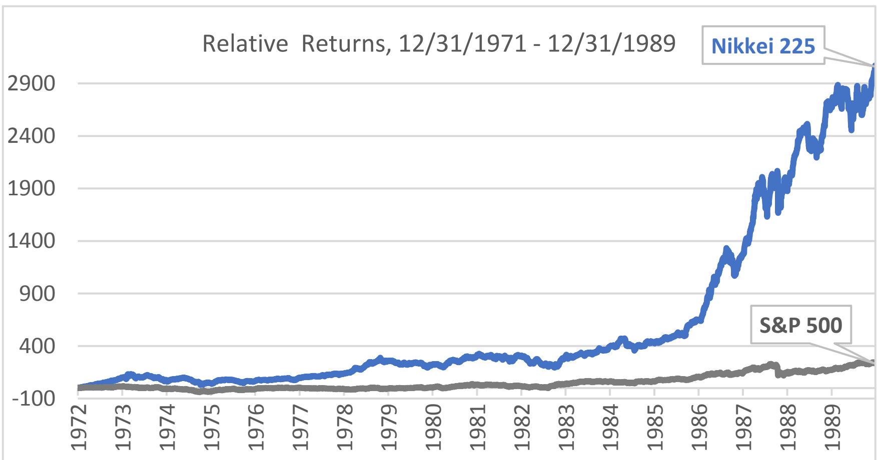
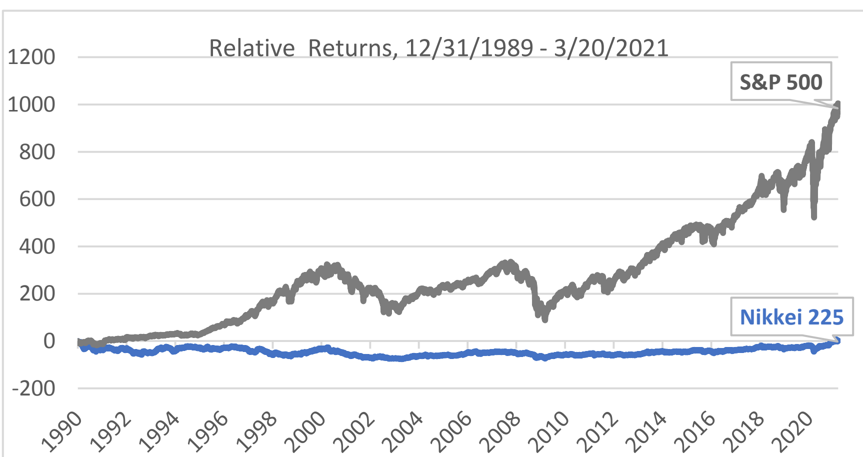
HORIZON KINETICS

JAPAN SPECIAL
OPPORTUNITY STRATEGY

Part 1: The Japanese Market You Know and the One You Don’t

Japan is the second largest developed economy in the world, and is the third largest overall, after the U.S and China. It is the largest weight, at 25%, in the MSCI EAFE Index, followed by the U.K, at 14%. For two decades, Japan was the best performing developed market in the world when, as a bubble, it peaked in 1989. Shortly thereafter, its economic growth trajectory slowed, and has trended at an average of only 1% annual real GDP growth for the last 29 years. In the over 30 years since its peak, the Nikkei 225 Index has yet, in USD terms, to re-attain that 1989 level.





Source: Bloomberg

Japanese publicly traded companies are notoriously opaque as to their management and shareholder disclosures, and they have maintained a studied indifference toward maximizing shareholder returns. To boot, they protected themselves from corrective action by hostile takeovers through their cross-ownership arrangements with one another.

With the well-known cultural policy of lifetime employment, corporate profit margins in Japan are nearly 10% lower than those of comparable companies in other nations. That, along with their cash-heavy balance sheets, resulted in lower returns on invested capital as well. This 'value trap' – there existing no external mechanism to force such companies to alter their policies – is reflected in the Nikkei 225 Index, which trades at both P/E-multiple and book-value-multiple discounts to other global indexes. There have been improvements in recent years, though, and regulatory changes to encourage greater transparency, efficiency and growth, and this has not gone entirely unnoticed. The Japanese stock market has begun to appreciate once again, but one can't say that it has engendered any broad-scale interest.

That is the Japanese market you know. There's also one that you don't. Most investors are familiar with large Japanese corporations such as Toyota, Honda, and Sony. However, these might be more properly classified with other mega-capitalization, global-scale companies than with the local Japanese economy. This is no different than for other nations, to which investors gain exposure primarily through their mega-cap multi-nationals. For instance, the top 10 holdings of the iShares MSCI France ETF (EWQ) account for 50% of that index. More important than EWQ's mega-cap concentration, over 70% of the revenues of those companies come from *outside* of France. By buying the iShares France ETF, one is, effectively, investing NOT in France.

