Japan Strategic Value and ESG Integration

Our Approach to ESG and Sustainability

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September 2020

Expertise acquired from investing in Japan over more than two decades has allowed us to develop a unique perspective on ESG in our home market.

Japanese companies have embraced ESG

"…in recent years we have seen a massive improvement in our ability to engage productively with companies, as we have seen many become more open to dialogue with investors… "

In recent years, we have seen a transformation in Japanese corporate governance. Companies were generally considered to be insider-dominated, unwilling to meet with investors and especially opaque to international investors, who often struggled to understand their strategies due to a lack of English documentation and communications.

With the advent of the Abenomics reforms, there has been a strong emphasis from the administration on improving corporate governance. The Japanese government led the charge by launching the Stewardship and Corporate Governance Codes in 2013 and 2015 respectively, with the aim of actively encouraging companies to become more transparent and responsive to shareholders.

Stock-based incentives have been added to compensation structures, as managers` interests have become more aligned with the interests of their shareholders. Some specific benefits of this trend include a stronger focus on raising ROE levels, some initial progress in diversifying corporate boardrooms, as well as the trimming of protectionist cross-shareholdings.

Direct engagement with corporate management has always been central to our research and analysis, but in recent years we have seen a massive improvement in our ability to engage productively with companies, as we have seen many companies become more open to dialogue with investors while adopting modern board structures and best practises. We now hold many more conversations, across many sectors and at multiple levels with Japanese corporate management.

Japanese companies come from a different starting point in their approach to addressing certain ESG issues. Being exposed to environmental risks such as more frequent seasonal flooding and increasingly severe typhoons (not to mention the ever present earthquakes), the need to address climate change is critical to their operations. There has been an increase in the number of companies committing to reducing their carbon emissions, and expanding into energy efficient alternatives.

From a governance perspective, boards are driving for more diversity and better governance. From a social perspective, companies are far more willing to reduce working hours and provide more flexible working arrangements for their employees.

The long view: Perspective from 20 years of Investing in Japan

> "ESG has always formed an important part of our investment strategy given our focus on corporate fundamentals and management. "

Even before these terms became commonly used, we have incorporated elements of ESG into our investment process. As new information sources have emerged over the years, our research and investment processes have evolved by integrating these new inputs to complement our existing fundamental research.

Of the three pillars of ESG, investors tend to focus predominately on the G, or `Governance` in Japan. We have certainly seen a number of far reaching improvements so far, especially as Japanese companies have historically had a poor reputation among the developed markets due to a perceived lack of transparency and poor communications with shareholders.

In `Environment`, we primarily look at the development of new energy efficient technologies to mitigate the risks of climate change. From a `Social` perspective, we consider how companies treat their employees and modernise their incentive structures. At the same time, we avoid ethically dubious companies that employ unsustainable business practices, such as overly aggressive tactics to expand market share.

As you can see, whether or not it has been described in those precise terms, ESG has always formed an important part of our investment strategy given our focus on corporate fundamentals and management. The ESG framework enables us to consider many different aspects - catalysts, opportunities and risks - when analysing the companies we seek to invest in.

Our approach to ESG integration is implemented on two levels – the firm level, and the JSV strategy level. The benefits of taking a multi-layer approach to ESG is that additional perspectives can complement and even enhance our existing research.

Firm level ESG Integration

> With extensive resources on the ground in Japan we are best placed to use our local expertise to provide the context in which to consider sustainability issues.

We work closely with our ESG specialists and equity research analysts, as they are able to provide valuable insights into the materiality of ESG issues across sectors and on an individual stock basis.

NAM`s Proprietary ESG Scoring System

Our analysts and ESG specialists collaborate to assess companies in four categories: the Environment, Social, Governance factors and the relevant SDGs. Altogether, there are as many as 80 or more items to evaluate, which are then assigned ESG scores. For example, metrics in governance include the company’s board structure, shareholder alignment, and the strength of oversight by independent directors.

As Portfolio Managers, we have full access to the evaluation items within each score. Given that some items may be immaterial and others may be formalities, we do not simply refer to these scores as they are still insufficient for our fundamental analysis. As we actively monitor signs of changes in corporate behaviour, the look-through access to our ESG scoring enables us to identify changes by items that are relevant to each individual company.

We strongly feel that our proprietary ESG Scoring system gives us an edge over other investment managers who only use ESG ratings issued by third parties.

The JSV approach
Best-in-Class Approach and the Symbiosis of Engagement

> "We seek to achieve *Symbiosis* amongst multiple stakeholders, based on careful dialogue and mutually constructive interactions to encourage best practice."

Since the launch of our Japan Strategic Value strategy over two decades ago, we have taken a long-term view to deliver the best possible returns in the value equity asset class. In essence, value investing is about unearthing under-appreciated stocks that are mispriced and trading at unfairly low prices, where the potential reward is greater than the risk. Taking a long-term view is essential to value investing, and our investment approach has remained consistent over this 20-year period.

