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Opalesque Roundtable Series '14

JAPAN

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Editor's Note

Don't miss the second wave of development for Japanese hedge funds

In Japan there were two important announcements on the last day of October 2014:

- **Governor Kuroda at the Bank of Japan increased the amount of quantitative easing** (Monetary base to be expanded by ¥80 trillion each year, up from ¥60-70 trillion currently)

- **Japan's large public pension fund announced that it was increasing its equity exposure** (A doubling in the allocation to local and foreign stocks to 25% each and a reduction in domestic bonds from 60% to 35%).

Both announcements acted to **boost Japanese equities and weaken the Yen.** A lower yen is positive for Japanese equities as it improves export earnings.

The fact that these announcements have come in the same week as the U.S. Federal Reserve ended its asset purchase program has given added impetus to the Japanese market moves. Since those announcements, a number of market participants believe that this is the start of a longer trend of strong Japanese equity performance and a weaker yen.

How a "Shame Index" can transform an equity market

Already earlier in 2014, the creation of the **Japanese Stewardship Code** together with the announcement of the Government Pension Investment Fund (GPIF) to adopt **JPX-NIKKEI Index400**; a new index which focuses on companies' ROE, provide additional key stepping stones in Japan's growth strategy. The 400 companies of which the index is composed are selected on strict financial criteria, including ROE, and must meet specific requirements around the efficient use of capital and investor-focused management.

Insiders have also referred to the index as "shame index", because it puts shame, a major driver for behavior culturally, on companies that are not included. Money inflow into this new benchmark will therefore stimulate both qualitative and quantitative reform in the Japanese equities market, while the Stewardship Code will contribute to more active engagement with company management, with the ultimate goal of promoting sustainable growth in the corporate sector. Companies in Japan are now actually thinking about providing value for shareholders, or at least they are forced to.

But the currency could be the strongest driver

For the first time in 29 years, since the Plaza Agreement, Japan is not fighting or competing with one arm and one leg tied behind its back. For 80% of the time since the Plaza Accord, the Yen has been more than 20% overvalued relative to the OECD's estimate of purchasing power parity. This degree of overvaluation gives an idea of the magnitude of the handicap under which Japan has been laboring for almost three decades.

The second wave of development for Japanese hedge funds

Chances are that we may be entering the second wave of development in the Japanese hedge fund space. The first wave was from 2001 through 2005 which not surprisingly was coincidental with the Koizumi prime ministership. Koizumi came to power and quickly established himself as a reform candidate who would go and solve many of Japan's problems and position Japan for the next hundred years of growth, as the post-World War II economic model was essentially broken.

He failed primarily because significant elements of Japanese society, most particularly within his own party, The Liberal Democratic Party, were not ready for significant structural reform. Believers in the Abenomics story point to the fact that a lot of the change that we are seeing now in Japan is a reflection of plans that were in fact put forward already 10-15 years ago on how to make Japan a better place. What is different now is that the political environment is much more conducive to executing those plans. At the same time, Japanese hedge fund managers today have the most cutting-edge approach to realizing value in a number of different strategies for their investors.

Is Japan is the easiest alpha generation market in the world?

Ed Rogers, whose Japan hedge fund of funds has been up each year (including 5.5% net in 2008) since 2006, except for 2011 (the year of the earthquake and tsunami), believes Japan is "the easiest alpha generation market in the world".

Many of his underlying Japan-only managers have added value and alpha every year, and his team "consistently finds that hedge fund managers are able to execute a variety of strategies leading to positive returns in really almost every single environment," with a "tremendous expansion in the variety of strategies now being captured in hedge fund form."

The Opalesque 2014 Japan Roundtable took place end of 2014 in Tokyo with:

1. Masaki Gotoh, Partner, Misaki Capital
2. Alexander Kinmont, CEO, Milestone Asset Management
3. Ed Rogers, Chief Executive Officer and Chief Investment Officer, Rogers Investment Advisors
4. Robert Welzel, Partner, WTS

The group also discussed:

• Value investing and "constructive activism" to reward investors: hundreds and hundreds of Japanese companies can be identified to provide major upside
• Why not all Japan-focused managers need Abenomics to perform
• How not get "betrayed" by Japan
• Why did the GPIF, the second largest pool of retirement savings in the world, decided to invest through the boutique Taiyo Pacific Partners LP and not through a firm like Blackstone, or J.P. Morgan Asset Management
• How do Japanese and Asian managers deal with AIFM and U.S. regulations?
• Why could in 10 years "Japan be okay and Europe a disaster"?

Enjoy!

Matthias Knab
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Participant Profiles

(LEFT TO RIGHT)

Robert Welzel, Masaki Gotoh, Ed Rogers, Matthias Knab, Alex Kinmont.

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Introduction

Ed Rogers
Rogers Investment Advisors

My name is Ed Rogers. In 2006 I launched Rogers Investment Advisors, Wolver Hill Asset Management and the associated group of Wolver Hill Companies. With eight staff based in our offices in HK and Tokyo we conduct over 350 face to face manager due diligence meetings in Asia a year. We directly and indirectly manage over $120 million in assets and have advisory relationships which cover multiple USD billions in AUM.

My last sell-side job was at Deutsche Bank in Tokyo, where I served on the Equities Management Committee and helped launch and manage multiple hedge fund related businesses.

Our first product at RIA was a Japan-only fund of hedge funds and we followed that with a Pan-Asian Seeding fund. Right now we are in the process of launching our third fund which would be a Pan-Asian Fund of Funds.

Robert Welzel
WTS

My name is Robert Welzel. I am a partner with WTS. WTS is primarily a law and tax consultancy. WTS was founded in 2000 by six partners and we have grown to currently 450 colleagues in Germany. We have also expanded into East Asia, too, and recently set up offices in Shanghai and Hong Kong.

I am trained as a lawyer and tax adviser and focus on the tax and regulatory issues of the asset management industry, including the hedge funds sector. At the moment, we see more and more interest of especially German but also European institutional investors investing in East Asia, especially East Asian hedge funds. On the other side, more and more funds in Asia are interested in attracting additional European investors and need some help to do this successfully. The changes and developments in European regulations are an additional burden for many asset managers, however, they also provide interesting business opportunities worthwhile to be evaluated in more detail.

Alex Kinmont
Milestone Asset Management

My name is Alex Kinmont from Milestone Asset Management. I have been in Japan on and off for most of the time since late 1985. At Milestone we focus on value investing, both long-only and long/short, for Japanese and international institutional investors.

As you may know, there are, broadly speaking, two types of value, a traditional type and a more modern type. We are of the more modern type. The traditional value approach was originally developed by Benjamin Graham, and it is very focused on value in the balance sheet. That is a valid approach and there is room for people to do that, but it's not our strategy.

We follow the newer approach where the Graham tradition was taken on and developed further at Columbia Business School with the focus becoming to buy financial productivity for much less than it is worth. What both methods have in common is an emphasis on a margin of safety. We always say that we are unwilling to get out of bed in the morning for less than a 30% margin of safety. We are also unwilling to put on our short where there is a smaller than 30% margin of danger. So this is the philosophy that has guided our approach since we have been in existence. We have been doing long-only for five years and a long-short for three.

Masaki Gotoh
Misaki Capital

My name is Masaki Gotoh, I am a partner of Misaki Capital. I have been in this industry for about 16 years, so I am probably the newest member of this group. I was at Goldman Sachs and Morgan Stanley before coming to the buy side. I joined a long/short hedge fund and later moved on to an engagement-based, quasi-long-only fund. The senior members of that team recently spun off and launched our engagement fund in October 1, 2014.

While we don’t like to use the term, “activist” may still be the easiest term to describe us. We like to use the word ‘constructive activism’ or ‘engagement’. Our philosophy is actually somewhat similar to Alex's; we also follow a value-oriented investment philosophy and also focus on margins of safety for our investments. However, being an engagement fund, we also take into consideration not only the first discount that the market is providing but also the second discount which is how much value can we expand to our investments.

