

Contrarian Investing: The Long and Short of Japan

In our last newsletter, we told you why you shouldn't worry about whatever the media happens to be focusing on at the moment, be it Enron, anthrax, or the latest computer virus scare – the time and energy that the media devotes to any one news story is inversely related to the likelihood of that story having a meaningful long-term effect on your investments.

Remember: the media is usually the last to catch on to the important problems, and by the time they are telling you how scared you should be, the danger is likely past.

In this month's letter, we are going to take this concept one step further by showing you how we take the conventional wisdom of experts (which is, after all, where the media gets its material) and use it to form our investment outlook and strategies. This month our focus is Japan, but before we discuss our outlook for this beleaguered market, we want to give you an overview of how we make the jump from consensus opinion to investment strategy – and what can go wrong along the way.

Fade the Evening News

Contrarian investing is a well-known concept, but the term is often misused and misunderstood. Contrarian investing is not about doing the opposite of what other investors do. Instead, it is identifying what everyone is excited or worried about (and the media is an excellent proxy for this), knowing that these sentiments have already been priced into the market, and then developing investment strategies that either “fade” the conventional wisdom (i.e. – bet the other way) or finding important, but overlooked, trends that are likely to move the market before the press catches on.

In the case of Y2K (see: fcNOTES, January 31, 2002), the consensus was that problems would occur and that there would be at least some disruption in financial markets and economies across the globe. *Overlooked* was the fact that Alan Greenspan and his cohorts at the Fed had bought into this theory and were increasing money supply dramatically in the event that there was a run on ATM machines in the waning hours of New Year's Eve.

The Fed was so concerned about what *could* happen to the banking system that it injected a massive amount of liquidity into the economy. While this decision cannot be blamed for creating the stock market bubble, there is little doubt in our minds that it caused that bubble to balloon in size and quickly reach critical mass. The short-term result was the opposite of what the experts expected: the equity markets rallied to new highs in the first three months of 2000. But the longer-term impact of the Fed's aggressive move to get in front of a possible crisis by increasing money supply was unexpected; realizing its error when no crisis materialized, the Fed tighten monetary policy and withdrew the excess reserves in a very short period of time, slamming the brakes once and for all on the extraordinary bull market of the 1990s.

Is Wrong the Opposite of Right?

The fact that the experts are never right as a group doesn't necessarily mean that the opposite of what they expect is what is most likely to happen. First, there is no such thing as “opposite” in markets, because markets are a continuum. If the experts think that the stock market will be up 5% in the next 12 months, does that mean that the market will be down 5%? Or will it be up 25%? The former seems like the “opposite” (down versus up), but the latter represents an error of greater magnitude (20 percentage points versus 10). This is what makes contrarian investing so challenging: it may be relatively easy to identify the consensus (just turn on the TV), but selecting from the range of alternative scenarios is usually quite difficult.

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Before we turn to Japan, allow us to illustrate this point by looking at a recent example of where we got it wrong in spite of going against the experts: last year's fourth quarter GDP number.

Everyone expected a fourth quarter GDP contraction in the United States after September 11. On September 26, just over a week after the markets reopened following the terrorist attacks on the World Trade Center and the Pentagon, the Wall Street Journal conducted a survey of 26 economists. The consensus estimate was that the economy would contract 0.6% in the fourth quarter. But they also believed that by the beginning of 2002, the economy would be coming out of recession, returning to growth by the spring.

What caught our eye was that even the five most pessimistic economists in this survey predicted that the U.S. economy would grow 1.4% and 2.6%, respectively, in the first and second quarters of 2002. The most optimistic respondents averaged +4.4% for Q1 and +3.5% for Q2.

We made a classic contrarian mistake: like everyone else, we assumed that a negative fourth quarter was a given (we actually expected it to be worse than the consensus estimate), and we turned our attention to what we thought were overly-bullish expectations of recovery for the first half of 2002. It seems we were not alone. By the time the GDP number was reported last month (January 31), the consensus among economists was a full 1% decline.

On the morning of January 31, the initial reaction of the commentator on CNBC was to wonder out loud if GDP number on the teleprompter was a typo. Instead of a sharp decline, the economy had actually *grown* 0.2% in the fourth quarter. (To add insult to injury, the revised GDP number was released this morning, showing that the economy grew by an astonishing 1.4% in the fourth quarter of last year!)

Once more we were reminded that even if the collective wisdom of the experts is always wrong, picking from the range of possibilities outside the consensus – down *or* up – is far from easy.

