Bubbles, SDAs and ETFs

COLing the Shots is a monthly publication by COL which provides insights on investment opportunities based on global and local developments that could affect the market. COLing the Shots aims to provide timely and relevant information and analysis as well as a model portfolio for successful investing.

Key Highlights

- Last November, economic analyst Jesse Colombo contributed two articles in Forbes magazine that caused quite a stir among investors. After citing the increase in debt levels and property prices, Mr. Colombo concluded that low interest rates are causing an asset bubble in the Philippines. Nevertheless, we think that it is premature to conclude that there is an asset bubble just because asset prices and borrowings are up as it is only normal for these to happen during times of economic expansion. Note central banks commonly cut interest rates to encourage investments and consumption during economic downturns. Moreover, we do not think that asset prices will drop steeply similar to what happens when asset bubbles burst as investors are not heavily indebted given that only 51% of deposits and SDA placements have been lent out by banks. Finally, we do not agree that unsustainable foreign fund inflows are responsible for the massive liquidity in the system as implied by Mr. Colombo. Most of the country's dollars come from OFW remittances and BPO revenues which continue to increase today. In fact OF remittances and BPO revenues increased by 13.7% and 24.3% in 2008, during the height of the global financial crisis.

- One of the greatest dilemmas of investors today is what to do with cash now that SDAs are no longer accessible. Comparing the alternative investments available to those who are deciding where to invest their excess cash, stocks seem to be the best option for those who have a long term investment time horizon.

- While bank deposits and money market placements are highly liquid and have low volatility, yields are very low. As a result, investors are at risk of significantly losing their purchasing power. Although bonds, especially longer dated bonds, provide higher yields, the price of bonds is highly vulnerable to rising interest rates. This explains why a lot of bond funds booked significant declines in their NAV per share earlier this year when the 10-year T-bond soared to 4.35% from its average of 3.32% during the first four months of the year.

- Admittedly, stocks are not a good short term investments because of their highly volatile nature. However, studies have shown that stocks generate higher returns compared to other asset classes over the long term. Although stocks initially respond negatively to the prospect of higher interest rates, stocks can continue to go up over the longer term as corporate earnings are more important in determining share value. Rising interest rates during the early stage of an economic cycle also indicate improving economic conditions, enabling companies to generate higher profits. For more conservative investors who don't want to veer too far away from fixed income investments, there are stocks that currently give out cash dividends that are higher compared to bonds.

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- An ETF is a security that tracks the performance of a portfolio of securities (such as stocks, commodities, etc.) but trades like a stock on an exchange. Last December 2, the Philippines launched its first ETF –the First Metro Equity Exchange Traded Fund Inc. FMETF is supposed to track the performance of the PSEi.

- The major benefits of buying ETFs include diversification, affordability. It is also cheaper to buy ETFs instead of mutual funds and unit investment trust funds which charge high levels of management fees.

- As far as FMETF is concerned, an investor in the said security can enjoy both diversification and affordability. However, FMETF's cost advantage over mutual funds and UITFs is still not yet clear as the expense ratio could hit 2.0%, which is similar to those of other funds. Moreover, FMETF's track record in replicating the performance of the PSEi still cannot be measured while liquidity is limited. Despite the shortcomings, it is still too early to judge whether or not FMETF is a good security. Most of its weaknesses seem to be the result of birthing pains as ETFs are still new and not yet popular among local investors.

- Since the last time I issued my COLing the Shots report, the PSEi has fallen by another 3% to 5,760. I admit that we made a mistake when we said last October that the worst is over as we did not anticipate the occurrence of Typhoon Yolanda, the lackluster third quarter earnings season, and the gravity of foreign investor selling. Nevertheless, we remain firm in our view that the bull market is not yet over and that the weakness we are seeing is only a correction. Even with the negative short term developments mentioned above, there are no strong fundamental reasons to justify a continuous drop in the market. We will discuss the reason for our optimism in more detail during our 2014 market outlook briefing scheduled for next month. For now, we reiterate our recommended strategy – that investors use this period to slowly accumulate stocks to position for the market's next run up.

Why I'm not convinced there's an asset bubble in the Philippines

Last November 21, economic analyst Jesse Colombo contributed an article in Forbes magazine entitled "Here's why the Philippines' Economic Miracle is really a Bubble in Disguise."

