Pension perspective

Pension Fund Management and Socially Responsible Investment (SRI)—Thoughts from Yakushima

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The 7,200-year old Jomon-sugi *cedar tree on Yakushima Island is a truly awesome sight to behold. This irreplaceable natural wonder presents a compelling case for socially responsible investment. Looking ahead, the Japanese version of the U.S. Sarbanes-Oxley Act is expected to encourage the development of SRI. Is this being so overly optimistic?*

In *Ukigumo* (Floating Cloud), novelist Fumiko Hayashi characterizes Yakushima Island as "raining 35 days out of the month." True enough, when I visited in March, the island was cloaked in dark rain clouds. Located 60 kilometers south of Kyushu's southernmost Satamisaki cape, the island is only 20 kilometers wide, but has a soaring 2,000-meter high mountain range and Kyushu's highest peak, Miyanoura-dake.

Tourist traffic to the island is booming, thanks to the high-speed ferry (two hours one way) introduced in 1989, and designation as a World Heritage Site in 1993. The highlight of the island tour is to see the ancient Yakushima cedar trees that date back thousands of years, and especially the *Jomon-sugi* cedar tree, said to be 7,200 years old. To reach this tree, which sits at an altitude of 700 meters, tourists need to pack a breakfast and lunch, and trek into the mountains for ten hours along a 22-kilometer roundtrip course. The remoteness of this symbol of Yakushima could explain part of its allure.

Suppose we had to put a monetary value on this World Heritage Site—what would the island be worth? The idea of calculating the economic value of nature may sound crass, but is actually a contentious issue in environmental economics. Estimating the value of nature is critical when choosing whether to use nature or to preserve it, or when assessing damages caused from the use of nature.

In Yakushima's case, the choice is between the benefit of using nature (use value) and the benefit of preserving it (preservation value) for future generations. Use-value advocates argue that the *Jomon-sugi* tour not only generates considerable enjoyment but instills a greater appreciation of nature. But preservationists say that access should be restricted to preserve nature for future generations to enjoy. If the use value and preservation value of nature could be expressed in monetary terms, we would simply weigh the respective costs and benefits, and choose the outcome that maximizes the aggregate value (however, we should note that the actual evaluation would encounter reliability and objectivity problems, whose details would fill a book).

A similar type of conflict exists in the investment world. The conflict is between direct stakeholders of an economic activity such as shareholders, managers, and employees, and indirect stakeholders such as local residents, consumers, and the government. When the wider range of stakeholders is considered, the common goal is no longer to use management resources in a way that maximizes the internal benefit. The benefit to outsiders—in the form of environment and legal compliance considerations—now must be internalized as a cost.

One way to internalize this benefit to outsiders (external cost) is by imposing legal penalties and taxes. But instead, Japan's capital markets turned to eco funds in the late 1990s. Eco funds are categorized as SRI (socially responsible investment) funds, or funds that invest in companies that actively engage in the environment business or excel at environmental issues. In recent years, SRI has developed beyond the environment to seek value across a broader range of external costs such as compliance and accountability.

The SRI investment philosophy is thought to be appropriate for pension fund investment because pension funds have a public nature and seek stable long-term growth. Unfortunately, Japan's SRI funds have underperformed other active funds, while their asset growth has stagnated. In fact, Morningstar's SRI index has recently trailed, or at best matched, the Topix index.

Another problem with SRI relates to the fiduciary duty of pension funds (by limiting investment opportunities, SRI may impair fund performance). However, the legal consensus on this matter seems to be leaning in favor of SRI. As a result, if SRI funds can improve their performance in the future, they stand a good chance of aggressively attracting pension assets. This puts high expectations on managers of existing SRI funds as well as new entrants.

SRI funds could also get a boost from the Japanese version of the Sarbanes-Oxley Act (J-SOX, referring to internal control requirements in the Financial Product Transaction Act of 2006). If the internal control reports required of listed companies are made publicly available, investors would no longer need to rely on survey data to make risk management comparisons.

Valuations would then deemphasize the traditional importance of financial statements and put more stress on social and environmental criteria, improving valuation accuracy. Specifically, financial statements would become more reliable and profit forecasts more accurate, while risk management would be better reflected in cost of capital (discount rate) estimates. As a result of these improvements, SRI funds will be able to make better investment decisions. Is this scenario so overly optimistic?

More debate may be needed to decide whether the spread of SRI philosophy in capital markets will eventually render SRI a meaningless distinction. But in the meantime, we should move further along in this direction. Moreover, in contrast to the difficulty of an institution-based approach to the environment—as seen by the U.S. refusal to ratify the Kyoto Protocol—through SRI, capital markets are already playing a vital role in securing global sustainability.

Looking ahead, people involved in pension fund management need to keep a close eye on SRI trends.