Carl Vine: Japan Holds the 'Most Fascinating Little Pocket of the Global Equity Market'

A longtime Asian equities investor talks structural change, a new shareholder focus, and opportunity in Japan (and China).

Christine Benz and Dan Lefkovitz • Apr 30, 2024

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Our guest this week is Carl Vine. Carl is co-head of Asian Investment for M&G, a UK-based asset manager. Carl joined M&G in 2019 and was appointed to the management team of the Japan and wider Asian equity strategies. Prior to M&G, Carl co-founded Port Meadow Capital Management, a boutique investment firm based in Oxford in

2014. He also worked for SAC Capital Advisors in Hong Kong, for TPG-Axon Capital, and for Prudential in both London and Tokyo. Carl is a graduate of Oxford University.

Background

Bio

M&G

M&G (Lux) Asian Fund EUR A Acc

M&G Japan Smaller Companies Fund Sterling R Inc

Japan Funds

"A Look Back on 2023 for M&G Japan Fund," by Carl Vine, mandg.com, Jan. 18, 2024.

"Investors Are Pouring Their Love (and Money) Into These Three Funds," by Christopher Johnson, Morningstar.co.uk, Feb. 14, 2024.

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“Is Japan the Investment Play of 2023?” by Darius McDermott, moneymarketing.co.uk, Jan. 17. 2023.

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“Something Fundamental in Japan’s Inflation Environment Is Changing,” Webcast with Carl Vine, mandg.com, June 22, 2023.

“Enter the Dragon: Why China Is Competitively Positioned,” by David Perrett, mandg.com, March 7, 2024.

Transcript

(Please stay tuned for important disclosure information at the conclusion of this episode.)

Dan Lefkovitz: Hi, and welcome to *The Long View*. I’m Dan Lefkovitz, strategist for Morningstar Indexes.

Christine Benz: And I’m Christine Benz, director of personal finance and retirement planning for Morningstar.

Lefkovitz: Our guest this week is Carl Vine. Carl is co-head of Asian Investment for M&G, a UK-based asset manager. Carl joined M&G in 2019 and was appointed to the management team of the Japan and wider Asian equity strategies. Prior to M&G, Carl co-founded Port Meadow Capital Management, a boutique investment firm based in Oxford in 2014. He also worked for SAC Capital Advisors in Hong Kong, for TPG-Axon Capital, and for Prudential in both London and Tokyo. Carl is a graduate of Oxford University.

Carl, thanks for joining us on *The Long View*.

Carl Vine: Thanks for having me. I’m excited to be here.

Lefkovitz: Absolutely. Well, the team at M&G says that you are a man in demand at the moment. Obviously, the Japanese equity market had a big year last year in 2023. The Morningstar Japan Index has put up more strong gains so far in 2024. Your strategy has gotten a lot of inflows. And we've been hearing a lot of bullish sentiment on Japan from guests of the podcast. So, wondering if you can put this in historical perspective for us. You've been doing this for a long time. Is this the best you've seen it for the Japanese equity market?

Vine: I've seen periods of strong share price performance throughout the course of my career, which when it comes to Japan started in 1997. So, we've seen some bull market cycles. I think what's different about what's happening currently is that it is incredibly well supported by the fundamentals, by the earnings. We've seen in previous cycles, thinking back over the last 25 years, we've had, I would say, more cyclically driven improvement in earnings, which has led to some excitement in the stock market.

I think what's really happening now is a realization globally that there's an incredibly strong and potentially long-term structural earnings story for the Japanese equity asset class. So probably more so than previous bull episodes. It feels to me like there's real substance to this. And the changes that we're seeing in Japan that are driving this increase in earnings, I think has got legs. So, in that sense, yeah, I think it's probably the best we've seen in that sense.

Benz: So, we definitely wanted to delve into some of those themes. But before that, we're curious to hear how you got into investing in Japan in the first place. In the 1980s, Japan was taking over the world. But when you started your career in the '90s, underweighting Japan was a no-brainer for international equity managers. So, focusing on Japan doesn't seem like an obvious career choice for someone at that particular point in time. Can you discuss your thinking?

Vine: Well, that's absolutely right. I sort of fell into it, I suppose. When it comes to investing more generally, I was pretty focused. I think back to my days at university, my first week, I should have been out enjoying myself in Freshers Week, as we call it. And I spent half the week in the careers office. So, I was pretty driven that my time at university was to really help me move on and have a successful career. And I spent a lot of time figuring out what I might want to do in life, and I ended up after reading pretty much everything in the career's library, narrowing down on two potential career paths. One was in consulting, strategic consulting, and one was in investing. As it turned out, when it came to the time to apply for jobs, I got zero interview calls for the consulting pathway. And I got a lot of interviews in investment. And I was very lucky to get an opportunity to join the Prudential's Graduate Scheme. And that happened. So, I was pretty focused on investing from the very beginning because I wanted a career that would offer me a lot of diversity. I've got a lot of different interests in life. And I think investing is one of those unusual endeavors where you can get the opportunity to look at a broad range of different things in the global economy.

The Japan aspect was a bit of an accident, if I'm honest. When I was at university, I had the great pleasure to study under Professor Stockwin and people like David Asher, who were great students of Japanese politics and economics. And that really, I think, fueled my interest in Japan as a political economy. But it never occurred to me that I would go into Japanese investing. It wasn't really until I got to the city in 1997 where a series of, frankly, almost serendipitous events led me to the Japanese stock market. So, in terms of Japan, I sort of fell into it. But then I fell in love with it, and I've not really looked back. So, it's been since '97 that I've been investing in Japan, and it's been an interesting ride.

Lefkovitz: Can we ask what it was that made you fall in love with it in the first place? What attracted you to investing in the Japanese market?

