NRI

Japan's Asset Management Business 2018/2019

Nomura Research Institute, Ltd.

FOREWORD

Japanese asset management industry in the midst of change

Hailed as a growth industry just a few years ago, Japan's asset management industry now seems to be at an impasse. Most notably, the retail investment trust business, contrary to previously optimistic expectations, has stalled and is showing no signs of re-embarking on a growth path. The industry's woes in the retail market segment have been compounded by a recent downshift in banks' demand for private fund products. However, looking beyond quantitative metrics such as AUM and revenue, we are encouraged by recent developments with the potential to drive dramatic growth even in the retail market segment.

Many such developments involve services targeted at working-age investors instead of retirees. The most promising ones include robo-advisory services that enable would-be investors to start investing in diversified portfolios via user-friendly smartphone apps by simply inputting a few parameters such as risk tolerance and investment targets. Other previously unavailable services include investment trusts with low minimum purchase requirements and flexible installment purchase options. With such services, investors can invest as little as a few hundred yen at a time in investment trusts as frequently as daily. Additionally, neophyte investors can get their feet wet by mock-investing their credit card points or online mall reward points to increase their point balances. These mock investment services were developed by relatively recent entrants seeking to offer services their own customers would value. From an economic rationality standpoint, they may not be considered particularly high-value services by many asset management business old-timers, but they have gained nearly 300,000 users in less a year from their launch. Such services are steadily expanding the asset management space.

The influx of new entrants into the retail market segment, including independent financial advisors that primarily serve high-net-worth individuals (HNWIs) and emerging HNWIs, shows no signs of abating. The same can be said of the discretionary investment management business also. There are now nearly 30 more asset management companies that offer discretionary managed account (DMA) services than there were five years ago. DMA services are clearly a highly attractive market that is still developing, not a maturing market. With various tectonic changes happening all at once, it is too early to predict which players will emerge as winners, but the ability to provide customer-centric investment products and services is indisputably the key to market leadership going forward.

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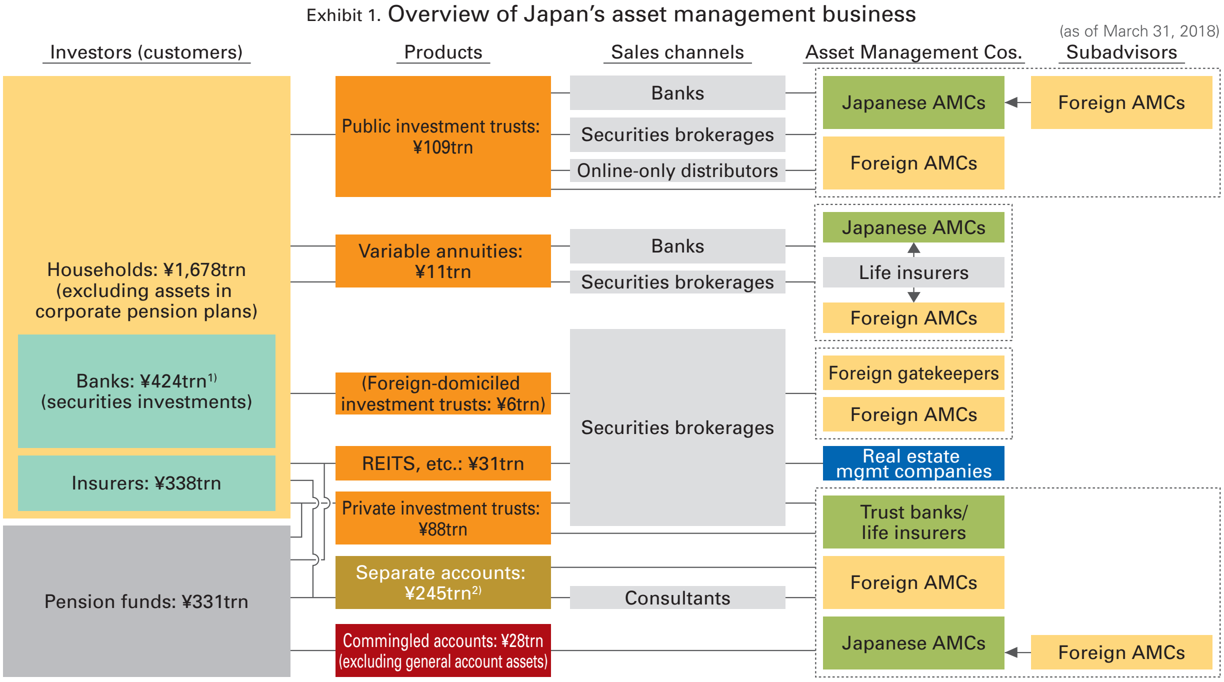
CHAPTER 1

Japanese investor trends

Hazy outlook for asset management industry

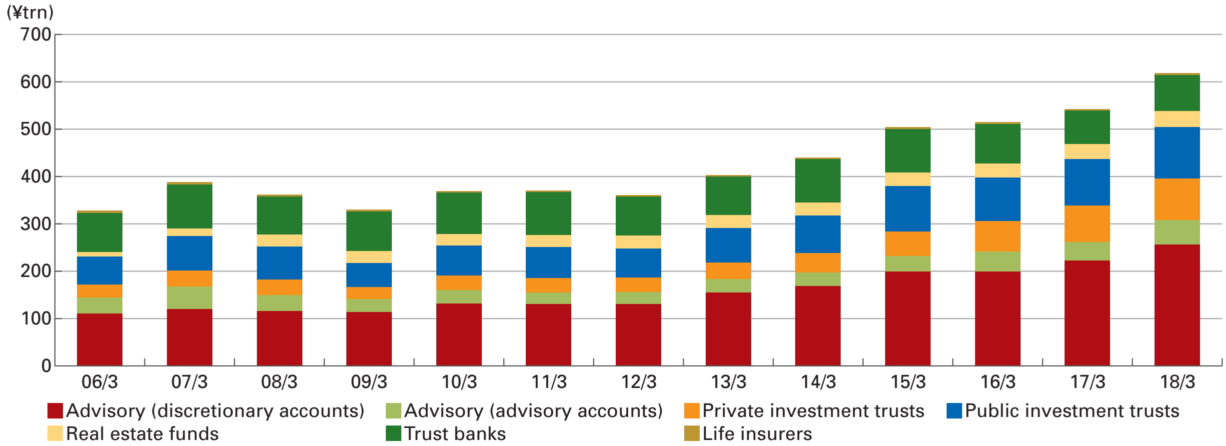
The Japanese asset management industry has grown for six straight years since its last cyclical trough in FY2011. Its growth has been driven primarily by banks' fund investments coupled with the Bank of Japan's ongoing ETF purchases. Recently, however, the asset management industry's growth prospects have been clouded by a major slowdown in growth in banks' investment securities holdings in FY2018 to date. Public investment trust (ex ETF) AUM has been flat since 2015. With fund distributors busy transforming their sales models to comply with the FSA's *Principles for Customer-Oriented Business Conduct*, dividend funds' AUM, which once accounted for 80% of total public investment trust AUM, has plummeted while AUM in investment trusts offered exclusively through advisory channels (e.g., fund wrap accounts) are growing rapidly. Investment trusts offered exclusively through DC retirement plans also continue to grow their AUM. Investment trusts offered exclusively through advisory and DC-plan channels now collectively account for over 20% of total non-ETF equity investment trust AUM. These funds are expected to see continued asset inflows over the medium to long term, though the inflows may wane at times, depending on market conditions.

Exhibit 1. Overview of Japan's asset management business



Note 1: Excludes Norinchukin Bank and Zenkyoren.
Note 2: Per Japan Investment Advisers Association data.
Source: NRI, based on data from various sources

Exhibit 2. AMCs' AUM



Note: Life insurer AUM are DB pension asset mandates.
Source: NRI, based on Investment Trusts Association of Japan and Japan Investment Advisers Association data and AMCs' business reports

Exhibit 1 presents a simplified overview of the Japanese asset management market at March 31, 2018, in terms of products and players, the latter comprising investors, asset managers and distributors. It shows which types of asset managers manage money for which investor classes, how investor assets are allocated and how asset flows are intermediated. Asset management companies (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 at March 31, 2018, totaled an estimated ¥2,009trn, a ¥61trn year-on-year increase mostly attributable to the household sector. Specifically, household financial assets accounted for ¥44trn of the ¥61trn increase while pension assets accounted for ¥16trn.

