

Serving two purposes – ESG and Investment Return

ESG indices outperforming traditional Japanese market cap indices

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Written in collaboration
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Quarterly analysis

Both the FTSE Blossom Japan Index and FTSE Blossom Japan Sector Relative Index outperformed the traditional FTSE Japan All Cap Index by 115bp and 136bp respectively. As the analysis shows, the outperformance was attributable to stock selection effect supported by Size factor, and Residual factor which represents non-traditional factors such as ESG.

This Japanese ESG indices and passive investment report, written in collaboration with SGX, reviews the development of Japan's sustainability standards, the ESG performance of Japanese listed companies compared to the broad-market index, and the growth of index-linked SGX FTSE Blossom Japan Index Futures.

Key highlights from this quarter's analysis:

- Q1 2023 was another strong quarter for FTSE Russell's Japan ESG flagship index series
- The outperformance of the FTSE Blossom Japan Index Series over the traditional market cap index is attributed to the stock selection effect
- Record open interest of US\$ 105M on the SGX FTSE Blossom Japan Index Futures, making it the leading listed derivatives solution on the FTSE Blossom Japan Index

More disclosure for ESG investment in Japan required (May Update)

In Japan, ministry-led movements to set definitions and guidelines for ESG investment are gaining momentum. First, Japanese Financial Services Agency (FSA) published 'The Code of Conduct for ESG Evaluation and Data Providers'¹ (the Code) in December 2022 in response to opinions that methodologies and process aren't transparent, and that it is difficult to understand that companies' ESG scores are different by each ESG evaluation provider.

The Code, which included six Principles² with their guidelines and concepts, is designed to be a voluntary code on a 'comply or explain' basis to encourage improvement by each data provider. FSA calls for organizations to express their support for the Code via public announcement, and the organizations supporting the Code will either comply with the principles and guidelines of the Code, and or explain the reasons why they do not comply with a particular principle or guideline.

FTSE Russell, which provides the FTSE ESG Scores integrated in various sustainable indices such as the FTSE Blossom Japan Index series, had been involved in the process and public consultation and announced its endorsement to comply with the Code in February 2023.

The FSA also announced 'Proposed Partial Amendments to the Comprehensive Supervisory Guidelines for Financial Instruments Business Operators, etc., regarding ESG Investment Trusts'³ in December 2022. The FSA responded to the comments received, and it promulgated and came into effect as of March 31 2023. There are a number of investment products that incorporate ESG factors in their names and investment strategies, which had increased both in Japan and overseas. At the same time, concerns over 'greenwashing' actual investments might not be commensurate with such ESG claims and are attracting attention globally.

Given this background regarding publicly offered investment trusts in Japan that position ESG as a key factor in the selection of investment assets (hereinafter referred as *ESG investment trust*), FSA proposed it is necessary to:

- consider ESG as a key factor in the selection of investment assets
- describe the selection process in the 'Objective and Characteristics of the Fund' section of the delivery prospectus

For example, managers need to disclose the target and real percentage of ESG assets in the portfolio as well as selected ESG theme details and the investment process with its integration and methodology.

ESG investment provided in Japan is expected to further increase the need and demand for passive investment using quantitative ESG scores based on transparent methodologies on these requirements.

