

JULY 11 | 1:00 PM EST

CAPITALIZING ON JAPAN:

WITH DAVID SALEM & ANDREW MCDERMOTT



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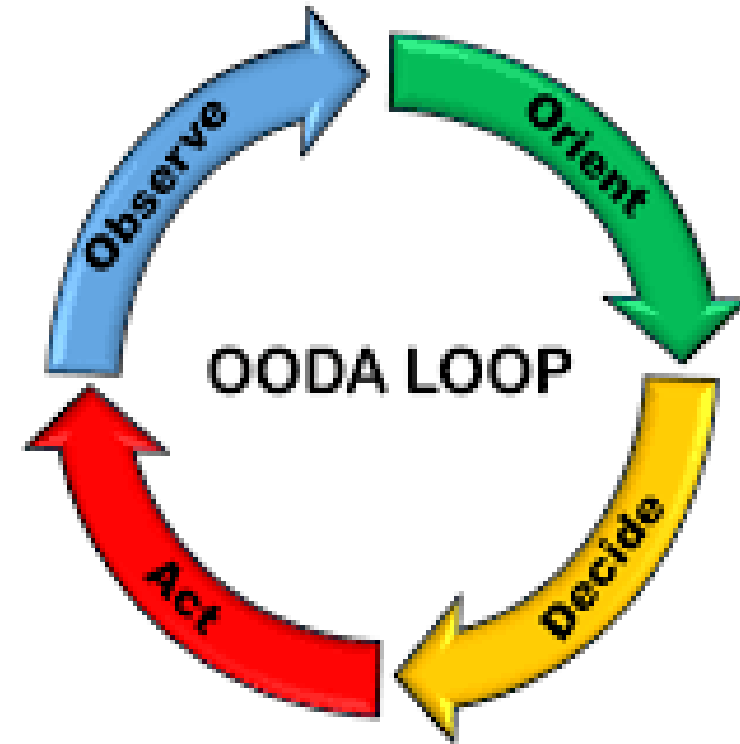
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A Real Conversation with Andrew McDermott

HEDGEYE

July 11, 2023

- Andrew's Capsule Bio
- Case Study in Capital Allocation #1: Berkshire
- Case Study in Capital Allocation #2: Intel
- Japan's Evolving Capacity to Make, Protect & Teach
 - Real vs. Financial Engineering
 - Atoms vs. Bits and Bytes
 - Comparative Pay Practices
 - Japan's Nuclear Power Assets
 - Japan's Growing Role in Constraining China
 - Japanese Firms' Growing Presence in the Southeastern US
- China's Evolving Role in Global Affairs
 - Chinese Economic Gains from Deng to Xi
 - China's Ascendancy in Academe and Boardrooms
 - China's "Investibility" in 2023 and Beyond
- The Business of Managing Other People's Money
 - "Sharpe World" and Related Concerns
- Citizenship in a Capitalist Democracy (h/t TR)



Capital Allocation @ Hedgeye

Narratives in Action: Japan, China, and...Nashville?

March 30, 1981



May 29, 2023



Investment Policy at BRK

- My interest in Japan is primarily in buying a significant business that meets the same standards we have for American purchases.

Warren Buffett, Dec. 9 2011

BERKSHIRE HATHAWAY INC.

ACQUISITION CRITERIA

We are eager to hear *from principals or their representatives* about businesses that meet all of the following criteria:

1. Large purchases (at least \$50 million of before-tax earnings),
2. Demonstrated consistent earning power (future projections are of no interest to us, nor are "turnaround" situations),
3. Businesses earning good returns on equity while employing little or no debt,
4. Management in place (we can't supply it),
5. Simple businesses (if there's lots of technology, we won't understand it),
6. An offering price (we don't want to waste our time or that of the seller by talking, even preliminarily, about a transaction when price is unknown).

The larger the company, the greater will be our interest: We would like to make an acquisition in the \$5-20 billion range. *We are not interested, however, in receiving suggestions about purchases we might make in the general stock market.*

We will not engage in unfriendly takeovers. We can promise complete confidentiality and a very fast answer -- customarily within five minutes -- as to whether we're interested. We prefer to buy for cash, but will consider issuing stock when we receive as much in intrinsic business value as we give.

Charlie and I frequently get approached about acquisitions that don't come close to meeting our tests: We've found that if you advertise an interest in buying collies, a lot of people will call hoping to sell you their cocker spaniels. A line from a country song expresses our feeling about new ventures, turnarounds, or auction-like sales: "When the phone don't ring, you'll know it's me."

What changed at Berkshire?

1998

Question: What about Japan? Your thoughts about Japan?

Buffett: My thoughts about Japan? I am not a macro guy. Now I say to myself *Berkshire Hathaway* can borrow money in Japan for 10 years at one percent. One percent! I say gee, I took *Graham's* class 45 years ago and I have been working hard at this all my life maybe I can earn more than 1% annually, it doesn't seem impossible. I wouldn't want to get involved in currency risk, so it would have to be Yen-denominated. I would have to be in Japanese Real Estate or Japanese companies or something of the sort and all I have to do is beat one percent. That is all the money is going to cost me and I can get it for 10 years. So far I haven't found anything. It is kind of interesting. The Japanese businesses earn very low returns on equity - 4% to 5% - 6% on equity and it is very hard to earn a lot as an investor when the business you are in doesn't earn very much money.

But time is the friend of the wonderful business; it is the enemy of the lousy business. If you are in a lousy business for a long time, you will get a lousy result even if you buy it cheap. If you are in a wonderful business for a long time, even if you pay a little bit too much going in you will get a wonderful result if you stay in a long time.

I find very few wonderful businesses in Japan at present. They may change the culture in some way so that management gets more share holder responsive over there and stock returns are higher. At the present time you will find a lot of low return businesses and that was true even when the Japanese economy was booming. It is amazing; they had an

incredible market without incredible companies. They were incredible in terms of doing a lot of business, but they were not incredible in terms of the return on equity that they achieved and that has finally caught up with them. So we have so far done nothing there. But as long as money is 1% there, we will keep looking.

2021

It's good to hear from you and to get an update on Japan. Our investing approach there is to be completely passive, but to respond to any ideas initiated by the five companies in which we've invested. They have all reached out, and my guess is that over the years something will materialize. We will avoid, however, proclaiming on anything Japanese, giving interviews to Japanese journalists, etc.

We want it clear that we are investors only and have not committed our funds to Japan with the idea of telling their government, their investors, their people or the CEOs of our investees what to do. I hope over time to build trust and a solid relationship, so that when a Japanese company – particularly one of our five – is looking to do something and is open to an investor from outside Japan, they think of Berkshire.

Has Buffett Lost His Mind?

FT, 9/20

[Buffett's] sudden, seemingly contrarian, interest deserves the attention of an investment community that has long shunned the world's third largest stock exchange. Foreign investors have been net sellers of Japan for almost five years, and remain underweight in global portfolios. Flows in and out of Japanese stocks, over the past couple of decades, are frustratingly uncorrelated with profits. Japan's pernicious "three Ds" (deflation, demographics and debt) have made it, for many global portfolio managers, **the place they can afford to ignore: you can be wrong, and still not lose your job.**

...

Source: FT, Forbes, highlight by MVP.

[continued] ... Yet by investing in Japan even as its Abenomics narrative evaporates, Mr Buffett is making a statement, as a value investor, about the US domestic market and the extremity of its current profile. He has chosen to make his statement using the most visible antithesis of that market: cash-rich, high-yielding, undervalued and unloved Japanese equities. Investors hungry for new opportunities will be hoping Mr Buffett is arriving early to a new trade, not late to an old one.

Forbes 9/20

Is this, once again, an expression of his enigmatic genius which will in due time show itself to have been a brilliant move? – or is he finally losing his touch? Does his "value" strategy still work?