The ¥2,009trn of total financial assets' professionally managed subtotal was ¥618trn[1)], a ¥75trn increase from a year earlier. However, this increase was largely attributable to asset price appreciation and statistical reclassification of existing assets, mainly in conjunction with AUM transfers to affiliated AMCs within bank and insurance groups. Assets managed on behalf of households and pension funds presumably did not increase much.

Developments among households, pension funds and financial institutions

Household financial assets (excluding corporate pension plan assets) at March 31, 2018, totaled ¥1,678trn, a ¥44trn increase from a year earlier. Their composition has remained largely unchanged, with bank deposits and insurance products accounting for roughly 80% of the total.

Disregarding asset price appreciation and changes in economic conditions, we estimate based solely on Japan's population aging rate that household financial assets will continue growing at a rate of ¥28trn per year over the five years through March 2023. Even with the population aging rapidly, household financial assets continue to grow because Japanese senior citizens are collectively not materially spending down their financial assets. Of the estimated ¥28trn of annual inflows to households' financial asset holdings, we estimate that ¥22trn, nearly 80%, will end up in bank accounts or insurance products. Of the remainder, we project that a bit over ¥4trn per year will flow into equity investment trusts. With diversified investment becoming increasingly common even in the over-55 age group, we expect annual inflows to products such as fund wrap accounts and balanced funds to average ¥6trn. Additionally, we expect working-age households' growing ownership of investment trusts within DC retirement plans and index funds outside of DC plans to drive investment trust inflows averaging ¥1trn per year. Meanwhile, dividend funds continue to experience net asset outflows that we expect to average around ¥3trn per year inclusive of dividend distributions.

Pension funds, Japan's largest institutional investors, collectively held an estimated ¥331trn of assets as of March 31, 2018. Public pension funds accounted for ¥220trn, two-thirds, of this total; corporate and other private pension funds, for ¥110trn. Relative to a year earlier, total pension fund assets increased by ¥16trn, of which public and corporate/other pension funds respectively accounted for ¥13trn and ¥2trn, though the increase was chiefly attributable to asset price appreciation. The Government Pension Investment Fund (GPIF) adopted a new performance-based compensation scheme for external managers from April 2018. The new compensation scheme reduced active managers' base management fee to parity with passive managers' while eliminating a previous cap on performance-based compensation that varies in proportion to excess returns. Active managers of GPIF mandates can look forward to earning high fees if they deliver high returns.

Financial institutions' investment securities holdings at March 31, 2018, totaled around ¥762trn, a ¥4trn increase from a year earlier. Of this total, banks (ex Japan Post Bank) accounted for ¥216trn, *shinkin* banks and credit unions for ¥68trn, Japan Post Bank for ¥139trn, life insurers for ¥314trn (Japan Post Insurance's share of which was ¥60trn) and nonlife insurers for ¥24trn.

Since the Bank of Japan (BOJ) embarked on quantitative and qualitative easing (QQE) in April 2013, financial institutions have been heavily investing in foreign securities and fund products out of a strong need to diversify into higher-yielding assets. However, now that the US Federal Reserve and European Central Bank are withdrawing monetary accommodation, Japanese financial institutions are exercising restraint toward foreign securities investments. Additionally, with the FSA stepping up oversight of regional banks' securities investment programs, the regulatory environment has become less conducive to continued brisk growth in financial institutions' securities holdings. Facing regulatory pressure to strengthen risk management capabilities vis-à-vis securities investment, financial institutions may be more willing than in the past to rely on support from AMCs and/or fund distributors. In other words, consultative relationships with such financial institutions are now more likely to lead to new business opportunities for the asset management industry.

1) With respect to trusts and life insurers, this total includes only assets managed on behalf of pension 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). Additionally, the total is not adjusted to correct any double-counting due to, e.g., private funds' ownership of public investment trusts or investment trusts' partial outsourcing of asset management to subadvisors.

CHAPTER 2

Current state of asset management business

1 Current state of asset management business

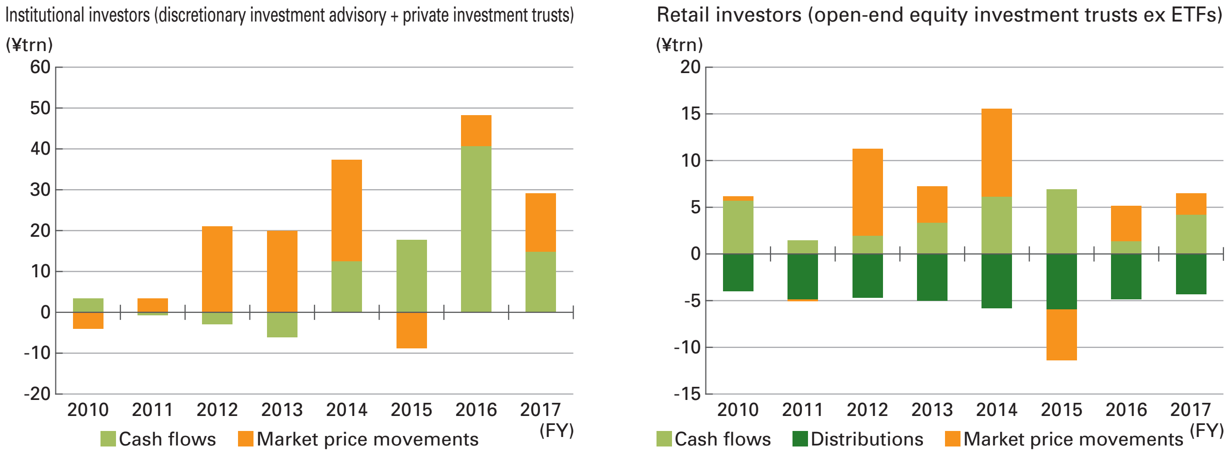
Using various data, including proprietary surveys, this chapter looks at how AMCs, defined as firms specializing in investment trust management and/or investment advisory services, are faring in their businesses.

All-time record revenues and profits in FY2017

Exhibit 3 plots annual changes in AMCs' AUM disaggregated by causative factor. First, in the institutional market segment (leftward graph: total of discretionary investment advisory AUM and private investment trust AUM), asset price appreciation boosted AMCs' AUM in FY2017 by some ¥14trn, nearly double the corresponding FY2016 AUM increase. Like in FY2016, asset price appreciation was predominantly concentrated in the domestic and foreign equity asset classes. Net inflows of new assets boosted AMCs' AUM in FY2017 by about ¥15trn, roughly equivalent to asset price appreciation's contribution to AUM growth. Although the net inflows appear to have decreased sharply relative to FY2016, some ¥27trn of FY2016's ¥41trn of net inflows stemmed from consolidation and functional reorganization of major Japanese financial and insurance groups' affiliated AMCs. Excluding this ¥27trn, asset net-inflows were nearly unchanged year on year in FY2017.

