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Opalesque Roundtable Series '17

JAPAN

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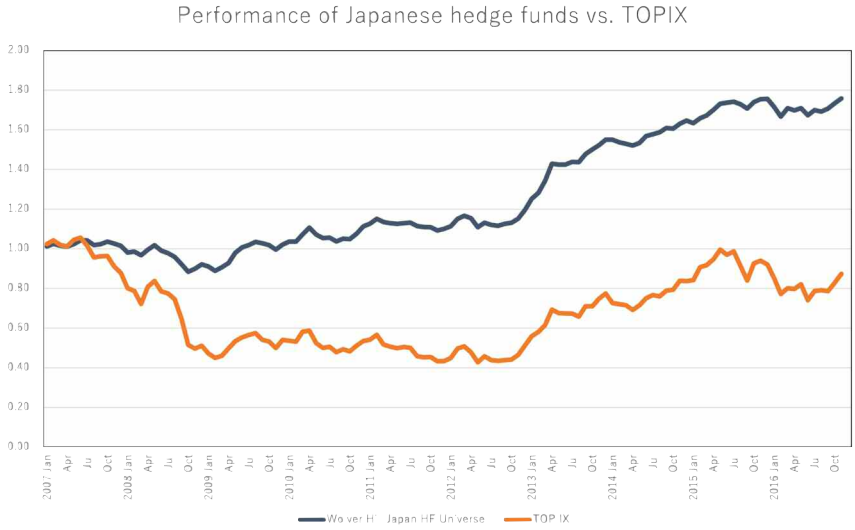
Editor's Note

Over the last five to ten years, there has been a hollowing out of the dedicated Japanese hedge fund community as many managers have moved offshore or toward a more Pan-Asian model. As a result, the market has been **supply constrained** and players on the ground in Japan say there is an **appetite for emerging managers** in spite of a difficult overall fund raising environment (page 6).

Since the financial crisis, Japan has seen its domestic hedge fund industry mature to a great degree. Around 2010/2011, the numbers of new launches outstripped the ones terminating, and right now, Japan is witnessing a proliferation and growth of **platforms** that help new managers to start up. This new generation of managers comes with **more experience** in hedge fund management and strategies, particularly shorting skills. Having managed money through different market cycles should put them in a better position to perform well over time (page 18-19).

Japan hedge funds consistently beat equity benchmarks

In fact, Japanese hedge funds are one of the few if not the only hedge fund industry which has been able to clearly outperform its main equity benchmark both in 2016 and over the longer term.



This is especially important in the light of the negative interest rate in Japan and the BOJ's comments that it would try to keep this low interest rate environment for a while. Regional banks, for example, still have 80% of their securities investments in JGBs, but the duration gets shorter, so they soon will have to invest differently and look at alternative investments as well (page 16).

However, often those investors don't have the internal skill-set, and so far Japan has not developed a large consulting or advisory industry that really understands alternatives. The result is that very sizeable amounts of assets are allocated suboptimally. CAIA, the Chartered Alternative Investment Analyst Association, has set up a chapter in Japan and strongly feels that in this environment they have a lot of value to add. The Japanese AIMA chapter was set up already in 2001 and continues to offer educational events for Japanese investors as well (page 10, 22).

Investing beyond the Narrative

When historically investors were looking at Japan, they have always tried to look at it through some narrative as in the case with the Koizumi reforms, or this time around with Abenomics. Some of the "fast money" has been going to Japan activism or governance-focused funds which have become another new narrative. Equity flows into Japan generally tend to ebb and flow based upon how foreign investors feel about a particular narrative. However, Alex Kinmont points out that *"these narratives are always wrong. They are irrelevant and wrong, but I accept that they are necessary."* (page 7-9, 13, 14)

What most investors would miss is the fact that Japan is an **extremely deep market with a lot of return dispersion,** which is ideal for an investor who can go long and short. More and more investors will see Japan not so much as a directional trade, but more as an opportunity set where they can find managers who work as stock-pickers throughout the market cycle. Another evidence of that is the range of firms like **Point72, Millennium and Viking** which all have offices in Tokyo and are running large multi-manager portfolios.The more the hedge fund market can expand, the more it will incorporate more variable bias strategies (page 7, 10).

This Opalesque Japan Roundtable took place end of 2016 in Tokyo with:

1. Shinichiro Shiraki, AIMA Japan
2. June-Yon Kim, Portfolio Manager, Azabu Value Partners
3. Peter Douglas, CAIA Japan
4. Alex Kinmont, CEO, Milestone Capital
5. Yoshiaki Iizuka, Head of Research, Rogers Investment Advisors
6. Rory Kennedy, COO, Rogers Investment Advisors

The group also discussed:

- Why is the demand for Japan hedge funds both slow and fast at the same time? (page 6)
- How long does it typically take to obtain a full discretionary investment management license or type I &II securities license in Japan? (page 18)
- Why do overseas investors often struggle when trying to identify Japanese hedge fund managers? (page 19)
- Why was Japanese hedge fund industry's "Lehman moment" actually in 2006 and not 2008? (page 8)
- What can the world learn from the last 30 years of Japan's economic history? What's the true nature and causes of deflation? (page 22-23)

Enjoy!

Matthias Knab
Knab@Opalesque.com

Participant Profiles

(LEFT TO RIGHT)

Matthias Knab, Alex Kinmont, June-Yon Kim, Yoshiaki Iizuka, Rory Kennedy, Shinichiro Shiraki, Peter Douglas

Cover photo: the lower slopes of Mount Fuji in Fujinomiya city, Shizuoka Prefecture Japan. © Hideo, under Creative Commons license

Introduction

Peter Douglas
CAIA

I represent CAIA, the Chartered Alternative Investment Analyst Association. I have spent a little over 30 years in the asset management industry of which 18 were in the alternative investment business. I ran a hedge fund research company in Singapore for 15 years, although these days, I spend much more time on physical assets. I was a director of AIMA for ten years, a director of the CAIA Association for eight years, and I currently help CAIA in North Asia, Singapore, and wherever else I can. I recently relocated back to Japan after 26 years and am thoroughly enjoying the lifestyle upgrade!

Shinichiro Shiraki
AIMA Japan

My name is Shinichiro Shiraki. I represent the AIMA Japan Chapter. I started working for a company called the Sanwa Bank in '93 where I was in charge for hedge fund and private equity investments in the 1990 as a fund of funds manager.

Then in 2004 I set up a company called Monex Alternative Investments. I sold that company to Astmax and merged it with Astmax Asset Management in 2012. The company has about $3.5 billion in assets, not only hedge funds and private equity funds, but also a mutual fund business. Then most recently, we sold one-third of our shares to Yahoo! Japan which opened the door for us to the FinTech area. So we are very excited to explore new business opportunities there.

Alex Kinmont
Milestone Asset Management

My name is Alex Kinmont. I run Milestone Asset Management which is a small firm investing in small companies. We do nothing but value, and nothing but Japan - no deviation from that.

As to my background, I was the top- down macro strategist at Morgan Stanley here for many years, and I also worked in real estate as both as analyst and later on as an investor. We have been running long-only funds since 2009 and long-short strategies since 2011.

June-Yon Kim
Azabu Value Fund

My name is June-Yon Kim. I'm a portfolio manager of the Azabu Value Fund, a recently launched a Japanese fundamental equity long-short fund. Previously, I was a portfolio manager at Fidelity Investments in Tokyo where I spent about 16 years. My mandates included Japanese alternative and long-only funds. In addition, I spent a few years outside of Fidelity as a long-short manager at a multi-strategy fund.

