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—Engagement Activities and Issues Facing Japanese Companies—

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Institutional investors are involved in invested companies in diverse ways such as exchanging opinions with company executives about management policy in addition to exercising their voting rights and submitting shareholder proposals. In some situations, company executives ask their opinions about the strategy of business operations. These reciprocal interactions are known as "engagement activities." In recent years, an increasing number of institutional investors have been endeavoring to increase return on equity investments through these activities.

Engagement activities differ from investor to investor depending on how they view enterprise value. This difference stems from viewpoints focusing on (1) market capitalization in the stock market, (2) business value or (3) intangible assets. Viewpoint (3) valuates the effects that intangible assets such as corporate culture and employee loyalty have on business performance, and is close to the way of thinking of executives. Investors who take this approach have much in common with the interests of a company's management team.

With an increasing number of investors selecting target companies according to enterprise value from a long-term perspective, this shift of focus can be regarded as returning to the fundamental principles of investment behavior. In response, companies must also follow these principles in managing business activities. What are important under these principles include the maximization of business value and making the best use of intangible assets that contribute to higher management quality. For these purposes, trustworthy relationships must be established with core shareholders as part of the requirements essential to maximize enterprise value.

When consideration is given to the limitations that Japanese investors present and the future current of investment activities, it is inevitable that Japanese companies need to deal with overseas investors. Companies as well as investors must act appropriately and remind themselves of the principles of a capitalist economy that lead to the increased productivity of society overall. By so doing, companies and investors must move forward together.

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I Investors Have Diverse Purposes

What do investors seek from a company's management team? Chiefly, investors seek high return on equity investment. The return consists of two kinds of sources: capital gains, the profit realized from the sale of equities that were purchased at lower prices, and dividend income (income gains).

Investors have a variety of purposes in their equity investments. Some investors repeat purchases and sales and consider capital gains as a source of return. Other investors retain equities for a long term and focus on receiving dividends as the distribution of a company's profits. Investors aiming at acquiring greater capital gains from a short-term perspective are often interested only in stock prices rather than in a company itself, and have little interest in the activities of company executives. In contrast, investors such as pension funds and shareholder activists, who have often recently been covered in the mass media, are trying to strengthen their relationships with company executives as part of their shareholder activism.

With investors having varied purposes and different requirements, what approaches should a company's executives adopt for investors?

In this paper, the purpose of corporate management is defined as "maximizing enterprise value from a long-term perspective." Based on this definition, consideration is given to the relationships that companies should establish with investors to achieve this goal. The focus of consideration is placed on institutional investors in this paper. In Japan, corporate shareholders own about 80 percent of the shares issued by listed companies, and they have strong influence on the management of each company. Among these corporate shareholders, this paper focuses on institutional investors such as pension funds whose principal objective is to earn revenues through the management of funds collected from customers because they have very high interest in the activities of company executives.

In this paper, explanations are first provided about investors (shareholders) who are interested in the activities of company executives. These investors are involved in the management of a company in various ways such as holding discussions with company executives about management policy in addition to exercising shareholders' voting rights and/or proposal rights at general meetings of shareholders. Besides the actions taken by investors, company executives sometimes seek opinions from investors about management strategy. Such interactions and communications between investors and company executives are referred to as "engagement activities." The authors intend to clarify the relationships between investors and a management team by explaining what engagement activities are.

At the next step, this paper explains why investors are engaged in such activities. Without a full understanding of the principles of investors' behaviors, it would be difficult for company executives to build beneficial relationships with investors. The principles of investors' behaviors are based on the basic concept of how to view the value of a company. Only when their engagement activities are considered from the perspective of how investors assess the value of an invested company would it become possible to understand the reasons behind the behaviors of investors.

In conclusion, this paper offers suggestions on what measures should be adopted by Japan's corporate executives to deal with shareholder engagement activities.

II Engagement Activities

In recent years, activist shareholders who actively maintain contact with companies and become involved in their management have also been increasing in Japan. In particular, the Pension Fund Association is well known as an enthusiastic activist shareholder. As one example, exercising voting rights is an investors' reaction to proposals made by companies and is regarded as one of the engagement activities on the part of investors. On the other hand, providing explanations about agenda items to investors prior to a shareholders' general meeting and sounding them out about their reactions is regarded as one of the engagement activities on the part of a company's management team. The following sections focus on investors' engagement activities towards company executives.

Engagement activities cover a wide range. Table 1 lists the major shareholder engagement activities. The influence that shareholder engagement activities usually have on enterprise value increases in the order of Activity (1) to Activity (5). In other words, Activity (5) is most likely expected to have the strongest influence on enterprise value.

1 Activities Focused on Shareholders' General Meetings

Activity (1) "exercising voting rights" and Activity (2) "shareholder proposals" are both related to shareholders' general meetings. The agenda items that should be resolved at these meetings differ from country to country. Differences are also seen in how to position voting rights as one of the shareholders' rights. Accordingly, the content of these activities and investors' approaches largely differ by country.