Berkshire: 2023

Morning Session - 2023 Meeting

23. Why Buffett invested billions in Japanese 'trading houses'

"Really wonderful partners. I don't have to do anything," the 92-year-old renowned investor, known as "the Oracle of Omaha," said.

- ▶ I'd also highlight the five meetings we had were really quite remarkable. I mean, these companies, the culture and the history around it, and how proud they are, you know, there's just moments of learning from them. So, it was just a great experience to spend really two days with the five companies.

Morning Session - 2023 Meeting

26. 'I feel better about the capital we've deployed in Japan than Taiwan'

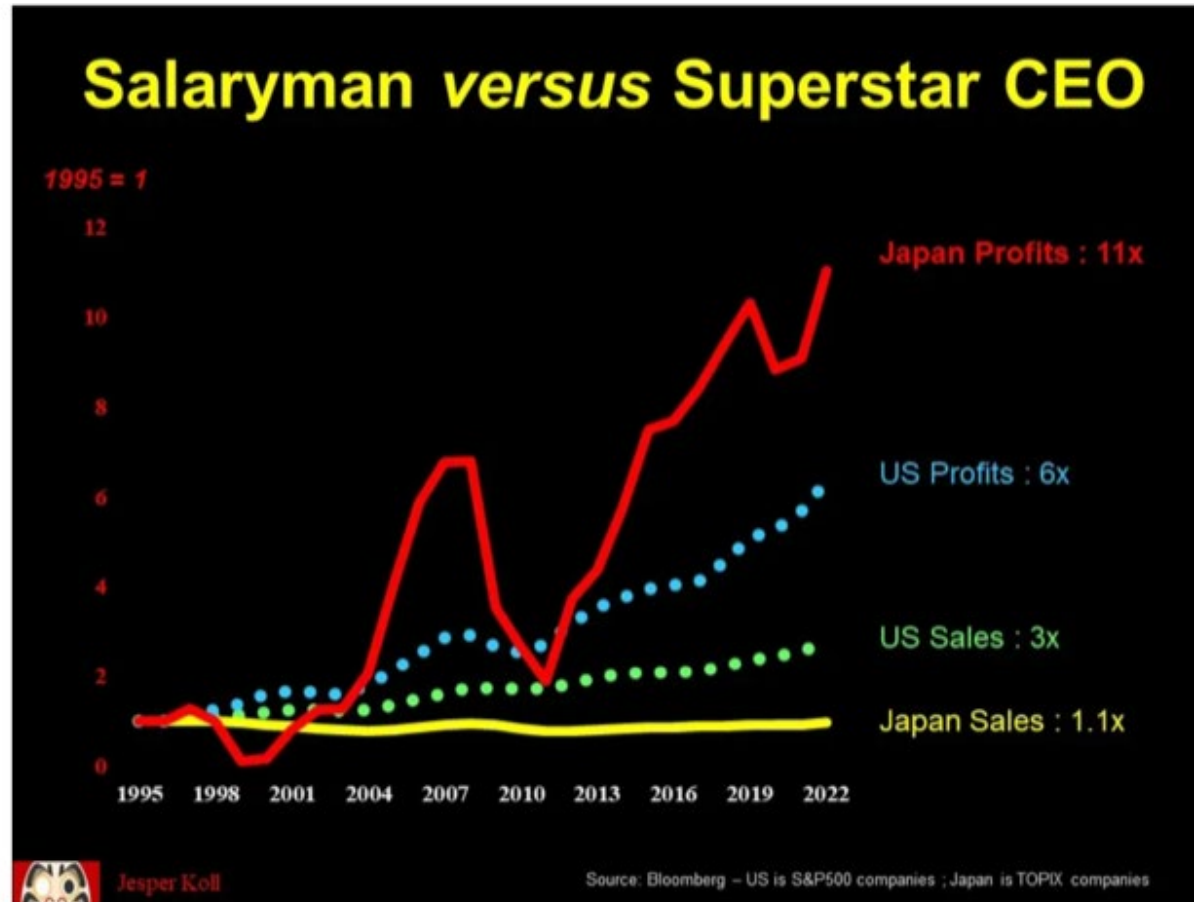
... But marvelous people and marvelous competitive position and everything, I'd rather find it in the United States. I feel better about the capital that we've got deployed in Japan than Taiwan. I wish it weren't so, but I think that's the reality. And I've reevaluated that in the light of certain things that were going on. Charlie?

CHARLIE MUNGER: Well, my view is that Warren ought to feel comfortable if he wants to. (Laughter)

WARREN BUFFETT: Yeah, yeah. Put that in the minutes. (Laughter)

Source: CNBC Warren Buffett Archives, MVP.

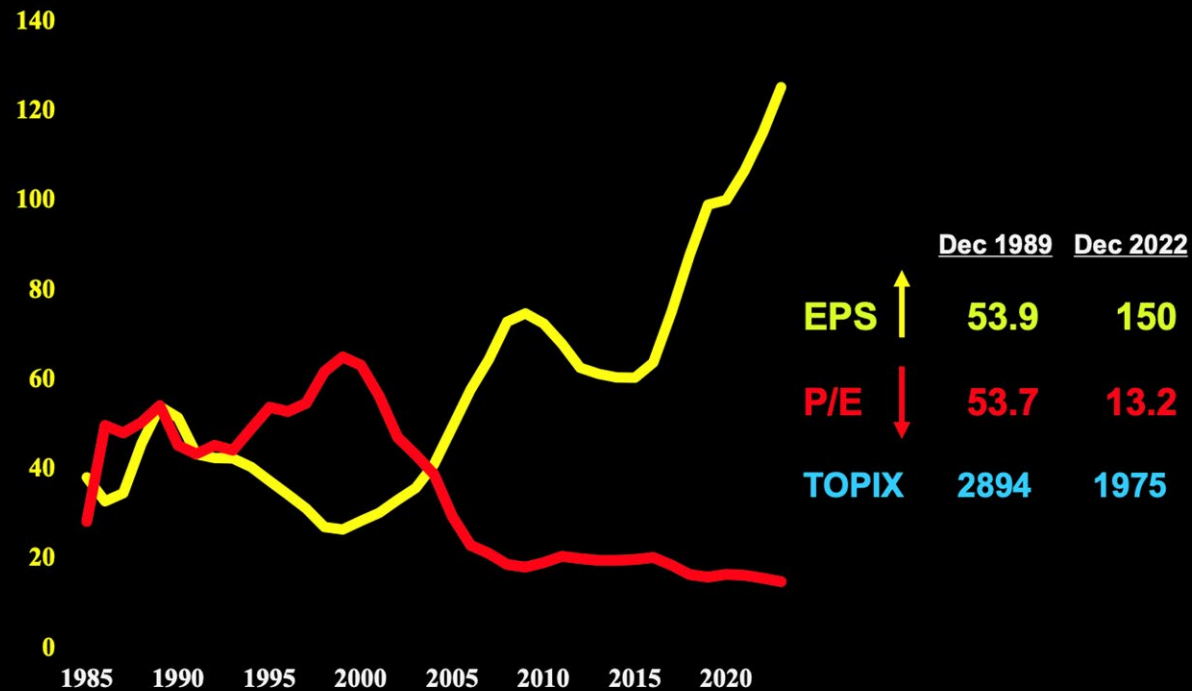
Salaryman versus Superstar CEO



Source: Japan Optimist, Bloomberg. US= S&P 500 companies. Japan: TOPIX companies.