Vine: I'm not sure I can even remember. I'm getting so old. I forget these things. If I think back—I've always been fascinated by systems, which is why stock markets are interesting to me, because they are complex, adaptive systems. And when I was at university, I was really interested in political theory, economic theory, different models of economies. And obviously, as you mentioned in the introduction, Christine, Japan had a particular model, which worked really well up until the late '80s and then it stopped working. So, as an intellectual question, that's really fascinating that we had this huge economy in the world that did things very differently, worked really well for a bit of time and then stopped working. So, I think that was the interest to me was that it was this incredible case study of how things can be done differently and what different results might come out of that. And actually, I think that historical context for me has been quite helpful to put into context what's really happening in the corporate sector in the last 10 years. And maybe we'll get on to that later. But I think that fascination was really about political economy, different models of democracy, different models of economy.

Lefkovitz: Why do you think it's taken Japan 30-plus years to recover from the bubble bursting?

Vine: That is a very good question. And there's probably a few PhD theses in the answer to that. I think honestly, they didn't want to change. They were pretty happy. The interesting thing is, let's say at the peak of the economy or at any point in the 15 years after that, if you spend your time looking at stock market and stock prices, you'd get the impression that everyone in Japan must be pretty depressed. But actually, as an economy, if you lived there and worked there, it was perfectly functional. It was a wonderful place to live and pretty vibrant still. And so, I think that things had worked so well for so long, there was such a lack of balance-sheet stress that I think that Japanese companies and politicians were potentially able to put their head in the sand, actually. When the world around them was changing, they were just slow to react and respond to that. That kind of developmental state, the top-down-driven economic model of the post-World War II period, which worked so well for so long and stopped working after we moved into a world of global trade, they could coast along for a while without really having to address that.

And I think it wasn't really until Abe came along in 2011-12 where he said, guys, we have a problem. If we keep coasting like this, we'll be busted in 50 years. We've got debt issues, we've got demographic issues, and we're losing. Japan has lost its competitiveness. We need to change the way we allocate resources in the economy. We can't have it being centrally driven anymore. We need a mechanism. And my proposal is we're going to use the profit mechanism as a way to signal where resources should go into the economy. And that was a big call in 2011-12, and people got excited about it at the time. But of course, changing how an economy allocates resources is a big deal. It doesn't just happen in a week. It has taken them many, many years to get to this position where they are now, where the flywheel, to use that kind of Jim Collins' concept, is really moving quite rapidly. And the way that the economy works is fundamentally different to how it's been for the last several decades. And that's positive for owners of equity and positive for profits.

Benz: Bank of Japan raised interest rates just recently in March 2024 for the first time in 17 years. That seems like a good sign. But there was also news earlier this year that Japan slipped into recession in the fourth quarter of 2023 and was overtaken by Germany as the world's third largest economy. So how do we reconcile those seemingly disparate data points?

Vine: There's a little bit of volatility in the quarterly GDP numbers in Japan. The way I think about the growth situation in Japan is as follows. Japan is not a high-growth economy; it hasn't been for some time. And my optimism over the next 10 years or so about Japanese equities is not predicated on a big GDP recovery. It's really about profit share to GDP, about productivity increasing. So, I'm not expecting huge GDP numbers out of Japan the next few years. I'm expecting that nominal GDP will probably be a bit better than it has been in the last decade because the GDP deflator is going to go from being negative to maybe modestly positive.

On the interest-rate side, you're right, we've had a 20 basis points increase just this week, as you said, which is hugely significant in terms of how long Japan has been running experimental monetary policy, and the fact that it's now on some path to normalization. And I think that is a good thing that we can get to a more normal. But of course, that's just reflecting a different pricing environment in the economy, which has been a real headache for companies. And I can't stress enough how—so, let's take the US or just what the Western hemisphere, economies in the Western hemisphere, companies that operate in a world where you can just raise prices 2% or 3% per year because. Compare that situation to a situation where you haven't raised product prices for 25 years; we haven't given pay rises just after 25 years. It is so hard without a nominal inflationary tailwind to grow nominal profits. It's really hard. So, in some ways, Japanese companies have done an amazing job in the last 15 to 20 years, given the lack of an inflationary impulse in the economy. And I think the fact that we've now moved into an environment where there is some impulse, let's not get carried away, but we do have a positive pricing dynamic in the market is good for nominal GDP. And of course, profits are nominal. So, I think that's positive.

But I think that the Japanese economy still has got some structural—I don't want to sound like a lush—the economy has got some structural headwinds for sure. I think there are mitigating factors where one shouldn't preoccupy themselves unduly with those structural issues, but they are there. And I don't think you need to be structurally really, really bullish about real GDP in Japan to want to own the Japanese equity asset class.

Lefkovitz: I think we want to follow up on some of the structural issues that you see. But first, wanted to ask you about the yen. Yen depreciation has really been dramatic. I think it's about 150 to the dollar. For many years, it was closer to 100. And as a result of this, a lot of the gains from Japanese equities have not been realized for foreign investors who are unhedged. So how do you factor in the yen into your investment calculus?

Vine: That is a great question. I should offer a caveat here that I'm not very good at forecasting anything and definitely not currencies. It would appear to me that if anything, the Japanese yen is probably cheap here, which is what conventional measures of exchange rates would suggest. But as we know, actual spot exchange rates often bear little resemblance to what the real effective exchange rate might suggest it should be. In the last decade, the Japanese equity market in total return terms in yen, it's been fantastic. It's right there with the S&P and depending on the precise month you measure across has actually outperformed. But in US dollar terms, nowhere near obviously because of the weakness in the currency.