¹ <https://www.fsa.go.jp/news/r4/singi/20221215/02.pdf>

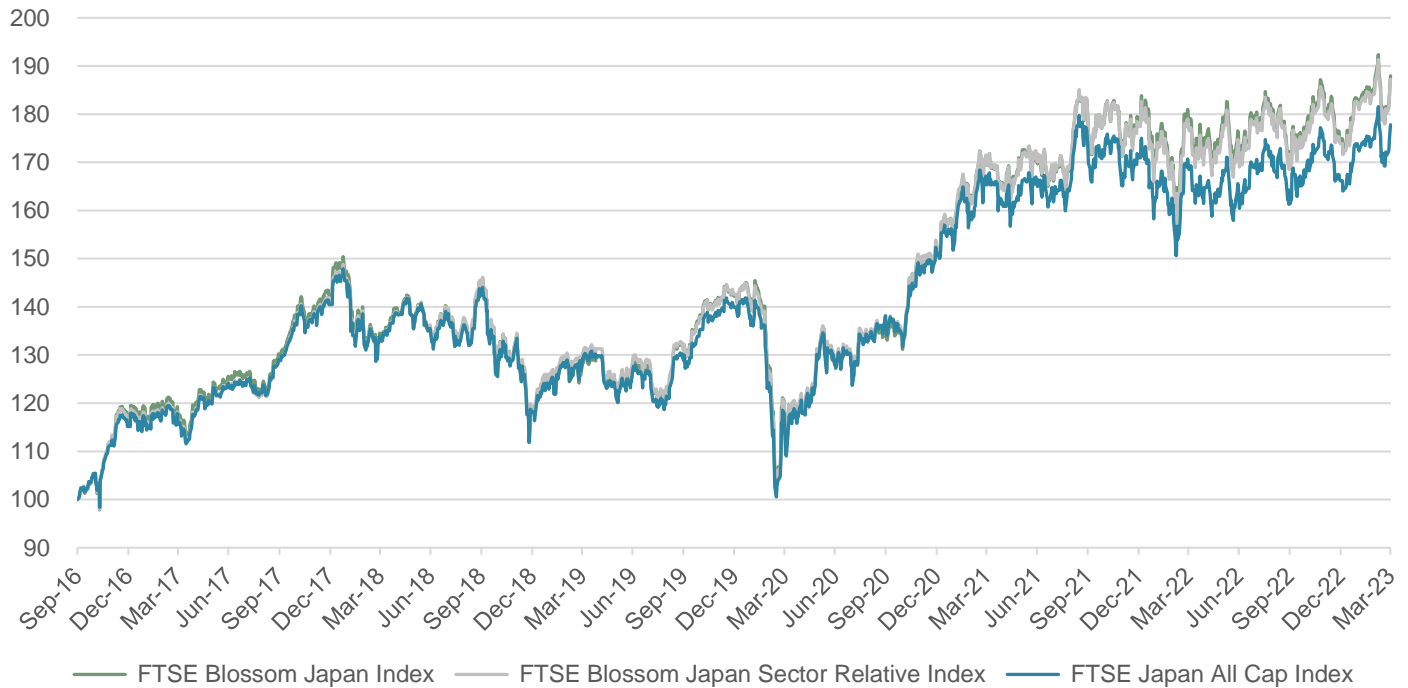
² Securing Quality, Human Resources Development, Ensuring Independence and Managing Conflicts of Interest, Ensuring Transparency, Confidentiality, Communication with Companies

³ <https://www.fsa.go.jp/news/r4/shouken/20221219/02.pdf>

FTSE Blossom Japan Index Series continues to outperform traditional market indices

The first quarter of 2023 was another strong period for FTSE Russell's Japan ESG flagship index series.

Exhibit 1. Performance (total return, JPY)



Source: FTSE Russell. Data based on Total Return in JPY, as of March 31, 2023. Past performance is no guarantee of future results. Please see end for important legal disclosures.

Both the FTSE Blossom Japan Index and FTSE Blossom Japan Sector Relative Index outperformed the traditional FTSE Japan All Cap Index by 115bp and 136bp respectively (Exhibit 2).

