Description for Investment Principles

1. Our overarching goal should be to achieve the investment returns required for the public pension system with minimal risks, solely for the benefit of pension recipients from a long-term perspective, thereby contributing to the stability of the system.

- Japan’s public pension system (Employees’ Pension Insurance and National Pension) is fundamentally managed as a pay-as-you-go system that incorporates the concept of intergenerational dependency, whereby contributions paid by working generations support older generations.

- In the light of a declining birthrate and an aging population, funding pension benefits solely with contributions from working generations would impose upon them an unduly excessive burden, so a fiscal plan has been drawn up to use the reserve assets (GPIF) to fund benefits and achieve fiscal equilibrium within about 100 years. After the fiscal balancing period, the fund is projected to hold reserve assets equivalent to one year of benefits, and is to be used for the benefit of later generations.

- GPIF’s mission is to contribute to the stability of the pension system by achieving the investment returns required for the aforementioned pension system. In other words, the most significant risk to GPIF is a failure to achieve such returns.

- We shall not pursue higher returns for their own sake. Our persistent goal is to secure the necessary returns required for the pension system from a long-term perspective.

- GPIF is one of the largest pension funds in the world, holding assets worth 149 trillion yen (as of June 2017). GPIF assigns the highest priority to the benefits of pension recipients and makes investments upon taking into consideration the size of the market in which we invest, while maintaining the value of reserve assets.
• We shall never use reserve assets to influence equity markets or to implement economic policies. We are committed to making investments solely for the benefit of pension recipients.

2. Our primary investment strategy should be diversification by asset class, region, and timeframe. While acknowledging fluctuations of market prices in the short term, we shall achieve investment returns in a more stable and efficient manner by taking full advantage of our long-term investment horizon. At the same time, we shall secure sufficient liquidity to pay pension benefits.

<< Diversified Investments >>
• As the western proverb “Don’t put all one’s eggs into one basket” suggests, it is evident not only from domestic and foreign investment practices but also from financial theories that investing in a diversified set of assets with different attributes is appropriate and effective for the safe and efficient management of funds in general.

• For example, appropriate investments in multiple diversified assets, e.g., investments in both bonds and equities that possess different risk/return profiles, would produce less volatility in returns over the long term while achieving the same expected returns.

• Diversification is thus our primary investment strategy.

<< Characteristics of each asset class >>
• Investing in bonds can generally expect principal redemptions at full maturity. In particular, domestic bonds yield yen-based cash required for pension payments to recipients. We also acknowledge that public bonds, which are generally considered to be safer than equities, can result in losses when interest rates rise. Should we continue to hold bonds whose nominal returns are lower than the rate of inflation of goods and wages, our reserve assets
would ultimately lose value in real terms.

- In general, returns of equity indices such as TOPIX, which broadly reflect overall markets, move in line with economic growth, and higher stable returns can be expected to be earned by investing in equities in the longer term. The basic principle of equity investment is to invest in those whose values are expected to rise in the long run. In the short run, however, market prices can often diverge significantly from intrinsic values for a variety of reasons.

- While overseas investments would allow us to enjoy the benefits of global economic growth, their market prices can be affected by fluctuations in foreign exchange rates and changes in the invested country’s political environment.

- While acknowledging the market fluctuations mentioned above, we believe that investing in different asset classes will contribute to achieving the investment returns required for the pension system, because: (1) market prices are expected to converge to their fundamental values over the long run, and (2) holding a variety of asset classes will bring the effects of diversification.

<<Long-term investment horizon>>

- In general, the longer the investment horizon, the higher the returns, in the same sense as time deposits in the longer term earn higher interest rates than ordinary deposits, which can be withdrawn at any time.

- By having a long-term investment horizon, we can avoid being forced to sell assets at disadvantageous prices, and hold and wait until market prices recover.

- According to financial projections for the public pension system, we need not spend down a significant amount of reserve assets for the foreseeable future (see the Note below), which would enable us to make investments over a relatively long term. Taking advantage of this
feature, we aim to achieve investment returns in a stable and efficient manner.

**Note: The long term nature of the reserve fund**

- The government is required to make assessments of the current status of pension finance ("Actuarial Valuations"), make projections, and verify its robustness every five years.

- According to the latest Actuarial Valuations released in June 2014, the level of reserve assets is expected to decrease for a while, then increase, peaking around the 25th year, and then decrease constantly toward the 100th year.

- Under this scenario, we hold the view that we can continue to make long-term investments during the period when the level of reserve assets remains high before its consistent decline begins (i.e., for about 25 years), and that we can continue such a strategy to the extent it does not affect our cash-out plan in the years after reserve assets pass their peak level.

<<Securing liquidity for pension benefits payments>>

- The pension reserve managed by GPIF has the important role of immediately providing liquidity to the government’s Pension Special Account ("Account") if the amount of funds kept in Account faces a cash shortage and is unable to meet pension benefits payments.

