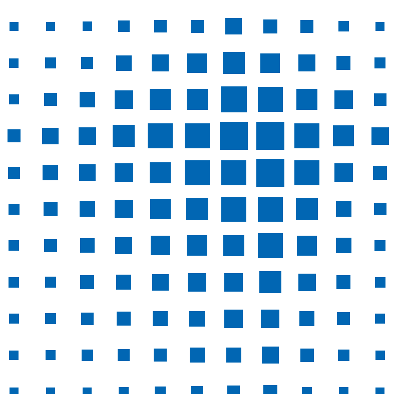


Japan's Asset Management Business 2012/2013

CHAPTER 1 **Japanese investor trends**

CHAPTER 2 **Asset management business's current state and asset management firms' management priorities**

CHAPTER 3 **Market trends and product strategy by client segment**

Nomura Research Institute, Ltd.

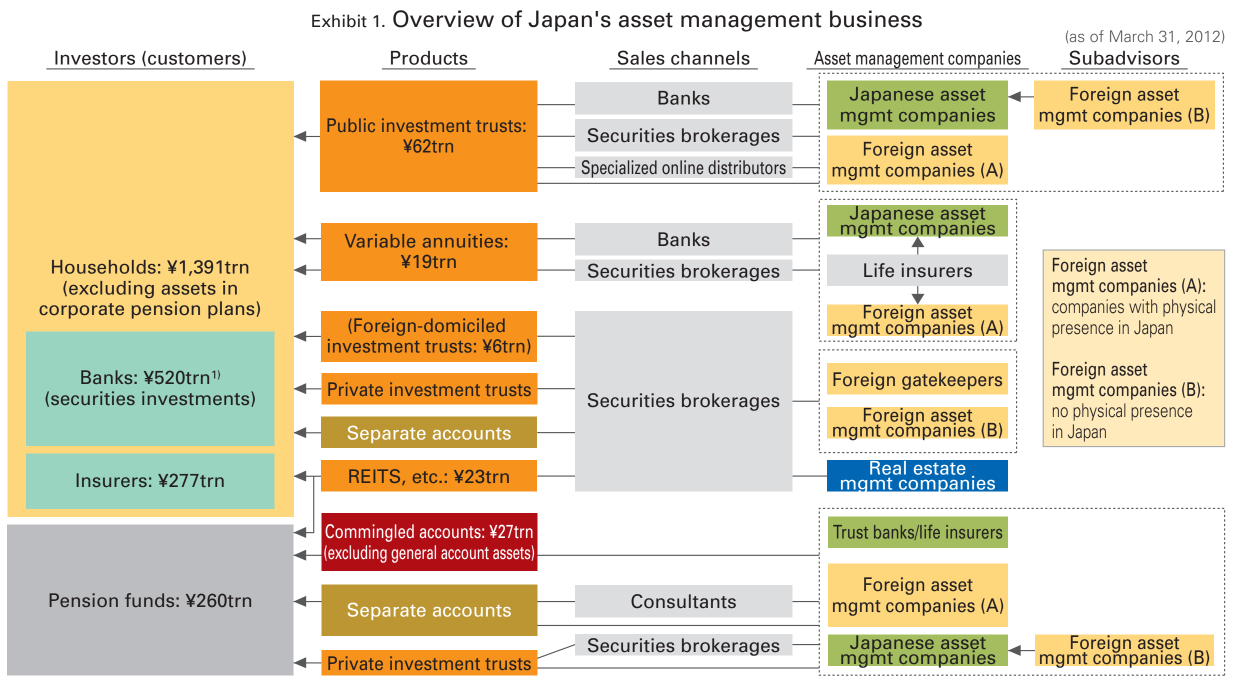
CHAPTER 1

Japanese investor trends

Financial assets roughly flat for past four years

Overall, the Japanese asset management market exhibited little change in FY2011 (year ended March 2012). With both assets under management (AUM) and asset management revenues roughly flat for four years since FY2008, Japan's asset management business shows no sign of picking up. Exhibit 1 presents a simplified overview of the Japanese asset management market as of March 31, 2012, in terms of its participants (investors and asset managers), products, and distribution channels. It shows which types of asset managers manage money for which investor classes, how investor assets are allocated, and how asset flows are intermediated. Asset management companies in Japan mainly serve three types of clients: retail investors (households), corporations including financial institutions, and pension funds. Adjusted to take into account that financial institutions’ securities portfolios are largely funded with retail customers' deposits, Japanese investors' financial asset holdings as of March 31, 2012, totaled an estimated ¥1,651trn, a ¥30trn increase from a year earlier. This increase was the net result of a ¥34trn increase in household financial assets offset by a ¥3trn reduction in pension fund assets. Household financial assets predominantly comprise safe assets, except among high-net-worth households. Household financial assets' total value

Exhibit 1. Overview of Japan's asset management business



Note 1: Excludes Norinchukin Bank and Zenkyoren.
Source: NRI, based on data from various sources

has consequently remained largely unchanged over the past five years despite the recent financial crisis.

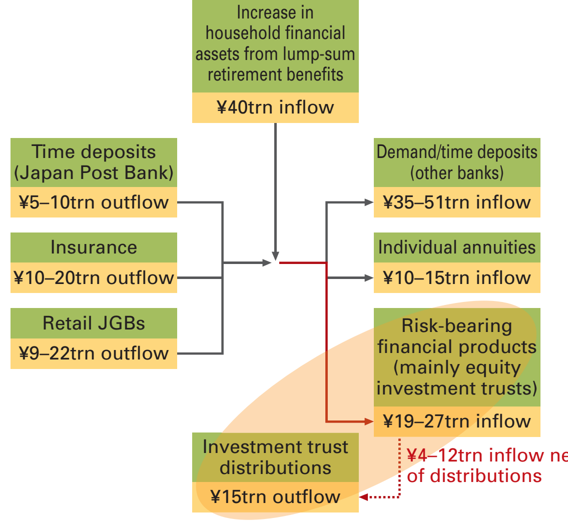
Of the total stock of financial assets, ¥337trn[1] or roughly 20% is managed by asset management companies. This percentage has likewise remained relatively constant over the past five years. Although investment trusts have promising growth prospects as investment vehicles for household financial assets, their growth has virtually stagnated, partly in response to capital markets' poor performance in recent years.

Household sector: ISAs' advent bodes favorably for investment trust inflows

As of March 31, 2012, household financial assets totaled some ¥1,391trn, a ¥34trn increase from a year earlier. Household financial assets' composition remained nearly unchanged from a year earlier, with bank deposits and insurance products accounting for over 70% of the total.

We present data-based estimates of household financial asset flows over the next five years in Exhibit 2. The numbers are largely unchanged from last year. Over the next five years, we estimate that households will see inflows of lump-sum retirement benefits, a key funding source for household financial assets, of roughly ¥40trn net of home mortgage repayments upon retirement. Income from lump-sum retirement benefit is in a declining trend now that the postwar baby-boom generation's retirement wave has ended.

Exhibit 2. Projected household-sector asset in/outflows by investment product (5-year horizon)



Source: NRI

Additionally, we estimate that households will reallocate ¥24–52trn in assets from Japan Post Bank time deposits, retail JGBs, and insurance products, mainly Japan Post Insurance policies, into other asset classes over the next five years, though the magnitude of such flows could vary substantially in response to interest rate movements. We thus project that, including lump-sum retirement benefit income, Japanese households will invest or reinvest a total of ¥64–92trn in financial assets over the next five years. How these funds will be allocated to specific asset classes is difficult to predict, but extrapolating current trends dating back several years, we estimate that ¥35–51trn, more than half of the total, will flow into ordinary bank deposits, ¥10-15trn will flow into individual annuities, and ¥19–27trn will flow into risk assets, chiefly equity investment trusts. We estimated inflows into risk assets at 30% of the total funds available for investment, based on average inflows into risk assets from the household sector over the past five years.

However, investment trust inflows have fallen sharply since the latter half of FY2011 while distributions from investment trusts to their unitholders have recently grown to an estimated ¥3trn per year. Net of such distributions, cumulative investment trust inflows from the household sector over the next five years may fall short of ¥10trn. On the other hand, the Japanese version of ISAs (tax-exempt individual savings accounts) will be launched in 2014. The government has set a target of ¥25trn in aggregate ISA balances by 2027. If half of this ¥25trn were invested in investment trusts, investment trust inflows could exceed ¥10trn over the next five years. Depending on how ISAs are designed, they could enable investment

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trusts to better fulfill their originally intended function of long-term asset building. Reallocation of assets from safe assets to ISAs is likely to substantially boost investment trusts' AUM. How the Japanese ISA scheme is ultimately structured will bear close watching going forward (see Chapter 3 below).