Yoshiaki Iizuka
Rogers Investment Advisors

My name is Yoshi Iizuka, I am head of research at Rogers Investment Advisors doing due diligence and analysis primary of Japanese hedge funds as well as Asian hedge funds.

My investment career started in the early '80s, and for 20 years I was in traditional investments, managing a Japanese public and private pension funds as well as US pension and mutual funds at Bankers Trust Company and American Express Financial Advisors. Then I moved to alternative investment. I started to manage my own Japanese equity long/short fund and was doing well in terms of managing the portfolio and fund raising until US subprime and Lehman shock happened. The performance started to deteriorate, and although it was still better than TOPIX, I failed to generate positive returns which I committed as a hedge fund manager to investors. I decided to close down the fund and return the money to the investors and joined Rogers Investments.

Rory Kennedy
Rogers Investment Advisors

My name is Rory Kennedy. I'm COO of Rogers Investment Advisors and have spent the last 10 working in the hedge fund industry both on the investor and manager side. Prior to the buy-side, I spent about 9 years on the sell-side. I am also participating today as a representative of CAIA. CAIA launched its first chapter in Japan this year and I am a founding committee member of the Japan Chapter.

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Matthias Knab We have a lot to talk about today, let's maybe start with June-Yon who has just started a fund. What is your outlook and what is the opportunity set you focus on?

June-Yon Kim: As a manager based in Japan focusing on Japanese equity long-short, I think this is a terrific place to be. Over the last five to ten years, there has been a hollowing out of the dedicated Japanese hedge fund community as many managers have moved offshore or they have moved toward a more Pan-Asian model. As a result, the market has been supply constrained so I do feel there is an appetite for emerging managers in spite of a difficult overall fund raising environment.

My partner, Oleg Zuravljov, and I primarily focus on the TOPIX 500 universe. Although many managers view the small cap universe as a more interesting opportunity set, we believe there are ample long/short opportunities in the large cap universe while taking less liquidity risk.

Rory Kennedy: I think if you go back 10 years, Japan was seen as a strategic allocation with ex-Japan Asia as a tactical allocation, because frankly the only place you could run every hedge fund strategy was in Japan at that time. Since 2006, I think the situation has reversed and Japan is now seen more as a tactical than strategic allocation. As June mentioned, many managers, even if much of their strategy is focused on Japan, they have broadened it to be considered Pan-Asian.

But **we still see significant demand for Japan-dedicated managers with good track records.** We have investors come to Asia all the time and saying, "Who are the new Japan managers?", because the pool of Japan-dedicated managers has shrunk considerably since the Lehman shock and where there used to be 20 to 30 managers solely focused on Japan in a year launching, now there are probably less than 10 launching each year. So if you can actually get launched, can articulate a good investment strategy and you can generate a reasonable track record, then clearly there's **pent-up demand** for people who want Japan in their book.

Alex Kinmont: I think we could say demand is both slow and fast at the same time. The big US endowments have, I think, scarcely moved into Japan, with the exception of allocations to activists, so that's where you have the fast and slow. **Activists** have the fast money and everybody else is scrapping over smaller and slow to move allocations.

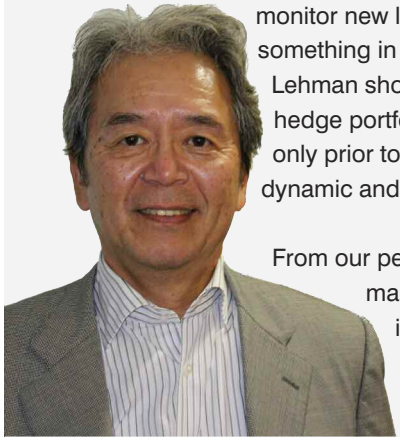
Europe and Asia have had their own issues. Asia will continue to suffer probably from a stronger dollar, and Europe really looks a mess. UCITS formats are good for long-only strategies but regulations and costs are quite unfriendly to hedge fund strategies. So I am not terribly optimistic that there will be a huge amount of demand for hedge funds from Europe; my hope is that *US allocators will diversify beyond activists.*

Yoshiaki Iizuka: ack in earlier days when I was thinking to venture a start-up hedge fund business in 2004, everybody at that time said there was a shortage of Japanese hedge funds. I was hesitating whether I should pursue the venture or not, but many of my friends in the hedge fund industry pushed my back and I decided to start-up hedge fund business and launched a Japanese equity long short fund in 2015. Up until 2006, every week there was a line of investors visiting my office from Europe, US, and Asia, but all of a sudden, as Rory mentioned, the gear shifted to Asian alternatives.

The Lehman shock caused my fund and many other Japanese hedge funds to close down, even though, as I mentioned in my introduction, my returns were still better than the TOPIX index. Consequently, the number of Japanese hedge funds have declined substantially, but around 2010/2011, the numbers of new launches outstripped the ones terminating. The **new generation of managers** started to come up with more experience in the hedge fund management.

Shorting stocks was my big challenge as I had only traditional investment experience. In a normal market environment, I was able to generate alpha from both long and short, but in when a crisis like subprime or Lehman shock hit the markets, I failed to do so. Many hedge fund managers with similar background like myself suffered.

But now, the new generation of the managers that is coming up, at least in Japan, typically have more hedge fund experience in different kind of market cycles and that should put them in a better position to perform well over time. We monitor new launches and talk to each of managers, and we find that a lot of those new managers have something in common, that is they have **hedging skills.** In a downward market, be it in things like a Lehman shock or tsunami or whatever the market collapse, those managers have their techniques to hedge portfolios and don't hesitate to apply them, whereas for managers with a traditional background only prior to hedge fund management, shorting is always a hesitation. But now, the markets are more dynamic and if one waits or hesitates, he or she can lose.

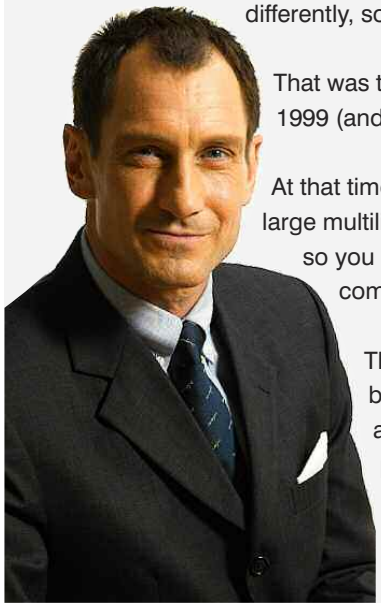


From our perspective, aside from surviving managers with long and excellent track records, hedge fund managers of this new generation will be very good prospects for the Japanese hedge fund industry.

June-Yon Kim: If you look at the Japanese hedge fund universe, it tends to be long-biased and therefore it tends to do well when we see some directionality, particularly in an up market. Also historically speaking, when people looked at Japan, they have always tried to look at it through some **narrative** as in the case with the Koizumi reforms, or this time around with Abenomics. Alex also referred to the flows where all the fast money is going to: activism or governance. This has become the new narrative.

I believe equity flows into Japan tend to ebb and flow based upon how foreign investors feel about a particular narrative. *But people miss the fact that Japan is an extremely deep market with a lot of return dispersion, which is ideal for an investor who can go long and short.* And I think the more the hedge fund market here can expand, the more it will incorporate more variable bias strategies. More and more investors will see Japan not so much as a directional trade, but more as an opportunity set where they can find managers who work as stock-pickers throughout the market cycle.

