RESEARCH SPOTLIGHT

Q2 2023 ESG IN JAPAN

After decades of serial underperformance following the bursting of an equity and real estate bubble at the end of the 1980s, in recent months Japanese equities have once more emerged as global outperformers. We believe the recent revival in Japanese equities can be attributed to a number of factors:

- Clear signs of an end to deflation and robust cyclical economic activity. The hangover effects of the real estate bust, demographic challenges and a tepid policy response led to the Japanese economy exhibiting sustained low inflation and often outright deflation over recent decades. However, the adoption of Abenomics in 2013 ushered in a sustained policy of aggressive monetary easing, which in recent times has combined with the upsurge in global inflation such that Japanese CPI is now printing comfortably above BOJ's stated target. In addition, Japanese economic activity and industrial data appears to be robust relative to other regions such as Europe, US and China.
- The rise of global inflation since the pandemic has fuelled interest in value investing. Long out of favour in an era of falling global interest rates and low inflation, value stocks have experienced a resurgence in recent years (as we have discussed in previous newsletters). Looking across global equities and screening on typical value investing metrics yields no shortage of Japanese companies. Indeed, as the FT recent pointed out[1], around half the Japanese equity market trades with a price/book ratio below 1.
- International equity investors seeking growth opportunities have in the last two decades looked towards China, however, recent geopolitical tension with the West, widespread corporate governance issues as well government crackdowns on Chinese tech companies have all made investors more weary of Chinese equity investing. A number of equity investors and strategists (including Warren Buffett[2]) have recently touted Japan as an alternative.
- Finally, and perhaps most importantly in our view, are the 'third arrow' structural changes underway in corporate Japan. Whilst the above factors arguably have little direct link to our field of ESG, the 'third arrow' of Abenomics focused on implementing structural reforms to improve Japan's long-term economic competitiveness and growth potential certainly does. A key component of these changes were corporate governance reforms. In the next section, we examine the 'G pillar' and some other ESG related drivers which we believe are significantly positive drivers for long-term investors in Japan.

ESG Drivers

In contrast to ESG being subject to political controversy as it is in the US (as discussed in our last newsletter Research Spotlight), Japan and Japanese businesses have, to some extent, embodied the spirit of ESG for over 400 years through a concept called Sanpo Yoshi. Sanpo Yoshi means 'three-way satisfaction': good for the seller, buyer and society. It is based on Confucius' Golden Rule, do unto others as you would have them do to you[3].

A small group of traveling merchants at the dawn of the country's modern economy era, the Omi Shonin, originated the philosophy. Because "they traveled far and wide for business [they knew] that building long-term trusting relationships" where they were accepted and respected by "the communities they traveled to was essential in order to generate success". [4] "They ensured that their commercial transactions provided benefits to all stakeholders, not only themselves...They would also give back to the communities by building schools and bridges, supporting local shrines, and paying taxes for poor families"[5]. The Omi Shonin grew to become one of Japan's most successful merchant groups and the philosophy of Sanpo Yoshi became adopted into Japanese culture[6]. Sanpo Yoshi is very familiarly reminiscent of what we would now refer to as corporate social responsibility or ESG—this Japanese philosophy has always been and continues to be built into the fabric of Japanese business.

Corporate Governance

Whilst one can argue the concept of Sanpo Yoshi has contributed to the acceptance of the importance of E & S considerations in Japanese corporate management, poor corporate governance has regularly been identified[7] as one of the factors contributing to the underperformance of Japanese equities over the last 30 years.

have been associated with inefficient capital allocation, limited shareholder rights, and a lack of independent oversight of management, lack of interest from foreign institutional investors and ultimately poor investor returns.

