

Index Insights | Sustainable Investment

Integrating ESG into core Japanese benchmarks

March 2022



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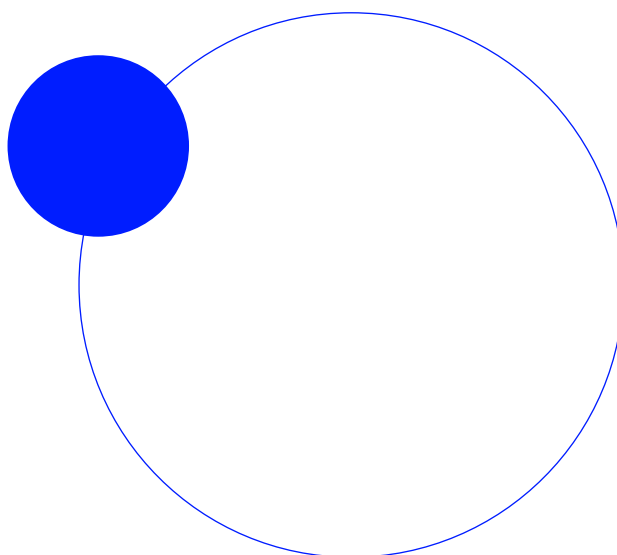


Introduction

Investors globally are developing investment strategies that aim to integrate environmental, social, and governance (ESG) considerations into their core approaches and are growing in sophistication. The Japanese sustainable market is no exception to this global trend and has blossomed in recent periods, creating a demand to integrate ESG criteria into the core benchmark construction and passive strategies of investors.

Recognising this shift, in 2017, FTSE Russell designed the FTSE Blossom Japan Index to help investors, and other market participants, integrate and promote ESG considerations. The FTSE Blossom Japan Index can be used to integrate ESG considerations into a diversified investment strategy. The index, as this paper will explain, can enhance ESG exposure based on FTSE Russell ESG Scores, while maintaining the index characteristics of a broad market benchmark, and also provides a strong basis for corporate engagement. In addition, in 2022, FTSE Russell developed a sector relative version of the FTSE Blossom Japan Index.

The FTSE Blossom Japan Sector Relative Index uses a sector-relative approach to reduce the deviation from the base index and identify a company's relative ESG scores in the business sector. The index also aims to address the climate transition by incorporating climate risk management criteria from the perspective of management quality. FTSE Russell's index methodology helps incorporate ESG into investment strategies, while using corporate disclosures and transparent methodologies. Scores and index calculation methodologies provide clear standards for companies' ESG compliance, support understanding and dialogue across the investment chain, and help support stewardship activities in investors' investment activities.



Integrating ESG into Japanese stewardship responsibilities

The introduction of the 2014 Japanese Stewardship Code was an important milestone for institutional investors interested in exercising their fiduciary duty as responsible owners of companies. The Code was revised in 2020 and underscores the importance of stewardship in encouraging the disclosure of environmental, social, and governance (ESG) information, and enhancing sustainable corporate growth and value over the long term. Since the signing of the Principles for Responsible Investment (PRI) by the Government Pension Investment Fund (GPIF) in Japan in September 2015, the number of Japanese signatories of asset owners and asset managers has continued to increase, exceeding 100 as of December 2021.

Japan has also further consolidated its commitment at a policy level to address climate change. In response to rapidly advancing global warming, the Paris Agreement was adopted at the UN Convention on Climate Change (COP21) in 2015. It aimed to substantially reduce global greenhouse gas emissions in an effort to limit the global temperature increase in this century to 2 degrees Celsius above the pre-industrial levels, while pursuing means to limit the increase to 1.5 degrees. In October 2020, Japan joined other countries worldwide and declared that it will aim to achieve a carbon neutrality by eliminating its total greenhouse gas emissions by 2050.

