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Special Edition

Concentrated investment focused on enterprise value

- Transcript of the interview of Mr. Kazushige Okuno by Sadayuki Horie -

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Executive Summary

With the Japanese equity market in a protracted slump in recent years, investors have been turning their attention to highly selective, concentrated investment strategies unlike conventional equity investment benchmarked against a broad index such as the TOPIX. At the forefront of the trend toward concentrated investment in Japanese equities is Kazushige Okuno of The Norinchukin Trust & Banking, who has a background in hedge fund and private equity investments. Mr. Okuno discussed the essence of concentrated investment with NRI's Sadayuki Horie.

Kazushige Okuno

CIO and General Manager,
Long-Term Concentrated Portfolio Management Division
The Norinchukin Trust & Banking

Joined Long-Term Credit Bank of Japan in 1992. Involved in bond trading at LTCB Securities and UBS Securities (in Tokyo and London). Hired by The Norinchukin Bank in 2003. After managing alternative investments, he launched a proprietary long-term concentrated investment fund, which migrated to The Norinchukin Trust & Banking in 2009.

Sadayuki Horie

Senior Researcher
Financial Technology and Market Research Department
Nomura Research Institute

Joined Nomura Research Institute in 1981. Developed NRI Bond Performance Index (currently Nomura-BPI). Developed option model and term structure model while assigned to NRI America in 1986–88. Seconded to Nomura Asset Management from 1996 to 2001. Currently Chairman of AIMA Japan Research Committee and visiting professor at Osaka University of Economics Graduate School of Business Information Systems.

Factors behind switch to concentrated investment

Horie: You are currently managing a fund with a concentrated portfolio of about 20 Japanese stocks and a long-term investment horizon. What led you to initially adopt this investment style?

Okuno: It all began with an internal fund that The Norinchukin Bank started in April 2007. The project was like a social experiment to see how well an investment style like Warren Buffett's would work in Japan.

Our style is to selectively invest in companies that we would be completely comfortable owning even if the Tokyo Stock Exchange suspended trading tomorrow and remained closed for the next five years, with no price quotes available. In other words, we aim to invest only in companies that we would never need to sell. The concept is very similar to a private equity approach, where daily price quotes are not available.

Before we began this project, I had been managing private equity, hedge fund and alternative investments for The Norinchukin Bank's Credit & Alternative Investment Division since 2003. Back then, even leading private equity funds such as the Carlyle Group and Advantage Partners were not yet big enough to do major deals on a solo basis. They would consequently invite us to co-invest in such a major deals as private investments. Because The Norinchukin Bank was well known as a major limited partner, many funds pitched large deals to us. I was in charge of the investment process whereby we analyzed prospective investee companies, met with their management, and committed to investing on a long-term basis. I believe that at that time The Norinchukin Bank was just about the only Japanese financial institution actively investing in private placements along with private equity funds.

Companies in which we invested at that time were extreme bargains, with EV/EBITDA multiples of, say, 3.5–4x. The private equity market subsequently overheated amid an influx of institutional investors. From late 2005 into 2006, we were pitched deals valued at EV/EBITDA multiples of over 10x and deals involving industries we considered unsuitable for buyout. Valuations increased due to excessive competition.

Horie: I believe private equity funds are still paying high prices for companies even today, but valuations were already pricey five or six years ago.

Okuno: That's right. As a result, we rejected nearly all of the private placement deals pitched to us since around mid-2005. Even allowing for a control premium in private equity deals, publicly traded companies appeared to us to be better values with higher-quality cash flows.

So I had the idea of applying a private equity approach to publicly traded companies. I though such an approach could be a winning strategy if we accurately assessed companies' value and committed to a long-term holding period. In autumn 2006, I proposed such an investment approach to The Norinchukin Bank's management and my proposal was approved.

At the time, I was overseeing a portfolio of both Japanese private equity and global hedge fund investments. Over 95% of The Norinchukin Bank's hedge fund investments are in North American funds. In Japan, hedge funds have an image of being short-term traders, but quite a few US hedge funds focus on company valuations like private equity funds and invest for three to five year holding periods. It was common for private equity fund managers to move to hedge funds after gaining some experience in private equity.