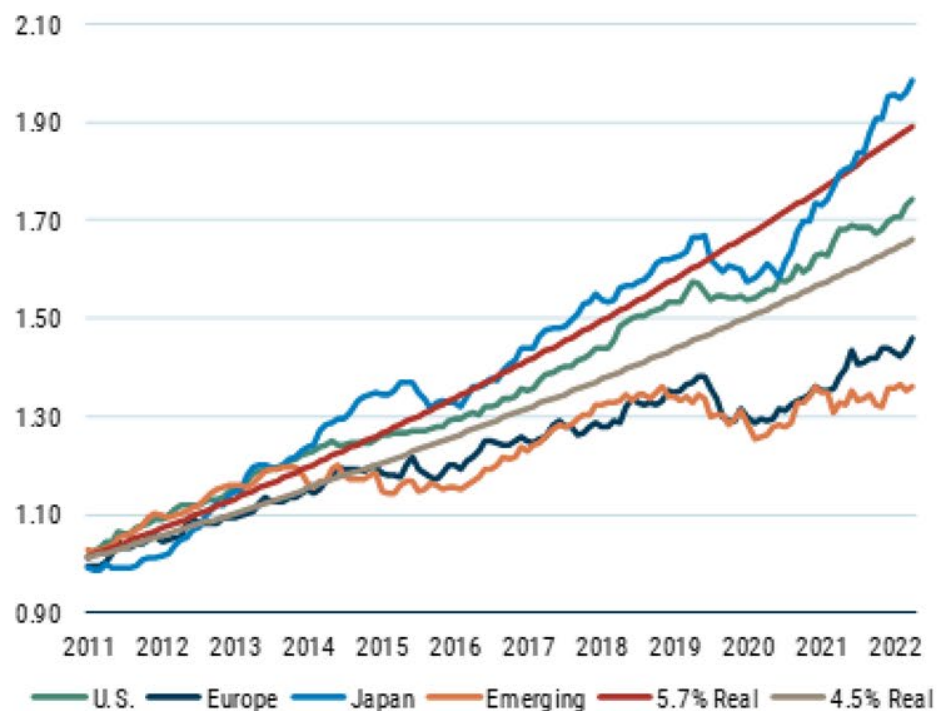
Profits UP, Valuation DOWN

Story of my Life -- Profits UP, Valuation DOWN

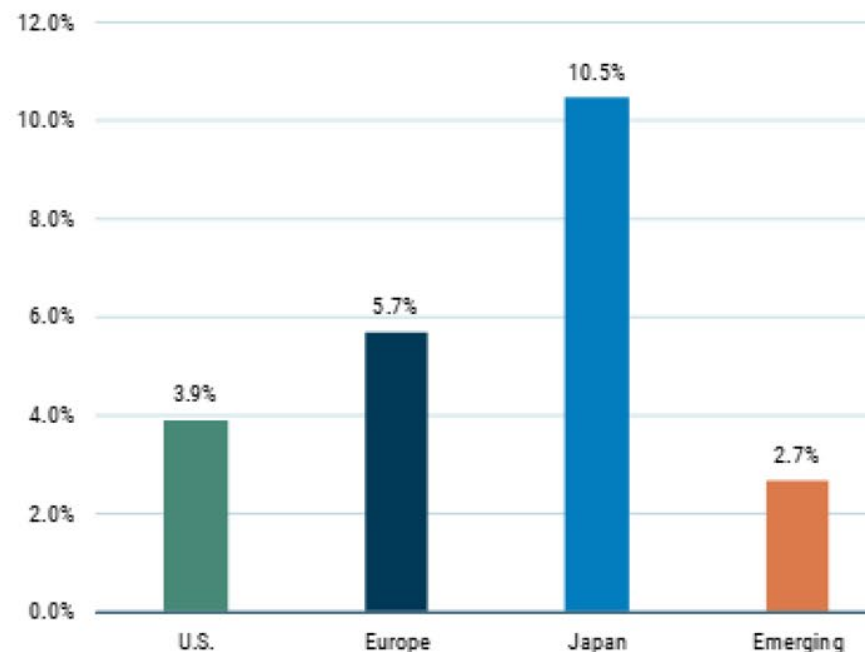


Japan fundamental outperformance

TRAILING 10 YEARS



TRAILING YEAR

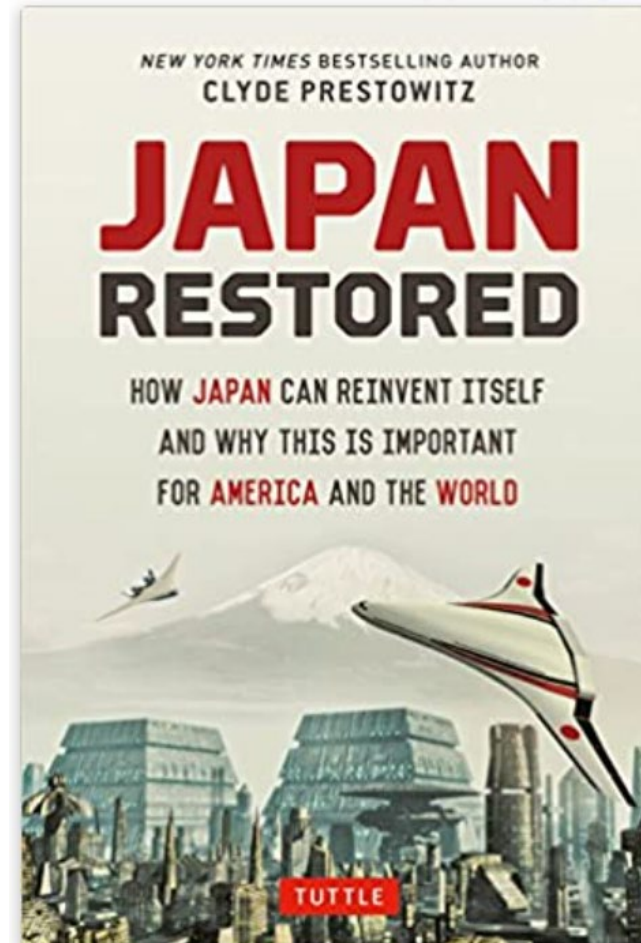
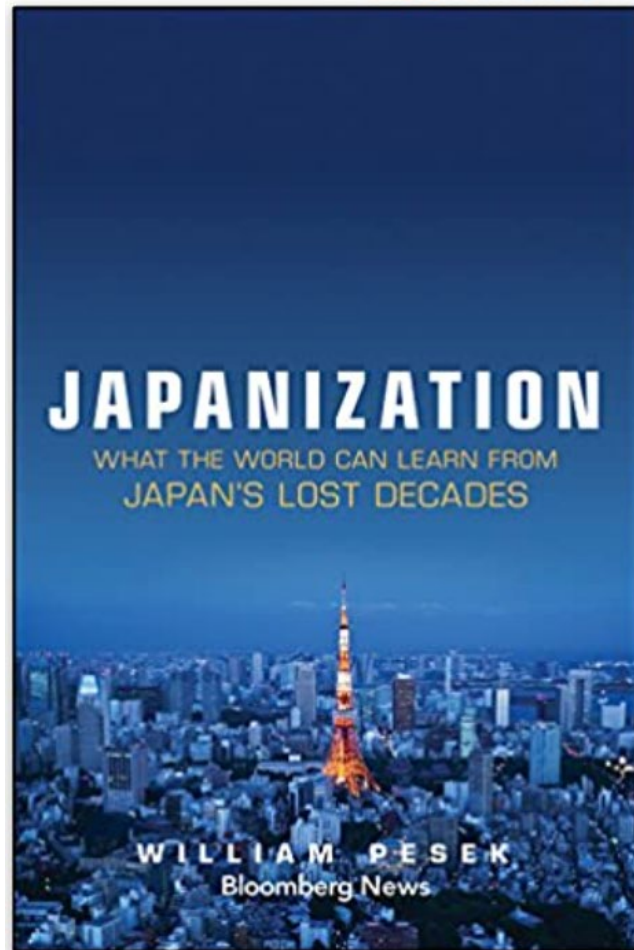


As of 3/31/23 | Source: GMO, MSCI

Data shows total return exclusive of valuation change. Valuation is a blend of price to sales, gross profits, book value, and smoothed earnings. Book value and smoothed earnings make use of GMO's proprietary accounting values.

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Narratives in Action: Japan, China, and...Nashville?