To remedy this situation the Japanese government has been actively promoting ESG principles and integrating them into its practices and policies. When Fumio Kishida became Japan's 100th Prime Minister he began to promote a "new form of capitalism" which he said will address inequality and climate change.[8] The belief is that if more people in society benefit from economic expansion, growth will be more sustainable. Supporters say that the prime minister is aiming for a system that "cares about the environment. It cares about society, it cares about the shareholders. It's inclusive capitalism. What Kishida is trying to do is much more important than what Abenomics did."[9]

One of the most relevant examples is reform to Japan's Corporate Governance Code. The revision of the Corporate Governance Code in 2015 aimed to align Japanese corporate practices with global standards. Some of the amendments include: promoting institutional investors' engagement in the mid-to long-term growth of companies through constructive dialogue, introducing a provision requiring companies to explain the reasons if they do not appoint outside directors and establishing for the first time in Japan a "comply or explain" framework for reporting on good corporate governance practices.[10]

New TSE rules require large listed companies to disclose the implementation status of shareholder engagement priorities they are involved in, including company personnel involved and actions taken[11]. Further reforms are also in the pipeline. For example, regulators are also considering requiring enhanced disclosure of human capital metrics, such as those proposed by the International Sustainability Standards Board[12].

One example of a result of these reforms is that the number of companies which have received shareholder proposals has significantly increased, whereas the number of new cases of shareholders' legal actions against company directors that Tokyo and Osaka district courts have received has decreased.[13] This is a good indication that shareholder engagement is increasing and producing effective outcomes in Japan.

Another goal of the government is to increase gender diversity on boards. As of last year, 18.7% of Prime Market companies had no female directors at all. Women made up only 15.5% of directors at the largest companies in Japan in 2022, compared with 31.3% in the US, according to the OECD[14]. From the next fiscal year onward, company reports must also include the ratio of women in management positions and the percentage of male employees taking childcare leave.[15]

Japan will also aim to have women make up at least 30% of directors at major firms by 2030, according to a draft plan issued by the Gender Equality Bureau who said more diversity can contribute to innovation and growth. The government will press for the target to be included in the regulations for companies listed on the Prime Market Index of the Tokyo Stock Exchange. The first step would be to require at least one woman on the board of all the index's firms by 2025.[16]

ECO Advisors has recognised the impact of board gender diversity and it remains a central component of our stewardship code and voting policy. Research indicates that companies with strong female leadership (deemed as three or more women) generated a Return on Equity of 10.1% per year versus 7.4% for those without and a superior average valuation compared to companies without strong female leadership[17]. Research has also found that companies lacking board diversity suffered 24% more governance-related controversies than average[18].

According to Oxford Business Law, the "main aim of these changes has been to improve companies' earning power, including improving their profitability and restoring economic growth... Japan has developed an economic system in which sustainable growth of companies and improvement to their corporate value can distribute benefits to their stakeholders more widely, leading to economic growth through investment and expansion of consumption. In such a system, a lack of monitoring capability among board directors, ineffective engagement with shareholders, and inadequate group governance are seen as barriers to improving profitability and economic growth."[19]

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[3] & [4] https://esgclarity.com/sanpo-yoshi-japan-has-long-done-esg-by-a-different-name/

[5] https://medium.com/social-innovation-japan/sanpo-yoshi-japans-responsible-business-philosophy-15db037a840e

[6] See #3 and #4.

[7] https://blogs.law.ox.ac.uk/oblb/blog-post/2023/01/future-japanese-corporate-governance-participation-sustainability-and

[8] & [9] https://www.bloomberg.com/news/features/2022-06-01/japan-leader-fumio-kishida-s-new-capitalism-scares-some-investors

[10] https://www.oecd.org/policy-briefs/japan--better-corporate-practices-for-higher-growth.pdf

[11] & [12] https://www.responsible-investor.com/japan-to-consider-governance-reforms-for-public-company-boards/

[13] See #7.

Considering the E in Japan's ESG

Corporate governance reforms are not the only ESG commitments Japan has made over the last few years. Japan has also released a series of new E pillar goals, commitments and regulations.

