

Bulbs, bitcoins and bubbles

By Graham Middleton, BA, MBA



"Bubbles aren't new, they take different forms but in each, gullible investors seeking unusual returns are exploited..."

There's a long list of historic bubbles, all of them exploited by those smart enough to rip into the wealth of those too innocent to understand how they were being conned. Some of the well-known historic ones have been:

- The Dutch Tulip mania of 1635;
- The Mississippi Company in Paris of 1720;
- The South Sea bubble of London of 1729;
- The Wall Street crash of 1929;
- The Poseidon mining boom in Australia in 1968;
- The crash of global stock markets in October 1987 which exposed Australian entrepreneurs;
- The Japanese stock market crash of 1989;
- The Melbourne commercial property collapse of 1991;
- The pine tree and later eucalypt plantation scams in Australia; and
- The collateralised debt obligation securities scam which led to the Global Financial Crisis of 2008/9.

The robber barons

There will be lots of others in various corners of the world including some big ones master-minded by the American "robber barons" of the late 19th century who shamelessly exploited their power over practically everybody else. Vanderbilt, the railroad king, closed the railway bridge to a rival company so its passenger trains could not enter New York. John D Rockefeller bought out oil refineries and deliberately closed some down to make his products scarcer and more expensive. He also ruined a major railroad when they didn't lower their price to carry his product by constructing an oil pipeline and driving it out of business. Carnegie and Frick had Pinkerton's security men fire on a crowd of striking steel workers. Eventually, the assassination of newly re-elected President McKinley unexpectedly brought Theodore "Teddy" Roosevelt to office and he legislated to break up the corporate empires of America's "robber barons".

Is Bitcoin another bubble?

There are those preaching that the block-chain technology is wonderful and that Bitcoin is different to fiat money issued by central banks without having appropriate security backing since countries went off the gold standard.

Already Bitcoin is producing imitators so inevitably, there will be a number of block-chain currencies.

Authorities are already starting to take notice and some prominent people have pointed out that Bitcoin provides an ideal platform for money laundering. The Chinese Government is shutting it down. Politicians hate anything that cannot be regulated in some way or taxed in some way and central bankers are bound to be concerned about it. We can be certain that right now, central bankers around the world are discussing with each other possible actions and that governments around the world are asking their central bankers what action should be taken. Initially, it seems bizarre because dealing with Bitcoin has similarities with trying to nail jelly to the wall. However, sooner or later, actions will be taken against block-chain currencies and at some point, whoever the mysterious people are who are holding significant Bitcoin accounts will, or at least some of them will, bolt to an exit by converting their Bitcoin into normal currency out of fear that others will beat them to the door. Once that happens, we can expect a major correction.

What are Bitcoin weaknesses?

It's a bit early to tell comprehensively but:

- The fact that they have already been labelled as being an unregulated means of laundering money will inevitably focus the attention of regulators and lawmakers on them around the world. Regulators will attempt to control the interface between the crypto currencies and the normal currencies of the world. It is likely that the major reserve bankers of the world will unite to find a means of controlling crypto currencies. Those who claim it cannot be done will prove to be naïve;

- The old saying is that if something looks too good to be true then it is. In this case, Bitcoin, which has appreciated to astronomical levels without a visible and rational economic base, can likewise just as easily collapse;

In the short term, the real threat to Bitcoin may come from lookalike block-chain currencies proliferating, which is already occurring; and

Crypto currencies will also promote a reaction from traditional financial service providers who, faced with competition, will be forced to slash fees on money transfers, which is good for most of us, but will eat away at the perceived advantage of the block-chain currencies.

If, in a year's time, there are many separate block-chain currencies, will Bitcoin still be multiplying its value?

A sucker born every minute

Circus promoter Phineas T Barnum observed that "there is a sucker born every minute". Phineas was referring to people paying to go into sideshows to see women with two heads, or variations on the Indian rope trick, or snake charmers. The fact that much of what they saw were illusions would have been in the back of people's minds but they paid willingly enough anyway.

The Dutch business class foolishly invested most of their assets in rare tulip bulbs in 1635 only to see the market collapse. The English gentry mortgaged their estates to invest in shares in worthless companies promoted in London coffee houses which doubled as the Stock Exchanges of the day, during what was dubbed the "South Sea Bubble". For a time, both the tulip bulbs and the share scrip in new companies increased rapidly in value but their subsequent collapses were swift and devastating.

