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By Larry Prager, CIO Americas

CREATING SHARED VALUE

The rise of ESG and its impact on investment performance

Introduction

Over the last ten years, the analysis of investment risks and opportunities through the prism of environmental, social and governance (ESG) factors has become established, and more mainstream. Moreover, the responsibility of the investor to protect an economy's ability to create long-term value, through the practice of active ownership, is also becoming more institutionalized. Given such, this whitepaper explores the evolution of ESG, how Nikko Asset Management ("Nikko AM") conducts it, and the impact that ESG has had on the investment industry.

Nikko AM – Our long-term involvement

As an early signatory to the UN Principles for Responsible Investment (UN PRI), Nikko AM has been involved in the movement towards sustainable investment since the late 1990s, launching some of the first sustainability-focused investment products in Japan. As a long-term global investor in equities, and debt securities of corporate and government issuers, we believe that the challenge of sustainable economic growth is core to securing long-term prosperity and value creation. Indeed, we believe that an economy and society built on sustainable practices will provide a healthy investment climate that can create returns for current and future beneficiaries of pension funds and investment products alike, and should be incorporated into every investment decision-making process.

The evolution of responsible investing

In today's investment world, the acronym ESG signifies non-financial inputs or factors that, we believe, should be part of all investment decision-making. Over the last ten years, the global investment industry has gradually accepted the proposition that environmental, social and governance-related information may be relevant and material to an issuer's operating and investment performance over the medium to long-term.

Indeed, while many investors argue that they have long taken these factors into account, it is becoming more acceptable to believe that fiduciaries have a duty to incorporate ESG information into the investment process if it is material. ESG is the lens through which the investment world analyses an issuer's impact on society in non-financial terms.

Whether it is the impact on the environment, on society, or in terms of how it governs itself, ESG factors help us to understand how a company influences development towards a sustainable path. Since the industrial revolution, concerns have been raised about the negative effect of development on human exploitation, inequality, the environment, and by extension, greater society. Activists, corporations and government agencies have questioned whether the world could continue to grow despite problems related to these concerns. In the corporate world, this discussion was couched in terms of corporate social responsibility from the 1950s and, before that, as a form of paternalism or social responsibility. Currently, the ESG acronym captures all of these concerns, with the E variously meaning economy or environment, the S coming from human resources or labor, and the G anti-corruption.

A long history

Of all the concerns that development brings, environmental damage has a high profile due to its long, and sometimes cruel, history. Remembered are the nuclear disasters of the 1970s and 80s at Three Mile Island or Chernobyl, and more recently 3/11 in Japan, or Love Canal in Niagara NY, and Flint Michigan, or the 1960s when the Cuyahoga River burned, a massive oil spill hit Santa Barbara, or when Japan's Yokkaichi City and Minamata area suffered tragic mercury poisonings. Longer ago were also the deathly smogs of London in the 1950s, Japan's Ashio Copper Mine pollution disaster in the 1890s, and England's Alkali Works Act of 1863, when laws on water quality were passed.

By the late 1960s and 1970s, most developed countries were forced to address the damage to their natural environments due to pollution from industrialization and the heightened risk of environmental disaster. Corporations responded with codes of behavior and corporate social responsibility (CSR) policies, while governments enacted legislation and international conventions (where volunteerism would not suffice).

CSR also has a long history, with a company's small cap 'csr' evolving from benevolent or paternalistic involvement in its community for a range of reasons – from business self-interest, to a sense of responsibility, or a combination of both. As CSR evolved over time in response to the problems of the community, it came with a set of propositions: earn a requisite profit efficiently, minimize waste and environmental pollution, and contribute to society through educational, health and welfare programs, philanthropy and volunteering. An early framing of the rationale for CSR came from a Harvard Business Review article in 1949, 'The Roots of Business Responsibility' and 'Business Responsibilities in an Uncertain World', which laid responsibilities out this way – trust in business exchanges, fairness between government and individuals, acceptance of law and ethical obligations, and that a business has the obligation to contribute to the well-being and progress of

individuals and society. And why not? Businesses leaders control resources that can make a contribution, and all businesses need a well-functioning community to be successful. In other words, business leaders are responsible for making their organization effective and conducting it so that it respects and contributes to society. Surprisingly, this was not an extreme view then, as the article argued that businesses actually believed in it as well.

