

Progress Report on Enhancing Asset Management Business 2022

May 2022



Contents

| | |
|--|-----------|
| Introduction | 1 |
| I. Dialogues with asset management firms to put client interests first | 2 |
| 1. Management structure | 3 |
| (1) Ensuring independence as an asset management firm | 3 |
| (2) Management structure focusing on expertise in investment management..... | 4 |
| (3) Expected roles of independent directors..... | 6 |
| 2. Product origination, delivery and monitoring (“Product Governance”)..... | 8 |
| (1) Sharpe ratios of actively managed funds’ | 8 |
| (2) Alpha of actively managed Japanese equity funds | 9 |
| (3) Asset management fee rates of actively managed funds | 11 |
| (4) Establish an effective product governance framework..... | 13 |
| (5) Product origination and early redemption that give top priority to client interests..... | 16 |
| 3. Clear visions and strengths..... | 18 |
| (1) Setting focused investment strategies | 18 |
| (2) Due-diligence of outsourced fund managers | 19 |
| (3) Performance evaluation and compensation structure to realize visions | 21 |
| (4) Initiatives to improve operational efficiency..... | 22 |
| [Column] Thorough implementation of customer-oriented business conduct | 23 |
| II. ESG funds | 27 |
| 1. Introduction | 27 |
| 2. Overview of the survey..... | 28 |
| 3. Background | 28 |
| 4. Practices of asset management firms..... | 31 |
| (1) Overarching principle | 31 |
| (2) Organizational structure | 32 |
| (3) ESG integration..... | 34 |
| (4) ESG ratings and data product providers..... | 37 |
| (5) Stewardship activities | 39 |
| (6) Disclosure | 41 |
| (7) Outsourcing..... | 45 |
| ~ Supervisory expectations for asset management firms providing ESG funds ~ | 47 |
| III. Other Issues..... | 50 |
| 1. Publicly offered funds | 50 |
| (1) Global comparison of Sharpe ratios and expense ratios | 50 |
| (2) Fee dispersion among passive funds linked to same indices | 51 |
| (3) Increase of funds with specific maturities..... | 52 |

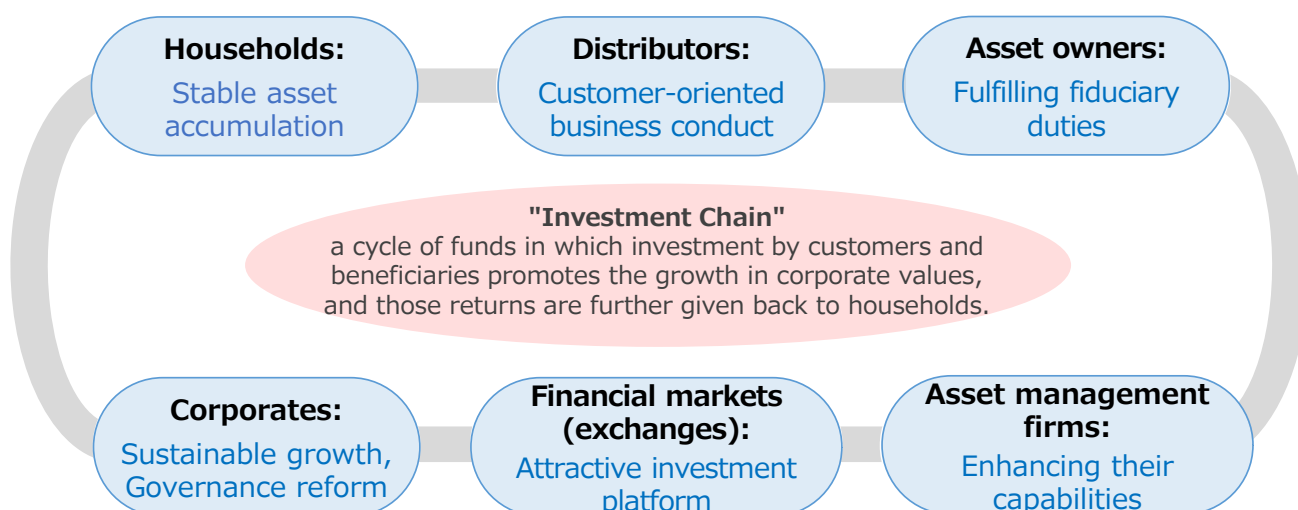
| | |
|---|-----------|
| (4) "Target investors" for funds with monthly distributions | 54 |
| (5) Funds with the risk of emerging market countries | 54 |
| (6) Disclosures of total return swaps | 55 |
| 2. Fund wraps | 56 |
| 3. Structured bonds..... | 59 |
| 4. Privately placed funds..... | 64 |
| (1) Expansion of the privately placed fund market..... | 64 |
| (2) Investor compositions of privately placed funds | 65 |
| (3) Asset composition and performance of privately placed funds by investor types | 66 |
| (4) Comparison between publicly offered funds and privately placed funds | 67 |
| 5. Defined benefit corporate pension (DB) / defined contribution pension (DC) | 69 |
| (1) DC: fee dispersion among passive funds linked to same indices..... | 69 |
| (2) DC: for a better selection of active funds | 70 |
| [Column] DB: Analysis of overseas pension funds and its implications for Japan | 73 |

Introduction

In order to achieve sustainable economic growth by dealing with various changes in the economy and society, such as increasing geopolitical tensions and the spread of COVID-19, it is important that each participant in the Investment Chain fully plays its expected role to achieve a virtuous cycle of funds. To improve the functions of the entire Investment Chain, JFSA considers the enhancement of asset management business to be an important issue, and has been discussing this with the industry

This is the third edition of the Progress Report since we published our first Report in 2020. In this Report, we delve into the issues that asset management firms need to address so as to strengthen its business operations and investment capabilities that put client interests first from the following three perspectives: "Management structure," "Product origination, delivery, and monitoring ('Product governance')," and "Visions and strengths." We also summarize expectations for asset management firms which handle ESG funds, based on our research and analysis as a response to the Green Wash concerns regarding ESG funds, which have increased in recent years. We also cover other topics including fund wraps, structured notes, and asset owners (corporate pensions).

We will continue dialogues with asset management firms on the issues and challenges presented in this Report for a better-functioning Investment Chain and the enhancement of asset management business.



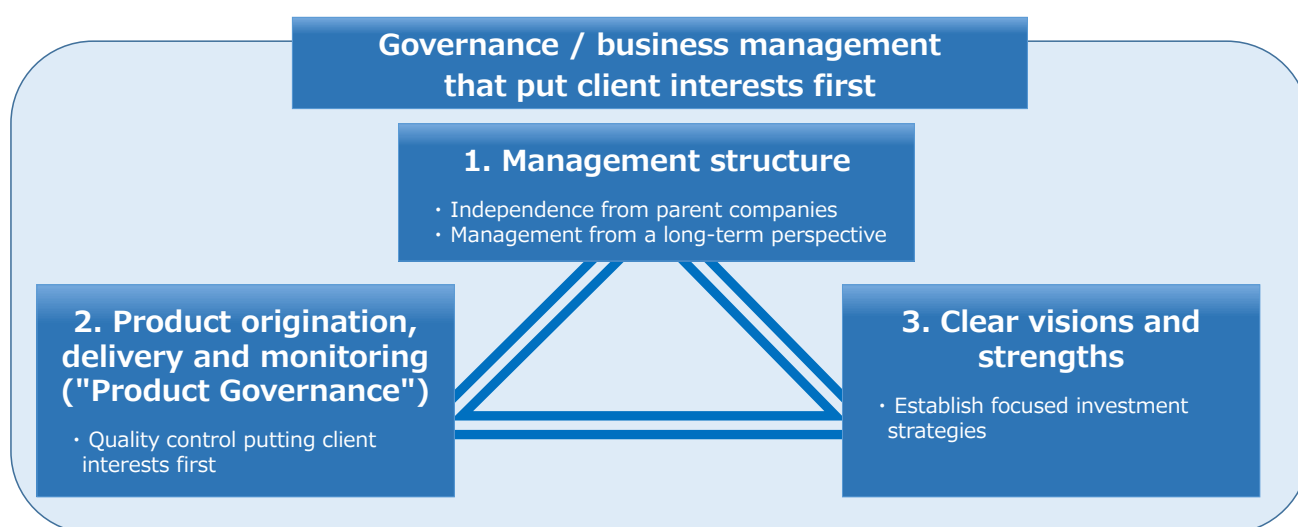
I. Dialogues with asset management firms to put client interests first

In order for asset management firms to achieve good investment performance over the long term and establish a stable revenue base supported by customers, it is necessary for them to develop an organizational framework and implement initiatives that give top priority to client interests. From this perspective, the FSA had dialogues with asset management firms in Japan and their parent companies regarding the progress of their initiatives.

Although each asset management firm is, to some extent, aware of the necessity to enhance its ways of business, and some are making steady progress in various initiatives through rigorous internal discussions, it is important for all of them to make continuous efforts to address, depending on each business model, issues for implementing operational practices that puts client interests first and strengthening their investment capabilities. For that purpose, they need to let their governance framework function properly and to make improvements and enhancement on the following three points: "1. Management structure," "2. Product origination, delivery and monitoring ("Product Governance"), and "3. Clear visions and strengths."

This report summarizes examples of initiatives taken by the firms and problems that require improvement. We will continue monitoring the progress of the initiatives, those effects and results, and engage in dialogues with them so that these dialogues will lead to the creation of a competitive environment and more effective initiatives by each firm.

(Figure 1-1) Initiatives to give top priority to client interests and strengthen investment capabilities



1. Management structure

We expect that senior management of asset management firms, including independent directors, responsibly inculcate the idea of client interest first throughout the organization and implement appropriate frameworks of governance and business administration.

(1) Ensuring independence as an asset management firm

From the perspective of ensuring independence, asset management firms shall reaffirm that their customers are the end investors of their funds, not the distributors of the funds, and attain the independence from their parent financial group. In this regard, the following initiatives are implemented by some firms:

- In several firms, discussions on their management structure are mainly led by independent directors at their nomination committee, which is independent from their parent group. They make decisions to increase the number of independent directors and to nominate top management by an internal promotion instead of a transfer from their parent company. Their parent company respect the conclusions.
- A firm recruited almost a half of directors and executive officers, including top management, from those with experience in investment management outside of its parent group, while keeping the number of those transferred from the group within another half.
- The president of a firm proactively communicates with its parent company on the topics about its positioning in the group and personnel policies focusing on expertise in investment management, aiming at ensuring independence of the firm from the group.
- Through instilling the concept of a new management plan, a firm reiterates to all employees that their customers are investors, not distributors.

For the effectiveness of business operations and enhanced investment capabilities which put client interests first, it is essential to establish an adequate monitoring system and let it function from the view point of a third party, such as utilizing independent directors. With respect to this point, we found the following actions taken by some firms:

- All firms we had dialogues with either appointed independent directors already or are in the process of appointing them. Some firms further expand the number of independent directors to strengthen their governance functions.

- While those with diverse backgrounds other than investment management were already appointed as independent directors in a firm, it considers to add talents with expertise in asset management business as independent directors.
- Japan's Corporate Governance Code asks companies to utilize independent directors. Several firms consider that in order to conduct convincing engagement activities with investee companies with respect the adequate ratio of independent directors in boards, the firms themselves also need to raise the ratio of independent directors in their own boards to the level consistent with that required for the investees.
- Along with the expansion of the number of independent directors, a firm implemented initiatives to transform its board of directors from a place where ordinary operational activities are just reported and approved to a place where issues are rigorously discussed. For example, its top management regularly consults with the chair of the board, who is an independent director, holding prior discussions to determine priority issues to be discussed at the board of directors.

In addition to the board of directors, each firm has established multiple committees or councils having independent directors to examine the status of socially responsible investment and customer-oriented business conduct. In order to maximize the interests of client investors, it is important for the management, by having strong governance framework, to ensure independence and to implement appropriate monitoring functions. In addition, each committee or council for monitoring shall not only make reports on daily operations but also bring up critical issues to the board about whether their businesses are conducted in a way that gives top priority to customer interests. The management should establish and improve processes for deepening internal discussions and continue tireless examinations on their own business conduct.

(2) Management structure focusing on expertise in investment management

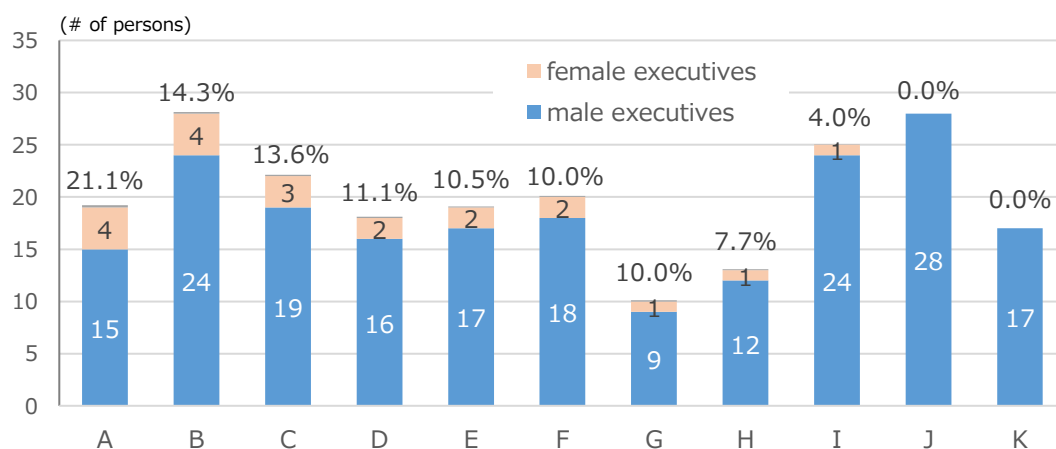
Asset management firms' top management is expected to develop an organizational framework for promoting business operations that put client interests first and efforts to strengthen their investment capabilities. To this end, it is important to appoint diverse talents with expertise in investment management to the board and to implement management practices that emphasize the importance of long-term investment management. In this regard, the following actions are taken by some firms:

- Some firms strengthen its management structure by appointing talents familiar with asset management business both within and outside of its group, and some other firms invite talents with abundant experience from external firms.

- While the average tenure of the top management at a large asset management firm is approximately three years, which is so partly because of regular personnel rotations in its parent group, there are a couple of firms where the tenure of the top management with strong expertise in investment management gets longer.
- Several firms reformed their management structures and, instead of appointing a person transferred from the parent group, appointed those promoted internally to the top management or executive officers based on their experience and achievements in the firm.
- Aiming at diversifying human resources, a couple of firms set quantitative targets for the ratio of women in manager positions. A firm not only sets the ratio of women in professional positions but also encourage women's participation in selective training of management skills. It also holds a symposium on how to promote women's active participation to management.

Each firm is expected to establish a management structure that puts client interests first and contributes to stronger investment capabilities by, for example, appointing executives based on their expertise, experience, and willingness to engage in investment management business. In addition, given that the Corporate Governance Code calls for ensuring diversity in human resources, including the promotion of women's active participation in the workplace, in order to lead to effective engagement with investee companies, it is necessary for each firm itself to further promote its initiatives to ensure diversity as well as fair performance evaluation among different genders.

(Figure 1-2) Ratios of female executives at large asset management firms (as of April 2022)^{1,2}



(3) Expected roles of independent directors

While each firm is increasing the number of independent directors, such an effort must not end up in merely fulfilling superficial formality. It is important for each firm to utilize independent directors substantially by letting them contribute to prioritize client interests and strengthen investment capabilities. During this business year, we exchanged opinions with independent directors of some firms on the matters such as the expected roles and desirable expertise of independent directors. The following initiatives and opinions were observed:

- In a firm where its independent directors regularly exchange views with the top management of the parent company, they discuss how the management structure of an asset management firm should be, particularly with regard to inviting talents for top management from outside of the group. In another firm, an independent director having academic research career in asset management makes recommendations based on his researches and studies about individual fund evaluations.
- Regarding skills and expertise required for independent directors of asset management firms, some said "Because asset management business is quite specialized, a background of investment management practice is necessary. At least, one in multiple independent directors should have enough knowledge about asset

¹ Average ratio of female managers in the Japanese corporations is 8.9%. That in the Japanese financial corporations is 12.7%. (Source: Teikoku Databank, "Survey of Corporate Attitudes towards Promotion of Women (2021)")

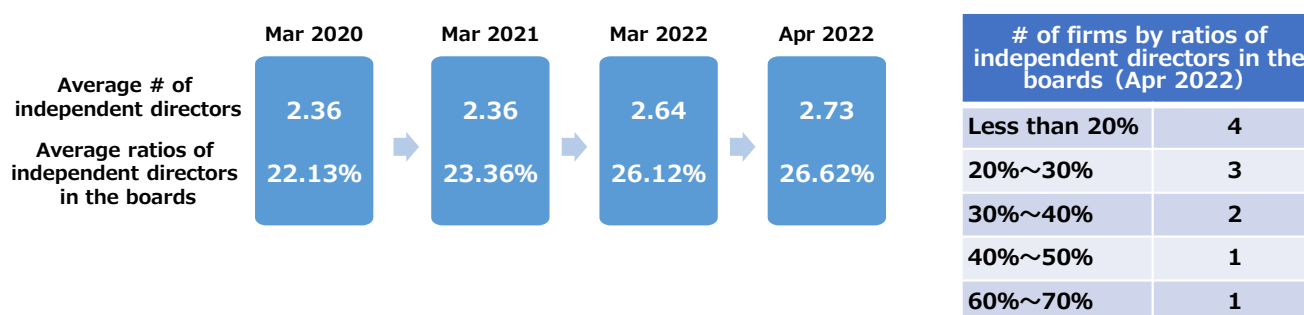
² Compiled by the FSA based on information on website of the firms.

management business.” On the other hand, some others said “Even if they do not have expertise or prior experience in asset management, they need to be able to ask critical questions and make effective recommendations to the management based on their respective knowledge in business, managerial, legal and financial practices in general.”

- With regard to reporting to independent directors, one said “Having a dedicated department or person in charge of supporting directors is extremely helpful, including providing relevant information prior to the discussions at the board, etc.” Another opined as “Each independent director has its own expertise and is different, it is necessary to provide tailor-made information depending on such differences.”

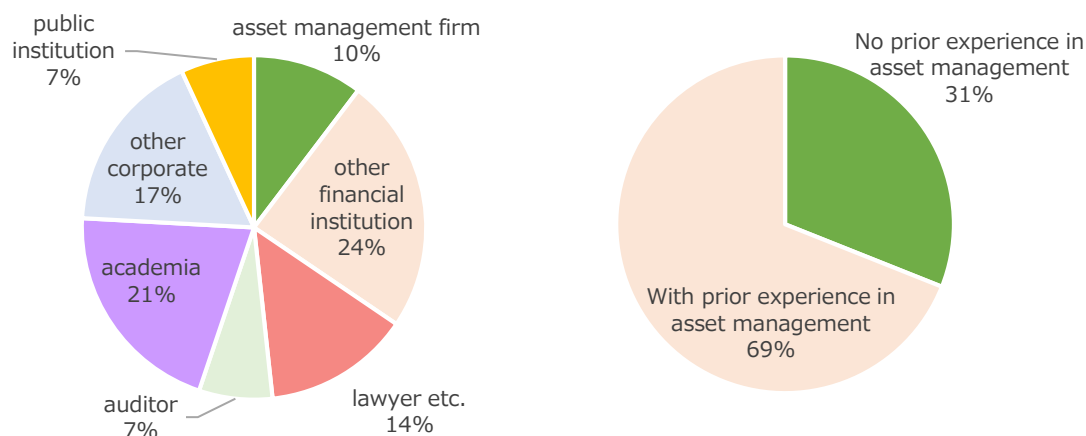
As for the desirable attributes of independent directors of asset management firms, while it depends on the different views by firms, we consider that it is necessary to appoint talents with knowledge and experience in the investment management business in order to effectively monitor initiatives to strengthen their investment capabilities. For independent directors whose backgrounds differ from that of asset management, a firm should give an appropriate level of supports, such as by providing detailed information, to them so that they could effectively contribute to strengthening investment capabilities in accordance with their respective knowledge and experience.

(Figure 1-3) Independent directors at large asset management firms³



³ Compiled by the FSA based on materials submitted by the firms.

(Figure 1-4) Breakdown of backgrounds of independent directors at large asset management firms (as of March 2022)³



2. Product origination, delivery and monitoring (“Product Governance”)

In order for asset management firms to carry out business conducts that give top priority to client interests, it is important for them to establish a product governance framework that controls the quality of individual products from the perspectives of "whether their products truly meet investors' needs and provide them with stable long-term returns" "whether their products are managed as envisioned at inception and generate returns commensurate with costs borne by investors," and "whether the investment strategies planned at the time of inception are maintained."

(1) Sharpe ratios of actively managed funds^{4,5}

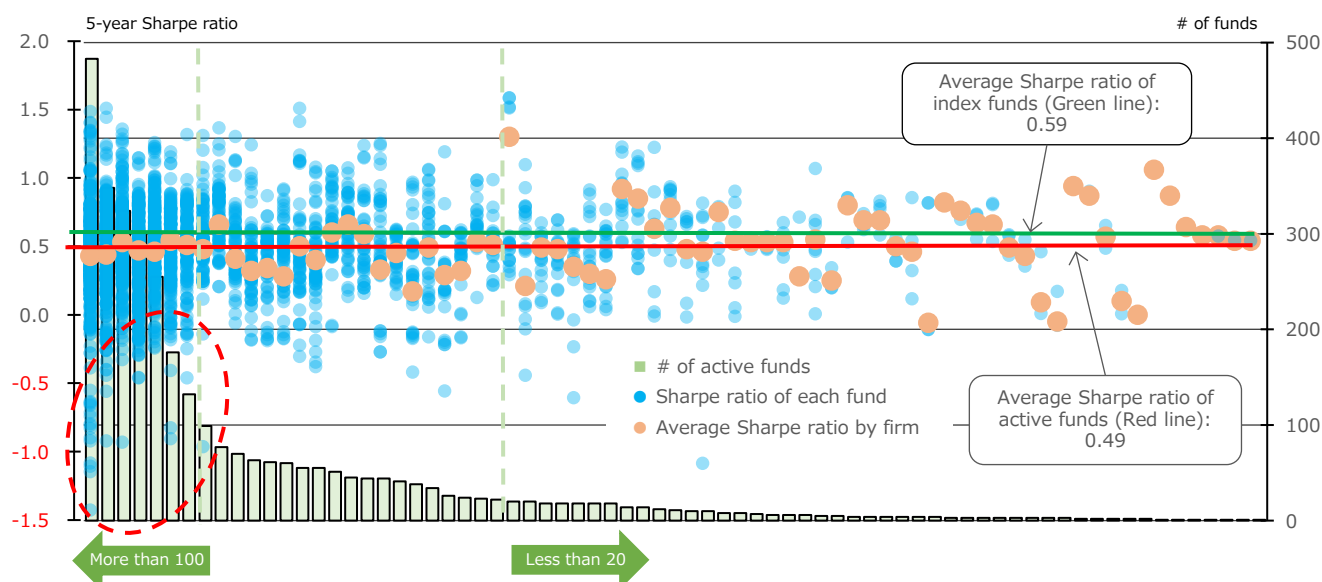
Figure 1-5 shows the Sharpe ratios of publicly offered active funds managed by asset management firms in Japan, where one column corresponds to one firm. The left-hand side axis shows the levels of Sharpe ratios. Blue circles in the Figure represent the Sharpe ratios of individual funds managed by each firm, and orange circles represent the average Sharpe ratios of the funds of each firm. The height of a bar represents the number of the funds (right-hand side axis) of each firm, arranged from the firm with the largest number of funds in decreasing order from left to right.

⁴ “Active funds” are funds that arbitrarily pick stocks (active management) and aim for returns that exceed a specified stock index. On the other hand, “index funds” or “passive funds” follow a specific stock index by investing in the same stocks in the index with the same compositions (passive management).

