Current Status and Challenges of Japanese Equity Engagement Funds

(Abstract)

This paper defines Japanese equity engagement funds (hereafter "EFs") as funds that engage in dialogue with corporate management with the aim of enhancing corporate value at investee companies.

Since spring 2023, EF activities have entered a new phase. In response to strong demands from public institutions, investee companies have significantly changed their approach. Discussions that directly relate to enhancing corporate value are now being taken seriously, shifting from superficial exchanges to substantive dialogue. Independent outside directors have increasingly become counterparties in these discussions, and proposals are more often accepted. The time between proposal and execution has shortened, leading to improved investment returns for EFs.

Historically, EF investments focused on undervalued small- and mid-cap stocks with stable cash flows. Recently, however, their scope has expanded to include large-cap and high-quality stocks. Whether they invest in "bad companies" or "good companies" depends on the EF's investment style, and both the proposals and investment horizons vary significantly based on their strategy.

EF proposals encompass a wide range of areas, including governance, capital policy, business and investment strategy, management strategy, and operations. The difficulty of implementing these proposals—and the associated challenges—can vary widely. This diversity of proposals brings external expertise into corporate management, strengthens governance discipline, and ultimately contributes to enhancing the value of Japanese companies.

Recently, there has been an increase in diversified EFs, including those with defined exit strategies and those managing public mutual funds. These funds aim to improve returns and broaden the investor base. It has become common practice to efficiently scale EF capabilities by leveraging external resources. Going forward, EF activities are expected to expand further in scope, scale, and investor diversity.

The future growth and scale of EFs will hinge on their ability to successfully promote reforms at large corporations and achieve high returns. Although overseas institutional investors currently account for the majority of EF clients, increasing investment from Japanese investors is desirable. This would allow the benefits of corporate value enhancement to be returned to Japan in the form of EF investment returns.

Table of Contents

August 2025

Sadayuki Horie

(PIF Japan Securities Research Institute, Senior Researcher)

1. What Are Engagement Funds?

What exactly are engagement funds (hereafter referred to as "EFs")? According to Japan's Stewardship Code (hereafter "SC"), engagement is defined as "purposeful dialogue grounded in a deep understanding of Japanese investee companies and their operating environments."[1] While the "purpose" varies depending on the investor, this paper defines EFs as funds that engage in dialogue with Japanese corporate management with the aim of enhancing corporate value. Such funds can potentially foster win-win relationships with companies and contribute significantly to enhancing their value.

Recently, there has been a surge in media coverage of funds referred to as "activists" making various shareholder proposals to Japanese listed companies. The ultimate goal of activist funds is to raise share prices at investee firms and deliver high investment returns to their clients. Achieving long-term share price appreciation requires improving profitability, and discussions between activists and companies often center on strategies to strengthen long-term earning power. In that sense, activists are essentially synonymous with EFs. However, the term "activist" has acquired certain connotations over time and may evoke different preconceived notions depending on the audience. Therefore, this paper opts to use the term "EF"—a term presumed to be relatively neutral—to describe activities primarily aimed at enhancing corporate value through engagement.[2]

In reality, EFs investing in Japanese companies have become increasingly active. According to Barclays, among the top ten engagement funds globally in 2024, five[3] are targeting Japanese companies. A survey by IR Japan found that, as of May 12, 2025, there were seventy-three Japan-focused EFs.[4] Furthermore, in global rankings of EFs by assets under management, at least three Japan-based EFs exceed ¥1 trillion, with some ranked among the top ten.[5]

This paper is based on over ten years of dialogue between the author and leading EF managers, aiming to provide an accurate overview of their activities. Note that this discussion focuses on engagement from a shareholder perspective; engagement by creditors—an area that is

---

[1] This definition originated from the initial version of Japan's Stewardship Code (SC) in February 2014. In later revisions, the phrase "based on a deep understanding" was expanded to include the consideration of sustainability—including ESG elements—in accordance with the investment strategy and medium- to long-term viability.

[2] Readers can substitute the term "activist" for "engagement fund" without issue.

[3] Five firms including Elliott Management, Strategic Capital, Oasis Management, Dalton Investments, and the so-called Murakami Fund.

[4] According to materials from IR Japan, activist funds of European and American origin are the most numerous, followed by domestic activists, ESG-focused activists, and Asian activists. However, among the Asian activist funds, those with large assets under management are often led by Japanese individuals who serve as both the management and investment heads.

[5] In many cases, the assets under management of EFs are not publicly disclosed. The figures cited in this paper are estimations based on the author's interviews and other engagements with EF managers.

also gaining momentum—will be addressed in a separate paper at another time.[6]

2. Evolution of Dialogue Between Investors and Corporate Management

Before describing the activities of EFs, let us briefly review how dialogue between investors and corporate management in Japanese companies has evolved over time. This dialogue has undergone three distinct phases, with public perceptions of "engagement" also shifting significantly over the years.

(1) Pre–Stewardship Code Era (Before 2014): A Niche Investment Practice

Prior to the introduction of Japan's SC in 2014, engagement with investee companies was considered a niche strategy pursued only by activist funds aiming to raise share prices through direct involvement in corporate matters. While portfolio managers and analysts of long-term investment funds engaged in discussions with company executives about enhancing corporate value, these exchanges were not viewed as special "engagement" activities. Instead, they were seen as part of routine investment analysis. Thus, engagement was largely recognized as a distinctive practice limited to EFs.

