

Issue VII – Green Shoots for ESG in Asia

Asia: Cutting Through the Noise Series

April 2018

Key Takeaways:

- Although Asia still lags behind other regions in environmental, social, and governance (ESG) criteria, we are beginning to see signs of change, with Japan's Abenomics playing a significant role.
- The current political climate in Korea is bringing into stark relief the importance of enhanced governance in broader Asia.
- Gender equality and women's empowerment are gaining increasing attention in Korea as the #MeToo movement takes hold.
- Technological developments and social media are improving transparency and accelerating the news cycle, pressuring large corporates.

Changes Afoot in Asia

For years, Asia has lagged behind other markets in prioritizing ESG. However, recent developments point to a narrowing of the gap, suggesting that Asia may receive greater attention from the global ESG investment community going forward.

For decades, the ESG movement has been fighting an uphill battle, with free-market crusaders like Milton Friedman enjoying the upper hand. Indeed, by and large, roaring economic growth and a deeply ingrained reverence for raw capitalism have traditionally made ESG a secondary consideration for the global investment community. However, almost 50 years after Friedman famously asserted that "the social responsibility of business is to increase its profits," large corporations securing outsized profits at the expense of broader society are at last facing heightened scrutiny.

While ESG is finally gaining momentum, Asia is decidedly lagging behind other regions in terms of adoption, as decades of fast growth and government-backed industry structures have compromised many relevant criteria. A case in point is the environmental damage caused by China's hyper-paced economic growth. However, we are seeing encouraging signs that China is working to address this issue; notably, the country's urban centers are estimated to have seen a 32% average decline in fine particulate concentration over the past four years.¹ All in all, the emphasis on ethics and sustainability in Asia should increase over the long term (albeit from a low base), and the region stands to become a meaningful player in ESG investments.

¹ New York Times, "Four Years After Declaring War on Pollution, China is Winning" (March 12, 2018)

Socially Responsible Investment (SRI) Assets by Region

Source: Global Sustainable Investment Alliance (2017)

Region	2016 (US\$ bn)	Compound Annual Growth (2014-16) (%)	Proportion of SRI to total managed assets 2016 (%)
Europe	12,040	5.7	52.6
United States	8,273	15.2	21.6
Canada	1,086	22.0	37.8
Australia / New Zealand	516	86.4	50.6
Asia excluding Japan	52	7.6	0.8
Japan	474	724.0	3.4
Global	22,890	11.9	26.3

As markets mature and global pressures build, Asia finds itself in the early stages of rising ESG awareness. This movement is being led by Japan, which launched a new index (Nikkei 400) that takes into account dividends, ROE, and governance standards in screening potential constituents. In addition, the country adopted a Stewardship Code in 2014, and the Government Pension Investment Fund (GPIF) became a signatory to the Principles for Responsible Investment (PRI) in late 2015.² Since the introduction of these measures, Japanese equities have been displaying tangible improvements in price behavior as management and shareholders engage in productive dialogue for their mutual benefit.

Nikkei 400 Screening Criteria

Source: Japan Exchange, Tokyo Exchange, Nikkei

Screening	<p>a. Screening by Eligibility Criteria</p> <p>Excluded from selection if they fall under any of the following criteria:</p> <ul style="list-style-type: none"> - Listed for under 3 years (excluding technical listings) - Liabilities in excess of assets during any of the past 3 fiscal years - Overall deficit in all of the past 3 fiscal years - Designation as Security to be Delisted, etc. 	<p>b. Screening by Market Liquidity Indicator</p> <p>The top 1000 issues will be selected from those eligible, excluding the above, in consideration of the following 2 items</p> <ul style="list-style-type: none"> - Trading value during the most recent 3 years - Market capitalization on the base date for selection
Scoring based on Quantitative Indicators	<p>The 1,000 issues selected in (1) will be scored according to the ranking of the following 3 items (1st: 1000 points – 1000th: 1 point). Then overall score is determined by aggregating those ranking scores with the following weights (there are handling issues for the overall scoring with negative ROE and operating profit)</p> <ul style="list-style-type: none"> - 3-year average ROE: 40% - 3-year cumulative operating profit: 40% - Market capitalization on the base date for selection: 20% 	
Scoring based on Quantitative Factors	<p>Following the scoring in (2), issues will be further scored based on the following 3 items. This score is complementarily added to the quantitative scores explained above (2)*</p> <ul style="list-style-type: none"> - Appointment of Independent Outside Directors (at least 2) - Adoption or Scheduled Adoption of IFRS (pure IFRS) - Disclosure of English Earnings Information via TDnet (Company Announcements Distribution Service in English) - The score is determined so that at most around 10 constituents are different from those chosen with only quantitative score above (2) 	
Determination of Constituents	<p>Following scoring in (3), the 400 issues will be selected in descending order of high scores as constituents</p>	

