Insights from *Dialogue on Enhancing Sustainability Investment Products*

1. Introduction

Developing sustainability **investment products that are attractive to a wide range of investors** would play an indispensable role in encouraging their wider market participation and accordingly **enhancing potentiality and sustainability of the economy and the society**, including those products that are to promote Green Transformation (GX).

In particular, expanding and providing investment products would essentially require the strategies and preferences of stakeholders to be mutually fitted, including those of asset managers, investees, and retail and institutional investors, and the FSA organized four-time series of "*Dialogue on Enhancing Sustainability Investment Products (Dialogue)*,"[1] believing that sharing diversified views is essential on this topic.

The following is a summary note by the FSA on insights it has gained through those dialogues, regarding future challenges and issues on the sustainability investment products.

2. Major views expressed on sustainability investment products in *the Dialogue*

1) On roles expected for sustainability investment products

- A wide range of investors' participation in the sustainability investment market would certainly contribute to enhancing the sustainability outcome of the economy and society, and at the same time, it would be equally important to promote understandings among investors that they, **as investors, have genuine opportunities of securing long-term investment returns through sustainability investment**.[2][3]

- Institutional investors have been increasingly adopting an investment strategy that seeks to achieve long-term growth in their assets under management by addressing sustainability issues through their investments. **Gaining a broad understanding of the existence of such investment methods among retail and other investors would eventually expand the base of sustainability investment**.

- For this purpose, **it is necessary to note and recognize that sustainability investment is not about the name or label of investment, but rather about investment strategies**

[1] The FSA's "Dialogue on Enhancing Sustainability Investment Products" was held four times from December 2023 to June 2024 with the participation of a wide range of stakeholders, including asset managers, distributors, retail investors, sustainability or investment experts, ESG data and evaluation providers, and investment information providers.

[2] In this report, the term "sustainability investment" is used to comprehensively encompass all the investments that take sustainability into account in investment decisions, which are usually referred to as "sustainable finance" or similar terms. Therefore, the "sustainability investment" in this paper includes "ESG investment," "impact investment," "green investment," etc., and does not limit the scope of its term by the product's particular names or investment methods.

[3] In this report, the term "product" is used to comprehensively encompass all the investment and financing opportunities including stocks, bonds, mutual funds, and loans, etc., and is not limited to listed or unlisted, publicly offered or privately offered products.

and practices including engagement with investees. While only 1% of publicly offered investment trusts in Japan are "ESG"-named products, there would presumably be much more products with investment strategies considering sustainability; the fundamental is to recognize the overall pictures of sustainability investment practices.

・ In particular, engagement with investees is an essential element of encouraging business transformation by sharing the perceptions and expectations on their sustainability and business issues between an investor and investees. Retail investors, however, do not thoroughly realize that such investment practices could lead to enhancing investee's business improvements and thus investment's medium- to long-term returns.

2) On characteristics of products (1) - realizing growth achievement through investment

・ Presently available "ESG"-named investment products do provide quantitative and qualitative information on considering factors, such as greenhouse gas emissions, diversity of board members, employment engagement, etc. They also typically explain their investment methods, such as 'screening,' or 'integration.' It would be, however, **commonly not easy to tangibly perceive, or retain a hands-on understanding on at the level of individual perception, how those sustainability-related investment strategies or investee's initiatives would lead to their sustainability or business outcome.**[4]

・ On the contrary, retail and other investors are rather interested in investment products whose use of funds and impact are clear and concise, such as: infrastructure bonds for improving community environments, crowdfunding for reconstructions from natural disasters, equity investment in local startups. **Providing investment opportunities and information would be essential that are tangible enough for each individual to examine, consent, and choose investments based on their own investment purposes and interests**.

・ To accurately understand investment effects would also be important for investments to realize a virtuous cycle of domestic financial flows to address social issues and create business opportunities.

(*) In Europe, to boost long-term investments in illiquid assets, such as infrastructure projects, unlisted companies, including those from retail investors ELTIF (European Long-Term Investment Fund) as a collective investment framework was introduced in 2015.

・ If investors could have a genuine observation that an investment or investee would

[4] Some asset managers explain on their websites general investment approaches and differences among them, and on this basis provide the definition of sustainability products of theirs.

address sustainability issues, fulfill business potential, and enhance investment returns all linked together, they could more easily make investment decisions based on long-term perspective.

3) On characteristics of products (2) (passive / active)

- Passive investment products are generally characterized by elements such as high liquidity, low fees, wide diversification and index-linkage. While diversification could average out the characteristics of the investment portfolio, the market-average nature of the investment may tend to make it difficult for investors to intuitively perceive the specific impact of the investment.[5]
- In contrast, active investment products tend to have relatively low liquidity and high fees, but they are expected to **connect investors with "good" companies** by such as individually selecting distinctive companies in line with the given investment strategy.[6]
- Sustainability investment products often need particular knowledge and organizations, such as expertise in social or environmental impacts, insights and experiences that lead engagement with investees to their sustainable growth, and framework or infrastructure for data collection.
- Sustainability investment and active investment would have several common expected functions: finding and improving the potentials of investees, providing expert, and cross-sectional analysis of ranges of companies, and carrying out proactive engagement to enhance future growth and sustainability.
- In active investment, we often observe cases where the success or failure of engagement leads to changes in investment ratios or investment decisions in active investment. Such cases could and should be observed in sustainability investment as well.
- In passive investment as well, there are expected to be, and in fact have been, various created products that **aim for long-term investment returns with an eye to sustainability,** incorporating non-financial factors in addition to financial indicators. Each characteristics of passive and active investment should be properly considered in product development and investment processes.[7]

4) On characteristics of product (3) - difference from thematic investing

[5] Generally referring to investment methods that aims to achieve the same investment performance as predetermined indices.
[6] Generally referring to investment methods where asset managers make their idiosyncratic investment decisions, which are usually made in an attempt to outperform the returns of a particular benchmark.
[7] Some estimates that passive products account for 30-40% of sustainability investment products' total AUMs in Europe and the US, and 10% in Japan, according to Morningstar "Global Sustainable Fund Flows: Q3 2023 in Review".

