Unappetising view of Irish equities

The disposition of the major market participants presents a difficult backdrop for the near term, writes Paul McCarville

Imagine you are hosting a dinner and have invited three people. Guest A was not very well after their last meal with you, Guest B has had a big lunch earlier and Guest C relishes your cooking, but has had a gastric by-pass.

If this was not bad enough, the dish for which you are reknowned is the subject of a health scare.

Unfortunately, this scenario may resemble the Irish equity market, whose main participants are like the guests above. Guest A is the overseas investor, Guest B is the domestic institution and Guest C is the private investor. The dish is Bank Bourguignon, that staple dish of the ISEQ.

If this scenario is unappetising, I present it to challenge the increasingly accepted view that cheap Irish equities are becoming a one-way bet. My analysis centres on the disposition of the major market participants.

Growth in turnover in Irish stocks has been dramatic, particularly over the last two years. Clearly something pretty extraordinary was going on – and it was not just the Celtic Tiger in full flight.

As well as significant buying by overseas investors, the growth was fuelled by an explosion of interest in contracts for difference (CFD). Turnover related to CFDs is estimated to have hit 40-50 per cent of the total in the last year or so.

We now have a situation in which at least four of the five largest investors at each of our six biggest plcs are non-Irish. It is estimated that 60 per cent of the market is owned by non-Irish investors. From being significant net buyers, the overseas investors have recently become significant net sellers, increasingly believing that the Celtic Tiger is running out of puff and fearful of the property market.

The Irish fund managers have been massively overweight in Ireland for many years – and continue to be. On September 30, the average managed fund had 16 per cent in Irish equities, which, even allowing for a significant level of home-country bias, is enormous, given that the market is about one third of 1 per cent of the world.

The extraordinary level of stock-specific risk and extreme sectoral skew militate against large positions, even for domestic investors.

These institutions had steady money flows to invest in recent years, until the second quarter when maturing SSIAs would have caused some selling.

Largely using the substantial gearing afforded by CFDs, the private investor has been a major player. Putting up €100,000 enabled an investor to trade more than €1 million of stock and, in a rising market, this must have seemed even better than investing in property.

Recent falls, margin calls and the effects of leverage have been very, very painful, with many CFD investors having to realise huge losses, liquidate holdings under pressure or put up other collateral. A significant reduction in CFD activity was bound to have serious implications for the market, given the scale it had reached, and it must be highly unlikely that this level will ever be reached again.

So overseas investors are fairly well chastened, given the scale of recent losses, and new ones will not be easy to find. Domestic institutions are strategically inclined to sell. The private investor's ammunition – and appetite – have reduced, and they may be starting to learn the value of diversification.

So, could the market continue to suffer from a lack of buyers for some time, with better and better value emerging? In short, yes – though if the market continued to fall, new buyers would emerge.

The problem with takeovers is that so much of our market is banks, the potential acquirers of which are also banks. Many of these have just seen their own shares pummelled and are now guarding their capital.

A key ingredient of buyouts is leverage, which may be a great deal less plentiful (and more expensive).

Value/income funds or managers will undoubtedly be attracted, but whether this would be big enough to make a real difference in the near term is hard to tell. It will take time to convince people who were used to hearing the Irish growth story about the Irish value story.

To conclude (and without offering a view on whether Irish stocks are intrinsically cheap – or any view on the international markets), it seems that the disposition of the major market participants presents quite a difficult backdrop for the near term.

Investors buying now, on the basis of an imminent turning point, could be severely wrong-footed by the weight of those whose preference is to sell rather than buy.

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Irish fund managers have been overweight for many years MAURA HICKEY