These include:

- A commitment under the United Nations Climate Change Convention to reduce greenhouse gas emissions by 46% from 2013 levels by 2030.[20]
- Promoting the development of innovative technologies by 2050 that enable Japan to contribute to the reduction in accumulated atmospheric CO2 globally to "Beyond Zero".
- A goal to achieve net zero GHG emissions by 2050.[21]

Against this backdrop, in 2021, the Ministry of Economy, Trade and Industry, in collaboration with other ministries and agencies, formulated the "Green Growth Strategy through Achieving Carbon Neutrality in 2050". The Green Growth Strategy outlines a roadmap for 14 specified fields that are expected to grow, including renewable energy and manufacturing industries.[22] As part of this strategy, a Green Innovation Fund of $15bn was created to encourage companies to take on ambitious challenges in R&D and assist ambitious green projects by companies and other organisations over the next decade, targeting areas essential to the circular economy, such as storage batteries, offshore wind power, next-generation solar cells, hydrogen, and carbon recycling.[23] [24] Earlier this year the Agency for Natural Resources and Energy published a two-pronged approach to supporting the generation and use of clean hydrogen and ammonia, one of the 14 growth focus areas. The first prong is a subsidy scheme for international hydrogen and ammonia supply chains. The second prong is a support scheme for industrial clusters for the utilisation of hydrogen and ammonia in Japan.[25]

Japan's commitments to climate goals, ESG, and R&D funding for clean technologies have already had important outcomes and set the standard for innovative growth. As of last year, companies listed on the Prime market are required to comply with disclosure requirements aligned with the Task Force on Climate-related Financial Disclosures (TCFD) recommendations.[26]

In our ESG driven analysis of Japanese equities we are increasingly finding that the companies in the 14 growth sectors that the Green Growth strategy focuses on are responding to the government E pillar commitments, R&D investments, and subsidies.

ESG in Japan: Evaluating the Impact

Amidst the recent outperformance of Japanese equities, we need to ask: is there evidence of an "ESG alpha" in the data that supports the theme? In order to validate the notion of ESG drivers that we describe above, it is necessary to look under the hood of the Japanese equity performance in recent years. Using output from our ESG data research platform, we outline below how ESG dynamics have impacted the overall Japanese equity performance picture in recent years.

The below analysis lends credence to the emergence of 'G pillar' & 'E pillar' drivers within the Japanese equity market in recent years. Whilst some of the pillars behind the revival of investor interest in Japanese equities are driven by cyclical economic factors which may be more short term in nature, we believe that the ESG related drivers we have described are far more structural, and will continue to be a significant factor in the Japanese corporate landscape and equity market in the years to come.

[14] https://www.bloomberg.com/news/articles/2023-06-06/japan-aims-for-women-to-make-up-30-of-directors-at-top-firms

[15] https://www.bloomberg.com/news/articles/2022-11-08/japan-s-new-disclosure-rules-to-help-g-7-s-worst-gender-pay-gap

[16] See #14.

[17] & [18] https://www.msci.com/documents/10199/04b6f646-d638-4878-9c61-4eb91748a82b

[19] https://blogs.law.ox.ac.uk/oblb/blog-post/2023/01/future-japanese-corporate-governance-participation-sustainability-and

[20] https://www.meti.go.jp/english/policy/energy_environment/global_warming/roadmap https://unfccc.int/sites/default/files/NDC/2022-06/JAPAN_FIRST%20NDC%20%28UPDATED%20SUBMISSION%29.pdf

[21] & [22] https://www.meti.go.jp/english/policy/energy_environment/global_warming/roadmap/

[23] https://green-innovation.nedo.go.jp/en/about/

[24] https://www.meti.go.jp/english/policy/energy_environment/global_warming/ggs2050/pdf/ggs_overview_all.pdf

[25] https://www.allenovery.com/en-gb/global/news-and-insights/publications/japan-unveils-green-subsidy-programme-can-it-compete-with-the-us-inflation-reduction-act#:~:text=Japan's%20Agency%20for%20Natural%20Resources,(the%20Supply%20Chain%20Subsidy).

