

ESG Investing: A Local, Not a Global, Issue

Wednesday, March 4, 2020



Yasuhisa (Justin) Tsurumi, Jake Walko, Leslie Norton, Alicia Ogawa

Featured Speakers:

Yasuhisa (Justin) Tsurumi - Senior Vice President; Head of Equity Investments,
Nippon Life Global Investors Americas, Inc.

Jake Walko - VP, ESG Investing and Director of Global Investment Stewardship,
Neuberger Berman

Leslie Norton - Senior Special Writer, Barron's

On Wednesday, March 4, 2020, the Center on Japanese Economy and Business (CJEB) hosted a panel discussion on environmental, social, and governance (ESG) investing trends in Japan and around the world. Alicia Ogawa, Director of the Project on Japanese Corporate Governance and Stewardship at CJEB, moderated the event.

Professor Ogawa began her remarks by noting the chasm that exists between the global drivers of ESG investing, and the different rules governing asset management across jurisdictions. Issues like climate change, diversity, and workplace safety generate interest in ESG worldwide, but ESG investing manifests itself in different ways depending on the country. Professor Ogawa discussed Japan's governance evolution following



Alicia Ogawa

the introduction of corporate governance codes by Prime Minister Abe Shinzo's government. Prior to corporate governance reform, Japanese companies were not accustomed to submitting themselves to oversight from external directors. Japanese companies have, however, demonstrated a consistent consciousness of conservation and resource scarcity.

Professor Ogawa then discussed the advent of ESG investing. In recent years, asset managers have received requests from asset owners such as pension funds to make investments with the potential for positive societal impact. Professor Ogawa observed that religious institutions have engaged in this practice for decades by excluding any investment inconsistent with their principles from their portfolios. In 2019, approximately \$21 billion worth of investment flowed to ESG funds in the United States, up 400% from the prior year.

Professor Ogawa noted the challenges associated with the rapid growth of ESG investing. ESG funds have drawn scrutiny from financial regulators and rating agencies. Access to standardized data is essential for portfolio managers to model cash flows and develop price

targets for these funds. Accounting standards must be developed to allow fund managers to accurately quantify diversity, worker safety, boards of directors' quality, and other factors used to evaluate companies in an ESG portfolio. Global organizations, such as the Sustainability Accounting Standards Board, are now seeking to promote a universal standard of measurement for ESG factors. Despite growing demands from asset owners for ESG products, Professor Ogawa reiterated the jurisdictional challenge facing asset managers. Politicians exert significant influence over the policies governing retail investing and the administration of pension funds. Asset managers operating globally must navigate the myriad of local rules and varying political environments that fundamentally alter their investment approach from one jurisdiction to another.

Professor Ogawa concluded her introductory remarks by discussing how ESG investing is integrated in central banking policy. Professor Ogawa observed that central banks evaluate ESG factors based on their potential to destabilize the financial system and economy. The stability of the financial system depends in part on the ability of banks to actively manage the long-term non-financial risks on their balance sheets. Professor Ogawa further noted that the degree to which governments encourage the transformation of legacy industries also has a material impact on the long-term stability of the financial system.

Professor Ogawa then introduced Yasuhisa (Justin) Tsurumi, Senior Vice President and Head of Equity Investments at Nippon Life Global Investors Americas, Inc. Mr. Tsurumi supported Professor Ogawa's earlier remarks, noting that governance continues to be an area of focus for Japanese companies. Executive compensation, board of directors' composition, and independent directors are among several corporate governance topics widely contemplated by

ESG-focused investors.

Mr. Tsurumi supplemented his remarks with a chart displaying the Nikkei 225 average from the 1950s to the present day. The Nikkei 225 dropped precipitously in 1989 due to an asset bubble and a failed monetary policy. Prior to the asset bubble, the Nikkei 225 and the overall economy grew steadily from the 1950s to the 1980s. Mr. Tsurumi noted that the Japanese government encouraged the creation of financial and industrial conglomerates in



Yasuhisa (Justin) Tsurumi

order to rebuild the country's capital supply following World War II. Through this corporate structure, companies offered guaranteed lifetime employment and increasing wages each year. The conglomerates were supported by a group bank, which then dispatched executives to the management team of each of the conglomerate's subsidiaries. The conglomerate structure proved an effective mechanism for corporate governance and contributed to steady economic growth.

Japan's monetary policy inadvertently contributed to the fall of the conglomerate structure. The low interest rate environment was intended to ease a strong yen but caused stock and real estate prices to skyrocket. The ensuing asset bubble caused a credit crunch. As a result, companies filed for bankruptcy, employee wages fell, and the economy entered a prolonged period of deflation. Under these conditions, the conglomerate structure was no longer feasible. Mr. Tsurumi observed that the conglomerate structure accounts for just 5% of

holdings today, down from 30% of holdings before the asset bubble.

Mr. Tsurumi observed that Japan is suffering from a shrinking economy and an aging society. 6 out of 10 citizens are over 50 years of age, and 8 out of 10 are over 40. As part of Prime Minister Abe's reforms, the government encouraged companies to take more risks when appropriate. However, an arbitrage exists between investors' required return on equity (ROE), and actual ROE generated by Japanese companies. In addition, companies are hoarding cash to mitigate their liquidity risk. This confluence of issues suppresses capital deployment in the economy. Mr. Tsurumi concluded his remarks by noting that his company encourages Japanese companies to either invest their capital or return money to shareholders. Moreover, Mr. Tsurumi stated that companies could improve economic conditions by dismantling the seniority system and increasing starting salaries for incoming employees.