Make, Protect, Teach

- Japan still makes things
 - 36% of 777, sole source for key materials
 - 96 key iPhone factories (2x US)
 - 25% of global shipping production,
 - 2x US score in Hamilton index of Advanced Manufacturing
 - Nuclear power plants, high-speed trains, semiconductors, robots, cars, batteries

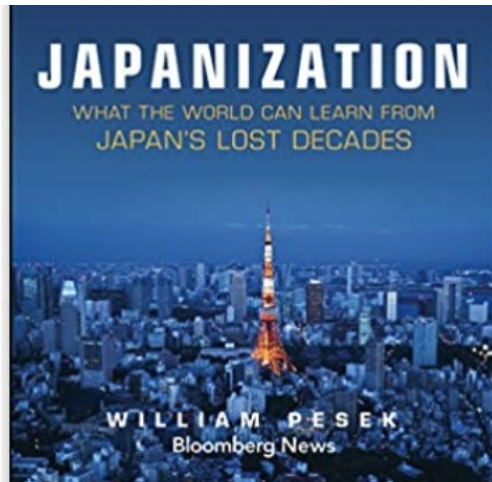
Make, Protect, Teach

- Japan protects us
 - Base of 7th Fleet
 - Borders China, N. Korea, Russia
 - Secures critical North Asia trade route
 - Provides diplomatic counterweight to China in Asia
 - Exemplifies benefits of moving from militaristic autocracy to liberal democracy in partnership with USA

Make, Protect, Teach

- Japan can teach us
 - That markets can heal themselves without PE
 - That engineers can lead without MBAs
 - That capitalism doesn't have to hollow out communities, even when recovering from a bust
 - That we can still make things
 - Japan has added 1mm manufacturing jobs in the US even as US companies have sent over 5mm overseas
 - Japan has confidence in our ability to recover our past

Narrative in motion



The Big Read Food security

+ Add to myFT

Can Japan feed itself?

Without immediate agricultural reforms, the country is vulnerable to an intensifying global food crisis

Japan was the future but it's stuck in the past

🕒 20 January

Narrative in motion

ECONOMY | THE OUTLOOK

In Contrast to China, Japan at G-7 Basks in Newfound Appeal to Companies

Tokyo can boast of political stability and improving economic dynamism, though longer-term challenges remain

OPINION | GLOBAL VIEW

As G-7 Host, Japan Schools the World

Amid challenges from Russia and China, the Indo-Pacific has replaced Europe as the central theater of global politics.

MAY 19 2023



Japanese economy

How Japan got its swagger back

Helped by an escape from decades of deflation, the stock market is at a 33-year high and the economy rebounding. But can this rally last?

But not for most investors

“I think Japan is highly underrated. It’s almost like everybody decided that Japan sucks coming out of what they had done years ago, and everyone ignores it. Any time I write anything about Japan nobody pays any attention to it; nobody wants to talk about Japan. It seems much better priced to me than the US”

- Bridgewater Associates Co-CIO Karen Karniol, at May 2023 Sohn Investment Conference

“There was no Japan discussion! I am not sure the word was mentioned by any speaker or questioner.”

- Attendee, London Value Investor Conference, May, 2023

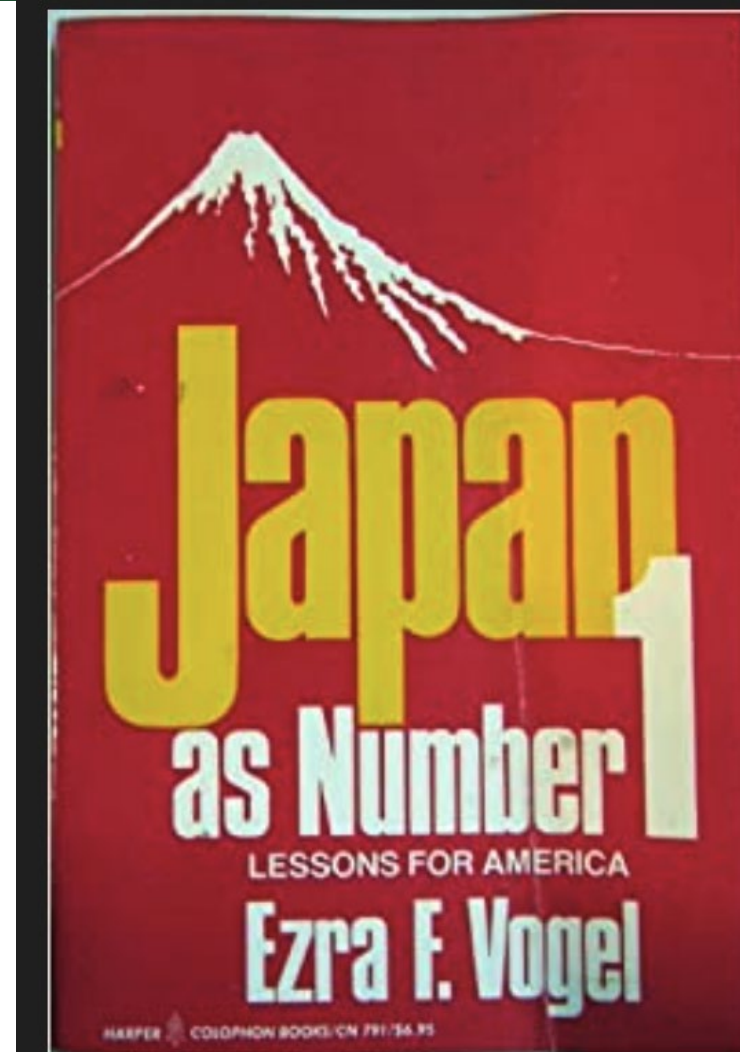
Same ol' river, same ol' sea

Table 3.2 Templeton Growth Fund Weightings

Source: Templeton Growth Fund annual reports. MSCI World index from 1974 only: previously, author calculations.
Compared to the World Equity Index

Equities as % of total	79%	100%	97%	63%	75%	88%	85%	94%	80%
Growth Fund	1955	1959	1964	1969	1974	1979	1984	1989	1994
North America	66%	69%	51%	16%	26%	76%	65%	55%	36%
South America	0%	0%	0%	0%	0%	0%	0%	0%	3%
Europe	12%	29%	43%	26%	5%	4%	12%	24%	28%
Asia Pacific	0%	2%	3%	4%	0%	3%	4%	15%	12%
Japan	0%	0%	0%	18%	44%	5%	4%	0%	1%
Total	79%	100%	97%	63%	75%	88%	85%	94%	80%
World Equity Index	1955	1959	1964	1969	1974	1979	1984	1989	1994
North America	76%	78%	77%	77%	61%	54%	57%	33%	39%
South America	0%	0%	0%	0%	0%	0%	0%	0%	0%
Europe	21%	18%	19%	18%	24%	26%	18%	24%	27%
Asia Pacific	1%	1%	2%	2%	2%	4%	3%	3%	6%
Japan	1%	2%	2%	3%	12%	15%	21%	40%	28%
Total	100%	100%	100%	100%	100%	100%	100%	100%	100%

Source: *Templeton's Way With Money*, Alasdair Nairn, 2012.



The China Factor

China accounted for almost half of the \$34bn inflows into emerging markets more broadly, according to EPFR. Frank Brochin, senior portfolio manager at The Colony Group, a US wealth manager, said “to some extent investors are realising that China is investable again”.

Source: Financial Times 4/8/23

US investors increase investments in foreign equities

Lengthy streak of underperformance and concerns over economic outlook leads asset managers to diversify portfolios

The Big Read

Opec’s gamble: can the global economy cope with higher oil prices?



Taiwan

China launches military drills around Taiwan after Tsai’s



News in-depth US

economy
US data raises hopes Fed’s efforts to curb

China: A Rock and A Hard Place?

