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Opalesque Round Table Series '13

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Editor's Note

Japanese hedge fund managers share insider views on Abenomics

Following the LDP's landslide victory in the 2012 general election, **Shinzo Abe** became Japan's Prime Minister again on 26 December 2012. In March 2013, he appointed **Haruhiko Kuroda** as the governor of the Bank of Japan. Kuroda is viewed as "an independent thinker, light-years from the consensus-seeking bureaucrats who have dominated Japanese policymaking for 20 years." Already in the first meeting of the Bank of Japan council, Kuroada announced a monetary stimulus roughly three times larger relative to the size of the Japanese economy than the Fed's quantitative easing in the U.S.

Abe describes his economical policies ("Abenomics") using the analogy of the **"Three Arrows"**: monetary policy, fiscal policy and structural reform with the ultimate aim of encouraging private investment and consumption. The third arrow will be fired only if Abe wins the Upper House election in July.

In the first quarter of 2013, Japan's economy grew at an annualized pace of 3.5%, possibly the highest growth rate in the G7. The Nikkei index is up almost 80% since bottoming six months ago, and during this time the yen has been in a downward slide against the dollar.

At the 2013 Opalesque Japan Roundtable on April 24th in Tokyo, local Japanese hedge fund managers put the success of Abenomics in a historical background, explaining why it does not really surprise them. The group also discussed:

- **What's "different" about Japan this time?**
- **Is the current boom sustainable? What are the drivers, and how long will it run?**
- **Which sectors offer the best opportunities?**
- **When exactly did the market sentiment towards Japan change?**
- **Why can Abe, other than most of his preceding prime ministers, actually succeed in bringing about the much needed structural reforms, the Third Arrow?**
- **Why should investors consider Japanese hedge funds?**
- **How do the Japanese themselves view and react to Abenomics?**
- **Will the yen continue to depreciate and with what consequences?**
- **Which investors were in this current "Japan trade"?**
- **But what about Japan's debt time bomb? Peter Tasker's scenario lays out what could happen at the point when the BoJ holds "a very large" amount of government bonds.**

Meet the participants of the Roundtable:

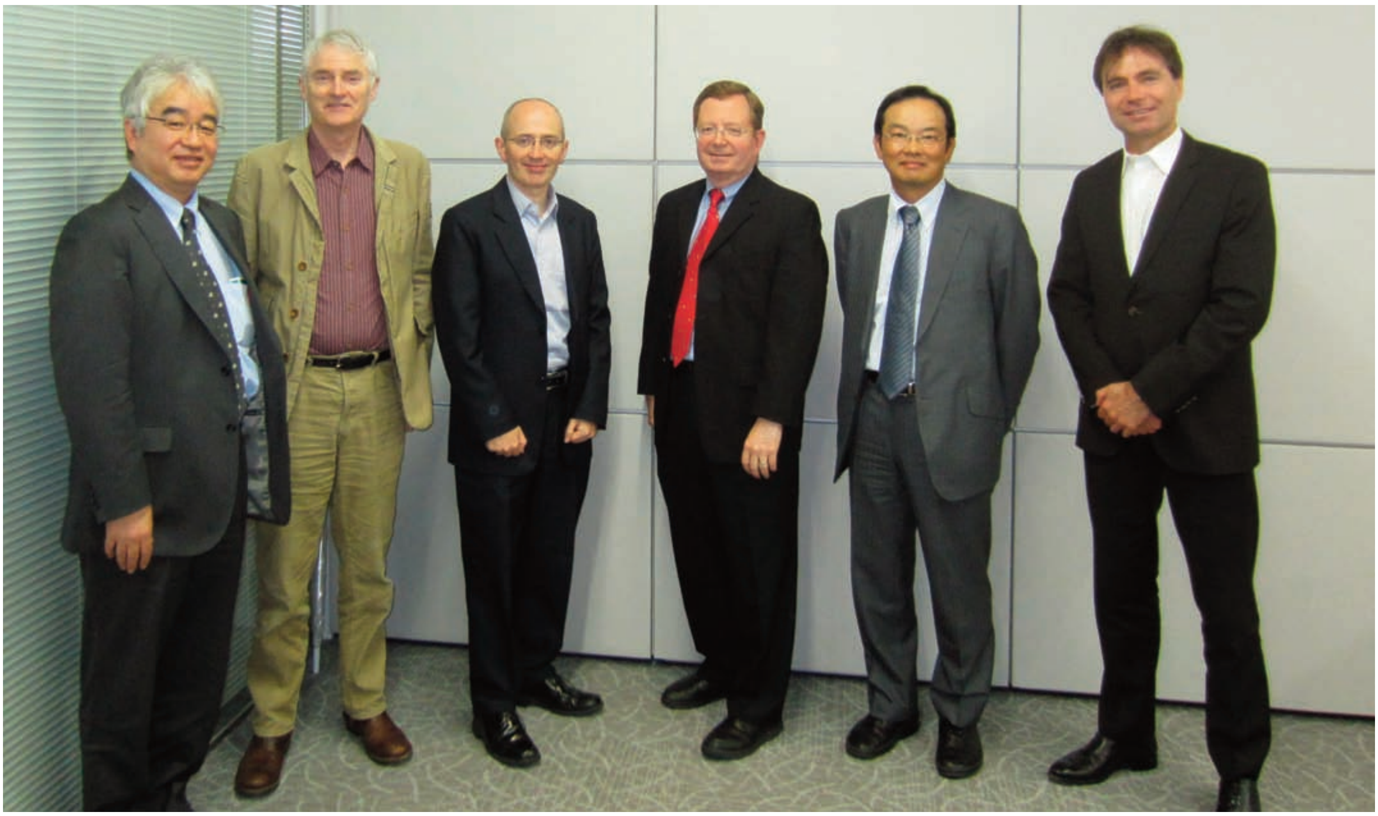
1. **Chris Wells, White & Case** (now with Bingham McCutchen)
2. **Masahiro Koshiba, UMJ**
3. **Peter Tasker, Arcus Research**
4. **Rory Kennedy, Rogers Advisory**
5. **Yasuhito Doi, Astmax Asset Management**

The Opalesque 2013 Roundtable Series is sponsored by Eurex and Taussig Capital.

Enjoy the read!

Matthias Knab
Knab@opalesque.com

Participant Profiles



(LEFT TO RIGHT)

Yasuhito Doi, Peter Tasker, Rory Kennedy, Christopher Wells, Masahiro Koshiba, Matthias Knab

Introduction

Christopher Wells
White & Case

I am Christopher Wells. I am a Partner at White & Case in charge of the Financial Services Group in Tokyo. My practice area is asset management focusing primarily on hedge funds and private equity funds with also some work on real estate and venture capital funds.

Yasuhito Doi
ASTMAX Asset Management

My name is Yasuhito Doi, and I work for ASTMAX Asset Management. I joined this company April 1st this year. Before, I worked for FGI Capital Partners. ASTMAX and FGI Capital Partners both are independent asset management companies in Japan. FGI Capital Partners concentrates on hedge funds and also pension funds. At ASTMAX, I am in charge of product developments.

