Inside the Market *By Patrick Bloomfield*

For contrarians, Japan beckons

The time to buy stocks is when they are down, but not out, and look as if they will survive to rise another day.

That is precisely the thinking that a few bold contrarians have in mind for the Tokyo market. As one example, the Microsoft Investor Network had a recent piece about three contrarians making their pitch at the Morningstar Mutual Fund conference in Chicago.

Montreal contrarian Benjamin Horwood, president of Value Contrarian Asset Management, echoes their theme: "For contrarians, recession-wracked Japan beckons."

Politically, at least, the calls are timely. Elections to Japan's upper house take place this Sunday. Once they are out of the way, Prime Minister Ryutaro Hashimoto and his government can get down to shutting down stretcher-case banks, getting problem loans off the books and cutting taxes — or so the optimists say.

Not every North American money manager shares this optimism. Most would like to wait until there are some credible indications of action.

Horwood makes no bones about the true nature of Japan's economic woes. Gross domestic product fell in the first quarter of this year at an annualized rate of 5.3%.

Japan, he stresses, is suffering more than a cyclical downturn in the business cycle. The dismal performance of the Tokyo stock market (once the top global performer) speaks for serious economic and political management.

Specifically, Horwood argues that the economy, and Japanese businesses in particular, allocate capital inefficiently. The financial system created after the Second World War was designed to turn Japan's impressive savings accumulation into cheap loans for industry through the banks.

Thus, the banks have not operated as profit-driven entities accountable to independent shareholders, but as government-influenced institutions serving industry — or what Horwood describes as the "incestuous" *keiretsu* system.

The *keiretsu* system is a grouping of industrial companies around one of the major banks. The banks own shares in these companies and make loans to them at cushy rates. The corporations, in turn, own shares in the banks and in each other.

In keeping with this cosy relationship, a bank keeps lending to companies in its group, even if it is in financial trouble. And the companies buy from each other, regardless of price.

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The net effect has been to insulate the bank-nurtured firms from the marketplace and from shareholders.

As Horwood suggests, this old pals network is changing. And it is no surprise that some of Japan's multinational success stories — such as Honda Motor Co. Ltd., Toyota Motor Corp. and Sony Music Entertainment (Japan) — have been independent of these institutional networks.

Horwood says contrary to the North American belief that managers are best motivated when their own money is tied up in the business, Japanese management usually owns no shares in the company it works for, although holding stock options has recently become acceptable.

Without holding a solid stake in a company, and with a ready capital conduit, what is there to spur management to pay heed to outside shareholders or the marketplace?

Japan's major impediment to economic recovery lies in the problem loans from its financial system, which Horwood estimates to be near US$551 billion. The government recently announced a bunch of initiatives broadly similar to the measures Washington took when it, too, faced the daunting task of cleaning up problem loans in its banking system.

But to make this work, you have to get bad assets (largely real estate) that are the collateral for the bad loans off the banks' books and into the marketplace. That is easier said than done, in the face of bankers' reluctance to bite the bullet. Investors around the world are waiting to see whether the government will follow through. Until something concrete is done to clean up the bad loan mess, expect them to remain skeptical.

But here is the other side of the coin: By the time Japan's rulers have cleaned up the country's banking system, the Tokyo stock market will be well off its lows. That is precisely Horwood's argument for looking at Japanese stocks now.

He recalls the early 1990s in North America, when the Dow Jones industrial average bottomed in October, 1990 — way ahead of the eventual recovery in the U.S. banking system.

Two years later, when banks were beginning to generate profit again, you could still buy Citicorp shares for US$11 The stock (CCI/NYSE) is worth about US$160 today.

Investing in the doom and gloom of a deep recession often generates the best gains. That is why Horwood is preparing his Japanese investment dossier right now.

Patrick Bloomfield, a Financial Post regular contributor, invests in securities and may hold issues mentioned in this column.