（Tentative translation）

Preliminary Report

September 2013

Panel for Sophisticating the Management of Public/Quasi-public Funds

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In the past meetings, the panel held hearings on the current situation of investment by public and quasi-public funds which are subject to our discussions, as well as by other investment management organizations inside and outside Japan. This report summarizes the issues under discussion at our panel based on these hearings.

It should be noted that public and quasi-public funds vary in size and characteristics and the application of each issue to these funds should be based on their sizes and characteristics.

1. Objectives of investment

There was an opinion that we should take into account how the relevant investment can contribute to the Japanese economy, as we are holding this discussion as part of the Japan Revitalization Strategy. In response, some members noted that trustees of these funds are required to invest funds for their respective objectives according to relevant laws. (For example, public pension funds are required to invest solely for the benefit of people covered by public pension plans.) In addition, one member pointed out that investment of public pension funds is closely related to pension finance and pension systems and is expected by the people to contribute to securing the long-term sustainability of the pension finance system without affecting future pension benefits or leading to a hike in premiums paid by working generations. Investment to benefit the insured will eventually contribute to the Japanese economy, while in turn, each fund will benefit from economic growth through their investment. Therefore, a virtuous cycle of economic growth and investment is expected.

2. Investment targets and policies

(1) Revising portfolios that heavily invest in domestic bonds

Present investment portfolios of public and quasi-public funds that invest heavily in domestic bonds may need to be revised to improve returns and hold down interest rate risks, considering the current situation of the Japanese economy, which is shifting from deflation to a mild inflationary environment. When doing so, depending on the features of liabilities of each fund, portions other than where reserves are expected to be tapped in the near future may need to be built from a long-term perspective.

(2) Investment return targets and degrees of risk tolerance

Some members commented that, since investment return targets of some funds are set relative to nominal wage growth rate and inflation rates, they might have been too low under the deflationary economy. However, others noted that setting investment return targets in line with nominal wage growth and inflation rates would be reasonable because benefits are linked to these rates. Some pointed out that the assumed long-term nominal investment return of 4.1% in the financial review of pension funds might have deviated far from the present realities. In addition, some pointed out that, while “safe and efficient investment” is being pursued, the specific scope of risk tolerance has not been specified.

When setting investment return targets, considerations should be given to the relationship between assets and liabilities. Building portfolios to attain these targets will lead to a “safe and efficient” investment. Nevertheless, return-maximizing efforts, including an upward shift of the efficient frontier indicating the relationship between expected returns and risks, might have been insufficient.

(3) Investment costs

Each fund has been trying to reduce brokerage fees in order to minimize investment costs, leading to a fall in brokerage fees to internationally low levels. Some members commented that this fact can be welcomed by the people who shoulder the costs. However, others noted that funds may have failed to acquire sufficient information and lost precious investment opportunities under the very low brokerage fees, as well as that the very low fees might have hindered the development of financial and capital markets. With regard to this, some pointed out that each fund would have to achieve accountability for the people shouldering costs if they were to pay more brokerage fees.

(4) Investment of surplus money

Independent administrative agencies, excluding the Government Pension Investment Fund, and national university corporations invest surplus money in safe assets in principle. Depending on the sizes and characteristics of their funds, however, there may be a need to adopt a middle-risk, middle-return approach to improve investment returns on the premise of appropriate risk control.

3. Portfolios

(1) Diversifying investments

There was an opinion that, under a long-term outlook on benefits and contributions in pension finance, the GPIF and the like should diversify investments by investing in new types of assets (including real estate investment trusts, real estate, infrastructure, private equities and commodities), taking into consideration the investment models of advanced public pension fund managers at home and abroad, as well as the progress in market environment development and risk control.

Meanwhile, there was another opinion that if new types of assets were to be introduced, with due consideration given to the characteristics of each fund, sufficient information would have to be provided to gain people's understanding.

(Note) Some pointed out that while investment diversification could lead these investors to be deemed as sovereign wealth funds, there would be no problem as long as they comply with the 2008 internationally agreed code of conduct known as the "Santiago Principles."