Our team, which is comprised of ex-management consultants, attempts to expand the absolute business value of our investments in our highly concentrated portfolio of 10-15 names, which requires a deep understanding of the industry, its players across the chain, and, most importantly, the catalyst for change which comes from the management teams of the companies. That is why, at least for how we implement the engagement, it is absolutely necessary for us to be physically located in Japan, with an all-Japan management consultant team that offers a highly customized solution to our investments.

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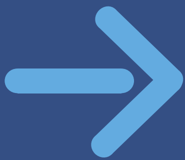
percent of the world's surface is covered by water.



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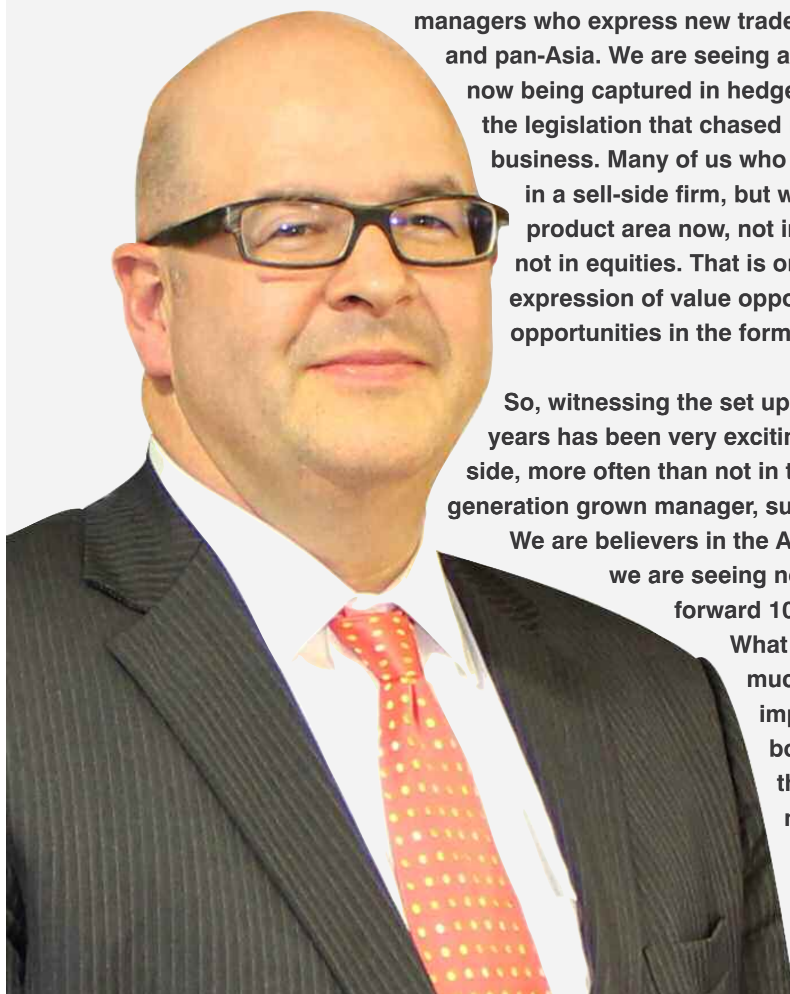
Matthias Knab What is your outlook for 2015? How will Japan and your funds do?

Ed Rogers: From our point of view, we seem to be potentially entering the second wave of development in the Japanese hedge fund space. The first wave was from 2001 through 2005 which not surprisingly was coincidental with the Koizumi prime ministership. Koizumi came to power and quickly established himself as a reform candidate who would go and solve many of Japan's problems and position Japan for the next hundred years of growth, as the post-World War II economic model was essentially broken.

He failed primarily because significant elements of Japanese society, most particularly within his own party, the Liberal Democratic Party, were not ready for significant structural reform. But, the idea that there was going to be significant change in Japan drove a lot of the initial growth in the Japanese hedge fund industry from 2001 through 2005. During that period a couple of hundred managers came into being. To demonstrate how small a world we live in - I had an interesting role in financing Gotoh-san's previous employer when I was on the sell-side. We wrote a $10 million check to help get them going back when there were very few hedge funds in the Japan space.

Then from February 2006 through 2012, nobody even wanted to hear the words 'Japanese Hedge Fund.' In fact, the word 'Japan' itself was kind of a four-letter word in the investment community. Abenomics and Prime Minister Abe have changed that dynamic significantly.



As a fund of funds where we are constantly looking for new managers, we are searching for managers who express new trade/investment ideas and how to capture value in Japan and pan-Asia. We are seeing a tremendous expansion in the variety of strategies now being captured in hedge fund form. The Volcker Rule, Dodd–Frank, a lot of the legislation that chased risk taking out of the sell-side firms are great for our business. Many of us who are now on the buy-side have spent significant time in a sell-side firm, but we can't do that anymore. You can't do that in any product area now, not in fixed income, not in foreign exchange and certainly not in equities. That is one of the main reasons why we are seeing the expression of value opportunities and how to capture these value opportunities in the form of newly grown hedge funds.

So, witnessing the set up of a good number of hedge funds over the past years has been very exciting. Sometimes they are coming straight from the sell-side, more often than not in the Japan space now, or we see a second or third generation grown manager, such as Misaki, coming out of existing hedge funds. We are believers in the Abenomics story. We think that a lot of the change that we are seeing now is a reflection of plans that were in fact put forward 10-15 years ago on how to make Japan a better place. What is different now is that the political environment is much more conducive to executing those plans, and then importantly the Japanese hedge fund managers, the boots on the ground guys starting businesses, have the most cutting-edge approach to realizing value in a number of different strategies. It's a marked difference from 2006 to 2012 where it was really almost impossible to get one of these businesses going.

Masaki Gotoh: We have a lot of similar viewpoints in terms of Abenomics. The unprecedented liquidity is fine, but from our perspective, not that interesting, and the first two arrows have been the easy part. There have been many changes that have been driven by the Abe administration that are providing a lot of tailwinds for our strategy and those similar to ours -- I would point to the Stewardship Code, the Corporate Law Amendments, corporate governance code, GPIF asset reallocation or even the JPX Index which has put ROE in the spotlight, whether the companies actually understand its implications or not. I think I read somebody calling it the 'shame index'; it's not that you're in but it's shameful if you're not. The reason for the focus may be misaligned, but at least it's better than not having a reason at all.

All these reasons are very positive for what we do and, in our view, for the market as a whole. Companies are now actually thinking about providing value for shareholders, or at least are being forced to. The government is actively pushing for investors to engage with companies, and thus, companies are now forced to listen and will be further pressured to do so with the governance code. Regardless of the rationale behind it, we feel this is going to be positive for the companies, and thus for the stock market as a whole, and I think that is not only a big change, but also one that is going to take time. Markets get overly excited and push up valuations across the board, but once it settles down, we'll be able to differentiate between the good and bad companies and management teams.

Alex Kinmont: Actually, we start from an entirely different perspective. We don't think that Japan is structurally deformed. So we don't think any reform is necessary or that the term means anything. Whether what is passed off as reform is present or absent is of no consequence to us. In the same sense, also, Mr. Koizumi, Mr. Abe – all the politicians are interchangeable. The fact is that the biases in public policy that are bad for the economy persist, the biases in public policy that are good for the economy persist, and it's the relative weighting between the two at any one time that's important.

To the extent than anything has changed, it's actually the currency. For the first time in 29 years, since the Plaza Agreement, Japan is not fighting or competing with one arm and one leg tied behind its back. For 80% of the time since the Plaza Accord, the Yen has been more than 20% overvalued relative to the OECD's estimate of purchasing power parity. I'm just using that because it's the usual term for such comparisons, not because I believe it's absolutely correct or because I believe the theory behind it.

This degree of overvaluation gives you an idea of the magnitude of the handicap under which Japan has been laboring for thick end of three decades.The politicians provide the mood music for changes in the currency environment. And now, quite suddenly, we have a currency which is around fair value. We can look at Europe and we can see the remarkable positive effects that Germany has enjoyed from having no upward pressure on the currency because it redenominated it into euros and the equally large, negative effects which the same mechanism has exerted on Italy, which is now also increasingly visible in France, by preventing those currencies from devaluing in the way that they have always done before. So, while I don't want to suggest that we are mono-manic about the currency or anything like that, we do think that the shift in the currency environment is the important event, and not the structure of the economy or Japanese business practices or anything else.

