Japan's
Asset Management Business
2015/2016

Nomura Research Institute, Ltd.

FOREWORD

Japan's asset management industry may be in new growth phase

Japan's asset management industry may have embarked on a new growth phase. Its assets under management (AUM) and asset management revenues, the former of which is approaching the ¥500trn milestone, both surpassed their FY2007 peaks in FY2014 and are likely to keep growing.

To continue expanding, however, the asset management industry must successfully navigate some big challenges. In the investment trust market segment, securities brokers and certain trust banks have switched to an AUM-based revenue model. If commercial and regional banks follow suit, they would need to embrace unconventional modes of intermediation, make major changes to their product offerings and undertake product structuring reforms. In the institutional market segment, banks' growing demand for fund products is imposing an increasingly onerous workload on asset management companies, largely due to fund look-through requirements. In response, asset management companies must improve their customer service processes. In the pension market segment, public pension funds are exhibiting a growing preference for distinctive investment products. Asset management companies unable to provide such products are unlikely to win mandates from public pension funds. Meanwhile, adoption of a stewardship code for Japanese equity investors has prompted asset management companies to undertake their own governance reforms and increased their responsibilities vis-à-vis their investee companies. With the governance code expected to bring about changes in corporate management policies also, it could have a major impact on Japanese equity investment strategies.

This report provides an update on Japan's evolving asset management industry through a variety of data, research and analysis while also highlighting challenges facing asset management companies seeking to expand their businesses. While the asset management industry has substantial growth potential, asset management companies may not be able to tap into this potential unless they can provide investment products and services tailored to clients' needs. We hope this report helps asset management companies with strategic planning.

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CHAPTER 1

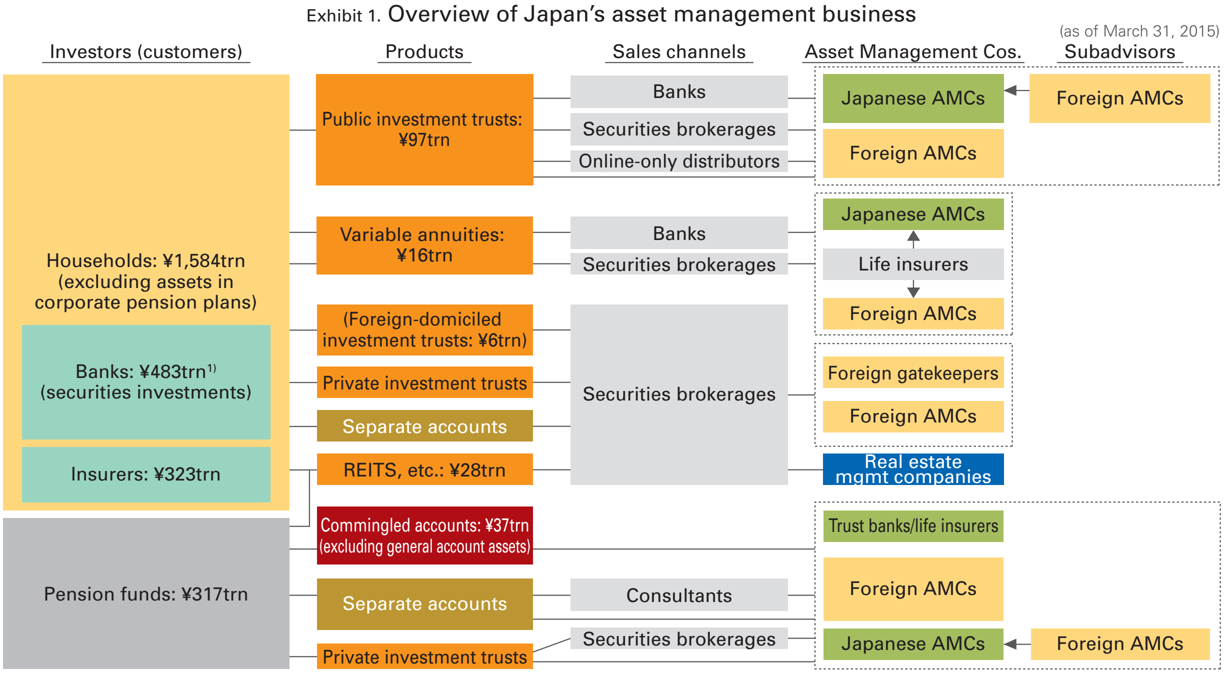
Japanese investor trends

Continued growth in financial assets

In 2015, Japan's asset management industry grew robustly for a second consecutive year. Assets in Nippon Individual Savings Accounts (NISAs), tax-exempt investment accounts available since January 2014, grew briskly, though not quite as rapidly as we initially projected. NISA investment trust holdings exceeded ¥3.5trn at June 30, 2015. In anticipation of a transition from deflation to an inflationary economic environment, public pension funds steadily increased their equity allocations in 2015 after the Government Pension Investment Fund (GPIF) raised its policy asset mix's equity allocation from 24% to 50% in October 2014. The GPIF plans to further diversify its asset holdings and proceed with governance reforms, including migration to performance-based compensation of external asset managers. GPIF reforms are expected to have a major impact on Japan's asset management industry.

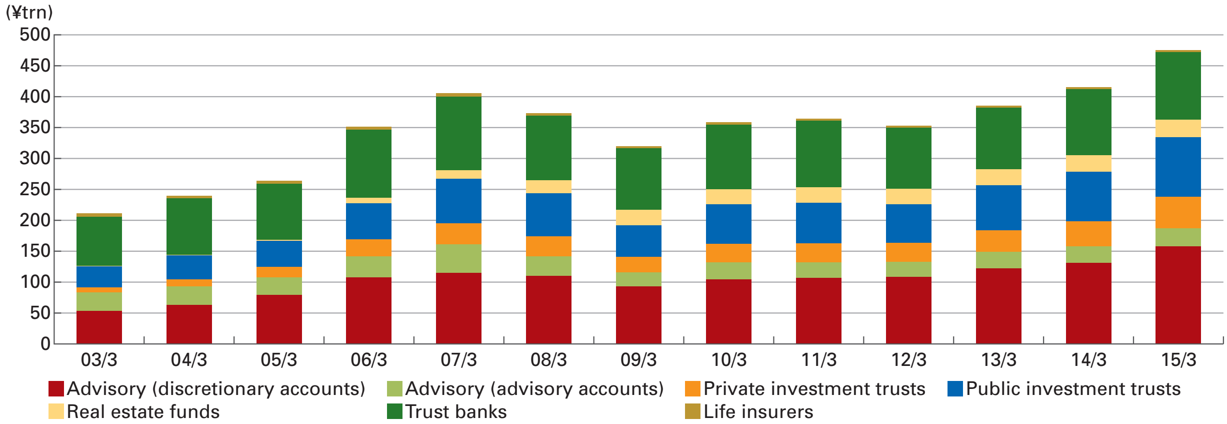
First, we present an overview of the Japanese asset management business as of FY2014-end. Exhibit 1 provides a simplified big-picture view of the Japanese asset management market at March 31, 2015, in terms of investors, products, asset managers and distribution channels. It shows which types of asset managers manage money for which investor classes, how investor assets are allocated, and how asset flows are intermediated. Asset management

Exhibit 1. Overview of Japan's asset management business



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

Exhibit 2. AMCs' AUM



Note: Life insurer AUM are DB pension asset mandates and do not include general-account assets with guaranteed returns.
Source: NRI, based on Investment Trusts Association of Japan and Japan Securities Investment Advisers Association data and financial statements in AMCs' business reports submitted to the FSA and Ministry of Finance's Kanto Local Finance Bureau

companies (AMCs) 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, 2015, totaled an estimated ¥1,901trn, a hefty ¥103trn increase from a year earlier. Of this ¥103trn, household financial assets accounted for ¥79trn while pension assets accounted for the remaining ¥24trn.

Of the ¥1,901trn total, ¥475trn[1] is managed by professional asset managers. Professionally managed assets are finally approaching ¥500trn after languishing in the vicinity of ¥350trn over the previous decade (Exhibit 2). The professionally managed share of total financial assets has risen from 20% to 25% over the same timeframe. Professionally managed assets still have substantial growth potential.

Developments among households, pension funds and financial institutions

Household financial assets at March 31, 2015, totaled roughly ¥1,584trn, a ¥79trn increase from a year earlier. Their composition remained largely unchanged during FY2014, with bank deposits and insurance products accounting for over 70% of the total.

In terms of the outlook for household financial asset flows over the next five years, lump-sum retirement benefits, a key funding source for household financial asset holdings, will decrease now that the postwar baby-boom generation's retirement wave has crested. Nonetheless, we estimate that some ¥17trn of lump-sum retirement benefits will annually flow into financial assets over the next five years. In addition, we estimate households will redeem ¥6trn of retail JGB holdings annually over the same timeframe, giving them a total of ¥23trn of available funds per year. We estimate that ¥18trn of this ¥23trn will be deposited into bank accounts and the remaining ¥5trn will be invested in risk assets, mainly equity investment trusts. However, investment trust inflows will be partially offset by investment trust outflows in the form of dividend distributions, which we expect to decrease to about ¥2trn per year. Net of these distributions, estimated annual investment trust inflows would be ¥3trn. In addition to this ¥3trn, we estimate based on NRI survey data that inflows to NISAs will average around ¥4trn annually over the next five years. NISA contributions can be invested in either stocks or equity investment trusts. Assuming a 50:50 split between these two investment alternatives, we estimate that at least ¥2trn will annually flow into investment trusts via NISAs over the next five years.

Pension funds, Japan's largest institutional investors, saw their assets increase substantially for a second straight year in FY2014. At FY2014-end, pension assets totaled an estimated ¥317trn. Public pension funds' share of this total was roughly ¥201trn, a ¥17trn year-on-year increase; corporate and other private pension funds' share was ¥117trn, a ¥7trn year-on-year increase. In the corporate pension fund space, the government is promoting dissolution of Employees' Pension Funds (EPFs) or their conversion into another type of corporate pension plan. Most of the roughly ¥20trn substitutional portion of EPF assets will be transferred back to the government, to be managed by the GPIF.

Financial institutions' investment securities holdings totaled about ¥806trn at March 31, 2015. Of this total, banks (ex Japan Post Bank) accounted for ¥257trn, *shinkin* banks and credit unions for ¥70trn, Japan Post Bank for ¥156trn, life insurers for ¥299trn (Japan Post Insurance's share of which was ¥66trn), and nonlife insurers for ¥24trn.

Despite their massive investment securities holdings, financial institutions account for a smaller share of AMCs' revenues than pension funds do, reflecting that banks' securities portfolios, which predominantly comprise bonds (particularly JGBs), are managed mostly in-house. Recently, however, banks' penchant for in-house portfolio management has started to abate in response to two factors. First, Abenomics has increased the probability of interest rates rising and, in turn, the risk of holding a JGB-centric portfolio. Second, the BOJ's purchases of JGBs maturing in 5-10 years are running at approximate parity with JGB issuance, making it difficult for others to purchase JGBs in this maturity sector.

Banks' investment behavior today is largely characterized by two trends. The first is containment of JGB interest-rate risk. The second is broad diversification into non-JGB assets, especially foreign assets in many cases, in pursuit of opportunities for higher returns. The banking industry as a whole, including regional banks, is increasingly investing in foreign securities through funds, usually private ones. Banks' holdings of "other securities," which include foreign securities and funds, grew substantially again in FY2014. Faced with a chronically adverse operating environment domestically, Japanese banks are heavily counting on securities investment as an earnings driver. Banks are likely to continue to step up investment in "other securities" for a while.

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 general-account assets with guaranteed returns (e.g., fixed-amount insurance, fixed annuities).

CHAPTER 2 Current state of asset management business

1 Current state of asset management business

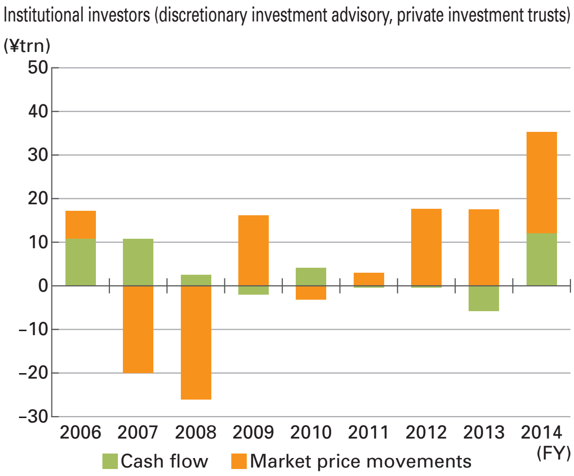
In this chapter, we look at the state of AMCs' business based on various data, including survey data (AMCs are defined herein as firms specializing in investment trust management and/or investment advisory services).

