Portfolio Manager Viewpoint

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Japan's environment, social and governance (ESG) story truly began in 2006 when the country's institutions signed up to the United Nations Principles for Responsible Investment (PRI),[2] but it only started to gain momentum in 2011 when the country established the Principles for Financial Action towards a Sustainable Society.[3] This momentum was carried over to the Japan Revitalisation Strategy set out in 2013 under Prime Minister Shinzo Abe's administration. As a backbone for the strategy, Japan's Stewardship Code[4] and Corporate Governance Code[5] were established in 2014 and 2015 respectively. Both of these have played a significant role in the quest for better corporate governance and increased awareness of environmental and social issues.

The Stewardship Code states that investors should be in dialogue with companies and work to solve problems through constructive engagement to enhance medium- to long-term investment returns,[6] while the Corporate Governance Code looks to facilitate transparent, fair, and timely decision-making by companies. The Government Pension Investment Fund (GPIF) in Japan, one of the world's largest asset owners, announced its intention to comply with the Stewardship Code in 2014 and signed up to the UN PRI in 2015. Due to its size and influence, the GPIF's commitment helped raise the sensitivity to ESG issues both from companies and institutional investors.

The Stewardship Code was revised in 2017,[7] to mandate full disclosure of voting results, and it was revised once again in October 2019 to incorporate long-term sustainability in the investment process.[8]
The Corporate Governance Code was itself revised in 2018[9] with several new guidelines added, such as minimum board independence requirements, mandating an objective CEO succession plan, and the unwinding of cross-shareholdings[10] to further enhance transparency. Another revision is planned in 2021 to further enhance the standard of corporate governance.

Key ESG focus areas

ESG covers a wide range of issues, but the key topics of discussion between corporate management and institutional investors in Japan include:

Board of directors structure
The amended corporate governance code requires that at least a third of board of directors be from outside the company, instead of just two. This is intended to encourage accountability around decision-making processes. Currently, around 70% of listed companies haven't met this requirement.[11] With regards to board diversity, the number of female directors as a percentage of the total has risen but was still only 5.2% as of 2019.[12] The government mandate is for corporates to increase this ratio to 10% in 2020.[13]

A related topic is executive compensation, which has been an area of scrutiny given the lack of transparency in decision-making processes determining executive compensation. Since the governance code also requires a transparent process for the removal of management and succession, more companies are establishing nomination committees to achieve the desired accountability.

Parent-subsidiary dual listings

One of the major issues arising as a result of parent-subsidiary dual listings is the creation of conflicts of interest, potentially putting minority shareholders in a disadvantaged position. The number of listed subsidiaries in Japan is still quite high: 238 compared to 28 in the US, and none in the UK (as at 2018[14]), and we view parent-subsidiary listings as running counter to the objectives of the governance code. That being said, we have observed some positive developments recently such as the dissolution of the dual-listing structure in some leading companies, including Hitachi, which sold Hitachi Kasei to Showa Denko, and also sold Hitachi Transport, Hitachi Capital, Hitachi Koki and Hitachi Kokusai; Toshiba, which sold Toshiba Plant, NuFlare Technology and Nishishiba Electric; and Mitsubishi Chemical, which sold Tanabe Mitsubishi Pharma.

Prime Minister Abe recently initiated a debate on the governance reform guidelines at the Council on Investments for the Future.[15] The proposals would require accountability of parent companies to minority shareholders, while encouraging subsidiary companies to increase the proportion of external directors who are independent from its parent company. We expect this will help accelerate the unwinding of the dual-listing structure, which would better align the interests of management and shareholders. We also expect this to result in the more effective allocation of underutilised capital, be it through investment in higher capital-returning projects or via the return of excess capital to shareholders.

Strategic shareholdings[16]

While cross-shareholding, whereby listed companies sit on large portfolios of one another's shares, has declined over time, we still observe that many companies do not comply with the Corporate Governance Code and provide no rationale for employing a strategic shareholding structure. The latest revision to required disclosures forced companies to provide details about strategic shareholdings.[17] Since this revised governance code states business transactions should not be based on strategic shareholding relationships, we expect further engagement to help unwind the cross-shareholdings, resulting in a more efficient use of capital.