Of the asset management industry's roughly ¥15trn of net inflows in FY2017, ¥11trn flowed into private investment trusts, a product mainly for financial institutions. While the private investment trust business catering to financial institutions has been

Exhibit 3. Changes in AUM broken down by causative factor



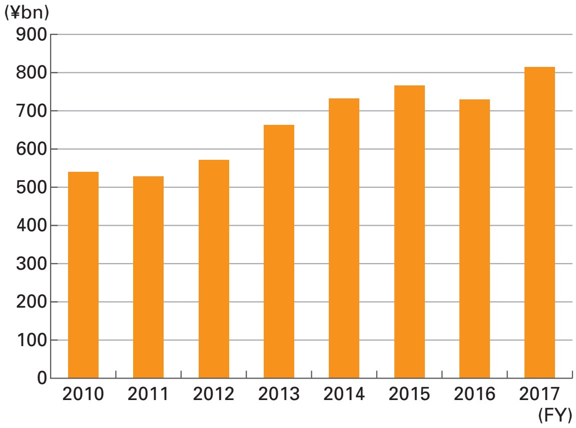
Source: NRI, based largely on Investment Trusts Association of Japan (JITA), Japan Investment Advisers Association (JIAA) and NRI Fundmark data growing rapidly in recent years, its net inflows have slowed from ¥15trn in FY2015 to ¥12trn in FY2016 to ¥11trn in FY2017. In FY2018 through August, private investment trusts have seen their net asset flows shift into reverse in the form of a ¥200bn net outflow. Discretionary investment advisory accounts' FY2017 net inflows totaled around ¥4trn. Excluding AUM transfers in conjunction with Japanese financial and insurance groups' aforementioned consolidation and functional reorganization of affiliated AMCs in FY2016, discretionary investment advisory accounts have not experienced much net asset flows in recent years.

In the retail market segment (rightward graph: open-end public equity investment trust (ex ETF) AUM), asset price appreciation accounted for about ¥2trn of AUM growth in FY2017 on top of some ¥4trn of asset net-inflows. Although net inflows rebounded after dipping sharply in FY2016, they were effectively negated by a roughly ¥4trn outflow in the form of dividend distributions. Retail investment trusts' FY2017 AUM (net asset) growth was thus solely attributable to price appreciation.

Retail investment trusts' aggregate dividend distributions decreased, albeit only slightly, for a second consecutive fiscal year in FY2017 after hitting an all-time peak in FY2015. Their decrease coupled with retail investment trusts' ¥2trn year-on-year increase in AUM at fiscal year-end implies that the retail investment trust market's average distribution yield[2)] decreased in FY2017. The average distribution yield indeed declined to the vicinity of 7% as of FY2017-end, down from around 8% a year earlier and 10% two years earlier.

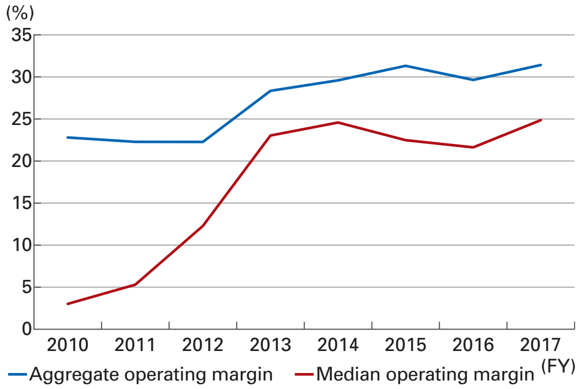
The asset management industry's aggregate management fee revenues grew substantially in FY2017 as shown in Exhibit 4. Based on data available at time of this writing, we estimate FY2017 management fee revenues at ¥810bn, up about 11% year on year to a new all-time record eclipsing the previous one set in FY2015.

Exhibit 4. AMCs' aggregate management fee revenues



Source: NRI, based on JITA and JIAA data

Exhibit 5. 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). Aggregate operating margin is calculated as the aggregate operating profits of the AMCs in the sample divided by their aggregate net operating revenues.
Source: NRI, based on JITA data

Exhibit 5 plots operating margins of domestic AMCs that manage public investment trusts, likewise based on data available at the time of this writing. In aggregate, the AMCs in our survey sample had a FY2017 operating margin of 31%, up about 1ppt year on year to approximate parity with FY2015's all-time record operating margin. Their median operating margin in FY2017 was 25%, up some 3ppt from FY2016 to approximate parity with FY2014's all-time record.

2 Outlook for asset management business

In sum, AMCs' revenues and profit margins resumed rising in FY2017 after dipping in FY2016 following four consecutive years of solid improvement through FY2015. The upturn in revenues and profitability was attributable to market performance and asset inflows to private investment trusts.

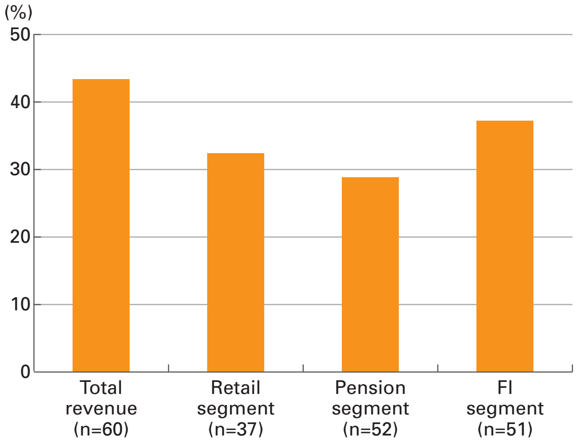
In FY2018, major equity markets are mostly up about 5% year on year on a YTD-average basis. If these valuation gains persist, FY2018 will likely be a second straight year of revenue and profit growth for AMCs. On the downside, private investment trusts' asset net-inflows, which contributed positively to FY2017 revenue growth, have turned negative in FY2018 through August as noted above. This reversal tempers an otherwise bullish revenue growth outlook.

At NRI, we annually survey AMCs' management (*NRI Survey of Asset Management Companies' Management Priorities*[3)]) to ascertain the asset management industry's consensus outlook and latest business conditions. The remainder of this chapter looks at how AMCs perceive their near-term business environment and what they are doing in response, as revealed by survey responses.

Outlook has turned downbeat despite still optimistic growth expectations

First, in terms of AMCs' overall revenue outlook, Exhibit 6 plots the percentages of survey respondents forecasting cumulative revenue growth (due to asset net-inflows, excluding revenue growth driven by AUM growth due to asset price appreciation) of at least 50% over the next five years on a company-wide basis and by business line (investor segment). Some 40% of the respondents expect their total revenues to grow at least 50% over the next five years. The investor segment in which the most respondents are forecasting five-year revenue growth of at least 50% is the financial institution segment, followed in descending order by the retail and pension segments.

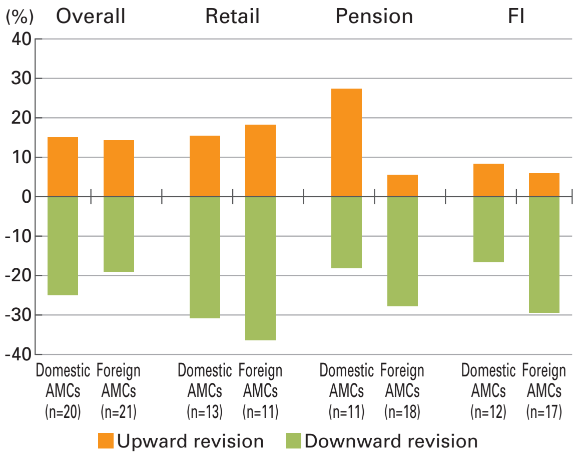
Exhibit 6. Percentage of survey respondents forecasting revenue growth of at least 50% over next five years



Note: FI: financial institution
Source: NRI *Survey of Asset Management Companies' Management Priorities*

