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America the overvalued

Evan Lorenz writes:

The air is thin at the summit of Mount S&P 500. It's richer by far—if value is what you like to breathe—in the foothills of global equity. In preview, *Grant's* is bullish on certain foreign companies and on a particular domestic situation with which the index-makers are happily uninvolved.

America's equities bestride the world—by one measure, their relative size has never been greater. Thus, in the realm of mid- and large-cap stocks, the MSCI USA index commands $28.5 trillion of market value; the MSCI World ex USA index, $16 trillion. That's 64% of developed-country market cap for the United States. It eclipses the prior record of 59% set at the tail end of the dotcom bubble. For perspective, America generates 44% of developed-nation GDP.

American outperformance was no thanks to domestic-fund flows. In the not-quite-three years ended November 2019, according to J.P. Morgan's first-quarter "Guide to the Markets," a net $43 billion exited open-end mutual funds and exchange-traded funds while $325 billion coursed into world equities. But as Joe and Jane stepped away, Corporate America stepped up: In the third quarter, according to the Federal Reserve's Flow of Funds report, domestic share buybacks zipped along at an annual rate of $598 billion.

Over the past three years, expressed in dollars, the U.S. MSCI index compounded at a rate of 14.6%, that of non-American developed markets at 9.3%. Now flip those results. If, either through a weaker dollar or diminished earnings, American stocks began to return 9.3% and foreign ones 14.6%, a decade would pass before U.S. equities returned to their historical weighting.

A comparison of American stocks with the home economy tells much the same tale. Thus, the market value of the Wilshire 5000 represents 178% of GDP, a level second only to the 183% mark set in 2000–01; 60% is the average of the past century (in 1929, the peak was 81%). Market caps have grown by 22% of GDP over the past two years alone, making American stocks a bigger asset class than American bonds. No surprise, then, that household net worth reached 528.4% of GDP in the third quarter of 2019, topping records set in the dotcom boom (447.1%) and the mortgage mania (493.4%).

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The United States was not always No. 1, if that is the correct descriptor of a bubble champion. Japanese equities peaked at 41% of global market cap in 1988 versus just 30% for American stocks, according to the World Bank—that was when Japan accounted for 16% of the world's GDP, America for 28%.

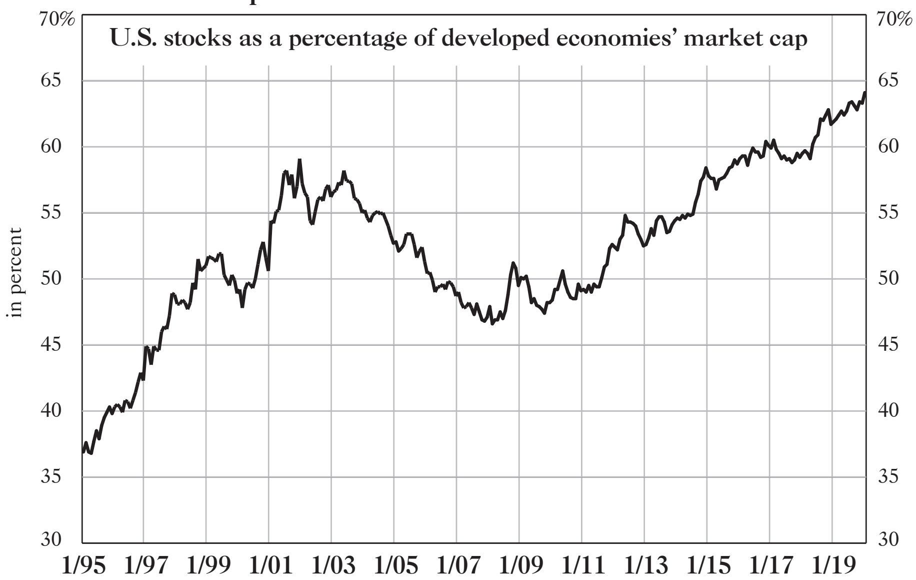
To jealous American eyes, Japan's inflated stock market, priced at more than 40 times earnings, represented not a risk but an insuperable business advantage over the comparatively sedate domestic market, quoted at 12 times earnings. "Japanese companies are finding it easier to raise relatively cheap capital to modernize, increase productivity and expand," as *The New York Times* put it on Oct. 27, 1989, two months and two days before the epic Tokyo top.

