



Will ESG Factors Lead a Flight Back to Active Investing in Japan?

As the focus on ESG intensifies, a passive approach appears limited.

January 2020

KEY INSIGHTS

- Prevalent passive and ETF investment strategies in Japan, particularly among foreign investors, are looking increasingly limiting within a market undergoing significant change.
- Japanese companies are rapidly adopting ESG best practices and, for investors wanting to be selective on this basis, a passive approach is potentially constraining.
- We believe that successful investing demands an investment process that actively seeks to identify sustainable companies positioned on the right side of change.



Archibald Ciganer

*Portfolio Manager, T. Rowe Price
Japanese Equity Strategy*

With the maturing of the equity market cycle, a growing conflict has become apparent in terms of investor positioning in Japan. At the heart of this conflict is an increasing focus on environmental, social, and governance (ESG) factors, with many investors wanting to understand more about the companies they own and their respective ESG credentials. This is especially the case for foreign investors in Japan, where passive and exchange-traded fund (ETF) vehicles dominate. In a market defined by dynamic change and disruption, gaining and acting on ESG insights is potentially being constrained by the prevalence of passive investment.

Passive Strategies Can Be Ill-Equipped to Address the ESG Challenge

The Japan equity market's fall from grace in the two decades that followed

the excesses of the 1980s bubble is well documented. One clear trend that has followed over the past decade has been a large-scale shift to passive investment strategies—coinciding with a sharp decline in active investment and supporting sell-side research. This diminishing availability of local research has recently dovetailed with a period defined by significant secular change, both locally in Japan, and globally—change that is cutting across economic, financial market, political, and societal dimensions.

While not isolated to Japan, investors are also increasingly demanding insights into any heightened ESG risks (and opportunities) of companies. Investors in passive strategies who want to understand more, or who want to influence positive change in company behavior or activity, can be constrained in their capacity to actively engage with their portfolio holdings.

“We believe that successful investing demands an investment process that actively seeks to identify sustainable companies positioned on the right side of change.

— Archibald Ciganer
Portfolio Manager, T. Rowe Price Japanese Equity Strategy

With many large, passive Japanese equity strategies run by global investment managers that have limited or no local research presence, engagement with companies is imperfect at best, reactive or absent at worst. Meanwhile, the ability to be selective and single out progressive companies with strong or improving ESG standards is an opportunity being lost, given that a traditional passive approach does not discern between good and bad companies on traditional fundamental, or ESG, grounds.

Policy and Regulation Changes Heighten the ESG Imperative

We believe that successful investing demands an investment process that actively seeks to identify sustainable companies positioned on the right side of change. This is particularly relevant in Japan—a market that is experiencing considerable change, with an evolving corporate landscape and where companies are rapidly embracing ESG best practices, particularly under the influence of government initiatives and the demands of local pension funds.