ASTMAX is a growing company – also on April 1st the firm merged with ITC Investment Partners, so now we are in the integration process of those two companies.

Rory Kennedy
Rogers Investment

I am Rory Kennedy, COO of Rogers Investment Advisors based in Tokyo. I have been in Tokyo over 13 years now. Rogers Investment Advisors specializes in Asian hedge fund due diligence with a particular focus on Japan. We have a Japan-focused fund of funds which has been around since early 2006. We also have a Private Equity fund which seeds emerging Asian hedge fund managers.

Peter Tasker
Arcus Research Ltd

Peter Tasker of Arcus Research Ltd. Arcus has been involved in managing hedge and long only money in the Japanese market since 1999. So we have seen many different kinds of market environment, booms and busts, financial crisis, the whole lot. I have been involved myself in the Japanese market since the early 80s.

Masahiro Koshiba
United Managers Japan (UMJ)

My name is Masahiro Koshiba from United Managers Japan (UMJ). UMJ was initially set up to provide a hedge fund incubation platform for local fund managers in Japan to be introduced to various institutional investors in Japan as well as overseas.

I have personally been involved in the hedge fund business since the year 2000. Additionally, I am currently managing the Kotoshiro Fund, a Japanese equity long/short fund.

Note that Mr. Wells has since moved his practice to the Tokyo office of Bingham, McCutchen in Tokyo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Matthias Knab Japan has become attractive again for investors with the current bull market. Can you explain to us the reasons for the current good investment climate in Japan and put it into a historical context?

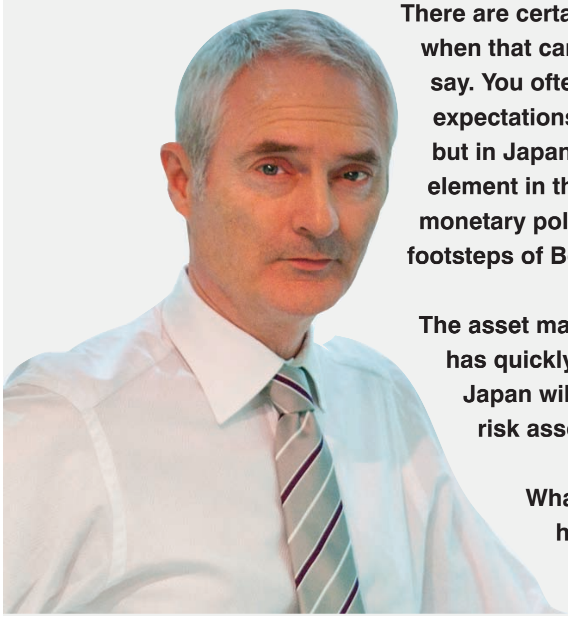
Peter Tasker Since the crisis of 2008, world financial markets have been in a completely different environment, and Japan in particular performed very poorly since then. For example, the Japanese equity market in Autumn of 2012 was actually below where it was in early 2009, which was the bottom for most world markets.

Peter Tasker: While most of the developed markets, even the troubled Eurozone, have made some progress up towards the highs of 2006-2007, Japan didn't. The Japanese market was a very poor performer, despite the fact that the profitability of Japanese companies had improved quite a bit and recovered 50% or 60% of the peak levels of 2006-2007. So you had the unusual situation where profits go up but the market went down.

This has to be seen within the context of a mega-bear market that has been running since 1990 in which the whole class of equities has been discredited in the eyes of the investing public in Japan and during which Japanese institutional investors found they did much better being in bonds and cash. That was essentially the lesson that they learnt.

As a result, coming towards the end of 2012 we found that the market was back to the level it was in 1983, which is extraordinary, and even more extraordinary was that it also fell below its 50 year moving average. That means that if you were averaging your way into the Japanese stock market every month since 1962, you would still be underwater in terms of capital gain as of autumn of 2012.

In other words, Japan has been in an almighty bear market that found its last phase after the global financial crisis with equities delivering continuing disappointment in spite of improving fundamentals. The trend to exit stocks and the manifest lack of faith in stocks were just extended.



There are certain signs that often indicate the bottom in any kind of asset class, but when that can be and what are the conditions that can create a bottom is very hard to say. You often need a trigger of a fairly substantial nature to change people's expectations. You might think that corporate fundamentals improving would do it, but in Japan's case they didn't. In this context the markets found this trigger element in the fundamental changes in macroeconomic policy and particularly in the monetary policy under the new Abe administration which, basically following in the footsteps of Ben Bernanke, aims to stimulate the economy via the asset markets.

The asset markets' intended role as a transmission mechanism to the real economy has quickly given a lot of confidence to investors, who have started to think that if Japan will at last be entering this Bernanke-style world this will be very good for risk assets.

What caused the explosive rise in the stock market was the incredible, historic, epic bear market meeting this dramatic regime shift in macroeconomic policy.

Rory Kennedy Peter has given an excellent historical and contextual overview, let me add a bit more background how the Japanese hedge fund industry has been doing recently.-

Rory Kennedy: I have been looking at the hedge fund industry for the last 10 years here in Japan. From an investment point of view, Japan has been the whipping boy for the rest of the world for years and years now. Overseas investors are used to disappointment in Japan and ask us a lot "what's so different about this time?" First of all, I don't think this is a sudden move and/or unanticipated move. Our firm detected a clear market sentiment change towards Japan that started around three years ago, when the markets were significantly undervalued for all the reasons Peter mentioned, but then external macro events got in the way.

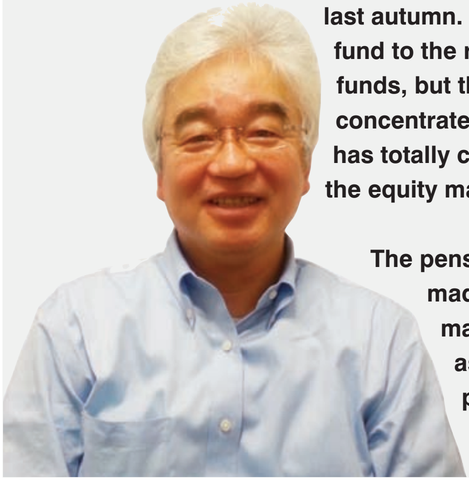
The market recovery that we are witnessing now could have happened already several years ago, but Japan and the hedge fund industry got hit by multiple punches. First 2008 with the Lehman shock and Madoff. Then when the rest of the world was recovering, in 2011 we had the Japanese earthquake/tsunami disaster compounded by the inept response of the Japanese government at the time. Then in 2012 along with the Greece shock and more global macro issues, the local hedge fund industry in Japan suffered from the AIJ Scandal, which was like a smaller version of the Madoff affair. But, at the beginning of each of the last three years, including 2012, there had been several months where Japan's stock looked like taking off and the Sell side started to talk that this could be Japan's year, with Japanese markets becoming a top trade idea. But each time, something external came in the way and knocked Japan back.