An ongoing debate

Challenges to the CSR line of thought have not been rare throughout history. It has been referred to as 'welfare capitalism' and was argued strongly against by high-profile economists like Milton Friedman, who believed that the pursuit of profit and increasing shareholder value are the only responsibilities of business. Before CSR, this way of thinking was referred to as 'trusteeship' or 'stewardship' in early American economic history, and centered on the idea that business leaders are also trustees of the public interest.

CSR has continued to change, rather than settling on a fixed meaning and scope. The 'what' and 'how' is still being debated, but sustainability as a responsibility has clearly been recognized by a growing number of businesses. It has also been supported by a number of organizations promoting sustainability strategies in their execution and disclosure, such as the Business for Social Responsibility (BSR) and the UN Global Compact.

Originally focused on influencing policy, the BSR's mission today is, in their words, 'to work with companies to integrate social and environmental considerations into their core business', in order to create a 'just and sustainable world.' Corporate philanthropy continues to be a powerful arena for businesses to impact society, especially in the US, with Stewardship Codes also evident in the UK, Japan, and Hong Kong.

Measuring and assessing the impact of CSR programs dates back to the 1970s, but the 1990s saw most of the framework effort and debate, with triple bottom-line reporting of profit, social and environmental outcomes. The Global Reporting Initiative, which creates a common reporting framework alongside stock market indices like the FTSE4Good or the Dow Jones Sustainability Index, has provided institutional support. More recently, CSR programs have included steps to verify information, and to engage with stakeholders to understand issues better, and to develop positive relationships.

A rather new trend is the use of CSR when formulating a competitive strategy, where companies attempt to develop or strengthen their competitive advantage by aligning CSR projects with their core business and governance, which helps to solve social problems.

So ESG and CSR have had something in common – the challenge that there is no consensus as to what they mean, how to do it, and whether they are appropriate. Today, though, this debate may be reaching its conclusion.

The UN is leading the way

ESG began to gain greater recognition in the investment world from 2006, with the establishment of the United Nations Principles for Responsible Investment (UNPRI). These principles call, first and foremost, for the incorporation of ESG factors into investment decision-making, and investor oversight of corporate decision-makers.

The UN PRI was established by global investors at the encouragement of the UN Secretary-General, who believed that long-term return creation required a financial system that is both economically efficient, and environmentally and socially sustainable. This is so that today's efforts to create value do not impair the ability of future generations to do the same.

The inclusion of non-financial issues into investment decision-making, however, is not at all new. Prescribing or discouraging certain behaviors and practices thought contrary to man's nature or God's law has been practiced for ages. Today, as in the past, investing in and financing endeavors like the production of alcohol, gambling, pornography, weapons of war, usury, and slavery, have all been excluded from the investment universe of many, especially religious-based institutions and social activist investors. The Vietnam anti-war movement and the anti-apartheid divestment campaigns in South Africa of the 1970s are a key marker in the history of the latter.

Today, this practice is more recognized by, and acceptable to, the broader investment community. While one cannot deny the link of ESG to the values-based investment tradition, the key driver of incorporating ESG issues into investment probably came from the environmental crises of the 1960s and 1970s, merged with the threat of climate change today. Corporations and governments have been pressured for change. Then too, the long-term risk of damage to the economic system and long-term value creation, and therefore investment returns, is a palpable threat to asset owners.

ESG gathers momentum

The United Nations Environment Programme - Finance Initiative (UNEP) began in 1991, as commercial banks joined with the UNEP and issued a joint statement on sustainable development. Thereafter, climate change began to figure prominently, with the role of the UNEP expanding at the Rio Earth Summit in 1992, which was the largest environmental conference held to date. The UNEP adopted major treaties on biodiversity, climate change and forest management, as well as the United Nations Framework Convention on Climate Change, which was extended by the Kyoto Protocol in December 1997.

In 1995, the UNEP expanded its work to the insurance industry and pension funds by launching the UNEP Statement of Environmental Commitment by the Insurance Industry. In 1997 the commercial bank statement was also expanded to include a wider set of financial services companies.

The goal of these initiatives was to first heighten awareness and dialogue on how the environment is related to trade and development, and secondly, to find agreement around including environmental considerations in credit and investment decisions, as well as to stimulate private sector investment in environmentally-sound technologies. Then in 2003, the Insurance and Banking Initiatives merged to become the UNEP Finance Initiative (UNEP FI).