(2) Post–Stewardship Code Era (2014 to March 2023): Mainstreaming

A major turning point came in February 2014 when Japan's Financial Services Agency introduced the SC, officially defining engagement as "purposeful dialogue."[7] The SC also articulated the concept of "stewardship responsibility"—the duty of institutional investors to enhance corporate value and foster sustainable growth through engagement, ultimately improving long-term returns for clients and beneficiaries.

This encouraged not only activist funds but also active and passive managers to pursue engagement more seriously. Engagement became broadly accepted and diversified. The launch of the Corporate Governance Code (CGC) shortly after the SC, along with the rise of environmental, social, and governance (ESG) investing in Japan, further contributed to the expansion of engagement practices.

EFs, which had previously focused mainly on enhancing corporate value and share price, broadened their scope to include structural governance measures, such as increasing the ratio of independent outside directors and reducing cross-shareholdings. With CGC guidance defining board responsibilities and investor dialogue, and ESG investing gaining momentum, engagement

---

[6] In Japan, the number of corporate bankruptcies exceeded 10,000 in 2024—the first time in eleven years, according to Teikoku Databank. In response, the government approved the Early Business Rehabilitation Bill at a cabinet meeting on March 4, 2025, signaling a push to strengthen the economy's metabolic renewal function through business revitalization. In tandem with these changes, foreign asset management firms known as "credit activists" have also begun engaging in the rehabilitation of Japanese companies.

[7] The author served as a committee member of the Expert Council on Japan's Stewardship Code from August 2013 to February 2014 and was involved in its formulation.

expanded to encompass areas such as environmental impact, diversity, and social contributions.

While topics such as carbon reduction targets and independent director ratios helped reinforce governance discipline, their direct link to corporate value enhancement remained unclear. As the scope and objectives of engagement widened, its efficacy became more ambiguous. Asset owners began evaluating engagement practices, leading some fund managers to request meetings merely to build a record of activity. This led to concerns that engagement might become superficial or symbolic. In this phase, both positive and negative impacts emerged from the diversification of investor objectives.

(3) Post–Tokyo Stock Exchange Initiative Era (From April 2023): Substantive Engagement

Although diverse engagement styles continue to coexist, a notable change in how investee companies respond to EFs began in spring and summer 2023. In March, the Tokyo Stock Exchange released papers promoting capital productivity and dialogue with shareholders. In April, the Financial Services Agency introduced the Action Program for Substantive Governance Reform, and in August, the Ministry of Economy, Trade and Industry (METI) published guidelines for corporate acquisitions. These guidelines notably replaced the term "hostile takeover" with "unsolicited acquisition," and emphasized that boards must sincerely address acquisition proposals—marking a shift in behavioral norms for directors.

These publications prompted a change in the mindset of independent directors and executive management. Corporate leaders were now compelled to take "capital productivity improvement"—a core discussion theme for EFs—seriously. Boards were expected not to ignore potentially value-enhancing proposals, and transparency in investor discussions became a norm. Consequently, engagement evolved into a critical corporate issue for investee firms.

This shift also affected how independent directors interact with investors. Previously, directors often declined meeting requests. But now, more of them regard themselves as representatives of minority shareholders and proactively seek proposals that enhance corporate value. One EF noted: "Since April 2023, we've seen a clear shift. Independent directors who previously refused our meeting requests are now increasingly willing to engage.[8] These discussions are not merely for information gathering. They're a chance to share concerns and dissatisfaction, encourage informed action at the board level, and ultimately promote our proposals. If they understand our ideas can boost corporate value, directors may raise them in board discussions—and sometimes support them. The time from proposal to execution has

[8] In an article titled "Dialogue between Outside Directors and Investors Doubles in Three Years" published by the *Nikkei* on May 22, 2025, it was reported that such dialogue has doubled at companies implementing related initiatives. The article cites a survey conducted by Mitsui Sumitomo Trust Bank, stating that, "According to a survey conducted by Mitsui Sumitomo Trust Bank of listed companies, the proportion of major companies (with a market capitalization of ¥500 billion or more) that have established opportunities for dialogue between outside directors and investors reached 48 percent in 2024."

shortened, leading to a virtuous cycle where our investment returns also increase."

With support from public institutions, EFs and investee companies now conduct substantive discussions focused on corporate value creation. This transformation appears to be contributing to better returns for EFs. Although most do not publicly disclose their performance, interviews indicate that several have achieved returns far exceeding benchmarks like the TOPIX, and their assets under management have grown significantly.

Meanwhile, EFs are delivering higher-quality proposals, with an increasing number of white papers and shareholder proposals emerging. According to Daiwa Institute of Research, the June 2024 shareholder meeting season saw a record-high 113 companies receive shareholder proposals, with 59 coming from institutional investors such as EFs. Research by Diligent Market Intelligence shows that activist-driven shareholder proposals targeting Japanese firms totaled 108 in 2024—the second-highest on record—after 2022.

At the same time, ESG-focused engagement by passive and ESG funds has become more active. As corporate value discussions with EFs intensify, companies must also respond to increasingly formalized engagement focused on ESG metrics. This growing variety of engagement goals has increased the burden on corporate investor relations departments.

3. Characteristics of Companies in Which Engagement Funds Invest

Next, this section will examine what kind of companies EFs select as investment targets. As proposals by EFs have increased, public interest has also grown, and analyses of their investment targets are being conducted by various media, including economic magazines.[9] Based on interviews with EFs, which have achieved excellent investment returns, this paper analyzes the characteristics of their investment targets and the reasons behind their investment decisions.

