



## 2<sup>nd</sup> Quarter Commentary

August 2025

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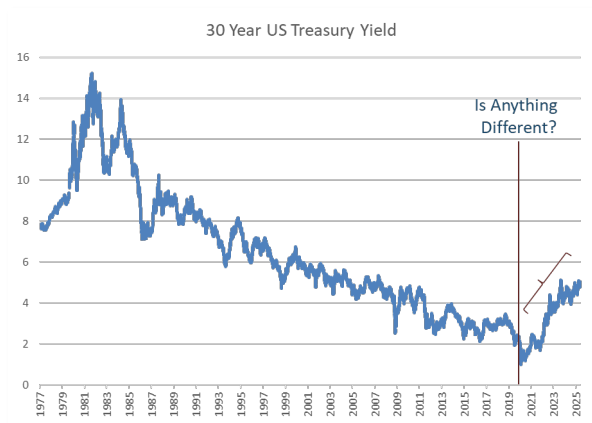
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## What We're Doing Now: The Index Risk Avoidance Dodge and Active Management Redux Edition, Part I

### 1. Introduction: Has Indexation Even Worked? (The Numbers Are In) And Ways to Escape It

Summer is a good time to pause and consider—in broad brushstrokes—where we are in the investment sphere. Year-end would be another natural time for reflection, but usually a more distracting period. Summer is more suited, aspirationally at least, to a relaxed mental stance.

The most obvious initial area for inquiry: What have the investment results been in the relevant past? *Relevant* past must be long enough to identify the underlying forces that shaped the results. If you're shepherding capital for an extended future, the look-back can't possibly be only three or five or even ten years. No more than you can extrapolate, even from a 10,000 square mile survey, what Texas looks like, with its 10 climate zones across 270,000 square miles that range from desert valleys to agricultural prairie to forested mountains.



Whatever the investment returns are, a follow-on question would be: Have the economic and market conditions changed? You'd think that the performance results, particularly in the Information Technology Era, now catapulted further aloft by AI, would be fairly robust.

Conveniently, as of May 2025, a slew of equity and bond ETFs now have 25-year records. There are many more with 23- and 24-year records. That first wave of ETFs were the most basic cornerstones of asset allocation models: straight-up domestic equities,

foreign stocks, large-cap, small cap, plain growth and value, and emerging markets. They pre-date the almost innumerable and more esoteric style, factor, and leveraged indexes that proliferated thereafter.

That's an extremely valuable store of data, perhaps no less than the famed 1976 Ibbotson & Sinquefeld historical returns study, "Stocks, Bonds, Bills, and Inflation." That 45 years of monthly time series data provided the missing statistical elements, particularly volatility and risk premiums (as between stocks and cash, or small-cap and large-cap), to complement the Capital Asset Pricing Model. They completed the basis for the now-industrialized asset allocation and indexation mode of investing. And as of May, everyone has access to from-inception results of perhaps the greatest investment experiment of the modern era. Results that are...odd...unexpected...not what we were taught.

## MARKET COMMENTARY

2<sup>nd</sup> Quarter 2025

August 2025

Annualized Total Return (as of July 31, 2025)	Ticker	Inception Date	25 Yr	Since Inception	Fund Age (Yrs)
iShares Core S&P 500 ETF	IVV	5/15/00	8.1		25.2
iShares S&P 500 Value ETF	IVE	5/22/00	7.3		25.2
iShares S&P 500 Growth ETF	IVW	5/22/00	8.2		25.2
iShares Core S&P US Value ETF	IUSV	7/24/00	8.2		25.0
iShares Core S&P US Growth ETF	IUSG	7/24/00	7.6		25.0
iShares S&P 100 ETF	OEF	10/23/00		8.0	24.8
iShares Dow Jones US ETF	IYY	6/12/00	8.1		25.2
iShares Russell 1000 ETF	IWB	5/15/00	8.1		25.2
iShares Russell 2000 ETF	IWM	5/22/00	7.5		25.2
iShares Russell 1000 Value ETF	IWD	5/22/00	7.6		25.2
iShares Russell 1000 Growth ETF	IWF	5/22/00	8.0		25.2
iShares Russell 2000 Value ETF	IWN	7/24/00	8.3		25.0
iShares Russell 2000 Growth ETF	IWO	7/24/00	6.2		25.0
iShares Russell 3000 ETF	IWV	5/22/00	8.0		25.2
iShares Core S&P Small-Cap ETF	IJR	5/22/00	9.1		25.2
iShares Core S&P Mid-Cap ETF	IJH	5/22/00	9.2		25.2
iShares S&P Mid-Cap 400 Value ETF	IJJ	7/24/00	10.2		25.0
iShares S&P Mid-Cap 400 Growth ETF	IJK	7/24/00	8.3		25.0
iShares S&P Small-Cap 600 Value ETF	IJS	7/24/00	9.1		25.0
iShares S&P Small-Cap 600 Growth ETF	IJT	7/24/00	8.7		25.0
iShares Russell Mid-Cap ETF	IWR	7/17/01		9.6	24.1
iShares Russell Mid-Cap Growth ETF	IWP	7/17/01		9.7	24.1
iShares Russell Mid-Cap Value ETF	IWS	7/17/01		9.2	24.1
iShares MSCI EAFE ETF	EFA	8/14/01		5.8	24.0
iShares Global 100 ETF	IOO	12/5/00		6.9	24.7
iShares MSCI Eurozone ETF	EZU	7/25/00		4.0	25.0
iShares MSCI Pacific ex Japan ETF	EPP	10/25/01		8.7	23.8
iShares MSCI Emerging Markets ETF	EEM	4/7/03		8.8	22.3
iShares Latin America 40 ETF	ILF	10/25/01		8.2	23.8
iShares Core US Aggregate Bond ETF	AGG	9/22/03		3.1	21.9
iShares 1-3 Year Treasury Bond ETF	SHY	7/22/02		1.9	23.0
iShares 7-10 Year Treasury Bond ETF	IEF	7/22/02		3.4	23.0
iShares 20+ Year Treasury Bond ETF	TLT	7/22/02		3.7	23.0
iShares TIPS Bond ETF	TIP	12/4/03		3.5	21.7

Source: Morningstar Direct

These since-inception ETF returns are not only contrary to expectations, they raise three serious challenges to the empirical basis of the capital asset pricing theory about the presumed returns from stocks and bonds, and index-based allocations—they can't *not* be questioned.

The first challenge is the ETF returns themselves; then the returns of gold; and of Bitcoin.

- **Equity indexation** proponents have long promoted a foregone conclusion that active managers couldn't beat the equity index. Now, *after a full generation, it seems the equity index can't even beat the equity index*—the presumed 10% base annual return:
  - The iShares Core S&P 500 ETF's 25-year return since inception is around 8%.
  - The MSCI EAFE ETF didn't even reach 6% over 24 years.
  - The iShares Core MSCI Emerging Markets ETF rate of return was 8.8%.
  - Not a single regional index—Europe, Asia, Latin America—approached the mark.
  - Bond ETF annual returns, whether short-term, long-term or inflation-indexed TIPS, ranged between 1.9% and 3.7%—*negative* after-taxes and inflation.

- What did achieve a 10% since-inception return is the **iShares Gold Trust**. Inception was 2005, so it's only a 20-year record. Unlike a stock index, though, there are no calculation complications in determining the actual gold return pre-dating the ETF, since gold is all this fund holds. There are no spin-offs or dividends to account for, weighting changes or index rebalancing, or company additions and deletions. The 25-year annualized return of gold since May 2000 is 10.4%

iShares Gold Trust (IAU) (as of July 31, 2025)	
Ticker	IAU
Inception Date	Jan 2005
10 Yr	11.35
Since Inception	10.16
Fund Age (Yrs)	20.54

No index configuration, even at the regional level, has been able to outperform simply holding metal in a fund for two-plus decades. This would seem to contradict modern portfolio theory, particularly since many economically important nations adopted business-friendly policies during those decades. In the U.S., those benefits ranged from lower interest rates; geographic labor-cost arbitrage; and from outright lower tax rates to the indirect geographic corporate tax arbitrage (why the largest U.S. global companies pay little to no taxes). Plus, over the past decade, with no help from directed government policy, came the gift to corporate profit margins of drastically lower commodity prices.

Going forward, separate from the loss of some or all of those factors that supported record corporate profit margins and valuations, indexation may face an even bigger challenge. A challenge of its own making. Indexation does not recognize qualitative attributes like valuation, since that is subjective and the realm of active management. Only descriptive statistics, like market cap, trading volume, industry sector, and price volatility determine index eligibility. There is no concept of excessive valuation:

As more money enters the ETF, the ETF buys more of whatever's already in it. If that's not well enough known, it's at least implicitly accepted.

### Scarcity Value

Imagine that each time you wanted to buy an uber-rare 1913 Liberty Head Nickel, last auctioned for almost \$4 million, and of which only five were created, the Philadelphia Mint created a new one? What would happen to that coin's market value? This is not entirely a fanciful idea. The five were clandestinely produced by a U.S. Mint employee the once, so why not again? Scarcity investing is the diametric opposite of ETF investing as now practiced (which means required and unlimited new share issuance for new money). Everyone gets the same price. Always.

By the same token (see clever token reference below)—in fact, by charter—**ETFs officially reject, cannot allow, scarcity**. It's not merely that they exclude securities of insufficient market value and trading liquidity; that's a lesser issue. Rather, they invite any volume of new money into the index, constantly issuing new ETF shares. If they don't, they're not functioning ETFs, they're closed to net new money.

- **Bitcoin**, in contrast, is based explicitly upon scarcity value; no more than the originally established 21 million coins can be created. Historically, predating even the 1602 invention of the publicly traded

limited-liability joint-stock-ownership company,<sup>1</sup> investors seeking after-inflation wealth preservation made explicit use of the inherent value of scarcity. In rare coins, art, or other collectibles that weren't subject to supply-based dilution. Even certain less-inflationary currencies have been used for the same purpose.

For example, the U.S. dollar depreciated by over 80% against the Swiss Franc in the 53 years since 1971. It now purchases that much less of generic anything from Switzerland. It's no accident of chance that while the Swiss money supply increased 10x in the 52 years from 1971, total U.S. money supply rose 30x. That's 6.7% annually, while U.S. GDP rose at a lesser 6.4%

rate. Although the Swiss Franc was itself being debased by 4.6% a year,<sup>2</sup> it had scarcity value relative to the Dollar, which was debasing more rapidly. Had Bitcoin existed then, the Swiss Franc would, in turn, have been debasing relative to Bitcoin.

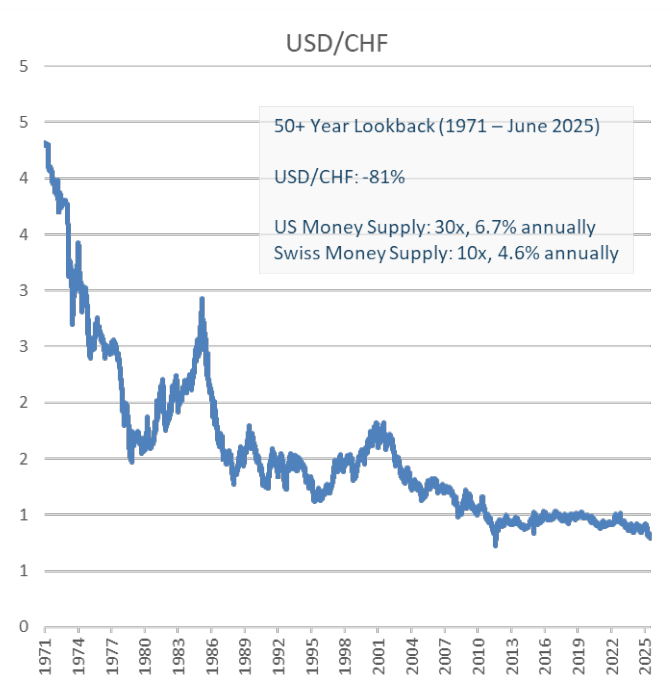
Scarcity need not be in a physical asset. It might be the most valuable of *financial* assets. That isn't just a theoretical concept; it can be acquired in the form of transactable instruments. Does that seem exotic?

