Sankala Group

Lessons from Kyuzo Murata

At the end of June, I mailed each of my clients a pair of *bonsai* pruning shears from Japan. I sent them mainly to convey a message that pertains to markets, but I ultimately hope their feel in the hand trimming plants will offer richer insights.

Never having cared for a bonsai tree, this idea came directly from the tools themselves. Last summer, while looking over a yard sale I came across a pair of beautiful wrought iron scissors. I happily paid two dollars for them, but only later realized I had gotten an exceptional deal. They were the sharpest scissors I had ever used. Intrigued, I did some research to see who had made them. Not only did I discover they were Japanese-made bonsai shears, but I was also led to some very engaging reading and the ideas I want to share in this letter.

First, some background. One of the great bonsai masters of 2Oth century was a man named Kyuzo Murata. In the 1930s, he served as the main caretaker of the Japanese Imperial Family's bonsai garden. During that time, along with his associate Shichinosuke Kawasumi, Murata invented many of the tools and techniques used in bonsai today.

A view into Murata'nursery, *Kyuka-En*, and his guest house.

When World War II broke out, Murata was selected by his community to become the head-man of his village so he could avoid the draft and protect the future of bonsai. Despite his position, local officials told him to forget about the small trees, and grow rice for the war effort. His character must have been quite strong because they actually left him alone when he replied, *"bonsai shows the importance of the unimportant."*

I'm not presenting all this to riddle-make. Although Murata's garden was called "Garden of the Nine Mists," the goal is not to mystify, but to draw some practical comparisons between bonsai and portfolio management that will hopefully resonate beyond the typical quarterly ear-bashing. I also want to use the metaphor to draw some attention to the importance of execution in generating investment returns, despite the fact that idea generation receives all the press.

So I'll jump right in. Over the course of the years, it's common for investors to grow disillusioned with their portfolios and repeatedly bulldoze them to start anew. Typically, they rebuild with enthusiasm, then at some point later neglect their investments again. This tends to lead to chaotic change, and thus they come full circle back to disillusionment. While people discuss cyclicality regularly in terms of the global economy, our awareness of it within our own portfolio management discipline may actually give us the superior edge.

The only way to hone this edge is with pacesetting, regularity of review, and conscientious rebalancing. Making inquires and adjustments during periods where little is happening or things are sailing along is particularly important. If we only apply attention during periods of accelerated change, we give up our chance to act in a calm and calculating manner.

Bonsai trees function in much the same way. Some *shimpaku* “old-time” junipers have been overseen by many generations of caretakers and are 800+ years old. These trees develop so slowly that decisions made by one person have an impact for centuries. As a result, caretakers don’t make big decisions in a single afternoon. If a tree would benefit from some trimming, they cut a few branches then sit back and reflect before moving forward again.

The same goes for a well-managed portfolio. The common error investors make is reacting to volatility, which knocks on into rushed decisions. Due to the fact things are moving rapidly, investors then compound the mistake by dealing their positions wholesale rather than breaking them up into smaller pieces. Over the last 15 years commissions have compressed to the point where we can afford to take our time, and make multiple small adjustments rather than large hacks. At a certain point, reducing trading costs any further is penny wise but pound foolish. It robs us of our time for reflection.

In general, bonsai are trimmed to cause “back-budding” which increases the density of foliage and concentrates the leaves closer to the trunk. On many trees, the act of trimming actually causes the branch to fork into two new shoots. This type of trimming is good for the tree’s long-term growth despite the fact that it reduces foliage in the near term. During Q2, we liquidated and/or short-sold positions in the Russell 2000. Some clients likely wondered why we would trim a branch that was growing so strongly. The reason is that it had become gangly, and the foliage was looking dispersed. (See the Q1 2013 letter for the detailed quantitative argument behind this “foliage dispersion” conclusion.) We want to redirect some of those still-vital resources elsewhere.

Another overgrown branch I mentioned in the last letter was the Phillipines’ PSEi. During Q2, I tried to garner interest in short-selling Phillipine stocks for the same reasons. At the time, the PSEi was climbing rapidly and many of the accounts it would have been appropriate for were hesitant on the idea. As it turned out, that branch was so over-extended that it actually broke off in the recent breeze of Federal Reserve “taper” discussion. It declined a stunning 27% in less than a month, going from a raging bull market to a full-fledged grizzly bear. Our long positions in Vietnam fared much better during the same window, so I was pleased we were able to identify one of the better relative-value trades in the ASEAN region.