In reply to Gallup's wintertime 1989 survey question about which country was "the world's leading economic power," 58% of respondents (they were American) picked Japan, nearly twice as many as chose the United States, and a majority projected that Japan would continue to dominate in 2000. Yet, between 1989 and 2000, the Nikkei 225 fell a cumulative 53.3%, including reinvested dividends, versus a positive 383% return for the S&P 500 (both measured in dollars). That decline came despite a 26% rally in the yen. Over the same span, U.S. GDP as a percentage of the world's total rose to 30% from 28% while Japan's slipped to 14% from 15%.

Virus-related anxiety aside, Americans are today a cheerful people. Gallup recently reported that economic confidence is at its highest since October 2000, a perhaps inauspicious marker. According to *The Economist*'s Big Mac Index, only two currencies (the Swiss franc and the Norwegian krone) are overvalued relative to the dollar. Measured by hamburger purchasing power, the euro, pound and yen are undervalued by 19.2%, 22.2% and 37.5%, respectively. Hence our search for potential overseas bargains.

"Japan, I think, is a very interesting area, in part because Japan is cheap," says Paul Isaac, the CEO and founder of Arbiter Partners Capital Management, LLC, a director of Grant's Financial Publishing and (to make a clean breast of interlocking entanglements) the steward of a material portion of the liquid net worth of the editor of this publication. "There are a lot of pretty good companies that are doing a pretty

The next Japan?



source: The Bloomberg

good job of being internationally competitive and having moderate growth in a tough environment while generating free cash flow."

Not for the first time, Japan is working to correct such corporate-governance blights as cross-share holdings and weak alignments of interest between shareholders and management. Thus, in the first section of the Tokyo Stock Exchange, the proportion of companies boasting at least two independent directors climbed to 91.3% in 2018, from 21.5% in 2014—a hint, a glimmering, of progress, as we Americans define it.

On Jan. 27, Nikkei reported that Basel III rules will require Japanese banks to set aside more capital against cross-share holdings, beginning March 2022—in the case of a hypothetical ¥10 billion ($92 million) of such equity, ¥2 billion versus ¥800 million today. Profit-starved as they are, the banks may thus become motivated sellers of stakes that, in any case, serve a more ceremonial than economic purpose (*Grant's*, Aug. 9, 2019).

In contrast, the United States is seemingly moving to distance itself from foreign investors. The Competitive Dollar for Jobs and Prosperity Act, a bipartisan 2019 Senate legislation to drive down the dollar exchange rate by taxing foreign purchases of American investment assets, is one such sign of the times.

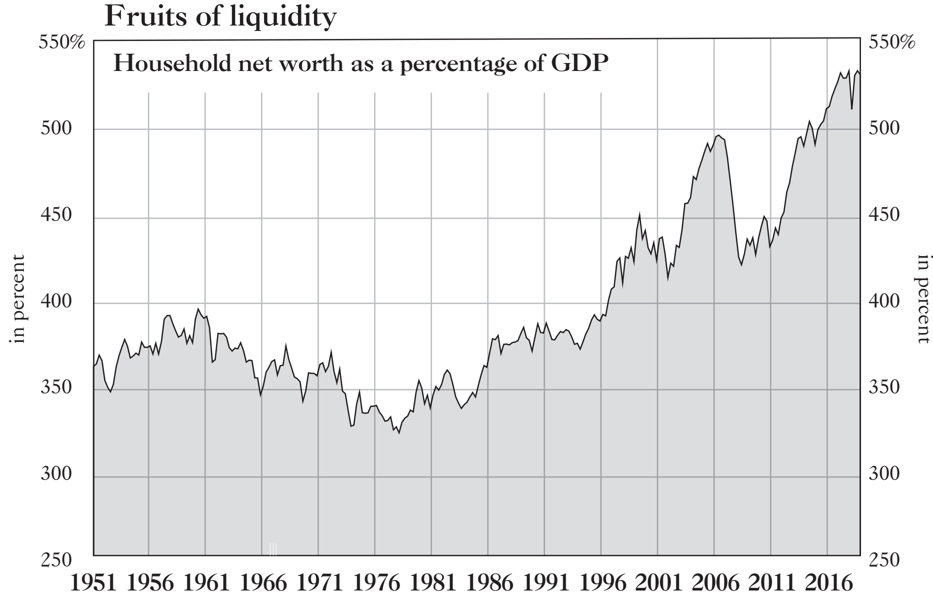
With the Nikkei 225 quoted at 18.6 times trailing earnings, the S&P 500 at 21.9 times (or even higher; see page 3), American and Japanese valuations don't look very different. But the elevated multiple on Japan's largest companies masks the presence of hundreds of cheap smaller ones. For example, if we limit our universe to stocks with market caps of between $100 million and $1 billion and with leverage less than two times earnings before interest, taxes, depreciation and amortization, there are 232 Japanese companies trading at less than 10 times earnings compared with 50 in America. Seventeen of the latter have to do with oil and gas.