For asset management institutions and corporations, the pace of institutionalization greatly accelerated from 2004 to 2006. In 2004, a group of asset managers that were members of the UNEP FI formed an Asset Management Working Group to consider how these sustainability issues could similarly be incorporated within asset management. Nikko AM was one of these asset managers.

The working group included twelve firms from nine nations, with nearly US$1.6 trillion in assets under management. The focus of this group was not just to consider the materiality of environmental and social issues in the management of mutual funds, pension funds and other institutional funds, but also how to do it, and how materiality could be reflected in valuations.

The formation of this working group was said to be in response to greater interest and scrutiny by asset owners, including governments and regulators, on whether corporate governance, environmental performance and labor issues were sufficiently analyzed by analysts and fund managers. Early contributions from sell-side research argued one, that environmental and social issues matter, two, that CSR can create shareholder value and three, that quality governance benefits shareholder returns.

In 2004, the working group released a report, 'The Materiality of Social, Environmental and Corporate Governance Issues to Equity Pricing', which comprised eleven sector studies by brokerage house analysts. The conclusion was unmistakable, with the report finding that 'the long-term protection of shareholder value rests upon rigorous integration of environmental, social and corporate governance issues in the valuation process.'

Is ESG material?

The answer to this question is yes.

In October 2005, the UNEP FI Asset Management Working Group released a study it commissioned from top UK law firm, Freshfields Bruckhaus Deringer, called 'A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment'. This study addressed the burning question as to whether it is an asset manager's fiduciary duty to include the consideration of ESG issues in investment decision-making. Their answer also was 'Yes,' bolstering the arguments of proponents, and catalyzing the process of whether addressing such issues would be a violation of fiduciary duty, and expose an investment manager to legal liabilities. Freshfields said that 'integrating ESG considerations into an investment analysis, so as to more reliably predict financial performance, is clearly permissible, and is arguably required in all jurisdictions'. Thus, the evolution of ESG became more fully developed.

'The long-term protection of shareholder value rests upon rigorous integration of environmental, social and corporate governance issues in the valuation process.'

Source: The Materiality of Social, Environmental and Corporate Governance Issues to Equity Pricing

Industry acceptance and the role of organizations

The formation of the UNPRI in 2006 was spearheaded by Kofi Annan, the UN Secretary General who, in his last year of service, invited some of the world's largest institutional investors to help develop the Principles. An international group of specialist and mainstream investors joined a variety of financial and non-financial experts to create these Principles, which were launched in April 2006.

The idea that certain environmental, social, and governance (ESG) issues can affect long-term investment performance, and are, therefore, material and should be included in the investment process, and that long-term financial returns and sustainable development are mutually dependent, was released on the investment world. Derived from the sustainability challenges of economic development on the environment and its impact on society, the mission of the UNPRI was to help create an efficient and sustainable financial system, with commitment to the Principles consistent with fiduciary duty.

UN Principles for Responsible Investment

PRINCIPLE 1: We will incorporate ESG issues into investment analysis and decision-making processes.

PRINCIPLE 2: We will be active owners and incorporate ESG issues into our ownership policies and practices.

PRINCIPLE 3: We will seek appropriate disclosure on ESG issues by the entities in which we invest.

PRINCIPLE 4: We will promote acceptance and implementation of the principles within the investment industry.

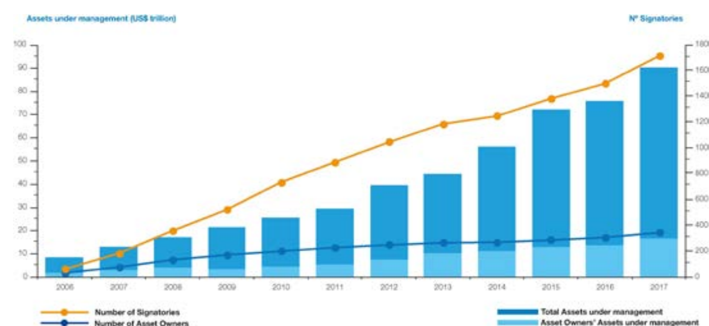
PRINCIPLE 5: We will work together to enhance our effectiveness in implementing the Principles.

PRINCIPLE 6: We will each report on our activities and progress towards implementing the Principles.

Strong support from investors

Since the release of these Principles, the number of signatories and the AUM represented has increased dramatically (see chart 1).