Peter Douglas: When I started to look at Asian hedge funds back in 1998, it was perfectly valid to argue then that Tokyo was going to be the center of the Asian hedge fund industry, for many of the reasons that June just explained. Japan was the biggest market in Asia, it was (and still is) a real market with functioning and trustworthy institutions, with real companies, in a diversified economy with 3,500 listed companies (almost 2,000 on the main market) and, as June said, they all behave very differently, so you can run a well diversified portfolio.



That was the reason that Goldman Sachs held the first Asian hedge fund conference ever in Tokyo in 1999 (and still hold it here even now, despite a few years' interim exile in Singapore).

At that time, the big trade for the Japanese hedge fund industry was, simply put, short the dinosaurs, the large multiline businesses that were slow to restructure – and also because you could find a stock borrow, so you can put the short on very straightforwardly – and go long the dynamic newer and smaller companies. Without exaggeration, that was the predominant trade for four or five years.

Then in 2006 we had the **Livedoor event.** For non-Japanese readers, Livedoor was an internet-based new-economy mini-conglomerate, run by a very charismatic founder, and it was the anchor of every retail investor's portfolio. The charismatic founder upset establishment, he was put behind bars and his company got delisted, and that collapsed the whole small cap bubble… and with it the Japanese hedge fund industry of the time. So I consider the Japanese hedge fund industry's "Lehman moment" to be actually 2006 and not 2008.

Alex Kinmont: I have a bit of a different view here. Certainly there was a period where there was a strong trend towards quality defined as a strong balance sheet, high margins and, broadly speaking, growth, sometimes growth at a reasonable price.

But that's totally different from the infatuation that certain investors had for go-go Internet/New Economy stocks in 2005 and January 2006. What really finished that market was not Livedoor, which is just an excuse for the many people were over-exposed on a pure momentum basis in that area. It was the draining of excess bank reserves by the Bank of Japan which began in the second week of February 2006. That tightening is what triggered the decline in the go-go sections of the market. Bank stocks went down, small cap growth went down, small cap value didn't go down. It actually had very little to with Livedoor and everything to do with tighter monetary conditions.

So when we look at 2006 and what happened in Japan at that time, I want to come back to a remark that June made about the need for a narrative. June was making that remark in the context of a narrative being required by people in order to feel comfortable allocating to Japanese funds. But *these narratives are always wrong. They are irrelevant and wrong, but I accept that they are necessary.*

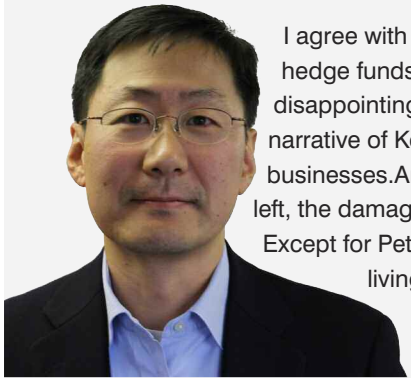
What happened in 2006 was unfortunately that a number of managers believed their marketing narrative, and that's always a disaster. But to claim that that is the same or a comparable phenomenon with Lehman strikes me as underestimating Lehman rather dramatically.

June-Yon Kim Hearing both Peter and Alex speak, I agree with both of you. Obviously Alex is a former strategist, so he is very familiar with what was going on with the overall market, and I would agree that it was a contraction of monetary conditions and then a tightening of the real estate market which really led to a decline overall. But I also believe that people associate the period with Livedoor.

Alex Kinmont This idea of an "Old Guard", or "The Establishment", which is always out to get anybody doing anything "new" and so on and is a wonky narrative and it just isn't true.

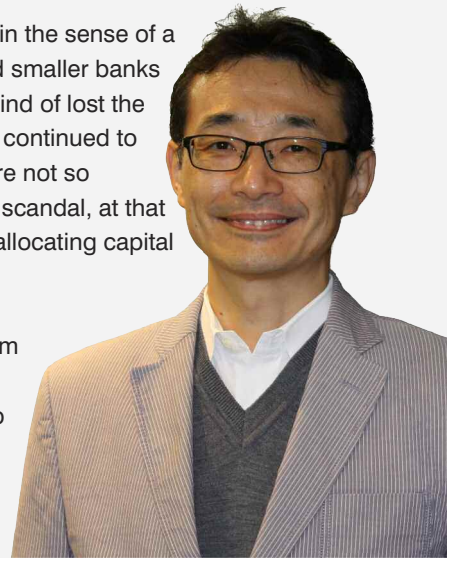
June-Yon Kim: Regardless of the narrative is the fact that from 2006 to 2008 we had a significant decline in the Japanese market particularly led by small and mid cap names where a lot of hedge funds played. As a result, you saw a significant decline in returns and you saw a lot of people who jumped into hedge funds from 2003 to 2005 probably becoming underwhelmed by their investment.

A second factor back then was that tax policy in Japan was unclear in regard to the issue of permanent establishment. A number of hedge funds where their principals were onshore felt that there was a risk that permanent establishment can be deemed for their fund and decided to move offshore, and they moved to more of a Pan-Asian model. As Japanese assets shrunk, they expanded into the growing market of Asia ex Japan.



I agree with Peter that the 2006 - 2008 period was definitely sort of the tipping point with Japanese hedge funds, but at the same time, I think in the end what really drove the industry were three years of disappointing returns given that expectations were so high going from 2003 to 2005 based on that the narrative of Koizumi reform. Assets left the market and people diversified their portfolios and their businesses.And by the time the FSA cleared the issue of permanent establishment, people had already left, the damage was done and no was coming back to Japan because of the high marginal tax rates. Except for Peter who has moved back, in general, Japanese managers who had moved there are happy living in Hong Kong and Singapore.

Shinichiro Shiraki: I would like to talk about **Japanese investors'** perspective investing in hedge funds. *Japanese institutional investors made a lot of investment in hedge funds since late '90s*, and unlike in Europe or US, for example banks and insurance companies were among the large institutional investors in Japan allocating capital to hedge funds.



There were also expectations that these investors would also allocate to local managers in the sense of a sort of home country bias. But in 2006, Basel II was installed and the Japanese large and smaller banks actually stopped or reduced their investment into all hedge funds. So unfortunately, we kind of lost the support from the banks who actually were early investors in hedge funds. Pension funds continued to allocate capital into hedge funds since 2003, but at the end of the day, some of them were not so sophisticated, which was also one of the reasons why in 2012 they were hit with another scandal, at that time the AIG scandal here in Japan. At that time, most small pension sponsors stopped allocating capital as well into the hedge funds.

So unfortunately, the local Japanese hedge fund industry has lost a lot of the support from local investors, which was there in the earlier years. So we have small group of hedge funds in Japan with over $1billion assets, and then we also have higher taxes, which also drove some of the more successful managers to places like Singapore or other sort of jurisdiction also to have a lower tax rate than Japan.

Peter Douglas: As I mentioned, CAIA, the Chartered Alternative Investment Analyst Association, has this year set up a chapter in Japan. One of the reasons for our perhaps belated focus on Japan is that we see here a *disconnect in respect of the need of Japanese asset owners to allocate intelligently into alternatives.* We see very smart people with absolutely the right intentions inside asset owning institutions, but without the toolkit to do the job.

This is partly because of organizational issues (institutions globally are always constrained by their organizational structure and cultures, so that's not a Japan-specific issue).

More specific to Japan, *we don't see an internal skill-set, and we don't see a big consulting or advisory industry* here that really understands alternatives; the result is that very sizeable amounts of assets are allocated suboptimally. Often the allocation goes to the largest "brand-name" manager, sometimes it's on the basis of consulting advice which is compensated by the manager, and very often it's without an in-depth understanding of the characteristics of the asset class or strategy.