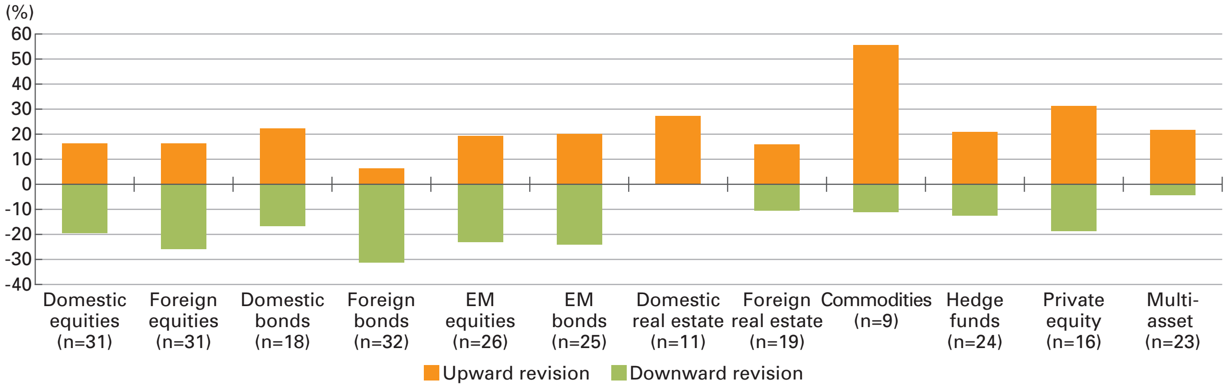
Exhibit 7 compares revenue forecasts between our latest and previous surveys by plotting percentages of upwardly and downwardly revised revenue forecasts among respondents that participated in both years' surveys. Some 40% of the domestic-AMC respondents and 30% of the foreign-AMC respondents left their company-wide revenue

Exhibit 7. Percentage of survey respondents that revised their revenue growth forecasts in 2018 relative to 2017 (overall and by business segment)



Note: Data samples are limited to AMCs that participated in survey in both 2017 and 2018. FI: financial institution segment.
Source: NRI *Survey of Asset Management Companies' Management Priorities*

Exhibit 8. Percentage of survey respondents that revised their asset in/outflow forecasts in 2018 relative to 2017 (by asset class)



Note: Data samples are limited to AMCs that participated in survey in both 2017 and 2018.
Source: NRI *Survey of Asset Management Companies' Management Priorities*

forecasts unchanged from the previous year. Of the company-wide revenue forecast revisions, downward revisions outnumbered upward revisions in both the domestic and foreign subsamples. Among foreign respondents, downward revisions outnumbered upward revisions across all three investor segments. Among domestic respondents, downward revisions outnumbering upward revisions in two of the three segments with the pension segment being the exception. In the retail segment, the bearish turn in sentiment is presumably mostly attributable to recently sluggish AUM growth and management-fee compression due to passive investing's growing popularity.

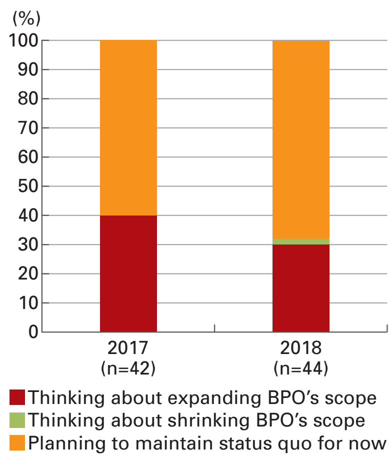
Exhibit 8 plots, by asset class, the percentages of survey respondents that revised their asset inflow forecasts upward or downward relative to their previous-year forecasts. The forecast revisions have a mild downward skew in traditional asset classes and an upward skew in alternative asset classes and the multi-asset class. Among asset classes in which downward revisions outnumbered upward revisions, foreign bonds had the strongest preponderance of downside revisions over upside revisions, presumably reflecting foreign bonds' poor investment returns in the wake of rising US rates. Meanwhile, the preponderance of upward over downward revisions in the alternative and multi-asset classes presumably reflects those asset classes' relatively high returns in a globally low interest rate environment and growing demand for such assets from institutional investors looking to benefit from portfolio diversification[4)].

3 Use of outsourcing among AMCs

Portfolio management outsourcing has continued to grow even amid BPO slowdown

Our latest survey included questions on current outsourcing usage and future outsourcing plans.

Exhibit 9. AMCs' future BPO plans

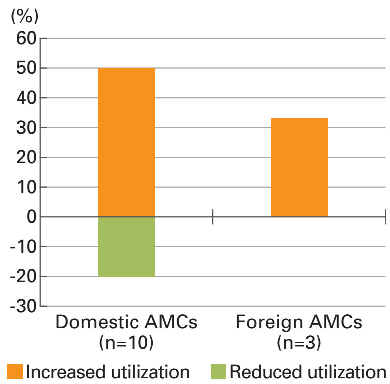


Source: NRI *Survey of Asset Management Companies' Management Priorities*

First, about 70% of the survey respondents currently use BPO (business process outsourcing) and an additional 20% are considering doing so, both roughly unchanged from our year-earlier survey. BPO use is already widespread. In response to a question about future BPO plans, some 30% of existing BPO users indicated that they are considering further expanding their BPO use. This percentage was down about 10ppt from the year-earlier survey, implying that growth in BPO use is slowing. In Japan, BPO in the asset management industry is often confined to back-office functions only. Companies may be increasingly reaching the conclusion that they have already outsourced everything they can or want to outsource.

Our survey also inquired about outsourcing of portfolio management (use of subadvisors). To highlight the change in survey responses from the previous year, Exhibit 10 plots the percentages of 2017-18 survey respondents that reported a change in their portfolio management outsourcing status in the 2018 survey. About 50% of domestic-AMC respondents and 30% of foreign-AMC respondents reported increased use of portfolio management outsourcing in 2018 relative to 2017. AMCs are outsourcing portfolio management to subadvisors in response to investors' increasingly diverse product needs.

Exhibit 10. Change in subadvisor utilization between 2017 and 2018



Note: Data samples are limited to AMCs that participated in survey in both 2017 and 2018.
Source: NRI *Survey of Asset Management Companies' Management Priorities*

AMCs that lack in-house portfolio management expertise in a given product could not be competitive in that product vertical without making a major investment of time and money. Performing in-house portfolio management for all products is not a realistic option. Portfolio management outsourcing is an effective means of meeting investors' product needs. With the Japanese investor population expected to keep becoming more diverse in terms of risk profiles and product needs as a new class of wealth-building retail investors emerges in addition to institutional investors and retirees, portfolio management outsourcing should continue to grow in prevalence.

Cost-cutting and identification of core competencies are crucial

The asset management industry is expected to experience continued management-fee compression due to the ongoing shift in demand toward passively managed funds, mainly in the public investment trust market. Given such an outlook, cost-cutting will likely become a more important priority for AMCs. Another priority in such an environment is formulating and executing growth strategies that clearly identify where your firm's competitive strengths lie in terms of core competencies.

Effective ways of reducing costs include utilizing new technologies (see Chapter 4 for more on new technologies) and improving operating efficiency through BPO in areas that are not core competencies. In Japan, AMCs have been progressively outsourcing back-office functions. Overseas AMCs, by contrast, have already heavily outsourced not only back-office but also middle-office functions and some are now even outsourcing front-office functions such as trading. Even in Japan, further expansion of BPO's scope could be an effective way to reduce costs.

Once an AMC has sufficiently improved its operating efficiency by utilizing BPO and new technologies, the remaining functions that constitute its core competencies may include portfolio management, sales, marketing and planning. In the portfolio management space, it is important for AMCs to strategically distinguish between products to be managed in-house as their own specialties and products to be managed by external subadvisors.

Because portfolio management outsourcing involves management-fee outflows, expansion of the internally managed product line (expanding/upgrading in-house portfolio management capabilities) could also be an effective cost-reduction strategy. On the other hand, with the passively managed share of AMCs' AUM expected to increase further, another potentially effective strategy is to gain a competitive advantage not through in-house portfolio management but by developing a high degree of skill in selecting and offering top-notch externally managed products and focusing on sales, marketing and planning.

In either case, AMCs need to re-clarify their long-term core competencies in light of their own strengths and investor needs and to reallocate existing human resources to those areas.

2) Calculated as trailing-12-month distributions divided by net assets.
3) NRI has conducted this survey annually since FY2007, most recently in September 2018. The 2018 survey's sample of valid responses encompassed 60 AMCs (32 Japanese, 28 foreign) that collectively account for 76% of the Japanese asset management industry's total AUM.
4) See the third chapter's fourth section for information on absolute demand levels on a product-by-product basis.

