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Corporate Governance in Japan

An Introduction to Governance, Capital Stewardship, and the Adoption of a New Policy by Japan's GPIF

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Table of Contents

David Blennerhassett

Pan-Asia Catalysts/Events

GMO Internet | Event-Driven

Corporate Governance In Japan

By David Blennerhassett | 21 Jan 2020

EXECUTIVE SUMMARY

If effectively implemented, the Japan Corporate Governance Code, the Japan Stewardship Code, the Engagement Guidelines and the CGS Guidelines would also represent a sea change in the role of Japanese boards in terms of management selection, management compensation, and capital deployment. *If*. This is largely a 'soft" law rather than a hard regulatory change, limiting the regulator's power to address minority rights.

There is a need to see improvement in governance, independence, board structure, and capital stewardship by a very large number of companies in Japan. Enhancement of diversity on the board will enable increased effectiveness and also strengthen companies' governance structure.

Investors are calling on companies to hire outside board members and tackle cross-holdings. The TSE-mandated Corporate Governance Code seeks at least two independent outside board members for listed companies and preferably a third, a majority, and provides an example of "at least one-third independent directors". But these examples, and other much-needed changes, remain inadequate.

One of the fundamental problems with the combination of the Japanese Corporate Governance Code and the Companies Act, and the lack of liability of directors for their own decisions, is that they can hang their hat on irrational economic arguments and there are no repercussions.

Investors want better "governance", however, international investors seek more than improving the box-ticking form prized by many Japanese companies. Analysing non-box-ticking ESG/governance is difficult. It is difficult to track and analyse. And even if box-ticking is evident, it is not necessarily true that doing so will raise long-term equity returns. It is possible it will raise costs, which would lower profit growth - this may be good for society, it may not be good for valuations.

International investors are more concerned with improving information access, management responsiveness to investors, and management efforts to make companies become better economic engines. International investors would like to see companies concentrate on their business rather than see them run long-short funds (i.e. hold cross-holdings) with investor capital, hold excess cash, or invest in real estate as an alternative source of income.

A Consultation Paper reviewing the TSE cash equity market - first mentioned in December 2018, followed by a Market Consultation, culminating in four documents posted on the FSA's website last November - make it clear to the TSE, governmental, and regulatory authorities that existing governance and stewardship levels don't cut it.

For now, there's a lot of technocratic navel-gazing.

DETAIL

In the midst of the TSE's exercise in trying to gain international credibility for its market structure, rules, listing criteria, and governance - having introduced new Corporate Governance Code amendments in 2019, launched a public display for TSE companies of how to unwind cross-holdings in 2018, seeing new METI guidelines on MBOs and Fair M&A in 2019, and over the past 12 months a TSE/FSA/semi-public discussion about changing the market structure of the TSE - the TSE will now amend its Listing Regulations to require only two years (instead of five) of auditor-approved financial reports to go from TSE2 to TSE1. Which ultimately looks like an utter gift to Toshiba Corp (6502 JP) .

The ongoing Ghosn/ Nissan Motor (7201 JP) fallout also spotlights the key governance issues. Sarah Parsons of consultant outfit Perspective opines that while corporate governance scandals are not the exclusive domain of Japan, unique cultural factors enable inadequate internal controls to propagate.

Parsons assigns blame to "insiders" or the impenetrable network of middle-aged men within the same company. Instead of raising their hands when issues unfold at the senior level, the choice is made to maintain harmony and not stir trouble.

> *Given the strict hierarchies in Japanese society, expecting individuals to blow the whistle on their peers – or, even worse, their seniors – is a cultural no-no.*
>
> *The consensus-driven and long-winded nature of Japanese decision making has in some cases led to a lack of willingness to be accountable and a tendency to avoid the consequences until forced.*
> *Parsons*

1. **An Introduction To Corporate Governance In Japan**
2. **Recent Developments**
3. **Committee vs. Corporate Auditor**
4. **Board Structure and Composition of the Board**
5. **Delegating**
6. **Remuneration of Directors**
7. **Precaution-type Anti-takeover Measures**

1. An Introduction To Corporate Governance In Japan

Companies in Japan are typically regulated by the Companies Act (Act No. 86 of 26 July 2005). In addition, listed companies in Japan are regulated by the *Financial Instruments and Exchange Law* (FIEL) and the *Securities Listing Regulations* (SLR) published by *each* securities exchange in Japan. Nevertheless, the securities exchanges in Japan generally follow regulations issued by the Tokyo Stock Exchange (TSE), Japan's largest bourse.

- Should a specific provision of the Companies Act be breached, shareholders or creditors can bring a lawsuit against the company. Japan's Financial Services Agency (FSA) enforces FIEL wherein certain indiscretions/violations may incur monetary fines or prison sentences, or both.
- The relevant securities exchange that issues the SLRs also enforces them. Sanctions for violations can range from issuing an improvement plan through to delisting in extreme situations.

2. Recent Developments

Since its introduction in 2006, the Companies Act has been quite amenable as to the board of directors' composition and the installation of a corporate auditor. SLR revisions in December 2009 then required at least one independent director and corporate auditor, provided such appointments were in conflict (i.e. an existing business relationship) with shareholders.

- On the 1 May 2015, a newly enacted Reform Act required large public companies to have an outside director, and be subject to explanation at the AGM if this was not in place. This was preceded by a TSE edict amending its SLR in February 2014, requiring listed companies to make best efforts to elect at least one independent director.
- The Corporate Governance Code (Code) was issued by the TSE on the June 1 2015 and was/is applicable to Japanese listed companies with an aim to facilitate and improve "*growth orientated governance*" such as a need for fair, timely and transparent decision-making. The Code also required that listed companies should appoint at least two independent directors.
  - Subsequently, Mitsubishi UFJ Trust and Banking (a major passive asset manager and trustee) said it would oppose the appointment of all board members if companies do not have at least two outside directors; Sumitomo Mitsui Trust Bank said it would oppose board appointments at companies with parent entities unless at least one-third of the board was made up of outside directors.
  - Asset Management One (a major domestic asset manager with nearly US$500bn in AUM) called for outside members to attend at least 85% of board meetings instead of 75% previously. Tokio Marine Asset Management also considered opposing appointments of outside members who had been in office for more than 10 years.
  - JPMorgan Asset Management reportedly decided to oppose appointments of presidents and other representative directors if outside members do not comprise at least one-third of boards. JPM previously opposed appointments only if companies did not have two or more outside board members.
  - According to U.S. consulting firm Spencer Stuart, the average percentage of independent outside board members in the US is 85% and 61% in the U.K, which compares to 33% for the top 100 Japanese companies.
- On June 1, 2018, the TSE announced revisions to the Corporate Governance Code regarding the following issues:
  - Cross holdings: does the company clearly explain the purpose (& appropriateness) of each cross-shareholding and the status of its cross-shareholdings, including any changes in its cross-shareholdings?
    - Does the company make clear its policy regarding the reduction of cross-shareholdings, and take appropriate actions in accordance with the policy?
    - Sony Corp (6758 JP) had not been a company prone to cross-holdings. Its holding in Olympus Corp (7733 JP) genuinely *originally* had a purpose but SONY decided that cross-holding had now served its purpose, and Sony announced last August it was selling its 5.05% stake in Olympus. This is Sony taking the JPX/TSE's guidelines and example (when the TSE

announced the sale of its stake in the SGX) - without specifically mentioning the Corporate Governance Code - from March 2018 to heart.

    - Bank Of Kyoto (8369 JP) sold shares in Nintendo Co Ltd (7974 JP) last February, but it was not clear the sale was because of a new focus on policy cross-holdings, or just BoK topping up profit before the end of the fiscal year. BoK later said it has no intention of selling any of their other 'designated shareholdings' in Nintendo, Omron, Kyocera, Murata or anyone else. *This should be considered a failure of corporate governance for the bank with regard to its own shareholders as the ROE on those holdings is lower than anyone's target for the bank.*

  - CEO Appointment/Dismissal and Responsibilities of the Board: Is there an established policy on CEO qualifications in order to appoint a CEO who can make decisions decisively to generate sustainable growth and increase corporate value over the mid- to long-term?
    - Is a qualified CEO appointed through objective, timely, and transparent procedures, deploying sufficient time and resource?
    - Is the board of directors constituted in a manner such that it is equipped with appropriate knowledge, experience, and skills as a whole and ensures diversity, including gender and international experience?
  - Stewardship for Asset owners: As a pension fund sponsor, does the company take measures to improve human resources and operational practices, such as recruitment or assignment of qualified persons, in order to increase the investment management expertise of corporate pension funds (including stewardship activities such as monitoring the asset managers of corporate pension funds), thus making sure that corporate pension funds perform their roles as asset owners?

3. Committee vs. Corporate Auditor

Prior to 2015's Reform Act, companies either had a corporate auditor or committee structure. In most cases, a corporate auditor was in place, which audits the execution of the director's duties. A committee oversees auditing (directors' duties and salaries, appointments/dismissals) and monitoring functions. A majority of the committee must comprise outside directors.

- The Reform Act introduced a third structure, an audit committee, comprising at least three directors, the majority of which must be outside directors.

- The ‘*comply-or-explain*’ rule for the appointment of outside directors under the Reform Act introduced in May 2015 has helped improved corporate governance, together with clarifying the liabilities and rights of parent companies with and their subsidiaries.

4. Board Structure and Composition of the Board

- **Corporate auditor.** While a company may opt not to elect a board of directors, as is its right under the Companies Act, most companies do so, and this requires at least three or more directors. Except with a company with a committee, a company with a board of directors is required to have a corporate auditor. The board has authority over the company's management, while a company's management decisions are the responsibility of other executive directors. The corporate auditor audits the execution of duties by directors.
- **Committee.** The key difference with a company with a committee is the potential delegation to executive officers in deciding the acquisition of assets, drawing down debt and appointment/changes to staff. The audit committee not only audits the directors' duties but also the appropriateness of those duties.
- **Audit committee.** The board will still implement internal control systems and supervise the business execution by other directors. Material operational/business decisions rest with the board; although shareholders are entitled (via the company's articles) can enable the board to delegate decisions to certain representative and other directors.

5. Delegating

Corporate auditor. Certain and generally standard day to day operational matters are delegated to representatives and other directors; however such delegation is unlikely to extend to the buying/selling of significant assets, the taking on of material debt, issuing shares and signing off on audited financial statements.

Committee. The nominating, audit and compensation committee all fall under the remit of the Companies Act and cannot be further delegated. Separate to the responsibility of the committees, the board has overarching decision-making authority with respect to management policy and the execution of the audit committee’s duties; amongst other matters.

Audit committee. Similar in respect to a committee.

In Japan, the board normally appoints the CEO (or its equivalent) from among its representative directors (for companies with a corporate auditor *and* a board of directors, or a company with an audit committee) or representative executive officers. That CEO will chair the board meeting.

6. Remuneration of Directors

- **Corporate auditor/audit committee:** the aggregate amount of the directors' remuneration is decided at a shareholders' meeting, and the board determines each director's salary within the parameters of this aggregate amount.
- **Committee. No shareholder approval is required.** The compensation committee decides each director's remuneration.

In addition, a listed company must disclose in its securities report a breakdown of the payment (salary, bonus, stock options etc) for each director/corporate auditor/executive officer if the remuneration for the fiscal year is ¥100mn or more. How this remuneration is determined must also be disclosed.

7. Precaution-type Anti-takeover Measures

(with assistance from Travis Lundy)

Typically in a takeover process, a bidder must furnish adequate information to the target's board as to the background of the bidder and the deal terms of the bid. The bidder must desist from acquiring shares in the target until such time as the target's board has reached a conclusion on the deal terms, which is required to be completed within 60 days.

- If the bidder does not comply (i.e. it *does* buy shares) and/or the board concludes the takeover will damage the company, or that the takeover will limit the value of the company, anti-takeover measure may be implemented. This may take the form of using warrants (free of charge or perhaps ¥1/share) to shareholders, which the bidder cannot exercise. (Such measures cannot, however, cannot be taken with the goal of entrenching the management or the board.)
- In Japan, the *Bull-Dog Sauce* case in 2007 was not the first instance where warrants were issued to shareholders to thwart a takeover, but it was the most famous. The Supreme Court decided that if the shareholders (who actually hold the company's corporate value) deemed the takeover to be damaging or likely to harm the value of the company and recommended the issuance of warrants, the issuance would be deemed valid. The warrants in that case were approved by 83% of shareholders.

    - Subsequent to this case, there have been fewer hostile acquisition attempts. PGM Holdings launched a hostile takeover bid against Accordia Golf in November 2012, however, the tender offer failed. Similarly, in March 2013, Cerberus Capital Management's hostile bid for Seibu Holdings Inc only resulted in Cerberus increasing its stake to 35.48% from 32.22%. Prospect Co's hostile tilt for Yutaka Shoji in December 2014 failed to acquire 51% of shares out.
    - Furthermore, FIEL's tender offer regulations were amended around the time of the Bulldog case, such that the Offeror was required to provide more detailed information on its offer. In turn, the target had the right to submit a questionnaire to the bidder. The effect of these amendments was a reduction in companies issuing or adopting anti-takeover measures subsequent to that, and poison pill measures have declined in popularity since then.
- The *Takeover Defense Measures in Light of Recent Environmental Changes* report by METI's Corporate Value Study Group, published in summer 2008, included the phrasing:
  "corporate value and the shareholders' common interests" is referred to as "shareholder interests"... and this report will follow this usage of the term. In relation to this, "corporate value" appearing in the "Guidelines" and in this report is conceptually assumed to be "the discounted present value of future cash flow of the company". This concept should not be arbitrarily stretched in the interpretation of the "Guidelines" or this report.
    - That tells you that if "corporate value" is deemed to be the DCF value of the company, it is up to the company to explain how the DCF of the company would be impaired to the detriment of shareholders through such a takeover event. It should be noted that if there IS a takeover event, the shareholders hurt by such a takeover would be the shareholders doing the takeover.
      This *should* make the entire process a very tricky one legally, but this being Japan, it is clear the arguments will get muddied.
        - If you, as an institutional investor, would sell to the Tender Offer at that cash price if it were friendly, but would not sell at the same cash price if it is *not* friendly, you are not doing the right thing by your *own* investors.
        - If you sell when it is friendly, you only sell if the price is above what you think it is worth. And then you let go because you no longer own it. You have chosen cash over the potential future of that company for the right reason. It is now someone else's problem. And management and the board works for the new owner.
        - If you would sell at that price, but would not do so if hostile because management asks you not to sell, *you are choosing company management over your own investors*. You are making a different economic decision. Of course, if you would not sell even if it were friendly, that is a different story, but be honest with yourself (far too many tender offers go through at too-low prices in Japan because the tender offers have 'management support' or 'board recommendation').

        - If there were a friendly takeover with exactly the same terms except for the fact that the cash price were 5% lower than the hostile takeover attempt, would you accept the lower bid? In either case, you are out, and no longer own shares, and management and the directors and employees owe you nothing in either case.
            - *If it is a cash offer against scrip, or scrip vs scrip, the calculus changes, and that is OK. But if it is cash deal vs cash deal or cash deal vs no deal, you as investment manager have a fiduciary duty to do the right thing by your own investors - a duty unaffected by the opinion of management's opinion of the would-be buyer of your shares.*

- While the 2008 METI Guidelines are a strong document in support of shareholder rights and the importance of directors doing the right thing by shareholders, there is one element that is short-sighted. The requirement for adequate information and time for shareholders to make a decision does not ONLY come in the case of a hostile large scale acquirer. If it is appropriate for investors to have the extensive information to make a decision to sell based on a Price and an Offer, if the only difference is information about the post-sale disposition of the company, then that should be required of all deals - not just hostile deals.
    - Furthermore, investor decisions to sell are made with information about the company's prospects and financials, and price. Information about the company's financials, and prospects are provided by the Company itself - that is part of the Board's Governance Code obligations. This should take care of all information about the company and its future that would be required by selling shareholders. Every investor can make a decision about whether to sell in the market every day, based on that information provided by the company which is adequately fulfilling its governance obligations. If someone bids for the whole company, they can make that decision as well.
    - While it may sound insensitive, if I am being asked to sell my shares, I do not need to know what the buyer is going to do with them. The effect of the Cash Buyer's purchase on corporate value is not my problem. Suggesting an investor should accept a lower consideration so that the board is happier with the outcome is tantamount to a request by the board for board and management entrenchment.
    - A Tender Offer is, if for more than 50% of the shares outstanding, functionally equivalent to a Shareholder Meeting agenda item to approve the purchase of 50+% of the shares and transfer control over major board decisions to that Buyer. If 51% of shareholders do not agree, the Tender Offer will not succeed.
    - If a Buyer who buys a number of shares which is lower than all of the shares but does so at a premium has plans which include actions which may lower the Corporate Value of the target, the

first to be injured will be the Tender Offeror. Other shareholders can make their decision. The Company can attempt to provide a more attractive alternative. It will be very easy for the Company to provide such an alternative in this case.