So the current upswing had been coming for years and therefore no one should really be surprised by the recent market moves. If people are surprised it's those who obviously haven't looked at Japan in a long time. What's really different this time though are the policy changes that Peter mentions.

One thing I came to understand during my time here is that Japan, contrary to western perception, does in fact change but change does not happen at the pace that is common in the West. On the other hand, the U.S. can react very fast, but can also over-react very fast.

Japan typically initially under-reacts, but then when you look at a certain issue five years later, you discover a lot of necessary change has been achieved. For example, the man on the streets in Western countries may still have images of Japanese companies that are made up of salarymen/lifetime employees ordered according to seniority, and while that still exists in Japan, around 30% of the workforce is made up of contract workers rather than permanent. There are significant changes going on behind the scenes.

Yasuhito Doi: As we discussed, we as Japanese managers know that Japanese equity was very cheap, but the cheap condition has continued for several years, so from that perspective it was a tough call when to actually enter and go long in a market. We actually tried to set up a Japanese equity long only concentrated value fund last autumn. But no securities firm responded to that idea because they could not sell our fund to the retail market. All sales personnel of security firms are more familiar with mutual funds, but they cannot take and elaborate on individual stocks, which will be required in concentrated bottom-up equity fund. So this was the situation last autumn, but Abenomics has totally changed the atmosphere and the game, now almost all retails try to participate in the equity market.



The pension investors however are still confused. AIJ fraud of last year here in Japan has made it very difficult to sell hedge funds, specifically for independent asset management companies. And up until now, they haven't shifted to the long only assets either, they may just start thinking about that. My impression is that the pension funds haven't changed the allocation that much. In addition, they may fear an increase of the interest rates.

Christopher Wells: **Peter's summary of the history of the capital market is spot on. Let me also add that since 1955, the equity capital market have played a less important part of the Japanese economy compared to the debt capital market.**

And because of that, it has gone through various phases. The Japanese economy had a great bubble back in late ‘80s, and then settled back down. It is extraordinary that last summer nothing had changed in almost 50 years.

However, I think what did change last autumn was a perception among the public and by institutional investors, and especially by foreign institutional investors as well as Japanese institutional investors, that the return of the LDP and Mr. Abe would mean a real policy change rather than just a continuation of the politics of the prior eight years which involved, a lot of political lashing out and posturing by the DPJ and LDP and resulting confusion with the bureaucracy.

The fact that Abe saw and has a strong following and ability to interact with the Japanese bureaucracy cannot be underestimated. Unlike any of the prior eight prime ministers, he is able to influence senior bureaucrats and even whole parts of the Japanese bureaucracy to get on board on certain important issues.

That doesn't mean he doesn't have his detractors and other issues, but the perception is that with the LDP coming back and restoring a good working relationship with the bureaucracy, real change could happen in areas as diverse as effective anti-earthquake, effective energy policies and the reintroduction of women into the workforce. This is e very encouraging at a time when Japan faces rather difficult demographics. It is very unlikely that all of those significant policy shifts could have been accomplished by any of his predecessors or without the support of the bureaucracy.

The real question though, I think the jury is out, is will there be growth in Japan? A lot of people think that inflation or targeted inflation is not growth. The better growth opportunities in many people’s eyes still are outside of Japan. The capital that is within Japan is quite substantial and I also believe that a lot of it still needs to go abroad to get global level returns even after the current boom we have seen.

What we have seen is a relatively small part of the capital portion of the economy enjoy a lot of investor interest and the result has been a run up in equity prices. However, the question is whether these prices will be sustained by earnings? They will only be sustained by earnings if those earnings get to the shareholders, and that raises another major issue of the last 15 years, which is the role and rights of shareholders in Japanese corporate enterprises, (i.e. their right to a reasonable return on capital investment).

Also, speculation is not earnings, so the question will be whether the Japanese corporations will be able to pay out earnings that will ensure that the current level of stock prices are sustained. On balance, there hasn't been a dramatic shift yet in household savings. Household savings are still in banks, they are not in the equity markets.

If you look at the statistics going back to the 1960s, as Peter was saying, 80% of Japanese households then owned equities; however by some time in the late ‘80s or early ‘90s, that number shrank down to less than 20% of households owning equities.

Even today, less than 7% of household savings is in mutual funds or equivalent products, and the percentage of overall family savings in banks has pretty consistently been stuck between 60% and 50% for over three decades. That is a huge concentration of capital in the banking system with few domestic opportunities.

Christopher Wells I don't know the exact numbers as of today, but I doubt that very much of that has shifted into the equity markets, or that it will stay in the equity markets unless Mr. Abe is able to ensure that Japanese corporations will pay out shareholder dividends and have substantial growth prospects, and that will be dependent on this restructuring of Japanese enterprise, which is a very uncertain thing as of today.

Masahiro Koshiba: I became a fund manager back in 1990 when the Nikkei was at 38,000 at the time the Japanese equity market was peaking. For the first 10 years during the 1990s, I was a long only manager at Daiwa Securities Group and at Deutsche Morgan Grenfell.

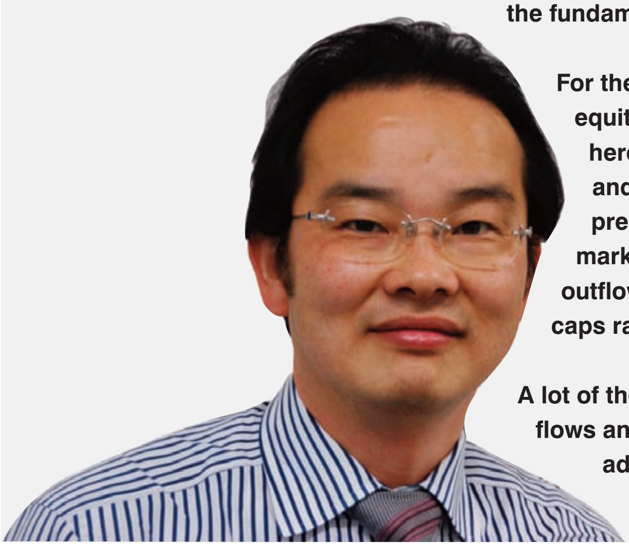
During this period, the Nikkei Index fell from 38000 all the way down to just below the 13,000 level and therefore it was like a survival game as a fund manager. Starting from the year 2000, I shifted my managing career to a long/short strategy and have been able to take advantage of the big volatilities in the market since the Nikkei Index has fluctuated in the 7000-18000 range. After 2000, due to the difficult business environment, Morgan Grenfell (now called Deutsche Asset Management) shut down their Japanese equity management divisions in London as well as in Tokyo, for not only their small-cap team but also the large-cap teams. This state of affairs is not only restricted to Deutsche: since 2006, JP Morgan, Fidelity and the other companies have reduced the number of small-cap fund managers and even Japanese asset management companies have closed many Japanese equities funds.

