



Opalesque Round Table Series '12 JAPAN

Opalesque Roundtable Series Sponsor:



Editor's Note

In May 2011 I was scheduled to come to Japan for our 2011 Roundtable which we had to postpone because of the tsunami and the Fukushima catastrophe. For the Opalesque 2012 Japan Roundtable, I stayed six days in Tokyo and found that the country has very nicely bounced back. Corporate Japan responded very well to the post-Tsunami challenge of re-opening factories. Many overseas investors still underestimate how well the Japanese people and corporations have responded to the situation, and for a number of reasons fail to realize the investment opportunities Japan now provides.

When it comes to investing into Japan, **many global investors believe that “nobody can make money in Japan.” But the reality is that this attitude makes it easier for the remaining players to make money in this market.** While long-only investors in Japan, including domestic pension funds, are withdrawing from the markets, the **hedge fund space continues to make money.** As everywhere else, the hedge fund space has also contracted in Japan, however the opportunity set has grown at the same time.

“Japan is a hedge fund investor’s paradise if you are seeking lowered correlations and therefore lower portfolio volatility,” says **Ed Rogers**, whose Japan hedge fund of funds returned close to 10% over the last five-and-a-half years, including a positive return in 2008, and has beaten TOPIX by over 60% over that period with less than one quarter of the volatility of the index. **David Baran’s** fund was launched in September 2003 when Nikkei was about 9,500. The index has fallen since then, yet his fund is still up 56% after fees. **Trond Hermansen’s** fund launched in April 2006 when the market was almost double where it is at the moment, but even during the challenging years since then has managed a net of fees compound annual return of more than 9%. Still, the industry struggles with the negative investor perceptions and macro issues of Japan. “If you could remove the word Japan from marketing materials and just show the performance numbers, many Japanese hedge funds would have over \$1 billion in assets,” says Rogers.

If you look closely, Japanese managers were amongst the best performing globally over the last couple of years. Apart from operating in the “largest and most diversified opportunity set with the least amount of coverage in the world,” another reason could be that many U.S. or European managers are not used to adapting to declining or flat markets. Some investors think that Japanese managers have the better skills to navigate and produce returns in such markets.

How do they do it? How can you make money in Japan?

Japan is cheap and at the same time a value-trap. The paradigm for most investors is to presuppose or assume a free market and that share prices will gravitate towards fair value. But Japan is different. Does Graham-Dodd and the typical value investing work here? If there is no market for corporate control and free float is so low that you cannot buy enough of it in the market, isn't the market itself then dysfunctional? Where are the returns coming from? Is there a way out for the markets?

The secret to achieving returns in Japan is that you'll have to do more than just long-only investing. **The unloved, under-covered nature of the Japanese market creates opportunities that ordinary fund managers are not capable of pursuing because it's too hard to extract the value.** Many Japanese firms, particularly the smaller ones, can boast about 40+% operating profits and 30+% EBITDA margins. They can have net cash positions and trade at 50+% net cash to market cap. Hundreds actually trade at over 100% net cash to market – which means the market is valuing these viable businesses at zero. “Investors in the U.S. equity markets would be falling over themselves to invest in a company like these – net cash, strong business moat and growth prospects,” says Baran. But being “cheap” isn't enough – **you need catalysts to unlock the value.**

M&A activity flourishing in Japan

Corporate activity is such a catalyst. Many of the large Japanese conglomerates started to buy back listed subsidiaries. Management buyouts are gaining popularity due to: 1) low valuations; 2) increasing costs of maintaining listing; 3) stricter listed company disclosure rules; 4) **cheap bank financing**; 5) improved legal framework; 6) increasing shareholder pressure; 7) greater willingness by senior managers to conduct MBOs; and 8) **Premiums are high (over 50%) because share prices are depressed.** Research from Daiwa looking at all parent subsidiary takeovers since the year 2000 showed that they happen at a premium of between 30% and 60%.

The Opalesque 2012 Japan Roundtable was sponsored by law firm Bingham McCutchen and Eurex and took place in May 2012 at Bingham's Tokyo office with:

- Akihito Miyake, [Bingham McCutchen Murase, Sakai Mimura Aizawa](#)
- Takashi Imai, [General Manager, Alternative Investment Department, Asahi Life Asset Management Co.](#)
- David Baran, [Founder, Symphony Financial Partners](#)
- Ed Rogers, [Founder, Rogers Investment Advisors](#)
- Shiro Hayashi, [Managing Director, Dalton Investments](#)
- Trond Hermansen, [Investment Manager, Sector Asset Management](#)

Hear a fascinating discussion about:

- Were the famous activist hedge funds of the late 2000s like Steel Partners, Murakami “too early?”
- How will Japan reform its pension fund management system after the AIJ fraud? Will there be a gatekeeper solution?
- What is the future of the Japanese equity market?
- The relaxation of the Financial Instruments and Exchange Act registration requirements for investment managers targeting only professional investors.
- Huge aggregations of wealth within the Japanese banking and insurance systems: what’s the opportunity? What does a move from the current 0-3% weighting in alternatives amongst Japanese pension funds to a 5-7% allocation mean for the global hedge fund industry?
- Is there really a correlation between GDP growth and stock market outperformance performance?
- Why are much less foreigners and much more Japanese people launching Japan hedge funds?

Enjoy the read!

Matthias Knab
 Director, Opalesque Ltd.
Knab@Opalesque.com

Participant Profiles



(LEFT TO RIGHT)

Matthias Knab, Akihito Miyake, Takashi Imai, Ed Rogers, Shiro Hayashi, Trond Hermansen, David Baran

Opalesque Japan Roundtable Sponsor



Introduction

Ed Rogers

Rogers Investment Advisors

My name is Ed Rogers. Since May 2006 I have managed a specialty Asia-based research and investment firm. Our firm entities include Rogers Investment Advisors, Wolver Hill Asset Management, and Wolver Hill Advisors, LLC. Our first product is a Japan-only fund of hedge funds, launched in November 2006. Our second product is a Pan-Asian seeding product launched in November 2009. All of our funds are focused on Asian alternatives. We have a total of 12 full-time employees in three countries: the United States, Japan, and South Korea. Our investors include US pension funds, European private banks, US Family Offices, Japanese financial institutions, and individual high net worth investors from around the world.

Takashi Imai

Asahi Life Asset Management

My name is Takashi Imai. I am from the Asahi Life Asset Management Company, which was established in 1985 by one of the Japanese life insurance companies. Our company is focused on long-only products, but we also invest in hedge fund strategies. Our fund of hedge funds is managed by four portfolio managers and has an over ten years plus track record. We also work with a New York based gatekeeper, a family office type of investor, who also gives us advice and helps us with due diligence, but we also do due diligence ourselves.

Akihito Miyake

Bingham McCutchen Murase

My name is Akihito Miyake. I am with the law firm of Bingham McCutchen Murase, Sakai Mimura Aizawa. I am a Japanese licensed lawyer having 12 years experience in the field of investment management. I give my legal advice on how to distribute foreign investment funds in Japan as well as on regulatory issues to securities companies, investment managers, investment advisors, etc. Before joining Bingham, I was working in the corporate disclosure division of the regulator, Financial Services Agency of Japan. Bingham's Investment Management Practice Group reflects the breadth and diversity of the investment management industry not only in the U.S. but also in other areas such as Tokyo, Hong Kong and London.

David Baran

Symphony Financial Partners

My name is David Baran. I am the Founder and Co-CEO of Symphony Financial Partners. With my partner Kazuhiko Shibata, Symphony advises two funds: the SFP Value Realization Master Fund which is an engaged value investment strategy fund focused on Japan, and a Pan-Asia macro fund called Sinfonietta. We have been operating since 2000 and launched our first fund, SFP Value Realization, in 2003.