- If a friendly buyer were to purchase the shares with board recommendation, based on future synergies and whatnot, the new owner would absolutely have the right to decide the disposition of the company's cash and high-value assets. That is one of the points of taking over a company. For a board to decide that it is against such is a sign of an effort to entrench itself.
    - A good example of this fallacy showed up in the case of Alpine and Alps. Alpine said it needed a large amount of cash - materially all of it - in order to conduct its business when it did not differentiate the source of that cash (equity or debt) and the joining of Alpine and Alps was going to be implemented, and followed immediately thereafter with the distribution of materially all of Alpine's cash to shareholders of the combined group through a buyback of post-merger shares. This cash was somehow not available pre-merger to the owners of that cash.

The Bull-Dog Sauce Situation
In the early-mid-Noughties, US-based activist fund purchased shares in Bull Dog Sauce (2804 JP) with their ownership becoming known among professionals when the share price passed about ¥1000-1200/share in 2004. In May of 2007, Steel Partners went over a 10% holding, and later in the month announced a Tender Offer to take over the company for ¥1584/share.
In the first week of June, the company announced that the takeover would harm corporate interests and proposed a 3:1 warrant issuance, which would not allow Steel Partners to convert their warrants. This would have the effect of lowering Steel Partners' stake from 10.25% to ~2.6%. The decision was put to the Shareholder's Meeting scheduled for June 24th, which was just four days before the end of the Tender Offer.
Steel Partners sought an injunction on the warrant issuance, and raised the Tender Offer Price to ¥1700/share. At the AGM, shareholders voted 83% in favour of the change in the Articles of Incorporation, and warrant issuance (i.e. more than 90% of non-Steel Partners shareholders voted against Steel Partners).
Steel Partners sought an injunction and extended the Tender Offer close date to 10 August. The Tokyo District Court rejected the injunction, as did the Tokyo High Court two weeks later in early July, with the High Court saying that discrimination against certain shareholders was allowed if the shareholder discriminated against had "abusive motive" (which it determined Steel Partners had).

Four weeks later (and on 7 August, just a few days before the end of the Tender Offer on 10 Aug), the Supreme Court upheld the rejection of the injunction and the principle of board discrimination of certain shareholders, calling Steel Partners an "abusive acquirer" (濫用的買収者). The warrants were issued on 9 August and Steel Partners was paid ¥396/share for every share they did not get as a result of warrant issuance (that ¥396/share was one-quarter of their original Tender Offer Price).

The important parts of the Supreme Court Decision were:

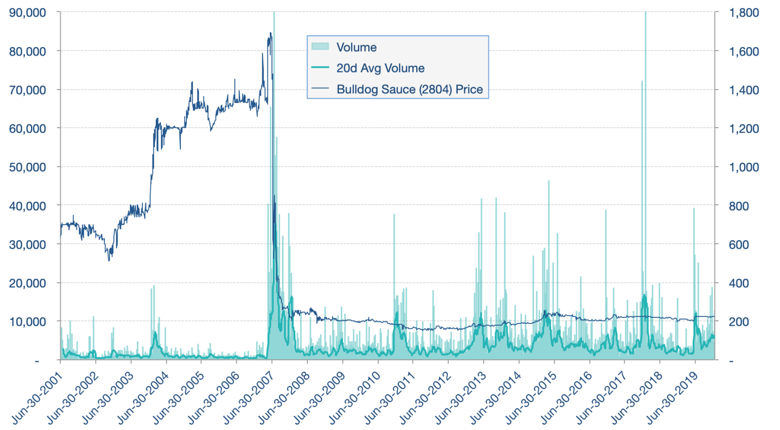
- Article 109 Para 1 of the Companies Act guarantees equal rights for all shareholders, but the so-called "Unocal Test" enshrined in precedent since Unocal vs Mesa Petroleum in the US in 1985 indicated that discriminatory treatment was allowable as long as the resulting discrimination was not unreasonable to the economic rights of the shareholder.
- A takeover defense does not need to exist in advance of a takeover attempt in order for it to be valid.
- The decision of whether or not control by the purchasing shareholder should be decided by shareholders themselves, not the board or management.
- Discriminatory warrant issuance is unfair if the effort is designed to entrench management or the board, but it was not the case in Steel Partners and Bulldog. Steel Partners was able to defend itself both in public and at the AGM.
- Receiving compensation in the form of cash was fair recompense for Steel Partners.

While the Unocal decision is famous as the underlying precedent for poison pill cases subsequent, the Delaware Courts would likely never have decided the way the Supreme Court did in Japan.

The key point for Steel Partners is that they were able to receive ~¥396/warrant of the shares for the warrants they were not allowed to exercise. That meant that the day the warrants were executed, every other shareholder got three more shares for ¥1 each and Steel Partners got ¥1,188 yen of cash and kept their 1 share.

In the chart below, the price adjusted for the price at the time of the Tender Offer. Since then, there has been a 1:10 reverse stock split, and a 2:1 stock split, making for a 1:5 net reverse stock split.

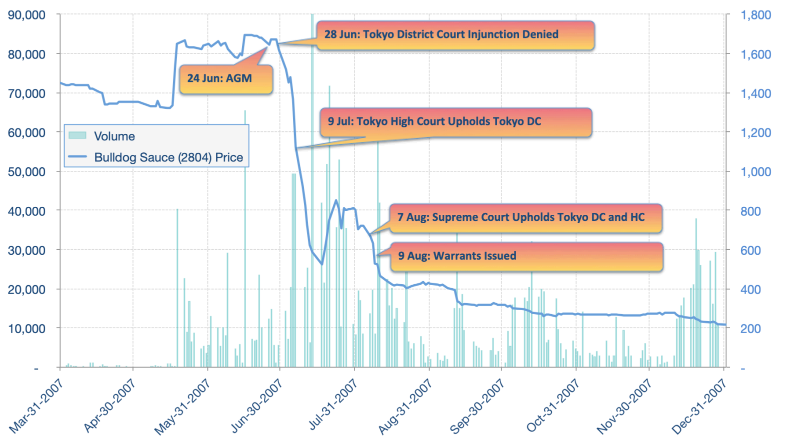
Bulldog Sauce (2804) History in the Runup to the TOB/Defense.... And Since....



source: capital IQ, company filings,

After the AGM when the shareholders overwhelmingly agreed to reject the Tender Offer and enable the warrants, the shares still traded much too high. There was not a lot of stock borrow. It was also a small-cap. The entire market cap was on the order of $250mm at the Steel Partners Tender Offer.

Bulldog Sauce (2804) Around the AGM And Court Decisions



The shares fell sharply, then rebounded to the ¥800 level - which was on a post-rights issuance basis effectively twice the Steel Partners TOB price - then it fell to about ¥500 around the Supreme Court decision date, then fell to the mid-low ¥400s. From there, it dribbled to ¥400 by later in August, then below ¥400 in September and below ¥300 in October, before heading to near ¥200 by year-end before

rebounding in mid-year when the Company renewed its poison pill defense. Steel Partners sold out in Q2 2008 having cashed out three-quarters of its position at ¥1188 on a pre-tender basis or ¥396/share on a post-rights issuance basis.
Everyone else ended up owning something which halved from the tender offer price within several months - and never came back.

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8. Directors - Appointments, Nominations, Dismissals

- The board typically nominates directors for a two-year period.
- For a company with committees, a nominating committee nominates directors with a maximum one-year term of office.
- For a company with an audit committee, a director of the audit committee must be separately nominated from other directors. The maximum term of office for a director who is a member of an audit committee is two years, and one year for other directors.
- Directors can be dismissed by a resolution at a shareholders' meeting.

9. Directors' Liability

Directors are required to perform their duties with a duty of care and adhere to all laws and regulations, and the company's articles and resolutions.

- **The business judgement rule (BJR)**. Provided a decision was undertaken without careless mistakes, via reasonable and proper due process, even if that decision resulted in damage to the company, Japan's BJR would conclude the director acted with adequate duty of care. Such a rule would not be used in a court of law if a conflict of interest was in place.
    - In June 2006, Apamanshop Holdings acquired the remaining shares of a partially-owned subsidiary at Y50,000/share after Apamanshop had previously set the value of the shares at Y10,000/share for the share-for-share exchange. The Supreme Court upheld the BJR as it ensured a "*smooth process of the share acquisition*", the maintenance of "cordial relations" and the value of the subsidiary may increase as a result of business restructuring.

10. The Role and Involvement of Outside Directors

Outside directors excludes directors who have previously been appointed as executive directors, executive officers or employees of the company, its subsidiaries, its parent companies or related companies.

- For a company with committees, a majority of each committee must be outside directors, while each committee should consist of at least three members.
    - For a company with an audit committee, the audit committee must have more than three directors as members, the majority of which must be outside directors.
    - There are no such outside director rules concerning the board composition of a company with a corporate auditor.
- Following the submission of the Company Act reform bill, the TSE revised its SLRs such that listed companies endeavour to elect at least two independent directors.
- The Code enunciates that if a company with a corporate auditor and a board of directors OR a company with an audit committee, and independent directors do not comprise a majority of the board, an optional advisory committees under the board, to which "*independent directors make significant contributions*" is to be established to strengthen the "*independence, objectivity and accountability of board functions*".

11. Legal Duties for Directors

Typically the legal duties for outside directors mirror that of other directors or executive officers, although a company's articles limit a company's liability to its outside directors.

- Outside directors should evaluate/appraise management's performance, issues arising from conflicts of interest, and management's decision process - all with a view towards improving and progressing a company's culture. Indeed, all directors should take on a similar role, just that outside directors are expected or perceived to do so impartially.
- In recent times, when a significant event takes places, such an offer, anti-takeover measures or an internal investigation, a third-party committee is formed to oversee any possible conflict of interest issues. These committees generally include an outside director.
- If a director seeks to carry out a transaction involving a conflict of interest, board approval must first be sought. Although the director in question is not entitled to participate at such a board meeting, he/she must still furnish all necessary information inveigled in the transaction.

12. Auditors

The corporate auditor audits the directors' duties, including the preparation of a company's financial statements.

- To uphold a corporate auditor's independence, its term of office must continue at least until the conclusion of the annual shareholders' meeting for the prior fiscal year.
    - For a company with committees that does not have a corporate auditor, the audit committee comprises directors (with a maximum one year term) that audits the directors' duties, including the preparation of a company's finances.
    - For a company with an audit committee, the audit committee comprises directors (with a maximum two-year term) which audits the directors' duties, including the preparation of a company's finances.
- Furthermore, a 'large company' (i.e. with balance sheet capital of [in its most recent fiscal year] of ¥500mn or more; or total liabilities [in its most recent fiscal year] of ¥20bn or more) and a company with committees are required to have either a certified public accountant or an audit firm. An accounting auditor's terms of office will continue until the annual shareholders' meeting (for the last fiscal year), and ends within one year after their election.
- Whether a company has a corporate auditor, an audit committee or is a company with committees, proposals regarding the election and dismissal of accounting auditors are submitted at a shareholders' meeting.

13. Financial Reporting and Accountability

FIEL requires all listed companies to prepare a securities report, within three months of the end of each business year, which includes consolidated financial statements; as well quarterly reports. Furthermore, a representative director or representative executive officer of a listed company must confirm the securities report or other reports conform with the FIEL.

14. Communications with Shareholders

If an enquiry is asked by a shareholder, directors, corporate auditors and executive officers are required by the Companies Act to adequately explain the agenda of the shareholders' meeting.

- The code states that the listed company should proactively promote constructive dialogue with shareholders to support sustainable growth and increase corporate value. Q&A sessions during shareholders' meetings are now *actively encouraged* in Japan.

15. Internal Control

Boards of large companies must develop internal control systems that ensure that directors comply with laws and the articles, and that company operations are appropriate.

- A listed company must develop internal control systems - such that directors comply with the relevant laws and articles - and submit internal control reports that describe such systems are in place to certify the financial reports of the company are made in compliance with the necessary laws.
    - The composition of the internal control systems and the compliance programmes may be decided at the company's discretion.
    - The **Whistle-blower Protection Act**. An employer of a whistle-blower is prohibited from treating said whistle-blower in a disadvantageous manner. Furthermore, a point of contact that is independent of management should be established for whistle-blowers.

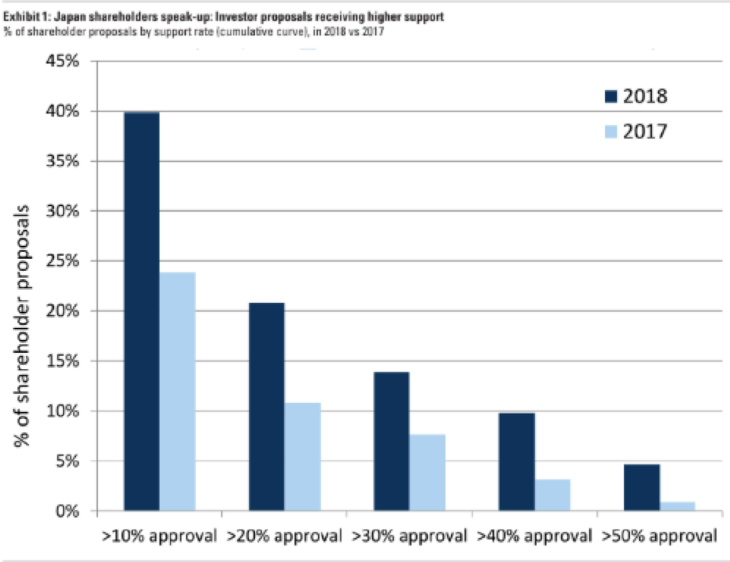
16. Shareholder Rights and Powers

Voting rights

Each voting share has the same voting right, therefore a company must treat its shareholders equally with respect to the class and number of shares owned.

- Minority shareholders' rights *may* extend to proposing a resolution/ agenda at a shareholders' meeting, to inspecting accounting books through to applying to a court for the dissolution of a company.
- Under the Companies Act, shareholders' approval is required for the following:
    - amending the company's articles;
    - mergers, corporate demergers, share exchanges and transfers, share capital changes;
    - appointment/election or dismissal of directors and corporate auditors; and
    - decisions regarding dividends.

- This would *generally* suggest shareholders have an influence on the board. Shareholders who *do* speak up, may be viewed as activists - and activism often comes with a negative tilt. A Goldman survey found 40% of proposals received 10% of shareholder support in 2017, a large step up from 24% in 2017.



Source: The Diplomat

17. Rights of Dissenting Shareholders

Shareholders may demand a company purchase their shares at a "fair price" if they object to a proposed agenda (specifically listed under the Companies Act), such as amendments to the articles or a specific merger/acquisitions.

- This price is determined via negotiation between the company and the dissenting shareholder, or failing that, a court. If an agreement is reached, the dissenting shareholder will receive payment within 60 days from the effective date in the initial proposal that the shareholder dissented on.
    - If the two parties are not able to reach an agreement within 30 days of the effective date, either the dissenting shareholder or the company file a court petition to determine a fair price.
- In the Supreme Court's decision in the Tecmo case, an appraisal case involving a share transfer between unrelated independent parties, it found that:
    - where there is no synergy or other increase in the enterprise value of corporation arising from the transfer, the fair price should be the value the shares had on the date on which the shareholder

made a demand to the company for the repurchase of its share, on the assumption the share transfer ratio in the share transfer plan *is* fair; and

    - if the share transfer comes into effect through a due process that is itself deemed to be fair, the share transfer ratio should be seen as fair - unless special circumstances prevail inhibit a shareholder from making rational decisions at a shareholders' meeting.
        - *This is quite obviously unsuitable in the real world because there is no third party verification required, and "Business Judgment Rule" can override any and all third party input and as long as the boxes are ticked, there are no repercussions on directors.*
- Appraisal rights in Japan are not straightforward. The takeaway is... best to get your own legal advice, and even then it is not easy.

18. Major Shareholders' Duties and Practice

Under the Companies Act, shareholders do not owe a duty of care to a company, other than paying for the shares in which they have subscribed.

- The exception under the SLRs is when a listed company undertakes specific transactions with its controlling/substantial shareholder. In this instance, am opinion from an independent third party must be sought to determine whether the transaction is in the minority shareholders' best interests.
- As an aside, controlling shareholders have no legal duty of care to the company or minority shareholders except in exceptional cases, such as a squeeze-out at low price. Such an act may be pursued under the Civil Code or other laws and pursuing such a case is straightforward.