I think—and I'm probably wrong and I'm just not clever enough, and I don't have a large language model in my head to figure it all out—but it would appear just looking at things simply that the yen really started to weaken at the beginning of 2022. What was happening at that time? Well, I think we had the rate differential really growing between Japan and the West. There is one other thing that happened that I don't think gets enough attention that it's a little bit weird if I'm honest with you is in the first quarter of 2022, we saw these inflation numbers building around the world and a little bit in Japan as well, nothing like in the West. And the Bank of Japan is trying to pin interest rates to where their target levels were—zero, slightly below zero depending on where we are on the curve—and the market started to challenge these upper limits. And so, I think it was in January was the first time of '22, Bank of Japan came out and put a limitless bid in the screen. Just imagine that. It said we will buy infinite numbers of these bonds at this price. It was kind of saying, "Don't test us. We will hit you with the infinity button." And then they did that then a dozen times over the course of 2022 when the market was trying to test these boundaries. And the yen weakened. You might say at many other points in history if a central bank had done that, the currency would have gone zero. It was pretty dramatic behavior from the Bank of Japan.

So, I think a combination of a willingness to be pretty radical with the currency in terms of that bond buy behavior, plus of course the interest-rate differential, probably—again probably—who really knows—ex-post-rationalizing stock market moves, and the currency moves is always a bit of a strange thing to try to do. But I think that's definitely been a big part of the weakening in the end. So, then we get to today where we're probably—again, don't know—closer to rates coming lower in the West, and we've now finally got some upward movement in Japan. Maybe that starts to unwind. I really don't know. The way I think about it from my portfolio is that I want a portfolio that is insulated from that one way or another. My job is to—and I say this because this is what my clients want me to do. My clients want exposure to the Japanese equity risk premium. Some of them hedge that exposure. Some of them don't. That's their call. I have some views on that, which we can talk about, if you like. They want to own the Japanese equity risk premium. They believe there's inefficiencies in the market and that we can maybe capture some of those and we can beat the market. What I don't want to do is to have my performance relative to the index be all about my ability to call the yen, which I think is approximately zero. It wouldn't surprise me if the yen goes to 120 in six months. Frankly, it wouldn't surprise me if it was at 180. So, I want to build a portfolio that doesn't really have any of that currency convexity in it. So, we've got a neutral portfolio with respect to currency exposure versus the benchmark, if that makes sense.

Benz: It does. And you mentioned that you have a thought on how people should think about going into Japan, hedged or unhedged. What's your take on the better way to do that, understanding that your clients have various risk exposures that they're looking for? But what do you think is a good framework to think about that question?

Vine: I'm going to make complete chicken and say hedge half of it, 50% hedged, 50% unhedged. I think it's really difficult, honestly, I do think it's really difficult. It feels to me that when you look at the productivity gains that are coming out of the Japanese economy, certainly at the listed corporate level. And you look at the structural repair in Japanese competitiveness and in many of the key KPIs for the structural health of the economy. And then you combine that with just the independently generated measures of the real effective exchange rate. It feels like the currency is too cheap. So, if you can buy an exciting stock market and achieve currency, that normally works out really well over multiple years. So, in that sense, you'd say just be unhedged.

I think I would then be humble myself and say, yeah, but there's such a good stock market story. Even if you paid a bit of money to hedge it, we're still going to generate really good returns, hedged returns over a decade. So why would you take it on? I think I'd probably net out somewhere in between actually and say hedge some and leave some unhedged. So, it's a little bit of a nonanswer, but that is actually what I would do. It depends though on what are the constraints of the particular client in question, obviously.

Lefkovitz: Well, going back to the deflation/inflation. I've seen the spring wage negotiations cited as an important factor, an important driver of inflation in Japan. Can you explain what those are and why they matter?

Vine: So, basically, this is where the unions come together, and they make their demands within various industries for how much they want base salaries to go up in the following year. And then what happens is they put their number up and then they get negotiated over the next six months, but that's the starting reference point. So, the starting reference point, I think in them was 5.3% or something, just over 5%. And last year they settled it in the low 4s from memory.

Just put that into context. It's been zero for a couple of decades. So, I've been speaking to hundreds of companies per year for the 26, 27 years in Japan. And I know people at companies who literally have not had a pay rise for two decades. So, I cannot overstate how big of a change this is to see two years on the trot now economywide wages going up 3%, 4%, 5%. That's an average. Some of the blue-chip companies in the listed sector have been paying 10%, 15% wage increases. This is this is a huge, huge change. And I think it's got really big implications.

I'm someone that's saying I think there's a really good earning story in Japan. So, someone might reasonably ask, but how are we going to get earnings growth when your labor costs are going through the roof? And I think it's all tied up with the overall system change in Japan. So, what's happening, I think, is that there's a new government-sponsored bargain in the corporate sector, which is, why don't you raise prices and use some of that to pay higher wages? So, again, hard to believe in a

Western context that a government and a central bank is trying to encourage a positive wage-price spiral. It's exactly what we've been trying to stop in the West. But we really do need it actually in Japan. Careful what you wish for. If it gets out of control, we're all going to be in the fetal position sucking our thumbs wishing we'd never really encouraged that at all. But I think we're so far from that.

And I think that the policymaking environment in Japan in the last couple of years has become frankly a bit more pragmatic. And pragmatic, I say that in the sense of—I mean, they've really tried everything. The Bank of Japan is full of some really clever people, and they really have tried a lot of things. They've been really experimental for a couple of decades. I used to be a very close BOJ watcher, probably less so these days. But I have noticed over the course of time that the narrative has shifted away from some various different elegant mathematical theories to something a bit more pragmatic and day-to-day in terms of interpretation of disinflationary forces we've had, which is there are no animal spirits. People don't want to go and buy things when they haven't had a pay rise for two decades. And this is a big part of Kishida's economic program in the last couple of years. He has come out and said, let's try something new on this inflation fight. Rather than try another super technical buying program of equities or REITs or bonds and twists and turns in the financial system, let's just encourage some wage growth and see what happens. Let's see if we can get some animal spirits back in the economy. And guess what? It's worked. It's totally worked. And so now what we have is, when you look at the Bank of Japan survey data, you've got companies more willing than ever to raise prices, you've got consumers more willing than ever to swallow them—within reason. We're not talking about huge prices. But it feels like we have broken that psychological logjam around the price-setting mechanism in the economy.