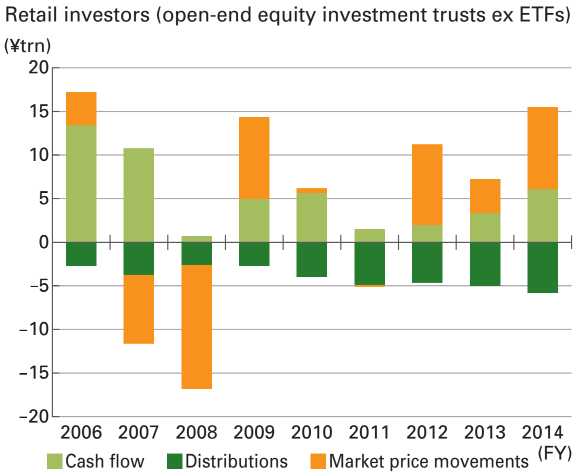
All-time record revenues

Exhibit 3 plots annual changes in AMCs' AUM disaggregated by causative factor. First, in the institutional market segment (left graph: sum total of discretionary investment advisory AUM and private investment trust AUM), AMCs' AUM increased in FY2014 by about ¥23trn due to asset price appreciation driven largely by continued yen depreciation and equity market gains, both dating back to the latter half of FY2012.

Asset inflows also contributed to institutional AUM growth, with net inflows totaling roughly ¥12trn, more than in recent previous fiscal years. Of this ¥12trn, private investment trusts accounted for ¥6.8trn, with the remainder attributable to discretionary investment advisory accounts. While financial institutions have been investing in private investment trusts for quite a while, inflows to private investment trusts picked up sharply in FY2014. Pension asset inflows to discretionary investment advisory accounts were largely attributable to public pension funds. Corporate pension funds have been transferring asset management mandates from AMCs to trust banks in recent years in the wake of three trends: a shift toward passive management, an increase in corporate pension funds' cash allocations and renationalization of the substitutional portion of EPF

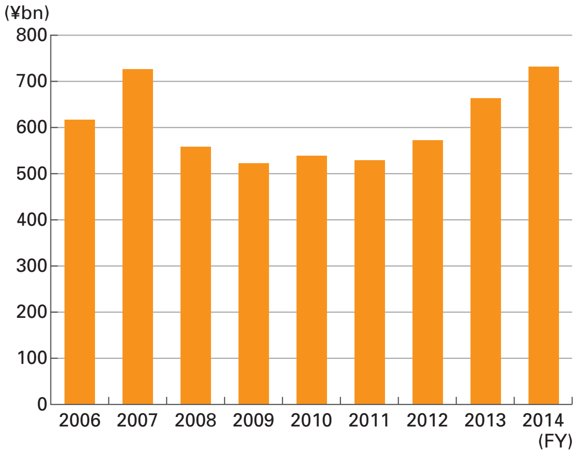
Exhibit 3. Changes in AUM broken down by causative factor





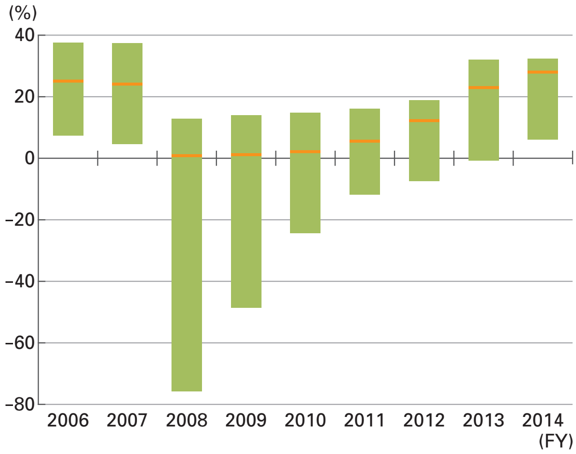
Note: Adjusted to reflect M&A and assets switched between contractual modalities.
Source: NRI, based largely on data from the Investment Trusts Association of Japan, Japan Securities Investment Advisers Association and NRI Fundmark

Exhibit 4. AMCs' aggregate management fee revenues



Source: NRI, based on AMCs' business reports and Japan Securities Investment Advisers Association data

Exhibit 5. Dispersion of AMCs' operating margins



Note: The above graph plots operating margin data for domestic public investment trust sponsors (number of AMCs in data sample varies among fiscal years). Operating margin was calculated as the ratio of operating income to operating revenues net of agency fees. Green bars represent the interquartile range (i.e., second and third quartiles) of respondent AMCs' operating margins. Red lines indicate median values.
Source: NRI *Survey of Asset Management Companies' Management Priorities*

assets. Overall, AMCs' corporate pension AUM did not increase in FY2014.

In the retail market segment (right graph: open-end public investment trust AUM), AMCs' AUM increased in FY2014 by ¥9.4trn due to asset price appreciation and by an additional ¥6.1trn due to net inflows (not counting distributions). Gross sales before redemptions totaled an all-time record ¥34trn. Redemptions, however, remained high at ¥28trn. Meanwhile, investment trust outflows in the form of dividend distributions were an all-time record ¥5.8trn. Net of both redemptions and distributions, open-end public investment trust inflows were only about ¥300bn. AMCs' FY2014 retail AUM growth was thus almost entirely attributable to asset price appreciation.

Exhibit 4 plots the asset management industry's aggregate management fee revenues. Based on data available at time of this writing, we estimate FY2014 management fee revenues at ¥730bn, slightly above the previous all-time record set in FY2007.

Exhibit 5 plots operating margins' interquartile ranges for domestic AMCs (investment trust management companies only). Domestic AMCs' median operating margin in FY2014 was 28%, likewise above its FY2007 level (based on data available at the time of this writing, like the FY2014 data in Exhibit 4).

In sum, revenue set a new all-time record and profit margins, on the whole, also were high in FY2014, but these positives were predominantly attributable to favorable market performance. The only investor segments in which AMCs experienced positive asset inflows net of both redemptions and investment trust distributions in FY2014 were the financial institution segment and a subsegment of the pension fund segment.

2 Outlook for asset management business

We annually survey AMCs (NRI *Survey of Asset Management Companies' Management Priorities*[2]) to ascertain their consensus outlook and the latest conditions in the asset management business. Based on the survey responses, we gauge AMCs' near-term outlook for their business environment.

Revenue outlook: domestic AMCs bullish on investment trusts; foreign AMCs, on pension segment

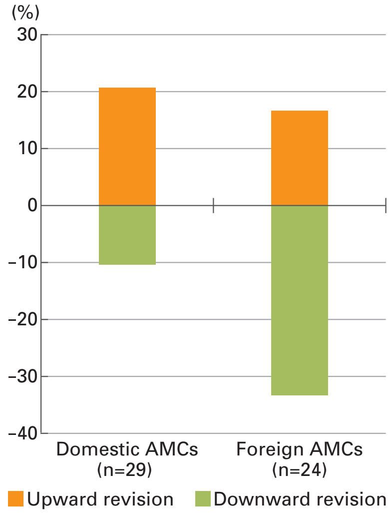
First, in terms of AMCs' overall revenue outlook, Exhibit 6 plots the percentages of upwardly revised and downwardly revised 3-5 year revenue forecasts (i.e., projected revenue growth rate due to asset in/outflows, excluding changes in AUM due to changes in market prices) in 2015 relative to 2014 among respondents that participated in both years' surveys. Among domestic AMCs, some 20% of respondents raised their company-wide revenue growth forecasts while about 10% lowered theirs. Among foreign AMCs, nearly 20% of respondents raised their revenue forecasts but one-third lowered theirs. Domestic AMCs appear more bullish than their foreign counterparts on the overall business environment's direction.

The data plotted in Exhibit 6 are disaggregated by market segment in Exhibit 7. The only segment in which domestic and foreign AMCs' respective responses differ markedly is the pension segment. Among foreign AMCs, some 30% of respondents upwardly revised their revenue forecasts for the pension segment, whereas hardly any domestic AMCs did so. In the investment trust segment, by contrast, a larger percentage of domestic AMCs than foreign AMCs raised their revenue forecasts.

Such forecast revisions presumably reflect differences in the investment trust and pension segments' respective business environments. Although investment trust inflows net of both redemptions and distributions have been insignificant in recent years, the investment trust market still has growth potential if the fund industry seeks to meet retail investors' long-term wealth-building needs. Many fund distributors have recently been cultivating demand for wealth-building products and services and financial groups as a whole are moving toward fee-based revenue models. These developments are important changes in the business environment.

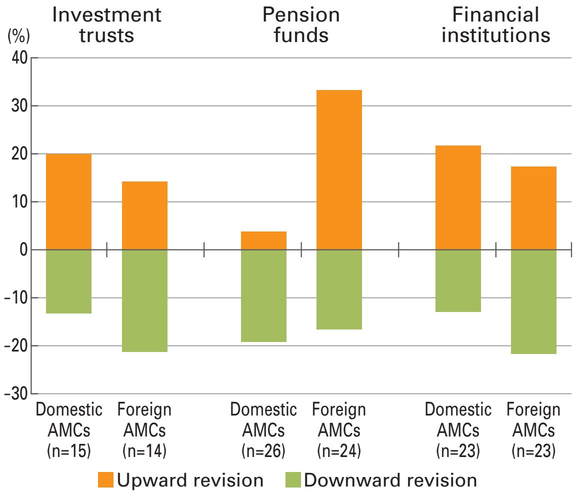
Amid such developments, AMCs affiliated with domestic fund distributors have the opportunity to increase their AUM, mainly in simple funds (i.e., funds with relatively little need to be differentiated

Exhibit 6. Percentage of survey respondents that revised their revenue growth forecasts in 2015 relative to 2014



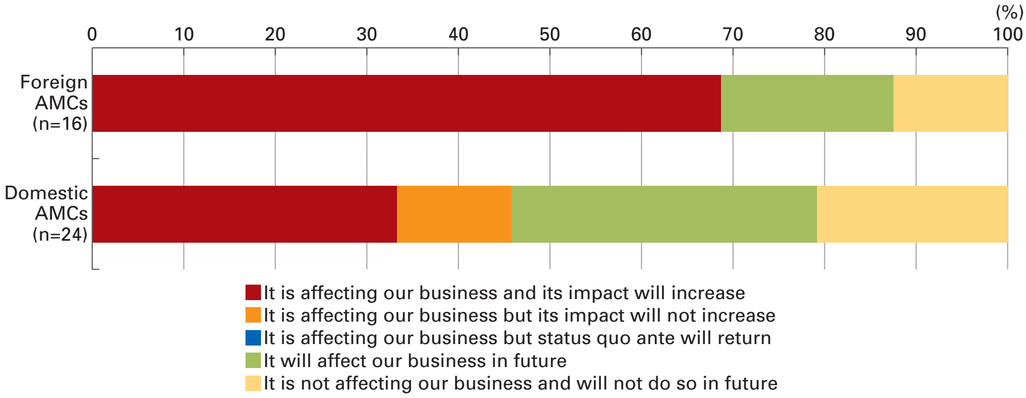
Note: Data samples are limited to AMCs that participated in survey in both 2014 and 2015 surveys.
Source: NRI *Survey of Asset Management Companies' Management Priorities*

Exhibit 7. Percentage of survey respondents that revised their revenue growth forecasts in 2015 relative to 2014 (by business segment)



Note: Data samples are limited to AMCs that participated in survey in both 2014 and 2015 surveys. Investment trust segment's data sample is limited to investment trust sponsors.
Source: NRI *Survey of Asset Management Companies' Management Priorities*

Exhibit 8. Effects of change in fund distributors' sales policies



Note: Survey responses of investment trust sponsors.
Source: NRI *Survey of Asset Management Companies' Management Priorities*

individually). Recent changes in the investment trust industry's environment are a tailwind for domestic AMCs whose strong ties with fund distributors are a key management resource. Conversely, these changes will generally constitute a headwind for foreign AMCs without affiliated fund distributors in Japan. In response to a survey question on the business impact of changes among fund distributors, roughly 70% of foreign AMC respondents reported that the changes are already affecting their businesses and their impact will increase in magnitude going forward (Exhibit 8). Foreign AMCs thus appear to be more concerned than domestic AMCs about changes in distributors' behavior.

In the pension market segment, by contrast, overall AUM have limited growth prospects, but AMCs' success hinges on their investment strategies themselves. AMCs capable of providing superior investment strategies therefore still have the potential to expand their pension businesses. With public pension funds increasing their risk-asset holdings and diversifying their sources of returns, foreign AMCs have been winning many active mandates from the GPIF et al. even in the domestic equity asset class. Even foreign AMCs with a minimal physical presence in Japan have been awarded mandates by public pension funds. If foreign AMCs focus on public and other major pension funds, they can adequately service this market niche with a few direct sales personnel. Additionally, by acting in a subadvisory role, they can access smaller pension funds' assets through trust banks. The pension market segment thus potentially offers substantial opportunity for foreign AMCs capable of providing differentiated investment strategies in a wide range of asset classes, including foreign assets.

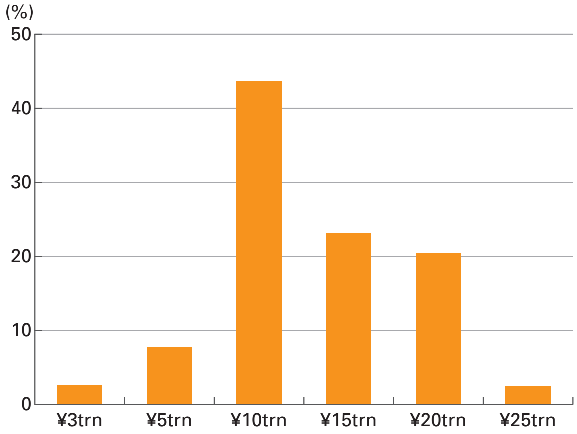
Outlook for growth in investment trust business driven by NISAs and DC plans

Institutional developments conducive to long-term wealth-building by retail investors include NISAs' advent and proposed defined-contribution (DC) pension plan reforms. In our survey, we asked respondents for their five-year forecasts of investment trust holdings in NISAs and DC pension plans.