Exhibit 2. Performance attribution analysis for FTSE Blossom Japan Index Series

FTSE Blossom Japan Index

	Quarterly change (2022/12 – 2023/03)				2015/12–2023/03				2015/12–2022/12			
	Industry Allocation	Stock Selection	Interaction	Total Contribution	Industry Allocation	Stock Selection	Interaction	Total Contribution	Industry Allocation	Stock Selection	Interaction	Total Contribution
Technology	-0.6	18.2	-0.1	17.5	-11.8	39.8	0.4	28.4	-11.2	21.6	0.5	10.9
Telecommunications	-1.3	1.4	-0.4	-0.3	-20.7	23.3	-5.5	-2.8	-19.4	21.9	-5.1	-2.6
Health Care	-1.6	0.3	-0.3	-1.6	-15.0	45.6	-0.8	29.8	-13.4	45.4	-0.5	31.4
Financials	-0.1	6.0	1.5	7.4	-4.5	148.1	21.4	165.1	-4.4	142.1	19.9	157.7
Real Estate	0.7	8.3	-4.7	4.4	-25.1	-85.3	-47.8	-158.3	-25.8	-93.7	-43.1	-162.7
Consumer Discretionary	0.1	61.8	0.3	62.1	8.0	338.4	9.4	355.8	7.9	276.6	9.1	293.7
Consumer Staples	1.7	21.4	-0.7	22.4	20.1	58.5	-7.1	71.6	18.4	37.2	-6.4	49.2
Industrials	1.9	-39.7	-3.3	-41.1	30.0	13.2	-44.0	-0.8	28.2	52.9	-40.8	40.3
Basic Materials	0.8	38.4	0.2	39.3	-6.3	192.2	-3.2	182.7	-7.0	153.7	-3.3	143.3
Energy	0.2	0.9	0.1	1.1	2.9	10.1	1.1	14.1	2.7	9.2	1.0	13.0
Utilities	-1.0	5.2	-0.5	3.7	-15.8	88.2	-3.2	69.2	-14.8	83.1	-2.8	65.5
Total Return (Local)	0.9	122.1	-7.9	115.0	-38.0	872.2	-79.4	754.7	-38.8	750.1	-71.6	639.7

FTSE Blossom Japan Sector Relative Index

	Quarterly change (2022/12–2023/03)				2015/12–2023/03				2015/12–2022/12			
	Industry Allocation	Stock Selection	Interaction	Total Contribution	Industry Allocation	Stock Selection	Interaction	Total Contribution	Industry Allocation	Stock Selection	Interaction	Total Contribution
Technology	1.0	-0.2	-0.1	0.7	5.2	-23.6	-1.5	-19.9	4.1	-23.5	-1.3	-20.7
Telecommunications	-0.9	-5.5	0.1	-6.3	-15.0	-76.9	1.0	-90.9	-14.1	-71.5	0.9	-84.7
Health Care	-0.4	12.0	0.4	12.0	-3.7	84.3	5.6	86.2	-3.3	72.2	5.2	74.2
Financials	0.4	-6.9	-0.1	-6.5	-2.6	85.6	-1.6	81.4	-3.0	92.4	-1.5	87.9
Real Estate	2.2	13.8	-1.7	14.3	3.0	-35.2	-7.5	-39.7	0.7	-49.0	-5.8	-54.0
Consumer Discretionary	0.2	70.5	0.0	70.7	2.4	250.7	-0.1	253.0	2.3	180.2	-0.1	182.4
Consumer Staples	0.4	3.8	-0.2	4.0	3.5	51.2	-2.5	52.2	3.1	47.4	-2.3	48.2
Industrials	-0.4	31.1	0.2	30.8	-7.7	263.5	2.7	258.6	-7.2	232.4	2.6	227.7
Basic Materials	1.0	14.6	0.1	15.6	3.8	36.9	-0.3	40.4	2.9	22.3	-0.4	24.7
Energy	0.3	-0.1	-0.1	0.1	4.8	-4.9	-1.1	-1.2	4.5	-4.8	-1.1	-1.3
Utilities	0.2	0.6	0.0	0.7	4.4	1.6	-0.3	5.7	4.3	1.0	-0.3	5.0
Total Return (Local)	4.0	133.7	-1.6	136.2	-1.8	633.1	-5.7	625.6	-5.8	499.3	-4.1	489.5

Source: FTSE Russell. Data as of March 31, 2023. Past performance is no guarantee of future results. Please see end for important legal disclosures.

As introduced in our previous report: [Growing focus on ESG in Japan: Disclosure, outperformance and roll costs](#), the outperformance of the FTSE Blossom Japan Index series over the traditional market capitalisation index since inception mostly has been attributable to stock-selection effect. This has also remained the case for both indices in the first quarter of 2023, as the stock-selection effect contributed 122bp for the FTSE Blossom and 134bp for the FTSE Blossom Japan Sector Relative.