CHAPTER 3

Market trends and product strategies by client segment

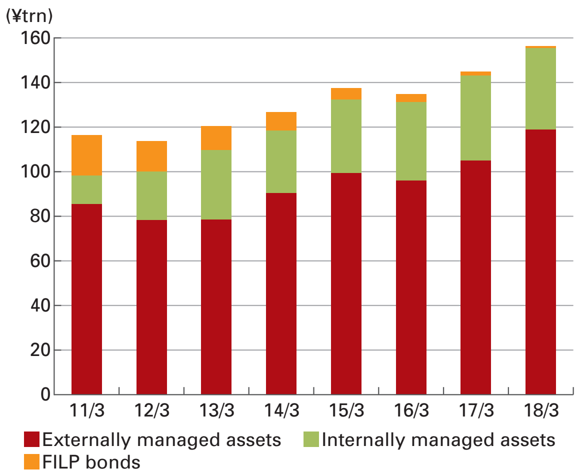
1 Pension business

Pension assets top ¥330trn

Japanese pension assets at March 31, 2018, totaled an estimated ¥331trn, up ¥16trn year on year to surpass their previous peak of three years earlier. Of this total, public pension schemes (National Pension, Employees' Pension Insurance and Mutual Aid Associations) accounted for two-thirds or ¥220trn, up ¥13trn year on year, while corporate pension plans and other pension schemes (National Pension Funds and the Small-scale Enterprise Mutual Aid System) accounted for ¥110trn, a ¥2trn increase from a year earlier.

The GPIF's AUM at March 31, 2018, totaled roughly ¥156trn, an ¥11trn increase from a year earlier (Exhibit 11). Except for ¥1trn of FILP (Fiscal Investment and Loan Program) bond holdings, virtually 100% of the GPIF's AUM are market-invested. In FY2017, the GPIF's rate of return on its market-invested assets was positive for a second straight year at +6.99%. Of the GPIF's market-invested AUM, ¥119trn was externally managed at March 31, 2018. While the externally managed share of the GPIF's AUM increased roughly ¥14trn from a year earlier, GPIF assets managed in-house decreased for the first time in four years, dropping to 24% (¥37trn) of total market-invested AUM from 27% a year earlier. Management fees paid to external managers by the GPIF in FY2017 increased some 20% year on year to ¥48.7bn, largely as a result of growth in foreign asset holdings and diversification of investment strategies. The GPIF's average management fee rate (calculated as a percentage of average total AUM during the fiscal year) likewise increased, rising above 3bps.

Exhibit 11. GPIF's AUM

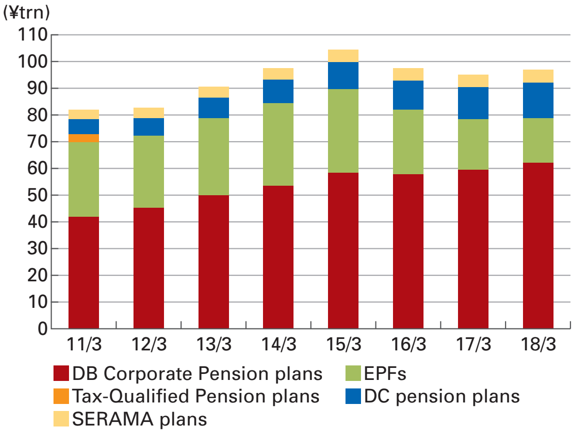


Source: NRI, based on GPIF annual reports

Mutual Aid Associations manage pension reserves earmarked for benefits payable to their respective constituencies, including civil servants and private school employees. Their pension reserves increased ¥3trn year on year to ¥56trn at March 31, 2018. Reserves for Employees' Pension Insurance benefits accounted for ¥31trn, more than half of the ¥56trn.

Corporate pension assets at March 31, 2018, totaled roughly ¥97trn, a ¥2trn year-on-year increase (Exhibit 12). Defined benefit (DB) pension plans' share of this total was roughly unchanged from a year earlier at ¥79trn. Employees' Pension Funds (EPFs) have been dissolving and/or transferring the substitutional

Exhibit 12. Corporate pension assets



Note: DC pension plan assets include iDeCo assets. SERAMA: Smaller Enterprise Retirement Allowance Mutual Aid
Source: NRI, based on data from the Trust Companies Association of Japan, Federation of Pension Plan Administrators and Organization for Workers' Retirement Allowance Mutual Aid

portion of their assets to to the government ahead of a March 31, 2019, deadline for compliance with more stringent actuarial and management standards. In FY2017, 41 EPFs were dissolved and 33 ceded the substitutional portion of their assets to the government, leaving 36 still in existence at fiscal year-end. The surviving EPFs ended FY2017 with 570,000 participants and assets of ¥17trn, a ¥2trn decrease from a year earlier. Of this ¥17trn, ¥12trn is held by the Pension Fund Association (PFA). Only eight EPFs are planning to stay in existence beyond March 31, 2019, meaning that the vast majority of remaining EPF assets will end up under the PFA's management.

Among DB Corporate Pension plans (non-EPF DB plans), contractual DB Corporate Pension plans continue to decrease in number but 43 fund-type plans were newly established in FY2017, increasing the number of fund-type plans to 748 and total DB Corporate Pension plan participants to over 9mn. DB Corporate Pension plan assets increased by ¥3trn in FY2017 to ¥62trn at March 31, 2018, offsetting the decrease in EPF assets. However, with EPF dissolutions and reversions of EPF assets to the state having already peaked, conversions of existing pension plans into DB Corporate Pension plans are set to slow to a trickle. We see little prospect of much growth in DB Corporate Pension assets going forward.

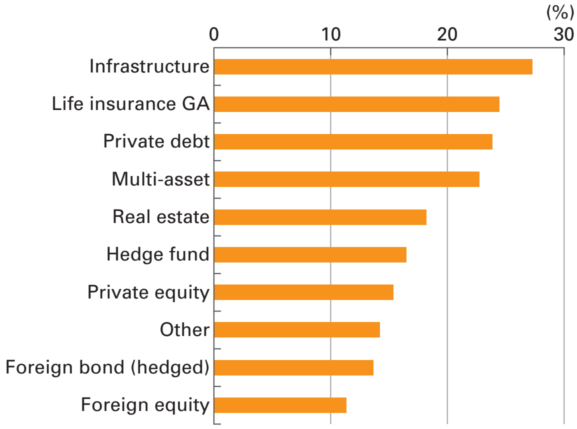
Defined contribution (DC) pension plans are steadily growing in AUM terms. Corporate DC pension plans collectively ended FY2017 with 6.48mn participants and assets of ¥11.7trn, up ¥1.1trn from a year earlier. Individual DC (iDeCo) retirement plan enrollment doubled in FY2017 to 850,000 participants at March 31, 2018, and had surpassed 1mn as of five months later. Additionally, a new DC retirement plan program was launched in May 2018 for small businesses with up to 100 employees but no corporate pension plan, not even a DC plan. Nicknamed iDeCo+ (iDeCo Plus) by the Ministry of Health, Labor and Welfare, the program is aimed at broadening retirement plan coverage among SMEs and micro-enterprises that might otherwise be unable to sponsor a retirement benefit plan. iDeCo+ allows eligible employers to contribute to their employees' iDeCo accounts on top of the employees' own contributions. As long as the combined contributions do not exceed the annual iDeCo contribution limit, there are no restrictions on the contribution split between employer and employee (the employer can even contribute more than the employee). iDeCo assets currently total ¥1.6trn. They should grow in tandem with iDeCo enrollment, partly by virtue of initiatives such as iDeCo+ to promote saving for retirement.

Pension asset management update

Next, we look at recent developments in the pension asset management space. First, a recent survey[5)] found that the most common challenges facing managers of DB Corporate Pension assets include (1) negative interest rates, (2) rising currency hedging costs, (3) portfolio-wide risk control and (4) generation of stable returns and sufficient investment income. In short, locking in income streams in a negative-interest-rate environment is a major concern at present.