First, cumulative purchases of financial products in NISAs totaled some ¥5.2trn as of June 30, 2015, 18 months after NISAs' launch date. Investment trusts and ETFs accounted for roughly ¥3.5trn of this total[3].

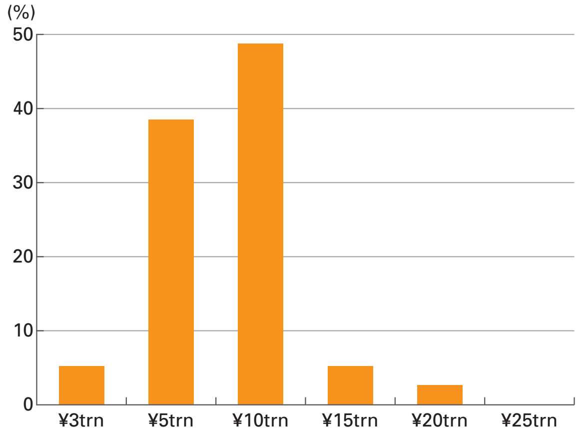
Exhibit 9 plots the distribution of survey respondents' forecasts of total investment trust holdings in NISAs as of March 31, 2021. If investment trust inflows via

Exhibit 9. Forecasts of NISA investment trust holdings five years hence



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

Exhibit 10. Forecasts of DC pension plan investment trust holdings five years hence



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

NISAs hypothetically maintained their annualized run rate to date of ¥2.3trn (disregarding changes in market prices), they would total about ¥12trn over five years (bringing cumulative investment trust purchases in NISAs to about ¥17trn). From this perspective, the base-case scenario for NISAs' investment trust holdings in five years should be ¥15-20trn. Some 40% of survey respondents concurred with this base-case scenario, choosing either ¥15trn or ¥20trn as their response. Meanwhile, a nearly equivalent percentage of respondents conservatively chose ¥10trn as their response. With high-yielding funds accounting for a large share of funds held in NISAs, some respondents may have conservatively factored asset outflows inclusive of dividend distributions into their forecasts.

Next, investment trust holdings in DC pension plans have grown roughly ¥400bn annually in recent years to around ¥3.3trn as of March 31, 2014[4].

Exhibit 10 plots the distribution of survey respondents' forecasts of total investment trust holdings in DC pension plans as of March 31, 2021. Based on such investment trust holdings' recent growth rate of ¥400bn per year, inflows of around ¥2trn (total holdings of about ¥5trn) should be the base-case scenario. While roughly 40% of survey respondents indeed chose ¥5trn as their response, nearly 50% chose the next highest response, ¥10trn.

Such optimistic forecasts likely factor in proposed DC pension plan reforms. The government has already raised the contribution limit for corporate DC plans and lifted a ban on matching contributions[5]. Additionally, a legislative bill to amend the Defined Contribution Pension Act is currently awaiting passage in the Diet. The bill's proposed reforms include expansion of eligibility to enroll in individual DC plans and adoption of measures to assist DC pension plan participants in selecting from among available investment options. Many AMCs presumably expect such reforms to accelerate growth in investment trust holdings in DC pension plans.

2) NRI has conducted this survey annually since FY2007. In 2015, NRI distributed the survey questionnaires in July–September and received valid responses from 68 AMCs (37 Japanese, 31 foreign).
3) Per data released by Financial Services Agency on September 15, 2015.
4) Per DC pension statistics published by the Federation of Pension Plan Administrators in November 2014.
5) In Japan, "matching" contributions are made by DC plan participants, not employers.

CHAPTER 3

Market trends and product strategies by client segment

1 Pension business

Major growth in both GPIF and corporate pension assets

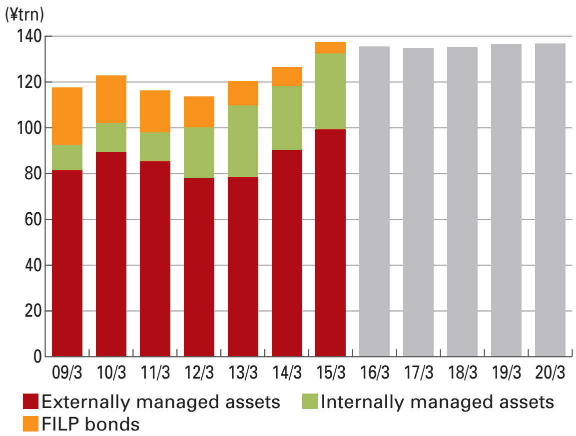
Japanese pension assets at March 31, 2015, totaled an estimated ¥317trn, a hefty ¥25trn increase from a year earlier. Of this total, public pension schemes (National Pension, Employees' Pension Insurance and Mutual Aid Associations) accounted for some 63% or ¥201trn, a ¥17trn year-on-year increase. Corporate pension plans and other pension schemes (National Pension Funds and Small-scale Enterprise Mutual Aid System) accounted for the remainder of ¥117trn, a year-on-year increase of ¥7trn.

Employees' Pension Insurance and National Pension reserves at March 31, 2015, totaled ¥146trn, accounting for over 70% of total public pension assets. Nearly all of this ¥146trn is managed by the GPIF. The GPIF's AUM at March 31, 2015, were ¥137trn, an ¥11trn increase from a year earlier (Exhibit 11). The GPIF's overall investment return in FY2014 was +12.3%, its highest annual return since its inception. The GPIF'S AUM outsourced to external managers increased roughly ¥9trn in FY2014 to ¥99trn, just shy of ¥100trn, while assets managed in-house increased around ¥5trn to ¥33trn. The GPIF's ratio of self-managed to externally managed assets increased to 1:3 in FY2014.

The gray bars in Exhibit 11 represent forecasts of the GPIF's AUM in each of the next five fiscal years based on the results of a 2014 actuarial valuation of public pension plans. The forecasts project roughly flat AUM over the five years through FY2019. While public pension benefit outlays are expected to exceed incoming pension insurance premiums for the foreseeable future, most EPF assets are expected to revert to the government as EPFs are dissolved and their assets re-nationalized from FY2014 (discussed below). When this prospective influx of EPF assets is factored in, the GPIF's AUM are projected to remain flat for a number of years.

Effective from October 2015, employee pension benefits have been standardized across all public pension schemes. Employees' Pension Insurance now covers even public employees and Mutual Aid Associations' pension reserves have been

Exhibit 11. GPIF's AUM (actual and forecasted)

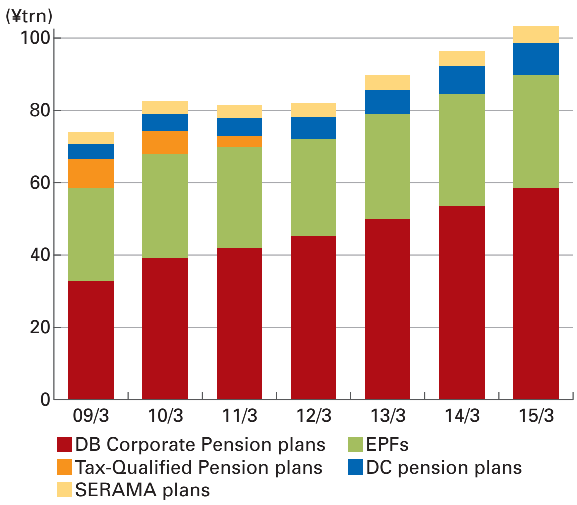


Note: Data for FY2015 and beyond are NRI forecasts based on the Ministry of Health, Labor and Welfare's 2014 actuarial valuation (using reference-case economic assumptions).
Source: NRI, based on GPIF's *Review of Operations in FY2014*, Ministry of Health, Labor and Welfare's 2014 Actuarial Valuation Report, and Federation of National Public Service Personnel Mutual Aid Associations' Actuarial Revaluation Results

segregated into two pools: the Employees' Pension Insurance Scheme's pension reserves (the so-called common-purse portion) and reserves earmarked for occupation-specific pension benefits. Common-purse pension reserves, which include about half (¥26trn) of Mutual Aid Associations' pension reserves, are to be managed by the GPIF, Federation of National Public Service Personnel Mutual Aid Associations, Pension Fund Association for Local Government Officials, and Promotion and Mutual Aid Corporation for Private Schools of Japan. These four entities have each determined their own target asset allocations based on a model portfolio unveiled in March 2015. The model portfolio is identical to the GPIF's new policy asset mix announced in 2014 (35% domestic bonds, 25% domestic equities, 15% foreign bonds and 25% foreign equities). All four of the entities managing public pension reserves will undoubtedly increase their actual equity allocations substantially.

Corporate pension assets at March 31, 2015, totaled roughly ¥104trn, a ¥7trn year-on-year increase (Exhibit 12). Defined-benefit (DB) Corporate Pension plans' share of this total was ¥58trn assets, a ¥5trn increase from a year earlier. Despite this asset growth, DB Corporate Pension plans continued to decrease in

Exhibit 12. 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

number in FY2014, as did total plan participants. EPF assets increased slightly to ¥31trn at March 31, 2015. EPF dissolutions and transfers of the substitutional portion of EPF assets to the government have increased sharply since a law essentially phasing out EPFs took effect in April 2014. Seventy-four EPFs were dissolved in FY2014 and 61 were dissolved in the first six months of FY2015. Nearly 90% of EPFs still in existence have received tentative permission to dissolve and allow the government to take over the substitutional portion of their assets and liabilities. DB plans' assets will likely start declining before long.

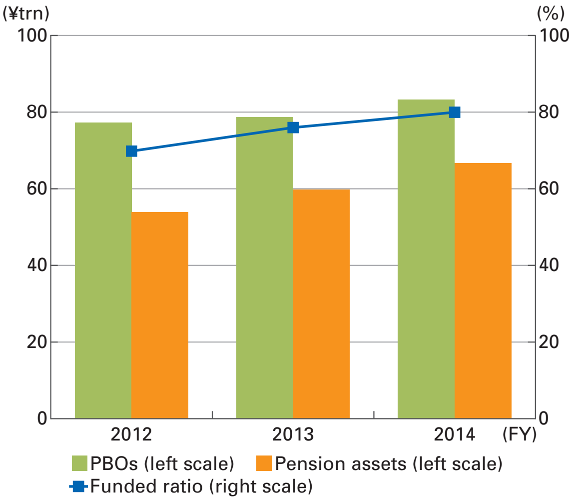
Corporate DC pension assets at March 31, 2015, totaled about ¥9trn, a year-on-year increase of over ¥1trn. Including individual DC pension plan assets of ¥1trn, DC pension assets totaled ¥10trn at FY2014-end. In April 2014, a Defined Contribution Pension Act amendment that would substantially expand the population eligible to participate in DC plans was submitted to the Diet. The amendment would permit hitherto ineligible individuals such as mutual aid pension plan participants (e.g., civil servants) and stay-at-home spouses (National Pension class-3 insured) to enroll in DC plans, thereby substantially increasing the enrollment-eligible population. Additionally, the proposed amendment would authorize simplified DC plans for small businesses and allow employers to make contributions to their employees' individual DC plans. The amendment is still under deliberation but if passed, it should contribute greatly to growth in DC plans' prevalence.

Further improvement in corporate pension plans' funded status

From the standpoint of pension benefit accounting, corporate pension plans' funded status continued to improve in FY2014.

Exhibit 13 shows Tokyo Stock Exchange (TSE) 1st Section-listed companies' pension assets, pension benefit obligations (PBOs) and their pension plans'

Exhibit 13. Corporate pension plans' overall funded status



Note: The above data pertain to 1,607 companies that were listed on the 1st Section of the TSE as of FY2014 and for which FY2012-14 financial statement data are available.
Source: NRI, based on Nikkei data

funded status, calculated as the ratio of pension assets to PBOs. First, PBOs increased ¥4.7trn in FY2014, mainly because many companies lowered the discount rate they use to calculate PBOs in response to a decline in long-term interest rates. Meanwhile, pension assets increased ¥6.9trn, resulting in an 80% funded status, a 10-point improvement from 70% two years earlier.

PBOs include benefit obligations (e.g., lump-sum benefits) not funded by pension assets. Adjusted to exclude these benefit obligations, corporate pension plans' funded status is nearly 100% (for the subset of TSE 1st Section-listed companies that issue J-GAAP-compliant financial statements and disclose the information required to calculate their adjusted funded status).