Chart 1: Responsible investment: an agenda gathering momentum



Source: US SIF

Arguably first adopted in a major way in the UK and Europe, in the last five years uptake of the Principles by asset owners and asset managers in the US has increased dramatically. There has been considerable interest among High Net Worth investors and Millennials, through a variety of investment instruments, with particular social impacts the main objective.

Research, indices, products and investment strategies incorporating ESG have also expanded substantially into new asset classes like private equity and real estate, with signs of expansion into fixed income too. Climate change especially appears to be a main driver of interest, with investment consultants to one degree or another now including ESG as a topical area in RFPs and due diligence questionnaires.

In the US, major asset owners have from the outset been instrumental supporters of many of the UN's initiatives, but initially support was relatively stronger from European financial institutions. More recently in Asia, especially Japan, major asset owners are showing considerable interest in ESG, with the world's largest public pension fund, the Government Pension Investment Fund (GPIF), a notable example. In 2017, according to the UN PRI, the Principles have nearly 1700 signatories, from over 50 countries, representing US$62 trillion.

The UN Global Compact

Almost simultaneously in 2005, the UN Global Compact (Compact), which was the CEO-led corporate sustainability initiative of the United Nations, was also kicked off. It was, in their words, 'a call to companies to align strategies and operations with universal principles on human rights, labor, the environment and anti-corruption, and take action that advances societal goals'. The Compact established ten Principles based on the ideals of four key UN initiatives, as well as seventeen sustainable development goals for 2030, which were focused on 'no poverty, zero hunger, good health and well-being, quality education, gender equality, clean water and sanitation, affordable and clean energy, decent work and economic growth, industry innovation and infrastructure, reduced inequalities, sustainable cities and communities, responsible consumption and production, climate action, life below water, life on land, peace, justice and strong institutions, and partnerships for the future'.

These goals target 'the most important economic, social, environmental and governance challenges facing the world,' according to the UN. The Global Compact's attempt to align each corporate goal with each other, and with the development goals of the UN, is 'CSR on steroids.' The Compact expresses its goals in terms of ESG, as well as with the governance topics of anti-corruption, peace and the rule of law on one hand, and integrating sustainability into their operations and relationships, and the development of international norms, on the other. The number of organizations pledged to the Compact has increased dramatically over the last 10 years. Over 8000 companies and 4000 non-businesses, from 160 countries, have committed to the Compact, with over half from Europe, followed by Latin America, Asia, Africa and then North America.

Increasing acceptance of ESG

The success of the Global Compact, together with the success of other sustainability organizations like the World Business Council for Sustainable Development and We Mean Business, demonstrates the huge acceptance of ESG and climate change in corporate society.

The World Business Council for Sustainable Development is another CEO-led organization that shares information on sustainability, develops tools for the integration of sustainability, builds resilience to social and environmental risks, collaborates with peers across the value chain, strengthens reputations and participates in policy development.

We Mean Business specializes in creating a low-carbon revolution. Over 450 companies with over US$8.1 trillion in revenue, and 183 investors managing over US$20.7 trillion, have signed commitments to take action against climate change. We Mean Business gives companies and investors a common platform to act and be recognized for bold leadership on climate change. Companies can commit to one – or all – of a set of innovative and practical climate initiatives, and they can work to scale low-carbon solutions to meet specific technology challenges to tackle climate change.

In recent years, investment associations in various countries and stock exchanges have adopted governance codes of behavior that echo the Six Principles with their own twists. These have sometimes moved what were voluntary commitments into a regulatory requirement.

Most informative for Nikko AM, perhaps, are the Japan Stewardship Code and the UK Stewardship Code. These codes speak of stewardship, sustainability, analysis and research, active ownership including proxy voting and engagement, and collaboration and collective action for the purpose of contributing to sustainable growth of the investee companies. The key twists are that ESG is allowed under the Japan Stewardship code if it is relevant to medium to long-term value enhancement, and thus material.

As for objectives, there are stated differences. While the UK Stewardship Code is focused on preventing the next financial crisis, and protecting and enhancing shareholder value, Japan's code is focused on sustainable, medium to long-term growth in shareholder value, with an eye to reviving Japan's economy. Both codes target better investor governance of company Boards. Meanwhile, The Hong Kong Corporate Governance Code is focused on ESG issues that have the potential to impact goodwill, reputation and performance, including those that may come from social or environmental risks. Our interpretation is that ESG issues, and the risks and opportunities, should be considered in all three codes, certainly if material in Japan and the UK, and perhaps more generally in the Hong Kong code.