[26] https://www.esginvestor.net/japans-fsa-to-mandate-climate-disclosures-from-april-2022/#:~:text=According%20to%20Nikkei%2C%20companies%20listed,recommendations%20starting%20in%20April%202022.

Our first hypothesis relates to corporate governance reforms driving improved returns. **Figure 1** to the right shows the performance of two equally weighted baskets of Japanese stocks, with 'High G' representing the top 25% of our eligible Japanese equity universe when ranked on our internal Corporate Governance evaluation and 'Low G' representing the bottom 25%.

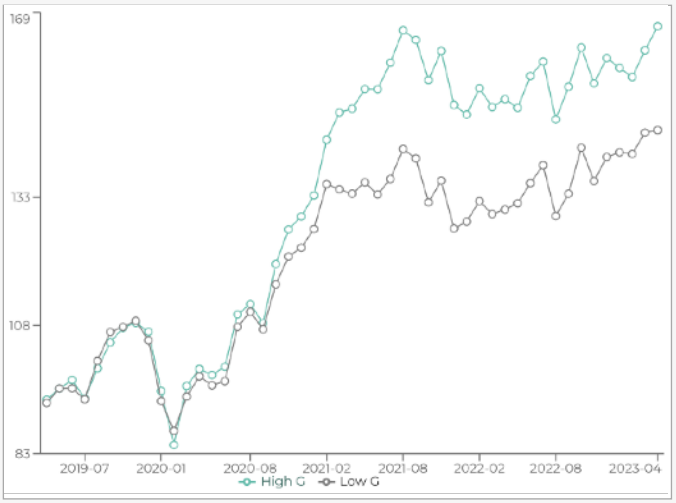

Figure 1

Period analysed 1st Jan 2019 - 30th April 2023. Chart shows the gross performance of a G Pillar evaluation score, and compares returns from the "leaders" vs. the "laggards". To do so, we calculate the monthly returns on equally weighted fractile (quartile) portfolios generated from our global equity investable universe. This analysis is based on one particular ESG data methodology and our investable universe parameters. It may not be possible in practice to fully hedge all risk factors, some securities may not be borrowable, and the analysis does not include any potential transactions or borrowing costs. This above chart does not represent an investable strategy or the returns an investor may have received.

Figure 2, shows the same baskets over the same time period, however, rather than showing the simple performance of the two baskets, it shows the performance having controlled for the influence of external risk factors such as sector exposure, valuation drivers and other technical and fundamental factors. This could be described as Japanese 'pure G alpha'.