Next, Exhibit 14 decomposes the change in pension assets during FY2014 by contributing factor for March year-end companies for which the requisite data are available for both FY2013 and FY2014. For a second consecutive year, pension assets' biggest growth driver was investment returns (whose contribution to year-on-year growth in pension assets was +¥6.7trn, including growth attributable to mergers and other

Exhibit 14. Factors behind changes in corporate pension assets

	FY2013	FY2014	Change
Beginning balance	49.7	54.7	+5.0
Contributions	2.7	2.4	△0.3
Benefit outlays	△2.7	△2.6	+0.1
Investment returns	5.0	6.7	+1.7
Ending balance	54.7	61.2	+6.5
Contributions to DC plans	0.5	0.7	+0.1

Note: Unit: ¥trn. The above data pertain to 1,289 companies that were listed on the 1st Section of the TSE as of March 31, 2015, have a March fiscal year-end, and for which FY2013-14 financial statement data are available.
Source: NRI, based on Nikkei data

miscellaneous factors). Employer contributions to DB plans decreased ¥300bn from FY2013 while contributions to DC plans increased ¥100bn.

In sum, corporate pension finances are in good shape from an accounting standpoint by virtue of the favorable investment environment of recent years. Nonetheless, companies continue to seek to reduce their DB pension risk. This de-risking trend is unlikely to reverse. Over the long term, this trend may give rise to new forms of corporate pension plans such as risk-sharing DB plans (tentative name) discussed by the Social Security Council.

2 Securities investment by banks

Regional and second-tier regional banks increased their investment securities holdings

According to Japan Bankers Association (JBA) data, Japanese banks ended FY2014 with aggregate investment securities holdings of ¥257trn[6], roughly unchanged from a year earlier but ¥28trn below their FY2012-end peak. Investment securities' share of Japanese banks' total assets likewise decreased, down 1.8 points to 25.3%. Factors behind the downshift in banks' investment securities holdings' growth rate since FY2013 include (1) the BOJ's unconventional monetary policy launched in April

2013 and (2) a renewed focus among banks on stepping up lending.

Among the various types of banks, city banks reduced their investment securities holdings while other banks collectively increased theirs. City banks ended FY2014 with aggregate investment securities holdings of ¥130trn, a year-on-year decrease of ¥4trn. Regional banks and second-tier regional banks respectively held ¥82trn and ¥17trn of investment securities at FY2014-end. Their holdings increased ¥5trn and ¥1trn during FY2014. Trust banks' investment securities holdings likewise increased in FY2014, up ¥1trn to ¥25trn at fiscal year-end[7].

Among assets other than investment securities, banks' aggregate deposits receivable[8] increased in FY2014. City banks substantially increased their deposits receivable in FY2014 for a second straight fiscal year. Banks other than city banks likewise increased their deposits receivable. The banking industry as a whole is keeping a portion of its funds available for lending or securities investment parked in deposit accounts. As of FY2014-end, city banks had deposits receivable of ¥102trn (a ¥30trn year-on-year increase), regional banks had ¥19trn (a ¥6trn year-on-year increase), second-tier regional banks had ¥4trn (a ¥700bn year-on-year increase) and trust banks had ¥14trn (a ¥6trn year-on-year increase).

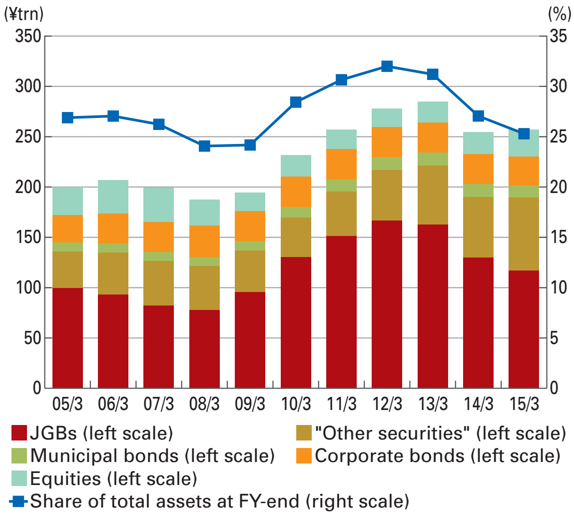
Meanwhile, the banking industry's aggregate outstanding loans increased ¥24trn in FY2014 to ¥523trn at fiscal year-end, at least partly in response to BOJ policies aimed at stimulating lending. Of the ¥24trn increase, foreign loans accounted for some ¥11trn[9]. Interest rates currently remain low, having gradually declined after the BOJ launched quantitative and qualitative easing (QQE). City banks and the few regional banks are becoming increasingly active in overseas loan markets in pursuit of wider lending spreads. At FY2014-end, city banks had ¥247trn of loans outstanding (a ¥13trn year-on-year increase), regional banks had ¥179trn (a ¥7trn year-on-year increase), second-tier regional banks had ¥48trn (a ¥1trn year-on-year increase) and trust banks had ¥42trn (a ¥2.5trn year-on-year increase).

JGBs' share of banks' securities holdings has dropped below 50%

Banks trimmed their JGB holdings in FY2014 to ¥118trn, a ¥13trn year-on-year decrease (Exhibit 15). The decrease reduced JGBs' share of banks' total investment securities holdings below 50% to 45.7%. In place of the divested JGBs, banks increased their holdings of "other securities[10]" and equities. They increased their "other securities" ¥12trn to ¥72trn, equivalent to 28% of their total investment securities holdings. Proceeds from JGB divestment were almost entirely reinvested in "other securities." Banks increased their equity holdings ¥5.5trn in FY2014 to ¥27trn, 10% of their total investment securities holdings.

Holdings of "other securities" and equities increased across all categories of banks in FY2014. At FY2014-end, city banks had ¥39trn of "other securities" (a ¥4trn year-on-year increase), regional banks had ¥17trn (a ¥5trn year-on-year increase), second-tier

Exhibit 15. Japanese banks' investment securities holdings by asset class



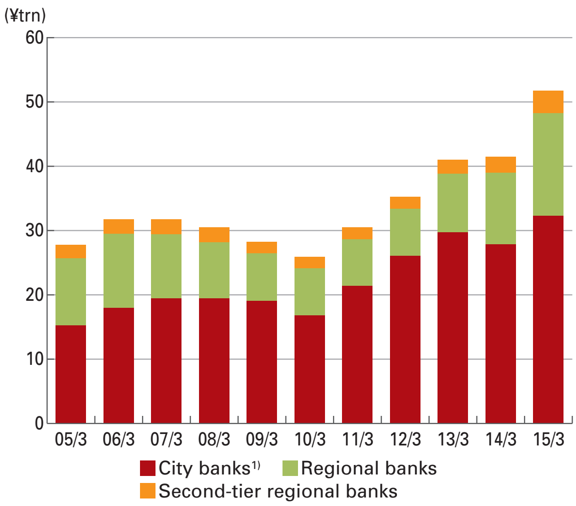
Source: NRI, based on JBA's *Financial Statements of All Banks* regional banks had ¥3.5trn (a ¥1trn year-on-year increase) and trust banks had ¥12trn (a ¥2trn year-on-year increase). Meanwhile, banks actively invested in equities for a second consecutive year against a backdrop of equity market appreciation. City banks' equity holdings at FY2014-end were ¥15trn (a ¥3trn year-on-year increase), regional banks' were ¥7trn, second-tier regional banks' were ¥1trn and trust banks' were ¥3trn.

Major growth in "other securities" holdings

According to the BOJ's *Domestic Bank Assets and Liabilities*, banks' "other securities" holdings (excluding securities held in foreign branch accounts) increased a hefty ¥12trn in FY2014 to ¥64trn at fiscal year-end. Of this total, foreign securities accounted for ¥53trn, a roughly ¥8trn year-on-year increase. Banks' non-foreign "other securities" holdings (e.g., funds[11], hedge funds, structured bonds) likewise grew sharply, increasing some ¥4trn year on year to ¥11trn at FY2014-end.

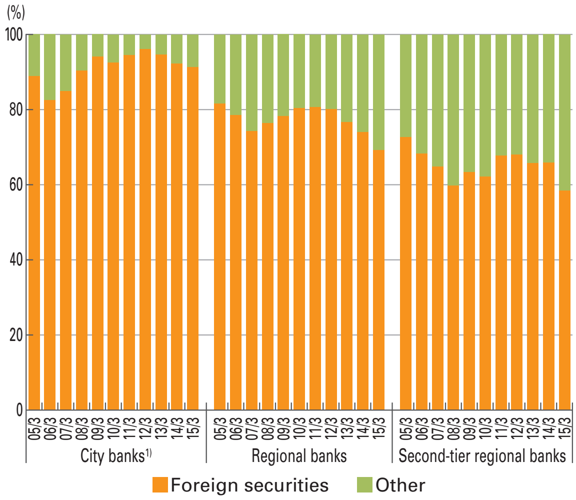
City banks, regional banks and second-tier regional banks all substantially increased their "other securities" holdings in FY2014 (Exhibit 16). City banks

Exhibit 16. "Other securities" holdings by bank type (excluding overseas branch accounts)



Note 1: City banks are Mizuho Bank, Bank of Tokyo-Mitsubishi UFJ, Sumitomo Mitsui Banking Corporation, Resona Bank and Saitama Resona Bank.
Source: NRI, based on BOJ's *Domestic Bank Assets and Liabilities*

Exhibit 17. Composition of banks' "other securities" holdings



Note 1: City banks are Mizuho Bank, Bank of Tokyo-Mitsubishi UFJ, Sumitomo Mitsui Banking Corporation, Resona Bank and Saitama Resona Bank.
Source: NRI, based on BOJ's *Domestic Bank Assets and Liabilities*

ended the fiscal year with ¥32trn of "other securities" (a ¥4trn year-on-year increase), regional banks with ¥16trn (a ¥5trn year-on-year increase) and second-tier regional banks with ¥3.5trn (a ¥1trn year-on-year increase).

The non-foreign share of "other securities" holdings increased across all types of banks (Exhibit 17). In second-tier regional banks' case in particular, the previously largely static non-foreign share of "other securities" holdings jumped eight points to 42% in FY2014. Growing enthusiasm for investing in "other securities" has become an industry-wide trend.

In terms of specific products, banks have been increasingly investing in ETFs, REITs, foreign government bonds and foreign corporate bonds since 2012. Some banks have recently started, or are considering, investing in more diverse products such as foreign equities, multi-asset funds, foreign domiciled investment trusts, energy assets/infrastructure and hedge funds[12].

For banks, fund investment has the advantage of compensating for deficiencies in securities investment know-how and/or management resources.

Specifically, fund investment enables banks to (1) diversify and internationalize their investment portfolios, (2) improve operating efficiency by investing in numerous assets at once and (3) access AMCs' market/asset class research and analytical capabilities, diversification capabilities and risk analysis/management capabilities.

Banks prefer investing in private investment trusts over public investment trusts for several reasons. First, private investment trusts can be tailored to banks' investment policies or investment needs (e.g., currency hedged/unhedged). Second, fund managers' information disclosures (e.g., about investee companies) can be customized to banks' specifications. Third, private investment trust holdings are easier to manage because the bank's ownership percentage remains constant. Fourth, gains on fund redemptions can be included in net interest income. Many banks invest exclusively in private investment trusts due to the ease of obtaining information required by the look-through approach to risk-weighting fund holdings for calculating regulatory capital ratios. In response to such needs of banks, AMCs and fund distributors have in recent years been developing private investment trust products that meet banks' requirements in terms of look-through transparency and timely information disclosure.

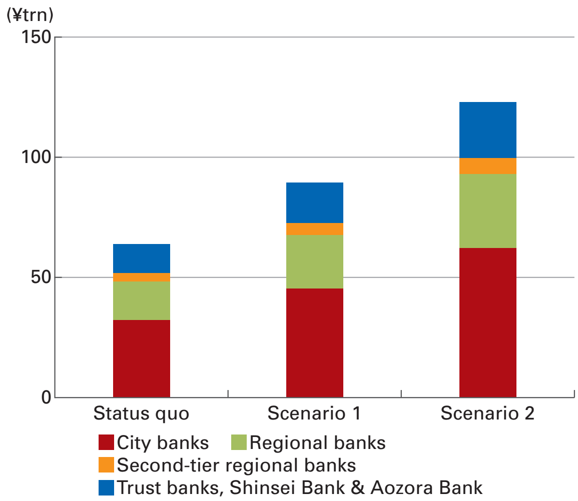
How much more will banks increase their "other securities" holdings?

Stepped-up investment in "other securities" was clearly an industry-wide trend in FY2014. Banks' investment behavior is trending in the direction of broadly diversified investment in non-JGB assets, including foreign assets, to capture profit opportunities while reducing domestic interest rate risk. Still faced with an adverse domestic business environment, banks are heavily counting on securities investment as an earnings driver. They will likely continue to aggressively invest in "other securities" for a while longer.

The extent to which banks continue to expand their investments in "other securities," particularly fund products, is a question of keen interest to AMCs and fund distributors. Based on historical data, we projected banks' "other securities" holdings in five years under two scenarios. The first scenario assumes that banks' "other securities" holdings grow for the next five years at their historical compound annual growth rate over the past 10 years. The second scenario assumes that they grow at their compound annual growth rate since QQE's inception. Both scenarios assume continuation of status quo financial and economic conditions.