⁵ This indicator measures the return per unit of risk (standard deviation) over a specified period.

On the right-hand side area of the Figure, firms with a relatively small number of funds have relatively good average performance. Among firms that manage only 20 or fewer funds, many of them exceed the average Sharpe ratio of active funds (0.49: the red line), and some of them, mainly independent firms⁶ and some multi-national firms, also exceed the average Sharpe ratio of index funds (0.59: the green line). Firms with a small number of funds tend to achieve good performance by focusing resources on their flagship funds. On the other hand, among firms that manage more than 100 funds, while some of their funds have achieved good performance, there are many funds having negative Sharpe ratios (circled by the red dotted line). We expect these firms to address these poorly performing funds from the perspective of client interests.

(Figure 1-5) Performance and number of active funds managed by asset management firms (Dec 2021)⁷



(2) Alpha of actively managed Japanese equity funds

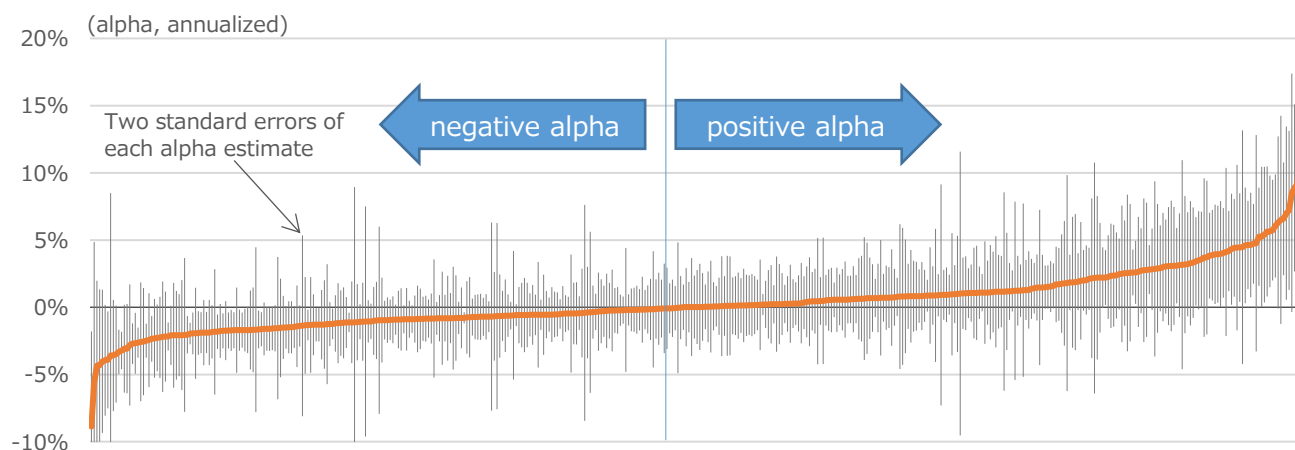
The value added expected for active investment is an excess return over passive investment linked to the overall market or a specific style ("value", "growth", "small", etc.). In order to quantitatively grasp the value added of actively managed Japanese equity funds, we statistically estimated the excess return (alpha) of each fund by time-series regression

⁶ "Independent firms" or "Independent asset management firms" in this Report mean the asset management firms that are not subsidiaries of large financial groups in Japan.

⁷ Compiled by the FSA based on data from QUICK Corp.

analysis⁸. Figure 1-6 summarizes the estimation results of 444 actively managed Japanese equity funds⁹. The results of the alpha estimates for the individual funds are arranged in ascending order from the left to the right, and the results are connected by an orange line.

(Figure 1-6) Alpha estimates of actively managed Japanese equity funds¹⁰



As shown in the Figure, approximately a half (219 out of 444) had negative alpha estimates, of which 32 had statistically significant¹¹ negative alpha. On the other hand, 35 had a statistically significant positive alpha. Active funds with negative alpha are estimated to have performed worse than passive investments.

Looking at individual funds with high alpha estimates, many funds were managed not only by large asset management firms but also by independent asset management firms. Funds with high alpha estimates tend to focus on small and medium-sized stocks as their investment style. One of the reasons for the high performance is that there is some room for fund managers to add value through research and selection of small and medium-sized stocks.

On the other hand, among the 32 funds with significantly negative alpha estimates, funds managed by large asset management firms accounted for the majority, while independent asset management firms' funds were not found at all. Of these funds, approximately 70%

⁸ Performance data of the funds are based on unit prices of the funds with dividends reinvested. Asset management fees and other expenses reflected in the unit prices are deducted from the performance. However, other costs not reflected in the unit prices, such as sales commissions, are not deducted.

⁹ The 444 funds are sampled from those existed at the end of March 2022 as having at least 4 year performance history during a period from April 2002 to March 2022.

¹⁰ Estimated by the FSA based on data from QUICK Corp., Nomura Securities Co., Ltd. (Russell/Nomura Japan Index), and the Bank of Japan.

¹¹ By two standard errors.

(23 out of 32) were funds launched more than 20 years ago, and approximately 40% (12 out of 32) were funds for defined contribution pension plans (DCs) which are supposed to serve for mid-to-long term investment.

(Table 1-7) Characteristics of funds with negative alpha (bottom 15 funds)¹²

| Asset management firm | Years since inception | AuM (Feb 2022) | Alpha estimate (annual rate) | t-value |
|-----------------------|-----------------------|------------------|------------------------------|---------|
| Large, domestic | 7.6 years | 170 million yen | -8.9% | -2.51 |
| Large, domestic | 10.3 years | 620 million yen | -3.9% | -2.17 |
| Large, domestic | 21.5 years | 880 million yen | -3.3% | -4.03 |
| Multinational | 23.8 years | 2.78 billion yen | -3.2% | -4.62 |
| Large, domestic | 20.3 years | 570 million yen | -2.7% | -3.59 |
| Multinational | 26.4 years | 2.17 billion yen | -2.7% | -2.37 |
| Large, domestic | 21.0 years | 6.73 billion yen | -2.6% | -4.72 |
| Large, domestic | 22.7 years | 500 million yen | -2.5% | -3.94 |
| Large, domestic | 15.8 years | 2.01 billion yen | -2.4% | -2.76 |
| Large, domestic | 17.3 years | 1.43 billion yen | -2.2% | -4.18 |
| Large, domestic | 20.2 years | 2.37 billion yen | -2.0% | -2.95 |
| Domestic | 18.4 years | 1.16 billion yen | -2.0% | -4.89 |
| Domestic | 20.4 years | 600 million yen | -1.9% | -2.51 |
| Domestic | 16.6 years | 2.29 billion yen | -1.9% | -2.36 |
| Domestic | 22.5 years | 3.54 billion yen | -1.9% | -2.48 |

In general, consumers invest in active funds, which have higher expense ratios than index funds, expecting higher returns than passive investments. A fund with a negative alpha indicates that it does not meet such expectations by investors. Most of large asset management firms had funds with negative alpha for a long time in their product lineups, which imply that there are issues in quality control of the funds managed by these firms.

(3) Asset management fee rates of actively managed funds

As shown in Figure 1-6, after deduction of expenses such as asset management fees, the alpha estimates of more than 80% of the active funds analyzed were statistically neither positive nor negative. Although these funds have achieved investment performance that

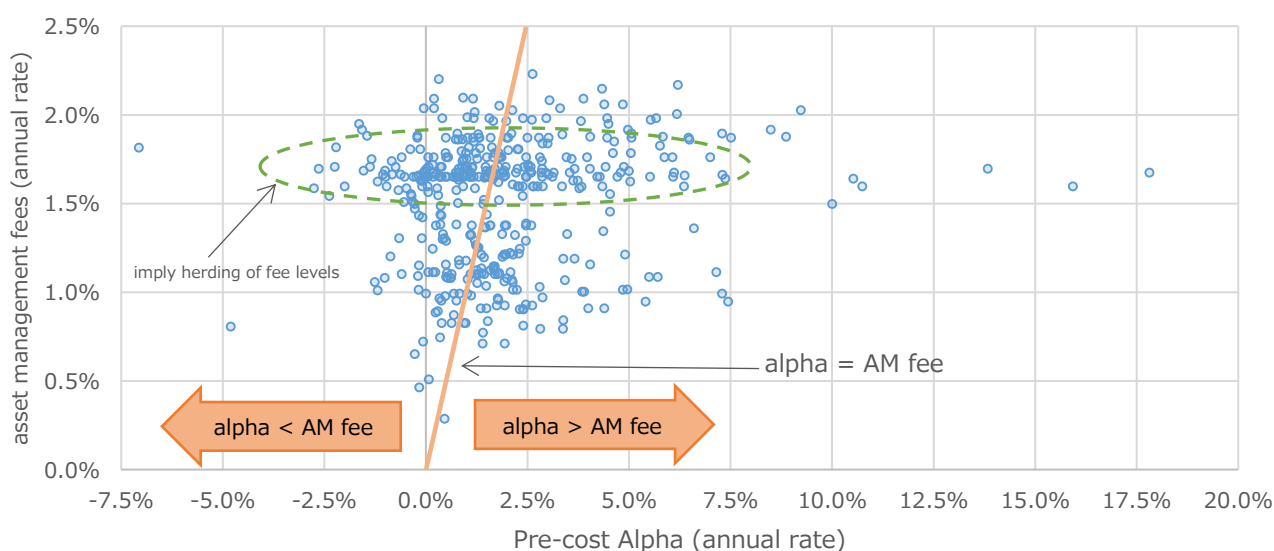
¹² In particular, those with t-values less than -4.0 (red dotted boxes) in Table 1-7 are estimated to have only a 1/10,000 chance or less probability that their true alpha would be positive. All of these funds have existed for a long time, around 20 years, in spite of the poor performance. These poorly performing funds, which may no longer be able to be improved, indicate that there are serious problems in the product governance framework of the firms managing these funds. The management of these firms should responsibly and promptly take the lead to improve monitoring framework to prevent such a fund from performing poorly for such a long time.

exceeds passive investment to a certain extent before deducting expenses, such performance might be offset by expenses and could not be delivered to clients as added value.

Therefore, as shown in Figure 1-8, we compared "alpha before deduction of expenses", which are obtained by adding the asset management fees to the alpha estimates, with the asset management fee rates. Many funds were found that the asset management fee rates exceeded the alpha estimate (dots distributed to the left of the orange diagonal line in the Figure). As sales commissions borne by investors are not taken into account in this analysis, it is thought that there are actually more funds whose total expenses including sales commissions are excessive over their alpha.

In addition, from this distribution of the pre-cost alpha and asset management fee rates in the Figure, it can be inferred that asset management fee rates are simply set across around the same levels without assessing or considering performance of individual funds. There is a possibility that asset management fee rates are not set according to the prospect of excess returns of funds at inception or not later reviewed based on actual performance results of the funds either.

(Figure 1-8) Asset management fee rates and alpha before deducting costs¹³



¹³ Estimated by the FSA based on data from QUICK Corp., Nomura Securities Co., Ltd. (Russell/Nomura Japan Index), and the Bank of Japan (same as Figure 1-6).

(4) Establish an effective product governance framework

Each firm had told us that they adequately put a performance monitoring framework in place by both of asset management departments and risk management departments and take actions to improve a fund performance, such as a replacement of a fund manager, as necessary. However, the alpha analysis above reveals that some funds, particularly those managed by large asset management firms, have performed poorly for a long time. For this reason, we consider that there are issues in effectiveness of the product governance framework of these firms.

When we held dialogues with large asset management firms regarding their responses to the funds that resulted in negative value added for investors for a long time, we found that most of the large firms that manage a large number of funds did not appropriately conduct quality control of their funds in a way to prioritize client interests. The examples are shown as below.

<Issues for the product governance that puts client interests first>

(1) Performance monitoring

Many firms do not appropriately monitor performance of funds after deducting expenses (such as asset management fees) from the viewpoint of clients.

- Although performance after expenses of a fund is presented in disclosure materials for investors, most of the large firms did not even calculate, share, nor monitor the performance indicators after expenses internally for the purpose of quality control of their funds. For example, if a fund generates a small excess return before deducting expenses, it is judged to be "no problem" by the firm. However, because the asset management fee rate of the fund far exceeds the small excess return, the fund's excess return after expenses is negative from the viewpoint of the investors. The firm, which does not internally monitor the performance after expenses at all, fails to recognize and examine it as a problem. As a result, the poor performance after expenses has continued for a long time and no action has been taken by the firm for that issue.
- There was one firm that when evaluating the performance of their active Japanese equity fund, which is one of their funds managed for a long time, they compared the fund performance with dividend reinvested with TOPIX ex-dividend, and without being aware of its irrationality, they have misunderstood that "this fund generates excess returns over TOPIX" for more than 10 years.
- While a firm adopts performance after expenses as one of the evaluation items to consider early redemption of a fund, monitoring results of a fund are not shared from

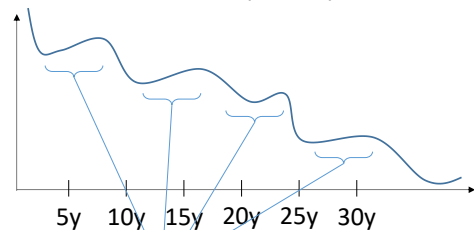
the committee for fund performance monitoring, which resulted in ineffective judgment of early redemption of a fund.

In many firms, sampling periods to flag poorly performing funds are set at only 1 to 3 years (5 years, at the longest) in their monitoring criteria. Most of the firms do not examine the performance from a long-term perspective since the inception of each fund. As a result, when a short-term performance of a fund improves, the fund is excluded from the watch list of fundamental reviews, which ultimately results in long-term sluggish performance of the fund.

- A firm, where the investment management division (1st line) and the risk management division (2nd line) respectively monitor performance, did not include long-term performance indicators into the monitoring thresholds used by the risk management division, and the division only looked at short-term indicators such as risk-return balance for only 1 to 3 years. From a long-term perspective, multiple lines of defense did not function properly in this firm.

(Figure 1-9) A typical image of a poorly performing fund

Cumulative returns (losses)



Judged as “improved” in 3-5 year scopes. But, the overall performance since inception deteriorates steadily.

(2) Setting appropriate asset fee rates and their verifications

When setting an asset management fee rate at the inception of a fund, most of the firms do not take into account differences in investment strategies among different funds or prospects of excess returns based on the historical track records of funds managed by the firms. Instead, they simply look at the fee levels of similar products of other firms, ignoring the material differences above. In addition, the verification of asset management fee rates after observing actual performance of a fund or the reconsideration about whether or not to continue investment with keeping the same asset fee rates have not been properly conducted.

- In a fund where approximately 30% of the portfolio is actively managed in value stocks and the remaining 70% is managed passively, the firm managing the fund set its asset management fee rate similar to that of funds managed by other firms where 100% of the portfolio is actively managed. Because this approach at inception was quite unreasonable, it resulted in a significantly negative excess return after deducting expenses. But the firm has not revised the asset management fee rate yet so far.

- In some firms, a division monitoring fund performance did not understand that maintaining a certain level of active risk (tracking error) is essential to generate excess return and to justify the high asset management fee rate of an active fund. The division failed to timely respond to a decrease in active risk of funds they monitor.
- Even for a case of a fund which has obviously generated significant negative excess returns for a long time, some firms do not take effective improvement actions, avoiding coordination costs with external fund-related parties such as distributors. Instead, they only change investment methods or replace investment managers, which can be done internally. These firms do not have a formal process or internal rules for fundamental improvement actions such as revisions of asset management fee rates or consideration of early redemption of a fund. Therefore, these firms could not take actions to or negotiate with external fund-related parties in a determined manner.

(3) Ensure effective governance by management

In many firms, because of the unclear allocation of authority and responsibility for quality control across divisions, systematic product governance by each division, such as product development, sales, investment, and risk management, does not work effectively. As a result, information sufficient to make appropriate decisions is not shared with the management, including independent directors, who are responsible for verifying the appropriateness of the quality control process. During a dialogue with a large asset management firm, we asked a director in charge of its investment management division about his opinion on the funds with poor performance. He told us "The poor performance is merely an unfortunate result by following respective investment policies. Because investors are able to switch to other funds with lower costs, we do not think it so problematic." This example indicates that even the management itself is not fully aware of the necessity of an effective product governance framework.

- About funds with poor performance, several firms told us "We have been discussing about it internally across divisions." However, specific actions were not taken due to the lack of clarity regarding which division has the authority and responsibility to implement improvement measures. They were not fully aware of that customer interests would be further undermined, the longer the problems were prolonged.
- In another firm, although the performance of major funds was reported to the management committee and the board of directors on a monthly basis, because the funds listed and the performance measurement period were limited, specific discussions on reviewing or improving non-performing funds had not been made among the management. In addition, while the firm had multiple committees supporting the management, they did not monitor fund performance after deducting

expenses, and cross-divisional verification within the firm did not function for client-oriented purposes.

It is important for asset management firms to ensure that the product governance framework effectively works for all funds they manage from the perspective of whether they put client interests first and provide value added to investors. The firms need to establish a framework to monitor, from a long-term perspective, such as since the inception of a fund, whether the investment methodologies expected at the inception has been properly implemented, and whether the returns of each fund are commensurate with the level of costs borne by investors, which shall not be limited to a mere comparison with similar funds managed by other firms.

In addition, if a firm finds that the investment management and performance expected at the time of product origination turn out to be actually impossible afterwards, and that it is difficult to take measures for improvement, it should consider more fundamental actions such as revising asset management fee rates or early redemption, putting the customer's interests as the top priority.

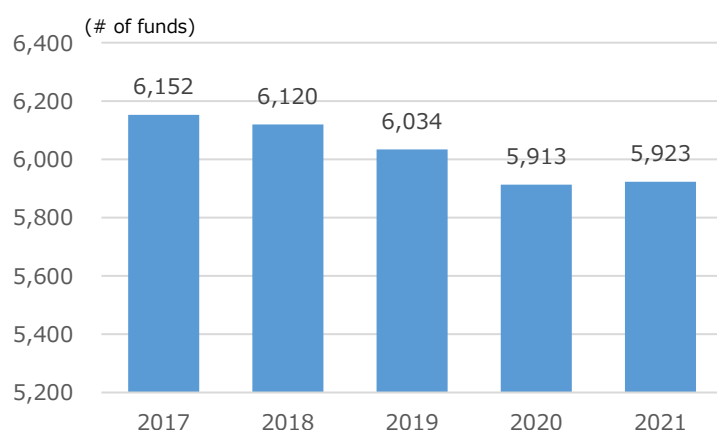
Since there could be differences in views and opinions by each department, such as product development, investment management, administration, and sales, on appropriate actions to be taken for improvement, it is necessary for the management to understand the actual situation of their own funds and take responsibility for constructing an effective monitoring process, such as clarifying the allocation of the product governance authority that controls each department. Some firms have advanced discussions to ensure the effectiveness of the product governance, and are already making efforts to improve it, such as monitoring performance after expenses and establishing systems for verifying performance from a long-term perspective. It is expected that the management of each firm will take the lead in actively conducting similar considerations and put them into practice as soon as possible.

(5) Product origination and early redemption of funds

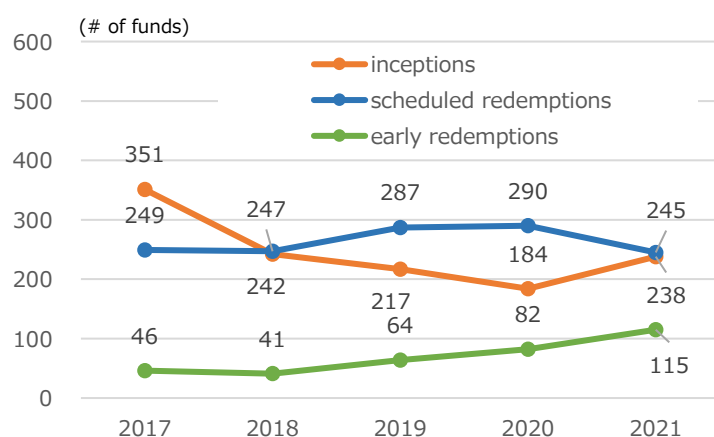
Since 2017, the number of newly launched publicly offered funds has been on a downward trend (in 2021, it increased mainly due to the enhancement of existing funds' sub-classes with different distribution periods and the launches of ESG funds). This is partly because some firms have introduced verification processes of a new fund through discussions at a product committee or a fund governance board to check whether similar products already exist, whether investment targets suit for sustainable, long-term management, and whether asset management fee rates are appropriate. In addition, with respect to poorly

performing funds or small funds that are not profitable for the firms, considering the possibility that these may potentially cause disadvantages to clients, each firm has developed an internal framework to consider early redemption of these funds. For example, some firms select candidate funds for early redemption annually based on certain criteria such as sizes of assets under management or profitability, and review whether or not to advance to early redemption by on its own judgment (Average number of early redemption at large asset management firms in 2021: 10.5 funds).

(Figure 1-10) Number of publicly offered funds (as of the end of each year)¹⁴



(Figure 1-11) Number of publicly offered funds newly launched and those redeemed at larger asset management firms¹⁵



On the other hand, the following issues were also identified in their consideration of early redemption of funds:

¹⁴ Compiled by the FSA based on data from the Investment Trust Association.

¹⁵ Compiled by the FSA based on data from QUICK Corp. and materials submitted by each firm.

- Sluggish performance of a large fund would have a more significant negative impact on customers than a small fund. However, many firms do not take into account performance after deducting expenses in the criteria for selecting candidate funds for early redemption and they tend to only focus on small funds.
- In a firm, early redemption is considered under a process different from that of a committee that evaluates performance of funds, therefore, for example, early redemption is not included into options of the measures for a fund whose performance declines for a long time.

In order to ensure that the product governance effectively works for all funds they manage, asset management firms need to develop a framework in accordance with number of funds they manage and resources they have.

3. Clear visions and strengths

(1) Setting focused investment strategies

We found some asset management firms took the following initiatives to identity their visions and strengths and made progresses toward realizing them.

- In addition to digitalizing data management and clerical work for passive management, which is their strong point, a firm further improves efficiency by consolidating mother funds, etc. As a result, also helped by stable inflows of client orders, the asset under management of their funds has increased significantly.
- Leverage the investment know-how of their own investment division, a firm enhances their ability to manage distinctive products, such as those investing in CLOs or MBS, for institutional investor clients.
- A firm has tried to manage global asset classes in-house, aiming at applying in-house fund management to all products they manage in order to commit to long-term investment. As a result, almost all major funds they manage have achieved positive alpha for the last 10 year.
- A firm consolidates resources for alternative investment within its group and promote collaboration in product development with other firms in the group. In addition to acquiring new large orders of hundreds of billions of yen-size from institutional investors for their alternative asset management product, they proceed to convert their existing high-quality products for institutional investors into publicly offered funds.
- To become a globally active asset management firm, a firm enhances sales and marketing resources overseas and acquires new and additional orders from foreign institutional investors.

In particular, with regard to independent asset management firms, the following initiatives were observed:

- Having built a successful track record with a business model specializing in fund-of-funds (FOFs) suitable for long-term dollar-cost averaging methods, a firm newly launched a self-managed fund that focuses on dialogues with investee companies, considering it as a social mission of asset management firms.
- After achieving good investment performance and expanding the scale of the firm, the CEO of a firm, also as its founder and asset manager, changed the structure of fund management teams by, for example, promoting team members to a chief fund manager, etc., in order to succeed fund management skills to younger generations for the purpose of enabling long-term investment management by the firm.
- By hiring human resources familiar with funds overseas and collecting information through alliance with private banks abroad, a firm develops a fund targeting at unique investment products which contribute to stable investment performance.

Asset management firms should differentiate themselves from others by focusing on their core competencies, acting creatively in their areas of focus, and realizing their own visions. In doing so, it is necessary for them to promote initiatives after securing necessary professional staff and developing a governance framework from the perspective of client interest first.

