

Panel for Sophisticating the Management of Public/Quasi-public Funds Final Report (November 20, 2013) Summary

1. Investment Targets and Policies

- Considering the current situation of the Japanese economy which is shifting from deflation to a mild inflationary environment, **current investment portfolios investing heavily in domestic bonds need to be revised.**
- It is necessary to **appropriately set investment return targets**, as well as to **consider the risk tolerance.**

2. Portfolios

- **Portfolios should be diversified by investing in new types of assets** (including real estate investment trusts, real estate, infrastructure, venture capitals, private equities and commodities).
- Consideration should be made to **increase the ratio of active investments.** When doing so, **one possibility would be to specially manage some active investments as baby funds** (a certain amount set within the fund's policy asset mix, which is invested in an independent and flexible manner).
- **Higher returns should be aimed at by selecting benchmarks ingeniously.** Funds should consider improvements including using other indexes that enable more efficient investment (e.g. the use of a new stock index that takes into account factors such as return on equity (ROE)).

3. Improving Governance and Risk Management Structure

- Consideration should be given so that **the relationship between funds and ministers in charge will not undermine the independence and creativity of the funds.**
- Decisions on key investment should be made under a collegial decision-making system, where **full-time experts with consideration given to conflict of interest, play a central role in collegially making decisions.**
- In order to diversify investments and to enhance risk management, it is essential for each fund to **introduce leading experts** and take measures such as **dedicated pay systems for those experts.**
- **Forward-looking risk analyses** covering both assets and liabilities should be conducted.

4. Maximizing Returns on Equity Assets

- When investing in equity assets including stocks, each fund is required to aim to improve returns on the premise of investing from a long-term perspective and **needs to hold close dialogues with investment targets and exercise voting rights appropriately.** To this end, each fund needs to **publish a policy based on the ongoing consideration of the Japanese Stewardship Code and urge investment outsourcers to comply** with the policy.

(Reference) Governance Structure of and Roadmap for the Reform of Large Institutions Dedicated to Fund Management (GPIF)

Governance Structure

- (1) By enacting new legislation, reform to a legal entity established based on a specific governing law (see Annex 2), and establish a structure in which important policies are collegially decided by members with sufficient knowledge of finance and investment.
- (2) As a transitional measure until the new legislation is complete, the investment committee, with multiple full-time members posted, should practically decide on important investment policies.
- (3) Restrictions on the number of employees, the wage levels, and expenses based on Cabinet decisions should be eased as much as possible to increase the expertise of the president, directors, investment committee members, and investment staffs.