New stewardship and governance codes

In addition to the codes discussed above, other organizations and countries have released stewardship codes.

For countries, the desire is often to reflect local requirements. The International Corporate Governance Network (ICGN), for example, has a goal to contribute to the creation of a global code, or 'passport' in their words, for investors investing in multiple markets. The seven principles of the ICGN Code similarly focus on the investor's governance practices, and their ability to act as a fiduciary. This ensures that stewardship policies outline 'responsible' investment practices, that investors monitor, assess, engage and collaborate, vote proxies in an informed and independent way, and most relevant here, promote 'long-term performance and sustainable success' and 'integrate material environmental, social and governance (ESG) factors in stewardship activities'. And finally, the ICGN Code proclaims that investors be accountable by disclosing publicly stewardship policies and practices, and report these to beneficiaries and clients.

The European Fund and Asset Management Association has also released a code for external governance, '*Principles for the exercise of ownership rights in investee companies*'. This states that an asset management company may want to intervene with investee companies when there are 'concerns about strategy and performance, its governance or its approach to social and environmental matters,' which is clearly ESG. In addition, there are at least eight additional codes, with extensive regulation also governing parts of the investor universe, in the US.

Another initiative that has helped ESG to gain acceptance in the industry is the Sustainable Stock Exchanges (SSE) initiative, launched in 2009, of the UN Conference on Trade and Developments (UNCTD), UN Global Compact, UNEP FI, and the UN PRI. This is a learning platform that explores how exchanges with investors, regulators and companies can enhance performance on ESG issues, and promote improved ESG disclosure among listed companies to encourage sustainable investment.

In 2012, five stock exchanges made a public commitment to sustainability, with over 60 exchanges (including nearly all major exchanges) now having pledged support to this SSE initiative, the exceptions being Hong Kong and Japan. Japan has, however, released two important codes in the last few years – a Stewardship Code and a Corporate Governance Code – both of which include ESG issues.

In November 2015, the World Federation of Exchanges (WFE) supported uniform disclosure on ESG topics from companies listed on member exchanges. The purpose was to create more uniformity globally in what companies release to investors and, to that end, the WFE laid out 34 factors in its disclosure requirements. This organization represents 64 stock, futures and options exchanges, clearing counterparties with over 44,000 listed companies, and a market cap of US$64 trillion.

A sustainability working group set up in 2014 'signaled' the organization's commitment to consider the issue of the 'purpose, practicality and materiality' of ESG data. The group recommended these guidelines for ESG disclosure to its organization, saying it 'focuses on principles and data, with correlating bottom line impacts, but it also implicitly counsels the improvement and harmonization of management practices'.

The 34 ESG 'Material ESG Metrics' from the WFE for disclosure cover the following categories:

Direct & Indirect GhG Emissions*	Injury Rate*
Carbon Intensity	Global Health
Direct & Indirect Energy Consumption*	Child & Forced Labor
Energy Intensity	Human Rights policy
Primary Energy Source	Human Rights violations
Renewable Energy Intensity	Board - Diversity
Water Management*	Board - Separation of Powers
Waste Management*	Board - Confidential Voting
Environmental policy	Incentivized Pay
Environmental impacts	Fair Labor Practices
CEO Pay Ratio	Supplier Code (SC) of conduct
Gender Pay Ratio	Ethics Code (EC) of conduct
Employee Turnover Rate*	Bribery/Anti-Corruption Code (BAC)
Gender Diversity	Tax Transparency
Temporary Worker Rate	Sustainability Report
Non-Discrimination	Framework Disclosures

Source: WFE

However, these are guidelines only, and disclosure is voluntary and not yet mandated. The US Securities and Exchange Commission, in April 2016, called for public comments on a Concept Release, which in part addresses expanding corporate disclosure requirements via Reg S-K to include ESG factors. This also looks at defining materiality, especially in the context of ESG factors. The proposal has attracted significant asset management support, along with opposition from business-supported lobbies. A change in SEC-mandated disclosure requirements for US public companies has, in our view, the potential to alter the discussions on materiality, and move forward the standardization of disclosure globally.

ESG versus Fiduciary Duty

This growth in assets and signatories for ESG, and the establishment of new stewardship codes, in and of itself, does not mean that the issue of materiality is resolved completely.