NATIONAL SECURITY

The China Hawk in Washington Rattling Corporate Boardrooms

Republican Rep. Mike Gallagher aims to counter Beijing by telling 'American companies to act like American companies'

Rep. Mike Gallagher proposes a U.S. pullback from China that would redefine the globally critical relationship between the two superpowers. ALEX WROBLEWSKI FOR THE WALL STREET JOURNAL

Navigating China Beyond the Reopening

Mar 6, 2023 | **Systematic Investing**

China's reopening and regulatory pivot marks a shift to a pro-growth policy era. What is the economic growth outlook for China beyond the reopening?

Investing in China

BlackRock

Investment in China is becoming more crucial as foreign investors often struggle accessing onshore markets. Know about this growing economy with BlackRock.

Who goes where?

"A simple way to take measure of a country is to look at how many want in.. And how many want out."

Tony Blair

"Japan is a place we fly over on the way to China"

PE executive at 2010 Investment Conference

Travel tells a story

BUSINESS / CORPORATE

The inside story of Buffett's big Japan bet, over glasses of Coke at Four Seasons



Legendary investor Warren Buffett was on a trip to Tokyo last month for a meeting with executives of Japanese trading companies in which he is raising his stakes. | BLOOMBERG

Source: Japan Times, Wall Street Journal, The Mainichi

CHINA ECONOMY

JPMorgan's Dimon reportedly making first mainland China visit in four years

PUBLISHED FRI, MAY 5 2023 4:08 AM EDT

Late in March, a flurry of top financial executives visited China for the first time since the Covid pandemic, as global financial giants seek to cement ties with Beijing at the start of President Xi Jinping's new term.

[Goldman Sachs](#) CEO David Solomon, [HSBC](#) CEO Noel Quinn and [Standard Chartered](#) boss Bill Winters were among those who held face-to-face meetings with Chinese officials and regulators at the time.

Alibaba's Jack Ma joins University of Tokyo as visiting professor

May 2, 2023 (Mainichi Japan)



Jack Ma. (Photo courtesy of the University of Tokyo)(Kyodo)

TOKYO (Kyodo) -- Jack Ma, the founder of Chinese e-commerce giant Alibaba Group Holding Ltd., has joined a research institute of the University of Tokyo as a visiting professor, the university said Monday.

The announcement came as the entrepreneur has kept a low profile for a few years since criticizing Chinese financial authorities in October 2020, after



Hope: Our Better Angels



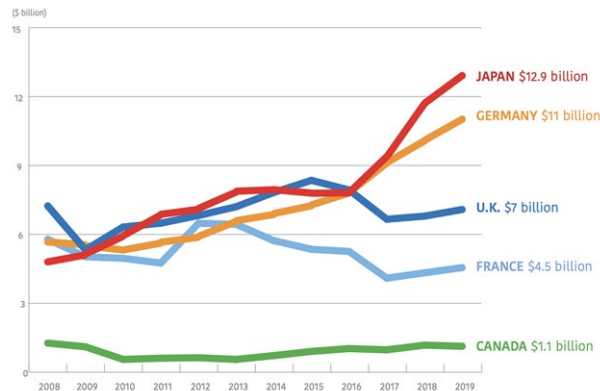
Japan as No.1 partner to the US

Comparison of Top U.S. Foreign Investors

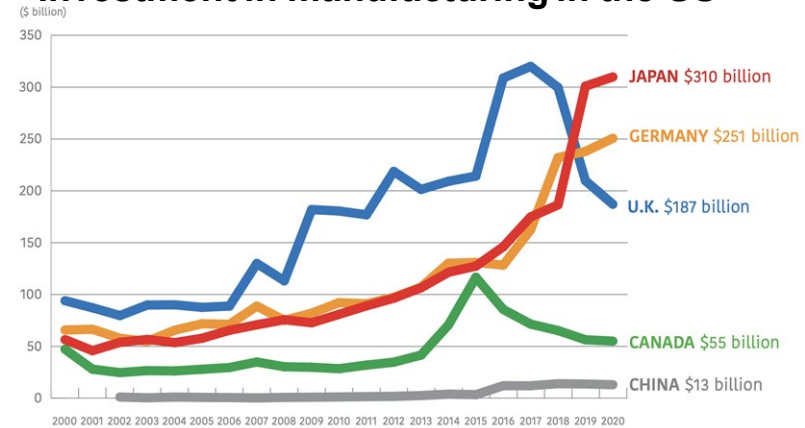
FDI Ranking	Japan #1	Canada #2	Germany #3	U.K. #4
FDI Total (2020)	\$679.0 billion	\$580 billion	\$521.9 billion	\$446 billion
Manufacturing Jobs	527,500	130,000	307,400	265,700
R&D Investment	\$12.9 billion	\$1.1 billion	\$11.0 billion	\$7.1 billion
U.S. Exports	\$82.3 billion	\$16 billion	\$47.2 billion	\$52.3 billion
Top 6 Industry Sectors	1. Auto Components 2. Industrial Equipment 3. Plastics 4. Automotive OEM 5. Software & IT Services 6. Metals	1. Software & IT Services 2. Financial Services 3. Business Services 4. Real Estate 5. Industrial Equipment 6. Food & Beverages	1. Industrial Equipment 2. Software & IT Services 3. Auto Components 4. Transportation 5. Chemicals 6. Plastics	1. Business Services 2. Software & IT Services 3. Financial Services 4. Communications 5. Industrial Equipment 6. Transportation

Japan is:
 #1 in Total Foreign Direct Investment in the U.S.
 #1 in Creation of Manufacturing Jobs in the U.S.
 #1 in Total R&D Spending in the U.S.
 #1 in Total Value of Merchandise Exports from the U.S.

