



Japan Special Opportunity Strategy - An Uncorrelated, Unrepeatable Graham Classic Value Opportunity

(Excerpted from the [4Q2020 Commentary](#))

Periodically, but very rarely, an investment opportunity in a non-U.S. stock market arises because of a regulatory or cultural change unique to that nation and to that time. It cannot be recreated anywhere else, not even on Wall Street. It typically has the character of some industry or sector that was artificially constrained for a long period of time, until the regulation or limitation outlived its usefulness or the economic distortions it created began to interfere with other policy goals.

By their nature, these instances are characterized by deeply discounted valuations of the companies in question. That makes them classic Graham value investments with high-return, low-risk possibilities and also, being so idiosyncratic, makes them uncorrelated with other asset classes. However, they are also distinguished from the value-trap challenge of classic value investing by an active value realization catalyst, namely, the new regulatory and policy change.

Such a process is now occurring in Japan. Japan has become of increasing interest to activist investors. They are attracted by the almost singularly low valuations and high cash balances of the publicly traded companies there. These reflect generations of cross-ownership arrangements between corporations as a defense against takeovers, as well as a proliferation of publicly listed subsidiaries that served a corporate culture of lifetime employment. It made for very inefficient operations and low returns on capital. Ownership structures are opaque, and managements have not been accountable to shareholders for capital allocation decisions, performance, or information disclosure. These practices were, in fact, successful: the incidence of hostile acquisitions in Japan is very, very low, and there was even a form of cultural prohibition against such activism.

Beginning several years ago, the government determined to revitalize the private corporate sector, including forcing publicly traded companies to gradually tear down the barriers to change that they had built up. Since 2013, year by year, additional regulatory directives have been enacted, ranging from the inclusion of outside directors on corporate boards, to tax law changes, to a change in the market structure of the Japan Stock Exchange. These effectively place both pressure and financial incentives on public companies to eliminate their publicly traded subsidiaries, either by spin-off or by acquiring them. The government's efforts are clearly bearing fruit, with corporate restructurings on the rise, along with hostile takeovers and the incidence of parent companies acquiring subsidiaries.

A recent rule change at the Tokyo Stock Exchange can seriously impact the listing status of both a parent company that has subsidiary and cross-holding ownership, and of the subsidiary itself. This rule change has a time component to it that is intended to play out over the coming year or so. Accordingly, we expect the rate of corporate restructuring activity to accelerate.

In every market, there are swathes of inefficiency. Sometimes it is information- and analysis-based, and often it is the liquidity divide – as between large companies and those of insufficient scale to interest institutional investors. There are almost 4,000 listed companies in Japan, hundreds of listed subsidiaries, and a wealth of return-on-research-effort possibilities. In that regard, our Japan team,



my colleagues Aya Weissman (co-Portfolio Manager and Director of the Asia Strategy) and Utako Kojima (Portfolio Analyst), have been engaged in company-specific research and novel strategy development for a decade.

The Japan Special Opportunity Strategy is an effective tool for investing alongside cultural norms that are entirely distinct and it can add functional, not merely semantic, diversification to a conventionally structured portfolio.

More discussions to come, from both a sociological and investment perspective.

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