(2) Due-diligence of outsourced fund managers

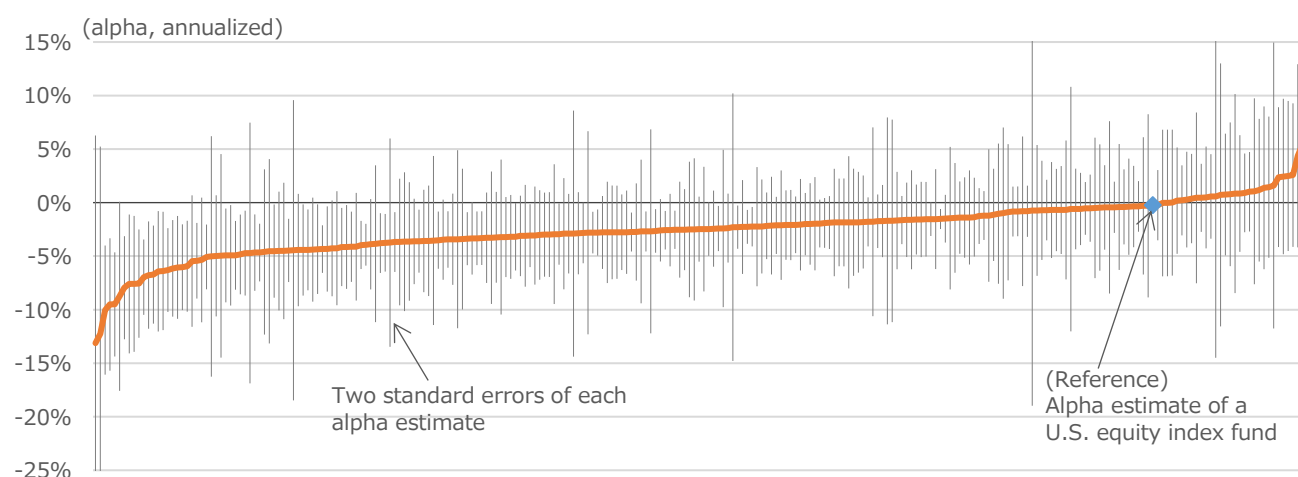
In the last five years, about half of large publicly offered active equity funds have been managed by outsourced fund managers. However, it is important for each firm to adequately allocate resources between in-house management and ability to source good external managers through clarifying its long-term strategies.

(Figure 1-12) Number of active funds managed in-house and those outsourced to external managers (Among top 100 funds by sizes of assets under management)¹⁶



As the alpha estimates of actively managed Japanese equity funds in Figure 1-6, we estimated alpha of actively managed U.S. equity funds as well, which tend to be often managed by external fund managers. As shown in Figure 1-13, none of the funds achieved a statistically significant positive alpha. In addition, we also performed the same analysis for one index fund of U.S. equity with a long track record as a benchmark. As a result, the alpha estimates of most of active U.S. equity funds were lower than that of the index fund. This indicates that investing in active funds instead of passive funds is not meaningful for U.S. equities from a statistical perspective. When considering to launch an outsourced fund of U.S. equities, firms should carefully select an outsourced fund managers and set asset management fee rates appropriately based on such a poor historical performance.

(Figure 1-13) Alpha estimates of actively managed U.S. equity funds¹⁷



During this business year, we found cases in which due diligence at the selection of an outsourced investment manager and subsequent monitoring were inadequate. In these

¹⁶ Compiled by the FSA based on "Survey on the investment performance of asset managers in Japan" (QUICK Corp., April 22, 2022).

< https://www.fsa.go.jp/common/about/research/20220421_2.html > (only in Japanese)

¹⁷ Estimated by the FSA based on data from QUICK Corp., Kenneth R. French (Dartmouth College) and the Bank of Japan.

cases, an asset management firm in Japan invested in a fund overseas managed by an external fund manager, but the firm did not perform due-diligence of the investment capabilities and performance of the external manager so that the firm was not able to even confirm whether the investment management methods promised to investors was actually conducted or not. While the firms of the cases wanted to differentiate itself from competitors by finding a unique external fund manager, they carried out the outsourcing without having an appropriate due-diligence framework in place, such as securing of personnel with sufficient knowledge and skills to fully check the status of asset management done by external fund managers in accordance with the uniqueness of assets to be invested.

Most of asset management firms in Japan face challenges to strengthen their ability to manage overseas assets. In a case of in-house management, a firm is required to have enough resources and abilities of asset management to generate returns exceeding expenses borne by investors. Similarly, in a case of outsourcing to external managers or FOFs, a firm should develop enough resources, personnel and systems to sufficiently perform due-diligence of external fund managers and continue monitoring of them. Utilizing outsourced managers is one of business models to meet with various needs of investors. However, given that the responsibility of an asset management firm which selects and monitors external managers is large, it is necessary for the firm to develop and manage products that win trusts from investors and enable them to put their money in the long term.

(3) Performance evaluation and compensation structure to realize visions

To strengthen their asset management capabilities, asset management firms implement the following initiatives in order to train and retain investment professionals, such as newly introducing or revising evaluation and compensation systems linked to investment performance, which is different from that applied to other employees in their group.

- Obtaining a specific permission from its parent group, a firm introduced an incentive-based compensation system for experienced fund managers. Deferred payments are made for its variable portion in order to align the incentives with long-term performance.
- Several firms do not take into account a size of assets under management or asset management fee income of a fund as the basis for calculating investment managers' bonuses, because these parameters do not necessarily reflect managers' skills in asset management.
- While most of the firms, on average, set about 30% of the total compensation of investment professionals as variable portion, there was a firm in which some 65% of

the total compensation of investment professionals became variable according to ranks or evaluation results. The performance measures for the variable portion of active fund managers varied by firms and by positions or evaluation results of the managers. The ratio of the variable portion linked to a quantitative measure ranged from 30% to 80%.

- While many firms set a three year evaluation period for investment performance, some firms introduced a longer, five year period.
- A firm outsourced the performance evaluation of fund managers to an external consulting firm specialized in evaluation of funds. The consulting firm evaluates a fund based on comparison with other funds, including those managed by other firms with similar investment strategies.

Each firm is staffed by not only investment professionals but also specialists in diverse areas such as product development, sales, risk management, and system administration. Asset management firms should structure a performance evaluation system which motivates all officers and employees in different divisions to prioritize client interests.

(4) Initiatives to improve operational efficiency

Some firms have taken the following actions to improve operational efficiency, mainly by the use of digital technology, in order to strengthen their competitiveness.

- A firm consolidated routine order placement operations, which had been carried out by fund managers themselves, into a new division dedicated for it and let the fund managers focus more on tasks related to investment decisions.
- The quantitative research team of a firm developed a new AI (artificial intelligence)-based model which quickly detects outliers in financial markets.
- A firm introduced an AI-powered chatbot processing frequently asked internal queries and responses.
- A firm launched a pilot fund adopting a single-party calculation framework¹⁸ where unit prices of the fund is calculated by only a trustee or a trustor and operated it on a trial basis.

While some pointed out that digitalization such as AI or an efficient use of big data has not contributed a better investment performance yet, we expect a further progress contributing for better investment results and more efficient operations.

¹⁸ Publicly offered funds in Japan usually adopt a two-party calculation framework where both a trustee and a trustor of a fund calculate unit prices of a fund and check it with each other, which has been a business practice of the industry for a long time and often criticized as a cause of high cost characteristics of domestic funds.

[Column] Thorough implementation of customer-oriented business conduct

The FSA published the "Principles for Customer-Oriented Business Conduct" (the "Principles") in 2017 and revised them in 2021. We surveyed 25 asset management firms (including some independent firms and some multinational firms) on the state of disclosures of implementation policies of customer-oriented business conduct by each firm. It revealed that 22 firms responded to the revised Principles and three did not (one of which explained the reason for non-compliance). While a few firms promote "customer-oriented business conduct" rigorously and disclose their policies etc., most of the firms' initiatives are only half way, and it is necessary for them to implement specific initiatives along with the policies and to further endeavor on clearer disclosures to clients.

Among the 25 firms, the FSA had dialogues with those particularly taking a distinctive approach from the following perspectives: (1) whether they provide information to customers in a useful and easy-to-understand manner; and (2) whether they disclose details of their initiatives that fully reflect the spirit of the Principles and specific actions that their employees should take to put the Principles into practice.

Examples of the initiatives and issues for a further development are summarized in accordance with the seven items of the Principles as follows.

(1) Establishment and announcement of policies on customer-oriented business conduct

- Number of asset management firms that have announced policies based on the "Principles": 113 / Number of the total registered asset management firms: 418 (as of February 2022)

(2) Pursuit of customers' best interests

- In order to put asset management firms' fiduciary duties (FD) into action, a firm has built frameworks for incorporate external opinions, such as by appointing independent directors and establishing an advisory committee to receive advice from external experts. Opinions from customer perspectives are reflected to improve business conduct of the firm.
- Some firms disclose performance, including investor returns, of all funds on their websites in a manner so that investors are able to compare them easily, while others highlight only information of funds that have achieved good performance.

Regardless of whether a fund performs well or not, it is necessary for firms to disclose a thorough, comprehensive information of all funds they manage.

(3) Appropriate management of conflicts of interest

- Some of asset management firms are subsidiaries of large financial groups where parent companies also tend to be distributors of fund products. In order to avoid conflicts of interest with the parent company or the distributor in the group, a couple of firms have quit double-hatting of executive positions of their parent companies by the presidents of the asset management firms. However, several firms still maintain the double-hatting which has a potential risk of conflicts of interest.

(4) Clearer disclosures of fees and other information

- Some firms eliminated a dispersion in the asset management fee rates of index funds sold through the same distribution channel and linked to the same benchmark.
- To contribute to clients' long-term asset accumulation, a firm introduced a structure where asset management fee rates gradually decrease along with increase of assets under management of funds.
- Some firms do not disclose asset management fee rates of their funds in a list by which investors can compare them at a glance on their website. Instead, investors have to check a asset management fee rate of each fund one by one by finding a PDF file of the prospectus of each fund. It may call into question whether they are seriously willing to disclose fees in a clearer way.

(5) Delivery of important information in an easy-to-understand manner

- In response to the recent situation in Ukraine, many publicly offered funds have temporarily suspended to accept applications for additional investment or cancellation. When an event that has a material impact on a fund occurs, it is important for each asset management firm to promptly deliver detailed explanations to customers on the current status and future outlook, etc.
- Given the asymmetry of information between individual clients and financial institutions, current disclosures about fees or explanations about risk of funds still need to be improved. Disclosures by asset management firms on their website or other media shall be enhanced in content and improved to be more easily understood so that the important information surely reaches to both current clients and future customers.

(6) Providing services suitable for customers

- Asset management firms should understand the current status of assets, transaction experience, knowledge, and goals and needs of end clients, and

arrange financial products and services that are suitable for the clients. However, there are still examples of product development that seems to prioritize the interests of distributors over end clients, partly because most of asset management firms do not have direct distribution channels to retail customers.

(7) Framework to appropriately motivate employees

- A firm uniquely said about the motivation of employees as "It is self-evident that all activities in the firm lead to client interests and that the smiles by all officers and employees are the source of the energies for the activities. Customer-oriented business conduct is realized by sharing and improving the values. We will enhance the values by respecting our colleagues who create values." However, on the other hand, some firms still state about employee training in a uniform stereotypical way as "We communicate this Policy, etc. to all officers and employees through training and other means in an appropriate manner."

Although the issues above were identified, we also found, through the dialogues with firms, the following initiatives in which some of departments in the firms voluntarily try implementing customer-oriented business conduct rather than waiting for actions by the top management.

- Article 1 of the Investment Trust Act declares "... to facilitate investors' investment in securities and other assets, thereby contributing to the sound development of the national economy." By considering the spirit of this Act, a firm revised its management vision. The firm will endeavor to install this vision both internally and externally to ensure customer-oriented business conduct to be performed thoroughly.
- A firm admitted that it had been unclear who their clients were, because their sales division tends to regard distributors of their funds as a customer instead of those who invest in the funds. Then, they defined all asset owners, both individuals and institutions, as "clients," and the distributors and outsourced external fund managers as "partners." The firm now discuss internally about what they can do more for their clients.
- Since the initial adaptation of the Principles, a firm has gotten involved not only its compliance department but also its front-office departments, including sales, and each department has prepared action plans to put the Principles into practice on its own responsibility. This has led to the thorough implementation of customer-oriented business conduct as part of the firm's corporate culture.
- A firm refers to their clients as "Fellows", which means a relationship where both the firm and clients work together to create values toward the same direction rather than facing with each other from opposite sides. At the same time, the firm

expects their employees to make the workplace a place of self-fulfillment, not just a place of labor. For this reason, the firm asks every employee to constantly check whether his or her values are in line with the firm's corporate philosophy, and provides opportunities for each employee to think whether his or her daily activities lead to the values that s/he truly wants to provide to the society. The firm believes the most ideal cycle is that the results of these activities lead to "fiduciary" from "Fellows" and its outcome is to be returned to employees as earnings.



II. ESG funds

1. Introduction

While ESG funds are drawing so much attention with growing interest in ESG and SDGs, asset management firms have set up ESG funds one after another. On the other hand, there are concerns that these funds claiming environmental considerations actually have different processes and may consequently be misleading to investors. This is the so-called “greenwashing”.

In general, funds in Japan aim to grow trust assets and often do not aim to create environmental or social benefits unlike so-called impact investment. In addition, asset management firms adopt various ESG-investment methods, and they do not necessarily consider ESG-factors as sources of excess returns in selecting investee companies. In some cases, they only consider ESG-factors as a part of their corporate analysis. Furthermore, there are differences between asset management firms in the consideration of ESGs factors when selecting investee companies and the depth of their subsequent engagement activities.

Against this background, the gap between the reality of various types of ESG funds and general investors' expectations for ESG funds appears to be one of the causes of the so-called "greenwashing". Therefore, it is expected that asset management firms engaging in ESG investment continue to work towards enhancing their investment processes by formulating their own clear ESG policies, while establishing the necessary organizational structure for appropriate ESG investments. In addition, asset management firms are expected to actively provide and disclose appropriate information in a consistent manner with their actual investment processes so that investors can correctly understand the content of investment products without misunderstanding, and make appropriate investment decisions by comparing them with other products.

In November 2021, the International Organization of Securities Commissions (IOSCO) published "Recommendations on Sustainability-Related Practices, Policies, Procedures, and Disclosures in Asset Management," as well as the enactment and implementation of disclosure rules (commonly known as SFDR) in Europe (March 2021), the development of guiding principles for ESG funds (July 2021) and the US SEC's proposal for fund names rule (May 2022). Foreign supervisors and regulators have also discussed and take policy actions in this field from the same perspective.

Since November 2021, the FSA has conducted a survey of 37 domestic asset management firms that handle 225 ESGs funds on their organizational structure, positioning of ESGs investments, investment strategy and processes, engagement, and disclosure. Then, from the viewpoint of protecting investors and attaining the development of sound markets, the FSA developed "Supervisory expectations for asset management firms providing ESG funds."

2. Overview of the survey

The survey covered 225 ESG funds (as of October 31, 2021) that met the following criteria. A total of 37¹⁹ asset management firms have established these ESG funds. Of the 225 funds surveyed, 172 were issued by 22 Japanese firms and 53 by 15 foreign firms.

[Scope]

- Funds labeled by QUICK Corp. based on the following conditions:
 1. Including any of the words "ESG," "SRI," "Environment," "Corporate Governance," "CSR," "SDGs," "Resolution of social issues," "Impact investment," "Women's activities," or "Human resources," or similar words as the name or nickname of the fund or "the characteristics of the fund" in the securities registration statement .
 2. Categorization on the asset management firm's website or direct request by the asset management firm
- Funds that the firms declared to be ESG funds
- Exceptions of those that the FSA has determined to be unlikely to be misidentified as ESG funds, such those without any statement of "ESG considerations" in the prospectus.
- Exceptions of one redeemed at the end of November 2021.

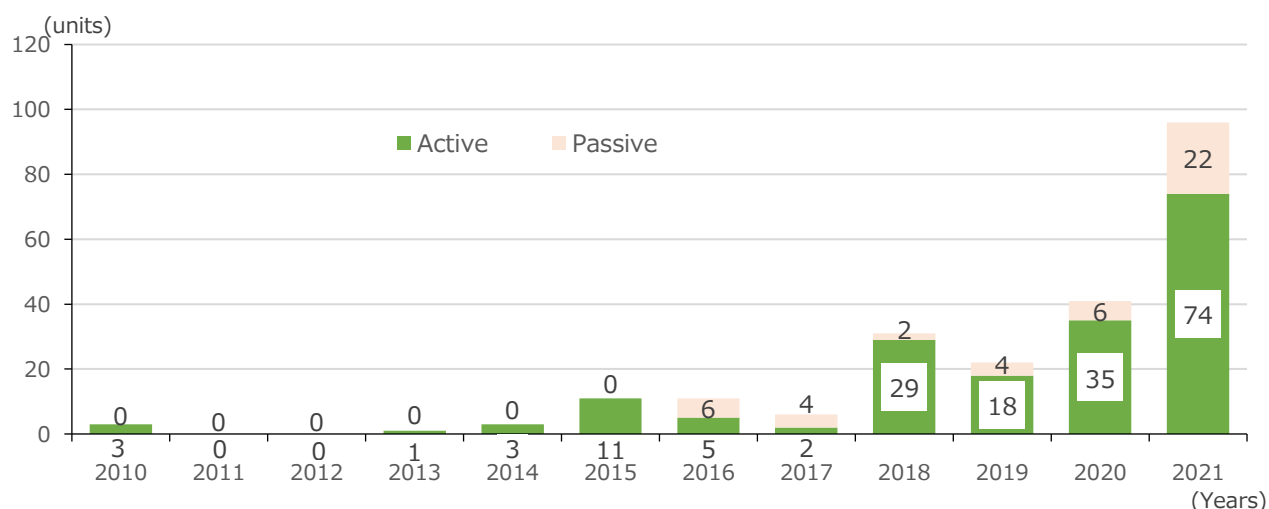
3. Background²⁰

The number of new ESG funds has been increasing with 96 (74 active funds and 22 passive funds) in 2021. This is more than double the number of the previous year (41 funds), and the growth of passive funds is particularly remarkable.

¹⁹ See Attachment 2 for a list of 37 firms

²⁰ All subsequent graphs unless otherwise noted are prepared by FSA. Also based on data as of October 31, 2021.

(Figure 2-1) Number of ESG funds newly established²¹



As of the end of October 2021, seven out of the 225 ESG funds (approximately 3%) have total net assets exceeding 100 billion yen, which are all active funds. These top seven funds accounted for 50% of the total net assets, indicating that investment funds tend to be concentrated in a few ESG funds. In addition, the total net asset value of passively managed ESG funds, at most, remains around 50 billion yen.

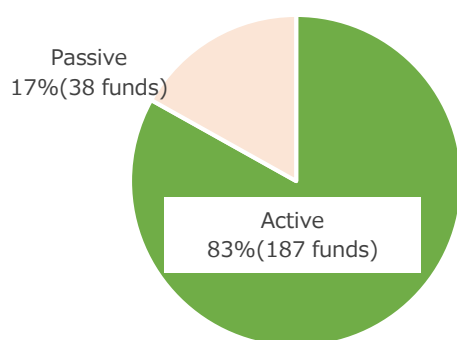
(Figure 2-2) Distribution of total net assets



Active funds account for more than 80% of all ESG funds in the survey (based on the number of funds), and the share of active funds is the same for each Japanese and foreign funds.

²¹ Aggregation is based on data extracted from the QUICK database. Reports submitted by each firm before October 2021 are also included.

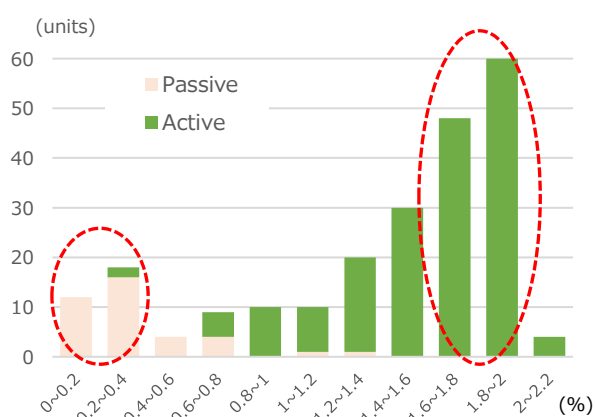
(Figure 2-3) Active / passive ratio



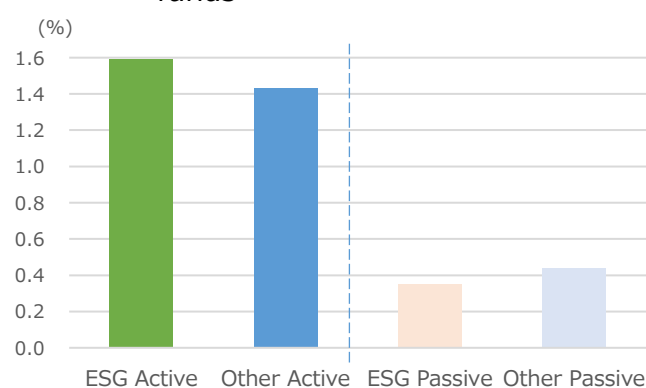
| | No. of funds | Ratio |
|----------|--------------|-------|
| Japanese | 172 | |
| Active | 141 | 82.0% |
| Passive | 31 | 18.0% |
| Foreign | 53 | |
| Active | 46 | 86.8% |
| Passive | 7 | 13.2% |

Many firms set the asset management fee ratio at 0.4% or less for passive funds and 1.6 to 2.0% for active funds. Regarding the average asset management fee ratio, ESG active funds are higher than other funds. This may reflect the fact that ESG active funds are more costly in the operational processes. On the other hand, ESG passive funds are lower among passive funds. This may be due to the fact that many ESG funds have recently been established, while passive funds as a whole become less expensive.

(Figure 2-4) Distribution of asset management fees



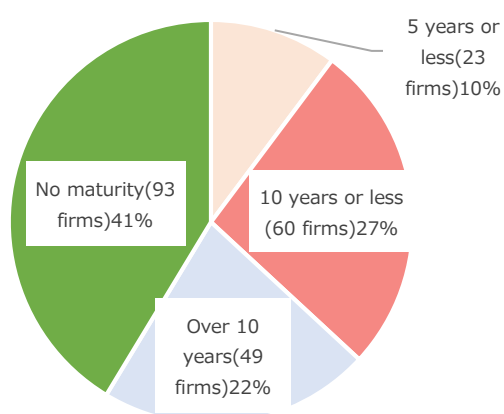
(Figure 2-5) Comparison of asset management fees between ESG funds and other funds



(Note) Simple average by funds

ESG funds with a redemption period of 10 years or less account for 37% of all ESG funds. In light of the medium to long term perspective required for ESG funds, it is necessary to explain reasonable reasons to customers for those with short redemption periods.

(Figure 2-6) Ratio by maturity



4. Practices of asset management firms

(1) Overarching principle

Many asset management firms are actively engaged in ESG-investment, positioning the pursuit of long-term returns and contributing to the development of a sustainable society as an important management issue. Specifically, we received the following responses regarding their basic views on ESG investment in this survey.

- ESG factors are an additional tool / new lens to improve returns by evaluating and identifying ESG-related business opportunities and risks that are not appropriately priced in the market.
- ESG factors, when properly addressed, can be a source of future growth for the firm and provide long-term performance advantages
- Combining "non-financial factors" with traditional financial criteria helps build a stable portfolio that delivers high investment performance over the long term.
- Inadequate treatment of ESG issues by a firm's management can lead to financial risks and reduce the long-term value of investments.
- ESG considerations do not imply "greening" all portfolios or excluding certain assets.

Given that characteristics of ESG funds is drawing attention, such as being ridiculed as "greenwashing," in order to enable customers to correctly understand the content of investment products without misunderstanding and to make appropriate investment decisions, it is expected that each asset management firms will continue to further strengthen their investment process approach and develop the necessary systems, such as providing clear explanations and disclosures in a consistent manner with the investment

process.