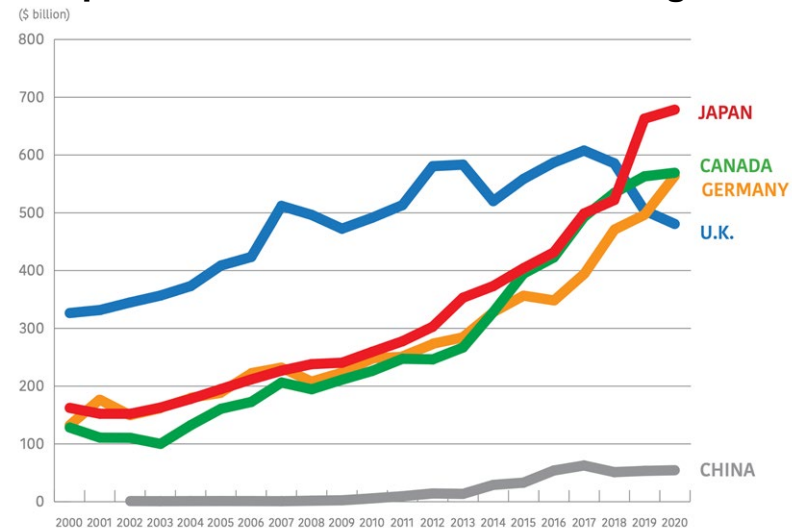
Japanese R&D spending



Investment in manufacturing in the US

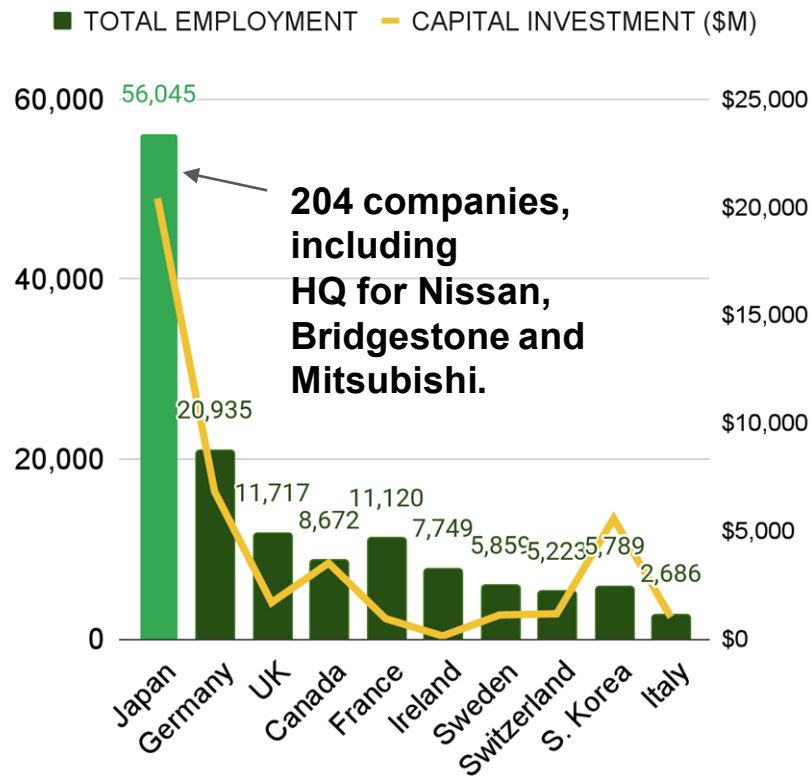


Japanese FDI in the US at record highs



Japan / Tennessee connection

Tennessee FDI, Top 10 countries



Data current as of March 2023. Source: TNECD, *The Tennessean*.

Tennessee receives half its \$38.5 billion in foreign direct investment from Japan. No other country comes close, and there are more than 200 Japanese companies in the state, mainly related to the auto industry.

The recent announcement of Ford and SK Innovation coming to the Memphis Regional Megasite to produce electric trucks was preceded decades ago by Nissan's decision to build cars in Middle Tennessee and later to move its North American headquarters to the region. In 2019, Mitsubishi announced the company was moving its U.S. headquarters to the Nashville area.

On the occasion of Mitsubishi Motors headquarters relocating to Franklin, Gov. Bill Lee noted, "The reputation of Tennessee's business climate and skilled workforce has attracted countless world-class businesses to our state."

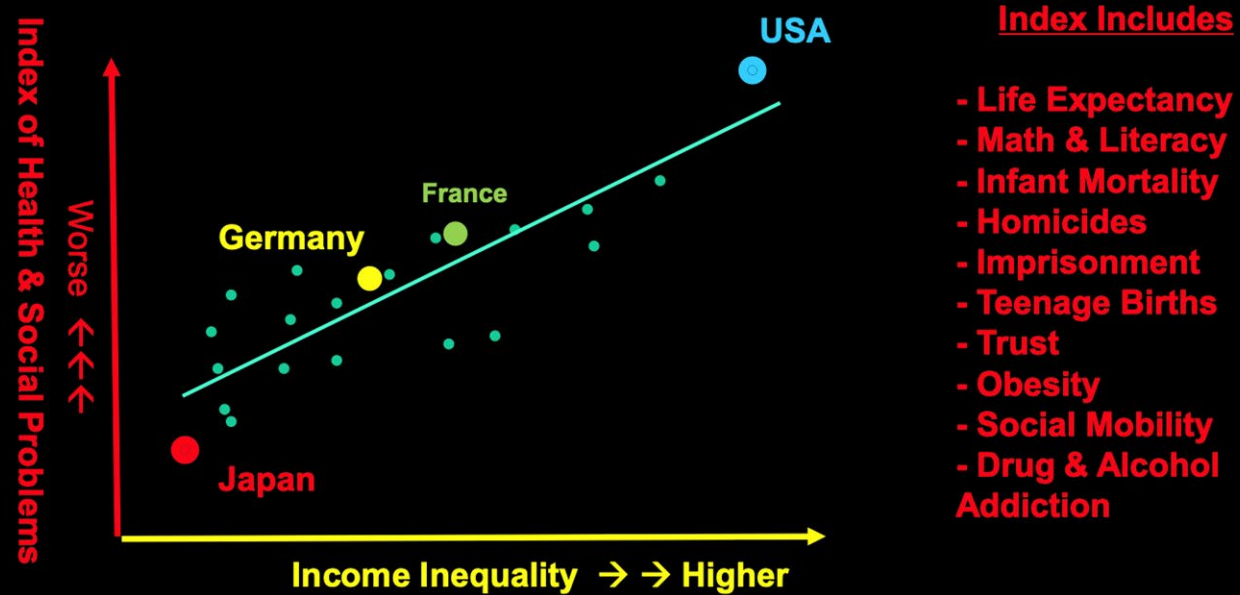
This economic climate didn't just happen. It was through the hard work of Tennessee political and business leaders decades ago to bring Japanese companies to the state.

It has been through the diligence of organizations like the State Department of Economic and Community Development, the Japan-American Society of Tennessee and the Nashville Area Chamber of Commerce that the climate endured and evolved to its current prominence in the prosperity of the state.

Source of Social Problems

Source of Social Problems

Health & Social Problems are worse in more unequal countries



Jesper Koll

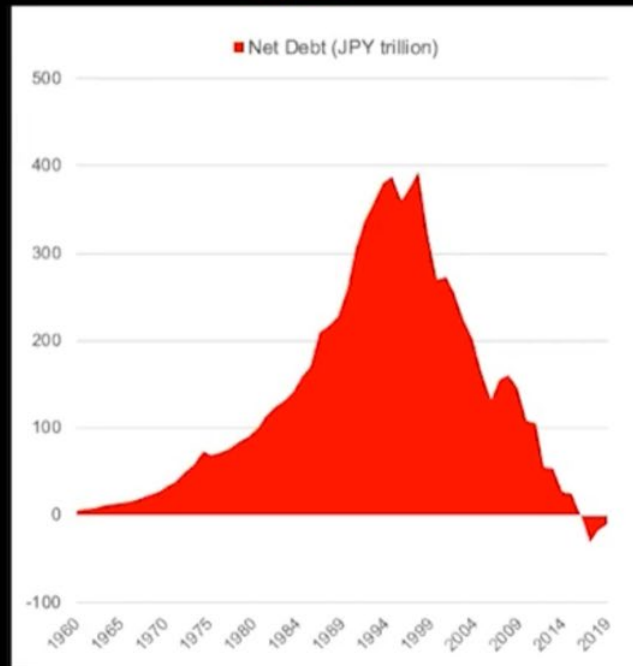
Source: Wilkinson & Pickett & The Equality Trust

Cash versus Debt

Cash versus Debt

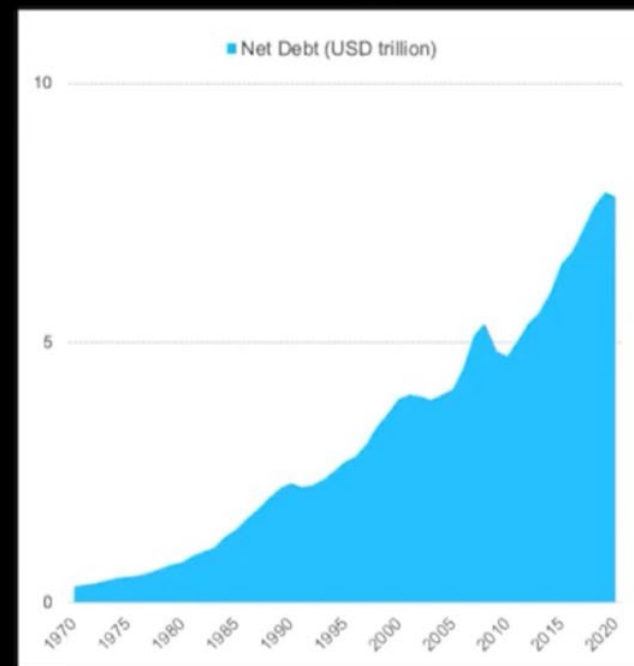
Corporate Sector Net Debt :