(1) Focus on Small- and Mid-Cap Stocks

The first characteristic of EF portfolio companies is that they are predominantly small- and mid-cap stocks (generally with a market capitalization of ¥200 billion or less). Of course, EFs, which have long invested in global companies, also invest in large Japanese companies. Recently, some EFs specializing in Japanese companies have increased their investments in large-cap stocks. However, small- and mid-cap stocks still account for the overwhelming majority of EF portfolio

---

[9] *Nikkei Business* (February 10, 2025 issue) identified activists likely to engage in significant proposal activities, based on data from the past twenty years, and outlined common characteristics of their portfolio companies. According to the analysis, the five characteristics are: (1) cash-rich status (high ratio of cash and short-term assets to total assets); (2) asset efficiency (low return on total assets); (3) institutional investor ownership ratio (high ratio of shares held by institutional investors); (4) stock price undervaluation; and (5) stock price volatility trend (low beta value). Additionally, Masatoshi Kikuchi (2025) states, "Since activists entering Japan are small in scale, they tend to target mid- and small-cap stocks. Generally, companies with low PBR and low ROE, as well as those with high policy-held shares and high net cash ratios, are more likely to become investment targets for activists."

companies.

There are several reasons why small- and mid-cap stocks are the core of the investment portfolio. The first reason is that a high ownership ratio is necessary to ensure that management takes investment proposals seriously. With only a small number of shares held, it is challenging for management to fully appreciate the significance of the investment; therefore, it is necessary to secure a relatively large ownership stake, such as 5 percent or more. Achieving such a ratio with large corporations is challenging from the perspective of an EF's asset size, making small- and mid-cap stocks the primary investment target.

The second reason is that small- and mid-cap stocks tend to be undervalued. Compared to large-cap stocks, they have relatively lower liquidity, making them less attractive as investment targets for funds with large asset sizes. As a result, there are fewer securities analysts and portfolio managers responsible for research, and these stocks are often undervalued compared to large-cap stocks, which are more likely to be targeted by a larger number of researchers.

Furthermore, the fact that small- and mid-cap stocks tend to have weaker corporate governance compared to large-cap stocks further explains the concentration of EF investment targets in this segment. In large-cap stocks, governance is generally well-established, and issues raised by EFs are unlikely to be left unaddressed for extended periods, with companies often taking proactive steps to address them. In contrast, small- and mid-cap stocks, which have relatively weaker governance, are more likely to have unresolved issues included in EF proposals, making them more susceptible to recommendations.

(2) Stable Cash Flow is Being Generated

Another characteristic of the companies EFs invest in is that they generate stable cash flow. This characteristic is not widely noted, but it appears to have been formed based on the past engagement experiences of EFs. For example, in the semiconductor business, the applications and required characteristics of products change rapidly. As a result, semiconductor companies may need to make significant investments in factories in the short term.

Even if issues such as excess cash on the balance sheet are pointed out, management may prioritize investment over shareholder returns, leading to disagreements with EFs. Additionally, management often focuses on improving operational efficiency, making it difficult for EFs to accept proposals for enhancing capital productivity. Given these circumstances, companies with stable cash flows are more likely to seriously consider EF proposals, increasing the likelihood of successful investments.

Stable cash flow can originate from sources outside the core business. In fact, companies that can generate cash flow more easily through rental income from real estate holdings or asset sales than from their core business are better positioned to return value to shareholders. Therefore, holding assets such as real estate that underpin cash flow is another characteristic of companies targeted by

EFs for investment.

Companies that have generated stable cash flow may become complacent about reinvestment opportunities and growth prospects, leading to inadequate balance sheet management and insufficient consideration of business growth and operating profit margins. As a result, there may be significant room for operational improvements. If such improvements are neglected, capital productivity may remain low, leading to undervalued stock prices, which increases the investment appeal for EFs.

(3) Low Ownership Ratio of Shareholders with Little Interest in Enhancing Corporate Value

The third characteristic is a low ownership ratio of shareholders with little interest in enhancing corporate value (such as listed companies with cross-shareholdings or founding families). This characteristic is not common to all EFs, and it is essential to note that it is a characteristic of EF investment targets that aim to increase the likelihood of securing a majority through shareholder proposals, such as those related to board member appointments. One of the characteristics of the ownership structure of Japanese listed companies is the increasing ratio of foreign investors and passive investors, and their high ownership ratios are a necessary condition for passing shareholder proposals.

The probability of shareholder proposals, such as those concerning the appointment of directors, being approved by Japanese EFs is low. Even for small- and mid-cap stocks, the EF shareholding ratio is typically around 20 percent or less, and in some cases, it is even lower than 5 percent. Therefore, the approval of EF shareholder proposals requires the consent of other shareholders. To obtain such consent, it is essential to understand both their shareholding motives and ratios.