In June 2017, the Task Force on Climate-Related Financial Disclosures (TCFD) released its final report, which has become the standard for companies to disclose their climate risk, recommend disclosure of governance, strategy, manage risk and provide metrics and goals. More recently, the Japan Exchange Group (JPX) confirmed that from April 2022, all companies in the Tokyo 'Prime' markets will need to report their recommendations in alignment with TCFD. In Japan's revised Corporate Governance Code, which was released by JPX in June 2021, the amendment addresses "enhancing the quality and quantity of climate change disclosures based on the TCFD or equivalent international framework" and "enhancing the quality and quantity of climate change disclosures in prime market listed companies." Also, Japanese companies are widely required to disclose sustainability and climate change measures, such as clearly stating that they will formulate a basic policy on sustainability and disclose their own initiatives.

FTSE Blossom Japan Index

Recognising this shift, FTSE Russell designed the FTSE Blossom Japan Index to help investors, and other market participants, integrate and promote ESG considerations. The name "Blossom" refers to the cherry blossom tree, which is one of Japan's most recognised national symbols. It also refers to the blooming nature of stewardship and the integration of ESG in Japan. The FTSE Blossom Japan Index can be used to integrate ESG considerations into a diversified investment strategy. The index, as this paper will explain, can enhance ESG exposure based on FTSE Russell ESG Scores, while maintaining the index characteristics of a broad market benchmark, and providing a strong basis for corporate engagement.

Index features

- **Facilitates ESG integration into the Japanese market** – supports improved ESG outcomes and drives better corporate sustainability performance and practices, using FTSE ESG scores
- **Applies ICB industry-neutral weighting approach** – minimises industry bias by applying industry neutrality to match industry weights of the index with those of the underlying FTSE Japan All Cap Index
- **Company engagement for transparency and disclosure** – increases transparency and disclosure in the capital markets to improve company engagement and investment stewardship practices
- **Selected by GPIF as a core ESG benchmark** – in collaboration with GPIF, promotes stewardship and high standards of corporate FTSE Russell ESG Scores and disclosures since 2017



FTSE Blossom Japan Index

FTSE Blossom Japan Sector Relative Index

Due to the growing importance of ESG and the need for companies to disclose information, FTSE Russell has supported investors and other market participants in integrating ESG into their investment activities for over 20 years. Since 2017, the FTSE Blossom Japan Index has been used to assist in the integration of ESG considerations into a diversified investment strategy. In addition, FTSE Russell has developed a sector relative version of the FTSE Blossom Japan Index, the Japan Sector Relative Index (referred to as SR), in 2022. This index, which selects companies with a higher ESG score within each sector, provides a narrower classification than traditional industries.

Index features

- **Facilitates ESG integration into the Japanese market** – supports improved ESG outcomes and drives better corporate sustainability performance and practices with using FTSE ESG scores
- **Applies ICB sector-relative selection methodology** – minimises sector bias through sector-neutral weighting to give a closer reflection of the Japanese equities market and reduce tracking error
- **Company engagement for transparency and disclosure** – increases transparency and disclosure in the capital markets to improve company engagement and investment stewardship practices
- **Supports the climate transition to a low carbon economy** – excludes high carbon intensity companies, while considering companies' climate governance for the transition to a low-carbon economy; also supports climate change efforts via the Transition Pathway Initiative with a Management Quality Score