The inclusion of social, environment and governance issues does not mean that values-based investors and ESG investors are necessarily speaking the same language, nor will they view the different issues in the same way. In the ESG 'strong' world view, what is important is whether ESG information contains risks and opportunities that can materially impact an issuer's

ability to create sustainable value over the long term. Different issuers face different material ESG risks and opportunities, with efforts by the Sustainability Accounting Standards Board (SASB) intending to establish some consensus around disclosure and investment analysis. ESG issues don't exist in a vacuum either, and must be weighed holistically. Issues that are relevant to some values-based investors may not be seen as sustainability issues by other investors.

ESG issues can exist but they may not be significant enough to be seen to have a material impact on society. Some issues that are material could be outweighed by management efforts to address that specific risk or other risks. It is likely that some of the sustainable development goals of the Global Compact will be seen as values, ethics, or morals-driven, rather than specifically material to medium to long-term performance. What is appropriate for a CSR program and disclosure, for example, may not necessarily be seen as material from an investment analysis perspective.

Today, it is fair to say that the question of ESG and fiduciary duty, and whether it is within one's fiduciary duty to consider ESG information or not, has been largely settled. The Freshfields report mentioned previously provided one leg of the argument in favor. Further support has come from the argument that an analyst or fund manager should consider ESG information that can impact operating or investment performance (and is thus material) over a long-term horizon. Another argument is simply that ESG will be considered 'where consistent with our fiduciary responsibilities.'

Climate change itself, and the perceived risks to the planet and the economy it represents, certainly has made environmental risks 'material' to a growing body of stakeholders. Pension funds with long-stream liabilities certainly see intergenerational risk, and recognize that they can't borrow returns from the future today via unsustainable practices, and then expect to have returns for beneficiaries in the future. With a long-term liability horizon, it is certainly within their fiduciary duty to future beneficiaries to act against practices that threaten future returns. In other words, as universal owners, the large pension fund and asset owners can't use the Wall Street 'rule' and just sell the shares. Externalities do matter. Given long-term horizons, diversification, and long duration liabilities, it is beneficial to work together to reduce future risk.

The development of fiduciary duty

Following on from the Freshfields's report, the UNEP FI Asset Management Working Group in 2009 released a new report 'Fiduciary responsibility', subtitled 'Legal and practical aspects of integrating ESG issues into institutional investment'. This report focused, from a legal perspective, on how best to operationalize ESG integration, on consulting firms covering ESG issues, practical issues of integrating ESG, and a literature review covering legal developments on fiduciary duty and ESG issues since the Freshfields report. Overall, the key conclusions of this report, often called Fiduciary II, are that in order to achieve the vision of the original Freshfields report, in which trustees integrate ESG issues into their decision-making, ESG issues should be embedded in the legal contract between asset owners and asset managers, with the implementation of this framework being governed by trustees via client reporting. This report also makes a case for consultants having a duty to proactively raise ESG issues within their advisory process.

In the US, support for the affirmative has more recently come from a Department of Labor (DOL) interpretative bulletin in 2015, which clarified its stance towards considering ESG issues in the investment process. While an earlier bulletin had stated that considering 'non-economic factors in selecting plan investments should be rare'…and 'documented', the DOL has now stated that this earlier bulletin in 2008 'has unduly discouraged fiduciaries from considering …ESG factors.' The bulletin goes on to clarify 'that plan fiduciaries should appropriately consider factors that potentially influence risk and return. ESG issues may have a direct relationship to the economic value of the plan's investment.'

This clarification from the DOL, which is responsible for regulation and enforcement of the Employee Retirement Income Security Act of 1974 (ERISA), has been of tremendous support to proponents of the Principles. The significant growth in the number of signatories to the Principles, and the assets under management that they represent, would seem to make the question moot.

Even so, a larger question in the minds of many is whether ESG factors, as they have become known, have an impact on the investment and operating performance of an issuer, and if they have, which ones, and how do you incorporate these into the investment process. Indeed, most performance analysis in the years following the release of the Principles purported to demonstrate the opposite, with much of this analysis looking at a traditional exclusionary approach, or looking at immaterial factors. Since then, the body of evidence has grown to substantiate the idea that ESG factors can impact investment performance by reducing risk, or increasing return, or both. Positive performance on certain ESG factors also tends to correlate well with operating performance.