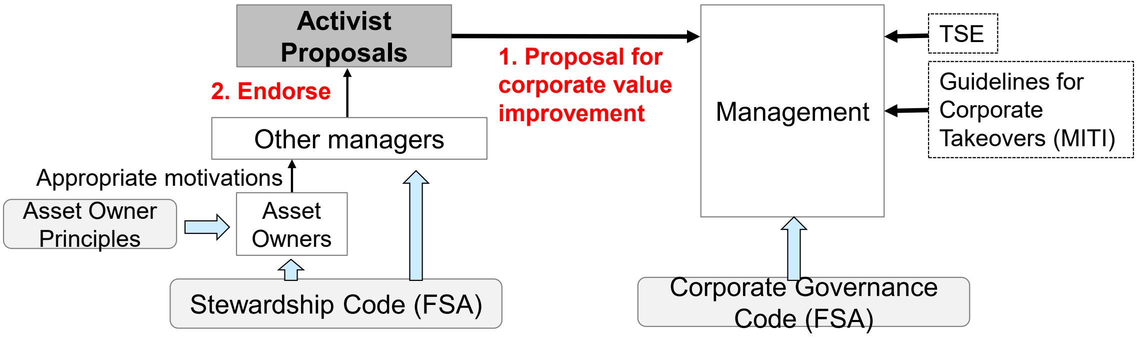
Among other shareholders, institutional investors, such as professional investment management companies and asset owners, are the most important in determining the outcome of EF proposals. Figure 1 illustrates the mechanism by which EF proposals, not limited to director election proposals, gain the support of institutional investors. The most important point is to convince these investors that EF proposals will contribute to enhancing corporate value. For example, the combined holdings of the Government Pension Investment Fund (GPIF) and the Bank of Japan account for approximately 14 percent of outstanding shares, and it is extremely important to obtain the support of the asset management companies to which they have outsourced their management.[10]

Even if a shareholder proposal is likely to lead to a short-term rise in share prices, it will be difficult to obtain support if passive managers determine that it will not lead to long-term corporate value enhancement. In the Japanese stock market, where passive managers account for a high

[10] Both the GPIF and the Bank of Japan entrust all their stock investments to external asset management companies, with the majority being passive investments. These funds are exercised in accordance with the voting criteria of the asset management companies to which they are entrusted.

proportion of investors, whether a proposal is made from a "long-term perspective" is key to securing a majority vote. Passive managers, due to the nature of their funds,[11] cannot easily sell shares of a company simply because its profitability is low, and must continue holding them. Therefore, proposals that contribute to enhancing corporate value are the most important factor in securing their approval.

Figure 1. Mechanism for obtaining support from institutional investors for shareholder proposals



(Source) Sadayuki Horie

One economic magazine highlights "high institutional investor ratio" as a characteristic of companies held by activist investors. However, it is reasonable to assume that the likelihood of shareholder approval increases when a greater proportion of institutional investors are predisposed to support initiatives that contribute to enhancing corporate value. In companies where shareholders with little interest in enhancing corporate value, including founding families and for-profit enterprises, constitute a majority, even proposals that clearly contribute to enhancing corporate value are unlikely to be approved.

With the establishment of the SC, it is recommended that asset management companies, including passive managers, disclose the details of their proxy voting decisions on an individual basis. As a result, they may face harsh criticism from external parties if they are unable to appropriately judge whether shareholder proposals contribute to corporate value.[12] Previously, passive managers with high holding ratios were subject to strong criticism from EFs for allegedly voting in favor of management. For example, they have been criticized for often supporting company proposals as long as they do not violate formal criteria such as ROE or the ratio of female board members. On the other hand, there is also criticism that passive managers tend to oppose company proposals in the event of a scandal, thereby encouraging EFs to conduct negative

[11] Passive managers are required to provide customers with returns in line with the benchmark and must maintain holdings of benchmark constituent companies in accordance with the benchmark's weighting ratios.
[12] At the 2024 shareholders' meeting, several asset management companies voted in favor of a resolution regarding the appointment of board members at companies with a high policy stock holding ratio, which was criticized in an economic magazine as differing from the asset management companies' voting criteria.

campaigns. While such criticisms exist, it is essential to make voting decisions, such as those concerning the appointment of board members, from the perspective of enhancing corporate value.

Furthermore, the Asset Owner Principles (AOP) formulated by the Cabinet Secretariat in August 2024 require asset owners themselves to verify whether their investment managers are exercising their voting rights appropriately. This requirement serves as an added incentive for investment managers to ensure responsible and well-considered proxy voting practices. The likelihood of proposals being accepted is expected to depend on several key conditions: the EF puts forward proposals that contribute to enhancing corporate value; the ratio of shareholder ownership is favorable to the company; and institutional investors exercise their voting rights appropriately, based on the perspective of enhancing corporate value.

(4) Bad Company or Good Company

Finally, a significant characteristic should be highlighted that varies considerably depending on EF investment strategies. This is whether a company is considered a “bad company” or a “good company.” A “bad company” refers to a company that generates stable free cash flow from its business operations but has low interest in shareholder-oriented management. Such companies may, for example, continue parent-subsidiary listings, exhibit corporate governance issues, hold excessive cash reserves on balance sheets with low capital productivity, and neglect to address low-profitability businesses, resulting in many areas for managerial improvement. On the other hand, a “good company” refers to a company with few of the aforementioned management issues and high-quality management but may still have room for improvement in its business strategy. These companies have the potential to further enhance profit margins through operational reforms and cost reductions.

A portfolio manager at an EF that primarily engages with global companies and has recently increased its engagement with Japanese companies stated, “We invest only in companies with high-quality businesses. We never invest solely based on ‘undervaluation,’ so there is little overlap in investment targets with other EFs.”

Whether an EF invests in a bad company or a good company depends on its investment style. Investing in bad companies is considered relatively straightforward in terms of proposing improvement measures because management issues are widely understood. However, there are challenges such as management opposing proposals and taking time to gain an understanding of the investee company. If the percentage of shareholders aligned with management is high, other investors may believe that the EF’s proposals are unlikely to be approved and may hesitate to actively support them, making it difficult to obtain a broader backing.

