ESG INVESTING SUSTAINABILITY IN QUESTION

—SIMPLIFIED FRAMEWORK AND BROADER PARTICIPATION ARE REQUIRED—

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SUMMARY

- The concept of environmental, social and governance (ESG) investing, which emphasizes societal values, is not universally accepted in the financial industry. Some investors have difficulty committing to ESG investing because the benefits of ESG compliance for a company are uncertain, the correlation of ESG scores to investment returns is unclear, and ESG scores may not be reliable.
- In addition, some companies are showing "ESG fatigue" as they are called upon to implement various measures related to ESG. While interest is growing due to the importance of ESG, both investors and companies may question the sustainability of ESG investing.
- To ensure that ESG investing remains a viable concept, and not merely an idealistic debate, it is necessary to simplify ESG investment frameworks and build systems to encourage more investors and companies to participate.

1. RISE OF ESG INVESTING

1-1. Overview of ESG investing

Due to growing awareness of social issues such as environmental crisis of global warming and social problems such as child labor, in recent years, there has been growing interest in ESG investing, in which investors consider a company's efforts regarding the environment, society, and (corporate) governance as one factor that affects their investment decisions. This is not actually a new concept. The same approach existed in the 1920s in the form of "ethical investing," refraining from investing in companies engaged in businesses such as tobacco, alcohol, and gambling (Fig. 1). Later, socially responsible investment (SRI) based on corporate social responsibility (CSR) got started in the 1990s.

Fig. 1. ESG related events

Year	Event
1920s	Christian foundations begin ethical investing, or avoiding investment in businesses such as tobacco, alcohol, and gambling.
1990s	Socially responsible investment (SRI) begins, based on evaluation of corporate social responsibility (CSR).
2006	The United Nations develops the Principles for Responsible Investment (PRI). Institutional Shareholder Services (ISS) revises the exercise standards of voting rights.
2014	Japan's Stewardship Code (SSC) is adopted.
2015	The United Nations adopts the Sustainable Development Goals (SDGs). The Tokyo Stock exchange adopts the Corporate Governance Code (CGC).
2016	The Financial Stability Board establishes the Task Force on Climate Change-related Financial Disclosure (TCFD). (Final recommendations issued in 2017.)
2017	SSC is revised. Japan's Ministry of Economy, Trade and Industry formulates the Guidance for Integrated Corporate Disclosure and Company-Investor Dialogue for Collaborative Value Creation.
2018	Japan's Financial Services Agency establishes the Guidelines for Dialogue Between Investors and Companies. The exercise standards of voting rights is revised.
2019	A proposal for SSC revision is submitted.

Source: Created by MGSSI, based on GSIA and other sources

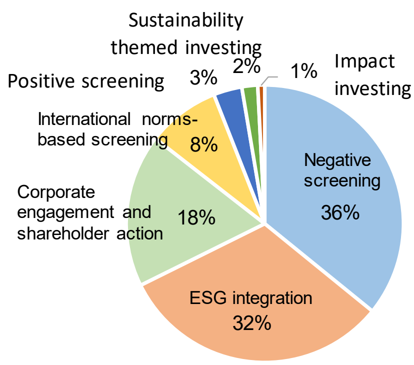
ESG began gaining more attention after the United Nations developed the six Principles for Responsible Investment (PRI) in 2006, mentioning the importance of ESG investing.

The Global Sustainable Investment Alliance (GSIA), an international organization that promotes sustainable investing, lists seven types of ESG investing: 1. Negative screening, 2. Positive screening, 3. International norms-based screening, 4. ESG integration, 5. Sustainability themed investing, 6. Impact investing, and 7. Corporate engagement and shareholder action. The largest of these strategies in terms of assets is the one with the longest history, negative screening, which had its origins in the above-mentioned approach of ethical investing. As of 2018, negative screening is the strategy used for 36% of ESG investing assets by value in major developed countries and regions (Fig. 2).