ESG at Nikko AM

We always strive to serve our clients' best interests, and believe that ESG issues are inextricably interwoven into the make-up of an issuer's DNA and the environment in which it exists. Depending upon the materiality and the time horizon, ESG issues can significantly affect the operating performance and risk of the issuer. Thus, we believe it is appropriate (and required) to incorporate ESG issues in investment decision-making. We also believe that sustainable practices are indispensable to long-term value creation and investment results, as they benefit greater society.

As a signatory to the UN PRI, our commitment to ESG does not end at our investment activities, but should also be consistent with how we try to manage and govern our own company sustainably, as described in our statements of core values and ethics. We agree that sustainability means meeting the challenges, opportunities and risks that face an organization and society today, and to 'meet the needs of the present, without compromising the ability of future generations to meet their own needs.' As these are, in the end, economic in nature, they are relevant and material to investment, but

currently take the form of challenges and crises facing the environment, society and in how we wholly and individually govern our behavior.

Our long-term involvement

As mentioned, Nikko AM has been active from the outset in incorporating ESG factors in our investment strategies, supporting growth through participation in related organizations, and through our active ownership practices. Soon after the Kyoto Protocol was signed in 1997, we began to consider how to reflect environmental concerns into our investment activities. Initially our efforts focused on thematic funds for the Japanese equity market, and an exclusionary equity process for both a global equity and a Japanese equity portfolio, both of which have continued to this day.

Our first thematic fund effort was the a Japanese equity fund launched in 1999 that was Japan's first environmental fund. Environment-based ratings were assigned to the investment universe, from which a portfolio was constructed using fundamental equity analysis. This ground-breaking fund was followed by two more funds focused on addressing environmental issues through responsible investing, and then an SRI-focused fund that donates a portion of management fees to the International Development Association, a part of the World Bank supporting anti-poverty programs in the poorest developing countries. Nikko AM was also an early creator of a fund focused on "green bonds" in collaboration with the World Bank.

Active in the UNEP FI since 2000, we have been involved with various organizations such as CDP, the Japan Sustainable Investment Forum, and Principles for Financial Action for the 21st Century along with being a signatory to various initiatives such as Japan's Environmental Principles, and promoting the incorporation of ESG issues within our investment activities.

Nikko AM has consistently strived to meet its commitments to the UN PRI - together with our culture of corporate social responsibility promoting employee activity in charities, volunteering, and environmental management, top management speaks at Triple Bottom Line Investing and governance conferences in Japan. This experience was put to good use when, after we signed the UN PRI in 2007, we began to incorporate ESG factors into our central research process, and explore the creation of an ESG rating system for Japanese equities from a risk and opportunity perspective, and a strong focus on corporate governance.

In Japan, Nikko AM was one of the first asset management companies to incorporate environmental and social considerations into its proxy voting policy, and publish both its policy and aggregated voting results. We are a signatory to the CDP, and a founding signatory in 2011 to Japan's Principles for Financial Action towards a Sustainable Society.

Since signing the UN PRI, our core implementation method is to integrate ESG into the investment process, from equity research to portfolio construction. As a team-centered investment approach characterizes our firm, the requirements of each team and strategy determine the details of each process. This is then complemented by active ownership through proxy voting and engagement with management, as determined by the teams.

A partnership approach

For nearly twenty years, Nikko AM has been involved in the debate and progress towards building a more a sustainable economy. We are also committed to our own corporate social responsibility, and constantly strive to build a corporate culture that reflects our commitments and beliefs, one that contributes to the healthy development of sustainable capital markets, and the economies and communities in which we operate. We strive to operate our firm in a manner consistent with our social responsibilities and encourage our employees to do the same. We also expect this of our suppliers and counterparties, and of the management of the companies in which we invest, who with us are the stewards of our clients' assets.

Within our investment activities, first and foremost is our fiduciary duty to our clients. Where we believe that an ESG issue is material to the investment and operating performance of the issuer in which they are invested, we will strive to fully incorporate that information. At the core, the research and portfolio construction process will incorporate all issues that we believe are material, including ESG.

At the same time, we understand that clients and beneficiaries may not always share our understanding of what is material. Clients and beneficiaries may also have particular requirements that they want reflected in portfolio construction. In both cases we believe it is essential to articulate our philosophy clearly, communicate our understanding to our clients, work with them to understand their requirements, and reflect those appropriately in the investment strategy.