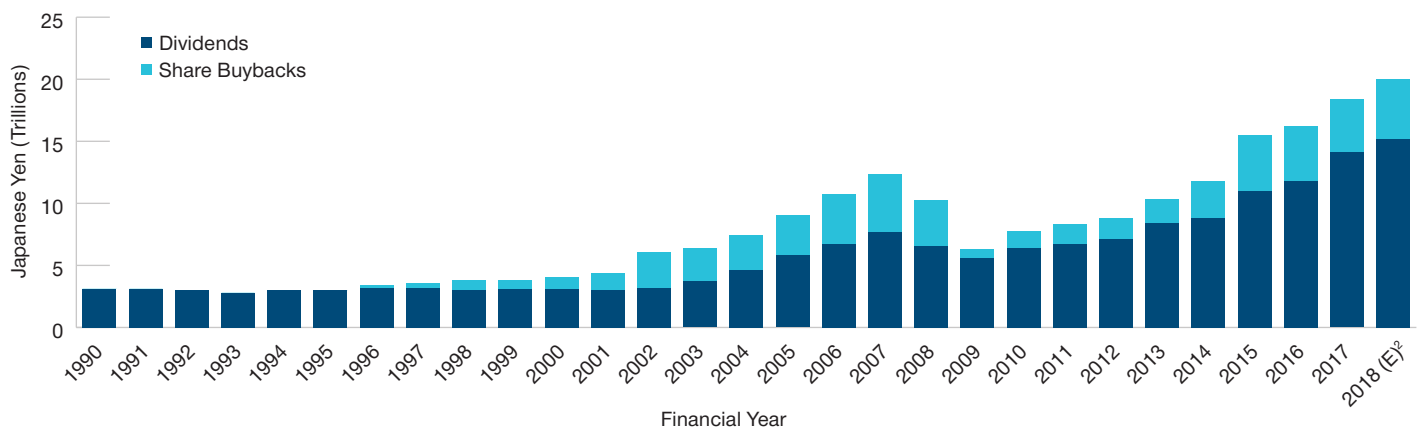
One of the most significant achievements of Prime Minister Shinzo Abe’s “Abenomics” economic revitalization strategy has been an improvement in Japanese corporate governance standards. These have, in turn, increased the emphasis on delivering higher returns for shareholders. New stewardship codes, for example, have been implemented with speed and determination, with tangible changes in corporate atmosphere.

Change implies active management and investment selectivity, both to optimize returns and to manage the risks that emerge as companies find themselves on the wrong side of change and evolution. This is true today more than ever with respect to ESG considerations, which we believe can only be fully understood by active engagement backed by real, face-to-face interactions with company management teams.

In contrast, the fundamental business model of passive management inherently involves a low-cost solution executed via investment in every company in a particular index. The outcome is the inclusion of companies

(Fig. 1) Improving Governance Means More Focus on Shareholder Returns

Total shareholder returns of all listed companies¹
As of June 30, 2018



Past performance is not a reliable indicator of future performance.

Sources: Corporate Reports, Japan Exchange Group/ Haver Analytics, and Empirical Research Partners Analysis.

¹ Listed on the Tokyo Stock Exchange (TSE); data exclude financials and utilities. Share buybacks net of share issuance. Based on governance reports submitted by mid-July each year.

² E = estimated data, latest available at time of publishing.

that some will find objectionable and that invest in activities and practices that are at odds with certain core values. This lack of selectivity, in a world increasingly focused on ESG factors and judgments about long-term sustainability (of business models and business practices), seems imperfect. This is especially the case in a market such as Japan, where corporate governance standards are evolving more rapidly than in any major developed market.

Investors Increasingly Demand an ESG Lens

Over the past year, we have discussed increasingly specific and complex ESG integration and exclusion requirements with clients, particularly larger institutions. Dialogue often emphasizes concerns around corporate engagement or the application of negative ESG screens to portfolios (omitting companies based on particular attributes, such as weapons or tobacco exposure). Most frequently, it focuses on the requirement for ESG factors to be embedded within the investment decision-making process, alongside the analysis of traditional financial data points.

This is important from an investment process perspective but also in terms of how it is shifting the investment opportunity in Japanese equities. To regard these concerns as transient would be an error, in our view, given the rapid adoption of ESG policies and the commitment of asset owners to influence corporates to the betterment of society.