Volatility itself one of the primary assets traded on the CBOE. It is not scarce, but it demonstrates the scale of demand that can exist for what is just a formula embodied in an index embodied in an ETF.

Bitcoin's market value, now \$2.3 trillion, would make it #8 in the S&P 500.<sup>3</sup>

Bitcoin ETFs total \$160 billion. If consolidated into one fund, this would be the eighth largest U.S. equity ETF.

**The U.S. Dollar vs. the Swiss Franc, Case Study**



Crypto ETF with AUM >1B	Ticker	AUM (\$MM)
iShares Bitcoin Trust ETF	IBIT	86,166
Fidelity Wise Origin Bitcoin Fund	FBTC	24,004
Grayscale Bitcoin Trust ETF	GBTC	21,475
iShares Ethereum Trust ETF	ETHA	10,686
ARK 21Shares Bitcoin ETF	ARKB	5,819
Grayscale Bitcoin Mini Trust ETF	BTC	5,436
Bitwise Bitcoin ETF Trust	BITB	4,820
Grayscale Ethereum Trust ETF	ETHE	4,288
2x Bitcoin Strategy ETF	BITX	2,929
ProShares Bitcoin ETF	BITO	2,719
Fidelity Ethereum Fund ETF	FETH	2,597
Grayscale Ethereum Mini Trust ETF	ETH	2,530
2x Ether ETF	ETHU	2,012
VanEck Bitcoin ETF	HODL	1,967
ProShares Ultra Bitcoin ETF	BITU	1,297
Crypto ETF with <\$1B	various	4,375
<b>Total Cryptocurrency ETF</b>		<b>\$183.12</b>

<sup>1</sup> The Dutch East India Company, which traded on the Amsterdam Stock Exchange, now known as Euronext NV

<sup>2</sup> M3 expansion vs. GDP growth of less than 1% per year

<sup>3</sup> As of July 30<sup>th</sup>, 2025

More conservatively measured, Bitcoin ETFs, which are only 7% of Bitcoin's total market value, amount to 8% of all the major S&P 500 ETFs.

Alternatively, Bitcoin ETFs would be the fifth largest U.S. listed **currency ETF**, just below the Swiss Franc.

Currency	AUM Rank	AUM (\$B)	# of ETFs
JPY (Japanese Yen)	1	\$701.75	3
EUR (Euro)	2	\$599.59	3
USD (U.S. Dollar)	3	\$505.07	3
CHF (Swiss Franc)	4	\$407.60	1
AUD (Australian Dollar)	5	\$94.60	1
CAD (Canadian Dollar)	6	\$93.34	1
GBP (British Pound)	7	\$91.33	1
Diversified	8	\$11.16	1
<b>Cryptocurrency</b>		<b>\$183.12</b>	<b>42</b>

Source: *etfdb.com*. As of July 30th, 2025

### Scarcity Investing

How does one buy scarcity? It can exist almost anywhere, if one is oriented to search it out. It is available to any individual investor—in that limiting sense, it's not so rare—but by operation of the iron law of supply and demand, it can't be available for everyone or for the largest investors. In a way, like rare earth elements: They are not exactly rare, in that they exist in abundance in the earth's crust, but in very low concentrations. They must be extracted from extraordinarily huge volumes of valueless soil overburden and waste rock.

Likewise, scarcity value in financial assets can exist in reasonable quantities—with the same limiting proviso: for some investors, just not for all—even in an entire nation, like **Japan**. To asset allocators, Japan might look like the iShares MSCI Japan ETF. They would be unaware that this index is only semantically Japanese, with little functional exposure to the domestic Japanese economy. The ETF's dominant companies are for the most part multi-nationals that derive the great majority of their earnings from *outside* Japan. What asset allocators are really doing is exposing themselves to the country's primary export markets.

iShares MSCI Japan ETF	
Weight of Top 10 Holdings	% Revenue Outside Japan
27.8%	77.2%

Beneath the surface of the index, though, there is something like rare earths, but incomparably better. Due to the unique attributes of the Japanese corporate and stock market regulatory systems, which are undergoing dramatic market-oriented changes after 30 years of inefficiency and dysfunction, there is no small selection of rare classic value and growth companies. Because of their nonpareil Japanese characteristics, they have very long term and substantially unimpeded expansion runways.

The notion of scarcity value combined with availability might seem a paradox. It can be resolved by an approach that might be called *anticipatory scarcity value*. John Templeton, perhaps the greatest public-markets equity investor on record, underperformed the S&P 500 for the first decade-plus of the Templeton Growth Fund's existence: from 1955 through 1968, and dramatically so for most of that span. But, in the full decade of the 1970s, the Templeton Growth Fund cumulatively returned almost three times the results of the S&P 500; annualized, 18.8% vs. 6.5%.<sup>4</sup> What was going on?

In the 1950s and '60s, first personally, then for the Templeton Growth Fund, he was investing in Japanese companies. He had observed that they were growing at far higher rates than U.S. companies. He also observed that while the published P/E ratios appeared to be normal enough, Japanese companies did not consolidate their subsidiaries on their balance sheets, contrary to U.S. practice. Adjusted to include their

<sup>4</sup> Templeton Growth A (TEPLX) 1970-1979



proportionate earnings of those subsidiaries, Japanese companies were actually trading at only a few times earnings.

Those investments eventually amounted to about half of the Templeton fund, and he stayed with them for many years before they eventually paid off. Had he not been in charge of his own job security, he surely would have been dismissed for cause long before his thesis was verified. After all, a decade-plus; how long is too long, for goodness' sake?

John Templeton was a picture of an essential distinction between indexation (the “crowd”, in his pre-ETF-era lexicon) and active management.

- The central concept of indexation is, let us be clear, *to get the same price as everyone else*. It was an elegant solution for the many, when an S&P 500 Index mutual fund was first proposed and practiced by John Bogle's Vanguard in 1975. In that era, the very small proportion of money in index mutual funds could get the so-called free-ride on the results and clearing prices established by everyone else, without actually impacting those prices.
- Contrarily, John Templeton *made use of, or took the opposite side of, everyone else's pricing*. He capitalized upon instances when the majority abandoned, sold, discounted or simply avoided certain securities or sectors to such an egregious degree that they in fact created the valuation opportunity for him. Mr. Templeton couldn't create the discount himself; only “the market” could.
- The index can't “see” pricing anomalies that it either creates or that exist outside its rule-set boundaries.

Today, Japan again presents unique valuation anomalies not available to the ETF crowd, though for very different reasons. Identifying these kinds of valuation distortions requires company-level analysis and judgement. And, importantly, without predetermined limitations because, well, the rules might be fixed, but the world changes every moment. All of which is the province of active management. Horizon Kinetics is lately applying two distinct Japan equity strategies, each of which is enabled by a different set of social and business structure factors now at play. These have created both unsustainably deep discounts and a different form of value realization process.

There is a cogent case for reversing the old active vs. passive assertion: Based on the changing nature of the U.S. economy from its profit-boosting glide path of the past couple of decades, as well as the distorting impact of indexation upon market structure and valuations, let us herewith flip the script and propose that it is a foregone conclusion that the indexes will no longer be able to beat the active manager.

Here are two idea pictures of what indexes can't see or do. Also, indexes are not good at such applied constructive irony:



## *Playing Some Jokes (good-humoredly, of course) on the Indexes*

*Alliance Bernstein LP (truly owning a diversified dividend growth portfolio instead of paying for it)*

On the one hand, people pay managers to diversify across large cap, small cap, international, emerging markets, bonds, and alternatives. They pay a fee on all that and get maybe a 1% or 2% dividend yield. On the other hand, you can *be paid* to get all of that in Alliance Bernstein, which is used in some income-oriented portfolios. As a unit holder, rather than being a client, you're a partial owner of this respected publicly traded asset manager. Meaning that instead of being a fee payer, you're a *fee collector*.

As an LP, the company pays out its earnings, and the recent distribution, which varies with operating profits, yields about 8%. Unlike most active managers, the company has been a recipient of net asset inflows for several years. Between such ordinary external growth, if it continues, and long-term appreciation of the portfolio, achieving an extra 2% is a modest hurdle. The company is also majority owned by Equitable Holdings, which in April increased its interest from 51% to 69% and also invests in Alliance Bernstein funds.

So, own the manager, take some of the fees, start off 80% of the way toward a 10% return. It's a different return model than buying a portfolio of ETF asset classes, or than a "dividend aristocrats" ETF that might have a 3%-ish yield.

## *Securities Exchanges as the Superior Index – Intro*

Observe these few numbers, an impressive expansion of which—and the explanation for which—will be elaborated upon in the 3<sup>rd</sup> Quarter Commentary, Active Management Redux Edition, Part II.

A U.S. investor seeking a diversified portfolio would have been better off owning CME Group for the past couple of decades than the S&P 500.

As of June 2025	20 Year Total Return (USD)	
	Cumulative, %	Annualized, %
CME Group Inc.	819.7	11.7
S&P 500	668.2	10.7
<b>Excess</b>	<b>151.5</b>	<b>1.0</b>
Hong Kong Exchanges & Clearing Ltd	3516.3	19.6
Hang Seng Index	236.4	6.2
<b>Excess</b>	<b>3280</b>	<b>13.4</b>
London Stock Exchange Group Plc	2095.2	16.7
FTSE 100	176.7	5.2
<b>Excess</b>	<b>1918.5</b>	<b>11.5</b>

Source: Bloomberg

Might this investor have wanted to invest in the U.K.? London Stock Exchange Group returned 3x more than the FTSE 100.

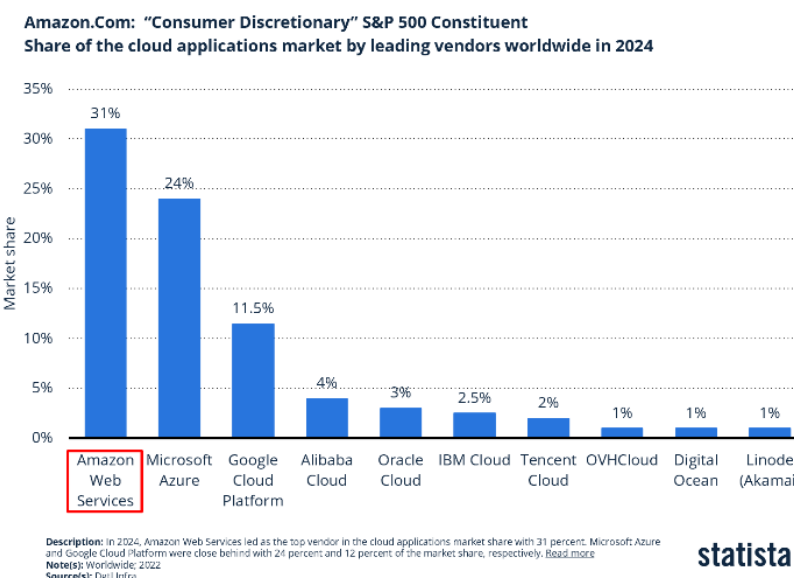
How about Hong Kong 20 years ago? The Hong Kong Exchanges & Clearing Corp. shares returned 3x more than the Hang Seng Index.

There are plain, sustainable financial and business model reasons why a securities exchange, which can be even more diversified in its economic sector exposure than the broad equity indexes, will outperform its local stock market over time. There are also good reasons to believe that securities exchanges as an equity class and strategy will do better in the next couple of decades than the past couple.

### *For the Forward-Looking ETF Investor (Using the Index Itself to Identify Scarcity)*

Having perused indexation's results in the current ETF era, a final couple of notes on factors that will suppress its return possibilities in the coming era.