For example, it was after the latter half of the 1980s that a major change began to occur in the US in terms of the concept of investors exercising their voting rights. In 1988, the US Department of Labor issued the so-called Avon letter, expressing its view that voting rights must

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Table 1. Outline of Shareholder Engagement Activities

Content of engagement activities			Characteristics	Open or closed
Engagement in a narrow sense	Little	(1) Exercising voting rights	• Voting for or against proposals made by the company at the general meeting of shareholders. • The agenda items that can be submitted to the general meetings of shareholders largely differ by country (the scope of such agenda items is most limited in the US). • Agenda items include the election of directors, any changes in the governance structure, any changes in the capital structure (capital increase, etc.), dividend policy, directors' remuneration, etc. • There are also many cases where opinions of advisory firms such as the Institutional Shareholder Services (ISS), a US leading provider of proxy voting and corporate governance services for institutional clients, are quoted, thereby evading direct involvement.	Open
		(2) Shareholder proposals	• Shareholders themselves submit agenda items at the general meeting of shareholders. • While exercising voting rights on proposals made by the company is a passive behavior, submitting proposals is considered an active behavior.	Open (often closed if proposals are submitted prior to the general meeting of shareholders)
	Influence on enterprise value	(3) Specific discussions and proposals	• Generally, investors and company executives have face-to-face talks about individual items related to company management; discussion items cover a wide range of topics such as management strategy and capital structure. • Among engagement activities in a narrow sense, this activity is regarded as the most active. • Investors must have human resources (requiring expenses) having specialties sufficient enough to talk about technical matters with company executives. • Some investors focus on the increase in value of intangible assets such as ESG items.	Generally, closed
		(4) Coordinating opinions among shareholders	• Coordinating opinions among shareholders and establishing cooperative systems. • Persuading shareholders having differing opinions.	Closed
Engagement in a broad sense	Large	(5) Becoming involved in management and executing business	• Electing directors/executive officers and/or appointing directors/executive officers nominated by principal shareholders. • Formulating plans for business reorganization. • Performing planned business activities. • Other related activities.	Closed

Notes:1) Engagement refers to interactions and communications between investors and invested companies' executives. 2) ESG refers to environmental, social and governance factors.

be diligently exercised as part of the duties of fiduciaries that manage the assets (shares) of pension funds. In response, the pension funds and their trustees (asset management firms) prepared guidelines for the exercise of shareholder voting rights, based on which shareholders started to exercise voting rights.

In the UK, in 1999, the London Stock Exchange adopted listing rules that require listed companies to abide by the Combined Code on Corporate Governance that sets out principles of good practice for corporate governance. Since then, the management of most listed companies has taken focused approaches to improving the quality of corporate governance. Each company's management provides explanations on a closed basis about the agenda items to be proposed at the shareholders' general meeting to investors who own a large number of shares prior to the meeting, and determines the final agenda items in which the opinions of these shareholders are incorporated. Incidentally, this style largely differs from that in the US, where management and shareholders generally discuss such matters at an open session without engaging in such consultations prior to the shareholders' general meeting.

For the following reasons, Activity (1) and Activity (2) are not considered as having significant influence on enterprise value.

- These activities are those related to resolutions to be made at the general meeting of shareholders held once a year.
- Most of these activities are generally announced publicly.
- It is considered exceptional that approval or disapproval of an agenda item such as proxy fights would influence stock prices.

2 Closed Activities Emphasizing Enterprise Value

Activity (3) "Specific discussions and proposals" is one of those activities that would influence the everyday behavior of company executives. In most cases, this activity is conducted on a closed basis. Company officials and investors have face-to-face talks about matters related to corporate management, and discuss a wide range of topics such as management strategy and capital structure.

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Many topics need not be included in the agenda of the general meetings of shareholders, but would affect enterprise value. These themes include the utilization of idle assets, improved disclosure, any changes in financial leverage ratio (debt to equity ratio), and proposal of growth strategy. It might be awkward if many proposals that were not very meaningful to company executives were made. Nevertheless, the greater the number of companies where shareholder engagement activities contributing to the maximization of enterprise value are conducted, the greater influence such activities would have on the entire stock market.

Activity (4) "Coordinating opinions among shareholders" is of significant interest in considering the relationships between an invested company's officials and its investors. Because investors have varied perspectives on management policy, conflicts of opinions occasionally occur among them. This activity refers to that of one investor who convinces other investors having differing opinions that a particular concept is more beneficial.

For example, let's look at the case in which a hedge fund (a Vodafone shareholder) demanded that Vodafone, the world's leading mobile telecommunications company, sell part of its overseas businesses. An asset management firm (also a Vodafone shareholder), a subsidiary of an insurance company, talked with Vodafone's management officials and judged that while the sale of overseas businesses might bring about an increase in stock prices from a short-term perspective, it would be highly likely that such sale would consequently damage enterprise value from a long-term perspective. Based on this thinking, the asset management firm explained to the hedge fund that the sale of the relevant businesses would most likely lead to damaging enterprise value from a long-term perspective, and persuaded the hedge fund to withdraw the sale request.

This case is interesting in that relationships between management officials and investors are viewed from the standpoint of whether a specific action will contribute to the maximization of enterprise value from a long-term perspective, rather than seeing them as confronting relationships. More precisely, one principal investor supported the management officials by encouraging a principal investor having an opposing opinion against the company's management policy to share a common goal of increasing long-term enterprise value and to jointly support the company in that endeavor.

Activity (5) "Becoming involved in management and executing business" is the activity with the highest level of commitment and has the greatest effect on enterprise value. A specific example is where a private equity fund acquires 50 percent or more of a company's shares, gains control of the company, converts the company into a privately owned company, replaces the company's executives, restructures the business and implements new business plans that it formulated. In such behavior, support is provided to businesses that the investor considers as contributing to the maximization of enterprise value.

III Investors' Perspectives on Enterprise Value

In order to correctly understand what influences many of these shareholder engagement activities would have on the efforts of management officials who perform business with the aim of maximizing enterprise value from a long-term perspective, it is essential to understand the principles of investor behaviors motivating their activities. These principles are largely dependent on how investors regard enterprise value.

By targeting investors whose intended equity holding period is the mid or long term (three years or more), this section explains the differences in their management techniques as compared to their thinking about enterprise value.

Figure 1 shows enterprise value in terms of book value on the right and enterprise value perceived by investors on the left.

