March 2010

"Crisis? What Crisis?"

This title of a popular 1970's record album (remember those?) is a somewhat apt description of the financial world at the present time. Government deficits are at post-World War II highs and will remain elevated for years. Economic growth remains anemic, especially among industrialized nations, and interest rates are headed higher. Trade imbalances, high unemployment and sovereign credit rating downgrades pose additional risks. Despite the foregoing, investors continue to ignore the risks and chase yield in the near zero rate environment that persists.

Although government deficits were higher during the war, they ended when the fighting stopped. The level of sustained deficit spending projected in many western countries over the next decade is unprecedented. The huge amount of government borrowing will lead to increased taxation, reduced spending and/or currency depreciation, all of which will negatively impact economic growth. Increased debt issuance and inflation worries have already resulted in a rise in long-term bond yields, a trend that we expect will continue as government credit quality deteriorates. Low interest rates have supported a fragile housing market, commercial real estate and the stock market. In the few countries that avoided most of the pain, such as Canada and China, there are fears of housing bubbles. Central banks are now reducing the liquidity that they provided during the credit crisis and are signaling that rates will rise sooner rather than later. When that happens, borrowers will have to deal with higher interest charges, which will add further stress on the global economy. On a positive note, the global banking system has been recapitalized, and China, India and Brazil are still growing at healthy rates. Our outlook, however, remains unchanged -- we anticipate slower economic growth than in past recoveries.

Based on most valuation metrics, equity markets remain rather expensive. This is true of virtually all mature and emerging markets, with one exception: Japan. In 1989, the Nikkei Index (the Japanese equivalent of the Dow Jones) hit a high of 38,000. Over twenty years later it stands at around 10,000. In so many cases, share valuations are a fraction of what they would be elsewhere. The obvious question is: why?

Japan is the world's second largest economy, soon to fall to third (behind China). As some of you may remember, Japan was the hottest stock market in the world in the late 1980's. Japanese companies were on a spending spree, buying landmark U.S. assets such as Rockefeller Center and Pebble Beach Golf Course, among many others. Books and articles were written about how Japan's long-term growth would eclipse that of the U.S. To quote the New York Times of November 3rd, 1989: "*Japan's Sony Corporation bought Columbia Pictures last month. Now Mitsubishi is paying $846 million for 51 percent of the Rockefeller Group, owner of Rockefeller Center, the vibrant Art Deco cluster of 19 buildings in the heart of New York City. Is the transfer of American assets to Japanese ownership something to worry about?*" Goldman Sachs, among many others, forecasted the continued ascent of Japan and created new valuation metrics to justify the stratospheric valuations of the Nikkei Index. As is so often the case, the opposite occurred.

Since 1989, Japan has been in a virtual recession. The real estate and stock market bubbles of the 1980's imploded and Japan's major banks were forced to go through a painful restructuring. Due in large part to poor regulatory oversight (sound familiar?), Japanese banks had allowed insolvent companies to continue to operate, in order to avoid declaring losses on loans. It took over a decade to clean up their financial system.

When the downturn started, the Japanese government was slow to address the problem. Stimulus spending was inadequate and poorly targeted. The central bank actually raised interest rates at first, further exacerbating the problem. By the end of the 1990's, the government had announced ten different stimulus packages, totaling almost one trillion dollars, but the economy never recovered. Ongoing government stimulus, combined with a weak economy, has led to Japan having the highest government debt-to-GDP of the G8.

Despite interest rates being reduced to almost zero (10-year Japanese government bonds yield 1.3%) and the ongoing stimulus, Japan remains mired in a stagnating and deflationary economy. Deflation helps explain Japan's high savings rate. People do not spend money when prices are declining, they save. The high savings rate has allowed Japan to finance its debt internally and not have to rely on foreign bondholders. Additionally, with a stock market that has fallen some 70% over the past twenty years, Japanese investors have gravitated toward bonds, notwithstanding their low yields. Therefore, despite a debt-to-GDP burden that is among the highest in the industrialized world, Japan is still able to finance its deficit at very low interest rates.

Japan also faces a demographic problem. As is the case with most industrialized countries, Japan has a low birth rate. However, due to historical and cultural reasons, and unlike most western nations, they have yet to embrace immigration as a means to solving this problem. The result is a country with the most aged population in the world and one that is now in decline. The only effective solution will be to encourage immigration. Until that happens, the savings rate will likely decline.

Given all of the above, investors have ignored the Japanese market for a long time and shares in so many Japanese companies are trading at valuations that defy rational explanation. Focusing only on companies with little or no debt and a long history of profitability and dividend payments, we have already found a number of companies whose share prices are trading for less than their working capital. In other words the value of their cash, receivables and inventories less their debts, is greater than their share price, even if we place zero value on their actual business! Given Japan's close proximity to high growth countries such as China, many of these companies are well positioned for export growth.

As conservative value investors, we are always searching for companies whose share price does not reflect its intrinsic value. Japan currently offers such an opportunity, which we are actively exploring. While it has been difficult to find undervalued companies in the present environment, we recently found and initiated a position in one such company: ING Group.

ING Group

ING Group is a Netherlands-based financial services company that is one of the largest providers of banking and insurance services in the Benelux region. Its insurance operation has an excellent business mix, with a strong market position in North America and a large exposure to emerging markets. On the banking side it has been particularly successful in the retail space, where it has built a strong franchise by focusing on simple products, transparency and cost efficiency. Their ING Direct division, which you may be familiar with, has become the world leader in virtual banking (with over 22 million clients). ING Direct's success can be attributed to a simple approach: attract consumers with competitive savings rates (which they are able to offer because their cost base per client is approximately 1/3 that of traditional banks) and then cross-sell other products.

Before the financial crisis, ING was regarded as a high-quality bank with a defensive profile. Their leverage and exposure to structured credit products and real estate badly wounded them and they were among the first European financial institutions to receive government support (October 2008). At the time, conditions for financial aid were quite punitive and the terms were considerably harsher than those associated with other European rescue plans. The terms were recently improved (subject to European Community review) when the company re-paid the Dutch State half of the 10bn Euros that they borrowed. If the deal is approved, they will likely enjoy a similar arrangement on the balance of the loan.

ING has taken substantial charges since the end of 2007, but the worst appears to be behind them. Although impairments still remain at elevated levels, the future losses look very manageable. One of the conditions of the government loan was that their dividend be suspended until the financial support is re-paid. In order to comply with regulatory requirements, the company is in the midst of a restructuring program. This will involve deleveraging, cost-cutting and a likely divestiture or split-off of their insurance assets.

The restructuring plan appears sound and ING should remain a top-tier financial services company. The current share price reflects a myopic view, with investors placing a heavy focus on short term balance sheet issues and being overly cautious about the sale of their insurance division. However, the underlying operations are profitable and margins are improving. Looking past these short-term issues, once the government loan is repaid, the dividend will be restored and the fair value of these shares should be reflected in the marketplace.

As always, we remain vigilant in ensuring that every investment we make meets our strict criteria and has a substantial margin of safety.

Sincerely,

Lorne Steinberg