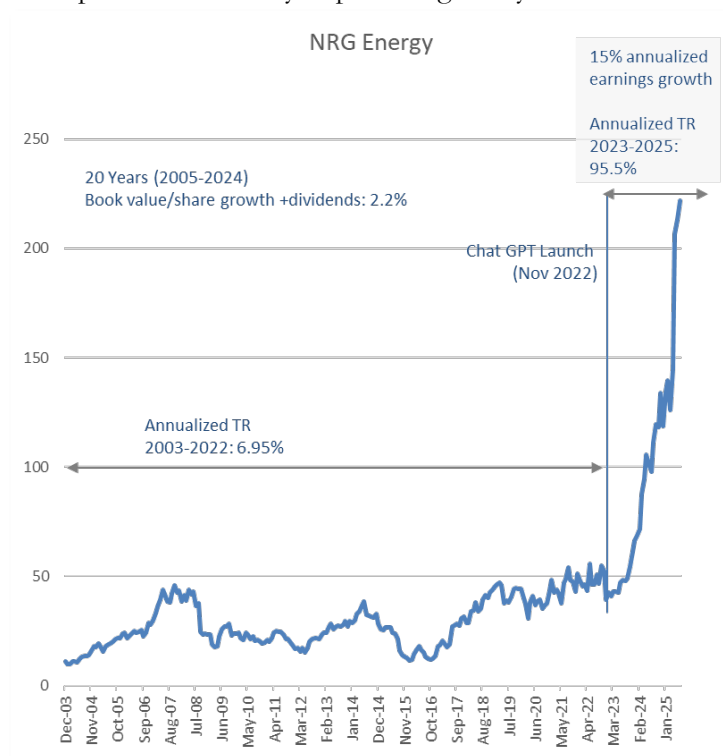
With the IT sector now over 44% of the S&P 500 (including so-called "Consumer Discretionary" Amazon and "Communications" Meta and Alphabet), it crowds out important economic sectors that were once important *index* sectors, too. Their future outperformance, should it come to pass, will not be captured as more than as a rounding error.



**Electric utilities** are one of those. AI data center expansion is already super-sizing many industries' growth rates, electric utilities among them.

The sector underperformed the market for decades. Regulated utility electricity output in the past 20 years *declined* by 10%. Net generation from all sources, including renewables, did rise, but only by 6%, or about 0.3% per year. The annual return, including dividends has been 7.8%.<sup>5</sup> That was one era. What if utilities meaningfully outperform the S&P 500 in the next 20 years?

One example among many is NRG Energy, which operates in 24 states. In the 20 years through 2024, the per-share book value, plus dividends, rose by only an annual 2.2%. The share price total return: 6.9% annually in the 18 years through 2022. That was a month after ChatGPT was released. Since then, the shares have quadrupled.



Source: Factset, Company's reports, Horizon Kinetics Research

<sup>5</sup> iShares U.S. Utilities ETF from inception (June 2000) to June 2025

NRG now sees 15% annualized earnings growth for the foreseeable future, based on demand growth that exceeds the rate at which new generation capacity can be built. That's unheard of in the modern era. It beats historical overall U.S. corporate sales and profit growth.

If Utilities could now be a growth sector, the investing problem is that while its 1990 S&P 500 index weight was 6.2%, it is now only 2.3%. The sector's positive optionality has been largely crowded out of future S&P 500 results.

The crowding-out implications are more extreme for base and precious metals, like copper, iron ore and silver, which for many of the same reasons are in a long-term demand phase. However, their production capacity has been reduced over the past decade, a condition that probably can't be cured for another decade. The price and profit implications of the eventual supply/demand imbalance are obvious.

Or gold, a dollar and economic-uncertainty hedge, which is likewise supply capacity challenged.

The sum of the two base and precious metals companies in the S&P 500, Newmont and Freeport-McMoRan, totals 0.24%.

A more extreme opportunity cost—meaning future returns that won't be captured by the index—resides in *unrepresented* sectors, which by definition manifest the maximum scarcity.

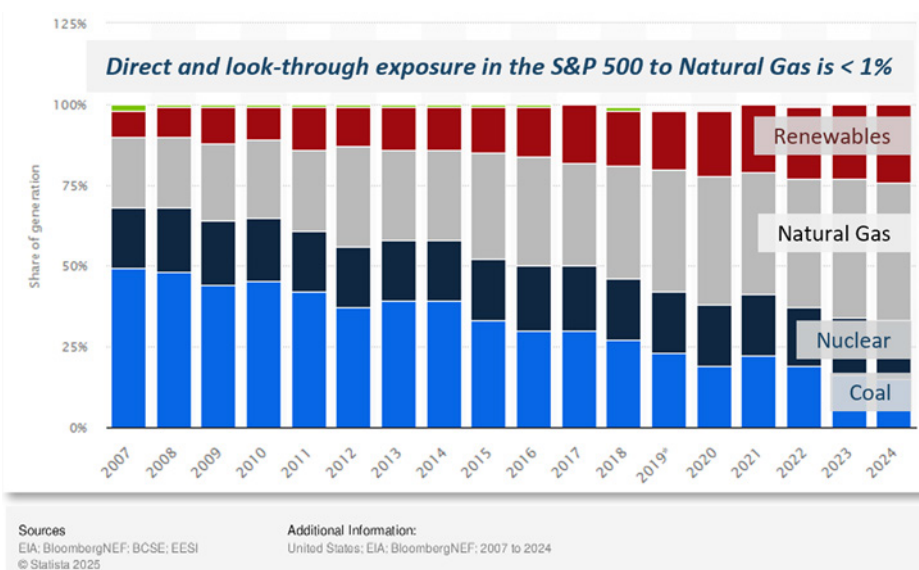
Those of greatest interest today would be whatever is a limiting factor in data center expansion, like hard asset companies that provide water, land, and natural gas.

The only direct natural gas exposure in the S&P 500—that is, through a hard asset company like a royalty—is 0.009%. That's through Texas Pacific Land Corp (TPL). That exposure is calculated as TPL's 0.03% weight in the index times the approximately 30% of the third-party oil and gas production volumes (from which it receives its royalties) that come from natural gas.

**Worldwide Production**

Metric	Gold	Silver	Iron Ore (billions)
Tons			
2014	2,990	26,800	1.43
2015	3,100	25,100	1.43
2016	3,110	25,700	1.45
2017	3,230	26,800	1.50
2018	3,300	26,900	1.47
2019	3,300	26,500	1.52
2020	3,030	23,500	1.52
2021	3,090	25,000	1.63
2022	3,060	25,600	1.54
2023	3,250	25,500	1.56
2024*	3,300	25,000	1.60

Source: Statista



One should probably add the asset-intensive exploration and production companies like ExxonMobil and Chevron. Those plus TPL amount to 1.92% of the S&P 500 as of August 1<sup>st</sup>, and natural gas is just over 30% of their weighted average production volumes. Calculated in the same way, the natural gas exposure in the S&P 500 just under 0.60%

Direct water exposure is non-existent, too, except through TPL. Land, too, probably, except for TPL.

The rising commodity prices that would enhance earnings growth at those “hard-asset” companies would simultaneously degrade the operating margins of the cloud and AI companies. As an exogenous factor, this would be a double-edged sword for the index: no index capture of the hard asset companies’ growth, even as the basis for their growth suppresses the index earnings.

Worse yet would be operating systems and companies that are absent from the index, but which present disintermediation, displacement or obsolescence risk. Among these are certain blockchain development companies, like WisdomTree. Its Prime digital wallet uses tokenization to allow users to spend, save, and invest in a way that bypasses and displaces intermediaries like banks and payment processors like Visa. Stablecoins just require a collateral custodian, without the dominant card processors or banking “rails.” By removing barriers to entry, they can commoditize banking and spending.

Both indexation and AI are robotic models, which are only as good as what they’re fed. Neither has reached actual intelligence (or Artificial General Intelligence in the case of AI). That’s why the best humans are still better than indexes and chatbots at, say, picking stocks. Ironically, it is the emergent AI companies that are the most threatening risks to the S&P 500 and which are driving the indexation system into dangerous territory. That’s because, at the business model level, the S&P 500 is competitively centered on the largest IT companies. Those companies are themselves investing the most heavily in their own AI capabilities, which capabilities can disintermediate much of their own business. More of which below.

This is a way of saying that the S&P 500 is no longer the holistic solution to equity investing that it originally was, an all-inclusive reasonably proportional representation of the economy (to the degree that the availability of publicly traded equities would allow, real estate being a major exception). Today, it excludes or very nearly excludes truly important sectors, both of the established and the emergent growth variety.

As well, the top of the index—though it’s not yet obvious on the surface—is under siege. There’s the whole rest of the world that exists outside of the index for active management to make use of.

## **2. Creative Destruction Wielded Broadly: AI Doesn’t Just Threaten Jobs, It Threatens The Mag 7**

The Magnificent 7 is the financial market vernacular for the extraordinarily successful IT/AI companies Alphabet, Amazon, Apple, Meta Platforms, Microsoft, NVIDIA, and Tesla. Their combined market value—\$21.3 trillion—is 33.2% of the S&P 500 index.<sup>6</sup> There is no historical precedent for such extreme concentration.

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<sup>6</sup> As of July 30<sup>th</sup>, 2025.

These largest companies in the world have attained their valuations because of a dominant competitive position. A sampling:

- Microsoft's is the dominant computer operating system.
- Alphabet's Google is the dominant internet search engine.
- Tesla had the dominant electric vehicle brand.
- NVIDIA produces the dominant semiconductor graphics processing unit (GPU) and the dominant application programming interfaces (APIs) for high-performance computing.
- Just below the Mag 7, others are relevant here. Among them: Visa and MasterCard, the 13<sup>th</sup>-and 16<sup>th</sup>-largest positions in the S&P 500, which own the dominant credit card payment systems. They are another 2.0% joint weight.

These dominant, unchallenged companies' high valuations reflect, in part, their anomalously high profit margins, which exist because they have been insulated from competitive threats for an inordinately long time. In a normal economy, large companies with enormous numbers of customers and very high returns on invested capital attract serious competition. For about the past quarter century, though, the Google search engine has had no effective competition.

Their high profitability is partly owed to a near unique phenomenon: Some of them did not have to pay for their essential operating assets. Unlike the cable television industry, those IT companies dependent upon the internet to operate their business—such as Google and Apple—did not have to build their own really, really costly cable and fiberoptic networks. The internet already existed and was free, so they weren't saddled with asset-intensive balance sheets and capital spending requirements that would have absorbed most of their earnings. Rather, it is the phone companies that maintain that network (and they're not too profitable, are they?). Central to the early success of other Mag 7 companies, like Facebook, was the low-cost or even zero-cost data and content provided by their users, and which the companies were at liberty to monetize. That was then.

Now, there is a Private Mag 7: SpaceX, Open AI, Stripe, Databricks, Fanatics, Scale AI, and Rippling. By definition, these companies are not yet public, but they do trade on private exchanges. Because there is a trading market, price data is available: SpaceX has a \$460 billion market value; the next largest is OpenAI, at \$325 billion. Collectively, the seven are worth \$1.016 trillion;<sup>7</sup> that's almost one-third the size of the \$3.037 trillion aggregate market value of the Russell 2000 Index. If and when—only after the index's one-year IPO “seasoning” requirements—these are included in the S&P 500, the Public Mag 7 weightings

	Valuation (\$ Bln)
SpaceX	460
OpenAI	325
Stripe	92
Databricks	76
Fanatics	17
Scale AI	29
Rippling	18
<b>Total Private Mag7</b>	<b>1,016</b>
<b>Total Russell 2000</b>	<b>3,037</b>

<sup>7</sup> Source: Forge Global. Forge Private Valuation indicates the most current price per share of a private company based on a combination of secondary market transactions, recent funding rounds, and indications of interest on Forge.

will have to be proportionately reduced. OpenAI, for instance, would be about the 25<sup>th</sup>-largest position in the S&P 500, by market cap, even with the private-market discount that must be in the valuation.

Such a re-weighting of the index is of little import compared to the competitive risks that the Private Mag 7 represent to the Public Mag 7.