Enterprise value in terms of accounting value (shown on the right) is defined in both a narrow sense and a broad sense. Enterprise value in a narrow sense consists of only tangible assets, which consist of "equity value" that falls under the interests of shareholders and "debt value" that falls under the interests of other parties such as creditors. From an accounting perspective, enterprise value is equal to "equity value plus debt value," and is the total sum of the enterprise assets indicated on the left side of the balance sheet. In a broad sense, enterprise value consists of tangible and intangible assets. Intangible assets include leasehold, goodwill and trademark rights. While intangible assets also include intellectual assets such as brands and know-how and intellectual properties such as patents and copyrights, only those assets whose acquisition costs are identifiable are recorded as assets in a ledger.

On the other hand, enterprise value perceived by investors (shown on the left side of Figure 1) is generally based on market value. The value indicated at the far left is "market capitalization," which refers to aggregate market value in the stock market. "Business value" (shown to the right of market capitalization) corresponds to purchase/acquisition price calculated according to the total market value including assets, debt and equities. "Intangible assets" perceived by investors refer to the quality of management officials and the quality of business as sources giving birth to a company's long-term cash flow. While such intangible assets are extremely difficult to enumerate, they are nevertheless considered as proxy variables to measure the ability to create cash flow.

The following sections explain investors' management techniques with focus placed on three different

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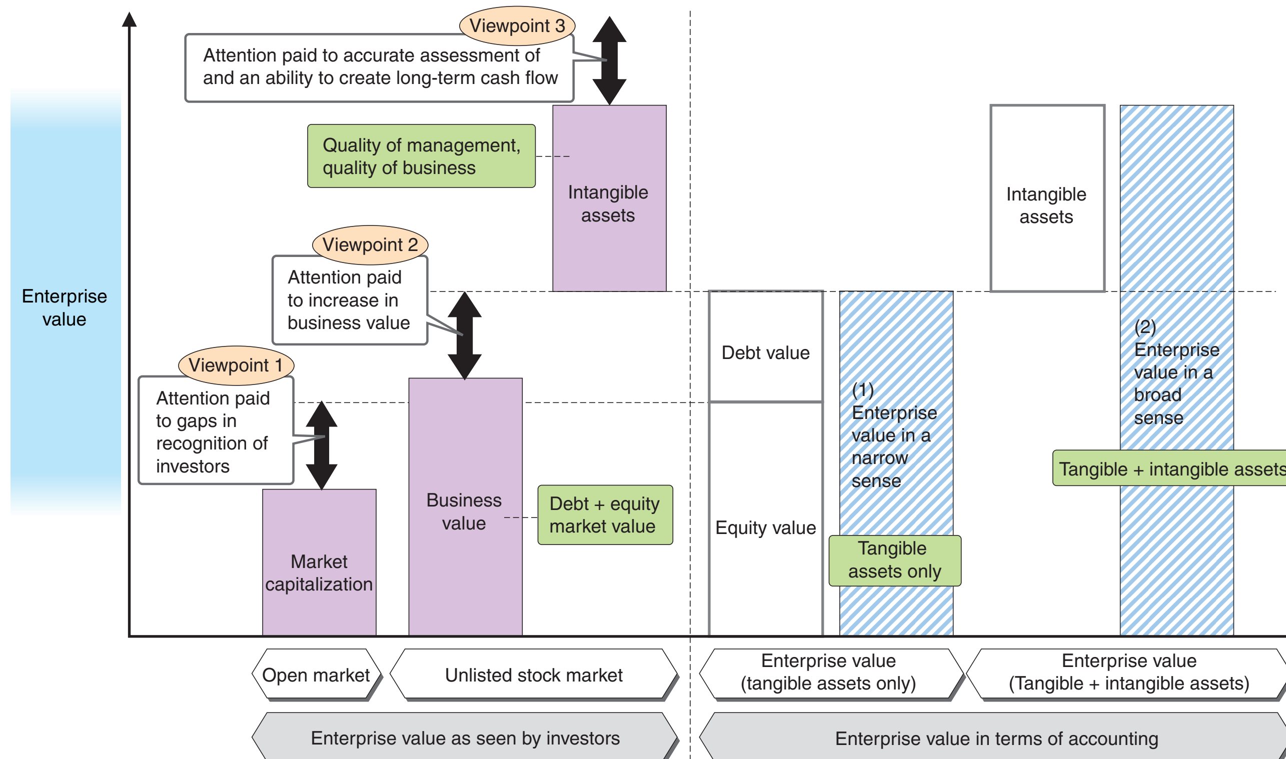
Figure 1. Enterprise Value as Seen by Investors vs. Enterprise Value in Accounting Terms



viewpoints in assessing enterprise value, and discuss how each viewpoint is related to engagement activities.

1 Focusing on Market Capitalization

The first approach (Viewpoint 1 in Figure 1) is the management technique paying attention to market capitalization. By way of example, consideration is given to the case where market capitalization in the stock market is lower than the book value of equities. The method adopted by investors (shareholders) in such a case is strengthening shareholder engagement to change a company's public image and change the recognition of investors toward the company, thereby increasing market capitalization and earning returns. This approach aims to narrow gaps between the appropriate equity value considered by investors (shareholders) and the equity value reflected in the market. There are several methods to implement this approach.

For example, suppose the case where a company receives a lower valuation than its real ability because of insufficient dialogue with investors. Example activities in such a case include the formulation of business operation plans that can be publicly disclosed, which contributes to improved disclosure, in an effort to bridge gaps between a company's actual ability and the valuation of investors. Another method to increase a company's rating would be to promote the appointment of independent outside directors to enforce management discipline, thereby minimizing the risk of the occurrence of inappropriate events. In addition, it would also be effective to persuade the company to withdraw its anti-takeover measures that compromise shareholders' rights.

