Index Insights | Sustainable Investment | Equity

Rewarding ESG disclosures

Improvements and challenges in ESG Scores of Japanese companies (Part 1)

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Written in collaboration with SGX

SGX Equity Derivatives

FTSE RUSSELL
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Quarterly analysis

This Japanese sustainable investment and futures report, written in collaboration with SGX, reviews the development of Japan's sustainability standards, the ESG performance of Japanese listed companies compared to the broad-market index, and the growth of index-linked SGX FTSE Blossom Japan Index Futures.

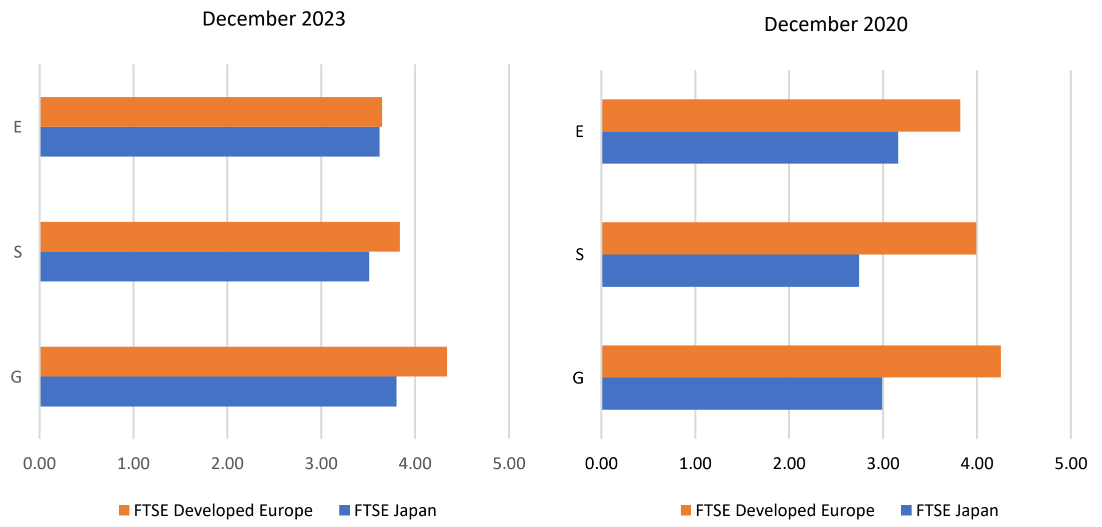
Key highlights from this quarter's analysis:

- The gap in ESG performance between Japanese companies and their European counterparts (as measured by FTSE Russell ESG Scores) is closing, with their Environmental Scores now nearing parity.
- However, challenges remain for Japanese companies, particularly in the Social domain, where disclosure rates still lag behind those seen in Europe.
- SGX FTSE Blossom Japan Index Futures continues to lead the Japan ESG derivatives space, and the broader Blossom Index family is also demonstrating significant outperformance versus the broader market.

ESG scores of Japanese companies improve

Since 2017, GPIF, Japan's public pension fund, and the world's largest pension fund in terms of assets under management (AuM), has significantly increased its passive ESG investment. A similar increase – although more gradual – has been seen among Japanese institutional investors more broadly. In last quarter's report, we highlighted the marked increase in the number of companies meeting the inclusion criteria of the FTSE Blossom Japan Index Series. The series is designed to measure the performance of Japanese companies that demonstrate specific ESG practices, and is driven by a set of inclusion criteria derived from FTSE Russell ESG Scores. To put the ongoing evolution of the Japanese market in context, we have explored how the latest ESG Scores received by Japanese companies – assigned in 2023 – compare to those received by European counterparts. When we carried out this same exercise in 2020, the European companies examined significantly outperformed the Japanese companies. So, to what degree has this picture changed?

Exhibit 1. FTSE Russell ESG Scores – December 2023 / December 2020



Source: FTSE Russell ESG Scores, June 2024. The Score data is weighted by market capitalisation.

Exhibit 1 compares each ESG pillar (E, S, and G) for 2023 and 2020 in terms of average scores in Japan and Europe (developed countries). When we look at this, two key facts emerge:

1. Japanese companies have significantly improved their ESG Scores over the past three years, approaching the European company average
2. In the E pillar, Japanese companies are nearing parity with European companies, but there is still a more meaningful gap in the S and G pillars

Growing investor engagement and corporate governance measures are boosting disclosure rates among Japanese companies

What are some of the factors behind the two facts emerging from the FTSE ESG Scores comparison above?