Financial institution market segment has promising longer-term potential

Pension funds, Japan's largest institutional investors, held an estimated ¥260trn in assets at March 31, 2012. Of this total, public pension schemes accounted for roughly ¥167trn, a ¥3trn decrease from a year earlier. Corporate and other pension assets increased slightly to ¥93trn at March 31, 2012. The decrease in public pension assets reflects that the Employees' Pension Insurance Scheme, the predominant public pension program, has been drawing down its reserves since FY2009. It experienced cumulative net asset outflows of ¥16trn in FY2009–11 and is projected see a ¥9trn net outflow in FY2012. Its assets are projected to continue to decrease for the next several years. Corporate pension plans likewise have little prospect of much asset growth. Overall pension fund assets are likely to continue to progressively decrease.

Financial institutions' investment securities holdings totaled some ¥797trn at March 31, 2012. Banks (ex Japan Post Bank) accounted for ¥279trn of this total, *shinkin* banks and credit unions for ¥66trn, Japan Post Bank for ¥176trn, life insurers (ex Japan Post Insurance) for ¥183trn, Japan Post Insurance for ¥75trn, and nonlife insurers for ¥19trn.

In comparison to pension funds, financial institutions still account for a small share of asset management companies' revenues despite their massive investment securities holdings. Nonetheless, financial institutions constitute a promising market segment for asset management companies from a medium- to long-term perspective. In addition to having huge investment securities holdings that are projected to continue to grow, Japanese financial institutions generally require outside expertise to manage holdings of foreign bonds, a product on which asset managers earn relatively high fee rates. Even as financial institutions reduce their equity holdings, they still have a strong need for distinctive products that offer high expected returns uncorrelated with bond returns. To expand revenues from financial institutions, it is crucial for asset management companies to understand financial institutions' distinguishing attributes. Asset management companies seem largely unaware that, in terms of securities investment, banks differ in two key respects from pension funds, which generally require proposals that take into account the totality of their securities portfolios. First, banks tend to invest from a short-term standpoint because their securities investments affect their reported earnings. Second, they have a strong tendency select products individually within each asset class in which they invest. Increasing client satisfaction by swiftly and straightforwardly taking action tailored to financial institutions' client attributes is a promising approach for asset management companies to capture asset inflows over the long term.

1) With respect to trusts and life insurers, this total includes only assets managed on behalf of pension/annuity customers. In the case of life insurers in particular, the total includes only special account balances, not assets in general accounts with guaranteed returns (e.g., fixed-amount insurance, fixed annuities).

CHAPTER 2 Asset management business's current state and asset management firms' management priorities

1 Asset management business currently lacks dynamism

We estimate the Japanese asset management market's size at ¥693.3bn in terms of FY2011 management revenues and ¥350trn in terms of AUM (including foreign clients' assets) as of March 31, 2012.

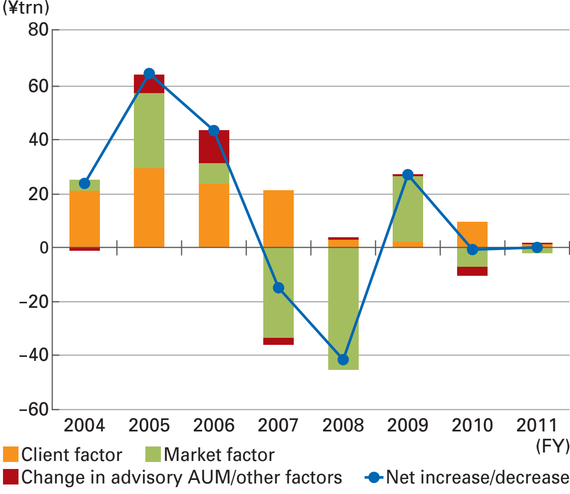
Below we look at the state of asset management companies' (investment trust and investment advisory firms excluding trust banks and life insurers) business and the challenges they face.

Asset management business remains in stasis

Exhibit 3 plots annual changes in asset management companies' AUM in recent years, disaggregated by causative factor. Asset management companies ended FY2011 with aggregate AUM nearly unchanged from a year earlier. The market factor (asset price changes) detracted from AUM in FY2011 while the client factor (net inflows of assets from clients) contributed positively to AUM growth. The two factors ended up roughly offsetting each other, but their respective impacts on AUM were both less than ¥2trn.

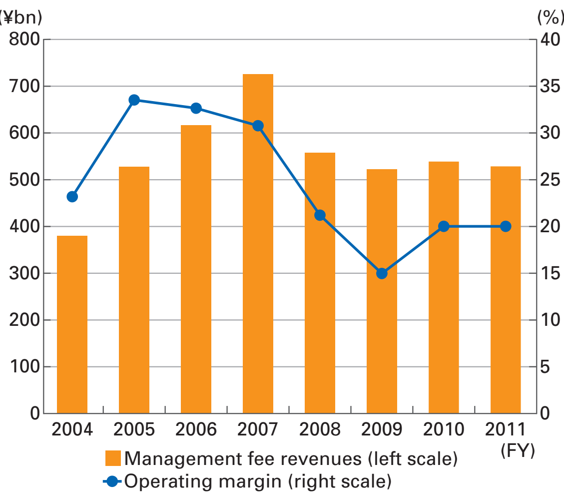
The client factor's positive contribution was almost entirely attributable to public investment trusts for a second consecutive fiscal year. However, when public investment trusts' net asset inflows (sales of new units net of redemptions) are adjusted by deducting distributions to unitholders, the resultant change in asset management companies' AUM was negative. Meanwhile, the market factor had only a

Exhibit 3. Changes in AUM broken down by causative factor



Note: Adjusted to reflect M&A and assets switched between contractual modalities.
Source: NRI, based largely on data from the Investment Trusts Association of Japan and Japan Securities Investment Advisers Association

Exhibit 4. Asset management companies' aggregate management fee revenues and operating margin



Source: NRI, based on asset management companies' business reports and data from the Investment Trusts Association of Japan and Japan Securities Investment Advisers Association

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Exhibit 5. Dispersion of asset management companies' operating margins

Note: The above graph is based on a sample of 62 asset management companies for which operating margin data were available. Operating margin was calculated as the ratio of operating income to operating revenues adjusted to exclude agency commission revenues. Green bars indicate the range of operating margins of companies ranked in the second and third quartiles. Red lines indicate median values.
Source: NRI based on data from asset management companies' regulatory filings and business reports

modestly negative impact by virtue of a temporary equity market recovery into fiscal year-end. Asset management companies' operating environment can thus be characterized as actually somewhat more adverse in FY2011 than in FY2010.

Asset management companies' FY2011 management revenues totaled an estimated ¥530bn, roughly unchanged from FY2010. Their FY2011 profitability was likewise largely unchanged from FY2010. The asset management industry's aggregate operating margin was an estimated 20% while individual companies' median operating margin was an estimated 8% (Exhibits 4, 5).

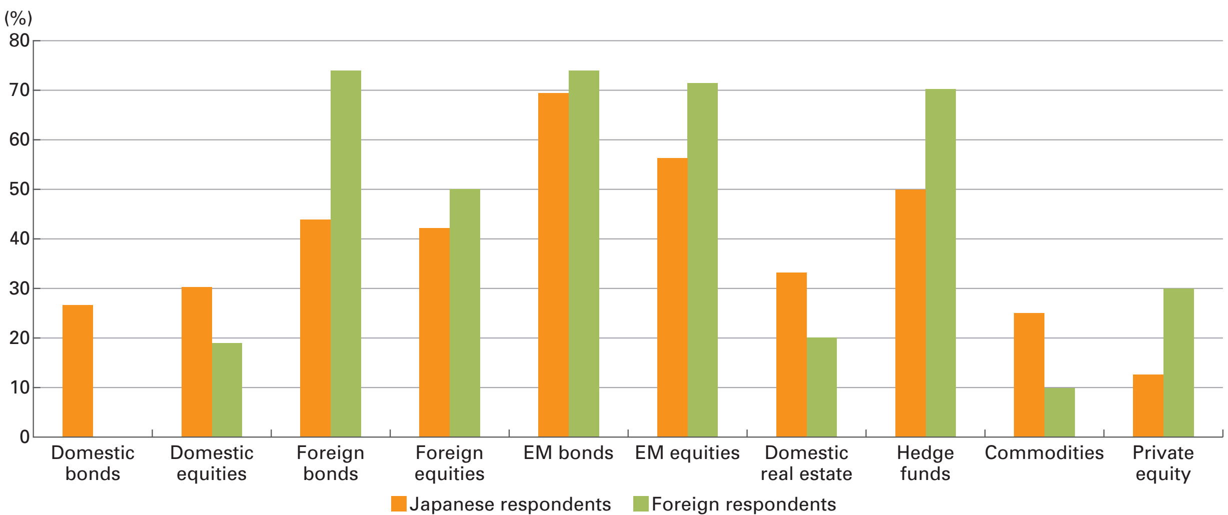
The asset management industry has indisputably stagnated in recent years from the standpoint of both size and profitability. What will it take for the industry to break out of this stasis?