When you’re redirecting resources, or doing what I have called contentious rebalancing, you don’t simply look for long branches to trade for short branches. While that is the typical mathematical rebalancing approach used by most advisors, I like to use a more selective discretionary process. I only want to place new resources in assets where I feel confident we are getting uniquely good value. Right now, the simple mathematical approach would have us selling stocks and buying bonds. With some exceptions I will discuss shortly, bonds still don’t fall into the uniquely good value category, so I’m looking elsewhere. A few under-performing equity markets are showing much more attractive long-term indicative returns.

For example, it may soon be time to add to our positions in large-cap Chinese equities. Over the last twelve months, we have been paid 2.57% in dividends from these positions vs. 1.89% from our S&P 500 positions. While these stocks have been range bound for 2 years, valuations remain comfortable and cash flows are stable. China Mobile, for example, whose stock price hasn't moved much since 2009, lifted the top line ~24% during that period, grew earnings 10%, and increased the dividend from 2.47 to 3.61 CNY. All the while, it trades at about the same market capitalization as AT&T, despite having ~707 million subscribers, about 7 times more than AT&T's mere ~107 million.

Other places I'm finding unique conditions are global utilities, Vietnamese equities, and increasingly Brazilian equities. If there is a global stock market correction during Q3, and we see some final capitulation in the IBOVESPA index, Brazilian stocks will likely be added to our portfolios for the first time ever. All the recent political turbulence in Brazil may be setting up an excellent buying opportunity for us.

Please take a brief moment and visualize a bonsai tree. To get a beautiful, balanced tree do you let the strong branches just keep growing, and shade out the weak but promising branches? No, the art lies in the redirection of energy from the strong branches to the promising weak, as they will be the ones that fill out the negative space in years to come. Our developed international equity targets have been around 18% for the last two years, with emerging market targets around 6%. If the current sell-off continues, we will be able to buy some wonderful businesses at great prices and so make a push towards 20% and 8% respectively.

Kyuzo Murata and one of his *shimpaku* junipers, estimated to be more than 600 years old.

I'd like to take this concept of negative space a little further. John Yoshio Naka was a renowned Japanese-American horticulturalist, who happened to live in Boulder, CO. When discussing how to think about density of foliage, Mr. Naka said, "*Leave room for the birds to fly through.*"

To date, the enduring negative space in our portfolios has been fixed-income. I've been opposed to significant bond investments for some time now. This has left us with higher cash positions than we would otherwise hold in a normal interest rate environment. However, for the first time, I'm looking at ways we can trap Massachusetts, New York, and Colorado AMT-free and tax-free municipal bond income.

Recently, statistical anomalies have arisen in the midst of the wider bond sell-off that have made certain closed-end fund (CEF) structures attractive for collecting yield while preserving a reasonable margin of principle safety. In ornithological terms these opportunities are relatively rare birds, and we have the space for them to alight in our portfolios.

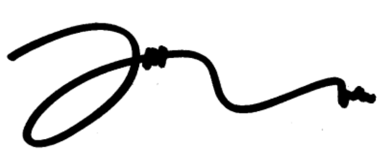
In brief, the municipal market has come under significant stress, and structural issues in a couple large ETF funds unexpectedly compounded the situation. I feel like I have my head wrapped around the implications of these developments, and see a few positions worth taking. Further, because the states we want this tax-exempt income in also happen to be some of the more solvent states (New York is the shakiest of the three), this situation is unique for us in its applicability. The only drawback is that these positions will require active trading because the juice is found in the fund structures themselves. Due to the unique nature of these opportunities, however, they cannot and will not meaningfully change our low bond exposure. Fixed-income will remain a significant part of the negative space in our portfolios. At the present moment, with both bonds and stocks retreating in tandem, that negative space is the only thing that is actually getting more valuable. Call it the rising "importance of the unimportant."

To wrap things up, three weeks ago I made a first attempt at a bonsai tree. It's a *yamadori*, meaning I went pretty far back into some craggy BLM land to find it. The search and the days after were very exciting for me. I built a training box for it, blended the soil, and did an initial prune. The last couple weeks have been quite a bit slower. There really isn't much action to take this season but to water it, and think about *keisho-sodai***.** That literally means "small size, great similarity."

I guess its continuing education, Japanese style.

Have a great 4th of July weekend,

Best,



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