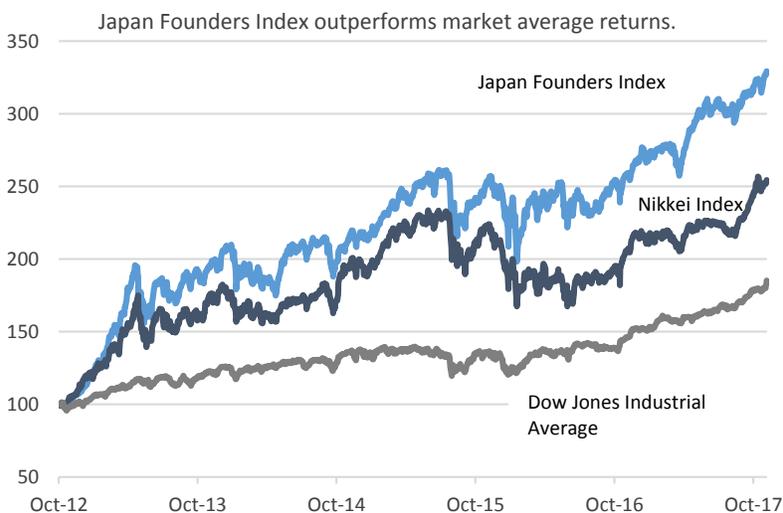


Founders' stocks are up 3x; the real meaning of the outperformance

The Nikkei-225 Stock Average Index (Nikkei Index) finished with a one-day ¥127 gain on November 30. While the ¥23,000 level has been a challenge for the Nikkei Index, those in the know are aware of the index called "Japan Founders Index" (the "Index"). The Index, which is managed by a US investment manager, is comprised of owner-operated companies such as Nidec Corp. and Keyence Corp. The Index level has tripled since the start of Abenomics in the fall of 2012.



Note: comparison with 100 = October 2012 Index price

More and more investors appreciate a management structure where the members of management are also large shareholders.

The Japan Founders Index consists of 139 owner-operator companies. It ranges from large-cap stocks, namely Softbank Group and Nidec Corp, to medium- and small-cap stocks like Outsourcing Inc. and Transcosmos Inc. The US investment adviser that manages the Index is Horizon Kinetics LLC ("Horizon"). The company manages about \$5 billion USD (¥560 billion) for mainly US based high net worth individuals and institutions such as pension funds. While its present investment allocation to Japanese equity appears limited, Horizon is a unique investment manager which focuses on owner-operators for its global equity investment strategies. "The strength of those owner-operators is that they engage in higher margin businesses," emphasized Ayako Hirota Weissman from Horizon.

The outperformance is obvious; since just before Abenomics started in October 2012, the Index has risen 3.3x, compared to the Nikkei Index rising 2.5x and the US Dow Jones Industrial Average returning 80%.

One example is Keyence Corp. The founder, Takemitsu Takizaki, built its distinct business model of fables manufacturing and direct distribution after experiencing bankruptcy twice. The foreign ownership of the company is approximately 50%. "It is true that its relatively low dividend policy (because the company prioritizes investment for growth) could improve; however, its business superiority makes the company an attractive investment," said Daisuke Nomoto from Columbia Threadneedle Investments.

Owner Operators with high foreign ownership

	Foreign Ownership ratio	Stock performance YTD
Keyence	49%	62%
Softbank	39%	22%
Nidec	35%	51%
Start Today	42%	70%
Obic	35%	52%
Digital Arts	21%	84%
Outsourcing	22%	2.7x

Foreign ownership as of March 2017 except Outsourcing as of Dec 2016.

Undoubtedly, there is a specific risk associated with investing in owner-operators. Nidec Corp clearly lists its high dependency on Chairman and CEO Shigenobu Nagamori as an operational risk in its annual reports. Fast Retailing Co Ltd Chairman and CEO Tadashi Yanai stepped down from President to be the Chairman in 2002, but returned in 2005. There is a possibility that the Japan Founders Index will underperform relative to the Nikkei Index if the negative aspects of owner-operators are exposed.

Do the companies run by agent (hired) managers (salaryman management in Japanese) focus on shareholder returns as much as owner-operators do? As stock options and trust-type equity-based compensation schemes are introduced, conditions for management to share the return goals of shareholders are increasing. This year, Benesse Holdings Inc and Yahoo Japan Corp introduced stock-based compensation, and now one in three companies incorporates a stock-based compensation scheme.

Tokyo Marine Asset Management's Jyunpei Kitahara said: "To significantly alter the management's mindset, stock-based compensation should reflect 10 years to 20 years' worth of long-term earnings performance of the company." He is convinced that if management increasingly focuses on long-term shareholder returns, Japanese equities can rise higher.

Among some investors who follow owner-operators, the current trend of strong corporate earnings revisions presents an opportunity for the reform of Japanese corporations in general.

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