Under the first scenario, banks' "other securities" holdings would grow to an estimated ¥89trn at March 31, 2020 (40% increase from FY2014-end). City banks' share of this total would be ¥45trn; regional banks', ¥22trn; second-tier regional banks', ¥5trn; and trust banks', ¥17trn. Under the second scenario, banks' "other securities" at March 31, 2020, would total an estimated ¥123trn (100% increase from FY2014-end). City banks' share of this total would be

Exhibit 18. Estimates of banks' "other securities" holdings at March 31, 2020



Note: Scenario 1 assumes that banks' "other securities" holdings grow through FY2019 at their historical CAGR for the 10 years through FY2014. Scenario 2 assumes that they grow through FY2019 at their CAGR since QQE's inception.
Source: NRI

¥62trn; regional banks', ¥31trn; second-tier regional banks', ¥7trn; and trust banks', ¥23trn (Exhibit 18).

However, numerous challenges must be overcome for either of these scenarios to be realized within five years.

Challenges to be resolved for banks to expand their fund holdings

NRI interview surveys of banks and AMCs have revealed challenges that must be resolved to facilitate greater fund investment by banks.

Banks obtain (1) fund look-through information required to calculate and report their regulatory capital ratios and (2) information required for day-to-day management (e.g., fund NAVs) from fund managers via fund distributors. Processing fund look-through information to calculate and report regulatory capital ratios imposes a heavy administrative burden on banks. Under the status quo, banks' capacity to further increase their fund investments is severely constrained. For example, banks obtain data to meet fund look-through requirements from AMCs or trustee banks, but the format in which the data are provided differs from one AMC to another. Even when two or more funds invest in the same stock, their managers sometimes rate the stock differently for risk-weighting purposes. Banks consequently devote substantial time and manpower to checking and compiling data received from fund managers. To lessen the look-through compliance burden, some banks impose limits on the number of stocks owned by the funds in which they invest, thereby forfeiting potential diversification benefits of fund investment.

Meanwhile, the types of required look-through information have increased amid the regulatory tightening since the global financial crisis. This trend has imposed an increasingly heavy administrative burden on AMCs. Given the burden of furnishing look-through information, foreign AMCs with few sales personnel are reluctant to offer their products to a broad clientele. One reason that providing look-through information imposes such a heavy burden on AMCs is that individual banks have different information requirements and formatting specifications.

With the Basel Committee on Banking Supervision's final standard on capital requirements for banks' equity investments in funds slated to take effect in January 2017, look-through requirements may become even more stringent than they are now[13]. In such an event, banks may become reluctant to invest in funds and/or AMCs may become reluctant to provide fund products to banks due to the increased administrative burden.

Second, as banks' fund holdings increase in number, banks must upgrade their portfolio management capabilities to include risk and performance analysis of their fund holdings in aggregate. Most banks have failed to upgrade such capabilities fast enough to keep pace with growth in their fund holdings. Banks have been strengthening their securities investment operations as a core business since around FY2012. Some banks are working on upgrading their capabilities through such means as acquiring portfolio management know-how by seconding personnel to AMCs. However, due to a lack of internal talent and/or know-how, quite a few banks are merely hiring more staff to lessen the existing workload.

Third, with the BOJ's QQE program constraining banks' ability to earn profits from JGB trading, banks are increasingly using funds as a trading vehicle. In doing business with banks, AMCs could provide added value by providing timely investment advice, including advice on the timing of fund redemptions and reinvestments. However, some AMCs have expressed concern that fund investment's recent popularity among banks will ultimately prove transitory because banks are not taking full advantage of fund investment's fundamental strength as a source of stable, long-term returns from portfolio diversification.

We recommend two initiatives to ensure that growth in banks' fund holdings and fund investments' growing importance as an earnings source do not end up being short-lived trends. First, banks, fund distributors and AMCs should work together to reduce look-through requirements' administrative burden by building industry-wide infrastructure that enables more efficient collection and exchange of fund look-through information. Second, AMCs should proactively educate banks about fund investment to encourage banks to utilize funds as vehicles to stabilize and increase their securities portfolios' overall returns.

3 Life insurers' asset management operations

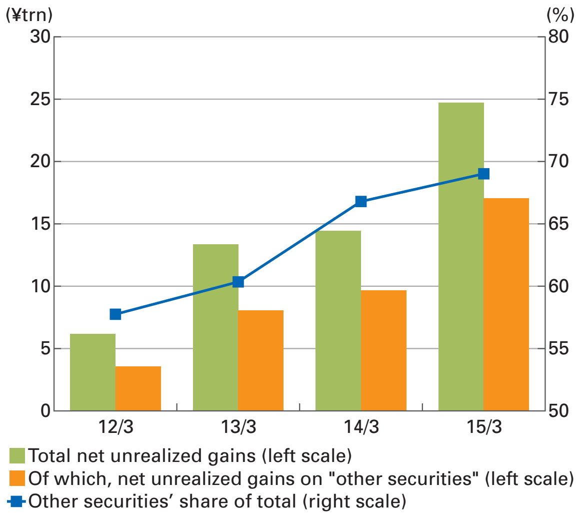
Life insurers reduced JGB holdings for first time in 17 years

Japan's 42 life insurers' investment securities holdings at March 31, 2015, totaled ¥299trn, a ¥16.6trn increase from a year earlier, according to the Life Insurance Association of Japan. Investment securities' share of life insurers' total assets at FY2014-end was 81.5%, up 20 basis points from a year earlier.

JGBs continue to account for the largest share of life insurers' investment securities holdings at 50% (¥149trn), followed by foreign securities at 24% (¥73trn), corporate bonds at 8% (¥25trn) and equities at 8% (¥23trn), all largely unchanged from a year earlier. However, life insurers' JGB holdings, which had grown uninterruptedly since FY1997, decreased by ¥1trn, their first decline in 17 years. Foreign securities holdings, by contrast, continued to grow sharply, up ¥11.8trn year on year, while domestic equity holdings grew for a third straight year, up ¥4.7trn. In FY2014, life insurers ceased amassing JGBs in the aim of controlling risk and expanded their investment universes more aggressively. Life insurers had been reducing duration mismatches between their assets and liabilities by continuously increasing their holdings of JGBs with residual maturities of 10 years or longer as a percentage of their total JGB holdings, but these long-term JGBs' share of total JGB holdings distinctly peaked in FY2014.

Another point that cannot be overlooked is that the factors driving growth in life insurers' holdings of risk assets such as equities and foreign securities include not only chronically low interest rates but also growing risk tolerance in the wake of growth in unrealized gains fueled by equity market appreciation and yen depreciation. The four biggest life insurers' net unrealized gains on securities holdings have grown from a mere ¥6trn in FY2011 to ¥25trn in FY2014. Net unrealized gains on holdings of "other securities" (securities other than policy-reserve-matching bonds, held-to-maturity bonds and equity holdings in subsidiaries and affiliates) in particular have grown to ¥17trn from ¥4trn in FY2011 (Exhibit 19). Unlike policy-reserve-matching bonds and held-to-maturity bonds, both of which are subject to tradability restrictions, "other securities" can be freely traded. Growth in net unrealized gains on "other securities" has increased life insurers' risk tolerance, potentially

Exhibit 19. Four biggest life insurers' net unrealized gains on securities holdings



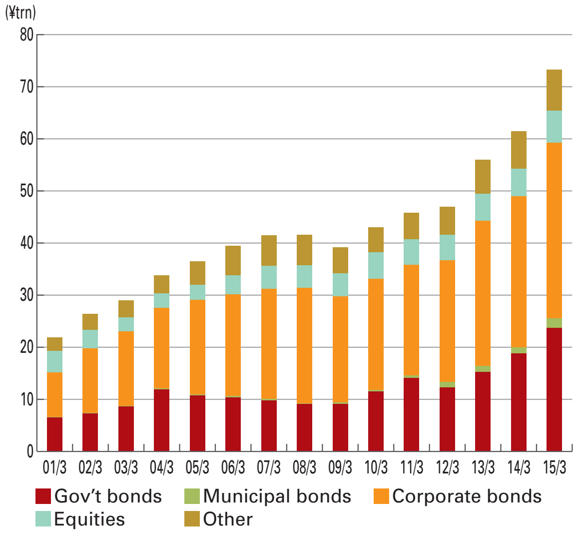
Source: NRI, based on four life insurers' financial statements enabling them to invest in somewhat higher-risk or less-liquid assets. Among individual life insurers, those with a larger cushion of net unrealized gains tend to have smaller JGB holdings as a percentage of their overall securities portfolios. Even life insurers that have hitherto consistently invested conservatively will likely increase risk-asset allocations in pursuit of increased investment returns in response to growth in net unrealized gains relative to their securities holdings' book value.

Accelerated diversification of investment strategies

Assuming that individual life insurance continues to account for most of life insurers' in-force business, we do not anticipate much change in life insurers' practice of investing predominantly in fixed-income assets duration-matched to policy reserves. With JGB market liquidity decreasing amid continuation of the BOJ's large-scale JGB purchases, life insurers could face a growing need to diversify (e.g., internationally) even within the fixed-income asset class.

Life insurance involving ultra-long-term fixed-rate interest payment obligations invariably exposes the insurer to the risk of major economic fluctuations during the policy term. Life insurers therefore need to diversify risk. With life insurers currently more risk-tolerant than usual, they may be willing to diversify into asset classes with varied risk profiles such as foreign credit and infrastructure, leading to expansion of their investment universes. In terms of foreign securities investment, life insurers have in fact been steadily diversifying their portfolios through such means as substantially increasing their holdings of corporate bonds and "other securities" (Exhibit 20). Additionally, their foreign government bond holdings' recent growth is partly attributable to diversification into peripheral sovereign debt. Life insurers' growing need to diversify beyond traditional asset classes may also lead to growth in outsourcing of portfolio management to external managers, mainly in asset

Exhibit 20. Life insurers' foreign securities holdings



Source: NRI, based on Life Insurance Association of Japan data

classes such as emerging-market equities, credit and alternatives.

Meanwhile, risk management will likely increase in importance as life insurers expand their investment universes. If life insurers increase their risk tolerances as they upgrade their risk management, they could accelerate diversification of their asset holdings. Whereas life insurers previously managed their portfolios to minimize losses amid an adverse investment environment marked by chronically low interest rates and equity market stagnation, they are likely to henceforth place more priority on maximizing returns from aggressive investment strategies backed by sound risk management.

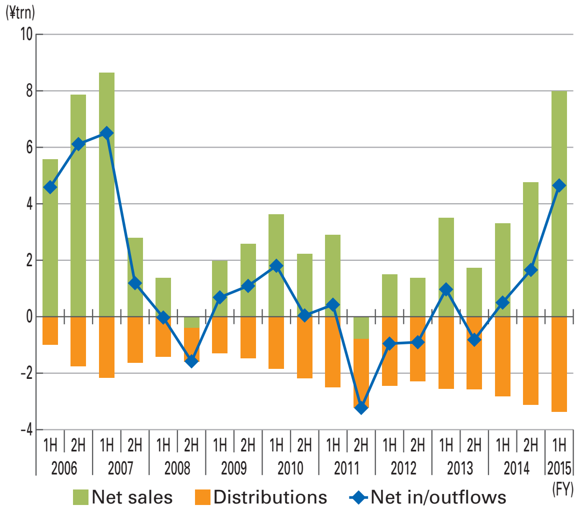
4 Retail business

Resumed net inflows for open-end equity investment trusts

Japanese public investment trust AUM has recently been growing rapidly, surpassing ¥100trn in May 2015. AUM in open-end equity investment trusts, which account for the lion's share of public investment trust AUM, surpassed ¥80trn for the first time ever before backtracking amid an equity market selloff. Despite this setback, open-end equity investment trust AUM as of September 2015 stood at ¥75.4trn, 60% higher than three years earlier. This increase was largely attributable to sustained NAV growth driven by equity market appreciation and yen depreciation, but asset inflows also greatly contributed to growth in open-end equity investment trust AUM since the first half of FY2014. Exhibit 21 plots open-end equity investment trusts' net in/outflows. Net of both redemptions and dividend distributions, asset flows were negative from the second half of FY2011 until turning positive again in the first half of FY2014. In the first half of FY2015, net inflows increased to ¥4.6trn, their third highest semiannual total on record, behind the first half of FY2007 and second half of 2006.

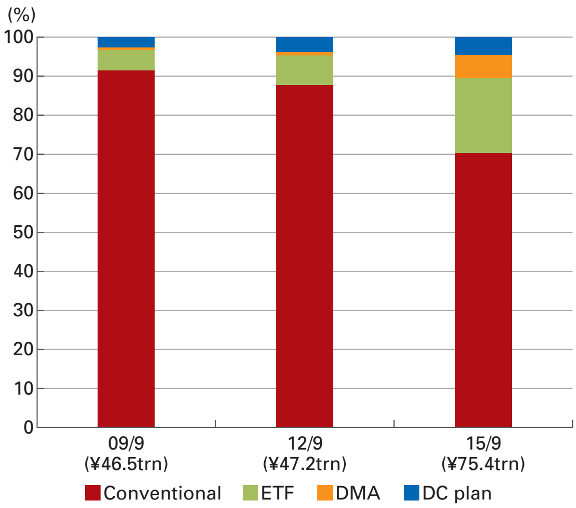
The investment trust market's expansion is being driven by several factors, one of which is diversification of the modes of intermediation linking AMCs and investors. In addition to conventional investment trust sales channels, other modes of intermediation include public equity markets, discretionary managed account (DMA) services and DC pension plans. Because banks, brokers and other intermediaries' roles and services differ depending on the mode of intermediation, AMCs often offer investment trusts available exclusively through one specific intermediation channel. We refer to investment trusts available through each of the aforementioned modes of intermediation as conventional investment trusts, ETFs, DMA investment trusts and DC investment trusts, respectively. Exhibit 22 shows changes in the percentage breakdown of AUM among these four categories of investment trusts. Conventional investment trusts' share of open-end equity investment trust AUM as of September 2015 was 70%, down from 90% as of three years earlier. ETFs, DMA investment trusts and DC investment trusts' respective shares of AUM all increased over the same timeframe. DMA investment trusts and ETFs in particular experienced rapid AUM growth of 1,000% and 300%, respectively, over the three years through September 2015. Below, we attempt to gauge future investment trust market trends in light of factors that will influence asset flows through each.

