

# OUR APPROACH TO ESG - JAPAN EQUITY TEAM

July 2018

## Our philosophy

Taking a strong approach to ESG issues is a necessary condition for companies to generate new growth. By investing in the stocks of such companies, we believe that excess returns can be achieved over the medium to long term.

The Japan Equity team aims to generate alpha by picking companies with superior ESG policies through a stock selection process that combines both negative and positive screening, and an optimization process that incorporates thorough management of risks.

## Our approach to implementing ESG considerations

When we conduct a historical comparison between leading ESG indices and the TOPIX, it is apparent that ESG indices do not always outperform the market. This implies that investing in companies with superior ESG policies on its own is insufficient for outperformance. Instead, a well-conceived approach is necessary when implementing ESG considerations. As with any investment, appropriate stock selection and portfolio management are crucial to improve performance and control risk within an ESG strategy.

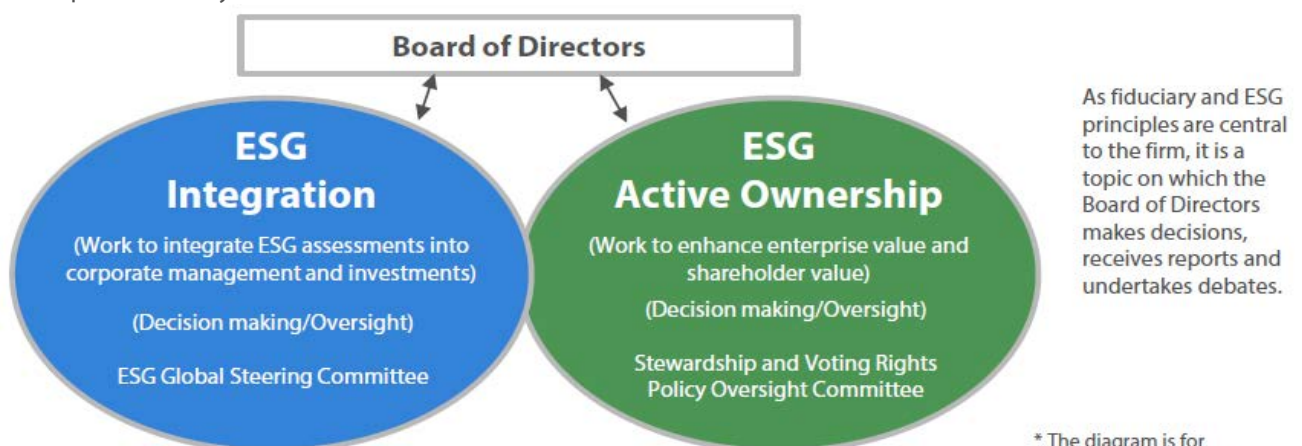
The Japan Equity team believes that a superior ESG investment process should:

- Pursue alpha through a combination of financial and non-financial information, including ESG
- Focus on ESG factors that lead to future earnings and strengthen competitiveness
- Involve consistent engagement with corporate management teams

## ESG integration and ESG active ownership

At Nikko AM, ESG is a central element of our management philosophy and something we believe to be essential for putting fiduciary principles into practice. We are therefore working to integrate ESG into all our investment decisions. Covering the Japan Equity team, the firm launched the Stewardship and Proxy Voting (S&PV) Committee in 2014, the Stewardship and Voting Rights Policy Oversight Committee (which oversees what is discussed at the S&PV Committee) in June 2016, and the ESG Global Steering Committee in November 2016, all of which meet quarterly.

ESG is implemented in our investment processes through taking two approaches: ESG integration and ESG active ownership. ESG Integration is defined as using ESG information to generate alpha. ESG active ownership is defined as engaging with companies to enhance capital efficiency and shareholder returns.