Exhibit 13 plots DB Corporate Pension fund

Exhibit 13. Asset classes in which pension funds want to invest more

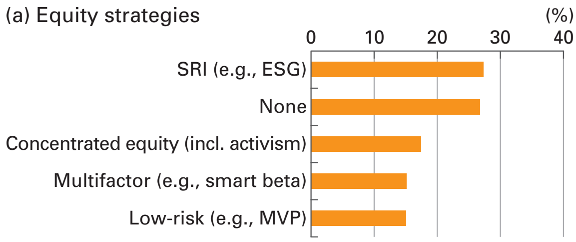


Note: GA: general account
Source: Nomura Securities Fiduciary Services Research Center survey of mainly DB pension funds (August 2018)

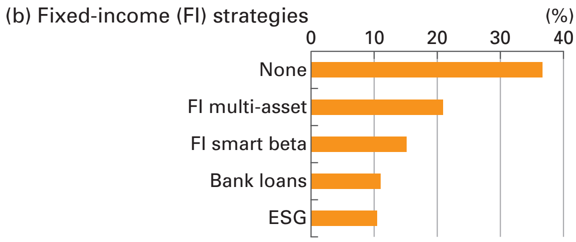
managers' responses to a survey question on asset classes to which the managers intend to increase their portfolio allocations. The top-ranked responses included infrastructure assets, general-account life insurance products and private debt, all of which are seen as promising income-generating assets. The percentage of respondents whose responses included private debt in particular increased substantially from the previous year's survey. Exhibit 14 summarizes survey responses regarding equity and fixed income products that respondents are interested in or want to add to their portfolios. On the equity side, the

Exhibit 14. Strategies pension funds are interested in or want to adopt

(a) Equity strategies



(b) Fixed-income (FI) strategies



Source: Nomura Securities Fiduciary Services Research Center survey of mainly DB pension funds (August 2018)

top-ranked responses until last year were low-risk strategies. This year, ESG (environmental, social and governance) investing and concentrated equity investing, including activist strategies, were more popular than low-risk strategies. Among fixed-income strategies, multi-asset products (unconstrained bond strategies) were highly popular for a second straight year, though the most common response was "none [of the choices]." The respondents' interest in fixed-income strategies is directed toward illiquid bond proxies with higher expected yields, such as infrastructure and private debt.

ESG investing has recently been garnering growing interest from both public and corporate pension funds as a topical asset management theme. The GPIF has been stepping up its commitment to ESG investment since becoming a Principles for Responsible Investing signatory in September 2015. In July 2017, it began passively investing in three ESG indices in the domestic equity asset class. In September 2018, the GPIF expanded its ESG allocation internationally by investing in a global environmentally friendly equity index. Other ESG initiatives in which the GPIF is involved include research collaborations on ESG investing in the fixed-income asset class and publication of ESG activity reports.

In the corporate pension space, the Ministry of Health, Labor and Welfare revised its guidelines on the roles and responsibilities of parties involved in management of DB corporate pension plan assets in April 2018. Its revised guidelines newly include provisions on stewardship responsibilities and ESG-related matters. In June 2018, Japan's Corporate Governance Code (CGC) was revised. The revisions included addition of a new principle on corporate pension funds' roles as asset owners. To comply with the updated CGC, corporate pension funds are fast becoming more interested in stewardship activities and ESG investing. The CGC revisions presumably largely account for ESG investing's inclusion among the products that DB corporate pension fund managers are most interested in adding to both equity and fixed-income portfolios.

Another notable event is the GPIF's adoption of a new performance-based compensation scheme for external managers from April 2018. The new compensation scheme reduced active managers' base management fee to parity with passive managers' while eliminating a previous cap on performance-based compensation that varies in proportion to excess returns. The GPIF adopted the new compensation scheme in response to its investee funds' widespread underperformance of excess return targets. By linking compensation more tightly to investment performance, the GPIF is seeking to incentivize its active managers to set excess return targets and upgrade their portfolio management processes, including capacity management. AMCs' responses to the GPIF's new compensation scheme and the resultant impact on investment returns bear watching going forward.

2 Securities investment by banks

Banks plagued by dearth of attractive investment opportunities

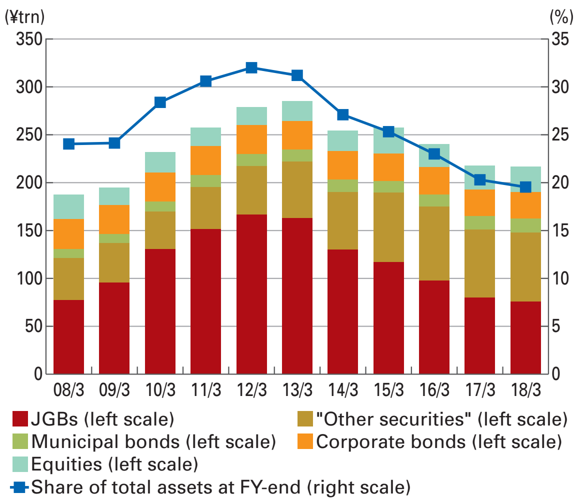
According to Japan Bankers Association (JBA) data, Japanese banks' investment securities holdings at March 31, 2018, totaled ¥216trn[6], nearly unchanged from a year earlier. While banks' investment securities holdings have decreased substantially since the BOJ launched QQE in April 2013, their year-on-year decrease tapered off to a mere ¥1trn in FY2017. Investment securities' share of banks' total assets at March 31, 2018, was 20%, likewise roughly unchanged year on year. Meanwhile, banks' deposits receivable from the BOJ et al. continued to grow sharply for a second straight year, up ¥26trn year on year to ¥228trn at March 31, 2018. City banks ended FY2017 with deposits receivable of ¥155trn (up ¥17trn year on year); regional banks with ¥36trn (up ¥5trn); second-tier regional banks with ¥6trn (up ¥700bn); and trust banks with ¥29trn (up ¥3trn). Such across-the-board growth in deposits receivable implies that banks are having difficulty finding enough sufficiently attractive investment opportunities.

City banks increased their investment securities holdings in FY2017 while regional and second-tier regional banks both reduced theirs for a second consecutive year and trust banks stood pat. City banks collectively ended FY2017 with investment securities holdings of ¥107bn (up ¥4trn), regional banks with ¥71trn (down ¥5trn), second-tier regional banks with ¥15trn (down ¥1trn) and trust banks with a materially unchanged ¥21trn[7].

Investment behavior diverged among different types of banks

In terms of the composition of banks' aggregate investment securities holdings (Exhibit 15), JGB holdings continued to decrease in FY2017 in both absolute and percentage terms, down ¥4trn to ¥76trn or 35% of total investment securities holdings at March 31, 2018. Banks' equity holdings, by contrast, increased the most of any category of securities, up ¥1.5trn year on year to ¥26trn. Behind equities, the

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



Source: NRI, based on JBA's *Financial Statements of All Banks* second-biggest increase was in municipal bonds, banks' holdings of which grew about ¥1trn to ¥15trn. In addition to local financial institutions, city banks also remained aggressive buyers of municipal bond offerings for a second consecutive year in FY2017. Banks' corporate bond and "other securities[8]" holdings ended FY2017 roughly unchanged from a year earlier at ¥28trn and ¥72trn, respectively.

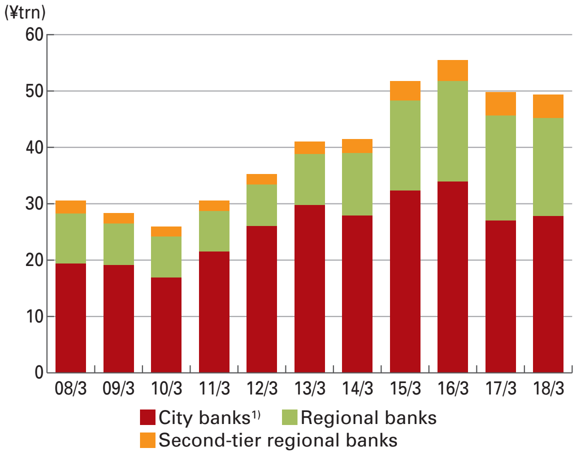
The breakdown of banks' aggregate investment securities holdings by type of bank reveals that investment behavior differed among the types of banks in FY2017. One difference was that city banks increased their JGB holdings while regional, second-tier regional and trust banks all reduced theirs. City banks ended FY2017 with JGB holdings of ¥46trn (up ¥2trn year on year), regional banks with ¥21trn (down ¥6trn), second-tier regional banks with ¥4trn (down ¥1trn) and trust banks with ¥41trn (down ¥1trn). A second difference was that regional banks reduced their "other securities" holdings by ¥1.3trn to ¥18trn while city banks and trust banks increased theirs by ¥700bn and ¥1trn to ¥36trn and ¥16trn, respectively. Second-tier regional banks' "other securities" holdings remained unchanged year on year at ¥4trn.