FTSE Blossom Japan Sector Relative Index

FTSE Blossom Japan Index Series methodology

ESG methodology

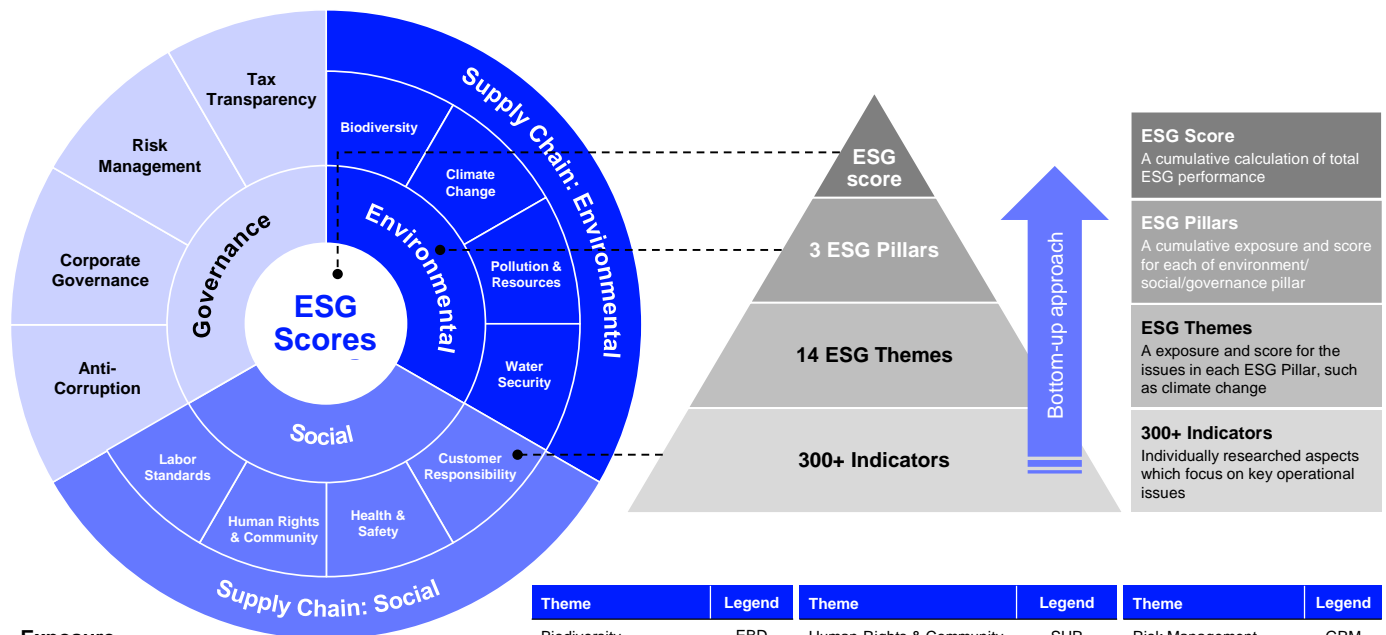
The FTSE Blossom Japan indices utilise the globally established ESG Scores methodology. Leveraging transparent methods established through more than 20 years of ESG experience, the index conducts positive screening using a methodology based on FTSE Russell’s ESG Scores, which measures a company’s ESG exposure and management of ESG-related risks.

The criteria used to assign an ESG score to a company are based on publicly available information—this model is designed under the supervision of FTSE Russell’s independent ESG Advisory Committee. The Committee consists of experts from the investment community, NGOs, unions, and academic societies.

A company’s ESG score is reviewed annually. To calculate an ESG score, each company is evaluated across 14 different themes using a model with over 300 specific indicators. On average, each company is assessed against 125 of these indicators. Each company is evaluated according to individual indicators selected by the supplier, business description, country of activity, etc. FTSE Russell also conducts engagement activities with companies on their ESG status, with opportunities for review before deciding on a final evaluation.

The following diagram summarises the ESG scores and data model:

Exhibit 1: FTSE Russell’s ESG Scores structure



Exposure

- Not applicable (0)
- 1 to 3, where 3 is high exposure

Score

- 0 to 5, where 5 is best practice

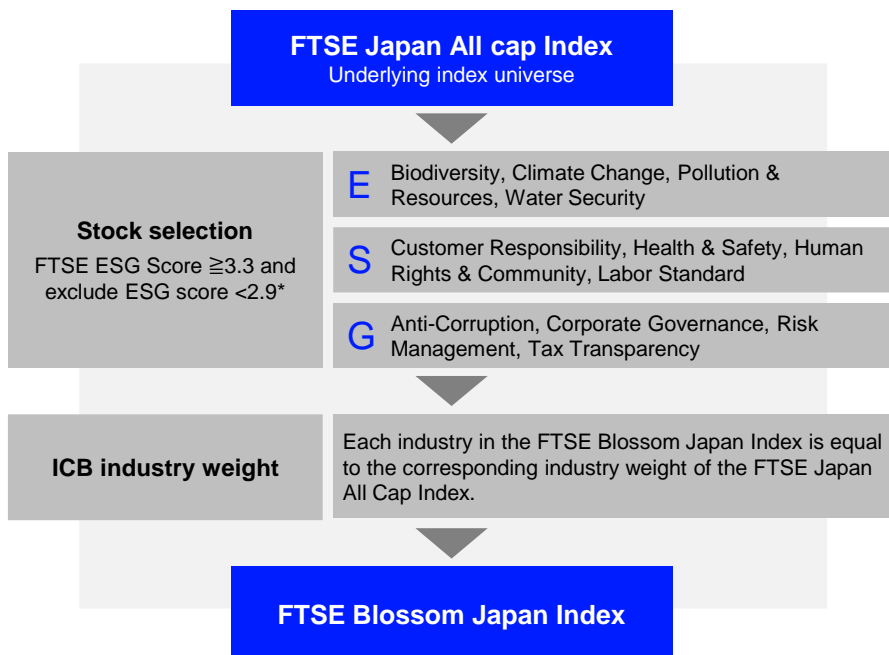
Theme	Legend	Theme	Legend	Theme	Legend
Biodiversity	EBD	Human Rights & Community	SHR	Risk Management	GRM
Water Security	EWT	Labor Standards	SLS	Tax Transparency	GTX
Pollution & Resources	EPR	Customer Responsibility	SCR	Corporate Governance	GCG
Climate Change	ECC	Health & Safety	SHS	Anti-corruption	GAC
Supply Chain: Env	ESC	Supply Chain: Social	SSC		