Specifically, while funds in Japan generally aim to grow trust assets, if a firm describe characteristics or investment process of its ESG funds stating that it takes ESG factors into account, it should improve the investment process and enhance the quality of disclosure so that it can clearly explain how the ESG factors affecting corporate values are identified and evaluated in the ESG funds, how it use ESG factors in portfolio decisions, and how engagement and the exercise of voting rights are conducted to improve ESG-related business opportunities and reduce business risks, while building the necessary organizational structure including the recruitment of personnel with expertise.

On the other hand, when ESG factors are only considered as one element of corporate analysis, the firm should not emphasize ESG and sustainability in the prospectus so as not to mislead investors as if the fund is mainly characterized by ESG (for example, a fund that identifies ESG factors as the source of excess returns and selects investees with high ESG ratings, or a fund that aims to create environmental and social impacts).

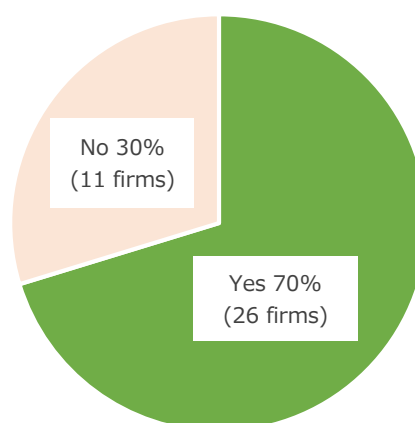
(2) Organizational structure

Each firm has various organizational structure related to ESG investment, including names. However, they have mainly set up divisions responsible for overall functions to strengthen the sustainability promotion system and divisions responsible for cross-sectional review of the investment process and engagement of each investment division.

(Figure 2-7) Main functions and roles of organizations related to ESG investment

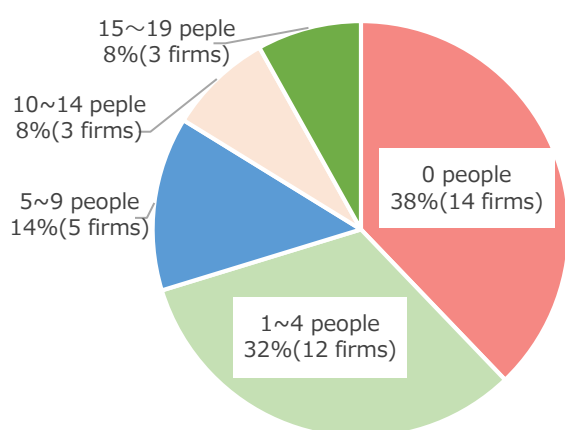
| Function | Overview |
|----------------------------|--|
| ① overall function | <ul style="list-style-type: none"> Oversee all processes, including strengthening the sustainability promotion system and enhancing ESG investment methods |
| ② Research | <ul style="list-style-type: none"> Acquisition and analysis of ESG information |
| ③ Planning and Development | <ul style="list-style-type: none"> Develop investment solutions and strategies Establish a system to implement ESG and responsible investment |
| ④ Support | <ul style="list-style-type: none"> Advice to investment and sales departments |
| ⑤ Stewardship | <ul style="list-style-type: none"> Engagement and voting |
| ⑥ Monitoring | <ul style="list-style-type: none"> Review and discuss implementation of ESG integration and engagement Ensure consistency of investment process across divisions |
| ⑦ Independent evaluation | <ul style="list-style-type: none"> Reporting and deliberation of ESG related activities on a committee where majority of members are independent outside experts |

(Figure 2-8) Whether there is a department or team dedicated to ESG



However, some asset management firms established a Responsible Investment Office to promote ESG investment, but there are cases in which all of members are double-hatters with other non-ESG departments. Or some of other firms do not have a dedicated department/team or ESG specialists at all. Firms shall put enough resources to implement ESG investment. In addition, another respondent stated "there is variation in skills and awareness among portfolio managers in the firm, and it is a challenge to establish an organizational structure, including the recruitment of appropriate human resources." Effective systems should be put in place to implement ESG investment, such as by strengthening the sustainability promotion system, establishing a department responsible for enhancing ESG investment methods, and recruiting ESG experts.

(Figure 2-9) ESG Experts²²



Each firm has its own internal common platform or database to share information among each team, improve investment decisions, and ensure consistency in investment processes. Information posted on the platform includes, for example, analysis results by in-house analysts (ESG ratings, ESG scores), ESG ratings and quantitative data from ESG ratings and data product providers, dialogue activities in engagements (content of ESG-related discussions with management and company responses), and records of voting results. The results of the exercise of voting rights may also be recorded.

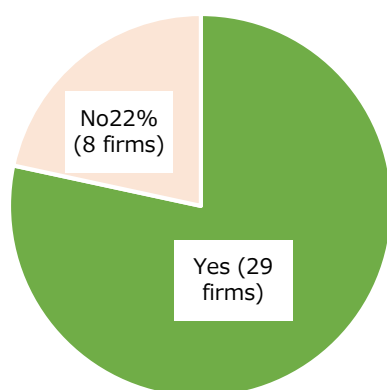
The reason why firms recognize that cross-organizational information sharing is useful includes: "Useful as an important source of information for decision making on individual investment decisions," "Useful for the investment team's own verification since information obtained from internal and external resources can be compared," "Useful for organizational actions such as follow-up and reporting on specific issues," "Available for confirmation of ongoing progress toward goals," and "Available for ensuring consistency in the investment

²² ESG experts are defined as dedicated staff who spend 90% or more of their time on ESG-related work.

process by linking investment decisions with subsequent exercise of voting rights."

On the other hand, challenges to improving the common platform / database include improving the ability to utilize data (assessing the appropriateness of information and increasing the number of data scientists), improving convenience (improving access to databases, implementing progress management functions, linking with financial and ESG data), and ensuring data reliability due to differences in disclosed data among companies and the proliferation of ESG data providers.

(Figure 2-10) Existence of a common platform for ESG information



(3) ESG integration

In general, approximately 70% of asset management firms make efforts to identify material ESG factors that will affect future corporate value. In this regard, the SASB (U.S Sustainability Accounting Standards Board) developed standards for disclosure and established sustainability issues that are likely to affect the financial performance of companies in each industry.

Under these circumstances, in ESG investment, about 70% of asset management firms strive to identify important ESG factors that will affect future corporate values. In addition, as it is difficult to conduct comprehensive analysis of a wide range of ESG factors, there are also cases where a firm lists up potential materiality in advance (development of materiality maps) and analyzes.

(Figure 2-11) Factors in the materiality map (examples)

| | |
|--------------------|--|
| Environment | Climate change, Natural resources, Water resources, Pollution and waste, Biodiversity, Circular economy |
| Social | Human rights and community, Diversity, Human resources, Health and safety, Educational disparities, Supply chain |
| Governance | Corporate action, Board composition and evaluation, Corruption prevention, Fairness |

Some firms use the SASB materiality map as a starting point for their ESG analysis and supplement their ESG assessments through their own researches, while others develop their own materiality maps. As for the materiality map, some firms said, "Materiality maps can be used as a tool for engagement with investee companies" "In order to complement the analysis of multiple investment teams in the firm, the responsible investment team uses the materiality map as to ensure horizontal consistency. Some pointed out the advantages and usefulness of the system.

On the other hand, some firms did not necessarily establish a systematic framework such as a materiality map, but prioritizes or weights ESG evaluation factors set by themselves, while others do not formulate a uniform materiality map and leave it to the judgment of analysts in order to avoid a formal evaluation because important ESG factors for individual companies differ depending on their business model and growth stage.

Approximately 80% of asset management firms utilize their own ESG scores in their ESG assessments, but their designs vary widely depending on factors such as the use of ESGs / data product providers, the number of evaluation factors, allocation of points, industry weighting, and how analysts revise the design.

Companies that use their own ESG scores say, "They are useful for screening and portfolio optimization." "It can serve as objective evidence for companies to deepen their understanding of ESG issues and increase the depth of engagement." "For more effective ESG integration, it will help function as a common language for analysts, ESG experts, and fund managers to discuss." Also, firms are reviewing their ESG scores from time to time, including reviewing the number of evaluation stages, updating evaluation factors, and reducing the dispersion of evaluations by fund managers.

(Reference 1) Own ESG scores framework in each asset management firm (examples)

- (Firm A) 36 evaluation factors, consisting of common factors for all industries and industry specific factors, are established. These are weighted based on the characteristics of each sector, and scores from multiple ESG ratings providers. Analysts conduct qualitative checks and revise the scores as necessary.

(Firm B) Ratings are calculated by combining data from ESG ratings and data product

providers, and are weighted based on the characteristics of each sector. ESG ratings are assigned to approximately 10,000 companies, ranging from 0 (lowest) to 10 (highest).

(Firm C) 143 evaluation factors are defined for each E/S/G/R (Risk Management) area and rated on a scale of 2 to 5, with quantitative points assigned. In addition, points are deducted from the average for each E/S/G/R area when the potential investee is involved in misconduct.

(Firm D) Each ESG factor is rated at 100 points for each question in the questionnaire. Next, ESG allocation is adjusted according to industry type and company size, for a final total of 300 points. For information on corporate scandals, the score is downgraded by -25/-50 points and the company is immediately excluded from the list of investment candidates in light of the seriousness of the information.

(Firm E) We evaluate companies on a 5-point scale for ESG factors based on relative comparisons within the same sectors. The evaluation axis is based on whether the company's efforts contribute to the enhancement of corporate values or whether they damage corporate values. For E and S, opportunities and risks are assessed separately. In addition, in order to evaluate the disclosure of information, we deduct points on those companies that do not disclose information.

(Reference 2) Weighting in own ESG scores

- Some asset management firms do not assign weights to each sector in their own ESG scores because investee companies vary widely in their business activities, and even a company may be in multiple industries. On the other hand, other firms assign weights to investee companies from the perspective of reflecting the sensitivity of each sector to ESG factors and the noteworthy materiality of investee companies, which influences their performance, differs from sector to sector.
- The weighting approach reflects each firm's view, for example, as follows :
 - ✓ Place greater emphasis on environmental issues related to energy production and management in the manufacturing sector such as the automobile industry, the energy industry, and the electric power and gas industry. (Example) E : S : G = 50 : 30 : 20
 - ✓ It is important for food and beverage companies how to control water consumption and treat wastewater. (Example) E : S : G = 50 : 30 : 20
 - ✓ In the information and telecommunications industry, which requires advanced skills and advanced technology, social issues such as employee satisfaction and retention rates are important. (Example) E : S : G = 10 : 50 : 40
 - ✓ In the case of banks and other financial sectors, governance issues such as board structure, corruption, bribery and instability are the main concern. (Example) E : S : G

= 10 : 40 : 50

- ✓ In companies dealing with people, such as the retail industry, diversity and other human capital matters are of high importance. (Example) E : S : G = 20 : 50 : 30

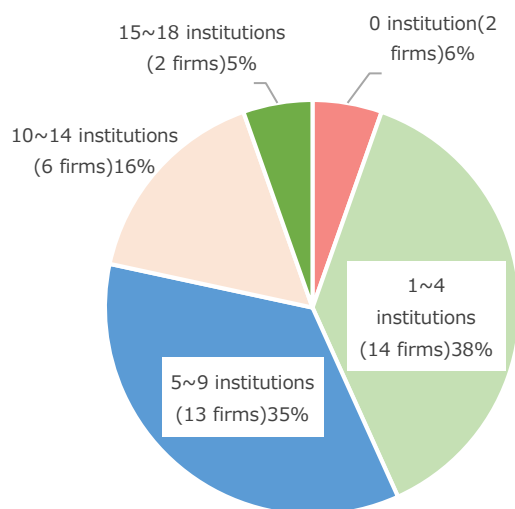
In order for ESG analysts and investment teams to accurately share the details and reasons of ESG evaluation of individual companies, and appropriately estimate corporate values and engage with companies, a firm should not solely rely on fund managers' discretions but also take systematic measures to ensure consistency and continuity as an organization. When considering ESG, it is necessary to develop a framework for effectively analyzing and understanding potential business opportunities and risks that may affect corporate values, such as by developing and enhancing an evaluation framework that utilizes their own ESG scores, with the aim of identifying important ESG factors in investee companies.

(4) ESG ratings and data product providers

The need for services provided by ESG ratings and data product providers is increasing due to the wide range of ESGs factors and the fact that the firms have to rely on estimates due to insufficient corporate disclosure. Approximately 60% of asset management firms use five or more ESG ratings and data product providers for corporate research and analysis. Specifically, MSCI and Sustainalytics are the most frequently used platforms, followed by ISS, Bloomberg, and CDP.

ESG ratings and data product providers say, "As a recent trend, we have received an increasing number of asset management firms' inquiries about individual data, not just to gather information, but from the perspective of considering how to use it in their own investment processes. The types of data they are interested in are also diversifying beyond carbon emissions. It can be inferred that asset management firms become more and more aware of the importance of data.

(Figure 2-12) Number of uses of ESG ratings / data product providers used



(Figure 2-13) Top 5 ESG ratings and data product providers used by asset management firms

| Institution | No. of firms |
|----------------|--------------|
| MSCI | 23 |
| Sustainalytics | 23 |
| ISS | 20 |
| Bloomberg | 18 |
| CDP | 12 |

(Reference 3) Major individual data used by each firm (examples)

- Carbon emissions, carbon footprint, and carbon intensity
- Data related to water for cooling and processing, volume of waste and waste to be incinerated, external costs of pollutants released into the soil, and air pollution
- Ratio of female employees, ratio of female managers, and ratio of female directors and executives in the diversity area
- Ratio of outside directors and independent directors on the board of directors

However, it has been pointed out that the ESG evaluations provided by each ESG ratings and data product providers have a low correlation due to differences in evaluation methods, and that the evaluations for the same company differ significantly. In this regard, research²³ is underway to attempt to resolve issues by focusing on evaluation factors, measurement indicators, and the weighting of each factor as the main variable factor in evaluation results. In addition, with regard to individual data provided by ESG ratings and data product providers, even GHG (greenhouse gas) emissions, which is one of the most widely used data, has still issues such as insufficient corporate disclosure and lack of global measurement methods, which force firms to rely on estimated values in many areas.

In order to confirm the accuracy and quality of such ESG assessments and data, some asset management firms verify the organizational structure of ESG ratings and data product

²³ MIT Management Sloan School : Aggregate Confusion Project Scope
<<https://mitsloan.mit.edu/sustainability-initiative/aggregate-confusion-project>>

providers (number of staff, experience, capability to provide information according to customer needs, and legal compliance system), the scope of companies surveyed, and the transparency and quality of assessment methods by comparing other companies in the same industry. In addition, some asset management firms actively conduct quality control through discussions, such as asking questions and pointing out issues for improvement to ESG ratings and data providers as part of the verification process.

(Reference 4) Examples of verification of ESG ratings and data product providers

- Based on the information obtained through the engagement, we recognized that the evaluation of the governance of Company X by ESG rating and data product provider A was incomplete. We therefore expressed our opinion to provider A that the evaluation should be reconsidered.
- ESG rating and data product provider B's report on Company Y included matters for which Company Y was not to be blamed. The findings by provider B was completely different from the company's perception. Upon checking with provider B, it was found that communication with the company was basically done by e-mail, and that only 20-30% of replies from the company to provider B were received. We urge the provider to improve the issues, including communication.

On the other hand, some asset management firms present and collect questions to ESG ratings and data product providers, but do not scrutinize the content, and they do not examine the appropriateness of the providers' ESG ratings because they use them only as a reference, and that they do not discuss the evaluation of individual companies with ESG ratings and data product providers. This indicates that they do not conduct due diligence on ESG ratings and data product providers.

Although issues have been pointed out with regard to the transparency of evaluation methods and the quality of data, asset management firms using ESG evaluation and data should appropriately review the quality of service, it is important to use ESG ratings and data product providers for in-depth corporate surveys and analyses. In addition, companies should explain and disclose the status of use and verification of ESG ratings and data product providers in order to contribute to constructive dialogue with investee companies as they disseminate information on their ESG initiatives (utilizing sustainability reports, etc.).

(5) Stewardship activities

Engagement and exercise of voting rights play an important role as one of the ESG

investment methods that are used in conjunction with ESG integration.²⁴ Many asset management firms recognize the significance of engagement in active investment as follows, and are working to improve corporate values while managing milestones (progress management).

- Deepen understanding of investee companies by discussing their businesses and management strategies, as well as their ESG-related business opportunities and responses to business risks.
- An opportunity to build long-term values by providing their views and guidance on ESG factors to investee companies.
- Encourage companies with significant deficiencies in the management of ESG factors to align their ESG policies, practices and disclosures with established industry best practices.
- Providing feedback on the exercise of voting rights and communicating expectations for the next business year and beyond allows them to share with investee companies the perspective of creating long-term corporate values.

(Figure 2-14) Milestone management (example)



In addition, some companies consider strengthening engagement activities based on more detailed milestone management toward active engagement, or having deep dialogues with investee companies whose issues have been centered on financial information analysis in collaboration with passive investment teams that analyze companies over the medium to long term.

²⁴ “Japan’s Stewardship Code” (Updated on March 24, 2020)

Guidance1-1. Institutional investors should aim to enhance the medium- to long-term return on investments for their clients and beneficiaries by improving and fostering investee companies’ corporate value and sustainable growth through constructive engagement, or purposeful dialogue, based on in-depth knowledge of the companies and their business environment and consideration of sustainability (medium- to long-term sustainability including ESG factors) consistent with their investment management strategies.

When aiming to improve corporate value over the medium to long term by considering ESG factors in the investment process, stewardship activities provide a valuable opportunity to discuss sustainable business models for investee companies and to communicate their ideas. There are various approaches to investment strategies and companies with high ESG ratings may be selected as potential investees. However, for example, even a GHG-emitting company with a low current ESG rating may also be selected as a result of their assessment that the expected share price of a company may be considered undervalued, even after taking into account the cost of capital investment and other factors associated with business restructuring, if its plans to shift to clean energy and decarbonization seem to be feasible,. In some cases, In particular, such investment strategies place greater emphasis on the role of stewardship activities to enhance corporate value.

When asset management firms take an investment strategy that emphasizes stewardship activities, the firms should proactively conduct stewardship activities to achieve corporate value growths by improving ESG-related business opportunities and reducing risks identified at the time of investment through corporate analysis and research.

In particular, in the area of climate change, the transition to decarbonization (transition) has become an issue, particularly in industries. Asset management firms are expected to engage in more active and continuous stewardship activities to promote such transitions if they position climate change as ESG issue to be addressed.

(6) Disclosure

While some firms prepare sustainability reports and responsible investment reports and explain in detail their basic approach to ESG investment, ESG integration, engagement policies, and specific examples, others do not make any such efforts at all and only focus on organizing their own policies and approaches as issues to be addressed.

With regard to individual ESG funds, some ESG funds indicate that they select investees from an ESG perspective and others claim that they invest in companies that contribute to the SDGs with themes such as the environment, medical care and health in the section of "Fund Characteristics" and "Investment Process" of the prospectus. However, compared to the descriptions in prospectus of some European ESG funds that mention methods such as stages, specific criteria, and scoring to narrow down the investment universe, Japanese ESG funds should improve descriptions in more detail.

In addition, it is expected that the firms will disclose continuously assets in ESG funds in their monthly reports or investment reports. However, many firms refer to the name of top 10 investees in a fund and their ESG related activities at best. It is difficult to understand how investment based on the investment process that considers ESG described in the prospectus leads to the growth of trust assets that is the purpose of the fund.

As a result of selecting investees with ESG considerations based on the investment process described in the prospectus, the firms should carefully explain to clients (investors) "how they currently assess the corporate value of investee companies in light of ESG factors," "what kind of engagement and voting rights they conduct to enhance corporate values in light of ESG factors of the investees, and the future policy." To this end, the firms should make efforts to enhance disclosure, not only in management reports and monthly reports, but also through the use of other media. In particular, when funds are named "ESG," "SDGs," "Impact," etc., they should explain and disclose more clearly how the product meets the characteristics indicated by the name, so that customers do not misunderstand the purpose of the name.

Some asset management firms recognize the importance of such disclosure, and state that "the content of the monthly report should be linked to the annual report so that it can be read in conjunction with the annual report" "we enhance the content of the investor reports, including disclosure of the status and results of engagements tied to specific investment strategies" "we enhance the content of actual engagement case studies."

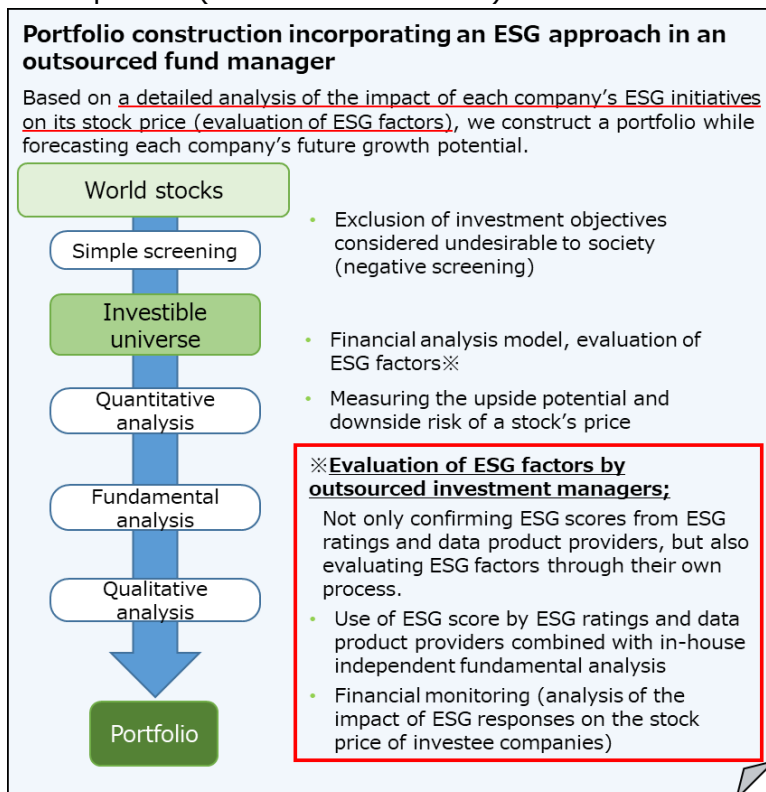
However, none of the asset management firms in this survey provides sufficient disclosures in light of the above points. Asset management firms should appropriately provide information and enhance disclosure in a consistent manner that conforms to its investment process, in order for investors to correctly understand the details of investment products without misunderstanding and make appropriate investment decisions by comparing them with other products.

(Figure 2-15) Example of Disclosure Documents (1) [XXX Fund (Firm A)]²⁵

Although the "XXX Fund" organized by the firm A largely introduces the ESG approach of the outsourced investment managers in the prospectus, the firm A insists that the fund is not an ESG fund. Therefore, they do not plan to strengthen the disclosure for sales materials and periodic disclosure.

²⁵ The FSA prepare based on actual cases.

<Prospectus (Investment Process)>



In addition, the monthly report contains only the names of the top 10 companies in the portfolio and a brief description of the future investment policy, which can be applied to any industry. For investors, there is a lack of explanation or information on why the firm expect these companies to grow over the medium to long term.