Exhibit 21. Open-end equity investment trust in/outflows



Note: Net sales are sales net of redemptions.
Source: NRI, based on Fundmark data

Exhibit 22. Breakdown of open-end investment trust AUM by mode of intermediation



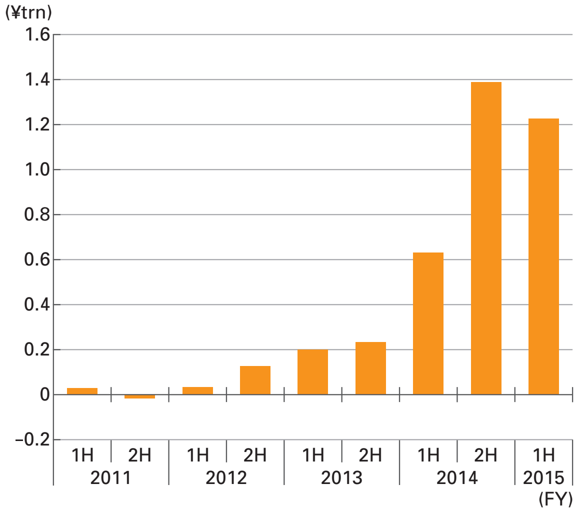
Source: NRI, based on Fundmark data

Rapidly growing inflows to DMA investment trusts

The DMA services mentioned above are also known as wrap accounts. Wrap account holders are charged a single fee based on their overall account balance for a suite of services, including discretionary account management, trade execution and account administration. If conventional investment trusts were held in a wrap account, the customer would end up being double-charged by the trust for certain services already covered by the wrap account fee. Many fund wrap providers therefore minimize account servicing fees by offering investment trusts exclusively for wrap accounts, which are distinct from conventional investment trusts. Wrap accounts include fund wraps and separate managed accounts (SMAs). The difference between the two is that the former's investment options are limited solely to investment trusts while the latter's include individual stocks and/or bonds in addition to investment trusts. With most wrap accounts being fund wraps, investment trusts are the main investment vehicle used in wrap accounts.

Asset inflows to DMA investment trusts have been on the rise since the second half of FY2012. Net inflows increased sharply in FY2014, approaching ¥1.4trn in the second half of the fiscal year (Exhibit 23). Such dramatic growth in inflows partly reflects that wrap accounts meet the needs of today's investors. Another contributing factor is that fund distributors are facing pressure to refocus their business models on asset gathering or customers' investment returns instead of sales commissions. Wrap accounts are still in their infancy, available from only a limited number of brokers and trust banks. With other financial institutions likewise seeking fee structures compatible with their new business models, the number of financial institutions offering wrap accounts, which are one viable revenue model, is bound to increase sooner or later. DMA investment trusts should therefore continue to experience net

Exhibit 23. DMA investment trust net in/outflows



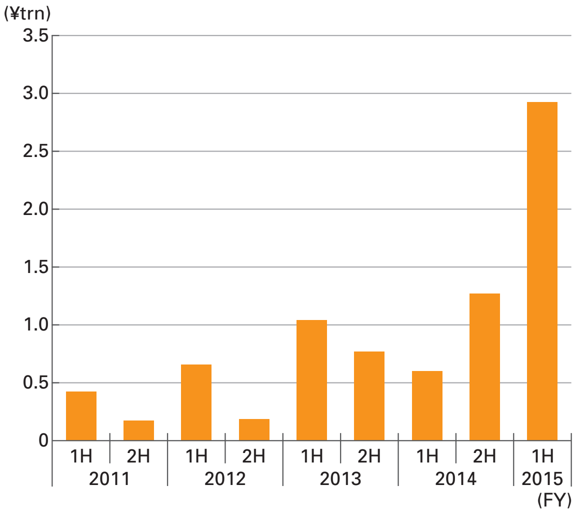
Note: Net in/outflows are sales net of both redemptions and distributions.
Source: NRI, based on Fundmark data

inflows for a while. On a monthly basis, net inflows slowed somewhat in response to the equity market selloff from August 2015. Industry insiders are closely watching whether the brokers and trust banks that were early entrants in the fund wrap market are able to maintain customer satisfaction and retain their fund wrap customers through periodic follow-up consultations, a distinctive feature of fund wraps. Wrap accounts' true value as a new mode of intermediation for investment trusts is now under scrutiny.

ETF inflows also are growing

ETFs are experiencing even more dramatic growth in asset inflows than DMA investment trusts (Exhibit 24). Over the three years through September 30, 2015, net inflows to ETFs totaled a cumulative ¥6.8trn, the main source of which was the BOJ. The BOJ reported ETF purchases totaling ¥4.9trn over the three years through September 30, 2015. When expanding its QQE program in October 2014, the BOJ stepped up its ETF purchases to an annual run rate of ¥3trn. In addition to the BOJ, city banks and regional banks also appear to be increasing their ETF holdings. According to Tokyo Stock Exchange data, city banks and regional banks are ranked third behind

Exhibit 24. ETF net in/outflows



Note: Net in/outflows are issuance net of both redemptions and distributions.
Source: NRI, based on Fundmark data

Exhibit 25. Japanese ETF availability (by asset class)

Asset class	Domestic ETF availability
Domestic bond	×
Domestic equity	○
Foreign DM government bond	○
Foreign DM government bond (currency hedged)	×
Foreign DM bond (including credit)	×
EM bond (USD)	×
EM bond (USD, currency hedged)	×
EM bond (local currency)	○
Foreign DM equity	○
EM equity	○
Frontier equity	○
High-yield bond	○[1]
Bank loans	×
J-REIT	○
Global REIT	△[2]
Commodities	○

Note 1: One foreign domiciled ETF is listed on the TSE. No domestically domiciled ETFs are available.
Note 2: Global REIT ETF availability is limited to two funds, a US REIT ETF and Australian REIT ETF.
Source: NRI

the BOJ and foreign investors in terms of their ETF holdings' growth rate.

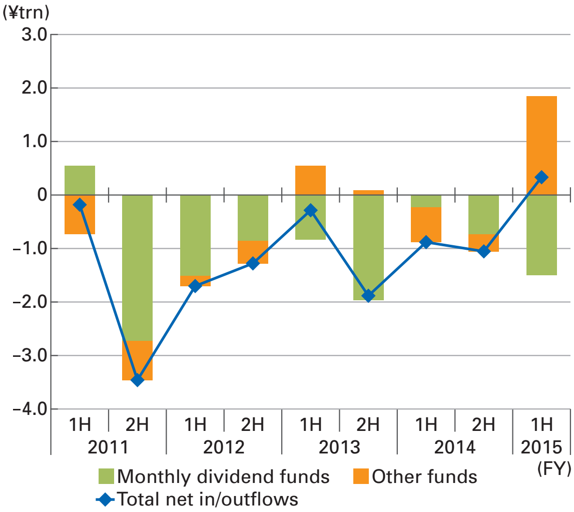
Retail investors also have been increasing their ETF holdings, albeit at a much slower pace than the BOJ and city/regional banks. Their share of total ETF ownership has consequently decreased from 10.7% in July 2012 to 7.2% in January 2015. How can the fund industry further increase ETF ownership among retail investors? Currently, retail investors who own ETFs are presumably mostly individuals who make their own investment decisions. This subset of investors alone is too small to drive much growth in ETF AUM. Retail investors who make investment decisions based largely on an advisor's advice seem to be in the majority. To promote ETF ownership among retail investors, the fund industry must promote ETF usage even among such advisor-dependent investors. One promising way to do so is by offering ETF-specific wrap accounts, which are already available in the US and elsewhere. Wrap accounts are rapidly gaining prevalence even in Japan, as discussed above. At some point, ETF-specific wrap accounts will surely catch on.

However, several deficiencies must be rectified for such ETF-specific services to gain popularity. The biggest deficiency is ETF availability. Although ETFs have proliferated in recent years, they are available in Japan in only about half of the asset classes in which pension funds and other long-term investors invest (Exhibit 25). In some prominent asset classes, no domestically listed ETFs are available at present. Japan's ETF lineup needs to be expanded further.

Continued net outflows for monthly dividend funds; resumed net inflows for other funds

Unlike ETFs and DMA investment trusts, conventional investment trusts experienced net outflows for eight consecutive semiannual periods through the second half of FY2014 (Exhibit 26). In the first half of FY2015, net inflows resumed, albeit by a mere ¥300bn margin. Among conventional investment trusts, monthly dividend funds have fared worse than other funds. Monthly dividend funds previously attracted heavy net inflows that continued uninterruptedly for years, except in the immediate aftermath of the Lehman bust. This trend came to an end in the latter half of FY2011, when the net inflows turned into net

Exhibit 26. Conventional investment trust net in/outflows (by distribution frequency)



Note: Net in/outflows are sales net of both redemptions and distributions.
Source: NRI, based on Fundmark data

outflows. Monthly dividend funds showed signs of regaining popularity in FY2014, but their net outflows have reaccelerated in FY2015. Monthly dividend funds are reportedly owned mainly by investors aged 60-79. With this age group set to gradually shrink going forward, asset inflows to monthly dividend funds may not have much prospect of recovering to their former level.

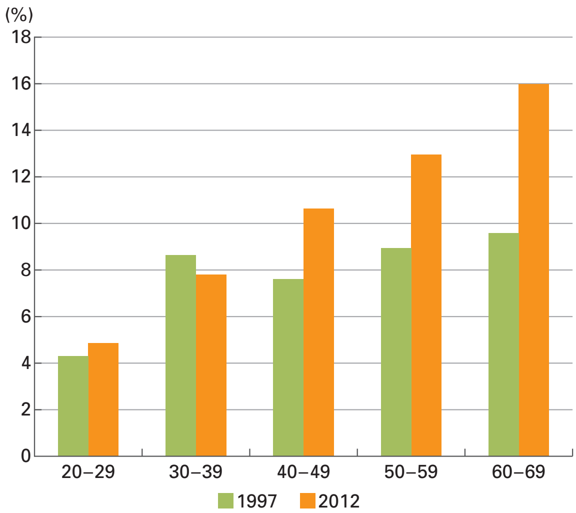
While monthly dividend funds are plagued by growing asset outflows, conventional investment trusts other than monthly dividend funds collectively experienced net inflows of nearly ¥2trn in the first half of FY2015. These inflows were heavily concentrated in domestic and foreign equity funds and tactical asset allocation funds. Funds other than monthly dividend funds have gained favor as NISA investment vehicles since NISAs' January 2014 advent. While the sustainability of recent inflows to funds other than monthly dividend funds remains to be seen, it hinges largely on widespread use of investment trusts as a long-term wealth-building vehicle.

Widespread use of NISAs and DC plans is key to sustained growth in investment trust AUM

Fund products' share of household financial assets is smaller in Japan than in the US, Germany and other leading countries. To begin with, relatively few Japanese own investment trusts. A 2012 NRI survey found that only 11.2% of survey respondents aged 20-69 owned investment trusts. Another distinctive characteristic of fund ownership in Japan is that it is lopsidedly concentrated among the elderly. Since the mid-1990s, the share of the population that owns investment trusts has increased only about 3 percentage points despite various measures to increase investment trust ownership, including lifting of a previous ban on investment trust sales by banks. In the 20-39 age bracket in particular, the percentage of the population owning investment trusts remained nearly unchanged between 1997 and 2012 (Exhibit 27). Investment trusts have completely failed to take root as a wealth-building vehicle among the younger generation.

Against such a backdrop, the government has been establishing wealth-building incentive programs, partly to promote broader ownership of investment

Exhibit 27. Investment trust owners' population share (by age stratum)



Source: NRI Questionnaire Survey of 10,000 Consumers products, particularly investment trusts, among the working-age population. One example is NISAs, launched in January 2014. NISAs holders benefit from tax-free treatment of capital gains on and dividends (distributions) from listed equities and equity investment trusts held in their NISAs. Effective from 2016, the government has raised the annual NISA contribution limit from ¥1mn to ¥1.2mn and authorized Junior NISAs for minors. Additionally, it appears to be willing to revise NISA rules to simplify account-opening procedures and otherwise enhance NISAs' convenience.