Now, having said all of that, we are coming at it from a slightly biased perspective. We do over 500 company visits a year as a team, visiting mainly small, cheap, but financially productive companies. So the sample of companies that we see is skewed towards reasonable people doing reasonable things in reasonable businesses.

Whenever we visit a large company, I have to say we are horrified. We are usually horrified by how badly managed they are. So there clearly is a problem, but we do think that the problem is specific to large companies and not a generalized management problem of the whole economy. As far as the evaluation of the opportunity set in Japan, to give a bit of perspective, there were 450 companies that we could theoretically consider investing in from the long side in November 2013, and a year later there are 430.

When we say we could theoretically consider investing in a firm it means that the company is financially efficient in terms of clearing its cost of capital and is more than 30% too cheap relative to our initial, mechanically estimated, intrinsic value, which is of course just the starting point of our analysis. Last year, most of those companies were sub $250 million. Now, the number of sub $250 million market capitalization segment counts 288 companies while the rest is above $250 million. The average market capitalization is a billion dollars.

So in a year, what has happened is that the large capitalization value opportunities have tended to present themselves to a greater degree while small capitalization value opportunities have tended to present themselves to a lesser degree. Our suspicion is that this trend probably continues for the time being. But the overall opportunity that this 15% of the total market presents is probably not going to change.

Masaki Gotoh: We as a firm do not have a strong macro view one way or the other, except to the extent of understanding portfolio risk, so we focus on our strategy from the bottom up.

I would agree that there are still many companies that are undervalued now, even after this huge run. Selecting the right timing and waiting for the markets to realize and fill the valuation gap is one methodology, and we too believe there are still many opportunities. We embrace the valuation gap but we continually try to provide the trigger to fill that gap and, more importantly, expand the business value.

Our analysis is highly qualitative as well as quantitative. We spend an extraordinary amount of resources analyzing the industry and understanding whether a company has a sustainable competitive advantage and, most importantly, why. Without a sustainable competitive advantage, it becomes just an operational efficiency story, which is important too, but then also is harder to sustain. We try to understand the culture of the company, the industry, and management, past and present, which led to the barriers to entry to sustain the competitive advantage.

Quantitatively, we focus on cash generation. Going back to ROE or ROIC or RO-anything, pick your favorite denominator, we find that it's not so much the leverage or the asset turnover that has depressed RO(X), but that it's often the margins. While all of our investments have high or leading market shares in a product or service, as well as higher margins than their local competitors, they still tend to have lower margins versus their global peers despite the fact that they are positioned similarly, if not better. In general, we think Japanese companies have not focused on the margins to the degree that they should, and tend to continue having a post-World War II mentality of top line growth where after a certain point, they start diversifying their businesses to areas that they probably shouldn't, either geographically or from a product or service portfolio.

We go to companies and say, look, you have 20% global market share, and your U.S. comp has 30%. You have 60% here in Japan. And yet, you make 5% operating margins while your U.S. comp makes 15%. Let's think about why that is. Perhaps inefficient R&D or marketing spend, overspending on the distribution channel in Japan, having underinvested overseas or invested inefficiently, or by value destroying acquisitions. Moreover, we would focus on the decisions that created the balance sheet they have now, both working capital and fixed assets. These individual choices have destroyed value because it has wasted resources, both human and financial.

We would offer methods to improve cash flows, whether it be margins or working capital improvements, and with the increased cash flow, consider potential growth strategies. After this, we can begin discussing business portfolio realignment and distribution to shareholders. But first, focus on cash flow improvement. The right hand side of the balance sheet isn't that important in understanding the business, in our view. That's a financial decision. We rather focus on how the left hand side is used to produce high normalized cash flows.

Ed Rogers: Coming back to Alex' comments, both as an aggregator of external capital, U.S. and European-based risk capital, and also as an allocator of that capital internally to different Japanese hedge funds, I think the macro environment and the Abenomics story is very important in two respects.

One, as an aggregator of capital, where I go and I speak to investors, family offices in the United States or pension funds or European private wealth management businesses, it's clear that Japanese managers are competing in the marketplace of global investment opportunities. Whether you believe in the change that Abenomics brings or not, the fact that global investors who have multiple investment opportunities have been forced to think about Japan again in a different way – because the country is in the news with some positive commentary, whether you believe that that commentary is warranted or not – is a good base to start with.

Readers need to keep in mind that as Japan-focused managers, you are competing with a China-only long/short, an Asia-event driven, macro or an Asian activist. So the question here is what is going to get somebody to write you the check? During the 2001-2004 period I saw some people with extraordinary performances go from managing less than $10 million to managing a billion dollars over two or three years.

And now, if you actually think about this, even this last five year period, positive returns from Japan managers were not simply correlated with the advent of Abenomics. There have been Japan-only managers who have added value and added alpha every year so that you would expect many of them to be managing $500 million to $1 billion or even $2 billion, because this market is big enough to sustain that size hedge fund – but they are not. They are literally managing $50 million to $150 million.

And the reason for this is because they have lost in that global marketplace of competition for that scarce allocation resource. This resource could be an individual, a family office, pension fund, endowment, whichever, who is willing to invest in a hedge fund. That's at the macro level. On CNBC, on Bloomberg, and through other media outlets I am constantly asking people to re-assess their thinking on what is this Japan opportunity and what does Abenomics represent. I hope to change their macro view of the world or the macro opportunity set to include allocating to Japanese hedge fund managers, either directly or preferably through my fund of funds, of course.

On the micro level, I focus on the same issue that Masaki brought up - how does Japan change? I think that Alex and I would fall into a certain category of foreigners fascinated by Japan. I came to Japan in 1987 out of an academic interest. At that point I had never even heard of hedge funds, to be perfectly honest. I didn't come here to create financial success; I came here to satisfy academic curiosity and intellectual curiosity about a culture, a country and people that I found fascinating and extraordinary, developmentally speaking, including its economical, military and political dimensions.

So, how does Japan change? If you look at the history of Japan, I think it takes existential crisis to create true change in this country. And in the last 400 years, there have been only few a moments of true existential crisis.

One such moment was back to 1603 when Tokugawa Ieyasu consolidated power in Japan and said, "here's the way we are going to do things. We are going to kill the foreigners. We are going to eliminate gunfire, weapons. We will establish a Shogunate and that will be the way we run Japan, forever if possible."

And that persisted until 1853 when Commodore Perry sailed in and fired off some cannonballs down in the Izu Peninsula - creating a very new calculus for the Samurai and other elites to survive, and there was a huge period of internal reflection about how Japan should position itself, and that led to significant "structural reform" – which today's naysayers on Abenomics Third Arrow best keep in mind. Remember, Japan essentially was the hermit nation – today's North Korea – of the world, until 1853. And then in roughly 45 years they underwent an industrial revolution that everybody else had spent about 200 years on. So the focus of the Japanese people when they decide to do something is extraordinary.

Culturally, it is important to note that Japan relies on shame-based prompting, if you will, of how to change behavior. I think it's very uniquely Japanese to think that you could change behavior by shaming somebody.

In Western society all you can really do with that is chase a guy out of office for some sexual misadventure or financial shortcoming. In Western society, the example negative ramifications of shaming are legion. Whereas I think Japan is one of the few societies in the world where shaming is so shameful, it's such a huge burden to bear, that it will change behavior proactively in order to not be so shamed, or begin to be recognized as somebody worthy of a proper stewardship role. This has been most evident as we see Japanese companies restructure themselves for inclusion into the Nikkei 400 – frequently referred to as the "Shame Index".

Let's turn this into a question for the two managers here: How much might this drive change at the company levels such that there will be an alpha capture opportunity where there wasn't one, i.e. you can create a more efficient company, you might create a more ROE focus? Again, ROE is just a number, it's just a metric, but is the mindset changing because of this shame-based structure to the point where all of a sudden companies will look and act what you might call more rational from a Western point of view, but it has actually come from a completely different place?

This process didn't really start out with a need to reward investors more for taking risk and buying our shares; this is about the shame of not being good enough to keep up with the Suzukis, if you will, who are now all of a sudden following the Stewardship Code. So that's really the question actually at the micro level, whether that pans out.