As a consequence of the bear market, there have been very few competitors on the ground. This has especially been the case after 2006 when overseas investors shifted their interest from Japan to the rest of Asia to markets such as China and India, and thus have neglected the Japanese market. Since there has been considerably less competition from various institutional investors, especially in the small-mid cap space, we have been able to find many alpha opportunities and anomalies in the market in our position as an independent fund manager investing in Japanese equities with excellent access to companies' senior management which is why we need quality fundamental research on companies. In that sense, before the introduction of Abenomics I was very happy with the state of affairs in the market since it was one that was marked by the neglect of overseas investors.

Until last summer, I wasn't focused on marketing at all. However, after enjoying such easy market conditions with a low level of competitors and two years of double digit returns, I thought it wouldn't be a bad idea to restart marketing so I traveled to Switzerland in October of last year. At that time, my marketer had warned me that it would be very difficult to book meetings for me, but he ended up doing a really good job and we had around three to four meetings a day.

However, their reaction was usually "thank you for coming, wow, we haven't heard about Japan in a long time!" We tried to give them a number of reasons to start thinking about Japan again as a good opportunity, but that was about it. I traveled to Switzerland again about two months ago, and of course the situation is 100% different than it was in 2012 after the introduction of Abenomics. Now, they said, "thank you very much for coming, I really want to meet with someone from Japan to hear about the developments of Abenomics and know what's happening on the ground there!"

So there is a big difference regarding the level of interest in the Japanese market from overseas investors and the marketing environment for my fund between before Abenomics and after Abenomics. However, looking at my fund strategy, I have not changed it because of the effect of Abenomics, and I am still focused on stock selection based on the fundamental research.



For the last 20 years, inflows and outflows from overseas into Japanese equity markets have had a very significant impact on the stock prices here. Let's say if foreigners buy around three trillion yen, the supply and demand balance in the market is ok as it eats up domestic selling pressure; but if they do not buy or buy less than three trillion yen, the market will go down. So a big swing factor is actually inflows and outflows from overseas. This fund flow has had more impact on large-caps rather than small-mid caps.

A lot of the volatility in the Japanese market has been coming from those flows and it has been creating market cycles since 1990. My personal adaptation to that fact was to stop doing long only strategies and instead I shifted to a long/short strategy. That allows me to hedge

against the unwanted effects of the external money inflows and outflows, and to continue concentrating on companies' fundamentals through research and making stock selections based on it. I have to say that with this approach I feel relatively safe compared to my first 10 years as a fund manager.

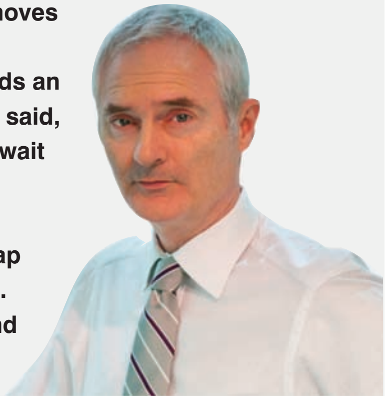
Another factor which has had an interesting impact on the market during the last five or six years is of course the shrinkage of the brokerage business in Japan. One effect of that is that the sell-side coverage and research on Japanese stocks has been reduced and limited to probably only the top 10%-20% of the total stock market in terms of market cap, with an obvious bias towards large-cap stocks. That also adds an element of volatility to Japanese large-caps, and is yet another reason why I have attempted to escape from large-caps and focus on the balance of those 80%-90% of Japanese stocks not being covered in my fundamental research and investments in order to produce a reasonable return. In those areas, since there is no coverage by brokers, you can easily find anomalies and alpha.

Talking about the Abenomics, big money flows are now entering into Japan brought on by this economic strategy and it is beneficial from an investment perspective and for doing fund raising for my business. Looking at the impact on my fund performance, I am making even more money now than in the previous three years. Still it is not due to my taking on market risks with a higher beta. It is instead due to the mispricing of 80% of stocks that corrected too quickly. I think that in the next one to two years there could be more corrections going on in the market as a consequence of the liquidity created by the new team at the Bank of Japan.

One of the outcomes from Abenomics as I said before is the interesting development in the market in which stock prices are normalizing faster. In my fundamental research on companies, I do focus on the actual value of the business for each company, so for example if the value of the business is much higher than the current price of the stock it will go into my long side portfolio. If the value of the business is much lower than the current price of the stock it will go into my short side. After Abenomics, those valuation gaps are narrowing faster, which is good from one side because I get a quicker reward than before in my positions, but I will also from now have to think about what will happen next after the current phase. The stock market is already up more than 50% since November, and both the long and short side are in the process of normalization as well.

Peter Tasker: That 50% move Koshiba mentioned is one of the most powerful and bold moves we have ever had in Japan's history, and it took a very short time. Of course, the fundamentals of companies don't change that quickly but the stockmarket does. That adds an element of complexity to your work as a fundamental fund manager because as Koshiba said, there are now strong external factors at play and affecting your stocks, so you can't just wait for fundamentals to drive the change in prices.

As value managers we are mainly looking at the gap between expensive stocks and cheap stocks. So fair value for us is a kind of relative fair value comparing stock A with stock B. What we want to see is a big difference in the valuation between our longs as a group and the shorts of as a group.



Peter Tasker

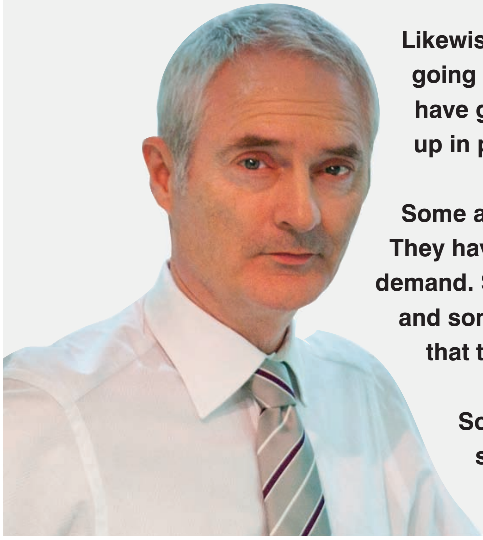
If they were the same, that wouldn't be good for us, so we want to see a big, big gap. And it is pretty big now, the deviations between stocks have become quite wild, as you would expect in a market which has moved so far so fast. We are starting to see stocks on 40, 50, 60 times PER which we haven't seen really for 10 years or more. Some of these are excellent medium term shorts. It is obviously very important to get your risk right in this kind of environment though, if you are short of stocks that are very volatile and long of stocks that are non-volatile then you could be in a disastrous position. So, it's very important to get the risk right and get your judgment of volatility right, and of course to get the alpha out of the stocks

For us the good thing in terms of the sharpness of the move and the wide current value spreads is that we can expect them to narrow, particularly now that investors' attention is starting to come back to Japan. Over the coming years we expect to see a tendency for these gaps to narrow and that should generate good returns to value.