On November 28, he came out with a second article to respond to denials that there is a bubble in the Philippines entitled "Here's What the Philippine Bubble Deniers Are Getting Wrong."

Both of Mr. Colombo's articles caused quite a stir among investors, with the November 21 article having more than 150,000 views in a span of less than two weeks and the second article having more than 18,000 views in four days.

A lot of well-respected people in the country have responded to this article to refute the claims of Mr. Colombo. Here are links to some of those articles:

- It's not a miracle, and it's not a bubble *(November 25, 2013, BusinessMirror)*
http://www.businessmirror.com.ph/index.php/en/news/opinion/23334-it-s-not-a-miracle-and-it-s-not-a-bubble

- Tetangco pops bubble talk *(November 26, 2013, BusinessWorld)*
http://www.bworldonline.com/content.php?section=Economy&title=Tetangco-pops-bubble-talk&id=79920

- 7 reasons why the Philippine economic growth is not a bubble in disguise *(November 26, 2013, RandellTiongson.com)*
http://www.randelltiongson.com/7-reasons-why-the-philippine-economic-growth-is-not-a-bubble-in-disguise/

A lot of friends and clients of COL who read the Forbes article also asked me for my view. I told them that I do not think there is an asset bubble in the Philippines.

I believe that the other writers have already done a good job on refuting the arguments of Mr. Colombo. So instead of refuting his arguments one by one, I'd like to approach the issue by analyzing the perspective of Mr. Colombo and why I don't agree with him.

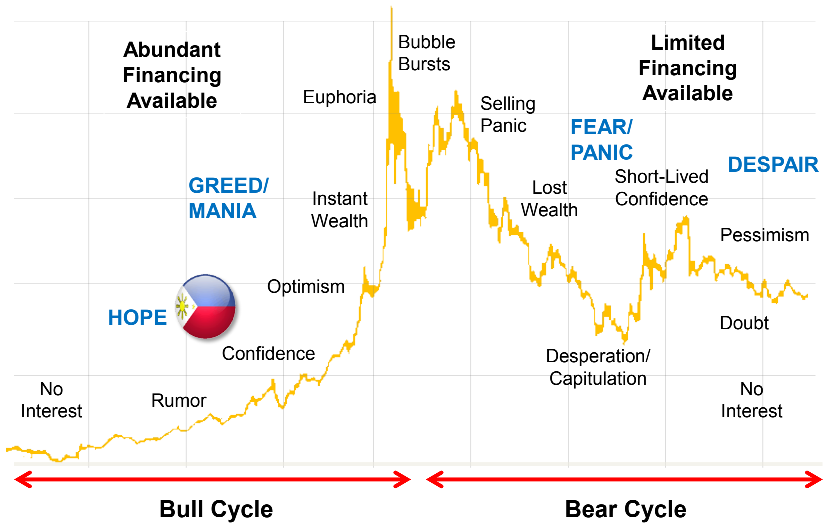
As mentioned by Mr. Colombo himself, the premise of his article is that the low interest rate environment in the Philippines is causing an asset bubble. There is nothing wrong with this view as it is widely accepted that low interest rates encourage the creation of asset bubbles.

I also agree that asset prices have gone up and so have borrowings.

However, I think that it is premature to conclude that there is a bubble just because asset prices and borrowings are up.

Let us look at one of our most favorite charts - the "bull-bear cycle." In the expansion stage or the "confidence and optimism" stage, it is normal for asset prices (both stocks and properties) and borrowings to go up. After all, one of the most common antidotes of the central banks in getting economies out of downturns is pumping liquidity into the system to encourage investments and consumption. I believe that the Philippines is at the expansion stage of the economic cycle or the "confidence and optimism" stage. Admittedly, we are closer to the peak than we are to the trough, especially with GDP growth hitting 6.6% last year and 7.4% during the first nine months of this year. Interest rates have also most likely bottomed with consensus expecting interest rates to increase starting next year. This I believe is the reason why Mr. Colombo is very uncomfortable.

Exhibit 1: Bull-Bear Cycle



However, while asset prices are currently elevated, I don't think they will drop steeply even with higher interest rates. This is what usually happens when asset bubbles burst.