CAIA feels strongly that in this environment we have a lot of value to add.

Shinichiro Shiraki: Well, Japan still has deep equity markets where hedge funds can manage their capital. Evidence is that firms like **Point72, Millennium and Viking** are all here and are running large multi-manager portfolios. So people set up a Japan office and allocate large amounts of capital to Japanese markets.

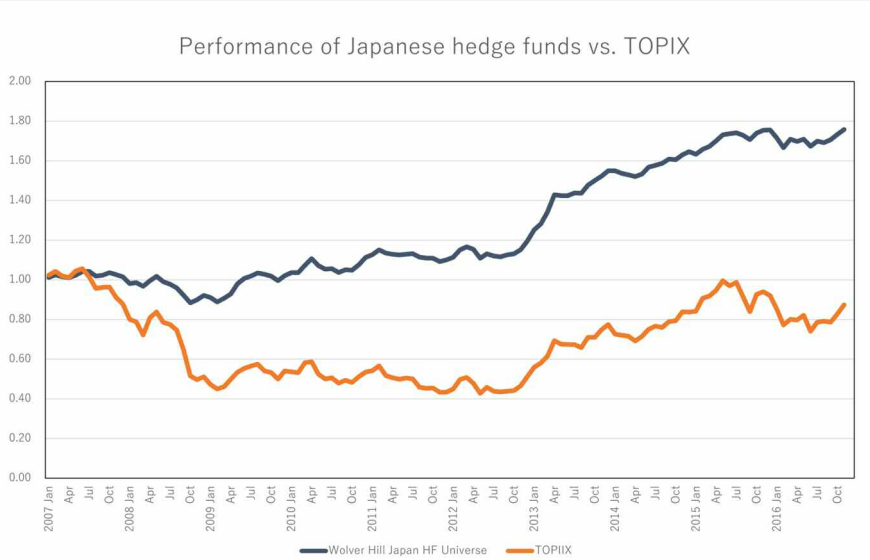
But again, those allocators are largely US-based or some from Europe, and of course also some local investors have put some capital into those macro managers. But my point here is that there seems to be room again for more home grown Japanese managers.

Matthias Knab What are the returns of Japanese managers this year? 2016 has been a challenge for many managers globally, also for the Japan based?

Yoshiaki Iizuka: During the first half of 2016, many Japan hedge funds suffered across the strategies. On average, the returns of the Wolver Hill Japan Hedge Fund Universe (WHJHFU) – these are the Japan strategy hedge funds that we monitor – were down -4.7% between January and June 2016. This is the largest drawdown as first half of year for many years. Although TOPIX was down -19.5% during the same period, it was a rather disappointing result. As we talk to managers, some of them complain markets, some of them lost confidence, some of them reduce exposures as they do not see the market direction, etc.

But there is one thing which gives us relief and confidence that is none of the managers started to changes investment styles. Back in early days, we have seen style-drift when managers not performing well. Those managers eventually left the industry. We have not seen any case of style-drift this time.

As market has become more normalized into the second half of 2016, majority of managers have recovered the performance. Average returns of WHJHFU turned positive, +0.2% year-to-date 2016 as of November 30 vs. TOPIX of -5.0%.



Rory Kennedy: **2016 performance by Japanese funds has been more or less flat in general,** and that is also an expression on what's happening globally, it's not unique to Japan. Market intervention, interference by central banks is hurting almost every strategy across the world. It's why investors globally are complaining about hedge funds not being worth the fees they pay them.

What I would say is that I don't think this current high-fee debate will affect Japanese hedge funds too much because as we said, Japanese hedge funds have already contracted so much that people who are peripheral and not really interested in Japanese hedge funds have long since left or they have quit because they didn't see Abenomics generate the easy returns that they had hoped for straight away. I think in other parts of the world you'll see a far bigger shake out of hedge funds because those managers have yet to prove their ability in very difficult circumstances whereas surviving Japanese managers have actually done that repeatedly over the last ten years.

June-Yon Kim: I was at the Goldman Hedge Fund Conference recently and Kathy Matsui, Goldman's Japan Strategist, asked the same question to a panel of speakers including myself, and my personal take is I think a lot of this comes from the fact that Japanese hedge funds, and hedge funds in general, actually tend to be long biased. I think one big problem with the industry is that hedge funds have failed to deliver lower correlation.

I really think this is an issue of beta more than alpha. Just look at some data SPIVA, an unit of S&P Dow Jones, put out. They have done studies of passive versus active managers, and actually what happens in the US is what you read about all the time. So in the US for the year ending June 2016, only 10% of active managers were able to beat their benchmark for one year, and only 5% of the managers for five years.

Interestingly, if you look at the Japanese data, and this is a pretty big sample, it's something like 470 funds, at the end of June, **72% of active managers beat their underlying index, and over five years it's 40%.** *These numbers are significantly higher than in the United States.* So again, going back to Japan as a market, it's a great market for long-short stock pickers because it there is a lot of inefficiencies and a lot of dispersion.

When a lot of institutions look at Japan, they tend to be reactive rather than proactive. Given its underperformance following the collapse of the bubble, Japan has been an easy market to ignore or be underweight. Investors tend to become interested in Japan only after it has performed well on an absolute basis. The problem is valuations levels have become much less attractive. People got excited about Japan in 2005 and they said, "Oh, Japan finally has normalized, we have a teens PE", but actually if you look on a cyclically adjusted basis, 2005 was the second highest period after 1989 in terms of valuation on CAPE basis.

I agree with Shin about funds like Point72 and Millennium, they are making significant investments here in Japan and hiring a lot of managers. Why are they doing this? Obviously, they see a lot of opportunity here in terms of stock picking where they see a lot of return dispersion, so they perceive a healthy environment to generate returns.

Peter Douglas: I've been following the alternative investment industry in Japan since 1998, and I have always seen it as the **alpha fountain of Asia**; it's a real market, it's large and it has an efficient financial infrastructure, there are plenty of smart money managers who know how to find the alpha – and surprisingly inefficient pricing that creates the opportunities. And as we were saying, there are only few large global institutions that see that.

Globally, the majority of institutions have largely stopped allocating to small managers. Today, most allocations decisions triage the management organization first, and the strategy second. This is not just a Japan story.

The overwhelming majority of capital owners want to allocate to a large fund management organization. While I see that as a dangerous distortion, the trend is unlikely to reverse soon and we have to accept it.

To Shiraki-san's point about not having many billion dollar managers in Japan, I'd comment that these days even $10 billion of AUM is considered boutique. But even if your hurdle is only $5 billion, how many indigenous $5 billion boutiques are there in Tokyo? Maybe one, maybe two? And this is still the world's second largest developed economy! The opportunity here is much bigger than the manager universe.

So I believe that the real issue is not so much whether the markets or hedge funds had a good year or not, it's more that there aren't the obvious local champions in Japan that appeal to major global allocators.

Matthias Knab Can we talk more in detail about the actual investment opportunities you has hedge fund managers see in Japan? Alex mentioned that flows would be going to Japan activist funds, what are the opportunities there?

Alex Kinmont: We don't do activism. There's obviously a great range of investors who can be labeled or who call themselves activist so generalization carries some dangers. But, at a broad brush level, we actually don't think there is any particular to Japan opportunity for activists.

