GAM Investment Meeting Notes

For accredited, professional, institutional and/or qualified persons only

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Japan

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- Over the past five weeks, our Japan funds have recovered some of their underperformance of the market for the previous four months or so. This underperformance has coincided with a period of some anomalous stock moves. These can be illustrated by looking at individual names, such as Kintetsu, a private railway company, and Nippon Paper – neither of which we own or are likely to own in the future. Both stocks outperformed the market by some 40% over the six-month period to mid-September.
- At present, Kintetsu has JPY 1.3 trillion net debt and shareholders' equity of just JPY 174 billion, which means that its net debt to equity ratio is 7.5x. To put the net debt position in another context, it is extremely large when compared with the company's highest ever annual profit of JPY 23 billion. With such a stretched balance sheet, it cannot fulfil our criteria for a good investment. Yet the stock trades on 2.5x book value, which surprises us. Nippon Paper represents a similar story. The company has more than JPY 800 billion of debt, which has not fallen at all over the past ten years, while its highest ever annual net profit was JPY 30 billion – and even this number was inflated by an unusually low tax charge.
- By contrast, the types of stocks we like in Japan have strong balance sheets and high cash flow generation. For example, Tokyo Electron – currently the largest holding in the portfolios – has transformed its JPY 131 billion net debt position ten years ago into a net cash position of JPY 292 billion today. That is, the company has created free cash flow after dividends of more than JPY 400 billion over a ten-year period. Given Tokyo Electron's current market capitalisation of JPY 726 billion, the net cash position means that the company has an enterprise value of just JPY 430 billion. Relative to its cash flow generation ability of the past ten years – and we have no reason to believe it will generate any less in the next ten – the company is cheap. We find it a very attractive investment.
- Our feeling is that the recent outperformance of stocks with poor fundamentals has been caused by hedge funds unwinding positions and covering their shorts. That outperformance has reversed over the past six weeks, however. Thankfully, companies with such poor underlying fundamentals are a minority within the Tokyo Stock Exchange. An aggregated study of equity market valuations based on a blend of measures reveals that 14 out of the 24 cheapest sectors in the world (ie the cheapest quartile) are Japanese. Conversely, only one of the 24 most expensive sectors is Japanese. That has not always been the case – in November 2008, when the market hit one of its previous lows, only four Japanese sectors ranked in the cheapest quartile, while nine were included in the most expensive.
- The Japanese market is cheap on a cyclically adjusted P/E, based on operating income. Although the market has been on a long-term downward trend on this valuation measure, it is currently 32% below the trend line. Relative to its own history, the market has rarely been cheaper, while it is also considerably cheaper than most other developed markets. The market currently trades on a P/E of 13x consensus earnings, while GAM Star Japan Equity has an average P/E of 11.3x, an average cash balance of 29% of market capitalisation and strong free cash flow generation. The portfolio's free cash flow yield (operating cash flow less capital expenditures) is between 9.3% and 10.9%.
- Despite low valuations, the market may continue to struggle in an environment of an uncertain growth outlook. Investors have remained concerned about the macro environment – particularly a possible slowdown in the US economy and Europe's debt crisis. With respect to the former, the Citigroup Economic Surprise index indicated that macro data coming out of the US has continued to be marginally better than expected, while Japan has surprised on the upside, emerging markets have remained flat and European data has begun to improve from having been quite disappointing. From our point of view, the recent retail and auto sales figures from the US are not consistent with those indicating a return to recession. Meanwhile, European equity markets bottomed versus world markets in mid-September despite the major increase in newsflow surrounding the eurozone, which suggests to us that the concerns may have been digested. Overall, provided that a global recession can be avoided, it will be difficult to beat the likely returns equities can offer.
- Finally in Japan, the potential scandal threatening to engulf Olympus is one blot on the landscape. The company's British chief executive was fired on Friday after he instigated a report on its previous M&A transactions. These included some large payments to unspecified advisors, which could raise the issue of corporate governance in Japan. On the other hand, it could also facilitate shareholders' better oversight of management decisions. For now, it is too early to tell.