This is one of the techniques adopted by asset management firms controlling funds in Japan that seemingly take a supportive approach for company executives. Rather than strengthening the ability of a company to produce profits from a long-term perspective, this approach is characterized by efforts to minimize gaps between true equity value and the recognition of investors as reflected in market value.

2 Focusing on Business Value

The second approach (Viewpoint 2 in Figure 1) aims to improve "business value" as seen by the market. Business value is generally calculated as the price at which a company can currently be sold or in the not too distant future (usually 5 years or less). There are not so many cases in which intangible assets that are difficult to assess such as proficient employees are included in this calculation. Major investors such as focus funds (investing in only a few companies in a concentrated manner), activists and private equity funds often adopt this approach in pursuit of the improvement of business value.

For instance, they propose a business operation plan that includes matters such as changes in capital structure, changes in management strategy and the sale of business to a management team. If no management team accepts their proposal, they might demand the replacement of management officials by taking a hostile approach.

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Because it takes time to improve business value through the sale of a business, the company is sometimes converted into a privately held company to implement the intended plan.

Because the period required to improve company value is longer than that required under Approach 1, an average of approximately three to five years is necessary from investment to sale.

3 Focusing on Intangible Assets

The third approach (Viewpoint 3 in Figure 1) pays attention to "intangible assets" as the "ability to create long-term cash flows." It is possible to say that this focus corresponds to the third responsibility of management executives, i.e., "maximization of the ability to create wealth" as defined by Peter F. Drucker, a sociologist, writer and management consultant, in his book, The Pension Fund Revolution (Transaction Publishers, 1996).

Sustainability investments and the method adopted by Warren Buffet, a well-known US investor, are considered to fall under this approach. Sustainability investments aim to maximize long-term returns by integrating the analysis of environmental, social and governance (ESG) factors with traditional stock analysis. An extremely long period is required to improve the ability to create cash flows, and the projected investment period is even longer than those required by Approaches 1 and 2.

The following section uses sustainability investments as an example to explain what processes are adopted to valuate the ability to create cash flows.

One asset management firm firmly believes that there are strong relationships between long-term corporate performance and the quality of a management team and business. Based on this investment belief, it considers that when valuating companies, ESG factors can serve as a proxy for expressing the quality of management and business. Essentially, intangible assets contributing to higher quality management differ by business category. This asset management firm has identified ESG factors that are related to the ability to create cash flows for each business category and each investment period.

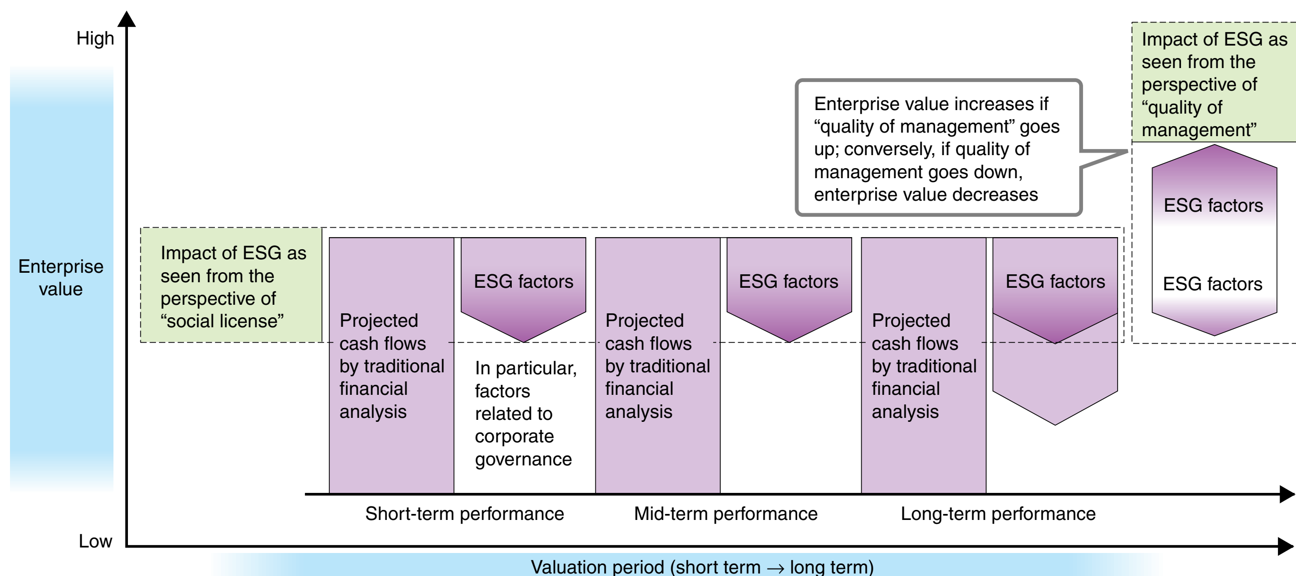
Figure 2 outlines the concept of sustainability investments in terms of the relationships between ESG factors and corporate performance. ESG factors have a variety of effects on corporate performance.

For example, consideration is given to the relationships between poor corporate governance structure and the shortfall risk of enterprise value in a short term (expressed on the left side of Figure 2). Such a case is often seen in Japan as well where an inappropriate event occurs due to poor corporate governance structure, and enterprise value is instantly damaged. This case suggests that corporate governance, which is an ESG factor, is deeply related to enterprise value shortfall risk.

In this approach, "social license" indicated in Figure 2 is defined as the minimum requirement to conduct business activities in society. The impact of ESG as seen from the perspective of "social license" implies that if a company fails to fulfill its ESG responsibilities, such failure would act as a shortfall risk and lead to a decline in enterprise value. In other words, the "social license" perspective focuses on shortfall risk as related to enterprise value.