Non-foreign "other securities" holdings continue to grow

After the BOJ launched QQE, banks spent three straight years diversifying into assets offering higher yields than JGBs do, namely "other securities" (e.g., foreign securities, funds). According to the BOJ's *Domestic Bank Assets and Liabilities*, banks' "other securities" holdings (excluding securities held in foreign branch accounts) at March 31, 2018, were nearly unchanged (up ¥1trn) year on year at ¥62trn after having decreased in the previous fiscal year (Exhibit 16). While their total remained largely unchanged in FY2017, "other securities" investment behavior diverged among the different types of banks.

Among banks' "other securities" holdings, non-foreign securities (e.g., fund[9], hedge fund, structured bond) holdings grew for a seventh straight year in FY2017 to end the fiscal year at ¥17trn, up ¥2.5trn from a year earlier. Investment in non-foreign "other securities" has become an important tool for banks to diversify their securities portfolios and enhance their earnings. Banks' foreign securities holdings decreased in FY2017 for a second consecutive year, down ¥2trn year on year to ¥45trn at March 31, 2018. The decrease was largely due to banks clearing their books of unrealized losses on US Treasuries (UST). Japanese banks had become aggressive UST buyers to diversify their securities portfolios after the BOJ launched QQE.

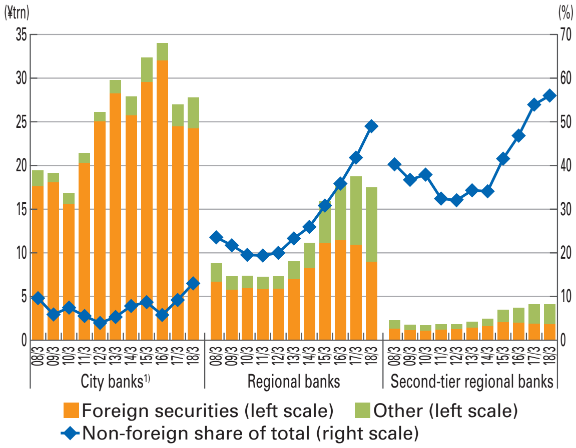
Exhibit 16. "Other securities" holdings by bank type (excluding overseas branch accounts)



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

Among the various types of banks, city banks and regional banks increased their non-foreign "other securities" holdings in FY2017 by roughly ¥1trn and ¥1.3trn to ¥3.6trn and ¥8.5trn, respectively, at March 31, 2018. Regional banks reduced their foreign securities holdings over the same timeframe by a hefty ¥2trn to ¥9trn to cut losses on UST holdings as mentioned above. The non-foreign share of regional banks' "other securities" holdings consequently rose to around 50% at March 31, 2018 (Exhibit 17). Second-tier regional banks' holdings of both foreign securities and non-foreign "other securities" ended FY2017 unchanged from a year earlier at ¥1.8trn and

Exhibit 17. "Other securities" holdings by bank type and by foreign vs. non-foreign



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

¥2.3trn, respectively.

Banks' securities investment activity in first half of FY2018

According to the BOJ's *Domestic Bank Assets and Liabilities*, banks continued to scale down their securities holdings in the first half of FY2018 also. Aggregate securities holdings at July 31, 2018, totaled ¥193trn, a ¥15trn decrease from four months earlier as a net result of a reduction in JGB holdings coupled with continued growth in "other securities" holdings. Foreign securities and non-foreign "other securities" holdings increased by ¥1trm apiece over the four months through July 31, the former to ¥46trn and the latter to ¥19trn.

City banks and second-tier regional banks have turned cautious toward foreign securities. Despite foreign securities' aforementioned importance as a portfolio diversifier, Japanese banks are concerned about how to control unrealized losses amid ongoing monetary policy normalization in the US and Europe. City banks increased their non-foreign "other securities" holdings by ¥500bn to ¥4trn in the first four months of FY2018. Regional banks increased their foreign securities and non-foreign "other securities" holdings by ¥100bn apiece over the same timeframe, implying a divergence in investment strategies among individual regional banks.

With new regulations on interest rate risk in banking books scheduled to be imposed on domestically regulated banks from March 31, 2019, most regional banks will presumably continue to tread cautiously vis-à-vis interest rate risk throughout FY2018.

Regional banks' securities investment programs under regulatory scrutiny

In July 2018, the FSA released an interim report on its monitoring of regional banks' securities investment programs[10]. The report raised red flags about regional banks' securities investments. Specifically, the FSA reported that regional banks appear to be assuming increasingly complex combinations of risks, including not only interest rate risk but also credit and liquidity risk, in their securities investment programs in the aim of earning a certain level of profits. The report expressed concerns about regional banks taking securities investment risks that exceed their management capabilities not only quantitatively but also in terms of qualitative factors such as their securities holdings' growing diversity and complexity.

The FSA asserts that regional banks must implement three safeguards to remain financially sound and preserve systemic stability. The first safeguard is to keep their risk-taking within the bounds of their risk-bearing capacity and risk-management capabilities. It includes building business models that are not overly dependent on securities investment. To stabilize earnings from securities investment programs, it is important for regional banks to confine their risk-taking to predetermined types of risk exposures kept within risk limits and unrealized-loss tolerances set by their Boards of Directors based on their own risk-bearing capacity and risk-management capabilities.

The second safeguard is to build portfolio management and risk management programs tailored to actual risk exposures, including recruiting and training of qualified personnel. The FSA considers this safeguard to be a key duty of regional banks' top management. Most importantly, the FSA wants regional banks to build stop-loss mechanisms as a precaution against unforeseen market volatility. Additionally, the FSA's interim report contains what could be interpreted as a requirement to strengthen portfolio-wide risk quantification capabilities. It also discusses building forex risk management capabilities. Upgrading foreign currency liquidity risk management is an urgent priority for major internationally active financial institutions.

The third safeguard is risk governance of securities investment programs by top management. The interim report recommended that regional banks utilize a risk appetite framework (RAF) to enhance such governance's effectiveness. The FSA defines an RAF as a management framework that uses risk appetite[11] as a common language for internally discussing risk-taking policies in their entirety, including capital allocation and profit maximization[12]. In a securities investment context, risk appetite means how much of which types of risk an investor is willing to assume–in other words, how much money may be invested in which investment products–in pursuit of investment returns. RAFs aim to stabilize profits by clarifying risk appetite, ensuring that all concerned parties are cognizant of risk appetite, and monitoring, assessing and controlling day-to-day business operations relative to risk appetite without assuming ill-advised risks in pursuit of near-term profits or neglecting emergent downside risks to profits.

Within overseas financial institutions, which are ahead of their Japanese counterparts in terms of implementing RAFs, risk appetite is recognized as a pan-organizationally uniform risk assessment standard and a means of transparent decision-making. Setting a risk appetite for securities investment is the first step toward effective risk governance.

AMCs need to get better at consultative sales

With banks investing more actively in fund products in response to the BOJ's QQE, AMCs and fund distributors have been putting more effort into consultative sales targeted at financial institutions. Our previous surveys have found that, like many pension funds, regional financial institutions, virtually all of which have a smaller securities portfolio management staff than major banks do, are heavily counting on AMCs and fund distributors' investment and administrative expertise. Such regional financial institutions' needs have in turn shaped AMCs and fund distributors' strategies.