Conclusion: We are all accountable

Within our firm, accountability for ESG integration lies with the Global Head of Investment, the Global Executive Committee and ultimately the Board of Directors, to whom progress on ESG is regularly reported by the ESG Steering Committee. Mandated by the Board, our ESG Steering Committee is the governance body responsible for fulfilling our firm's commitment to the UN PRI.

The core members of the ESG Steering Committee are the leaders of our equity and fixed income investment teams across the globe. As we believe ESG issues are inseparable from our fundamentals-based investment process, the incorporation of ESG into the investment process is the direct responsibility of all investment professionals at Nikko AM, rather than a separate team of ESG specialists. Each team addresses ESG issues in their own specific investment policy statements. Thus, the Global Head of Investment is responsible for the implementation of ESG into everything we do, along with monitoring and assessing the capabilities of the investment teams.

The firm realizes that the sustainability practice is evolving, and will help to continuously develop our abilities in

incorporating ESG by providing tools and information, and annual training of the investment teams, as well as encouraging our service providers to continue developing how they incorporate ESG into their products and services. Where we invest through external managers, we consider a manager's incorporation of ESG and practices relating to the six principles during the research and due diligence process.

Within the industry, we are accountable to the UN PRI and to other signatories of the Principles, and recognize our responsibility to report our progress to all PRI asset owner and investment manager signatories annually. Through this reporting, we hope to contribute to signatory accountability, signatory transparency and signatory assessment.

Appendix

Japan's Environmental Finance Principles

We understand the basics of a sustainable society as being able to live today free from the fear of tomorrow. In order for this to occur, this generation must seek to solve the various issues faced by humans and our planet – not only for our own benefit but also for future generations – by pursuing an environmentally-friendly lifestyle that coexists with nature.

The Principles

1. We will recognize our roles and responsibilities, taking into account the precautionary approach, and promote those actions that contribute towards shaping a sustainable society.

2. We will contribute to the formation of a sustainable global society through the development and provision of financial products and services leading to the development and increased competitiveness of 'industries contributing to a sustainable society' as represented by the environmental technologies and services sector.

3. From the perspective of regional development and improvement in sustainability performance, we assist the environmental programmes of small and medium enterprises. We will also back activities that will raise environmental awareness among citizens and support disaster readiness and community activities.

4. In the formation of a sustainable society we will recognize the importance of cooperation with diverse stakeholders and will not only participate in its activities but will endeavor to take a proactive role.

5. We will not be limited to complying with environmental laws and regulations but will take active steps to reduce our own environmental footprint through resource and energy savings as well as encouraging our suppliers to do likewise.

6. We will recognize activities that will further profile sustainability as a business issue and will endeavor to disclose information on our activities.

7. In order to implement the above actions we will aim to raise awareness of environmental and societal issues on our own board and support them to take an active role through their duties.

Recommended Actions

Signatories in the asset management, securities and investment banking sectors are encouraged to take action proactively in the following areas.

(1) Integrate environmental and social considerations into the operations of its core business (including but not limited to the development of products and services). For example:
Refer ESG-related issues in the standards, regulations and guidelines of asset management and reflect them into the investment and lending decision-making processes.

Specify ESG considerations in the proxy voting guidelines. Accumulate examples of CSR report analysis in the selection of investee companies and utilise them to improve its own CSR activities.

Utilise comments and advice from external experts to improve its own ESG activities.

Invest in products which consider ESG issues and contribute to a sustainable society to the extent consistent with its fiduciary responsibilities.

Proactively encourage investee companies to disclose ESG information and promote awareness and action on ESG issues amongst its suppliers.

(2) Integrate environmental and social considerations within its business processes. For example:
Promote the reduction in paper use by electronic delivery of the prospectus.

Promote environmental considerations in paper and printed materials such as sales and internal documents.

Promote paperless meetings and internal documents via the use of information technology.

(3) Disseminate information to society and engage with various stakeholders. For example:
Externally disclose its asset management and investment activities based on the six principles of the Principles of Responsible Investment.

Externally disclose on ESG considerations in its proxy voting activities such as its position, structure and voting results. Participate in international initiatives related to asset management.

Appropriately display and/or disclose the purposes and effects of environmental and sustainability related products.

Promote public awareness on the environment and sustainability issues (such as by holding seminars for students and the business community).

Promote employee participation in social activities such as environmental protection activities run by communities and other organizations.

Provide information to investors on its website.

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