19. Shareholder Activism

Under the Companies Act, provided a shareholder has held shares for at least six consecutive months, it can demand a company file an action to pursue a director or corporate auditor's liability to a company. If a company does not respond to such a filing within 60 days, the shareholder can proceed to file such action on behalf of the company.

- A shareholder may also sue a director or corporate auditor of a company should that shareholder own at last 1% in the parent of the company in which the senior personal are being pursued; AND, the holding in the company equates to at last 20% of the total assets of the ultimate parent company.

Proxy battles

Under the FIEL, a shareholder (or the company) that solicits a proxy must provide the other shareholders with a certain set of documents (such as a proxy and reference materials that table the agenda).

- It is difficult for a shareholder to be successful in proxy fights, as the shareholder won't know the shareholders' meeting agenda until the notice is sent by the company. Moreover, the company may refrain from providing the information of other shareholders to a shareholder who wishes to solicit the proxy, however, most shareholders who wish to undertake a proxy effort usually prepare a position (large enough and for a long enough period of time) to have the right to inspect "the books and records of the company" and can thereby obtain a shareholder's list.

20. The Stewardship Code

(with assistance from Travis Lundy)

To further improve corporate governance, a group affiliated with the FSA published the "*Principles for Responsible Institutional Investors - Japan's Stewardship Code*" in February 2014 as a prelude to the introduction of the Japan Corporate Governance Code, which had been in the works for years.

- The aim of this code is to push institutional investors to fulfill their own fiduciary responsibilities by upholding higher standards for the management of companies in which they own stock via promoting "sustainable growth of companies through investment and dialogue".
    - Basically, get investors more immersed/involved in companies invested by increased dialogue, with a view to increased transparency, and in turn better-run companies.
    - The TSE had, on its own, done a bit to promote better corporate governance. It created its own Governance Code in 2004 called The Principles of Corporate Governance for Listed Companies, and the TSE institutionalised Corporate Governance Reports two years later, and in 2009 introduced the independent directors/kansayaku system (albeit this came far behind the rest of the world, and with extremely weak follow-through).
    - However, the TSE-built Corporate Governance Code was something of an afterthought and few companies even paid lip service to it. It was entirely voluntary and the TSE as much as admitted it had no teeth.
    - After the GFC, there were more political efforts to create a Governance Code with some teeth - an effort which had to be led by the government - in order to make sure Japan did not get left behind because of perceptions by international investors that Japan was not a good place to invest after a series of hostile

activist attempts in the five years prior to the GFC laid bare the relatively naked efforts at entrenchment by Japanese management.

- Because any Governance Code was going to be somewhat alien to the way most Japanese companies had traditionally treated shareholders, the introduction of the Stewardship Code was designed to create expectations about how investors were to behave in order to be 'Good Investors' (which the hostile activists clearly were not).
- If the government defined what the goal of good stewardship was in its interaction with companies, it could define what the goal of good governance was. That became the mantra of the idea to "promote sustainable growth of companies and improve corporate value over the medium to long term."
- Seen in a slightly cynical way, the Corporate Governance Code would effectively give Japanese companies a guidebook on what they had to say in order to tick the boxes. The Stewardship Code would give investors the boxes they needed to tick to be "Good Investors."
- Seen more opportunistically, it gave investors a stick to use on recalcitrant companies, and all they had to do was say "I'm doing my part!" because they had signed up to the Stewardship Code.
- However, back to 2014 with the introduction of the Stewardship Code, in its formulation, much was made of the fact that Japan needed one to be like other markets. Its clear basis was the UK Stewardship Code, and it is also quite clear that the Japanese Council working to create a Japanese version borrowed quite liberally from the UK Code.
  But the Japanese version was different. In unsubtle ways.

Comparison Between The Seven Basic Principles of UK vs Japanese Stewardship Code

UK 2010 Version	Japan 2014 Version
Institutional investors should:	So as to promote sustainable growth of the investee company and enhance the medium- and long-term investment return of clients and beneficiaries, institutional investors should...
1. publicly disclose their policy on how they will discharge their stewardship responsibilities.	1. have a clear policy on how they fulfill their stewardship responsibilities, and publicly disclose it
2. have a robust policy on managing conflicts of interest in relation to stewardship and this policy should be publicly disclosed.	2. have a clear policy on how they manage conflicts of interest in fulfilling their stewardship responsibilities and publicly disclose it.
3. monitor their investee companies	3. monitor investee companies so that they can appropriately fulfill their stewardship responsibilities with an orientation towards the sustainable growth of the companies.
4. establish clear guidelines on when and how they will escalate their activities as a method of protecting and enhancing shareholder value	no direct analog.instead, a much watered-down version below seeking consensus rather than assertion of steward's obligation to fight for shareholder rights.

	4. seek to arrive at an understanding in common with investee companies and work to solve problems through constructive engagement with investee companies.
5. be willing to act collectively with other investors where appropriate	no analog
6. have a clear policy on voting and disclosure of voting activity	5. have a clear policy on voting and disclosure of voting activity. The policy on voting should not be comprised only of a mechanical checklist; it should be designed to contribute to the sustainable growth of investee companies.
7. report periodically on their stewardship and voting activities	6. report periodically on how they fulfill their stewardship responsibilities, including their voting responsibilities, to their clients and beneficiaries.
	7. To contribute positively to the sustainable growth of investee companies, institutional investors should have in-depth knowledge of the investee companies and their business environment and skills and resources needed to appropriately engage with the companies and make proper judgments in fulfilling their stewardship activities.

The Codes of each have been amended since then, with the Japanese Stewardship Code amended in 2017 ahead of an amendment to the Corporate Governance Code in 2019.

- **Effectiveness?** Fostering good stewardship is a good thing. Nevertheless, the Code is not legally binding. Institutional investors can opt-in or opt-out. And even if they opt in, they are not bound to strictly adhere to the provisions of the Code. All they have to do is explain why they are not abiding by the provisions.

- A key concern was the Code may flounder without a critical mass of support from institutional investors, especially conservative corporate pension funds.
- As at 30 April last year, 246 institutions have signed up, including six trust banks, 23 insurance companies, 33 pension funds and 177 investment managers.
    - This includes Panasonic's employee pension fund, leaving the employee pension fund of Japan's largest company, Toyota, as a key holdout towards signing the code.
- GPIF. the Government Pension Investment Fund, or GPIF, is the largest fund - pension or otherwise - in the world. Last December, the GPIF announced a revised *"Policy to Fulfill Stewardship Responsibilities"*.
    - An ever-increasing emphasis on strong stewardship policy at the GPIF is a good thing for both the GPIF and its beneficiaries and for the role of stewardship at Japanese investors.
    - Still, the GPIF does not actually execute the stewardship of the management of its portfolio. It has a stewardship policy with regard to the investment managers to which it allocates, and those investors - such as Blackrock, State Street etc. - have their own stewardship policy, which is probably somewhat affected by the interaction they have with the GPIF, but is distinctly their own.

21. Recent Consultation Papers Towards a New Market Structure

Four documents were posted on the FSA website last November, divided into the issues, the basic concept of the New Market Structure; and towards a new TOPIX Index. The aim of the New Market Structure is to get rid of the current five or more venues and establish a three-part market structure:

- A "Prime" market, comprising large-cap, liquid blue chips, which would adopt a high standard of governance, etc.
- A "Growth Market" to replace MOTHERS and JASDAQ Growth; the designation of being on this market would indicate that a) the companies were in the capital-raising phase rather than the money-earning phase, and b) that these companies might be riskier than other listed companies.
- And a market tranche for everyone else - companies neither growthy enough to be given a pass on lower-quality disclosure or profits nor blue-chip enough to be deemed suitable for Prime.

The basic outline appears to be a watered-down version of the least stringent possibility mooted after the first meeting of the TSE-sponsored in 2018. And changes won't take place for years. For the vast majority of investors there will be nothing to do.

22. Toshiba's Gift

Last November, the Nikkei had an article (Japanese, English) saying that the TSE will amend its Listing Regulations to require only two years of auditor-approved financial reports to go from TSE2 to TSE1. It would do this, apparently and bizarrely, to correct disparities between the requirements for the several boards of the TSE.

- The FSA and TSE have just spent a full year in the process of "*review[ing] the market structure in order to further incentivize listed companies to proactively improve their overall value as corporation, in addition to further attracting diverse global and domestic investors by providing attractive investment opportunities*."
- A featured proposed measure is to create a "step-up market" - a "TSE Prime" - which would highlight higher governance and standards for the bluest of the blue chips, separating them from the multiple thousands of less well-regarded companies which make up the lower half of TSE1, almost all of TSE2, and JASDAQ Standard. The goal is to gain further credibility for the exchange and its major listings by differentiating the new rules from the old rules and old standards.
- This audit change to unify the standards to the lowest common denominator is an odd way of asserting that credibility. It also provides a gift to Toshiba and its investors, and a return to TOPIX.

Smartkarma insights referenced in this insight:

[Nikkei] TSE Rule Change to Allow Toshiba An Early Return to TOPIXGPIF World's Largest Fund To Suspend Global Stock LendingTSE & FSA Think "Prime" - The World Yawns. Murakami Vs Toshiba Machine: A Question of Shareholder Rights or Rights for Shareholders

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Bnp Paribas | ESG

They're Here: ESG Short Sellers

By Kyle Rudden | 31 Jan 2020

EXECUTIVE SUMMARY

ESG short selling – i.e., shorting based on ESG metrics and catalysts – isn't new, but is undergoing a radical evolution. Short-term ESG trading opportunities are a new reality. Traditional ESG funds are breaking etiquette and mimicking hedge fund long/short strategies. Hedge fund heavyweights are here, some betting against ESG *itself*, as if ESG is overvalued or ripe for a catalytic correction.

Originally, my plan was to address ESG short selling in different report, on another topic. However, a recent decision by Japan's Government Pension Investment Fund sparked a firestorm around the age-old ESG short-selling debate – whether shorting is ideologically at odds with ESG, responsible, sustainable, social, ethical, green, moral, or whatever-you-want-to-call-it investing.

I feel the ESG community (and media) shot a wooden duck by sprinting down the same tired ethics path with blinders on, re-hashing increasingly antiquated arguments and ignoring more important trends in ESG short selling. The ethics of short selling still matter, but such a myopic focus is naïve to, or perhaps in denial of, fundamental changes to the ESG landscape over the last few years.

Thus, I wanted to share my thoughts sooner rather than later. This was to be a brief critique of the recent ruckus over ESG short selling. Clearly, it snowballed. I stopped before descending the rabbit hole from which I'd never emerge (ESG long/short back tests and walk forwards). Still, this evolved into a deeper dive into ESG short selling and hedge funds. There are seven sections, which:

1. Articulate my rationale for having a contrarian (bullish) imperative on an innately bearish topic
2. Summarise GPIF's decision to suspend stock lending and opine on its broader ESG implications
3. Explain why and how I think securities lending, shorting selling, and ESG can peacefully coexist
4. Highlight three broad trends that are enabling and driving changes in ESG-driven short selling
5. Note how ESG mutual funds are shorting as a turbocharged ESG screen ("long virtue, short sin")

6. Discuss the recent influx of hedge fund assets into the ESG arena, including several key nuances
7. Illustrate how hedge funds are shorting ESG "greenwashing" and/or arbitraging dodgy ESG data

Conventional wisdom is that ESG investing is a long-term, long-only, buy-and-hold game. That is still largely the case, but the range of potential ESG investment horizons is widening. For the first time in my eleven years of ESG investment research, I can envision shorter-term, trading-oriented ESG opinions as a complement to long-term biased ESG research. We'll see where this leads.

DETAIL

Why a Bullish Imperative on an Inherently Bearish Topic?

I will start with my rationale for having a contrarian (bullish) imperative on an intuitively negative subject. After all, short selling in general is innately bearish, ESG short selling is sheer blasphemy, and those some are betting against the sanctity of ESG, the basis of my career. Shouldn't I be more bearish? No, and the reasons, in a somewhat decreasing order of significance, are as follows:

- **Opportunity:** To make money. My ESG mantra is "alpha first" and short selling, though not for everyone, is a valid alpha-generating (and risk-reducing) strategy; another tool in the toolbox.
- **Intelligence:** Short sellers have a knack for uncovering what others don't (or refuse to) see, and ESG short selling can lead to information discovery and even flush out a black swan or two.
- **Motivation:** More pervasive ESG short selling could serve as a powerful external motivator for issuers to improve ESG performance (we all know how managements fret over short interest).
- **Affirmation:** The fact that ESG short selling is being embraced by "smart money" hedge funds is a testament to ESG's alpha value, and could further insight into the ESG-alpha connection.

A quick word on vernacular. I use "ESG short selling" as a convenient catch-all, but where it is more nuanced I will qualify that phrase ("ESG-driven" or "ESG-related"). Also, unless stated, I am usually referring to shorting vis-à-vis long/short equity strategies (versus a hedge or opportunistic trade).

- **ESG-*Driven* Short Selling:** This includes all short selling *formally* driven by ESG criteria and/or catalysts. It is a broad category, but the unifier is that short selling is explicitly ESG-driven, not merely ESG-*related*. Most of what this report discusses is ESG-driven short selling.

- **ESG-*Related* Short Selling:** Sometimes, short selling isn't ostensibly tied to the ESG acronym, but for all intents and purposes it is related to ESG. An example is thematic funds (e.g., climate change). If a fund's sole focus is "E" (not "S" or "G"), it isn't strictly ESG, but it is ESG-*related*.

GPIF Re-Ignited Ethical Debate Over ESG Lending/Shorting

> ***People think I have two horns and spread syphilis.***
> *– Jim Chanos, Kynikos Associates*

GPIF's decision to suspend stock lending is the spark that re-ignited a recent firestorm around ESG, and both lending and short selling. Reaction varied, from effusive praise to accusations of fiduciary irresponsibility and greenwashing. Sporadic talk of lending took a back seat to the absolute ruckus over ESG short selling, but all of it fixated on ethical arguments against ESG lending/shorting.

- The overall view is that securities lending facilitates short selling, and short selling is anti-ESG
- Some of that sentiment is rooted in ethereal conceptions of morality and common ESG decency
- A common claim is that short selling reaps benefit for few from the misfortunes of many others
- Some say ESG begets social good over the long-term, but shorting hurts long-term investments
- Another belief is that one shouldn't profit from a "bad company" at all, even if via short selling

The myopic focus on ethics is a mistake. Ethics do matter, but sprinting down the same tired ethics path with blinders on is a bad idea. At least approach it from the perspective of this decade, instead of using yesteryear's antediluvian arguments as if naïve to, or in denial of, the current state of ESG. Nonetheless, that focus on ethics after the GPIF news is somewhat understandable since:

- Despite going mainstream, the ESG mindset is still grounded in altruism, ethics, ideology, etc.
- GPIF's rationale was based on "doing the right thing," and GPIF's move is what started all this
- Ethical concerns re: ESG lending and shorting are still highly relevant, notably for ESG purists
- That group, more traditional ESG investors, spoke loudest and dominated the recent discourse

GPIF Feels Lending Conflicts With Stewardship and VotingYou would never know it by the media coverage, but the GPIF decision wasn't explicitly about short selling. GPIF's explicit and primary rationale is about stewardship and voting – i.e., the short-term nature of lending conflicts with long-term stewardship and voting responsibilities. Short selling is a prominent subtext, however, and is of course inextricably related to stock lending.

GPIF expressed specific concerns about transparency in lending; knowing who borrowers are, what motivations they have, and how they vote the shares. Hiro Mizuno, GPIF's CIO, said that GPIF tried working with brokers and custodian banks to improve transparency, but to no avail, and that GPIF would consider reversing its decision if key transparency issues are resolved in the future.

Suggested Readings on GPIF and Governance in Japan The GPIF move is an impetus for this report, but not its focus, so I'm limiting this section to a basic overview. For detail on GPIF's decision, Japan's Corporate Governance Code, Japan's Stewardship Code, etc. I suggest starting with the following Smartkarma Insights:

- GPIF World's Largest Fund To Suspend Global Stock Lending by Travis Lundy
- Elon Musk Has a New Friend in the GPIF by Brian Freitas
- Corporate Governance In Japan, a Smartkarma Original by David Blennerhassett
- GPIF: Stewardship: GPIF's Active Managers Choose Stocks They Like! by Travis Lundy

Purely by the Numbers GPIF's Move is Not Very Significant

Corporate responsibility aside, from a purely numbers standpoint this just isn't that significant; for GPIF, or for markets. A limiting factor is that it only applies to foreign stocks in GPIF's portfolio, or about 25% of assets (GPIF doesn't lend Japanese shares, and will continue lending debt securities).