Open AI, which operates ChatGPT, could conceivably provide competition that **Alphabet's Google search engine** has never had to face. The basic ChatGPT service is free and is not advertiser-based, which is inherently different than Google's business model. Used as a search engine, ChatGPT can avoid the advertiser-directed Google searches.

Those who use it this way will draw traffic from Google and, at the least, exert a negative impact on the market value of the all-important Keywords purchased by Google advertisers. Google's basic business is based on the sale of these search terms for advertisers who bid for them in an auction. The high bid for a keyword earns the right to the first position in a Google search, the second-highest bid earns the right to the second position, and so on.

It is quite conceivable that Google will experience serious keyword advertising revenue drain, but this will not necessarily show up in overall traffic volumes. That's because most of Google's search traffic is for low-priced trivial searches, which are an operating expense with little revenue opportunity. It's not that a chatbot will drain a lot of traffic; rather, it will drain the most lucrative traffic—the non-trivial search activity—thereby degrading Google's now-astonishingly-high profit margins.

Another feature of ChatGPT is the Sora Video Generator. Importantly, it can create video directly from text. This is a direct threat to **YouTube** and its content advertising model. If the content is created on ChatGPT, it will bypass YouTube. People who wish to send these text-generated videos to others might be bypassing **Instagram and Facebook**, which share a business model of selling advertising space on the social media platforms.

Although ChatGPT was first available to the public in November 2022, the more-powerful stable-release version (OpenAI o3 and o4-mini) only became available a few months ago, in April 2025, so it's too early to assess the impact on Google revenue. Nevertheless, it one might reasonably anticipate it. As a search engine—aside from its other applications—ChatGPT enhances productivity compared to reviewing the many almost irrelevant Google search results.

The more powerful generations of ChatGPT pose other competitive threats. The new version, ChatGPT 4 is available on a subscription basis for a monthly fee of \$20. Among its many features, it can analyze fairly long documents and provides limited access to Sora video generation. ChatGPT 4 Pro, at \$200 a month, can analyze far larger documents and provides unlimited or extended access to a variety of the same and higher-level analyses and services. There is, of course, a Teams version for businesses, with a lower per-user monthly fee.

Among ChatGPT4's features, you can practice speaking a foreign language with a virtual native-speaking partner. This dramatically reduces the utility of many forms of foreign language learning content now available on Google's **YouTube**. It is very difficult to resist the conclusion that OpenAI is a serious



competitive threat to the Alphabet core economic model. Alphabet is 3.6% of the S&P 500 (which, just to mention, is larger than the entire Energy sector of the U.S. economy, as embodied in the index).

Just as significant on a different front, all this will de facto place OpenAI in the cloud business, since people will surely wish to store or save the results of their ChatGPT queries and their text-generated Sora videos. More than 100% of Amazon.com's earnings come from its cloud computing subsidiary, **Amazon Web Services** (albeit only 15% of total revenues).

OpenAI is the key partner in the \$500 billion **Stargate** data center project in Abilene, Texas.<sup>8</sup> This money is to be spent in the next four years. The planned data center campus is so massive that it is difficult to imagine this will not pose a threat to the cloud computing businesses of **Apple, Amazon Web Services, Microsoft, Alphabet and Meta Platforms**. Microsoft is an investor in OpenAI, although the size of its stake is not yet public.

Stargate isn't the only such project. In May, OpenAI, Oracle, NVIDIA, Softbank, and Cisco announced a plan to build Stargate UAE in partnership with G42, the artificial intelligence holding company of the United Arab Emirates.<sup>9</sup> In 2024, the UAE announced the creation of a company that plans to invest \$100 billion in AI-related projects, mostly in the U.S. **Microsoft** is involved in this venture as well.

Irrespective of how profitable data center investments will or will not be, the imperative to build them is dragging the Mag 7 cloud computing companies from their historically asset-light, high-return-on-invested-capital models back into the real world. They are becoming more asset-intensive, with all that this implies for free cash flow margins, financial flexibility and—ultimately—cyclicality.

Another of the Private Mag 7 is **Scale AI**, which offers a subscription-based model that provides accurate labels for data used in artificial intelligence applications such as mapping and autonomous driving. Meta Platforms recently agreed to buy a reported, but not verified, 49% stake. An annual Scale AI subscription averages \$93,000. This is a very important figure, not for the service itself or for Scale AI. Rather, for a central topic it highlights.

Scale AI does not directly compete with any of the Mag 7 companies. Indeed, it can be said to assist their transition into the field of artificial generative intelligence. But, it makes clear that success in this field depends on access to accurate data. As mentioned, an important part of the success of some of the largest IT companies has been low- and zero-cost data. This important legal ground is now being contested.<sup>10</sup>

There are multiple copyright infringement lawsuits against **Microsoft** and **OpenAI** alleging the use of intellectual property without permission and without payment, 12 of which were recently consolidated in

Alphabet Inc. Capital Expenditure Burden		
% Change since Mar 2023		
Net Income	88%	
PP&E	257%	
Purchases of PP&E	% of Net Income	% of Shareholder Equity
June 2025	80%	6%
March 2025	50%	5%
March 2024	42%	4%
March 2023	42%	2%

<sup>8</sup> <https://openai.com/index/stargate-advances-with-partnership-with-oracle/>

<sup>9</sup> <https://openai.com/index/introducing-stargate-uae/>

<sup>10</sup> Horizon Kinetics Under the Hood: What's in *Your* Index - The AMAGF IT/Social Media Stocks – Some Factual Observations (September 2020), [https://horizonkinetics.com/app/uploads/AMAGF-Bubble\\_Sep2020\\_FINAL.pdf](https://horizonkinetics.com/app/uploads/AMAGF-Bubble_Sep2020_FINAL.pdf)



Federal Court in New York. **Meta Platforms** lost a copyright infringement case in New York Federal Court in 2024 that resulted in an order that it pay \$30 million to a number of publishers.

This June, Meta won a copyright infringement lawsuit by 13 well-known authors over the use of a “shadow library” (that is, undisclosed and unpaid for) to use their books to train an AI model. However, the finding in Meta’s favor was on narrow grounds, the judge indicating that the plaintiffs used the wrong arguments and with insufficient evidence. But he did not foreclose the likelihood of success for a more properly prepared suit. The tenor of the judge’s opinion is encapsulated by this excerpt:

“In cases involving uses like Meta’s, it seems like the plaintiffs will often win, at least where those cases have better-developed records on the market effects of the defendant’s use. No matter how transformative LLM training may be,<sup>11</sup> it’s hard to imagine that it can be fair use to use copyrighted books to develop a tool to make billions or trillions of dollars while enabling the creation of a potentially endless stream of competing works that could significantly harm the market for those books. *And some cases might present even stronger arguments against fair use.*”

If the next set of plaintiffs wins similar litigation, the cost of data will increase significantly, much to the detriment of the large content-based IT firms of both the public as well as private variety. On the other hand, if future plaintiffs fail, individual authors will have little alternative but to severely restrict the circulation of their work to licensed users that will agree to restrict the use of the material. The meaning of the public domain will inevitably change, and the cost of data and interpretive material will also rise. The current practice that large technology firm data is proprietary—while the data of everything and everyone else is in the public domain—unsustainable.

However, even unrestricted data access is potentially problematic for some of the dominant IT companies. It is conceivable that a service such as ChatGPT could identify the manufacturer of any product now available on **Amazon** and place a user in direct contact with the producer—and even place the order!—thereby disintermediating Amazon.

How valid will the above risk scenarios turn out to be? It doesn’t really matter to what degree any of these specific threats come to pass or not. The critical observation is that for 25-odd years, the world’s largest companies have been insulated from competitive threats and have managed to record high returns on equity without precedence. Now, competitive forces are being released that have been absent for a very long time. The high Mag 7 valuation multiples partly reflect the relative absence of competition. As competition emerges, those multiples should trend lower in accordance with the more normal historical experience.

What can that look like? Both Tesla and Alphabet face obvious competitive challenges. Tesla has already experienced negative earnings comparisons, and has ceded the number one ranking in electric vehicles to the Chinese company BYD. Lesser competitors like Rivian have emerged. Although the global unit sales of battery electric vehicles in 2024 were higher than in 2023 (but would have been lower except for China),

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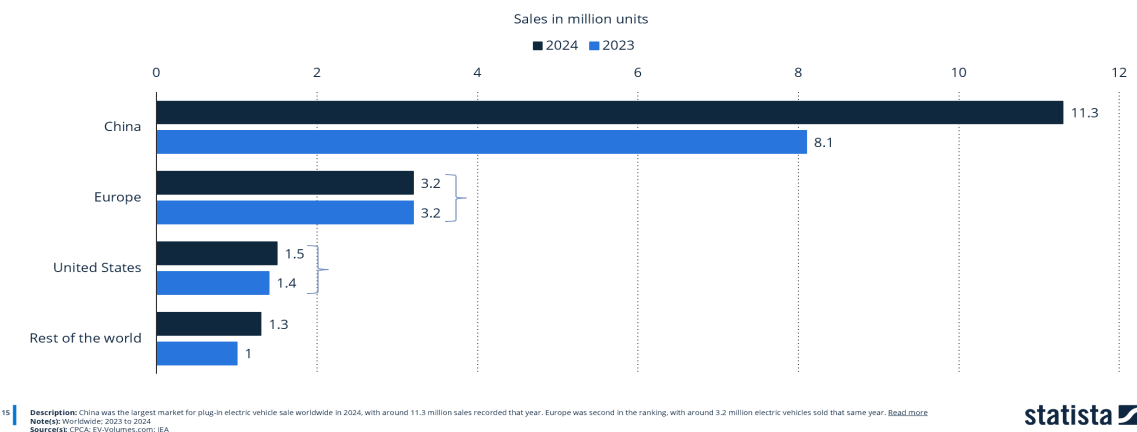
<sup>11</sup> The law allows limited unauthorized use of copyrighted material that, properly blended with new material, becomes essentially new content.

the dollar value of sales was modestly lower.<sup>12</sup> That's not just Tesla; that's the entire EV market. Moreover, in many geographies, the tax credit for electric vehicle purchases is being removed.

Nevertheless, Tesla trades at about 175x the 2025 earnings and 115x the 2026 earnings projected by an average of 35 Wall Street analysts who typically work for large brokerage firms. That is presuming the projected earnings materialize by the required dates. The methods of producing earnings projections at such firms often result in figures that the so-called independent analytical community might find at odds with observed qualitative and financial results. Irrespective of such professional finickiness, Tesla's market value comfortably exceeds the combined market cap of the world's leading automobile manufacturing firms.

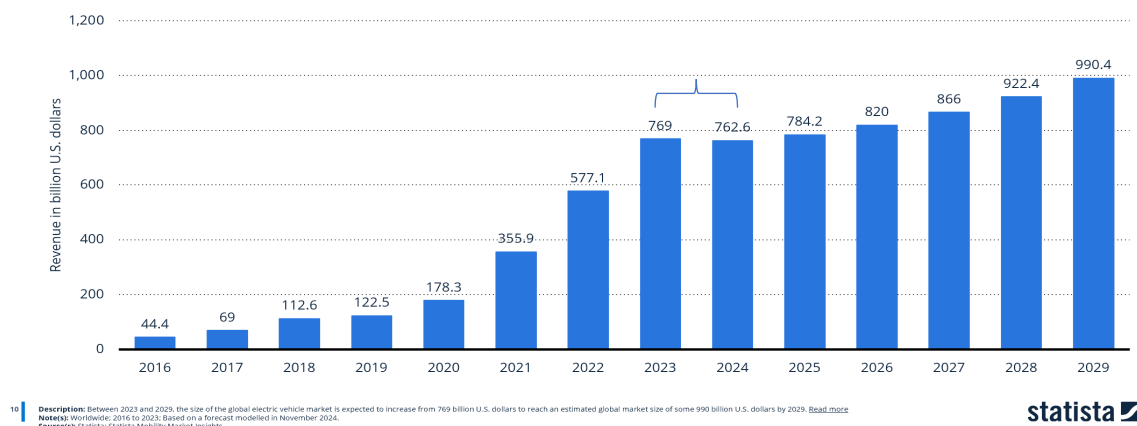
### Plug-in electric vehicle sales worldwide in 2023 and 2024, by main market (in million units)

Largest regional EV markets based on sales 2023-2024



### Global revenue for electric vehicles between 2016 and 2023, with a forecast through 2029 (in billion U.S. dollars)

Global electric vehicle revenue forecast 2016-2029



<sup>12</sup> Statista Mobility Market Insights

Similarly, Alphabet is confronted with the emergence of the so-called chatbot. This is an obvious threat to the near-monopoly status of the Google search engine. The search engine was one of the most lucrative business models ever devised. Google's version of a chatbot, Gemini, has been gaining active users at an extremely rapid pace, though still about one-half the ChatGPT figures, and Meta AI is not far behind. The nature of the race is less important than that there is robust competition. Nevertheless, Alphabet trades at 19.5x consensus 2025 earnings forecasts. The consensus forecast remains for 23% earnings growth in 2025 versus 2024.