Meanwhile, in Hong Kong, we are set to see the introduction of controversial dual-class shares, which give certain shareholders greater voting rights than others. Proponents argue that dual-

class shares could protect companies—especially new-economy companies (whose business strategies require decision-making based on a long-term, specialized vision)—from short-term profit-

² SCMP, "Why is Asia lukewarm to sustainable investing?" (October 14, 2017)

seekers. And with China's emerging tech companies increasingly opting for New York listings, Hong Kong Exchanges and Clearing (HKEX), is hoping that the introduction of the new stock type will help attract more high-profile initial public offerings (IPOs). Among corporate governance advocates, however, the proposal has raised concerns of potential abuse by company insiders. Still, we note that there are visible long-term positives in place in Hong Kong, where listed companies will soon have to make mandatory public disclosures about company policies/plans to address operational risks that have implications for the environment and society at large. HKEX has also mandated that listed firms make general disclosures on their ESG policies and compliance with relevant laws and regulations. All in all, the ESG movement is progressing at varying paces (and with differing priorities) across Asian markets.

Lessons from Korea's Political Scandal

The current Korean political climate (as well as the scandal that helped shape it) is a good reminder of why improvement in the governance element of ESG is needed in Asian countries, where intimate relationships between owners of large corporations and the government are relatively commonplace. The Asian industrial model executed successfully by Japan, Korea, Taiwan, and now China is based on strong policy support for exporters. Tax subsidies, currency support, and advantageous bank loans are some of the measures used to help export champions win market share in the competitive global arena. This policy environment has directly spawned massive conglomerates such as Japan's zaibatsu, Korea's chaebol, and now China's state-owned enterprises (SOEs). The sheer scale and political influence of conglomerates and their controlling families inevitably lead to corporate governance issues where minority shareholders' interests and rights are tamped down.

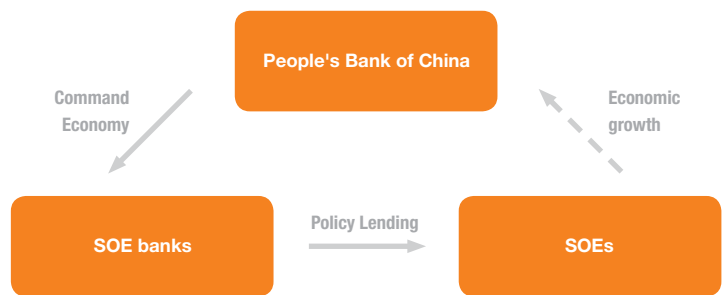
Japan Inc. Triangle

Source: Mirae Asset Daewoo Alpha Strategy Team (2018)



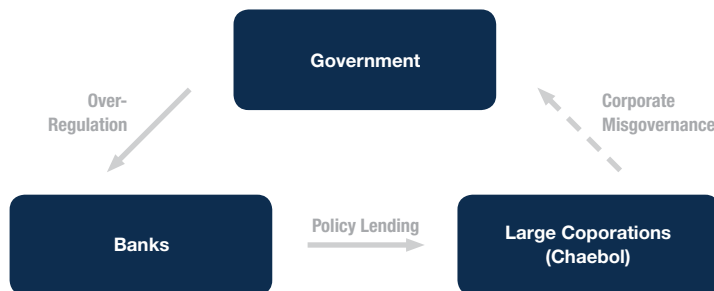
China Inc. Triangle

Source: Mirae Asset Daewoo Alpha Strategy Team (2018)



Korea Inc. Triangle

Source: Mirae Asset Daewoo Alpha Strategy Team (2018)



The Korean chaebol-government alliance sprung from good intentions. Out of the poverty of the 1970s, the government devised an industrial model to boost the competitiveness of the chaebol, arming them with government-directed financing and subsidies. The financing support provided to Korean exporters during periods of global slowdown is a feature that was used by Japan during the 1980s and is now being adopted on a massive scale by Chinese SOEs.