Japan



Jesper Koll

US



Source: MoF and Federal Reserve

Household Wealth

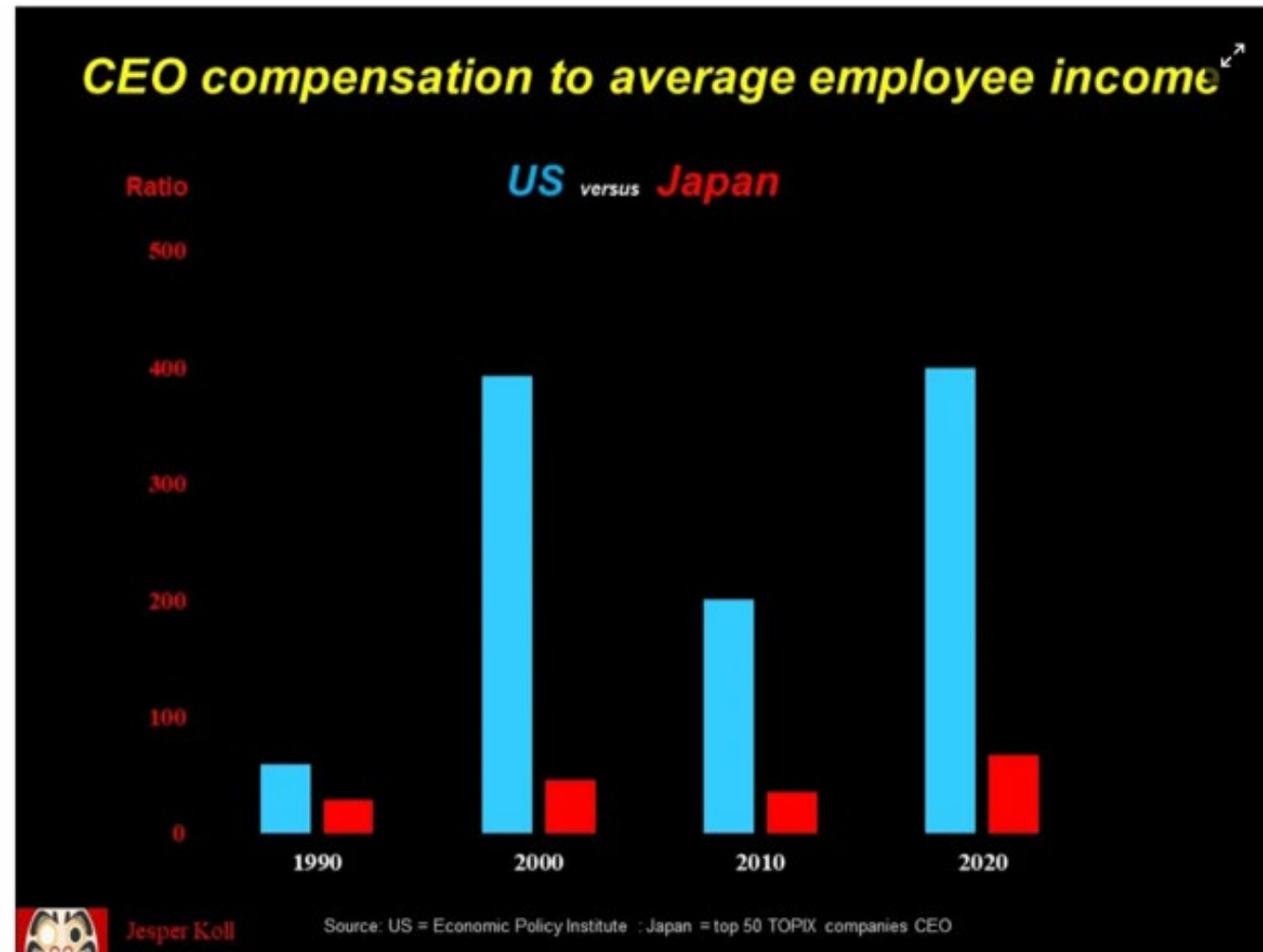
Household Wealth

Financial wealth per adult in US\$ -- Global Wealth Report 2020 Credit Suisse

	<u>Median</u>	<u>below \$10K</u>	<u>above \$1M</u>
Japan	\$123k	11.0%	3.5%
USA	\$79k	26.3%	8.8%
Germany	\$65k	10.6%	4.3%
UK	\$132k	18.0%	4.7%
Australia	\$238k	9.8%	9.4%
China	\$24k	20.1%	0.5%

Source: Credit Suisse Global Wealth Report 2020

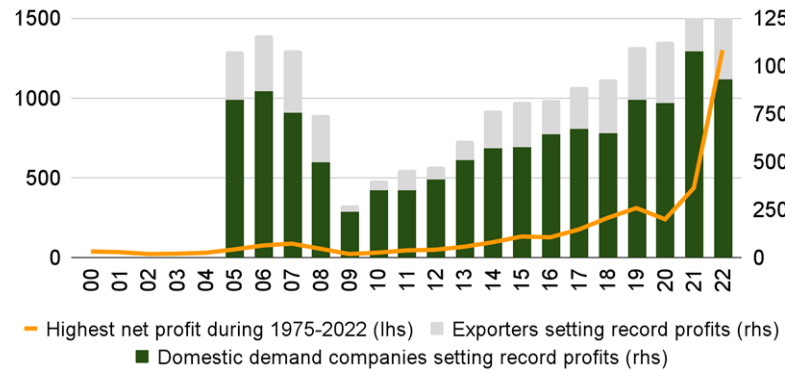
CEO compensation to average employee income



Source: Japan Optimist, US= Economic Policy Institute, Japan= Top 50 Topix companies CEO.

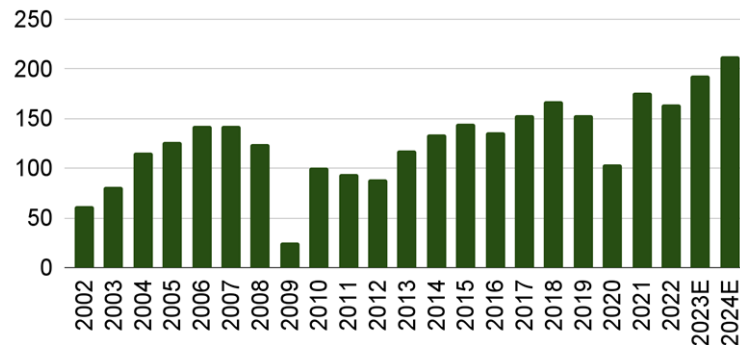
What changed in Japan? (1)

Companies reporting record high net profits were at historical highs in 2022



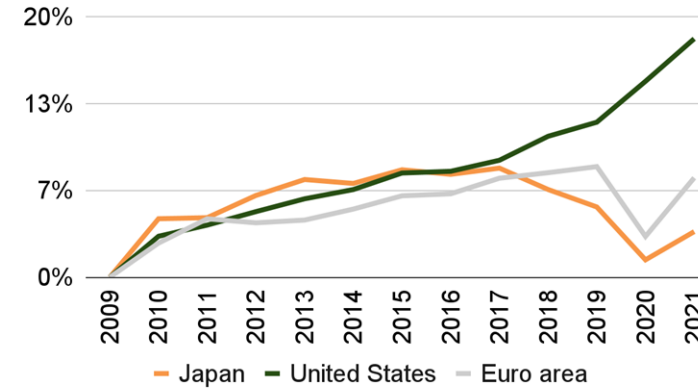
Using Nikkei Valuesearch data for FY21. Exporters as defined as companies with >20% overseas sales. Source: Toyokeizai, Shikiho, Nikkei, MVP.

TOPIX EBIT / share set record highs in CY 2021 despite COVID...