On the other hand, when investing in high-quality companies where management has a clear understanding of key challenges, and there are few obvious balance sheet issues, EFs work closely with management to review the business portfolio and reform operations. Some EFs refer to this corporate reform as "Good to Great," meaning to turn a good company into a great one, in reference to the title of a famous book by renowned management consultant Jim Collins. However, these management issues cannot be resolved overnight, and other challenges arise due to the difficulty of implementation. In addition, the stock prices of these companies are often not undervalued, which means there may be less room for stock price appreciation compared to bad companies, potentially hindering the improvement of investment returns.

The choice of whether to invest in a bad company or a good company depends on the EF's investment philosophy regarding corporate reform and the skills they possess. The time required for reform also varies significantly, and in general, investments in high-quality companies tend to be longer.[13]

4. Classification of Engagement Themes and Difficulty of Proposals

Now, let's take a closer look at the specific proposals made by EFs. As is well known, EF engagement proposals focus on how to resolve the "agency problem," which arises from the conflicting interests between shareholders—the legal owners of a company—and management, who act as their agents.

Regardless of investment style, the goal of EF engagement is to improve capital productivity, represented by metrics such as ROE and ROIC, and ultimately, to increase stock prices. Figure 2 organizes engagement themes and their content from the perspective of improving capital productivity. To achieve the goal of enhancing corporate value and increasing stock prices, there are four main themes: (1) governance; (2) capital allocation policy; (3) business and investment policy; and (4) management strategy and operations. Tamura (2025) refers to themes (2) and (3) collectively as "capital allocation issues," but for convenience, this discussion distinguishes between (2) capital allocation policy, which primarily concerns discussions on capital allocation, and (3) business and investment policy, which focuses on discussions related to cash flow generation.

(1) Governance

The primary themes of governance are selecting excellent decision-makers and proper evaluation of their capabilities. It is not investors but managers and employees who are responsible for executing corporate value enhancement. It is clear that selecting excellent top management capable of demonstrating strong leadership is the top priority for enhancing corporate value.

[13] This is a general trend, with the average holding period for certain EFs investing primarily in bad companies being approximately seven years, longer than that of EFs investing in good companies.

Figure 2. 4 Engagement Themes to improve capital productivity

Theme		Purposes	Typical examples
Governance		Selecting excellent decision-makers	①Selection of board members ②Selection of top management (CEO)
		Evaluating the capabilities of selected decision-makers properly	①Selecting appropriate KPI ②Establishing mid-term business plan ③Designing appropriate compensation scheme
Capital Allocation	Capital Allocation Policy	Achieving optimal capital structure	Determining the appropriate combination of capital and debt based on the company's growth stage
		Executing appropriate capital allocation	Balance between dividend payment and internal reserve
	Business & Investment Policy	Designing appropriate business portfolio	Appropriate allocation to goods, money and human resources to maximize long-term profitability
		Appropriate capital allocation	Appropriate capital allocation to R&D, M&A and other capital expenditures
Management Strategy and Operations		Designing appropriate management strategy	
		Constructing appropriate operation process	Building an operational process to achieve sales improvement, cost reduction, and higher profitability

(Source) Sadayuki Horie based on "Moving capital productivity mountain Research" (2014) and Tamura (2025)

In Europe and the United States, where the scope of shareholder rights established by law is narrower than in Japan, most shareholder proposals focus on the first theme, the selection of board members. It is common to follow the procedure of appointing individuals who can initiate corporate reform as insiders (directors) and then having them lead the reform after gaining a deeper understanding of the company's internal workings.

Another key aspect of governance is selecting appropriate KPIs to accurately evaluate the capabilities of decision-makers, i.e., executives. Even after appointing outstanding individuals, sustainable corporate value enhancement cannot be achieved unless appropriate incentives are provided to motivate them to pursue value creation, and their implemented strategies are evaluated appropriately. For example, measures may include setting KPIs such as total shareholder return (TSR) to evaluate management performance; clarifying the definition of equity spread (ROE minus equity capital cost) to accurately measure shareholder value; establishing a medium-term business plan to promote appropriate goal setting and create a feedback loop for management reform; and designing a compensation scheme that includes performance-based incentives linked to corporate value.

(2) Capital Allocation Policy

Within the broader issue of capital allocation policy, two themes can be identified: achieving optimal capital structure and executing appropriate capital allocation. Optimal capital structure refers to determining the appropriate combination of capital and debt based on the company's growth stage, with the ultimate goal of maximizing corporate value. It is necessary to consider how to raise capital and borrow funds, and where to allocate capital to various businesses and assets. For example, if there are signs that the company's capital efficiency is declining, such as a large amount of cash and deposits on the balance sheet relative to the scale of the business, or low-yielding real estate with little synergy with the core business, proposals such as increasing dividends using cash on hand may be considered.

Additionally, if the stock price is undervalued relative to the company's perceived shareholder value, and there are no investment opportunities with expected returns exceeding the cost of equity, share buybacks may be considered to adjust the capital structure to an appropriate level. Furthermore, the flow of cash generated from investments in businesses or assets is also important. This includes determining how much to reinvest, how much to allocate to debt repayment or dividends, and how much to retain as retained earnings. Of course, future outlooks for high-profit investments are inherently uncertain, and the amount of capital required for investment may vary depending on the stage of growth the company is in.

While the concept of optimal capital structure is generally well understood, there are often differing opinions between companies and EFs regarding the appropriate level of leverage. It is natural that management, seeking to avoid increasing bankruptcy risk, and shareholders, who theoretically only have a claim on residual profits, have different perspectives, and reaching consensus requires in-depth discussions on optimal capital structure.

