Haven't we seen this before?

"May you have the hindsight to know where you've been,

The foresight to know where you are going,

And the insight to know when you have gone too far."

– Irish Blessing

Last year, we witnessed the greatest economic slowdown since the great depression. This followed the bursting of the US housing market bubble and the subsequent financial market meltdown that went on to envelop commodity markets and emerging markets.

Whilst evidence of economic recovery continues to grow, it is notable that it is emerging economies that have led the recovery and sub-Saharan Africa, which has comfortably outperformed the globe in terms of economic growth since 2001, was one of the best performing regions last year. So good is this area that a cover story run by Time in March 2009 proclaimed that: "Africa offers more opportunity than any place in the world."

Debt bubbling over

To facilitate recovery in advanced economies, however, we saw policy makers in the developed world throwing money at their problems in the hope that the troubles would disappear. Sadly, this is a far-from-likely outcome. The US federal deficit, at 9.9% of GDP, is the highest it has been since World War II and national debt is approaching 100% of GDP – well beyond the safety threshold of 90%. Perhaps the clearest anecdotal evidence of ballooning government involvement in the US is given by the fact that while the US median household income has risen 32% in real terms since 1970, government spending has escalated by 221%. This meteoric rise in spending is unsustainable, and brings to the US a debt burden that is unprecedented.

Things are no better across the Atlantic. The unfortunately-named PIIGS, Portugal, Ireland, Italy, Greece and Spain, are laden with debt and Pimco's Bill Gross describes UK gilts as "resting on a bed of nitro-glycerine". Again, anecdotal evidence offers enlightening insights: European capital markets are pricing the risk of large company default at the same level as government default. This is a profound feature of the capital market landscape.

Unfortunately for governments in these advanced economies, tax revenues are proving to be woefully inadequate to repay the debt and reduce the fiscal deficits. While governments could still reduce spending and wait for economic growth to play catch up, thereby retiring their national debt, countries instead have resorted to the "Zimbabwe option" of printing money.

This is clearly another bubble in the making and a sharp rise in price inflation is a likely result. Another likely implication is that advanced economy currencies will become engaged in a race to the bottom. This substantially complicates the risk of investing in these markets. As things stand, investors should avoid sovereign debt – especially in advanced economies – until pricing excess has worked itself out of the system.

But that's not all

Simultaneously, another bubble is forming in China. While the Chinese economy has succeeded beyond all expectations, it would be a mistake to equate economic growth with investment success.

In the past 20 years, China has been flooded with capital. This has led to over investment and, in its wake, returns on capital have collapsed. But investors are mesmerized by China, to the extent that still more capital is being sucked into the country, further squeezing returns. Chinese credit extension has grown 30%, leading to high multiples on equities and real estate – each a classic sign of an asset price bubble. Other evidence of a bubble can be seen in the Graham and Dodd price-earnings ratio of 50 times in China. This is more than three times the "fair" ratio of 15 times. To boot, the view that these multiples can be justified because China is growing fast reeks of the "this time is different" approach to investing.

To be clear, the mood that is sweeping capital markets at present is a form of "one-wayism". Investors believe that China is a one-way bet to success: this concerns me. As Peter Tasker observed: "… there has never been a bubble that hasn't burst …".

So where does this leave investors?

Investment success is as much about what to avoid as it is about what to buy. We need to be acutely aware of the risks posed by asset price bubbles. For this reason Cannon Asset Managers has no direct exposure to China and no ownership of advanced economy sovereign bonds in any form.

As deep value managers, we seek out-of-favour investments where assets are mispriced. To borrow from Joel Greenblatt, I know a place where great companies are sold at half price everyday and it's called the market. Two examples of this type of opportunity are given below, and each provides a clear demonstration of our investment philosophy.

More than a flash in Japan

Japan has been written off by most investors because of its aging population, massive debt and price deflation. But, when investors become too pessimistic, there can be enormous opportunity and we see deeply underpriced assets in Japan.