Activism in its early forms rested on misapprehensions plus a prescriptive notion that corporate governorship should be the same everywhere in the world as in the United States. You can do things in America with very small percentages of the shares that you just can't do in any other serious country – that's just a feature of the American market, of a US governance regime that gives a lot of weight, a lot of influence, to potentially activist external shareholders. Nobody is saying it's good or bad; it's just the way it is.

But court decisions in Japan have tended to insist that 33.4% means 33.4% and 50.1% means 50.1%. The point about **activism in Japan is that it is a great deal more expensive than doing the same thing in America,** and that fact isn't really explained. That's the first misapprehension. The prescriptive notion that everywhere should be like America then comes into play. I think we are all grown up enough to see that that's far from unproblematic.

The reality here is that if you want to own 33.4% or 50.1% of something that's great, you can influence the company. But then the problems reveal themselves – for instance, the activist will always be a less eligible buyer than a trade buyer; of simple stuff like, should you get hold of it go and try to sell it. Again, to the extent that modern activism is based on small minority stakes, there are no real opportunities for a 10% stake and hoping it will affect the company. There are, though, a lot of inexpensive stocks where taking a small minority position irrespective of influence over management might be attractive on a pure, value basis.

The second misapprehension is that the corporate sector is somehow going out of its way to shaft the external shareholder.

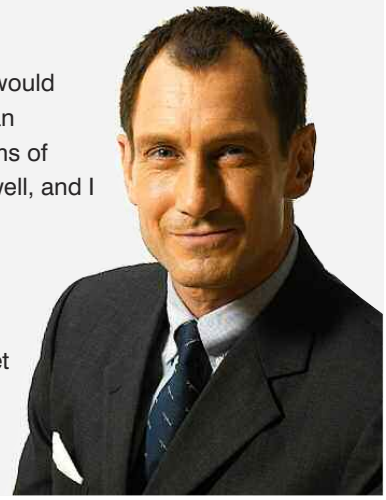
Actually, very large fractions of the corporate sector run very poor businesses, and they run those very poor businesses in a very difficult economic situation. So we should focus first of all on whether the **business returns** are there rather than trying to manipulate the balance sheet to take money

out of a company that may not generate any cash. Low returns are not caused by balance sheet structure; balance sheet structure is derived from deflation and low returns.

And then finally, there's a basic misapprehension behind all of this in regard to the **position of the Japanese banks.** The main bank of a company is usually also a shareholder of that company. So typically, the bank has the effective equivalent of a preferred equity claim on the company, constituted out of its holding of common stock combined with its loan exposure to the company. It strikes me as presumptuous in the extreme for an external investor to think that they can come in and disturb that relationship by taking money out of the company that the bank would wish to have lying behind its own credit position vis-à-vis that company.

So once more, this is a great narrative and it appeals to the prejudice that the Japanese are funny, sort of wonky people that need to be educated, missionary style, into the ways of capitalism, justice and peace, but it's largely nonsense.

Peter Douglas: Empirically, **activism has worked extremely well in Japan.** We follow several activist managers, and while each is slightly different, they annualize at 7%-8%, with a lot less volatility than a general equity fund. Maybe they're less "hedged" than most long-short funds, but they're a very sensible way to own Japanese equities. I'd characterize them generally as "value with an active catalyst".



However *we need to make a distinction between American activism and Japanese activism.* I would agree that the foreign activists that have tried to get things done in Japan have generally had an unhappy and unsuccessful experience. The Japanese activists have had a difficult 2016 in terms of performance, but if we looked at a 10-year track record most of them have done consistently well, and I believe the conditions remain in place for them to continue to do so.

I agree with Alex that the good activists aren't trying to sell a philosophy. Rather, they find companies that want to change and are looking for either external resource or capital or other outside support for what they want to do – and the investor then works with the company to get where they want to go. That has worked well, and I don't see any reason why that should not continue to work well.

June-Yon Kim Peter, I wonder how the activist funds have done relative to a benchmark? Have they actually added value above and beyond a passive investor?

Peter Douglas We seeded one back in late 2006. The Nikkei 225 index is more or less the same level as it was then. The manager's NAV is up 99%. I don't think that's an uncommon experience.

As an aside, I would add that that's another data point that argues strongly against taking an index approach to Japanese equity investing – but that's a different conversation.

Rory Kennedy I think even in 2016 a number of Japan activist funds are outperforming the market. Peter mentioned the important distinction between Japanese activism versus the Western. I should note that the activists which are indigenous to Japan don't even call themselves true activists, they call themselves **"friendly activists"** or they are using an **"engagement"** approach. Almost every Japan-focused activist manager I have spoken to will not invest in a company that is not open to working with them; which is completely different to the normal "aggressive" activism style in the West.

Matthias Knab Any other comments about the opportunity set for hedge fund managers in Japan? This morning the papers wrote that GDP growth has been positive again in the third quarter in real terms and coming up to 2.2% annualized. That was a big news on the cover page of the newspaper today.

Alex Kinmont: We go out of our way to try to ensure that GDP growth doesn't matter to our portfolio! We think that opportunities are more or less undiminished over the past few years– that is, opportunities to buy into well-managed companies at a very big discount to their intrinsic value, and to sell poorly managed companies with deteriorating businesses, which are selling at significant premiums to their intrinsic value. And *the GDP growth rate doesn't really affect that.*

We do a crude screening of the market to get rid of what we call "no hopers". It's a "negative" screening to make sure that we don't waste our time on visiting and talking to companies which are never going to make the grade in terms of our valuation and capital efficiency parameters. That leaves a group of companies that you could think about as possible investments, just as a starting point before we do any real work on the businesses.

Before Mr. Abe arrived for the second time, there were about 1,200 companies out of a sample size of 3,500 companies that were not ruled out a priori from consideration as serious investments. I am just talking about the long side here. That number went down – very quickly - to about 700 in the earliest stages of the 2012-3 recovery and then worked its way down to about 325 in the spring, early summer of last year (2015) and then came back up to 800 in the early part of this year. The pool is now about 600 businesses.

Matthias Knab What's responsible for these changes?

Alex Kinmont Mostly valuation - the share price. The rise and fall of share prices reveals or obscures value in the market. So we would say that the opportunity today, and obviously we have to be very careful about all the qualifications that you attach to this sort of statement, is still about half or a little better than half of the opportunity that was around before Mr. Abe turned up again but about the same as has been offered since mid-2013.

Rory Kennedy I think Matthias' comment about GDP also ties back to what we discussed earlier about narratives. Often foreign investors need to have some obvious catalyst to invest (long or short) in Japan. It might be Abenomics, the Fukushima earthquake or GDP growth, or even Abenomics not working. However, although managers like June and Alex have to acknowledge the narrative as it may be perceived overseas, their job is to find portfolio stocks to long and short and to generate alpha. By focusing simply on narratives, we would just appeal to that beta hunting crowd, but the hedge fund manager's job is to find alpha at the individual stock level.

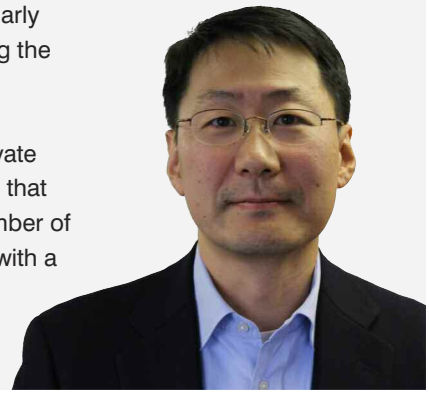
June-Yon Kim: We are fundamental bottom-up managers; however, at the same time we recognize that Japan has a few characteristics which also affect us, and one of those characteristics is **pronounced cyclicality**. A high level of manufacturing export exposure and the lack of secular growth are principal drivers of this economic cyclicality.