Upon an evaluation of the relevant indicators, each company receives both a measure for exposure and a score for each of the themes. The exposure (0 to 3, where 3 is the highest) is a measure of the relevance of each ESG theme to the company, whereas the score (0 to 5, where 5 is the highest) reflects the quality of the company’s management of the issues related to each ESG theme. The exposure is determined by factors based on their relevant impacts to specific ESG issues, such as business activities and geographical footprint. For example, a chemical company would have a higher exposure to the “Pollution and Resource” theme than a software company and would therefore be assessed on more indicators for that theme. The chemical company would also be “graded” on a tougher curve, which means a higher percentage of indicators would be required to get an equivalent score for that particular theme. As a result, the ESG Scores reflect a company-specific measure of ESG performance based on the relevance of the 14 themes in the data model.

Index methodology – FTSE Blossom Japan Index

The FTSE Blossom Japan Index methodology takes as its starting universe the FTSE Japan All Cap Index, which is comprised of large-, mid- and small-cap Japanese companies that are constituents of the FTSE Global All Cap Index. Each company in the underlying universe is assigned an ESG Score ranging from 0 to 5, with 5 being the highest score.

For the existing FTSE Blossom Japan Index, if a company has an ESG Score above the inclusion threshold, currently 3.3, it is eligible for inclusion in the index. In other words, it is possible to target the higher FTSE Russell ESG Scores for Japanese companies within the index. Any company at risk of exclusion has a one-year grace period if its ESG Score is below the exclusion threshold, which is currently 2.9, or if it has one or more ESG themes assessed as high exposure with a corresponding score of 0.



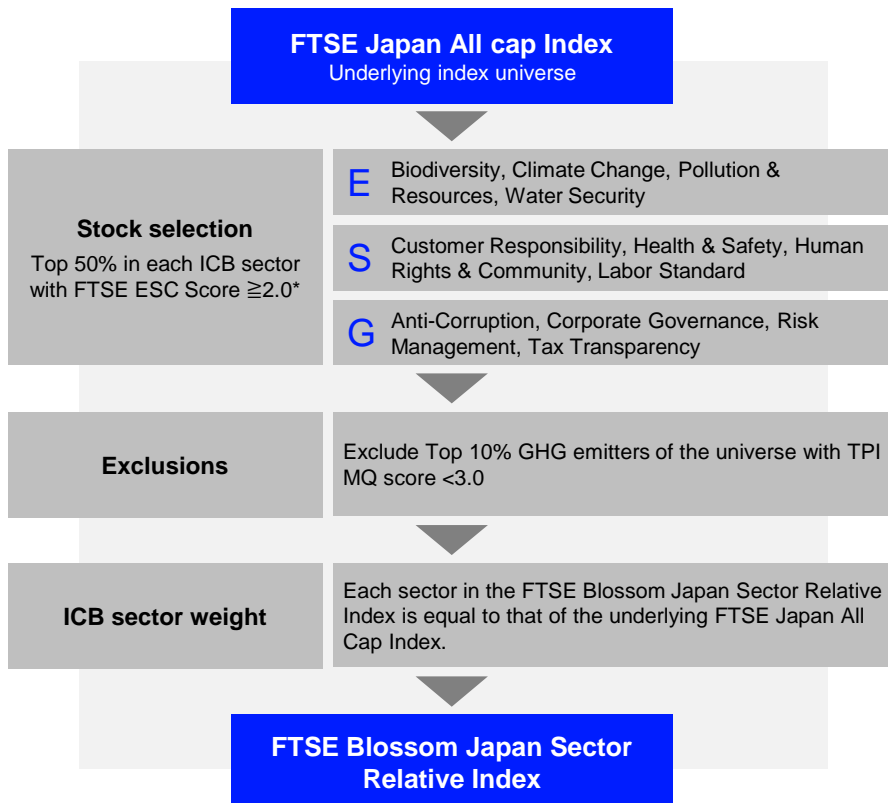
* Constituents of the FTSE Blossom Japan Index with overall ESG Score falling below 2.9 or the new minimum score requirements for the Climate Change theme, or having one or more ESG Themes assessed as high Exposure with a corresponding score of 0, are at risk of deletion from the FTSE Blossom Japan Index. Existing constituents whose ESG score falls below 2.9 can remain in the index for a period of one year to provide an opportunity for the score to increase to meet eligibility requirements.