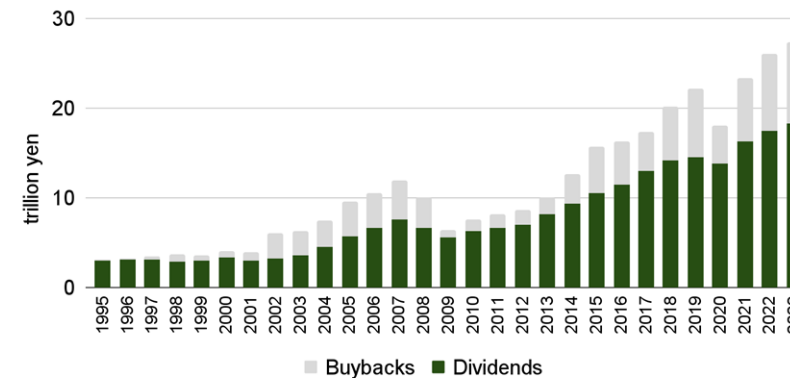
Data in CY. Source: Bloomberg

Per capita GDP growth has been healthy since 09 (Constant 2017 PPP \$, 2009=0%)



Source: World Bank, MVP.

... alongside increase in shareholder payout



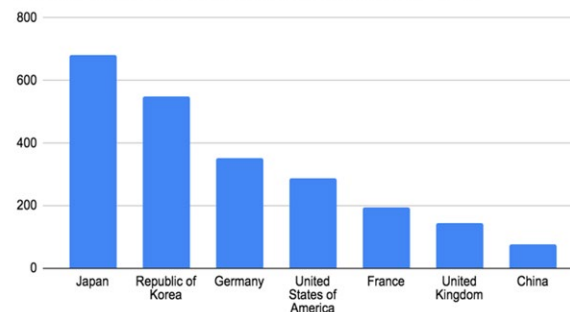
Data in FY. Source: Daiwa, MVP.

What changed in Japan? (2)

Growth in Labor Productivity			
	1995-2018	1995-2009	2010-2018
US	1.8%	3.0%	0.0%
UK	3.6	5.9	0.0
Italy	1.2	1.2	0.8
Canada	1.9	0.1	2.5
Germany	-0.7	-2.0	0.8
France	1.8	2.2	1.9
Japan	0.5	-0.5	2.2

Source: Japan Productivity Center

Patent Applications Per Capita (Working Age, 2020)



Source: Statista, FRED, WIPO. Units: Applications per million aged 15-64

Cost per year, US\$		
	1989	2020
Harvard	\$18,000	\$80,000
Keio	9,000	13,000
Tokyo University	6,000	7,500

Source: MVP, Harvard Crimson, Nippon Times

Pension assumptions: Discount rate/expected returns/comp increase*			
	Late 80s	2000s	2020
Japan			
Public (GPIF)	na/5.5%/na	na/4.5%/na	na/4(1.7real)/na
Private^	na/5.5%/na	2.0%/2.5/na	0.5% /3.0/3.4
CPI, LTM	2.60%	-2.40%	-1.30%
JGB, 10yr.	6.40%	1.32%	0.01%
US			
Public (Calpers/Pew)*	8%/8/na	8%/8/na	7%/7/na
Private (GE)	8.5%/8.5/6.5	5.8%/8.5/4.2	2.6%/6.3/3.0
CPI-U, LTM	4.8%	-0.40%	1.40%
UST, 10yr	8%	3.85%	0.93%

*For Public 89, 90: Pew (89=1992avg), 2020=Calpers.
^For Private: NTT, Hitachi, Toyota: 20F from closest year available.
All other data: Bloomberg, BLS

US Manufacturing Erosion (1)

A healthy defense industrial base is a critical element of U.S. power and the National Security Innovation Base. The ability of the military to surge in response to an emergency depends on our Nation's ability to produce needed parts and systems, healthy and secure supply chains, and a skilled U.S. workforce. The erosion of American manufacturing over the last two decades, however, has had a negative impact on these capabilities and threatens to undermine the ability of U.S. manufacturers to meet national security requirements. Today, we rely on single domestic sources for some products and foreign supply chains for others, and we face the possibility of not being able to produce specialized components for the military at home. As America's manufacturing base has weakened, so too have critical workforce skills ranging from industrial welding, to high-technology skills for cybersecurity and aerospace. Support for a vibrant domestic manufacturing sector, a solid defense industrial base, and resilient supply chains is a national priority.²⁵

The decline in the U.S. manufacturing industry, relative to prior periods of great power, creates a variety of risks for America's manufacturing and defense industrial base and, by extension, for DoD's ability to support national defense. Risks range from greater reliance on single sources, sole sources, and foreign providers to workforce gaps, product insecurity, and loss of innovation.

US Manufacturing Erosion (2)



Source: U.S. Bureau of Labor

Figure 12: A Sharp Relative Decline in Manufacturing Employment in the U.S. Economy

Japan has NOT done this ...

B. Decoupling of Design and Manufacturing

As U.S. companies lost their domestic supplier ecosystems, design decoupled from manufacturing and many firms shifted focus from designing and building products to designing and selling products. With increased offshoring of manufacturing, many companies have excised their process engineering capabilities, further reducing technical innovation and deterring future investment in next generation manufacturing.³⁷ Together, these effects jeopardize the ability of America's manufacturing base to supply innovative products and skilled workers to the industrial base, threatening capabilities needed for national security.

Machine tools are power-driven machines used to shape or form parts made of metal, plastic, or composites to support both production and prototyping operations. Critical to creating modern defense and non-defense products, machine tools impact the entire supply chain and multiple sectors. The U.S. once led the world in the innovation and capacity of its high-end machine tools sector, but U.S. standing has dropped significantly since 2000. Key changes in machine tool consumption affected global patterns of production. Until the mid-2000s, China accounted

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for no more than 15% of global machine tool consumption. By 2011, China's machine tool consumption accounted for 40% of the global total.⁴⁵ As its need for machine tools increased, China leveraged its low cost of capital and labor to build domestic machine tool factories and required foreign companies to execute joint ventures to access the Chinese market. The combined effects of the 2008 recession and a general trend of industry consolidation further reduced the number of machine tool manufacturers. In 2015, China's global machine tool production skyrocketed to \$24.7B,⁴⁶ accounting for 28% of global production,⁴⁷ while the U.S. accounted for only \$4.6B, after China, Japan, Germany, Italy, and South Korea.

These challenges to the overall manufacturing sector reduce the capability and capacity of U.S. defense production, with potential long term ramifications on the industrial base, national security, and the U.S. economy.

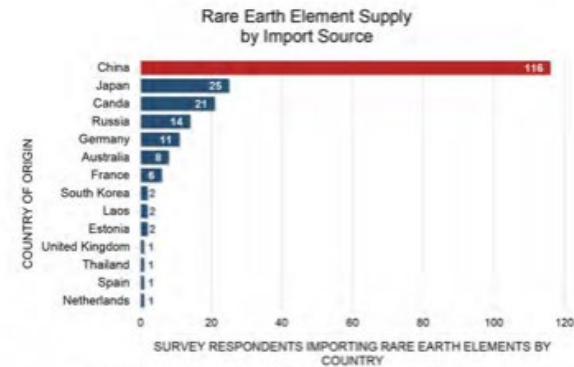
Source: DOD 2018

C. The Loss of Production of Strategic and Critical Materials

As part of the increasingly global manufacturing and defense industrial base, imports of strategic and critical materials, such as rare earths, have increased, causing a trade-off between supply dependency and lower costs. Rare earths are critical elements used across many of the major weapons systems the U.S. relies on for national security, including lasers, radar, sonar, night vision systems, missile guidance, jet engines, and even alloys for armored vehicles.³⁸ A 2016 study by the Department of Commerce's Bureau of Industry and Security reported that 66% of respondents, the majority of whom are vendors to DoD, indicated they imported rare earth or related materials.

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Source: U.S. Dept of Commerce, Bureau of Industry and Security Strategic Materials Assessment, Rare Earth Elements - 2016

Figure 14: 2016 Rare Earth Element Imports