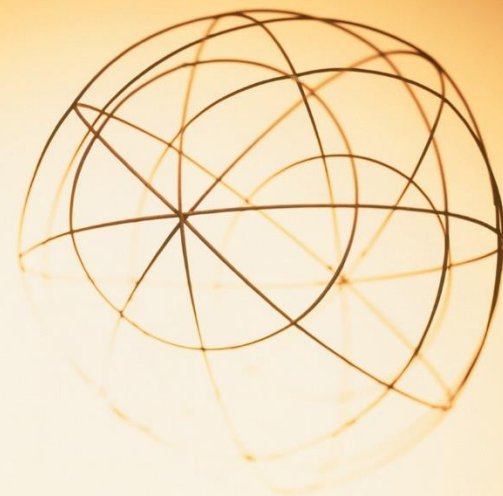


## Japan Securities Summit in New York Japanese Capital Markets: Initiatives to Enhance its Value and Functions



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**Former Vice-President & Treasurer, World Bank**

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# Agenda

- **Risk Management and Corporate Governance**
  - **Key ingredients to strengthening the corporate sector and economic growth**
- **Japanese companies as an attractive investment opportunity**
  - **Potential for strong business environment given ongoing reforms**
  - **Japan uniquely positioned in the current context of global financial markets**
  - **Investment opportunities will depend on delivering on the reforms**

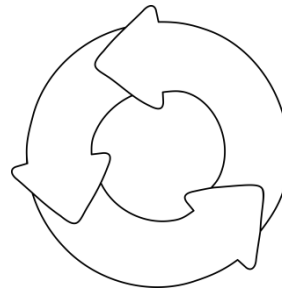
## **Risk Management and Corporate Governance**

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## Core Precepts of Risk Management and Corporate Governance

### Risk Management

- Needs to be an all-encompassing philosophy about preserving shareholder value
  - Integrity
  - Setting the right tone at the top
  - Establishing the right risk awareness culture and hiring the right people to carry that culture
  - Based on three pillars



### Corporate Governance

- **G20/OECD Principles of Corporate Governance:**
- Procedures and processes according to which a corporation is directed and controlled
- Build an environment of trust transparency and accountability
- Essential for fostering long-term investment, financial stability and business integrity
- Leading to supporting stronger growth and more inclusive societies

Most corporate failures result from poor corporate governance which materialize through risks, including reputational risk

## Three Fundamental Pillars of Risk Management

- **Governance**: Strong overall governance ensuring separation of roles and responsibilities
  - Proper checks and balances
  - “Tone at the top” that permeates the entire organization with the values to support ethical behavior embodied in the notion of ‘doing the right thing’
  - Every member of the organization must play his own respective part as a risk manager
- **Organization and controls**: Strong and independent risk management organization operating in true partnership with the business and other control functions such as compliance, legal and finance
- **Analytical Framework**: Robust and comprehensive framework to measure, manage, communicate and mitigate risks

# Good governance requires internalizing the value that reputation has to the firm

- Nothing is as valuable as a company's **reputation** to protect the franchise value over the long run
- At the corporation level, good governance ensures an environment which strives to **maximize shareholder value**
  - Efficient allocation of resources
  - Protect and facilitate the exercise of shareholders' rights and ensure the equitable treatment of all shareholders
  - Ensure timely and accurate disclosure of all material matters, including risks
- More broadly, good governance is the basis of **fair and transparent markets**

# The importance of good corporate governance has many dimensions

## Micro

### Access to Capital

An increasing volume of empirical evidence indicates that well-governed companies receive higher market valuations. However, improving corporate governance will also increase all other capital flows to companies : from domestic and global capital; equity and debt; and from public securities markets and institutional investors and other private capital sources.

### Firm Performance

Improved governance structures and processes help ensure quality decision-making, encourage effective succession planning for senior management and enhance the long-term prosperity of companies, independent of the type of company and its sources of finance.

