interplay of demand and supply. Prices rise when demand exceeds supply, as potential purchasers (the 'demanders') compete against each other to purchase to limited supply. The opposite occurs when supply exceeds demand. Here, suppliers need to offer to sell at lower prices in order to attract the buyers.

For this reason, the falling auction clearance rates indicate a softening property market: the increase in the number of auctions shows an increase in supply and the fall in clearance rates shows a decrease in demand.

The largest fall in clearance rates occurred in the Sydney market, where just 57.7% of 11,250 properties sold at auction. This was a marked fall from the rate of 66.8% for the three months from July to September 2017. Melbourne might be regarded as the auction capital of Australia, with 15,768 properties being presented for auction during October, November and December. This is almost 50% of all auctions across the country. As it happens, clearance rates in Melbourne were also the highest in the nation, at 68.1%. This was still a fall from the previous quarter's rate of 72.6%.

Between them, Melbourne and Sydney accounted for 83% of all properties presented for auction during the period. This is why national statistics need to be read with caution: whenever a 'national' property market statistic is reported, this statistic is heavily influenced by these two major markets. To understand what's happening in more local markets, we need local data.

As reported by Corelogic, the auction clearance rates for each capital city (except in Tassie, where the researchers group results for the whole state - a wise move given there was only 95 auctions for the three-month period) were as follows.

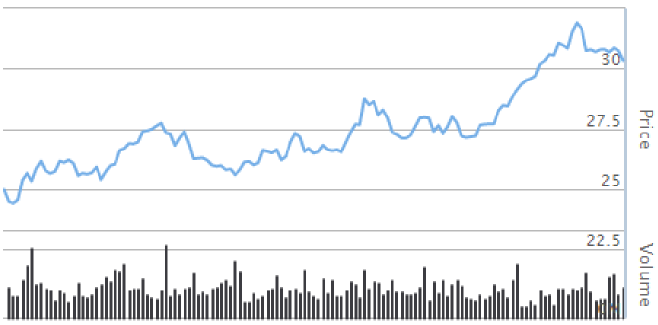
City	Clearance rate	Percentage of total properties brought to auction nationally
Melbourne	68.1%	48.6%
Canberra	66.3%	3.6%
Adelaide	63.3%	4.7%
Sydney	57.7%	34.7%
Tasmania	57.3%	0.3%
Brisbane	46.7%	6.2%
Perth	39.7%	1.7%

The Share Market

Unlike the property market, the sharemarket remains open on every day other than public holidays. However, similarly to the property market, volumes in the sharemarket tend to be lower during the month of January.

Volume is a critical factor when it comes to sharemarket investment. This is a key thing to remember when thinking about the value of shares that are traded on any sharemarket. In the sharemarket, the reported price will be the price at which the most recent transaction took place. For larger companies, transactions are almost constantly occurring. This means that the reported price will be very close to the price at which you will actually be able to buy or sell shares in that company. For smaller companies, this is not the case. For smaller companies, the reported price might have no real relationship at all to the price at which the next trade will take place.

To understand this, have a look at the following two charts, which we have sourced from the website of the Australian Stock Exchange. The first chart is for BHP. The blue line shows the price at which the last transaction for each day took place. The black bars at the bottom of the graph show the number of transactions that took place on each given day. As you can see, while there are definitely days of relatively high volume, a significant number of share transactions occur each day. This is consistent with BHP's position as one of Australia's largest companies. Shares in BHP are changing hands pretty much al the time the market is open.



Compare BHP's graph to the following graph for a company named Domacom. Once again, the blue line is the price at which the last trade on any given day took place. The black bars at the bottom represent the number of shares that changed hands on any particular day. (Note: the scale for the black bars is not the same as the scale on the BHP graph. The number of shares traded in BHP is vastly higher than those traded in Domacom. We show you just how much higher below).

As can be seen, there were many days on which virtually no shares in Domacom changed hands.

The term for all this is 'market depth.' The greater the volume of buyers and sellers looking to trade, the greater the depth. When you see a reported price, you need to also think about the market depth for shares in that company. Where market depth is substantial, then the reported price will basically be very close to (if not exactly the same) as the price at which you could buy or sell shares in that company. But where market depth is shallow, that is not the case.

We demonstrate this with the part of the Domacom graph that is coloured yellow. This period coincided with a spike in the volume of shares traded in this company. The date is Friday, September 22 2017 and 662,000 shares changed hands. This was also a period of substantial price reduction. On Thursday, September 21, 32,000 shares changed hands. The last sale occurred at 9.9 cents per share. On Tuesday, September 25, 65,000 shares changed hands. The last trade for the day was at 6.4 cents per share.

Think about that for a moment: at first glance it looks like a 35% fall in the value of shares in just three days. But the story is not that simple. What the spike really shows is that somebody really wanted to get rid of some Domacom shares. And because there was little market depth, they had to offer a substantial discount (up to 35%) to find someone to buy them.

Looking at the graph, you might think that whoever bought shares at 6.4 cents has done very well. The last reported transaction, on January 29 2018, occurred at $.12 per share. This would suggest almost a 100% return for whoever bought the shares at six cents. Not bad for three months.

But again, things are not that simple. On Monday January 29 2018, when the price was 12 cents, only 32,000 shares changed hands. Had someone wanted to sell the 662,000 shares they bought in September, they would need to offer a much lower price to attract a buyer. Only 32,000 shares changed hands at 12 cents. How much would the price need to drop if someone wanted to sell an extra 630,000?

This means that a large parcel of shares in a company with little market depth is not worth what the 'market price' might suggest. As a result, the quoted price for a company such as Domacom is not very informative. It tells you what has happened, but offers little guidance about what would happen if you tried to buy or sell.

This is not a problem for larger companies such as BHP. There is always many buyers and sellers for shares in companies like this. To illustrate, look at the spike in trade on BHP's graph above. This spike occurred on Thursday, September 7, 2017, when 17,323,000 shares changed hands. The price closed at $27.33. This suggests that shares to the value of at least $473 million changed hands on that day.

How easily a shareholder can find a buyer for their shares is sometimes referred to as 'liquidity.' If there are more buyers, the shares are more liquid. If there are few or no buyers, the shares are 'illiquid.' So, if you are looking to buy shares in individual companies, check out their liquidity. Illiquid shares are much higher risk. You need to factor that into your thinking. You don't want to get stuck holding a parcel of shares that no one wants to buy

The Legal Stuff

General Advice and Tax Warning

The above suggestions may not be suitable to you. They contain general advice which does not take into consideration any of your personal circumstances. All strategies and information provided on this website are general advice only.

Please arrange an appointment to seek personal financial and/or taxation advice prior to acting on anything you see on this website.

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