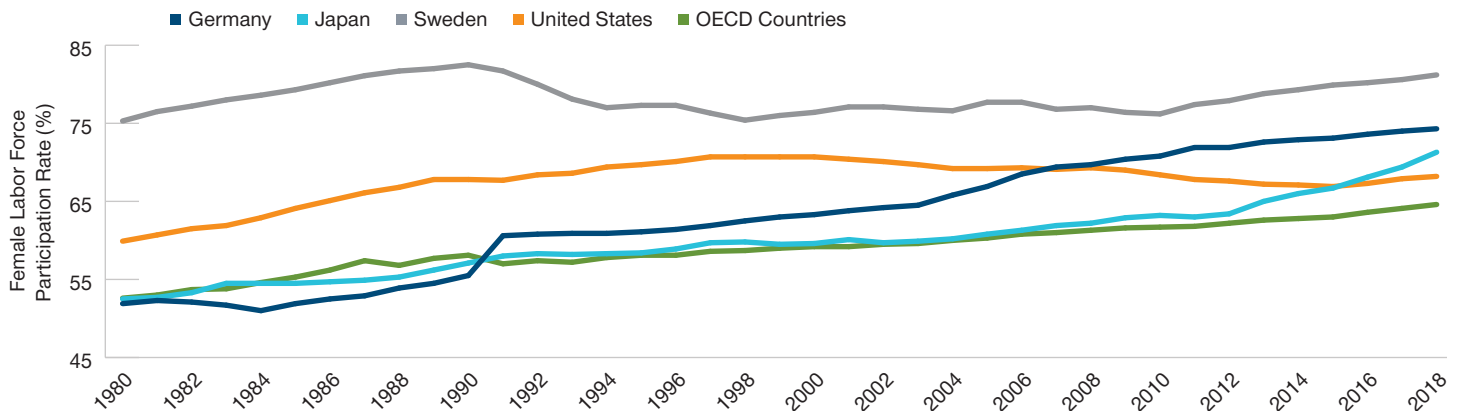
ESG Best Practice Is a Journey, Especially in Japan

While improvements in corporate governance have served to lift shareholder returns in recent years, the next stage of Prime Minister Shinzo Abe's reform agenda focuses on addressing workplace diversity. Here again, the commitment to change is real and progressive.

Workplace diversity, and the representation of women in senior management, in particular, are being given explicit focus and attention by a government that sees female workforce participation as a solution to Japan's demographic shrinkage. These are topics that we will continue to engage with Japanese companies going forward in order to fully understand these dimensions of change—and their impact on performance—on a stock-by-stock basis.

(Fig. 2) Efforts to Boost the Number of Women in the Workforce Are Working

Japan's female labor participation rate (%)
As of December 31, 2018



Source: OECD (2019). OECD Labour Market Statistics: Female Labour force participation rate data set: <https://data.oecd.org/emp/labour-force-participation-rate.htm>, accessed on December 10, 2019. Analysis of data by T. Rowe Price.

“...our company engagement programs have always been driven by our fundamental research and supported by local market expertise.

— Archibald Ciganer
Portfolio Manager, T. Rowe Price
Japanese Equity Strategy

Greater Insights From Dedicated ESG Resources and Investment Processes

Tremendous progress has been made in Japanese corporate governance in recent years. We believe this focus on improvement will only gather pace, creating both risks and opportunities for companies as they respond to, or fall behind, the pace of change. Active management approaches can be agile to identifying these potential winners and losers and managing them within the investment portfolio.

At T. Rowe Price, our company engagement programs have always

been driven by our fundamental research and supported by local market expertise. In recent years our research platform has been bolstered by substantial investment in our dedicated ESG research team, which provides proprietary analysis to integrate into our investment decision-making. This provides us with a deeper understanding of potential ESG risks or opportunities in our investment universe and identifies opportunities for engagement with our portfolio holdings. Combined with the deep expertise of our nine-strong Japanese equity research team, this positions us well to actively respond to the evolving investment needs of our clients.

WHAT WE'RE WATCHING NEXT

An environment of modest global growth should continue to help corporate Japan perform well; however, we are mindful of the trade conflict between China and the U.S. Any escalation here is a key risk, for Japan and globally, and we continue to monitor developments closely. While the ideal scenario is that trade war concerns ease and sanctions are lifted, we believe that our quality bias can potentially hold us in good stead if the trade situation deteriorates and jeopardizes the supportive growth environment.

T. Rowe Price focuses on delivering investment management excellence that investors can rely on—now and over the long term.