Trond Hermansen

Sector Asset Management

My name is Trond Hermansen. I am with Sector Asset Management, which is a Norwegian-based company founded in 1999, managing more than \$1 billion. I have 17 years' experience investing in Japan. I joined Sector in 2006 and then launched the Sector Zen Fund, which is a Japanese equity long/short fund with a deep value investment style.

Shiro Hayashi

Dalton Investments

My name is Shiro Hayashi. I work together with Jamie Rosenwald who is one of the founding partners of Dalton Investments. My primary mission is to help him on managing Asian equity strategy mainly from Japan perspective. Dalton Investments was established by three founding partners including Jamie in 1999 and currently manages \$1.7bn in three strategies of Global Equity, Asian Equity and Distressed Debt. All are based in philosophy of two disciplines. The one is value investing. Yes, we buy stock at deep discount against the intrinsic value to gain margin of safety. The other focus is what we call "alignment of interest." It simply means if management of the company has same motivation with shareholders. Jamie has grandfather who worked with Benjamin Graham, and he himself has 30yrs carrier of value investment. And has good track record of substantially outperforming TOPIX in the past 17 years based on two disciplines.

Everybody wants more from the market. Our innovations make it happen.

Financial institutions, corporations and investors are under pressure to find new opportunities to grow their business and hedge their risk.

Success for them means making the right call in an environment they can trust.

One that's built for speed and adaptation. And one that balances innovation with safety.

For more than 10 years, Eurex Group has been turning ideas into opportunities in the fastest, most challenging market conditions.

By trading and clearing a growing multi-asset product range.

Through benchmark technology and risk management.

Across Europe, in the U.S. and through partners around the world.

In financial and commodity derivatives, bonds, repo and post-trade services, Eurex Group is helping to shape an environment where decisions can be made quickly, reliably and with the assurance of integrity.

So everyone can get more from the market.

Find out more at www.eurexgroup.com



Eurex Exchange ✓ International Securities Exchange ✓
European Energy Exchange ✓
Eurex Clearing ✓ Eurex Bonds ✓ Eurex Repo

Eurex Group includes Eurex Exchange, the International Securities Exchange (ISE), European Energy Exchange (EEX), Eurex Clearing, Eurex Bonds and Eurex Repo.

Eurex Group is part of Deutsche Börse Group.

Matthias Knab

Exactly one year ago I was scheduled to come to Japan for our 2011 Roundtable, we had to postpone it because of the tsunami and the Fukushima catastrophe. So, coming here one year after those terrible events I find that Japan has very nicely bounced back, everything seems back to normal. You here at this Roundtable lived through the events; can you share with us where is Japan now and what is the situation from the investment side?

Ed Rogers: I think everybody around the table and also frequent visitors to the country would say the change between now and this time a year ago is dramatic.

One year ago there was something like a general panic when you mentioned the word “Japan” to investors or the media. There was fear about the long-term effects of the Tsunami, how to clean up the Fukushima nuclear power plant, etc.; anything related to Japan was overwhelming. Most investors frankly gave up on Japan. In addition, the Japanese government deficit continues to scare off many investors.

One year later, we see a tremendous change in investor attitudes and in fact within Japan itself. The government response to the clean up has somewhat predictably created a lot of political turmoil in Japan. We expect this turmoil to continue and the long-term effects on the political process in Japan will be dramatic, but we believe positive for investors.

Corporate Japan responded very well to the post-Tsunami challenge of re-opening factories. Immediately after the disaster, Toyota for example said that of the 500 suppliers in their logistics food chain around 485 were damaged in some way, and it could take one to one and a half years to repair the damage to their supply chain. The reality is that

Toyota’s numbers just came out doubling earnings and 85% to 90% of their supply chain was repaired within four months of the Tsunami.

That suggests that last year's estimates of the damage Japan had suffered and its long-term implications were widely exaggerated and overestimated. Having been a resident in Japan for 17 years and a lifetime student of Japan, I felt strongly at that time that the world dramatically underestimated the Japanese people’s ability to respond to the crisis they were facing. We still feel that many global investors - not Japanese investors, but many overseas investors - still underestimate exactly how well the Japanese people and corporations have responded to the situation. Therefore, they are failing to realize the investment opportunities that Japan now provides.

Ed Rogers



Takashi Imai: I agree with Ed that Japanese corporations in general have the ability to adapt to any change of circumstances, market shifts, etc. For example, over the last 30 or 40 years Japanese companies experienced a very strong Yen against the U.S. dollar. Of course, they are suffering from it, also now, but are alive and generally in a good shape.

Twenty years ago people thought that if the Yen hits 80, then we would be diminished from the world market. However, we are still here, so I believe we can survive economical challenges further on. However as Ed pointed out, on the government level we have a burden of the fiscal debt. Another problem is the declining population. These types of macro or political issues should be discussed seriously and I believe they are the keys and we have to do something in the near future.

Takashi Imai



David Baran: Hang on Takashi-san. We do not need to do something in the near future. We needed to do something five years ago! The problem I fear is that now it's too late!

Japan's bottleneck is exactly this belief that tomorrow we can fix this problem. We can leave it to the BOJ or the DPJ, or the LDP and they will fix the problem. The politicians are a big part of the problem, so relying on them for the fix is like leaving the wolves to guard the sheep.

But let's not dwell on insurmountable issues here. Let's talk about how to benefit from this dysfunction. The main hurdle we see for investors is that somewhere along the line Japan has become an asset class. The decision making process is no longer focused on whether one can find well-managed profitable companies at attractive prices. Instead investors are deciding whether to invest in Japan or not. Unlike 2005, today what you hear is "let's just forget about Japan, we'll go right to China, or South Korea, or somewhere else. We always lose money in Japan."

I find that kind of thinking myopic and uninformed. Symphony knows hundreds of Japanese companies making great products profitably; they are fantastic global cash cows and generate tremendous free cash flows. Oftentimes the conundrum is that they aren't able to decide what to do with their money, so it piles up on the balance sheet.

Their margins are often better than their competitors globally. We are talking about 40+% OP and 30+% EBITDA margins. And many of these companies have net cash positions and trade at 50+% net cash to market cap. Hundreds actually trade at over 100% net cash to market – which means the market is valuing these viable businesses at zero. And most of these are good companies. Investors in the U.S. equity markets would be falling over themselves to invest in a company like these - net cash, strong business moat and growth prospects.



The problem is less at the corporate level for small and mid-caps, but with the perception of Japan as a whole being burdened by macro issues like 225% net debt to GDP, demographics, competition from China, and the Yen.

All these macro issues are troublesome and make it all the more difficult for somebody in New York or London or Geneva to say "hey, I want to make some money so I am going to put it into Japanese equities." And adding insult to injury, Japanese institutional money across the board has been moving out of Japanese equities at an accelerating pace, including for example domestic Japanese pension funds who have shown themselves woefully unskilled at generating their required returns of 3% or 4%.

David Baran

So, aside from those of us at the table who is left buying Japanese equities now?

Trond Hermansen: It is not difficult to agree on some of the big picture issues here, but I think at the end of the day, those issues are pretty well known. Also, it is important to put things into perspective, the market today being at 9,000 looks horrible compared to almost 40,000 more than 20 years ago. However, it is important to realize that the big derating versus the rest of the world happened in the 1990s between December 1989 and the bottom of the Asian crisis in 1998.

After that, Japan has been moving more like a geared play on the global economy, but the fact is that it looks so hopelessly low because it was such a bubble 20 years ago. Having said that, our firm is not so focused on the big picture regarding Japan, because we are very bottom-up oriented and what we like about Japan is the fact that this market is very neglected due to the bad perception of things happening here. This means that the market is under-researched and most stocks are very cheap. It is a very good opportunity for generating alpha through a long/short vehicle.