And to put it into context, as a Western-trained analyst, a critical part of your financial model is the price-setting mechanism. How does the company establish prices? And for many years in Japan, when I would interview companies, I'd say, how do you determine the price of your product? And they would look back at me blankly and say, "Well, what do you mean? We set the price in 1987, and that's sort of what it is." Again, it's hard to believe, but it's true. And I can't give you some eloquent theory of inflation in Japan or anywhere else. I'm not sure the inflation theories have really helped any economy, actually. What I can tell you at the coal face, those answers are no longer blank stares. For the first time in my career, companies are saying, well, we've started using an algorithm to determine a discriminatory pricing mechanism. We're actually going to go and hire a chief pricing strategist, a role that you'll see all over Fortune 500 companies. So, the way that prices are thought about in the corporate sector is totally changing. And now there's a bit of wage growth in the economy. The consumers are a bit more accepting. As I said before, careful what you wish for. But moving from a disinflationary environment to a modestly inflationary environment is very good, I think, for the equity asset class, which delivers nominal profits after all.

Benz: We wanted to ask about policies related to investing in Japan. Tokyo Stock Exchange has really pushed for better capital allocation with an eye toward improving shareholder returns. They're focused on price/book. Can you talk about that whole effort and how big a factor it is?

Vine: You've really hit on what I think is a very important aspect of the rally in Japan that we've seen in the last year and a half. I think the anatomy of that rally, I feel, was started in late December '22 when the Bank of Japan finally came out and said, look, we might be thinking about changing interest rates. Obviously, it then took them another 15 months. But the cat was out of the bag then that they may be winning this long-term fight against inflation. And then obviously Warren Buffett became a bit more vocal in early '23.

But then around the same time as Buffett, we had Yamaji (Sama) of the Tokyo Stock Exchange come out and do something, which I think honestly is quite extraordinary in some sort of global context. So, the head of the stock exchange came out and very publicly said, any company that's got a price/book ratio—not my favorite metric as it happens, but anyway—any company that's got a price/book ratio of less than one—so about half the stock market at that point—you need to write me a letter of apology. I'm paraphrasing a little bit here and being a bit flippant. But that is what he said, I want you to write Tokyo Stock Exchange and tell us what you're going to do about it. And his message, the message that was then given with more nuance across TV interviews and radio interviews and podcasts and so on, was you need to make a decision whether you want to be listed on my stock exchange or not. If you want to be on my stock exchange, you need to understand your cost of capital, both what it should be and what you need to do to earn at least that cost of capital. And I want you to write that to me and my team at the Tokyo Stock Exchange and then we're going to make that information public. And then in a year's time, which is now about seven weeks ago, I'm going to name the companies that have not yet written that letter and I'm going to do this all publicly. So, we're going to get into the shame motivation. They gave them one year to get it done, then he said, I'm going to name and shame.

So pretty radical for the head of a stock exchange to take that level of stance and to be supported. It's not like the Cabinet Office didn't leak out messages that he was overstepping the mark. He was well supported. Nobody held him back whatsoever. So, I think for me as an investor, particularly with our engagement orientation, where we've been trying for a long time to build an investment program that tries to help companies on their journey of self-improvement. This has made my job so much easier actually, because it's not just a foreign investor that's turning up and telling you to do various things with your balance sheet. You've now got the head of the stock exchange saying, if you don't understand your cost of capital, go and find out. And if you don't want to do that, fine, you can delist. And being listed in Japan is quite prestigious. So, we've seen a response. We've definitely seen a response. We've seen a response from investors. Investors took that pressure very positively. The only game in town in 2023 in terms of intramarket behavior, frankly, was—well, there were two. There were semiconductors, but then really the big game was low price/book stocks. They all outperformed indiscriminately, I should say. But a pretty amazing aspect of what we're seeing in Japan now is this state-coordinated sponsorship of really trying to cajole the corporate sector to improve returns on invested capital. There's not that many times in history where I've seen such a top-down focus on that.

Lefkovitz: That's fascinating. Have you seen a meaningful reduction in the number of companies that trade below price/book? I'm curious what you're seeing in terms of capital allocation and how companies are using profits for dividends versus share buybacks versus reinvestment.

Vine: I'd say the changes that we've seen in the last year, it didn't just start a year ago. This really did start, as I said, in the 2011-12 period when Abe came out and said, we're going to do things differently, the social contract is going to change. We've seen over a decade of growth in dividends, growth in earnings. Compound earnings growth has been about 8%, 9% in Japan over the last decade. It's pretty impressive for an economy that's been bereft of any growth. And it's not overly blessed in the technology sector like the US. So that's been some pretty impressive, very broadly spread earnings growth. We've had dividends growing more. So, I think dividends have probably compounded, I think almost about 12%, something in that region for over a decade now. Payout ratios are still pretty low, about 40% in Japan. Lots of scope for further increases in dividends. Every year, for as many years I can remember we've had successive increases in buybacks. So yeah, Japan is getting religion about more efficient deployment of capital.