I think certainly at the macro level, in 2013 we saw much, much more interest in Japanese vehicles from global investors, who do have a world of choice quite frankly of where they put their money. Hopefully, what we have seen recently with the GPIF moves and the BOJ moves continues to stimulate that interest on the part of global investors.

Masaki Gotoh: I think what makes the Abe administration interesting is exactly that point. Until recently people have been so focused on the macro level because Japan has been a trading market and the focus had been on outside factors like FX, commodities or interest rates, etc. Japan wasn't a real stock-driven market but a sector- or factor-driven market.

That means it has been less about stock picking, but more about selecting the right factors at the right timing. Of course I am speaking with self-interest, but I think that that has begun to change and fundamentals become the driver of long term returns, or at least more so than in the past.

Take governance. I think governance overall in Western markets has generally been to control excessive greed. In Japan, stronger governance is needed to better expand the potential of the business for its customers, its employees, and, of course, its shareholders. By earning more, you can provide better services or products, pay your employees more, and offer a better risk-adjusted return for your shareholders.

That means the task of the outside directors isn't really to control for over-compensation or monitoring against excessive risk, but more about how to get them to maximize returns on capital, and generate a better incentive scheme for management.

With the Stewardship Code or JPX or the corporate governance code, it's about getting management to excel from a financial perspective as well, rather than just from an operating perspective.

Ed Rogers: In my view the topic of outside directors is really fascinating. Companies like Enron and WorldCom did have outside directors, but that didn't stop them from malfeasance in the least. One corporate focus since the 2008 global financial crisis has been, "let's get outside directors so that we can rein in this executive pay that went absolutely crazy in the financial services world", but none of that existed in Japan. The differential between the average worker and the president of a Japanese company, whether it's financial services or not, is minuscule compared to what Jamie Dimon makes versus the average worker in any listed company. Mind you that we are talking about literally tens or even hundreds of times more differential in compensation.

That's not what you need in Japan. You actually need, in a way, people to get a bit more greedy here. You need some outside directors go into the companies and say, "let's raise the prices!". Okay, it might cause some discomfort, but unless people do it, they won't be able to escape this deflationary spiral trap. So in Japan, raising prices can be part of running a company better. Most firms here don't need any input or guidance how to run their business better in the way that Western companies need to be run better. They don't need directors saying, "hey, you greedy manager of the business, get your hand out of everybody else's pocket!", which is frankly where financial services has gotten to, in many cases, and certain other industries as well.

Or think about the short-termism where the CEO and his management team are just leering at their call options and if they are in the money or are they out of the money? How many corporate decisions are driven by that one question alone in the United States of America over the last 20 years?

This has never been the case in Japan, so that is not the problem here. You don't need those outside directors for that. But if you do bring on these directors, who, again, are fighting a totally different dynamic of how to be perceived as good and right in this country, then a company can have enormous, in fact an exponentially beneficial upside.

Alex Kinmont: I totally accept what Ed says about the importance of telling a story of change. I am also aware that one is a bit of a party-pooper to suggest that it isn't really that important fundamentally.

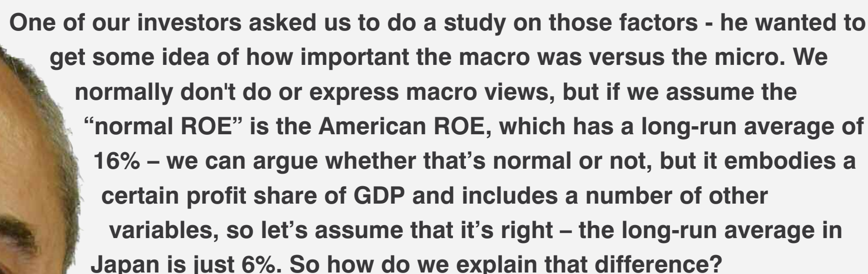
However, I think there is a certain danger in all of this. We are long-term committed to Japan. We are not going anywhere. So the difficulty with relying on a story of change is that there will also always be a period of disappointment. It's just unrealistic not to expect that. So it's like being locked in a sort of a Faustian bargain.

You are going to be locked into huge inflows, which can push the market up 6,000 or 7,000 points on the Nikkei, and then you have a period where all or half that money goes out again, and markets can fall back to a position that will be worse than when the cycle of optimism began. What you'll get is even more cynicism towards Japan.

I think we have all been around long enough to have heard the words, "Japan betrayed me." But Japan didn't, your expectations betrayed you. Japan didn't do anything at all. So I do worry, and maybe it's wrong to worry in an up-cycle with inflows, but each time this happens I worry that we are also storing up trouble for ourselves in the future.

As far as the companies themselves are concerned, this is a very difficult area. The total volume of profit in any economy is determined by macro factors. Capitalists cannot get up in the morning and decide to earn more money. They can find themselves in a position of earning more money, but they cannot drive earning more money on their own.

The distribution of profits between capitalists is where capitalists' efforts come into play. For example, we could say that company A should earn more because it's a great business with a great product, but we have to be aware that company B is at the same time expanding the market for a different, new, product and taking a larger percentage of the total volume of profit in the economy, so this implies that company A could actually earn less. That means we have to keep an eye on two variables at the same time: the company's share of the total volume of profit and the movement in the total volume of profits which is determined by macro factors.



One of our investors asked us to do a study on those factors - he wanted to get some idea of how important the macro was versus the micro. We normally don't do or express macro views, but if we assume the "normal ROE" is the American ROE, which has a long-run average of 16% – we can argue whether that's normal or not, but it embodies a certain profit share of GDP and includes a number of other variables, so let's assume that it's right – the long-run average in Japan is just 6%. So how do we explain that difference?

Well, the work that we did suggested that the difference between 6% and 11% or 12% was wholly a macro phenomenon. By contrast, the bit that we could demonstrate what could potentially be explained by a lack of management effort to make money was the remaining 4% or 5% points

So roughly speaking, 60-70% of the problem is macro and 30-40% of the problem is micro. We would find in more benign macroeconomic conditions that automatically the general run of companies would more profitable. Put differently, *if we assumed that the same macro conditions had worked on the United States as had been experienced by Japanese economy over the last 20 years , then the average American ROE would have been 11% not 16%.*

So we are very, very skeptical about the idea that there is an awful lot that changing management structure can do in the aggregates in Japan. It has to be a story that is told at the micro level that this company can take a greater share relative to other companies. And that's what we see with competitive positioning - winners and losers emerging against what has been an unhelpful macro backdrop. It's not really an issue of management orientation, and therefore we are quite skeptical of all that stuff. But again, I'm very aware that the sample of companies that we've spend our time with, we're in bed with, is just a very, very skewed example of financially efficient enterprises where there isn't very much upside anyway for that sort of thing, from that perspective.

Matthias Knab Alex, you mentioned that it was the wrong expectations that led investors to experience disappointment with Japan. But is there something as the "right" expectations, and what would those look like?

Alex Kinmont: I think you should start by questioning your basic assumptions. What I mean is that Japan is always considered 'odd' - but is it? If Japan was situated somewhere near where Switzerland is situated geographically, Japan would not be considered unusual. It is a perfectly normal G-7 country as long as you do not compare it with the United States. The reality is that all the other six countries are perfectly normal if you don't compare them with the United States. It is just that the United States is the outlier, and because Japan is always compared with the United States, it looks peculiar. But if you compare it with Continental Europe, it's not that peculiar at all.

Almost all of the so-called structural difficulties that seem to present themselves are phantom difficulties, and all of the 'reform' solutions that seem to present themselves are phantom solutions. Japan is basically just about all right, and therefore, just like our approach, spend your time on finding the really good businesses in Japan. I think Masaki is doing the same thing, looking for the really good businesses available at undervalued prices in Japan. It will reward you in exactly the same way as it rewards you in every other market around the world. You don't need to build a Japan story on top of that.

Masaki Gotoh: I would largely agree with that. When it comes to expectations like you said earlier, they move much quicker than reality, and the reversal always happens. I have only been in this business half the time as both of you and yet I have seen this several times already.