Fig. 2. ESG investing strategies and proportions of assets (2018)

Type of investing strategy	Summary of investing strategy
Negative screening	Companies in certain industries defined as unethical are excluded from the portfolio.
Positive screening	The portfolio is structured based on the idea that companies with high ESG scores will perform better over the medium to long term.
International norms-based screening	Companies that fail to meet criteria based on international ESG norms are excluded from the portfolio.
ESG integration	Investment decisions are made by including non-financial factors such as ESG in the selection process, in addition to financial information.
Sustainability themed investing	The portfolio is structured on a specific theme related to ESG.
Impact investing	Investment is directed to companies that provide relevant technologies and services for the purpose of solving social and environmental problems.
Corporate engagement and shareholder action	Reforms related to ESG issues are promoted by shareholder voting and dialogue with companies.

Source: Created by MGSSI, based on Sustainable Japan and other sources

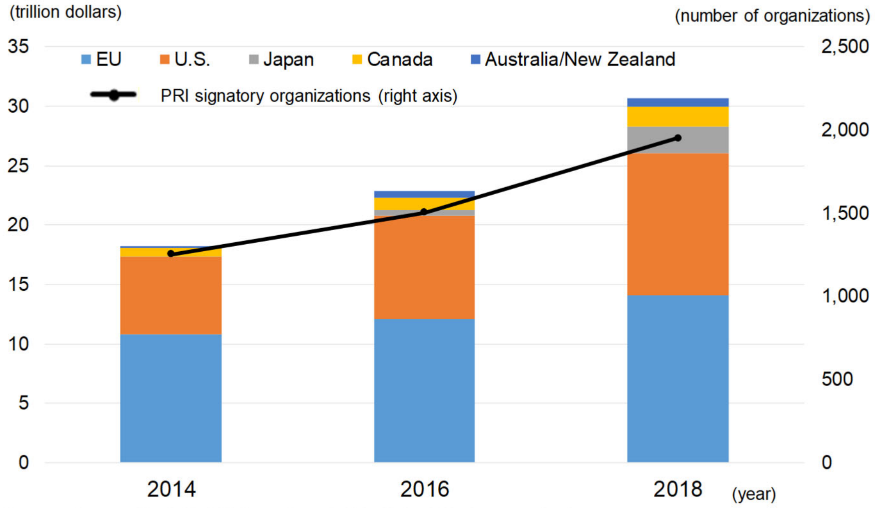


Source: Created by MGSSI, based on GSIA

1-2. Growth of ESG investment market

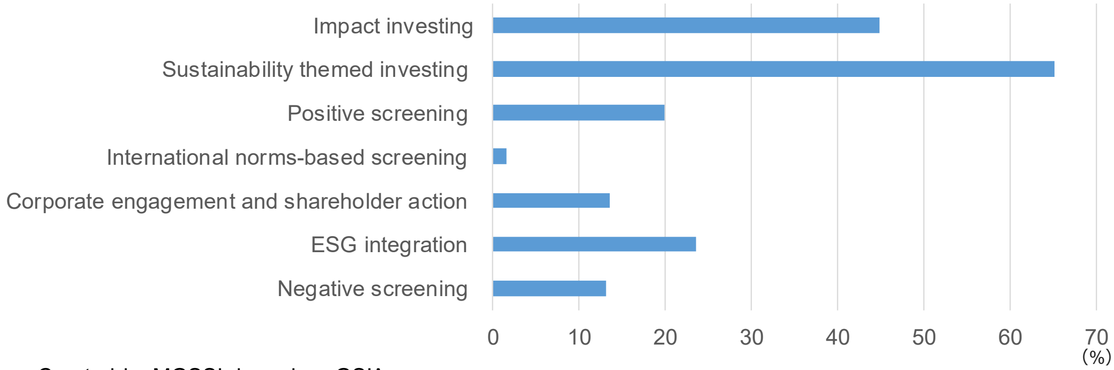
In the financial industry, more and more asset management companies, pension funds, and other asset owners are signing the Principles for Responsible Investment (PRI), accelerating a trend toward including ESG when evaluating targets of investment. For example, an asset management company affiliated with J.P. Morgan, a major U.S. financial firm, began evaluating investment targets from the standpoint of ESG for all assets except index-linked funds in 2019. Japan's Government Pension Investment Fund (GPIF) adopted five related indicators for domestic and international stock in 2017, including the MSCI Japan ESG Select Leaders Index, and began using them in the management of assets totaling 1 trillion yen. This has led to market growth in ESG investing. According to GSIA, ESG investments in major developed countries and regions have grown at an average rate of 14% per year since 2014, rising to $30.7 trillion as of 2018 (Fig. 3). This represents approximately 30% of all investments in those countries and regions. Impact investing and sustainability themed investing have also shown remarkable growth, although those markets remain smaller than that of negative screening (Fig. 4).