*Foregone Lending Fees are Minimal*GPIF is giving up US$125-150 million in annual fees (2.5 basis points as per *Financial Times*). That's nothing to scoff at – especially in times of negative interest rates, and since lending fees are lower-risk income – but it's still small. It seems even smaller when you take into account that a third gets eaten by intermediaries' fees. Or when you think of it as just 1.0 basis points of the total portfolio.

*No Material Impact on Lending Pool*It won't reduce global lending by much. GPIF controls US$1.6 trillion in assets, or about 10% of the Japanese market and 1% of global market cap. Foreign equities, the only holdings affected, are just over 25% (~US$400 million) of assets. GPIF likely didn't lend 100% of foreign stocks, so the impact on the global lending pool is less than US$400 million (a half a percent of global market cap).

Source: GPIF, Financial Times. *Allocation of Foreign Equities is 54% U.S., 5% U.K., 4% Hong Kong, 37% spread over 40 countries.*

Unlikely GPIF's All-or-Nothing View is Adopted by OthersIt's not the initial splash of GPIF's announcement, but rather its outward ripples that *could* make it a more significant event. The big question is whether it signals other institutions to follow its lead. I'm certain it has spurred dialogue, but I'm less sure it will have sweeping effects, for two reasons:

1. **This Isn't a New Issue:** GPIF made waves because it's huge and took an extreme approach, but others have been contemplating the lending/ESG relationship for a while and many (notably in Europe) have already addressed the issue with formal policies that strike a balance.
2. **GPIF Move is Extreme:** As per above, other existing policies have found a balance, and I expect that in the future most other institutions will do the same. I am by no means disparaging GPIF's all-or-nothing approach, but I feel that there are ways for lending and ESG to coexist.

Stock Lending, Short Selling, and ESG Can Peacefully Coexist

I might ruffle some feathers by saying this, but here it goes. I believe that: 1) securities lending and ESG need not be mutually exclusive, and 2) responsible short selling doesn't undermine ESG ideals.

Securities Lending and ESG Needn't Be Mutually ExclusiveWith diligent thought and execution, lending and ESG can coexist – peacefully side-by-side at the very least, and possibly even symbiotically. Lending can be approached in a way that is pragmatic for today's diverse ESG milieu, and still faithful to ESG principles and greater-good objectives.

Securities lending (and borrowing) engenders liquidity and efficiency, and is an integral element of well-functioning capital markets… and to the sustainability of global economic systems (economic stability is a Triple Bottom Line pillar). Securities lending policies can be designed to mitigate the ethics arguments against it, including those about voting and short selling. For example:

- Maintain a priority shareholder engagement list and restrict or recall all securities on that list
- Have the *ad hoc* ability to recall securities at any time (e.g., to engage re: an unplanned event)
- Allow or restrict lending during specified time periods (e.g., allow only after shares are voted)
- Screen and monitor lending counterparties for compliance with ESG policies, preferences, etc.
- Apply ESG criteria to collateral (e.g., if don't invest in tobacco, no tobacco stocks as collateral)
- Establish rules to avoid preferential tax treatment (e.g., don't lend same week as record date)

Lending, Taxation, and the Cum-ex Scandal The last bullet point above warrants clarification, since "preferential tax treatment" would seem like a good thing. It could be in some cases, but is unethical if it results from lending transactions. For example, an unethical investor might try to use a short-term transaction with borrowed stock within a week of the stock's dividend date for tax manipulation.
Similar to that generalization is the Cum-ex trading scandal, a colossal tax evasion scheme that absconded with US$60 billion. The incredibly complex swindle involved German tax law loopholes, rapid trading around dividend dates, and differences in the taxation of dividends for individuals (at a 25% capital gains rate) and corporations (at a 15% corporate rate).

Responsible Short Selling Doesn't Undermine ESG IdealsAbusive practices aside, short selling isn't intrinsically unethical. Opinions make markets, and that includes opinions that stock prices should be lower. Shorting is a legitimate investing and hedging strategy (most of the time anyway), and it plays a key role in liquidity, price discovery, and market efficiency. That applies to ESG short selling as well. The operative word, however, is "responsible."

The real issue for me is behavioural, not whether shorting is or is not categorically unethical. What is far more critical is *why* investors sell short, and *how* they conduct themselves in the process. Like the one bad apple that spoils the bunch, it takes just a few naked shorts running around spreading their nasty bits of misinformation in public – "short and distort" – to reinforce the case against it.

Evolution in ESG Short Selling is Driven by Three Big Trends

Historically, when ESG was still an obscure niche, short selling was exceedingly rare. If it occurred, it was trivial in size and impact, done without fanfare, and for reasons that didn't overly offend the ESG psyche – e.g., as a risk management tool (hedging) or as a kind of turbocharged negative ESG screen. There are numerous reasons for the above, a few of the more noteworthy being:

- In the formative days, ESG motivations were at their holiest and short selling was just sacrilege
- Early ESG AUM was dominated by fund types (e.g., mutual funds) that generally don't sell short
- Links between ESG and alpha/beta weren't well understood (kind of important for short selling)
- ESG data was available for a small fraction of issuers, leading to low ESG information dispersion
- The market wasn't yet saturated with long-only ESG investment products (more on this shortly)

Today, things are different. ESG-driven short selling is more accepted, prevalent, and varied. There is modest yet palpable shift in disposition among traditional ESG investors; they're more accepting of short selling. Also, the influx of investors new to ESG – notably hedge funds – brings a markedly new disposition to ESG short selling. The latter has a greater net influence on ESG short selling.

Three broad and interrelated trends/forces are behind the changes in ESG short selling. In a quasi-chronological (and perhaps semi-causal) order, those three interrelated trends/forces are:

1. **Mainstreaming of ESG:** The over-arching and enabling trend is ESG's transition from niche to mainstream, which has dramatically altered the ESG landscape in favor of ESG short selling.
2. **Irrational Exuberance:** ESG's "bull run" in popularity gave rise to exuberance, including some of the irrational kind – i.e., over-promising and under-delivering on ESG (aka "greenwashing").
3. **Information Asymmetry:** Despite ongoing improvements, ESG data is notoriously unreliable, and that often creates high levels of "ESG intelligence dispersion," which can aid short selling.

Mainstreaming of ESG is the Overarching Driver of ChangeThe mainstreaming of ESG – its meteoric rise from obscure do-good investing niche to widespread global acceptance – is the force behind everything else. I already discussed this in ESG Alpha: Fluff or Stuff?, but to summarize several key points relevant to this report, the mainstreaming of ESG:

- Increased global ESG-related AUM to just over US$30 trillion in 2019 (a 10-year CAGR of 200%)
- Diversified ESG thinking, motives, and strategies beyond the pure altruism of ESG's earlier days
- Broadened the range of investors/assets to include alternative investments such as hedge funds
- Loosened attitudes re: ESG short selling, mainly due to the influx of non-traditional ESG money
- Fueled ESG's bull run and issuers' over-exuberance in the form of greenwashing and misselling
- Exacerbated some of the big systemic problems with ESG data such as a lack of standardization

Over-Exuberance Can Lead to Greenwashing and MissellingThere is nothing wrong with a little enthusiasm, particularly after years of ESG advocacy falling on deaf ears. Everything in moderation, though. It seems as if almost everybody has been drinking the ESG Kool-Aid, and inevitably a few issuers went full-on bottoms up and trousered. ESG has become as much a marketing device as it is the acronym for a serious sustainability/ investment framework.

Issuers are constantly being assessed, ranked, rated, scored, and added or dropped to/from the ESG index *du jour*, so it's understandable (though not excusable) that many companies got carried away with greenwashing and misselling – i.e., bragging about token ESG programs or exaggerating ESG achievements. This is a problem (and opportunity for some) when it affects issuers' securities.

ESG Data Asymmetries Create Short Selling OpportunitiesI discuss this subject in more detail later. For now, suffice it to say that ESG data is infamous for its multiplicity of shortcomings. The underlying issue is a lack of standardization in reporting (who, what, when, etc.). That engenders high ESG "information dispersion" which, for smart money, can create short opportunities or aid in making an existing short position thesis work out as planned.

Traditional ESG Investors: Going "Long Virtue and Short Sin"

Defining a "traditional" ESG investor is more ambiguous by the day, but I am generally referring to firms, strategies, and funds (e.g., mutual and pension funds) that approach ESG investing in more conventional ways. Common traits are: 1) ESG is central to their identity, 2) there's a greater-good motive, 3) they employ some form of ESG screening, and 4) they are long-only for equities.

Traditional ESG investors are increasingly embracing short selling, but it is still a small percentage that do, and an even smaller fraction that do so as an alpha strategy (most use it to hedge). For the more adventurous – mainly mutual funds mimicking hedge fund tactics – the most common use of short selling is as a more direct and proactive kind of negative ESG screen.

Short Selling as a Kind of Turbocharged Negative ESG ScreenFor example, a fund might begin by screening out poor ESG performers (or other types of exclusion criteria such as "sin stocks") from a pool of potential long positions. Thus far, that is a typical long-only strategy, but now they also allow a limited short position (e.g., -30% of assets). It avoids being long bad ESG stocks (as previously), but now also allows active shorting, if the risk/reward is right.

Assuming the rationale for the long exclusion (the initial negative screen) reflects expectations for stock performance, versus a purely ethics-based exclusion, then this kind of strategy is a chance to generate additional alpha, reduce risk, increase diversification – *and* invest in a way that integrates the fund's ESG values more directly and effectually. It's a relatively ESG-friendly way of shorting.

Clearly, this approach doesn't work as an alpha strategy if expectations for stock performance isn't a major criterion among the initial exclusion criteria. For example, if long exclusion screens are mainly based on ethical criteria (e.g., for faith-based or ethical investors) and less on financial criteria, this strategy becomes moot. I suppose shorting on ethics could achieve activist goals ("Take that, you dirty coal stock!"), but that's not what I am talking about here.

That is an over-simplified example. Presumably an investor would have additional criteria, beyond those of the initial negative ESG screen, to assess the appropriateness of *actually* entering into the short positions suggested by the screening process. Some additional criteria could be ESG-related, but others should be more customary to short-selling. It's case-specific, but below are examples.

ESG	Non-ESG
• Quality, transparency of corporate governance practices	• Cash flows, balance sheet strength, ROA, ROC, ROE, etc.
• History of self-dealing, sexual harassment, and litigation	• Level of investment banking activity (e.g., M&A, ECM)
• Social benefits or detriments of products and services	• Short interest, trend and momentum, liquidity, float, etc.
• Write-offs, one-time charges, changes in accountants	• Management ownership, recent insider selling activity
• Executive/Board compensation, tenure, turnover rates	• Timing of short-thesis catalysts, over/under valuation

Appleseed is a Case Study in Traditional ESG and Short SellingIn my opinion, a quintessential example of a traditional ESG investor successfully balancing time-honored ESG values with the evolving ESG landscape – and a clear forerunner in traditional ESG's integration of short selling – is

Appleseed Capital. Appleseed is the ESG/impact investing arm of U.S. asset manager Pekin Hardy Strauss Wealth Management (just under US$1 billion in AUM).

Appleseed is small in terms of AUM (its flagship Appleseed Fund is ~US$150 million in net assets), but it is a giant in progressive thinking vis-à-vis ESG long/short. It has advocated ESG short selling for years, such as in ESG Integration in Short Selling from 2017 and later A Sustainability-Focused Investor's Guide to Short Selling: Creating Long/Short Strategies with ESG Criteria.

If you're curious, but not curious enough to spend time reading those documents, this video is a time-friendly summary courtesy of Appleseed's CEO and Portfolio Manager Joshua Strauss (as well as the video editors at Skytop Strategies). Another interesting, albeit long, video on ESG short selling (including Appleseed's Matthew Blume) is Long Short ESG Strategies for Endowments.

Hedge Funds are Leading ESG AUM Growth Rates, However…

This Insight is about emergent trends in ESG short selling, especially shorting ESG greenwashing, which is largely the purview of hedge funds. It is not an exhaustive discussion of hedge funds and ESG in general. Still, I want to briefly outline the growing role hedge funds are playing in the ESG ecosystem. I'll start by getting a few random'ish points out of the way, then move into detail.

- ESG investing by hedge funds can take different forms, and is not always clearly labeled as ESG
- Especially hard to identify are those that only occasionally (and opportunistically) consider ESG
- The "ESG-opportunist" group includes the funds that are shorting ESG greenwashing/misselling
- ESG short selling by hedge funds is not limited to greenwashing, or long/short equity strategies
- Another big area for hedge fund/ESG activity (including shorting) is sustainability/ESG activism
- Hedge funds affect ESG in other ways (e.g., as signatories to responsible investment initiatives)

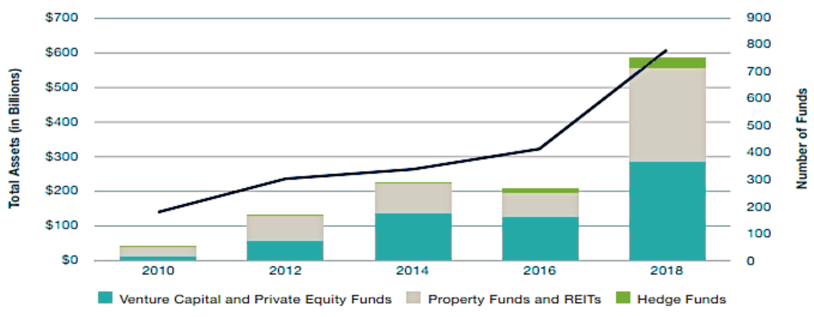
Most important, though, is the recent growth in hedge fund ESG AUM. In the early days, ESG AUM was dominated by mutual, pension, and endowment funds. With one exception – impact-oriented private equity and venture capital – there was almost no ESG capital from alternative investments, especially hedge funds. Today, alternative vehicles (and especially hedge funds) are a driving force behind ESG AUM growth *rates*. There are two important and related caveats to note, however:

1. ESG AUM growth *rates* are high for hedge funds, but hedge funds trail in absolute dollar terms
2. Genuine hedge fund ESG AUM is likely overstated, partly because ESG adoption is often forced

Hedge Fund ESG AUM Growth Rates Belie Absolute DollarsIt is important to differentiate between growth *rates* and growth in absolute dollars. When coming off a near-zero base, it's not that difficult to post impressive year-over-year ESG AUM growth rates. However, in absolute dollars, hedge fund ESG-related (see remark below) AUM is still rather small, and is still trailing other alternative investment vehicles (e.g., VC, PW, and real estate funds).

For this section, I'm not being overly-specific regarding definitions. "ESG-related AUM" includes ESG proper, and all other closely-related concepts such as sustainable investing, socially-responsible investing, and the like.

ESG Incorporation by Alternative Investment Vehicles 2010-2018*(Note: Absolute numbers are U.S.-only but relative growth is indicative of global trends)*



Source: Forum for Sustainable and Responsible Investment Alternative Investment Highlights.

Estimates for hedge fund ESG AUM are all over the place, since public disclosure is limited and ESG investing by hedge funds often happens without being branded as ESG. My simple extrapolation of data from the Alternative Investment Management Association suggests up to 10% of global hedge fund AUM could be allocated to "responsible investments." Other estimates range from 5-20%.

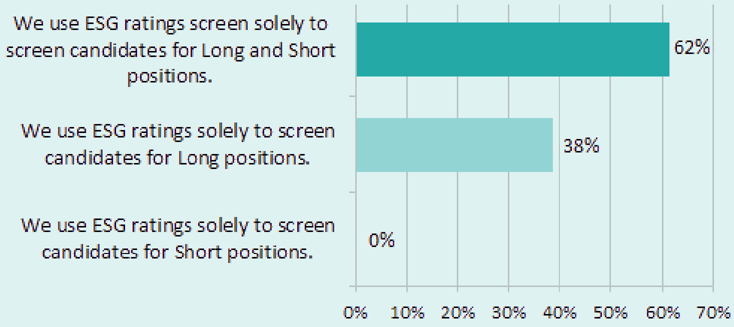
Whatever the percentage, hedge fund AUM in "responsible investments" is small in absolute terms. Using a mean percentage (of the 5-20% range), which is generous, implies US$450 billion based on all hedge fund AUM of US$3.6 trillion (2019 Preqin Global Hedge Fund Report). That is 1.5% of the US$30.7 trillion in global sustainable/ESG AUM as per the Global Sustainable Investment Alliance.