When asset bubbles burst, bear markets take place, and during bear markets, asset prices fall to extremely cheap levels. For example, during the 2008 bear market, the PSEi traded at only 9.1X P/E, more than two standard deviation lower than its historical average P/E of 15.0X. URC, one of the current stock market favorites, was trading at only Php4.60/sh or 5.1X P/E.

The main reason why asset prices fall to extremely cheap levels during bear markets is because investors have too much debt and as such are forced to sell their assets at any price.

Going back to the article of Mr. Colombo, while he showed that debt levels in the Philippines are going up in absolute terms, he never showed the levels of debt relative to GDP. In my opinion, the current level of debt/GDP is still very comfortable such that investors will not be forced to liquidate assets at any price if and when interest rates go up. Moreover, although debts are increasing in absolute terms, the government's debt/GDP ratio is actually falling.

In fact, one of the main problems right now in the country is that there is just too much liquidity. Combining the amount of money in deposits and SDAs, only around 51% has been lent out. With this, I would hardly think that we are overleveraged and that asset buyers are "weak hands" that would sell at any price with the first sign of trouble.

Mr. Colombo also highlighted the fact that property prices have doubled from 2004 to 2013. However, since it took nine years for property prices to double, the implied annual increase is only 8%! Hardly bubble like in my opinion.

In his article, Mr. Colombo also implied that unsustainable foreign fund inflows are responsible for the massive liquidity in the system – which is why the popping of the bubble in China will cause the popping of the bubble in the Philippines. Mr. Colombo is concerned that foreign funds flowing out of the country will force interest rates to go up. The central bank will need to raise interest rates to prevent the peso from weakening significantly, similar to what is happening to India and Indonesia currently. Sources of unsustainable foreign fund flows include OFW remittances and BPO revenues in Mr. Colombo's opinion.

Despite concerns that OFW remittances and BPO revenues are unsustainable, they have been very resilient. In 2008, during the global financial crisis, OFW remittances still increased by 13.7% while BPO revenues jumped by 24.3%. Conditions today are much better than they were in 2008 so the likelihood of a steep drop in OFW remittances leading to a significant rise in interest rates and a sharp depreciation of the peso would be much less in my opinion.

While Mr. Colombo kept on saying that he is very concerned that 53% of OFW remittances come from the US, the truth is, they do not. The only reason why it appears to be so is because these remittances are coursed through American banks.

There is nothing wrong with being conservative and Mr. Colombo seems to be very conservative as he is warning about growing bubbles in numerous places and industries aside from the Philippines including Canada, Australia, Nordic countries, China, emerging markets, internet startups, and U.S. higher education. However, if we were to be as conservative as Mr. Colombo, we would miss a large part of bull markets. As discussed earlier, it is normal for central banks to cut interest rates to spur economic growth and for asset prices to go as a result of economic recoveries. It is for this reason that I think we should stay invested despite the risks highlighted by Mr. Colombo. I do not think that there is an asset bubble yet in the Philippines.

Before I end this discussion, I'd like to share this interesting blog by Oliver Segovia, founder and CEO of AVA Online Group. Oliver approached the bubble argument quite differently from academics as he shared his thoughts on the definition of a bubble and anecdotal evidences of a bubble based on his experiences in other countries where property prices and borrowings have gone up more substantially, and the incentive of Mr. Colombo in writing his bubble article.
http://oliversegovia.com/2013/12/03/i-can-buy-you-you-and-this-economic-bubble/

Life without SDAs

One of the greatest dilemmas of investors today is what to do with cash now that SDAs are no longer accessible.

Starting this month, the BSP will no longer allow "non-trust entities" such as retail investors to park their money in SDAs.

The BSP's SDA was previously one of the most popular short term investment vehicles for cash. At its peak earlier this year, there was around Php1.9 Tril in cash parked in the said facility. Of the said amount, non-trust entities accounted for an estimated Php1.4 Tril.

The popularity of SDAs is not surprising given falling yields on other popular short term instruments and Filipino's preference for fixed income investments. For example, the yields on all denominations of T-bills have dropped by more than 300 basis points from their 2010 levels to only 0.75%, 0.35% and 0.20% for the 364 day, 182 day and the 91 day denominations respectively. Yields on time

deposit have also dropped from around 3.1% in 2010 to only 1.04% currently!
Surprisingly, despite the steep drop in interest rates and the stellar performance of the stock market, the number of retail investors in the Philippines has only increased from 499,000 in 2010 to 525,000 as of end 2012 according to the data from the PSE.