Regarding the significant reduction in the gap between Japanese and European companies' Environmental Scores, the generalised tightening of greenwashing-related regulations may have been a significant factor. While Europe is generally acknowledged as being the most advanced market globally in terms of ESG adoption, the fall in average European ESG Scores between 2020 and 2023 was more pronounced than the corresponding rise in Japanese Scores. This could be explained by changing definitions of ESG metrics and performance enshrined in regulatory initiatives. Even so, the substantial improvement in the average Japanese Score is noteworthy in its own right. One of the factors driving that improvement is likely to have been the increase in disclosure rates among Japanese companies, encouraged by GPIF, among others. The revision of the Tokyo Stock Exchange's (TSE's) Corporate Governance Code[1], released in June 2021, encouraged all listed companies to disclose their sustainability policies and related information. Index inclusion is an attractive prospect for Japanese companies aiming to attract passive investment. So, due in part to the positive impact of GPIF's increasing passive ESG investment and engagement activities, Japanese companies have disclosed more ESG information.

The scores in Exhibit 1 are based on a market cap-weighted average. However, if this weighting is removed, the scoring gap between European and Japanese companies widens. This means that while large international companies in Japan have actively disclosed their ESG information, there is still gap in disclosure rates among domestic companies and small/mid-caps.

[1] Publication of Revised Japan's Corporate Governance Code | Japan Exchange Group (jpx.co.jp).

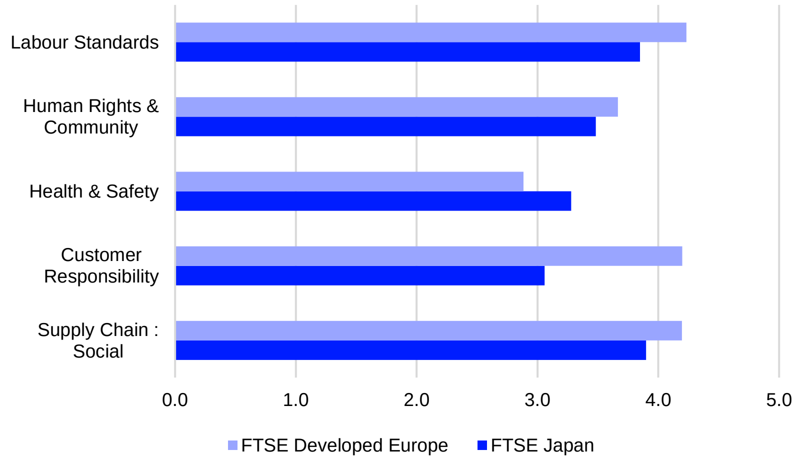
The FTSE Blossom Japan Index facilitates disclosure and enables company engagement

Small-cap companies were first included in the company universe underlying the FTSE Blossom Japan Index in 2021, GPIF has invested in the new FTSE Blossom Japan Sector Relative Index. Since 2022, this index has selected the top 50% of ESG-scored companies in each sector, with many of recent additions being small-caps. Both average Japanese ESG Scores and the level of communication between small-caps and FTSE Russell have improved significantly in the last 3 years. If this trend continues, sooner or later domestic companies and SMEs in Japan will also begin to disclose more ESG information.

Trends and Challenges of Japanese Companies in Social Disclosure (S-Score)

Next, let's take a closer look at each ESG pillar, starting with S.

Exhibit 2. FTSE Russell Social Theme Scores – December 2023



Source: FTSE Russell ESG Scores, June 2024. The Score data is weighted by market capitalisation.

Looking at Exhibit 2, we can see that Japanese companies received lower average S Scores than their European counterparts on four of the five themes measured.

The scoring mechanism for E Scores emphasises the importance of disclosures with a focus on climate change, and many Japanese companies have disclosed their exposure to physical and transition-related climate risks in line with the guidance of the Task Force on Climate-Related Financial Disclosures (TCFD). We believe that the increased adoption of global disclosure standards like the TCFD has contributed to the improved E Scores recorded among Japanese companies. On the other hand, S covers a wide range of themes, and the themes which are deemed important for (or material to) a company differ widely based on its industry and activities. Therefore, it remains difficult to standardise company disclosures.