### Firm-level labor productivity

Weak governance firms have lower labor productivity than do good governance firms (NYU Stern review of 3,200 US Firms). An issue critical to a country such as Japan which needs to increase substantially labor productivity given its demographic challenges

### Overall Economic Competitiveness

More efficient allocation of resources, risk taking and innovation, all qualities observed in companies with better governance, lead to a more competitive and resilient national economy

Sources: IFC, OECD

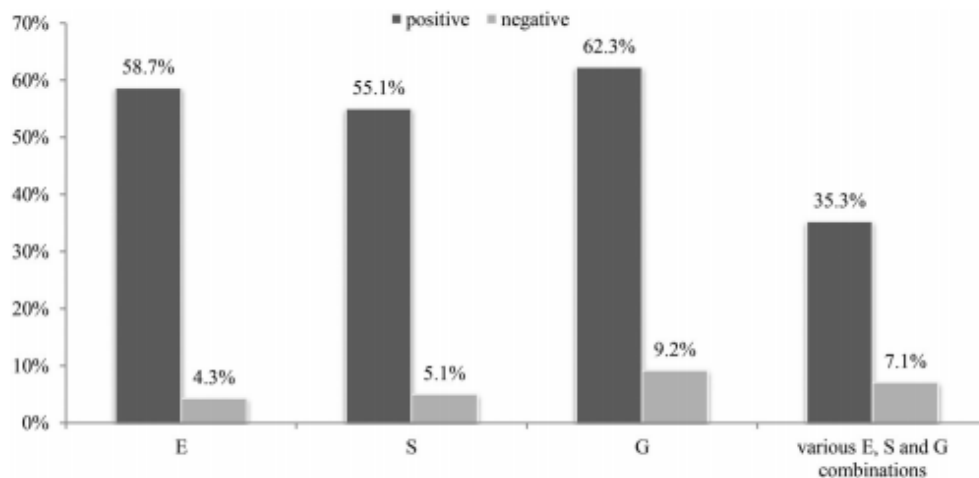
## Macro

### Key Ongoing Corporate Governance Reforms

- Outside directors
  - The Company Act was amended in June 2014 to provide that any company without an outside director (OD) shall explain why it is inappropriate to have an OD
  - Topix firms with outside directors: from 55% in 2012 to 94% in 2015
  - This has created an environment where activist investors can influence management to increase shareholder value
- Stewardship code
  - Encourages institutional investors to fulfill their fiduciary duties for their clients through enhanced dialogue with companies, disclosure of voting activity
  - More than 200 companies, including Principal Global Investors Japan, signed up to the Code
- Corporate governance code
  - Addresses shortcomings with respect to OECD recommendations
  - Shareholder rights and equal treatment
  - Transparency
- Enhancing efficient use of capital and increased ROE
  - Eliminate cross shareholdings
  - Stock buy backs
  - Development of JPX Nikkei 400 index incorporating ROE and governance considerations