(2) Benchmarks of passive investments

Many funds track the TOPIX index, which covers all the companies listed on the first section of the Tokyo Stock Exchange, as a benchmark for passive investment. Given that TOPIX includes stocks lacking sufficient investment profitability, however, funds may have to consider improvements including tolerating some deviation from the index or using other indexes that enable more efficient investment (including, for example, the use of a new stock index under consideration by the TSE which will take into account return on equity).

(3) Revising portfolios and hedging policies flexibly

Some members called for flexibly revising portfolios and hedging policies in view of recent trends, including rapid changes in economic and market environments. On the other hand, others noted that long-term portfolio investment approaches with timely portfolio-rebalancing, would be more efficient and contribute to stabilizing financial markets.

(4) Foreign-assets ratio

Some members called for raising the foreign-assets ratio of investment portfolios in anticipation of higher investment returns and investment diversification effects. Others noted that investment managers should consider implications for the domestic economy, including with regard to when the funds will have to respond to cash-outs, when deciding to increase the foreign-assets ratio.

4. Governance

(1) Ultimate responsibility for asset investment

At some public and quasi-public funds, the minister in charge of each fund holds the ultimate responsibility for the investment. Some members noted that such arrangements have affected the independence and originality of fund managers, while others pointed out that, while the minister as the insurer in public pension schemes may naturally be held responsible for the investment actions of each pension fund, each fund should be allowed to adopt flexible investment approaches.

(2) Need for a collegial decision making system

In order to make investments, appropriate organizational arrangements are required for funds to take true stewardship responsibility as trustees. As far as the president of the organization has the sole decision-making power and responsibility under the current non-collegial decision-making system, however, depending on the size and characteristics the organization, this system may fail to function adequately. More desirable may be a collegial decision-making system where full-time experts collegially make decisions on key investment policies with considerations given to conflicts of interest.

Further discussions are required on whether an independent administrative agency would have to be reorganized into a government-authorized corporation to introduce the collegial decision-making system.

(3) Securing expert employees

In order to diversify investments and enhance risk control, it is essential for each fund to introduce leading experts and dedicated pay systems for those experts. Further discussions are required on whether an independent administrative agency would have to be reorganized into a government-authorized corporation to do so.

(4) Stakeholders' participation in investment management

Some expressed an opinion that the governance system for public pension fund investment should be improved to reflect the views of employers and employees who pay pension premiums, while others noted that they should not be involved in individual investment decisions. There was also an opinion calling for attention to the facts that people covered by a pension scheme include citizens of various generations and positions and that tax revenues are spent on the maintenance of social insurance systems.

5. Risk control

(1) Building portfolios based on forward-looking risk analyses

Some members pointed out that public pension fund managers should conduct forward-looking risk analyses covering both assets and liabilities in view of future economic outlooks (covering interest rates, inflation rates and other macro variables) to build investment portfolios and that risk analyses based only on past data would be insufficient.

(2) Measures in view of post-deflationary economy

We may have to consider sufficient risk control and asset assessment in view of interest rate hikes after Japan's departure from deflation, and may need to take relevant measures promptly.

(3) Risk control for investment of surplus money

Despite the existing rule that limits the scope of assets for independent administrative agencies' surplus money investment to safe assets, there are cases where agencies have invested surplus money in structured investment products and incurred heavy losses. There may be a need for them to implement risk control measures meeting fund sizes and investment realities, including the adequate use of market prices in fund management.

6. Maximizing returns on equity assets

Each fund, when investing in equity assets including stocks, is required to try to improve returns on the premise of long-term investment. For this purpose, each fund, even though being public or quasi-public, may need to hold close talks with investment targets and exercise voting rights appropriately through investment trustees on behalf of insured people. To this end, each fund may need to work out and publish investment policies based on the result of the Financial Services Agency's ongoing consideration of a Japanese-version stewardship code and urge investment trustees to comply with these policies. However, there was an opinion that care should be taken to prevent excessive involvement in business management or any formal exercise of voting rights based on stereotyped policies. Another opinion called for taking into account ESG factors as non-financial factors in addition to financial factors.

(Reference)

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