The economy is highly geared to world economic growth. In the recent recession, Japanese industrial production fell by three times the world average, but in the trough to recovery phase, it is witnessing a three-fold rate of growth relative to the world average and this goes straight to the top line.

In addition to growing at a faster pace, Japan's profit growth is 30% faster than other manufacturing-led economies. Moreover, Japan's fastest growing market is China. So if you believe in China and want exposure, a far cheaper route is via Japan. In fact, Japanese assets are so modestly priced that the price:book ratio of Japan's Topix index (equivalent to the US's S&P500) is only 0.7 times the world average, while its relative p:e ratio is close to an all-time low.

The typical listed Japanese company has the equivalent of 25% of its market capitalisation in cash on the balance sheet, making these assets that much more attractive.

Building Value in South Africa

Turning to the case of South Africa, while pessimism abounds at home, this should not translate into a negative market view. In spite of the despair, there are structural factors, such as our fiscal prudence and monetary restraint, which will support our economy. Our inflation rate has declined and is relatively low and stable. Infrastructure spending is to continue, supported by the budget policy statement.

Cyclical factors play to this same theme. The global economy is pulling out of recession which will support our export industries. Domestic demand and production are beginning to recover, as seen in the vehicle sales and manufacturing figures, while a fillip is anticipated from this year's FIFA World Cup. Whilst earnings have slumped in the past 18 month, from this low base, we expect to see a recovery of some 20% over the next year.

Within this landscape, there are interesting opportunities. One of the best examples is the building and construction sector. The state is set to spend R850bn on infrastructure over the next three years. In addition, we can look to US$22bn per annum infrastructure spending in Africa, A$297bn over five years in Australasian and Pacific infrastructure and US$272bn construction in the Middle East over the next five to seven years.

South African building and construction companies are likely to be the beneficiaries of much of this spend, but this is yet to reflect in their prices. In 2007, Murray & Roberts was on a p:e ratio of 35. It is currently in single digits. Group 5's p:e has fallen from 25 times to 6 times, despite better than 20% earnings growth over the last year.

In this setting, Aveng makes a compelling case. With a market capitalisation of R14bn, the company had cash of R8bn at its June 2009 year-end. The company's EBITDA earnings were R3bn, yet it is priced on a price:book ratio of only 1.5 times, a p:e ratio of 7.4 and a healthy dividend yield of 4.1%.

Immediate earnings growth may be muted, and probably negative, for these companies. Beyond that, however, there is important growth, even outside our borders.

Another example of a fallen angel is GijimaAST. This technology counter has a market capitalisation R1.1bn and cash of R625mn at the December 2009 interim period. GijimaAST's annualised EBITDA was R250mn and the counter is on a p:e ratio of 7.5 times and its maiden interim dividend puts it on a dividend yield of a high 6.3%.

Being contrarian is the only way to beat the herd

In a world that has seen much relief in the past year, we bring the view that this time is never different. Successful investing is about two key attributes. The first of these is about knowing what doesn't work in investing or, more clearly, what not to own. Asset price bubbles provide the clearest cases where investors risk capital loss. On this score, William Bonner in Mobs, Messiahs and Markets (2007) notes "If an investor merely recognizes the way mob sentiment works, he is far ahead of most others." The current landscape makes evident that the devastating bubbles of the past decade are not yet something of the past.

The second key attribute is a keen understanding of what works in investing. On this score, three features stand out. The first is a willingness of the investor to build portfolios that look different to the market: the only way you can hope to beat the market is by being different to the market. Equally, this contrarian stance demands a second attribute, namely perspective, or the ability to see what others miss or refuse to see. Third, by embracing these factors and seeking those stocks which are mispriced relative to their true worth (i.e. value stocks) an investor will be able to construct a portfolio which can outperform the market.

Only a small minority of professional investors has consistently beaten the market and they are overwhelmingly contrarian, value managers.