INVESTMENT REVIEW

One of the bores about becoming a bigger organisation is that the financial press take an interest in our views. A murmur about the desirability of underwater basketweaving companies at a *pâté de foie gras* party, and the interest is noted; expatiate on the possibility of a bull-run in titanium, and someone, somewhere records it for posterity. These are, in normal times, the warble flies of life; a lazy flick of the bovine tail keeps them on their wings, and life continues as before.

It is relevant today because we are known as a house to favour Japan: we have almost one-third of our equity exposure there – and for those who have had bin-liners over their heads for the last three weeks or so, we can report that there has been a massive earthquake, social dislocation and economic mayhem, and a sickening fall in the Japanese stockmarket.

The valuation which accompanies this investment report should deal decisively with the question: have our portfolios been badly hit? The answer is: scarcely at all, and the reason for this is the same reason which always applies in a Ruffer portfolio – it is not that we did not lose a lot of money in Japan (we did), but that other, offsetting, assets did sufficiently well largely to neutralise that mischief. If investors wish to worry about their money at Ruffer, they should worry that we lose the ability to find differing sorts of investments which act as offsets to one another. It is this ability which has kept the portfolios safe these many long years.

The rest of this investment review will largely be taken up with assessing the future of Japan through an investment lens. In this we are much helped by regular visits to that country; indeed we had two members of the team out there when the earthquake struck: they got out safely: Kentaro Nishida returned to Japan the following week to assess the situation on the ground, and this report relies heavily on his insights.

Our conclusion is that, while in the short term the direction of the markets is anybody's guess (and may well be frighteningly volatile), this is a turning point which will introduce the structural changes in Japan and, in turn will lead to a sustained bull market lasting for years. There is, frankly, no other market for which this is a remotely possible outcome.

Our enthusiasm for Japan at the beginning of the year was opportunistic. The political background was poor even by their desultory standards: the mire was hardening from mud to concrete. It left the Bank of Japan, always timid, always looking over its shoulder at the politicians, free to tiptoe towards a policy of boosting the stockmarket. This argued for a tradeable rally in Japan (which duly happened) – but the danger was that this rally would relieve the anxieties of the authorities who would feel a corresponding lethargy in tackling the structural problems.

Japan's problem is its timidity. A senior official in the Tokyo Stock Exchange explained to us that 'Japanese investors suffer from vegetable spirits' – and not only the investors. The refrain we heard on our trip was, 'If only there were a crisis' then changes could occur. We now have that crisis: Japan is reeling. The economy, beset with supply dislocations, electricity rationing and infrastructure damage, is bound to contract in the short term. The oil price is sky-high; this is an unlikely combination since economic contractions are usually brought about by conditions which cause oil demand, and by extension oil prices, to fall. And the yen, which needs to go down, to combat the deflationary forces, was forced up, as money was repatriated. A three-pronged trident aimed at the throat of Tokyo: the options for doing the wrong thing – of opting for a deflationary solution – are now decisively removed. Having a first-hand Japanese insight into the situation is immensely valuable. Kentaro's view is that although there is a strong reluctance to accept that existing models and ways of behaviour are no longer working, when the Japanese do accept it, they will change their ways with comprehensive effectiveness and lightning speed. The original westernisation of Japan during the Meiji dynasty is typical of this, as was its post-war reconstruction in the 1950s and 1960s. We are witnessing, we believe, another such turning point.

One of the striking features of a first visit to Japan (I am told) is that what looks from the outside like a twenty-year old recession looks from the inside like a very rich country at ease with itself. The inexorable rise in debt which has accompanied this prosperity would not look alarming in the west, because the size of the western economies has grown, too: little matter that much of it was 'money illusion' (ie inflation): nominal growth of gross domestic product was the necessary ingredient. Last year Bank of Japan officials noted the widening gap between rising government expenditure and falling tax-take: this was laughingly referred to as the alligator's jaws. Now they all appreciate that it's snap-back time.

We expect to see massive injections of liquidity into the system from the Bank of Japan. They know exactly what to do; up until now, they have chosen not to do it. The effect will be to bring about top-line growth to companies: and to the economy as a whole. It will be bad for the yen (which will be good for Japan). It will cause interest rates to go up: everybody in the west worries about the harmful effects of increased borrowing costs, but what about the boost to savers? In a country where literally all the debt is owned locally, that is pretty much a one-for-one transfer. It will, over time, remove anomalies, and anomalies are the bane of economic effectiveness.

One of the least convincing arguments against long-term hope for Japan is demographics. Statistics show that the last Japanese couple die of old age in about 150 years' time. It's a ridiculous argument, matching almost the eminent Victorian economist Professor Jevons' theory that recessions were caused by sunspots. For one thing, known problems nearly always get solved – it's the unknown ones which do the damage. Secondly you could cite example after example of a static population economy performing in line with those whose population is growing. France's failure to grow its population from the 1850s up until the 1920s seems to have had no adverse impact on its GDP growth (although it did alarm the military strategists as Germany grew stronger in terms of the numbers of its citizenry).

If there is a worry in all this, it is that both our Japanese investments and our index-linked holdings are jam-tomorrow ideas, which leaves us somewhat at risk if we find ourselves in a jam today. We think it is an acceptable one: the risk is neither probable nor extreme, but it highlights an eternal truth: the performance of the portfolios here does not come without risk.

Jonathan Ruffer

April 2011