That's an old story. And I think the Japanese equity story, some people are just fatigued with it. They say, I've been hearing about Japanese restructuring calls for 20 years. And I have some sympathy for that. It has been going on for a long time. But you haven't seen for 20 years the types of changes that you're seeing now. So, the fact that it's an old story doesn't mean to say that it's a story you should ignore. The facts are bearing out that something very big is happening. I think we're entering a new chapter now of the balance-sheet reform, which is before it was more at the edges, we'll do a few buybacks, we'll nudge up the payout ratio. I think we're now seeing examples of companies saying, "Actually, I'll go from a 30% payout ratio to an 80% because it's the appropriate thing to do." We're seeing less incremental change and we're seeing changes more driven by first-principle thinking rather than let's just do a bit more than we did last year. So, we're seeing some more radical changes.

We're also seeing the concept of the best owner, the best owner concept in corporate finance. Let's say, I've got five divisions and I think I'm the best owner of these two divisions, but those three would probably be more competitive if they were part of another company. Simple concept, but it's never really been pervasive in the thinking of boards of directors in Japan. That's totally changed. Every company we speak to now that's got more than one business line, which is most of Japan—a lot of diversification in the corporate sector—they're all figuring out, actually, we're going to focus on these two or three things where we've got global competitiveness and these two or three things we're going to go and find out who else this business needs to live with. That corporate re-optimization is releasing massive corporate value across Japan. And I think it will be a multiyear trend. That won't happen overnight.

Benz: Another old story that we wanted to follow up on is corporate governance, where historically we had heard bad things about corporate governance in Japan. We hear a lot about cross-shareholding, poison pills, lack of independent directors, and so on down the line. Are you seeing any improvement on that front?

Vine: I think there's just been massive improvement, honestly. Again, going back to Abenomics, his so-called third-arrow reforms. So, I think the history lesson here that's relevant is in the early 2000s, private equity started to arrive in Japan, and we started to see a few hostile takeovers. Because, as I said before, it's not new that there's been hidden value across the Japanese. It was like the US with Chainsaw Al in the '70s and '80s. It looked like that was going to happen in the early 2000s. And then the government came along and put a put a stop to it. And there's a few high-profile cases. I won't mention names because they're big figures today. But some people went to prison for bad behavior in that it was starting to get, in 2003, '04, '05, a bit like the Wild West. It was out of control. The corporate raiders turned up to try and take advantage of all these huge mispricings. And it was an exciting time, but the government said no. And I think the government was right to say no, because the legal framework was not in place for that to happen in an equitable way.

And Japan effectively said, this is not going to be Russia. We're not going to have four people who are going to just take all these assets for themselves. And so, they shut it down. And then Abe came along in 2011-12 and said, that was the right thing. We need the barbarians at the gate, but we need a few structures in place. So here is what we're going to do. And then what happened in the 10 years since is that first we had the Ito review, which was a let's take an inventory of corporate governance in Japan versus best practice globally. One of my colleagues co-authored that actually. That led to the corporate governance code. Then we had a stewardship code, then they revised both, and then they revised them both again. And then they introduced proxy-voting guidelines to make sure that there were robust frameworks and practices and checks and balances for voting capital to actually have a voice. Then fair M&A guidelines. And so, there's been a whole series—a monumental shift in the institutional and legal framework in the last decade within which companies operate.

Maybe that's too much history. I apologize if so, but I think that this is not just a story of all companies becoming more focused on corporate governance. This is a deliberate shift in the framework. You can't just turn up in an economy and say, hey guys, please go and allocate capital in a different way. You need rules, you need incentives, you need carrots and sticks. And so, it's taken a while to get those in place, but we've had gradual improvement. But now, I'd say, if you were to take that inventory today, I think corporate governance is good in Japan. And I say that comparing it to global best practice.

Are there a few areas that need tidying up still? Yeah, sure. There are a few companies that are dragging their heels on that road to improved governance, without question, but we've seen so much improvement. Time and again, I'm now bumping into companies that are doing very interesting, quite radical things. And I say, where's this change come from? And it's being driven by the independent directors on the board. So, this is working, actually. It's not working as quickly as some would like, but that's the difference between stock market time zones and real economy time zones, I think.

Lefkovitz: Well, let's switch gears and talk a little bit about how you approach investing in the Japanese equity market. Morningstar's manager research team describes you as style agnostic, so not wedded to either growth or value investing. Why do you think that's the best way to approach the Japanese equity market?

Vine: I think it's the best way to approach any equity market, if I'm totally honest with you. I think that if you said, Carl, what's the equilibrium return framework model for a stock or a bond? I can tell you and you'll know it. Present value of cash flows, mumble, mumble. If I said, what is the equilibrium return model for growth or quality or value? I have to say, I don't know. I'm pretty sure there isn't one. So, I just think an awful lot of oxygen is wasted when it comes to conversations about value and growth. Don't get me wrong. I've paid my dues. I've read every value book, maybe not ever written, but I'm a student of value investing. Who wouldn't want to buy things that are priced at less than their worth? Of course, I'm in the business of doing that. But the idea that I would then just only buy stocks that all have similar characteristics when my clients actually asked me to beat a benchmark is a bit silly.

If someone gave me money and said, "This is an absolute return, I'll see you in 20 years, do the best you can," that might be different. But if the client wants me to beat a particular benchmark, then I don't think it's an intelligent way to go about things, to infuse that portfolio with a lot of factor risk. One, because I can't predict anything, as I've said—but I've got no framework within which even to think about what factor will outperform another factor over a given period of time. And in Japan, I can tell you the volatility between factor returns intraquarter, let alone from year to year, is gutwrenching and career-ending, I should say, and also encourages clients to do the wrong thing at the wrong time. So, I just think if your job is to beat a benchmark, I think it's silly.