Fig. 3. Trends in global ESG investing and PRI signatories



Source: Created by MGSSI, based on GSIA, United Nations, and other sources

Fig. 4. Average annual growth of ESG investing by type (2014-2018)



Source: Created by MGSSI, based on GSIA

2. EXPECTATIONS AND CHALLENGES FOR ESG INVESTING

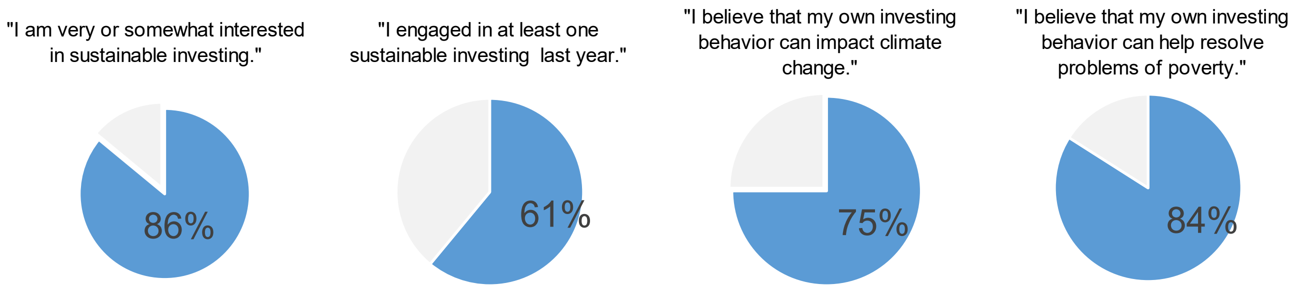
2-1. Rising expectations for market growth

These trends are expected to continue spreading in the future. Companies are notably urged by the financial industry to make ESG efforts. BlackRock (U.S.), the world's largest asset management company with more than $7 trillion in total assets under management, has announced a policy to strengthen ESG integration in investing, in light of possible risks to sustainable economic growth due to global climate change. BlackRock has shown its stance to engage in shareholder voting against an investee company's decisions if it fails to disclose information on climate change risks. In addition, it has announced that it will divest from companies that derive at least a quarter of sales from coal by mid-2020.

In addition to aspects related to the environment (E), which tend to get a great deal of attention, and corporate governance (G), which can be closely linked to a company's performance, investors are also calling for companies' efforts in the area of society (S). For example, at the annual meeting of the World Economic Forum in Davos in January 2020, David Solomon, the CEO of Goldman Sachs, a major US financial firm, said that his firm will not serve as lead underwriter for European and North American companies that do not have at least one woman on the board of directors at the time of the initial public offering. This policy would go into effect on July 1, and that a minimum of two female board members would be required starting in 2021. It is possible that in the future, not only listed companies but also venture companies may need to show a commitment to ESG, even before going public.

One factor behind the financial industry’s move toward ESG compliance is the presence of the millennial generation: they are said to regard societal values such as the environment as important as economic value. By one estimate, the transfer of wealth to millennials through inheritance and the like will reach $30 trillion over the next decade, and millennials are expected to own a rapidly rising percentage of the assets of all generations, making them a force that cannot be ignored for the financial industry. According to a survey by Morgan Stanley, a major U.S. financial firm, 86% of millennials in the U.S. are interested in sustainable investing, which is closely related to ESG (Fig. 5). They are twice as interested as older generations in purchasing sustainable brands and three times as eager to work for a company with outstanding ESG compliance, and 90% of them want to hold ESG-related financial products in their 401(k). It is increasingly important for companies and the financial industry to align their actions to the needs of this younger generation.