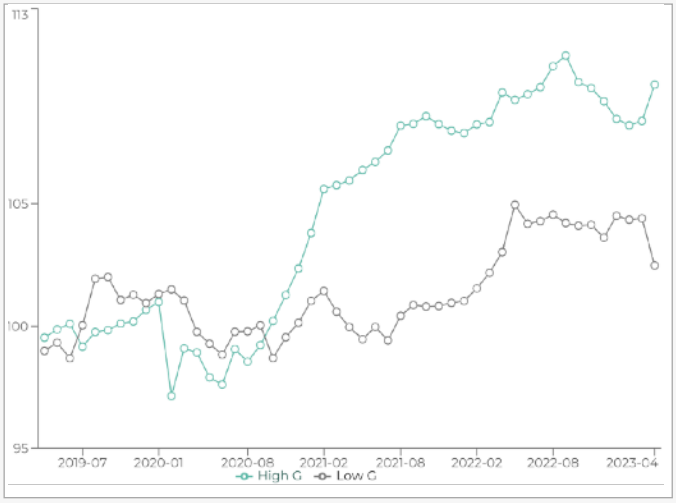

Figure 2

Period analysed 1st Jan 2019 - 30th April 2023. Chart shows the performance of an industry-relative G Pillar evaluation score, and compares returns from the "leaders" vs. the "laggards" on this G pillar evaluation – while controlling for other risk factors that may drive the performance. To do so, we calculate the "fully hedged" monthly returns on equally weighted fractile (quartile) portfolios generated from our global equity investable universe, removing the explanatory effects of exposure to market, industry, country, and style factors: these portfolio returns thus represent the theoretical returns of a "fully hedged" portfolio to all model risk factors, i.e. "alpha". We then calculate the cumulative difference in the "fully hedged" portfolio returns, representing an "alpha" after controlling for other risk factors

Turning to the Environmental pillar, an area which has seen performance challenges globally in recent times, **Figure 3** shows the performance of two equally weighted baskets of Japanese stocks, with 'High E' representing the top 25% of our eligible Japanese equity universe when ranked on our internal Environmental evaluation and 'Low E' representing the bottom 25%.

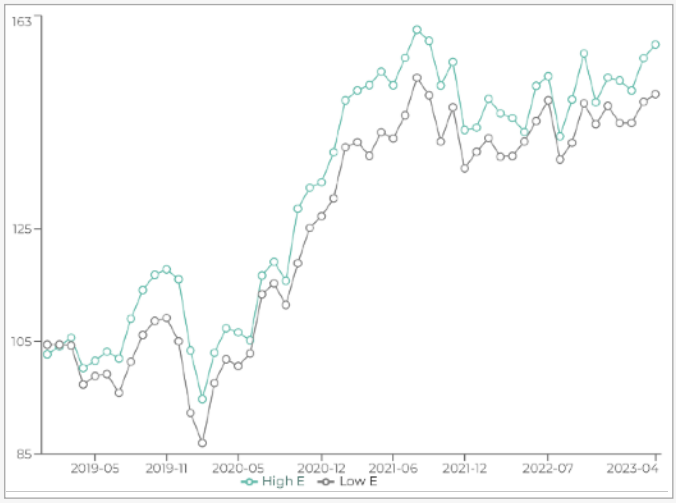

Figure 3

Period analysed 1st Jan 2019 - 30th April 2023. Chart shows the gross performance of a E Pillar evaluation score, and compares returns from the "leaders" vs. the "laggards". To do so, we calculate the monthly returns on equally weighted fractile (quartile) portfolios generated from our global equity investable universe. This analysis is based on one particular ESG data methodology and our investable universe parameters. It may not be possible in practice to fully hedge all risk factors, some securities may not be borrowable, and the analysis does not include any potential transactions or borrowing costs. This above chart does not represent an investable strategy or the returns an investor may have received.

Figure 4, shows the same baskets over the same time period, again, rather than showing the simple performance of the two baskets, it shows the performance, after having controlled for the performance influence of external risk factors, i.e. Japan 'pure E alpha'.

Figure 4

Period analysed 1st Jan 2019 - 30th April 2023. Chart shows the performance of an industry-relative E Pillar evaluation score, and compares returns from the "leaders" vs. the "laggards" on this E pillar evaluation – while controlling for other risk factors that may drive the performance. To do so, we calculate the "fully hedged" monthly returns on equally weighted fractile (quartile) portfolios generated from our global equity investable universe, removing the explanatory effects of exposure to market, industry, country, and style factors: these portfolio returns thus represent the theoretical returns of a "fully hedged" portfolio to all model risk factors, i.e. "alpha". We then calculate the cumulative difference in the "fully hedged" portfolio returns, representing an "alpha" after controlling for other risk factors.