But the Korean working class has been showing growing dissatisfaction with the widening income gap and lack of chaebol contributions to the broader economy, especially following the scandal that prematurely ended Park Geun-hye's presidency. In a departure from the traditional thinking of the past, working class households no longer see the success of the chaebol as synonymous with the prosperity of the country. Similar to the phenomena that helped Donald Trump win the US presidential election, globalization and free trade have led to chaebol increasingly investing in production overseas at the expense of domestic employment. The Korean public feels that the chaebol benefited from decades of government support in the form of subsidies, policy lending, and tax breaks to achieve their competitive edges. The returns of late, however, have been seen flowing primarily to the elite, or, in the latest political scandal, to an individual who happened to have a personal relationship with the president.

On 27th November 2016, over two million citizens gathered in Gwanghwamun Square to demand Park's impeachment—almost twice the number of people that assembled in the same plaza in June 1987 to demand Korea's first democratic presidential election.

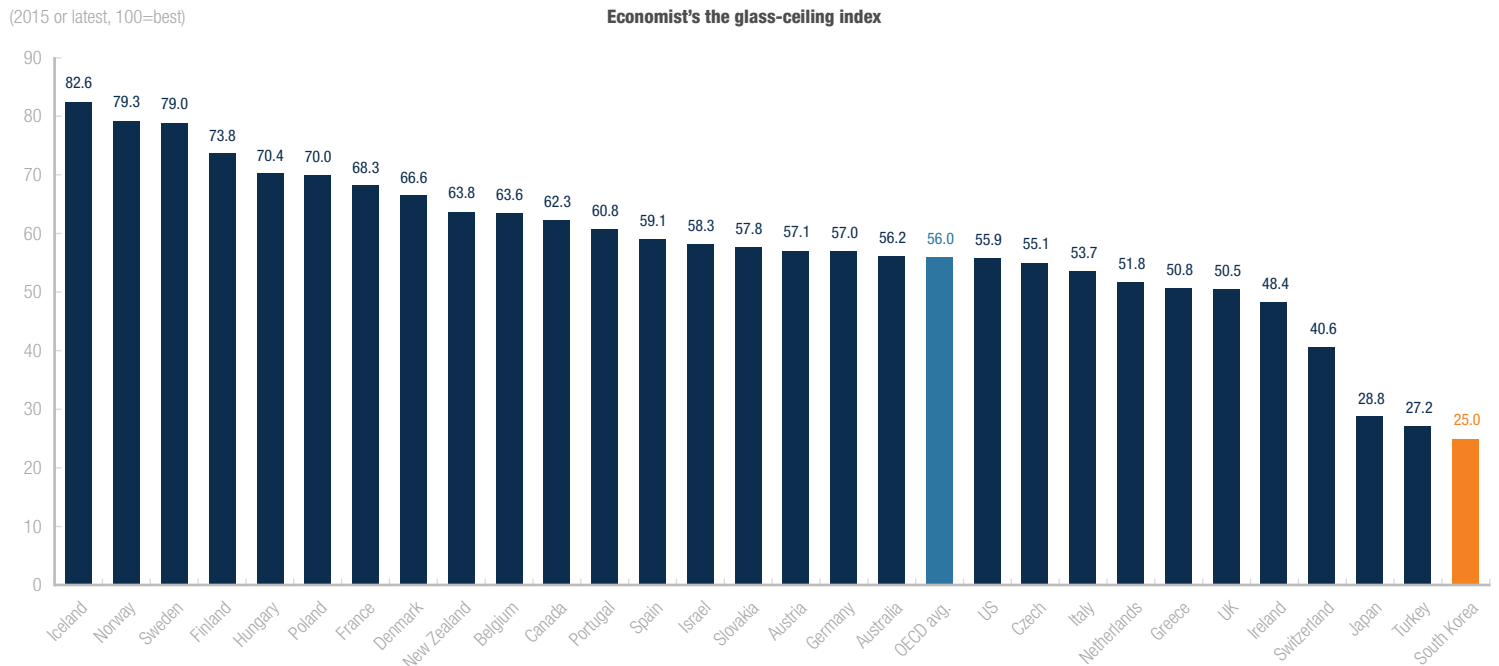
As the cozy relationship between the government and the chaebol raises the ire of the general public, corporate gains at the expense of minority shareholders will increasingly draw greater scrutiny. We note that there has been some progress made on minority shareholder rights as evidenced by the dividend payout policies announced last year.³ In our view, we are seeing something resembling Korea's second political awakening—which could eventually give way to a full-fledged minority shareholder revolution.