BarclayHedge Survey is Even More OptimisticA recent survey by hedge fund industry researcher BarclayHedge draws the most optimistic conclusions about hedge fund ESG growth. It's based on a sample size of just 70 funds, so I wouldn't over-generalize its findings, but they are still quite interesting and worth noting.

Of the 70 respondents, 41% "take ESG factors into consideration." For those, ESG applies to an average of 52% of assets. Making the wild assumption that respondent funds are average for the hedge fund industry, this would roughly equate to about US$750 billion in ESG AUM.

I think what's more relevant than any wild inferences is the year-over-year growth indicated by respondents. In last year's survey, for those applying ESG, only 42% of assets were subject to ESG versus 52% this year. Moreover, they expect that 52% to jump to 58% next year.

We're talking about hedge funds here, so it isn't surprising that most (62%) use ESG ratings for long/short screening, versus long-only (38%). Of those using ESG to screen short ideas, 61% say they weigh Governance most heavily, followed by Environmental (28%) then Social (11%). When screening for long ideas, it's 56% Governance, 26% Social, 18% Environmental.



I should point out two things. First, respondents are indicating whether/to what extent they use ESG *ratings*. That might interesting, but from an ESG short selling perspective, it's going to be the hedge funds NOT using ESG ratings that are likely to perform best. Second, other surveys indicate that Environmental (not Governance) is behind hedge fund ESG shorting.

Hedge Fund ESG AUM Statistics are Probably OverstatedThe second caveat is that ESG AUM statistics in general are often based on surveys, and things like "takes ESG into account" don't necessary mean formal ESG integration. One common question is "Which if any ESG factors do you take into account?" Since almost every investor takes governance into account, that might get a 100% positive response, but is it truly ESG-indicative? Probably not.

Determining ESG-related AUM for hedge funds is further complicated by the primary driver of ESG adoption by hedge funds – i.e., investor demand. Put bluntly, some percentage of what is classified as ESG-related AUM is being "forced" on hedge funds by their investors. Thus, a smaller percentage of estimated hedge fund ESG AUM is actually from voluntary, committed ESG investing strategies.

ESG-minded pensions and endowments – big sources of capital for hedge funds – are pressuring hedge funds to get on board the ESG train. This can manifest in different ways, from assessing the "ESG'ness" of hedge funds and fund managers before investing, to imposing ESG constraints after having invested. A survey by Preqin illustrates a disconnect between investors and hedge funds.

Fig. 1: Investors with an ESG Policy in Place for Their Hedge Fund Portfolio

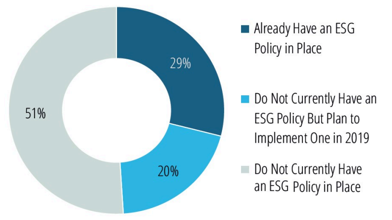
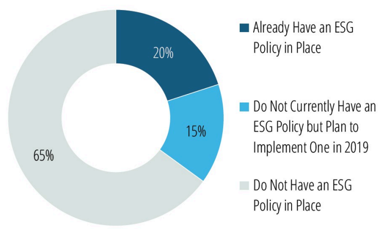


Fig. 2: Hedge Fund Managers with an ESG Policy in Place



Source: Preqin (Will Hedge Funds Ever Truly Embrace ESG Principles?).

My point is simply that not *all* hedge fund ESG AUM is genuine ESG AUM. I do, however, recognize that many hedge funds have a real commitment to ESG. They include informal (the quasi-negative screen) and formal long/short strategies, sustainability and ESG activism, ESG thematic strategies (e.g., climate change), ESG integration into other strategies, and opportunistic ESG approaches.

Some Hedge Funds are Shorting Greenwashing as a Strategy

The GPIF news is an impetus for this report in that it re-started the debate about ESG short selling, but there is something specific within the ensuing debate conversation that grabbed my attention. It is a small group of hedge funds, mostly ESG outsiders, that smell an opportunity in shorting the ESG bull run and all the marketing hype – aka greenwashing and misselling – that comes with it.

Theoretically, any investor employing some form of ESG shorting strategy could, intentionally or unwittingly, wind up shorting ESG greenwashing. However, there is a big difference between incidentally shorting greenwashing, and shorting greenwashing as a core strategy. The end results might be similar, but the latter is far more fascinating.

I conceive of this group as part real, and part abstract. There are real names (i.e., hedge fund firms, funds, and managers) that have communicated an ESG greenwashing short strategy, a few of which are listed below. I also include, abstractly, firms unknown in name but of kindred spirit. For me, the intrigue doesn't lie in specific names, but in their ESG outsider status and contrarian views.

- **Morphic Asset Management:** Morphic is Ellerston Capital's (both Australia-based) long-short specialist arm. Morphic is dedicated to ESG (and thus not entirely ESG-opportunistic), but CIO and PM Chad Slater runs the Trium Morphic ESG Long-Short Fund, which fits with this group.
- **Muddy Waters Capital:** Renowned short-seller Carson Block is "really skeptical of ESG" and he labels his ESG greenwashing strategy a "morality short." He says Muddy Waters is branching out from its focus on governance to target issuers which are harming society, but claim otherwise.
- **UBS Group:** The hedge fund business of UBS Group AG (UBSG SW) plans to launch a long-short fund to in part bet against ESG hype mainly in environmental areas such as carbon footprinting and regulatory reform. CIO Kevin Russell noted that UBS will not rely on third-party ESG data.
- **Etho Capital:** Etho is an advisor to hedge funds, not a fund itself, but it deserves mention. Etho CEO and CIO Conor Platt sees ESG's strongest contribution to alpha as being, unequivocally, on the short-side and specifically greenwashing-related to ESG data/information inefficiencies.
- **Various Others:** Although slightly less vocal about their ESG greenwashing strategies, but still connected to the idea, are other several firms including Man Group plc (EMG LN), BNP Paribas (BNP FP), Acadian Asset Management, Caxton Associates, and Crossbow Partners.

Shorting ESG Greenwashing Can Make Sense for Hedge FundsESG investing, in any traditional sense, simply doesn't work well for hedge funds. Absolute returns and ESG ideals are often at odds; ESG loves convention, constraints, benchmarks, and other things that hedge funds hate; and most importantly ESG investing is a long-term buy-and-hold endeavor.

So why would hedge funds even bother with ESG greenwashing? I see three broad reasons why an ESG greenwashing short strategy (specifically) would be an attractive ESG angle for hedge funds, and for some even more attractive than any other conceivable ESG-related investing angle.

1. **Non-Committal:** This is a purely opportunistic ESG strategy and doesn't involve any long-term commitments to ESG – in spirit, public perception, or practical investment of resources.
2. **Skills-Consistent:** It relies on short-term ESG data/intelligence asymmetries in ways that favor hedge funds' strengths in exploiting information gaps, especially vs. long-side "competition."

3. **Trading-Biased:** Related to the last point, shorting ESG greenwashing has a pronounced short-term trading bias; a true rarity in ESG investing which leans toward long-term buy-and-hold.

Let's Be More Specific Regarding What ESG Greenwashing IsIssuers are increasingly touting (it's always positive, otherwise they keep their mouths shut) their ESG stuff – in shiny sustainability reports, in special website sections, and on earnings calls. Alas, merely talking about ESG doesn't will the talk into reality. When words and actions don't reconcile – especially when there's intent behind the disconnect – it's greenwashing (aka misselling).

Greenwashing takes different forms, and varies in severity – in terms of moral egregiousness, level of deception, and materiality to investing. Putting a minor tree-planting program on the cover of a glossy sustainability report is one thing. Wholesale lying about ESG performance in areas material to investing is another thing. A few general examples, in increasing order of inexcusability, are:

- Over-selling of a minor (but very real) ESG achievement for its public relations/marketing value
- Exaggerating the impacts of minor ESG achievements in order to come across more sustainable
- Talking up the anticipated benefits of ESG programs before they're a reality, and with clarifying
- Flagrant falsification or exaggeration of ESG performance, especially in high-materiality areas

As I keep saying, financial considerations must accompany ESG factors and catalysts in screening for ESG greenwashing short candidates. So I'm not going to put Saudi Aramco (ARAMCO AB) on a short list *per se*, but it is a good ESG case study for the third bullet point above – hyping the future as if it is today's reality (to be fair, while Aramco is *overly*-optimistic about future ESG performance it doesn't try to mislead). More in Saudi Aramco and ESG: When Assets Become Liabilities.

Greenwashing: The Amazon Example Business Roundtable is an association of U.S. CEOs. It promotes ethical governance, among other things. In August, it released Statement on the Purpose of a Corporation, a standard for corporate responsibility that reflects a marked shift away from shareholder primacy. It was signed by 181 CEOs committing to running their firms to benefit of all stakeholders.

One of those signatory CEOs was Jeff Bezos of Amazon.com (AMZN US). Just after signing – and agreeing to "invest in employees" and "provide important benefits" – Amazon slashed benefits for 1,900 part-time workers at Amazon-owned Whole Foods. That's only 2% of its workforce, but that's not the point. It was diametrical to what Bezos agreed to.

Amazon stands out because of timing (a mere month between signing and cutting benefits), but other ESG offenders signed on as well. Several of them are associated with major ESG events covered in ESG and Stock Prices: Fat-Tail Events. Johnson & Johnson (JNJ US) re: the opioid crisis, Wells Fargo (WFC US) re: account fraud, and Boeing (BA US) re: the 737 MAX.

Granted, it isn't greenwashing if it represents a genuine change in ways, but *caveat emptor*!

Just How Might an ESG Greenwashing Short Strategy Work?Getting back to ESG greenwashing and short selling strategies. As it usually goes with hedge funds, the aforementioned firms don't exactly provide an over-abundance of detail regarding the specifics of their greenwashing short-selling *modus operandi*. The conversation is always very theoretically.

However, it's easy enough to make some educated guesses and generalized observations. Basically, the premise is that *certain* kinds of ESG misrepresentation inflate the value of a stock, or obfuscate downside risks, and that a catalyst event (or multiple) will lead to a correction in ESG-valuation. A viable greenwashing short candidate requires three fundamental ESG-related characteristics:

1. **Extreme Greenwashing:** Gross misrepresentations of ESG issues that are material to investing for a specific sector, industry, and issuer. White lies are bad, but not necessary good short ideas.
2. **Information Asymmetry:** Dodgy data engenders ESG information dispersion, and that is what makes this strategy work (and why hedge funds are well-positioned to make it work for them).
3. **Unique Insights/Catalysts:** Lastly, one needs ESG data and intelligence that others don't have plus a good sense for the catalyst or catalysts that will make the short thesis work as intended.

As with the negative screening example earlier, more traditional (non-ESG) criteria are also needed to judge the sensibility of *actually* taking on the short position. Those are investor-specific, and not the focus here, but things like company and industry fundamentals, liquidity, short interest, trends and momentum, catalysts other than short-thesis catalysts, valuation, etc. Oh, an exit strategy too.

*Extreme Greenwashing*As stated earlier, ESG greenwashing comes in many flavors. As morally offensive as they all might be, being morally offensive alone doesn't make a good short candidate. For an ESG greenwashing short strategy to work, the greenwashing at hand must be: 1) substantial (not minor) and 2) affect ESG metrics of high investing-materiality for a specific sector, industry, and issuer. For example:

- Product safety is highly-material for consumer products and health care, but less for financials
- Greenhouse gas emissions are material for energy, utilities, transportation; less so for services
- Data security (breaches) can crush technology or financial stocks while barely affecting others
- Labor practices/human rights are big for textiles and retailing, but elsewhere are a lesser issue

Note: The Sustainability Accounting Standards Board's (SASB) Materiality Map is an excellent resource for sector- and industry-level ESG metrics and materiality (*investing* materiality). Click on a sector to expand its industries.

*Information Asymmetry*ESG data is infamous for its many inherent shortcomings. The ESG data issue is improving, but it is still enough of a train wreck to generate high levels of "ESG information dispersion," essentially big disparities in the perceived ESG-value of a stock. While these asymmetries in ESG intelligence can be a long-only investor's worst nightmare, they are an ESG short seller's sweet dream.

I said "perceived" ESG-value of a stock because ESG ratings are highly questionable and often very conflicting. The concept of information asymmetry and overlaps with the next section, and I will continue to flesh this out below.

Think ESG information asymmetry, which ultimately boils down to ESG-value and ESG-returns, as akin to stock dispersion in non-ESG long/short strategies – the more of it, the greater the potential for alpha generation. Certain sectors and industries are sustainability/ESG disruptors, and thus big drivers of ESG dispersion, lending themselves well to ESG short selling (especially greenwashing).

A prime example is Energy and Utilities in the context of climate change. Even if ESG ratings were accurate, there would be significant dispersion; mainly between clean energy companies and fossil fuel firms. If you take ESG data issues into account, you would expect to see more disparity within each of the groups. The long/short is, in theory, the best of clean energy/the worst of fossil fuel.

Major of ESG Data Shortcomings

- **Discretionary:** ESG disclosure is still mostly optional. Thus, not all issuers provide ESG data and for those that do, it's self-reported, highly-selective, and has pronounced rosy-bias (issuers tend to disclose when things are good, not stay quiet when they aren't).
- **Inconsistent:** Organizations like SASB are moving ESG towards more standardization, but we're not quite there yet. ESG information is neither standardized nor normalized, making it painfully difficult to perform meaningful fruit-to-fruit comparisons.
- **Qualitative:** ESG data is very qualitative and subjective. Add the lack of standardization as described above, and that makes a substantial portion available ESG data exceedingly difficult to quantify for analysis; almost to the point of being worthless.
- **Sluggish:** ESG disclosure isn't regulated, so ESG data update cycles are at best monthly, often just annually, and sometimes not even consistently one or the other. That's utterly unconscionable when global capital markets move quickly, and in real time.
- **Retrospective:** Source ESG data reported by issuers – which forms the basis for all third-party ESG ratings – is woefully backward-looking. That's a big problem for ESG-related investing. When was the last time you invested based on historical EPS alone? Exactly.

*Insights and Catalysts*Third-party ESG ratings have value, to a point. They are mainly useful for exploratory analysis and cursory screening. However, they offer little or no value for short trades where original intelligence is needed. Ratings providers repackage source data, push it through their black boxes, then sell the same ratings and data to thousands of investors. Everyone has the same intelligence.

Leading providers are doing more to source original data, including from alternative sources, and they do offer bespoke products. But still, they are trying to sell the same product as many times over as is possible. Period.

Winners in ESG short trading will be the ones getting their own original ESG data and insights, and those data/insights will be at the long-tail end of the ESG information curve. Not from the rating of the month club, from mining alternative data, deriving new quantitative metrics from qualitative data (e.g., unstructured text). This is where hedge fund intellect and skill sets shine.

TruValue Labs is a stand-out exception regarding my overall feelings about the value of ESG data providers. I forgive them for their liberal use of "AI" but TruValue Labs is an innovator in applying machine learning, natural language processing, and other data science to ESG.

New Investment Horizons and ESG Research Possibilities

In my opinion, the single most fascinating aspect of all of this is a clear shift in the ESG investment horizon. Conventional wisdom is that ESG investing is a long-term, long-only, buy-and-hold game. That maxim holds for most ESG investing, but the range of ESG investment horizons is widening.

For the first time in my eleven years of ESG investment research, I can see formulating and sharing shorter-term trading-oriented ESG opinions, as a complement to long-term biased ESG research. A more rounded voice on ESG-related investing, and a hearkening back to my squawk box days.

We'll see where this leads.

Ideas are always welcome.

Travis Lundy

Pan-Asia Catalysts/Events

Quantitative Analysis

The GPIF's New Policy Mix

By Travis Lundy | 01 Apr 2020

EXECUTIVE SUMMARY

Yesterday, the GPIF announced its new policy mix in Adoption of New Policy Profile. This was the quinquennial policy review and

The big change was moving domestic bonds to 25% ±x% from 35% ±10% and moving foreign bonds from 15% ±4% to 25% ±6%, then because the mix now has its central policy points at 25% each for domestic bonds, domestic equity, foreign bonds and foreign equity, each with somewhat wide margins for slippage, there are additional limits requiring that equities stay within 50% ±11% (while bonds can be 50% ±13%).

GPIF

Adoption of New Policy Portfolio

- Government Pension Investment Fund ("GPIF") manages assets in line with its policy portfolio, which specifies the target allocation for each asset class. GPIF has adopted a new policy portfolio as follows.