Another theme to note is that many Japanese companies continue to develop social policies independently – with Board oversight – rather than basing them on UN or OECD principles. As FTSE Russell's scoring methodology – like many others – requires disclosures concerning the alignment of company policies and processes with certain such pieces of international guidance, this more independent approach by Japanese companies can result in them making fewer social disclosures.
In addition, in the theme of Health & Safety, FTSE ESG Scores require disclosures of "Investigations and findings of reported incidents, or no health & safety incidents leading to injuries or fatalities occurred ". But some responses received, such as "no important incidents" do not meet our disclosure standards, as they suggest that incidents occurred, but do not provide the required details.

In addition, although disclosures on the Human Capital and Human Rights themes by companies or their broader groups has progressed, there is little disclosure of policies and performance relating to human rights in the supply chain, human capital in the community, and consideration for impacts of business activities on society.

On the theme of Customer Responsibility, where the largest Social-themed gap exists between Japanese and European companies, our scoring methodology requires disclosure of responsible advertising practices (related to alcohol, tobacco, gambling, and similar products with the potential to cause negative societal impacts). These disclosures should cover any activities and actions that take into account consumers including minors, socially vulnerable groups, and developing countries (such as active disclosure of negative aspects and activities to prevent addiction). However, there are not many Japanese companies that disclose clear policies and corporate behavior or action relating to this theme.

Social disclosure is becoming increasingly important

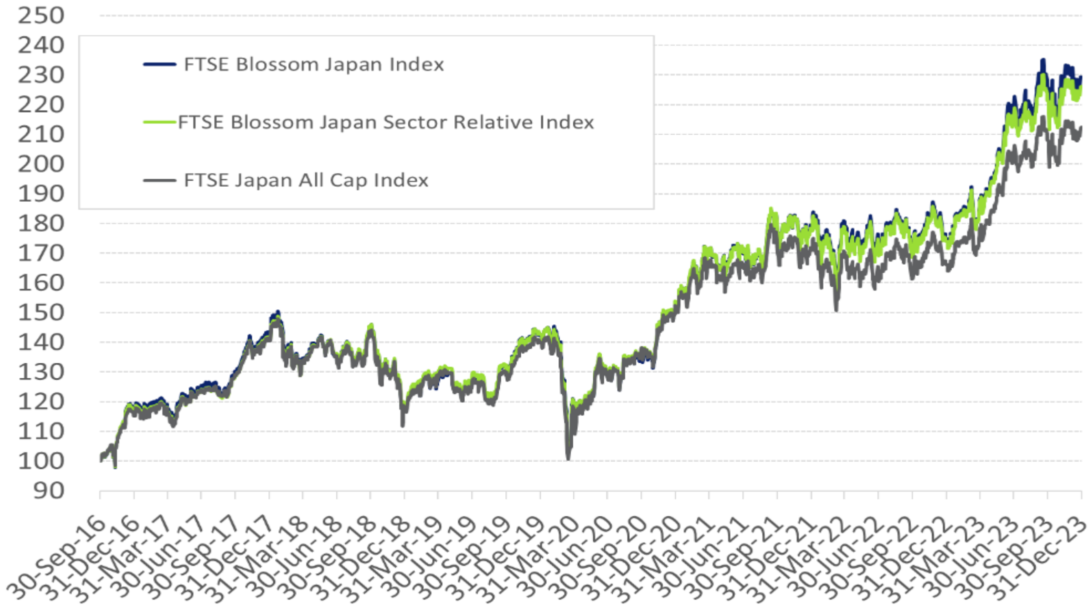
While the risks posed by social factors to companies and investment performance are becoming increasingly important to investors, Japanese companies still lag behind their European counterparts when it comes to Social disclosures (especially in terms of risk management), and tend to prioritise corporate revenue over social impact.

We will provide analysis of the ESG disclosure challenges of the G pillar for Japanese companies in part 2, in the next quarterly report.

ESG factors driving further outperformance of Blossom over the traditional market index

Q1 2024 was a very strong quarter for the Blossom index series. While both Blossom and Blossom SR indices extended their long-term outperformance relative to the benchmark FTSE Japan All Cap Index (Exhibit 3), it is noteworthy that the quarterly outperformance by both indices was also strong, largely driven by the significant contribution of the ESG factor.

Exhibit 3. Blossom Index Series outperforming FTSE Japan All Cap Index



Source: FTSE Russell. Data as of December 31, 2023.