Although the growth forecast for Alphabet is considerably slower than its historical norm, the notion that it could possibly experience an earnings decline appears to be inconceivable. Yet, displacement of formerly dominant companies by emerging competition has been the historical norm.

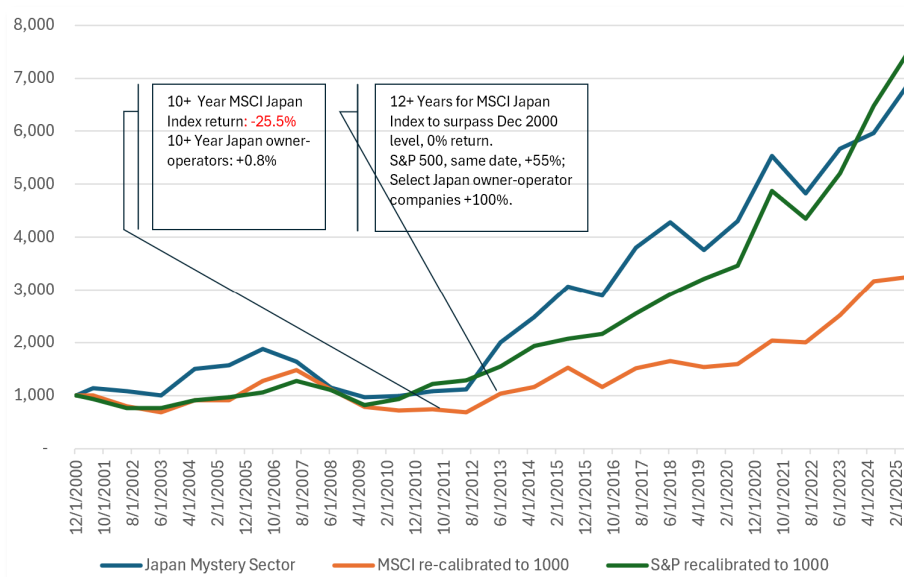
### 3. Japan: An Attractive Market for *Conventional* Asset Allocation, But Hiding an Exceptional Uncorrelated Growth Sector “Beneath”—The Entrepreneur Layer of the Japanese Market

Now here's an entirely—really, entirely and refreshingly—different proposition. Like an asset allocation palate cleanser.

#### *Understanding the Owner-Operator, or Entrepreneur CEO, Equity Sector*

Once in a long while is found a protected, deeply undervalued, completely uncorrelated sector of a market that offers an uncommonly attractive long-term investment opportunity. “Protected” in that the broad investment community is either unaware of it or flatly disinterested. The crowd is absent and the efficient market is nowhere in the vicinity. Which, in circular reasoning, is why the valuation discount exists in the first place. As John Templeton found in Japan 70 years ago, and as is occurring for different reasons in Japan today.

First a picture, then the story. For the 12 years from December 2000, after the Dotcom Bubble collapse, the Japanese stock market had a negative return. By the time it broke even in mid-2013, the S&P 500 for the same period was up 50%. A particular sector of the Japanese market—not an industry sector, nor a value or other style sector, but a qualitatively distinct sector nonetheless—was up 100%.



For the 24.5 years through June 2025, the MSCI Japan Index returned an annualized 4.9%. The S&P 500 return was 8.6%, and for the particular Japan sector just mentioned, 8.2%. That's a touch less than the S&P 500, not quite neck and neck, the difference attributable to the performance of the S&P 500's IT/AI sector in the past several years.<sup>13</sup>

What's remarkable is that its annual return was 66% higher than its own moribund domestic market, and its cumulative return was 112% greater, somehow defying the dominating systemic factors of its own economy and financial markets. Of course, those are just simple [performance](#) numbers.

In numbers that resonate with CFAs and MBAs, this sector exhibited high-magnitude outperformance relative to its benchmark MSCI Japan Index, but with low correlation to the index (a correlation coefficient of 0.83) and low price risk or volatility relative to the index (a beta of 0.80). Which means a high alpha, which in many circles is the chest of gold at the end of the risk-adjusted relative return rainbow.

What the heck could it be?

A general form of this phenomenon actually exists in the U.S. If one were to measure the long-term performance of publicly traded companies, past and present, whose CEOs were also their owners—defined as having the largest equity interest *and* for whom that equity was the greatest part of their wealth—you'd have a timeline of the greatest successes in the S&P 500. A sampling: IBM, in its day (the Watson Family); Wal-Mart (Sam Walton), Telecommunications Inc. (John Malone); Starbucks (Howard Schultz); plus, of course, Apple; Microsoft; Amazon (you know who); and, hot out of the oven, NVIDIA.

Those CEOs' average tenure was a full generation. Their stock price returns bear no resemblance to the market: outperformance on the order of 12% points a year or more. *Weirdly (maybe not), this is about exactly the level of outperformance by the Templeton Growth Fund in the 1970s.* This phenomenon persists across different eras and economic cycles—though only until that control person left, after which reversion to the mean kicked in. In other words, if you were to measure it, you'd find a significant identifiable inefficiency that, by the lights of the Efficient Market Hypothesis, shouldn't exist. After all, all interested parties have access to the same publicly disclosed information and have the freedom to act upon it.

Here's a blast from our Horizon Research past<sup>14</sup>: The figures in the below table of performance by S&P companies while they were controlled by such owners—which averaged 19 years, and as long as 31 years—do not include Berkshire Hathaway, because the study was through 2010, while Berkshire was excluded from the S&P 500 until 2020. (Why would just about the largest company, with just about the best return record, be excluded for most of its modern history? To answer a question with a question: “Goodness, what sector is it in?” and “How much trading liquidity does it have?”)

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<sup>13</sup> As of June 30<sup>th</sup>, 2025. Calculated using Total Returns in local unhedged unless otherwise noted.

The returns stated above contain back-tested performance. The Japan Founders Index was launched on September 8<sup>th</sup>, 2014. See Important Disclosures for important considerations when evaluating back-tested performance data. The Horizon Kinetics Japan Founders Index (the “Index”) was created by Horizon Kinetics LLC (“Horizon Kinetics”) a U.S. financial institution and parent company to one SEC-registered investment advisory subsidiary. Indxx, LLC (“Indxx”), a third party, has a contractual arrangement with Horizon Kinetics whereby it has agreed to calculate certain index components. Source: [https://www.indxx.com/indices/other/horizon\\_kinetics\\_japan\\_founders\\_index](https://www.indxx.com/indices/other/horizon_kinetics_japan_founders_index)

<sup>14</sup> Reprinted in Horizon Kinetics Research Group, *Owner-Operators*, March 2014

# MARKET COMMENTARY

2<sup>nd</sup> Quarter 2025

August 2025

Company	Owner/Operator	Start Date	End Date	Tenure (Yrs.)	Annualized Return		Difference
					Company	S&P 500	
Apple (Jobs' first tenure)	Steve Jobs	Dec-80	Jun-85	4	(10.6)%	8.1%	(18.7)%
Apple	Steve Jobs	Jan-97	Present	14	34.3%	5.7%	28.6%
Amazon.com	Jeff Bezos	May-97	Present	14	40.6%	4.9%	35.7%
Bed, Bath & Beyond	Feinstein, Eisenberg	Jun-92	Present	19	23.0%	8.0%	15.0%
Dell	Michael Dell	Jun-88	Present	23	24.5%	9.4%	15.1%
Hewlett-Packard <sup>1</sup>	Hewlett, Packard	Jan-62	Sep-93	32	12.3%	6.1%	6.2%
IBM <sup>2</sup>	Watson Family	Jan-62	Jan-71	9	9.8%	3.2%	6.6%
Intel <sup>3</sup>	A. Grove, G. Moore	Nov-82	Nov-04	22	20.3%	13.2%	7.1%
Loews Corp <sup>4</sup>	Tisch Family	Jul-80	Present	31	14.7%	10.9%	3.8%
Leucadia National	Steinberg, Cumming	Jun-78	Present	33	24.2%	12.8%	11.4%
Microsoft	Bill Gates	Mar-86	Jun-08	22	29.2%	10.5%	18.8%
NIKE	Phil Knight	Dec-80	Present	31	14.5%	10.8%	3.7%
News Corp <sup>5</sup>	Rupert Murdoch	May-86	Present	25	6.7%	9.5%	(2.8)%
Oracle	Larry Ellison	Mar-86	Present	25	29.5%	9.5%	20.0%
Polo Ralph Lauren	Ralph Lauren	Jun-97	Present	14	10.0%	4.5%	5.6%
Charles Schwab	Charles Schwab	Sep-87	Present	23	23.1%	8.9%	14.2%
Starbucks (Schultz's 1st tenure)	Howard Schultz	Jun-92	Jun-00	8	38.0%	20.0%	17.9%
Starbucks	Howard Schultz	Jan-08	Present	3	18.1%	(1.1)%	19.1%
Telecommunications Inc <sup>6</sup>	John Malone	Jan-73	Dec-98	24	30.3%	14.3%	16.0%
Wal-Mart Stores <sup>7</sup>	Sam Walton	Aug-72	Apr-92	20	20.5%	6.7%	13.8%
Wynn Resorts	Steve Wynn	Oct-02	Present	8	32.9%	6.3%	26.5%
				19	Simple Average		12.6%

<sup>1</sup> Although William Hewlett and David Packard first offered shares to the public in 1957, share price data is only available back to January 1962.

<sup>2</sup> The Watson family has led IBM from the time that Thomas J. Watson became the general manager of Computing Tabulating Recording Corporation (later International Business Machines) in 1914. Watson's eldest son, Thomas Watson Jr., retired from the company in 1971. Although IBM was first listed on the NYSE in 1916, readily available prices begin in January 1962.

<sup>3</sup> Gordon Moore co-founded Intel with Robert Noyce in 1968. The company went public in 1971; however Intel share prices prior to 1982 are not readily available. Note that Andy Grove was Intel's third employee and ran the company until November 2004. It is Grove who is widely considered Intel's key business and strategic leader, and is described as having "participated in founding Intel".

<sup>4</sup> Brothers Preston Robert Tisch and Laurence Tisch began what would come to be Loews Corporation in 1956, and Loews went public in 1959. However, prices are currently only readily available from July 1980.

<sup>5</sup> News Corp was incorporated in Australia in 1979; however, share price data is only available to May 1986.

<sup>6</sup> John Malone joined Telecommunication Inc (TCI) as CEO in 1973 until it was acquired by AT&T in 1999.

<sup>7</sup> Wal-Mart was initially traded over-the-counter in 1970. It was listed on the NYSE in 1972, which is when readily available share price data begins.

This next section, and the rest of this *Commentary*, are written together with Utako Kojima, portfolio manager of Horizon Kinetics' Japan Owner Operator ETF/日本 オーナーオペレーター ETF (JAPN). Launched in May, JAPN invests in owner-operators who also have a high degree of management skills, specific industry knowledge, deep networks, and a strong commitment to long-term growth. This owner-operator factor is just about the only demonstrated, persistent way to solve the much-studied, never-cured agency and incentive alignment problem in public equities.