You can look at the most recent expectations or into the 2005 phase where you can argue that major change didn't materialize, or at least not in the time horizon markets had expected and that, arguably, it's still in the process of materializing. We may still be in the midst of the second cycle, as Ed mentioned earlier.

So when we speak to potential investors, we try to be very aware of whether investors are calling us simply because they want to be in Japan because it's hot; and whether they will be right out of the door if and when it collapses, because it's going to happen again. We want investors who will say, "we're in it for the long run". If you're just looking for macro, then you should put your money elsewhere, because that's not what we're going to provide you.

We will provide you with a very specific return profile. We're selecting only a few opportunities where we have conviction that we can help change. That's why we have a 15-name portfolio, and that's why if and when we run a billion dollars or more, we'll still have a 15-name portfolio. Otherwise, you'd have to think about the macro environment and trends, and that's not where we excel. We believe there are great companies here and many where the market is offering a discount, just like Alex says. And we also hope that we can provide even more value for these companies through our engagement.

So in terms of expectations, I'm in total agreement in that, "let's become stock investors rather than market timers." If you want to just "be in Japan", why not just buy ETFs. The investor can choose the timing and exposure. We instead hope to provide a unique return profile.

Ed Rogers: Let me address that ETF and reflect on Alex's comments as well. We are all to a certain extent affected by the investment tourist who thinks, "Japan is hot, so now I want to get in", and then when sentiment turns he wants to get out again. We have been managing a Japan-only portfolio since 2006 and given this almost decade of experience we believe there is significant and demonstrable alpha in this market. Japan is still highly inefficient, and there are many different ways, many different trading strategies or many different approaches you can use to capturing alpha here.

The great thing about Japan is that in almost every one of these strategies, you find a very inefficient environment that you can exploit to create superior returns. We should go back to 2008 and say to that international investment tourist, *"What you have got to do is to change your mindset here. You may want to have a dedicated exposure to Japan, the second largest developed economy in the world which at the same time is also the most unwatched, unloved, and un-participated in equities market in the world in relative terms."*

In 2008 our fund of funds portfolio was up net, after all fees, over 5.5%. That was achieved with investments in 14 different managers who had dramatically different trading strategies.

We think Japan is one of the few places in the world where you could do something like that in size. We could have managed a billion dollars easily in 2008. You can easily manage a billion dollars in this economy, whether it's a single manager, single strategy, long-short hedge fund. Certainly, in a fund of funds context you could manage multiple billions.

The other aspect is that the degree of correlation amongst the other G-7 countries is enormously higher than to Japan. You find that Japan can be very countercyclical. So then when you drill down to the level of individual managers and individual strategies, you can truly start to insulate your portfolio from that 40%, 50% drawdown that you experienced in 2008 when you were a U.S.- or European-centric investor. We believe that aspect will continue to remain unique to Japan.

I may sound completely self-serving here, but in my view you ought to be willing to pay something to get access to that uniqueness, and an ETF isn't going to do it, quite frankly.

Matthias Knab What is the level of investor interest right now? Over the last couple of years there was this exuberance about Abenomics, but what is the level of investor interest right now?

Alex Kinmont: I think Mr. Kuroda at the Central Bank has just lifted it quite significantly. Our impression was that the 'faster' capital that was free to move quickly actually tended to move in 2013, which meant that there wasn't that much left over for such a kind of capital reallocation into Japan in 2014.

So 2014 investor flows into Japan were generally from the slower, and arguably the higher quality capital, that may have concluded that it didn't need to bother with Japan in 2013 given what was going on at home and in the Yen -Dollar rate. If you take into account that a large proportion of the higher quality capital is from the U.S., and the S&P beat Topix in Dollars in 2013 and so-far in 2014, that isn't too surprising. But it also seems to me that the U.S. remains the big untapped pool of opportunity for Japanese strategies.

But what it will take to move that capital, if until now they are not responding to Mr. Kuroda, that is anybody's guess. You see, the decision making process of the typically high quality capital will eventually be influenced by what is going on globally when the time comes for them to make the decision, rather than what is happening now.

I believe it is quite clear that more capital will come into Japan because of this latent potential - but the big question is when will the U.S.really come to consider Japan seriously as a proper investment destination?

Masaki Gotoh: We try to focus on investors that understand our strategy, because it is not mainstream yet. Two years ago, I had difficulty getting overseas investors to listen to our proposition. Today we are in the position to get calls from people that were uninterested before. But like Alex implies, it takes time.

Real, long term capital is starting to look at Japan, whether it be because of Abenomics or other reasons. What also provides a tailwind for us is that activism in Western markets, and particularly in the U.S., appears to have become mainstream in the last couple of years. There are several reasons for that but what has been shown in the last several years is that the strategy has outperformed other hedge fund indices. U.S. activism, whether it be aggressive or not, has shown that it can produce alpha. And I think people are hopeful that this happens in Japan too. We want to make sure it does, but that it is done correctly and long-lasting which means, we want to secure an environment that has societal backing.

But again, we should try to control expectations. Some people rushed early into activism in Japan in the early 2000s, and it did not work out; it basically branded activism as evil. Therefore, we have to make sure the strategy is applied at the right pace.

But let me clarify, I don't think aggressive activism is wrong. I don't think working for shareholders is evil at all. It's just that there is a way of doing things and an appropriate speed of implementation that is socially acceptable at that point in time, and at the right level of financial sophistication which, arguably, is still in its infancy in Japan.

You need to have media and social backing. That is true with politics when you contrast Koizumi-san versus Abe-san. The politicians have gotten the media on their side, at least for now. And when you have the media on your side, then you can get society on your side and buy you time to realize your views. From our perspective, we also need the right organizational support, which we have attempted to create for the companies we work with.

Robert Welzel: When it comes to investors, the AIFMD affected the European alternative investment industry significantly. The AIFMD is also relevant to Asian managers, who intend to market their funds products to Europe. The one year grandfathering period during which Asian funds could still approach potential clients on a private placement basis just recently elapsed. This private placement regime is more or less only applicable in U.K. and Switzerland. Germany, which had a very favorable private placement regime in the past abolished these marketing opportunities, too.

What does this mean? First; how do investors still get access to interesting fund managers, and on the other side, how can fund managers approach their potential investors in Europe? There are plenty of pools in Europe, and especially German institutional money, which have to be invest to generate additional returns. A significant re-allocation is on the agenda.

If you compare and consolidate Dodd-Frank, FATCA, EMIR and other tax and regulatory developments, I think it's very interesting to think about how the future business models of the fund industry will be impacted. WTS run some comparison between the U.S. regulations and the AIFMD, and it is very interesting from my perspective, to evaluate the upcoming tougher regulations in Asia, too. Probably the burden for managers will rises, but this might even provide for additional marketing opportunities, too.

For example, marketing in Europe:
The product placement regime, with exception in the U.K. and Switzerland, is more or less not existing any longer. But if you compare the level of regulation in Asia, the regulatory framework is probably somehow comparable to the European AIFM level. Fund managers evaluating their specific situation might gain access to new, distribution channels and to new distribution routes, especially to professional and semi-professional investors. And 60% of the money in Europe is institutional money, and institutional money only invests in regulated fund managers. So it's quite bifurcated, and the same applies in respect of taxation.

We sometimes hear from Japanese managers that it would be difficult and challenging to comply with these reporting needs. This analysis is, from my point of view and experience, a little bit questionable. I can assure managers that the reporting compliance is not rocket science, it is manageable.

I believe that international managers are able to bridge this gap and fulfill all the enhanced reporting needs of continental European institutional investors. European investors are broadening their investment horizon, getting more and more familiar with non-traditional, non-European strategies. We are of the opinion that Asian managers, too, can be more successful in raising additional European money, because we see significant interest from that the European investor base.

Ed Rogers: We are fascinated by this issue. On the one hand you have institutional investors around the globe, even our own government pension fund GPIF here in Japan, who are saying they want to and that they have to increase allocations to vehicles such as hedge funds managers. But that is immediately followed by the statement that the infrastructure, the legal and the compliance has to expand. But that, on the manager's side, is not just mind share, but real cost.

Someone managing $25 million or $50 million will probably be reluctant to spare $300,000 a year to keep the AIFMD guys happy. And frankly, nor should he. I think that is a waste. Multiply that expense across 10 different managers and you are paying out $3 million a year. Wouldn't you rather like to hire more analysts and other value adding Intellectual Property personnel?