We launched our fund in April 2006 when the market was almost double where it is at the moment, but even during that difficult time we have managed a net of fees compound annual return of more than 9%.

Over 3,800 companies are listed in this market, and more than 2,600 have no analyst coverage. Although some of them are tiny and too small even for us, I believe that this is a fantastic opportunity and you can really buy good businesses at a very, very low price. Some of these more domestic stocks - they had already started to go down massively in 2006 and 2007 even before the financial crisis. Then the financial crisis in 2008 took them even lower.

So, we are not talking about the Sonys and the Sharps, because nobody knows what will happen to them eventually. They have poor balance sheets and they might look cheap, but they are not true value stocks in our opinion. However, you can find good niche companies with very solid balance sheets and good cash flow, and so on, and it really makes sense for us to buy those.

Trond Hermansen



Shiro Hayashi

I believe what we are seeing is a growing divergence between winners and losers, and between the country and companies. We do see a lot of opportunities in Japan.

Increasing pressure of global competition drives CEOs to take “jump-off cliff” action, where more and more CEOs are giving up on the vertical integration model, giving up on lifetime employment, and even giving up on Japan.

Outsourcing is one of our favorite themes as the growth of the sector is structural, like other themes – for example aging or Asian consumption. And actually almost everything is very cheap. Many sectors are in fact still very undeveloped. The outsourcing market of HR/Accounting field here is just 5% compared to the U.S. We own names of this theme in logistics, marketing, and back office services, and all of them performed very well so far.

Shiro Hayashi



Because our primary goal is protect our clients' capital against any possible risk scenario, betting on business cycles, politic action or market sentiments are not our business. Instead, we focus on structural growth of the economy in a value universe.

Ed Rogers: Japan is easy to hate and it is well hated amongst the investor community and there is a lot of Japan bashing in the financial media in particular.

If I got a dollar every time somebody in the financial media compared the present Nikkei index versus where it topped at around 40,000 I would be retired by now. But the reality is that this attitude makes it easier for us to make money in this market. We have the largest and most diversified opportunity set with the least amount of coverage in the world.

As Trond mentioned, the coverage of Japanese companies by the Japanese themselves is probably 30-40% below what it was at peak coverage. That is great, because Japan is actually a market with relatively sound financial reporting. The data companies are publishing is for the most part accurate and meaningful. Almost no one believes what they read in an annual report coming out of China. I do not mean to bash China in particular, but in contrast to other Asian nations Japan is a developed country in a legal and a political sense. From an investor's point of view that makes it a much safer place when it comes to how far you can trust the information you are getting from companies upon which you make your investment decisions.

If you look at the top quartile of returns of Japanese hedge fund managers over the last four or five years, they have dramatically outperformed the indices not only in Japan, but also global indices. 2008 is the poster child for Japanese hedge fund outperformance. Our Japan-only fund of hedge funds was up almost 6% in 2008. That number represents the return streams of about 14 different hedge funds, none of which had an allocation greater than 15%. In 2008, the average investor globally was down 35-45%, so in that one year alone the Japanese hedge fund industry proved its value to investors around the world - if they would only pay attention to the numbers.

I agree with David's comments that people think about Japan as an asset class. It is a Japan-on, Japan-off trade, but in the end this is an investor education issue, as you can't really think of a \$6 trillion economy as a single asset class. Rather, it's a highly diversified economy with all sectors represented: pharmaceuticals, autos, small companies, and large companies like Toyota, which have 25% of their manufacturing, based in Japan. Toyota is a global company just like Coca-Cola or any of the other 500 largest companies in the world.

As an investor, you can buy a levered global export-driven return stream here. For example, you can find Japanese companies that are direct plays on the China growth story. You can feel far more comfortable going long or even short those companies if your goal is to get long or short China.

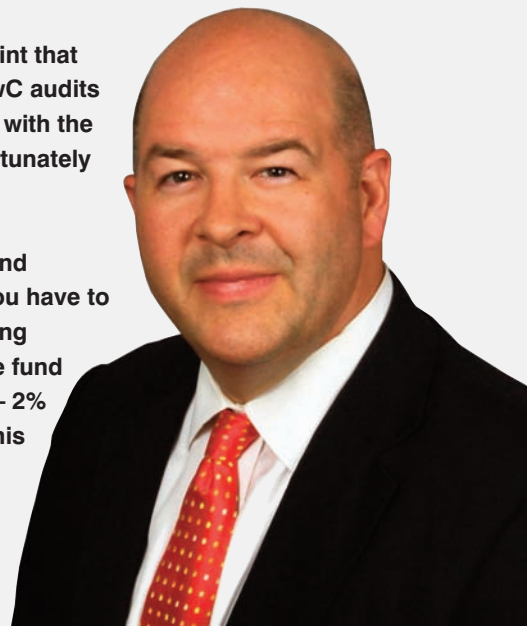
Our flagship fund of funds returned close to 10% over the last five-and-a-half years, and this includes a very challenging 2011, where we lost almost 9%. We have beaten TOPIX by over 60% over that period with less than one-quarter of the volatility of the index. Japan is a hedge fund investor's paradise if you are seeking lowered correlations and therefore lower portfolio volatility.

If you are looking for alpha and if you believe in the efficient frontier and diversification of your portfolio, our Japan-focused fund of hedge funds would seem to offer an immediate and obvious opportunity, but as it's Japan it is sometimes hard to convey this to investors even when you put a five- or six- year track record in front of them. Somewhat confusingly they will say, "the returns are great, but it's Japan and nobody can make money there."

Our response to that is, "our numbers are positive so we just proved the point that some people do actually make money here, and that's a good diversifier. PwC audits our funds, so what's the problem then?" Without any doubt, we are dealing with the largest investor perception - or distortion - problem in the world here. Unfortunately this problem sometimes includes the Japanese themselves.

However, we do see some signs of change here with regard to the hedge fund community. The issue around "nobody can make money in Japan" is that you have to do more than just long-only investing. Long-only investors in Japan, including domestic pension funds, are withdrawing from the markets, while the hedge fund space continues to make money. The institutions' return targets are so low - 2% to 4% - that you can easily create a portfolio of hedge funds that achieves this return target number quite with a volatility of less than say 5% or 6%.

Ed Rogers



Right now we are getting asked to build portfolios with these profiles. We have our flagship Japan-only product, but we are asked to do research and help build portfolios that are volatility as well as return targeted, and that seems to be a significant trend over the last year amongst the Japanese pension fund community.

Ed Rogers: We see a move from the current 0-3% weighting in alternatives amongst Japanese pension funds to a 5-7% allocation. Keep in mind that we are talking about a \$3.5 trillion industry, so that will be a huge move in assets. A lot of money is coming into the alternatives space from Japan, and some of that money will be domestically placed. In fact, it could be a significant portion as investors move from long-only Japan exposure into a hedged Japan product. Japan-focused managers will benefit from this shift.



We don't expect that the incredible amount of alpha that is available here together with positive return streams will go away anytime soon because we do not see investors' attitude changing in general. We have a good track record and a 93% client retention rate over the last five-and-a-half years. If you think about it, that is pretty amazing because this includes 2008 and 2011, and despite the talk of Japan collapsing and falling off the face of the planet, our investors are still allocating their money to Japan.

I wish I had the answer to how we deal negative investor perceptions about Japan. If you could remove the word Japan from marketing materials, and just show the performance numbers, many Japanese hedge funds would have over \$1 billion in assets.