“G” Is for Gender Equality

Aside from governance, there is another “G” that is increasingly gaining attention in Korea: gender equality. We would argue that Korea needs improvement in women's rights and opportunities not only for the sake of social justice, but also for long-term economic growth. In our view, Korea has much to gain from the pursuit of gender equality, which could unleash a population of skilled but currently underutilized professionals with the potential to boost productivity in an economy transitioning from manufacturing to services.

Korea is Last for Female Workers

Source: The Economist, Mirae Asset (2018)



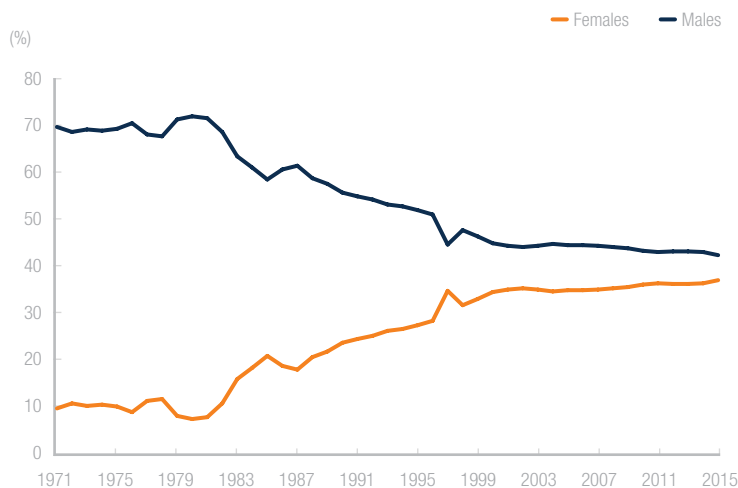
³ Financial Times, "Samsung Electronics plans more than \$25bn in dividend returns" (October 31, 2017)

Following its birth in the US, the #MeToo movement spread rapidly in Korea after a former prosecutor alleged that her supervisor groped her in front of her male colleagues. Amid a public outcry, the Korean government commissioned an independent inquiry into the incident, further empowering hundreds of other Koreans in a wide range of fields to voice their own experiences. The intensity of the Korean #MeToo movement appears to be even greater than that of its US counterpart, possibly signaling a sea change in gender issues. Without understating the importance of this issue within social and moral contexts, we argue that the accelerating pursuit of gender equality will have important economic and investment implications as well. Indeed, in addition to bringing much-needed awareness to workplace harassment and abuse, the #MeToo movement is shining a light on the untapped potential that Korea's underutilized female workforce holds.

Despite Korea's post-war economic growth, the dominance of manufacturing and labor-intensive industries has been a drag on efforts to move beyond outdated social ideals and expectations. While Korean women have made significant strides in education since the 1970s (almost completely narrowing the gap with men in this regard), this progress has not translated into equal opportunities in the workplace in both quantity and quality. The result is that despite Korea's relative economic strength, the country ranks lowest among OECD nations (by many measures) in terms of gender equality.