Japan

During President Bush's recent trip to that nation, you doubtless heard a lot about the "axis of evil," but what you are not hearing very much about (unless you make it a habit to read your newspaper cover-to-cover) is that the world's second largest economy is experiencing its third and most severe recession in a decade.

And that's just the tip of the iceberg.

The Nikkei stock average (the Japanese equivalent of our Dow) recently fell to an *18-year low*, while the unemployment rate in Japan has risen to 5.6%, the *highest ever* in that country. Japanese consumers seem content to let their money mildew under their mattresses (why put it in a bank when interest rates are effectively zero?), investors are pulling money out of the stock market, and the banking system in Japan remains mired in hundreds of billions in bad loans.

Indeed, Japan's banks are arguably the most serious problem facing the world's financial system. To give you some perspective on the magnitude of the bad loans weighing on the Japanese banking system, during the S&L crisis in the United States in the 1980s, nonperforming loans rose to about 5% of all lending. Today, it is estimated that this figure in Japan is around 20% – or even higher.

So What?

Three recessions in a single decade. An economy trapped in an accelerating deflationary spiral. A banking system that has been in crisis for as long as we can remember. Years of talk about bank reform and corporate restructuring with little action.

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What else is new? Everyone knows that Japan is a mess, and no one seems to care anymore. Indeed, earlier this week we mentioned to a few of our readers that we were going to be discussing Japan in this month's newsletter, and their reaction was... "Why?"

You can probably figure out our answer to that question given our belief that it is what the media isn't reporting – and what people are therefore ignoring – that should worry you.

Some day, and probably soon, the media will look back at Japan, as they are doing today with terrorism and Enron, and ask, "how did we let it get to this point? Weren't all the danger signs there for years? And if the U.S. knew this, then why didn't we put more pressure on Japan to fix things before their problems caused *our* economy to tank?"

The answer lies in the relationship between public opinion and political will. Just imagine if the SEC had announced at the height of the bull market that it was going to tighten accounting standards and aggressively audit the financial reports filed by companies like Enron. Can you imagine the outrage? The bottom would have fallen out of the stock market, as investors jumped to the conclusion that the regulators knew something that they didn't. And the same experts who are today castigating the SEC and other agencies for not preventing Enron from happening would have flocked to the television to denounce an "interventionist" government for jeopardizing American prosperity.

There has been no "Enron-like" perception-changing event in Japan – yet. This helps explain why our media cannot grasp the seriousness of the problem. Japan remains an abstraction to Americans, something they read about from time to time on page ten of the newspaper, but nothing that keeps them awake at night worrying. But worry you should.

Crisis and Opportunity

Although our near-term outlook for Japan is negative (crisis looms, with dire implications for our own economy as well as for that of the rest of the world), we are already turning our attention to what we believe will be a compelling investment opportunity in that nation. Remember what we wrote last year (December 30): "Late in a bear market, a consensus builds that stocks will never again be worth owning, as investors who have been pounded every time they 'bought on the dips' simply lose faith." It has taken eleven long years to get there, but it is becoming clear to us that the few remaining optimists on Japan are finally losing faith.

Economists are almost unanimous in their opinion that Japan needs to fix the country's banking system, certain to be an extremely painful process, and increase the money supply aggressively, all of which appears unlikely in the near future as Prime Minister Junichiro Koizumi's popularity is fading in Japan thus making it more difficult for him to push through politically-unpopular reforms.

Wall Street professionals, who for much of the late '90s favored Japanese stocks, if only because they had been down for so long that recovery must be "inevitable," have finally given up hope. Indeed, even the most die-hard contrarians seem to be ignoring Japan these days – a very good sign that its economic woes are approaching a bottom. Looking beyond the possibility of a near-term crisis in Japan, we therefore see a compelling opportunity for the intrepid investor.

Giving Up Hope

Japan has been a tempting contrarian play for years, and it has burned investors every time. Back in December of 1999, as our bull market was roaring to new heights, James Grant, editor of Grant's Interest Rate Observer and outspoken contrarian, argued in favor of investing in Japan in an interview with Forbes magazine: "Japan is in cash. A year-and-a-half ago you literally could not get a safe deposit box. They were occupied by people storing cash... That, to me, is bullish. Comfort isn't what delivers investment return. It is doubt, skepticism and demonstrated

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underperformance...I own Japanese stocks, mostly small caps. Ten years ago, people were talking about Japan as some bulls now talk about America: that it was to be the colossus of the world economy. Lo and behold, it didn't work out. So Japan ten years later is on sale. That interests me."