So, what we do do then is—it's not just that I'm style agnostic. I go out of my way to make sure that I don't have too much style risk in the portfolio. I don't want to have conversations with the clients where I say, "Sorry, tough year, quality wasn't good this year," or, "Hey, had a great year because growth or value did XYZ." I just want to say that we're stock-pickers, and we build a portfolio where the risk in that portfolio is driven by wholly intentional bets about what we do own and what we don't own versus the benchmark, where those bets are concentrated around companies we've been covering for a long period of time, where we're not tourists, where we've earned the right to a differentiated perspective about price of risk of those securities, where we've identified a debate or controversy where we think the markets misinterpreted something or unduly extrapolated something, and we think that risk premium is something that we can capture for you, and then we build a portfolio of those very company-specific bets. We call it esoteric risk, where you've got esoteric risk driving the active risk in the portfolio. So, at the end of the year or whatever discrete period, if we're ahead or behind, I should be able to explain that on the basis of here were the things that we did in the portfolio, and they worked or they didn't work. I don't want to say the Bank of Japan cut rates and value did XYZ. I think that's not a conversation I ever want to have with a client. That's low-quality stuff, I think.

Benz: You've said that you're focused on where the market is mispricing change. Can you discuss where you're seeing some of those mispriced areas today?

Vine: Yes. So where do we see mispricing? We see mispricings in growth, in quality, in value, and then we see mispricings around change. We're seeing a lot of it around change at the moment, because there is so much change. So, what's really good for me as a discretionary stock-picker, as an active manager, is the type of change that we're seeing, like generational change in corporate behavior, that is not something that algorithms so far have been set up to do. So, I feel that there's a window here where the old-fashioned human discretionary manager has got one up against the crew at Renaissance or whatever algorithmic trading platform.

The opportunity set in Japan around change is not incremental, it's big. If we take a company like Sanrio, which owns the character IP Hello Kitty. You guys have probably heard of Hello Kitty.

Lefkovitz: Absolutely.

Vine: Yeah, you've heard of it. Well, just a couple of years ago, that character IP, which by the way has sold more merchandise revenue in 50-year history than Mickey Mouse has since 1926, was sat in a $1 billion enterprise value company. That just wouldn't happen in the United States. It wasn't making sales look like a ski slope. Sales have gone down every year for 10 years, profits have gone down, wasn't earning a lot of money. It wouldn't screen well on price/book or EV/EBITDA or anything, because it wasn't doing a very good job commercially. It was doing a great job of building memorable and durable character IP. That's an opportunity for us to go and sit with that company and ask for an introduction to be helpful, to help them think about their commercial strategy, which we've done. The company is now earning record profits, is expanding globally like it never has before, it's got brilliant strategy, executing really well in China and the US and so on. Computer algorithm is not very good at spotting that. That risk premium is ours, because we've covered that company for a very long period of time. We've had a view about if they did X, Y, Z, they might be a radically different version of themselves and not a stock that could go up 50% to 100% but could go up 10x or 20x. If you think about the value of the character IP, it's extraordinary. There aren't many algorithms that are really good at spotting that. There are not many spreadsheets that show that type of opportunity.

One of the things that I'm so excited about this change is one of the changes is that shareholders have a voice. I'd like to think it's partly about the way that we approach Japanese companies and the way we choreograph our interactions with them that buys us an audience. It's also now a legal requirement, which it wasn't 10 or 15 years ago, but we are finding it much easier to have the types of conversations that I've wanted to have for 25 years, where we can say you've got some amazing potential. You're not quite realizing it. Let's work together to tease out some changes in your corporate and commercial strategy that might take your margins not from 1% to 3% but to 25% because that's the potential that you have.

So, the mispricing of change in some sense is about knowing where do those price/potential opportunities exist? Where are they in the corporate landscape? Because they don't really show up readily on screens. That's really about 25 years in the saddle of seeing an awful lot of companies and thinking about what makes them tick and what they could do differently and what their global opportunity set is and what it might be in an ulterior universe where they behave differently. So, that change element to me has been unlocking some great opportunities for us, how we approach investing, and particularly our engagement platform.

Lefkovitz: I wanted to ask about Toyota and Honda, the two big motor companies I think are among your largest holdings. What do you think the market is getting wrong about those?

Vine: I think that the answer to that today is very different to what it was a year ago. A year ago, when they were material overweights in our portfolio, I think… Well, the answer was different in each case. Honda, what was the market getting wrong? It was pretty much just the earnings. A big part of our process is, we talk about we don't generate excess returns from superior forecasts. We're just trying to price risk in a superior fashion. I'm going to tell you that we had earnings forecasts that were much bigger than consensus. So, what am I talking about?

The point there was I don't have a crystal ball that's better than anyone else. I can't see the future better than anyone else. However, sometimes the consensus, just by the pure logic that it's using, is an order of magnitude wrong. What happened with Honda is that, like all autos during the pandemic years, huge supply chain issues and so the volumes were down 30%. No problem with demand for the products. They had downs like literally two days' inventory. In the old world, if you lose 30% of volumes, they would have been bleeding red ink all over their income statement. What they had done is very aggressively lowered their breakeven point. And so, our sense, and if you listen to what the company was saying publicly was that a great deal of that reduction in the breakeven point was permanent.

So, when the company said at the beginning of 2023, we're expecting 25% volume growth this year, for some reason, the consensus did not take into consideration the lower breakeven point. So, if you go through a period—if any company in any industry—if you lower your breakeven point, then you get huge volume growth. You get a nonlinear response from your earnings. And so, our sense was—again, we don't try to be too precise about this—but that earnings could be 50%, 60% higher than the consensus purely based on the facts-based approach of what's happened to the company's breakeven point. That happened, and the stock was a great performer in the first nine months of – over the whole year, actually of 2023. So that was just about the consensus not being very thoughtful about its forecasts.