Filipinos' preference for fixed income instruments and aversion to the stock market are not surprising given sky high interest rates in the past. After all, if you could earn a guaranteed return north of 10% without any volatility, why should you bother with investing in stocks?

However, while the current level of interest rates might be too low and unsustainable, neither are rates expected to go back to where they were 10 years ago.

A lot has changed during the past few years. For one, the government's finances have improved significantly with the deficit to GDP ratio falling to 2.3% and the debt to GDP ratio dropping to 51.4% as of end 2012. Given the strength of its finances, the government doesn't need to borrow as much and pay as much in terms of borrowing cost.

The Philippines' external account position has also improved tremendously, thanks to the strength and resilience of our OFW remittances and the BPO sector. OFW remittances have increased by a CAGR of 8.2% during the past five years to US$21.4 Bil as of end 2012 while revenues from the BPO sector have increased by a CAGR of 21.4% during the same period to US$13 Bil as of end 2012. In fact, while the current account position of most of our ASEAN neighbors has deteriorated recently, ours continues to improve. Consequently, there is no need to keep interest rates high to defend the peso. In fact, the BSP is more concerned with the strengthening of the peso as it is hurting our OFWs by reducing the peso value of their remittance. The strong peso is also hurting the exporters as it makes our exports less competitive in the global market.

These favorable changes in the Philippines have been recognized by the three major global ratings agencies - Fitch, S&P and Moody's. Consequently, all three ratings agencies upgraded the country's credit rating this year to "investment grade," also leading to lower interest rates over the longer term.

Finally, there is still a lot of excess liquidity in the system. Of the total funds deposited in commercial banks, only 67% has been lent out. Adding the amount of funds held in SDAs by non-trust entities, the ratio drops even further to 51%.

In short, while current level of interest rates might not be sustainable, a significant increase in the near term is not expected.

Comparing alternatives. . .

At this point, I'd like to compare the alternative investments that are available to those who are deciding where to invest the cash that will be released from their SDA placements.

Bank Deposits: The major advantage of keeping cash as savings or time deposit in the bank is that it is very liquid. However, since banks are currently awashed with cash as discussed earlier, they only give a very low yield on deposits. The yield on savings deposit is now around 0.25% to 1.00% while yield on time deposit is only around 1.00% to 1.50%. Moreover, the said rates are significantly lower than our inflation rate of 2.8%. As a result, investors that keep all their funds in cash are putting themselves at risk of losing a significant part of their purchasing power.

Money Market Fund: A money market fund is a pooled investment that places the funds of its investors in highly liquid short term instruments. Yields of money market funds are higher compared to savings and time deposits because money market funds have access to higher yielding short term instruments that are not accessible to retail investors for reason of size. They are also allowed to invest in SDAs. Unlike other types of funds such as equity funds, bond funds or balanced funds, money market fund are less volatile given the nature of its investments.

Unfortunately, interest income that money market funds receive from their investments are not paid out to investors. For example, assuming that a money market fund trading at an NAV of Php100/sh receives an interest income from its SDA placement of Php2.00/sh, the fund cannot pay this out to investors. Instead, the interest income is reflected as an increase in the fund's NAV per share from Php100/sh to Php102/sh. In this respect, some investors might not view the money market fund as a suitable replacement for fixed income investment.

Moreover, while yields are higher compared to bank deposits, they are still lower than inflation.

Bonds: Bonds provide higher yields, especially for those who are willing to hold longer dated papers. The longer the date to maturity, the higher the yield. For example, the yield of the 10-year T-bond is currently 3.4%, while that of the 25-year T-bond is 4.9%.

However, the price of bonds is highly vulnerable to rising interest rates. This is because the principal value as reflected by the price drops as interest rates go up. After all, as interest rates go up, newer issued paper of similar maturities have to pay out higher coupon rates. Consequently, the price of an existing bond has to adjust to reflect this reality. Moreover, the longer the term of the paper, the greater is the volatility of its price. I know that this can be confusing, but I'd like to illustrate what happens through an example below so you can visualize how prices of bonds with different maturities respond to adjustments in interest rates.