Finally, turning to the hypothesis of ESG gaining traction from a low base historically and that momentum in ESG may relate to equity returns, **Figure 5** shows the performance of two equally weighted baskets of Japanese stocks, with 'High momo' representing the top 25% of our eligible Japanese equity universe when ranked by a 2 year change in our internal company ESG evaluation and 'Low momo' representing the bottom

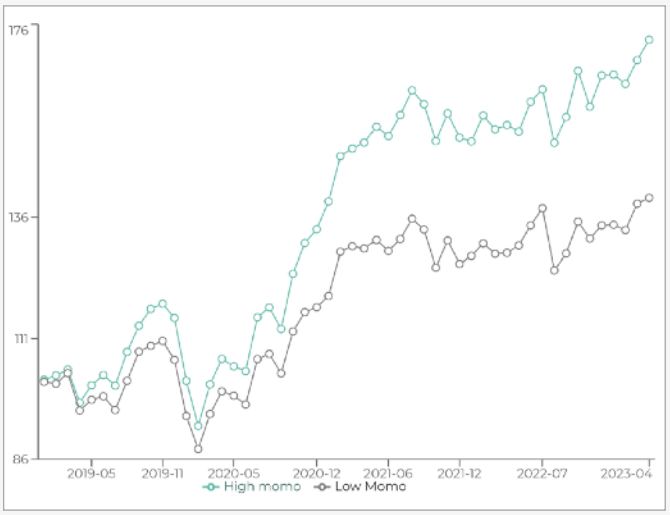

Figure 5

Period analysed 1st Jan 2019 - 30th April 2023. Chart shows the gross performance of a ESG momentum evaluation score, and compares returns from the "leaders" vs. the "laggards". To do so, we calculate the monthly returns on equally weighted fractile (quartile) portfolios generated from our global equity investable universe. This analysis is based on one particular ESG data methodology and our investible universe parameters. It may not be possible in practice to fully hedge all risk factors, some securities may not be borrowable, and the analysis does not include any potential transactions or borrowing costs. This above chart does not represent an investable strategy or the returns an investor may have received.

Figure 6, shows the same baskets over the same time period, again, rather than showing the simple performance of the two baskets, it shows the performance, after having controlled for the performance influence of external risk factors, i,e, Japan 'ESG momentum alpha'.

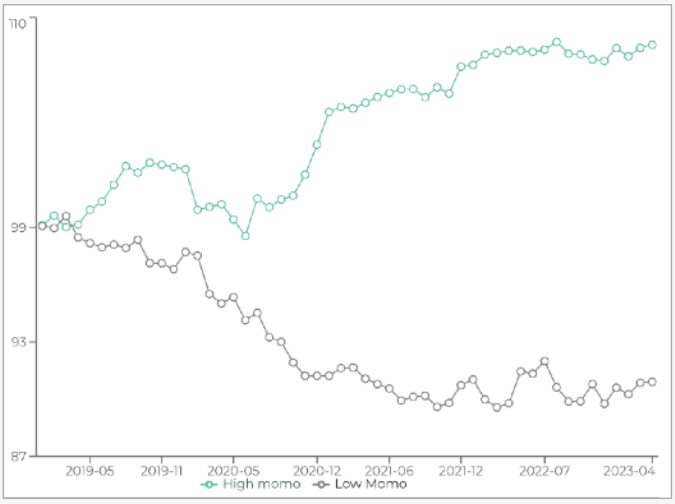

Figure 6

Period analysed 1st Jan 2019 - 30th April 2023. Chart shows the performance of an industry-relative ESG momentum evaluation score,and compares returns from the "leaders" vs. the "laggards" on this ESG momentum evaluation – while controlling for other risk factors that may drive the performance. To do so, we calculate the "fully hedged" monthly returns on equally weighted fractile (quartile) portfolios generated from our global equity investable universe, removing the explanatory effects of exposure to market, industry, country, and style factors: these portfolio returns thus represent the theoretical returns of a "fully hedged" portfolio to all model risk factors, i.e. "alpha". We then calculate the cumulative difference in the "fully hedged" portfolio returns, representing an "alpha" after controlling for other risk factors.