## Impact of Governance on Corporate Financial Performance



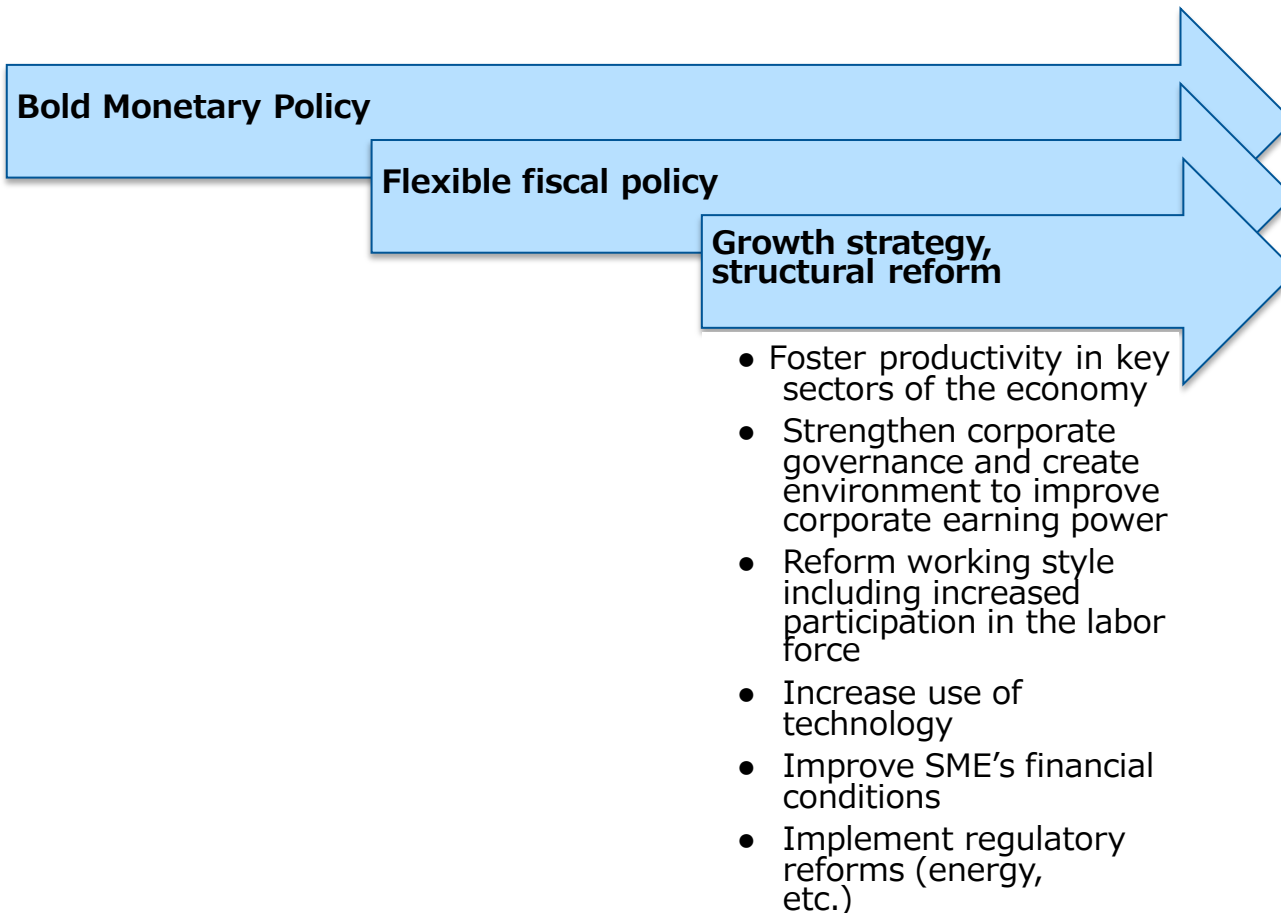
- Recent review of 2,000 studies of the impact of Environmental, Social and Governance (ESG) criteria on financial performance of firms
  - Vast majority of studies showed a positive correlation of these three factors, governance being the highest
  - The link is particularly strong with market-based measures of performance (firm valuation)
- Evidence suggests multiple mechanism leading to this increase in financial performance
  - Increased manager efficiency
  - Fewer resources wasted on nonproductive activities
  - Reduction in tunneling, asset-stripping, related party transactions, and other ways of diverting firm resources away from shareholders
  - Lower cost of capital
  - Increased availability of external finance

Sources: Gunnar Friede, Timo Busch & Alexander Bassen (2015); Journal of Sustainable Finance & Investment; Love Inessa (2011); The World Bank Research Observer

## **Japanese Companies as an Attractive Investment Opportunity** \_\_\_\_\_

# The ongoing reform process in Japan is taking a holistic approach to address obstacles to growth

## “Abenomics” Arrows



Japan is showing strong leadership in executing this comprehensive approach in a manner few other countries are doing

# Strong Business Environment

- Framework needed for efficient markets is already in place: institutions, systems, policies and rules
- Tradition of public innovation and entrepreneurship
- Strong, comprehensive reform agenda which will well position Japan vis-à-vis other economies as alternative investment prospects

## Ranking in World Bank's Doing Business Index (Five Largest Economies)

- The World Bank's *Doing Business Index*, which is based on various criteria, ranks 189 countries in terms of the ease of developing and running a business.

Country	Ease of doing business	Protecting minority investors	Resolving insolvency
United States	7	35	5
China	84	134	55
Japan	34	36	2
Germany	15	49	3
United	6	4	13

Source: World Bank Group

- Japan is in a unique position given the slowdown in other economies due to varying reasons
  - Political, structural
- Implementing corporate governance reforms should help unleash corporate profitability
- If implemented as envisioned, the reforms will create conditions which should enhance corporate and market performance over the next two to three years
- Investment opportunities might include
  - Banks
    - Especially as they reduce cross shareholdings
    - Currently are among the cheapest in the developed world
  - Tilting toward exporters
    - Have a unique advantage
  - Tourism
    - Including domestic transportation
  - Telecoms
    - Increased data usage

- This could be Japan's moment!!
- It needs to seize the opportunity and come through with the reforms.
- These are tough but needed reforms. We believe Japan will benefit in the long-run by sticking with the plan and not being diverted by short-term political expediency

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