



# Financial Crisis Report

Written and Edited by David M. Miyoshi

## Advancing in a Time of Crisis

### THE NEXT BIG FINANCIAL CALAMITY?

Inside this issue:

1. **The Next Big Financial Calamity?**
2. **Japanese Stocks to Soar?**
3. **Is This America's Destiny?**

Except for the Great Depression, we are experiencing the most economically unstable period in the history of the modern world. This period will be marked with extreme fluctuations in the stock, commodity and currency markets accompanied by severe and sometimes violent social disruptions. As is typical of such times, many fortunes will be made and lost during this period. After talking with many business owners, executives, professionals and government officials from around the world, the writer believes that for the financially astute investor, this is a time of unprecedented opportunity given the global trade unbalances and distortions in the commodity and currency markets. The *Financial Crisis Report* is a free compilation of the opinions of David Miyoshi as well as of those advisors he himself subscribes to (with appropriate credits given) on how to benefit during this time of crisis. The writer receives no compensation of any kind from any advisors whose articles or ideas may appear in this report. The reader is welcomed to check on all sources of information mentioned herein. Because the opinions and observations of this writer and other advisors are provided herein without charge, the reader is asked to make his/her own judgment on the contents.

There are two basic ways of valuing the stock of a corporation. Both ways rely on assumptions to arrive at a current and future price.

The first way of valuing stock is to calculate the sum of the future cash flows it will provide to investors. Seasoned investors quote the famous adage that a stock is worth no more than the sum of the future cash flows it will provide investors. These cash flows can go directly to investors in the form of dividends or be reflected in a growing future share price or both. But to make this model work, we need to rely on the assumption of growth. And that is a problem because who knows what the future will bring? Even a very large mature company who has a steady history of paying dividends can for whatever reason either stop the dividends or change them. But, without a crystal ball that actually works, these models are the best we can do, as long as they are kept up to date.

The second way of valuing a stock is to value the assets (i.e. inventory, buildings, equipment, etc.) of the company. The operative assumption here is that the valuation of the assets is correct. In other words, we trust the accounting, which is a reasonable expectation given that accounting firms (at least in the developed countries) are highly regulated by government and organizational rules. But is this expectation truly realistic? Back in the 1980's this issue was aired by Richard Maybury, a well-known investment advisor who publishes the *Early Warning Report*. But at that time no one really took notice or even seemed to care about such a problem.

But let's illustrate this assumption. Suppose you wanted to buy shares of a large auto parts manufacturer and with that expectation you

inspect the balance sheet of the company and you note that it has 7,345,280 pistons packed in small cardboard boxes which are currently housed in shipping containers in ports in Hong Kong, Sao Paulo and Calcutta. Can you believe that? Do you think that a team of auditors got on a plane, flew to these ports, unloaded the shipping containers, counted the pistons, repacked the boxes, placed them back into the shipping containers and flew home? Of course, most of us do not expect that to happen because the time and effort involved to get an exact count of the number of parts just would not seem worth it.

But let's see what an accountant does. Wikipedia states "An accountant is a practitioner of accountancy or accounting, which is the measurement, disclosure or provision of assurance about financial information that helps managers, investors, tax authorities and others make decisions about allocating resources". The operative words here are "measurement" and "provision of assurance". In other words, an accountant doesn't just check the arithmetic but he should also verify the accuracy of the original counts. But to count more than 7,000,000 parts would amount to a lot of work.

This is why an auditor relies on a provision in AU Section 331 of today's Public Company Accounting Oversight Board statement, approved by the U.S. SEC: "In recent years, some companies have developed inventory controls or methods of determining inventories, including statistical sampling, which are highly effective in determining inventory quantities and which are sufficiently reliable to make unnecessary an annual physical count."

Therefore, it is perfectly acceptable for an audi-



## THE NEXT BIG FINANCIAL CALAMITY? (continued)

tor not to count every single piece of the inventory. He can just take a sample and trust the rest to the company's own records. These days, very little accounting is about counting. Instead, the auditor takes statistical samples, trust computers and checks math. So he avoids having to count all the pistons.

Now, as a practical matter, in the U.S. (as well as in many developed countries in Europe and Asia) this does not pose much of a problem because businesses are generally regarded as being honest. Even in the aftermath of Enron (and perhaps partly because of it) it is very rare for a business to falsify the data. But the U.S. and the developed countries still only comprise just a portion of the world economy. What about the rest of the world? With globalization, it is now a one-world economy and everything is now inter-connected. It would be reasonable to presume that each member of the Fortune 500 owns assets or has alliances in scores of countries.

So how accurate is the accounting in those other countries? Finding an error that is accidental is much different from finding one that is skillfully crafted and creatively hidden. Companies overseas may claim they have the assets but do they really?

The book *One Point Safe* written in 1997 by Andrew and Leslie Cockburn, describes the accounting (or lack of it) for Russia's nuclear weapons. There is no way to know how many nukes the Russians have lost because the accounting was so bad no one knows how many they had. And if we can't trust their accounting for nukes, how can we trust their accounting for auto parts or anything else?