As of June 2015, 9.21mn NISAs had been opened. In other words, 9% of Japan's adult population opened NISAs within 18 months of NISAs' inception. Individuals aged 60 and older reportedly still account for a majority (55%) of NISA holders, but their NISA ownership share has started to steadily decrease. Working-age (20-59 year-old) individuals accounted for 60% of the NISAs opened in the first six months of 2015. Additionally, financial institutions are actively rolling out workplace NISAs offered to company employees pursuant to an agreement with their employer. Workplace NISAs should help promote wider NISA usage among the working-age population.

NISAs are important for the investment trust business. A cumulative total of over ¥3.5trn of investment trust (including ETF) purchases have been made in NISAs as of June 2015. Investment trusts held in NISAs have a low redemption rate (estimated at around 10% per year). Net of both redemptions and distributions, cumulative investment trust inflows via NISAs through June 2015 are estimated at roughly ¥2.8trn. Based on this estimate, NISAs accounted for more than half of equity investment trusts' (including unit trusts') aggregate net inflows of ¥5.2trn over the 18 months through June 2015. As NISAs gain popularity across a broad range of age demographics, the investment trust market should benefit from sustained inflows of long-term investment capital.

Another vehicle intended to help the working-age population build wealth is DC pension plans. Available in Japan since 2001, DC pension plans have a total of 5.52mn participants as of June 2015. Of this total, corporate DC pension plans have 5.3mn participants while individual DC pension plans have only 220,000. One reason that individual DC plan enrollment is so low is eligibility restrictions. Such restrictions reportedly make it difficult for financial institutions, which help to drive growth in DC plan enrollment, to proactively identify and approach prospective customers eligible to enroll in individual DC plans. In response, the government has proposed expanding individual DC plan eligibility to permit enrollment by currently ineligible individuals such as stay-at-home housewives (National Pension class-3 insured), corporate pension plan participants and mutual aid pension plan participants (e.g., civil servants). These reforms would increase the population eligible to enroll in individual DC pension plans to over 20mn. An NRI survey found that 30% of stay-at-home housewives, civil servants and other mutual aid pension plan participants would be interested in participating in an individual DC pension plan. Additionally, if individual DC plan eligibility is expanded, the expansion coupled with the aforementioned workplace NISAs should synergistically drive growth in these retirement savings vehicles' uptake. Workers' tax-advantaged saving options would expand to include both NISAs, which offer the freedom to withdraw funds at any time, and DC plans that lack such freedom but provide greater tax benefits. Meanwhile, by offering both workplace NISAs and DC plans to companies, financial institutions would be able to provide investor education and other informational services at a lower cost than they could by offering the two types of accounts separately.

Another reform proposed by the government would make it easier for companies that sponsor

DC plans to designate an investment trust as the default investment option. Currently, the investment trust market's annual asset inflows via DC plans are only about ¥200bn, but these inflows are stable. If the government's proposed reforms are adopted, investment trust inflows via DC plans would surely increase.

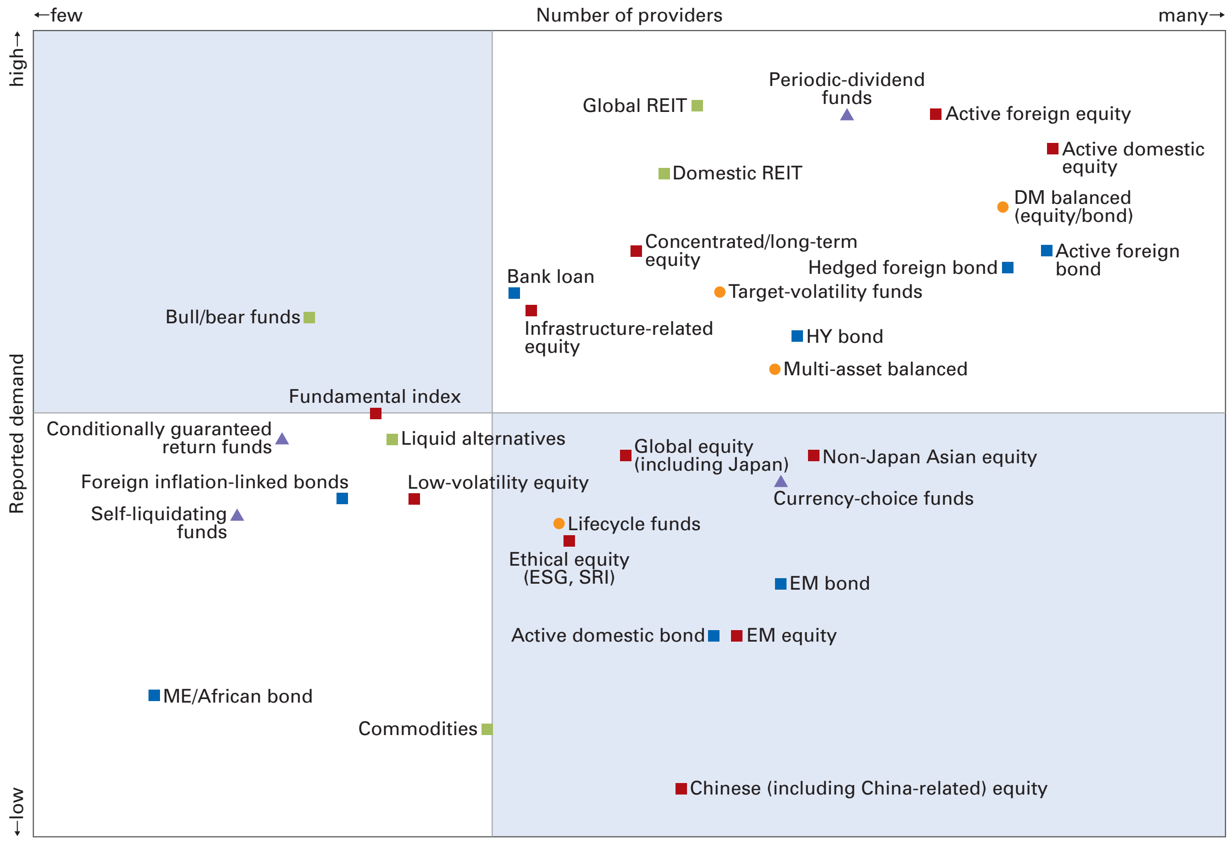
5 Product market trends by client segment

We have created 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 AMCs) against the products' current availability (assessed based on the number of providers that offer each product). They are useful for identifying promising products (strongly demanded products offered by few providers (upper left quadrant)) and products facing intense competition (poorly demanded products offered by many providers (lower right quadrant)). Exhibit 28 presents our product opportunity maps for a subset of products.

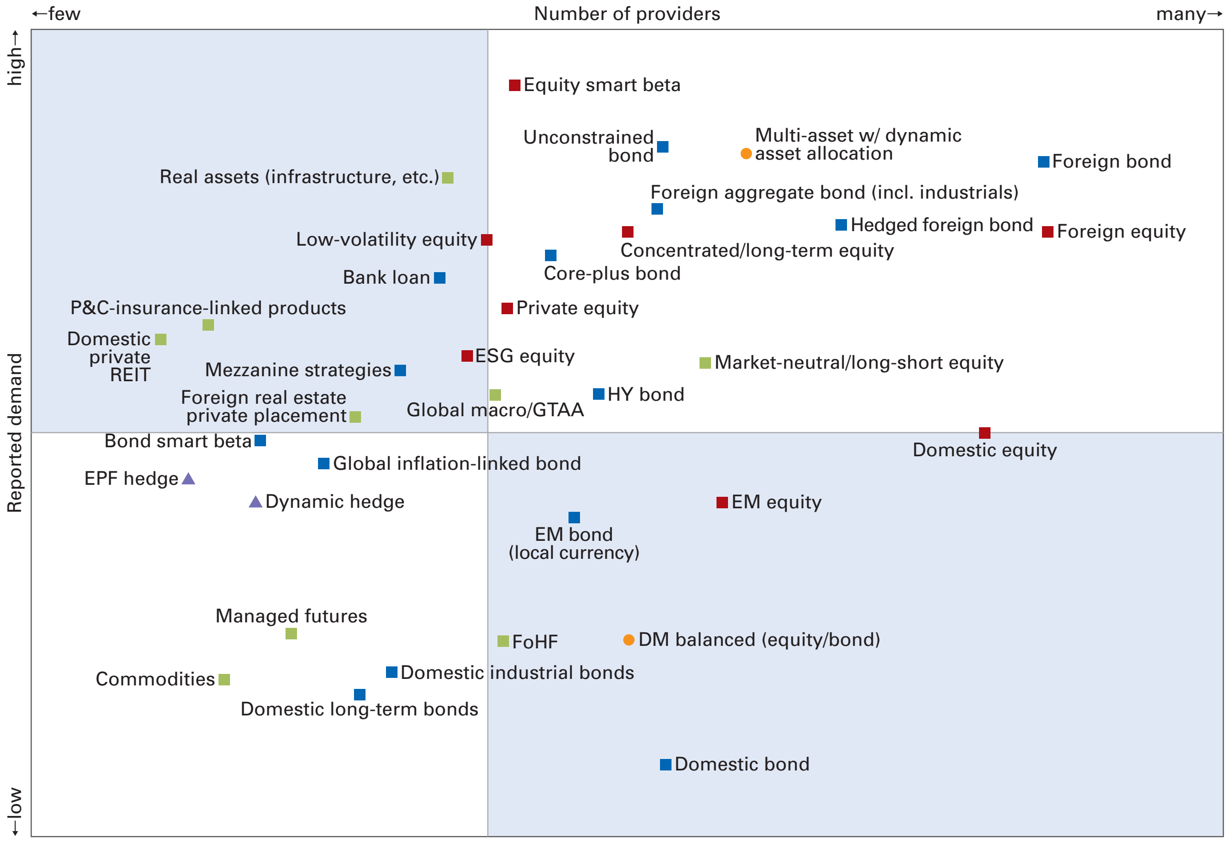
In the retail investor segment, domestic equities remain highly ranked on the demand scale (vertical axis), together with periodic-dividend funds and domestic and foreign REITs. In previous years' surveys, high-yield (HY) bond and bank loan products were also highly ranked in terms of demand, but their demand rankings were lower in the 2015 survey, reflecting that both the high-yield and bank loan markets have softened since mid-2014. Emerging

Exhibit 28. Product supply and demand maps by client segment

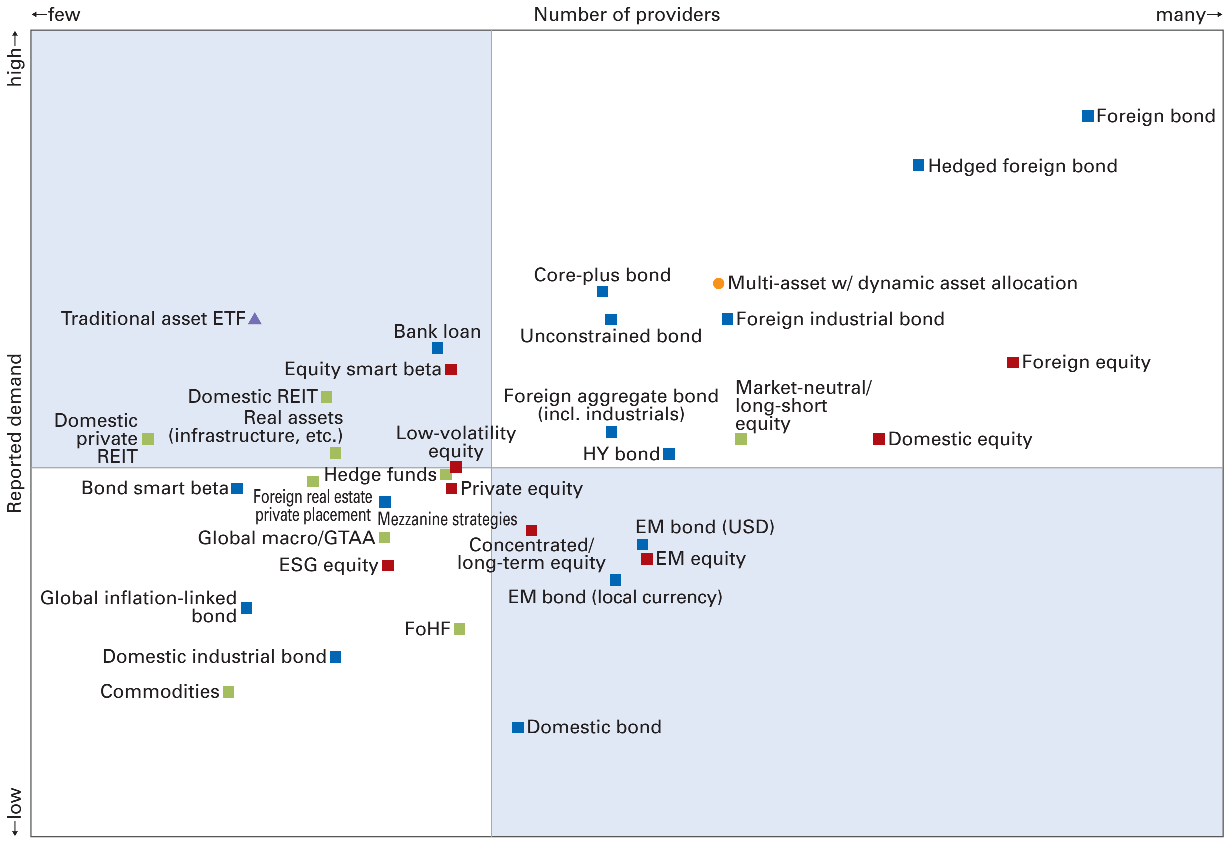
(a) Products for retail investors



(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 AMCs' assessment of demand). The horizontal scale represents the number of AMCs that offer the product (scaled by number of providers not by value).
Source: NRI, based on *Survey of Asset Management Companies' Management Priorities*

market (EM) equity and bond products were likewise ranked lower on the demand scale in 2015 than in previous years. Balanced funds, by contrast, were ranked higher on the demand scale in 2015. These changes in demand rankings imply that although funds' distribution yield remains important, demand for long-term wealth-building products also is gaining recognition.