Exhibit 3 compares the accumulated performance attribution results of the Blossom Index for the periods 2015/12/31 - 2023/12/31 and 2015/12/31 - 2024/3/29. ESG remains the dominant factor behind the index's long-term excess return, contributing +1,612bp for a total excess return of +1,945bp for the 2015/12/31 - 2024/3/29 period. ESG was also the main source of quarterly excess return, accounting for +466bp of the +728bp added in 2024-1Q.

Exhibit 4 shows the same analysis for the Blossom Sector Relative Index. Similar to the analysis for the Blossom Index, Blossom SR's strong performance was also driven largely by ESG factors, both in terms of long-term accumulative performance and the latest quarterly performance. ESG factors contributed +911bp of the total +1,102bp excess return over the traditional market index, and +248bp of the total +279bp quarterly excess return.

Exhibit 4. Factor Attribution Analysis (Blossom vs FTSE Japan All Cap, bps)

Period	Industry	Value	Quality	Volatility	Momentum	ESG	Residual	Total Excess
2015/12/31 - 2023/12/31	-187	163	-155	-166	183	1,146	233	1,217
2015/12/31 - 2024/3/29	-178	203	-158	-214	402	1,612	277	1,945
Quarterly Change	9	40	-3	-48	218	466	45	728

Exhibit 5. Factor Attribution Analysis (Blossom SR vs FTSE Japan All Cap, bps)

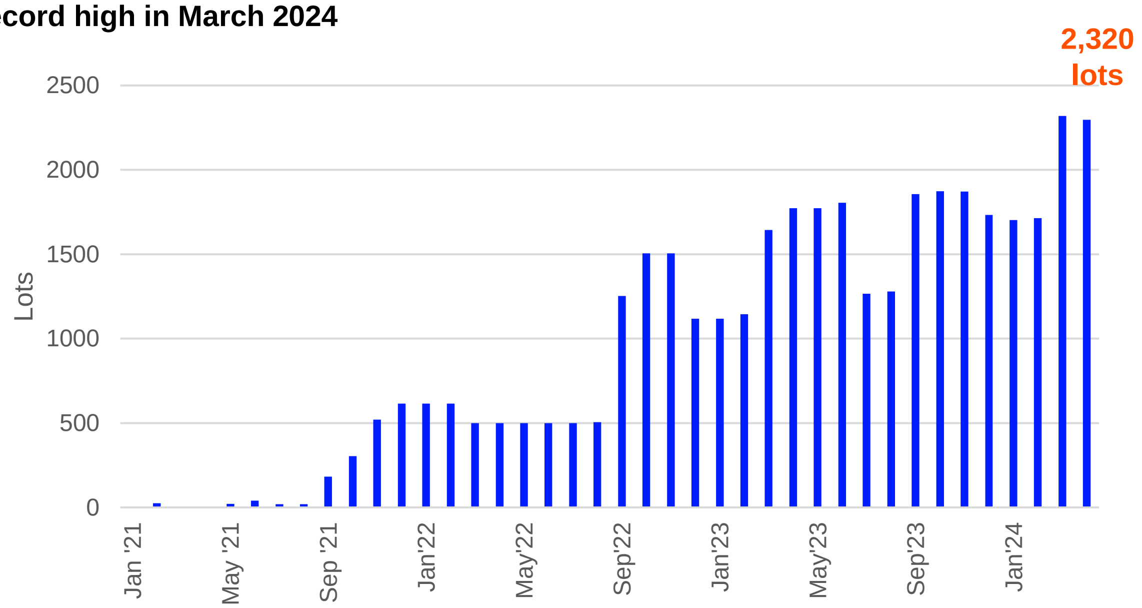
Period	Industry	Value	Quality	Volatility	Momentum	ESG	Residual	Total Excess
2015/12/31 - 2023/12/31	-24	34	-151	-60	255	663	107	823
2015/12/31 - 2024/3/29	16	40	-171	-74	356	911	25	1,102
Quarterly Change	40	6	-20	-14	101	248	-82	279

Source: FTSE Russell, Data as of March 29, 2024. Data covers the period from December 12, 2015 to March 29, 2024.

SGX FTSE Blossom Japan Index Futures, favoured tool for dividend equitisation in Japan

SGX FTSE Blossom Japan Index Futures continues to lead the Japan ESG derivatives space with another record month. As of March 2024, month-end notional Open Interest reached a high of US$173M.