Ed Rogers

David Baran: Recently I explained to someone how it's possible for Symphony to consistently make money investing in Japanese equities. It's pretty straightforward; we don't worry about the big macro issues facing Japan, many equities are so cheap that we can invest in profitable companies at negative enterprise value. Basically the business is being sold for less than the cash on the balance sheet. But this is not a new phenomenon and we are not the typical value investors. We don't sit around waiting for the market to re-price the company, nor are we activists pounding the table demanding management to do something to raise the share price. We genuinely want to see the companies do well, and we want to see the share prices do well, so we help management achieve those goals any way we can. It's hard work but in the long run it is highly profitable.

It's important to remember though that buying cheaply is only half the trade. We make money by causing the share price to go up 1X, 2X, 3X our cost.

So, yes, there are lots of things to buy here in Japan if you have found and defined your method, but if you tell others you are investing in Japan, they think you have got horns coming out of your head and ask, "why would I want to buy something in Japan?" But if instead you said you invest in Poland, Brazil or Vietnam, they get very excited.

Over the years I have come to the conclusion that most investors, even hedge fund investors, are biased towards thinking in terms of GDP growth. They look to invest where GDP growth is strongly positive. They are asking which BRIC, Southeast Asian or Latin American country they can get involved with in order to get the tailwind from the economic growth? As we all know chasing GDP growth has been not a very good trade and not statistically correlated to relative stock market outperformance performance either. A decade ago you would have gone into China instead of Brazil and you would probably be up 10% in China over the past decade compared to 50% or 60% in Brazil.

We already discussed that this is where investors need more study and also that Japan is a country not an asset class. You can buy Japanese real estate; credit; sovereign debt; even agricultural land - any sector and categorization of assets you would buy in the United States or Europe, you can participate in here. So saying "I will not invest in Japan" is unjustifiably limiting your investment opportunities.



David Baran

David Baran: As Ed mentioned, just looking at how big investors like Paulson got burned in Sino-Forestry and other scams, the one thing that people do not put enough emphasis on is the rule of law. Japan has a great rule of law. If you have an issue with a company or counterparty, you can sue them. Symphony has done it; we fought back the first poison pill in this country. We took our case to the local court, the secondary court, and then the Supreme Court, and won all 3 times. There is a rule of law and it worked in our and our investors' favor. The court and the TSE said this poison pill does not make sense, we will throw it out. Now, you would just not have that process to fall back on in a Chinese investment.

Ed Rogers

Neither in Indonesia nor in Vietnam nor many other frontier Asian markets...

David Baran: Exactly. The true risk adjusted returns you can pick up by judiciously investing in the unloved, under-covered companies cannot be replicated elsewhere in the world. We would never invest the way we invest in Japan in places like Indonesia or Vietnam, forget about China.

The unloved, under-covered nature of the Japanese market creates opportunities that ordinary fund managers are not capable of pursuing because it's too hard to extract the value. Symphony has been running SFP Value Realization Master Fund successfully since 2003 and the reason it works for us is that we have the capabilities – the team, the tools and the tenacity – required to extract value from these companies.

When we started the strategy we originally looked at acquiring Japanese companies in a private equity structure. We thought, “gosh these companies are cheap, let us go and buy them, private equity in Japan is excellent.” We quickly realized that control of good companies was not for sale at any price in a private equity type transaction. But we also realized that competing in an auction to buy a mediocre private company, we can buy significant stakes in listed companies at valuations much lower than the private market and then convince management that they need to do a control transaction at a significant market premium, and that is how we would get paid. That's how it all started.



This is real alpha creation. The numbers speak for themselves. We started the SPF Value Realization Master Fund in September 2003, Nikkei was about 9,500, and now we are at just 9,000. So, Nikkei is down about 5.0%, but our SFP Value Realization Fund is at 56% after fees.

David Baran

I hope I didn't oversimplify because our process is a bit more complicated than just looking to buy something cheap.

At the moment we are very happy. Investors are walking away from a \$10 bill that is lying on the floor that costs you \$3 to pick up. This is okay because the less investor focus on what can be done here, the more opportunity there is for us.

Takashi Imai

As fund of hedge funds manager, we feel that investing in the hedge funds that are generating returns only from alpha, not from beta is more attractive considering current market condition.

We have invested in various trading oriented hedge funds from the U.S., Europe and Japan and we found that the Japanese managers performed amongst the best for the last couple of years. One reason could be that many U.S. or European managers are not used to adapting to declining or flat markets. We found that Japanese manager often do have the better skills to navigate and produce returns in such markets. Therefore, if the world economy stays put in the current low growth stage, then people like you tend to outperform the rest of the world. That means Japanese or Japan-focused managers should enjoy good opportunities and a positive outlook going forward.

Takashi Imai



David Baran: We run two funds, Sinfonietta our Asia Macro fund and our the SFP Value Realization Fund, our Japan Fund, which is basically long-only but was up 8% or 9% versus the market itself which was down 17%. People then are astonished and ask, “how did you accomplish that?” which puzzles me because creating alpha is our job. I do not care what the market did, I do not even want to look at it, my job is to worry about my companies and how to see their share price goes from x to 2x, and to do everything we can to get there.

We then started our second hedge fund - Sinfonietta, the Asia macro fund – on the back of all our experience of investing in Japan. When I look at my peers in the Asia-focused fund space, my view is that most of them are more like 130/30 funds. They are typically long, or even longer than that, if I analyze their return streams. We have been living the Japan experience for two decades now. We were very worried about the markets, however we did not assume the markets would implode, even though there is a possibility of that happening. And once that happens, as we all know, it is usually too late to trade.

In any case, Sinfonietta was up 28% in 2011 and while it wasn't necessarily the easiest year of trading that fund, it was its least stressful year, because we were prepared for certain events as we did not really expect that everything was going to be perfect.

I think Takashi is right on the money saying that a lot of managers do not know how to adapt, particularly smaller managers. I mean Ray Dalio is in a league by himself, but a lot of smaller managers, guys that are open for investments, struggle.

David Baran



Ed Rogers Also some large managers, look at John Paulson.

David Baran That is right, don't even get me started on Paulson...

Back to Japan, I believe the managers here have had the single best experience over the past five to ten years to cope with the markets going forward, because they had to deal with markets that are irrational from the bottom-up and over reactive from the top-down, which is exactly the battle that is going on right now.

For example, I could look at the lot of names within U.S. equities and I think they are quite attractive, but I am not sure I want to buy them because possibly the world is about to implode. There is this battle if the S&P will go up or down being fought by both top-down and bottom-up guys, but I don't think they are really prepared for what this environment with all the different pulls and pushes means for them. We will see what everybody's returns will be this year, but also if I look back to 2011, hedge funds should not have lost money there, because there were plenty of opportunity to trade, and that is your job.

David Baran



Ed Rogers: For the last six years since we have been running this business, we have been comparing Japanese hedge funds with Asian hedge funds. We are averaging about 300 manager due diligence visits a year in the Asian space, both Japan and Asia ex-Japan hedge fund managers.

There is absolutely no doubt in my mind that it has been harder in Japan than anywhere else in the world to make

money and survive as a hedge fund. I also found the same in my previous role when I was working with Deutsche Bank and was dealing with the global hedge fund space.

It has been a struggle to survive in Japan and therefore Japanese managers have been tested, and quite a few have been weeded out. For non-Japanese managers this weeding out process may only be starting now. Hedge funds managing money in Japan have been very well tested, in my opinion, on their alpha producing capabilities.

When I was interviewing hedge fund managers in Hong Kong, Singapore, or Australia say in 2006 to 2008, these people woke up everyday thinking they would finish each year with double-digit returns because of the strong beta tailwind in their markets. You can't even call a lot of them hedge fund managers, as they did not really care about being truly hedged. Now, these managers are falling apart as they don't know how to survive in this challenging market.

In fact, some of the larger American hedge fund managers tell us "hey, this is a lot harder than I thought it was! I have had my glory years and made a lot of money, maybe it's time now to retire in the Hamptons and watch the surf roll in."