Exhibit 2: Illustration of Changes in Bond Prices due to Rising Interest Rates

	Bond Prices		
	Current Rate*	**+100 bps**	**% change**
5-year	100	95	-5.00%
10-year	100	92	-8.00%
25-year	100	88	-12.00%

*Current 5-yr, 10-yr and 25-yr bond rates at 2.95%, 3.4% and 4.9% respectively, assume that coupon rate is at par with current bond rate

Bonds' vulnerability to rising interest rates explains why a lot of bond funds booked significant declines in their NAV per share earlier this year when the 10-year T-bond soared to 4.35% from its average of 3.32% during the first four months of the year. While bonds make great investments during periods of falling interest rates, they make poor investments during periods of rising interest rates.

Stocks: Admittedly, stocks are not a good short term investments because of their highly volatile nature. In that respect, investors with a short term investment time horizon should not invest in stocks. However, for those that have excess cash, investing in stocks is one of the best alternatives available today. Studies have shown that stocks generate higher returns compared to other asset classes over the long term. Although stocks initially respond negatively to the prospect of higher interest rates, stocks can continue to go up over the longer term even with rising interest rates. This is because corporate earnings are more important in determining share value, and rising interest rates during the early stage of an economic cycle indicate improving economic conditions, enabling companies to generate higher profits. Last October, I already showed that stocks can continue to go up even with rising interest rates.