If you look at the economic cycle, you can broadly characterize an economy in four stages: early expansion, late expansion, early contraction, late contraction. Historically, if you looked over the last 30 years, Japan as a market has only seen absolute returns in expansion when the economy has been growing. In the other phases, performance tends to struggle.

Growing up in this type of environment, in spite of being a fundamental investor, I have become acutely aware of the need to look at and *think about the macro as well.*

Now, when I say we think about the macro, we aren't trying to forecast the economy, so we aren't macroeconomists by any means, but we just try to understand what phase we are in, and based upon that assessment, we are able to adjust our risk accordingly. But still, the basis of our investments is very much fundamental bottom-up.

When I look at the total aggregate data right now such as OECD leading indicator, GDP growth, et cetera – where we are right now with the Japanese economy would be consistent with phase 3, which is early contraction. And if you think about how the market has done year to date, it's not surprising the absolute returns have been poor year to date.



Now, the big question about this positive 2.2% GDP print is, do we see reacceleration? Private consumption was actually flat while the majority of growth was driven by net exports. From that perspective, I believe it is important to focus on the sustainability of reacceleration of a number of economic data points coming from China and reacceleration of US GDP. If this continues with a backdrop of a weaker yen, I would see an assessment of late expansion as more appropriate.

Matthias Knab We already started to talk about developments within the Japanese investor community, is there anything to add?

Rory Kennedy: Peter already mentioned a fact which is true across the world, but particularly in Japan, about investors having a bias towards larger, more established managers. The risk of that over the long term is that while they may feel they are building a diversified portfolio by investing in large US managers, of course many of those managers are in the same trades, and so they may not be getting the diversification that they believe.

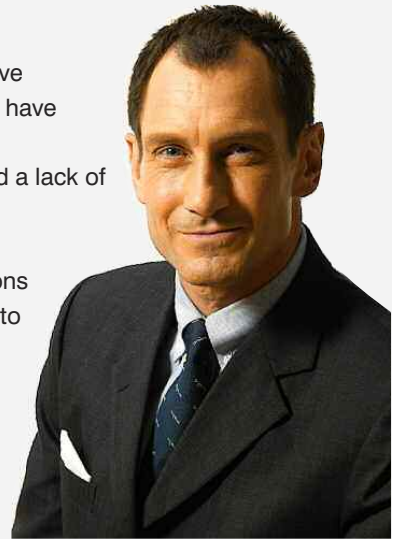
Another trend is that many of the largest hedge fund managers across the world are losing assets. But at the same time, **Japan is one of the few developed countries that is actually allocating more to hedge funds.** Whether it's GPIF, the largest pension fund in the world or Japan Post Bank, there are major potential allocators here which are looking at investing in alternatives really for the first time and the negative interest rate environment here is only making that more urgent.

So, *it's attractive again to come to Japan to raise assets.* Many larger managers who don't have an office here have started to travel to Japan in order to try and meet these larger investors as potential sources of new capital. But at the same time, Japan is not a simple "fly in, fly out" destination. You need to have a base of operations here and preferably be licensed here, or

many of the large local allocators will simply not deal with you, particularly on the pension fund side.

We have recently is to work with some of these larger international managers. Some of them have tens of billions AUM but no presence in Japan, and given the current dynamics, they don't want to take a year and spend a million dollars just setting up an office and getting the license, with no potential reward for a couple of years. Because anyone who knows anything about Japan knows that the fundraising cycle is very slow. It can take you two years to raise money from any particular client, and that usually doesn't work well for managers who are focused on what they can raise in the next quarter. So we have been working with some larger managers to try and fill that gap, if you like, because they need to have knowledgeable local representation.

Peter Douglas: We haven't talked much about culture and language, but it matters.



I mentioned already that I believe the lack of understanding by Japanese investors of alternative products is huge. GPIF and perhaps Japan Post may be the exceptions in that they appear to have been staffing themselves with experienced professionals. Knowledge is by far your best risk management tool. But apart from that, generally what I see is a gulf of non-understanding, and a lack of deep connectivity to the global financial services arena.

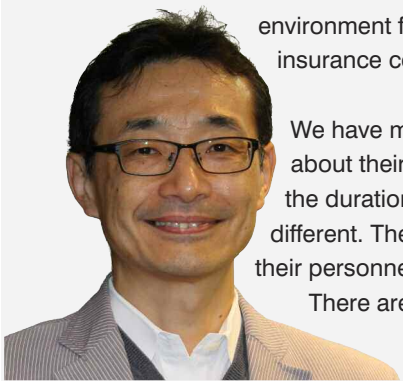
When I talk to major Japanese investors here I meet smart people, who know their organizations well, know their constraints, and have generally realistic expections. They are honestly trying to achieve the right outcomes, but very often there is not just that level of under-the-skin integration with the global financial services industry. Even when both sides are speaking English, they're not really speaking the same language. I therefore think the biggest risk, if anything, is cultural, from that perspective.

Rory Kennedy Is that getting better or worse?

Peter Douglas It's getting worse. For example, when I was at business school in the beginning of the '90s, my school had a cap of 20% of any one nationality. And back in the late '80s, early '90s, that 20% cap was invariably filled with Japanese participants. Now, that would be less than 5%.

So over the last thirty years, I'd say that in terms of the business and financial services community, Japan has become less international. Shiraki-san, please tell me I'm wrong!

Shinichiro Shiraki: I don't want to disagree with you, but I have a bit of a different angle about the Japanese investor space now. We have a negative interest rate in Japan and the BOJ said it would try to keep this low interest rate environment for a while. That is impacting the Japanese investor space of course, largely banks and insurance companies, which actually could be hedge fund investors in Japan.



We have many **regional banks** as our clients. Recently I had a discussion with that type of investors about their diversification of investments. Still 80% of their securities investment assets are JGBs, but the duration gets shorter, so they have to do something and allocate the capital into something different. They will have to look at alternative investments as well, but there is a capacity constraint in their personnel. There are not many people who know about alternative investments, even the basics. There are very few experienced risk management people in those regional banks knowing about

alternative assets. Of course mega banks are very different than those regional banks. But the capital in the end will have to go somewhere, so they started looking at hedge funds again, market neutral strategies, or CTAs, strategies that are very liquid, transparent and understandable.

But I also have to add that in most of the cases, they prefer large over transparent and liquid, so unfortunately I don't see their money coming down to the smaller local Japanese hedge funds. That is unfortunately a bit of an issue.

Peter Douglas I was talking to a Japanese university a couple of weeks ago, who are trying to develop their endowment fund. They told me that constitutionally they were not allowed to invest in anything which entailed a risk of loss of capital, and therefore negative yield JGBs is creating a very immediate problem, and hence they were looking for a way to invest in alternatives. Shiraki-san, do you see other examples of this?

Shinichiro Shiraki: The answer is that I don't know. What I can say is that banks, life insurance companies and some asset management companies have accepted the negative interest rate environment in the sense that they may allocate certain capital into some kind of negative yield products. But that negatively yielding side of the investment universe is getting larger and people are facing restrictions, and so many investors are in cash, but cash could be negative as well.