(Old)

	Domestic bonds	Foreign bonds	Domestic equities	Foreign equities
Target allocation	35%	15%	25%	25%
Deviation Limits	±10%	±4%	±9%	±8%

(New)

		Domestic bonds	Foreign bonds	Domestic equities	Foreign equities
Target allocation		25%	25%	25%	25%
Deviation Limits	Asset class	±7%	±6%	±8%	±7%
	Bonds/Equities	±11%		±11%	

- The allocation to domestic bonds in the new policy portfolio has decreased due to declining interest rates and lower bond yields in Japan, while the foreign bond allocation has increased due to the relatively higher interest rates on these instruments. The new policy portfolio meets the GPIF's return target (real investment return* of 1.7%) with the lowest risk.
- Furthermore, in addition to the current deviation limits set for each asset class, new deviation limits for total bonds and total equities have been established in order to strengthen risk management on the equity side. As a result, whereas the permissible range for total bond holdings will be the two individual bands added together – that is 50% + 13%, the range for equity holdings will be limited to 50% + 11% by the total equity holdings band.
- The new policy was determined after 13 meetings of the Board of Governors and will be implemented beginning April 1, 2020. A working sub-committee consisting of economics and finance professionals was established under the Board of Governors to streamline deliberations. The committee held 32 discussions on matters related to the policy portfolio from a comprehensive, multi-dimensional, technical perspective.

*Nominal investment return less nominal wage increase

This was basically flagged last week, and discussed in GPIF Policy Mix Changes Ride to Global Risk Rescue.

The GPIF also amended its Q2 and Q3 investment results announcements to include the allocations of each asset (see below). That is *somewhat* important because it could suggest that the GPIF is finished with any large scale movement of assets across the various asset buckets (because the specific reason mentioned last fall as to why they had stopped publishing the asset breakdowns was so that there wouldn't be speculation and front-running of their moves.

Then again, maybe this is reverse psychology.

This morning saw news that CIO Mizuno-san had finished his term and left, and that former head of fixed income trading and former co-head of Japan markets at Goldman Sachs Mr. Eiji Ueda would be named CIO this afternoon. I see the official appointment of a man with that name as a 'director' earlier this afternoon.

More discussion of where we stand and what could happen next below.

DETAIL

The New Data and New Allocation

The known data was the middle blue portion. the Sep and Dec 19 allocation marks were unknown until yesterday's releases (new Sep19 release, new Dec19 release). The Adoption of New Policy Portfolio announcement in English is simple. What you see above is all there is. In Japanese, there is a presentation with a longer explanation.

- There is an additional limitation which is that equities across domestic and foreign buckets shall be 50% ±11%.
- "Alternative investments" (infrastructure, private equity, etc) shall see a limit of 5% in total, and shall be separated into the appropriate policy asset class (dom bonds, equity, foreign bonds, foreign equity) depending on each investment's risk/return characteristics.
- Short-Term yen assets and yen-hedged foreign bonds shall be considered to be Domestic Bonds.
- Short-Term foreign currency assets shall be considered to be Foreign Bonds.

We do not yet know what happened in terms of re-allocation within Q1 (the last fiscal quarter to end-March 2020). Assuming no other action was taken, the most urgent thing to do is allocate about ¥2.0 trillion out of domestic bonds/currency into some mix of the others. In terms of putting money to work easily (with the least impact), the best places to do that are probably an increase in passive allocation to foreign bonds and foreign equities. Buying ¥2 trillion of stocks is "easy" relatively speaking, but it can be seen. And large change with minimum impact and minimal disclosure is best done in foreign securities.

GPIF Investment Policy Allocation and Current Situation - Moving to 25% Each

		Dom Bonds		Dom Equities		Foreign Bonds		Foreign Equities		Short Term Assets	
Historical and Current Policy Allocation Mix											
Mar-06 - Mar-10		67%	±8%	11%	±6%	8%	±5%	9%	±5%	5%	±0%
Apr-10 - Jun-13		60%	±8%	12%	±6%	11%	±5%	12%	±5%	5%	±0%
Since Oct-14		35%	±10%	25%	±9%	15%	±4%	25%	±8%		
Oct-19 Amendment*		*Hedged Foreign Bonds are considered to be Domestic Bonds for allocation purposes*									
Starting 1 April 2020		25%	±7%	25%	±6%	25%	±8%	25%	±7%		
30 Jun 19 Alloc (¥trln)	**KNOWN**										
Allocation Per Asset Class (¥trln)		43.0		42.4		29.6		46.6		8.2	
Adjust for Hedged FBs (¥trln)		+1.3				-1.3					
Adjusted Total (¥trln)		44.3		42.4		28.3		46.6		8.2	
Alloc %		*26.1%*		*25.0%*		*16.7%*		*27.5%*		*4.8%*	
31 Sep 19 Alloc (¥trln)	**NEW**	**ACT**	*Est*	**ACT**	*Est*	**ACT**	*Est*	**ACT**	*Est*	**ACT**	*Est*
Allocation Per Asset Class (¥trln)		43.4	*43.4*	39.0	*39.0*	30.6	*29.4*	42.6	*42.5*	10.4	*8.2*
Adjust for Hedged FBs (¥trln)		+1.3	*+1.3*			-1.3	*-1.3*				
Adjusted Total (¥trln)		44.7	*44.7*	39.0	*39.0*	29.3	*28.1*	42.6	*42.5*	10.4	*8.2*
Alloc %		*26.9%*	*26.7%*	*23.5%*	*24.0%*	*17.6%*	*18.1%*	*25.7%*	*26.2%*	*6.3%*	*5.0%*
31 Dec 19 Alloc (¥trln)	**NEW**	**ACT**	*Est*	**ACT**	*Est*	**ACT**	*Est*	**ACT**	*Est*	**ACT**	*Est*
Allocation Per Asset Class (¥trln)		42.2	*43.0*	42.4	*42.4*	32.6	*29.6*	46.8	*46.6*	5.7	*8.2*
Adjust for Hedged FBs (¥trln)		+1.9	*+1.3*			-1.9	*-1.3*				
Adjusted Total (¥trln)		44.1	*44.3*	42.4	*42.4*	30.7	*28.3*	46.8	*46.6*	5.7	*8.2*
Alloc %		*26.0%*	*25.3%*	*25.0%*	*25.0%*	*18.1%*	*17.4%*	*27.6%*	*27.5%*	*3.4%*	*4.8%*
19 Mar 20 Alloc (¥trln)	**EXPECTED**	**Est**	*Old Est*	**Est**	*Old Est*	**Est**	*Old Est*	**Est**	*Old Est*	**Est**	*Old Est*
Allocation Per Asset Class (¥trln)		40.8	*41.6*	31.4	*31.4*	33.6	*30.6*	33.5	*33.3*	5.7	*8.2*
Adjust for Hedged FBs (¥trln)		+1.9	*+1.3*			-1.9	*-1.3*				
Adjusted Total (¥trln)		42.7	*42.9*	31.4	*31.4*	31.8	*29.3*	33.5	*33.3*	5.7	*8.2*
Alloc %		*29.5%*	*17.3%*	*21.6%*	*12.7%*	*21.9%*	*11.8%*	*23.1%*	*13.5%*	*4.0%*	*3.3%*
Adjusted Alloc		***33.4%***		***21.6%***		***21.9%***		***23.1%***		***0.0%***	
NEW MARCH 2020 TARGET	**POLICY**	25.0% ±7%		25.0% ±6%		25.0% ±8%		25.0% ±7%		0.0%	
Change to MidPoint		*-4.5%*		*+3.4%*		*+3.1%*		*+1.9%*		*-4.0%*	
Buy/Sell (¥trln)		**-6.5**		**+4.9**		**+4.5**		**+2.8**		**-5.7**	
MUST TRADE NOW		**-2.0**									

** The 1 October 2019 amendment to the policy affected, as of 31 March 2019, ¥1.284trln of bond holdings, and this brought the number down to about 18%*

***The "Situation Now" is based off the most recent publication of assets, which was for the 30-Jun-2019 position. Since then, the GPIF has not updated its asset allocation, which is a deliberate effort to avoid being front-run according to then-CIO Mizuno.*

source: GPIF reports, Quiddity

What Are the Bases for Establishing this Policy Mix?

Like last time, the mix is designed to earn results which will pay for the demographic change AND assume long-term *real* liability growth of 1.7% a year.

It started with the Cabinet Office long-term Total Factor Productivity Growth Case and Base Case, then separated each of those cases into three separate sub-cases, and assigned portfolio returns to each one based on the concept that they want the GPIF to be a "100 year portfolio."

My understanding of the risk reward of certain outcomes, and the likelihood of investment returns of assets based on certain inputs is quite a bit different than theirs.

- Their model has marginal inflation having a significant positive multiplier to TFP gains based on their base case. Given the increase in service vs raw materials as a component of GDP consumption, and the shape of Japan demographics in the century to come, I don't see supply scarcity being the major problem.
- To weight foreign bonds equally with Japanese equities against a combined yen liability makes an assumption on the long-term move in USDJPY. It is an explicit bet that USDJPY will appreciate vs its forward rate by something approaching 1-2% a year, forever. Given the experience of Japanese funding in dollars recently, I am hesitant to think that anything other than an explicit forex bet.
- Having a large pension CIO deciding portfolio construction base parameters assuming yen deflation vs Rest Of World as their base case strikes me as odd.
- If one is to assume a constant and steady weakening yen trend will last for decades, one would want to be in forex, OR in investments which have operational leverage to such an outcome. That would be Japanese listed companies.
- Overweight explicit FX risk vs implied FX risk plus inflation protection based on a case tree which involves domestic inflation having a higher-than-1 multiplier to marginal TFP growth despite local demand scarcity (declining population fighting for same resource market) is an outcome I might not have chosen.

Of course, they are using the last 25 years as their data set for deciding on return expectations, relative return expectations, and correlations. They are not looking at the metrics which have changed over time.

- 25 years ago, Japan had a high PER and the US and Europe a relatively lower PER.
- 25yrs ago, the capital structure of listed Japan vs the capital structure of listed US and European stocks had a considerably different relationship to today.
- US and European bonds have had a long-term positive return over the past 25yrs, but to assume that the yen return in US and European bonds will be, starting now and continuing over the long-term, 2.6% is a bit rich. To be sure, bond yields have backed up recently but this has been an 18-month process and I promise you the return and correlation mix which led to this decision was not formulated on 30 March but likely before the back up in yields and fall in stock prices.

- Some of the rest of the analysis looks like they have been *explicitly* data mining - i.e. they have come up with the best portfolio construct for the next ten years based on the returns shown over the past 25-35 years. Given the starting points and absolute numbers are completely different now than at the start of any 10-year period in the past 35 years, I have my issues with this.

But… it's their portfolio mix, not mine.

What Will Happen Next?

We do not yet know what happened in Q1.

What DO We Know?

- At a bare minimum, I expect the GPIF sold ¥2 trillion of yen bonds or yen cash and bought foreign cash and/or foreign assets or some Japanese equities.
- We know something about what has been traded by Domestic Trust Banks in three of the four major categories recently (the Ministry of Finance collects data from major investors (and for Japanese trust banks, you can expect it is all of them) and the TSE collects data on a weekly basis for investor categories (I have applied the weekly data to the appropriate month, which over a quarter should be close enough)).
- Based on that, it would appear that in January and February, Japanese Trust Banks were big buyers of foreign bonds. It is not clear whether these were yen-hedged or not, but for every yen-hedged bond they bought in Q1 they would have had to increase their net sale of yen bonds. Going back 15 years (the entire history under the currently-reported data series), January and February were the two largest months of net buying of foreign debt securities by trust banks in history. By a long ways.
- So I expect the vast bulk of the transition trade was an increase was foreign debt securities funded by selling of domestic bonds. I expect more than ¥2 trillion was executed.

		Domestic Equities		Foreign Bonds				Foreign Equities			
		Net Buy of Domestic Equities	Quarterly Net	Trust Bank Buys	Trust Bank Sells	Net Buys of Foreign Bonds*	Quarterly Net	Trust Bank Buys	Trust Bank Sells	Net Buys of Foreign Equities	Quarterly Net
2017	Jan	+42.7		2,628.6	2,209.6	+419.1		831.1	893.6	-62.5	
	Feb	-174.9		2,583.9	2,367.2	+216.7		1,077.1	1,243.8	-166.7	
	Mar	-278.7	-410.9	3,173.9	3,121.1	+52.8	+688.6	1,112.3	1,595.6	-483.3	-712.5
	Apr	-84.3		3,236.3	2,686.4	+549.9		1,110.5	877.5	+233.1	
	May	-100.9		3,093.5	2,720.0	+373.6		1,554.6	1,346.9	+207.7	
	Jun	+184.2	-1.0	3,146.9	2,876.1	+270.7	+1,194.2	1,151.0	1,289.9	-139.0	+301.8
	Jul	+283.6		2,701.4	2,312.6	+388.9		1,181.1	1,149.5	+31.5	
	Aug	+92.1		2,854.4	2,134.2	+720.2		1,273.3	1,108.9	+164.4	
	Sep	-109.8	+266.0	2,834.6	2,257.4	+577.2	+1,686.3	1,105.7	1,068.0	+37.7	+233.6
	Oct	-113.3		2,648.1	2,320.3	+327.9		1,032.0	911.8	+120.2	
	Nov	-2.0		2,859.3	2,438.4	+420.9		1,473.5	1,313.6	+159.9	
	Dec	+355.1	+239.8	2,179.0	2,055.1	+123.8	+872.6	906.8	789.3	+117.5	+397.6
2018	Jan	+73.3		3,794.7	2,969.7	+825.1		1,077.7	1,093.8	-16.2	
	Feb	+387.5		3,803.7	2,786.6	+1,017.1		1,406.9	1,129.4	+277.5	
	Mar	+5.2	+466.0	3,902.4	3,224.8	+677.6	+2,519.8	1,258.8	1,120.5	+138.3	+399.6
	Apr	-3.2		3,511.2	2,775.3	+735.9		1,866.1	1,295.2	+570.9	
	May	-166.9		3,249.5	2,808.8	+440.7		1,909.1	1,468.1	+441.0	
	Jun	+511.7	+341.7	3,136.3	2,934.8	+201.6	+1,378.2	1,488.8	1,122.3	+366.5	+1,378.4
	Jul	+132.9		2,610.5	2,524.0	+86.4		960.3	937.0	+23.3	
	Aug	+58.2		2,842.9	2,643.4	+199.6		1,314.2	1,086.5	+227.7	
	Sep	-66.3	+124.8	2,471.1	2,506.3	-35.2	+250.8	1,278.6	1,139.0	+139.7	+390.7
	Oct	-148.5		3,333.7	3,039.8	+293.9		1,725.3	1,772.1	-46.7	
	Nov	+124.8		3,553.7	2,318.0	+1,235.6		1,336.2	1,217.9	+118.3	
	Dec	+597.7	+574.1	3,024.2	2,510.2	+514.1	+2,043.6	1,204.4	968.9	+235.5	+307.1
2019	Jan	+70.2		3,172.5	2,809.8	+362.7		998.2	893.7	+104.5	
	Feb	+115.7		2,724.2	2,483.9	+240.3		1,154.0	1,122.2	+31.8	
	Mar	-127.7	+58.1	3,364.3	3,221.4	+143.0	+746.0	1,267.8	1,294.8	-27.0	+109.3
	Apr	+76.4		3,574.5	2,820.8	+753.8		882.3	1,027.4	-145.1	
	May	-77.2		3,337.3	2,743.6	+593.7		1,724.9	1,438.0	+286.9	
	Jun	+283.4	+282.6	3,173.4	3,065.7	+107.8	+1,455.3	1,311.0	1,068.7	+242.3	+384.1
	Jul	+213.6		2,789.6	2,564.5	+225.1		1,022.1	921.2	+100.9	
	Aug	+50.2		3,782.5	2,979.8	+802.7		1,282.0	996.3	+285.7	
	Sep	-34.5	+229.3	3,631.0	3,344.5	+286.5	+1,314.3	876.0	898.0	-22.0	+364.6
	Oct	-306.5		3,221.8	2,636.0	+585.6		937.3	899.1	+38.2	
	Nov	-443.0		3,059.3	3,028.4	+30.9		1,719.8	1,552.6	+167.2	
	Dec	+116.9	-632.5	2,556.1	2,787.9	-231.7	+384.8	981.0	845.3	+135.8	+341.2
2020	Jan	-159.5		4,483.2	2,358.1	+2,125.0		766.6	928.0	-161.4	
	Feb	-328.2		5,241.3	2,910.7	+2,330.5		1,461.6	1,572.1	-110.5	
	Mar	+295.6	-192.0				+4,455.5				-271.9

*Foreign Bonds Transaction data includes the sum of "long-term debt securities" and "short-term debt securities"

source: Ministry of Finance, TSE/JPX, Quiddity

We will know later this week what Trust Banks did in terms of net investing in domestic equities in the week to 27 March.