Exhibit 3: S&P 500 from 1993 to 1995

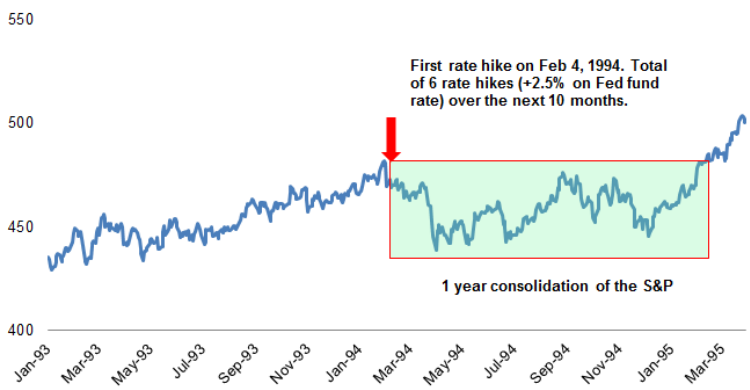


Exhibit 4: S&P 500 from 1993 to 2001

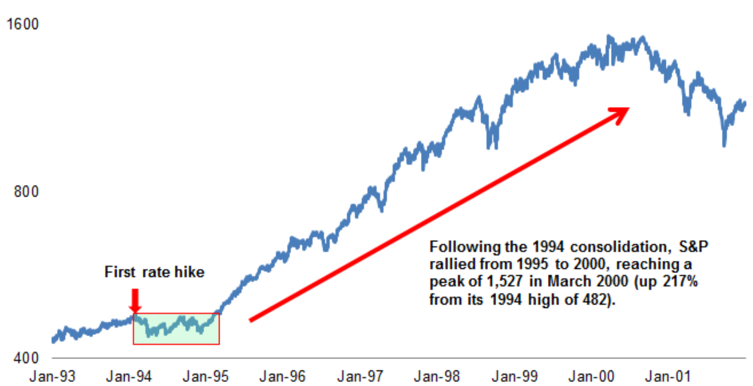


Exhibit 5: S&P 500 from 2003 to 2005

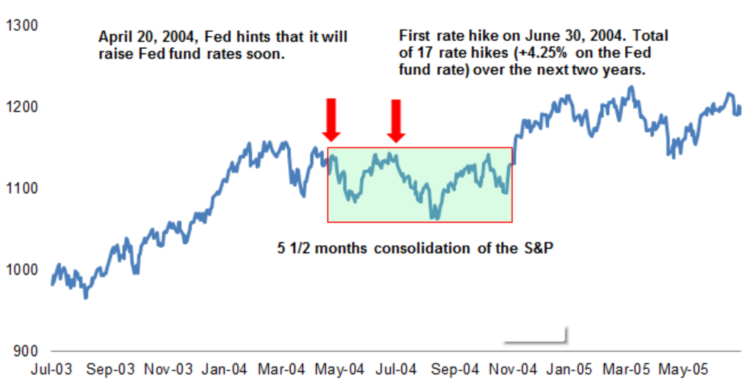
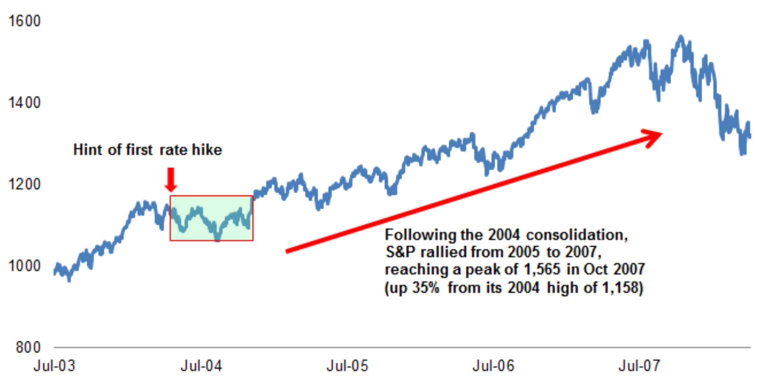


Exhibit 6: S&P 500 from 2003 to 2008



For more conservative investors who don't want to veer too far away from fixed income investments, there are stocks that currently give out cash dividends that are higher compared to bonds and these dividends are paid out to investors on a regular basis, acting as a proxy to "fixed income." Investors also stand to benefit from capital appreciation provided that they have a long term investment time horizon.

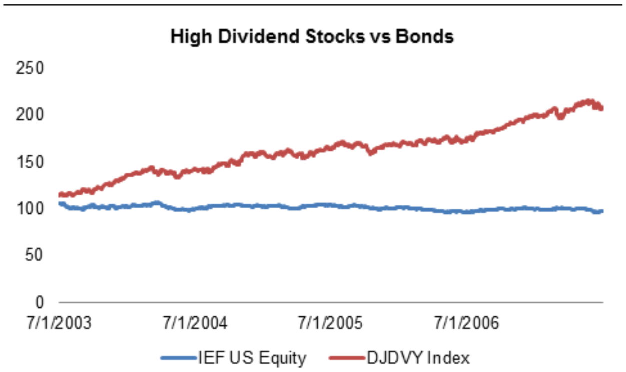
Exhibit 7: Selected Stocks with High Dividend Yields

Stock	13E Div Yield*
BDO	3.00%
SCC	3.40%
PIP	3.20%
GLO	4.90%
TEL	6.80%

*As of December 10, 2013

More importantly, comparing the total return of bonds and high dividend yielding stocks during periods of rising interest rates, high dividend yielding stocks still outperform bonds.

Exhibit 8: Comparative Return of High Dividend Stocks and Bonds



I admit that bonds have certain characteristics such as certainty of cash flows that make them attractive to investors, especially for those that need "guaranteed income." However, given the significant outperformance of stocks compared to bonds, I believe that stocks deserve to be part of every investor's investment portfolio. In fact, now would be a good time to start investing given that market is undergoing a correction.

Exhibit 9: Comparison of Different Investment Instruments

Investment Instrument	Positives	Negatives
Bank Deposits	Very liquid	Low yield; High risk of losing purchasing power
Money Market Fund	Liquid Yield higher than bank deposits	Interest income is not paid out to investors Yields still below inflation; High risk of losing purchasing power
Bonds	Higher yields, especially for longer dated bonds	Bond prices drop in response to higher interest rates Prices of longer dated bonds are more sensitive to interest rate movements
Stocks	Returns are higher compared to other asset classes over the LT Less sensitive to rising rates over the LT Dividend yield of some stocks are higher than bond rates	Highly volatile, especially in the ST

The Philippines' first ETF- Pros and Cons

An ETF is a security that tracks the performance of a portfolio of securities (such as stocks, commodities, etc.) but trades like a stock on an exchange. Last December 2, the Philippines launched its first exchange traded fund or ETF –the First Metro Equity Exchange Traded Fund Inc. (FMETF). FMETF is an ETF that is supposed to track the performance of the PSEi or the Philippines' benchmark equity index.

ETFs provide numerous benefits for retail investors, explaining the significant increase in the size of their assets globally. Note that total assets of ETFs have increased by a CAGR of 28% during the past nine years to US$1.9 Tril as of end 2012. The major benefits of buying ETFs include diversification, affordability. It is also cheaper to buy ETFs instead of mutual funds and unit investment trust funds which charge high levels of management fees.

