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Why pay more?

Evan Lorenz writes:

In debate at the Fall 2017 *Grant's* Conference, Jeremy Grantham denied that American stocks were in a bubble. Yes, valuations were high, the co-founder of GMO, LLC conceded, but the characteristic euphoria of great market tops was nowhere to be seen.

There's plenty to see now, and the prescient Grantham has duly turned bearish. While the 59% rally in the S&P 500 over the past three-plus years tilted him in that direction, what sealed the deal was the rise of "really crazy investor behavior," says he, now evident in "record amounts."

Bubbly examples abound. Thus, two Mondays ago, six penny stocks accounted for 18% of total domestic equity turnover. Polling its members on Jan. 13, the American Association of Individual Investors reported that every last one—100%—were bullish. That astounding result turned out to be the product of a software glitch, but it looked plausible enough in the context of a news flow featuring, on Jan. 14, a Reuters dispatch talking up the uses of astrology in timing bitcoin purchases.

So the question before the house becomes, What to do? Timing the top of a bubble is nearly impossible. This publication dissected the problems in structured mortgage credit in minute detail in the issue dated Sept. 8, 2006; the S&P 500 rallied for another 13 months. (And in the history of calling tops, a 13-month miss almost passes for a bull's-eye.) However, there remain cheap assets outside the 50 states—Japanese equities, for instance, some of whose praises we are about to sing.

Of course, not everyone believes that the S&P 500 has rocketed to unsustainable heights. While the Shiller cyclically adjusted price-to-earnings ratio for the blue-chip index towers at 34.7 times, a level seen in only the dot-com boom and 1929, eponym Robert Shiller does not think this indicates overvaluation. In a Dec. 1, 2020 *Project Syndicate* article, the famed Yale professor said that American stock prices, adjusted for real bond yields, make sense. "[W]orld-wide," Shiller declared alongside co-authors Laurence Black (founder of the Index Standard) and Farouk Jivraj (head of quantitative investment-strategies research at Barclays Investment Bank), "equities are highly attractive relative to bonds right now."

Left unsaid is whether bonds, too, are in a bubble. As we go to press, $16.9 trillion's worth of paper is priced to yield less than zero.

In a memo published last week, Howard Marks, co-founder and co-chairman of Oaktree Capital Management, concurred with Shiller, albeit for separate reasons. Yes, valuations are higher than in previous eras, but corporate information is ubiquitous, as it wasn't before. Which means, among other things, that undervaluation tends not to persist for as long as it once did (though value investors we know could produce reams of counterexamples). "But there are real differences as well," the bond guru continued. "We've rarely had businesses as dominant as the tech leaders, with the growth runways they have and the profit margins and capital efficiency they enjoy making them more dominant with each passing day." So, high values might be a rational reflection of business fundamentals.

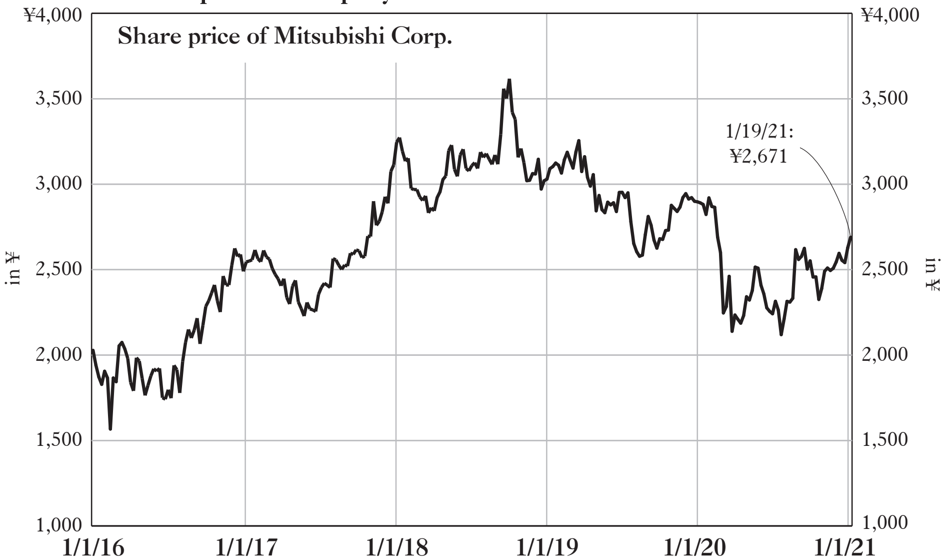
You may not be willing to bet the farm that this time is different, and, thankfully, you don't have to. There are pockets of inexpensive securities across the globe. Grantham identifies emerging-market and value stocks in general. However, not every investor has the mandate to dive into less developed markets, which suffer from low liquidity and patchy corporate governance. Japan, which hosts a large cohort of cheap, export-oriented stocks, might just be the ticket.