Fig. 5. Survey of U.S. millennials' attitudes on sustainable investing (2019)



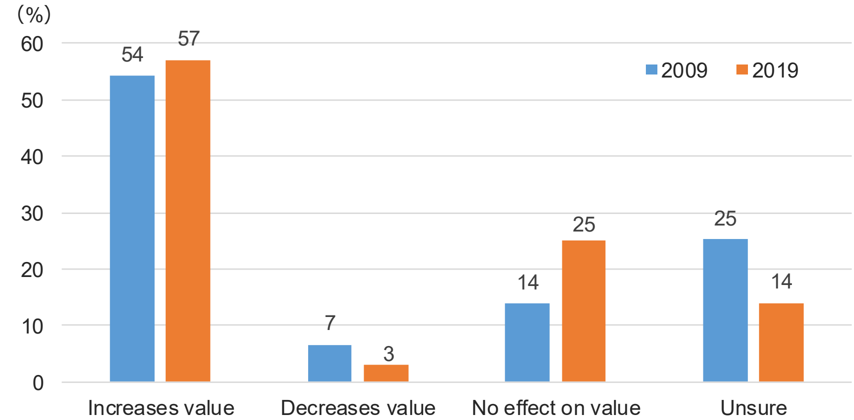
Note: 1,000 active individual investors in the U.S. were surveyed.
Source: Created by MGSSI, based on Morgan Stanley

2-2. Challenges in ESG investing (1): Uncertainty regarding the benefits of ESG compliance

Although interest in ESG investing is growing, the response of investors is not necessarily one of uniform enthusiasm. Business Roundtable, an association of chief executive officers of major U.S. companies that is chaired by Jamie Dimon, CEO of J.P. Morgan and a leader of financial industry, announced in 2019 that it will move away from shareholder primacy, which tends to be a shortsighted approach, and engage in business in a manner that respects the interests of all stakeholders, including employees and local communities. However, the industry as a whole has not shown its readiness to accept this attitude, and the U.S. Council of Institutional Investors has expressed strong opposition. In Japan as well, the GPIF has begun including ESG scores in its analyses for investment. However, according to Mercer, a U.S. pension consulting firm, as of May 2019, only about 0.13% of all corporate pensions have accepted the Japan Stewardship Code, which was developed to promote ESG investing.

One factor in this outcome is a perception among some institutional investors that a company's ESG compliance is not connected to the creation of economic value, and that an investment style that focuses on ESG will, therefore, not necessarily result in high returns. An opinion survey of corporate executives and investors about ESG was conducted in 2009 and 2019 by McKinsey, a major U.S. consulting firm. In 2009, a majority responded that a company's ESG compliance would "increase" shareholder value; and the percentage giving that answer was only 3 points higher in 2019; however, the percentage stating that ESG would have "no effect" on shareholder value increased by as much as 11 points over the same period (Fig. 6). The same survey found a significant decline over that 10-year period in the percentage of respondents who believed that a company's ESG compliance is effective in "developing new growth opportunities" and "improving business efficiency and reducing costs," suggesting a lowering of expectations concerning a direct boost to business profitability (Fig. 7).

Fig. 6. Opinion survey on how a company's ESG compliance affects shareholder value



Note: Major companies and institutional investors around the world were surveyed. There were 238 respondents in 2009, and 558 respondents in 2019.
Source: Created by MGSSI, based on McKinsey

Fig. 7. Responses to "What does a company's ESG compliance affect?"