Mitsubishi Corp. (8058 on the Tokyo Stock Exchange), Japan's biggest general-trading company and a core component of the larger Mitsubishi group, is one of these value specimens. A jack of all trades, it's engaged in infrastructure, food, consumer products, oil, liquefied natural gas and commodity trading. In the quarter ended Sept. 30, the big earners were mineral resources (38% of net income; met coal, copper, iron ore and aluminum), natural gas (18%) and automotive (12%; parts manufacture and a 20% stake in Mitsubishi Motors Corp.). The petroleum and chemicals division, which lost ¥22.1 billion, was the one and only net-income detractor.

Mitsubishi Corp. trades at 8.5 times trailing earnings and 0.79 times book value. Its 4.7% dividend yield outpays the MSCI U.S. REIT index, which is priced to deliver 3.8%, despite the gaping difference between 10-year government yields in the United States (1.6%) and Japan (-0.06%).

Rated A2/single-A, Mitsubishi Corp. is lightly leveraged in the financial sense. Its greater leverage is to worldwide economic growth, as witness the 26% revenue slump in the 12 months ended March 31, 2010, the fiscal year at the end of the Great Recession. No net loss resulted in that period. It took the commodity markets' annus horribilis, fiscal 2016, to deal the company its

Fruits of liquidity



sources: Federal Reserve, U.S. Bureau of Economic Analysis first full-year net loss, of ¥75.5 billion, since World War II.

Nippon Active Value Fund (NAVF in the U.K.), a closed-end fund committed to the idea that good things happen to cheap stocks—even, eventually, to Japanese ones—is due to list any day in London. James B. Rosenwald III, cofounder and managing partner of Dalton Investments, Santa Monica, Calif., is the fund's chief investment officer. A long-established seeker of Asian equity value, he's understood to be planning a concentrated portfolio of 5 to 20 stocks with market caps of less than $1 billion; the annual management fee will be 85 basis points. Under Rosenwald and his partner and co-founder, Steven Persky, Dalton generated an 8.1% compound annual return on its Japanese investments between July 1, 1996 and the third quarter of 2019, while the MSCI Japan index returned 1.1% per annum.

Tomorrow didn't happen

source: The Bloomberg

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The great American levitation hasn't raised all stocks, a non-revelation to which long-suffering value investors and the still-more-afflicted tribe of small-cap investors can sorrowfully attest.

"If you look year-to-year at the flow of funds, you will see with pretty great synchronicity that the amount of funds in a given year that flow into indexed products (ETFs and mutual funds) more or less equaled the money flowing out from active management," Steven Bregman, the president and cofounder of Horizon Kinetics, LLC, tells me. With low fees, ETFs need large asset bases in order to generate profits, which limits BlackRock, Inc. and peers to stocks with high daily trading values.

This demand for liquidity means that ETFs, whatever their purported mission, often wind up holding the same constituent companies. Thus, Apple, Inc., Microsoft Corp. and Facebook, Inc. figure among the top four holdings both of Invesco's QQQ Trust Series 1, which tracks the Nasdaq 100, and the SPDR S&P 500 ETF Trust, which supposedly follows a representative swath of big-cap American stocks, not just tech stocks.

Nothing if not versatile, Apple, Microsoft and Facebook (along with Mastercard, Inc. and Visa, Inc.) account for slightly more than one-fifth of the holdings of the U.S. Vegan Climate ETF (VEGN on the NYSE Arca). A kind of thematic fig leaf is Beyond Meat, Inc., which represents only 10 basis points of the portfolio.

It's no front-page news that the usual suspects dominate American equity investing. Last year, Facebook, Apple, Amazon.com, Inc., Netflix, Inc., Alphabet, Inc. and Microsoft accounted for 26% of the S&P 500's 31.5% rally. As of Dec. 31, Apple and Microsoft comprised 4.6% and 4.5%, respectively, of the S&P 500.

According to Bregman, four decades of data suggest that a kind of magazine-cover jinx attaches itself to many stocks that, at the close of the year, constitute 3% or more of the market cap of the S&P 500. Thus, Microsoft and Cisco Systems, Inc. accounted for 4.9% and 3% weights, respectively, of the blue chips at year-end 1999; they spent the next five years racking up cumulative losses of 12.4% and 18.5%. International Business Machines Corp. topped out at 6.4% of the S&P in 1985 and over the next five years fell by 2.6%.