Peter Tasker: The rationale to what's happening in my view is twofold. Partly, there is a catch up to earnings as mentioned, earnings for the market had gone up a fair amount already in the last four years, while the market took no notice. So many companies have already rebuilt profits to a good extent, and now we're seeing a very sudden catch up of those stocks.

The other thing that we are seeing is a big improvement in certain kinds of companies that for some reason react fast to the stimulus. These companies are mainly financial. For example, securities houses are seeing enormous profits again. In this kind of industry everything can change in a couple of weeks and it only takes a couple of months to move from disaster to absolute bonanza. So they are making absolutely vast profits now due to the sudden explosion of volume.

In the real-estate industry, the condominium market is not quite as fast as that, but we can see already the prices of condos are rising, inventory is very low. So, the potential for a big improvement in profitability can be seen in certain areas of the real estate market already.



Likewise, even though it doesn't show in profits because of the hedging, exporters are going to see much better margins. They are seeing them already in reality but they have generally hedged through maybe six months, nine months ahead. It won't show up in profit numbers for a while, but nonetheless it's already happening.

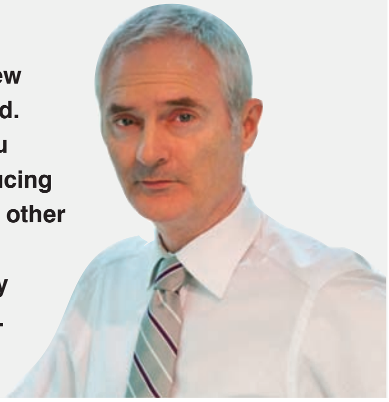
Some areas of the tech industry and consumer electronics are a slightly different story. They have been very depressed, very badly hurt by the strong Yen and weak domestic demand. Suddenly, they have gone to a situation where they can make a lot of money and some of these huge sprawling companies like Hitachi, are seeing levels of profit that they haven't seen since the early 1990s.

So all these things are happening very fast; consumer confidence has risen very sharply too. Sales of luxury goods at department stores are a very small part of consumer spending, of course, but they have improved dramatically.

Peter Tasker

That means we are seeing a few specific areas that have improved quickly, while many areas really haven't changed much yet. You are going to get this kind of division in the market at this stage between the minority of areas that are really benefiting immediately, and the rest of the market where as yet there is not too much to see, particularly where profits have already been rebuilt, like the auto sector.

Peter Tasker: If we are really seeing a move from deflation to inflation if it's successfully negotiated, then the last time we had this kind of move was in the 1930s and there are few people active in financial markets who have really seen this before anywhere in the world. None of us really know what happens to asset prices and people's psychology when you move out of deflation. The last 30 years have been all about moving out of inflation, reducing inflation, which has been successfully done. Now, we may have a decade heading in the other direction. You have a really global effort to reflate. But Japan is the only country that's actually been in deflation, and now they want to get out of it. This is a huge shift in policy and will have a radical impact on perceptions if it is successful, so anything can happen. Absolutely anything.



Rory Kennedy: The number one question we get from investors right now is of course "but is this run sustainable?" A number of factors at play here in Japan leads us to believe that the Japanese market has considerable further upside.

For the first time probably since Koizumi, we have a Prime Minister in Shinzo Abe whose popularity ratings have actually gone up after election rather than gone down. So the Japanese populace is supportive of the changes so far.

Secondly, the governing LDP are most likely going to win the Upper house elections being held in July - that will give them majorities in both Houses of Parliament allowing them to push through potentially painful fiscal reforms needed to reform the economy.

Every country thinks they are unique of course when they are not. But one of the areas that Japan is a little bit more unusual compared to other countries is the homogeneity of the population - how Japanese can tend to think alike and act alike and move as one. When the economy has been bad in Japan, this homogeneity has been viewed by overseas investors as a structural weakness. But when you flip things around, and if you can get the people united in a certain direction, what apparently was a disadvantage now becomes an enormous advantage. It takes time to turn the oil tanker around, but when you do, it's hard to stop the tanker moving forward. And from what we have seen from our contacts across Japan and different parts of society, this is actually happening.

The governing LDP are pretty much united on the direction Japan needs to go in. The bureaucracy that rules Japan behind the scenes, for the first time in a generation, recognizes that things can't go on before, so they are supportive as well. And now the people, through the benefits they are seeing in a weaker Yen and the booming stock market are getting behind Abenomics.

So if the public "three arrows" of Abenomics are monetary easing, increased government spending and fiscal reforms, I think the hidden three arrows of Abenomics necessary to succeed are the government, the bureaucracy and the people all to act in concert and that's what we are seeing right now.

Rory Kennedy

So I can't predict how long this particular stockmarket will go on for and there are likely to be corrections along the way, but the changes happening now will be wide ranging and positive.

But if you are an investor, who looks from a pure geographic allocation basis then there have to be more positive signs in Japan now than have been for 20 years, and certainly compared to the troubled developed markets around the world.

Yasuhito Doi: I think that the Japanese equity market will continue to go up for a while. I can't say how long, but intuitively I think that a continued depreciation of the Japanese Yen will contribute to the upward trend of the equity market, together with the impact of international investors buying Japanese equity, as Koshiba San already mentioned.

So, I don't think this is a time to sell Japanese equity, but I also don't know the point in time when to close your positions, whether it will be in one, two or three years. My concern is more about the bond market. If the Abenomics succeeds to control the interest rate, it's okay. It will make investors happy. But if the interest rates goes up too much or too fast, Japanese banks' asset will depreciate. It may have some big impact to the total Japanese economy. So in a sense I am cautious about the total environment of the investment in Japan.

And also, at least my clients, e.g. a pension fund, as I said haven't really shifted yet to long only equities. Because of the aging society, many pension funds probably need to pay out more money than they receive from the younger generation. They do not have high risk tolerance, so they do not want to have the volatility

of the equity, but they do not have a confidence to invest into hedge funds.

Some pensions try to diversify their portfolio into real assets or other alternative asset classes like alternative energy, for example solar. It is not a big trend but because one of their goals is to have diversified portfolios. That could provide some opportunities for alternative managers to work more with Japanese pensions going forward.

Christopher Wells

I agree with Peter's analysis concerning the stock prices of a certain segment of "good" Japanese companies, with strong earnings and strong product potentials. These companies probably have recovered to a point where the price to earnings ratio is reasonable for those companies.

I think that by the same token stock prices in other segments of the economy may have overshot their real market value in the recent run up. I think the question will be whether the many challenges Japan is still facing will weigh down those companies that have become very efficient with a strong Yen and have very good business models, and whether the Abenomics can re-instill a sense of new value creation.

In the '60s and '70s, we saw whole new business sectors created by firms that now are major Japanese companies (Panasonic, Sharp, Sony, Toyota, etc.). I personally don't see similar creative efforts in the Japanese economy today, I don't see the same entrepreneurial drive to create new global products. To me, many parts of the Japanese industry remain very inward looking and not necessarily terribly competitive on a global stage, except for the 50 or so global leaders like certain Japanese car manufacturers and others that are still doing very well.