Making money in a hedge fund is very tough. Every day you have to be on your toes and need to examine your trade assumptions. In my view, not all hedge funds are prepared for the next five years, given the gloomy outlook on the world economy.

Ed Rogers



Matthias Knab

Can you give us more background in the recent developments in the Japanese hedge fund community?

Ed Rogers: Let me start out by saying that in a year like 2008, one of our best managers was up over 27% and as mentioned our fund of funds was up approximately 6%. We have U.S. pension fund money and family office money, we know we helped our investors survive one of the worst years for investing in the last hundred years. 2008 has permanently changed people's lives, because millions of them have less money in their individual accounts and in their corporate pension fund accounts.

Many Asian and Japanese hedge funds provide monthly liquidity for competitive reasons. Even when they got up to \$1 billion, they did not do what the typical, large U.S. hedge fund would do next, which is tell their investors that the next \$100 million they take in would be subject to a two- or three- year lock-up, and by the way the management fee will be locked in as well. Asian managers maintained monthly liquidity and one third of the managers we are invested with have no gating provision at all.

In my view, these managers run their business for the investors and just not their own sake, and despite delivering very positive returns and certainly delivering significant alpha, it was heartbreaking to see them suffer significant redemptions in 2008 and 2009. We saw managers with excellent performance go from over a billion dollars to less than \$200 million under management, because the end investors were so impacted or so terrified that they all wanted their cash back.

Ed Rogers



We saw 15-20% attrition rates and a lot of good, smart managers decide to close down because it is very hard to stay in business with less than \$100 million. That is just a financial reality; that is the math.

There is another dramatic change in the Japanese hedge fund space compared to ten years ago. Back then, 95% of the people I spoke to about launching a Japanese hedge fund were foreigners. They were people who had been living in Japan, who were culturally or linguistically familiar with Japan, understood how Japan fit into the world, and saw an opportunity to run a hedge fund. Only 5% of the new launches were from Japanese managers. Today, the number is almost reversed; almost all the new managers we speak to in the Japan space are Japanese who are coming from a proprietary trading desk or from another hedge fund or asset management company.

You need to be aware that within the Japanese banking and insurance systems there are huge aggregations of wealth that have for the most part been managed entirely domestically. There are quite a few people with deep experience running billions of dollars of investments, and they are all Japanese. That is actually a nice thing for people like us who operate from here because many of them do not speak a word of English. It is getting harder and harder for overseas investors to find those managers to invest in because if you do not speak Japanese it is impossible to do the due diligence.

Ed Rogers



I had already mentioned that possibly 5% of the currently \$3.5 trillion Japanese pension money could be coming into the alternative space over the next 3-5 years and could finance a significant number of domestic Japanese hedge fund managers, which remains a great opportunity set for us.

Matthias Knab

Tell me more about the Japanese startup hedge fund managers?

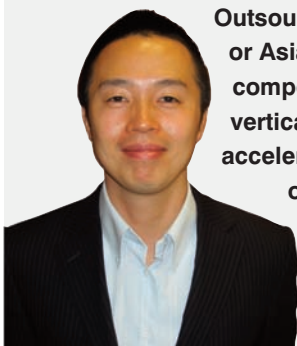
Ed Rogers

We are talking with about ten startup managers at the moment, and again, they are not necessarily easy to find if you do not speak Japanese and if you don't sit here in Tokyo. This industry is by no means dead in the same way that this country is by no means dead. Yet the external world does not see it and does not feel it, and when you tell them about it they do not believe you, because our message contradicts what the typical western media say.

People cite the demographic and other macro problems, and don't see that China has the same if not worst demographic issues, as do Italy, Spain, Germany, and so on. However, some Japanese corporations and for sure the skilled managers that operate in this market are doing quite fine. You would think that Japan would be a godsend to European pension funds, given what Europe is about to go through, as we can easily demonstrate 3-5% annualized returns on volatility of less than 6%.

Shiro Hayashi

I believe what we are seeing is a growing divergence between winners and losers, and between the country and companies. We do see a lot of opportunities in Japan.



Outsourcing is one of our favorite themes as the growth of the sector is structural as theme like aging or Asian consumption. And actually almost everything is so cheap. Increasing pressure of global competition driving CEOs to take "jump-off cliff" action. More and more CEOs are giving up on vertical integration model, giving up on lifetime employment, and even giving up on Japan. Those accelerate growth of the sector and the market in Japan is undeveloped. Just illustrate potential, outsourcing market of HR/Accounting field in Japan is just 5% of that of U.S. We own names of this theme in logistics, marketing, and back office stuff. All of them performed very well so far.

Shiro Hayashi

Because our primary goal is protect our clients' capital against any possible risk scenario, betting on business cycles, politic action or market sentiments are not our business. Instead, we focus on structural growth of the economy in value universe.

Trond Hermansen: I would like to add that in my view value as an investment style has actually been working consistently over the last four decades in Japan. It worked during the 70s and 80s and it has also worked since that time, maybe the big exception was the end of the 1990s with the TMT bubble (Technology, Media, Telecommunications). We are also value based and do our screenings based on well-established methodologies, inspired by Benjamin Graham and others.

The interesting thing is that working with this proven process has given us a very consistent tailwind and while the market has halved since we launched the fund, we have still produced a very strong absolute return. Our short positions have been a major contributor in achieving this result. We are very focused on minimizing the downturn during difficult times and have a dynamic hedging policy in place.

For the long positions, we strongly believe in value. However, as Shiro mentioned, it is important not to invest in value traps. You clearly find a lot of names on the screenings that are cheap for a reason. Having been doing this for 17 years every day, if we find the same company over and over again on the same screening, obviously, it is likely to stay there. One of the positive aspects of the diverse Japanese market is that there are new names all the time - stocks that are cheap now are not necessarily the same that were cheap after the financial crisis in 2008, for instance. Even though we have had a very strong performance, we often rotate the portfolio into cheaper names on the long side. The valuation of our portfolio has more or less stayed the same; the long book is still only at around 0.6 times book, for instance, with very strong companies in it.

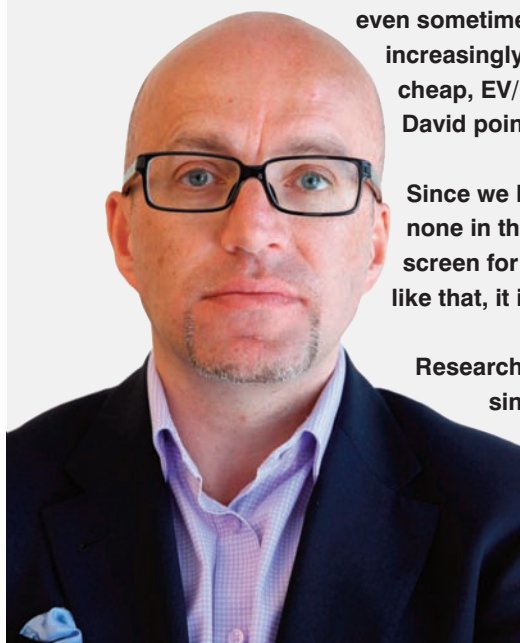
I would also like to highlight a positive change in Japan on the corporate activity front, particularly with smaller firms. In the past, often when you were a minority shareholder in a subsidiary of a larger company for instance, that used to be a big liability, because you were often literally screwed as a shareholder. Things have changed, and there are a number of logical reasons why these shareholders are better off now. After the 1980s, Japanese companies understood that the domestic economy was going ex growth, so as a response to that they diversified their businesses. They invested in new firms and also spun off firms as listed subsidiaries. That segment was a few years ago over 400 stocks - that is a pretty big universe and by itself larger than many other markets in Asia.

