Time To Say Goodbye …

On July 10th 2008, we launched the Pelargos Japan Alpha Fund and after 148 newsletters the time has come to wrap it up and move on. The past 13 years have been incredible in every aspect. We are extremely grateful for our clients' trust and faith in us to run a hedge fund strategy during these most challenging times. Our strategy and investment team survived longer than most in a business with high death rates. Our track record speaks for itself, however the investment flavor 'Japan' has become too niche to support our business.

A Walk Down Memory Lane

At the moment of launch, we knew that the upcoming crisis of 2008 was a defining moment in history and the future would be vastly different from the past. Mentally prepared to cope with the unknown, we had a head start in 2008 and from there onwards stumbled from one crisis into next. Capital markets are the greatest teachers of all. In 2008, US banks imploded and a global bank run was in the making. Back then, the general public was upset, disturbed, but by no means realized the immensity of the crisis. Cash was king and only a monumental shift in monetary policy could stabilize the financial system. We experienced an immense shift in central banks (CB) policies, from orthodox policy as lender of last resort, towards so called unorthodox policy. CBs became buyers of last resort, supporting risk assets with 'whatever it takes'. Whilst the US banking system was swiftly and sufficiently backstopped by the US government, the Euro zone blew-up in 2010. The bank run of 2008 was in replay mode with a run on sovereigns. Remember the PIIGS? Greece, Italy, Spain, Ireland and Portugal were on the brink of bankruptcy and as bond investors panicked the ECB had to fire 'its bazooka'. The sound money countries had already stacked up their German marks, Austrian schillings and Dutch guilders to re-introduce just in case the euro went to dust. The Swiss Central Bank (SNB) 'was forced' to peg the Swiss franc to the euro, which eventually failed and the SNB started to buy equities. As of today, the lucky Swiss are still amongst the biggest shareholders of Apple. Maybe this single trade is the best trade in financial history ever, how crazy is that?

In 2011, Japan faced a different crisis of consequential proportion. The tsunami and Fukushima nuclear incident triggered the Bank of Japan (BOJ) to start buying equities and eventually gave rise to Abenomics. Negative rates, yield curve control, CBs buying equities became the new normal and market distortion became apparent to informed investors very quickly. ETF buying on risk-off days induced a distinct momentum behavior, which was a new feature in Japan. Capital markets are social constructs and CBs engaged in hand holding to reassure investors all is well. Whilst we never believed any of these "newly found", unorthodox monetary tools will do any good, we had to acknowledge that CBs are far from poetically independent and have a distinct social utility. They are simply run for the 'greater good' of society and political context determines the extent of power CBs are granted. The ability to print-money means that CBs have unlimited balance sheets and with no funding constraints their fire power is by definition is bigger than any private capital market participant's. Therefore, the Wall Street adage 'don't fight the Fed', is as true in Japan as it is elsewhere, betting against it was a recipe for disaster. The unintended consequences are and were obvious to see. Price discovery would slowly, but surely disappear. With CBs setting the incremental cost of capital rather than educated, informed market participants, capital markets in itself became the 'greater good'.

Price discovery is the essence of capitalism, and capitalism is democracy. History has taught that only a free society that can freely interact and trade will be able to achieve common wealth in the long run.

The BOJ's interventions and the global shift to index trackers / ETFs led to socialism in capital markets. We quickly learned that debating policy effectiveness and unintended consequences are in a sense useless. The price is the price, manipulated or not, as investor you have to deal with the cards you are dealt, otherwise you will exit the 'gene pool' quickly.

With policy intervention determining the narrative and frustration exceedingly elevated, we embraced the start of the 2014 Corporate Governance Revolution in Japan and moved to a more concentrated, engagement-driven approach.

During our 13 years' stint we had 7 Japanese prime ministers, 2 Japanese central bank governors, 4 US presidents and 3 US central bankers. The past 20 months were mired by a global health pandemic, yet another defining moment in history. Nothing in investing will resemble the preceding period. Crises come and eventually go, what we have learned is that on an incremental basis tomorrow resembles yesterday, but the further out in time, the less and less it resembles the past. This is the biggest fallacy of quant and risk parity strategies. Systematic strategies rely on historic volatility and correlations. Volatility is not a measure of risk and risk is not a number. Knowing and understanding what assets and business models you own is real risk management. Correlations might hold up in the short-term, but history has shown that it will be dislocated by whatever event happens next, and nobody knows which unknown hits next. By the way, not pretending to know the future is a good thing, it makes for a humble and better investor. It forces you to think about varying outcomes and to position for it. Therefore, we never believed in portfolio optimization tools. We learned the hard way that it is not value or growth, it needs to be both. This barbell approach is the way to deal with radical uncertainty. Deep value, unloved businesses in combination with exponential disruption. Linearity combined with convexity. At the end, our fund appreciated 64% net of all fees, whilst the broader market measured by the Topix appreciated 49% over the same period, but has had more than triple the realized volatility. The long-only fund, which we only launched in February 2020, appreciated a whopping 32% during its short life of only 22 months compared to 16% for the benchmark.