Poseidon

In 1968, a small mining company, Poseidon, announced a nickel find at Windarra in Western Australia. There was a worldwide shortage of nickel at the time and the share price rocketed from 60 cents to 280 dollars. Unfortunately, more

thorough geological sampling revealed that the deposit was nowhere near as rich as previously thought and would be of marginal profitability to mine. The price collapsed. However, the event had spurred a great deal of interest in the Australian sharemarket and a number of speculative mining stocks rocketed upwards and inevitably collapsed. A Senate Inquiry revealed that a great deal of misleading information had been fed into the sharemarket and this in turn led to much more regulation.

Eucalypt tree scams

Some years back, an assortment of characters knocked on Synstrat's door trying to get us to sell Eucalypt schemes to clients. The pine tree plantations had already been revealed to be worth too little in value. Fortunately we had learned the lessons as to what was wrong with these schemes and from the day of its founding, Synstrat has never sold a timber lot. Commissions of 9% (possibly 10%) were readily available to sell them but they had fatal and obvious flaws:

- For a start, any investment which has to pay so much in commission to sell it has fundamental weaknesses;
- People didn't seek to buy timber lots, rather they were forcibly sold by unscrupulous accountants and advisers with some very questionable tax advice;
- There was no secondary market where a timber lot investment could be bought and sold. For example, in respect of Government corporate bonds, there is an active market and bonds of a variety of maturity dates are bought and sold on it daily. If the timber lots had been a strong investment, such a market for different years of plantings would have emerged. The fact that it didn't indicated that they were dud investments; and
- The tax benefits were exaggerated and the debt agreements that purchasers signed were glossed over, but emerged to bite them hard many years later. In reality, these schemes weren't tax deductions but rather tax deferrals and as events later revealed, many of the timber lots fell well-short of the values which had been projected in sales pitches early in the life of these schemes.

Today's equivalent to eucalypt plantations

High rise apartments sold off the plan by property spruikers are now causing misery as the resale process in the secondary market reveals that in many cases buyers paid way above value. Many of these high rise apartment blocks will turn into future vertical slums and will present peculiar problems as they age because the body corporate which needs to update features of the building into the far future will find that many of the owners' apartments are not prepared to contribute to necessary capital expenditure.

The ethical geologist

Many years ago, I was a dad helping out at a school camp. Another dad was a geologist on holidays from work in Ghana. At the time, there wasn't a lot of work for geologists in Australia. He indicated that he had been offered work, but had declined on ethical grounds. An arm of the Bond Corporation had wanted him to sit in an office tower in Perth and write "promising reports" about mining explorers that the corporation had an interest in, implying that they had made profitable discoveries. They did not want him to spend time actually supervising the drilling of exploratory holes. What they were really asking him to do was participate in a fraud. He had turned down the offer even though it had meant working in Africa, far from home. The Bond Corporation was later bankrupted and Alan Bond spent time in jail! The story illustrates how markets can be misled by unscrupulous people.

Rights issues made to its long-serving but gullible shareholders

Trevor Sykes, a one-time broker, was probably the best financial journalist Australia has produced and an absolute encyclopedia of information on the mining industry. He wrote a book about a mythical company, Blue Sky Mines, whose real purpose was to mine the sharemarket by feeding it plausible but fake geology reports then conducting capital raisings via the medium of rights issues to its long serving but gullible shareholders. The

board of Blue Sky Mines then splashed the money on benefits to its directors and executives. Trevor Sykes' book was a light hearted spoof on what had occurred during the mining boom when investors' greed and gullibility overtook caution and they were taken advantage of by unscrupulous promoters.

Football teams and failed entrepreneurs

Alan Bond, John Elliott and Geoffrey Edelsten were all one-time chairmen of AFL clubs, North Melbourne, Carlton and the Sydney Swans and all became failed entrepreneurs. Another entrepreneur was Joseph Gutnick, known to the stockmarket as "Diamond Joe" because he promoted a company which predicted diamond discoveries based upon the predictions of an aging Jewish prophet in New York! Joseph Gutnick was also briefly the chairman of the Melbourne Football Club. More recently, colourful mining identity turned politician Clive Palmer owned a soccer team, while the Newcastle Knights and the Gold Coast Titans were briefly under the control of entrepreneurs Nathan Tinkler and Michael Searle. Both clubs' ownership collapsed and they had to be reconstructed with stronger backers. When prominent business figures enter stage right, the lesser supporters shut their wallets and exit stage left. The long term supporters of football clubs reason that if their club is being used by an entrepreneur to promote his own image, they will reduce their support on the basis that if Bond, Elliot, Edelsten, Gutnick, Palmer, Tinkler, Searle, et alia want the glory, they can pay to keep the football club afloat. It's noticeable that when entrepreneurs become club chairmen, the fortunes of the football clubs concerned have tended to decline.