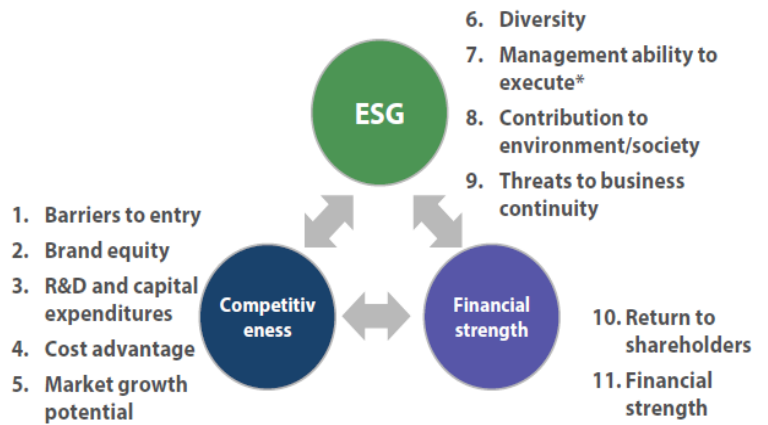
\* The diagram is for illustrative purposes.

## 1. ESG integration

### a. CSV evaluations of individual stocks: Positive screening

All Japan equity active investment strategies incorporate CSV evaluations\*, which take ESG factors into consideration. CSV, or creating shared value, is a methodology that assesses how companies balance their engagement of ESG issues on one hand, and the pursuit of profitability and competitiveness on the other, in order to create value for both society and shareholders. Our analyst research has incorporated CSV evaluations since 2013.

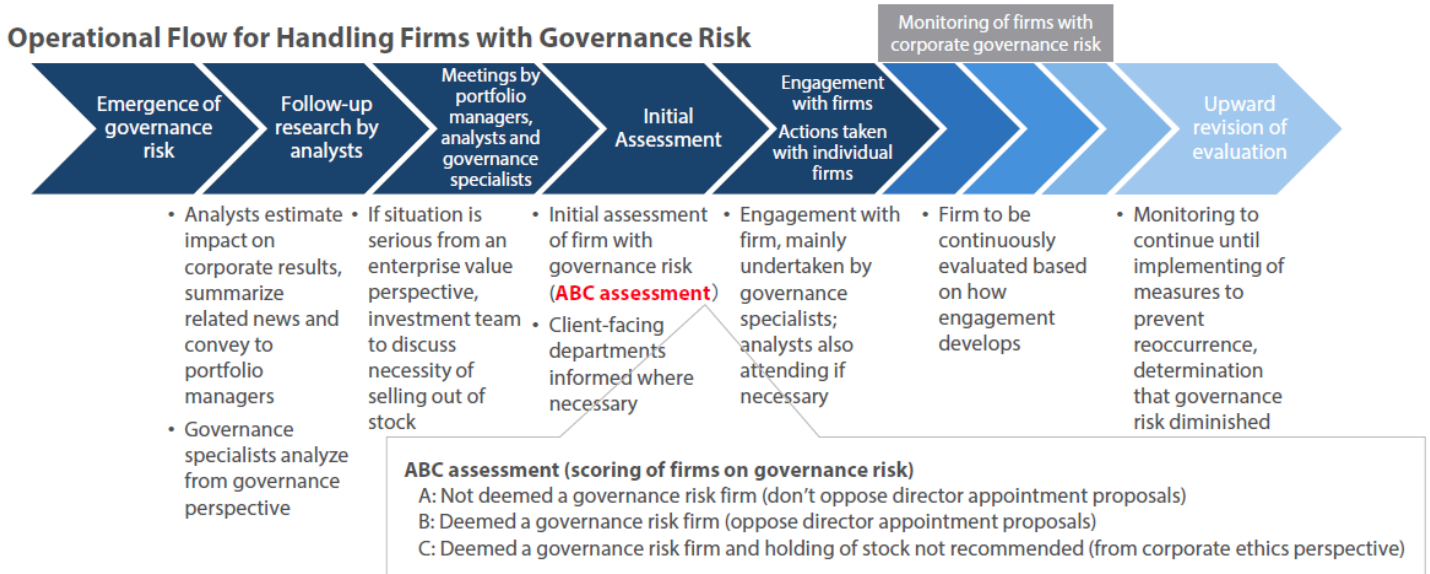
\*CSV evaluation: a score which applies the CSV theory proposed by Harvard University professor Michael Porter (that creating social value leads to economic value) by comprehensively evaluating a firm its competitiveness, ESG factors and financial strength.