Back To The Future

With equity markets hijacked as 'social utility for the greater good', we reverted back to the essence of equity investing. Quality engagement and becoming an active catalyst to enhance a company's returns on capital are the antidote to passive investing, Japanese equities are a fantastically fertile ground to deploy engagement value strategies. Assets are vastly undervalued because nobody cares. The management teams are ignorant of the respective company's share price being undervalued due to social stigma and due to lack of incentives. Occasionally board of directors are financial illiterate to an extent that they are incapable of determining the equity value of the company they manage. There are 3600+ listed companies in Japan and whilst hiding as a salaryman amongst the herd used to be safe, being singled out is the greatest nightmare of any soon-to-retire CEO.

Lessons Learnt

The corporate governance progression in Japan is for real. Since the introduction of the Stewardship Code and the increasingly stringent Corporate Governance Code we had 3 -4 corporate actions/restructurings per year, most of them buy-outs, which accounted for a reliable stream of stock specific, uncorrelated alpha. This year we were involved in take-over targets Secom Joshinetsu, Nippo, Daibiru and the three-way merger involving Maeda Road for which we already received a juicy premium in March 2020. Other ghosts of the past, which ceased to exist as listed entities, because the majority owner had chosen to bid for it were Fujitsu Frontech, Hitachi High Tech, Asunaro Aoki, Best Denki, Sammy Networks, Iida Home, Hajime Construction, etc etc. However, our initial engagement work on Heiwa Real Estate in 2016 was certainly most gratifying. The Board of Directors was so conflicted that even the FSA could not look the other way.

Knowing where to find those opportunities is one thing, but how to size these positions is even more important. Because, after all, not losing money is the most important rule in money management. Therefore, during those most turbulent times our mind space was occupied by how to cover the left tail (of the return distribution); the losses. Knowing what you own is part of risk management. Trusting the management team is risk management. However, most importantly, understanding that 'knowing' has its limitations and more often than not it's not what you do not know that gets you in trouble, but that what you believed to be true.

People Lack Imagination

If you told me in 2000, that within 8 years Lehman Brothers, Bears Stearns and many others would be gone, I would not have believed you.

If you told me in 2000, that by 2020 almost all Japanese and European sovereign debt as well as some corporate bonds would be trading at negative yields, I would have questioned your mental capacity.

If you told me in 2000, that by 2021 the BOJ owns almost half of all outstanding government debt and 10% of all outstanding equity in Japan, I would have said that's impossible.

If you told me in 2000 that Trump would be president in 2016, I would have laughed at you.

If you told me in 2000 that a former US president would not accept the election outcome and a mob would storm the US Capitol, I would have called you crazy.

If you told me in 2000 that a global pandemic would hit in 2020 and the US market rallies to new all-time highs, I would have called the ambulance and asked for medication.

If you told me in 2000 that in 2021 you have a little device called smartphone with which you have to show a QR-code in order to proof your vaccination status to enter a restaurant, I would have called you a conspiracy theorist.

This is an excellent thought experiment, because we spend too little time thinking outside the box. As such, we tend to underestimate tail risks and once they hit we tend to overestimate those that recently occurred.

There is more you do not know, than what you do know.

If you believe to know more than the market participants on the other side of the trade, make sure you know how much you are willing to loose and bet big. After all, survival rate in this business is defined by how you deal with what you do not know.

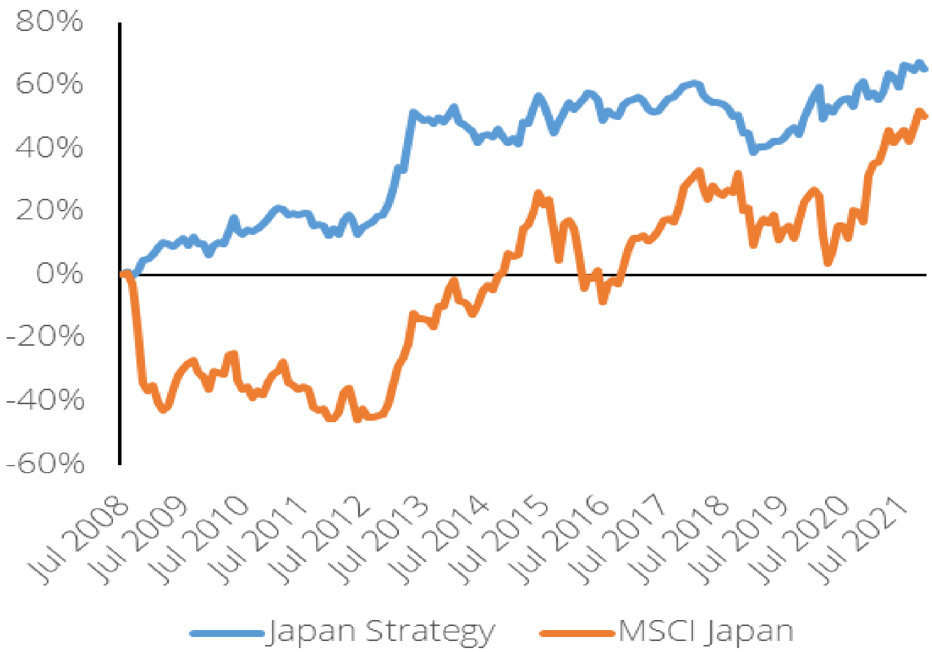
Thank you for your trust.

