Sunglasses and Cockroaches – Six Rules for Surviving in a Bear Market

By Michael Skocpol
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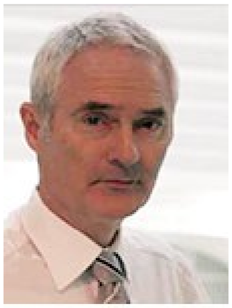
Peter Tasker

After more than three decades investing in Japanese securities, Peter Tasker has little patience for other investors' self-pity – and he doesn't want to hear your horror stories from 2008.

"For the last 23 years I've been eating, drinking, sleeping, living 'bear market,'" Tasker said at a recent lecture. "When we talk about a bear market – a real bear market – what we are talking about is stocks crashing and staying crashed. People are wiped out. I'm not talking a few individuals, I'm talking a generation."

Tasker is a highly respected analyst whose focus has been on the Japanese market. He is the author of a number of best-selling books on Japan and its economy.

Japan and the lessons of its so-called "lost decade" – which has now long outlived that moniker – were the focus of Tasker's lecture, which he delivered at a strategy conference hosted by Societe Generale in London last week. He offered hard-learned lessons about what it takes to invest in the kind of persistently dour environment that has prevailed in Japan since the 1990's, peppered with occasional tongue-in-cheek holier-than-thou admonitions like the one above.

Tasker's talk covered three major themes: (1) the relevant features of the kind of persistent, post-bubble bear market that Japan has experienced over the past two decades; (2) what strategies make money in such an environment; and (3) common myths and misconceptions about Japan and the headline-grabbing shift that its economic policy has undergone in recent months.

His overarching theme was just how differently a long-term malaise like Japan's forces you to see the world, and how a patient, survivalist outlook – pessimistic but constantly adaptable – is the key to finding success when market headwinds are unrelenting.

"It's a kind of Stockholm syndrome. After a while it changes you," Tasker said. "You just get used to it and adapt to it. And as you adapt to it, you create it."

We'll hear Tasker's perspective on recent developments in Japan, but first let's review how he described the investing philosophy that's allowed him to find success in the Japanese marketplace – and why he's proud to declare his kinship with the lowly cockroach.

What “a real bear market” looks like

Tasker began his talk by laying out in more detail the environment he has faced trying to invest in Japan since the bubble burst there.

The clearest illustration of just how bad things have been in Japan, and for just how long, said Tasker, is if you consider a Japanese person who is nearing their 30th birthday. He or she “finds that the stock market is at the same level as when they were born,” Tasker said – the market today is at the same level it reached in 1984.

When an economy crashes as badly as Japan’s did, Tasker said, the effects are wide-ranging and persistent – and they include some consequences you don’t necessarily consider. The Japanese markets for the last 20 years, Tasker said, can be viewed as having experienced “a course of continual decline” – “a deflationary, very low-growth, stagnant environment with a lot of financial risk” – that defies traditional notions of how markets are supposed to work.

After all, even the stormiest conditions are supposed to take a turn for the better sooner or later, aren’t they? Not if things have gotten bad enough, according to Tasker. “At some point, conditions improve. You see the fundamentals start to turn positive,” he said. “And guess what? Nothing happens, because nobody is there. Nobody is watching. That is the most soul-destroying part.”

That’s in part because Japan’s crash was so severe that it decimated broad swaths of its financial industry, Tasker said – jobs that have not returned. Tasker couldn’t help ribbing his audience for the dire headlines in London, where he was speaking, reporting that financial jobs are down 6% since the 2008 crash. “Luxury!” Tasker joked.

Meanwhile, uncertainty abounds. Lack of growth in overall economy means “much greater profit volatility” and therefore more cost-cutting for Japanese companies. The kind of lifetime-with-a-single-company employment that Japan is known for “now applies to a very small segment of the Japanese workforce,” Tasker noted, adding that more than a third of Japanese workers are now employed on significantly less secure part-time contracts.

All of which has meant shaken faith in the fundamental role of equity markets. Japanese households these days keep more than half their assets in cash or cash equivalents, Tasker noted. Companies keep “balance sheets stuffed with cash,” which they are reluctant to bring to market. And Japanese investors find they rarely have anywhere to turn to eke out even meager returns, thanks to the disadvantages of investing in yen.

“Japanese pension funds have a required return of around 2% or 3% a year, and they have a great deal of difficulty in making it every year, because everything from the yen point of view looks terrible,” Tasker said. “So it is not just Japan that is deflating. From the Japanese angle, the Japanese perspective, the entire world is deflating.”

The name of the game is value

In such an environment, what works well is somewhat counterintuitive: In Tasker's experience, value investing the way to go.

Tasker said that his experience contradicts those who might argue that in a stagnant, risky marketplace, "more companies are going to go bust, are going to need restructuring, are going to need to issue more equity as you get into more financial difficulties," rendering value stocks a bad bet.

On the contrary, Tasker said, these stocks have greatly outperformed expectations, while safer-looking growth stocks have shown themselves to be much more vulnerable to the vagaries of a persistently sour economy.

"Bad markets are about surprise and they are about de-rating," he said. "What gets de-rated is the stuff that is highly rated. The stuff that is lowly rated has got that much less of a hurdle to jump and that much less potential to be de-rated."