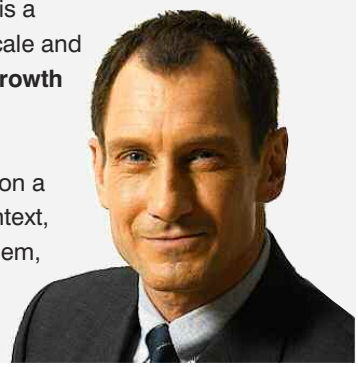
So they have a very immediate demand to allocate capital to yielding products, which could be swaps, Asian fixed income or still US Treasuries, etc. But given currency fluctuations, we are also in a very costly FX environment for hedging out currency risks, so the total net yield could be negative as well should they invest into US Treasuries and such. But it is creating a huge problem now and I expect that we will see changes anytime soon of the asset allocation of those regional backs and large institutions.

Matthias Knab What changes do you expect?

Shinichiro Shiraki: One thing I expect to happen is that these investors will **mitigate their current constraint on liquidity.** I mentioned that they have constraints around transparency, liquidity, etc., but now they have already started to allocate capital into *infrastructure, private real estate funds*, *REITs, etc.* Some of those assets don't have a mark-to-market price, so they may not even see any negative performance on it. So they will mitigate the constraint on the liquidity, but capital preservation is very relevant to them, they still want to keep those assets and not losing money.

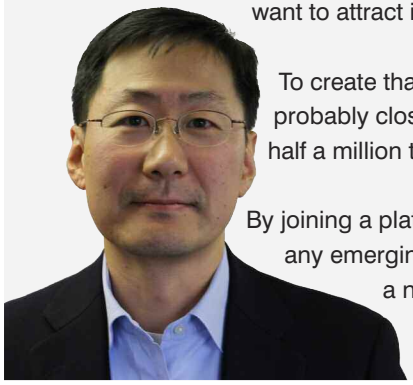
As Peter mentioned, hedge funds are difficult and perceived as difficult. They could be losing money, and investors don't really always understand if the fund created alpha or not. And given the current market environment, it is difficult or impossible to project tomorrow's net asset value. These things also make it kind of difficult for institutions to allocate capital.

Peter Douglas: I have a question for June. It strikes me that not just in Japan, but globally, there is a disconnect between skill at the level of the individual manager, versus the need of investors for scale and an organization they feel comfortable with. As a result of that we have seen a **proliferation and growth of platforms.**



June, I know you must have thought about this quite long and hard when you decided to launch on a platform rather than as a standalone manager. Could you talk us through that? In a Japanese context, are platforms attractive options, why they are attractive options, are they growing, who is using them, why they are using them?

June-Yon Kim: A platform is an obvious choice in Japan for an emerging manager, given the fact that startup costs are relatively high. The regulatory hurdle is also higher compared to, let's say, operating in the United States or Hong Kong. If you want to attract institutional capital, you have to create a robust operational infrastructure around you.



To create that infrastructure and the necessary regulatory umbrella, you are looking at a timeline probably close to a year in terms of getting regulatory approval and then you need anywhere between half a million to one million dollars in run rate cost just to support the infrastructure.

By joining a platform, your time to market is much faster and your run rate cost is much lower. So I think for any emerging manager who starts out with less than call it $200 million or so, I think a platform is really a no-brainer in terms of time to market and the ability to manage your business growth.

Rory Kennedy: This is a trend all across the world I think. For knowledgeable institutional investors to give you money, you have to have the entire infrastructure around you already built.

Japan is particularly difficult because of high regulatory capital requirements compared to Hong Kong and Singapore. In addition to the length of time it takes to get a license, it's also that of course everything has to be done through the Japanese language, which are barriers that don't really exist in Hong Kong or Singapore.

It will take you probably close to a year to get the full discretionary investment management license or type I &II securities license from scratch, so going onto a platform reduces your start-up time considerably. We have been working on a selective basis working with managers such as June, because he recognizes that when you make that decision to leave your firm and set up, you don't want to have to take a year afterwards and incur these kind of cost in an industry which ultimately is very, very difficult to succeed in.

Matthias Knab Are there more platforms like yourself?

Rory Kennedy I would say there are a few in Japan, but they don't necessarily advertise themselves as much. The trend in Japan is probably similar to what you see in other parts of Asia, which is some established managers struggling with costs and therefore they bring other managers under their license to help share those costs.

We are trying to do it in a bit more of an institutional fashion and only when we think we can add value to the manager's setup.

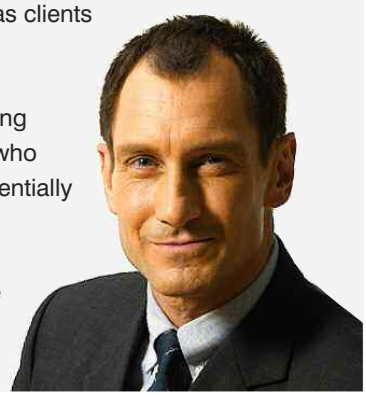
Matthias Knab You said you work on a selective basis with managers and bring them onto your platform. Can you tell us more about the nature of these managers, the numbers, the quality, what do you see?

Rory Kennedy: A characteristic of most Japanese wannabe fund managers is that because they have worked for Japanese institutional firms, they have two main drawbacks:

One, very often is that they don't speak English very well, unlike the Chinese and Korean managers; and two, they don't have as much personal money. If you have worked for a long time and are a successful fund manager at a large American institution, you are probably a multi-millionaire. That is not true in Japan: even with a strong track record, you were likely still a "salaryman".

Therefore, when Japanese managers want to set out on their own, they usually don't have enough personal capital to even hope of setting up the infrastructure that's now demanded by most professional investors. So, depending on their strategy, they have to go either to a multi-manager platform as Point72, or Millennium (if a trading-type strategy), or they trade PA, or they might come to a platform such as ours.

Peter Douglas: When my research firm found great Japanese managers that we felt our overseas clients should be interested in, we'd rarely get much traction, for the following reason: You or I see an experienced manager who knows how to manage money in difficult markets, who has got deep institutional experience, who works long hours, understands her fiduciary responsibility, and a long track record of success… but your midtown allocator sees some Asian bloke with poor English who might as well inhabit a different planet. The **cultural disconnect** is real, and prevents a lot of potentially great allocations.



Here, a good platform can help mitigate that, because at least you have somebody sitting by the side of you who knows how to play the game in New York or London.

Rory Kennedy: You are certainly right there, but we can't just blame it all on midtown US investors who don't allocate; to some extent we have to point the finger at large Japanese institutions. There's a tremendous scarcity of risk capital in Japan and it's frankly quite disgraceful. It is not uncommon for us to meet a Japanese manager who has managed billions of dollars at a local institution. They have worked for that institution for potentially decades and have made a great deal of money for that institution. However, when they go independent they are seeded with nothing or only a few million dollars

by their former employer, whereas the same equivalent in American institutions, they are often sponsored to the tune of hundreds of millions of dollars.

It's frustrating that these local institutions don't allocate in size to their own people, which they could do, because of a cultural bias against allocating outside of their own conglomerate or for fear of encouraging an exodus.

Alex Kinmont I can't get excited about the alleged impropriety of the low risk appetite exhibited by Japanese investors. The economy has been being deflated for most of the last 20 years. Bond prices are just now backing off all-time highs. What were they supposed to do? *The Japanese institutions are "overweight" the winning asset class over the last 20 years.* Who was wrong? It's not culture. It's to do with the objective facts of economic circumstances as they present themselves, to use a Marxisant turn of phrase.

Peter Douglas Do you think that that will change?

Alex Kinmont: Well, it depends entirely on the macro. There are some interesting straws in the wind, but there have been straws in the wind before and there has been no major change of direction. This is one of the reasons why we don't make bets on macro. But we can certainly say that fiscal policy looks as if it's going to be going back to neutral from tight, and such a loosening is usually associated with a better period for the economy and for the stock market.