What has been the great failure of the last several decades is the inability of the capital market to rationalize Japanese businesses, whether it is through shareholder value investing or forced mergers by persons holding bank debt or similar leverage. There is a huge reluctance to restructure Japanese industries, and in fact the reluctance has been greater in the last two decades than it was in the first two decades of the "Japanese economic miracle. It has been a huge policy challenge for the Japanese government to decide how to ensure a rationalization will happen in that portion of the economy that really requires it, especially in light of Japanese demographics.

The other issue many people have talked about for years now is the hollowing out of the Japanese economy. Japan's economy is now very significantly a service economy, but the service profile and business model of Japanese service companies cannot be that easily transplanted outside of Japan. That is, of course, also true for service sectors in Europe or the United States but the challenge is much greater for Japan.

Targeting inflation is something economists have talked about for a long time, up until recently, nobody has really tried to do it. Everybody you talk to will confirm what an incredible experiment Abenomics is.

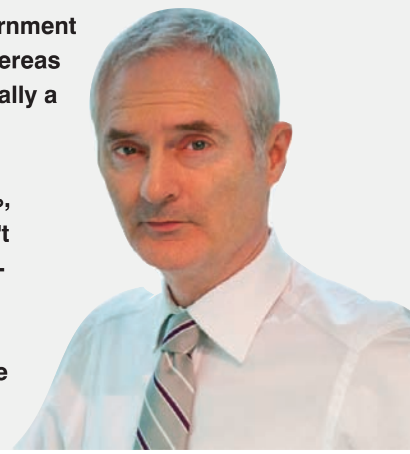
One clear effect of inflation is that it will be an incentive for the older generation (over 65), which owns 75% of Japanese wealth, to start thinking how to spend some of it now. If they continue leaving the money in the bank, its value will go down 2% per year or more. During my entire time in Japan over the last 30 years, this tendency towards saving and the lack of consumption has always been Japan's single biggest economic problem.

I don't know on what exactly the 85 year old super wealthy people are going to spend their 2% of inflation, but hopefully they will do it for their kids and maybe their grandkids or great grandkids, we will see. However, at least a part of the Abe government policy is to try to force some of that capital back into the consumption part of the economy.

My own sense is that the market has clearly overshot investor expectations at this point and there will be a correction. I agree it is probably not going to happen in the next three or six months, but I suspect it could easily happen in the next 12 to 24.

Rory Kennedy: **When you meet overseas investors, another question we often get is "what about Japan's debt time bomb?" Peter and Koshiba san, what do you tell investors when they ask you that? The other infamous issue is aging demographics, which are bad in Japan but as a matter of fact it's just as bad or worse in China, South Korea, Singapore and Hong Kong. But the Japanese government debt is what concerns people overseas most – it is already over 200% of GDP and if the current administration is going to make it much higher, is it is a nightmare waiting to happen? What do you say to people who ask about that?**

Peter Tasker: **The answer to that is not well understood anywhere in the world. People make a lot of fuss about debt in the United States even, which has got historically quite low levels of public debt. So there is a lot of political commotion about debt, and some people have aggressively shorted bonds even in the US, and that of course turned out to be a disastrous trade. In Japan this trade has been called the widow-maker. Now we've got a situation where the BoJ is basically buying the entire annual insurance of government bonds. This means that there are actually no new bonds coming onto the market, whereas Japanese institutions require bonds. This has created a situation where there is actually a shortage of bonds.**



The rational level for bond yields would be 2% or something like that, maybe over 2%, looking forward to the sort of inflation being targeted. But in the meantime, it wouldn't surprise me if they stayed at a very high level for quite a while because of this policy-generated shortage.

I think that, against what many people are expecting, it is entirely likely that Japanese bonds actually go up for a while.

Masahiro Koshiba: **The Japanese government obviously has too much debt and the trade account is now a deficit. After the big earthquake in 2011, Japan had to shut down a good many of its nuclear power plants, and to maintain the energy production we were forced to buy oil and gas at a cost of three or four trillion yen annually, and that turned the trade account from surplus to negative. But still, Japan as a whole including the private sector has large net assets, and the current account is still showing a surplus as a good amount of income is coming from overseas, and it is actually more than the trade account deficit. It's well known that Japan doesn't need to rely on any foreign investors to support Japanese government bonds, as the vast majority of bonds are held by domestic investors. The question is how long will that condition continue?**

Let me also add some thoughts about the spending patterns of wealthy Japanese seniors. At the moment, it seems that the point where they have the maximum level of savings is actually when they die. It seems to be part of their psychology is to continue to build savings, because they are worried about having no money in the future. Still, when the wealthy die, they of course cannot take their money with them. Perhaps the new policies of Mr. Kuroda, the new Governor of the Bank of Japan, (like trying to buy as many JGBs as possible) have already sent some signals to change the financial attitude of average Japanese. In fact we have already seen that the savings ratio is actually coming down, and that the Japanese have started to spend more money after Abenomics.

Along with that and the continued printing of money by the BoJ, some people have also started worrying about the value of Yen not only against foreign currencies but also against any real assets here in Japan like automobiles, property, or even golf course memberships. Thus, now the idea of keeping money in a savings account is under review as to whether it is a good or bad thing. If I look around at my friends or

some company or business owners, they have already started to shift money out from the Japanese Yen to overseas currencies after Abenomics. Part of that is because they clearly feel that the value of the Japanese Yen will be going down in the long run, or at least for two years during which the BOJ will be printing huge amounts of money.

Mr. Kuroda did say that unless he sees a 2% inflation rate, he will continue to print money. I am not sure if investors should take up a fight with the Bank of Japan over that, or rather follow along with them on it. Even the average investor can participate in this scenario by buying ETFs, while the sophisticated investor may try to take a short Yen position. For all those reasons, one of the most important things we have to focus on is the average senior's attitude and reaction to the actions of the Bank of Japan.

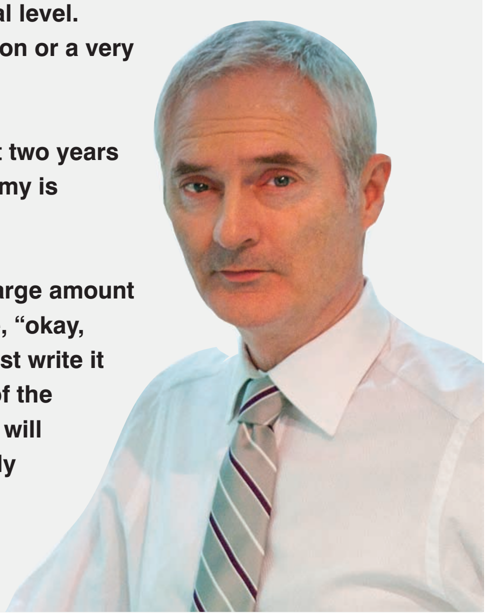
Peter Tasker: The fact that people die with so much wealth is irrational, no? But it is an extreme expression of the fact that Japan actually doesn't have too much debt, it has too much savings. I want to put it in a different way that Japan's balance sheet is too big. People save more money than they should, and the private sector doesn't need money because it already has a good positive cash flow.