<Monthly Report>

● Top 10 stocks

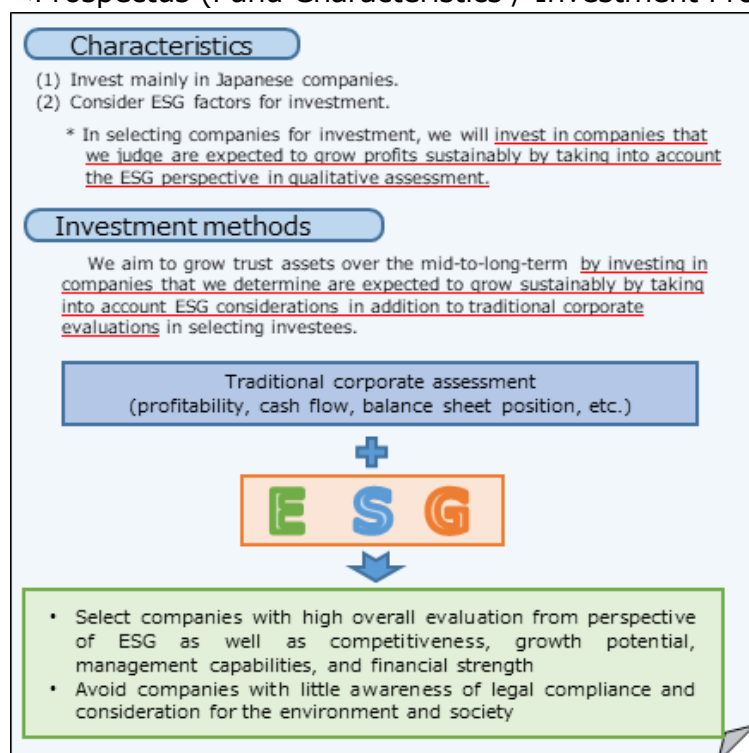
| | 銘柄 | Country | 業種 | Ratio |
|----|-----------|-------------|-----------------|-------|
| 1 | AAA LTD | US | Wholesale Trade | 5.1% |
| 2 | BBB CORP | Netherlands | Machinery | 4.9% |
| 3 | CCCC CORP | US | Materials | 4.6% |
| 4 | DDD LTD | Canada | Fertilizer | 4.5% |
| 5 | EEE PLC | UK | Retail Trade | 4.3% |
| 6 | FFF PLC | UK | Marine product | 4.0% |
| 7 | GGG PLC | Ireland | Food Retailing | 3.8% |
| 8 | HHH SA | France | Materials | 3.6% |
| 9 | IIII INC | US | Machinery | 3.4% |
| 10 | JJJ LTD | US | Agriculture | 3.4% |

【Future investment policy】
 There are various investment opportunities against the backdrop of technological developments that enhance the convenience of the XX industry. Our policy is to invest in companies that benefit from changes related to XX, conduct ESG evaluations, and have the mid-to-long-term growth potential.

(Figure 2-16) Example of Disclosure Documents (2) [YYY Fund (Firm B)]²⁶

Although the firm B adds "ESG" to the fund name of the YYY Fund and state in the prospectus that it takes into account ESG perspectives and invests in companies that it judges to have sustainable profit growth potential. However, there is not enough information for investors to understand the path towards improving corporate value, and the explanation is abstract.

<Prospectus (Fund Characteristics / Investment Process)>



The monthly report simply provides an overview of the top 10 companies in the portfolio and comments on them. The content of the report can be applied to other companies as well. It is difficult for investors to understand how investments based on ESG investment processes lead to the growth of trust assets (the purpose of the fund).

<Monthly Report>

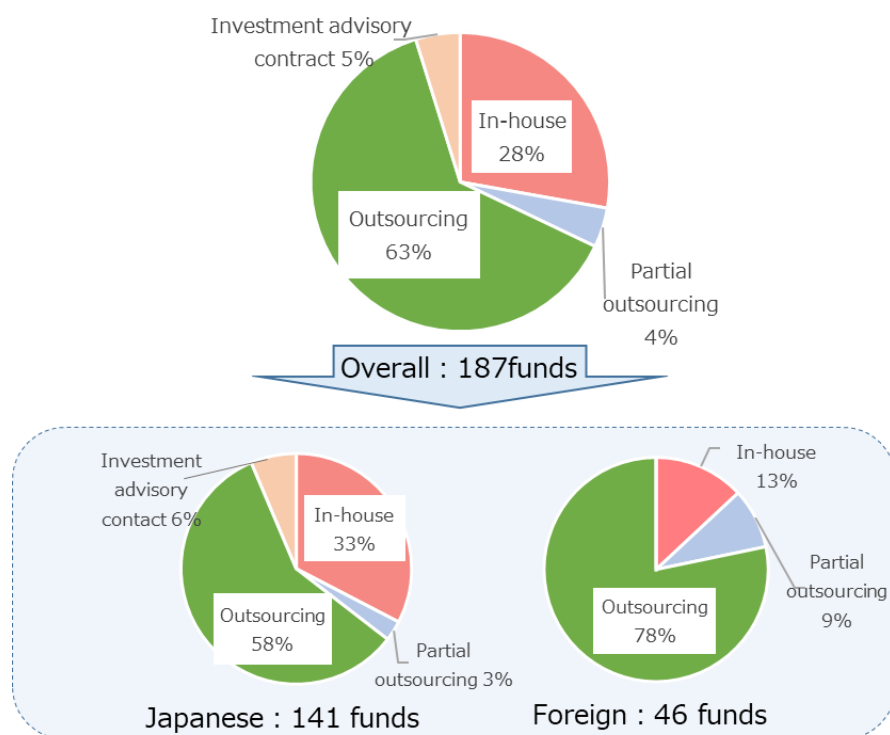
| | Name of company | Industry | Ratio | Comments |
|---|-----------------|----------------------|-------|---|
| 1 | AAA group | electrical equipment | 4.9% | Making efforts to create sustainable social value from a long-term perspective in various business areas such as <u>finance and electronics.</u> |
| 2 | BBB HD | financial business | 4.6% | A large company that appreciates its management ability to grow overseas business through M & A. We also <u>expect further shareholder returns going forward.</u> |
| 3 | CCC Transport | Transport | 4.5% | A manufacturer providing products to railway companies around the world, <u>offering a variety of products for locomotives and passenger cars.</u> |
| 4 | DDD Energy | Utilities | 4.3% | A utility holding company that provides electricity services in the United States and also <u>sells natural gas.</u> |
| 5 | EEE Group | financial business | 4.0% | A financial group with growth potential through international operations. <u>Strengthen stakeholder engagement functions by inviting external advisors.</u> |
| 6 | FFF Service | Utilities | 3.8% | A utility company that <u>owns and operates an electricity transmission network</u> in the UK and the US. |

²⁶ The FSA prepare based on actual cases.

(7) Outsourcing

Approximately 70% of the ESG funds subject to the survey outsource all or part of their investment management on a unit basis.

(Figure 2-17) Ratio of outsourcing of investment management in active ESG funds



Even in cases where outsourcing is used (including cases in the form of FOFs and investment advice), from the viewpoint of fulfilling its fiduciary responsibility to investors (customers), an asset management firm should check and understand the management structure of the outsourced investment manager, investment strategies (investment methods and management methods), management performance, etc., with appropriate frequency and depth, as in the case of in-house investment, from the viewpoint of fulfilling the fiduciary's responsibility. In addition, they should promote the development of systems to confirm and understand the management systems of outsourced investment managers, and provide accurate information to customers according to the characteristics of products.

This survey reveals that many asset management firms confirm the actual status of their outsourced investment managers' operations through checking materials prepared by them, holding regular meetings, sending questionnaires, and checking the status of accounts at the trustee (trust bank). In some cases, the firms use their own questionnaire to confirm the details of the investment system including number of employees, years of business experience, compensation structure, whether or not the firm had signed the PRI (Principles

for Responsible Investment), investment strategies for each individual fund, investment examples, and so on. However, the depth of the questions varies among the firms, with some firms not including the management structure in the question items and others asking only general questions about the investment strategy adopted by the firm.

(Figure 2-18) Questions / confirmations regarding outsourcing (examples)

| | |
|-------------------------------|---|
| Investment resources | number of ESG experts, year of work experience, whether there is a department or team dedicated to ESG, linking ESG to compensation |
| Investment strategy | Definition of ESG, data used, process for integrating ESG factors (criteria for ESG evaluation, materiality evaluation, methods for measuring ESG risks, methods for incorporating ESG factors into performance forecasts), collaboration with ESG ratings and data product providers to improve research capabilities |
| Investment performance | daily trading data, daily confirmation of portfolio |
| Engagement | dialogue with investee companies, investment policy for companies with identified problems with ESG factors |

In order to timely monitor the investment status of outsourced investment managers, some firm enhances the quality of reporting content compared to that of a regular fund outsourcing contract. Even in the case of FOFs format, some firms concludes contracts with the outsourced investment managers to obtain daily stock information and detailed ESG-related analysis data.

However, some asset management firms are only aware of the content of materials from the outsourced investment managers. In addition, other firms do not fully understand the ESG investment strategy of the outsourced investment managers or the status of engagement activities, saying "We do not specifically understand it" or "We guess engagement activities would be implemented as appropriate."

Note that asset management firms need to carefully consider the use of outsourced investment managers if the firms do not have its own approach of ESG investment and have considerable room for improvement on the investment process as a whole, because it is difficult for them to properly manage outsourced investment managers from the viewpoint of fulfilling the fiduciary responsibilities.

~ Supervisory expectations for asset management firms providing ESG funds ~

In cases where an asset management firm states, for example, "ESG factors are taken into account" as an explanation of the characteristics and investment process of ESG funds it provides, the FSA expects that the firm will improve the matters described in each of the following items.

(1) Overarching principle

The investment process and approach should be further strengthened on a continuous basis, and clear explanations and disclosures should be made in a consistent manner based on the investment process so that investors can make appropriate investment decisions.

- ✓ While building the necessary organizational structure with sufficient human resources with expertise, the investment management firm should work to enhance its investment practice and ensure better disclosure so that it can clearly explain how it identifies and evaluates ESG factors that affect corporate value, how it uses them in portfolio decisions, and how it engages and exercises voting rights to improve ESG-related business opportunities and reduce business risks.
- ✓ When considering ESG factors only as one element of corporate analysis, the firm should not emphasize ESG and sustainability in its disclosure documents to prevent investors from misleading as if the main characteristics of the funds are ESG (for example, a fund that identifies ESG factors as the source of excess returns and selects companies with a high ESG score, or a fund that aims to create environmental and social impact).

(2) Organizational structure

A firm should develop effective systems for ESG investment, including the establishment of a department responsible for strengthening the sustainability promotion framework, enhancing ESG investment methods, and applying ESG experts.

(3) ESG Integration

In order for ESG analysts and investment teams to accurately share the details and reasons of ESG evaluation of individual companies, and appropriately estimate corporate value and engage with companies, fund managers should not rely solely on their own judgment, but also should take systematic measures to ensure consistency and continuity as an organization.

- ✓ In integrating ESG considerations, a framework for effectively analyzing and understanding potential business opportunities and risks that affect corporate value

should be developed, such as by developing and enhancing an assessment framework that utilizes ESG scores, with the aim of identifying material ESG factors in investee companies.

(4) ESG ratings and data product providers

In order to conduct in-depth corporate research and analysis, appropriate verification of ESG ratings and data product providers should be conducted from the viewpoint of ensuring the accuracy and quality of ESG evaluations and individual data provided by the providers.

- ✓ Organizational structure of ESG ratings and data product providers (number of staff, experience, ability to provide information according to customer needs, and compliance structure), the scope of the company subject to the survey, and the transparency and quality of the evaluation method should be verified in comparison with other ESG ratings and data product providers. Quality control should be actively performed through discussions with the providers, asking questions or suggesting what they should improve.
- ✓ While disclosing its ESG initiatives (for example in sustainability reports), a firm should explain how to use and verify ESG ratings and data product providers to contribute to constructive dialogue with investee companies.

(5) Stewardship activities

In accordance with its investment strategy, a firm should proactively conduct stewardship activities to achieve corporate value growths by improving ESG-related business opportunities and reducing business risks identified at the time of investment.

- ✓ In cases where a firm positions climate change as an ESG issue to be addressed, FSA expects that the firm conducts engagement and exercise of voting rights in more active and continuous manner from the perspective of encouraging the transition to decarbonization, mainly in industries with large amounts of greenhouse gases.

(6) Disclosure

In order for investors to correctly understand the details of investment products without misunderstanding and make appropriate investment decisions by comparing them with other products, appropriate information provision and disclosure should be promoted in a consistent manner that conforms to its investment process.

- ✓ A firm should strive to enhance disclosure of its policies and initiatives by, for example, explaining its basic ESG approach, ESG integration, engagement policies and specific examples, in its sustainability report or responsible investment report.
- ✓ The characteristics and investment process of ESG funds should be adequately

disclosed in the prospectus.

- ✓ Where a firm invest in a company considering ESG factors based on the investment process described in the prospectus, efforts should be made to enhance disclosure, not only through investment reports and monthly reports, but also by using other documents, so that the firm can explain in detail "how the corporate value of investees is currently evaluated based on ESG factors" and "what engagement and voting rights are exercised toward improving the corporate value of investees based on ESG factors, as well as future policies."
- ✓ In particular, when assigning names such as "ESG," "SDGs," and "impact" to the funds, it is necessary to explain and disclose more clearly how the products meet the characteristics implied by the names so that customers do not misunderstand the meaning of the names.

(7) Outsourcing

From the viewpoint of fulfilling fiduciary responsibilities, outsourced investment managers should be appropriately managed and accurate information should be provided to customers in accordance with the characteristics of products.

- ✓ Even in cases where outsourcing including fund-of-funds type and investment advisory is used, as in the case of in-house investment, it is necessary to confirm and understand the outsourced managers' investment structure, investment strategies (investment methods and management methods) of invested assets, investment performance, etc., with appropriate frequency and depth.
- ✓ A system for appropriate management of outsourced investment managers should be established.

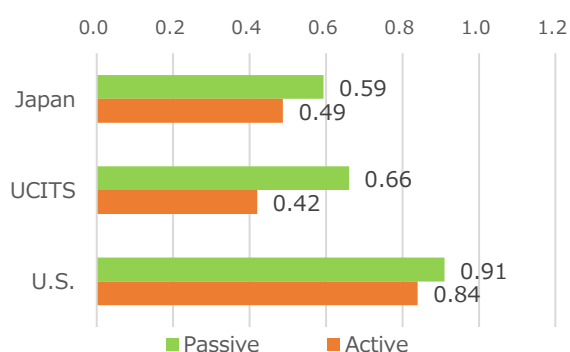
III. Other Issues

1. Publicly offered funds

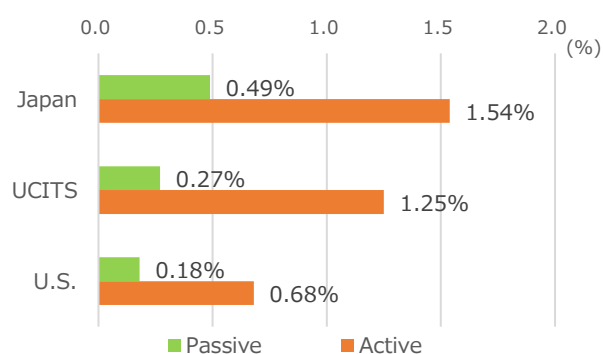
(1) Global comparison of Sharpe ratios and expense ratios²⁷

U.S. mutual funds have an advantage in both the Sharpe ratio and the expense ratio²⁸ over funds in Japan and Europe (UCITS funds). A comparison between passive funds and active funds in Japan, Europe, and the U.S. reveals that the Sharpe ratios of passive funds are higher than those of active funds in all of the three regions. The expense ratios of passive funds are lower than those of active funds in all of the tree regions.

(Figure 3-1) Global comparison of Sharpe ratios²⁹



(Figure 3-2) Global comparison of expense ratios²⁹



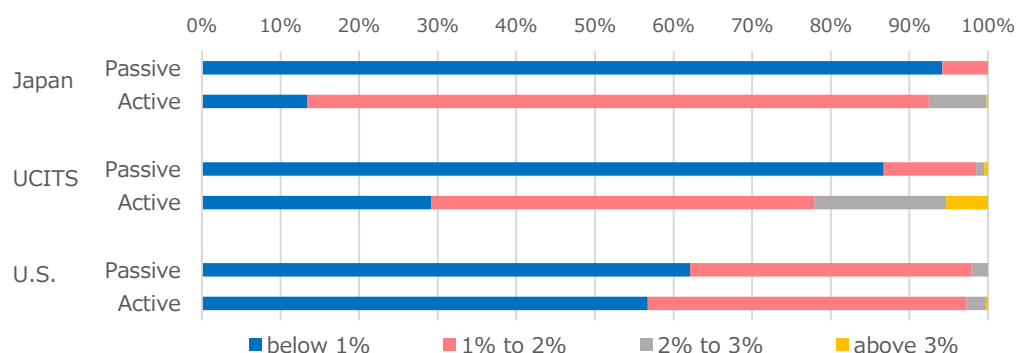
²⁷ Funds subject to the comparison are publicly offered investment trusts in Japan, and U.S.-based mutual funds and UCITS (excluding ETFs) that have been under management for five years as of the end of 2021. UCITS are funds established and managed in accordance with EU laws. Figures 3-1 and 3-2 show the weighted average using the initial (December 2016) balances of each fund. Figure 3-3 shows the distribution by the number of funds.

²⁸ A measure of the ratio of asset management fees and other expenses to the average asset balance of a fund.

²⁹ Compiled by the FSA based on the data from by QUICK Corp. and Ibbotson Associates Japan, Inc.

In the U.S., funds with an expense ratio of less than 1% account for the majority of active funds, while in Japan, funds with an expense ratio of 1% or more but less than 2% account for the most of them. On the other hand, as for funds in Europe (UCITS funds), expense ratios vary widely. We consider that it is because UCITS funds are launched to various countries in Europe where market rates of expenses differ with each other due to different competitive environment in each country.

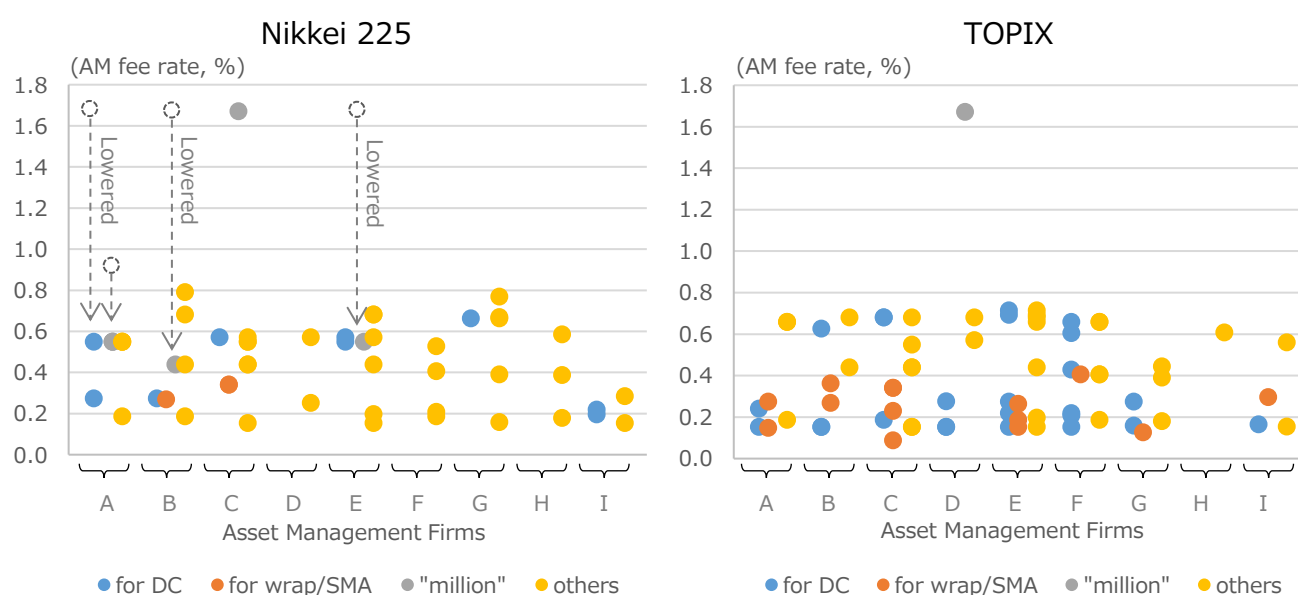
(Figure 3-3) Comparison of distributions of expense ratios²⁹



(2) Fee dispersion among passive funds linked to same indices

Among passive funds linked to a same benchmark, there is a dispersion in their asset management fee rates still even within those managed by a single asset management firm and distributed through a same channel. However, a couple of asset management firms have lowered asset management fees of some of their funds in order to eliminate the dispersion. There are also a few firms which currently engage in discussions with distributors to lower the fees and eliminate the dispersion. From a customer-oriented perspective, it is expected for the entire industry, including not only asset management firms but also distributors and trust banks, to review the fee structure of their passive funds and to revise the fee levels to appropriate levels.

(Figure 3-4) Asset management fees of index funds by asset management firms³⁰



(3) Increase of funds with specific maturities

Publicly offered funds which invest in equities are usually expected to contribute to long-term asset formation by consumers. However, actually, these funds in Japan are often launched with relatively short maturities, such as 5 years. Some asset management firms justify this practice, saying "It is difficult for us to make a decision of an early redemption of a fund arbitrarily, because some investors may not prefer it or coordination with distributors, which incurs additional costs by an early redemption, tends to be very difficult. Instead, we set a relatively short maturity date of a fund in advance, and are able to close the fund by scheduled redemption. However, our original intention is to manage the fund for over a long period of time, and we try extending the maturity, whose process is much easier than an early redemption."

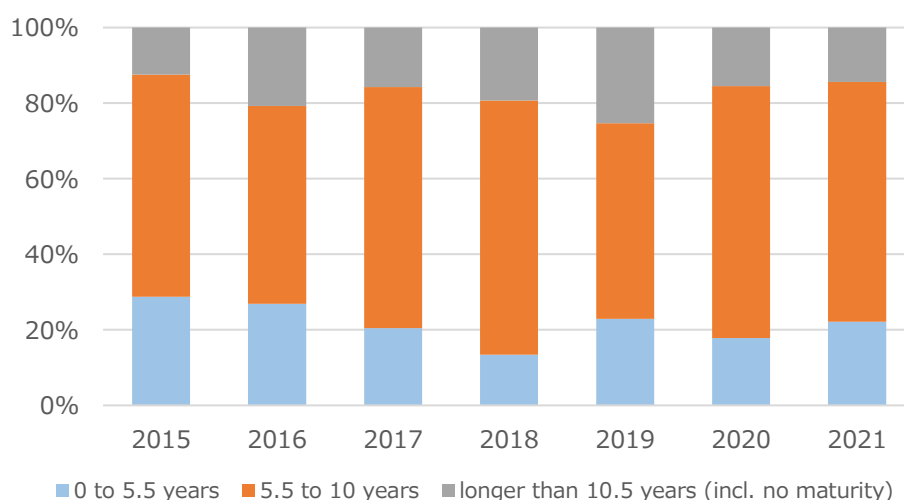
The FSA believes that publicly offered funds which are expected to serve for long-term asset formation should target at investment over a long period, such as, for example, over 20 years. We also consider that it is not a desirable practice to circumvent processes of an early redemption by setting a short maturity. We recognize the necessity of an early redemption of a fund in a case where investment performance expected at its inception later turns out to be impossible. However, the early redemption should be done by utilizing terms of a fund dedicated for that purpose, which must not be evaded by the use of the short maturities.

³⁰ Compiled by the FSA based on data from QUICK Corp. "Lowered" means a change from the previous report (analysis as of October 2020).

In addition, setting a short maturity raises the following issue from the perspective of the product governance. Generally, for publicly offered funds sold over the counter, approximately 3.3% of the sales commission is charged to customers. Then, for example, with respect to a fund whose maturity is set at 5 years, a firm is naturally required to develop the product so that it provides customers with added value that exceeds not only annual asset management fees, etc. but also the 3.3% sales commissions during the 5 year period. Furthermore, the situation would become more difficult for a firm if, for example, 3 years have passed after the launch of the fund with the 5-year maturity, because the fund is expected to deliver added-value exceeding 3.3% in only the remaining 2 years, which is very challenging for most of funds. Both asset management firms (product development side) and distributors (sales side) need to provide investors with fully reasonable explanations on these points.