\* For example, corporate governance is evaluated by analysing the degree to which business plans are successfully completed

### b. Approach to firms with governance risk: Negative screening

Firms that have been involved in criminal conduct/fraud and/or accounting fraud, or that have caused environmental or social problems, are classified as having governance risk. The Japan equity team excludes firms with perceptible corporate governance risk from its investment universe, while also seeking to promote better governance by engaging with the firms it invests in.



## 2. ESG active ownership

- The **Stewardship and Voting Rights Policy Oversight Committee** was formed in June 2016. Members, most of whom are from outside the firm, focus on whether Nikko AM's proxy voting and engagement are in line with investor interests.
- **Active Ownership Group** was established in March 2017 to specialize in engagement with small and mid-sized firms. Two active ownership analysts cover all names listed on the Tokyo Stock Exchange First Section outside of the 1000-name sector analyst research universe. These include stocks in passively managed portfolios (approximately 1,070 names). Analysts prioritize firms to engage with based on considerations including corporate earnings, asset efficiency and shareholder return. Engagement reports are created to track progress and be shared internally; feedback is also provided to active investment portfolio managers.
- The Japan Equity team contributes to the continued growth of investee companies through **engagement and proxy voting**. It also acted ahead of competitors in disclosing proxy voting records on its public website from 2002. With the objective of aligning its stewardship activities (e.g. proxy voting) with the faithful execution of its fiduciary duty, the team works to ensure that these activities are based on a consistent decision-making process and appropriate decision-making criteria.

## Japan equity ESG strategy lineup

Japan ESG Equity Strategy	Japan Equity CSV Active Strategy	Japan Equity SRI Concentrated Investment Strategy	Japan Equity ESG/CSV Smart Beta Strategy
<ul style="list-style-type: none"> <li>• Uses ecological screenings by The Good Bankers (a Japanese leader in ecological research) and CSV ratings by Nikko AM</li> <li>• Aims to secure active return over the mid to long term by investing in environmentally friendly firms with strong profits and growth potential</li> </ul>	<ul style="list-style-type: none"> <li>• Invest mainly in stocks of firms that combine social contributions with medium-and long-term corporate growth</li> <li>• Analysts assess stocks by assigning ESG points, competitiveness points, and financial strength points and adding them together to calculate CSV scores</li> <li>• Based on research produced by analysts, portfolio managers construct portfolios while comprehensively considering valuations and other such factors</li> </ul>	<ul style="list-style-type: none"> <li>• Aim to obtain excess return by investing in stocks of firms listed on the Japanese stock market that not only excel in efforts to resolve environmental problems, but also have strong records on training, treating employees well and contributing to society</li> <li>• Select stocks by narrowing them down based on SRI ratings provided by advisory firm The Good Bankers</li> <li>• The portfolio manager builds the portfolio by selecting stocks in consideration of factors such as earnings and valuations</li> </ul>	<ul style="list-style-type: none"> <li>• Within TOPIX 500, determine names to invest in using “quantitative CSV scores”, calculated based on firms’ labor productivity and efficiency in investing in personnel, and “qualitative CSV scores” calculated by analysts</li> <li>• Names with low scores are excluded from the portfolio (negative screening)</li> <li>• Portfolios are also constructed based on investment weighting calculations that factor in float-adjusted market capitalizations</li> <li>• Rebalanced monthly</li> </ul>

### Nikko AM’s Commitments:

Nikko AM has been a **signatory of United Nations Principles for Responsible Investing (UN PRI)** since 2007. Nikko AM has also launched Japan’s first SRI fund and has a history of innovation across all asset classes. Our adoption of the Japan Stewardship Code is set out on our website.

Nikko AM is a member/signatory of the following organisations and initiatives:

- **Principles for Financial Action for the 21st Century:** Nikko AM actively engaged in initiatives from Japan's Ministry of Environment as one of the members of the drafting committee, and we are a steering committee member of Principles for Financial Action for the 21st Century
- **CDP (formerly Carbon Disclosure Project)** – Nikko AM is a signatory since 2006, a global disclosure system that enables companies to measure and manage their environmental impacts.

*It is important to note that we do not exclude particular asset types, industry sectors or securities wholly on moral or ethical grounds, unless this is expressly built into the product’s investment strategy or client agreement.*

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