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GLOBAL RESEARCH

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May 29, 2024

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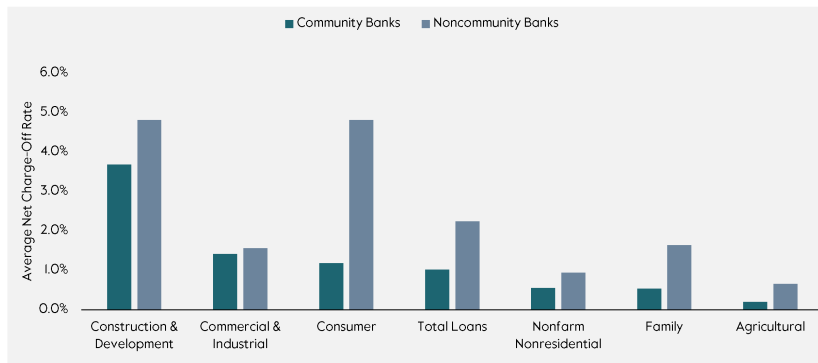
During the Global Financial Crisis (GFC), credit investors found that many securitization pools were *overdiversified*. The problem was not just inadequate information to analyze the large number of underlying mortgages, but a misapplication of "diversification" to excuse poor asset selection based on the assumption that the correlation in default intensity across credits mattered more than their individual risk-return characteristics.

Employed in this manner, "diversification" intensified rather than reduced losses. Loans originated by community banks based on specialized, local knowledge outperformed during this period (Figure I), as did commercial mortgage-backed securities (CMBS) collateralized by a single asset rather than a diversified pool of loans.

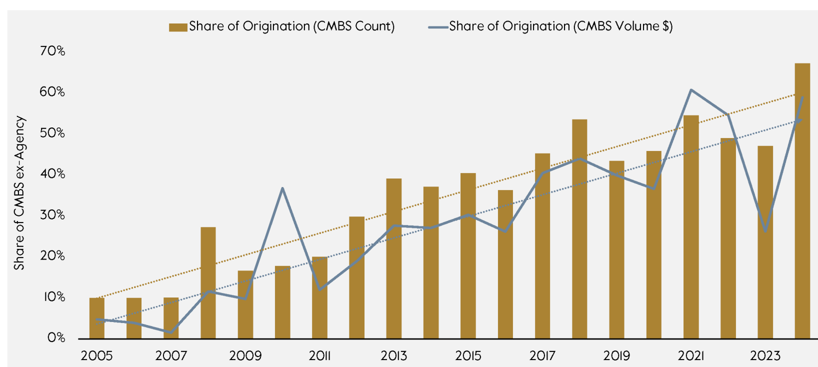
Figure 1: Average Net Charge-Off Rate, 2008-2011



Source: Carlyle Analysis; FDIC, May 2022. There is no guarantee these trends will continue.

Since the GFC, securitization markets have swung decisively towards idiosyncratic exposures. Single-asset deals now account for 60% of CMBS issuance, a 12x increase from their 5% share in the years preceding the GFC (Figure 2). Office loans account for much of this growth, typically involving well-known “trophy” properties thought to be insensitive to broader market conditions. While single-asset office deals solve the information problem presented by diffuse and often inscrutable collateral pools, they violate the basic axiom of modern portfolio theory: don’t put all your eggs in one basket.

Figure 2: Single Asset Share of CMBS Issuance



Source: Carlyle Analysis; Bloomberg, May 23, 2024. There is no guarantee any trends will continue.

Investors in the AAA tranche of the CMBS collateralized by the office property located at 1740 Broadway found this out the hard way, recently losing over 26% of their principal – an astonishing loss rate for securities with credit enhancement designed to avoid default in the most stressed hypothetical scenarios. Losses were so severe due to idiosyncratic risks related to tenant concentration and lease expiration that might have otherwise been diversified away. Sectoral diversification would have been useful here as well, as office has become much less correlated with other property types since the onset of the pandemic.

Diversification limits what we can know about each underlying asset, but this comes in exchange for some protection at the portfolio level against that which we cannot know, or reasonably anticipate. It’s one thing to learn from the mistakes of the past but quite another to drive using the rearview mirror.