Horie: Private equity funds and hedge funds occupy somewhat different niches, but their underlying concept is the same, namely generating returns based on companies' value. They are like two sides of the same coin.

Okuno: That's right. At Japanese hedge funds, however, hardly anyone was using an investment strategy similar to the private equity approach. Why not?

In Japan, hardly anyone who runs a private equity fund has capital market experience. Japanese private equity funds operate in accord with corporate finance theory. Meanwhile, the people in capital market do not trust corporate finance. Actually, I think there is validity to both sides' complaints about each other. However, the two sides are at odds with each other, with neither willing to compromise.

Horie: So you started running your own fund?

Okuno: We started five and a half years ago in April 2007. Researching a company is extremely time-consuming, including interviews with management and visits to production facilities. As a result, we had invested in only three companies by the end of 2007. A year later, at the end of 2008, our portfolio had grown to around 13 companies, helped by the fact that prices had become reasonable in the aftermath of the Lehman bust. Previously, several truly good companies that we would have been able to hold for a long time were overvalued, so we had refrained from investing in them. By the end of 2008, we finally had a respectably sized portfolio. In February 2009, we moved our team and portfolio from The Norinchukin Bank to The Norinchukin Trust & Banking in the aim of marketing our fund to pension funds.

Horie: How many companies do you have in your portfolio now?

Okuno: We have 20 companies in our large- and mid-cap portfolio.

How to accurately assess companies' value

Horie: Everywhere you go nowadays you see advertisements related to investing, including many that promote Warren Buffett's investment approach. There are even books on the Buffet approach targeted at individual investors. Personally, I think it would be difficult for individual investors to follow the Buffet approach. What is fundamentally different about your method of assessing companies' long-term value?

Okuno: To begin with, there is a difference between companies suitable for short-mid term investments and companies for holding over the long-term. When we select companies to own on a long-term basis, we always consider three points. The first is that the company must be in a high-value-added industry. Second, even if the company is in a high-value-added industry, we would not invest in it if it has many rivals in its industry. Predicting which companies will beat out the competition is too difficult. Third, we do not invest in companies if their industry is contracting.

I always use a fishing analogy to explain this process. If there are no fish where you are fishing, you will never catch anything no matter how hard you try.

Horie: And even if there are fish, you won't catch any if the fishing hole is crowded with other fishermen.

Okuno: In addition, if you visit the fishing hole weekly and it gets smaller every time you go, you will soon no longer be able to catch fish. These three criteria are ambiguous but important.

Based on my experience over the past five and a half years, these three criteria constitute 60–70% of the process of determining whether a company is a suitable long-term buy-and-hold candidate.

The companies we select using these three criteria have characteristics such as consistently high operating margins, excellent asset efficiency, and pristine balance sheets. Such companies are always cash-flow positive and consequently do not accumulate much debt on their balance sheets.

Horie: Many portfolio managers use only quantitative metrics such as ROE to screen stocks. Do you feel that an investor's skill comes in to play in a process that assesses a company's true strength behind its, for example, high ROE?

Okuno: If you start with quantitative metrics, bias will come into play when you investigate the underlying causality. For example, if you are screening stocks by industry, you may conclude that a certain company is strong without taking into account the inter-industry competitive landscape. A good example is the Pachinko industry (Pachinko is a Japanese gambling pinball game). If you quantitatively screen companies in the Pachinko industry, you would likely conclude that Pachinko machine makers are good companies with oligopoly power. However, Pachinko machine makers compete not only within their own industry but also with the game industry. The bottom line is that you have to think about competition from the broader standpoint of how consumers spend their leisure time.

Horie: In other words, investors must thoroughly analyze underlying causes. To do so, they need an extremely deep understanding of companies within the context of their industries. Is such an understanding generally too difficult for most people?

Okuno: Common sense suffices in some cases. Take, for example, a company like Coca-Cola, which happens to be an investee of Warren Buffett. Such companies that are crucially integral to their industries are well suited to our qualitative screening. Even laymen can identify such companies.

Horie: To change the topic slightly, in recent years many asset managers, mainly major firms, are offering highly concentrated Japanese equity funds. How do you differ from other managers?