With the Nikkei 225 trading at 40 times trailing earnings, Japan is not obviously on sale, but the Nikkei is a price-weighted index, i.e., the highest-priced stocks are overrepresented, instead of market-cap-weighted, like the S&P 500. Thus, Fast Retailing Co. Ltd., Japan's seventh largest stock by market cap, is the top component of the Nikkei with an 11.7% weighting and a trailing price-to-earnings ratio of 105.7.

Price-insensitive investors are legion in the United States; in Japan, one dominates. At the end of November, the Bank of Japan's portfolio of ETFs owned a 7% stake in the 2,171 companies that constitute the first section of the Tokyo Stock Exchange.

The bank "just buys anything and everything," Jaewoo Nakajima, who leads Evercore ISI's Japanese research team, tells me. "The expensive companies become more expensive, and less expensive companies become less cheap, but not at the same pace. So that's actually been one of the unintended consequences of BoJ asset purchases."

One-stop reflation play



source: The Bloomberg

That distortion notwithstanding, there is much to like about Japan. In the past three periods of global growth acceleration (2003, 2013 and 2017), relates Nakajima, the Nikkei leapt by an average of 33%. It would be nice if that precedent held during the ardently anticipated return of the world to good health and free spending.

Then, too, Japanese companies did not stand stock-still after the double blows of the global financial crisis and the 2011 Fukushima earthquake. Corporate profit margins, Nakajima says, averaged 2% for 15 years through the mid-aughts. It's testament to Japan's successful restructuring drive that post-Covid profit margins retreated to 5% from almost 7% of sales. Five percent (as a percentage of sales) may be low by American lights, but it's a vast improvement over what used to pass for acceptable Japanese corporate profitability.

In a Dec. 16, 2020 survey of corporate management intentions, the ISI analyst found that 83% of respondents planned to increase their dividend, while 58% anticipated boosting capital outlays. Last week brought news that Japanese machinery orders climbed by 1.5% from a month earlier, against expectations of a 6.5% decline (and following a 17.1% rise in October). Resurgent Covid along with the new year's lockdowns will hardly help matters, but Japan's front offices appear to be focused on better days ahead.