So the only place that money can go is either to overseas or to the government, those are the only two places it can go. Most of the Japanese are very cautious savers, so they want security, which means government bonds. So they put money in the bank and the bank buys the government bonds, or they buy some fixed interest product with mostly a very low coupon.

So the Japanese government continues to be in a quite comfortable position to get finance. It's not a problem, the interest rate is very low. Wealthy Japanese putting their money overseas could have the effect of causing structural decline in the Yen. We already expect inflation to be around 2%, and if the Yen goes down more than 2% per year that translates into a pure competitiveness gain for Japanese companies. It is quite likely that there will be a profit bonanza that could take profitability of Japanese companies to levels we've never seen before, and as a result of that we could see extremely strong equities.

The other point that's worth mentioning which is an aspect of public debt that people don't really understand, is that governments in all countries have the power to get all the assets of the private sector. In the worst case they just say "give it to me". However in the realm of public debt, the government doesn't really have any assets, it is just distributing money from one set of people to another set of people. That's all they are doing, moving it from here to here. This can go on for a long time, there is no reason it has to stop until voters tire of the game.

Personally, I don't think it's a great idea to be in bonds, because there are far better things to do with your money in Japan, and because at some point yields will have to go back to a kind of normal level. Nobody really knows when that will happen; I don't think it's going to be very soon or a very sharp rise, but it will come.



Fortunately in the case of the banks the average maturity of bonds held is about two years so the capital loss will be quite manageable, provided that the rest of the economy is reflating as we hope.

One thing that is clear is that at some point the Bank of Japan will have a very large amount of government bonds. It could just cancel them, right? They would simply argue, "okay, we're not going to sell them back, we're just going to keep them forever. Let's just write it off!", and that will be it. Their balance sheet will have to be rebuilt, but the rest of the government's balance sheet will look a lot better because the debt-to-GDP ratio will suddenly take a good drop down. Of course the Bank of Japan will be technically bankrupt, but that is not a particularly meaningful concept for a central bank. There would need to be new authorized capital for the Bank of Japan, but in the end this is just more money going around in circles within government.

Christopher Wells 90% of Japanese government debt is owned by Japanese investors, which is quite unique in the G20. This is not the case in the United States or in most European countries. That's why you don't bet against the Bank of Japan because, as Peter says, they can turn the switch and move the money from one side of the economy to the other, and they will.

The other interesting comment is that the equities could show a very strong rise because of targeted inflation and the stimulation effects. If that scenario plays out, it also means that companies that aren't necessarily very international now could become much more international.

People have been predicting a collapse in the Yen mostly because of the debt-to-GDP ratio for a long time, so the real question is that once the Yen becomes so competitively cheap, once we go down this hill, where will it stop? What's the "real" parity level for the Yen? For example, what is the rational level that the Yen could go to in the next 12 months against the dollar?

Yasuhito Doi: 10 years ago I already said the Yen is too high, it should depreciate, but during those 10 years, it always appreciated. But right now, I feel that the trend has changed and that the Yen is in a sustained down trend. I don't know where the bottom will be, but I think that it will take some time to change the current trend.

Ten years ago, the second largest economy was Japan, and in future, Japan will be ranked number four or five, and Yen may become less important in the world economy. So also from a global macro perspective, the Japanese Yen would be weaker in such future environments, and this will help with Japanese economy.

I am optimistic with the equity market right now, but there are a several political uncertainties we have to consider as well. There will be an election in the summer, and maybe LDP will win with high probability at the moment. This will help the economy and equity market. But at the same time, the Japanese politics will become more conservative and maybe we will see more conflicts with our neighbor nations, which could result in negative impacts on the market.

Matthias Knab How are Japanese hedge funds doing in this environment?

Rory Kennedy: Over the last couple of years, the biggest characteristic in Japanese hedge funds has been the lack of replacement for disappearing hedge funds. Globally, the hedge fund industry is known for its survival of the fittest nature. Every year, approximately 20% of hedge funds die and another 20% or so start up as new funds. I do believe that this year that trend will change in Japan. Anecdotally, I do see a growth in new Japanese hedge funds. Some of those will be called pure Japanese hedge funds, and others may opt to label themselves "North Asian" funds saying they can invest across Asia but if you take a deeper look you may see that the majority of their assets are actually in Japan at all times, and that they simply chose the wider label to avoid the "bad press" factor that they feel is still hanging over Japan from the recent past.

Our fund of hedge funds tracks about 100 Japanese-focused hedge funds who can be based all over the world. A good number of those funds, for example, the market neutral strategies, has delivered steady returns in the last couple of years as you would hope in a difficult trading environment. That of course is now changing massively. With this bull market, market neutral is no longer a strategy in favor, but rather long only and/or long bias are gaining traction. The best performing Japan funds out there are those with a heavy long bias and some of the activist funds have delivered extremely high

returns as well. Of course, such long only or long biased funds will also suffer in a large correction.

From a data point of view, it isn't easy to give exact data on the number and asset size of the Japanese hedge fund industry. We find that no matter which database you look at, the numbers are always stale or incorrect and we use our own research to get a clearer picture. For example, the largest and oldest hedge funds only report to certain databases or they have shifted assets out of Japan into Asia, and now they are shifting back again.

Another trend that started already a couple of years back is that the new funds are more and more being set up by Japanese nationals, rather than by foreigners or "gaijin", as they are called here. This is another very positive sign for the industry.

In general, the Japanese hedge fund industry is no different than the rest of the world in that the biggest problem is still asset gathering. Just like everywhere else, the bigger funds have gathered more assets than the smaller funds even though academic research from across the world has found that smaller funds outperform the largest funds.

Over the last five or six years I have also found a particular structural issue in the Japanese industry here. When Japanese institutions have sponsored hedge funds, they seem to do it in a very half-hearted manner. Even local giant institutions with hundreds of billions of assets under management may put only $10-20m to launch a hedge fund with the belief that somehow their brand name will get that fund on its feet. This contrasts sharply with the west where managers can still get $100m tickets to launch from their former employers or from certain seeders.

So I think the missing piece for us in the Japanese hedge fund market is for Japanese institutions – when they periodically get serious about sponsoring hedge funds - they need to do it properly in size and they need to do it professionally. In other words, they shouldn't just pick the guy who worked for them managing a mutual fund, they need to go and find external professionals who can deliver returns in multitude of environments.