Okuno: I believe that we differ from other funds in our initial approach. My understanding is that other funds derive their returns from trading. If you trade on a daily basis, you become a day trader. I am not sure how long other funds hold stocks, whether it is three months or a year on average. In any case, they generate returns by buying low and selling high. They buy stocks with the intention of selling them. If they do not sell, they have failed. If a stock reaches its target valuation early, they have succeeded.

In contrast, we want to buy only companies that we will never need to sell. We sell only when we have erred in the three-step analysis that I mentioned earlier.

That is why our investment project is called the Long-Term Concentrated Portfolio Management Division, not the Equity Investment Division.

The source of our returns is sustained appreciation in the value of our investee companies. We analyse Japanese companies as comparing of their competitiveness and valuation with global top competitors and invest in only companies which can compete for top positions in industries. In this sense, we are not targeting Japanese stocks from the outset but just some excellent companies happen to be listed in Japan.

Horie: If that is the case, wouldn't it make more sense for clients to award Japanese equity investment mandates not to Japanese asset managers but to foreign asset managers that analyze industries and compare companies from a global perspective?

Okuno: There are many Japanese who speak English and are able to analyze foreign companies. Overseas, however, few can speak Japanese. Japan is quite idiosyncratic. In some respects, foreigners cannot communicate fully with Japanese unless they understand the Japanese language.

With stocks, first-hand familiarity is another issue in addition to the language barrier. For example, can someone who has never used an Omron thermometer really evaluate Omron?

Of course, I believe that great companies absolutely share common DNA no matter what their nationality is. Irrespective of language, I think it is possible to pick stocks based on this DNA shared by all great companies.

However, being Japanese, I believe that no one is better at selecting Japanese companies than we are.

Future outlook for concentrated investment

Horie: So is it a good idea to build a competitive advantage in investing mainly in Japanese companies?

Okuno: That is the fast track to success in my opinion. There are plenty of foreign investors who want to buy and hold Japanese companies on a long-term basis. Compared to Japanese, foreign investors are more familiar with the Warren Buffett approach that we use.

I think they are mystified by the TOPIX's poor performance. In fact, some stocks listed on Tokyo Stock Exchange's First Section have achieved long-term stable gains and surpassed the peak reached before Global Financial Crisis. If you analyze such Japanese companies' competitive advantages and compare valuations globally, their share price performance is not far behind that of their overseas rivals. I would not at all be surprised if such companies deliver returns on a par with the S&P 500.

Horie: In other words, the argument that Japanese stocks are losers because the broad market indexes such as the Nikkei 225 or TOPIX have performed poorly is completely meaningless.

Okuno: Exactly. Whether a company is a global or domestic company, what is important is its ability to generate strong cash flows. Whether its stock is listed on a stock exchange is in fact irrelevant.

Horie: Even if a company has positive cash flow, equity investors tend to care about how much of that cash flow is distributed to shareholders at the discretion of management or the board of directors. What is your view on this issue?

Okuno: This may be another of Warren Buffett's sayings, but I believe that honest management is important. From a long-term investor's standpoint, there is absolutely no problem if a company does not distribute cash to shareholders, as long as it does not squander the money. If a company is truly great, I would rather see it heavily invest its cash flows than pay dividends. Dividends are taxable.

Horie: So you invest with confidence in investee companies' ability to generate strong cash flows in excess of dividend payouts.

Okuno: In Japan, the winners and losers among industries and companies are becoming increasingly apparent. In such an environment, our investment style works extremely well. In Japan, various industries have been shrinking for the past 20 years. Going forward, the same thing could happen in other developed countries in Europe and the us. I believe such an investment style will work even better in the future.

Horie: This investment style should remain effective for a long time.

Okuno: I expect it to gain further momentum globally going forward.

From such a perspective, the investment method we are using may be ahead of its time globally, given that no other economies are shrinking like Japan.

When we first adopted this investment style three or four years ago, some of Japanese investors were almost questioning my sanity, but today it is well accepted. I expect the same thing to happen in European and US equity markets in three years. When it does, I believe that we will have a big competitive advantage if we are the only asset management firm in Japan able to offer this investment style.

Horie: Thank you for a very interesting discussion.

about NRI

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