Toyota was different. Toyota was very different. I feel like Toyota has been a bit of a punching bag in the global auto sector in the last few years, particularly since the electrification trend took off. And I think the reason for that is that they have the audacity to say that this is all a bit complicated. And other companies in the world just said, look, just go electric. That's the solution. And I think the market didn't reward them for saying, well, it is a bit complicated, actually, we might need a few different approaches. And so, I think somehow Toyota ended up being painted, unfairly, by the global lobby group as a climate-denying backslider, when in fact nothing could be further from the truth. And our encouragement to Toyota in 2023 was you probably should get on the front foot about this, why don't you start holding some technology days? Let's just remind the global auto community, the investment community, the pundits that you're leading the charge to solid-state batteries in the world—that you've got many technologies where you're 10, 15 years into your R&D projects that really are going to move the needle on the decarbonization of mobility as complex as that is. And they did that during 2023. And I think the company saw a huge rerating as a consequence. And now when I listen to the narrative about Toyota, it really is different from 12 or 18 months ago. It's gone from, well, they're behind in electrification to actually, they've got some world-leading technologies along the way to the new mobility, whatever that looks like in 10 or 15 years' time.

So, I think what the market was getting wrong was living in the echo chamber of Tesla and not looking objectively at the technology assets that Toyota actually has. Of course, what also helps in 2023 was that—and this is probably a blip, not a permanent trend—but consumers said that they really prefer at this point, the early adopters on full electric had started to get saturated and the broader mass market said, we're a bit nervous about fully electric vehicles, but we do quite like this idea of hybrid/plug-in hybrid, and that really is Toyota's sweet spot. So that definitely helped them in terms of profit delivery. So, we had a bit of positive profit surprise. But we did have, I think, a reassessment thanks to some proactive PR activity from the company of really where they are in that technology roadmap to the new mobility.

Benz: So, sticking with individual companies, earlier you referenced Warren Buffett and Berkshire Hathaway has stakes in five Japanese trading houses. Wondering if you share his enthusiasm for these stocks?

Vine: Who am I to go against Warren Buffett? I wish he'd turned up earlier. I think we don't have to speculate anymore in terms of what he found attractive, because dear Charlie Munger told us—he gave a podcast, I think it was maybe October or November of 2023 before he sadly passed away. And he spoke about it. He said, look, this is the biggest yield arbitrage in our career. We bought 5% dividend yield stocks funded from less than 1% debt, so no currency risk in businesses that traded below book at single-digit P/Es that had really diversified businesses, paying out less than 50% of their earnings to get that dividend yield, that had global footprints in businesses, that had plausible growth stories earning US dollar assets. He said it doesn't get any better. So, yes, we have shared that enthusiasm.

I would say I think there's an awful lot more that Berkshire Hathaway could be doing in Japan, opportunities where the scale fits their balance sheet, opportunities where the value proposition would fit their investment approach. And I suspect we will see more activity from Berkshire in Japan. It wouldn't surprise me anyway.

Lefkovitz: Carl, I think you run a Japan Smaller Companies Fund. I guess, stereotypically, I would assume that smaller caps in Japan are more domestically oriented. Curious if you could give us a sense of the small-cap space and what kind of opportunities you're seeing there?

Vine: I really love small caps. I think Japanese small caps in particular are just the most fascinating little pocket of the global equity market. I know on your own podcast in the past, you've had guests talking about how globally small caps are just super attractively priced. I think in Japan, what's amazing is, it's big. There's a lot of small-cap companies and a lot of them have got coverage of zero. And so, in the large caps, we have to do really clever things, like, find out when the consensus is using the wrong logic for Honda's earnings. In the small caps, you have to be no more clever than being the only one looking. And that's refreshing. What's really important part of our process is to understand why is something mispriced. And oftentimes in the small-cap universe in Japan, it's mispriced because no one's looking.

So, we find globally relevant companies, so a lot of them are domestic, but a lot of them are global as well. They'll have 20%, 30% of their sales that address global customers that are growing, they're normally underpriced, and companies that are well run with relevant products. They're not just the low price/book cigar butts, but we've got growing companies trading on superlow valuations that are also still facing the upside opportunity set of more westernized strategies in terms of commercial and business approaches. You just see some crazy valuations in small caps, and it's not purely just in that domestically focused area. It's in companies that are well run, that have got globally competitive products, typically in niche areas, but you get companies that have been growing for decades, just grinding out sustainable growth. So, I think it's a fantastic part of the equity market in Japan where you really find some just crazy pricing anomalies.

Benz: You used to run long-short portfolios. What would you be shorting in Japan if you could, if that were part of your mandate?

Vine: Oh my gosh. I'm going to get myself into trouble with that question. Well, there's a reason why I stopped shorting things, which is less enjoyable for me than watching companies win and succeed.

I'm not going to say any names because my compliance police will come and slap me on the wrist. Unlike a year or 18 months ago, I think there are now a few pockets of euphoria around the semiconductor space in Japan. Not just Japan, but there's definitely some in Japan. In the semiconductor-production equipment area, I think there are some valuations that require such monumental delivery of earnings to make sense that the prospective risk/reward would favor being underweight or being short. I think there's little bit of excessive euphoria. Effectively, there's not been many AI ways for investors to access the AI thematic in Japan, not obvious ones. So that kind of fast money has concentrated in a relatively small number of names where you've got global competitiveness, and that in Japan means in the semiconductor-production equipment area.

I am talking about some of the best-run companies in Japan, brilliant businesses, fundamental stories are great, but where valuations are multiple standard deviations away from where they've ever been. And I'm a huge bull on AI. Don't get me wrong. But I feel that the concentration of relatively fast speculative money in a small group of stocks, where the underlying earnings are not really doing that much and when there is quite a lot of exposure to Chinese (SPE) capex, which is unsustainably ballooning, I think, it feels to me that that risk of ownership is quite drastically mispriced. So, I think that's an area where one could source underweights or shorts. But they're pretty racy. Those stocks are pretty volatile at this point. But in some medium-term sense, I think they're probably pricing in some perfect outcomes.