In our ESG assessment framework, we believe it is necessary to assess ESG issues in their totality while looking out for *Catalysts, Opportunities and Business Risks*. These are long-term performance drivers, and are therefore essential to our fundamental analysis.

Best-in-Class Approach to Carbon Intensive Sectors

While some funds adopt a blanket exclusion policy, we take a best-in-class approach, where we select leading frontrunners that meet our ESG criteria. Industries such as energy and materials are essential to the proper functioning of society and the economy, so excluding these sectors would lead to missing out on some meaningful engagement and investment opportunities.

This approach allows us to invest in companies that have adopted effective ESG practices relative to their industry peers. For example, energy companies that are actively developing alternative forms of clean energy.

Instead of excluding whole sectors from the portfolio, we prefer to engage with selected companies to support their transition towards becoming less carbon intensive and more energy efficient.

`Symbiosis` - our approach to engagement

Defined as the `long-term interactions between two different organisms`, our engagement is based on careful dialogue and mutually constructive interactions to encourage best practice.

Engagement – `Symbiosis` and Knowledge Sharing

Our approach to engaging with companies is to take multiple stakeholders into consideration, rather than just the interests of shareholders. We seek to achieve `Symbiosis` amongst multiple stakeholders, based on careful dialogue and mutually constructive interactions to influence and encourage best practice.

Our approach to engaging with companies is to accept that multiple stakeholder perspectives need to be taken into consideration, and that ultimately, these wider interests may well be aligned with the narrower interests of shareholders.

We call this “Symbiosis”, defined as having a constructive dialogue with companies and encouraging best practice, while also supporting them by sharing our insights from an investment perspective.

Engagement is typically conducted in collaboration with our ESG specialists. At other times, we the Portfolio Managers lead these meetings and direct the dialogue on our own terms.

We meet with companies directly to assess their capabilities, identify the issues they face, and understand the underlying culture of the company. Through these company engagements, we also aim to identify material factors that will help us to form our investment decisions. We will make adjustments to our valuations and outlook of a company as a result of our assessment of material factors, and this may lead to an increase or decrease in the portfolio weighting.

ESG Case Studies

GUNZE, Plastic films

(Environment, Symbiosis, Knowledge Transfer)

- GUNZE is a textile and functional materials manufacturer that produces a line of plastic film packaging materials with low environmental impact. This technology and R&D-driven company has developed films using renewable raw materials for bottle labels that are easy-to-peel and recycle, helping the firm to capture a large share of the Japanese market. By developing products using biochemical-based materials, the firm aims to reduce the use of petrochemical raw materials.

- With marine plastic waste increasing worldwide, there are stricter regulations for single-use and disposable plastics. Compliance with these regulations is required by the SDGs (Sustainable Development Goals) adopted by all United Nations Member States.

- GUNZE built a factory producing shrink label in Vietnam. Given the growing environmental concerns surrounding marine plastics, the Portfolio Managers, together with ESG specialists, met with the CEO to address their concerns on this decision. After a series of discussions including issues such as ROE improvements, we concluded the performance of the firm will improve and made the decision to continue to hold this stock. We will continue to have regular meetings with the firm's senior management going forward.

Fuji Film, Medical Equipment, Imaging

(Early investment recognizing their true potential)

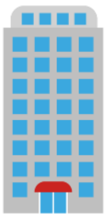
- Fujifilm is a pioneer in diagnostic imaging and information systems for healthcare facilities, helping medical professionals perform more effectively and efficiently. More recently, Fujifilm`s subsidiary won federal funding from the US to manufacture COVID-19 vaccines.
With many different businesses ranging from film, supplements to medical devices, Fujifilm was a classic example of a conglomerate discount. The firm gradually strengthened its medical imaging offering by committing a significant portion of their resources to strengthen their AI capabilities. Concerns over litigation risk due to a terminated merger deal with Xerox may have also weighed on the stock's valuation.

- The Portfolio Managers attended product demonstrations at medical imaging conferences, and listened to healthcare practitioners to gauge how well Fujifilm`s products were being received by frontline medical practitioners. After confirming positive feedback from professional users, and meeting with a key individual from the firm, we were convinced that FujiFilm's potential in medical imaging would make the company one of our top holdings given the technology's ability to reduce healthcare costs, and improve initial diagnosis and post-treatment quality.

- From an `S`, social perspective, the company`s information systems provides a solution to reducing healthcare costs, an increasingly common problem amongst developed countries. In addition, we believe the company will contribute positively in an aging society.

- With attractive valuations, strong financial performance and materially positive social impact, we built a significant position in this stock. The portfolio weighting was increased from 0.25% to 2%. We believe we are one of the earliest buy-side firms to recognize the company's strengths and potential in these key technologies.