"If you are the biggest company in an industry and you are earning a very high return on invested capital," says Bregman, "then you are the biggest, sweetest, most efficient target." Besides, mega-corporations can attract the unfriendly eye of the government. American Telephone & Telegraph Co. was a 5.5% weight in 1981. A 1982 consent decree with the Federal Trade Commission at length turned Ma Bell into seven Baby Bells. Microsoft's post-dotcom returns suffered from the 2001 antitrust settlement with the Department of Justice. Today, one of the few points on which warring Republicans and Democrats can agree is that Facebook and Google are too big for their britches. Ten days ago, Reuters reported that the European Commission is working on rules to break the dominance of Facebook, Google and Amazon in the EU.

The pool of cheap domestic companies with lightly leveraged balance sheets and with market caps below $1 billion is smaller than you'd think. For one thing, EZ access to credit has sustained the unprofitable lives of firms that might have otherwise failed (36% of Russell 2000 companies generated a net loss over the past 12 months). For another, some of the more liquid Russell 2000 members are themselves favored index constituents. For instance, 29.9% of the shares of Badger Meter, Inc., a pick-not-to-click in the Jan. 10 edition of *Grant's*, reside in portfolios managed by BlackRock, Inc., The Vanguard Group, Inc. and State Street Corp. For all these reasons, the Russell 2000 trades at a whopping 38.6 times trailing earnings—and be aware that Russell excludes negative earnings in its calculation.

Even so, some promising values slip through the indexation net. Texas Pacific Land Trust (TPL on the New York Stock Exchange), of which the aforementioned index trio owns just 0.51%, may be one of the most successful unindexed companies you've never heard of.

A survivor of the 1888 bankruptcy of the Texas and Pacific Railway Company, Texas Pacific received 3.5 million acres of land for the benefit of the railroad's former bondholders. "It spent over a century, with the exception of two years, gradually buying back shares," Bregman tells me with the conviction appropriate to a man whose firm holds 23.1% of shares outstanding.

"On a per share basis, the acreage per share was always climbing," he says. "We first wrote about it in 1995 when the split-adjusted share price was $5. We said this is an internal compounding machine. Unlike any other business we know, it doesn't have any balance-sheet risk. There is no debt. The trustees were prohibited as a form of risk control from engaging in any active business. Goodness knows over the century how many alluring business propositions came their way. They did what they were allowed to: They sold property and bought back shares and paid a dividend."

Texas Pacific holds 900,000 acres from the original 3.5 million. It generates revenue a) by selling land and b) from royalties, grazing fees, water rights and easements. In a peculiarity of the long-ago bankruptcy, the trust was granted land in a checkerboard-like pattern. Any pipeline, infrastructure or crew that crosses one of TPL's lots must pay a fee in exchange for the right to operate.

From 2010 through 2019, the trust reduced shares outstanding by 20% and expanded EPS by 3,437%. It boosted dividends per share by 2,900% and book value per share by 2,878%. At the end of the third quarter, the trust had $249.9 million in cash, $3.5 million in operating lease liabilities and no debt.

Compare and contrast Tejon Ranch Co., a land-rich, former *Grant's* click-to-pick. Tejon owns 270,000 of contiguous, largely undeveloped land 60 miles north of Los Angeles. Since we last wrote about the company on Nov. 30, 2012, the stock has sunk 37.6% versus a 169.7% return in the S&P 500. Over this period, Tejon has generated little in the way of net income, expanded its share count by 30% and paid no dividend.

Not that the Texas Pacific bulls are satisfied, either with performance or governance. The TPL board comprises three trustees, each of whom serves for life. There have been four shareholder meetings in the past 30 years by Bregman's count last April. It's the contention of Horizon and other shareholders, including SoftVest, L.P. and the Tessler family, that TPL has sold land and mineral rights at below-market prices. Last year, they pressed TPL to convert from a trust to a standard corporation with a board elected by the shareholders.

The lobbying worked. On Jan. 22, TPL issued a press release recommending conversion into a C-corp. While TPL is not optically cheap at 18.9 times trailing earnings, the change in governance may unlock earnings power. With a definitionally solid balance sheet and no drilling exposure, TPL is also one of the lower-risk ways to play a higher oil price. It just so happens that TPL's West Texas acreage sits over the prolific Permian Basin.

"In one of the few times I used an Excel spreadsheet for analysis," says Bregman, "we projected forward TPL for 20 years under a couple of different scenarios for oil prices and we said, 'If you just hold your shares and don't sell them, in 20–30 years you might be the last shareholder, and you would be incredibly wealthy. You would also own half-a-million acres (or whatever was left) in West Texas.' "

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