Sure, there are lawyers, accountants or other people that can solve these problems for you, but hedge funds don't go into business to pay lawyers and accountants. They only survive in business if they are providing returns to their investors. And investors increasingly understand now that this has become a more expensive business to be in. But, as I said, institutions are precluded from investing unless they can check all these infrastructure boxes that are becoming less and less meaningful, but for sure more and more expensive.

So, we expect changes in the structure of the industry: One, we are hopefully moving forward in Asia with starting more platform businesses. You need an aggregator just from the perspective of aggregating capital, which is a hard and expensive process: getting on a plane, flying around, selling yourself is an expensive process, and that also means you as the manager are not sitting here real-time in Asia watching the portfolio, by the way, which is also bad. That's one.

Two, apart from the intellectual investment exercise, there is this business exercise of, again, extraordinary legal and compliance constraints that you have to live with before some investors will even let you in the door.

So how do you deal with that? These are nontrivial costs. Having a full-time legal or compliance officer, that's $150,000 or $250,000 a year. Lawyers, sorry, don't come cheap. I am not trying to throw any stones. The costs are there, if you do that in-house or if you outsource it.

15 years ago, this was not the case. You could run a hedge fund business far, more cheaply than you can now, and you could also expect to get that institutional money far quicker.

I think Europe is actually in one of the worst situations of all. The AIFMD has driven people around the bend. Again, who apart from a bunch of bureaucrats in Belgium, is enjoying this? I don't know. But you have made it almost impossible for many Europeans to sensibly invest now, and driven up the cost of due diligence on managers and sourcing appropriate managers, and it will eventually turn around to bite them all in the butt.

Matthias Knab At the same time, the facts are now established by the regulations in the U.S. and Europe. Tell me more, how have those been perceived here in Asia? How do people react?

Ed Rogers: At the individual manager level, I will let the other guests respond, but when it comes to Europe the fact is that many here have taken Europe out of the equation as far as where you market. What is also interesting is that the closer you get to Asia, the more capitalist you find the behavior of the government.

It's easier now to source institutional money from Temasek, for example, or GPIF. GPIF funded guys like Taiyo (Taiyo Pacific Partners LP)! I mean, these are not guys with a big name. It's not Blackstone, or J.P. Morgan Asset Management. It's not who would you expect a trillion dollar bucket of money select to allocate to. Rather, from the conventional view you would expect that a firm would need at least $50 billion in assets to even be included in the conversation.

But, my point here is that you are seeing far more flexibility amongst the Asian sovereign wealth funds or sovereign substitutes than in Europe. In the U.S. I would say it's kind of a middle ground; they haven't made it impossible, but they have made it hard enough that we also know many managers who will admit it's kind of a burden for them to take U.S. money, and some of them outright reject it. Others will be more accommodating, and we at Rogers IA have had to help coming up with solutions in assisting the funds finding the right tax reporting, etcetera, or paying some of the costs ourselves to create access.

I think Europe might be in a position where with the full imposition of the AIFMD requirements managers don't want to talk to European investors anymore. That, conversely, is not really where you want to be as an investor, believe me. But the managers here just say, "Look, you have made it too hard." That won't be helpful for Europe to manage its way out of a really poor environment for investing locally, which is the situation investors there are faced with.

You can also look at who is putting new money into Europe right now? You have got to have a whole lot of conviction about a whole lot of things, and probably quite a few people disagree with you when you are excited about putting money into Europe.

Robert Welzel: I agree with you, Europe at this point in time may probably not be the hot spot to invest, nevertheless there are very substantial amounts of money to be invested.

Ed Rogers Sure, there is retained earnings all over the place.

Robert Welzel This is the case.

Alex Kinmont: You asked about what managers here think. Of course, we are just a small operation here in Tokyo, so our opinion doesn't count for anything, but one could say that Europe wants to bottle up European capital in Europe. Fair enough, but that isn't a terribly enticing prospect for the manager when, as Ed says, the costs associated with managing institutional capital, capital of a type that one would want have have become exorbitant relative to fees.

It probably means European savings will be continued to be managed by the asset management subsidiaries of Italian banks - fair enough! But for us here in Japan, shouldn't we just be spending our time at home rather than going to Paris, Luxembourg and so on? Flights to Europe are very expensive as well; it's much cheaper to go to the U.S. West Coast.

As far as the U.S. is concerned, the view that the U.S. appears to have taken is that U.S. capital or substantial subset of it is the highest quality in the world and every manager wants it. And in order to qualify for getting it, you have to play by American rules. That seems to me to be a totally fair bargain. The European bargain seems to me skewed and arguably unattractive. That affects managers' perception of where they put their efforts to engage with investors. And in an industry as ours, any such effort has to be rather limited, because you can't just spend your time away from the portfolio, even if you turn over as little as we do.

Matthias Knab Ed, let's look again at the international investors' perception of Japan. What do you see happening in terms of investor interest and flows into Japan, what trends do you see?

Ed Rogers: Well, the truth is that probably even a week from now I may answer this question in a slightly different manner. We have had extraordinary actions by the BOJ and the GPIF as far as portfolio weightings that I believe will make Japan much more part of the international allocators' mind share and allocation process.

That said, I spend about a third of my time on the road, both as an aggregator and an allocator. We have a team of five who constantly focus on primary and secondary manager due diligence, and then I get involved in the last 20% of manager interviews within our allocation process. That means I spend a lot more of my time actually marketing the business or really marketing the concept of, *"you need to have Asia in your portfolio, or you need to have Japan in your portfolio, what do you want, check out my menu..."* I am interfacing with investors all the time in the United States really trying to win the battle for mind share. Where do they put their money?

I am encouraged when I see things like the GPIF and the BOJ keeping Japan on the front burner, if you will, of investor conversations. And I will be honest with you, those initiatives have also come at a great time of year. There are lots of people reviewing their portfolios trying to figure out what they want to look like in 2015. The Japanese have timed this incredibly well.

By the way, make no mistake, as someone who has been foreign exchange trading for eight years to see an extraordinary move on the last business day of the month that changes things dramatically, that is typically a Japanese play. That is how Japan, Inc. acts, now and historically, and we are all very aware that they know that the world is watching...

Now matter how insular you believe the Japanese officialdom may be – they are very aware that their actions have global implications. So are they dragging Japan and Abenomics back on to the front page of investor magazines? Yes, they are, and will that meaningfully translate into more dollars allocated to this space? I do think so, as long as managers such as Alex and Masaki continue to prove that they can sift through that and create attractive returns. Of course, the sort of rising tide is going to lift all boats on a day like today, but some will rise more than others.

But over time, let me express that again, the alpha extraction from the market here is best done by professionals, not by ETFs. Having set up in 2005 I am still the new kid on the block, everyone else has been doing this for 15 years or more. None of us in the investment space in Japan is a fly-by-night practitioner. I believe investors will have to weigh into that and make provisions to pay for accessing that talent base. Investors need to find vehicles that increase their aggregate returns, unless they have reached some sort of conclusion like the Europeans who seem to be saying, *“oh, well, forget it, we will just leave our money where it is and let it die there...”* That is an option and maybe that is their best option, then so be it.

We tend to think that risk capital in particular is like water. It’s going to find its level where it needs to go to, and if it needs to sink down deep to water some plant that is going to be our fruit, then so be it. That on its own is a hard process, but what has happened is that some places have created many legal and structural impediments to risk capital going where it really wants to be.

In a way, all of us on the manager side are trying to find a way to remove impediments for risk capital to get where it should be, so that it can get allocated at the right level of change – “constructive engagement”, if you will.

I remember in high school we had a “Job’s Day” where kids’ dads came in and talked about their jobs. One of them was actually a consultant and a partner at McKinsey in Washington D.C. So we asked him, “What’s your job?” We were a bunch of eighth and ninth graders and had no idea what a management consultant was. He said, “Well, think about this way. You are in a football game - do you want to be one of the players or do you want to be one of the referees or one of the coaches? If you want to be one of the referees or one of the coaches, be a management consultant because you can offer advice, but you are not actually the guy on the field kicking the ball all around.”