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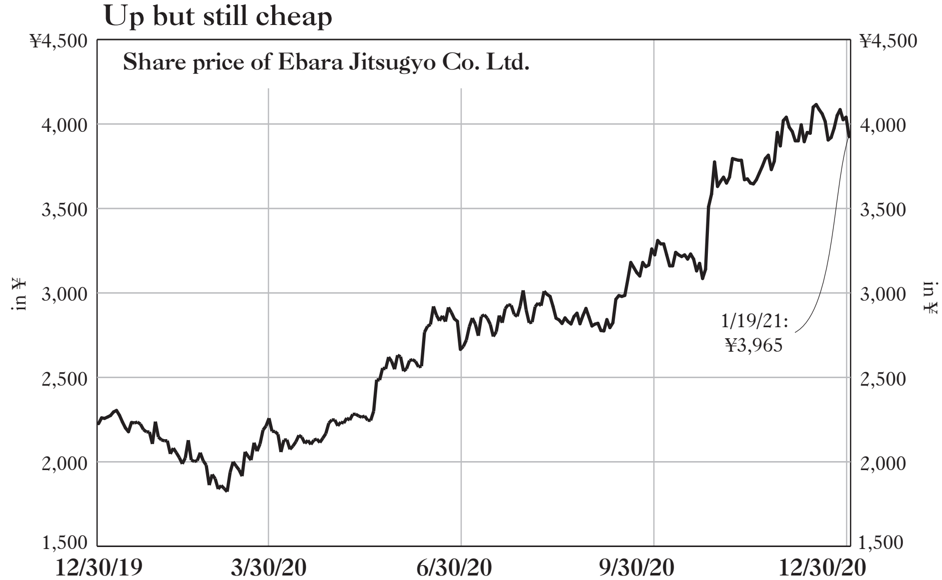
A handful of highly valued Japanese companies masks a host of reasonably valued, well-financed ones. In the Feb. 7, 2020 issue of *Grant's*, you'll find the bull case for Mitsubishi Corp. (8058 on the Tokyo Stock Exchange), the storied trading house. Six months later, Berkshire Hathaway, Inc. disclosed a 5% stake in Mitsubishi, as well as 5% positions in peers Itochu Corp., Mitsui & Co., Sumitomo Corp. and Marubeni Corp., for a total investment of $6.5 billion.

Japan's trading houses resemble private-equity portfolios rolled into a single ticker, minus the nosebleed leverage. Mitsubishi's collection of wholly owned subsidiaries and investments spans 10 business divisions and includes a 20% interest in Mitsubishi Motor Corp. and a 50% holding in Japan's Lawson, Inc. convenience-store chain. In the fiscal year ended March 31, 2020, the three most important contributors to the bottom line were mineral resources (40.9% of net income; metallurgical coal, copper, iron ore and aluminum), natural gas (13.5%) and food (10.3%; everything from farming to fast-food restaurants). Lightly leveraged, Mitsubishi commands a single-A credit rating.

Mitsubishi's broad exposure to foreign markets (55% of sales originated in Japan) and commodities furnishes grist both for the bull and bear sides of the argument. "The company's mainstay natural gas, automotive [and] coking coal businesses are all facing tough operational environments," Hidenori Kusunoki, who rates 8058 a hold for Mizuho Securities Equity Research, wrote on Nov. 24. Since that report, the price of liquefied natural gas shipped to Japan or Korea has jumped to $8.52 (and soared past $19 a few times last week) per million BTUs from $6.75 and the price of met coal from Australia has risen to $136.15 per metric ton from $101. Think of Mitsubishi as a one-stop reflation play.

Covid has left its unwelcome calling card. Earnings per share are expected to collapse to ¥153 in the year ending March 31, 2021, from ¥358 in the prior

Up but still cheap



source: The Bloomberg

year. Despite its broad exposure to global industrial production, Mitsubishi has posted a full-year loss only once—that was fiscal 2016—since the end of World War II.

"They are only in the broadest sense Japanese companies," says Paul Isaac, CEO and founder of Arbiter Partners Capital Management, LLC, a director of Grant's Financial Publishing and the overseer of some Grant family funds, as most trading houses derive a large portion of sales abroad. "Yet, they're still trading at single-digit multiples of earnings and, in some cases, discounts to tangible book, and they're paying 4% to 5% dividend yields."

These are towering yields not only in Japan, where the 10-year government bond is priced to fetch 0.04% and the Nikkei 225 a dividend yield of 1.4%, but also in America. The ICE BofA US junk-bond index offers a yield of 4.3%, whereas investment-grade rated Mitsubishi delivers a 5% dividend yield.

Since our analysis last February, Mitsubishi has generated a 3.5% loss versus a 22.5% gain for the Nikkei, both including reinvested dividends. In other words, you can purchase the stock at around the same levels as Warren Buffett paid. Mitsubishi is priced at 17.4 times the estimate for the plague-stricken fiscal year ending March 31, 2021, at 7.5 times fiscal 2020 earnings and 75% of book value. Of the 12 analysts who cover the stock, eight say buy and none sell.