Disclosures

Environmental considerations are an aspect of ESG engagement that have been gaining interest globally in recent years. Japan has been ahead of this trend in terms of disclosure on environmental activities, proactively disclosing non-financial information through the Integrated Report. The Rio Earth Summit in 1992 was a catalyst for Keidanren, the Japanese business federation, to request that its member companies publish environmental impact reports. According to the GPIF, 72.4% of companies make voluntary disclosures of relevant ESG information,[18] either referring to the Global Reporting Initiative guidelines[19] (40.7% of companies); the International Integrated Reporting Framework[20] (33.3%); or the remainder referring to the Ministry of Environment's Environmental Reporting Guidelines,[21] the "Guidance for Collaborative Value Creation" published by the Ministry of Economy, Trade and Industry; or the "Guidelines for Investor and Company Engagement" published by the Financial Services Agency.[22]

Meanwhile, the Task Force on Climate-related Financial Disclosures (TCFD)[23] has been receiving attention by offering a framework for disclosing information related to climate change. TCFD was formulated in 2017 to help institutional investors and financial institutions better understand how climate-related risks and opportunities will impact future income statements and balance sheets.

Japan is the world's biggest TCFD-supporting country.[24] As of June this year 285 Japanese public and private entities have expressed support for the task force, a total of 1,293 signatories and many are already making disclosures in accordance with the framework. We expect further disclosure efforts under the TCFD to drive better-quality engagement with stakeholders regarding companies' sustainability practices.

Sustainable investment assets are growing in Japan

ESG investing has significantly increased globally, and Japan is no exception. The amount of global sustainable investment reached $30.7 trillion in 2018 in the five major markets of Europe, the US, Canada, Japan, Australia and New Zealand, up 34% relative to 2016. Japan was the main contributor to this growth with sustainably managed assets growing more than 300%[25] during the period. Not surprisingly, in tandem with this shift Japanese corporate management is increasingly willing to address corporate governance issues, capital efficiency and returns on capital. The GPIF, which manages roughly ¥160 trillion[26] ($1.5 trillion), is integrating ESG factors into its investment principles. The rule of thumb is that when GPIF establishes a new policy, others will follow. Hence, we expect the influence of sustainable investment in Japan to gain further traction in areas such as ESG integration,[27] ESG screening, engagement and shareholder proposals.[28 29]

As a related topic, activism has risen in Japan, too. We are witnessing the trend of public engagement increasing

Figure 3: Growth of sustainable investing assets by region in local currency (asset values are expressed in billions), 2014-2018

	2014	2016	2018	Growth per period Growth 2014-2016	Growth 2016-2018	Compound annual growth rate (CAGR) 2014-18
Europe	€9,885	€11,045	€12,306	12%	11%	6%
US	$6,572	$8,723	$11,995	33%	38%	16%
Canada (in CAD)	$1,011	$1,505	$2,132	49%	42%	21%
Australia/New Zealand (in AUD)	$203	$707	$1,033	248%	46%	50%
Japan	¥840	¥57,056	¥231,952	6,692%	307%	308%

Source: Global Sustainable Investment Alliance, 2018 Review.

via shareholder proposals at AGMs. Although Japan's activism has been primarily concentrated on governance issues as opposed to environmental, activists are showing an increased desire for board representation and are also willing to engage in proxy battles to achieve their objectives.

Our approach

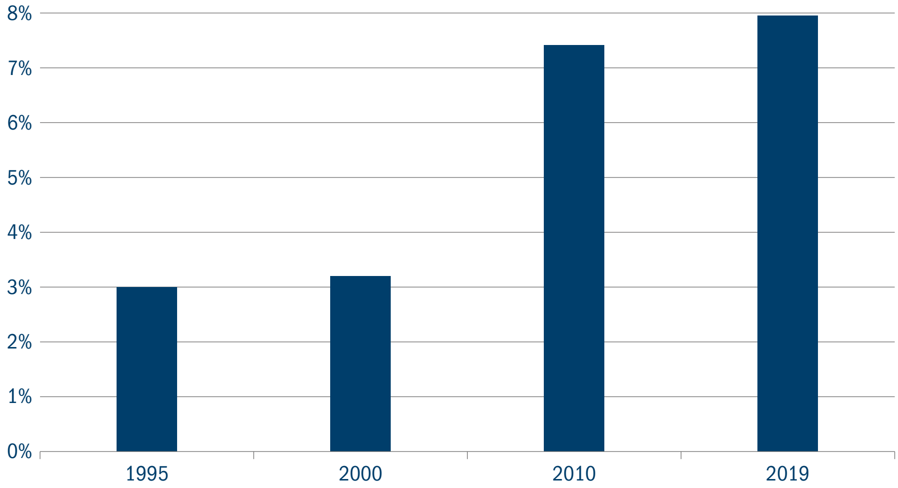
The series of revisions to the codes has motivated Japanese corporate management to be more focused on profitability and capital efficiency than it has in the past. Consequently, the return on equity (ROE) of Japanese companies increased from the low single digit level in the 90s and 2000s to around the 8% level in 2019 (9.8% in 2018), narrowing the gap with European companies (9.8% in 2019).[30] Along with corporate governance reform, the agenda in our meetings with many Japanese senior management teams has changed noticeably, with a greater focus on long-term strategy including capital management policy, board structure and quantitative goals to demonstrate their commitment to environmental issues and outcomes.

