

# What Makes a Country or Market Capital Friendly?

Featuring

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INVESTMENTS

In this conversation, Redwood portfolio managers Alexi Makkas and Don Smith break down how governance reforms, capital return frameworks, and evolving policy environments are shaping international markets, and how these changes may be creating new investment opportunities outside the U.S.

**ALEX BERNSTEIN:** Hello, I'm Alex Bernstein and you're listening to The Alger Podcast: Investing in Growth and Change. Today we're talking about what makes a country or market capital friendly, where we're seeing meaningful changes globally, and how do these changes reshape investment opportunities. Joining me for the conversation are Redwood portfolio managers Alexi Makkas and Don Smith. Alexi and Don, thank you guys so much for coming on the podcast today.

**ALEXI MAKKAS:** Thanks for having us.

**DON SMITH:** Thank you, Alex.

**ALEX:** So, Redwood has developed an investment framework centered around the term capital friendliness. What does that term mean?

**DON:** Capital friendliness means a variety of things. It refers to the desirability of a country or market, for



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institutional and individual investors, as they seek to earn a positive return on their capital. And, really, in terms of practical application, at the highest level, it means the return potential when an individual or institution invests with alignment, things like protection of capital, predictability of outcomes. And we find that capital tends to flow towards countries or markets where shareholders are empowered to earn an effective return by rules, regulations, and other policies. And some of these, in action, are things like rising dividends, increased buybacks as a percentage of earnings, the reduced tolerance for holding large piles of cash on balance sheets, and targets of increasing returns on invested capital, returns on equity, et cetera.

One of the things that we've always been very keenly focused on is governance and the treatment of shareholders by companies and company ownerships, management. So we take a real keen interest in whether boards are independent, what happens with activists, what are management's incentives, are they aligned with shareholders, and, what's happening with things like cross shareholdings in countries like Japan.

**ALEX:** For U.S. investors, many of these characteristics have long been part of the investment landscape. Why is this framework becoming increasingly relevant in non-U.S. markets?

**ALEXI:** We looked really historically to try to understand what's been happening and where we are now. And an interesting point of divergence really started during the financial crisis, 2009 and '10, coming out of it. The U.S. took a pro-growth approach from fiscal and monetary perspective, but also a regulatory environment. Whereas, really, the rest of the globe took a more of an austerity approach, in particular in Europe, and we believe those policies were anti-growth. A couple of the characteristics that the U.S. saw, best in class governance and capital allocation discipline. We think, that led to a dominance in asset light, high ROIC type platforms.

Going back to one of Don's points, aggressive buybacks have been a critical part of the overall approach. And all this structurally provided a better environment for EPS growth and ultimately that being the core driver of stock prices, as we see it. So, what's changed? We see structural changes that are in place and, particularly going back to 2024, where globally, 1.6 billion people across 74 national elections in 62 countries really were a secondary and tertiary key driver of what we see as sustainable changes, in markets outside the U.S.

And we're not arguing, "anti-U.S." or to "sell all U.S." and buy international. We're seeing really a policy convergence, where other economies, geographies, and governments are now copying the U.S. playbooks. So, we're seeing that in governance reform, shareholder pressure, and then a focus on capital return and expectations of those.

At the same time, a bit of a rotation away from some of the U.S. dominant sectors, software and Internet consumer platforms that have dominated within the U.S., and some structural changes in industrials, energy, financials, defense, materials. These are core areas of opportunity outside the U.S.

And we believe what we see is sustainable growth because there's now fiscal spending, a reindustrialization, and then a massive energy

transition. And these are global drivers.

**DON:** The reason some of these things are so important in non-U.S. markets is, we've found, there's a very high correlation between the valuations companies and markets are given as to returns, returns on equity, returns on invested capital. So, what we're seeing is a real significant amount of change and, both in terms of perception, as well as in underlying fundamentals. So, we believe it's this change that's really a key driver for non-U.S. markets.

**ALEX:** When you look across international markets, where are you seeing the meaningful shifts toward capital friendliness taking hold?