Hypercompetitive Japan

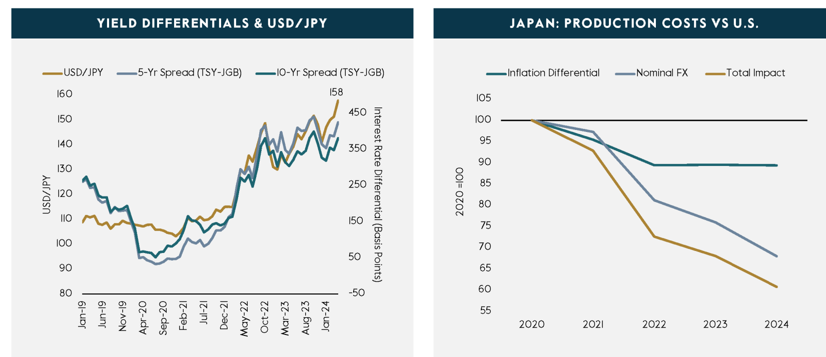
Tokyo never feels cheap. But relative prices there have declined to levels that approximate that sensation for visitors from the U.S.

Since the onset of the pandemic, the yen has declined by about 30% relative to the dollar. This decline is almost precisely what one would expect given the widening spread between

the yield on Treasuries relative to Japanese Government Bonds (JGBs) of the same maturities. Though the yield on the 10-year JGB has recently risen above the psychologically significant 1% level, past relationships suggest it probably needs to rise another 50bps to alleviate downward pressure on the yen.

In addition to a weaker currency, Japan has also experienced 10% slower cumulative growth in wages and prices than the U.S. Taken together, this means it's about 40% cheaper to operate today in Japan, in dollar terms, than was the case four years ago (Figure 3). Inward FDI has already showed signs of picking up in response.

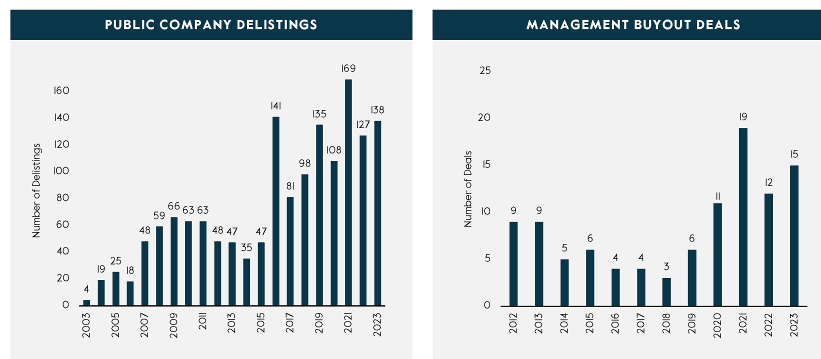
Figure 3: Japan's Sharp Decline in Relative Production Costs



Source: Carlyle Analysis; Bloomberg, IMF WEO Database, May 2024. There is no guarantee any trends will continue.

But a weaker yen is hardly the most exciting aspect about Japan's investment environment. The corporate governance and stock exchange reforms are having their intended effect. Delistings, buyouts, spinoffs, and asset sales continue to accelerate as management teams restructure operations in pursuit of the higher returns demanded by shareholders, regulators, and activists (Figure 4). Judging by the optimism and booming business volumes of M&A advisors, the surge in Japanese asset prices – the Nikkei is the world's top-performing index over the past year – does not yet reflect the scale of the improvement in the profitability outlook.

Figure 4: Governance, Stock Market Reforms Having Intended Effect



Source: Carlyle Analysis; S&P Capital IQ, RECOF, May 2024. There is no guarantee this trend will continue.

Korea Tries to "Value Up"

Global investors' enthusiasm for the Japanese market has not been lost on the Korean Financial Services Commission (FSC), which unveiled corporate governance reforms of its own earlier this year. If Japan was ripe for reform, that's doubly the case in Korea.

Last year, about two-fifths of listed companies in Japan were priced below the accounting value of their assets. This was 9x higher than in the U.S., but 35% *less* than in Korea. Likewise, the number of listed companies in Japan is over 2x U.S. levels, on a per capita basis, but 34%

lower than in Korea (Figure 5). These figures are intimately related because both are symptoms of a languid market for corporate control. The implied productivity of capital is low – hence the discount to book value – but frictions in the system of corporate governance inhibit (minority) shareholders from forcing companies to consolidate, restructure, or sell themselves to more ambitious owners, leading to a bloated number of listed companies.

Figure 5: Korea Needs Reform

Source: Carlyle Analysis; Nikkei Asia, March 2024. World Bank, May 2024. There is no guarantee this trend will continue.

Though FSC Governor Lee Bokhyun has [openly warned of delisting Korean companies]() that fail to meet new guidelines, participation in the program is voluntary thus far. But investors shouldn't be discouraged. As was the case in Japan, the ship of state has clearly turned in the direction of reform, with corporate inefficiencies rightly seen as an intolerable drag on growth in light of demographic realities.

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