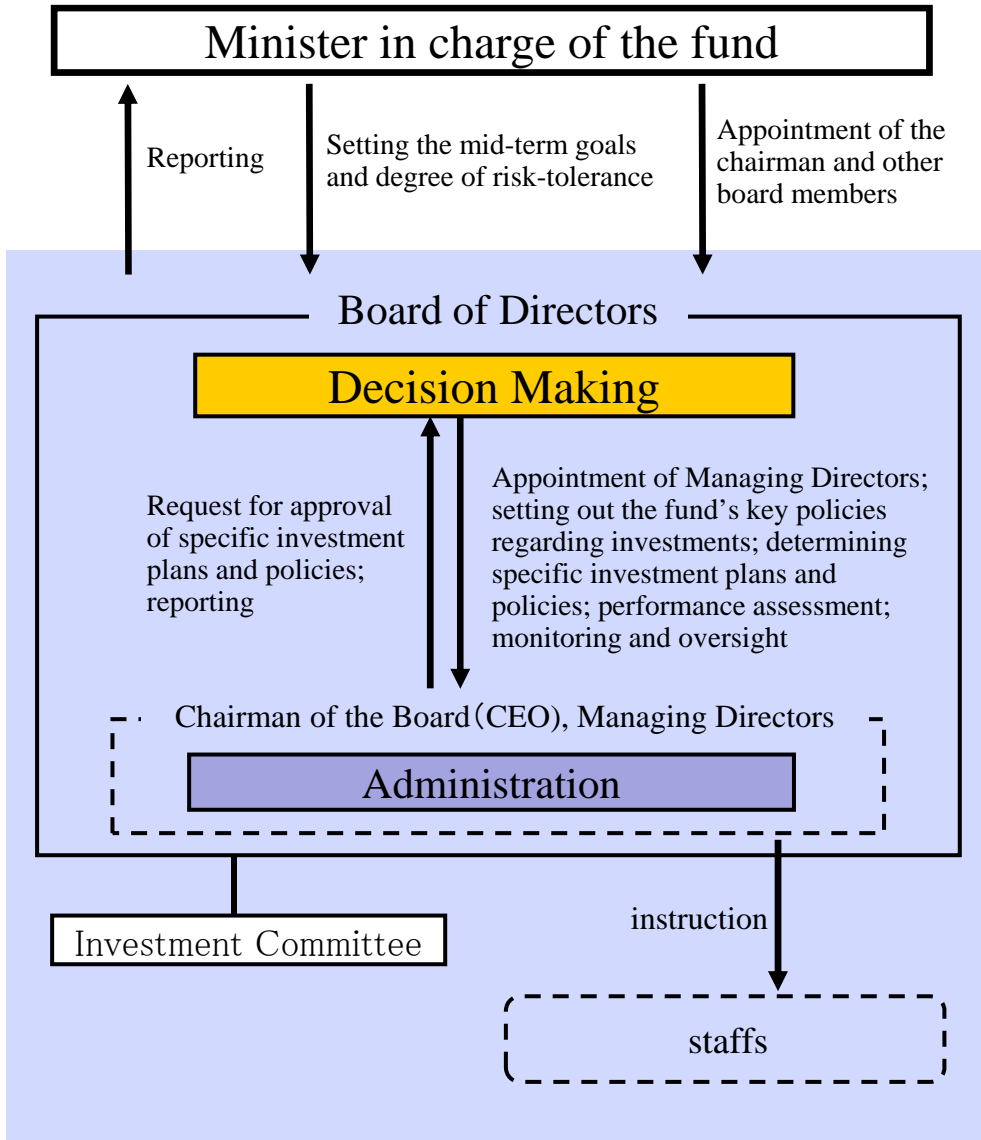
* In light of the need to hold close communication with the markets, it should be headquartered in Tokyo.

Roadmap for Reforming GPIF

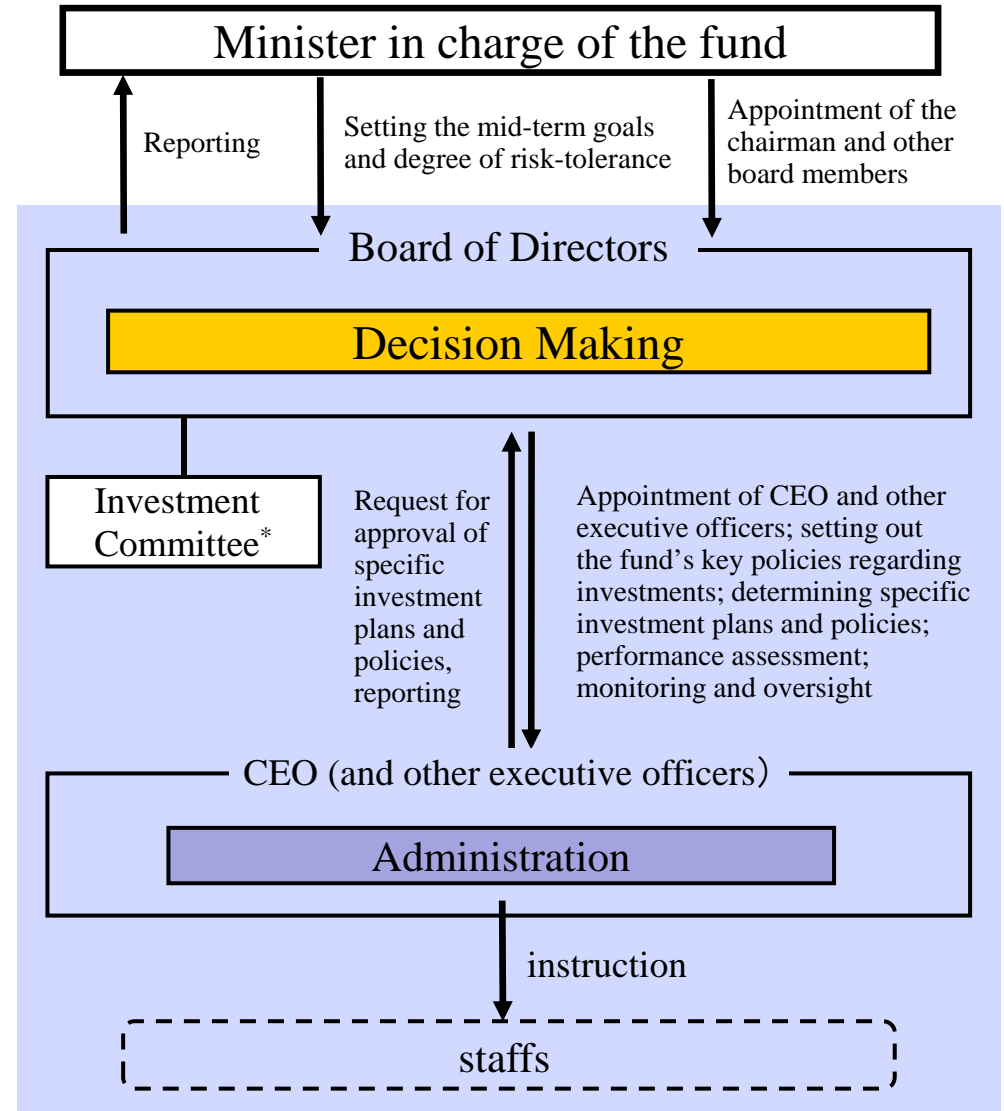
- (1) They need to start revising their portfolio and continuously revise their governance, including management of risks, consistent with portfolio revision.
→ Specific recommendations in each of the following phases are recommended (see Annex 2).
 - (a) issues to be addressed immediately
 - (b) issues to be addressed in about one year
 - (c) targets to be achieved after legal revision
 - (2) It is important to implement portfolio revision and revision of the governance structure, including risk management, in each phase as a set.
- * Bearing in mind the sizes and characteristics of each fund, three mutual aid associations (i.e. pension funds for employees of the national & local public service, and private schools) and other large fund managing institutions need to promptly revise their investment and risk management as well.