Christopher Wells: In our legal practice, up until maybe a year ago, the largest source of business was people coming to Japan to raise capital and helping those people with their compliance and their licensing, etc. Starting about a year ago, for the first time in eight to 10 years, we found more people interested in seeking a discretionary asset management licenses in order to actually manage investments here. That group includes domestic hedge funds as Rory mentioned, but the people we see most are global institutional groups wanting to come to Japan and set up a trading operation that also can raise capital for their offshore fund strategies, but which also has a very significant domestic focus. We did several of such DIM set-ups last year.

There is a discretionary management "lite" regulatory registration ("Pro-DIM") since April 2012 and we've seen some of those be completed but frankly the AUM size limitation of 20 billion yen has been a significant disincentive to people other than possibly startup managers.

Christopher Wells We haven't been seeing this, but it would be great if there were more startup managers that were in Japan using the Pro-Dim model as a stepping stone to a full DIM operation. Unfortunately, however, I think that a combination of factors has made that less attractive. First, there is concern that the regulator is too strict in granting registrations post the AIJ scandal. Second, a large portion of the hedge fund industry in Japan that was built in the early 2000s is on a structure which involves offshore management based onshore research and advice (the "standard model"), Even after creation of the permanent establishment tax safe harbor and Pro-DIM registration, unfortunately we have not seen any substantial return of those offshore management operations to Japan. Third, the regulatory environment (on the inspection and enforcement side) is perceived to be very harsh for discretionary asset managers.

Rory Kennedy We think the new Pro-DIM license – a kind of light touch registration - is a big step forward for Japanese startup managers, although it remains to be seen how popular it will become

Rory Kennedy: But one thing is for certain, the Pro-DIM license removes nearly all of the regulatory arbitrage that has happened over the last five to 10 years, where Japanese managers went to Hong Kong and Singapore to set up there, because it was considered easier both for fund regulatory and tax reasons. Hong Kong hasn't really changed, it already had a manager friendly environment, but Singapore has gotten significantly stricter in the last year to the point where you can now also set up your firm in Japan in the same time with the same amount of regulatory burden as you would have in those other markets.

So in regards to new Japanese start-up managers, it's no easier for them to go set up overseas. Secondly, academic research from around the world has shown that managers who are closer to their investment market outperform those who are further away from it so it makes more sense for them to stay and run their funds from Japan.

Christopher Wells: One thing I haven't seen here is local managers getting money from Japanese allocators. The lack of a major domestic seeding or financing party can be seen as reflecting a lack of confidence in their own "home grown" managers. It is very disappointing.

If the equity markets continue to perform, now wouldn't be a bad time for domestic investors to fund domestic managers. I am not just talking about pension funds, but also trading and insurance companies, or banks, including certain specialized banks. These firms seem mired in conservatism. They don't have a belief that these young, specialized managers can make them a good amount of money that they themselves cannot make (or have not made) in domestic and/or in foreign markets. I think that's a very unfortunate comment on the Japanese hedge fund industry. May be that will change, I hope it will change, but again, for the moment I do not see it changing in fact.

Masahiro Koshiba I have been involved with the Japanese hedge fund business since 2000, so we do have to admit that the industry went through a growth and maturation period already. From 2000 to 2003, a number of very good funds were set up and were quite successful, then from 2003 to 2005 there was a boom in Japan-based hedge funds and a lot of new funds were created. Unfortunately, too many funds did the same kind of strategy of long small-caps and short long-caps. After delivering record returns in 2005, starting from 2006 that particular strategy was disastrous.

Masahiro Koshiba: Following 2006, probably most of the money from overseas shifted from Japan to Asia Ex. Japan, markets like China, India, Korea, Taiwan, Philippines, etc. I haven't seen much money flow from overseas into Japanese hedge funds since that time. However, as I said before after the introduction of Abenomics, overseas investors have started to look at Japan-based hedge funds again. For me as a fund manager, this is a very good environment, as there are not that many competitors now doing what I do and as I have already mentioned the sell side coverage from the brokerages focuses only on some 100 or 200 stocks from a total of 3000. For fund managers like myself, especially if you are based in Japan and have the ability to do research on the ground with a long-short strategy, there is real alpha that you can capture here. I am not sure whether many people realize how good the environment is for Japan-based hedge funds at the moment. Nevertheless, there will probably be some more money coming our way in the near future.

Matthias Knab I am wondering, who are the investors who were actually benefiting from this 50% market rise? Who was in that trade?

Rory Kennedy: The rise in Japanese stocks has been fairly evenly spread across cap size and most sectors so it's not just one type of bet to have gotten right. It's very hard to say which investors got everything right. But one group of people who obviously were in this trade are the survivors – those hedge fund managers that have seen several cycles and are still around and operational. These include the managers who are here in the room, people like Koshiba san and Peter.

Matthias Knab What kind of end investor was in this trade?

Rory Kennedy: I would say it's the investors who were always a bit more independent-minded and never believed that there was no value in Japan. Happily, we ourselves are in that category and our fund of hedge funds is up over 10% so far this year as well. Like us, some investors haven't focused on the macro news in Japan. We're not just investing in a country but into hedge funds. In every environment there will be some hedge funds that can make money. For those investors who have been beneficiaries of the recent Japan rally, this is just proof of what they always believed in.

Most people who invest in hedge funds say they are looking for alpha, but in reality they are looking for beta or alternative beta, trying to ride trends or waves. That's not why we are in the business. We are in the business of finding alpha on a consistent basis, and that means risk-adjusted returns. There are going to be some Japan managers who will be up over 100% this year, in fact there are some that we are aware of who already are. Still, that doesn't mean performance is our only criteria. As a firm, we aren't invested in some of those high-flyers because we are not just performance chasers or they may have not passed our operational due diligence.

Also, to be fair to those investors who have missed the current rally, if you were an overseas investor, there was career risk involved with investing in Japan for several years. It was easier to take the beta in ex-Japan Asia, so if an investor had stuck with Japan, he may have underperformed for the last years. And of course, the opposite is now true. The investors who have ignored Japan and kept it at a weighting close to zero for many years now, if they get to the end of this year and they haven't invested in Japan, then they will have a different question to answer. You can still predict Japan is going to come to a sorry end for all this Abenomics, but if that takes several years and you didn't take any of the profits during that period, you will probably be questioned on this lost opportunity.

Rory Kennedy So in fact, we predict that more-and-more people will be coming back to this market. At some point we may even see "negative indicator" investor types out there entering the market when it has peaked, but that's another reason why we believe the current run is sustainable, because so many investors have yet to come back to Japan.

Christopher Wells: Which investors have been profiting from the run-up? I believe a lot of that is fortuitous. A number of investors like mutual funds or certain pensions are required to have global allocations, so also to Japan, and probably they have cried every year for some time about those positions.

Today, they are very happy that they had that allocation that was required. Some of those institutional investors tried to write down or reallocate their Japanese allocation to China or other places in Asia, and I believe those investors now regret that move that left them underexposed to Japan. So apart from the local managers who were obviously in the trade and possibly some astute momentum traders, the other winners are those overseas investors whose Japan allocation had been sleeping for some time in their portfolios, and all of a sudden it is the best performing part of their investments.