Coupled with Columbia Threadneedle's integration of ESG issues into our investment process, through the use of our proprietary RI tools, and through our research intensity, we think Japan is a market which increasingly has much to offer.

Source:

2 https://www.unpri.org/pri/an-introduction-to-responsible-investment/what-are-the-principles-for-responsible-investment
3 https://www.env.go.jp/policy/keiei_portal/kinyu/gensoku-en.html
4 280 institutional investors signed up as of March 2020. *The stewardship code was revised in March 2020, with the addition of items such as taking into account sustainability.*
5 As of July 2019, 21.3% of TSE1 constituents (457) were complying with all 78 principles in the code, 65.4% (1,404) were complying with at least 90%, and 13.4% (287) were complying with fewer than 90%.
6 https://www.fsa.go.jp/en/refer/councils/stewardship/minutes/20170131.pdf
7 https://www.fsa.go.jp/en/refer/councils/stewardship/20170529.html
8 https://www.fsa.go.jp/en/refer/councils/stewardship/20200324.html
9 https://www.fsa.go.jp/en/news/2018/follow-up/20180330-1.html
10 The structure that a publicly traded company owns stock in another publicly traded company to interlock business relationships and to protect itself from takeover actions.
11 https://www.jpx.co.jp/english/equities/listing/cg/tvdivq0000008jb0-att/b5b4pj000002xyj7.pdf
12 http://www.gender.go.jp/policy/mieruka/company/yakuin.html
13 http://www.gender.go.jp/english_contents/index.html
14 https://www.jpx.co.jp/equities/improvements/study-group/nlsgeu000004acah-att/nlsgeu000004hgca.pdf
15 https://japan.kantei.go.jp/98_abe/actions/201903/_00012.html
16 Shareholdings for the purpose of maintaining business relationships or take-over defense including cross-shareholdings.
17 https://www.jpx.co.jp/english/news/1020/b5b4pj000000jvxr-att/20180602_en.pdf
18 https://www.gpif.go.jp/en/investment/summary_report_of_the_4th_survey.pdf
19 https://www.globalreporting.org/Pages/default.aspx
20 https://integratedreporting.org/resource/international-ir-framework/
21 https://www.env.go.jp/policy/j-hiroba/kigyo/2018Guidelines_E20190412.pdf
22 https://www.gpif.go.jp/en/investment/summary_report_of_the_4th_survey.pdf
23 https://www.fsb-tcfd.org/
24 https://www.fsb-tcfd.org/tcfd-supporters/
25 http://www.gsi-alliance.org/wp-content/uploads/2019/03/GSIR_Review2018.3.28.pdf
26 https://www.gpif.go.jp/en/investment/190905_Esg_Report.pdf
27 The investment that systematically incorporates ESG (environmental, social, and corporate governance) factors into regular management processes (e.g., ESG evaluation, screening, and due diligence prior to investment, and monitoring and engagement after investment).
28 Communicating with corporations as a shareholder based on engagement policies. Or, exercising shareholder rights other than voting rights.
29 http://japansif.com/2019survey-en.pdf
30 MSCI Japan and MSCI Europe, data from Bloomberg, June 2020.

Figure 4: Return on equity in the Japanese equity market



Source: Bloomberg as at 31 July 2020.
Past performance is not a guarantee of future results.

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