Exhibit 3 breaks down the style factor attributions for the FTSE Blossom Japan and Blossom Japan Sector Relative indices. As the analysis shows, there was substantial contribution from the Size factor for Blossom Japan Index in the first quarter of 2023. This is often the case when the global stock market rallies significantly during short periods of time on the back of positive macro expectations. Interestingly, the Residual factor, which includes non-traditional factors such as ESG, showed slight reduction for FTSE Blossom Japan Index while showing significant increase for FTSE Blossom Japan Sector Relative Index. This is due mainly to the difference in the number of constituents of the two indices. Unlike the original FTSE Blossom Japan Index which consists of 250+ mainly large stocks, FTSE Blossom Japan Sector Relative Index contains more than 500 stocks including mid/small cap stocks. Although mid/small cap stocks tend to have lower ESG scores than large cap stocks in absolute terms, as FTSE Blossom Sector Relative Index is designed to overweight stocks that have relatively stronger ESG scores to its industry peers, its ESG-based stock selection performance does appear more cleanly as ESG-related attribution.

Exhibit 3. Style Factor Attribution

FTSE Blossom Japan Index

Period	Industry	Value	Quality	Volatility	Size	Momentum	Residual	Total Excess in JPY
31/05/2015 to 30/12/2022	-106.0	133.8	-67.5	-271.8	461.9	132.6	351.8	634.9
31/05/2015 to 31/3/2023	-112.3	169.3	-80.4	-301.0	612.6	128.1	333.1	749.4
Quarterly change	-6.3	35.5	-12.9	-29.2	150.7	-4.5	-18.7	114.5

FTSE Blossom Japan Sector Relative Index

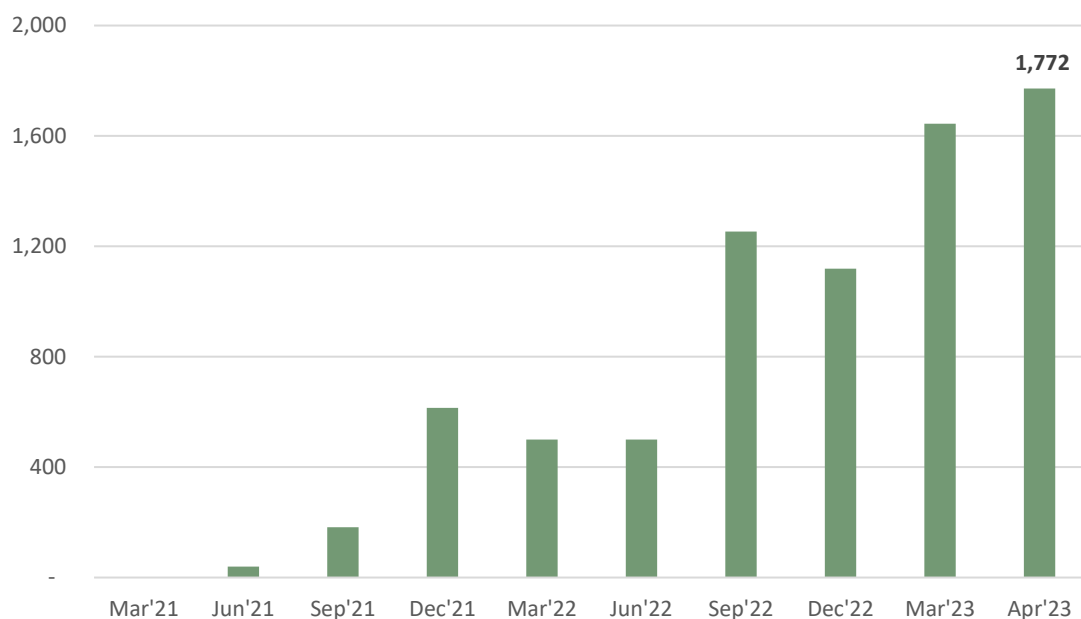
Period	Industry	Value	Quality	Volatility	Size	Momentum	Residual	Total Excess in JPY
31/05/2015 to 30/12/2022	0.4	83.5	-115.9	-123.6	33.9	183.9	399.4	461.6
31/05/2015 to 31/3/2023	2.9	101.7	-126.9	-132.8	99.1	192.3	458.9	595.2
Quarterly change	2.5	18.2	-11.0	-9.2	65.2	8.4	59.5	133.6

Source: FTSE Russell. Data based on March 31, 2023. Past performance is no guarantee of future results. Please see end for important legal disclosures.