We don't know if Mr. Grant held on to those Japanese stocks, but if he did, we can assure you that he is hurting – Japan may have waned as our markets waxed in the '90s, but no such reversal has occurred in the past few years. And we have not heard Mr. Grant talking up Japan lately.

Mr. Grant is not alone in quietly giving up hope for a Japanese recovery. During Barron's annual roundtable earlier this year, a three-part series highlighting the investment outlooks for the year ahead from Wall Street's most celebrated personalities, we were struck by the nearly unanimous opinion that investing in Japan is a bad idea:

- Barton Biggs (Morgan Stanley Dean Witter's chief global strategist): *"Japan is still a disaster, and getting worse."*
- Abby Joseph Cohen (managing director and chair of the Investment Policy Committee of Goldman Sachs): *"The Japanese economy has either been in or close to a recession for 10 years."*
- Felix Zulauf (Zulauf Asset Management): *"Japan is a disaster. I do not believe Japan is ready for a major step forward in deregulation. The country is now four years into negative nominal-GDP-growth territory. I do not see a major turnaround coming."*
- Even Marc Faber (Marc Faber Limited), well known for his contrarian investment approach, was pessimistic about the investment opportunity in Japan: *"If by accident the situation in Japan improves, and it would have to be a big accident, at the margin there is potential for quite a substantial upside."*

Contrast the pessimism about Japan in this year's Barron's round table with opinions in years past. Barton Biggs, who just a couple months ago (see above) said, "Japan is still a disaster, and getting worse" had a much different opinion a few years ago. At the end of 1998, Barton Biggs' favorite market for 1999 was Japan (Source: Business Week, December 28, 1998). At the end of 1999, Barton Biggs' favorite market for 2000 was still Japan (source: Business Week, December 27, 1999). By early 2001, Mr. Biggs' enthusiasm for Japan had begun to wane, though he remained cautiously optimistic: "Japan, the second biggest economy in the world, is just beginning to recover." (Source: Barron's, January 15, 2001) As 2001 wound down, Mr. Biggs clung to hope: "With a new Prime Minister in place, there are finally signs of real reform. Japan has been through a depression comparable with the U.S. in the 1930s. But it has tremendous potential if it can get its act together in the next five years. Also, Japan is incredibly cheap. Japanese stocks sell on average at 70% of corporate sales--vs. 200% in the U.S. and 120% in Europe." (source: Business Week, September 10, 2001)

In spite of the pessimism expressed by the participants in this year's Barron's round table, the media isn't paying enough attention to the disastrous implications of the situation in Japan. This always leads us to believe that the worst is yet to come. But if investment professionals like Mr. Biggs who have been so bullish on Japan for so long are finally giving up on Japan, having been burned so many times in the past decade, there can be no doubt in our minds that a terrific investment opportunity is not too far off.

The Road Ahead

There is a concept known as "reversion to the mean," which is based on the observation that all market capitalization weighted stock market indexes (even those in other countries) tend to have similar returns over very long periods of time (30 years or more). Because of this, when stocks

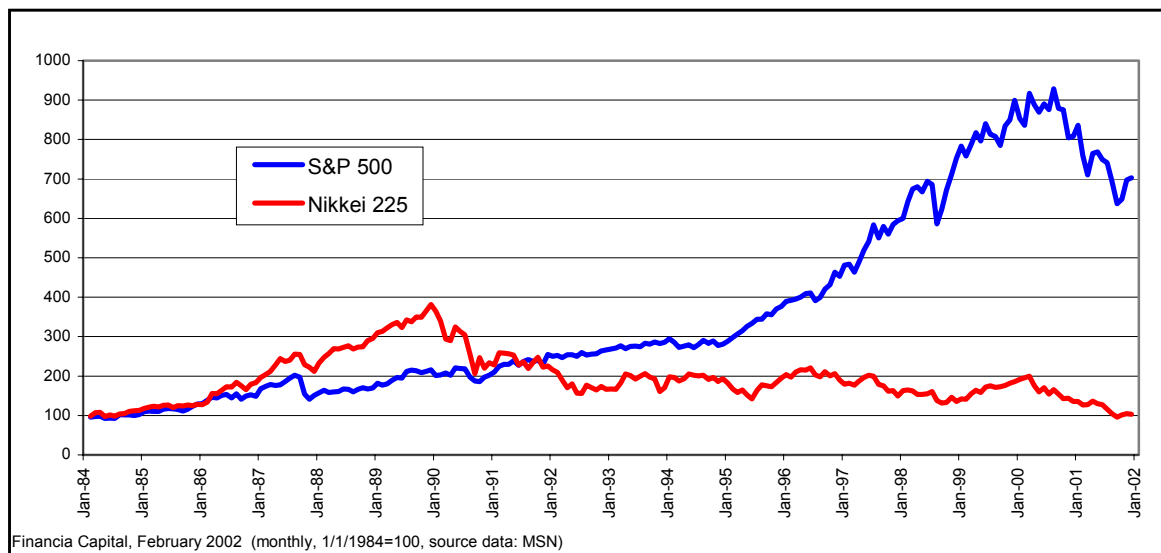
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as a group experience a prolonged period of higher-than-average growth, they are likely to experience a period of larger-than-average declines to restore the long-term average.

