



Buy Japan

Tim McElvaine

Okay, I admit it. I am a value investor. That strange beast that fears good news and basks in the shadows of disappointment and despair. Most important, I do not wish ill will on anyone but I need a competitive advantage when I am going to invest and that advantage is a willingness to invest when others are fearful. The situations I am involved in often are messy but I am an optimist. I believe in people, in their ingenuity, in their ability to rise like the phoenix from a difficult situation. I call this ABBA investing. This acronym represents what I look for in investing and is as follows:

A – Accident

As Sir John Templeton said, *“If you’re going to buy the best bargains, you have to buy the things that other people are selling.”*

What that means to me is I deal in nightmares, not dreams. I look for people who are selling for reasons other than prices such as:

- The sector, industry or a region people are avoiding.
- Bad news such as a dividend cut, downgrade, or unexpectedly poor results.
- Special situations such as a spinoff, emergence from bankruptcy or a rights issue.

B – Bird in hand

I worked for over a decade with Peter Cundill and he was one of my largest clients. Peter’s focus was: *Protect the downside. Worry about the margin of safety.*

This means that when I invest, I want to have a margin of safety based on our purchase price. I also consider what the stock may be worth in 3 years. Things I consider include:

- Replacement value
- Liquidation value

- Private market value
- Sum-of-the-parts value

B – Brick house

Many times Indy champion, Rick Mears, said it best when he said, *“To finish first, you must first finish.”*

Bottom line is that I want to ensure the company has the capacity to survive and prosper. Think about the story of the Three Little Pigs; the pig with the brick house survives the wolf. There will always be wolves in business and my job is to look for cheap brick houses. I consider:

- Balance sheet strength
- Free cash-flow generation and capital requirements
- Market share, competitive positioning and the relative cost of production

A – Alignment

The last part of my process is to think about the incentives and focus on the board and management. Warren Buffett said, *“If you’ve been playing poker for half an hour and you still don’t know who the patsy is, you’re the patsy.”*

In the 1970s, the Kinks had a hit with the song Lola. It was a story about a young man who meets a woman named Lola in a bar. After a fun-filled evening of drinking, dancing and snuggling, our hero is surprised to discover Lola is in fact a man, not a woman. Similar to this story, I prefer to understand, prior to the “final act”, the motivation and interests of the board and management. Things I consider include:

- Stock ownership of directors and management
- Insider buying
- Management compensation programs
- Independence of the board

This brings me to an area I have invested in, on and off, for the last 20 years with reasonable results. I am referring to Japan. First, as a point of clarification, I am not a perma-Japanese bull.

Japan has suffered recently with the terrible earthquake and tsunami. This was a horrible human tragedy that will undoubtedly have a significant impact on economic activity. Further, Japan has significant problems in what I call the D²: debt and demographics. I mean the population is, on average, relatively old and the government has a significant amount of debt. Frankly, I do not know the solutions.

As a value investor there are always negatives. The margin of safety is generated by the price you are paying. In other words, my focus is on what I am paying and what I am getting. You get a lot in Japan today.

The bull case rests on cheap valuations both on cyclically adjusted PE (which rivals the valuations of February 2009) and cheap on a price-to-book basis. Many of the businesses have great balance sheets and strong operations. Corporate governance is, of course, different from the U.S. and Canada and varies widely between companies. This takes some reflection prior to investing. A final positive is that there is a lot of liquidity in Japan as a result of government injections into the system as well as funds arriving in Japan due to repatriation of overseas investments. Cheap valuations, plus liquidity, usually equal higher equity prices.

So much for the macro view, I am a bottom-up stock picker. What I mean is, as described above with ABBA, I pay far more attention to what I am buying than the noise around the situation. Japanese securities I have bought recently include Sony Corporation (symbol 6758), Kikkoman Corporation (2801) and Monex Group (8698). (The numbers are their Japanese symbols if you are able to access the Japanese market.) Sony's ADR has an active market in the U.S. and its symbol is SNE. Kikkoman and Monex rarely trade outside of Japan, so please be careful if you are contemplating a purchase. Their symbols are KIKOF and MNXBY respectively.

Finally, this is not a decision done in the isolation of an office. I was in Japan in February (pre-quake) and will be back in Japan in late April. So, my fund owns a lot of Japan, based on price. That's what I do. I'm a price-sensitive contrarian. Sure my portfolio might not lead to great cocktail party discussions but I sleep well at night.

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Dale's note: Tim developed his value-oriented philosophy during his 12-year career with Peter Cundill & Associates Ltd, where, amongst other capacities, he served as manager of the Cundill Security Fund (1992-99), co-manager of the Cundill Value Fund (1998-2003) and chief investment officer (1998-2003).