Revenue forecasts have become more cautious

We conduct an annual survey of asset management companies (NRI Survey of Asset Management Companies' Management Priorities) to ascertain their consensus outlook for the asset management business[2]. Following is an update on their outlook based on our latest survey data.

First, in terms of asset management companies' outlook for AUM growth, Exhibit 6 plots the percentages of survey respondents that expect to experience annual AUM growth attributable to net asset inflows of 10% or more over the next 3–5 years, broken down by asset class. Many companies expect hedge fund products and foreign assets, most notably emerging market funds, to see net

Exhibit 6. Percentage of respondent companies projecting AUM growth of 10% or more by asset class (broken down between Japanese and foreign respondents)



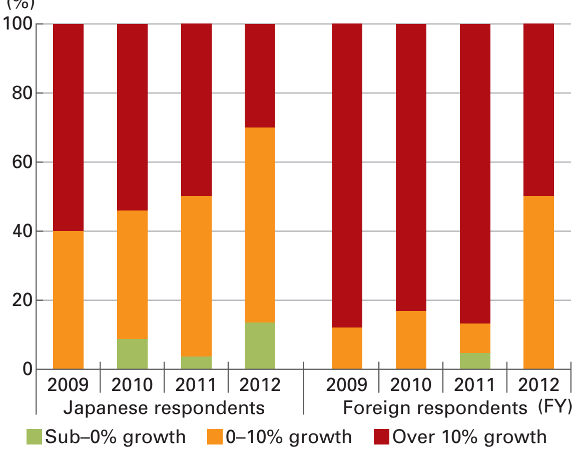
Note: Percentages of respondents that project AUM growth of 10% or more due to asset inflows over the next 3–5 years.
Source: NRI *Survey of Asset Management Companies' Management Priorities*

asset inflows equivalent to at least 10% of AUM. The percentages of respondent companies projecting such net inflows to foreign bond funds and hedge fund products increased sharply in comparison to the previous year's survey. For commodity products, by contrast, the percentage of such respondents decreased substantially.

Next, Exhibit 7 plots the breakdown of annual revenue growth rates expected by survey respondents over the next 3–5 years, together with the corresponding data from previous years' surveys. For comparison, the data are presented separately for domestic and foreign-owned asset management companies.

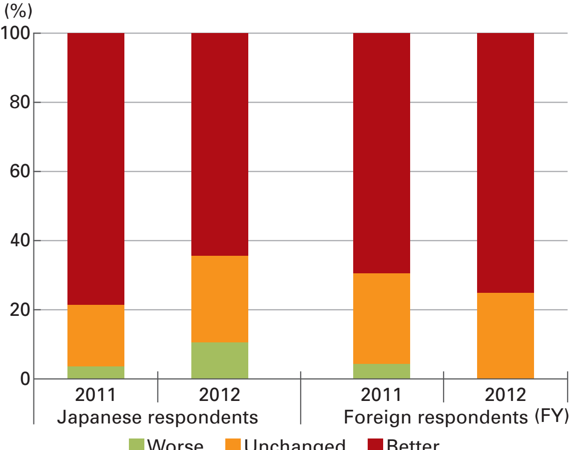
Revenue growth forecasts have become more cautious for both domestic and foreign asset management companies. Most notably, the percentage of foreign asset management companies that project revenue growth of 10% or more fell to 50% in 2012 from nearly 90% in 2011. In previous years' surveys, the vast majority of foreign asset management companies consistently reported bullish revenue growth expectations, but such bullishness subsided dramatically in 2012. Among Japanese asset management companies, the corresponding percentage of survey respondents decreased from around 50% to 30% over the same timeframe. Like

Exhibit 7. Breakdown of respondent companies' revenue growth forecasts (broken down between Japanese and foreign respondents)



Source: NRI *Survey of Asset Management Companies' Management Priorities*

Exhibit 8. Respondent companies' operating margin forecasts



Note: Percentages of respondents that respectively expect their operating margins to be better, worse, and unchanged in 3–5 years.
Source: NRI *Survey of Asset Management Companies' Management Priorities*

the net asset inflow projections presented in Exhibit 6, revenue growth expectations are partly influenced by changes in AUM due to the market factor. The diminished bullishness evident in the 2012 survey results likely reflects that the investment environment remains uncertain and investor risk tolerances are decreasing in response to such uncertainty.

Our survey inquired about operating margin expectations also (Exhibit 8). The percentage of Japanese asset management companies that expect their operating margins to improve over the next 3–5 years decreased to around 60%. This decrease is understandable given the link between operating margin and revenues, expectations for which were downbeat as discussed above. Foreign asset management companies' operating margin expectations exhibited a different pattern. Asset management businesses' profit margins are basically linked to revenues and AUM, assuming that companies have the same business model. Among foreign asset management companies, however, profit margin expectations remain largely unchanged despite a more cautious revenue outlook.

2 Cost structures differ in terms of resilience to external change

Foreign asset management companies do indeed

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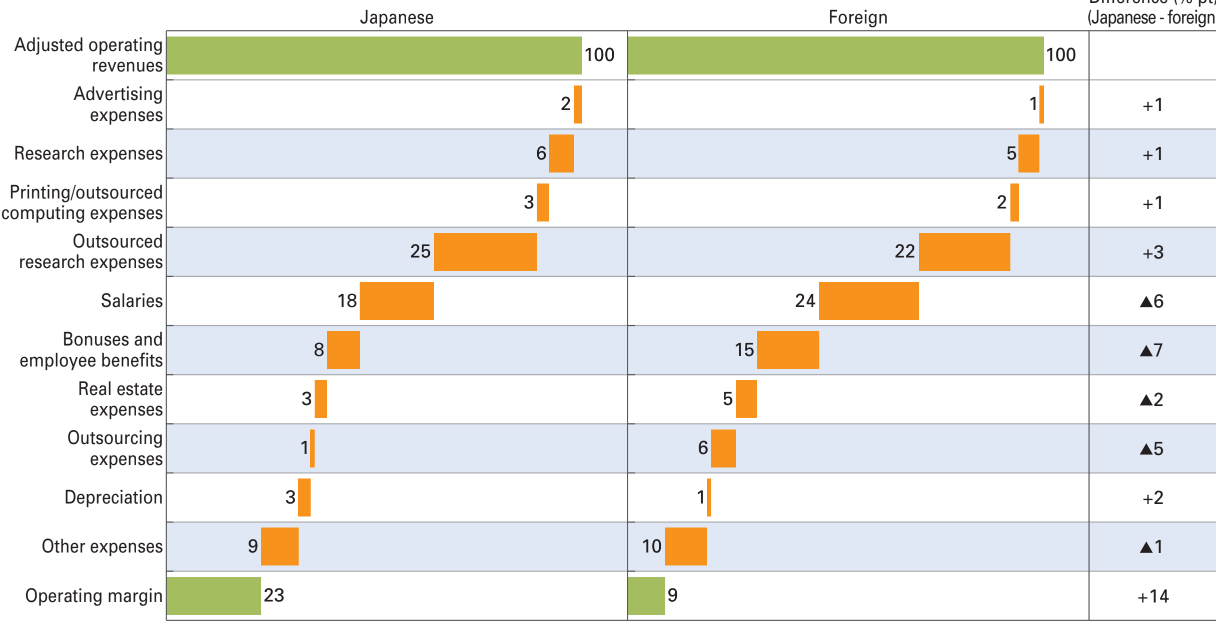
Exhibit 9. Differences in cost structure between Japanese and foreign asset management companies



Source: NRI, based on asset management companies' regulatory filings and business reports

have more control over their profit margins than their Japanese counterparts do. Exhibit 9 compares Japanese and foreign asset management companies' cost structures (major expenses' breakdown as a percentage of adjusted operating revenues) based on asset management company financial data that we have collected. Final operating margin is 27% for Japanese companies and 9% for foreign companies, both of which were unchanged from the previous fiscal year[3].

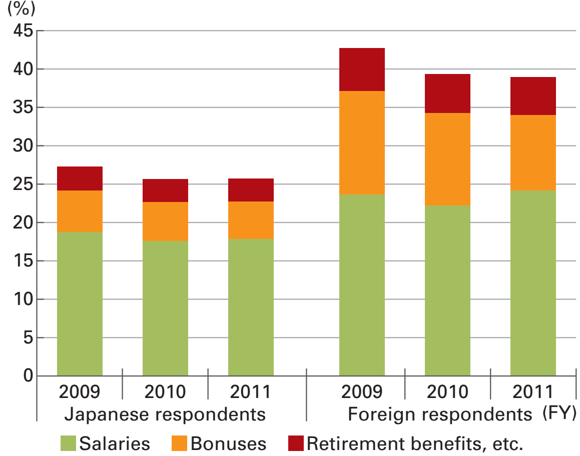
Personnel cost initiatives

The expenses that account for the largest shares of operating revenues for both Japanese and foreign asset management firms are outsourced research expenses and personnel expenses (salaries and bonuses).