(3) Business and Investment Policy

Another issue related to capital allocation is investment decisions regarding businesses that generate cash flow, such as determining how much to allocate in terms of resources (goods, money and human resources) to each business; identifying businesses to divest; and deciding how much to invest in capital expenditures, R&D, and M&A. These decisions, which can significantly alter a company's business portfolio, have the potential to drastically change its revenue structure and risk profile, and thus have a significant impact on corporate value. They are also decisions where disagreements between EFs and management are likely to arise.

The area where opinions most often clash between the two parties is their approach to business diversification and concentration. From the perspective of EFs, which can assemble their own portfolio of investee companies, it is preferable for individual investee companies to focus on high-profit businesses. By contrast, from the perspective of corporate management, diversification is often considered necessary for long-term corporate growth and survival.

It is believed that dialogue between the two parties is necessary to quantify the synergies among multiple businesses and clearly articulate the narrative that business diversification contributes to long-term corporate value enhancement. However, since this involves value judgments regarding the future prospects of businesses, differences in opinion are likely to arise. In some cases, rather than achieving synergy, increased complexity leads to the so-called conglomerate discount, which negatively affects valuation. One CEO of a listed company who has actively engaged in investor relations and has had direct exchanges with with EFs remarked, “There is an unbridgeable gap between investors and corporate managers,” and it is likely that this gap is particularly pronounced in the approach to business portfolios.

EF proposals for business reforms cannot be linked to corporate value enhancement without a deep understanding of the SWOT analysis[14] and industry structure of the investee company, making it difficult to create appropriate proposals. Even if a proposal is approved, it is the company that must implement it, and it will take a considerable amount of time to achieve results. Reforms in business and investment policies should be considered significantly more difficult to propose and implement than reforms in capital policies.

(4) Management Strategy and Operations

This type of reform involves restructuring management strategies in response to changes in the business environment, proposing strategies such as delisting to facilitate business reforms, and implementing organizational restructuring or operational reforms that lead to increased sales, cost reductions, and improved profit margins. Tamura (2025) describes proposals at this level as “strategies that require deep knowledge of internal corporate management” and classifies them as the most difficult “Level 3.”[15]

For example, EF proposals to delist listed companies as investment targets in order to rebuild their business models over a long period are now being made in the Japanese stock market. Proposals for organizational design and process improvements are also being made to enable efficient operations. In US corporate research, operational efficiency is cited as one of the key characteristics of companies with competitive advantages in their industry, with efficient companies reportedly able to produce similar products at one-third to one-half the cost of the industry average.

It is challenging to make these proposals based solely on external information, and a thorough understanding of the organization’s internal circumstances is necessary. In some cases, trading may be suspended temporarily, and proposals may be made from an insider’s perspective, which could put the investor at a disadvantage compared to an outsider who can trade freely. When a listed company is

---

[14] A framework for analyzing internal and external environments, such as a company’s strengths, weaknesses, opportunities, and threats, and formulating business strategies.

[15] Tamura defines Level 1 as “capital allocation related to finance (defined in this paper as capital allocation policy)” and Level 2 as “capital allocation related to business (defined in this paper as business and investment policy).”

delisted, it may take a considerable amount of time to relist, which can reduce investment efficiency. In cases of delisting, various measures such as management changes, business portfolio reviews, and operational reforms similar to those implemented by private equity (PE) funds may be necessary.

Unlike capital policy improvements, where a clear solution is widely recognized, various approaches to reform exist; therefore, it is generally more difficult to successfully implement such engagement activities to enhance corporate value than to improve capital policy. Private equity funds may implement such detailed improvement measures to improve profitability, but in the case of EFs investing in listed companies, it is necessary to take measures, such as becoming a board member or entering into a non-disclosure agreement (NDA), to support reforms from within the company. During such periods trading is typically suspended (further details are provided in Section 5).

5. Recent Trends in Engagement Funds

As mentioned in Section 2, EF engagement has become more substantive since spring 2023. This section will explore the specific changes that have occurred.

(1) Increase in Meetings with Independent Directors

As noted in Section 2, interviews with EFs have indicated an increase in meetings with independent directors, and this has also been confirmed in surveys of listed companies. Traditionally, when EFs sought to meet with investee companies, their initial request was to first meet with top management, such as the CEO. However, recently, it has become more common to request meetings with independent directors first. There are several reasons for this. When EFs present their proposals to top management, if approved, the executive team can actually implement them, making reforms more likely to progress. However, if the proposals are not approved, further discussions cannot proceed, and the proposals will not be implemented. If discussions break down, the only options left are to abandon further persuasion and sell the shares or submit a shareholder proposal and confront management. In other words, this approach carries the risk of being dependent on the top management's views and receptiveness regarding the proposal.

In contrast, some independent directors view themselves as representatives of minority shareholders. If they are convinced that an EF's proposal will contribute to enhancing corporate value, they may bring the proposal forward for discussion at a board of directors meeting. Furthermore, if there are executive officers who are proactive about reform, they can serve as internal champions, increasing the likelihood of the proposal being implemented and shortening the reform period. Even if top management does not agree, it is possible that the board of directors could make decisions to pursue reform.

In fact, through meetings with independent directors, there have been instances where proposals have been implemented and profits have improved, resulting in increased investment returns compared to before. While it is unlikely that independent directors with a strong sense of responsibility as representatives of minority shareholders will form a majority, it is expected that the awareness of independent directors will begin to change after April 2023, and that EF proposals could serve as a catalyst for corporate reform, with such cases increasing in the future.