Index methodology – FTSE Blossom Japan Sector Relative Index

In contrast, the FTSE Blossom Japan Sector Relative Index has an absolute ESG Score of 2.0 or above, with the top 50% stocks in each sector considered eligible. This sector classification is more granular than the industry classification employed by the FTSE Blossom Japan Index (see the appendix).

After the ESG screening methodology is applied to the base universe, the top 10% greenhouse gas (GHG) emitters in the base universe with the TPI Management Quality Score of 2.0 or less are excluded, and the weight of each score is determined so that it becomes 'neutral'. At the same time, the upper limit of the incorporation of individual stocks is also taken into account. Sector neutralisation of the FTSE Blossom Japan Sector Relative Index is based on the FTSE Japan All Cap and designed to match the weights of sectors in the underlying index.

Therefore, the methodology of the FTSE Blossom Japan Sector Relative Index allows broad access to the underlying Japanese stock market with a sector-neutral weighting application. It has characteristics similar to the FTSE Japan All Cap Index and enhances ESG exposure in the index through ESG standards and climate transition management.



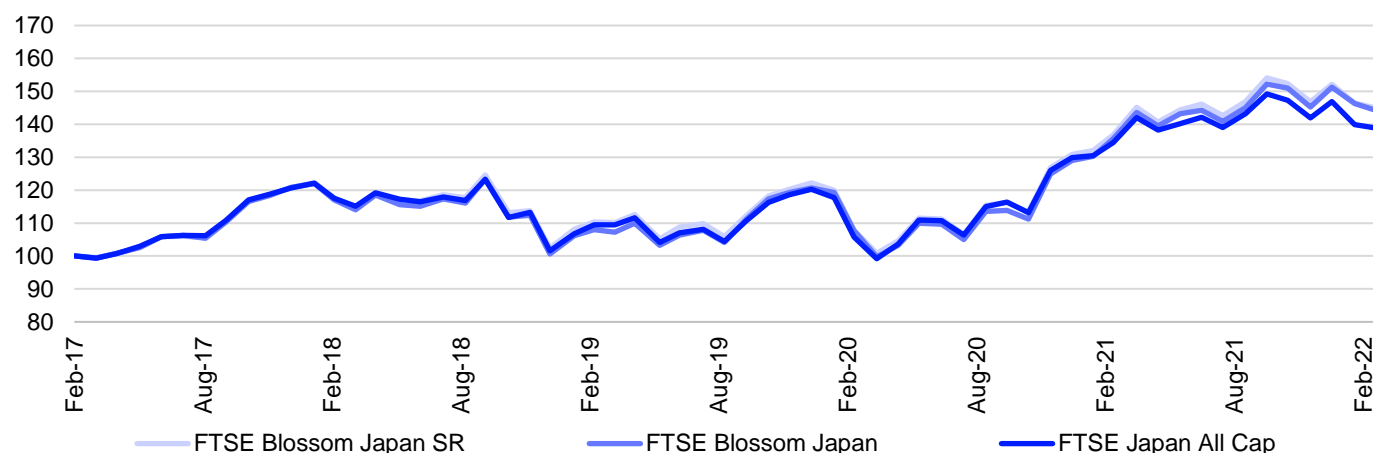
* The top 45% or more stocks are added to the index, and in the case of exclusion, the bottom 45% (out of the top 55%). In addition, the review of the incorporated stocks is carried out twice a year in June and December.