Securities firms and banks, which are distributors of funds, in particular, are required to develop sales strategies to identify products that survive over the long term. Also, in a case where a fund they sold turns out to be unsuccessful and has become a small fund which its asset management firm is unable to continue managing, the distributors should be prepared for the case, which includes having necessary systems for that action, to promptly cooperate with the asset management firm regarding the consolidation or early redemption of the fund, giving top priority to customers' interests.

(Figure 3-5) Maturity periods of publicly offered equity funds³¹



³¹ Compiled by the FSA based on data from QUICK Corp, excluding funds for DC, funds for fund wraps, ETF and index funds.

(4) "Target investors" for funds with monthly distributions

There have been strong demands for funds with monthly distributions. Particularly, in recent years, funds which adjust monthly distribution amounts according to investment performance have gained popularity. The FSA recognizes that a certain type of customers, such as the elderly, who wants to have periodic income from their assets, may prefer funds with monthly distributions. However, these products are not suitable for those who expect a growth of assets over a long-run, such as the younger, because funds with monthly distributions have disadvantages in terms of taxes and lose a benefit from compounding returns. Therefore, target investor base will naturally differ depending on the distribution methods of funds. In addition, we have found that many U.S. equity funds, which have seen a large inflow of funds in recent years, are set up with monthly distributions. If the target investors of the funds with monthly distributions are those who need periodic income from assets like the elderly, distributors shall carefully consider whether these target investors are also suitable for the relatively high risk of overseas assets like U.S. equities.

However, according to the key information sheets prepared by distributors of the funds with monthly distributions, we found cases where the distributors bundle multiple funds with different distribution cycles into one key information sheet and seem not to distinguish different target investor bases. Regardless of whether a fund is with or without monthly distributions, the target investors stated in its key information sheet is simply set as "those who aim at an asset growth over mid-to-long term". The practice is not reasonable, because funds with monthly distributions are not suitable for those aiming at asset accumulation for the long-term. We ask distributors to reconsider the current practice in light of the spirit of the key information sheets.

(5) Funds with the risk of emerging market countries

Looking at the performance ranking³² of publicly offered funds in fiscal year 2021, the worst 10 funds all consist of funds investing in assets of either Russia or Central and Eastern Europe. In fiscal year 2020, most of the worst 10 funds were Turkish-related or Brazil-related. For two consecutive fiscal years, the magnitude of emerging markets-related risks has become evident.

At first glance, the expected returns of funds investing in assets of emerging market

³² Compiled by the FSA based on data from QUICK Corp, excluding bull-type, bear type, long/short type, other leveraged type, VIX linked type, and funds substantially overlapping with other funds (funds sharing same mother funds, etc.).

countries or funds whose performance linked to emerging market currencies appear high, which, however, is a reflection of high risk. It should also be noted that high costs of the funds tend to be overlooked due to the high expected returns. For this reason, when individuals aiming at the long-term asset accumulation invest in funds related to emerging markets, it is desirable to take careful measures reflecting the high risk, such as limiting the allocation to a small part of well-diversified portfolio as well as paying close attention to the high costs.

(Figure 3-6) Worst 10 funds by returns in FY2020

| Fund name | Sales commission | Real asset management fees | Cumulative returns | Investment area |
|--------------------------|------------------|----------------------------|--------------------|----------------------|
| A Bond Open | 3.30% | 1.47% | -23.0% | Turkey |
| B Bond Fund | 3.30% | 1.36% | -22.3% | Turkey |
| C Bond Open | 3.30% | 1.31% | -20.9% | Turkey |
| D Government Bond Ladder | 0.55% | 0.47% | -11.8% | North America |
| E Bond Fund | 3.85% | 1.81% | -10.6% | Brazil |
| F. Sovereign funds | 3.30% | 1.47% | -8.7% | Brazil |
| G-Bond Open | 3.30% | 1.47% | -8.7% | Brazil |
| F Bond Open | 3.30% | 1.47% | -8.7% | Brazil |
| G Bond Open | 3.30% | 1.71% | -8.5% | Brazil |
| H Bond Fund | 3.30% | 1.65% | -7.8% | Brazil |

(Figure 3-7) Worst 10 funds by returns in FY2021

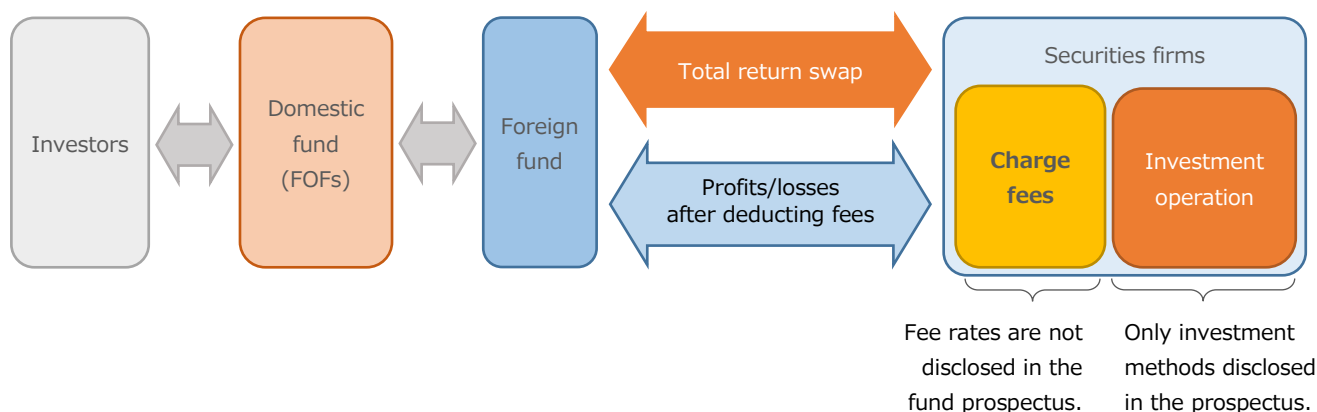
| Fund name | Sales commission | Real asset management fees | Cumulative returns | Investment area |
|--------------------------|------------------|----------------------------|--------------------|---|
| I Bond Open | 3.30% | 1.36% | -90.5% | Russia |
| J. Equity Fund | 3.85% | 2.07% | -89.2% | Russia |
| K Open | 3.85% | 2.15% | -88.5% | Russia |
| L Bond Open | 3.30% | 1.46% | -72.0% | Russia |
| M Equity Fund | 3.30% | 1.66% | -69.1% | Russia |
| N Equity Fund | 3.85% | 2.07% | -56.2% | Russia, Central & Eastern Europe |
| O Equity Fund | 3.30% | 2.07% | -56.0% | Russia, Central & Eastern Europe |
| P share investment trust | 3.30% | 2.07% | -55.5% | Russia, Central & Eastern Europe |
| Q Share Fund | 3.85% | 1.72% | -54.6% | Russia, Central & Eastern Europe |
| R Share Fund | 3.30% | 1.85% | -45.4% | Russia |

(6) Disclosures of total return swaps

In recent years, some of publicly offered funds use a financial product called “total return swap”, which is a type of derivative contract. A total return swap embedded into a fund is a financial instrument in which the fund receives outcomes linked to a specific investment

method from the counterparty of the swap. If the outcome is negative, instead, it is the fund who makes payment to the counterparty. When a total return swap is used, an index linked to the performance of certain investment method is usually set, and changes in the index value are referred to when the fund receives from or pays to the counterparty.

(Figure 3-8) Structure of the use of a total return swap



The primary purpose of the use of total return swaps by a fund is to gain outcomes from certain investment strategies, which are carried out by the counterparty of the swap on behalf of the fund, without incurring their operational burdens. But, of course, the outcomes do not come without a cost. The counterparty always collects a certain fee from the results of the specified investment strategies, and the fee is deducted from the receipt by the fund. However, when a fund is structured as a FOFs investing in a foreign-based fund which uses a total return swap, there are cases where the fee level of the total return swap is not disclosed to fund investors in the prospectus of the fund.

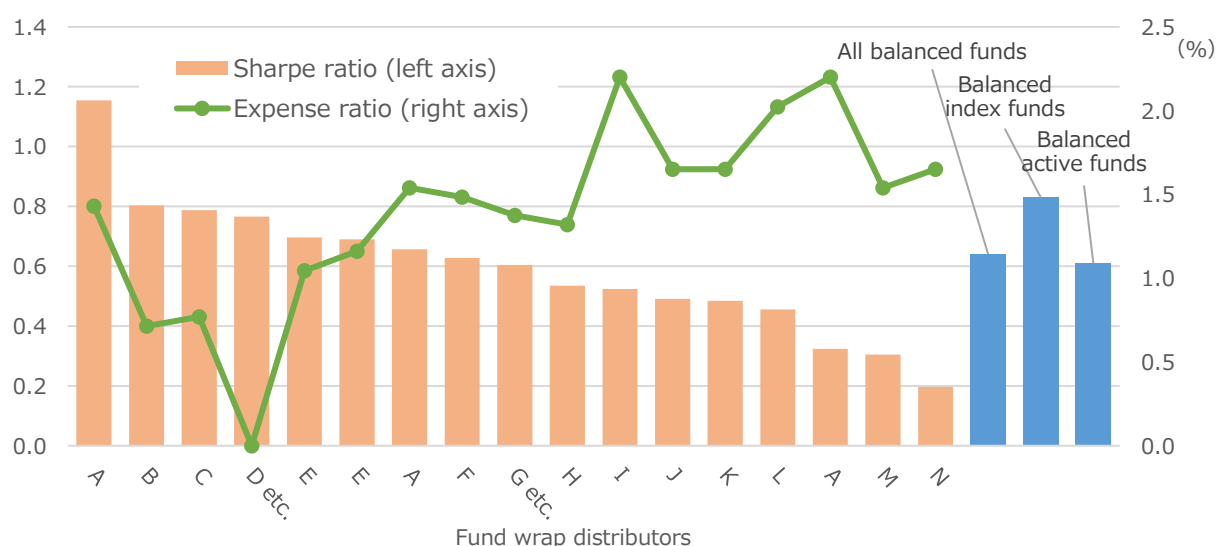
While the prospectuses of these funds tend to provide a relatively detailed description about the methods of the investment strategies employed, the outcome that fund investors receive will be lower than the actual investment results of the methods disclosed in the prospectuses. The difference, which equals to the fee level of a total return swap, is one of important information about the performance of a fund and shall be disclosed in its prospectus.

2. Fund wraps

According to Japan Investment Advisers Association, the number of fund wrap contracts has increased by 4.0% as of the end of December 2021 compared to that as of the end of March 2021, and the value of fund wrap contracts has increased by 7.2% in the same period, indicating that fund wraps are still on the rising trend.

While many fund wraps benefited from a strong market environment and performed positively in 2021, there are differences in quality. Looking at the 5-year Sharpe ratio after deducting costs, there are still many fund wraps whose performance is inferior to that of balanced funds. Fund wraps with higher costs tend to perform worse. Also, we found a fund wrap which, although calling itself as a “stable type”, introduced a new quantitative model to predict the optimal allocation of funds. However, the model later turned out to be not effective at all and the distributor of the fund wrap revised the model after that I. While it is obvious that each model has its own model risk, the model was provided to customers without sufficient verification of actual performance, and as a result, the model risk was passed on to customers. Such a practice is not appropriate for a product labelled as “stable”.³³

(Figure 3-9) Sharpe Ratios after deducting the expenses of fund wraps³⁴



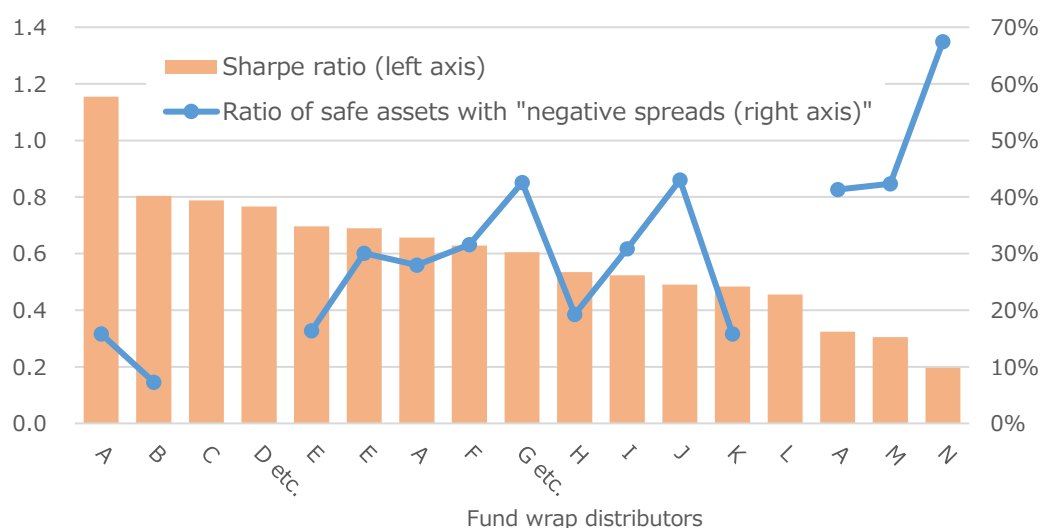
Most of the fund wraps incorporate certain amount of safer assets, such as domestic bond funds or developed country bond funds with currency hedging. If a customer of a fund wrap wants a conservative asset allocation, the ratio of such safer assets will become high. However, while the overall expense ratio of a fund wrap is often 1.5% or more per annum, it is very difficult for safer assets to achieve returns of more than 1.5% under the current low interest rate environment. Because of that, the safer asset portion of most of fund

³³ There are mainly three types of expenses borne by customers of fund wraps: (1) asset management fees, etc. of funds included in a fund wrap; (2) fees for a fund wrap; and (3) investment management fees for a fund wrap. In this Report, the sum of (2) and (3) is referred to as “expenses of a fund wrap,” “expenses of a wrap,” or simply “expenses.” Some distributor (“Company D, etc.” in Figure 3-9) set (2) and (3) to 0, and indirectly receive remuneration from (1), asset management fees, etc. of funds included. All Sharpe ratios for fund wraps in this report are figures after deducting all expenses from (1) to (3) above.

³⁴ Compiled by the FSA based on data from QUICK Corp. Same distributor names appear more than twice, because there is a case where a distributor deals with multiple fund wrap products.

wraps tends to carry “negative spread”, in which its return is overwhelmed by its cost. As a result, the higher the allocation ratio of safer assets in a fund wrap is, the poorer its performance is.

(Figure 3-10) Ratios of safe assets with "negative spreads" and Sharpe ratios³⁴



(Figure 3-11) Safe asset funds with “negative spreads” that account for more than 10% of a fund wrap³⁵

| Wrap sales companies | Name of fund | Asset classification by QUICK | Investor returns | Cost of fund wrap | Investor returns net of expenses | Within the fund wrap Balance ratio (as of end of 2021) |
|----------------------|----------------------------|-------------------------------|------------------|-------------------|----------------------------------|--|
| Company A | Foreign Bonds | Developed markets bonds | 1.14% | 1.43% | -0.29% | 11.9% |
| Company E | Bond Premier | Domestic bonds | 0.41% | 1.16% | -0.75% | 17.7% |
| | Japan Bond Index | Domestic bonds | -0.89% | | -2.05% | 12.2% |
| Company A | Select Bonds | Developed markets bonds | 0.64% | 1.54% | -0.90% | 22.6% |
| Company F | Japanese Bonds | Domestic bonds | 0.15% | 1.49% | -1.33% | 31.5% |
| Company G, etc. | Fixed income / stable | Developed markets bonds | -0.08% | 1.38% | -1.46% | 40.4% |
| Company H | Japan Bond Fund | Domestic bonds | 0.55% | 1.32% | -0.77% | 19.2% |
| Company I | Domestic Bond Passive Fund | Domestic bonds | -0.01% | 2.20% | -2.21% | 30.8% |
| Company J | Japan Bond Index | Domestic bonds | 0.29% | 1.65% | -1.36% | 41.2% |
| Company K | Domestic Bonds | Developed markets bonds | 0.38% | 1.65% | -1.27% | 15.8% |
| Company A | Japan Bond Index | Domestic bonds | -0.48% | 2.20% | -2.68% | 14.0% |

³⁵ Compiled by the FSA based on data from QUICK Corp.

| | | | | | | |
|-----------|---|-------------------------|--------|-------|---------------|--------------|
| | Open foreign bonds (H) | Developed markets bonds | 1.16% | | -1.04% | 18.2% |
| Company M | Japan Super Long-Term Government Bond Index | Domestic bonds | -0.71% | 1.54% | -2.25% | 34.3% |
| Company N | Open Hedged Foreign Bonds | Developed markets bonds | 1.55% | 1.65% | -0.10% | 67.4% |

In general, it makes sense for clients who prefer a conservative asset management to increase the allocation to safer assets. However, as there are multiple options of safer assets, there is no necessity for clients to use a high-cost fund wrap at all. The “negative spread” would rather harmful to a conservative asset management. What is worse, since a fund wrap has a balance-based fee structure, distributors have an incentive to increase client assets, including safer assets, to be included into a fund wrap as much as possible, which causes a conflict of interests with clients. Distributors should reconsider whether a fund wrap with high cost and a high allocation of safer assets is truly reasonable and contributes to clients’ best interests.

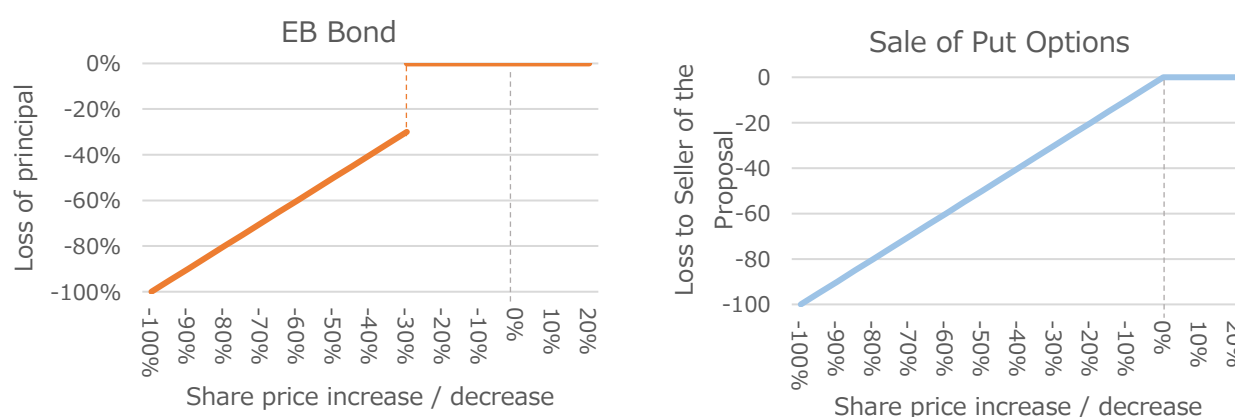
3. Structured bonds

With the cooperation of several distributors, the FSA obtained data of equity exchangeable bonds (“EBs”), one type of structured bonds, sold to retail customers in the past. EBs account for a large portion of structured bonds in Japan. The sample date consists of 856 EBs sold to retail clients in April 2019 (total issuance amount in Japanese yen is approximately 67.4 billion yen), which are all privately offered. The sampled EBs include not only those linked to domestic equities but also those linked to overseas equities. We looked at product terms, redemption histories by the end of December 2021, and returns and market value information as of that point.

EBs are bonds whose redemption amounts and schedules are linked to price movements of specific equities. When a price of the linked equity falls by more than a certain percentage (-20% to -30%, etc.), the redemption amount of its EB starts varying from face value (par) along with the moves of the share price through a mechanism called “knock-in.” As a result, large losses are likely to occur in EBs when stock prices fall significantly. On the other hand, when the stock price rises more than a certain threshold (+5% etc.), its EB is redeemed at face value through a mechanism called “knock-out”, so upside returns are limited.

Such a knock-in and knock-out mechanism of an EB is similar to a short position of a put option³⁶ of an equity. It is often said as "An EB effectively incorporates a short position of a put option." When a put option of an equity is sold, the loss becomes very large as the equity price referenced by the option declines. As shown in Figure 3-12 below, while losses on an EB increase as its equity price falls, returns on the EB are limited, because it is redeemed at face value when the equity price rises by the knock-out. Even among professional institutional investors, only few investors underwrite the short positions of put options on equities, which is perceived as a high-risk transaction. Thus, a purchaser of an EB should assume a risk that is significantly different from the general image of a straight bond usually sold to retail investors.

(Figure 3-12) Conceptual diagrams of relationship between an EB's redemption amount and share price, and its comparison with a put option³⁷

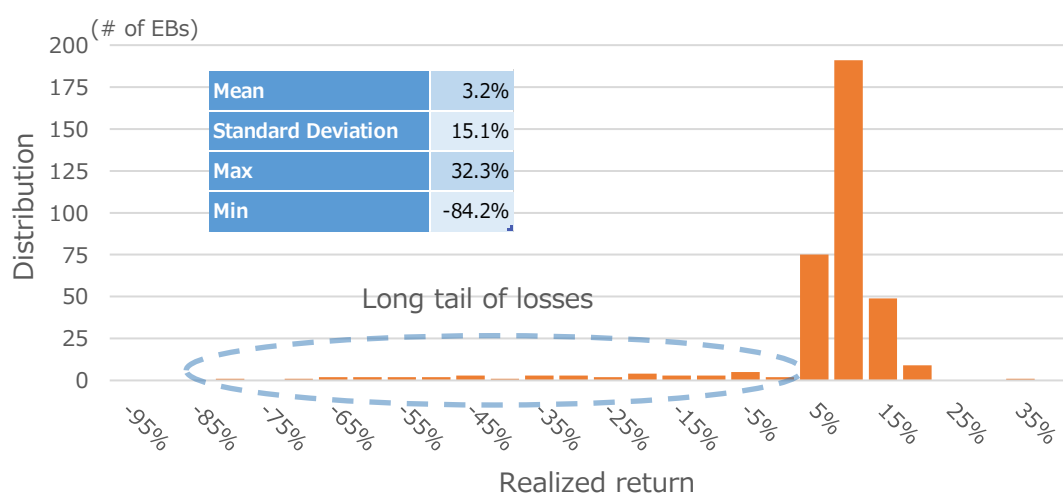


In fact, in the sample examined this time, there was an extreme case where 80% of principal of an EB was lost in only three months. Looking at the distribution of returns (Figure 3-13), although the frequency itself is small, we can see that the range of loss rates is wide. Therefore, its risk (measured by the standard deviation of the distribution) is quite high and has a so-called "tail risk" nature.

³⁶ A "put option" is a "right" to sell a stock at a pre-determined price. A person who purchases a put option can make profits by selling the stock at a pre-determined price, if the actual price is down to that lower than the pre-determined price. On the other hand, a person who "sells a put option" is required to fulfill the "obligation" by purchasing the stock at the predetermined price from the counterparty who has the right, and incurs a loss when the stock price drops.

³⁷ The "share price" is assumed to increase or decrease constantly until the maturity of an EB. Income from coupons of an EB or premium from the sale of a put option are ignored.