T.RowePrice[®]

Important Information

This material is being furnished for general informational purposes only. The material does not constitute or undertake to give advice of any nature, including fiduciary investment advice, nor is it intended to serve as the primary basis for an investment decision. Prospective investors are recommended to seek independent legal, financial and tax advice before making any investment decision. T. Rowe Price group of companies including T. Rowe Price Associates, Inc. and/or its affiliates receive revenue from T. Rowe Price investment products and services. **Past performance is not a reliable indicator of future performance.** The value of an investment and any income from it can go down as well as up. Investors may get back less than the amount invested.

The material does not constitute a distribution, an offer, an invitation, a personal or general recommendation or solicitation to sell or buy any securities in any jurisdiction or to conduct any particular investment activity. The material has not been reviewed by any regulatory authority in any jurisdiction.

Information and opinions presented have been obtained or derived from sources believed to be reliable and current; however, we cannot guarantee the sources' accuracy or completeness. There is no guarantee that any forecasts made will come to pass. The views contained herein are as of the date written and are subject to change without notice; these views may differ from those of other T. Rowe Price group companies and/or associates. Under no circumstances should the material, in whole or in part, be copied or redistributed without consent from T. Rowe Price.

The material is not intended for use by persons in jurisdictions which prohibit or restrict the distribution of the material and in certain countries the material is provided upon specific request. It is not intended for distribution to retail investors in any jurisdiction.

Australia—Issued in Australia by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. For Wholesale Clients only.

Brunei—This material can only be delivered to certain specific institutional investors for informational purpose upon request only. The strategy and/or any products associated with the strategy has not been authorised for distribution in Brunei. No distribution of this material to any member of the public in Brunei is permitted.

Canada—Issued in Canada by T. Rowe Price (Canada), Inc. T. Rowe Price (Canada), Inc.'s investment management services are only available to Accredited Investors as defined under National Instrument 45-106. T. Rowe Price (Canada), Inc. enters into written delegation agreements with affiliates to provide investment management services.

China—This material is provided to specific qualified domestic institutional investor or sovereign wealth fund on a one-on-one basis. No invitation to offer, or offer for, or sale of, the shares will be made in the People's Republic of China ("PRC") (which, for such purpose, does not include the Hong Kong or Macau Special Administrative Regions or Taiwan) or by any means that would be deemed public under the laws of the PRC. The information relating to the strategy contained in this material has not been submitted to or approved by the China Securities Regulatory Commission or any other relevant governmental authority in the PRC. The strategy and/or any product associated with the strategy may only be offered or sold to investors in the PRC that are expressly authorized under the laws and regulations of the PRC to buy and sell securities denominated in a currency other than the Renminbi (or RMB), which is the official currency of the PRC. Potential investors who are resident in the PRC are responsible for obtaining the required approvals from all relevant government authorities in the PRC, including, but not limited to, the State Administration of Foreign Exchange, before purchasing the shares. This document further does not constitute any securities or investment advice to citizens of the PRC, or nationals with permanent residence in the PRC, or to any corporation, partnership, or other entity incorporated or established in the PRC.

DIFC—Issued in the Dubai International Financial Centre by T. Rowe Price International Ltd. This material is communicated on behalf of T. Rowe Price International Ltd. by its representative office which is regulated by the Dubai Financial Services Authority. For Professional Clients only.

EEA ex-UK—Unless indicated otherwise this material is issued and approved by T. Rowe Price (Luxembourg) Management S.à r.l. 35 Boulevard du Prince Henri L-1724 Luxembourg which is authorised and regulated by the Luxembourg Commission de Surveillance du Secteur Financier. For Professional Clients only.

Hong Kong—Issued in Hong Kong by T. Rowe Price Hong Kong Limited, 6/F, Chater House, 8 Connaught Road Central, Hong Kong. T. Rowe Price Hong Kong Limited is licensed and regulated by the Securities & Futures Commission. For Professional Investors only.

Indonesia—This material is intended to be used only by the designated recipient to whom T. Rowe Price delivered; it is for institutional use only. Under no circumstances should the material, in whole or in part, be copied, redistributed or shared, in any medium, without prior written consent from T. Rowe Price. No distribution of this material to members of the public in any jurisdiction is permitted.