The impact of ESG as seen from the perspective of the "quality of management," which is expressed on the right side of Figure 2, connotes the thinking that only first-rate management executives can develop intangible assets from a long-term view, and can increase the ability to create cash flows. Principally, this perspective focuses on the upside potential of enterprise value.

Figure 2. Relationships between ESG Factors and Corporate Performance as Considered by an Asset Management Firm Specializing in Sustainability Investments



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This approach assumes that first-rate management executives are those individuals (or groups) who have specific abilities. Such abilities include instilling all those concerned with corporate management philosophies, demonstrating such philosophies in actual business activities and operating a company with mobility as geared toward any change in the competitive environment such as limited natural resources and regulatory trends. Investors taking this approach also focus on the "quality of business" such as keeping ahead of competitors and creating high barriers to prevent others from entering such a business field, thereby maintaining high brand strength in the relevant field.

One of the characteristics of this approach is the implementation of "materiality assessment." Materiality assessment is conducted to determine to what extent and which ESG factor(s) affects corporate performance. Only because the investor has knowledge of the important factor(s) that affect enterprise value, the interest of the investor is considered to match the interest of management executives. By way of comparison, it can be said that the first approach of "focusing on market capitalization" and the second approach of "focusing on business value" are requirements or subsets of the third approach of "focusing on the ability to create long-term cash flows."

IV Corporate Management Required to Follow Principles

What has been explained so far suggests that institutional investors have returned to their starting point. More precisely, the principles of investment activities, i.e., investing in companies that can generate added value from a long-term perspective are again in practice. While not all institutional investors conduct their investment activities according to these principles, the number of institutional investors that pursue long-term investments is expected to gradually increase.

On the part of a company, in order to meet these expectations of institutional investors, corporate management must also be consistent with these principles. In other words, a company must deploy business operations in such a way as to maximize enterprise value from a long-term perspective. By dividing them into three themes, this chapter explains the principles of corporate management that a company must follow.

1 Focus Must be Shifted from Short-Term, Imaginary Vision

It is not possible to build trust among investors and encourage them to invest in a company if the company fails to develop an explicit growth vision and increase its ability to create cash flows through implementing such a vision. While this is the natural expectation of investors, currently, Japanese companies are unable to fully meet such an expectation and their abilities to create cash flows are lower than those of overseas companies[1].

In addition, it must also be noted that visions of growth developed by Japanese companies tend to focus on short-term activities and become ambiguous in the long term. In many companies, mid-term plans cover approximately three years of business activities. They often fail to develop plans and growth strategies for longer periods. Some companies equate their shot-term goals with their vision.

When they explain their growth strategies from a long-term perspective, they often take an indefinite outlook. Only a limited number of companies present an explicit vision after ten years. With only an ambiguous vision made public, investors are unable to project a company's future growth. It cannot be helped but to call a vision imaginary if the vision does not provide investors with an accurate projection for future growth. There are concerns over the current situation where companies that make excessive efforts to concede to the current capital market that demands short-term returns reach a decline in their appeal to long-term investors.

The declaration of a long-term, explicit vision and the establishment and implementation of strategies based on such a vision are synonymous with efforts to maximize enterprise value, which corresponds to Viewpoint 2 in Figure 1.

2 Definition and Maximization of Intangible Assets Contributing to Higher Quality of Corporate Management

Some economists assert that Japanese companies have more intangible assets than do those of overseas companies. However, whether this is true is questionable.

Most research activities on intangible assets in Japan are conducted within the framework of "intangible assets in their capacity as Japanese companies," and often do not include such material viewpoints as business category, company size and maturity. Accordingly, in many cases, intangible assets are explained within a conceptual framework such as culture respecting harmony and employee diligence. In some other cases, specific measures to increase the value of intangible assets tend to lean toward strengthening the ability of technical innovation and giving an emphasis to human resource development for such purposes.

Forward-looking institutional investors generally have their own criteria to valuate intangible assets for each business category, based on which they conduct analyses of ESG factors. Japanese companies were generally rated low in such analyses[2]. While the valuation of

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institutional investors does not mean everything, Japanese companies should recognize that such analyses are one way of evaluating companies.

What Japanese companies must do is to comprehensively review their own intangible assets, identify intangible assets that would increase the quality of corporate management and actively strengthen such assets. It would also be important to share the objectives of such activities with institutional investors. These activities correspond to Viewpoint 3 in Figure 1.

3 Building Trustworthy Relationships with Core Shareholders

The building of trustworthy relationships with shareholders, which is discussed in this section, is distinct from the idea of bridging investors' recognition gaps (Viewpoint 1 in Figure 1).

Essentially, the process of facilitating mutual understanding and developing common recognition with investors does not contribute to increasing enterprise value. Even if investors invest in a company after giving it a full examination, what is to be improved is the stock price only, and such action does not lead to an increase in cash flows that the company generates. In other words, enterprise value does not increase.

On the other hand, it is more significant for a management team to build trustworthy relationships with core shareholders that provide funds over a long period of time. This is because cooperating with each other would lead to creating the foundation necessary to implement strategies to increase enterprise value. Based on such a foundation, management executives can engage in activities aimed at maximizing enterprise value without being disturbed by the demands of short-term investors.

However, most Japanese companies adopt less than enthusiastic approaches to dialogs with shareholders, and try to maintain some distance from them to prevent any intervention in corporate management. In particular, currently, increased attention is being given to shareholder activism, causing companies to take a defensive attitude toward shareholders.

In the future, Japanese companies must promote "reciprocal engagement (making reciprocal approaches)" with shareholders. Reciprocal engagement refers to a process where the two parties talk with each other, understand each other, share the direction and promise each other to move forward. As explained in Chapter III, not all activist shareholders take hostile approaches toward management. Long-term shareholders do exist, and they wish to build a trustworthy relationship with management executives. For companies that place an emphasis on corporate management from a long-term perspective, it is this theme of building a trustworthy relationship with shareholders that is an important issue for corporate management.