Note: Major companies and institutional investors around the world were surveyed. There were 238 respondents in 2009, and 558 respondents in 2019.
Source: Created by MGSSI, based on McKinsey

A variety of studies and analyses have examined the relationship between ESG scores and investment returns., Opinions are divided as to whether ESG leads to higher returns, and there is no definite answer yet. Due to factors such as the signing of PRI and acceptance of the Japan Stewardship Code, institutional investors are now called upon to take ESG into consideration; however, as long as fiduciary obligations include the pursuit of higher returns, it seems clear that committing to ESG investing will be difficult if this is not clearly correlated with returns. In 2016, the U.S. Department of Labor, which regulates corporate pensions, stated that taking ESG investing principles into consideration with regard to investment decisions and voting is not a violation of fiduciary obligations under the Employee Retirement Income Security Act (ERISA); however, the department issued new guidance in 2018, stating that fiduciaries should take care not to harm the economic interests of beneficiaries by relying too readily on ESG factors.

Institutional investors may also be concerned that companies could cite a commitment to ESG as an excuse to justify poor business performance. This concern is also the reason behind the criticism of the U.S. Business Roundtable's decision to move away from shareholder primacy; and there is undeniably some perception that these are idealistic arguments. Although Japanese companies are under less pressure from institutional investors to pursue short-term profits than U.S. companies, their investors may well be uncomfortable with focusing on efforts that may not help to improve business performance or capital efficiency.

2-3. Challenges in ESG investing (2): Reliability of ESG scores

Another issue is the reliability and validity of ESG scores as an indicator for investment decisions. The problem is that different types of business are subject to different criteria. For example, the scores issued by some rating agencies are affected by the volume of fossil fuels that Walmart, the largest U.S. retailer, consumes for its distribution channels, while the fossil fuels used for deliveries outsourced by U.S. electronic commerce giant Amazon are not reflected in its scores. Moreover, different rating agencies use a variety of criteria in their scores, and the resulting variation in scores for the same company tends to reduce the credibility of ESG scores. According to a survey by MIT, the average correlation coefficient among ESG scores assigned by five different ESG rating agencies to a sample of 823 companies was just 0.61, much lower than the 0.99 average correlation coefficient among credit scores assigned by credit rating agencies such as Moody's and S&P (Fig. 8).

Fig. 8. Correlation coefficient among ESG scores of ESG rating agencies for the same sample companies (n = 823 companies)

Correlation coefficient:	Less than 0.1	0.1-0.3	0.3-0.5	0.5-0.7	More than 0.7

Rating agency	Overall ESG score					Environmental score					Social score					Governance score				
	A4	KL	RS	SA	VI	A4	KL	RS	SA	VI	A4	KL	RS	SA	VI	A4	KL	RS	SA	VI
Asset4	-	0.42	0.64	0.67	0.71	-					-					-				
KLD	0.42	-	0.49	0.53	0.48		-					-					-			
RodecoSAM	0.64	0.49	-	0.68	0.71			-					-					-		
Sustainalytics	0.67	0.53	0.68	-	0.73				-					-					-	
Video-Eris	0.71	0.48	0.71	0.73	-					-					-					-

Source: MIT Sloan School of Management

As one example of the credibility issue with ESG scores, Siemens, a German firm that boasts MSCI's highest AAA rating for ESG, decided in December 2019 to supply signaling systems for development of the Carmichael coal mine in Australia, in spite of concern over the environmental impact of this coal mining project. In response, environmental activists and others severely criticized not only Siemens but also Black Rock, its major shareholder, for its inaction, and BlackRock then rebuked Siemens.
In general, major IT companies such as Google, Apple, Facebook, and Amazon (GAFA) tend to have high ESG scores. However, this is said to be due in part to their ability to devote abundant corporate resources to putting out good-looking reports and other ESG-related disclosures, thereby enhancing their scores. However, this is not the same as true ESG compliance.

Non-financial information such as ESG compliance is not easy for external agencies to determine with any accuracy, unlike financial information, which is stated in quantitative terms. In addition, neither companies pursuing ESG nor asset management companies seeking to make ESG-informed investment decisions have clarity about which rating agencies they should rely on. Due to these issues, the conventional concept and framework of ESG investing is limited in how well it can inform investors of meaningful investments.