(2) Challenges in Investing in Large-Cap Stocks

As discussed in Section 3, EF investment targets are characterized by being small- and mid-cap companies with stable cash flows and a low ratio of shareholders with little interest in enhancing corporate value. However, recently, investments in large-cap stocks have been increasing. For example, there has been a growing number of cases where EFs are making proposals to large-cap companies such as Seven & i Holdings, Kao, and Kyocera.

There are several reasons why EF investments in large-cap stocks are on the rise. First, EFs, which have historically engaged with overseas companies, have begun investing in Japanese companies. There are still many large Japanese companies with stable cash flows and relatively low stock prices compared to their European and American counterparts. Compared to previous Japan-focused EFs, these companies have relatively large asset sizes and have successfully engaged in numerous business strategy reforms and operational improvements, making them attractive targets for investment. Another reason is that large-cap stocks tend to have a higher proportion of institutional investors, increasing the likelihood that their proposals will be accepted. Examples include Value Act Capital's investment in Seven & i Holdings and its appointment of outside directors at Olympus and JSR to support management reforms.

Second, there is a limitation on the amount of capital that can be invested in small- and mid-cap stocks alone, making it difficult to secure additional funds from clients. It is speculated that Oasis Management's investment in large-cap stocks, such as Kao and Kyocera, is aimed at securing more funds from clients.

Third, if the proposals made by EFs contribute to enhancing corporate value, it has become easier to secure support from other institutional investors. Even without holding a stake of 5 percent or more, if an EF can come up with high-quality proposals, other institutional investors are more likely to agree with them, making it easier to implement reforms. If EF engagement expands to large-cap stocks and proposals are implemented, resulting in corporate management reforms, this could contribute to an overall rise in stock prices in the Japanese stock market. This would be a welcome development for the Japanese stock market as a whole.

On the other hand, large companies have a large number of analysts and asset management companies conducting corporate analysis, and their stock prices are relatively less undervalued compared to small- and mid-cap stocks. Additionally, their governance is relatively robust, and there are few obvious capital policy issues that are neglected in small- and mid-cap stocks. Furthermore, there are limited measures available to improve capital productivity in the short term, making it more challenging to enhance corporate value through engagement. Whether these challenges can be overcome will be a litmus test for the contribution of engagement to enhancing the corporate value of large-cap stocks.

(3) Utilization of NDAs

EFs that tackle business reforms, organizational restructuring, and operational reforms, which are difficult to implement without gaining access to the company's internal operations, have traditionally relied on appointing individuals capable of implementing reforms to the board of directors or, in some cases, having the investment manager of the EF serve as a director to support reforms from within the company. However, this approach has begun to shift in recent years. When fund personnel become board members to drive corporate reforms, this imposes investment constraints on the EF, such as being unable to trade during that period. Additionally, a significant drawback for the fund is that reform efforts demand considerable time and attention. EF investment teams are generally small, typically consisting of around ten to twenty people. Although the number of portfolio companies is not particularly large, many EFs typically engage with around ten companies to achieve diversification. Maximizing the efficiency of engagement is a critical challenge for EFs.

In response, the use of NDAs has gained traction. Under this approach, EFs enter into an agreement with companies to obtain detailed information and develop proposals, while the companies are responsible for developing and implementing the actual detailed procedures. While access to insider information and the inability to trade during the contract period are the same as those of a board member, after submitting its proposals, the EF acts as an external consultant, significantly reducing the time commitment compared to serving on the board of directors. This approach also enables engagement with a larger number of companies. One EF has already been using this method for the past seven years. It appears that multiple EFs are shifting from the approach of "becoming a board member" to "signing NDAs to support reforms."

(4) Utilization of External Resources

Many EFs do not have a large number of investment staff. Therefore, it has become common practice for large EFs to utilize external legal and consulting professionals for engagement activities. To thoroughly assess the future prospects of a company before investment, some EFs commission consulting firms staffed by former CEOs of top companies to conduct global industry trend research. Additionally, it has become standard practice to maintain ongoing contracts with numerous law firms to handle multiple litigation cases and assist in drafting white papers.

Some larger EFs have assets exceeding ¥1 trillion, and certain funds outperform the TOPIX in terms of investment returns by a wide margin, likely generating substantial success fees. Such EFs are expected to leverage their abundant capital to propose initiatives to larger and broader companies, aiming to further enhance investment returns.

(5) Establishment of Special Funds

Another new trend is the emergence of EFs with specific objectives. For example, there are cases where funds are being established to serve as a repository for policy stocks that are being requested to be reduced by CGC for listed companies. Since the sale of policy stocks in the short term can cause a significant decline in stock prices, these funds purchase them at market value. Furthermore, these funds aim to achieve high investment returns by working closely with the management of the acquired companies over the long term to implement management reforms. It appears that these funds are also tackling challenging tasks such as restructuring business portfolios and improving operations. Financial institutions holding large amounts of policy stocks are contributing capital to these funds, which are seen as meeting the needs of both financial institutions seeking to sell policy stocks and the companies being sold. Funds with clear exit strategies are also emerging. These funds invest in undervalued listed stocks, delist the companies, and increase their corporate value to achieve investment returns.

Unlike PE funds, these funds focus exclusively on listed companies that can be acquired at undervalued prices. They typically build partnerships with major shareholders of companies with high stock ownership ratios to become a majority shareholder and advance management reforms through delisting. In Japan, some listed companies have founding families that retain a high stock ownership ratio, and the risk of being acquired by competitors increases if they do not implement management reforms on their own. Some funds have already made actual investments in target companies, and similar cases are likely to increase in the future.