- Sustainability investment tends to be linked to certain business areas or environmental technologies such as "environmental (E)," "social (S)," and "governance (G)." Therefore, it is sometimes seen as one of so-called thematic investment products that focus on specific fields such as industries and technologies.[8]

- Sustainability investment is **essentially an investment concept or strategy and practice to foresee medium- to long-term investment returns through investment activities such as industry-wide analysis and engagement**.

- Even for products that invest in the same environmental project, so-called "thematic investment" focusing on the project area and "sustainability investment" focusing on the long-term potential of the project are categorically differentiated.

- The point is that the latter gives strategic consideration to contributing to its long-term asset management, identify the long-term sustainability of the investment target and take constructive investment actions toward this target, rather than making decisions in the investment field.

5) Method of providing the product;

- Sustainability issues cover a wide range of areas, such as decarbonization and human rights, and their impact on corporate value is complex.

- Although sustainability is essentially concerned with the long-term growth and the sustainability of the economy and society, the details of the issues, the terminologies, and their relationship with investment and business are usually complex. As mentioned in (2), it would not be easy for retail and other investors to briefly understand that, for instance, their own funds could contribute to both building assets and tackling social or environmental issues. Product providers would need to note the conciseness of their products and explanations.

- Therefore, for instance, **producing flagship investment products** would allow retail investors to have clearer understanding of sustainability investment and make investment decisions. Furthermore, **the vision and actions of role-model fund managers, asset management companies, and corporate executives would possibly help to clarify specific images of and build trust on those products**.

- Originality and ingenuity would also be important for the preparation of data to visualize the sustainability and impact of each investment product. For example, in Japan, disclosure of the equities included in investment trusts tends to be focused on the top 10

[8] Thematic investments often focus on the prevailing economic environment and investors' interests to determine investees, such as AI, robotics and healthcare.

stocks with the largest market capitalization in the trust. Disclosing more names of the stocks of the fund may provide potential benefits such as clarifying specific investment impacts, although care is needed with the disclosure's impact on funds' investment strategies.

3. Major insights gained through the dialogues on future directions

- Sustainability investment is in essence not a product name but an investment strategy and practice including engagement with companies. In reality, however, its essence is not easy to grasp and it tends be understood as one of thematic investments.

- On the other hand, it is pointed out that products with clear use of funds and concise investment impact in fact tend to draw investment interests more widely, as they provide tangible, hands-on understanding on real-world investment characteristics and outcomes.

- As regulations on explanation and disclosure of sustainability investment products, European regulations and Japanese Supervisory Guidelines stipulate the obligation to explain when selling investment products promoting sustainability, however, these are not in their nature to provide a common understanding of the specific and central content or classification of sustainability investment products.

  (*) In Europe, a public consultation was conducted until last December on the possibility of a framework for comprehensively classifying and disclosing sustainability profiles of ranges of investment products, including products that do not explicitly promote sustainability, as a way of addressing potential issues with the SFDR.

- In order to expand sustainability investment opportunities, providing opportunities and information would be important to be able to actually experience the fundamental value and effects of investment based on investors' needs, such as contributing to sustainability impacts and investment returns, not aiming to increase the offerings of "ESG" -named products.

- At the same time, it is not always easy to gain a concise understanding of the specific contents and effects of sustainability investments. It is also expected to include risks and other factors depending on the characteristics of the investment. Therefore, including these views, comprehensively discussing how to identify key points and to gain understanding would be important.

- To this end, while taking into account various past initiatives by asset managers or others developed after the said revision of the Supervisory Guidelines, exploring and discussing the following themes are worth consideration:

- nature of investment opportunities and characteristic , based on *fact-finding surveys* on investors preferences and intentions;
- approaches on innovations and its possibility that lead to *flagship sustainability investment opportunities*, including collaboration among stakeholders such as asset managers, distributors, information providers, and investors; and
- *core concepts and practices* on investments that can achieve sustainability and growth, that are easy for businesses and investors to understand and could be clues to consider elements such as fundamental value, strategy, and explanations of sustainability.

・ To encourage better understanding among beneficiaries including retail investors and more robust practices by providers, these discussions would preferably not be based on abstract expressions or technical terms but would be concise or accompanied by specific pictures towards investment impacts and actual growths, which will be easily understood by a wide range of parties concerned.

(*) The above *core concepts and practices* may include, for example:

- investment strategy, such as selecting investees with excellent initiatives and making investments after analyzing the sustainability impacts and the implications;
- product descriptions and disclosures to investors in an easy-to-understand manner, such as how sustainability issues are incorporated into investment strategies; and
- collaboration and engagement to identify business issues related to sustainability of investees and support their solutions.

In any case, it is expected that discussions will take place from a broad perspective while also considering the effects and issues of overseas initiatives.