But we can say that monetary policy is turning tighter, and that's usually associated with a poorer period for the stock market.

And we can say – with confidence – that all the rest, pseudo-macro tittle-tattle about "structural reform" et cetera, is completely irrelevant.

So I think one is left with the picture where it would be unwise to take any major bearish or bullish bets on pure macro from a Japanese perspective – an outlook that rather throws the ball back into the court of Mr. Trump.

Rory Kennedy Just to clarify, Alex, I am not talking about purely about equities or a macro view here; I am talking about that local institutions have been slow to allocate to alternatives, and particularly alternatives managed by people that they know themselves.

Alex Kinmont Yes, but June has pointed today that the returns of the Japanese hedge funds are – or have been – heavily influenced by the direction of the overall market. My question is why would Japanese investors have allocated to that asset class if they were in the deflation given that deflation is bad for equities. To me, it all makes sense.

Rory Kennedy: Again, sorry, just to emphasize, when I am talking about Japanese large institutions investing in alternatives, I am not talking about solely in Japan. They have been slow to invest in Asia. They have been slow to invest all around the world in alternatives, with the exception of the large or more sophisticated such as the insurance companies. I think it's safe to say that most Japanese institutional investors, including pension funds, have not had the returns gained from allocations to alternatives over the last 20 years that their peers in the rest of the world may have had.

It's been shown time and time again academically; by having a reasonable allocation to alternatives across the liquidity range: from CTAs at one end, all the way up to venture capital at the other end, having a solid allocation to alternatives has been beneficial to your portfolio over the last couple of decades.

And my point is that they haven't been even willing to allocate to their own people who have been allocating successfully to those strategies. So they haven't created a homegrown industry of allocators with experience.

Alex Kinmont My point is that the right asset allocation in retrospect in this situation was to hold JGBs, which is what they did.

Matthias Knab I still think this is an important discussion to have, and as Shiraki-san said, the asset allocation of Japanese investors will or has started to change because of the ever increasing universe of bonds with negative yields at some point just becomes unsustainable for the investors.

In that context, I was wondering, Shiraki-san, how is AIMA doing in Japan, how has the association been developing and what are your activities?

Shinichiro Shiraki: We launched the AIMA Japan Chapter back in 2001. We have done a lot of educational events for Japanese investors, so for institutional investors, like banks, pensions and insurance companies. We are publishing papers and offer seminars for them.

We also work closely with the other jurisdictions, especially AIMA Singapore and Hong Kong in Asia from a regulatory perspective. We also invite the regulators to talk with people from the hedge fund industry. The Japanese FSA was very eager to learn about the Japanese hedge funds and global hedge funds, especially mid-2000, so 2004-2009 and right after the Lehman crisis.

So we have good relationships with both investors and the regulators. We also tried to increase number local members here, but this is not so easy, we all need to help growing the size of the industry so that we can have new sets of local managers here.

Matthias Knab Peter, how is CAIA doing in Japan, any further updates?

Peter Douglas: CAIA has now almost 9,000 members globally. We are growing in a stable fashion and should reach 10,000 in 2017. In Japan, we still have a relatively small number of members, just over 100, but we are beginning to see a pick up. We have a really excellent local chapter committee, who are working really hard to create a great member experience here; that's really important to us.

The marketplace is also creating a tailwind for us. Asset owners, not just in Japan, are realizing that they do have to understand multi-asset investment in a way which perhaps they didn't need to, or didn't have tools to, in the past. Despite its "alternative" moniker, CAIA is really at its core a multi-asset designation for professional investors.

My challenge here is to try and identify the extent to which industry education is part of industry development. Having spent 21 years in Singapore, pretty much anything that matters happened because somebody smart in the government planned it that way, and then almost equally smart people rolled it out and executed it. We witnessed first hand that a big part of industry development in Singapore has been an explicit and controlled **policy focus on industry education,** and CAIA is fortunate to have had a seat at that table.

Our opinion is that such an approach would be very helpful for the Japanese industry too. I take Alex's point that at the end of the day money probably does trump culture, but in turn, as Peter Drucker said, culture trumps strategy. CAIA can provide a global network to local professionals and engage them in the culture of alternative investments, and in the Japan of 2016 that's a key benefit. Moreover, our mission since the beginning was to be the intersect between academic research and practitioner activities globally, and also there we hope that we can help Japanese asset owners.

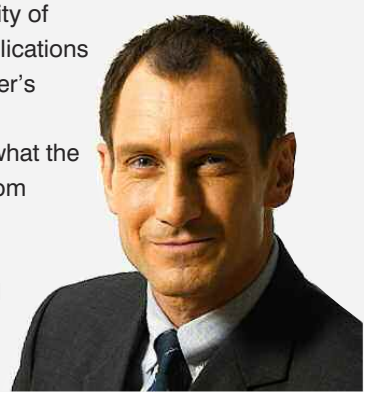
So Japan is going to be increasingly important to us. Our CEO, who obviously covers the globe, will have been here twice i 2016, and it's very rarely that he goes to two countries twice in one year. Japan in our view is back on the way to being as important as its size would suggest.

Shinichiro Shiraki: I just wanted to add that AIMA Japan has been producing our global AIMA Japan Conference for the last 11, 12 years now. In June 2017 we will have the next one which will be well attended as well, we usually have about 200 people attending that conference. We invite local politicians and the pension managers and many other investors to come and attend together with our local investment managers, and we are very happy to have global and overseas managers and representatives joining us in that event.

Rory Kennedy: I attended a hedge fund conference here recently and what was interesting for me was to see the profile of some of the American & European investors. These were typically people in the 30's, 40's, and 50's, and yet for many of them it was their first time to Japan or the first time in 10 years. And I think that says a lot of what is going on.

It is not necessarily that Japan may be a more interesting investment destination to them right now, perhaps its because *the rest of the world is becoming more and more like Japan.* Maybe these visitors can gain some insights by coming here and learning what the future holds for the rest of the world.

Peter Douglas: Let me add one more vignette. I mentor a group of MBA students at the University of Massachusetts in Amherst. Their assigned project for this semester was to think through the implications of a zero interest rate world; very quickly they realized this was much too big for a single semester's project. So they had to narrow it down to what they felt was most meaningful, and the way they narrowed it down was to do a study of the last 30 years of Japanese economic history and see what the similarities or differences were with current US macro picture to find out what they could learn from Japan that might be relevant to the US.



So to Rory's point, maybe the world is looking to Japan because the rest of the developed world may in some way be following Japan's modern economic trajectory.

Matthias Knab It's interesting what you are saying. Let me quote what Mike Coleman, a Singapore based commodities manager who participated at our recent Singapore Roundtable, was saying:

"I remember reading an article several years ago saying, 'For 20 years, we in the West have criticized the Japanese for doing a terrible job. In fact, we should be congratulating them for the fantastic job they've done and that nominal GDP has been positive every year.' In the face of massively negative demographics, the Japanese have really done a good job in a massive deflationary environment. We will be lucky if we do half as good the job, and at the moment it looks like we're not."

Alex Kinmont: Japan has actually done very poorly for a very long period of time - there's a lot of obfuscation about this, but no mystery. The reality is that since 1996-97, average real wages per hour have fallen back to where they were in 1990. What caused this horrific outcome? A consistent bias towards contractionary policy at the Bank of Japan and the Ministry of Finance.

The lesson that should be learned from Japan is not that deflation is natural, or some sort of ineluctable working out of demographic, or other, factors that descend from heaven, but that *if you "want" deflation, you will get it.*

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