In China the U.S. SEC recently requested the Chinese Big Four firms (Deloitte Touche Tohmatsu, Pricewaterhousecoopers, Ernst & Young and KPMG) to hand over audit work papers related to audits of Chinese companies listed on U.S. stock exchanges and accused the Deloitte firm of violating the Sarbanes-Oxley Act and the SEC Act of 1934. This action led to the Chinese government issuing new rules requiring the Big Four to bring in local Chinese managers to replace expatriate managers. So accounting problems are now beginning to unfold in China as well.

Accounting systems throughout the world are based on the fundamental assumption that most people behave honestly and tell the truth and are not committing fraud. We assume very few people are deliberately trying to cheat us so we don't need to count every last nut, bolt, brick or piston. And we especially trust computers.

Now, is it possible that foreign criminals have noticed this inclination of trust on our part? If we think about the amount of enmity that exists between Washington and Moscow or Washington and Beijing or Pakistan (and certain other countries) would anyone in these countries care if their crooks were ripping off their U.S. enemy?

So accountants may be trusting people in these foreign locales that they really should not be trusting. In this regard, we should always keep in mind President Reagan's admonition "trust but verify".

Accountants and auditors should be aware of the effect of history on the psychology of the people they are auditing. The winners in a war rarely remember much, but the losers never forget. I think this even applies in a cold war. When I recently visited St. Petersburg Russia, I remember checking in to the hotel and when I showed the receptionist my U.S. passport, I was treated quite rudely.

But, the point to be taken from this experience is we should try to see things from the other person's point of view. Most of the world has been attacked and invaded repeatedly. An auditor should study the history of the country in which he is working. He should go in with an attitude of, these people have a hundred good reasons to hate outsiders and swindle them, and so I should be careful and meticulous in my work. Furthermore, what Americans may view as dishonesty, people in other countries may view as simply the way things are done. Americans have a difficult time accepting that other people think differently from them.

The bottom line is our accounting system operates on the assumption that we can take the word of someone and input that into our computers as a record of the business data. A computer can be wonderful, if the person at the keyboard is honest and meticulous. The computer can do thousands of useful computations per second. But if he is a highly clever crook, the computer can commit thousands of thefts per second.

In a country with the most complex legal system in the world, Americans have come to rely on laws to protect them. The counterpoint to that is that everyone has thought about how businesses can fudge their figures but they have been taught to simply disregard it because it's so obvious that the U.S. government regulators must already be taking care of it. However, as globalization in business becomes the norm, and we are required to rely more and more on the accounting records of foreign entities to conduct our business and invest our money, our trust in the government accounting rules, whether they be of our own government or that





JAPANESE STOCKS TO SOAR?

of a foreign country, to protect us from business fraud may be misplaced. And the more rules these governments' issue, the more we become to rely on the system, to the point where if our faith is ever breached by a world-wide accounting scandal (i.e. "the mother of Enron's"), the ensuing trust crisis in the global financial system may become catastrophic because without some basic level of trust, how can anything function.

Thus while the U.S. real estate crisis and the mortgage and federal debt crisis have been huge in their economic effects throughout the world, comparatively speaking, a global accounting crisis would be even more devastating to the world economy.

Now that the world public has been sensitized to the economic blunders of such august institutions as the U.S. Treasury, the EU community, the major banks and multinational companies by the past federal debt fiasco, the dotcom collapse, the real estate implosion, the Euro crisis and the like, the world mainstream media, like a school of sharks seeking blood, will pounce on any new accounting scandal and blast it out of proportion to a public willing to recognize and believe the treachery and duplicity about which they report. This will result in a loss of trust and confidence in our economic system that will totally undermine the successful consummation of any and all business transactions.

Therefore, it behooves us to ensure that such a crisis never happens. In this effort, it will be up to the governments to ensure that realistic and practical rules are being scrupulously enforced to ensure that accurate accounting is being conducted in their jurisdictions and that accountants and auditors are conscientiously conducting their due diligence on the accuracy of data especially in locales where such accuracy is not dependent upon the ethics of people who feel no obligation to be honest with us. May God (and the accounting profession) help us in this endeavor.

D. Miyoshi

JAPANESE STOCKS TO SOAR?

In September 2007, the unpopular Shinzo ABE resigned as Japan's Prime Minister. After his resignation, Japan's stock market (the Nikkei) fell by half. And the Japanese yen soared 40% versus the U.S. dollar. But now the Japanese elections are over and ABE and his LDP party are back in power. ABE won by promising to not repeat the same mistakes he made in 2006. In fact he promises to do the exact opposite. Before the elections ABE demanded that the Bank of Japan

("BOJ") print money in unlimited quantities. He also supported virtual zero interest rates. This sounds eerily familiar to Ben Bernanke's Quantitative Easing Scheme in the U.S. If the BOJ prints yen in unlimited quantities and keeps interest rates near zero, we can expect asset values for Japanese stocks and real estate to soar (just as they will in the U.S. under Bernanke). "ABE" could become a new acronym for "Asset Bubble East".