Have a merry Christmas and a wonderful 2022.

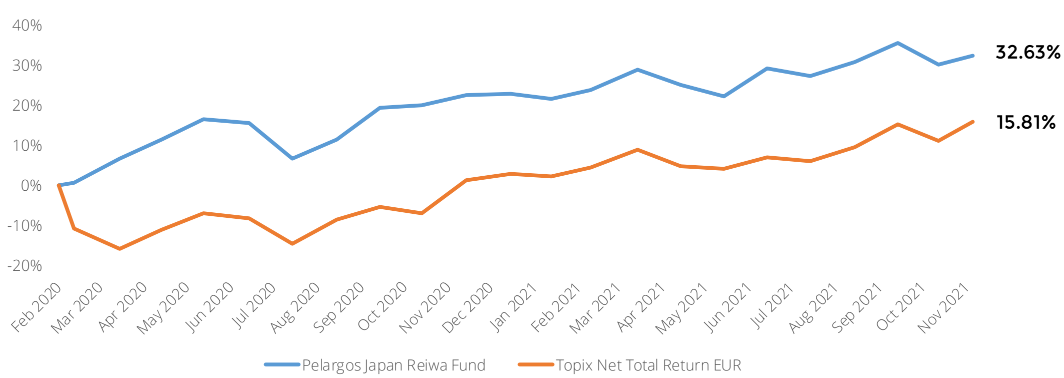
Michael Kretschmer & Richard Dingemans

Please follow us on LinkedIn. We will be publish a series of notes: www.linkedin.com/in/michaelkretschmer/

LONG-SHORT FUND



LONG-ONLY FUND



FUND PERFORMANCE LONG/SHORT

CLASS B EUR

Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD	ITD
2021	-1.38%	1.55%	3.76%	-0.97%	-1.66%	4.27%	-0.29%	-0.70%	1.54%	-1.28%	-0.67%		4.03%	64.11%
2020	1.70%	-6.30%	2.66%	-1.17%	1.80%	0.83%	0.23%	-1.54%	3.86%	1.16%	-2.95%	0.82%	0.67%	57.76%
2019	1.05%	0.00%	0.51%	0.98%	-0.04%	0.56%	1.54%	0.90%	-1.46%	3.43%	2.35%	2.34%	12.75%	56.71%
2018	-0.26%	-1.77%	-1.03%	-0.63%	-0.06%	-0.36%	-0.87%	-1.66%	0.36%	-3.69%	-0.13%	-4.14%	-13.45%	38.99%
2017	0.56%	-0.92%	-1.63%	-0.57%	0.23%	1.32%	1.18%	0.46%	0.99%	1.25%	0.20%	0.14%	3.22%	60.59%
2016	1.27%	0.92%	1.18%	-0.19%	-1.06%	-4.33%	2.12%	-1.05%	-0.29%	2.38%	1.77%	0.78%	2.07%	55.58%
2015	-1.24%	4.89%	-0.27%	3.25%	2.57%	-1.67%	-2.94%	-3.01%	2.46%	1.88%	2.06%	-1.42%	6.36%	52.42%
2014	-3.16%	-0.60%	-0.56%	-0.99%	-2.24%	1.44%	0.23%	-0.60%	2.06%	-1.89%	-1.24%	0.96%	-6.52%	43.31%
2013	5.35%	-0.58%	6.98%	6.48%	-1.07%	-0.78%	0.31%	-0.92%	1.18%	-0.80%	1.46%	1.73%	20.57%	53.31%
2012	-1.38%	3.81%	1.35%	-1.21%	-3.83%	1.76%	0.84%	0.93%	1.32%	0.58%	2.50%	4.06%	10.95%	27.15%
2011	0.93%	-0.03%	-1.55%	0.14%	-0.14%	0.42%	0.03%	-3.63%	0.69%	-0.38%	-2.60%	1.68%	-4.48%	14.60%
2010	0.73%	-0.23%	3.52%	3.69%	-3.11%	-1.31%	1.23%	-0.37%	0.91%	1.13%	1.40%	1.89%	9.67%	19.97%
2009	2.07%	1.67%	-0.73%	-0.67%	1.34%	1.13%	-1.93%	2.24%	-1.68%	-0.39%	-2.99%	2.84%	2.75%	9.40%
2008							0.96%	-1.35%	1.40%	3.44%	0.52%	1.39%	6.46%	6.46%

FUND PERFORMANCE LONG-ONLY

Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD	ITD
2021	-0.81%	1.60%	4.09%	-2.87%	-2.29%	5.72%	-1.33%	2.51%	3.74%	-4.00%	1.85%		7.98%	32.63%
2020		0.74%	5.93%	4.50%	4.60%	-0.81%	-7.66%	4.43%	7.08%	0.54%	1.97%	0.28%	22.83%	22.83%

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