The global financial crisis

There were many causes but the main one was cavalier lending by banks without proper due diligence. This occurred in mainland Europe including Greece, the UK and most notably in the USA. The US banks made so called "NINJA" loans, meaning that they lent money to people with no income, no job

and no assets or others not quite so bad but with little chance of meeting their repayment obligations. The loans enabled the borrowers to buy rental properties in new developments creating a property building boom but without normal buyers or sufficient tenants. The bank loans were then packaged up with some better loans and the packages were known as collateralised debt obligations (CDO's). The CDO's were submitted to a ratings agency for a rating stamp and based on the rating assigned by the ratings agency, they were then on sold to investors as gilt edged securities. Obviously, some ratings agencies were prepared to rubber stamp CDO's for their big Wall Street clients who they feared would not give them more work if they conducted their ratings task diligently. A number of Australian municipalities and charities invested in CDO's. Unsurprisingly there was widespread failure and various legal actions for recovery. Central bankers limited the scope of the financial crisis by buying up lots of poor performing securities from American banks after the failure of one big Wall Street bank - Bear Stearns. There were significant bank failures elsewhere and significant rescue of banks by the US Federal Reserve, European Central Banks and the Bank of England.

The US housing market suffered a huge fall but now nine years later has made a significant recovery. In Australia, the worst aspect of the GFC was avoided because the vast amounts of cash in our superannuation system enabled superannuation funds, particularly self-managed superannuation funds to purchase rights issues in large Australian companies including Rio Tinto, Wesfarmers, Macquarie Group and the four major banks, thereby enabling those organisations to continue their previous rate of company operations, employment and lending. The huge impact of superannuation money flowing onto the balance sheets of those companies was never acknowledged by politicians who wanted to take credit for their own actions but as a proportion of total market capitalisation, the amount of new money raised by companies in Australia during the GFC was the greatest of any country in the world. A key lesson is that maintaining a strong retirement savings system is a critical factor in keeping

Australia financially stable. Indeed, the absence of a sufficiently high national propensity to save was the reason behind the scenes that our national superannuation system was established under the Hawke/Keating government. However, to make it saleable to the populous, it took the form of a superannuation system for our retirement. Its real underlying purpose was to balance the amount of foreign debt Australia had and indeed to reduce the rate at which foreign debt was being created by diverting some spending into savings. In turn, this is the reason why there are taxation savings incentives associated with superannuation.

The overall lessons

- Bubbles aren't new, they take different forms but in each, gullible investors seeking unusual returns are exploited;
- If it sounds too good to be true, it almost certainly is; and
- Wealth is created by hard work, sensible decision making and saving.

About the author

Graham Middleton personally has been advising dentists on strategic, practice management, valuation and conflict resolution processes for 31 years, the last 24 as a founding partner and director of Synstrat Management Pty Ltd and Synstrat Accounting Pty Ltd. He was once a regular army officer, and later Director Human Resources Management, of the Attorney General's Department of Victoria. He is considered an expert on dental practice valuation and practice performance benchmarking. He has spent many years advising dentists in respect of their business and financial strategy and measuring their practice and financial performance. He is the author of Synstrat Dental Stories, the Synstrat Guide to Practice Management, 50 Rules for Success as a Dentist and Buying & Selling General & Specialist Dental Practices. He is a long-term contributor to the Australasian Dental Practice magazine. The Synstrat Group is an independent data-based organisation providing management, benchmarking, valuation, financial and accounting services to the dental profession. Synstrat Management Pty Ltd is a Licensed financial services company. Both Synstrat companies are owned by the same directors who work within the Synstrat Group. For more information, call (03) 9843-7777 Fax: (03) 9843-7799 Email: dental@synstrat.com.au or visit www.synstrat.com.au.

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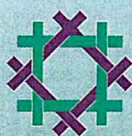
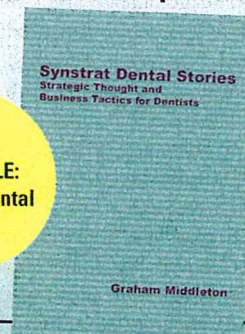
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