Actually, analysts have been predicting this event for years, only to be disappointed. And investors who have bet on this event over the past few years have lost their shirts. The market has defied those predictions for so long that many were thinking it would never happen. But as Carmen Reinhart and Ken Rogoff pointed out in their book *This Time Is Different*, "in the history of financial crisis, when an accident is waiting to happen, it eventually does." Well, the beginning of that accident has likely begun with ABE and his LDP party now holding the reins of power in Japan.

With ABE in, the BOJ seems to be losing its independence. ABE even suggested the 1998 law that granted the central bank independence from government should be rewritten or simply scrapped. ABE wants the government to take over the printing presses to destroy the currency and create inflation. But why is that?

Debt as a percentage of gross domestic product has reached 237% in Japan. No country has ever crossed the 250% threshold without having a financial crisis. Will this time be different? Probably not.

The only reason why Japan has been able to accumulate so much debt without having a crisis is because about 94% of the country's debt is held domestically. But this source of financing is losing its grip. Because of the growing population of retirees, savings of Japanese private companies and households are shrinking. The government will soon have to find demand for its bonds elsewhere outside of Japan. But who would want to invest in such unstable debt instruments paying a mere 0.7%.

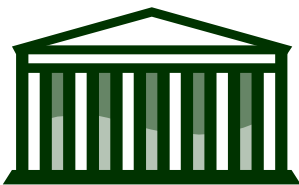
International investors will certainly demand a higher interest rate and that is something the Japanese government cannot afford. The government already spends a quarter of its budget in interest payments. The only solution is to follow in the footsteps of the U.S. Federal Reserve and start monetizing debt in a much more aggressive way. In other words, the BOJ will print trillions of yen to buy government bonds.

But investors who bought bonds from Italy, Greece, Spain and





IS THIS AMERICA'S DESTINY?



Advancing in a Time of Crisis



Financial Crisis Report



David M. Miyoshi is a California attorney and real property broker, having earned a Bachelor of Science degree from the University of Southern California, a Juris Doctor degree from the University of California, an MBA degree from Harvard University and an international graduate degree from Waseda University in Tokyo.

He is CEO of Miyoshi Capital LLC, an international investment advisory company. In Vietnam, he led a Combined Action Platoon as an officer in the U.S. Marine Corps.

He is listed in 14 Who's Who publications and specializes in international business and finance.

Portugal found out the hard way that those bonds were not as safe as they thought. Those who are buying Japanese bonds today will have the same experience.

But for investors here is the opportunity to really profit by shorting the Japanese yen and buying Japanese stocks, especially the companies that generate most of their sales abroad (which is the majority of the major Japanese companies). This is because a falling yen is good for Japanese exports since it makes them cheaper to foreign buyers.

So if in the past you have been thinking of investing in Japanese stocks, now is the time to begin your research in earnest on the Tokyo Stock Exchange. To begin with, Japanese stocks are currently extremely cheap as indicated by the Wisdom Tree Japan Small Cap Dividend Index (DFJ) which is now trading at an incredibly cheap .65 times book value (i.e. liquidation value). This index holds stocks of medium size companies with a market value of less than \$2 billion. At this value, these stocks would have to rise almost 50% just to get to liquidation value. Compared to comparable U.S. stocks which are trading at more than two times book value, these Japanese stocks are truly bargain priced. These stocks would have to rise more than three times just to equal their U.S. stock counterparts. And if we look at price to sales ratios, these Japanese stocks would have to rise four times to be in line with U.S. stocks.

So, with the start of "ABE", one should expect to make a lot of money trading stocks in the Land of the Rising Sun.

D. Miyoshi

IS THIS AMERICA'S DESTINY?

In 1887 Alexander Tyler, a Scottish history professor at the University of Edinburgh, had this to say about the fall of the Athenian Republic some 2,000 years prior: "A democracy is always temporary in nature; it simply cannot exist as a permanent form of government. A democracy will continue to exist up until the time that voters discover that they can vote themselves generous gifts from the public treasury. From that moment on, the majority always votes for the candidates who promise the most benefits from the public treasury, with the result that every democracy will finally collapse over loose fiscal policy, (which is) always followed by a dictatorship."

"The average age of the world's greatest civilizations from the beginning of history, has been about 200 years. During those 200 years, these nations always progressed through the following sequence:

- From bondage to spiritual faith;
From spiritual faith to great courage;
From courage to liberty;
From liberty to abundance;
From abundance to complacency;
From complacency to apathy;
From apathy to dependence;
From dependence back into bondage.

We are now just beginning the year 2013. This editor's opinion is that we are at the complacency to apathy stage.

But more importantly, where do you think we are on this sequence?

D. Miyoshi



1055 Wilshire Blvd.
Suite 1890
Los Angeles, California 90017
U.S.A.

Phone: 310-378-0615
Fax: 310-378-0000
E-mail: david@miyoshicapital.com
www.miyoshicapital.com
http://about.me/dmiyoshi