**ALEXI:** I'll just start on Europe. Germany historically has been the driver of economic growth for the EU. Germany has been mired in a period of malaise, low growth, policies that were arguably antigrowth, whether it was from energy or industrial and other regulatory issues. And so, what we've seen is essentially a one eighty, where Germany has now removed the debt brake, so it's allowed itself to really drive some economic growth through fiscal stimulus, a massive infrastructure plan, and we think that will lead to internal German growth. But as historically has been the case, we believe, that will lead to additional economic activity outside of Germany within the EU. That's one major driver. And then another is European defense in Germany is at the forefront of that.

And then one other interesting thing that we're seeing within Europe, Southern Europe, so Portugal, Spain, Italy and Greece. We think that all four are doing well. There's fiscal discipline, political stability, and we believe Southern Europe's been outgrowing the rest of Europe.

What we're seeing and anticipating is a reacceleration in the core of Europe, but also continued stability and also contribution to growth from Southern Europe, and that has us excited about the opportunities. And this isn't an assumption that this is going to be a one-year process. This is going to be a long-term process.

**ALEX:** When you look at regions like Europe or Asia, is there a spillover effect at work—where progress in one market or country helps catalyze change elsewhere?

**DON:** There's definitely a feedback loop that's positive. And Japan was really the leader in the internal improvement campaign driven by the Tokyo Stock Exchange, which focused around improving valuations by increasing returns to shareholders and improving returns through unwinding cross shareholdings, improvement of free flow, governance, corporate behavior shift with buybacks, activists gaining traction. Where that's come to manifest itself next, but very clearly is, in a way mimicking it, is in South Korea where we are at a much earlier stage.

And you couple that with an industry exposure in Korea, they are an integral part of the semiconductor supply chain with a few predominant examples, Samsung and SK Hynix, standing out among global companies. But, also, we believe they have very strong representative companies across industrials, electrification, defense, and areas like nuclear power. So, we think, Korean exporters and technology companies are really quite well positioned for where we see the world headed in the next three to five years.

**ALEX:** I want to shift from a country-level view to a sector perspective. As these capital-friendly dynamics start to take shape, how are they showing up at the sector level—and which areas have been most

compelling from your perspective?

**ALEXI:** Sure. So, the industrials make up a lot of the underlying exposures that we have. We don't set themes top down. Everything we do is bottoms up. But as you can imagine, when you come up with a series of great investments or ideas that have compelling characteristics, they're going to have similar drivers. The industrials, as you mentioned, really contain defense companies, power, and electrification. We believe that is a global driver of growth.

Within power and electrification, this isn't solely an AI driven cycle. This is a natural cycle that's globally in place right now.

And then, I mentioned AI data centers are a massive power demand, we're all well aware. That's just now beginning to kick in. Electrification broadly, in particular in Europe, so whether it's EVs, heat pumps, other more sustainably driven policies that demand more electricity. And then globally, the grids have been underinvested to maintain all of this. A variety of industrial companies have exposures to all of these. And there are global winners and a lot of them outside the U.S.

And on defense, the primary driver that we've been seeing is really the EU demand that started, as you can imagine, with Russia, Ukraine, but that has now spread to Asia as well. Our exposures there vary from European holdings, across all market caps, to now some Asian and Korean in particular, defense companies. We even have a holding in Bharat, which is an Indian defense company. And what we're seeing is also internal within each country, for spending on its own defense, but also the demand in Europe is so high, they and their capacity is not able to meet their demand. So, some of the Asian defense OEMs are now exporting to European governments as well. We believe they're a multiyear long-term, up cycle, that we are bullish about, and, and are

exposed to.

**ALEX:** Let's bring this down to the company level. Can you share a couple of examples that you think best reflect these capital-friendly dynamics? Don, why don't we start with you.

**DON:** One company that fits squarely in this lens of defense build out is Rheinmetall in Germany.

Rheinmetall is the largest German defense manufacturing contractor. They do everything from tanks to artillery shells to ... they're extending into missile space, maritime.