V The Reality that Japanese Companies Should Reconsider

In order for Japanese companies to survive and grow, it is inevitable that they put the principles discussed in this paper into practice in operating business activities. This section explains why it is unavoidable from the aspects of both the reality facing Japanese companies and the fundamental principles driving a capitalist economy.

1 Quantitative Limit of Japanese Investors

As of June 2009, the stock market still remained severely depressed. The aggregate market capitalization of the three sections of the Tokyo Stock Exchange (first, second and mothers sections) decreased from ¥578 trillion at the end of July 2007 to ¥296 trillion at the end of May 2009. The general expectation would be that even if Japanese companies were to achieve limited growth in the future, market capitalization would recover to ¥400 – 500 trillion if the financial crisis currently facing the world economy were to end.

Nevertheless, the assets under management (AUM) by Japanese institutional investors are not sufficient enough to cover aggregate market capitalization in the stock market. As shown in Figure 3, it is not possible for Japanese institutional investors alone to supply all the funds needed by Japanese companies.

Let's look at the asset management business of representative Japanese institutional investors. While the AUM managed by Japanese corporate pensions is about ¥90 trillion, Japanese equities account for 23 percent of this total, or about ¥20 trillion. Little, if any, prospect of major growth is seen in the AUM managed by corporate pensions because of an accelerating withdrawal of pension funds due to reasons such as the predictable retirement of an increasing number of baby boomers. While the AUM managed by public pensions is about ¥200 trillion, Japanese equities account for 13 percent, or about ¥26 trillion. It appears that opinions are divided in managing such AUM—one is that in order to secure the target yield on investment of 4.1 percent, risks must be taken; the other is that risks should not be taken because of expanded losses incurred by the current financial crisis. Accordingly, it seems that the agreed direction has not yet been established.

The AUM managed by Japanese life and non-life insurance companies is about ¥230 trillion, of which Japanese equities account for slightly less than 11 percent, or about ¥21 trillion. While the AUM is increasing, the percentage of Japanese equities is in a declining trend, and the absolute value is also decreasing.

The total amount of securities portfolios managed by Japanese banks remains at the level of slightly less than

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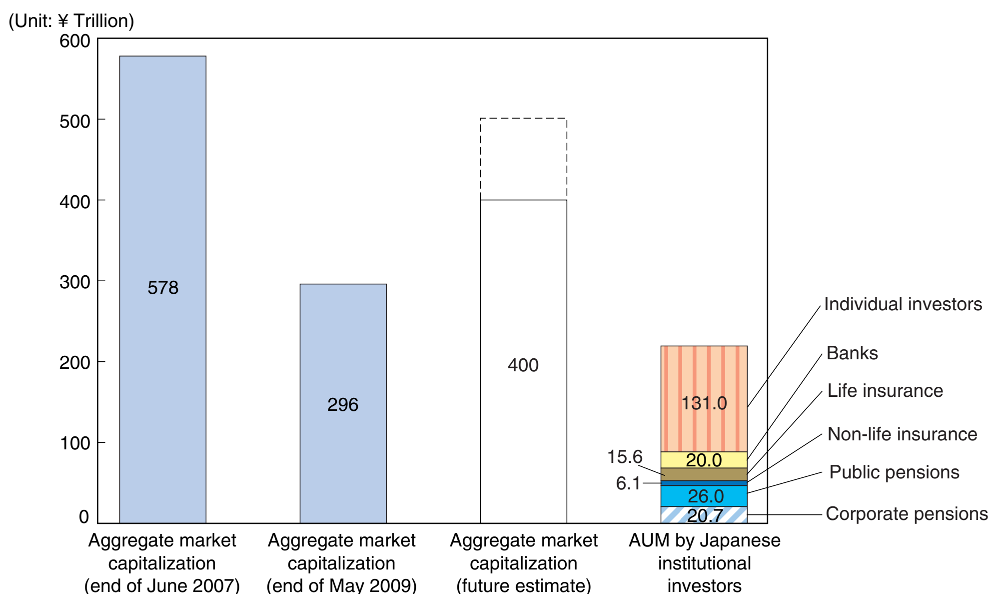
Figure 3. Gap between Market Capitalization of TSE and Assets under Management by Japanese Investors



Note: TSE three sections refer to the Tokyo Stock Exchange First Section (for large companies), Second Section (for mid-sized companies) and Mothers Section (for high-growth startup companies).
Source: Compiled based on "Japan's Asset Management Business 2008," Nomura Research Institute, November 2008, and materials published by the Tokyo Stock Exchange, the Life Insurance Association of Japan and the General Insurance Association of Japan.

¥200 trillion, of which ¥20 trillion is allocated to equities. This amount is projected to decrease in the future due to the planned sale of shares in which investments were made based on banks' management policies that focused on relationships rather than on investment returns. The Mizuho Financial Group has already announced its plans to reduce such policy-oriented shares by 20 percent over the coming two years.

While some economists give expectations to individual investors rather than to these institutional investors, the amount of equity investment including investment trusts by individual investors is about ¥131 trillion. Even if this amount were to double, it is impossible to support Japan's capital market by Japanese investors alone, as shown in Figure 3.

Accordingly, in order for Japanese companies to achieve sustainable growth or to maintain the current business scale, it is essential that Japanese companies attract the interest of overseas investors. In view of the fact that individual overseas investors do not have an adequate understanding of Japanese companies and it is difficult to expect them to see Japanese companies as a major investment target, it is vitally important to attract the interest of institutional overseas investors.