The closed-end Nippon Active Value Fund plc (NAVF on London) buys smaller-cap Japanese stocks. The corporate M.O. is to hold 20 or fewer positions and engage with management teams to improve shareholder returns. When diplomacy fails, NAVF says it expects to play the role of an activist investor to force change.

Ebara Jitsugyo Co. Ltd. (6328 on Tokyo), a profitable maker of wastewater-treatment devices, is an early, ongoing success story. Despite what many a western banker might judge to be an overcapitalized balance sheet (net cash foots to ¥8.5 billion, or 31% of Ebara's market cap), the company generated returns on equity of 13.3% in the third quarter and 11% in full-year 2019.

"They have a very nice business, a very sort of flavor-of-the-month business in that it's a green sort of business in wastewater treatment," Gifford Combs, a managing director at Dalton Investments, LLC and a member of NAVF's investment adviser, tells me. "It is a market leader in Japan. And it's the sort of business that would command a very decent valuation from any number of potential acquirers."

Under pressure from NAVF, Ebara increased its dividend to ¥100 per share from ¥60 in November, which helped to push the share price higher by 82.4% last year. Even so, Ebara trades at 13.2 times trailing earnings, or 6.3 times enterprise value to Ebitda, and sports a 2.5% dividend yield. And the dividend hike notwithstanding, Ebara's payout ratio is just 33% of earnings. "We haven't sold any," Paul ffolkes Davis, chairman of NAVF's investment advisor, tells me. "We think that there is more to go for here, and there will have to be some further actions on the part of the company."

In his eight years as prime minister, Shinzo Abe took up the cause of the shareholding public by urging Japanese companies to boost dividends and unwind cross-shareholdings. While Abe left office last September, activist investors in small-cap stocks are getting another helping hand, or perhaps a prod, from the Tokyo Stock Exchange.

Currently, Japan has five market classifications: the first and second sections, Mothers, Jasdaq and the Tokyo Pro Market. In 2022, the exchange will reclassify stocks into just three: prime, standard and growth. On June 30, companies with free-float market caps of ¥10 billion ($96 million) or less will be notified that they need to come up with a plan to meet new listing requirements, e.g., by getting major shareholders to unwind cross-holdings, or be moved to the standard section in 2022 from today's first section.

There's more at stake here than mere prestige, though there's no gainsaying the value of a first-section listing for the upwardly mobile Japanese public corporation. First-section companies make up the Topix index, the grouping that ETFs track. And the ETF connection is no small thing given that the BoJ has pledged to buy between ¥6 and ¥12 trillion's worth of those funds every year. Americans know all about such dynamics. Index-anointed stocks are where the action is, or, at least, where the action has been, on both sides of the Pacific. In Japan, over the past six months, Japan's small-cap stocks have lagged the Topix by 7%.

"I don't think that most companies really understand the implications of this, which is that a lot of small-cap companies are going to be, to use the British soccer expression, 'relegated' to the second section," says Combs. "One obvious option is, before this happens, take the company private and control your own destiny and then relist the company at a different time in the future when you have a higher valuation, either because you built the company out with additional acquisitions or mergers or you simply command a higher valuation."

As of Dec. 31, Nippon Active Value Fund held 20 stocks. The fund does not advertise its holdings unless it goes activist or if filing thresholds force a disclosure. (So far, only five positions have been publicly named.) On average, those 20 investments traded at 11.9 times trailing earnings, 3.5 times enterprise value to Ebitda and carried net cash balances equal to 24% of their respective market capitalizations.

Since listing on Feb. 20, one day after U.S. stocks carved out their pre-Covid top, the Nippon Active Value Fund has grown net asset value by 14%, despite 12% of assets sitting in cash as of year end. The fund trades at a 4.5% discount to NAV and charges a 0.85% expense ratio.

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