The company expects revenues because of their very strong visibility and backlog to grow from ten billion of euro revenues in 2025 to 50 billion in 2030, with a great majority of that being organic growth driven by backlog and demands from countries across Europe. With Germany being the leader, there's investor skepticism over the company's ability to achieve this high growth with adequate margins and returns. We believe that could happen, even if there is some delay on the ability to build it out, perhaps in any given year because of supply chain impediments or other things. But it really illustrates this enormous trend, and Rheinmetall and some of their peers are building backlog.

**ALEX:** Alexi, did you have one that you want to talk about?

**ALEXI:** Sure. I can talk about Hitachi. So historically, Hitachi was a sprawling Japanese conglomerate spanning dozens of loosely connected businesses, everything from consumer electronics, appliances, hard disk drives, TVs, construction machinery, financial services, and the list goes on and on. But common attributes or maybe that's not the right word,

but characteristics of these are low margins. There were heavy cross shareholdings across these businesses, weak capital discipline. And today, after ten years of restructuring through Japan's governance reforms, we view it as a focused high quality digital infrastructure platform. We have exposure through Hitachi to grid modernization, decarbonization solutions, other industrial improvements as well.

And from the governance perspective, nine out of the 12 directors now are independent on the board. Portfolio simplification, so the company has gone from 22 subsidiaries to zero. It's really eliminated the complex conglomerate structure that it had before, and that also attributed to its, "Japan discount." And now there's a framework in place. So, the company put in an explicit return on invested capital relative to cost of capital framework. It's put in place longer term targets, of seven to nine percent revenue growth, 13 to 15 percent EBITDA margins, 12 to 13 percent ROIC.

So, these are targets that were never in place before and, essentially, a company driven approach, to hit those targets. And, what's the outcome of this? So, ROEs now are in the low teens, where historically Hitachi had been in the low single digits. And so here, we're getting a combination of a company that's evolved through the mandated changes from a governance perspective, but also growth, from the end markets that they have and leadership positions in those. So, we've seen earnings growth, coupled with valuation upside, and this has been a core holding for a period of time now.

**ALEX:** You've all really developed this capital-friendly thesis over the past year. Are you prioritizing companies that check the capital friendly boxes?

**DON:** Alex, you know, the backdrop is we're very much looking for companies where we can see

positive surprises and company fundamentals driving improvement in revenues and earnings growth. And what these corporate governance or self improvement angles give us is an idiosyncratic source of returns so that we're not just relying on economic improvement or pure beta type of drivers, but there's a number of levers. Or when we find a number of levers that we think are under the company's control to drive their fate and effectively their earnings growth over time, we find that to be extremely attractive, particularly when it's not recognized by the market.

**ALEX:** For investors with significant U.S. exposure, how should they think about the thesis of capital friendliness?

**ALEXI:** So, I think the way to think about it is, we believe, U.S. is high quality, international is improving quality, high margins versus margin expansion. The U.S. is more highly valued, and we believe the international markets still maintain the opportunity to drive more upside to valuation. And then the type of exposure, so, U.S. growth is predominantly tech, healthcare, some consumer, and parts of industrial, and then lots of opportunities in industrial, financials, materials, energy, et cetera, outside the U.S. So, there are varying ways to think about it, but it's not geography. It's a lot of these other characteristics.

**ALEX:** This is the last question I've got. I always like to come back to the company. Why Alger/Redwood?

**DON:** I'll start on what we think we do, hopefully, well. At Redwood/Alger, we focus on finding multiyear holdings of companies where we have a significantly different view and much higher view of earnings growth and revenue growth over a multiyear period than the market expects.

We build a concentrated portfolio focused on a limited number of very high-quality businesses on which we have a high conviction, where our view is significantly different than that in the market. By doing so, we're able to leverage our team's collective experience and really have a high conviction, low turnover portfolio that we think can achieve exceptional results over time through different market cycles.

**ALEX:** Don, Alexi, thank you so much for joining me on the podcast.

**ALEXI:** Thanks, Alex. It's been great talking to you.

**DON:** Thanks, Alex. We appreciate your time. Great talking to you.

**ALEX:** And thank you for listening. For more information on Redwood and capital friendliness, and for more of our latest insights, please visit [alger.com](http://alger.com).

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