What has happened in finance is that we have enabled a whole bunch of referees and people on the sidelines who are doing nothing but talking about investments, management processes and how money should be invested, but the reality is that the players on the field are Alex, Masaki, and myself, to a certain extent, are the guys allocating the risk capital. If you chain them to the ground and then you drown them, they will die, and the whole industry frankly will suffer, and you as an investor will all of a sudden have nothing to invest in.

It appears to me that the question has become a coin toss issue whether we have over-regulated the industry to the point where smaller startup managers who have good ideas are still able to thrive and become larger, bigger, better managers executing bigger, better trade ideas at the billion dollar level. I think the jury is still out on that.

I am still in this business, so I have voted with my feet that there is a business model that accommodates this. I look again at the GPIF and how they select their managers. I don’t mean to pick on Blackstone or JP Morgan Asset Management, those are perfectly fine, excellent, wonderful companies, but why did the GPIF not simply go through guys like them to allocate their money? Instead, the GPIF made a statement, and this is typically Japanese. The message encompasses a whole bunch of different things about the Stewardship Code, things the Japanese Government is suggesting to their people, how they want to see people act. Selecting a firm like Taiyo is a pretty strong statement about wanting Japanese corporate management to take a different view of the world.

You have got to understand that Japan is an incredibly dynamic, changing market right now. I don’t think this will be more of the same. I think we will see tremendous changes in individual companies, but obviously not across the board. That rising tide will find some people drown in it while other people float quite nicely.

When you put yourself in the seat of a U.S. pension fund manager, an Italian hedge fund manager or the French Government or an U.S. family office, they all have different reasons for wanting to invest in these sorts of products, and they also face different impediments. It's of course much easier to be a family office investor, so, as Alex was saying, it makes a lot more sense for him to take five different trips to the United States and be with a 100 different U.S. family offices and probably get a 5-10% hit rate on new capital coming in, because family offices are way better at taking risk right now than an institution that needs to check 35 different boxes on, like "Do you have a compliance officer?"

Alex Kinmont: The problem in Europe is also Japan's problem – assets are managed within financial conglomerates, not by focused, boutique managers, and those big financial conglomerates already have balance sheet exposure to the equity market. That means their risk appetite goes up when the local equity market goes up, and it goes down when the local equity market is falling That's not great news for Europe but could be a way out for Japan.

Whatever you think about what Mr. Kuroda has done, is doing, or will do, Mr. Bernanke and Mrs. Yellen have shown that if QE has no other effects, it does tend to raise the share prices. Whether that's good or bad for the economy is a totally different question, but it does have that effect. And actually, the Federal Reserve's own research bears this out.

That means here in Japan we have balance sheet exposed institutions benefiting from a rising market, therefore they will be able to take more risk. However in Europe we have balance sheet exposed institutions affected by a totally collapsed capital market. Well, where are people like us going to spend our time? And that situation would be the same whether or not there was regulation coming into play as well.

I think Europe is going to be tough for quite a while. It's slightly off the point, but it's going the same way as Japan. It has decided it just doesn't care about certain issues, and this happened in Japan in the early 1990s.

Ed Rogers You are right, that happened in Japan in the early '90s, but not today.

Alex Kinmont: No, not today. In ten years time we will come back and Japan will probably be okay while Europe will still be a disaster. Everybody will ask, "Why was it impossible for Europe to learn from Japan?" I suspect that will be the big lesson when we'll be looking back in the next 10 or 15 years.

In this context America is a different story as the country is so unusual in the way that it does things and how it puts things together.

As far as the macro situation for Japan is concerned, it is finely balanced, and in any single period the negatives could outweigh the positives. But on the positive side of the balance sheet we have one overwhelmingly supportive development - which is very slow burn, but with enormous effects. It is that the currency is no longer a dead weight on the economy. It is no longer a stone dragging down Japan, tied to Japan's feet and dragging it to the bottom of the pool. And that will work, as I say, very slowly, but consistently on the positive side of the ledger.

In any individual period, as we have just seen, the MOF can do silly things, like raising the consumption tax, for instance. And since it has been such a success they want to do it again. So they have learned nothing and in this respect are like the Bourbons, learned nothing, forgotten nothing.

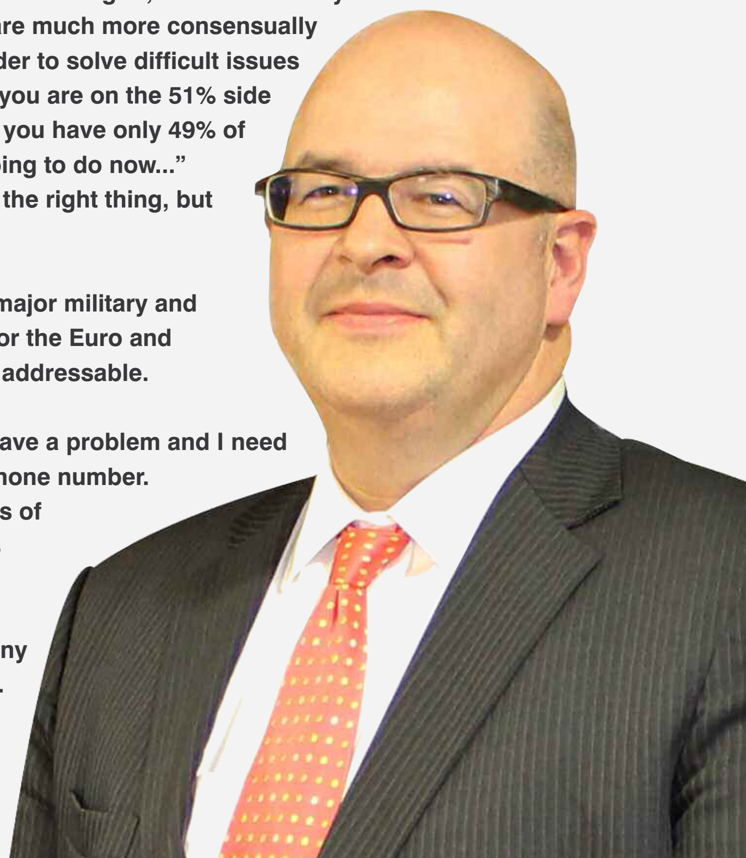
And so they will continue to do silly things. For instance, it requires a whip and chair to keep the Bank of Japan on the strait and narrow. At least one of the policy board members who voted for the increase in the buying of bonds this autumn is actually committed to wanting to tighten. He is quite clear that he wants to tighten, but for political reasons he voted for loosening - because he thought it would make it easier for the MOF to raise taxes instead. You really can't make this stuff up.

Anyway, you have still got all of these tendencies on the negative side of the ledger. In any one period it can be the case that the negatives outweigh the positives, but taken over a very long period it is more likely that, very slightly, the positive of the currency outweighs the negatives.

So what we are likely to get is a rewind of the story of the last 20 years. Just as Europe goes into the story of the last 20 years in Japan, Japan rewinds at the same slow pace that it went into the deflation, it rewinds out, and into mild but persistent inflation.

Ed Rogers: I love how Alex compared and contrasted Japan, Europe and the United States. Back at the end of 2008 or beginning of 2009 we put out a note saying, as bad as this all seems to be – and the financial crisis was pretty bad at that time – that the United States is going to respond better than any other economy to this crisis, because the political system is structured much more towards resolution of conflict.

If 51% of the people say, "okay, let's make a difference, let's change!", then the country will move forward. Japan and Europe on the other side are much more consensually driven, politically speaking, and therefore it is much harder to solve difficult issues than it is in the United States. In the United States when you are on the 51% side you kind of say to the others, "Too bad for you, you lost, you have only 49% of the people on your side, so listen, here's what we are going to do now..." And, by the way, what the 51% have decided may not be the right thing, but there is fairly quick action taken in response to crisis.



Europe is ungovernable in a crisis. Everything from the major military and political crisis of Kosovo to the economic crisis of 2008 or the Euro and sovereign crises, they just don't have a hierarchy that is addressable.

You can go back to Henry Kissinger who said, "When I have a problem and I need to solve it with Europe, who do I call?" There's no one phone number. Whereas when you call the President of the United States of America, you know you have got the guy, the puck stops there.