Jake Walko

Professor Ogawa then introduced Jake Walko, Vice President for ESG Investing and Director of Global Investment Stewardship for Neuberger Berman. Mr. Walko discussed a few metrics that underscore growth in ESG investing. One-third of request for proposals and due diligence questionnaires received by Neuberger Berman globally ask questions directly related to ESG investing. The United Nations Principles for Responsible Investment has received over 2500 signatories since the initiative was launched. Mr. Walko noted that half of all ESG-related regulations had been implemented in the last two years. The overwhelming majority of

regulations focus on investors, how they perform due diligence before investing, and how to subsequently monitor those companies.

Mr. Walko discussed the competitive, media, and regulatory pressures on ESG investing. Asset managers seek to deliver long-term performance for their clients, attract more customers, and collect fees. Mr. Walko observed that this approach has been easier to execute as both the quality and collection of ESG-focused data have improved. Asset managers can leverage data to determine which companies more efficiently produce their revenue in terms of emissions, water use, or any other metric relevant to their clients. Mr. Walko noted that enhanced data scrubbing technology is enabling journalists to dissect fund performance and report how asset managers are performing for their clients. In addition, media coverage of issues like income inequality, succession plans, climate change, the Me-Too Movement, and clawbacks have all generated significant investor interest in ESG. Mr. Walko discussed the regulatory pressures on ESG investment. Mr. Walko observed that asset managers must cater to the highest standard to avoid the added complexity of parsing different rules in each jurisdiction where business is transacted. Mr. Walko concluded his remarks by noting that asset managers want to deliver a return that is aligned with the values of their clients.

Professor Ogawa then introduced Leslie Norton, Senior Special Writer for Barron's. Ms. Norton noted that Barron's ESG coverage began following Morningstar's introduction of its sustainability rating system in 2016. Barron's leveraged Morningstar sustainability ratings to evaluate the performance of funds predicated on ESG investing. Ms. Norton highlighted the discovery that a greater proportion of ESG-based funds outperformed the S&P 500 index than did traditionally managed active equity funds. Ms. Norton noted that the rise of the Me-Too Movement in 2017 increased interest in understanding the impact that social issues have on

the underlying value of securities. Guess and Wynn Resorts, as an example, saw their share prices drop precipitously after their CEOs were accused of sexual misconduct. That same year, Blackrock Chairman and CEO Larry Fink published a letter urging portfolio companies to define their social purpose beyond generating a profit.

Ms. Norton noted that companies are managing reputational risk by adopting the stakeholder capitalism framework. One industry-led initiative to adopt this framework proposes that companies include a statement of corporate purpose and a description of significant audiences in their 10-K filings. Although shareholders are the only stakeholders with a proxy ballot, Ms. Norton



Leslie Norton

observed that the growth of social and online media has empowered customers and employees with additional leverage to advocate for their interests. Google's 20,000 employees organized a walk-out to protest the way the company handled sexual harassment allegations.

Ms. Norton concluded her remarks by discussing results from a survey that Barron's administered to its subscribers. 50% of survey respondents were not aware of the term 'ESG.' When respondents were given the definition of ESG, 88% indicated awareness of this approach to investing. 30% of respondents expressed either somewhat or strong interest in ESG investing, compared to 21% of respondents five years ago. Among those respondents who indicated interest in ESG investing, 39% made changes to their investment strategy to incorporate sustainability factors. Ms. Norton noted that while studies and anecdotal evidence demonstrate the value provided by sustainable funds, comprehensive data will not be available

to investors until these funds flow through a full market cycle.

Professor Ogawa asked the panelists to explain the divergent attitudes towards ESG investing across the world. Mr. Walko discussed the different regulatory approaches taken in the United States and the rest of the world. The Securities and Exchange Commission has focused on creating an environment more conducive to corporate groups. Conversely, the Japanese Stewardship Code revised its partial disclosure requirement for material proxy voting results to encompass all proxy voting results. Mr. Walko further noted that a lack of uniformity presents challenges to asset managers. Under U.S. jurisdiction, asset managers lack the latitude to make the necessary portfolio adjustments to address risks like climate change. In contrast, other jurisdictions' rules recognize the risks and permit asset managers to act accordingly. Mr. Tsurumi discussed the Task Force on Crime-related Financial Disclosures as a potential global solution to the fragmented regulatory environment.

Professor Ogawa asked Ms. Norton to discuss the ESG factors that concern central banks. Ms. Norton noted that the Federal Reserve Bank of San Francisco recently stated that understanding climate risk is essential to achieving its mission to promote a healthy and stable economy. Specifically, the Central Bank cited extreme weather events, such as hurricanes and wildfires, as potential disruptors to the country's electronic payment system. Disruptions to the payment system require consumers to have cash on hand to acquire vital goods and services like health care and education.

Professor Ogawa thanked the panelists for their time and invited the audience to join CJEB for a post-event reception.