Letter from Tokyo

Japanese asset owners get responsible

As elsewhere in the world, increasing scrutiny is being paid by investors in Japan to environmental, social and governance issues, with employment at the top of the list.

Let me confess at the outset of this letter that the concept of "Responsible Investment" and "ESG" (Environmental, Social and Governance) issues was quite new to me a year ago.

However, that has started to change now as, like asset owners elsewhere in the world, Japanese public pension funds, such as National Public Service Personnel Pensions and Local Government Officials Pensions, are paying stronger attention to Responsible Investment.

Likewise, the Japan Trade Union Confederation ("Rengo"), which with 6.8 million members is the largest national-level trade union group, as well as the major supporter of the incumbent Democratic Party of Japan, has been advocating Responsible Investment and is now drafting a set of guidelines which focus on ESG, and in particular employment. Rengo has a strong influence on a number of public and corporate pension funds through its union members and states in a recent paper titled A RENGO Perspective on the Corporate Legal Framework and Investment Fund Regulation:

"It is problematic that workers' capital, in forms such as pension funds, ends up, through investment funds, having the effect of making employment unstable, and thus turns out to be a cause for the deterioration of working conditions. In the West, in particular, an increasing number of pension funds now monitor the effects of their investments on employment and working conditions at the companies where they put their money, and oblige the fund trustee to give consideration to the workers at acquired companies. Japan must also incorporate consideration for the effects on employment and labor conditions into the policies for the operation of pension funds, etc."

Similarly, a pension fund director recently told us: "Investing in venture capital funds is easier than investing in buyout funds, as the former tends to increase employment while the latter tend to reduce employment. I personally believe buyout funds could increase jobs in the long run, but it is not easy to convince other board members whose backgrounds are not in the financial area."

This issue is also well recognised by the government. In fact, the Ministry of Economy, Trade and Industry ("METI") has been studying the impact of private equity on employment.

It seems ironic to me that buyout funds are seen as being incompatible with Responsible Investment. Paying attention to non-financial factors in the investment process and holding active dialogue with investee companies ("engagement") in order to improve a company's performance and risk management has always been the norm for private equity fund GPs, while it may be a relatively new approach for public equity investors.

Having said this, among the ESG factors, GPs' commitment to the "social" factor, and employment in particular, has historically been opaque beyond the obvious arguments in favour of private equity such as "if the buyout fund had not invested in the company, it could have gone bankrupt", or "even if the fund does initially reduce headcount, if successful, it could eventually hire a lot more people than before".

Looking ahead at the impact of the emphasis on Responsible Investment, a quantitative measurement of a GP's ESG performance would be a useful tool to assuage some LPs' doubts on the asset class' performance in this field. Admittedly this would be a huge challenge. "Employment performance", among other things, could be the most sensitive piece of information for a GP to disclose, but it will not escape LPs' attention. Any Japanese GP who is looking to tap local pension funds will have to have a well-prepared Responsible Investment policy.

In fact, as the UK's CDC Group has already started to do, more and more LPs globally will incorporate a GP's ESG performance as an integral part of their fund evaluation process. Given the level of influence a GP has over the portfolio company, I have every reason to believe LPs will expect GPs to achieve much more than their public equity counterparts in the field of ESG.

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