Outsourced research expense flows mainly to subadvisors to which asset management functions have been outsourced. In foreign asset management companies' case, it includes costs allocated to the Japanese subsidiary in conjunction with the launch of new products in the Japanese market that utilize the parent company or other affiliate's front-office resources.

Among personnel expenses, salaries (i.e., base salaries) are equivalent to 18% of operating revenues for Japanese asset management firms and 24% for foreign asset management firms. For bonuses, which are tightly linked to individual and company performance, the corresponding percentages are 8% and 15%, respectively. What is notable about these expenses from the standpoint of maintaining profit margins is not their level but how they are split between salaries and bonuses. At Japanese asset management firms, bonuses which is linked to company performance amount to a small share of operating revenues. Japanese asset management companies' total personnel expenses consequently have a high degree of downward rigidity. At foreign asset management companies, by contrast, bonuses account for a much larger share of operating revenues, enabling management to adjust personnel expenses relatively flexibly. In recent years, foreign asset management companies have in fact cut bonuses in both absolute terms and as a percentage of revenues (Exhibit 10). Their ability to exercise such flexibility is one factor conducive to maintaining profit margins in an adverse operating environment.

Exhibit 10. Personnel expenses as a percentage of operating revenues

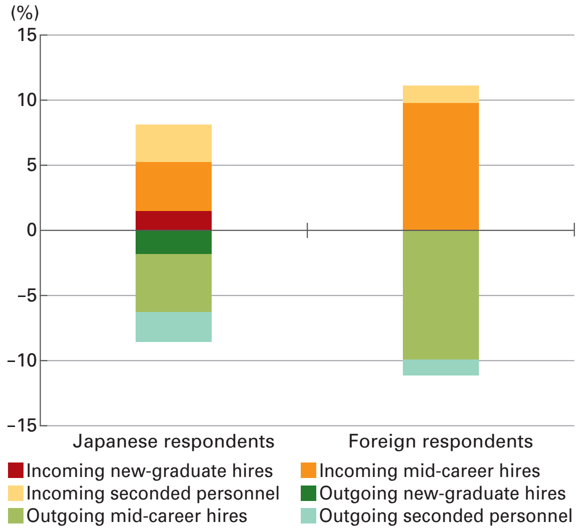


Source: NRI, based on asset management companies' regulatory filings and business reports

Another notable difference between Japanese and foreign asset management companies is workforce fluidity. Exhibit 11 plots 2012 survey data on asset management companies' hiring and separations during the preceding 12 months, broken down between Japanese and foreign firms.

It shows that although both Japanese and foreign asset management companies' aggregate headcounts were essentially unchanged during the year, the foreign firms replaced about 10% of their collective workforce with mid-career hires. Japanese

Exhibit 11. New hires and separations by employee attribute (as a percentage of headcount at fiscal year-end)



Source: NRI *Survey of Asset Management Companies' Management Priorities*

firms also experienced considerable workforce turnover, but their turnover was partly attributable to personnel transferred or seconded from or to a parent or other affiliated company. Excluding such intragroup reshuffling, the Japanese firms' workforce turnover rate was about half that of foreign firms. This is another respect in which foreign asset management companies have considerable latitude to control costs.

Outsourcing and asset-lite business models

Two expenses that account for substantially different, albeit relatively small, shares of Japanese and foreign asset management companies' respective revenues are depreciation of fixed assets and real estate expenses, which chiefly comprise office rent expense (Exhibit 9). Specifically, in comparison to Japanese asset management firms, foreign asset management firms' real estate expenses account for a larger share of revenues while depreciation accounts for a smaller share. Such a cost structure suggests that foreign asset management firms adopt a financially nimble management approach by avoiding use of fixed assets that give rise to long-term depreciation charges.

Another expense that differs substantially in magnitude between Japanese and foreign asset management companies is outsourcing. Outsourcing expenses mainly involve outsourcing of certain back-office business processes to external service providers. Outsourcing expenses' share of foreign asset management firms' revenues is five percentage points higher than their share of Japanese asset management firms' revenues. Foreign asset management firms clearly tend to utilize outsourcing, whereas their Japanese counterparts prefer to keep business processes in-house.

The advantage of outsourcing is that it converts highly downwardly rigid personnel expenses and fixed

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investments that entail large initial outlays and long-term depreciation charges into variable expenses that vary as a function of AUM or workload. In addition to the difference in personnel cost structures discussed above, outsourcing is another factor that helps foreign asset management companies maintain profit margins.

Cost-structure transformation as a path to growth

Such differences in cost structure between Japanese and foreign asset management companies stem largely from differences in business customs and the organizational capabilities and infrastructure that the companies have built and upgraded over many years. If Japanese asset management companies change their HR policies, including compensation schemes, and adopt measures such as outsourcing to convert fixed expenses to variable expenses, they would have to radically change their management approach. Such change would entail various adjustments, most notably changes in corporate culture.

Japanese asset management companies have two options in terms of their operational direction. One option is to expand and strengthen front-office capabilities and transform into organizations that integrate all operational functions from asset management to product origination and customer service. The other option is to utilize subadvisors more extensively for asset management functions and focus more on customer service and domestically oriented operations other than asset management. In either case, Japanese asset management companies must improve their efficiency through such means as outsourcing and exiting market segments in which they are uncompetitive and unable to utilize as a differentiation source. Meanwhile, they must relocate their existing human resources to high-priority business domains.

Effective cost control is nothing more than a means of realizing such a growth strategy. Not until asset management firms stabilize their operational foundations by means of cost control can they concentrate their resources in their core businesses. If the Japanese asset management industry can enhance its competitiveness through such efforts, it should be able to re-embark on a growth path.

3 Value of having physical presence in Japan is in question for foreign asset management firms

Foreign asset management firms with Japanese subsidiaries or branches are facing a quandary in terms of how to conduct operations in Japan.

A recent development emblematic of this quandary is that the Government Pension Investment Fund (GPIF), when it started to invest in emerging market equities, awarded four of its six emerging market equity mandates to Japanese firms and only two to foreign firms, even though emerging market equities is regarded as a forte of foreign asset management firms. However, all four of the chosen Japanese firms are providing emerging market equity products to the GPIF through a horizontal division of labor, whereby they essentially outsource portfolio management to foreign asset management companies that do not have a substantive physical presence in Japan. The functions performed by the Japanese firms are mainly product design and client reporting.

The GPIF example illustrates that even asset management companies without a local subsidiary or branch office in Japan can enter the Japanese market in a subadvisory role, provided that they have top-caliber asset management capabilities. Management of foreign-asset products provided to Japanese pension funds is increasingly being re-outsourced to overseas asset management companies without a physical presence in Japan. This trend suggests that utilization of subadvisors, a widespread practice among investment trusts offered by Japanese asset management firms, is becoming increasingly common in the investment advisory market segment

also. This reflects that Japanese asset management firms possess client reporting capabilities and the ability to domestically design products by seeking out outstanding external asset managers.

This means that foreign asset management companies with a Japanese subsidiary or branch office should reassess the purpose of their presence in Japan. The key criterion by which Japanese fund sponsors or asset management companies evaluate external managers is their portfolio management skills. Whether they have a physical presence in Japan is irrelevant. From foreign asset management companies' standpoint, just having a marketing presence in Japan instead of a subsidiary or branch office may be a more efficient approach to entering the Japanese market as a subadvisor. The key issue facing foreign asset management companies that already have a physical presence in Japan is not cost control as discussed above but how to achieve success in their Japanese operations.

The answer may be to develop domestic asset management capabilities in Japan. Historically, many foreign asset management companies have managed domestic assets (mainly Japanese equities) as a component of global portfolios while their Japanese sales forces have focused mainly on locally marketing foreign asset management products offered by their overseas parent company or affiliates. However, as Japanese assets' appeal diminishes, foreign asset management companies are shifting their focus more toward marketing foreign products to Japanese investors. Although Japanese assets are seen as lacking in investment appeal, there is still a need for certain products such as concentrated funds and absolute return funds. Foreign asset management firms may need to further upgrade their asset management capabilities and refocus on their core mission as asset managers.

2) NRI has conducted this survey annually since FY2007. In 2012, NRI conducted the survey in August–September and received valid responses from 58 companies (31 Japanese, 27 foreign). The respondent companies have total AUM of ¥140trn (¥34trn of public investment trust AUM, ¥30trn of private investment trust AUM, ¥73trn of discretionarily managed AUM, and ¥14trn of investment advisory AUM).

3) Because foreign asset management companies exercise a certain amount of discretion in setting transfer prices, comparison of their operating margin levels is largely meaningless. As often noted, most foreign asset management companies do not use reported operating income as a management metric. We compared only designated expense line items and did not discuss operating margin levels. Additionally, the percentages in Exhibit 9 were calculated by totaling the companies' expenses for each line item. Consequently, they disproportionately reflect major asset management companies' cost structures.