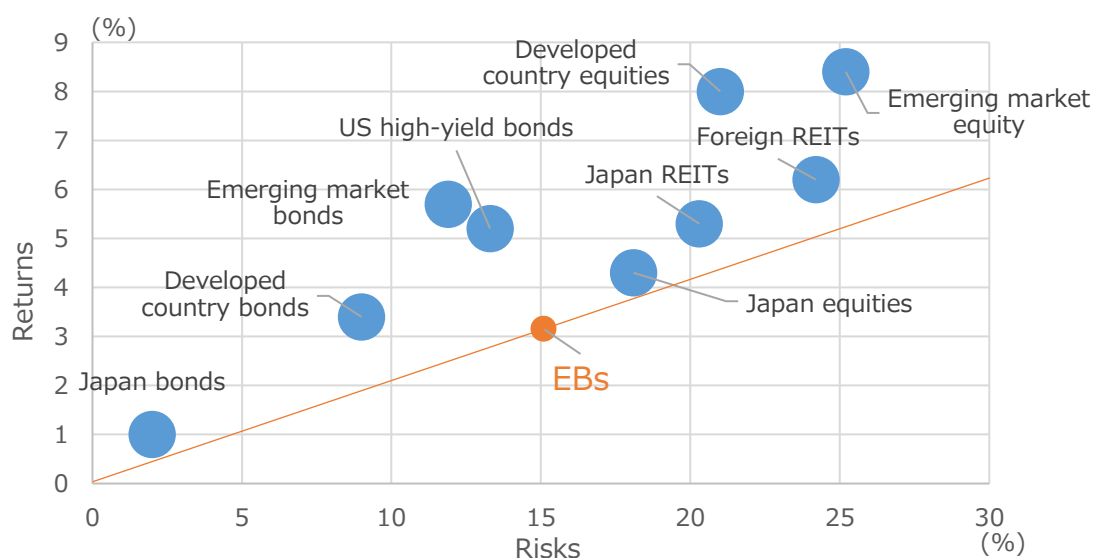
(Figure 3-13) Distribution of returns of EBs³⁸



Comparing EBs returns with the long-term risk-return ratios of other asset classes, as shown in Figure 3-14, the returns on EBs are not high enough to justify their risk. Since the risk-return ratio of EBs is inferior to that of equities, and the correlation of EBs with equities is strong due to the product characteristics, there is almost no justification to purchase EBs instead of equities. On EBs, distributors often explain to retail investors as "EBs' coupon is high instead of abandoning capital gains on equities." However, from the data, it cannot be said that a coupon of EBs is high enough to match with the value of the foregone capital gains.

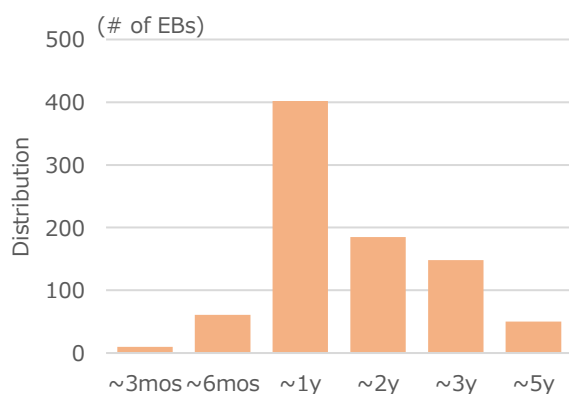
³⁸ Compiled by the FSA based on materials submitted by distributors of EBs. Returns are annualized. Calculated from the data of fixed-coupon EBs (364 bonds) out of all sampled EBs. As for EBs which did not mature by the end of 2021, returns are calculated by using the market values at that point.

(Figure 3-14) Comparison of risk / return ratios^{39,40}



Another characteristic of EBs is its short term nature. Not only more than half of them are launched as short-term products with a scheduled maturity of one year or less from their beginnings, but also they are structured so that early redemptions easily occur. Of the EBs with a scheduled maturity of 2.5 years or less that have already matured in this sample, only less than 20 percent survived to their scheduled maturities. For these EBs with a scheduled maturity of 2.5 years or less, the average realized life was only 0.62 years.

(Figure 3-15) Distribution of scheduled maturities⁴¹

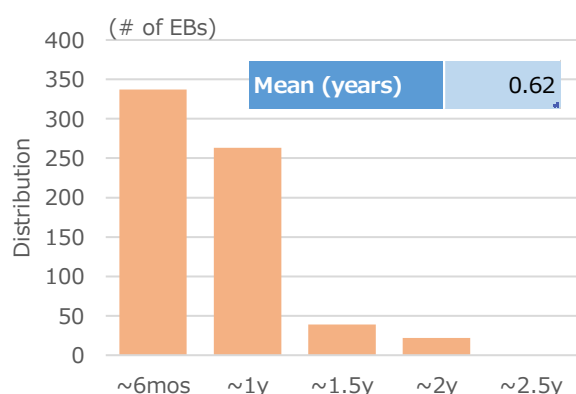


³⁹ Compiled by the FSA based on materials submitted by distributors of EBs. Risks & returns of asset classes other than EBs are estimated by the FSA based on data from Ibbotson Associates Japan, Inc.

⁴⁰ Risk & return of EBs are calculated from the distribution in Figure 3-13. On the other hand, note that risks & returns of the other asset classes are estimated from time-series data from 2002 to 2021 (from 2006 to 2021 for REIT asset classes).

⁴¹ Compiled by the FSA based on materials submitted by distributors of EBs.

(Figure 3-16) Distribution of realized maturities⁴¹



EBs' effective cost borne by investors (the difference between the face value (investment principal) and fair value) is estimated to be around 5-6% of the face value on average, estimated by industry interviews conducted by the FSA and other public information. However, since the realized life is as short as 0.6 years, the realized, effective cost per annum reaches to around 8-10%. Such a high cost may have contributed to the poor risk-return ratio shown in Figure 3-14. From the viewpoint of distributors or originators handling EBs, this characteristic enables them to earn large profits in a short period of time, creating incentives for actions similar to a churning, where distributors, primarily to generate excessive commissions, repeatedly sell new EBs to investors who have received early redemption in a short cycle.

Any financial institution that handles structured bonds should naturally be aware of the above-mentioned characteristics of those products such as EBs. However, as far as we know, none of the financial institutions has made any efforts to voluntarily conduct analyses similar to those in this report and publish them available to investors. In other products such as publicly offered funds, historical information of risks, returns, and costs is usually disclosed in their key information sheets. Given that the annual sales of structured bonds reach 4 trillion yen⁴² at least, each financial institution that handles structured bonds or its industry association should enhance information disclosed to customers, such as by voluntarily compiling performance data of structured bonds and regularly publishing it, or by disclosing effective costs of each structured bond in its key information sheet.

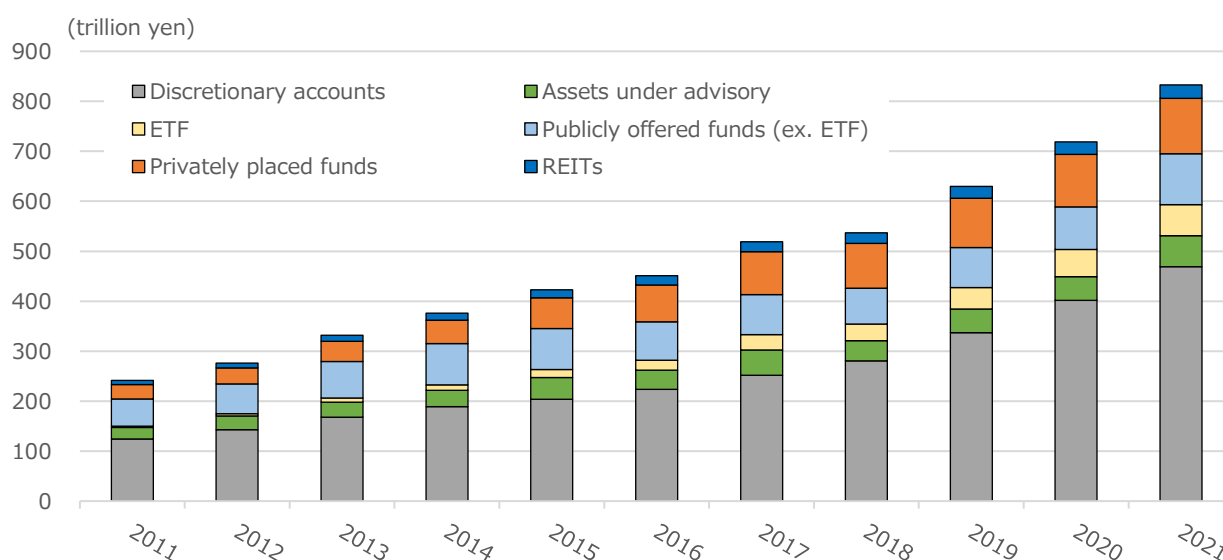
⁴² Figures for FY2021 from "Quantitative data analysis on the distributors of mutual funds and other assets" (the FSA, June 2020). As the analysis is a sample study, the true total amount is considered to be larger.

4. Privately placed funds

(1) Expansion of the privately placed fund market

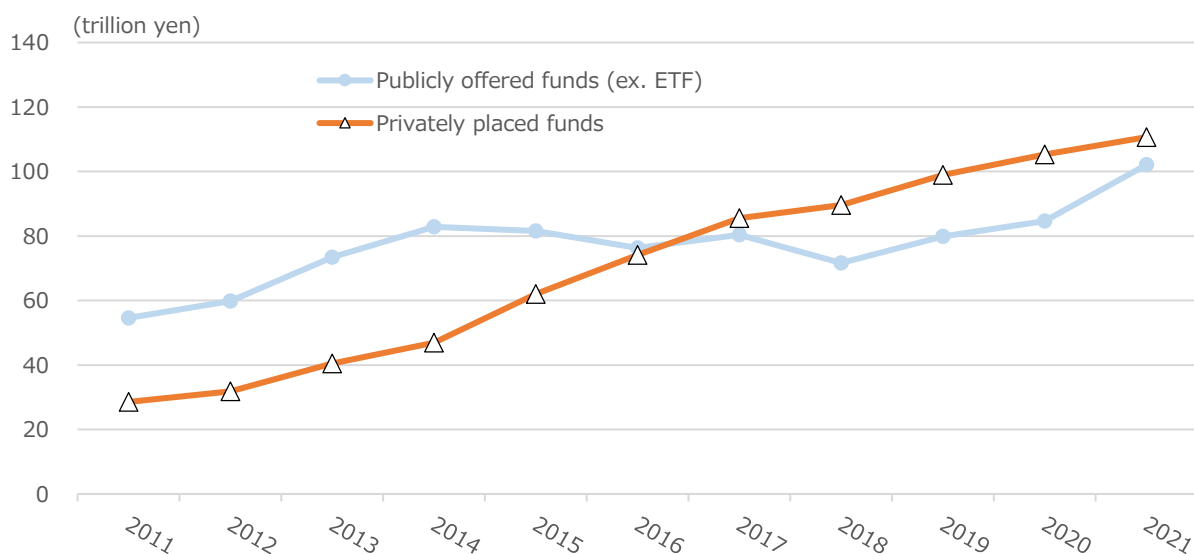
The total value of assets under management of asset management firms in Japan is over 800 trillion yen, and is expanding, particularly in privately placed funds for institutional investors and discretionary investment accounts. The balance of privately placed fund increased from around 30 trillion yen at the end of 2011 to around 110 trillion yen at the end of 2021. The balance of discretionary investment account increased from around 120 trillion yen to around 470 trillion yen in the same period. In terms of total net assets, privately placed funds exceed publicly offered funds excluding ETFs.

(Figure 3-17) Volume of assets under management of asset management firms in Japan⁴³



⁴³ Compiled by the FSA based on data from the Investment Trusts Association and Japan Investment Advisers Association.

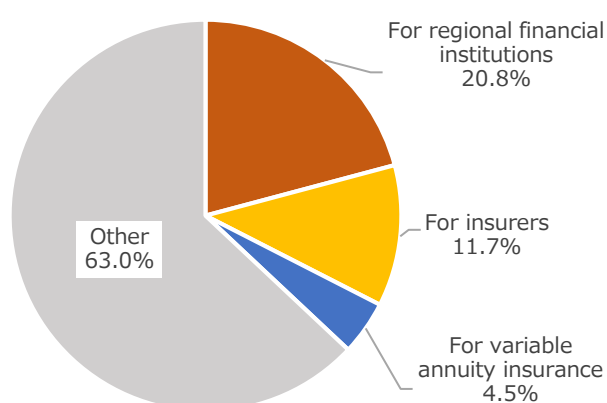
(Figure 3-18) Total net assets of privately placed funds and publicly offered funds⁴³



(2) Investor compositions of privately placed funds

In Japan's privately placed fund market, if we exclude a few large financial institutions included in "Others", funds sold for regional financial institutions account for the largest portion, followed by those for insurance companies and those for variable annuity insurance.

(Figure 3-19) Composition of Investors in the Private Placement Investment Trust Market (based on net assets)⁴⁴

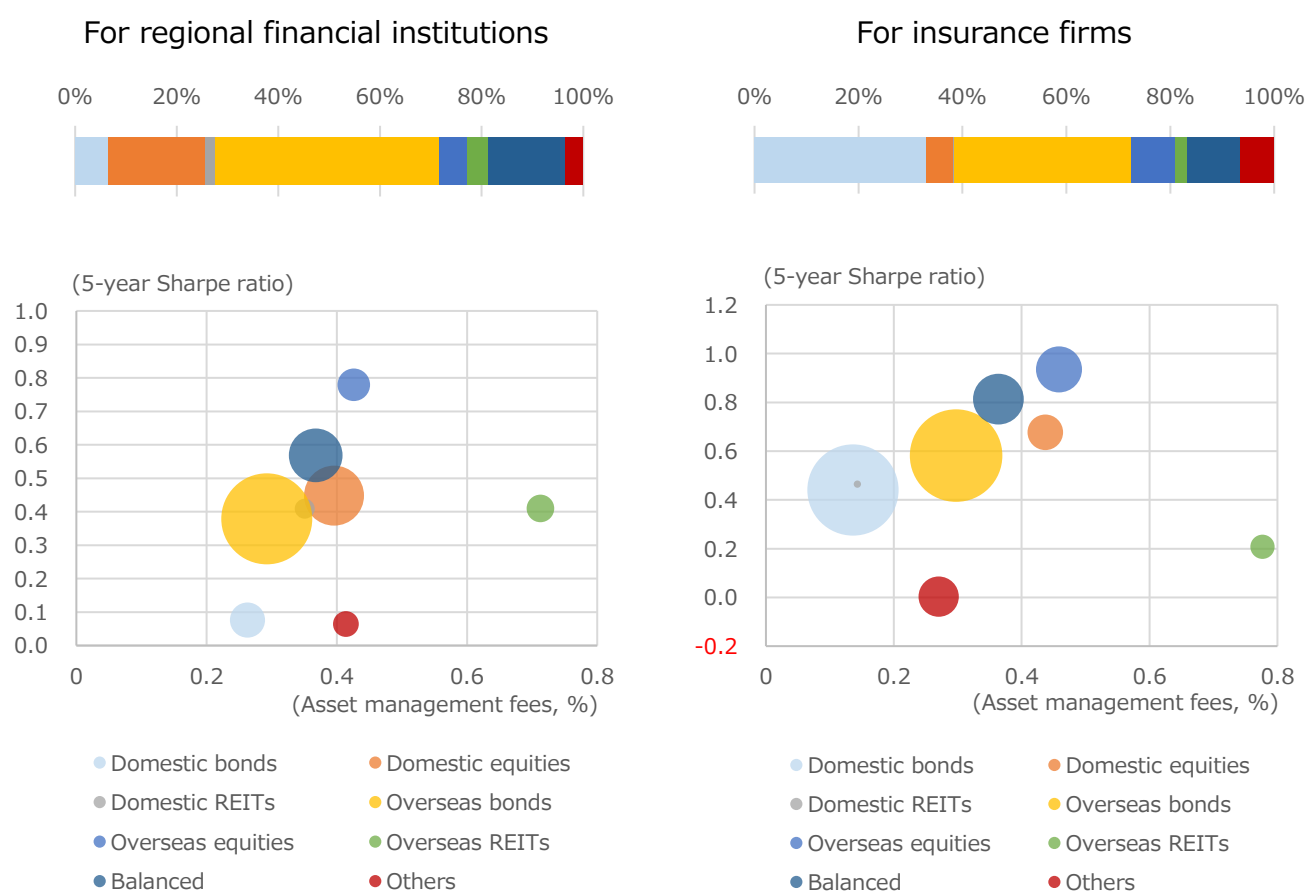


⁴⁴ Compiled by the FSA based on data submitted by asset management firms having large net assets of privately placed funds.

(3) Asset compositions and performance⁴⁵ by investor types

There is a wide variation in the composition of asset classes of privately placed funds by investor. Overseas bonds account for a large proportion of the funds for regional financial institutions, while both domestic bonds and overseas bonds account for a large proportion of those for insurance companies. In addition, in the case of those for variable annuity insurance, the balanced funds account for more than 80%.

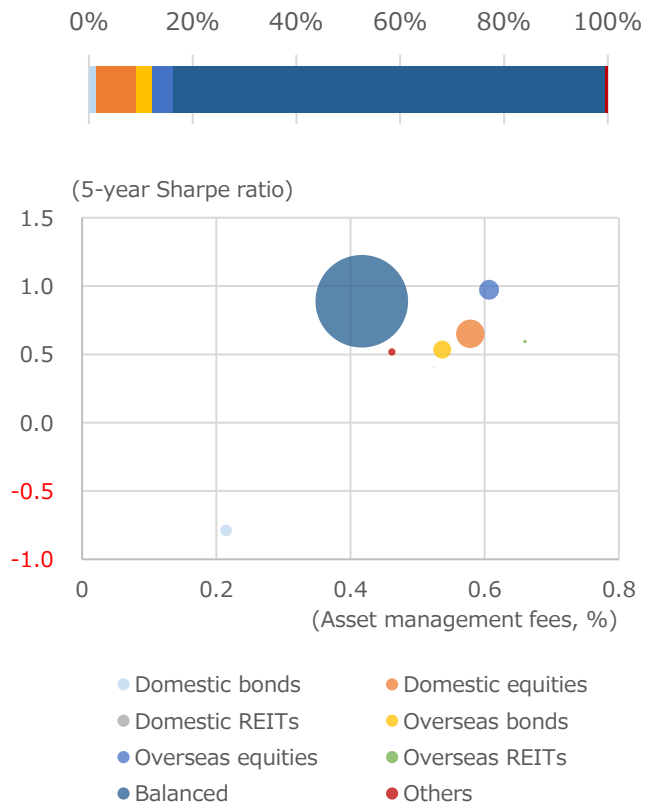
(Figure 3-20) Asset compositions by investors⁴⁶



⁴⁵ Privately placed funds with a track record of five years until the end of 2021 are covered. Asset compositions are as of the end of 2021. The Sharpe ratios are the weighted averages of the five year Sharpe ratios based on the net asset sizes at the beginning of the five year period (as of the end of 2016). The size of the circles in Figure 3-20 represents the size of net assets.

⁴⁶ Compiled by the FSA based on data submitted by asset management firms having large net assets of privately placed funds.

For variable annuity insurance

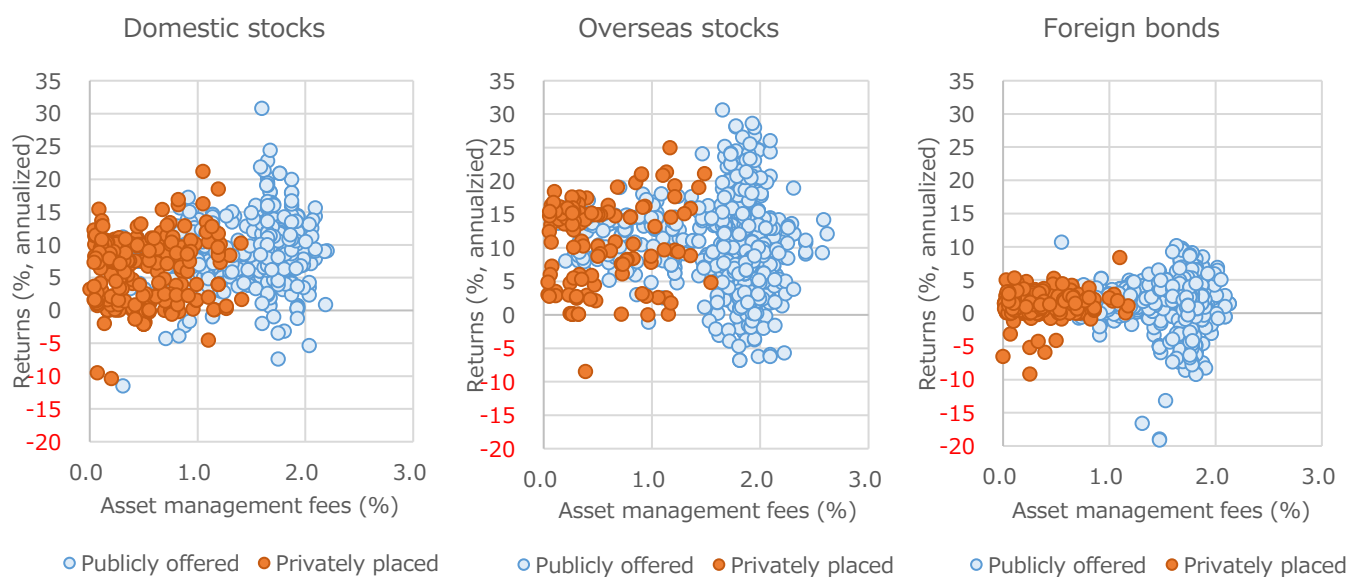


(4) Comparison between publicly offered funds and privately placed funds⁴⁷

Privately placed funds for institutional investors are offered with lower costs than publicly offered funds. This can be attributed to the fact that clients of privately placed funds are larger professional institutional investors. There is a large gap in asset management fee rates for all asset classes: domestic equities, overseas equities, and overseas bonds.

⁴⁷ Individual funds by asset classes are plotted by annual returns over the five years until the end of 2021 and asset management fee rates as of then. Funds which do not have a five year performance data are excluded.

(Figure 3-21) Comparison between publicly offered funds and privately placed funds⁴⁸

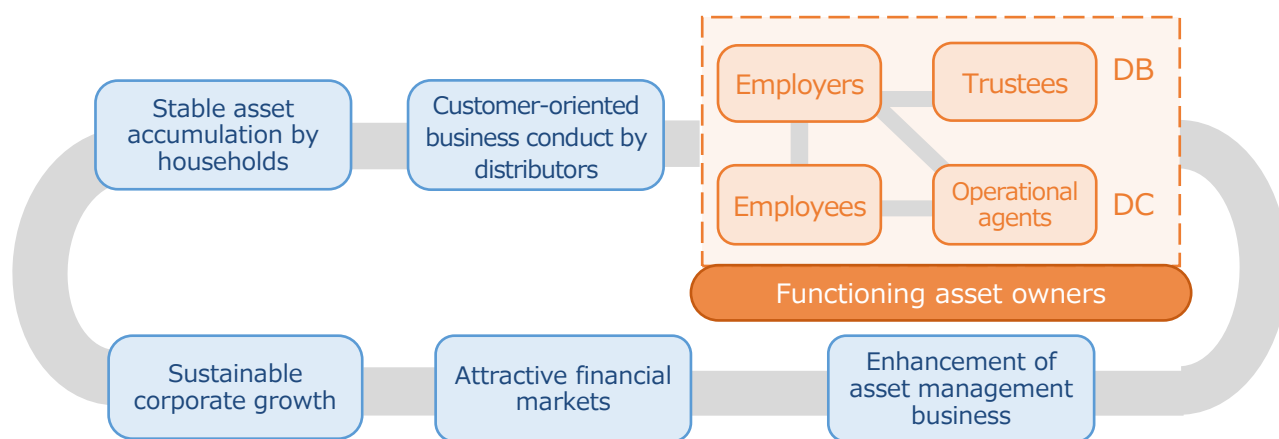


⁴⁸ Compiled by the FSA based on data from QUICK Corp. and data submitted by asset management firms having large net assets of privately placed funds.

5. Defined benefit corporate pension (DB) / defined contribution pension (DC)

The "asset owners" in the Investment Chain mean, in the context of DBs, employer companies (or their corporate pension fund entities), which manage pension funds by investing in stocks and bonds of both domestic and overseas through investment trustees (trust banks, life insurers, investment advisers, etc.). In DC, the "asset owners" are employees, where employer companies and operational agents (banks, trust banks, life and non-life insurers, securities firms, etc.) that support a DC scheme play an important role in selecting and proposing the lineup of investment products (funds, deposits, insurance products, etc.) that DC participants invest in.