Record Open Interest in the SGX FTSE Blossom Japan Index Futures

SGX FTSE Blossom Japan Index Futures marked a significant milestone this recent quarter by achieving a **record open interest of \$105M** (1,772 lots), making it one of the largest Asia ESG futures by open interest notional.

Exhibit 4. Growing Open Interest (Lots) of the SGX FTSE Blossom Japan Index Futures

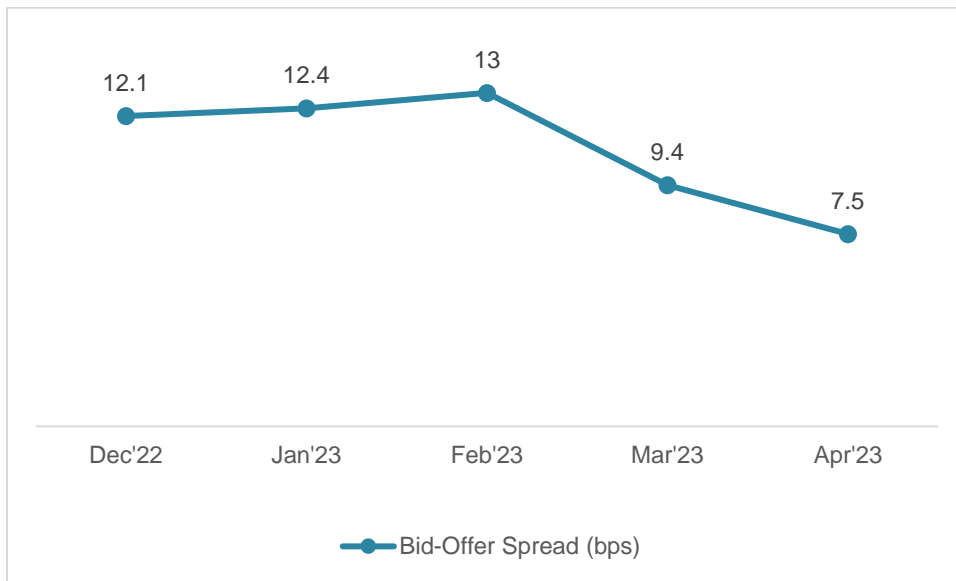


Source: SGX. Data as of end-April 2023. Past performance is no guarantee of future results. Please see end for important legal disclosures.

SGX saw an increase in activity over the last week of March, which coincided with the dividend ex-date for most Japanese stocks. The uptick in volumes and open interest during this period suggest that end-users have been using the futures for cash equitisation. For investors tracking the FTSE Blossom Japan Index or even highly correlated broad-based indices, SGX's futures are a cost-efficient solution to equitise dividends, therefore minimising the cash drag on performance.

Other than dividend equitisation, the improving liquidity of the SGX futures have also made it an appealing alternative for risk management, especially for portfolios with an ESG mandate. Traditionally, investors with ESG mandates have deferred to hyper-liquid, broad-based index futures for risk management and/or cash equitisation.

Exhibit 5. Tightening screen orderbook during Japan trading hours



Source: SGX. Data as of end-April 2023. Trading hours exclude lunch break between 11.30 – 12.30 (JST). Past performance is no guarantee of future results. Please see end for important legal disclosures.

However, with the increasing tradability of the SGX futures – both on-screen and on block – investors can consider the futures as a derivative product that could align with their ESG mandate. As illustrated by Exhibit 5, bid-offer spreads on-screen have improved with the introduction of new market makers, tightening average spreads to 7.5 bps in April.

For investors looking for an ESG derivative that provides exposure to the Japanese market, the SGX FTSE Blossom Japan Index Futures offers a listed solution that will suit multiple use-cases.

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