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CHAPTER 3

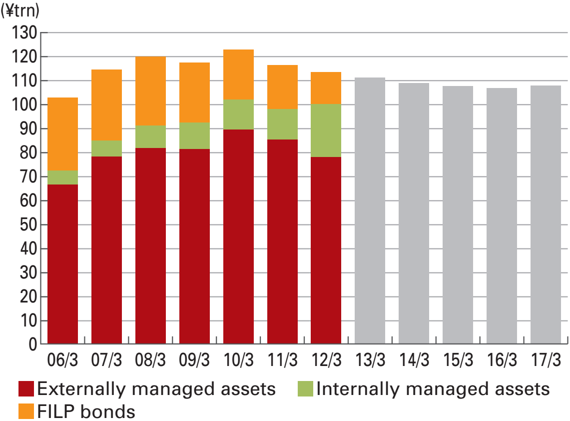
Market trends and product strategy by client segment

1 Pension business

AUM continues to shrink, albeit modestly

Japanese pension assets totaled an estimated ¥260trn at March 31, 2012. Of this total, public pension schemes (National Pension, Employees' Pension Insurance, and Mutual Aid Associations) accounted for some 65% or ¥167trn, a ¥3trn decrease from a year earlier. Corporate and other pension plans accounted for the remaining ¥93trn, an increase of ¥1trn from a year earlier.

Exhibit 12. GPIF's AUM (actual and forecasted)



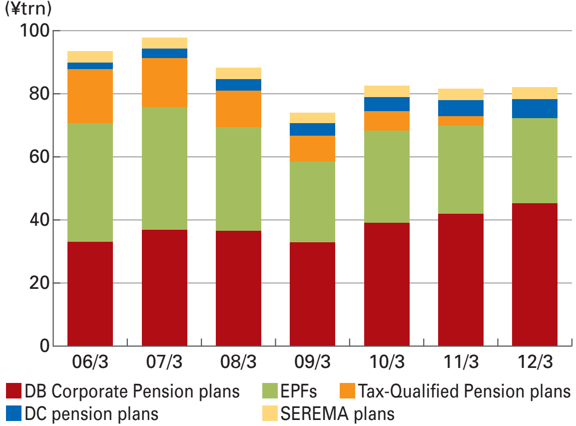
Note: Data for FY2012 and beyond are NRI forecasts based on the Ministry of Health, Labor and Welfare's FY2010 actuarial valuation.
Source: NRI, based on GPIF's *Review of Operations in FY2011* and Ministry of Health, Labor and Welfare's FY2010 Actuarial Valuation Report

Of total public pension plan assets, the Employees' Pension Insurance and National Pension programs account for over 70% or ¥119trn, nearly all of which is managed by the GPIF. At March 31, 2012, the GPIF had AUM of ¥114trn, a ¥3trn decrease from a year earlier. Although the GPIF experienced ¥6trn in asset redemptions (drawdown of reserves) in FY2011, its AUM decreased by only half that amount because it earned a +2.3% return on its assets (Exhibit 12). However, its AUM outsourced to external managers decreased by a sizable ¥7.2trn. This decrease resulted from the GPIF increasing its internally managed AUM by ¥9trn, which it parked in funds available to meet drawdowns of pension reserves.

With pension benefit expenditures expected to continue to exceed receipts from pension insurance premiums for the foreseeable future, the ongoing drawdown of pension reserves is set to continue. Exhibit 12 plots a five-year forecast of the GPIF's AUM based the Ministry of Health, Labor and Welfare's FY2010 actuarial valuation of public pension schemes. The forecast projects that pension reserves will continue to gradually decrease in FY2012 and beyond. For FY2012, the planned drawdown of pension reserves is nearly ¥9trn, but if investment returns are subpar, the GPIF's AUM could be reduced to the vicinity of ¥100trn at FY2012-end.

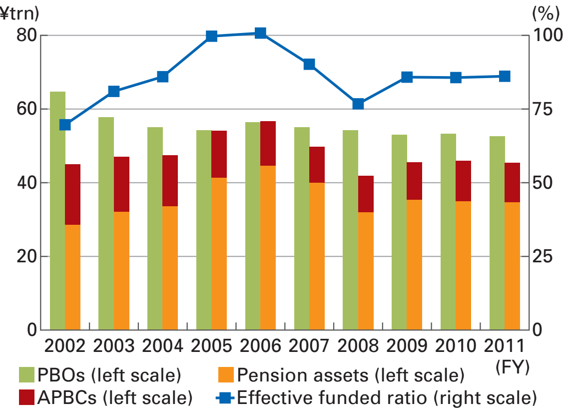
Corporate pension assets totaled ¥83trn at March 31, 2012 (Exhibit 13). Corporate pension plan assets increased in FY2011 despite Tax-Qualified Pension plans' complete phase-out effective March 31, 2012. Among defined benefit (DB) plans, DB Corporate Pension plans grew in number to 15,000, a 50% increase from a year earlier, as a result of conversion of Tax-Qualified Pension plans into DB Corporate Pension plans. DB Corporate Pension plan assets also grew, up ¥3trn year on year to ¥45trn, equivalent to over 60% of total corporate pension assets at March 31, 2012. Employees' Pension Fund (EPF) assets

Exhibit 13. Corporate pension assets



Note: SERAMA: Smaller Enterprise Retirement Allowance Mutual Aid
Source: Trust Companies Association of Japan, Life Insurance Association of Japan, Federation of Pension Plan Administrators, and Organization for Workers' Retirement Allowance Mutual Aid

Exhibit 14. Corporate pension plans' overall funded status



Note 1: The above data pertain to Tokyo Stock Exchange 1st Section-listed companies with Japanese GAAP-compliant financial reporting.
Note 2: PBOs are net of prepaid pension expenses. Effective funded ratio = (pension assets + APBCs)/PBOs
Source: NRI, based on Nikkei Digital Media data

decreased ¥1trn to ¥27trn over the same timeframe amid an increase in companies opting to offload the so-called substitutional portion of their EPF assets and liabilities to the government (*daiko-henjo*).

Defined contribution (DC) corporate pension plan assets totaled ¥6trn at March 31, 2012, a ¥1trn increase from a year earlier. The increase was a large one in comparison to recent years. It is unclear how much if any of this increase was attributable to Tax-Qualified Pension plans' phase-out, but a growing number of companies with DB Corporate Pension plans are apparently considering adopting DC plans, partly in response to a pending revision of Japanese accounting standards for pension benefits (effective from FY2013) in addition to deterioration in the investment environment. Whether growth in DC plan assets accelerates bears monitoring going forward.

Sponsor companies' growing concern about pension risk posed by a change in accounting standards

Companies that sponsor corporate pension plans face a challenging environment.

Exhibit 14 plots the funded ratio for Tokyo Stock Exchange 1st Section-listed companies' pension plans under Japanese accounting standards for postretirement benefits. The funded ratio's three determinants—pension assets, accrued postretirement benefit costs (APBCs), and pension benefit obligations (PBOs)—have remained nearly unchanged since the end of FY2009, when pension assets rebounded from the post-Lehman market downturn.

However, the pending revision to Japanese accounting standards for postretirement benefits is a concern for sponsor companies. Under current accounting standards, losses resulting from shortfalls in the actual return on pension assets relative to the expected return are typically amortized over a number of years and their unamortized portion is not recognized on balance sheet. Under the pending accounting standard, however, the unamortized balance of these losses will be recognized on balance sheet at fiscal year-end. Pension plans' funded status will thus be reflected more directly in the sponsor's financial statements.

Pension concerns also plague SMEs that participate in multi-employer EPFs. EPFs are under pressure from political accusations of institutional fatigue and reform proposals in the wake of the AIJ scandal. Many multi-employer EPFs are increasingly counting on investment returns on pension assets as they mature and their member-companies' risk tolerances decrease.

Going forward, pension plan administrators will likely place more priority on survivability and income generation.

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As benefit obligations loom increasingly larger in their collective consciousness, pension plan administrators are likely to become more interested in solutions conducive to LDI (liability driven investment), downside risk containment, and absolute returns. Meanwhile, investment products that generate stable income returns to fund growing benefit obligations are also likely to garner increased interest. How to meet these two needs will be a key issue in pension asset management.

2 Securities investment by banks

Banks' investment securities holdings continue to grow

Japanese banks ended FY2011 with aggregate investment securities holdings of ¥279trn, a ¥21trn increase from a year earlier. Investment securities accounted for 32% of total bank assets at fiscal year-end, their largest share of the past 10 years (Exhibit 15). JGBs account for 60% (¥167trn) of banks' investment securities holdings, followed by "other securities" with an 18% (¥51trn) share, corporate bonds with an 11% (¥30trn) share, and equities with a 7% (¥18trn) share. Relative to FY2010, banks substantially increased their holdings of JGBs and "other securities." Banks' equity holdings decreased again in FY2011 amid the ongoing divestment of strategic equity holdings by banks that hold such securities.

