ENGAGEMENT, NOT EXCLUSION, REAPS ESG REWARDS IN JAPAN

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For asset managers and investors, engaging directly with the management of invested companies is a powerful means of changing their behaviour and inducing sustainable business practices. Along with the exercise of voting rights, engagement offers investors the opportunity to make their voices heard with respect to environmental, social and governance (ESG) among other business issues.

Asset managers initially applied ESG criteria mainly by excluding from their investment strategies those companies that exhibited unacceptable or unethical behaviours.[1] Exclusion can be effective but is essentially a negative approach, seeking to induce behavioural change by punishing companies. Engagement, by contrast, is positive, offering invested companies the opportunity to lay the foundations for sustainable long-term growth. Amundi has found that engagement, rather than exclusion, encourages companies to adopt more responsible corporate behaviour.

Engagement also delivers portfolio growth, something that is evidenced by Amundi's experience in Japan, says Shizuko Ohmi, Head of ESG at Amundi Japan. In 2017, the firm established the Japan Engagement Strategy. The strategy demands Amundi holds no more than 30 stocks for a relatively long (three to five year) period. It focuses on companies with growth potential and a healthy balance sheet, but with considerable room for ESG improvement. The strategy, says Ms Ohmi, is to engage directly with the management of these companies to improve their capital allocation, as well as their ESG awareness. Since its launch, the strategy has seen both overall positive financial returns and a higher volatility than was initially benchmarked.[2]

ENGAGEMENT FOR LONG-TERM IMPACT

To achieve these results, Amundi Japan employs three approaches to engagement with companies on ESG:

- **Engagement for influence.** At meetings with company executives, recommendations are made on cross-cutting themes that are common to a company's business sector. Currently, major themes include paying a living wage, eliminating child labour and reducing food waste.
- **Ongoing engagement.** This is an intensive process where ESG analysts meet with companies in order to better understand the sectoral challenges of integrating ESG. This type of engagement aims to develop specific practices within an organisation that will improve its ESG rating and encourage companies to adopt best ESG practices.[3]
- **Engagement through voting.** Amundi's corporate governance team votes at general meetings of invested companies.

Ms Ohmi and her team provide hands-on advice to company managers using the first two approaches. "Top management of Japanese businesses is not always aware of sustainability issues," says Ms Ohmi. "Our first step is usually to convince them how important ESG is to global investors. Then we explain to them how they can improve their ESG rating." Ultimately, she says, senior managers understand the virtue

[1] Such behaviours include the production or sale of anti-personnel mines, cluster bombs and other internationally proscribed weapons, the violation of human rights, and the generation of significant revenue from the extraction of coal. See *Amundi Engagement Report 2017*, June 2018.
[2] Source: Amundi Asset Management, as of 31/1/2019. Net performance is in Japanese yen. The benchmark is TOPIX.
[3] This is a proprietary rating system developed and applied by Amundi analysts.

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of integrating sustainable practices into their business models. When all else fails, Ms Ohmi's team can exert indirect influence by voting on corporate governance issues at general shareholder meetings.

ENGAGEMENT IN ACTION

Direct engagement can lead invested companies to change their behaviours. Ms Ohmi cites an example of how a fast-growing household goods company had a low ESG rating, which was an obstacle to its ability to attract investment. "We explained to the firm's top management that weak disclosure and weak monitoring were dragging its ESG rating down. The firm is now working with external consultants to improve the ESG rating, and has even established an ESG department to spearhead the improvement efforts."

Amundi's engagement with senior management officials also led two Japanese apparel firms to establish minimum wage guidelines for its suppliers. The same type of interaction led a fast-moving consumer goods company to implement the regular monitoring of agricultural producers in its global supply chain to ensure the elimination of child labour.

The top managers of Japanese companies are supporting such initiatives to change behaviours, says Ms Ohmi, because they increasingly understand the connection between their ESG ratings and their ability to attract investment, especially from sustainability-conscious overseas investors. Japanese firms are increasingly convinced that responsible environmental, social and governance practices are good for business. ESG engagement is integral to spreading that belief, in Japan and elsewhere in the world.

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