However, this was not always a profitable strategy and over the past years there have already been more than 100 buyouts of minority shareholders in these types of situations. In the past, these transactions may even sometimes have happened at a discount, however now takeovers are happening increasingly at a quite favorable price. Maybe due to the fact that lots of stocks are cheap, EV/EBITDA multiples are very low; maybe their EV is negative in many cases as David pointed out.

Since we launched the fund in 2006, we have had 13 takeovers in our long book and none in the short book. The average premium has been around 40%. We always screen for value in the first place, but if we can find an interesting ownership structure like that, it is an added bonus on top of the low valuation.

Research from Daiwa is backing this. They looked at all parent subsidiary takeovers since the year 2000, and the most common pattern is that they happen at a premium of between 30% and 60%, which is very nice. Also, there is a positive side effect from the demographics. A lot of companies in Japan were founded after the Second World War. Their founders are getting very old now and that opens up the possibility of ownership change.

Trond Hermansen



For example, one of our best stocks recently has been a small company where the founder passed away at an age of 92. That opened the way for a change in ownership and for new management. The stock was a deep value Ben Graham-type stock, and just with a few logical changes it went up 200%.

Ed Rogers

Let me ask you a question. You have been watching this market for decades, can you please tell us more about the profound changes that you have seen in small- and mid- cap companies? A lot of these companies are still core 40-60% family owned and run, so the family cares about the business and you would expect more rational behavior because rather than a shareholder's it is their own family's money that is going to go down the tube if they don't manage the company well. That can be very different from managing somebody else's money.

One of my suppositions is that these managers have been very pro-active, for example, in outsourcing or setting up factories outside of Japan. Maybe in 2005 it was in China, in 2015 it is probably Cambodia or Laos, because we know the cost structure in China has changed dramatically over the last ten years.

What are some of the changes you have seen from 1995 to 2005, and what do you think things look like by 2015?

David Baran

This is what we do; we are the guys that cause MBOs and other corporate actions to happen. This is how we generate alpha and make money for our LPs.

There has been a dramatic change in companies' willingness to take corporate actions in order to propel a company to the next stage. This willingness generally did not exist in the mid-90s. To give you an example, in 1998 we met with the president of a small listed Nissan Motors subsidiary. We explained to the management that it is inevitable that the firm will get sold off as part of Nissan's restructuring. We explained that Symphony had secured proxies on 16% of the company from other shareholders. Nissan owns 32%. We said "Let's jointly pursue an MBO, we will show you how to do it", and they literally did not know what an MBO was. They did not know what the acronym stood for.

That company was eventually bought out by a private equity fund. Our investors got a very nice return based on our efforts. But that episode shows how little knowledge company management has of the financial tools available to them, not only to protect the company from hostile takeovers etc. but also to protect the operating integrity of the business.

Most companies also need to reconsider their listing status. There are 3,800 listed companies in Japan of which 88% have a market cap less than \$1 billion. Only a very small portion of these companies raise money in the capital markets, and many of them have no debt.

Whereas some people may look at price to book, we look at EV to EBITDA, and all of our companies are significantly net cash. These companies are both profitable and have strong balance sheets, but their stock trading volume is \$10,000 a day if you are lucky, and it costs them at least \$1 million a year to stay listed between all the new regulatory requirements and running investor relations.

For many companies, the obvious thing to do is to de-list and privatize. Now interestingly, we have gotten to a point where Japanese banks and securities firms have realized this is a good way for them to make money. One example is Sanjo Machines, which makes cam rods for every Honda engine. Honda cannot make an engine without their cam rod. This company had not lost money in 40 years yet was trading at 200% net cash to market cap with zero debt. This flies in the face of logic. Why would it trade there for so long and why would anyone sell shares at that price?

David Baran



We saw an opportunity. It took some time but we bought 25% of the company. We knew everything there was to know about this company and pushed them towards a management buyout. Before long they came to us with their buyout proposal.

Some substantial price negotiations took place before settling on a 135% premium. Aside from the massive premium we generated, it's important to note that we were the ones that pushed the management towards a buy-out, and we did that because it was the action that made most economic sense. Symphony's role here was critical – despite the economics, the MBO would never have happened had Symphony not been actively pushing management toward taking this corporate action.

On the other side of the deal were other factors providing us tailwind. Sanjo's bank was more than happy to lend them money. They made a 300 basis point origination fee and lent money for the purchase of a net cash company.



One of the most significant changes over that past three or four years is that corporate Japan is now being led to the “buyout trough” by their banks. But don't let the term MBO mislead you. The prime motivation is not management caring about their own well-being. We see hundreds of companies and management teams, and in very private financial discussions I can tell you that they rarely pursue a course of action that is the most advantageous for themselves or their families. I have seen it time and time again. They will do what is advantageous to their clients, to their employees, to their suppliers, maybe their shareholders, and then themselves. They are not thinking “let us do an MBO because I can do it at 15% premium and it is worth 100% premium.” Even in the Sanjo discussions, the president did not realize how much money he was going to make through his transaction.

David Baran

There are clearly very attractive opportunities to take advantage of the gap between the value being attributed to a stock in the market, and the potential value that can be achieved through a significant corporate action like an MBO. Things are different if a larger company that is doing a roll up of a subsidiary, like Hitachi rolling up something. However, some of the numbers are still a little bit strange, not all of them are 30% or 50% premiums, although I think 60% was the average last year. Sanjo's premium was 135% and when we did the roll up of Aloka, the 120% premium gave us a great performance then in 2010. That premium was totally negotiated by us. It was not something that Hitachi Medical had planned. Of course, they had planned on paying, but Nisshinbo and ourselves negotiated the deal.

The uninformed may think that these premiums are high. My actual feeling is they are low and unless you own enough of the stock, get engaged with management you may not be paid at fair value. I would expect that over the next five years or so this trend towards fair value will continue, because investors like yourselves and others will start to demand that the right price be paid.

We cannot do all the heavy lifting, other investors need to come out and ask for transparency and fair value. I remember the worst MBO I have seen here was the drinks company Pokka that CITIC and Advantage Partners acquired. The bid price was so incredibly low but nobody counterbid. The shareholders didn't even protest. We were looking at each other saying “well somebody has got to do a hostile counterbid here, this is ridiculous.”

I am sure we are all competent analysts, but the problem is we assume a free market and that share prices will gravitate towards fair value. If there is no market for corporate control and free float is so low that you cannot buy enough of it in the market, then the market itself is dysfunctional. That is one of the reasons why Japan is cheap and at the same time a value-trap.

Slowly things have started to change. Over the past five, six years we have moved closer to market for corporate control as a result of legal and regulatory changes and the banking sector, together with a better understanding of the costs and benefits of being an unlisted vs. listed company.

This process has been less a function of irate or activist shareholders, because quite frankly when the first activists started to raise money in 2003, I can think of names like Murakami, Steel Partners, Symphony and a few others... I am trying to think of who else was around that is no longer around, because that model did not exist or work yet, it simply was too early. Graham-Dodd and typical value investing may be fine in 2020 when you get a real market for corporate control, when for example a firm like Glaxo could be going after somebody with a real hostile bid. If you could do that in Japan, the Nikkei would be at 20,000.

David Baran



Trond Hermansen: Hitachi is a prime example of this parent-subsidary situation. I believe Hitachi has over 900 subsidiaries in total, and 17 of them were listed at one time. Without having the strongest balance sheet in the first place, Hitachi has bought back almost half of their listed subsidiaries at very nice premiums.



Hitachi is a typical Japanese conglomerate and a great example, as it demonstrates what is important here. The parent is making losses almost every year, but most of the subsidiaries are quite profitable. So, from a tax perspective it makes sense to bring it into one company, as their efficient tax rates have been far too high. These types of transactions allow them to tremendously optimize the tax situation. In addition, as David was saying, the banks have the money to finance these deals, so even Hitachi with their not too strong balance sheet can do them. The banks are dying for projects like this, because a lot of these targets are quite cheap and trade at low EV/EBITDA or other multiples. This type of financing therefore offers a good risk-return proposition for the banks.