In our December letter (December 30, 2001), we observed that it is very unusual for U.S. markets to be down more than two years in a row. But the magnitude of gains that U.S. markets experienced in the late 1990s were also very unusual (especially in the tech-heavy Nasdaq), and a subscriber to the reversion to the mean theory might suggest that a longer-than-normal bear market is exactly what one would expect following such an extraordinary bull market to bring the long-term trend back in line.

The same holds for the opposite scenario: a market like Japan's, which is experiencing an astonishingly-long period of miserable returns (see chart below), must at some point go through a period of above-average performance to revert to mean.

S&P 500 (U.S.) vs. Nikkei 225 (Japan)



If you subscribe to this theory, and we believe that it has a fairly solid statistical basis, then you have to view the Japanese stock market as a coiled spring. It is anyone's guess when it will break out, but the fact that so many formerly-bullish experts are turning their backs on Japan is reason enough to think that we are getting close to that point.

In conclusion, here are the two most important things to remember as you keep an eye on Japan:

- 1) Japan has not yet become an "Enron," in so far as the media is still largely ignoring the seriousness of the problem, and, for that reason, investing in Japan remains a dangerous proposition.
- 2) But for the first time we can remember, the experts are starting to give up hope of any kind of meaningful recovery in Japan, and that foreshadows an enormous opportunity for investors who can ignore the voices of those who have tried and failed so many times in the past to predict a recovery.

We will periodically return to Japan and update you on our thoughts. For the time being, keep watching the news and be alert to increasing concern about Japan.

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With respect to the equity markets in this country, our advice has not changed. Last month we recommended that you avoid equities and stay in cash. Since then, the Dow has shown some strength, breaking out above the psychologically-significant 10,000 level (up 1.9%). But don't be fooled by the performance of the 30 stocks that make up the Dow; the Nasdaq has fallen sharply in the past month, down 10.5% since January 31.

A similar pattern was observed throughout 2000 and 2001, as the Dow held up fairly well while the Nasdaq plummeted. It will end badly this time as well. Our outlook for the U.S. equity markets remains negative.

Ian Fraley
Managing Principal
Financia Capital, LLC

Sean Bill
Managing Principal
Financia Capital, LLC

Stephen Brennan
Strategic Analyst
Financia Capital, LLC

PS – In our January letter, we used the Year 2000 computer “crisis” to illustrate the inverse relationship between media hype and market direction. Some of our readers took this to mean that we believed that the Y2K problem had never existed in the first place. “I think that you are downplaying a lot of work that went into fixing stuff for the Y2K just because nothing blew up,” writes reader Simon Sabato. “I guess it's a typical problem for people in security, etc. - when you do a really good job everyone ends up wondering why they paid you in the first place... The problem was very real. There were *lots* of issues that cropped up in IT; for example, Microsoft had a gazillion patches for operating systems, and especially for Excel, that needed to be applied.”

Simon's point is well taken, and we want to set the record straight: we did *not* mean to imply that the Y2K issue wasn't real, any more than we were suggesting that the terrorist attacks didn't happen in September or that accounting problems didn't exist at Enron. While countless software programmers, hardware engineers, and IT managers were working hard to make sure a crisis didn't happen, the media was waking up to the ratings potential of spinning doomsday scenarios about a disaster that *might* happen. Believe us: the same kind of hard work is going on right now in the government agencies responsible for preventing terrorist attacks on U.S. assets and in the accounting firms responsible for signing off on the numbers reported by our nation's largest companies. But as far as the media is concerned, the real dangers lie ahead of us, not behind us.

We can debate how serious the Y2K issue really was, but our point was that because the media had finally caught on, the danger was greatly diminished. With respect to your investments, Y2K might as well have been an elaborate hoax.