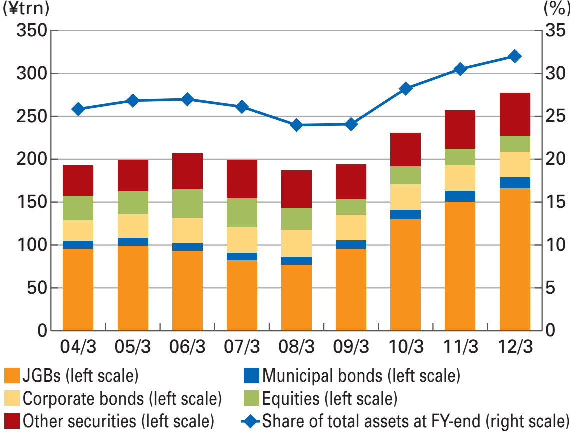
Among the various types of banks, major banks increase their securities holdings by the largest margin in FY2011 as in FY2010. Specifically, major banks increased their investment securities holdings by 11%, first-tier regional banks by 9%, and second-tier regional banks by 8%. Trust banks' investment securities holdings were unchanged year on year at FY2011-end. This continued growth in banks' securities holdings was driven by growth in deposits coupled with sluggish growth in lending. Banks' outstanding domestic loans increased 2.5% (¥11trn) year on year to ¥458trn at March 31, 2012. Their deposits grew 2.1% (¥13trn) to ¥617trn over the same timeframe. Deposits thus increased by a larger margin than outstanding loans.

"Other securities" holdings increased for second consecutive year

Banks' "other securities" holdings grew for a second consecutive fiscal year to end FY2011 at ¥51trn, a ¥6trn increase from a year earlier. Within the "other securities" category, foreign securities holdings increased ¥4.5trn year on year to ¥39trn. The remainder of "other securities" holdings (e.g., funds, hedge funds, structured bonds) grew ¥1.5trn in FY2011 after decreasing slightly in FY2010 (Exhibit 16).

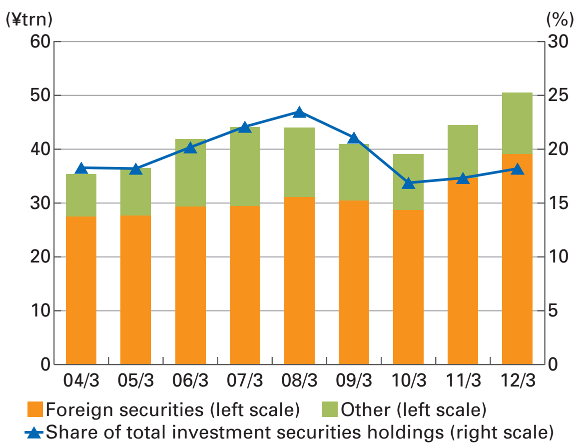
Among different types of banks, city banks increased their "other securities" holdings by the largest percentage margin for a second consecutive fiscal year.

Exhibit 15. Japanese banks' investment securities holdings



Source: NRI, based on Japanese Bankers Association's *Financial Statements of All Banks*

Exhibit 16. Composition of banks' "other securities" holdings

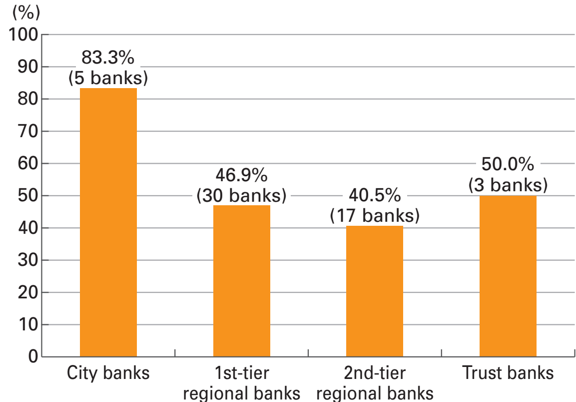


Source: NRI, based on Japanese Bankers Association's *Financial Statements of All Banks* and Bank of Japan's *Domestic Bank Assets and Liabilities*

Their holdings grew 24% to ¥32trn at March 31, 2012. In contrast, first- and second-tier regional banks and trust banks' "other securities" holdings were roughly unchanged year on year at March 31, 2012. Of the six city banks, five increased their "other securities" holdings in FY2011, whereas only two did so in FY2010. The trend toward active investment in "other securities" has broadened across the city bank subsector (Exhibit 17). City banks' growing enthusiasm for investing in "other securities" reflects several factors. First, with JGBs accounting for nearly 70% of their investment securities holdings, they cannot afford to become more dependent on JGBs from the standpoint of interest-rate risk management. Second, issuance of electric utility bonds temporarily came to a halt in the aftermath of the March 2011 earthquake in northeastern Japan. City banks consequently needed to find substitute investment vehicles. Third, they need substitute investment vehicles to also replace the strategic equity holdings that they are in the process of divesting. Fourth, their profits are under growing pressure from sluggish demand for loans and shrinking net interest margins. While "other securities" investment preferences differ among individual banks, city banks favor bonds, including US Treasuries, US government agency bonds, and securitized products (e.g., RMBS, CMBS, CLO, ABS).

First- and second-tier regional banks' investment stance toward "other securities" differs substantially among individual banks. In FY2011, 30 of 63 first-tier regional banks and 17 of 42 second-tier regional banks increased their "other securities" holdings. Of these 30 first-tier regional banks, 24 predominantly increased their holdings of foreign securities, including sovereign bonds, government agency bonds, international institution bonds, and corporate bonds issued by Japanese companies' overseas affiliates and foreign companies. Another five[4] of the 30 banks predominantly increased their investment trust holdings (including ETFs, REITs, and partnership equity interests). Such holdings also include fund investments intended as a hedge against bond holdings' interest rate risk. Of the 17 second-tier regional banks that increased their "other securities" holdings, 13 predominantly increased their foreign securities holdings, mainly foreign bonds (including yen-denominated foreign bonds). Three[5] of the 17 predominantly increased their holdings of investment trusts, including REITs and ETFs.

Exhibit 17. Percentage of banks that increased "other securities" holdings in FY2011



Source: NRI, based on Japanese Bankers Association's *Financial Statements of All Banks*

Securities investment trends in FY2012

While banks' securities investments remained heavily concentrated in JGBs in FY2011, banks stepped up their pursuit of investment returns for a second consecutive fiscal year in response to a further decline in their net lending margins. Regional financial institutions' outstanding domestic loans have recently resumed growing but given the domestic economic outlook, banks are likely to continue to rely on securities investment as a key earnings source for a while.

Amid concerns about the heavy interest-rate risk posed by banks' growing JGB holdings, banks have started to assume more credit risk, currency risk, and overseas interest-rate risk from the standpoint of risk diversification. This trend gained further momentum in the first half of FY2012. Since the financial crisis, banks have been under pressure from financial regulatory authorities to implement risk management programs tailored to their investment holdings. In selecting assets, banks continue to place priority on safety, liquidity, and transparency.

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For example, while major banks have been increasing their holdings of foreign bonds (e.g., sovereign and government agency bonds, corporate bonds, securitized products) in response to suspension of electric utility bond issuance and their ongoing downsizing of strategic equity holdings, the foreign products in which they are choosing to invest are highly rated and highly liquid. Additionally, internationally active Japanese banks, most of which are major banks, are scheduled to begin complying with Basel III in stages from the current fiscal year. They are consequently replacing their holdings of investment products (e.g., funds) not compatible with the new regulatory standards.

In contrast to major banks, regional financial institutions are typically constrained from investing in diverse asset classes by insufficient human resources or portfolio management expertise. Their main source of investment income is domestic corporate bonds[6]. However, some two-thirds of regional financial institutions that increased their domestic corporate bond holdings in FY2011 increased their "other securities" holdings also. Depending on liquidity conditions in the domestic corporate bond market, the other one-third of regional financial institutions may likewise increase their holdings of "other securities" such as foreign bonds and funds[7].

Additionally, regional financial institutions that have adopted internal models to evaluate their deposits and were previously extending their bond portfolios' duration have now shifted into a cautious posture (e.g., shortening duration, hedging) amid warnings about overexposure to JGB interest-rate risk. Given their growing JGB holdings, regional financial institutions have a strong need for investment products that will offset losses when domestic interest rates rise. Fund products[8] are one such option.

With internationally diversified investing becoming a major trend, funds have gained favor as a means of investing in diverse assets. When investing in overseas assets, both major banks and regional financial institutions count heavily on external fund managers' research, analytical, and risk-management capabilities in the investment selection process.

As noted above, banks are progressively reducing their equity holdings, which already account for a small slice of their portfolios. From the standpoint of portfolio diversification, however, they will likely continue to invest in equity products such as individual stocks and equity investment trusts. ETFs, for example, are favored for their high degree of transparency and liquidity. They are utilized as a means to capture investment returns through tactical trading. Some major banks and regional financial institutions are investing even in foreign ETFs.