Trond Hermansen

Many of the smaller companies may recognize the need to de-list because of the costs, and although I agree with David that the premiums have been too low, they have been good enough to be a good alpha generator for us over the last few years, and I concur that going forward the situation will only be getting even better. Still, you have to be picky and look for the right situations because clearly there are companies out there where either the parent company or the management do not really care about this situation and might not pay you a high premium.

Again, I believe in value investing where through a diversified portfolio you stack the odds in your favor. Take the example from this January where Fuji Media, one of the largest media groups here in Japan, bought Sankei Building, one of their listed subsidiaries at 150% premium. That clearly also improves sentiment for other similar real estate companies and demonstrates that there is this huge unrealized value in this market.

You need to be a Japan specialist to access these opportunities, which we believe are actually a pretty unique theme in the global context. As you are aware, corporate activity in Europe is not fantastic. There you are dealing with a balance sheet recession where banks are shrinking their balance sheets. Here, in Japan, we have a different situation.

Matthias Knab

Are you on your own when you are doing these types of transactions or are there any international investors on your side having the same goals and strategies?

Trond Hermansen

I believe several people have the same strategy. David and Symphony have been involved as a major investor in these kinds of deals. At the moment, we are not large enough to do that. When I was managing money on behalf of a large Norwegian pension fund, we were a couple of times the largest foreign investor in companies being taken over.

For instance, at the time Origin Toshu was being taken over by Aeon, Aeon came in as a white knight paying more than 45% premium compared to the stock's last 3 months average. This was fantastic, as the stock had already turned quite expensive before that. At the moment the challenge is to communicate our strong performance and all these opportunities to potential investors.

Matthias Knab

Tell us more about the demand from Japanese institutions for alternative investments?

Takashi Imai: We find that our clients are more interested in the alternative space than before. They are not differentiating between offshore or domestic hedge funds and categorize all of them as alternative investments. Hedge funds are popular among all of alternative strategies. Maybe last year the preference has been for the larger hedge funds and also for the larger CTAs. Some of the Japanese institutions were starting to selectively invest into single strategy hedge funds parallel to their core investment in fund of hedge funds.

This expansion should have been continued, however the recent AIJ fraud negatively impacted the industry here. Some pensions have become reluctant to invest into any alternative strategy, while others may have more diversified their portfolio. For example, one pension fund had over 20% of their assets invested with one asset manager, they redeemed maybe 15% from that manager and invested 5% each into new funds. This is one reaction to the AIJ fraud.

Takashi Imai



Matthias Knab

Can someone maybe summarize and give us more background about this recent scandal with AIJ?

Ed Rogers

AIJ is a Japanese DIM-licensed asset management company accused of having possibly defrauded small- and mid- sized Japanese pension funds – close to \$2 billion – in a Ponzi scheme structure that indirectly affected 880,000 employees depending upon those pensions.

This is obviously much smaller than the Bernie Madoff fraud, but the fallout is a very serious matter in Japan. The Japanese regulatory authorities are intensely interested in this and still have to respond. They have or are in the process of inspecting all 300 or so DIM licensed entities in Japan. The DIM license is very important because it allows you to directly approach Japanese pension funds or institutional investors and sell directly to them.

We are now in May of 2012 and it might be another three to six months before we really know the results of the government investigations. How the Japanese authorities will respond will be of enormous importance to the market regarding the regulations and policies they will put into place to govern pension fund investing. Given Akihito Miyake's experience as a regulator, would you share with us your views?



OPALESQUE'S GOT

TALENT

Find countless new ideas, opportunities and investment talent in the new:

Emerging Manager
Fund Database

A SQUARE (Alternative Alternatives)
Fund Database

- ✓ Performance
- ✓ Diversification
- ✓ Uncorrelated
- ✓ Alternative
- ✓ Alpha

Logon now at www.opalesquesolutions.com

Opalesque subscribers get free access!

Akihito Miyake: In my personal opinion, I regard the AIJ scandal just as a fraud to the mid- to small-sized pension funds, which did not have deep experience, particularly in alternative investments. The issue here is that it was just a fraud that happened by accident, it wasn't due to a lack of regulation or supervision by the government authorities.



Such a mid- to small -sized pension fund does not have sufficient human resources that can undertake adequate due diligence activities. So, I do not believe the AIJ case can be a good reason or justification to impose much heavier regulations on the alternative investment managers or the industry as a whole. Instead, we should think about requiring pension funds to appoint any person who can undertake due diligence on the fund managers in which the pension fund would be investing. In that context, I think it is important to educate the pension fund managers as well.

Akihito Miyake

David Baran We talk with a lot of pension funds and many were as surprised as we were about the AIJ case.

David Baran: What was most shocking with AIJ was not only the extent to which a bad fund manager fabricated returns, but also the extent to which some pension funds had invested with them. In the case of AIJ, what really upsets us is the lack of realization by the FSA and others that the people managing the pension funds are not necessarily qualified to do so.

You can tell right away when you look at the allocations of some of those pensions. I am assuming this is public information, but apparently there are a number of pension funds that had between 25% and 40% of their assets allocated to AIJ. Can you imagine a pension fund giving 40% of their assets to a managed futures fund or CTA anywhere in the world?



David Baran

Ed Rogers You are right, in most of the developed world it is a hard and fast rule that at the investment community level you cannot have more than “x%” of your assets in any one manager, and that number is a single digit number.

David Baran: The problem here goes beyond discerning if there was one bad apple in the investment management barrel. The problem extends to the education and qualifications of the pension fund managers. That seems to be sub-standard or non-existent.



What are the pension fund manager qualifications at the smaller company level? How is the position filled? Can for example the head of HR say he wants to change his daily work routine and starts running the pension fund? Running the pension fund means you are in-charge of all the money that has been collected by all the people that worked here for the past 10, 20, 30 or 40 years. It is a tremendous burden and without sufficient education and rules, more disasters like this will happen.

We have heard that a lot of the investors in AIJ were part of this defacto “kuchikomi club”, a kind of word of mouth group that started with one influential pension fund manager saying, “Oh, this is a good fund to be in.” And a dozen people would then invest in it without doing any due diligence.

Just requiring more due diligence may not be enough. We probably need to see a whole scaffolding system built around the pension fund management industry that qualifies people and fund managers and defines the rules.

One AIJ investee heard that something not right and pulled their money out. Six months later the AIJ President and the sales team visited to reassure them that they passed the FSA investigation without incident. Remarkably the investee agreed to reinvest. They never bothered to check AIJ's claims. The truth was that there had never been an investigation! Well, that was easy to find out, you do not even need a due diligence person to do that. Just common sense.

David Baran



Ed Rogers: I believe the answer to the AIJ scandal has to be the implementation of a gatekeeper solution with a regulatory structure around it. There are going to be some real rules around how pensions can invest. This is the only solution in my view.

We have seen the same in the United States, where for example a pension committee can be made up of non-investment professionals. They are not investment professionals and it is impossible to think that all of a sudden we are going to educate 2,000 pensions in Japan on how to conduct hedge fund due diligence. We need to create a framework structure, clear rules, and a reasonable gatekeeper process. The FSA can vet the 20, 30, 50, or 100 gatekeepers far easier than 2,000 Investment Committees each of which has 5-12 people.