Korea—This material is intended only to Qualified Professional Investors upon specific and unsolicited request and may not be reproduced in whole or in part nor can they be transmitted to any other person in the Republic of Korea.

Malaysia—This material can only be delivered to specific institutional investor upon specific and unsolicited request. The strategy and/or any products associated with the strategy has not been authorised for distribution in Malaysia. This material is solely for institutional use and for informational purposes only. This material does not provide investment advice or an offering to make, or an inducement or attempted inducement of any person to enter into or to offer to enter into, an agreement for or with a view to acquiring, disposing of, subscribing for or underwriting securities. Nothing in this material shall be considered a making available of, solicitation to buy, an offering for subscription or purchase or an invitation to subscribe for or purchase any securities, or any other product or service, to any person in any jurisdiction where such offer, solicitation, purchase or sale would be unlawful under the laws of Malaysia.

New Zealand—Issued in New Zealand by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. No Interests are offered to the public. Accordingly, the Interests may not, directly or indirectly, be offered, sold or delivered in New Zealand, nor may any offering document or advertisement in relation to the Interests be distributed in New Zealand, other than in circumstances where there is no contravention of the Financial Markets Conduct Act 2013.

Philippines—THE STRATEGY AND/ OR ANY SECURITIES ASSOCIATED WITH THE STRATEGY BEING OFFERED OR SOLD HEREIN HAVE NOT BEEN REGISTERED WITH THE SECURITIES AND EXCHANGE COMMISSION UNDER THE SECURITIES REGULATION CODE. ANY FUTURE OFFER OR SALE OF THE STRATEGY AND/ OR ANY SECURITIES IS SUBJECT TO REGISTRATION REQUIREMENTS UNDER THE CODE, UNLESS SUCH OFFER OR SALE QUALIFIES AS AN EXEMPT TRANSACTION.

Singapore—Issued in Singapore by T. Rowe Price Singapore Private Ltd., No. 501 Orchard Rd, #10-02 Wheelock Place, Singapore 238880. T. Rowe Price Singapore Private Ltd. is licensed and regulated by the Monetary Authority of Singapore. For Institutional and Accredited Investors only.

South Africa—T. Rowe Price International Ltd ("TRPIL") is an authorised financial services provider under the Financial Advisory and Intermediary Services Act, 2002 (FSP Licence Number 31935), authorised to provide "intermediary services" to South African investors.

Switzerland—Issued in Switzerland by T. Rowe Price (Switzerland) GmbH, Talstrasse 65, 6th Floor, 8001 Zurich, Switzerland. For Qualified Investors only.

Taiwan—This does not provide investment advice or recommendations. Nothing in this material shall be considered a solicitation to buy, or an offer to sell, a security, or any other product or service, to any person in the Republic of China.

Thailand—This material has not been and will not be filed with or approved by the Securities Exchange Commission of Thailand or any other regulatory authority in Thailand. The material is provided solely to "institutional investors" as defined under relevant Thai laws and regulations. No distribution of this material to any member of the public in Thailand is permitted. Nothing in this material shall be considered a provision of service, or a solicitation to buy, or an offer to sell, a security, or any other product or service, to any person where such provision, offer, solicitation, purchase or sale would be unlawful under relevant Thai laws and regulations.

UK—This material is issued and approved by T. Rowe Price International Ltd, 60 Queen Victoria Street, London, EC4N 4TZ which is authorised and regulated by the UK Financial Conduct Authority. For Professional Clients only.

USA—Issued in the USA by T. Rowe Price Associates, Inc., 100 East Pratt Street, Baltimore, MD, 21202, which is regulated by the U.S. Securities and Exchange Commission. For Institutional Investors only.

© 2020 T. Rowe Price. All rights reserved. T. ROWE PRICE, INVEST WITH CONFIDENCE, and the bighorn sheep design are, collectively and/or apart, trademarks or registered trademarks of T. Rowe Price Group, Inc.