## *A stronger form of this phenomenon exists in Japan, as will be described shortly.*

But to appreciate the special application in Japan, it's best to first appreciate the basis for this in the U.S., on familiar cultural ground. In behavioral finance, what's known as the agency problem is a much studied, as-yet unsolved area of academic study. The challenge: aligning the economic interests of senior management, acting as agents for shareholders, with those of the shareholders themselves. Put another way, inducing management to make the same capital allocation and risk/reward decisions as the non-professional owners would if any individual shareholder were running it as their own business. It would seem simple enough, yet is intractable nonetheless.

The general-case CEO is an agent hired to the task. The initial impulse was that with large enough cash performance bonuses, this executive will be highly incentivized to expand the company or increase profits as rapidly as possible toward the ultimate goal of a higher value and stock price. It didn't seem to work, no matter how creatively the formula was adjusted, such as introducing stock grants instead of cash bonuses, then restricted stock, then stock options with out-of-the-money strike prices, as if this would make the CEO think like a shareholder. In practice, it just invited short-term tactics to raise the share price but not

necessarily improve the business end of things. Then came non-share-price performance targets like return on equity, or on total equity and debt capital, or peer-company-based comparisons.

The compensation structure experiments never bore fruit because of a few prominent reasons, which all amount to the same thing, none of which can be formularized on a spreadsheet. They have to do with the reality of personally experienced risk and reward. Just about *everyone* games—or, less judgmentally, is influenced by—the incentive rules by which they are asked to play. It's normal and rational, but for corporate management can induce unintended, self-defeating behaviors for shareholders.

*Distorted Reward System:* The agent CEO might move heaven and earth to achieve whatever near-term incentive-based goals are set. The question is *how and why?* Some will try to achieve them even if they hobble longer term results beyond the time horizon that releases those rewards. In some businesses, firing employees is the surest way to raise earnings in the short term, even if growth eventually suffers from the loss of institutional knowledge or client service quality. That's a camouflaged contractionary strategy. In the expansive direction, acquisitions to boost revenues or some other reward metric is also an easily executed strategy, even if it eventually diminishes return on capital by overpaying or taking on greater balance sheet risk and finance costs. The variety of gaming tactics is as endless as circumstances allow.

If the rejoinder is that stock awards have gravitated over time from outright grants toward multi-year benchmarking and vesting, the counter-rejoinder is: Hah! When did you ever see a 20-year vesting agreement? No stock constructively owned or salable for two decades?

*The Free-Ride or Capital-at-Risk Litmus Test:* What about CEOs who accumulate enormous amounts of stock? It *still* can't make them think like an owner. The confounding factor is that the stock was *granted* to them. They never really paid for it, not out of their own savings or borrowings from relatives; they didn't have to sleep on the office floor. It's not really their personal capital at risk; it's house money. And with house money, it's natural to take acquisition valuation risks or issue stock more freely than would a true owner with substantially all of their wealth at risk in the company. The kind of risk that keeps you up all night. Scores of such agent decisions, each in their turn diverging from an owner's likely decision, compound and magnify over time.

*Commitment Issues:* An agent CEO can accept that role at a company, receive a sign-on bonus, try an expansion or profit-recovery strategy for several years, receive the annual benchmarked grants, have the plan not quite work out in the end, then move on to another such position at another company. That's a normal career path. Contrary to appearance, such a CEO's path to wealth is not really through the success of the business, but through a document. An often highly complex, highly negotiated and often-reviewed document called a compensation package.

The owner-operator doesn't have that "option," so to speak, doesn't even think that way, can't simply step away into a new seat. It's *their* capital at risk, not house money; it's *their house*. That's another variation of decision-shaping risk that the agent CEO escapes.

Now, compare and contrast the U.S. market, in this regard, with Japan. How did Japan owner-operator stocks have a positive return during a decade when the Japan index declined 25%, and how did it return a



cumulative 100% over the 12 years from the Dotcom Bubble collapse, while the MSCI Japan Index was flat?

The answer comes straight from the agency problem lesson. One can easily imagine an agent CEO building a new production plant, in the name of expansion, without clear expectation of a sufficiently high return on invested capital. It happens all the time. One can imagine a CEO reducing or delaying expansion spending during an economic downturn in the name of conservatism and protecting capital.

An owner-operator might do the opposite, *not* expanding during an ebullient M&A period, because the prices are too high for an adequate return on capital. They might then expand rapidly and prosper during a recession because they “know” some particular opportunity—a new production plant, a revamped product line—will offer a high return on investment at an opportunistic purchase price in a buyer’s market.

If they find that opportunity, they’ll invest; if they don’t, they won’t: they *always* intend to earn a positive long-term return on investment. It’s not heads you win, tails you lose for them—that’s for other people’s money, not their own. *Of course* they’ll generate higher returns on capital over time.

### *The Conventional Japan vs. The Unique Japan*

Conventional metrics legitimately describe Japan as an intriguing place for asset allocation today:

- It wasn’t until February 2024, after 35 years, that the Nikkei 225 Index surpassed its 1989 financial bubble high. The only U.S. analogue was the recovery from the Great Depression.
- At that 1989 peak, the Japanese equity market reached 37% of the global stock market capitalization, more than twice its 15% GDP share and greater than the U.S. stock market value at the time. Japan’s weighting in the MSCI ACWI Index is now 4.9%.
- Today, the MSCI Japan index trades at a P/E of 16.6x versus an S&P500 multiple of 24.1x, and a Eurozone MSCI Europe Index multiple of 15.8x. On the other hand, Japanese corporate net profit margins and ROE are, each in turn, only 7.7% and 8.7%—single digits—versus a U.S. 12.8% and 18.6%, and a Europe 10.5% and 11.2%. There’s a very large profitability gap.

**Global Valuation Comparison**

		P/E FY24	P/E FY25e	P/B Current	EV/EBITDA FY25e	ROE FY25e	Div Yield FY25e	10yr Bond Yield Current
Japan	TPX index	15.6	16.6	1.5	6.4	8.7	2.6	1.4
China	MXCN Index	10.8	12.9	1.6	10.2	11.1	2.2	1.6
India	MXIN Index	25.3	24.3	3.8	14.7	15.2	1.5	6.3
Asia ex-Japan	MXASJ Index	14.4	15.1	1.9	9.9	11.9	2.4	NA
US	SPX index	24.7	24.1	5.2	16.3	18.6	1.3	4.2
Europe	SXXE Index	13.8	15.8	1.9	10.6	11.2	3.2	2.6

Japanese universe is TSE 1. Chinese universe is MSCI China Index. India universe is MSCI India Index. US universe is S&P 500. European universe is STOXX Europe 600. Asia ex Japan universe is MSCI AC Asia ex-Japan Index. As of 6/30/2025.  
Sources: Bloomberg

- The sub-par profitability, though, is changing. It is largely the residue of decades of the famously anti-competitive corporate cross-ownerships, which protected against outside activist shareholders, of lifetime



employment and overstaffing policies, and the like. The past decade has seen steady and insistent pressure by regulators—as a matter of national interest—to force increased transparency and accountability to outside shareholders, and to simplify the complex web of parent company/subsidiary holdings.

Change examples:

In the past decade, Tokyo Stock Exchange Prime Section companies with nominating and compensation committees rose from about 12% to 85%, and the proportion of companies with at least one-third independent directors on the board rose from 6% to 95%. The number of companies with specific shareholder return targets rose from about one-third to two-thirds.

As a result, profitability measures have visibly increased in the past ten years. Another indicator that the policy changes are moving the needle is that the number of merger and acquisitions doubled during the last decade to 2024's historical high of 4,700.

The market is becoming more accessible, and foreign ownership of Japanese equities has increased from 19% in 2000 to over 32% in 2024.

This type of data describes a market ripe for increased institutional allocations to Japan. But hardly the path to investment glory, because the indexes will not provide exposure to the domestic market, only to the largest-capitalization, predominantly multi-national export-oriented companies.

This is the narrow aperture of the financial lens into the Japanese market provided by the \$15 billion iShares Japan ETF (EWJ): Of around 4,000 publicly traded companies in Japan, there are 183 holdings. Of those, the top 50 account for 67% of the fund. So, give or take, 95% of the Japanese market is missing from the index. Typical: number 50 in the ETF, Fujifilm Holdings, with a \$25 billion market cap, gets only one-third of its revenues from Japan.<sup>15</sup>

A counterpoint approach is an elegant method of direct participation in the domestic economy through the most dynamic and reliable growth companies in Japan. It has a history—our Japan and Asia team has been following that market closely for over 17 years—that gets us to the present.

In Japan, where lifetime employment is the norm, the professional- and career- incentivized management culture that permeates the U.S. corporate world barely exists. Once hired as a new graduate, an employee

Japan Equities Top-Heaviness Statistics

	Number of Companies	Proportion of Market by Count	Market Capitalization (\$MM)	Proportion of Market by MV
Japan Equity Market	3898	100%	6,367,130	100%
Large-Cap Companies*	119	3%	4,158,785	65%
iShares MSCI Japan ETF	182	5%	4,632,744	73%

\*Large-cap includes companies with market cap greater than USD 10 billion  
Source: Bloomberg, iShares MSCI Japan

Company Name	% of Revenue Sourced within Japan	iShares MSCI Japan ETF (EWJ)
Toyota Motor Corp	22.6	4.4
Sony Group Corp	23.3	4.2
Mitsubishi UFJ Financial Group	43.3	4.1
Hitachi Ltd	38.8	2.9
Sumitomo Mitsui Fin'l Group	41.6	2.5
Keyence Corp	35.6	2.0
Nintendo Ltd	21.7	2.0
Recruit Holdings	46.6	1.9
Tokio Marine Holdings Inc	47.6	1.8
Mizuho Financial Group	33.0	1.8
Mitsubishi Corp	48.5	Na
	<b>36.6%</b>	<b>27.7</b>

Source: MSCI, ETF Database as of 3/31/2025

<sup>15</sup> As of July 31<sup>st</sup>, 2025

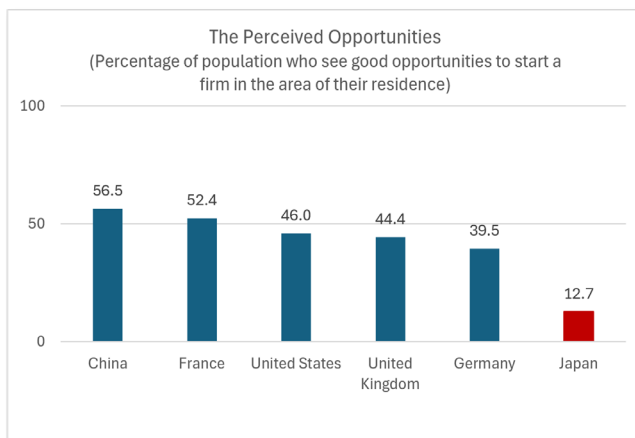
proceeds through various divisions and functions of the company, and their title and wages generally follow a predetermined seniority progression that the employee knows from Day One.

A new employee is by design trained as a generalist specialized for that specific company. They are expected to carry out their job functions precisely as their predecessors did and handed over through multi-rotation periods. More importantly, they are advised against undertaking any unnecessary perceived opportunity that may risk changing the existing businesses and workflows.

In Japan, founding one's own company means outright disposing of this kind of stable and assured career life—a counter-cultural adventure that parents, relatives, and friends almost always keenly persuade against. Anyone who turns away from being a “salary man” is unlikely to be able to reenter the secured-lifetime-employment path, one reason among many that entrepreneurship in Japan is a much higher-risk prospect than an American could imagine.

