



11 October 2010

Diamonds amidst rubble

“..the really big uncertainty is the political economy. Japan, in essence, has accepted a long period of private sector deleveraging and stagnant growth without much social upheaval. Whether voters in America or Europe will do the same, without either forcing their governments to resort to inflation or default, is crucially unclear.”

- Gillian Tett, The Financial Times, 8 October 2010.

“Sir, ‘Can the Fed prevent Japanese-style deflation, a period of falling prices associated with economic stagnation, from taking hold?’ is a common refrain nowadays.

“The US Federal Reserve’s obsession with Japan is pretty disastrous. First, Alan Greenspan opened the taps wide for too long, fearing Japanese-style deflation, which fuelled the housing bubble that led to the recent financial crisis. Now, fearing the lost decade plus, the Fed is probably going to keep easing until some different but unpleasant outcome is the result. Stagflation perhaps, or hyperinflation ?

“This is so ironic, because for so long people have sneered at the Japanese for their inability to steer their economy to recovery. Perhaps because they have sneered so much, it is no longer possible to admit that after a huge housing bubble bursts, there is nothing to do except suffer many years of economic indignity.

“The fixation with Japan was not helpful during Mr Greenspan’s watch, nor I fear will it be of much use this time. The Japanese may be different, but they were not stupid.”

- Letter to the editor of The Financial Times from Mr Takashi Ito of Tokyo, Japan, 17 August 2010.

A friend recently recounted a story about a businessman who sold his firm in the late 1990s and was wondering what to do with the proceeds of a few hundred million dollars. Which, he asked, is the asset in the world that is most unloved, most detested, most out-of-favour, most ignored ? Which asset would cause most investors to vomit or hurl themselves from a tall window rather than even consider purchasing it ? With the counsel of my friend, the businessman identified gold as that asset, and invested accordingly. From its low of around \$250 per ounce, correctly also identified by our former Chancellor, Gordon Brown, albeit inadvertently as the launching point for his sales of 395 tonnes, gold has risen by roughly 400% since. But given that gold is conventionally

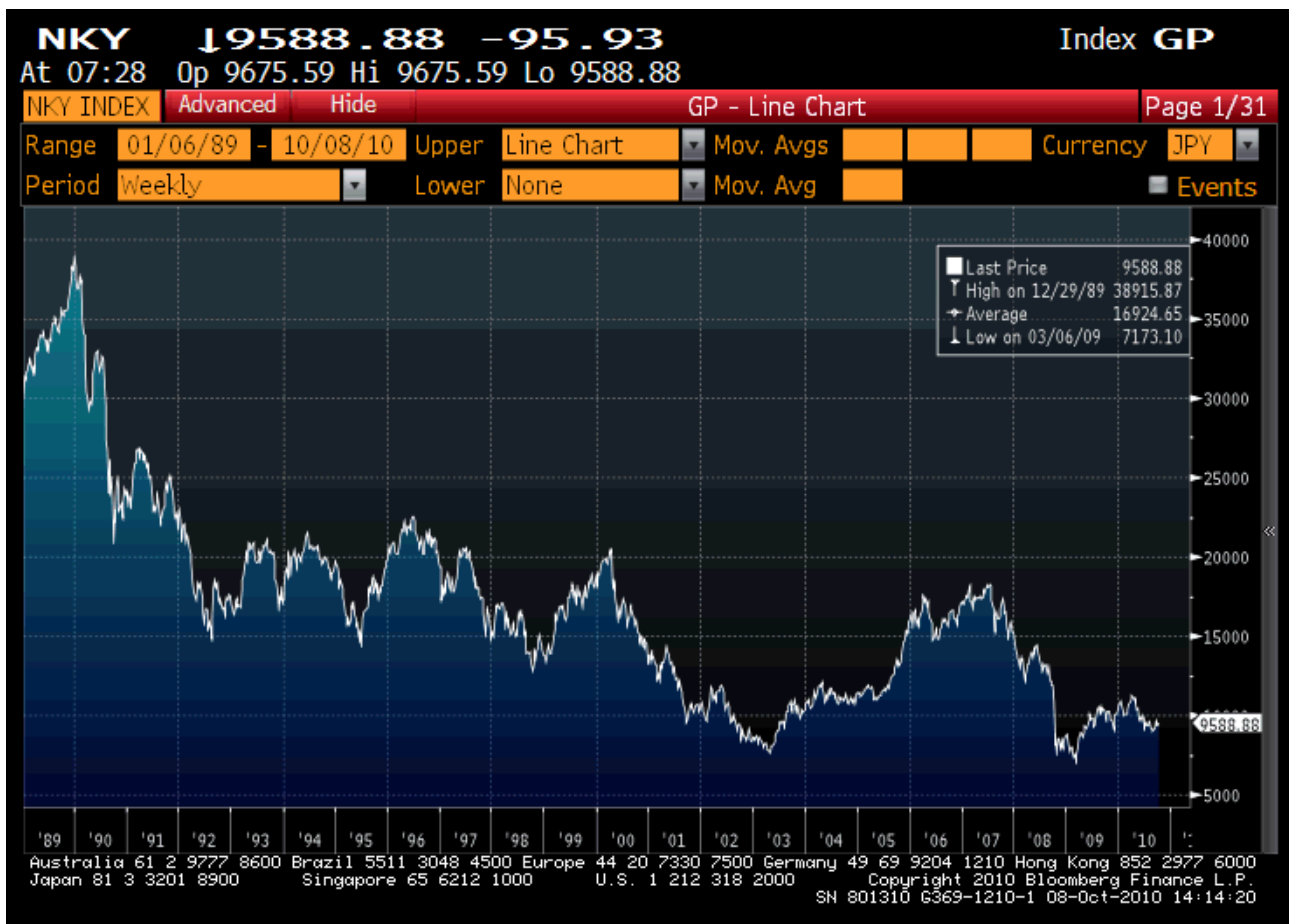
denominated in currency or money that could be fairly described as not entirely real, where it ends up is anybody's guess. We simply suggest that, notwithstanding the growing risk of a near term correction, it will end up higher than a level that is increasingly described as bubbly by people who perhaps put overmuch faith in pieces of paper and their electronic equivalents with precisely zero inherent value.