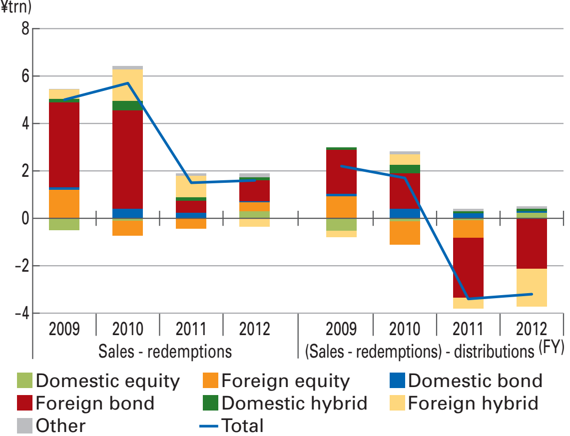
3 Retail business

Public investment trusts are now seeing net outflows when distributions are factored in

Domestically chartered public investment trusts' AUM totaled ¥59trn at September 30, 2012, down ¥8trn over the 18 months from their post-Lehman peak of April 2011. Of this ¥8trn decrease, only a little over ¥3trn is attributable to asset price declines. The remainder was attributable to a major reduction in client-driven net asset inflows (purchases less redemptions of investment trust units) and an increase in distributions, which are asset outflows under the discretionary control of investment trust management companies.

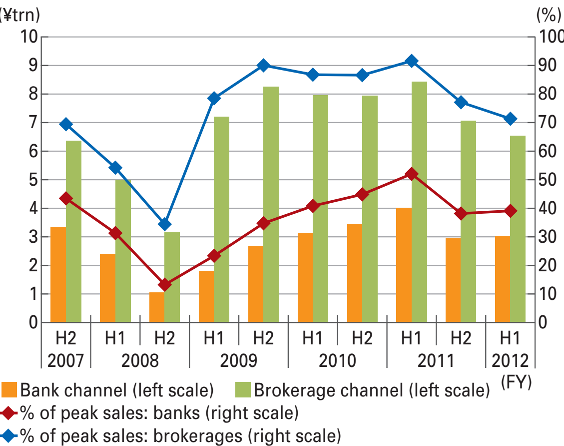
Exhibit 18 plots asset inflows and outflows for open-end equity investment trusts, which account for 80% of public investment trust AUM. The left half of the graph, which plots client-driven inflows and outflows, shows a sharp decrease in inflows in FY2011. Foreign bond funds, which have hitherto accounted for the bulk of asset inflows, and foreign hybrid funds, including foreign REITs, experienced particularly steep declines in inflows. These two types of funds have gained popularity by virtue of their high distribution yields, but when adjusted to factor in such distributions, their net inflows have turned negative (right half of Exhibit 18).

Exhibit 18. Open-end equity investment trust in/outflows (ex ETFs)



Note: FY2012 data are annualized fiscal-first-half data.
Source: NRI, based on Fundmark data

Exhibit 19. Open-end equity investment trust sales (ex ETFs)



Note: FY2012 H1 data are semi-annualized sales for the five months through August.
Source: NRI, based on Fundmark data

Since the second half of FY2011, reductions in previously high distributions have become prevalent, mainly among foreign bond funds and REITs. Many funds that have reduced their distributions have experienced redemptions far in excess of the reduction in their asset outflows due to decreased distributions. Many foreign bond funds and REITs have been paying distributions in excess of their investment returns for several years. They will likely reduce their distributions at some point. If they do, public investment trusts could experience sustained outflows and, unless asset prices rise substantially, reductions in AUM also.

Investment trust sales declining in both brokerage and bank sales channels

After falling sharply in the aftermath Lehman Brothers' collapse, investment trust sales rebounded in the brokerage channel first (Exhibit 19). Brokerages' investment trust sales recovered to over 70% of their previous peak in the first half of FY2009 and 90% of their peak in the second half of FY2009. In the bank sales channel, by contrast, investment trust sales recovered more slowly, reaching 50% of their previous peak in the first half of FY2011.

Since the second half of FY2011, however, investment trust sales have resumed declining in both channels, falling back to 70% and 40% of their previous peaks in the brokerage and bank channels, respectively. The catalyst behind this downturn was a precipitous decline in sales of the funds that had spearheaded the post-Lehman recovery in investment trust sales, including currency-choice funds, Australian dollar bond funds, and foreign REITs. The sales decline was triggered by widespread cuts in such funds' distributions.

Diminishing investment appetite for investment trusts

Japan's population between the ages of 60 and 80, the age group said to be the investment trust industry's main clientele, has grown 40% over the 15 years from 1997 to 2012. Growth in the over-60 population was a key driver of investment trust AUM's rapid growth in the 2000s. However, Japan's population decline reaches into this age group also. The population between the ages of 60 and 80 is projected to peak around 2015 (the investment trust industry's so-called 2015 problem). This age group's population growth rate has already slowed to the vicinity of 0%. Going forward, the investment trust industry must increase investment trust ownership rates (penetration rates) across all age groups to achieve growth in AUM.

However, individuals who want to own investment trusts are decreasing in number. According to the NRI Questionnaire Survey of 10,000 Consumers, the percentage of respondents who want to increase

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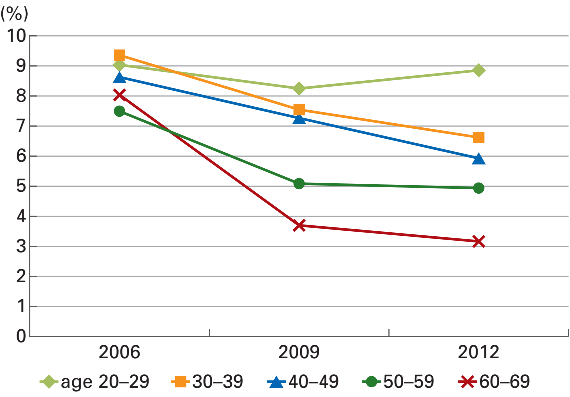
Exhibit 20. Percentage of survey respondents who plan to increase investment trust holdings or want to invest in investment trusts for first time



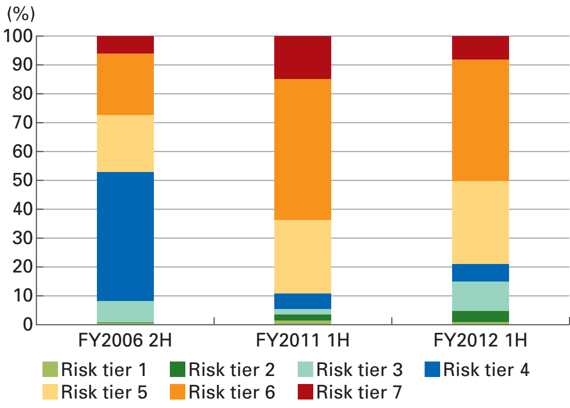
Note: Includes holdings of foreign currency deposits.
Source: NRI Questionnaire Survey of 10,000 Consumers (2006, 2009, and 2012)

their investment trust holdings or start investing in investment trusts has declined in recent years (Exhibit 20). In the 60–69 age group, this percentage has decreased 4.8 percentage points between 2006 and 2012. It has likewise declined among younger respondents, albeit to a lesser extent, falling roughly 2–3 percentage points in the 30–39, 40–49, and 50–59 age groups. In light of such, increasing investment trust ownership rates will not be easy.

Focus on marketing high-risk investment trusts impedes expansion of investment trust ownership

One notable trend in investment trust sales in recent years is that the best-selling funds have been mostly high-risk funds. To illustrate this point, Exhibit 21 plots investment trust sales broken down by risk tiers.

Exhibit 21. Breakdown of open-end equity investment trust sales by risk tier (ex ETFs)

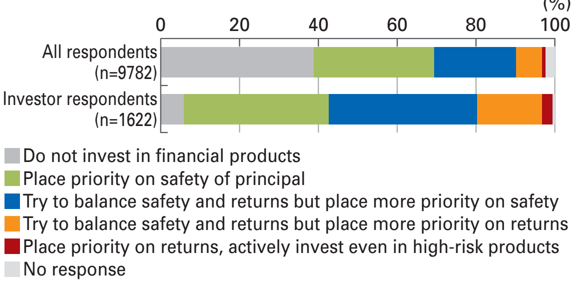


Source: NRI, based on Fundmark data

We ranked investment trusts into seven tiers based on individual funds' daily volatility (measured over a six-month timeframe) in accord with an investment trust risk classification scheme used in Europe. In the second half of FY2006, when investment trust sales hit their peak, funds in risk tiers 1 through 4, the latter of which includes many global bond funds, accounted for about half of total investment trust sales. Risk tier 6 and 7 (equity funds, etc.) accounted for only 20% of total investment trust sales. In the first half of FY2011, funds in risk tiers 1–4 accounted for a mere 10% of investment trust sales while those in tiers 6–7 accounted for 60%.