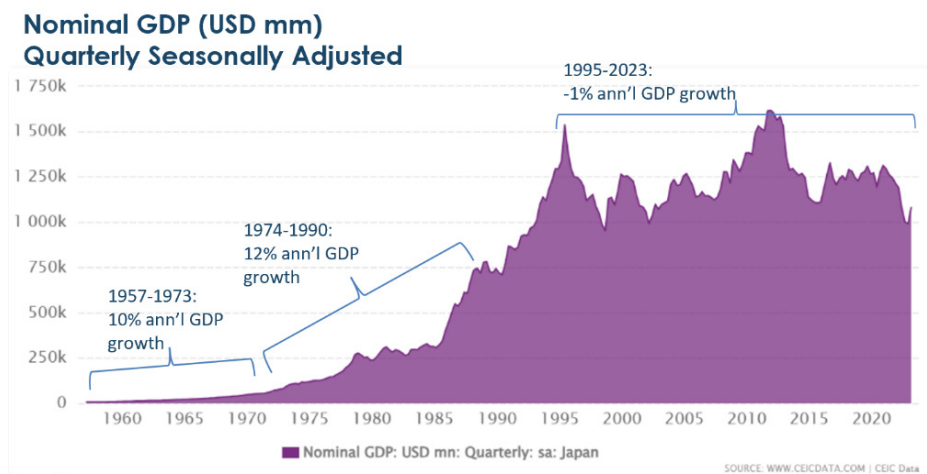
This low level of entrepreneurship was actually captured in a survey. According to the World Bank, a dramatically lower proportion of Japanese see good business opportunities. And they rank high for fear of failure with respect to starting a business.

It should be mentioned that the concept of lifetime employment is not an inherently cultural tradition. In post-World War II Japan, perhaps the only viable economic policy was to build prosperity by concentrating on the export market. Japanese companies could not possibly afford to pay wages on the American scale. Job security was a reasonable exchange for acceptance of a lower salary, which gave Japan an important competitive advantage in the global market. By around 1955, Japan had restored its prewar standard of living, after which it commenced an economic expansion that is probably without parallel.



Source: World Bank, Global Entrepreneurship Monitor 2022  
Survey of population age 18-64 (individuals involved in any stage of entrepreneurial activity excluded)

Japan was able to grow GDP by about 10% annually between 1957 and 1973. Its 1973 GDP was about 4.6 times higher than in 1957, while the U.S. expanded 2.9x during the same period. The practice of lifetime employment continued even after the 1989 collapse of the asset-price bubble. Had this happened in an American context, it would have quickly ended. In Japan, the practice continued.

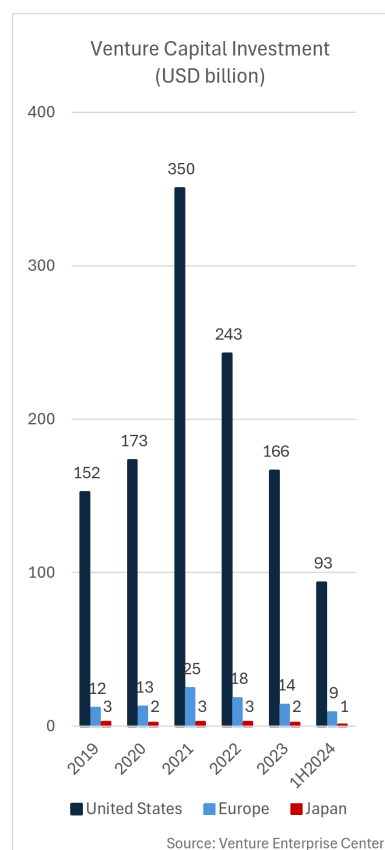


The disinclination toward entrepreneurship is not a matter of motivation or social trait either. Unlike in the U.S., the availability of risk capital is significantly limited. The size of venture capital investments in Japan is a rounding error relative to the U.S., despite Japan's economy being about one seventh of U.S GDP. It is uniquely socially and financially challenging to be an entrepreneur in Japan, apart from the ordinary challenges of growing a startup business to scale.

However, there is likewise a uniquely Japanese silver lining for owner-operators attempting to bring a differentiated and competitive business to critical mass, then scaling it. Because those very barriers suddenly become major advantages. First, the non-creative and change-averse business practices of the country's largest companies create an open field of opportunity for an entrepreneur with a superior product or service to take share without a facing a ready counter response.

Second, because of the dearth of entrepreneurship, even in an untapped market beneath the umbrella of the incumbent giants, there is practically no competition from other entrepreneurs.

One founder explained this based on personal experience. He once tried to bring his online platform business to the U.S., but within ten days, he learned there were so many competitors trying to enter the same market in different ways that he had to withdraw. He was shocked, because he'd never experienced that in Japan: Even after his company proved that the business could generate a high return on equity and lucrative cash flow with a huge market opportunity, no serious competitors emerged.



Japan's economy, the fourth-largest in the world, is massive enough to support decades of double-digit growth for a new entrepreneurial competitor before reaching its expansion limit. And that market is largely ignored by foreign investors for a variety of reasons—not least of which are its cultural, linguistic and social entry barriers. Although it must be said that they did not pose an impediment to John Templeton 70 years ago.

The small population of Japanese entrepreneurs do not have to compete, as they would in the exceedingly well-developed U.S. startup culture and infrastructure, with savvy professional CEOs with their armies of financially motivated talent and ready funding. It's an attitude and capability that is virtually nonexistent in Japan. This is one of the ways in which the dominant companies' competitive "umbrella" works in the entrepreneur's favor:

A new business, being, being relatively small, presents little obvious threat to a conglomerate focused on its global expansion.

More central to the point, even if it *is* noticed within a given conglomerate, the particular business division whose sector is now being vigorously pursued is rarely assigned a capital allocation or the resources to compete and take market share domestically—it's not a perceived need, because of long established inter-company cross-shareholdings and market share arrangements.

More importantly, those "salary men" and women *do not want to change* their operations; attempting so entails serious internal career risk, as any such proposal would be received as radical. That makes it easy, from an internal review perspective, to dismiss the risk of losing market or missing growth opportunities. It is not uncommon for the President and CEO, when asked about a strategy to combat competitive threats or simply about a possible business restructuring to strengthen operations and financial returns, to say that those tasks would be best done by their successors.

There are legitimate reasons for the frequent criticisms that Japanese management's change actions are characteristically overly late and too small. This is the incumbent competition, the silver lining, that owner-operators face.

While Japan is always discussed in a context of—and compared to—other developed markets, it is a uniquely isolated social and economic ecosystem. The Japanese business community is well aware of this and does criticize itself for being left behind in the global competition in areas like automobiles, semiconductors and consumer electronics, where it once led the world.

The country's business leaders deplore what has been domestically referred to as Japan's Galapagosization, after the Galapagos Islands, known for their isolation—almost 600 miles west of the Ecuadorian coast—and unique natural ecology. For owner operators taking on some specific market segment, this uniquely *non*-competitive environment offers a rich climate for creative business development, if an analogue may be drawn from Darwin's famous islands.

A final set of barriers-to-entry in favor of domestic entrepreneurs guards against threats from abroad. These barriers include Japan's closed corporate structure and the limited information available. That is

buttressed by the language barrier and the habitual sense that Japan is a mature economy marked by a declining population and aging society, which is not actually borne out by the statistical record.

Accordingly, Japanese entrepreneurs have a three-ringed set of protective competitive moats: against the stagnant dominant corporations at home; against domestic startup competitors, because that's a desert; and against foreign competitors trying to enter Japan.

#### 4. A Japan Entrepreneur Growth Company In the Flesh

What does an entrepreneur-controlled growth company in Japan look like in the flesh? An origin story and current review of one such company is appended to the end of this *Commentary*. As of today, this company has taken a 10% market share in the most domestic-economy type of business in a mature sector: elevator maintenance and repair services, which had been 95% dominated by five major conglomerates.

Just over 30 years ago, the Chairman, himself a licensed elevator inspector, had an insight and a plan of action: He believed he could earn double-digit operating margins at half the price of the leading elevator manufacturers that pretty much owned the service side of the business. Starting with no capital and no staff, he would change into a suit when visiting prospective customers as a sales rep, then back into his work clothes for his inspection and maintenance work.

He's innovated everything from servicing technology to employee education and training, always looking to increase efficiencies even while expanding. Growth only accelerated after the company came public in 2017, and continual efficiency improvements keep driving operating margins higher. He owns over 20% of the stock; with his shares worth nearly \$500 million, that is certainly substantially all of his wealth.

The most recent five-year revenue growth has been 18%, and per-share profit growth over 25%. What he believes to be the achievable market share goal will be accomplished on a decades-long continued growth path. Looked at properly—or, at least, one way—the shares are priced in traditional value-stock territory. This is the type of company that is simply not accessible through the conventional index approach to asset allocation.

#### Portfolio Spotlight: Japan Elevator Service Holdings (6544 JP)

##### *Background*

Japan Elevator Service Holdings (JES) is the largest independent elevator and escalator maintenance and repair service provider in Japan, with a 10% market share. Typical clients are building owners and real estate maintenance and management companies legally required to have annual inspections on their elevators and escalators. They generally enter contracts that include an annual inspection, monthly checkup, and repairs when necessary. This arrangement provides a recurring and stable revenue stream. There are over 900,000 elevators and escalators under such contracts in Japan, and the

number has expanded about 3% annually during the past decade.

When Chairman, CEO, and President Katsushi Ishida founded JES in 1994, the elevator and escalator service market was over 95% dominated by five manufacturers: Toshiba, Mitsubishi, Hitachi, Fujitec, and Japan Otis. The remaining 5% was shared by hundreds of independent service providers; manufacturers competed for new elevator and escalator sales and installation.

However, in this business, once one receives installation orders, the maintenance service contracts naturally accrue to the manufacturer, as it already has full understanding of the models; most importantly, it can



easily set aside adequate replacement parts. Moreover, manufacturers have no incentive to take maintenance contracts for competitors' models, just like Toyota dealers will not actively seek maintenance work for Ford automobiles. As a result, the service price is set high enough to recoup the low profit, if any, resulting from the price competition around installment.

Maintenance and repair services, even for a standard model, require thousands of parts. Covering available models of major brands with guaranteed timely service means having an inventory of more than 150,000 parts. The control panel is the most crucial, in that genuine manufacturers' control panels have unparalleled performance and durability compared to generic versions. The inability to secure these often hinders independent service providers from providing high-quality services on par with manufacturers, and is a hurdle in expanding service networks.

Another obstacle is the ability to hire qualified inspectors. In Japan, only inspectors with a national qualification—which requires certain electrical and electronic engineering degrees and years of on-the-job experience—can conduct annual inspections. Independent operators need an appropriate number of such inspectors to sufficiently cover their customer base.

### *An Owner-Operator's Entrepreneurial Counter-Perspective*

At this point in the description of this industry, one might justifiably conclude that this slow-growth sector offers hardly any business opportunity for independent operators, other than competing in a zero-sum game to take small market share

However, in the early 1990s, Chairman Ishida—a licensed elevator inspector himself—saw a business opportunity in an industry whose high barriers to entry could actually become a competitive benefit upon overcoming them and achieving sufficient scale.

Having worked for a building maintenance company, and for an independent elevator maintenance service provider, Chairman Ishida was convinced a well-run

business could generate double-digit operating margins, even at half the price of the leading manufacturers. To seize market share, he was determined to build a company that would provide services at their level or better.

So, in 1994, at age 28, Chairman Ishida founded the company alone—with no funds, no partners, and no employees. Nevertheless, he was determined to provide the highest-quality professional service from day one. When visiting potential customers as a salesperson, he would change into a business suit, then switch back to workwear to do maintenance and inspections. He reviewed inspection reports directly with customers before and after; this was not common among typical industry engineers, who would focus on the inspection work itself and delegate customer communication to a sales department. He often slept at the office to respond to emergency calls.

As the number of contracts grew, he needed to hire



and train more employees, and he needed to procure enough parts for timely service. For the first three years, JES was literally a hand-to-mouth operation, and Chairman Ishida had to fund the running cost with short-term loans just to meet immediate cash needs. Within ten years, though, the number of maintenance units reached 5,000. At this point, he managed to hire a full management team to run the business.