The reason? It's a function of how large the consumer sales base of France is in relation to global demand – the domestic market is simply not large enough to support mega-cap company size. In order to serve the massive liquidity needs of the pool of global investors, ETF organizers require global-scale trading liquidity, which requires a global-scope sales base.

The paradox: when investors seek the diversification benefits of *local* economies, they're really getting essentially the same exposures they have already, such as within the S&P 500: of global multinationals. How different, in terms of systemic risk, is Toyota from General Motors or Daimler Chrysler, or Nestle from General Mills or Coca-Cola?

The same goes for Japan. Japan has a very large economy, rich in complexity. There are over 3,800 publicly listed companies, with a total market capitalization of $7 trillion. Yet, the iShares MSCI Japan ETF ("IWJ", $13 billion of AUM, 301 constituents) includes fewer than 10% of those companies. And those large- and mega-cap companies do not represent or provide exposure to the Japanese economy.

The top 10 holdings (3% of the companies, 22% of the index value) of the iShares Japan ETF get 63% of their sales from outside Japan; the top 20 (one-third of the index by weight) get 61% of their sales from exports. Investors' exposure, in this sense, is to the economies of Japan's primary *export* markets – the U.S., Europe and other developed economies – and their cyclicality, not to those of Japan.

Moreover, the Japanese market itself has the same concentration and exposure misallocation risks as other markets. The 139 largest companies in Japan – in principle, fewer than 4% of the opportunities – account for almost two-thirds of the market value of the entire Japanese stock market. Only one-third of those largest companies source over 70% of their sales from Japan.

ishare MSCI Japan ETF vs. Japan: Top heaviness

	The number of companies	Market cap
Japan Equity Market (3862 companies, $7 trillion market cap)	100%	100%
Large-cap companies* (139 companies, $4.5 trillion market cap)	**4%**	**64%**
ishare MSCI Japan ETF (301 companies, $5.5 trillion market cap)	**8%**	**79%**

*market cap above $10 billion

Source: ishare MSCI Japan ETF, Bloomberg as of 3/15/2021

Beneath the surface of the large-cap layer of the Japanese stock market, though, exists an entirely different stock universe. These are the publicly traded subsidiaries of larger corporations. This so-called parent-child structure has been in place for generations. It is an unintended consequence, an outgrowth, of the corporate lifetime employment culture, which will be discussed more fully in the body of this report. And it has contributed to the seemingly institutionalized pattern of low profit margins, low innovation, and low sales growth that has come to characterize Japanese industry in recent decades.

ishare MSCI Japan ETF Top 10 Holdings:

Company	% of Rev OUTSIDE Japan	MSCI Japan Index weight
Toyota Motor	76	4.0
Softbank Group	21	3.5
Sony Corp	70	3.2
Keyence Corp	53	2.0
Recruit Holdings	45	1.6
Mitsubishi UFJ Financial	48	1.7
Nintendo Co	77	1.5
Shin-Etsu Chemical	73	1.4
Tokyo Electron	86	1.4
Takeda Pharmaceutical	82	1.5
Average and total weight	**63**	**21.8**

Source: ishare MSCI Japan ETF, Bloomberg

These parent-child subsidiaries are truly local, extremely cheap by any standard and historical measures, and are now about to undergo a revaluation. The process has already started. Following several years of increasingly insistent regulatory changes by the government to enforce shareholder accountability, which has determined that the existing corporate structure has interfered with a return to national economic vibrancy – the Tokyo Stock Exchange recently enacted dramatic rule changes that will take place in stages over the next 24 months. These will require parent companies to either divest or acquire a large swathe of those subsidiaries.

These subsidiary companies typically trade below book value, some even below net cash on the balance sheet. The valuation opportunity is not only extremely unusual historically amongst global equity markets, in today's markets it is unique. As importantly, this phenomenon is entirely idiosyncratic – it will be entirely de-linked from the rest of the world's markets, even from the Japanese market – a truly non-correlated return pattern, and one structured for a relatively predictable positive return. Moreover, as a discrete sector, these subsidiary companies are themselves highly diverse and uncorrelated with one another.

To properly understand the investment case for this universe – why these parent-child subsidiaries are undervalued and how they will stop being so – one must understand the manner in which they developed, their historical constituencies, and the cultural and corporate interests that protected them; and, likewise, the changing political forces that have arrayed to undo them.

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