We will know sometime between 7 and 14 days from now what happened in foreign bonds and foreign equities last month for Trust Banks.

We will know between 2 weeks and 3 months from now what the end of fiscal year allocations and results were, with substantial detail available in early July with the Annual Report.

Longer-Term

There is a new CIO replacing the outgoing Mizuno-san. Media is reporting that it is Eiji Ueda, the former head of FICC trading at Goldman Sachs Japan who was later co-head of markets in Japan.

Mr. Ueda has more natural experience with risk-taking and risk control than any CIO the GPIF has ever had. While his background is in fixed income, I expect that his understanding of the risk factors of equities in a portfolio given macroeconomic conditions to be completely up to the task.

I expect that the New Policy Portfolio has been designed *without* his input, and it is his job to manage within the constraints of that new policy mix and its parameters.

For that, I expect that when stability returns to the ability to forecast equity returns over the longer-term, some of the foreign bond portfolio will roll into domestic equities.
I expect there may be some allocation into PE funds on domestic equities as it may have policy consequences, and would reduce the "mark to market risk" of owning some domestic equities. However, I expect it to take time to allocate such monies.

Travis Lundy

Pan-Asia Catalysts/Events

Tokyo Stock Exchange Tokyo Price Index Topix | ESG

Recent GPIF Moves - Rebalancing & ESG

By Travis Lundy | 13 Apr 2020

EXECUTIVE SUMMARY

As noted in the last insight about The GPIF's New Policy Mix (and its preceding GPIF Policy Mix Changes Ride to Global Risk Rescue), the GPIF has changed its policy mix.

Apparently, going to *exactly25% each*, *plus or minus a fair bit*, on domestic bonds, foreign bonds, domestic equities, and foreign equities, provides the lowest risk profile while reaching the GPIF's real investment rate of return target of 1.7%.

GPIF

Adoption of New Policy Portfolio

- Government Pension Investment Fund ("GPIF") manages assets in line with its policy portfolio, which specifies the target allocation for each asset class. GPIF has adopted a new policy portfolio as follows.

(Old)

	Domestic bonds	Foreign bonds	Domestic equities	Foreign equities
Target allocation	35%	15%	25%	25%
Deviation Limits	±10%	±4%	±9%	±8%

(New)

		Domestic bonds	Foreign bonds	Domestic equities	Foreign equities
Target allocation		25%	25%	25%	25%
Deviation Limits	Asset class	±7%	±6%	±8%	±7%
	Bonds/Equities	±11%		±11%	

- The allocation to domestic bonds in the new policy portfolio has decreased due to declining interest rates and lower bond yields in Japan, while the foreign bond allocation has increased due to the relatively higher interest rates on these instruments. The new policy portfolio meets the GPIF's return target (real investment return* of 1.7%) with the lowest risk.
- Furthermore, in addition to the current deviation limits set for each asset class, new deviation limits for total bonds and total equities have been established in order to strengthen risk management on the equity side. As a result, whereas the permissible range for total equities would be 50% +13% (i.e. the combined lower bound of the two individual bond bands) if each asset class was considered separately, the range for equity holdings will be limited to 50% +11% by the total equity holdings band.
- The new policy was determined after 13 meetings of the Board of Governors and will be implemented beginning April 1, 2020. A working sub-committee consisting of economics and finance professionals was established under the Board of Governors to streamline deliberations. The committee held 32 discussions on matters related to the policy portfolio from a comprehensive, multi-dimensional, technical perspective.

*Nominal investment return less nominal wage increase

This is the target for the future. A target which it will meet. With 50%, or roughly 40% to up to 60+% of notional, and far more than that of mark-to-market risk, in foreign currency.
And that is the lowest risk portfolio tested.
How do we know they will meet that target? Because they backtested the policy mix over the past 25yrs post-bubble returns to March 2019. Using annual data. It was also tested against the last 34yrs of returns. Using annual data. And everyone knows that using 25-34

> data points over the past 25-34 years is likely to provide near certainty of what will happen to yen returns in foreign currency assets. [narrator: no, it won't].
> As of the start of this new policy on 1 April, the yen-hedged 10yr US Treasury rate was about -0.6% rather than the average 4.1% yield over 25yrs less a yen hedge to get to 2.6%.
> The current prospective yen-hedged return is 3.2% below the bogey rate of 2.6% in yen. To get back to a yen-hedged rate of 2.6%, the entire GPIF portfolio has to take a loss of something like 7-8% at the policy mix of 25% foreign bonds. Either that or they can hold on to the bonds they have and expect USD/JPY to rise 2% a year to get to ¥130 to the dollar by March 2030.
> But that is the base assumption. USD/JPY has to go up 2% a year to make this work.
> Practically speaking, of course, that might not be required. If USD/yen rose and bond yields rose in the interim, the domestic equities portfolio might outperform the expected 5.6% annual return and make up for the interim losses, and income from the equity portfolio could be used to reinvest a larger amount at higher yields. The assumed correlation between the two assets in yen terms is close to zero.
> But all that requires aggressive rebalancing when the yen-denominated asset portfolios get out of whack with the policy mix rates.

All this should tell you is that the policy mix as it was when they decided this in March was substantially different than the history which informed the decision (markets move, who'da thunk?), and the result is that to match that return going forward, the yen has to weaken substantially, and consistently, and effectively permanently. That's the base investment case.

The Other News Out From the GPIF is About ESG

The presentation (only in Japanese) about the change in policy makes considerable mention of the concept of ESG and stewardship, and suggests an interesting breakdown of what stewardship means for passive investing and active investing conducted by the GPIF's sub-managers. The minutes of the last several Investment Committee and Governors' meetings also refer quite a lot to ESG.

The presentation and minutes also talk quite interestingly about index construction and engagement with index providers.

And We Have March Data And May Glean What GPIF Did in FYQ4

Late last week, the Japanese Ministry of Finance reported its survey of large asset managers and trust banks of the flows in international securities, and the TSE reported the weekly and therefore March totals for trust bank activity in equities.

The picture painted may tell us something remarkable about what happened in the last quarter.

Much more below.

DETAIL

What Are the Flow Updates?

When the GPIF announced on 31 March what its new investment policy mix was, officially, it also announced revised versions of its Q2 and Q3 investment results to include what the asset mix was at the time. As previously discussed in these pages, the GPIF had decided to avoid its traditional transparency specifically so that the market would not "guess" what it was going to do and front-run it. Given that the GPIF announced a change in yen-hedged bonds within the policy mix on 1 October 2019 (such that yen-hedged bonds would thence be counted in the domestic bond allocation rather than the foreign bond allocation), it seemed clear the intention was to raise exposure to foreign bonds. And so they did.

Trust Bank Flows in Risk Assets Per Month & Quarter

		Domestic Equities				Foreign Bonds				Foreign Equities			
		Trust Bank Buys	Trust Bank Sells	Net Buy of Domestic Equities	Quarterly Net	Trust Bank Buys	Trust Bank Sells	Net Buys of Foreign Bonds*	Quarterly Net	Trust Bank Buys	Trust Bank Sells	Net Buys of Foreign Equities	Quarterly Net
2017	Jan	1,264.7	1,223.1	+41.6		2,628.6	2,209.6	+419.1		831.1	893.6	-62.5	
	Feb	1,291.8	1,466.9	-175.1		2,583.9	2,367.2	+216.7		1,077.1	1,243.8	-166.7	
	Mar	1,759.9	2,041.0	-281.1	-414.6	3,173.9	3,121.1	+52.8	+688.6	1,112.3	1,595.6	-483.3	-712.5
	Apr	1,453.9	1,541.6	-87.6		3,236.3	2,686.4	+549.9		1,110.5	877.5	+233.1	
	May	1,746.0	1,896.4	-150.4		3,093.5	2,720.0	+373.6		1,554.6	1,346.9	+207.7	
	Jun	1,864.7	1,621.9	+242.8	+4.8	3,146.9	2,876.1	+270.7	+1,194.2	1,151.0	1,289.9	-139.0	+301.8
	Jul	1,702.4	1,420.1	+282.3		2,701.4	2,312.6	+388.9		1,181.1	1,149.5	+31.5	
	Aug	2,033.7	1,938.2	+95.5		2,854.4	2,134.2	+720.2		1,273.3	1,108.9	+164.4	
	Sep	1,773.1	1,883.8	-110.6	+267.1	2,834.6	2,257.4	+577.2	+1,686.3	1,105.7	1,068.0	+37.7	+233.6
	Oct	1,704.5	1,814.4	-109.9		2,648.1	2,320.3	+327.9		1,032.0	911.8	+120.2	
	Nov	2,916.4	2,963.1	-46.6		2,859.3	2,438.4	+420.9		1,473.5	1,313.6	+159.9	
	Dec	1,800.0	1,418.9	+381.1	+224.6	2,179.0	2,055.1	+123.8	+872.6	906.8	789.3	+117.5	+397.6
2018	Jan	2,033.0	1,787.8	+245.2		3,794.7	2,969.7	+825.1		1,077.7	1,093.8	-16.2	
	Feb	1,860.8	1,682.0	+178.8		3,803.7	2,786.6	+1,017.1		1,406.9	1,129.4	+277.5	
	Mar	1,612.5	1,583.3	+29.2	+453.2	3,902.4	3,224.8	+677.6	+2,519.8	1,258.8	1,120.5	+138.3	+399.6
	Apr	1,768.0	1,773.2	-5.2		3,511.2	2,775.3	+735.9		1,866.1	1,295.2	+570.9	
	May	2,106.0	2,214.8	-108.9		3,249.5	2,808.8	+440.7		1,909.1	1,468.1	+441.0	
	Jun	1,996.5	1,560.2	+436.3	+322.2	3,136.3	2,934.8	+201.6	+1,378.2	1,488.8	1,122.3	+366.5	+1,378.4
	Jul	1,672.9	1,541.9	+131.0		2,610.5	2,524.0	+86.4		960.3	937.0	+23.3	
	Aug	2,298.2	2,244.4	+53.9		2,842.9	2,643.4	+199.6		1,314.2	1,086.5	+227.7	
	Sep	1,685.3	1,755.0	-69.8	+115.1	2,471.1	2,506.3	-35.2	+250.8	1,278.6	1,139.0	+139.7	+390.7
	Oct	2,855.4	2,867.5	-12.1		3,333.7	3,039.8	+293.9		1,725.3	1,772.1	-46.7	
	Nov	1,883.6	1,901.1	-17.5		3,553.7	2,318.0	+1,235.6		1,336.2	1,217.9	+118.3	
	Dec	1,939.8	1,353.0	+586.8	+557.2	3,024.2	2,510.2	+514.1	+2,043.6	1,204.4	968.9	+235.5	+307.1
2019	Jan	1,898.5	1,727.0	+171.5		3,172.5	2,809.8	+362.7		998.2	893.7	+104.5	
	Feb	1,740.7	1,709.5	+31.2		2,724.2	2,483.9	+240.3		1,154.0	1,122.2	+31.8	
	Mar	1,712.0	1,857.3	-145.3	+57.5	3,364.3	3,221.4	+143.0	+746.0	1,267.8	1,294.8	-27.0	+109.3
	Apr	1,775.5	1,698.8	+76.7		3,574.5	2,820.8	+753.8		882.3	1,027.4	-145.1	
	May	1,549.2	1,584.9	-35.8		3,337.3	2,743.6	+593.7		1,724.9	1,438.0	+286.9	
	Jun	1,694.8	1,413.4	+281.5	+322.4	3,173.4	3,065.7	+107.8	+1,455.3	1,311.0	1,068.7	+242.3	+384.1
	Jul	1,921.6	1,669.0	+252.6		2,789.6	2,564.5	+225.1		1,022.1	921.2	+100.9	
	Aug	1,329.2	1,334.3	-5.1		3,782.5	2,979.8	+802.7		1,282.0	996.3	+285.7	
	Sep	1,471.1	1,506.0	-34.8	+212.6	3,631.0	3,344.5	+286.5	+1,314.3	876.0	898.0	-22.0	+364.6
	Oct	2,432.5	2,751.1	-318.6		3,221.8	2,636.0	+585.6		937.3	899.1	+38.2	
	Nov	1,548.7	1,978.6	-429.8		3,059.3	3,028.4	+30.9		1,719.8	1,552.6	+167.2	
	Dec	1,658.3	1,533.7	+124.5	-623.9	2,556.1	2,787.9	-231.7	+384.8	981.0	845.3	+135.8	+341.2
2020	Jan	1,129.8	1,288.6	-158.8		4,483.2	2,358.1	+2,125.0		766.6	928.0	-161.4	
	Feb	1,231.8	1,550.0	-318.2		5,241.3	2,910.7	+2,330.5		1,461.6	1,572.1	-110.5	
	Mar	2,568.7	1,835.9	+732.8	+255.7	3,979.7	4,408.5	-428.8	+4,026.7	2,525.0	1,241.0	+1,284.0	+1,012.1

**Foreign Bonds Transaction data includes the sum of "long-term debt securities" and "short-term debt securities"*

source: Ministry of Finance, TSE, Quiddity

The data for foreign bonds includes both long-term debt securities and short-term debt securities as separately reported by the Ministry of Finance. The foreign equity flows are also from the MOF. The domestic equity flows are reported by the TSE. None of these flow totals are exclusively tied to the GPIF. The GPIF allocates mandates to asset managers, and those asset management contracts may include trust banks, but *all* of the trillion dollars-plus of monies in those three categories are in accounts at trust banks, so it shows up in the data for trust banks' trust accounts.

There was ongoing buying of foreign bonds in each quarter last year. This amount was in excess of the amount implied by the asset allocations at quarter-end and quarterly performance by the most significant GPIF benchmark of the various asset classes, as shown below (note that not all the numbers add up - the GPIF changed the content of its reporting between March 2019 and June 2019 to exclude certain assets (it looks like the annual report includes a second portfolio, but quarterlies do not) and flows).

Quarterly GPIF Investment Flows by Asset Category (in ¥trln)				
	Dom Bonds	Dom Equities	Foreign Bonds	Foreign Equities
Apr19-Jun19	(4.76)	0.02	0.98	0.25
Jul19-Sep19	2.21	(0.02)	1.21	0.09
Oct19-Dec-19	(3.22)	0.00	(0.04)	0.42
Jan20-Mar-20				

It is important to note that these flows are "principal" flows (i.e. allocations to managers) and do *not* include the mechanistic reinvestment of dividends and coupons, which would be an ongoing artefact of GPIF flows. An example of this would be that the Foreign Bond portfolio at ¥32trln or so would have coupon reinvestment flows of something like ¥150-200bn a quarter. Total GPIF purchasing quantity of foreign bonds registered in the MOF data in the second calendar quarter of 2019 would have been something like ¥1.15-1.2trln. Total recorded was ¥1.45trln. Non-GPIF was about ¥300bn. In Q3, it would have been ¥1.35-1.40trln. Total recorded was ¥1.31trln. Non-GPIF was small negative. In calendar Q4, it *looks like* GPIF did buy, but the technical move of foreign bonds with yen hedge to the domestic portfolio would have offset that. On a net basis, the table above shows it did almost nothing, but it is not clear that is the case.

What DOES show up is that in Q1 this year, trust accounts bought ¥4+trln in foreign bonds. This happened at the same time as the GPIF changed its foreign bond allocation AND its domestic bond allocation as of April 1 (which is a bit like an index inclusion).

As shown below, IF the GPIF purchased ¥4trln in foreign bonds in Q1, it would have offset the amount that it was short foreign bonds against its 25% policy midpoint, but it only really NEEDED to sell yen fixed income and cash assets, replaced with either foreign currency assets or yen equities.