- As such, we think it is imperative to pool proceeds from coupons and redemptions of domestic bonds in advance in accordance with the fiscal projection and to preserve highly liquid assets to prepare for an unexpected situation where Account needs an immediate liquidity injection.
3. We formulate the policy asset mix and manage and control risks at the levels of the overall asset portfolio, each asset class, and each investment manager. We employ both passive and active investments to attain benchmark returns (i.e., average market returns) set for each asset class, while seeking untapped profitable investment opportunities.

<< Formulating the policy asset mix>>

- When investing in the long term, it is considered to be more effective and bring about better results to determine the policy asset mix and maintain it over a long period, rather than frequently changing asset allocation in response to short-term market movements.

- In this sense, formulating the policy asset mix is the most important decision GPIF has to make. Hence, a rigorous procedure is established whenever the medium-term plan, including the policy asset mix, is created or changed; i.e., with the approval of the Board of Governors, the President of GPIF submits the plan to the Minister of the Health, Labour and Welfare, and the plan becomes effective, when authorized by the Minister.

- When revising the policy asset mix, we aimed to achieve the investment returns required for the pension system from a long-term perspective with minimal risks.

<< Risk control>>

- The most significant risk for GPIF is a failure to achieve the investment returns required for the pension system. Meanwhile, there are a variety of risks to be controlled in day-to-day investment operations.

- Such risks include not only market risk, liquidity risk, credit risk, and country risk associated with invested assets, but also broader investment and monitoring processes, such as risks related to outsourced investment managers, custodians, and GPIF’s operations, etc.
• We identify those risks associated with overall assets, each asset class, and each investment manager in advance, and monitor and manage them at regular intervals, and as necessary.

• Furthermore, as a long-term investor, we stay vigilant to the emergence of new risks that need to be controlled in accordance with changes in the economic environment or evolution of investments, and we address such risks in a flexible and prompt manner.

<< Securing benchmark returns (i.e., average market returns)>>

• In the capital markets, investors use a variety of information and trade investment assets based on their own motivations. In particular, assuming an investment horizon that is long enough for information to become widely available and for many investors to conduct an enormous number of transactions, market prices are expected to converge to their intrinsic values, and are neither undervalued nor overvalued. In this regard, the markets are considered to be efficient in general.

• This view is compatible with passive investments (i.e., investment strategies in line with indices that parallel price movements of overall markets), and this style is useful for large long-term investors such as GPIF.

• On the other hand, the market prices of securities can be left undervalued or overvalued in cases where public information is not sufficiently shared among investors, markets are overreacting to uncertain information, or the number of investors is limited.

• This view is compatible with active investments (i.e., investment strategies that deliberately deviate from indices reflecting price movements of overall markets in pursuit of gaining excess returns) and alternative investments.

• GPIF shall combine passive and active investments, aiming to secure benchmark returns
(i.e., average market returns) set for each asset class, while seeking untapped profitable investment opportunities based upon a thorough examination of the fundamental sources of such investment returns.

4. **By fulfilling our stewardship responsibilities (including the consideration of ESG (Environmental, Social, and Governance) factors), we shall continue to maximize medium- to long-term investment returns for the benefit of pension recipients.**

- The "Council of Experts Concerning the Japanese Version of the Stewardship Code" for the Financial Services Agency recently released the "Principles for Responsible Institutional Investors <Japan's Stewardship Code>," in February 2014. Stewardship responsibility is construed as “the responsibility of institutional investors to aim to increase medium- to long-term investment returns for clients or beneficiaries by promoting enterprise value enhancements and sustainable growth of invested companies through constructive dialogues for purposes (“Engagements”) based on a deep understanding of invested companies and their operational environments.”
- GPIF promotes the engagement between the investment institutions and the companies they invest in. GPIF can benefit from higher returns if the engagement improves the medium to long term corporate value and leads into an overall market growth. GPIF will fulfill its stewardship responsibilities by aiming to build a virtuous circle in the investment chain.
- GPIF will fulfill its stewardship responsibilities by accomplishing work it can perform on its own, understanding and monitoring the work performed by the investment institutions, engaging with the investment institutions, and disclosing an annual summary on activities undertaken.
- Through various activities that fulfill stewardship responsibilities, GPIF will strive to contribute
to the stability of the pension system by increasing the medium to long term returns for the insured person while considering the ESG (Environmental, Social, and Governance) as well. As for the expected effect of risk reduction, the longer the investment period, the higher the return after risk adjustments.

In implementing the above investment principles, GPIF is committed to strengthening its organization and earning the trust of the public.

- We fully recognize that any investment strategies established following the above “Investment Principles” would end up as a pie in the sky unless the organization is equipped with sufficient capabilities.

- Organizationally, GPIF considers it instrumental to demonstrate high levels of professional expertise to fulfill its mission. We shall deploy sufficient human resources, encourage individual staff to improve their professional skills, and nurture a diversity of talents and capabilities, while fostering a sense of organizational unity.