Performance analysis

The Sector Relative Index is built to be closely aligned with the wider market. As shown in Exhibit 2 and Table 1, both the FTSE Blossom Japan Index and FTSE Blossom Japan Sector Relative Index have marginally outperformed the returns of the FTSE Japan All Cap Index and achieved this outperformance amid a slight rise in volatility, since 2016 and over the last three years.

The FTSE Blossom Japan Sector Relative Index performs similarly to the market by minimising the deviation from the underlying benchmark sector exposure, while increasing the percentage of companies with high ESG scores within the sector and reducing the percentage of those with low ESG scores.

Exhibit 2. Five-year monthly performance (total return JPY)



Source: FTSE Russell. Data based on monthly returns from February 2017 – February 2022. Past performance is no guarantee of future results. Please see end for important legal disclosures.

Table 1: Annualised performance and volatility (total return JPY)

Year-on-year performance – total return (JPY)

	Year-on-year return (%)				
	2021	2020	2019	2018	2017
FTSE Blossom Japan Index	17.2	7.0	19.8	-16.7	22.1
FTSE Blossom Japan Sector Relative Index	16.3	7.0	19.4	-15.2	21.5
FTSE Japan All Cap Index	13.1	8.0	18.4	-15.8	22.0

Annualised performance and volatility – total return (JPY)

	Annualised return (%)				Volatility (% pa)		
	1Y	3Y	5Y	Since 22/09/2014	1Y	3Y*	5Y**
FTSE Blossom Japan Index	6.4	10.2	7.6	8.2	17.0	18.2	15.2
FTSE Blossom Japan Sector Relative Index	6.0	9.6	7.7	7.7	16.5	18.0	14.9
FTSE Japan All Cap Index	3.4	8.3	6.8	7.5	15.9	17.6	14.8

* Based on weekly data ** Based on monthly data

Source: FTSE Russell. Data based on February 2022. Past performance is no guarantee of future results. Please see end for important legal disclosures.

TPI Management Quality Score

The FTSE Blossom Japan Sector Relative Index also incorporates a management quality score as analysed by TPI to assess each companies' climate transition risk management. The TPI is a global initiative led by asset owners, and supported by asset managers, founded as a joint initiative between the UK's Church of England National Investing Bodies (Church of England Pensions Board, the Church Commissioners, and CBF Funds) and the Environment Agency Pension Fund. Launched in 2017, TPI uses publicly disclosed company information sourced and provided by TPI's data partner, FTSE Russell, and has rapidly become the "go-to" corporate climate action benchmark, with 120 investors having expressed their support for the TPI, totaling \$40 trillion in assets under management (as of February 2022).

Corporate management quality (MQ) is a set of indicators covering issues such as corporate policies, emissions reporting, verification of climate change risks and transitions, target settings (short- and long-term), strategic risk assessments, and executive compensation. Based on their performance against these indicators, companies are classified into one of five levels in line with their business description and taking into account their GHG emissions, etc.