In 2007, JES hit a milestone as an independent service provider: matching the service capabilities of the leading manufacturers upon developing a 24-hour remote monitoring and controlling service. This

technology enabled the company to monitor elevator and escalator operating status 24 hours a day, seven days a week—and to detect small irregularities, which enabled targeted preventive repair and parts replacement to reduce the incidence of malfunctions and breakdowns. Until that moment, this type of service had only been provided by the leading manufacturers, as it required access to the control panel, and required resolving their unique data transmission and protocols. Toward this goal, Chairman Ishida had hired system engineers to research and develop a remote monitoring system compatible with various models of elevators and escalators, and even obtained a patent on the technology.

That same year, JES established an original engineer-training program and internal qualification system called “Step 24.” Even before this program, Chairman Ishida undertook a training program that systematized the skills and experience of top engineers, and collected and researched maintenance information and data for various models. Through what became a 24-lecture series and on-the-job training, new employees could acquire the skills and knowledge needed to attain a national inspection license in one year. Moreover, the program trained engineers to individually conduct full maintenance work for several models, enabling the company to provide equivalent quality services to the leading manufacturers.

Critically, and unlike these competitors providing maintenance only to their brands, this meant JES was now able to leverage its operation as its engineers expanded their capabilities and productivities to include more elevators in a given coverage area. Being an engineer himself, Chairman Ishida respected engineers and always knew they were the cornerstone of the operation (later, in 2019, he set up a “Engineer Meister Program” with five accreditation levels to incentivize engineers with the best skill sets to maintain the service quality).

At the same time, Chairman Ishida sought to publicly list JES to increase its credibility and transparency in furtherance of expansion. It took just over a decade to prepare for the listing; the focus was on human resource development, enhancing technology and capability, and securing genuine parts. JES went public in 2017.



The same year, JES completed construction of an R&D test tower and innovation center with ten elevators to examine control systems and motors. It conducted thousands of tests—allowing further improvement on maintenance and repair offerings and operational efficiency—and developed new services for the market.

In 2018, the company developed its next-generation control system, Quick Renewal, which was compatible with the general models of all the equipment manufacturers. Typically, elevators’ stated useful life is 20 to 25 years; in practice they operate 25 to 30 years. At that point, they need a full renewal, which entails replacing the control system, motors and all electric systems—and requires about one full week of downtime. Quick Renewal necessitates just a half-day of down time, and at half the price.



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Illustratively, a building operating for 60 years usually requires three full equipment renewals. With Quick Renewal, three controller system replacements are needed, but only two motor replacements, leading to a significant reduction of customers' downtime and maintenance cost. For JES, Quick Renewal was an important offering to induce customers to switch maintenance companies and add to its service contracts portfolio.

The growth in the number of maintenance units accelerated following the company's IPO and introduction of new services. JES's market share reached 10% in 2023; in 2024 it added over 13,000 units, taking another 1.3% of market share.

It is important to recognize this "the only one" position Chairman Ishida has built since founding JES. Its maintenance units' failure rate is as low as 1%, equivalent to that of leading elevator and escalator manufacturers, and one-fifth that of the independent service providers.

The JES offering price remains about 30% to 40% below that of the leading manufacturers. For independent service providers, it is not easy to set a competitive price without operational scale, since they need to hire licensed engineers and procure parts, essentially where JES was in its early years.

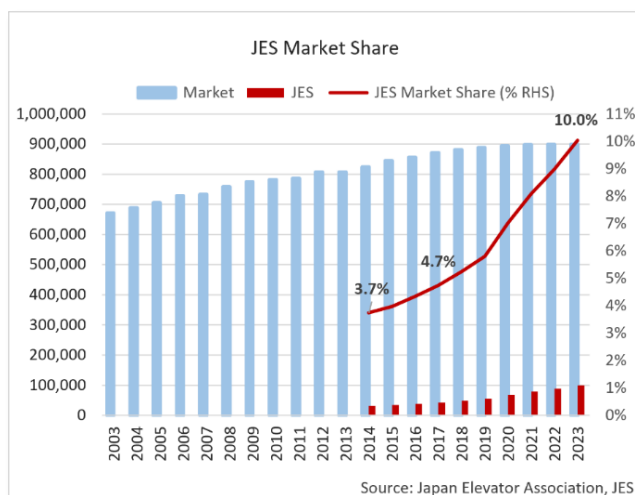
As a result, the company is taking market share both from the manufacturers and the smaller independent providers. In the recent inflationary environment, those competitors have been raising their prices, while JES continues to focus on advancing its market share, thereby accumulating more maintenance contracts.

The company is also expanding its coverage area, entering second- and third-tier cities and acquiring smaller independent service providers, which usually start from a loss-making position until the branch achieves sufficient scale.

Even with the advancements to date, having improved the operating margin from 12.7% to 17.7% during the last five years, management appears

confident about reaching 20% in the coming two years. In the longer term, once the growth investment spending decelerates, management sees a 30% margin as a natural, sustainable profitability level.

Most recently, inquiries from real estate management companies are rising as they try to lower elevator and escalator maintenance costs as part of broader building maintenance cost reductions. JES also established strategic tie-ups with banks that are financing new real estate development or re-development as another avenue to secure new maintenance contracts.



There is an opportunity for even more expansion domestically. In other developed markets outside Japan where major maintenance providers compete, independent service providers typically represent a 50% market share. That should be possible in Japan, too. For the near term, JES is aiming to take at least a 30% market share, approximately three times its current level.

*Valuing an Owner-Operator Company: Not Always a Near-Term Metric Ratio*

At a glance, the company's stock does not appear undervalued relative to its global peers, with a price-to-earnings ratio of 43 and an enterprise-value-to-EBITDA ratio of 24.8. In fact, this would be significantly overvalued for the global-scope

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companies, which effectively occupy the same mature industry. For instance, Otis Worldwide and Schindler Holding's average annual revenue growth during the past five years were, respectively, 1.8% and flat.

However, the valuation figures are quite misleading if viewed on a forward-looking, normalized operating basis. For one thing, as discussed further below, JES could raise its revenues 50% if it were simply to match its incumbent competitors' pricing. But it sees greater long-term value, still, in maintaining its growth spending and market share capture strategy.

As the only independent firm of the bunch, Chairman Ishida sees a blue ocean market that is large, substantially untapped, yet—in practical terms—is without significant competitors. Following annualized revenue growth of 18% in the past five years, and annualized per-share earnings growth of about 26%, the company still has only a 10% market share. More importantly, it achieved this with the highest EBITDA margin, 1.3x greater than the next most profitable competitor, and a return on equity that is 1.5x the next-highest among its peers.

During the same growth period, JES continued investing in its operational capacity expansion; the number of employments and the inventory accumulation grew about 10% and 28.5% annually. Upon eventually reaching a mature stage at, say, 30% market share, similar to where leading manufacturers are, the company's intensive expansion spending and investments will no longer be necessary.

JES could shift focus to improving operational efficiency to reach the 30% operating margin goal, in which case it could generate about \$200 million<sup>16</sup> in net income annually. This is based on the revenue

reaching \$975 million by simply multiplying its current revenue by three, which would happen upon increasing market share to 30% from the current 10%. JES could achieve this by taking shares both in existing markets and new second- and third-tier cities, and reaching 30% operating margin as nationwide service network branches become profitable and reach scale in matured stage.

What is not included in this assumption is the overall market growth driven by inflation and the 2-3% volume growth observed in the industry during the past decades. Most importantly, this does not include the potential price hike JES can conduct, which is 50% today. But the difference is widening as competitors are raising prices. The JES share price today represents just over 12x this stable net profit stream.

While the industry shares a recurring-revenue-stream business model, JES does not—unlike its peers—manufacture elevators or escalators. It is a pure service company, not constrained operationally as it can target elevators of various brands (installment is mid-single-digit operating margin business). Revenue growth potential is an important factor in determining the future operating cash flow and, hence, the enterprise value with a benefit of compounding. Annual growth of 20% to 25% results in a doubling of the earnings every three to four years.

One may wonder why Mitsubishi and Hitachi (Toshiba is a private company) are omitted from the valuation table above. As most observers know, they have many other businesses, including HVAC, defense equipment, energy transmission, semiconductor modules, system integration and

Ticker	Name	Market cap (\$ million)	Revenue (\$ million)	EBITDA 12M (\$ million)	Net income (\$ million)	EBITDA Margin	Net Margin	Return on Equity	Revenue Growth (5 year)	EPS Growth (5 year)	P/E (FY2027)	EV/EBITDA (FY 2027)	Dividend Yield
6544 JP	Japan Elevator Service Holdings Co Ltd	2,507	324	69	36	21.2%	11.2%	30.3%	18.3%	25.8%	43.0	24.8	0.8%
OTIS US	Otis Worldwide Corp	39,341	14,261	2,355	1,645	16.5%	11.5%	Negative Equity	1.8%	9.5%	22.1	16.2	1.6%
SCHP SW	Schindler Holding AG	38,794	12,762	1,813	1,079	14.2%	8.5%	20.5%	0.0%	1.9%	28.0	15.3	2.1%
6406 JP	Fujitec Co Ltd	3,197	1,584	137	95	8.7%	6.0%	9.5%	6.1%	8.7%	20.8	12.1	2.8%

<sup>16</sup> Currency conversion at Y145/USD including the valuation table. Valuation table is as of July 8<sup>th</sup>, 2025.

operation, and factory automation machinery, among others. Review their earning presentations and you will be challenged to find a discussion of elevator maintenance, since it is always part of a larger division.

These are the supposedly daunting competitors beyond the reach of smaller or startup firms, at least according to the economic texts. Yet, over and over in different industries, owner-operators like Chairman Ishida have found not competitive obstructions, but competitive opportunities, when it comes to taking on firms with standard corporate ownership structures and operating methods.

In Japan, where lifetime employment is a norm, there is no expectation at these corporations that managers at any of their small divisions would come up with new strategies—let alone new products and services—that could change industry rules or business standards. Nor is there any incentive to do so. In fact, such employees are advised against taking unnecessary risks that could disturb operations and businesses that have been passed on from their predecessor managers. In this sense, competitors are not even managed professionally, in terms of western corporate culture standards.

More importantly, owner-operators are not professional managers either; they do not build their networks and careers for their own personal benefit, but rather for the benefit of the business that they own and in which their own capital is at risk. Their path to retirement comfort or wealth is not through their compensation package, but through the company's never-ending advancement and expansion, and through their equity. It is impossible to build what Chairman Ishida has built by seeking solely to reap personal financial returns and professional rewards. It requires extraordinary determination to keep fighting on the same battlefield, in both good times and bad, to build “the only one” position in the industry.

Chairman Ishida owns 21% of JES. As with typical successful owner-operators, this represents more than just a number of shares in financial terms. It is the ownership and responsibilities in operational excellence, safety, building strong corporate culture, and achieving the ultimate goal of surpassing those leading manufacturers. Bringing the shares public is not the goal, but rather a tool to achieve the goal.

Owner-operators have no compromise in achieving such goals. Given that JES undercuts its competitors' service prices by 30-40%, it could easily hike prices by about 50%. In an environment where competitors are raising prices, JES keeps them flat and focuses on taking market share—a decades-long strategy.

Professional management would find it daunting the point of impossibility to replicate that single aspect of Chairman Ishida's multi-dimensional, generation-long strategy-set. Raising prices in the JES circumstance by just a couple of percentage points could lift margins and annual earnings sufficiently to meaningfully benefit an executive's career and stock-based compensation, at least in the short term. This is the essence of the agency problem in linking management incentive systems to performance. The situation is distinctly different for business owners—they're not hired agents, so the agency problem is nonexistent for them.

This is the opportunity—not stocks, per se, but the owner-operators in which we truly invest. And in this instance, their opportunities often exist solely because of the uniquely Japanese business culture.

-Utako Kojima

*Sources: JES corporate website and presentation books. “Shinen no Keiei” (Principled management) Katsushi ISHIDA, Gentosha Media Consulting, 2022.*

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*Past performance is not indicative of future results. The information contained herein is subject to explanation during a presentation.*

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