By way of example, he recalled that in 2003, shortly after Japan experienced its second banking crisis in less than a decade, the press widely publicized a group of companies, dubbed the "Dirty 30," which were supposed to be on the verge of inevitable bankruptcies in the wake of the crisis. "A couple of those 30 companies did in fact go bust," Tasker said. "The remaining 27 or 28 quadrupled and quintupled stock prices."

Conversely, Tasker said, "People find a group of companies that appear to be great because they are bucking the trend of the poor economic environment and appear to be prospering. Guess what? It doesn't last."

For Tasker, the lesson of Japan is that when markets sour, seeing everything through the dark lens of pessimism is best. "What is dangerous, actually, is optimism," he said. "You have to wear your sunglasses. Be like Bono and wear your sunglasses all the time, even in the shower."

Finding your inner cockroach – six rules for survival

Cockroaches may or may not take over the Earth after the human race wipes itself out, but they are proven survivalists – 300 million years and counting – and, according to Tasker, they make pretty good role models in a bear market. Tasker laid out five lessons he's learned from his antennaed role models.

1. **Be omnivorous.** Cockroaches survive by being some of nature's least-picky eaters – they've even been known to eat plastic, according to Tasker. Likewise, "as a value investor you have to be prepared to look at anything, looking across the spectrum of

all kinds of stocks," Tasker said. "Sometimes they may be slightly unappetizing – or putrid, even, as the Dirty 30 I mentioned. But if they are cheap enough, if the price is low enough, they are worth looking at."

2. **Have a hard shell.** Tasker advised bear market investors that they would have to learn how to endure pain, because the kind of investing that succeeds in these markets requires taking risks that won't always turn out well. "People say to you, 'Look, everybody knew this company had trouble, had problems, everybody knew about their management. You are supposed to be experts and you invested in it. Look at what happened. You're an idiot,'" Tasker said. "What can you say? You just smile and say yeah."

3. **Thrive in extreme conditions.** Cockroaches keep going in any weather, and so should you. Tasker said this was one of the benefits of focusing on value. "Value stocks did well in Japan in the 1980s as well," Tasker noted. "During a ferocious bull market they did well, and they have continued to do well in the bear market, and the financial-crisis-type environment since then."

4. **Learn how to scuttle…** Just as cockroaches can quickly scuttle in any direction when the light comes on, you have to be able to move from one definition of value to another as conditions change – be relentlessly responsive to the market situation as it evolves.

5. **… but be prepared to hide in the dark.** Market conditions shift inevitably, but it doesn't happen overnight. In the meantime, you need to have the patience to wait things out, even when it feels dark and lonely. This is particularly true in Japan, because, thanks to Japan's decimated financial sector and aversion to equities, analysts simply don't cover parts of the market, because no would-be analyst can make a decent living. "For patient investors, you can hide in these positions for a long time," Tasker said. "They can rise quite significantly, and still no one cares. You can exit, and still no one cares. Nobody has even noticed."

Forget what you think you know

In closing, Tasker discussed some common misconceptions about Japan, and gave some hints about where it might be headed.

For one thing, Tasker said, the common conception that Japan has been maintaining persistently low interest rates for too long isn't really accurate. Though nominal rates have indeed remained low for some time, he said, Japan has actually had positive real interest rates because of its relatively consistent deflation in recent years. "The reality is there has been a real interest rate, a significant real interest rate, in Japan, which all borrowers have had to contend with," he said.

A related myth, Tasker said, is the old saw among many economic thinkers that Japan's experience proves the ineffectiveness of quantitative easing (QE). In fact, Tasker said, Japan has never really attempted the kind of "full-blown" QE program that the U.S. and Britain, for example, have in recent years.

True, Japan's adopted a policy of maintaining interest rates at zero for a time in 2001 and 2002, but headline deflation at the time exceeded one percent. "They never penalized holders of cash," Tasker said. "Holding cash continues to be a good thing to do in Japan."

The Fed has purchased long-term bonds as part of Operation Twist. But Japan's approach to easing was fundamentally different. "The main focus has been buying short-term bonds off the banking system and creating current balances at the central bank itself," Tasker said. "Though it is not zero, there has been very little purchase of long-term bonds" from nonbanks.

What's more, Tasker said, "the mood music was completely different" – Japan's lack of conviction in its easing programs was evident. "When they occasionally did these things, they just let the market know that they didn't believe they were going to work. And as soon as they possibly did, they would quit and start raising rates," he said.

One knock against QE is that it leads to overvaluations, but Tasker saw that as a non-issue in Japan. It's true that distorting effects may show up in the asset markets before they'd hit the real economy, he said, but Japan's situation is simply not one where overvaluation should be a salient concern, he said. After all, if the Japanese market is below its 50-year moving average –Tasker told his audience – it's hard to look at that and see overvaluation.

All of this, Tasker said, points to just how fundamentally different your outlook has to be to properly appraise the situation in Japan. It's almost as if, for the Japanese, the passage of time isn't a relevant variable anymore.

"It is like going back into the medieval period," Tasker explained. "In the modern period we tend to think as years go by the world changes, and there is some kind of upward gradient. They didn't think like that in the medieval period. It was just seasons that change. The world doesn't change."

Michael Skocpol is an editor and staff writer for Advisor Perspectives.