GPIF Investment Policy Allocation and Current Situation - Moving to 25% Each

		Dom Bonds		Dom Equities		Foreign Bonds		Foreign Equities		Short Term Assets	
Historical and Current Policy Allocation Mix											
Mar-06 - Mar-10		67%	±8%	11%	±6%	8%	±5%	9%	±5%	5%	±0%
Apr-10 - Jun-13		60%	±8%	12%	±6%	11%	±5%	12%	±5%	5%	±0%
Since Oct-14		35%	±10%	25%	±9%	15%	±4%	25%	±8%		
Oct-19 Amendment*		*Hedged Foreign Bonds are considered to be Domestic Bonds for allocation purposes*									
Starting 1 April 2020		25%	±7%	25%	±6%	25%	±8%	25%	±7%		
30 Jun 19 Alloc (¥trln)	**KNOWN**										
Allocation Per Asset Class (¥trln)		43.0		42.4		29.6		46.6		8.2	
Adjust for Hedged FBs (¥trln)		+1.3				-1.3					
Adjusted Total (¥trln)		44.3		42.4		28.3		46.6		8.2	
Alloc %		*26.1%*		*25.0%*		*16.7%*		*27.5%*		*4.8%*	
31 Sep 19 Alloc (¥trln)	**NEW**	**ACT**	*Est*	**ACT**	*Est*	**ACT**	*Est*	**ACT**	*Est*	**ACT**	*Est*
Allocation Per Asset Class (¥trln)		43.4	*43.4*	39.0	*39.0*	30.6	*29.4*	42.6	*42.5*	10.4	*8.2*
Adjust for Hedged FBs (¥trln)		+1.3	*+1.3*			-1.3	*-1.3*				
Adjusted Total (¥trln)		44.7	*44.7*	39.0	*39.0*	29.3	*28.1*	42.6	*42.5*	10.4	*8.2*
Alloc %		*26.9%*	*26.7%*	*23.5%*	*24.0%*	*17.6%*	*18.1%*	*25.7%*	*26.2%*	*6.3%*	*5.0%*
31 Dec 19 Alloc (¥trln)	**NEW**	**ACT**	*Est*	**ACT**	*Est*	**ACT**	*Est*	**ACT**	*Est*	**ACT**	*Est*
Allocation Per Asset Class (¥trln)		42.2	*43.0*	42.4	*42.4*	32.6	*29.6*	46.8	*46.6*	5.7	*8.2*
Adjust for Hedged FBs (¥trln)		+1.9	*+1.3*			-1.9	*-1.3*				
Adjusted Total (¥trln)		44.1	*44.3*	42.4	*42.4*	30.7	*28.3*	46.8	*46.6*	5.7	*8.2*
Alloc %		*26.0%*	*25.3%*	*25.0%*	*25.0%*	*18.1%*	*17.4%*	*27.6%*	*27.5%*	*3.4%*	*4.8%*
19 Mar 20 Alloc (¥trln)	**EXPECTED**	**Est**	*Old Est*	**Est**	*Old Est*	**Est**	*Old Est*	**Est**	*Old Est*	**Est**	*Old Est*
Allocation Per Asset Class (¥trln)		40.8	*41.6*	31.4	*31.4*	33.6	*30.6*	33.5	*33.3*	5.7	*8.2*
Adjust for Hedged FBs (¥trln)		+1.9	*+1.3*			-1.9	*-1.3*				
Adjusted Total (¥trln)		42.7	*42.9*	31.4	*31.4*	31.8	*29.3*	33.5	*33.3*	5.7	*8.2*
Alloc %		*29.5%*	*17.3%*	*21.6%*	*12.7%*	*21.9%*	*11.8%*	*23.1%*	*13.5%*	*4.0%*	*3.3%*
Adjusted Alloc		***33.4%***		***21.6%***		***21.9%***		***23.1%***		***0.0%***	
NEW MARCH 2020 TARGET	**POLICY**	25.0% ±7%		25.0% ±6%		25.0% ±8%		25.0% ±7%		0.0%	
Change to MidPoint		*-4.5%*		*+3.4%*		*+3.1%*		*+1.9%*		*-4.0%*	
Buy/Sell (¥trln)		**-6.5**		**+4.9**		**+4.5**		**+2.8**		**-5.7**	
MUST TRADE NOW		**-2.0**									

The other flows:

- It looks like there was about ¥0.76trln of investments made in foreign equities, though because of the variety of indices, and the lower correlation of the sub-benchmarks to the whole, this may be spurious data.
- It looks like there was no net investment in domestic stocks in calendar Q2-Q4.
- The TSE data in the first table shows the total of trust account net investment in domestic equities in March 2020. Of that, one could imagine about ¥490bn would have been for dividend reinvestment (as the benchmarks are almost all explicitly "gross" or "dividend-included" mandates as described in the notes of the back of the last Annual Report (p92).

Based on the combination of asset allocation data from the GPIF, flow data from the MOF data, and flow data from the TSE, it would appear that the GPIF made decent-sized investment allocations in FYQ1-Q2, then a very large one in Q4 to foreign bonds. It would appear that they may have made some allocations to foreign equities. It appears as if they made no allocation to domestic stocks in FYQ1-Q3, and it appears as if they may have executed some dividend reinvestment in Q4 (Jan-Mar 2020) but not a significant re-upping of weights towards the midpoint as equity prices fell.

What Is Remarkable

When you look at the whole of the data and the activity, a remarkable possibility falls out of the cracks. It appears as if the GPIF made substantial new investments in foreign bonds in January and February this year to match the investment policy bogey for April 1. Given the 1 October change in the categorization of foreign bonds with a yen hedge, they were making room for more foreign bonds (without hedge). Given the new policy allocation maximum for domestic bonds announced 31 March, they would have had to sell a fair bit of yen fixed income+cash, and to get to the policy midpoint on foreign bonds, they would have had to buy a bunch of foreign bonds.

Important, however, was that it appears the GPIF made that allocation without the policy mix having been completely agreed. They made those investments in January, in February clearly exceeding their old allocation limit maximum, before the actual policy changes were approved.

The fact that CIO Mizuno was on his way out, and *most* knew it, and the President was also on his way out, and *everyone* knew it, it looks like Mizuno-san's last hurrah was to get foreign bonds higher, leaving the aftermath of a sharp drop in Japanese and global equities to the next CIO, who was selected and approved as of 1 April. I do not know, but I expect his selection was known for months too, and he may have been invited in as an observer at some point, and as a fixed income person at heart, he may have helped provide some impetus to FYQ4 investment moves.

What Else Is Remarkable? ESG Investment

The increased importance of ESG/governance/stewardship was one of the things that Mizuno-san impressed upon people as being the thing he was most proud of during his tenure (I even speculated last autumn and winter and again this spring that his next job might be to aim at a similar job, concentrating on ESG, but with better pay).

The minutes of the last several meetings including the ones in the runup to the decisions on the new Investment Policy all made some comment about ESG investing, its importants, and the modalities around investing in it. If I permit myself to skip through pages and pages of commentary back and forth on the matter, what stands out is…

1. There is widespread recognition that ESG investing is an important topic. Mr. Mizuno made that his top basic priority. Others on the board recognize it.
2. There has been an effort by the GPIF already to engage with index providers in public matters - i.e. requests for comment - and private matters (discussion about index construction, formulation, strategy, and execution), and it appears some discussion about engaging an index provider to create a custom index with more serious ESG chops than what is out there now - as one board member put it "everyone seems to have an ESG version of their basic index".
3. They have clearly put off for later the idea of hiring someone to build that index for them. They seem reluctant to jump without more study. There seems to be some skepticism that it is possible to know how much good stewardship or strong stewardship can help in returns.
4. FY2020 includes in its research plan (as per the Minutes of the 37th Meeting 6 Feb 2020) the idea that budget will be allocated to study the nature of ESG differences and how ESG and stewardship by passive investors can be measured. There is a start to the idea now that some passive managers will be paid an extra fee for their stewardship work, and others will simply be "general" passive managers. The split, and the progress that the GPIF has made to separating those two types of managers is not yet clear.
5. There will be more and greater emphasis in reporting by managers to the GPIF and by the GPIF to the public about the efforts made on behalf of beneficiaries to improve returns through governance, transparency, and stewardship efforts. I remain skeptical that there will be a lot there. What would really, really help is a strong policy about what measures, behaviors, etc are applicable. That would mean a much more specific governance code ("we expect this") and stewardship code ("we will do that") for the GPIF to adhere to. For the moment, those policies are being established by the sub-managers, and then it is up to the GPIF to determine how well they have done what they promised to do. It may be important for the GPIF to put its own stamp on things, but I get the feeling that is years away.

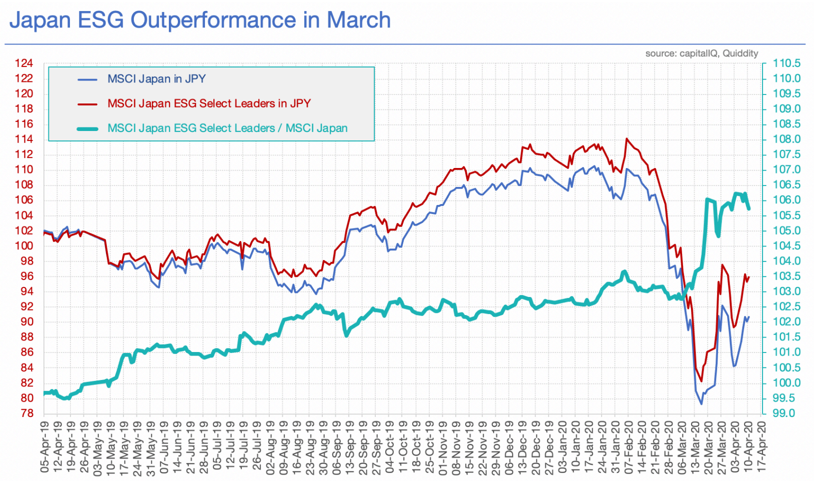
I am honestly stumped by how the GPIF will come out of its studies to promote or encourage better stewardship. Will it decide to invest in only good companies? Will it conclude that governance improvement is a key determinant of higher ROE and high multiples therefore they should concentrate investment in the best governed companies? Or will they decide that the *improvement* in governance is what drives the rise in profitability and multiples therefore they should buy the worst-governed companies and try to improve governance?

It is not clear what they deem as stewardship. As I pointed out in the FT comment, of the 2380 stocks in their portfolio, 2100+ are owned by 6 passive managers for GPIF for TOPIX, and by 8-10 passive GPIF managers for most large caps in the top 500-1500 of those stocks, and the last 200 stocks not in TSE First Section would be owned by a couple of managers, but would represent a truly tiny portion of the overall portfolio. But averaging 6-7 passive managers (and a few more active managers) per stock in the portfolio, and averaging one visit or contact a month per manager per company might mean an average of 6-7 x 12 x 2200 = 158,000 contacts. That is a lot of contact. All that has to be recorded, analysed, etc. Then, to do it *right* - i.e. to do a job not done by a computer ticking boxes - there has to be a qualitative overlay. Rules made by a person. So far I see little debate of what that means. There is zero subtlety. Even Mr Mizuno who was widely quoted and spent lots of time with media and speaking in public did not seem to have a good sense of a kind of stewardship line in the sand.

Nevertheless, it is important, and the data shows we may see an increased allocation.

How do we know that?

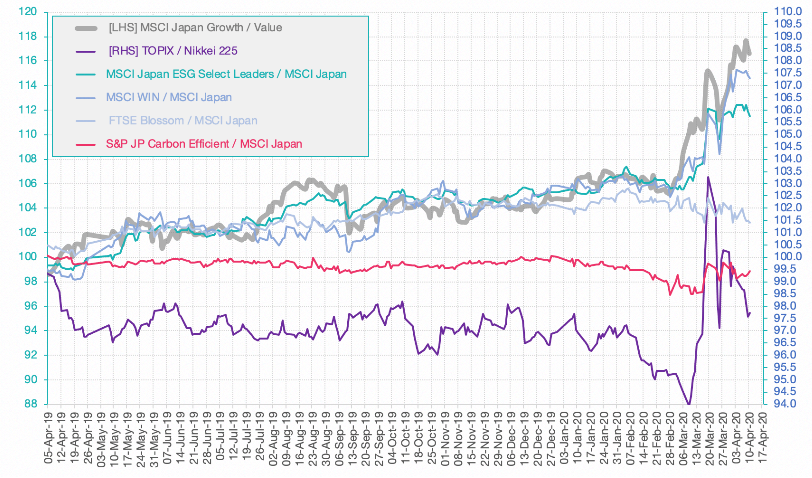
Because in March, in the three weeks running up to the end of the fiscal year, we saw significant outperformance of the MSCI Index vs MSCI Japan. The green line below shows statistically VERY significant outperformance of MSCI ESG in the space of a week, coinciding with the last down leg of the market, and then the rebound. That outperformance functionally seems to have stopped a day or two before the end of the ex-date for settlement within the fiscal year. It was noticeable real-time, and I got several comments about it from eagle-eyed Smartkarma readers.



Interestingly, that sharp rise was shared by both the MSCI WIN / MSCI Japan long/short pair, and the MSCI Japan Growth /Value long-short pair.

It is notable that over the period between the start of the fiscal year and February 28th, the r-squared between MSCI Japan Growth/Value and MSCI ESG/Japan Index was 0.08, but between February 28th through March 27th the r-squared rose to 0.45, which suggests it was quite idiosyncratic, though the construction of the ESG index favours large caps vs small caps, and favours companies which appear to have a higher revenue/employee ratio.

vs Other Indices/Biases, And GPIF SmartBeta & ESG Benchmarks

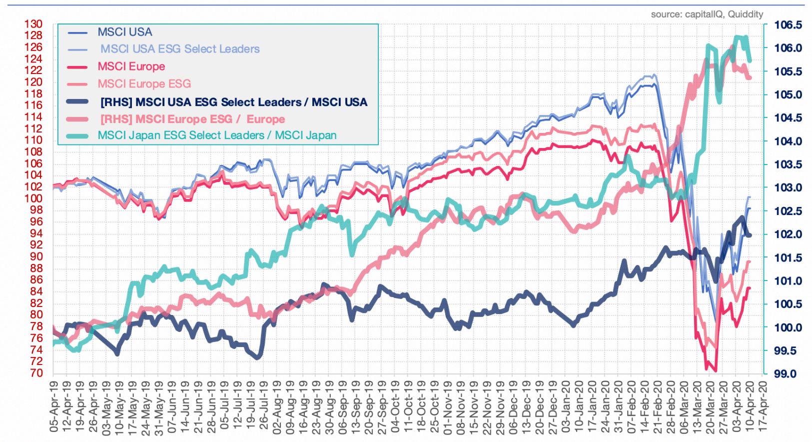


Was this perhaps a global thing? Did ESG/Normal index ratios move sharply elsewhere during the crunch?

The answer is… *somewhat?*

The chart below looks dramatic, with the thick lines rising sharply. But that is a very compressed scale. The ESG vs Normal long/short performance is measured on the right hand side and from 6 March until 27 March, the gain was a bit over 1% in Europe and flat in the USA (actually -0.01%). That does not indicate that the move was driven in the same way using the same dynamics, even though globally, the ructions were extremely similar.

vs USA and Europe ESG Performance in March



So What Might Have Happened?

The GPIF has a history of doing transition trades to the tune of ¥500bn-¥1trln over the space of the last couple of weeks of the fiscal year. The reason for this is that the mandate can end as of the end of the fiscal year, and be transitioned to a new manager as of the beginning of the new fiscal year, and the execution friction or performance is not applied to the individual manager but is part of the 'cost' of allocating.

It appears as if there was some money moved into MSCI ESG Select Leaders Index and the MSCI WIN Index which had ¥804bn and ¥475bn allocated, respectively, as of the end of March 2019, on their way to a prospective allocation of ¥1trln each (¥1trln each across the three indices was the original target). There may have been other allocations made during the year as well. We will not see this until June or July when the GPIF reports its allocations by benchmark, but it would fit that the GPIF would allocate to one or two of the "successful" ESG indices.

The GPIF does not, as far as I can tell, allocate any funds to ESG indices outside of Japan.

Any additional allocation above and beyond the ¥3trln may be a move towards driving more passive to such indices ahead of trying to move still more passive money to a NEW passive ESG strategy to be named later.

So What Happens Next?

It seems relatively clear from the TSE data that the GPIF did not aggressively buy equities on the dip as they would have been expected to do when prices for equity and debt bifurcated dramatically.

That is the job of an asset allocation policy. Rebalancing is a key tenet of such a policy. HOWEVER, this rebalancing effort would have taken place in the final days of the old President (Takahashi-san) and old CIO (Mizuno-san), ahead of the arrival of the new President (Miyazono-san) and new CIO (Ueda-san) and it is possible that did not happen precisely because of the handover.

I would suggest that GPIF is now underweight Japanese equities and overweight foreign bonds. Further weakness in Japanese equities would play into the hands of a rebalancing GPIF. Governance is getting better. Shareholder return rates are getting better (lowering equity duration), and multiples as a whole are substantially below global multiples of book.

> The allocation policy expects to get 5.6% return from Japanese equities based off the last 25yrs. While covid-19-impacted earnings for FY20 (to March 2021) are anyone's guess, the presumption is that at some point there is a wall of worry to climb on the other side, and

> starting at a level below book, and ROE above that level and rising, buying below book with a governance tailwind seems like a decent thing to do from a policy allocation perspective.

This insight is labelled Bullish.

I expect GPIF flows into Japanese equities.

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