Ed Rogers



As anywhere else, Japanese pension funds have to make money. The math is inescapable; they need at least 2-4% annualized returns. AIJ was just a testimony to how little due diligence experience there is out there in the investment world. As David said, this was based on word of mouth like "I know a guy who set up this fund, it is run by an ex-Nomura guy", etc. - if you are not an investment professional, do you think you have checked all the boxes in the right way? Do you have boxes or a process at all? As an investment professional when you go into such a shop you should see a number of red and yellow flags. However, the average person does not have the experience to do that, and it is impossible to think that in a six-month or even a six-year period they would gather all the required experience.

Akihito Miyake

I would like to add two points. One is, for mid- to small-sized pensions, it would be very difficult to use gatekeepers, because their fees tend to be too expensive compared with the size of their pension funds.

Ed Rogers

What is more expensive? Paying a gatekeeper 1% or losing 100% of your investment?

Akihito Miyake

I would pay 1%, but I still think this is a very difficult decision for many smaller pension fund managers.

The second issue is the expected rate of return is too high compared with the current stock market and interest rate environment. I understand the current expected return is set around 4.0-5.5% which could have been achieved very easily two or three decades ago when the interest rate was relatively high, but not now with the weak stock market situation and almost zero interest rate world we are in.

David Baran: You hit the nail on the head here. The truth is that domestic institutions like pension funds do not care or choose not to do anything about the weak stock market. However, the weak stock market is not some unexplainable mystery. ROEs are low because companies are hanging on to profits and building up cash on their balance sheet over and above what they could possibly justify. Why wouldn't they? Shareholders don't kick up a fuss about ROE as long as they are getting a consistent 1-2% dividend yield. However, they are neglecting the fact that share prices should be and could be 50%, 60%, 70% higher if management exhibited better, or should I say more proactive financial management.

Remarkably Japanese pension funds are actually reducing their Japanese equity exposure instead of increasing it and taking a stand, which is what is going on in the United States and Europe. If you look at some of the recent discussions within the corporations there, for example say on pay, investors tell management that "you should take a lower salary because share prices have not performed and it is our right to have a say in how to run the company."

Aside from the dwindling crowd of foreigners, Japanese equities are pretty much owned by the Japanese. The Japanese stock market is a domestic problem that can be solved domestically. So far they choose not to. But if and when they choose to do something, things will surely change.

One key issue with the stock market currently is that it fails at generating levels of return consistent with the financial performance of the underlying companies. Corporate performance is generally fine. But the share price performance of the corporations is not fine, and hence you have all the optionality in buying these dirt-cheap names.

The question remains: Who is going to move first to reform the equity market? Certainly the pension funds are going to lose out, because they are set on reducing their Japanese equity exposure how many times have we seen this? They are going to get out of the asset class that is the cheapest and when it starts to move they will all be trying to get in again. This is good for our fund, but it's the wrong trade for them.

David Baran



Shiro Hayashi

I think everybody in this room is a beneficiary of AIJ case. This is not a problem of educational level, but a problem of discipline that lead to this disaster.

It's simply a matter of discipline that you shouldn't put your money on what you don't understand. Investments should not be that difficult things only MBA students can understand. I was told that I must be able to explain your thesis to my mother when I started my carrier in this industry.

We usually own 30 to 40 companies in the portfolio. We don't trade much and keep holding stocks patiently until share price reach its intrinsic value. As a result, our annual turnover is below 30%. Everyone can understand our investment and no fraud could happen here.

Matthias Knab

Do you have more comments about the Japanese financial regulations?

Akihito Miyake

I would like to introduce some updates about the Japanese financial regulations. There are two noteworthy trends - one trend is the Japanese regulations are becoming more stringent in some aspects, and the other is they are becoming more relaxed in the other aspects.

One stringent trend is that the FSA is now requiring investment advisors to ensure adequate human resources than before. As for fund (partnership) managers and distributors who are exempt from registration requirements under the Financial Instruments and Exchange Act, the FSA is now requiring those to submit more information, especially regarding the investors. These are the aspects where the regulations are becoming more stringent.

The other trend is related to investment managers. Under the former framework, it was very difficult to be registered as an investment manager, because the registration requirements were considerably burdensome. From this April, if the investment manager's assets are contributed only by professional investors and the amount of assets under management is JPY20 billion or less, their registration requirements are relaxed to some extent. Under this new framework, it is expected that those who wish to start investment management business targeting only professional investors may start their business much more easily.

Akihito Miyake



Matthias Knab

Who are your investors, and what trends do you see within your own investor base?

Trond Hermansen

We have one core investor in Norway and several other Norwegian investors, but also European and Asian investors. They have to qualify by the so-called MiFID rules as professional investors in order to invest in our funds.

Ed Rogers

We run an advisory business where we advise offshore funds, Cayman-registered vehicles. The vast majority of our money is actually Japan-sourced money. We still see appetite on the part of Japanese investors for some form of Japanese equities exposure. We also have US pension fund and European private bank money.

The good news is that Japanese institutional investors have an ongoing appetite for long/short and alternative investing, and I believe they can be a major source of growth for our industry going forward.

In the end, the demand for the Japanese equities product will be there, it is inescapable. There is too much money here that has to be invested in the Japanese stock market for business, cultural, and other reasons.

David Baran: One last thought when it comes to international investors investing in Japan. If they come here, they tend to be in the top 15% of the listed names by market cap. These names are over-covered but there is plenty of liquidity. Regrettably that really doesn't mean much. Olympus is big and liquid, so what? Liquid, well covered, and heavily researched means absolutely nothing. Look how fast Goldman Sachs disappeared from the scene with Olympus. The day after they issued a 170-page report recommending investors to buy Olympus, the scandal became public. The next day Goldman dropped coverage.

It seems to me that investors seeking exposure to Japanese equities have thoughts in their mind like "We need large cap, listed equities with lots of liquidity and lots of analyst coverage, this should pretty much guarantee we don't generate any alpha...." Of course, I am exaggerating, but it is a good idea for people to reconsider their basic assumptions, because thinking like this leads one away from where the real opportunities lie.

David Baran



accurate

professional reporting service

No wonder that each week, Opalesque publications are **read by more than 600,000 industry professionals in over 160 countries**. Opalesque is the only daily hedge fund publisher which is actually read by the elite managers themselves



Opalesque Islamic Finance Briefing delivers a quick and complete overview on growth, opportunities, products and approaches to Islamic Finance.

Opalesque Futures Intelligence, a new bi-weekly research publication, covers the managed futures community, including commodity trading advisers, fund managers, brokerages and investors in managed futures pools, meeting needs which currently are not served by other publications.

Opalesque Islamic Finance Intelligence offers extensive research, analysis and commentary aimed at providing clarity and transparency on the various aspects of Shariah compliant investments. This new, free monthly publication offers priceless intelligence and arrives at a time when Islamic finance is facing uncharted territory.

Alternative Market Briefing is a daily newsletter on the global hedge fund industry, highly praised for its completeness and timely delivery of the most important daily news for professionals dealing with hedge funds.

A SQUARE is the first web publication, globally, that is dedicated exclusively to alternative investments with "research that reveals" approach, fast facts and investment oriented analysis.

Technical Research Briefing delivers a global perspective / overview on all major markets, including equity indices, fixed Income, currencies, and commodities.

Sovereign Wealth Funds Briefing offers a quick and complete overview on the actions and issues relating to Sovereign Wealth Funds, who rank now amongst the most important and observed participants in the international capital markets.

Commodities Briefing is a free, daily publication covering the global commodity-related news and research in 26 detailed categories.

The daily **Real Estate Briefings** offer a quick and complete oversight on real estate, important news related to that sector as well as commentaries and research in 28 detailed categories.

The **Opalesque Roundtable Series** unites some of the leading hedge fund managers and their investors from specific global hedge fund centers, sharing unique insights on the specific idiosyncrasies and developments as well as issues and advantages of their jurisdiction.

OPALESQUE

www.opalesque.com