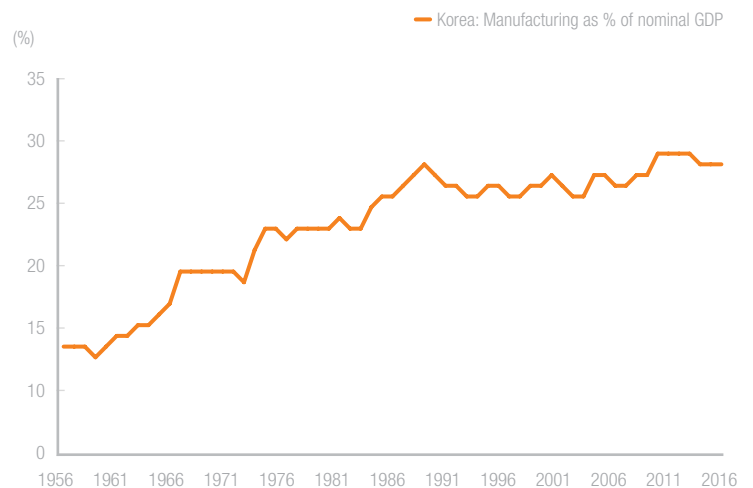
Gender Breakdown in College Enrollment in Korea

Source: Korea Education Statistics Service (Accessed in 2018)



Korea Manufacturing as % of GDP

Source: Statistics Korea (Accessed in 2018)

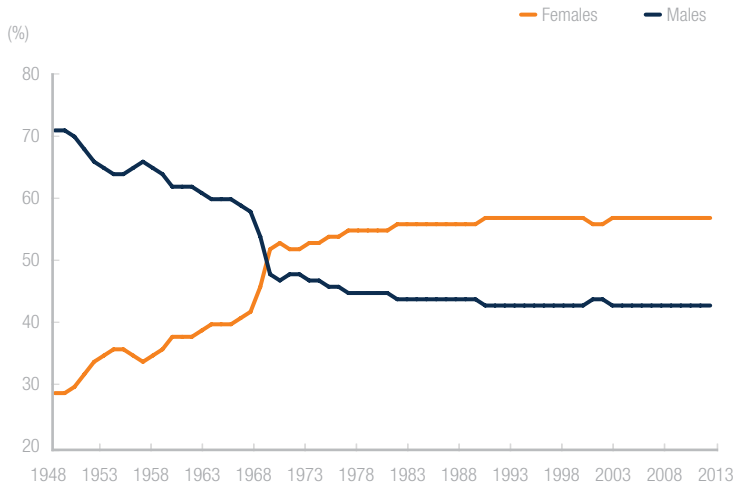


We believe that the history of the US labor market provides valuable clues about the path toward workplace gender equality in Korea. In the US, the gender gap in education began to narrow significantly immediately after World War II. However, it wasn't until the 1970s,

when the US labor market started to transition meaningfully away from labor-intensive manufacturing toward services and soft industries, that the gap in employment began to close.

Gender Breakdown in Tertiary Enrollment in the US

Source: National Center for Education Statistics (Accessed in 2018)

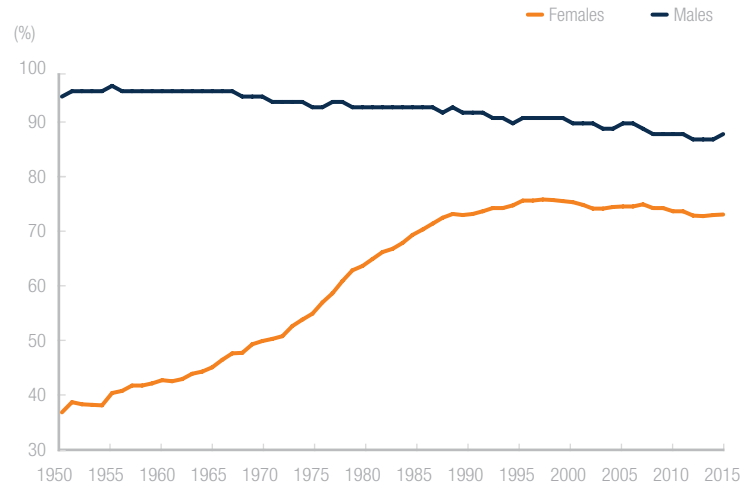


The lesson here is that access to education in and of itself is not sufficient to close the gender employment gap; rather a meaningful shift in the labor market is needed to lock in structural change. Notably, the Korean labor market currently finds itself at an inflection point similar to the one seen in the US in the 1970s. In other words, Korea is starting to transition away from heavy industries and toward retail, services, entertainment, and healthcare. Already, women occupy a significant number of leadership positions in many of Korea's growth industries.