High-risk funds generally charge high sales commissions. From fund distributors' standpoint, they are an efficient source of commission revenues. For investors, such funds' high expected returns are appealing but due to their high risk, demand for such funds is limited to investors with a sufficiently high risk tolerance. In fact, the 2012 NRI Questionnaire Survey of 10,000 Consumers found that very few investors place priority on returns over safety when investing (Exhibit 22). Additionally, even investors with a risk tolerance high enough to purchase high-risk funds presumably do not invest much money in such funds. Accordingly, sales of high-risk funds may contribute to growth in fund distributors earnings on a short-term or limited basis, but from a broader, longer-term standpoint, the amount of earnings that can be derived from such funds is limited because the pool of investors willing to invest in such funds and the amount of money they are willing to invest are limited. It is important to pursue short-term revenue

Exhibit 22. Survey respondents' investment posture toward financial products



Source: NRI Questionnaire Survey of 10,000 Consumers (2012)

growth and medium-term growth potential in a balanced manner. There is a large pool of prospective investors who would be willing to purchase low-risk investment trusts. Developing and offering products targeted at such investors should lead to market growth.

Japanese ISAs should spur growth in investor class

Japanese ISAs, tax-exempt investment accounts modeled after the UK's ISAs, will make their advent in 2014. Investments that may be held in the new ISAs include listed equities and equity investment trusts. Concurrent with ISAs' advent, an existing tax break on investments in listed equities and equity investment trusts will lapse (with the applicable tax rate rising from 10% to 20%). The time period for purchasing assets in an ISA is currently limited to three years (2014–16). Additionally, the maximum amount that may be invested in an ISA is a relatively modest ¥3mn per investor. In light of such, many fund distributors are hesitant to enthusiastically embrace ISAs.

Against such a backdrop, the Japanese government added two new objectives for ISAs in its national revitalization strategy adopted by the Cabinet in late July 2012. The objectives are (1) broadly providing households with opportunities to build assets through long-term, diversified investment and (2) facilitating and promoting asset building based on self-reliant efforts. Additionally, the Financial Services Agency's list of proposed FY2013 tax reforms includes indefinitely extending the period during which assets may be purchased in ISAs, raising the limit on total nontaxable investments, and adding bonds and bond investment trusts as ISA-eligible products. The government's Tax Commission will deliberate on FSA's proposal from this autumn. Whether the FSA's proposal is adopted remains to be seen, but if the Tax Commission places importance on the new ISA objectives recently added by the Cabinet, it should make ISAs a permanent institution as a matter of course. In such an event, the Tax Commission would presumably expand the list of ISA-eligible financial products also.

Japanese ISAs' benefits are easily understandable even by persons with no investment experience. ISAs should also give investment trust distributors an incentive to focus on expanding their customer bases. ISAs are consequently likely to contribute substantially to enlarging the pool of investment trust investors. Asset management companies will likely be called upon to offer products that meet the investment needs of a new class of investors. In return, ISAs will offer asset management companies a good opportunity to substantially increase their earnings.

4 Product market trends by client segment

Exhibit 23 presents product opportunity maps for three investor segments (retail, pension funds, and financial institutions) based on data from our Survey of Asset Management Companies' Management Priorities. These maps plot the strength of investor demand for various products (as assessed by asset management companies) against the products' current availability (assessed based on the number of companies that offer each product). They are useful for identifying promising products (strongly demanded products offered by few companies (upper left quadrant)) and products facing intense competition (poorly demanded products offered by many companies (lower right quadrant)).

In the retail investor segment, domestic REITs and frontier equities are asset classes deemed to be in strong demand relative to the number of companies that offer products in those asset classes. The former are presumably favored for their high distribution yields; the latter, for offering even more growth potential than emerging market equities.

Distinctive products that are in strong demand include self-liquidating funds and conditionally guaranteed return funds. Both essentially offer investors the ability to transform cash flows in accord with their liquidity

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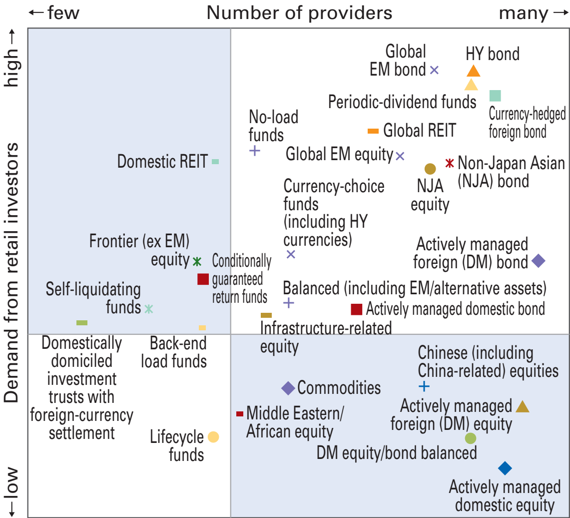
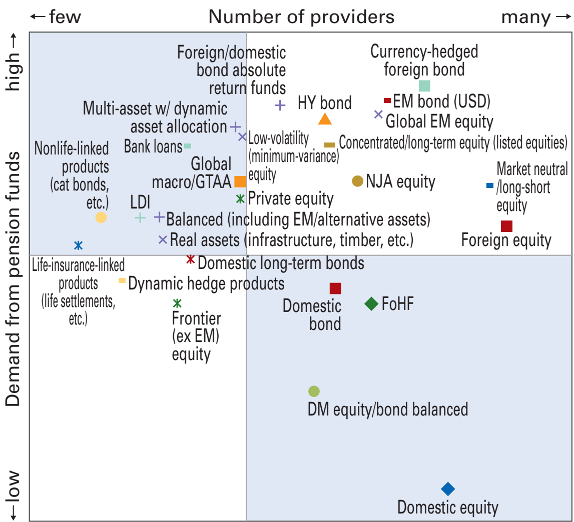
Exhibit 23. Product supply and demand maps by client segment

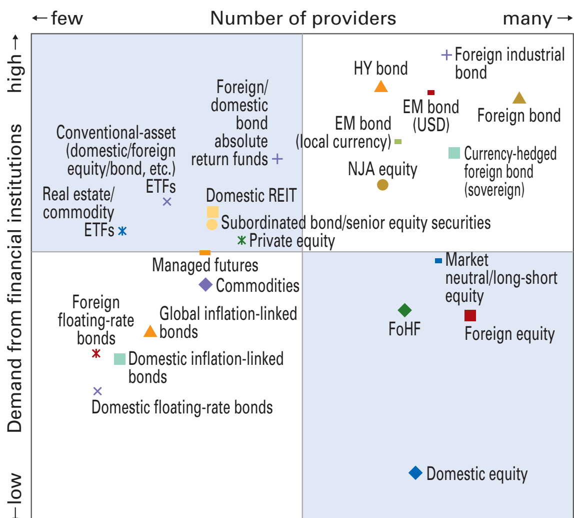
(a) Products for retail investors



(b) Products for pension funds



(c) Products for financial institutions



Note: The vertical scale is an indexed scale of the strength of demand from clients (based on asset management companies' assessment of demand). The horizontal scale represents the number of asset management companies that offer the product (scaled by number of providers not by value).
Source: NRI, based on *Survey of Asset Management Companies' Management Priorities*

needs. Such products meet the needs of retirees and individuals near retirement, who collectively constitute the bulk of retail investors at present. Such products' position on the map stands in stark contrast to that of lifecycle funds, which are mainly targeted at young investors seeking to build assets. Demand for lifecycle funds is perceived to be weak by survey respondents.

In the pension fund segment, products linked to life and nonlife insurance policies, bank loans, and real assets are regarded as promising asset classes. These assets presumably help to diversify pension assets' risk sources. They are intended to meet the needs of investors that aim to capture a broad variety of risk premia (e.g., insurance, credit, liquidity risk premia) while rebalancing portfolios overexposed to equity risk.

The pension fund map's upper left quadrant also includes multi-asset investment products, LDI products, and long-term domestic bonds. Some domestic pension funds are recognizing the limitations of static asset allocations. Such pension funds favor investment strategies that aim to control downside risks and capture absolute returns by dynamically adjusting their asset allocations. LDI products and long-term bonds are apparently expected to enjoy strong demand amid growing concerns about the pending revision of accounting standards for postretirement benefits and EPFs' substitutional benefit risks.

In the financial institution segment, promising products include ETFs, domestic REITs, subordinated bonds and senior equity securities, and private equity. While these products are already being actively utilized in banks' securities portfolios, they are not offered by many asset management companies. ETFs in particular are favored as a convenient instrument for managing risk and returns. They have become popular among financial institutions in recent years.

4) One of the banks was unaccounted for.
5) One of the banks was unaccounted for.
6) Industrial bonds, public sector bonds, bank debentures, etc.
7) Foreign bond funds, bank loan funds, etc.
8) Bond bear investment trusts, foreign bond funds, bank loan funds, etc.

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