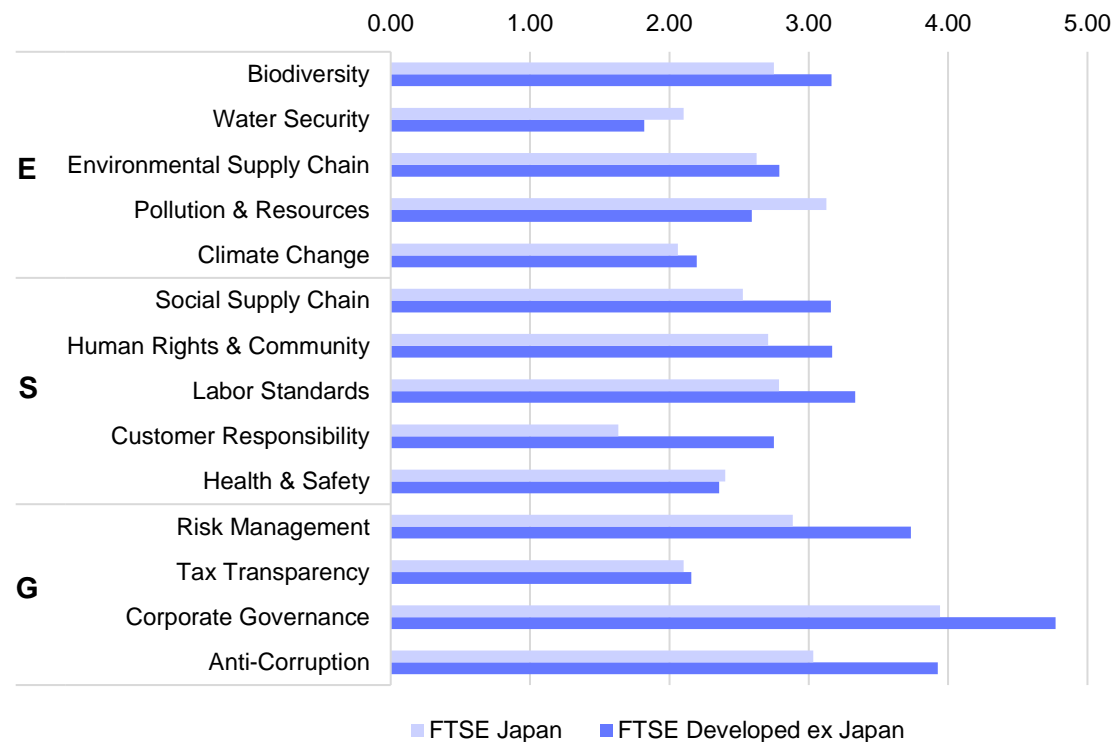
- Level 0 – Unaware of (or not Acknowledging) Climate Change as a Business Issue
- Level 1 – Acknowledging Climate Change as a Business Issue
- Level 2 – Building Capacity
- Level 3 – Integrated into Operational Decision-making
- Level 4 – Strategic Assessment

This assessment methodology complies with the Task Force on Climate-related Financial Disclosures (TCFD), and is not only relevant to companies' GHG emissions, but also evaluates companies whose physical and transition risks are appropriately managed in response to their transition to a low-carbon economy. The FTSE Blossom Japan Sector Relative Index excludes the top 10% of GHG emitters in the base universe, but if the company's TPI Management Quality Score is 3 or above, then the company becomes eligible for inclusion.

ESG practices in Japan

In December 2021, Japan was the fourth lowest developed market for ESG practices and had the lowest average ESG score within the G7 compared to large- and medium-sized stocks in developed economies, as represented by the FTSE Developed Index. Exhibit 3 represents the Japanese market's average ESG Scores by theme and shows that the scores have been historically lower than that of the developed markets ex-Japan in 11 of the 14 themes. In particular, the Customer Responsibility and Anti-Corruption themes show the greatest differences.