In recent years, questions have been raised about the American style of corporate management, which puts a priority on shareholders' rights. In consideration of such problems, discussions are frequently being held on what kind of Japanese-style management is appropriate. During these discussions, some argue that Japanese companies should limit their relationships to only Japanese investors. Some assert the "theory of national isolation" in which shareholders of Japanese companies are limited to Japanese investors. However, given the quantitative limit that was explained so far, it is obvious that such thoughts are unrealistic.

2 Globalization of the Capital Market is Unavoidable

In addition to the quantitative limit, qualitative changes in the investment behavior of institutional investors in the future would constitute a bottleneck for the above-mentioned theory of national isolation. In this section, as an example of such qualitative changes, a "global sector approach," which is spreading among institutional investors, is discussed.

Briefly speaking, the global sector approach is a concept that classifies investees not by region or country but by industrial sector or business category. More precisely, the basic ideas behind this concept are that classifications such as the European market or the North American market no longer have much meaning, and that classifications such as the automobile market or the precision machinery market are more suitable for actual business activities.

The expansion of this approach largely stems from the globalization of business activities. For instance, "I want to invest in an automobile manufacturer in the North American market" is already outdated. Most automobile manufacturers including those based in Japan and Europe are evolving business operations in the world market. The number of business categories that serve only specific geographical markets is becoming limited. This concept applies not only to export-oriented companies but also to domestic-demand-based companies such

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as electricity, gas, retailing and distribution whose business activities are gradually becoming global.

In other words, investing in Toyota Motor Corporation does not mean investing in the Japanese market. Similarly, investing in Royal Dutch Shell is not synonymous with investing in the British or Netherlands market and investing in Google does not mean investing in the US market. The thinking that it is no longer reasonable to divide the world market into domestic and overseas markets and that the world market should not be divided is becoming mainstream.

This change in concept will diminish the traditional home country bias. "Home country bias" refers to the tendency of investors to over-allocate their portfolios to financial products in their home nation where they have experience and a lot more information. The adoption of a global sector approach would mean that investors will build an epitome of the global market within their portfolios. If the proportion of market capitalization by region were to be 4 in North America, 3 in Europe, 2 in Asia and 1 in other countries, asset allocation by institutional investors would be in the same proportion. In short, the percentage of investments that investors make in their home countries would decrease.

Innovative European and US institutional investors have already started to change their investment behavior to that adopting the global sector approach. Eventually, Japanese institutional investors will face the need for adopting a similar approach. If they fail to do so, they will not be able to secure the funds that will become necessary for pension and insurance payments in the future.

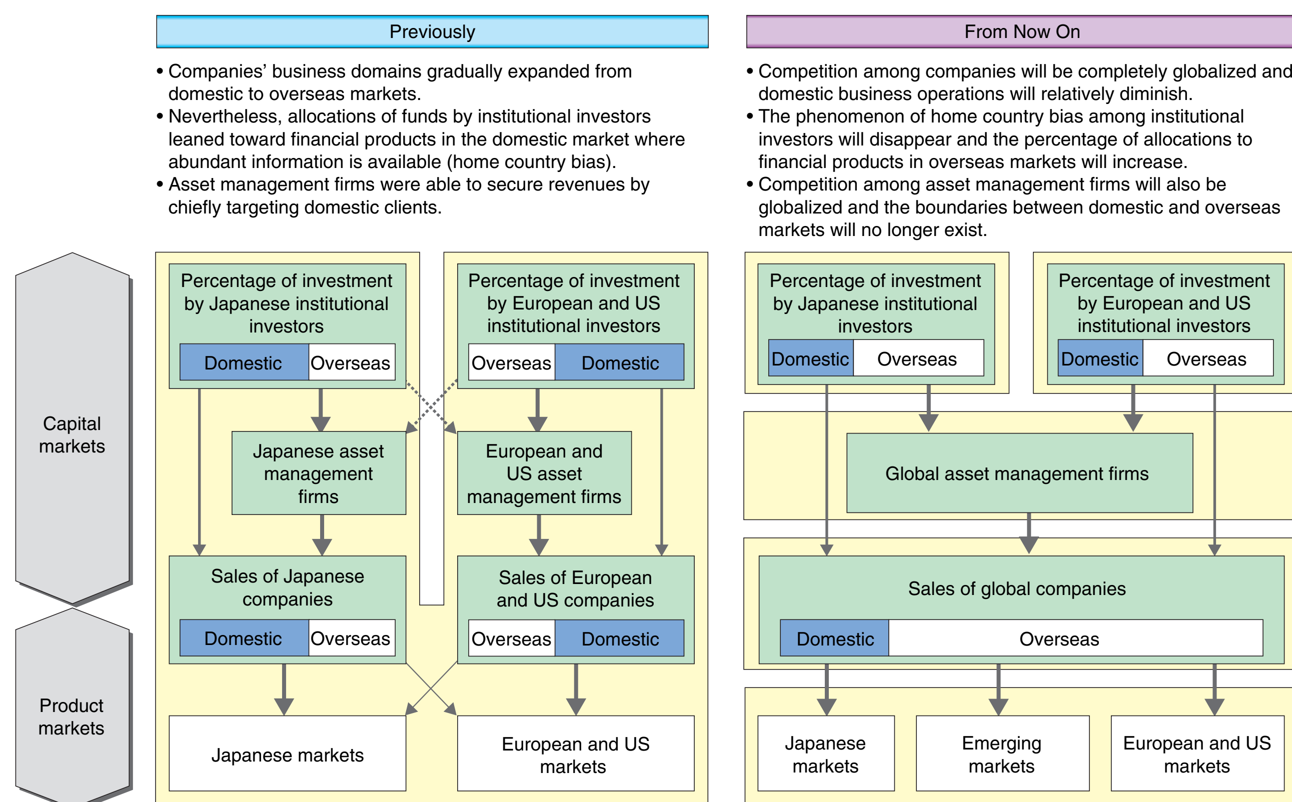
With an increasing number of Japanese institutional investors adopting the global sector approach, asset management firms that manage funds on behalf of their clients such as pension funds are also likely to change the targets of their investments from Japanese companies to global companies. This is because the concept is spreading that in selecting investee companies in the global markets, New York and London, where information and experts are available from all over the world, are more suitable than Tokyo, where information is mostly limited to the Japanese market.