And for Japan it has been the same sort of thing. For many years there has been simply a lack of leadership, period. Every six to twelve month we got a new prime minister. You can't govern if there is nobody who is actually governing.

The United States political cycle, as much as you might dislike the raucous nature of American politics, it does create more of a mandate I think for problem solving than we have seen in Europe, or more pressure actually than mandate. More pressure can be applied to politicians to do something, whether it's the right or the wrong thing. Whereas in a crisis here – I mean Japan sort of was able to sit there for 20-odd years before anything meaningful really happened.

So, as we said, the ugly question for Europe is if they will be looking more and more like Japan in say five to ten years? I think that is probably more a political issue than an economic issue. I believe the politics will drive the economics to a certain extent.

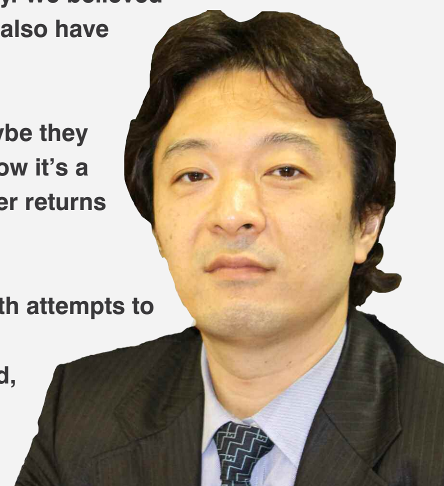
Matthias Knab So what is your take on the outlooks for your funds going forward?

Ed Rogers: We have been in business for eight full years now and we have only had one year where we had lost money, and that was 2011. That, as you may remember, was the year of the earthquake and tsunami, and 78% of that loss occurred in literally in less than three minutes on March 17, 2011.

We think Japan is the easiest alpha generation market in the world where we consistently find that hedge fund managers are able to execute a variety of strategies leading to positive returns in really almost every single environment, barring the immediate Act of God crisis such as the earthquake, tsunami, and nuclear problems that we faced in Fukushima.

We believe the outlook for returns in Japan remains absolutely fantastic. Regarding the outlook for individual hedge fund businesses here and their asset gathering capabilities, jury is still out whether we have captured enough mind share to generate significant amounts of new inflows for those managers to manage. I hope so. I hope to be part of the solution to that problem. But I think that remains a far greater challenge than actually managing the money well. The challenge is to get somebody to give you money to manage in this market.

Masaki Gotoh: We have been following the same investment strategy for ten years. Our firm is just newly formed, but the strategy hasn't changed, although we've adjusted and improved it along the way. We believed there was value then; we believe there is value now. The main difference is that we also have the momentum now.



I am hopeful that the changes that we have touched on earlier are permanent – maybe they won't be, but that won't change our strategy. We had some headwind before, and now it's a tailwind. I think it has become easier to execute and believe it can translate to higher returns than before.

Despite the momentum that Abe-san has, recently you read more negative news with attempts to take down Abe-san's administration. It seems that some are back to their political games and perhaps that trend could also hurt us at some point again. But like I said, we will continue what we do and hopefully the results will continue to prove themselves over time.

Matthias Knab Masaki, obviously you have launched your new firm recently – can you please tell us more about your launch, who seeded you?

Masaki Gotoh: Regulations in Japan are no simpler than anywhere else when it comes to starting a fund. The regulatory red tape here is enormous, but we felt it important to go through the process and demonstrate that we are committed and here locally.

It took us a year to build the infrastructure and organization, one that is for the sole purpose of engagement from a local perspective. Our team is physically located here with long relationships with Japanese businesses, government, and academia, and the same can be said about our strategic partners. That has helped from the legitimacy and establishment viewpoint.

We were seeded by a large domestic asset manager here in Japan, as well by one of our partner organizations.

We were in a fortunate position and the timing was great, and I am not talking about this month's returns. This year has been a year that has supported the engagement platform we have built, and thus we also have been fortunate to have some positive media exposure. We were able to attract several local institutions and respected and established individuals that can use our vehicle to express their view.

We have successfully operated the strategy for nearly 10 years despite all of the headwinds. We have been able to identify interesting companies that have wanted to change or have been able to convince them to change. And now we are fortunate that we have the backing of Japanese establishment to help in the process.

I hope investors, both globally and domestically, who are patient and believe in the story, an unwavering story that we will be saying for the next ten years and beyond, will come to believe that we can successfully offer a unique return profile. If you believe in our strategy for the long term, I think this might be an interesting vehicle for you. If not, so be it. I know there are many other successful strategies, and Ed can point you to all the right people.

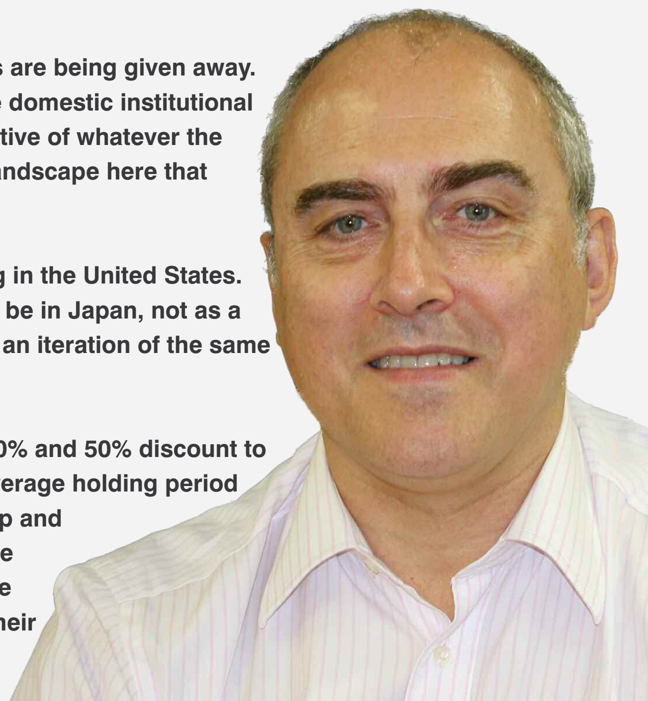
Alex Kinmont: Let me start with some thoughts about what could go wrong? What is worth thinking about? The threat to the sort of stuff that we do, on the one side, is that the market goes up and we don't go up by very much, which can happen. The market goes up a lot based on macro punters pushing around the futures, and that could happen given the degree to which people have ignored Japan for many, many years.

If they all decide not to ignore Japan, and we saw this in the early part of 2013, the effects can be absolutely enormous. A strategy that makes some money but not very much in a market that makes a lot isn't a terribly attractive proposition to investors. That's a big risk but we survived 2013.

And the other big risk is that for some reason - and what do we know about the exchange rate? - the exchange rate goes back to 80 or something like that. Who knows? We don't take positions based on macro variables because we don't know, but we are aware that that sort of thing could be a threat to realization of value in our strategy.

As far as the outlook is concerned, as I suggested earlier, the pool of opportunity has not shrunk. We were very optimistic a year ago, we were optimistic two years ago, and we remain optimistic today. On the long side, we can continue to buy great businesses, competitive businesses with 'wide moats' protecting their high market shares, and they are available at very depressed valuations. For such businesses the average discount to our estimate of intrinsic value or replacement value is nearly 45%.

That means that stocks of great companies and great businesses are being given away. That seems to me to be a feature of a market which has very little domestic institutional sponsorship, and that isn't going to change that quickly, irrespective of whatever the GPIF does. It's a great big fund, but it isn't going to change the landscape here that quickly.



We are lucky to have the support of a specialist in value investing in the United States. We tend to think of ourselves as a value strategy that happens to be in Japan, not as a Japanese strategy that happens to do value. Everything we do is an iteration of the same underlying philosophy.

If we can continue to buy competitive businesses at a between 30% and 50% discount to intrinsic value, we should be able to make decent returns. Our average holding period is almost two years, and that includes stocks which have come up and achieved our targets early and so left the portfolio early. There are quite a few stocks we have held for three to five years, and we are happy to hold them for another five until the market recognizes their value.

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