Desirable Governance Structure

(Pattern 1)



(Pattern 2)



(*) The board deliberates and decides on the key goals and main policies such as policy asset mix and asset classes, while more specific investment plan and policies are deliberated and decided at the investment committee consisting of the members of the board and others where appropriate. Establishment of other sub-committees such as risk management committee and governance committee should also be considered.

Roadmap for Reforming Fund Management

	Issues to be addressed immediately	Issues to be addressed in about one year	Goal to be achieved
Investment Reform (Diversifying investments etc.)	<ul style="list-style-type: none"> ● Revise investments within the current policy asset mix (flexible investment using the permissible range of deviation, reviewing active investment) ● Consider investment return targets and degree of risk tolerance ● Consider the use of new benchmarks in passive investments 	<ul style="list-style-type: none"> ● Decide on a new policy asset mix based on the results of the reexamination of pension finance ● Invest in new types of assets (mainly in liquid assets and assets that can be evaluated without difficulty) ● Establish baby funds 	<ul style="list-style-type: none"> ● Invest in new types of assets (including illiquid assets and assets of which constant evaluation is difficult)

Reforms of investment and governance must be implemented as a set

Risk Management Reform	<ul style="list-style-type: none"> ● Consider and implement measures for risk management in preparation for inflation and interest rate hikes (such as investment in inflation-linked bonds, using derivatives for risk-hedging) ● Consider forward-looking risk analysis 	<ul style="list-style-type: none"> ● Build a portfolio based on forward-looking risk analysis taking into account the results of the reexamination of pension finance 	<ul style="list-style-type: none"> ● Implement risk management measures corresponding to investment in new types of assets (including illiquid assets and assets of which constant evaluation is difficult)
Governance Structure Reform	<ul style="list-style-type: none"> ● Introduce incentive fees based on mid- to long-term performance of outside portfolio managers ● Consider securing leading experts 	<ul style="list-style-type: none"> ● Make investment committee membership a full-time position following the relaxation of limitations on the number of employees, wage level, and costs; hire leading experts 	<ul style="list-style-type: none"> ● Establish a governing body and a fund management system with a high level of expertise by reforming to a new type of legal entity