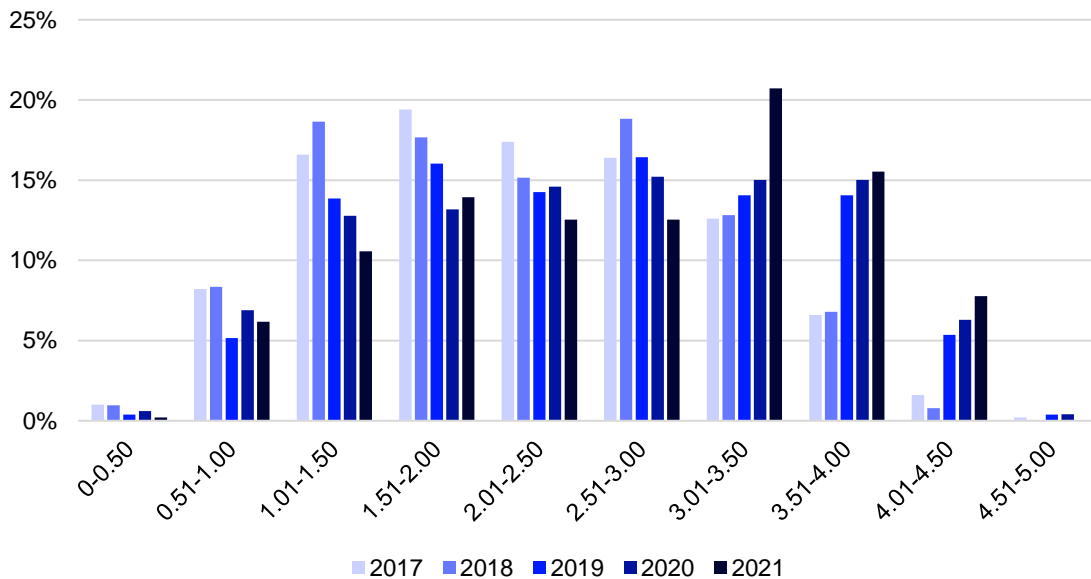
Exhibit 3. ESG Theme Score: FTSE Japan vs FTSE Developed ex-Japan



Source: FTSE Russell. Data as of 31 December 2021. Please see the end for important legal information.

Although the average score of the ESG score as demonstrated by the FTSE Japan Index is still lower than that of developed countries, there is an improvement in the average of ESG scores of Japanese companies belonging to the FTSE Japan Index over time. Since 2017, when FTSE Russell started calculating the FTSE Blossom Japan Index, the number of companies scoring above 3.0 has increased significantly (the end of September for each fiscal year in Exhibit 4).

Exhibit 4: Historical distribution trend on ESG Scores by constituents of the FTSE Japan Index (2017-2021)



Source: FTSE Russell. Data as of 31 December 2021. Please see the end for important legal information.

Conclusions

With strong global sustainable investment asset growth, investors are increasingly taking steps to integrate ESG into core investment benchmarks and therefore are looking for those that incorporate ESG philosophy and reflect a wide range of market exposures.

As this paper shows, the FTSE Blossom Japan Sector Relative Index uses a sector-relative approach to reduce the deviation from the base index and identify a company's relative ESG scores in the business sector. The index also aims to address the climate transition by incorporating climate risk management criteria from the perspective of management quality.

The FTSE Blossom Japan Sector Relative Index, along with the existing FTSE Blossom Japan Index, maintains similar index characteristics to a broad market benchmark, while increasing an investor's exposure to an improved ESG profile. FTSE Russell's index methodology helps incorporate ESG into investment strategies, while using corporate disclosures and transparent methodologies. Scores and index calculation methodologies provide clear standards for companies' ESG compliance, support understanding and dialogue across the investment chain, and help support stewardship activities in investors' investment activities.

Appendix

Breakdown of FTSE ICB Industry and Sector

Industry	Sector
Technology	Software and Computer Services, Technology Hardware, and Equipment
Telecommunication	Telecommunications Equipment, Telecommunications Service Providers
Health Care	Health Care Providers, Medical Equipment and Services, Pharmaceuticals, and Biotechnology
Financials	Banks, Finance and Credit Services, Investment Banking and Brokerage Services, Closed End Investments, Open End and Miscellaneous Investment Vehicles, Life Insurance, Non-Life Insurance
Real Estate	Real Estate Investment and Services Development
Consumer Discretionary	Automobiles and Parts, Consumer Services, Household Goods and Home Construction, Leisure Goods, Personal Goods, Media, Retailers, Travel and Leisure
Consumer Staple	Beverages, Food Producers, Tobacco, Personal Care, Drug and Grocery Stores
Industrials	Construction and Materials, Aerospace and Defense, Electronic and Electrical Equipment, General Industrials, Industrial Engineering, Industrial Support Services, Industrial Transportation
Basic Materials	Industrial Materials, Industrial Metals and Mining, Precious Metals and Mining, Chemicals
Energy	Oil, Gas and Coal, Alternative Energy
Utilities	Electricity, Gas, Water and Multi-utilities, Waste and Disposal Services

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