Lefkovitz: It's interesting, when we asked our colleagues at Morningstar Japan what they'd like to ask you, they said, ask about valuation. I guess the domestic managers that they're talking to, some of them are concerned about pockets of froth in the market.

Vine: I think there are some pockets, not all of it, but there are some pockets in semis. But I would say by and large, I don't see… So valuations have expanded from being unreasonably low to probably reasonable now, where for many stocks, the return now over the next seven or 10 years is going to come down to the earnings, which I'm fine with, because I think we're going to get another decade of high-single-digit earnings growth, which will be then further bolstered by buybacks and the dividend. I think the equity market is fine. What we don't have in Japan is this massive concentration that you see in the S&P 500. We're now through the concentration in the US that we saw in the peak of the tech bubble in 1999-2000. We're nowhere near it in Japan. I mean, really nowhere near it.

So, I'd say that when you look at not just what's the aggregate valuation of different markets around the world, and I think Japan is fine, it's not as attractive as it was 18 months ago, purely from valuation perspective. But when you look at the composition of that, it's very healthy. Earnings growth is coming right across the corporate sector, not just from seven companies. And there are broad sets of valuation appeal across the market. We've got a few pockets emerging in semis where valuations are looking pretty stretched. But it doesn't feel dangerous overall for the market to me, not yet.

Lefkovitz: I wanted to sneak in one more question if we could, Carl, and it's a big question. It's about China. I think you lead a Pan-Asian equities team that invests, not just in Japan, but other Asian markets. It seems like Japan and China have switched places. In Japan, China seems to be facing a lot of challenges currently, and parallels have been drawn to Japan in terms of the property bubble bursting that we've seen and demographics, of course. Curious how you're viewing China now, what similarities and differences you're seeing between China and Japan?

Vine: We've covered currency, which is where I normally humiliate myself. And now we're going to talk about China, where there's so much geopolitical… We're going to listen to this podcast in a year's time and think, that guy really didn't know what he was talking about. So, let's have some fun though. Why not?

So usual caveats aside, I'm not in the business of predicting what stock markets are going to do over the next one or two years, and so on and so on. So, let's get those caveats out of the way. But let's have some fun. I'll go out on a limb and say, I'm basically bullish about Chinese equities. And I say that specifically in the context of a diversified global equity portfolio. In that context, I personally would be overweight Chinese equities. China is not without risks, obviously. I would say that the risks are pretty known, and they've been talked about for a long time. I think it's important as investors, we need to differentiate between the risk itself and then the price of risk.

A lot of the risks that has been coming to fruition in China, both in the economy and the stock market in the last year or so, have been known about for some time. The time to worry about them was probably five years ago, less so today, where the price of that risk is, I think, quite extreme. The equity risk premium in China is massive today. I'm not saying that I don't worry about the geopolitics of China. Of course I do. It's really worrying. And I don't really have much of an edge in terms of how that pans out. I can say that we are being paid a pretty handsome risk premium to take that on. So, I don't want to have a digital binary conversation of will China do X or Y? But as I said, in that context, particularly taking into consideration the correlation characteristics of the Chinese equity market, in a global portfolio context, I think it's really interesting.

So, what are the problems in China? We've got the geopolitics. I've got nothing further to add than what you could find in ChatGPT on that. And then, of course, you've got real estate. And I think real estate is… Again, let's not underestimate just how massively China has misallocated capital, particularly with respect to real estate in the economy in the last 20 years. It's pretty monumental. Various people have views about whether it's bigger or not than Japan. But let's just say it's really big and it's a problem, has been a known known. China is now going through that painful process of rebalancing it. It had to be done and bitter pills are being taken.

If we go back a year, the concern was China's going to go for it and try and rebalance this real estate problem. This historic and monumental misallocation of resources, that's pretty scary because we're going to have a financial system problem in both the shadow banking system and the regular banking system. And what happens socially when residential real estate prices start falling 30%, 40%, we might have systemic collapse. So, people were really worried and that got priced in.

Let's now come forward a year. What's happened? Well, Shenzhen resi prices are down 30%. There's a little bit of complaining going on. There's a little bit of protesting. The system has not collapsed. MPLs, dead bodies are coming to the surface. The system has not collapsed. A year ago, unemployment for the sub-25-year-old cohort was literally 25%. It was properly scary. It's now 12%, 13%. Also still scary, but it's halved. So, for me, I think that there's a difference obviously in investing than traveling and arriving. I don't know where we are on say a 12-hour clock. We haven't finished this adjustment phase. We haven't. We're a good way through it and the wheels haven't fallen off, but I feel like the risk premium is not mark to market for the developments and the fact that it's been painful but relatively orderly. We've not gotten into the world of unanticipated consequences yet. So, I have to say, when I just see world-class companies, companies that can grow 10% to 20% plausibly for many years to come, when you find them trading between 8 and 15 times earnings with strong balance sheets and improving governance, in a global context, it feels pretty exciting.

Lefkovitz: Well, Carl, thank you so much for joining us on *The Long View*. This has been great.

Vine: You're very welcome. Sorry, it was a bit of a long *Long View*. I tend to be long-winded. I apologize for that.

Benz: No, thank you, Carl. You've been terrific. We've appreciated you being here.

Vine: Thanks for the great questions.

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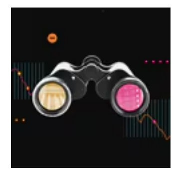

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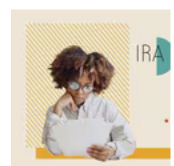

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