Exhibit 6. Open interest (lots) of the SGX FTSE Blossom Japan Index Futures at record high in March 2024



Source: SGX. Data as of January 2021 - April 2024. Past performance is no guarantee of future results. Please see end for important legal disclosures.

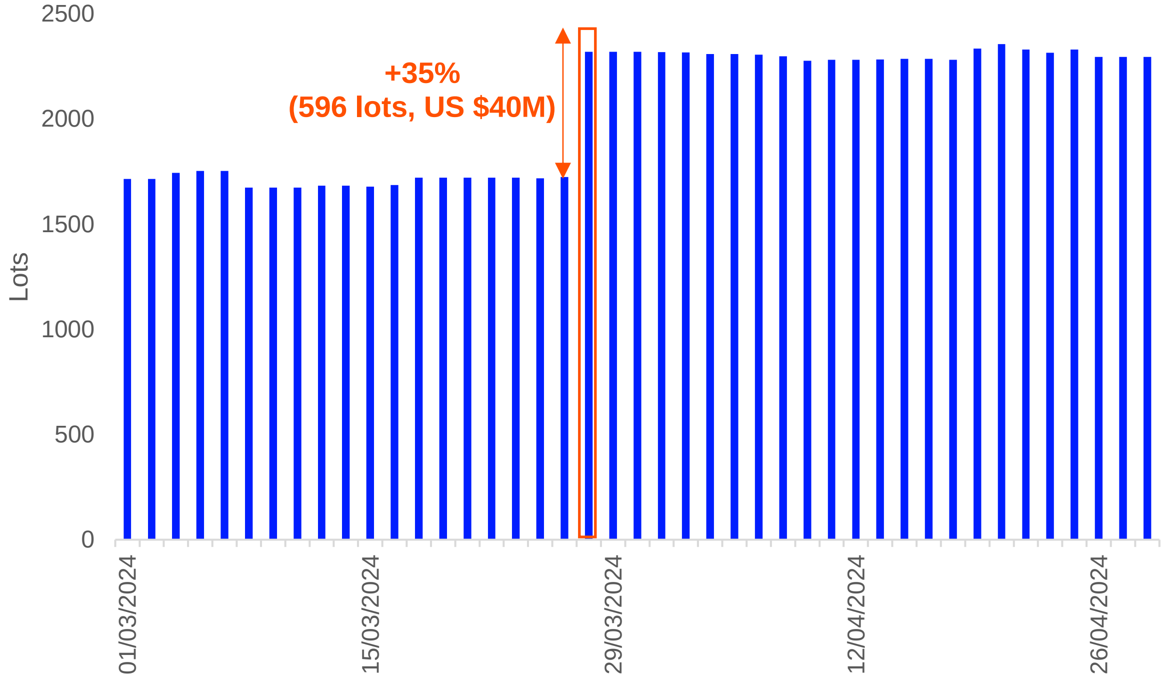
With growing internationalisation of FTSE Blossom Japan, spreads post the onshore Japan cash close (T+1 Session) have tightened significantly from an average of 17 bps in June 2023 to 9 bps in April 2024, thanks to more market-makers contributing to the order book.

Exhibit 7. SGX FTSE Blossom Japan Index Futures T+1 Session orderbook

Source: SGX. Data as of June 2023 - April 2024 excluding onshore holidays and calendar spreads. SGX FTSE Blossom Japan Index Futures T+1 Session hours: 14:55 SGT – 05:15 SGT +1. Past performance is no guarantee of future results. Please see end for important legal disclosures.

With a tighter round-the-clock orderbook, international investors who are benchmarked against TOPIX or seeking Japan ESG exposure can easily make the switch to an SGX FTSE Blossom Japan index future.

Exhibit 8. Open interest (lots) of the SGX FTSE Blossom Japan Index Futures during the month leading up to dividend equitisation at end of March 2024



Source: SGX. Data as of March 2024 - April 2024. Past performance is no guarantee of future results. Please see end for important legal disclosures

With the ex-dividend date for Japanese companies having passed on 28th March 2024, market participants utilised SGX FTSE Blossom Japan Index Futures for dividend equitisation. Open interest had increased by 35% compared to the previous day 27th March 2024, to 2,320 lots (US$173M) as of 28th March 2024. Market participants executed mainly through blocks, with banks pricing competitively with good size.

The next ex-dividend date season will most likely be on 27th September 2024. We expect to see a similar level of activity again, as portfolios seek to equitise dividends to minimise cash drag, and continue to utilise the right derivatives for their portfolios.

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