6. Future Prospects for Engagement Funds

EF activities have been gaining momentum since spring 2023, with a focus on enhancing corporate value. However, compared to traditional active managers, the amount of assets under management remains relatively small, with the total estimated to be less than ¥10 trillion.[16] While this figure is unlikely to grow tenfold in the short term, if the quality of proposals continues to improve as seen in recent years and investment returns increase, there is a high likelihood that more funds will be allocated by institutional investors, including global asset owners.

In a recent interview, a US family office investment manager stated that they are seeking global investment themes and currently view “Japanese equity activism” as the most attractive theme, with plans to allocate up to 25 percent of their total assets to this area. This fund has, in fact, been investing in Japanese EFs for the past six years. Interviews conducted in New York, London, and Oslo in March with institutional investors, including asset owners, revealed strong expectations for management reform at Japanese companies. There are numerous investors worldwide who believe that Japanese companies offer ample opportunities to achieve high investment returns

[16] According to IR Japan, the total investment by activist investors as of the end of 2024 is estimated to be ¥9.7 trillion.

through management reform. It is certain that investment amounts will increase if EFs continue to deliver high investment returns.

In contrast, the amount invested in Japanese EFs by domestic institutional investors is extremely small. Even EFs based in Japan have a majority of their assets under management from overseas institutional investors, not just those based overseas. It is deeply regrettable that, despite Japanese companies' earnest efforts to enhance corporate value and the resulting high investment returns from EFs, the beneficiaries of these high returns are primarily overseas institutional investors. Some Japanese corporate pension funds have expressed concern about their parent companies receiving shareholder proposals from EFs. There are also cases where financial institutions, including insurance companies, invest in Japanese EFs based overseas, but the amount is still negligible. If engagement with large-cap stocks proves successful and leads to increased corporate value, EFs should be recognized as a viable investment strategy for equities and no longer considered a specialized investment style. Recently, the number of publicly offered mutual funds managed by EFs has been increasing, albeit slowly. It is desirable that the investor base expands and that Japanese investors also begin to reap the benefits of EF investments.

EFs can play a vital role in instilling a positive source of tension for Japanese corporate executives. This is because, over the past decade, it has been confirmed that many EFs are seriously committed to enhancing corporate value and utilizing external resources, and are sincerely striving to support reform at their portfolio companies. Portfolio companies must maintain their business portfolios and capital structures at optimal levels and make informed management decisions, ensuring they are the best owners for their companies. Otherwise, they may receive various proposals for management reforms from EFs. Japanese companies can also gain insights into corporate value enhancement through dialogue with EFs, and it is strongly encouraged that they engage in such dialogue.[17] The activities of Japanese stock EFs are still in their infancy. As their asset size expands and they issue more proposals, they are expected to make meaningful contributions to the enhancement of Japanese corporate value.

(References)

Barclays Shareholder Advisory Group. *2024 Review of Shareholder Activism*. 2025.

Diligent Market Intelligence. *Shareholder Activism in Asia 2025*. 2025.

Greenwald, Bruce, and Judd Kahn. *Kyōsō Senryaku no Nazo o Toku [Competition Demystified: A Radically Simplified Approach to Business Strategy]*. Translated by Kazumi Tsujitani. Tokyo: Diamond Inc., 2012.

[17] A board member of a major company that appointed an EF investment manager as a board member reportedly stated, "Talking to you is like hiring a high-priced management consultant for free."

IR Japan. *Financial Results for the Fiscal Year Ended March 2025*. May 13, 2025.

Kikuchi, Masatoshi. *Gaikokujin tōshika no shikōhō to mōkekata [How Foreign Investors Think and Make Profits]*. Tokyo: Nippon Jitsugyō Publishing, 2025.

Makino, Nao. "Sōgyōka mochibun ga ōi kigyō no gabanansu [Governance in Companies with High Founding Family Shareholdings]." Lecture, Japan Securities Analysts Association, June 19, 2023.

Nikkei Business. "Akutibisuto no ronri – dēta de yosoku nerawareru 40-sha [The Logic of Activism – Predicting 40 Target Companies Using Data]." *Nikkei BP*, February 10, 2025.

Nikkei. "Shagai torishimariyaku to tōshika to no taiwa, jisshi kigyō 3-nen de 2-bai ni [Dialogue Between Outside Directors and Investors Doubled in Three Years]." *Nihon Keizai Shinbun (Nikkei),* May 22, 2025.

Ōta, Hiroshi. *Kōporēto gabanansu nyūmon [Introduction to Corporate Governance]*. Tokyo: Iwanami Shoten, 2025.

Tamura, Toshio. "Akutibisuto no renzu de jisha o miru [Seeing Your Company Through the Lens of Activists]." *Financial and Capital Markets Research*, no. 17 (March 2025): 43–63.

Yama o Ugokasu Kenkyūkai, ed. *ROE saipinkoku nihon o kaeru [Transforming Japan, the Country with the Lowest ROE]*. Tokyo: Nikkei Publishing, 2014.

Yoshikawa, Hidenori, Kazuki Yamamoto, and Corporate Value Advisory Team. *Akutibisuto tōshika dōkō (2024 sōkatsu to 2025 e no shisa) [Activist Investor Trends (2024 Summary and Implications for 2025)]*. Tokyo: Daiwa Institute of Research, February 10, 2025.