As shown in Figure 4, in a similar way as with globalization of the product markets, the capital markets must also follow a path toward globalization. There are an increasing number of reasons that will force Japanese companies to deal with overseas institutional investors.

3 Principles of Capitalism

In recent years, terms such as shareholder activism and activist shareholders are often used, and discord between shareholders and company management has frequently been reported by Japan's media. This situation tends to give people the impression that investors are "rogues." The idea that investors are villains is not new. Rather, it is a long-established concept that "investors as wealthy people are enemies of ordinary citizens." Nevertheless, even if we regard investors as

Figure 4. Elimination of Home Country Bias through Globalization of the Capital Market



Principles Maximizing Enterprise Value Expected by Institutional Investors

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villains, we cannot improve society without them. In the current capitalist economy, the basic idea is that everybody becomes an investor, and benefits from the profits.

Given the fact that our society is based on capitalism, investing in companies that are able to create added value is identical to increasing the productivity of overall society, i.e., increasing return on investment. The fundamental mechanism driving a capitalist economy is that overall, society will acquire wealth by investment.

In Japan, attention is continuously paid to the relationships between employees and companies and between consumers (customers) and companies. However, the relationships between individuals in the capacity of investors and companies tend to be forgotten. As shown in Figure 5, an individual can be an investor, consumer and/or worker. This multifaceted nature of each individual person tends to be ignored.

Individual people have relationships with companies in multilateral ways. From all aspects, the maximization of enterprise value is desirable. This is because the maximization of enterprise value will bring about increased wages to workers, enhanced quality of products and services to consumers and more return on investment to investors. In this sense, company executives have responsibilities for society as social trustees who are required to maintain a balance between these interests. Accordingly, company executives must play extremely significant roles in effectively driving the capitalist economy.

Similarly, institutional investors are also part of society, and must fulfill their responsibilities and, at the same time, must have their rights. They must act appropriately as they determine investees for the huge amounts of funds consisting of pension contributions and insurance premiums collected from people. This responsibility affects overall society. If they act inappropriately, they will be exposed to criticism; if they think investees are following an incorrect course, they must express their views to have them change. In this way of thinking, the situation that led to the emergence of the term "activist" is itself somewhat incorrect. In other words, "silent shareholders and/or unthinking shareholders" who manage funds without any principles or positions, must be subjected to criticism.

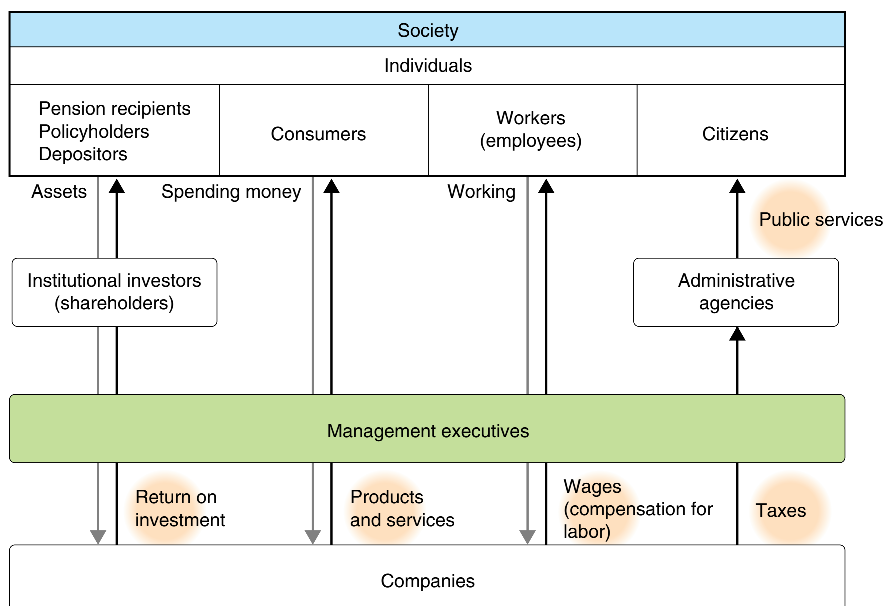
We must be reminded of and share this fundamental mechanism of capitalist economy as major principles of our society. The authors hope that Japanese companies will follow these principles in evolving their business operations.

Notes:

1 The research reports suggesting the low capability of Japanese companies to create cash flows include the book written by Akinori Marumo, where he compared the return on capital stock in Japan and that in the US. According to this comparison, while the return on capital stock in Japan declined during the period of 1990 – 2004 from a level of 7 percent to a level of 3 percent, the rate in the US increased from a level of 8 percent to a level of 11 percent. Return on capital stock is defined as follows: Japan: The ratio of corporate profits published in national income statistics to capital stocks of private enterprises. US: Similarly, the ratio of corporate profits to stocks of private enterprises.

2 According to Goldman Sachs's Global Investment Research in June 2007, Japanese companies received low ratings in ESG analyses. Scores for the ES (environmental and social) factors were at a level of 50 percent. They

Figure 5. Social Meaning of Enterprise Value Maximization in a Capitalist Economy



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are far behind companies in Norway, Finland, Denmark, France, Switzerland, Canada, Australia, South Africa and Brazil that acquired scores at a level of 60 percent. Scores for the G (governance) factor were at a level of 40 percent, which represents the lowest level among major countries excluding Russia and China.

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