The term "greenwashing," referring to companies whose environmental involvement is for appearance only, has been around for some time; but more recently, the related term "SDG-washing" is increasingly being used to indicate a similar tendency with regard to the SDGs, which are closely related to ESG. In fact, in a survey of more than 1,000 companies around the world conducted by Ethical Corporation, a British research firm, over 70% responded that they have incorporated the SDGs into their business strategies; however, only 13% of the total had actually set clear goals related to the SDGs and begun applying them in business operations at the departmental level. Because of these problems, some funds are short-selling companies with high ESG scores, on the assumption that investing decisions based on superficial ESG scores have distorted market share prices.

At present, companies are called on to engage in various efforts related to ESG, including information disclosure. Along with the disorderly state of rating agencies, companies who need to respond to these agencies are beginning to experience "ESG fatigue." The credibility of the scores may even be affected by whether companies are able to respond to surveys concerning ESG and the like with the same amount of energy that they can devote to responses related to their financial statements. At present, this market appears to be booming as capital continues to flow into ESG funds; ESG investing was developed in order to promote sustainability, but if these problems continue to fester, the resulting situation could affect the sustainability of ESG investing itself.

3. INITIATIVES FOR ESG INVESTING TO HOLD SUSTAINABLITY

3-1. The importance of a comprehensive approach

It will not be easy to find effective, realistic solutions to all of these problems. New tactics and new efforts will be needed in order to ensure the viability of ESG investing, which is increasingly important. This could be said to include the move to develop standards for disclosure of non-financial information, including the standards of the Global Reporting Initiative (GRI); but in actuality, the existence of so many of such standards is a source of confusion. Steps must be taken for worldwide integration of those standards.

It is important to consider whether standards are being created by certain interested parties in a unilateral manner. Although ESG investing refers to actions by investors, it is, of course, companies who engage in ESG compliance and are the targets of such investing. Therefore, it is important to take the views of companies into consideration when formulating disclosure standards. Company-led approaches are drawing attention; for example, the Value Balancing Alliance (VBA), led by corporations such as BASF, a German chemical company, is seeking to establish new accounting standards for ESG investing. The aim is to convert the environmental, human, and social impacts of the activities of companies into monetary terms, creating a method of calculating corporate value as well as accounting standards on that basis, to allow for comparison and analyses between companies. For example, contributions to the human capital formation through human resource development and contributions to society by means of employment and tax payments are among the activities that would be converted into monetary terms. The number of companies, including Japanese companies that have announced their intention to participate is still limited; however, this could potentially help to eliminate the lack of transparency associated with ESG scores.

To develop meaningful solutions, comprehensive efforts will be required on the part of companies, institutional investors, and related agencies and organizations, moving beyond the struggle to take the lead in developing standards that will be advantageous for themselves.

3-2. The potential for new procurement methods

Even if many stakeholders including companies, institutional investors, and public institutions are attempting to address a variety of issues related to ESG, the fact is that economic value is the primary pursuit of most investors in the traditional stock and corporate bond markets, and there may be limited potential in trying to pursue social value at the same time.

Considering these circumstances, "green bonds" (which would be considered "sustainability themed investing" under the categories of ESG investing as mentioned above) are expected to become a new source of funding in the future, as a new way to raise funds with an emphasis on social value. In addition, "transition bonds" are now coming into use, providing a new mechanism that will enable more companies to procure funds for green projects. The use of funds procured through green bonds is limited to projects that have clearly defined outcomes to benefit the environment, such as renewable energy projects, and only a limited number of companies are able to issue these bonds. With transition bonds, in contrast, the focus is on a commitment by the issuer to take action in order to become greener in the future, based on the concept of recognizing gradual steps toward transitioning into a green company.

3-3. Two factors to promote the sustainability of ESG investing

The importance of companies' efforts for ESG compliance is without question, and an external environment for acceptance of those efforts by investors is taking shape. The moves described above are practical endeavors aimed at going beyond idealism to ensure long-term viability. They do not solve all of the current challenges, but provide stepping stones toward eventual solutions. The necessary outcome can be summarized in two points: developing a rational mechanism for ESG investing that is as simple as possible, and promoting participation by companies and investors in the ESG investment market. These two points are interdependent, and ESG investing will become more sustainable into the future when a positive cycle is established in which the former triggers the latter, and the latter provides further impetus for the former.