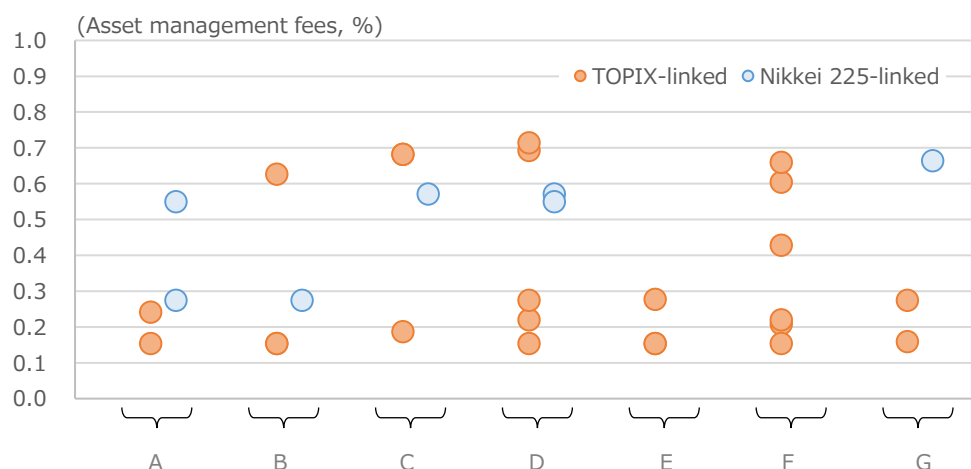
(Figure 3-22) "Asset owners" in the Investment Chain



(1) DC: fee dispersion among passive funds linked to same indices

As shown in Figure 3-4, a few index funds lowered their asset management fee rates, but the fee dispersion among DC-only index funds remains large and shows no signs of significant improvement. In order to improve this situation, which may hinder the asset formation by employees who are the final beneficiaries of DC, it is desirable not only that asset management firms voluntarily review asset management fees but also that both employer companies and operational agents such as banks, trust banks, life and non-life insurance companies, securities companies, etc. should strictly select funds lined-up in their DC programs.

(Figure 3-23) Asset management fee rates for DC-only index funds by asset management firms⁴⁹



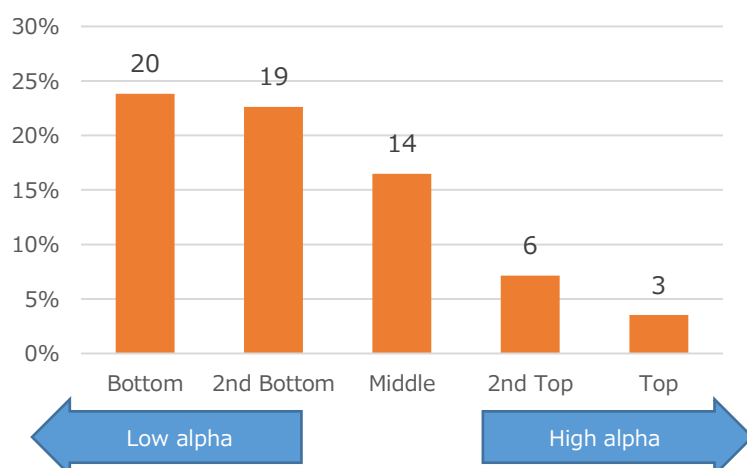
Since asset management fee rates of index funds can be relatively easily compared, it is necessary for employers companies that implement DC to actively select products by themselves and to avoid disadvantage for DC participants. It is also important for them to educate DC participants about these problematic products. In addition, operational agents should voluntarily provide both employers and employees with information on differences between their current DC product lineup and other more cost-effective products and support investment education for them.

(2) DC: for a better selection of active funds

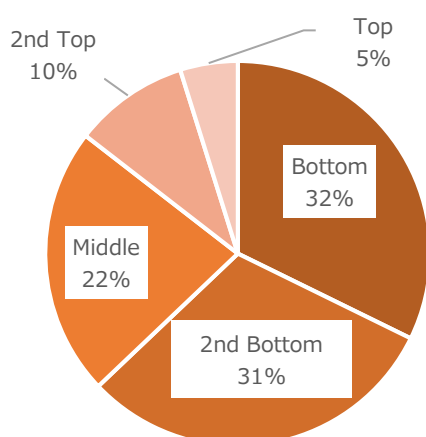
According to an analysis of the alpha of actively managed domestic equity funds, groups with poor alpha tend to have more funds for DC. While 32% of DC-only funds are in the lowest alpha group and 31% are in the second lowest, only 14.5% are in the top two alpha groups.

⁴⁹ Compiled by the FSA based on data from QUICK Corp. Funds plotted are publicly offered open-ended equity funds sold to DC only and linked to Nikkei 225 or TOPIX as of March 2022.

(Figure 3-24) Number and percentage of DC-only funds by 5-quantile of alpha⁵⁰



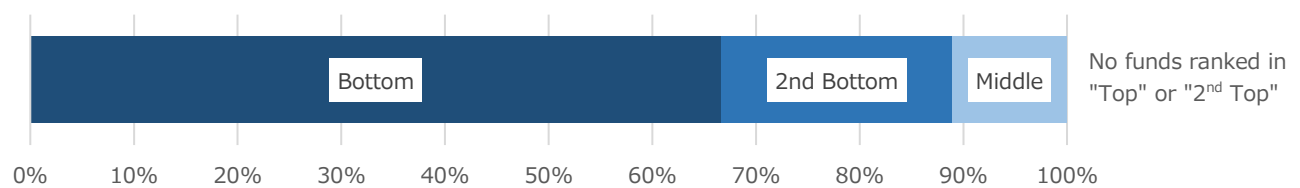
(Figure 3-25) Ratio of 5-quantile of alpha of DC-only funds⁵⁰



Funds that have clearly shown poor performance over a certain period of time tend to continue performing poorly in future. It is relatively easy to select funds based on such a viewpoint. Both employer companies that implement DCs and operational funds should select funds, prioritizing employees' best interest, which encourages asset management firms to strengthen their investment management capabilities and improve the quality of their products.

⁵⁰ Estimated by the FSA based on data from QUICK Corp., Nomura Securities Co., Ltd. (Russell/Nomura Japan Index), and the Bank of Japan.

(Figure 3-26) Performance of low-alpha funds in the next 10-year period^{50,51}



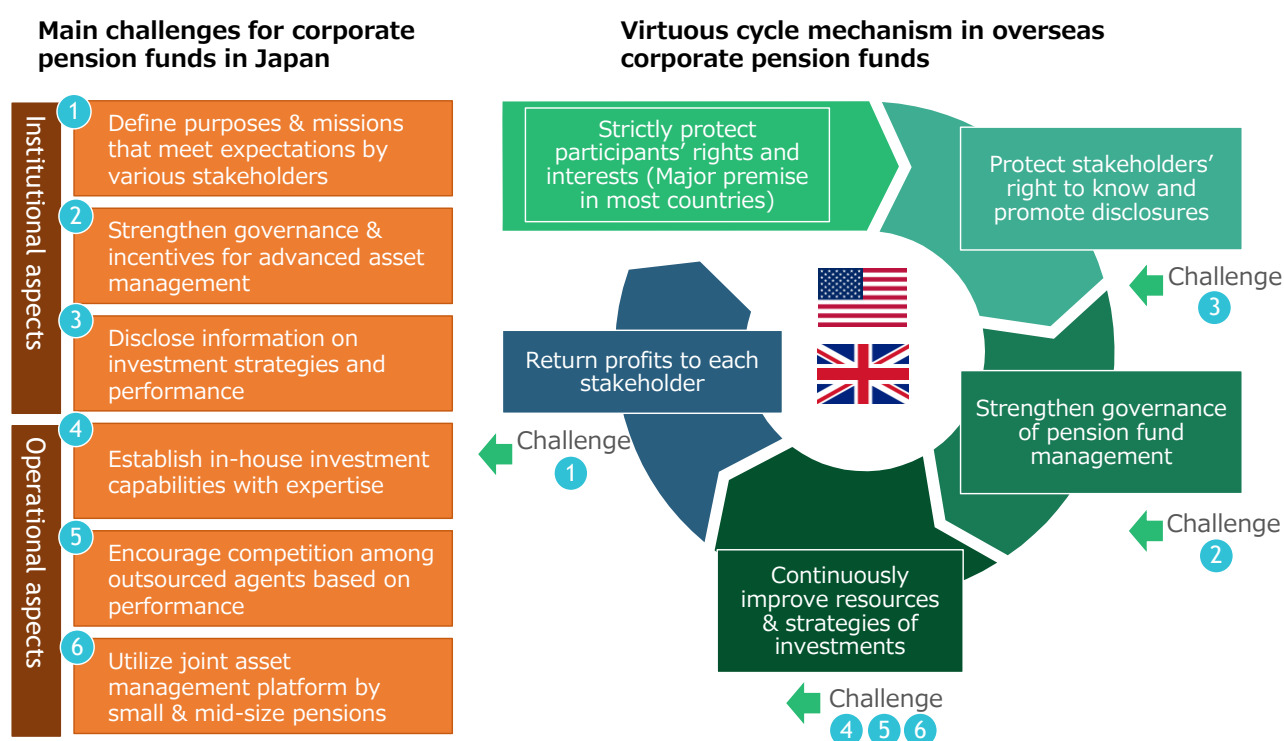
As noted earlier, privately placed funds perform relatively well, because their clients are institutional investors with high financial literacy. In DC products, it is expected that the markets are to be improved by more competitive product selection skills of employer companies, which will lead to good investment outcomes for DC participants. In addition, operational agents should actively provide employer companies with information on the relative evaluation of active fund performance and encourage them to choose products competitively, as is the above case with the DC-only index funds.

⁵¹ First, alpha of domestic equity active funds are estimated separately for the period from April 2002 to March 2012 and for the period from April 2012 to March 2022. Those whose t-values are less than -2.0 in the first period estimation are sampled as "low-alpha funds". This Figure shows in which 5-quantile of the second period estimation the low-alpha funds are located.

[Column] DB: Analysis of overseas pension funds and its implications for Japan

According to a survey commissioned to Boston Consulting Group, in corporate pension funds of other countries, on the premise to protect participants' rights, information disclosure is more advanced and investment management capabilities and systems are more sophisticated. This leads to a virtuous cycle in which investment profits earned by pensions are returned to multiple stakeholders.⁵²

(Figure 3-27) Corporate pension funds: main challenges in Japan and mechanisms of virtuous cycles overseas



As a solution to issues of corporate pensions in Japan and to create a virtuous cycle similar to that seen in other countries, the survey proposed to establish information disclosure rules that take into account more diverse stakeholders, to enhance external monitoring and audits of the investment management activities, and to strengthen of internal and external systems by upgrading resources and systems for investment management. More specifically, the following three proposals were made as possible directions of future discussions on

⁵² "Survey on the situation of corporate pension funds in Japan" (Boston Consulting Group, published on May 20, 2022)

<<https://www.fsa.go.jp/common/about/research/20220520.html>>

corporate pensions in Japan: (1) enhance disclosures on investment strategies and resources to increase transparency of actual investment performance of each pension fund; (2) strengthen external oversight and internal incentives to achieve high investment performance through sophisticated investment skills; and (3) introduce eligibility requirements for investment managers of the pensions and strengthen oversight of third-party service providers regarding conflicts of interest and inappropriate transactions.

(Figure 3-28) Possible directions of actions (draft)

| Proposal | Directions of actions (draft) |
|--|---|
| <p>(1) Establish information disclosure rules that take into account a wider range of stakeholders</p> | <p>Enhance the disclosure of not only financial information but also investment strategies and systems to improve the transparency of the investment management activities of each fund</p> <ul style="list-style-type: none"> • In addition to the disclosures for investors of corporate levels, consider enhancing disclosures by corporate pension funds themselves, which includes sharing annual reports submitted to regulatory authorities or issuance of annual reports of the pensions. • However, note the burden and cost for the disclosures. |
| <p>(2) Strengthen external monitoring and audit of investment activities</p> | <p>Strengthen the oversight by external monitoring and audit encouraging pension funds to adopt high-level investment skills and to achieve high investment performance. Empower internal incentives through such monitoring</p> <ul style="list-style-type: none"> • As exemplified by the role of the Pension Benefit Guarantee Corporation (PBGC) in the U.S, strengthen external monitoring and audit protecting the interests of beneficiaries. • Through monitoring and audit of risk-adjusted returns, pursue an appropriate balance of risk-taking and better investment performance in accordance with projections of cash inflows by contributions and outflows by benefit payments |
| <p>(3) Develop internal and external systems to enhance investment management systems and strategies</p> | <p>Introduce eligibility requirements for investment managers of corporate pensions</p> <ul style="list-style-type: none"> • Require appointing persons with practical experience in long-term for investment managers and promote the use of external professionals (e.g., Outsourced Chief Investment Officer (OCIO)) <p>Strengthen monitoring of conflicts of interest and inappropriate transactions by third-party service providers</p> |

- High switching costs and distortions in selection processes of providers and products caused by reciprocal relationships in other business areas

Develop systems and resources to become Qualified Institutional Investors

- In particular for large corporate pensions, consider setting certain thresholds of scales of assets to require higher levels of systems and resources for investment management, including requirements of governance and management structure (by the guidelines for defined benefit corporate pension plans, etc.)

Details of alpha analysis

Following the analytical framework in Fama and French (1993)⁵³, alpha shown in Figure 1-6 were estimated by the time series regression analysis of the following three factor model.

$$R_{i,t} - RF_t = \alpha_i + \beta_{iM}(RM_t - RF_t) + \beta_{iSMB}SMB_t + \beta_{iHML}HML_t + \varepsilon_{i,t}$$

For actively managed domestic equity funds, definitions of the terms in the model and the underlying data used for the terms are as follows:

| | |
|-----------|--|
| $R_{i,t}$ | Returns of a fund i . Monthly return data of unit prices with dividends reinvested of the fund. Asset management fees and other expenses which are usually reflected in the unit prices are deducted. But other costs such as sales commissions which are not reflected in the unit prices are not deducted. |
| RF_t | Risk-free interest rate. Monthly average of daily data of unsecured overnight call rates published by the Bank of Japan. For monthly conversion, the published values (annual rates) are divided by 12. |
| RM_t | Market returns. "Total Market" monthly returns (with dividends reinvested) of Russell/Nomura Japan Index |
| SMB_t | Size factor (<u>S</u> mall <u>m</u> inus <u>B</u> ig). Difference in monthly returns between "Small" and "Large" of Russell/Nomura Japan Index |
| HML_t | Value factor (<u>H</u> igh-Book-to-Market <u>m</u> inus <u>L</u> ow-Book-to-Market). Difference between monthly returns of "Total Market: Value" and "Total Market: Growth" of Russell/Nomura Japan Index |

Coefficient estimates of the regression analysis are as follows:

| | |
|---------------------|--|
| α_i | Alpha. Monthly excess returns |
| β_{iM} | (Market) Beta |
| β_{iSMB} | Sensitivity to size factor. A higher value indicates a tendency toward small stocks, and a lower value indicates a tendency toward large stocks. |
| β_{iHML} | Sensitivity to value factors. A higher value indicates a tendency to value stocks; a lower value indicates a tendency to growth stocks |
| $\varepsilon_{i,t}$ | Error term |

⁵³ Fama, Eugene F.; French, Kenneth R. (1993), "Common risk factors in the returns on stocks and bonds", Journal of Financial Economics

While multiple data vendors, including Japan Exchange Group, have compiled factor indices of the Japanese stock market, the reason for using Russell/Nomura Japan Index is to ensure objectivity so that anyone can reproduce the same analysis in this paper, because the long-term time-series index values of Russell/Nomura Japan Index since the end of 1979 is available on the website with free of charge.

The estimation period is 20 years from April 2002 to March 2022. The funds subject to the estimation have investment performance data for more than four years during that period and have an outstanding balance as of the end of March 2022 (that is, the length of data period used for the estimation of each fund varies by funds).

Statistical values (annual rates) of the explanatory variables are as follows:

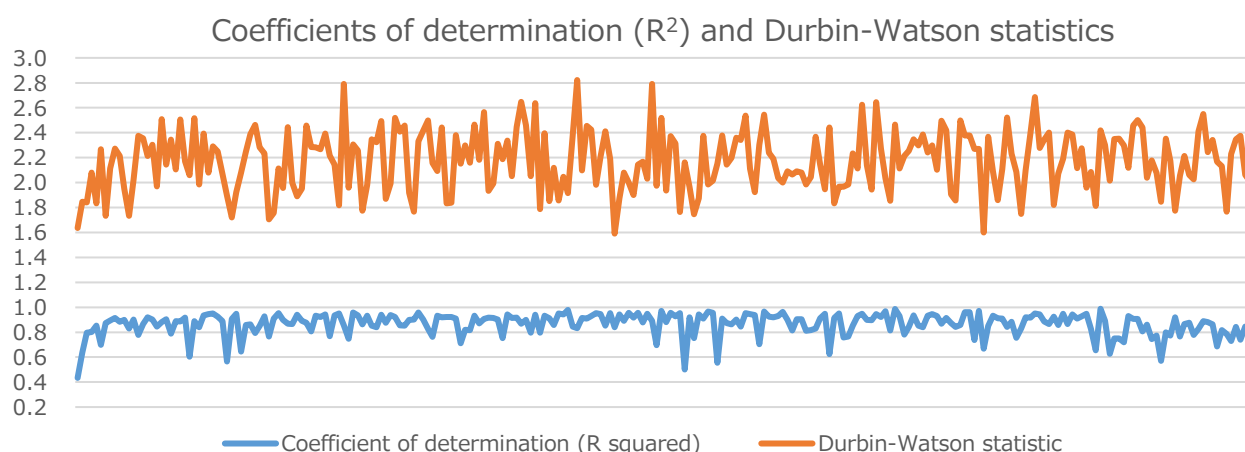
| | Mean | Standard deviation |
|---------------|-------|--------------------|
| $RM_t - RF_t$ | 6.49% | 17.09% |
| SMB_t | 1.95% | 8.04% |
| HML_t | 1.59% | 7.34% |

The correlations between explanatory variables are as follows. Problematic values for a regression analysis are not found.

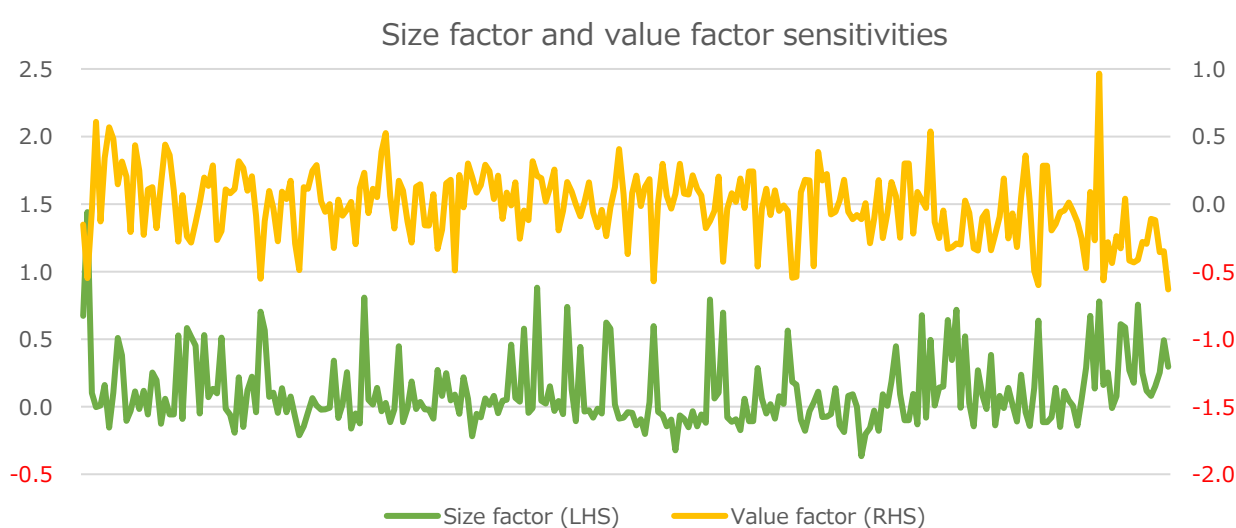
| | $RM_t - RF_t$ | SMB_t | HML_t |
|---------------|---------------|---------|---------|
| $RM_t - RF_t$ | 1.00 | 0.10 | -0.21 |
| SMB_t | 0.10 | 1.00 | 0.02 |
| HML_t | -0.21 | 0.02 | 1.00 |

The estimates other than alpha are as follows. In the following figures, the estimation result for each fund is arranged from left to right in order from funds with lower alpha to funds with higher alpha as in Figure 1-6.

First, the coefficients of determination (R-squared, adjusted for degrees of freedom) are above 0.9 on average, indicating a generally good fit of the model. The Durbin-Watson statistics are distributed around 2.0, and no serious autocorrelation is observed.



The estimates of the sensitivity to size factors tend to be positive for most of the funds, meaning that the actively managed domestic equity funds generally tend to invest in smaller stocks. Funds on the right hand side with higher alpha tend to show particularly higher sensitivity to small equities. Regarding the sensitivity to value factors, funds with high alpha tend to be tilted toward growth stocks.



Similarly, the analysis of actively managed U.S. equity funds in Figure 1-13 is based on a time series regression analysis of a three factor model as well. Data prepared by the same method as that of Fama and French (1993), available on Kenneth R. French Data Library website⁵⁴, were used for explanatory variables. Since the dependent variables are JPY-denominated unit-prices of the funds, month-over-month changes of USD/JPY exchange rates are also added to the explanatory variables.

⁵⁴ <https://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html>

List of asset management firm surveyed on ESG funds

| |
|--|
| AXA Investment Managers Japan Ltd. |
| Schroder Investment Management (Japan) Limited |
| Russell Investments Japan Co., Ltd. |
| Asahi Life Asset Management Co., Ltd. |
| AllianceBernstein (Japan) Ltd. |
| Invesco Asset Management (Japan) Limited |
| PineBridge Investments Japan Co., Ltd. |
| HSBC Asset Management (Japan) Limited |
| SBI ASSET MANAGEMENT CO., LTD. |
| Asset Management One Co., Ltd. |
| Goldman Sachs Asset Management Co., Ltd. |
| Shinkin Asset Management Co., Ltd. |
| Shinsei Investment Management Co., Ltd. |
| Sumitomo Mitsui Trust Asset Management Co., Ltd. |
| Amundi Japan Ltd. |
| Sompo Asset Management Co., Ltd. |
| Daiwa Asset Management Co. Ltd. |
| Tokio Marine Asset Management Company, Limited |
| Nikko Asset Management Co., Ltd. |
| Nissay Asset Management Corporation |
| Okasan Asset Management Co., Ltd. |
| Norinchukin Zenkyoren Asset Management Co., Ltd. |
| Nomura Asset Management Co., Ltd. |
| BlackRock Japan Co., Ltd. |
| Eastspring Investments Limited. |
| Pictet Asset Management (Japan) Ltd. |
| Capital Asset Management Co., Ltd. |
| Sumitomo Mitsui DS Asset Management Company, Limited |
| Mitsubishi UFJ Kokusai Asset Management Co., Ltd. |
| Meiji Yasuda Asset Management Company Ltd. |
| BNY Mellon Investment Management Japan Limited |
| UBS Asset Management (Japan) Ltd |
| ICHIYOSHI ASSET MANAGEMENT CO.,LTD. |
| CHIBAGIN ASSET MANAGEMENT CO.,LTD. |
| Rakuten Investment Management, Inc. |
| Resona Asset Management Co., Ltd. |
| Global X Japan Co. Ltd. |

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