But whether gold effortlessly coasts through \$1500 and beyond, or implodes messily in the short term on the back of unsustainable hot money inflows, is not really the point of this week's commentary. The point is to ask: which is the most unloved, most detested, most out-of-favour, most ignored asset today ?

Quite possibly it's Japan.

A 75% fall from a high reached back in 1989 sounds, and indeed is, grotesque. But perhaps the shattering decline, and just as dismally the longevity of the drift southwards, is better represented visually:

The sun also rises, just not for 20 years so far – Nikkei 225 Index, 1989 to 2010



(Source: Bloomberg LLP)

As Ito-San's felicitous phrase has it:

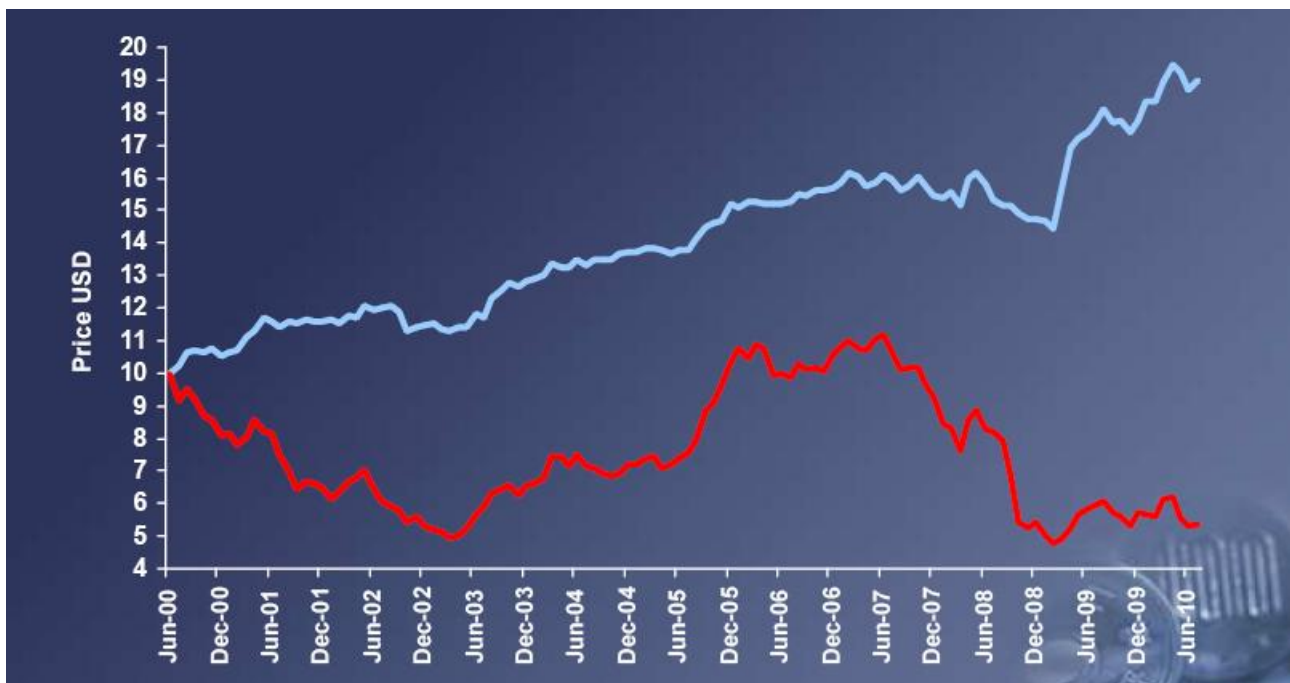
“many years of economic indignity”