Olympus, medical equipment/imaging



- In the same industry, Olympus is an example of a stock that we have avoided largely due to ESG issues.

- In addition to the accounting scandal in 2010, from which the company is still trying to recover, the company is also fighting allegations that it failed to warn medical facilities about potential infection risks from tainted scopes.

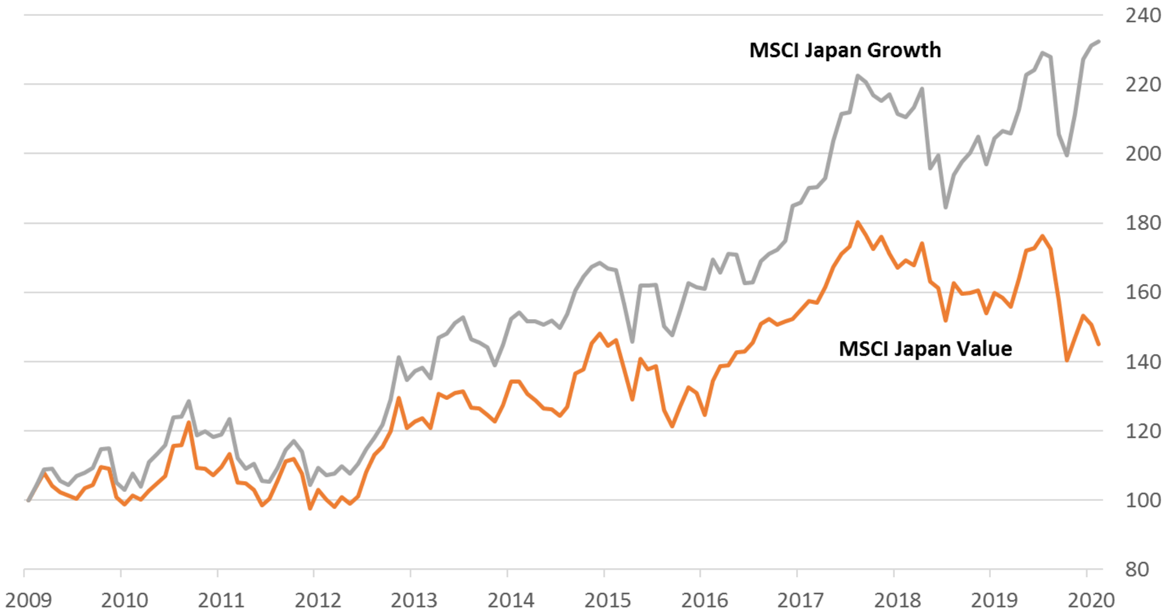
- These incidents reinforce our concerns about the company's poor governance and lack of due attention to social issues that leave it vulnerable to significant contingent risks. We have avoided this stock regardless of its undervaluation and/or potential.

ESG Matters in Value Investing

The Nomura Japan Strategic Value fund celebrates its 20th anniversary this year. However, with large and persistent return differences between growth and value stocks, the fund has faced headwinds in recent years.

It is extremely difficult to predict when value stocks will regain favour and recover, but as a value investor, it is worth noting that some growth stocks have been trading on excessively high multiples, and these stocks can be highly sensitive to changes in market sentiment or events.

Japanese Equities Style Performance
In USD, June 30 2009 =100



Gross cumulative returns from 30/6/2009 to 31/7/2020
Source: MSCI. Please refer to the disclaimer at the end of this document.

So far this year, value has underperformed growth by about 19 percentage points. In the past 12 months, value underperformed by about 21 percentage points, and this has been the same story over the past ten years.

We believe this divergence is driven by a number of factors such as short-termism and the popularity of a narrow range of technology focused investments, which have pushed up the performance of a handful of growth stocks, as well as pressurising stock prices of sectors considered to embody value stocks such as autos, financials and energy. In another sense, it could be argued that a blanket approach to ESG investment has left many of these best in class stocks from “old economy" sectors languishing. However, this trend has also left behind many well managed companies with sector-beating ESG metrics trading at attractive valuations.

We believe this is a good opportunity for patient long term investors. Moreover, we believe that the pressure on value stocks has led to further mispricing in the market, thereby representing potential investment opportunities for long-term investors.

Our thoughts on Third Party ESG Scores:

While we utilise ESG scoring data from third party providers, we are also wary of their limitations. As a relatively new concept in its application to investment management, there is a lack of standardisation and regulatory authority. This leads to different providers applying their own definitions and methods in their scoring systems.

ESG ratings are not necessarily transparent nor standardised, therefore requiring further interpretation to understand the different ratings. Ultimately, therefore, we believe the right thing to do is to conduct ESG research on our own terms as part of our own basic corporate research, and continue to invest in fundamentally good companies.

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This fund displays higher volatility due to its composition / the techniques used by the fund management, i.e. unit prices can fluctuate upwards or downwards within short periods of time.

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September 2020