As compensation and conditions for female employees improve,

Labor Rate Participation in the US

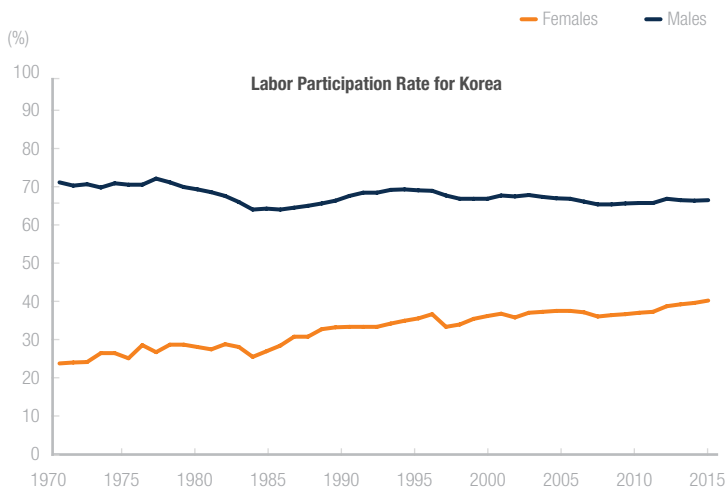
Source: U.S. Bureau of Labor Statistics (Accessed in 2018)



Korean women will be incentivized to remain in the workplace longer, not only boosting economic productivity but also partially solving the problems posed by declining demographics. For years, Korea has been looking for ways to avoid Japanese-style economic sluggishness caused by low birth rates and population aging (While Japan has recently begun encouraging females to participate in the workforce under Abenomics, these efforts should likely have been made two decades earlier.). In our view, if Korea is able to successfully empower its women, it may still have a chance to avoid the situation facing its neighbor.

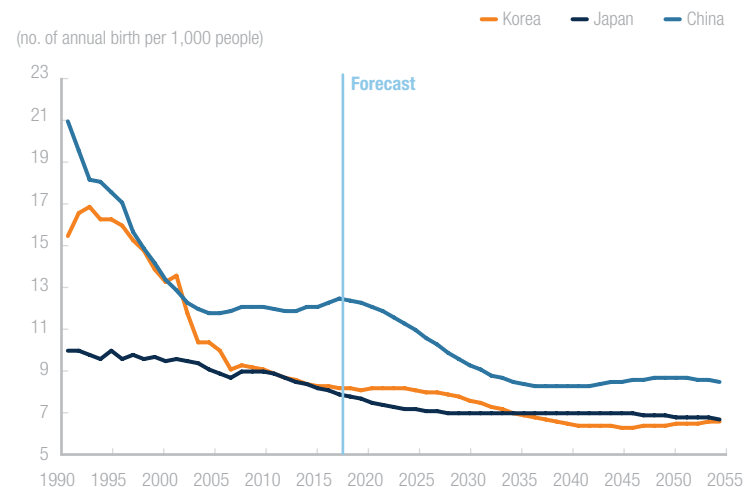
Korean Ladies Can Solve Korea's Demographic Cliff

Source: Statistics Korea (Accessed in 2018)



Demographics for Japan, China, and Korea

Source: CEIC, Mirae Asset Daewoo Research (2018)



Poised for a Quantum Leap

In addition to political trends, technology and social media are also beginning to help even the playing field for minority shareholders by putting companies and management under the microscope and driving an increase in transparency. Traditionally, large corporations have exerted significant influence over the mainstream media by purchasing direct ownership interests and/or leveraging their advertising dollars; as a result, they have had significant success in managing public perception. However, with the increasing importance of social media and the rise of the 24-hour news cycle, the general public now has greater—and faster—access to information, placing more pressure on large corporates.

Even China, which is renowned for its tight grip on the media, struggles to contain social media. Going forward, policymakers will continue to face challenges in this area, as it is always difficult to put the genie back into the bottle when it comes to technological advances.

All in all, we believe technology can be an important tool for the Asian ESG movement as it prepares to make a quantum leap forward. In our view, by leveraging technology/social media and riding shifting political winds, the ESG movement in Asia will make tangible progress in the coming decade relative to developed nations, especially given the low base of expectations. Those firms that take the lead in ESG within Asia may very well emerge as winners, with their efforts translating into share outperformance and greater investment appeal.

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