– in a single chart.

The past is prologue, but what could the future hold ? Japan-watchers have seen so many false dawns, they may admittedly have forgotten what daylight looks like, but from a purely contrarian perspective, Japan's equity market, we suggest, would be pretty hard to beat – as opposed to that of China, which couldn't currently be more wildly popular if it tried. And from a valuation perspective, the proposition has some backing from fundamentals (which we concede look less compelling when fears of global quantitative easing are driving equities, bonds and commodities prices higher together):

- Corporate cash balances are at record highs
- The yen is close to its strongest level in 15 years
- Share valuations are reasonable if not outrageously low
- The Topix Index as a whole trades below book value.

But given the perennial tendency of Japan to disappoint, is there any way of hedging the risk of further sustained market or economic disappointment ? We believe there is: by utilising an existing long / short Japan fund with the following 10 year track record:



Key: — A certain long / short Japanese equity hedge fund
— Japan's Topix Index

Over the past year, the fund in question has delivered a return of +7.1% (versus -10.6% for Topix).
 Over the past 3 years, the fund in question has delivered +18.9% (versus -50.2% for Topix).
 Over the past 5 years, the fund in question has delivered +37.9% (versus -29.5% for Topix).
 Since inception in June 2000, the fund in question has delivered +89.7% (versus -46.6% for Topix).
 Convention and regulation dictate that we should add that past performance is not necessarily an indicator of future performance, but the historic value generated by this fund is, by any assessment, remarkable.

The flip side to the broader Japan argument is that what is wildly popular could end up being a savage disappointment. Investors at present can barely get enough of China, and 60-year old fund management veterans are publicly coming out of retirement just to participate in the market. (The

Shanghai Composite is down by 16% year-to-date, as if as a subtle reminder that you cannot buy what is popular and do well.)

The potted summary this week ?

- 1: While the momentum of real or anticipated QE2 is driving markets indiscriminately higher in the short term, there may be real benefit in pursuing contrarian strategies, and you cannot get more contrarian than Japan.
- 2: The Japanese experience in many respects makes an awkward investment precedent for western markets now mired in exactly the same kind of debt-laden, low growth, bank-knackered, property-knackered, deflationary swamp.
- 3: Trying to forecast gold prices would be a fool's errand, but given the widespread currency debauchery on offer, we would prefer to remain invested than try and game the market. As Gillian Tett implies, inflation and / or default is not much of a choice, but gold is a realistic answer to the quandary – and to the currency question too.
- 4: While Japan looks cheap and feels deeply unpopular, exactly the opposite holds for China. [For more on this topic..](#) But as a way of playing the Japanese equity opportunity, a robust long / short equity fund looks like an astonishingly promising opportunity in a world largely bereft of such things. More on this theme to follow in due course: watch this space.

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