As far as FMETF is concerned, an investor in the said security can enjoy both diversification and affordability. Investors of FMETF can enjoy the diversification provided by the PSEi without having to buy all 30 stocks comprising the index as the fund itself is invested in the said stocks. Moreover, an investor only needs a minimum of Php1,000 to invest in FMETF, much less than what he would need to replicate the composition of the index.

Unlike ETFs in more developed countries, there is a risk that FMETF may not provide much cost advantage compared to most mutual funds and unit investment trust funds (UITF). According FMETF's management fee is only 0.5% per annum. However, as far as the expense ratio is concerned, the fund management company only states that it should be not more than 2.0%. At this point, we don't know if the cap will be hit, although FMETF could initially suffer from high costs given the absence of scale brought about by its small asset size of less than Php1.0 Bil. However, if the expense ratio does reach 2.0%, FMETF would no longer have a cost advantage over mutual funds and UITFs. Nevertheless, the expense ratio may go down once FMETF becomes more popular and grows in size.

Moreover, since FMETF just listed recently, its track record in replicating the performance of the PSEi still cannot be measured (Is buying FMETF a good proxy to the PSEi?). Since December 2, the PSEi has lost 5.2%. In contrast, FMETF only fell by 1.9%. While this may seem good, FMETF's outperformance makes it unattractive to investors who are looking to buy the security as a proxy for the index.

Liquidity is also limited, and this may be the reason why there is a sizable disparity between the performance of FMETF and the PSEi. Since its listing, FMETF's average daily value turnover is only Php13.6 Mil. There have also been days when value turnover was much less.
Despite the shortcomings, it is still too early to judge whether or not FMETF is a good security. Most of its weaknesses seem to be the result of birthing pains as ETFs are still new and not yet popular among local investors. It should be interesting to see how the ETF industry develops in the country going forward.

No fundamental change justifying the market's ongoing weakness

Since the last time I issued my COLing the Shots report, nothing has changed as far as the country's fundamentals are concerned. However, the market continued to weaken, with the PSEi down by another 3.0% to 5,760.

I admit that we made a mistake when we said last October that the worst is over as we did not anticipate the occurrence of Typhoon Yolanda, the lackluster third quarter earnings season, and the gravity of foreign investor selling. Nevertheless, we remain firm in our view that the bull market is not yet over and that the weakness we are seeing is only a correction. Even with the negative short term developments mentioned above, there are no strong fundamental reasons to justify a continuous drop in the market. We will discuss the reason for our optimism in more detail during our 2014 market outlook briefing scheduled for next month. For now, we reiterate our recommended strategy – that investors use this period to slowly accumulate stocks to position for the market's next run up. At the PSEi's current level, valuations are starting to look attractive, with the PSEi trading at only 15.6X 14E P/E, only slightly above its 10 year historical average P/E multiple of 15.0X.

Exhibit 10: COLing the Shots Model Portfolio

	Current Price	FV	Buy Date	Buy Price	Current Return	Buy Below Price
EEI	9.89	13.00	30-Mar-12	6.07	62.9%	10.40
PGOLD	39.00	51.00	11-Jun-12	24.60	58.5%	40.80
MEG	3.20	4.78	11-Jan-13	3.11	2.9%	3.82
TEL	2,644.00	3,560.00	11-Jan-13	2,636.00	0.3%	2,848.00
DNL	6.03	10.50	14-Feb-13	6.00	0.5%	8.40
RLC	19.96	30.00	5-Aug-13	22.70	-12.1%	24.00
AC	558.00	753.00	5-Aug-13	600.00	-7.0%	602.40

Investment Rating Definitions

BUY	HOLD	SELL
Stocks that have a **BUY** rating have attractive fundamentals and valuations, based on our analysis. We expect the share price to outperform the market in the next six to twelve months.	Stocks that have a **HOLD** rating have either 1.) attractive fundamentals but expensive valuations; 2.) attractive valuations but near term earnings outlook might be poor or vulnerable to numerous risks. Given the said factors, the share price of the stock may perform merely inline or underperform the market in the next six to twelve months.	We dislike both the valuations and fundamentals of stocks with a **SELL** rating. We expect the share price to underperform in the next six to twelve months.

Important Disclaimers

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