In the pension fund segment, demand for equity smart beta, unconstrained bond and multi-asset products remains strong. With pension funds de-risking, demand among pension funds for equity products is generally perceived to be weak, but equity products such as smart beta, low-volatility, long-term concentrated investment strategies and private equity are highly ranked on the demand scale. The pension segment is distinguished from the other two segments by stronger demand for foreign equity than domestic equity products.

In the financial institution segment, equity smart beta products were ranked more highly on the demand scale than in previous years, but demand rankings were otherwise largely unchanged. Demand among financial institutions remains focused primarily on foreign bonds, including credit products, which offer attractive yields plus the added benefit of international interest-rate risk diversification. Bond products that aim to deliver alpha derived from AMCs' distinctive skills, such as core-plus bond funds, unconstrained bond funds and multi-asset products that include equity exposure also remained strongly in demand.

The supply landscape was largely unchanged from previously across all three segments, with relatively few products that can be called promising from the standpoint of their outward characteristics. AMCs must clearly differentiate their existing products based on distinctive investment philosophies, processes and product attributes. To do so, they will need strong product planning capabilities that combine ideas from both asset management staff in contact with capital markets and sales staff in contact with clients and fund distributors.

6) JBA data includes overseas branch accounts.
7) The JBA total differs from the sum of the city bank, regional bank, second-tier regional bank and trust bank subtotals because it includes Shinsei Bank and Aozora Bank's securities holdings also.
8) Deposits receivable are deposits held at the BOJ, Japan Post Bank, and other financial institutions in addition to negotiable deposits receivable.
9) Per the BOJ's *Domestic Bank Assets and Liabilities*.
10) "Other securities" are foreign securities and domestic securities other than JGBs, corporate bonds, municipal bonds and equities.
11) Fund holdings reported by banks. Some financial institutions report fund holdings as the funds' underlying assets based on look-through information.
12) According to NRI interview surveys of banks and AMCs.
13) The new standard will (1) tighten look-through requirements, (2) increase the frequency of funds' financial reporting and (3) require look-through information to be verified by an independent third party such as a securities depository, custodian bank, or management company.

CHAPTER 4

In pursuit of further revenue growth

Rethinking Japanese equity investment

Having provided an overview of Japan's asset management business based on statistical and survey data, we conclude with some recommendations for AMCs from the standpoint of management reforms we consider essential to achieving revenue growth over the next five years.

First, in terms of Japanese equity investment, AMCs should develop long-term, valuation-based investment strategies. If Japanese companies are committed to improving their profitability in response to Japan's recently adopted Corporate Governance Code and other such initiatives, Japanese equities could become a core asset class capable of delivering absolute returns to investors. If AMCs can develop investment strategies that deliver high excess returns over benchmark, they could definitely gain favor among investors and benefit from large asset inflows. By developing investment strategies that appeal to retail investors that invest in individual stocks, AMCs could potentially increase Japanese equity investment trust AUM from just ¥10trn at present to over ¥30trn.

Japan-based AMCs must offer superior investment strategies in the Japanese equity asset class to avoid ending up as a mere intermediary between Japanese investors and foreign AMCs to which they outsource management of funds that invest in foreign assets. Until 2012, Japanese equity benchmarks themselves performed poorly for more than a decade. Moreover, many Japanese equity products were largely unappealing to investors, having failed to consistently outperform their benchmarks. Japanese equity products were consequently unable to attract much capital from investors. Japan-based AMCs should commit themselves to the mission of delivering high absolute returns above benchmark to investors by developing the ability to discern companies' true value. To do so, they must clarify their management policies, including development of their portfolio management capabilities.

Toward twofold growth in investment trust AUM

The second challenge is achieving major growth in investment trust AUM. We gauge investment trusts' AUM growth potential from two angles: changes in fund distributors' business models and household financial assets' distribution. Our conclusion, as explained below, is that over the next five years investment trust AUM has the potential to more than double from some ¥100trn at present.

When making investment trust purchases, a very high percentage of Japanese retail investors follow fund distributors' advice instead of independently making their own decisions. Fund distributors' investment trust sales models therefore have a major impact on retail investors' investment trust purchases.

Investment trusts have hitherto been regarded as a vehicle for earning short-term returns. Even today, the best-selling funds are mostly high-risk products that advertise high monthly distributions. However, fund distributors' shift to AUM-based revenue models such as the fund wrap model may transform investment trusts into a long-term wealth-building vehicle. With AUM-based revenue models, fund distributors pursue continuous growth in client AUM as their sales target. Such a target incentivizes fund distributors to recommend diversified portfolios that deliver stable returns and, in turn, should change investment trusts' image into that of a long-term wealth-building vehicle.

Even among experienced investors, investment trusts are strongly perceived as an aggressive asset growth vehicle instead of a vehicle for saving for the future, as is evident from the current rankings of best-selling funds. An NRI survey of individual investors asked respondents to classify their personal financial asset holdings into three categories: money for daily consumption, money set aside for the future and money invested in pursuit of aggressive asset growth. Additionally, the survey respondents were classified into three categories based on their investment experience (experienced, inexperienced but interested, and inexperienced and not interested). We then estimated the amount of financial assets in each of the resultant nine subcategories.

By our estimate, experienced investors have around ¥140trn invested in pursuit of aggressive asset growth and ¥300trn set aside for the future. Currently, retail investors have investment product holdings totaling ¥200trn split roughly evenly between investment trusts and direct ownership of individual stocks. This ¥200trn presumably corresponds to experienced investors' ¥140trn of aggressive growth investments and a portion (¥60trn) of experienced investors' ¥300trn invested for the future.

The important point is that if investment trust holdings were regarded as money set aside for the future, investment trust AUM could approach ¥300trn, the amount of financial assets that experienced investors have set aside for the future. If fund distributors continue to shift toward AUM-based revenue models and start to routinely recommend diversified investment trusts that generate stable returns, investment trusts should gain widespread recognition as a vehicle for saving for the future.

Such business model reforms are already underway at some major brokers and trust banks that offer fund wrap accounts, although such accounts account for only a small share of investment trust AUM so far. A fund wrap is an arrangement whereby a retail investor grants discretionary investment authority to a fund distributor, which constructs a portfolio comprising multiple investment trusts on behalf of the investor. Fund wrap investors are charged fees based on their account balances, not sales commissions. Fund wrap AUM have been growing at a torrid pace, more than tripling to over ¥4trn during the 12 months through April 2015. Additionally, the products offered in fund wrap accounts are not high-risk funds that pay monthly distributions equivalent to a double-digit annualized yield. Most fund wrap offerings are moderate-risk, moderate-return portfolios with a balanced, diversified asset mix that includes passive funds.

By switching to such AUM-based fee structures, fund distributors may gain access to the rest of experienced investors' ¥300trn earmarked for the future. In such an event, investment trust AUM could conceivably grow to over ¥200trn within five years.

If this growth scenario becomes reality, what role would AMCs have to play? Fund distributors would recommend investment products in the aim of achieving stable growth in customer assets, taking into account customers' investment preferences. The typical portfolio would presumably be diversified in terms of both asset classes and investment strategies. Instead of offering trendy products tailored to the contemporaneous investment environment, the fund industry would need to develop diversified and distinctive investment products with long-term staying power and package them as portfolios in the aim of steadily amassing customer assets. With fund distributors responsible for constructing customers' portfolios, AMCs would play the crucially important role of providing superior investment products that constitute the building blocks of those portfolios.

Potential transformation of pension business

A third challenge is expansion of the pension business, which is widely regarded as having little if any growth potential.

Despite ongoing asset outflows to meet benefit outlays, the GPIF's AUM are projected to remain unchanged or even increase by virtue of inflows from re-nationalization of EPF assets in conjunction with EPFs' de facto phase-out.

Having been granted a substantial increase in its staffing budget, the GPIF will presumably upgrade its asset management capabilities. It will generally pay performance-based management fees going forward. Compensation paid to AMCs capable of delivering excess returns will increase accordingly. AMCs stand to benefit from major revenue growth, contingent on their investment returns. At the same time, the GPIF will become increasingly selective in awarding mandates to AMCs that distinguish themselves from rivals. Differentiation of investment strategies from competitors' consequently could be very important. The competitive landscape is likely to change as such differences in AMCs' investment strategies become a key determinant of success or failure in the pension businesses.

Earning excess returns over a model portfolio's rate of return is not easy for any pension fund. If, for example, a pension fund attempts to capture excess returns in every asset class by tilting its portfolio allocations toward a specific style such as value or growth, it could end up underperforming its model portfolio over the long run. It is therefore important to combine, to the extent feasible, multiple investment strategies capable of delivering excess returns. Pension funds may pursue stable, long-term excess returns by better clarifying the roles that they want external managers to individually fulfill.

Companies that sponsor DB pension plans tend to stringently control pension risk under a recently adopted accounting standard that requires postretirement benefit expenses and liabilities to be reported on the face of financial statements without delayed recognition. This tendency will persist, meaning that DB corporate pension funds will likely continue to focus on risk diversification (e.g., broadly diversified investments) in pursuit of maximally stable income returns based on expected returns of 2-3%.

While broader diversification is a common theme for both public and corporate pension funds, the two types of pension funds will have very different needs going forward. For example, public and corporate pension funds will differ in terms of their stance toward equity investment and their asset management staffing levels. Public pension funds are likely to pull far ahead of corporate pension funds in terms of management capabilities also. AMCs will need to deal with the two types of pension funds differently.

Challenging the bank market segment

A fourth challenge is reforming services for banks as investors. As of March 31, 2015, banks (excluding Japan Post Bank) held "other securities," which include fund holdings, of roughly ¥64trn, a total that had grown at compound annual rates of 7% over the preceding 10 years and 14% since the BOJ launched QQE. If banks' "other securities" holdings were to henceforth grow at a CAGR of 10%, roughly the midpoint between 7% and 14%, they would reach the vicinity of ¥100trn in five years. Fund holdings' growth rate is harder to predict, but fund investments' share of banks' "other securities" holdings would likely increase from below 20% at present. Additionally, Japan Post Bank has started recruiting asset management professionals to upgrade its securities investment capabilities after its November IPO. It may substantially increase its fund holdings in pursuit of higher returns. Overall, banks' fund holdings have the potential to increase far beyond their current level.

Banks have a strong tendency to select investment products on an asset-class-by-asset-class basis. In this sense, they differ from pension funds, which generally require product proposals that take into account the totality of their securities portfolios. AMCs should swiftly and straightforwardly tailor their product proposals to financial institutions' distinctive attributes as clients, thereby increasing client satisfaction. Such an approach should help win and retain lucrative asset management mandates. Additionally, from an accounting standpoint, banks tend to seek to increase their annual net business profits by selling appreciated fund holdings to lock in unrealized gains. Banks, unlike pension funds, thus tend to be short-term investors that redeem better-performing funds earlier than underperforming funds.

An alternative point of view is that banks are no longer well served by the status quo in terms of how they manage their securities portfolios. Proponents of this viewpoint argue that instead of investing surplus funds to boost their reported earnings on a year-by-year basis, banks should construct more robust portfolios aimed at capturing longer-term total returns like pension funds do. The Financial Services Agency is currently strongly encouraging banks to take action to improve their earnings. With their loan books barely growing, banks are counting heavily on securities investment as an earnings source. Regional banks, however, lack adequate in-house portfolio management capabilities. They may need support from AMCs with sufficient portfolio management expertise.

In such cases, the AMCs' role would not be limited to fund management. AMCs would be called upon to also provide a wide range of other services, including strategic advice on day-to-day securities investment activities, portfolio risk management, portfolio monitoring and reporting. In some cases, an AMC's role may also include advising bank clients on portfolio construction from an ALM (asset-liability management) standpoint that encompasses the bank's entire balance sheet. Relatively few AMCs are capable of providing such services. Those with the requisite capabilities may be able to build client relationships like the strategic partnerships between certain AMCs and major overseas pension funds or sovereign wealth funds.

Some observers are highly skeptical about how much detailed data, including balance sheet data, banks disclose to AMCs. They are concerned that even if an AMC initially wins a mandate from a bank, the bank will ultimately end up insourcing the mandate and the AMC would lose the business. Whichever viewpoint is correct, both imply that how AMCs deal with banks may change substantially. AMCs need to be aware that the balance of power in the bank market segment could shift dramatically depending on how they respond to banks' changing needs.

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