Nonetheless, AMCs and fund distributors are clearly not consulting adequately with regional banks, as evidenced by anecdotes contained in the FSA's aforementioned interim report to illustrate regional banks' governance and risk assessment/management deficiencies. For example, one regional bank with a minuscule portfolio management staff has invested in hundreds of foreign bonds, investment trusts and structured bonds, including products with complex risk profiles, without ascertaining the risk attributes of the assets it owns. Moreover, it has paid hundreds of millions of yen in trust fees and commissions to fund distributors. Another regional bank has been internally approving investment trust purchases using proposals prepared by fund distributors without even checking or analyzing the investment trusts' monthly investment performance. A third regional bank has invested in investment trusts recommended by fund distributors without evaluating the investment trusts' investment performance or fees in comparison to other similar investment trusts.

A consultative sales approach requires an AMC or fund distributor to offer proposals that are tailored to the client financial institution's circumstances and meet its needs. It is important to formulate such proposals from the standpoint of the client's overall portfolio, not from the standpoint of a single product, after ascertaining what the client already owns. Additionally, after selling products to a financial institution, an AMC or fund distributor must provide product-specific support. By providing ongoing expert input from a portfolio-wide perspective instead of simply forwarding prospectuses and/or look-through information, AMC/fund distributors would not only be a source of valuable information for client banks' investment decision-making processes, they should also reap new business opportunities from stronger client relationships.

3 Retail business

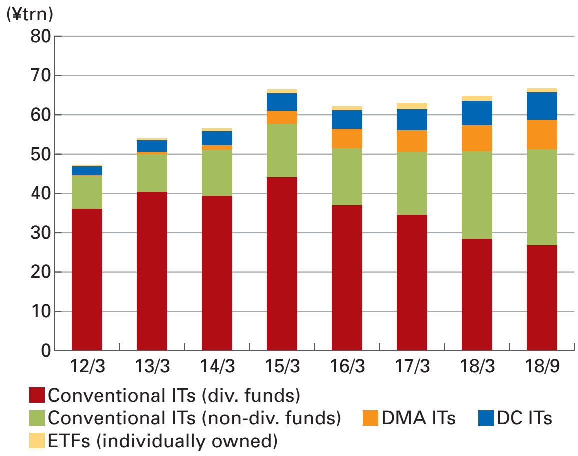
Dividend funds' popularity is waning

Public open-end equity investment trusts (abbreviated below as "equity investment trusts") have collectively been growing nearly monotonically in AUM terms for the past several years, according to Investment Trusts Association of Japan (JITA) statistics. As September 30, 2018, equity investment trust AUM stood at an all-time record of ¥103.1trn, a twofold increase from ¥50.2trn as of March 31, 2012. AUM growth over the six and a half years through September 2018 was driven mainly by ETFs. One difference between ETFs and conventional (i.e., non-ETF) equity investment trusts is their ownership composition. Whereas conventional equity investment trusts are putatively almost entirely owned by individual investors, ETFs are mostly owned by institutional investors and central banks. Individuals own about 3% of ETFs per the most recent data, down from around 10% previously. In light of such, Exhibit 18 plots equity investment trust AUM owned by individuals. It presents a completely different picture than the aforementioned growth reported by JITA statistics. After growing from FY2011 through FY2014, individually owned equity investment trust AUM leveled off for a while before finally recovering to parity with its previous peak in September 2018.

The bars plotted in Exhibit 18 present individually owned equity investment trust AUM broken down by retail distribution channel. The channels include ETFs purchased through the equity market, DC investment trusts offered through DC retirement plans, wrap-account investment trusts offered exclusively through discretionary investment advisors and conventional investment trusts. Additionally, conventional investment trusts are further broken down into dividend funds (those that distribute dividends at least quarterly) and non-dividend funds.

What stands out most in Exhibit 18 is that the breakdown of AUM by product has changed substantially while total equity investment trust AUM have remained largely unchanged. Specifically, dividend fund AUM are down sharply from ¥44.2trn at March 31, 2015, to ¥26.8bn at September 30, 2018. Dividend funds' share of total equity investment trust AUM has recently fallen to 40% from a peak of nearly 80%. One factor behind its decline is that the population aged 60 to 75, the main age group that buys dividend funds, peaked in 2015 and has since embarked on a mild downtrend. Another factor is that fund distributors have started to pivot away from

Exhibit 18. Open-end equity investment trust AUM (individually owned share) by fund type



Note: ETF data were adjusted to reflect the individually owned share of ETF AUM. The other types of investment trusts are assumed to be 100% individually owned. DMA ITs: investment trusts distributed exclusively in the discretionary managed account channel. DC ITs: investment trusts distributed exclusively in the DC plan channel.
Source: NRI, based largely on Investment Trusts Association of Japan and Japan Securities Depository Center data

promoting high distribution yields as their funds' sole selling point.

Non-dividend funds have been growing their AUM to offset the steep decline in dividend fund AUM. Between March 31, 2015, and September 30, 2018, their AUM increased by ¥11trn, ¥8trn of which was attributable to asset net-inflows. Seventy percent of these asset inflows went into foreign equity funds, mainly ones related to digital technologies such as AI, big data and vehicular automation. While such inflows to thematic funds are an episodically recurring phenomenon, not a rarity, in the Japanese investment trust market, other less conspicuous but domestically unprecedented trends have been emerging recently.

Diversified investment steadily gaining prevalence

One trend that has started to become evident in various investment trust distribution channels in recent years is geographic and/or cross-asset diversification of investment trusts' investment universes. Balanced funds, for example, are experiencing heavy asset inflows, mainly via the bank sales channel. They saw a similar influx of assets in the mid-2000s but their popularity back then was driven by a dividend fund diversification trend. Today, by contrast, retail investors are shifting their focus from pursuit of high distribution yields to pursuit of relatively stable, all-weather investment returns. As evidence of such a shift in focus, balanced non-dividend funds' asset net-inflows since April 2015 have totaled ¥1.7trn versus only ¥300bn for balanced dividend funds. Even among balanced non-dividend funds, those with sub-median target equity allocations have attracted the lion's share of asset net-inflows since April 2015. Balanced funds have generally performed well since April 2015, largely by virtue of a favorable market environment, particularly in equity markets both in Japan and globally. The possibility of such inflows grinding to a halt once performance deteriorates cannot be ruled out, but individual investors are at least gaining more understanding of diversified investment.

Additionally, investment services offered based on consistent medium/long-term investment rules are also steadily growing in prevalence. These discretionary managed account (DMA, a.k.a. fund wrap) services offer portfolio-wide asset diversification by combining multiple single-asset-class funds into portfolios that meet customers' respective needs. Investment trusts designed exclusively for the DMA channel have seen their AUM grow from ¥3.4trn to ¥7.5trn over the three and a half years through September 2018. DMA services have historically been available in Japan mainly from major securities brokerages, but other players, including online brokers and major banks, have started to enter the DMA channel over the past two years or so. Even regional banks have recently started launching DMA services in collaboration with investment advisory firms specializing in fund wrap accounts. Given their medium/long-term commitment to compliance with consistent investment rules, DMA services should continue to enjoy stable growth as an investment trust distribution channel.

Another channel through which investment trusts are offered as diversified investment vehicles is DC retirement plans. AUM in investment trusts offered exclusively through DC plans have grown 60%, from ¥4.5trn to ¥7.0trn, over the three and a half years through September 2018. DC plans have promising long-term growth prospects as an investment trust distribution channel for several reasons. First, DC plans have steady inflows of investable funds in the form of monthly contributions. Second, the number of DC plan participants is virtually certain to grow. Third, the government apparently plans to continue rolling out reforms to make DC plans even more user-friendly. Fourth, investor education for participants is seen as an important aspect of DC plans. DC plans should prove to be a highly effective vehicle for imparting diversified investment experience to the working-age population.

Of investment trusts owned as diversified investment vehicles, just the types discussed above have already amassed AUM of ¥21.6trn, roughly one-third of total individually owned investment trust AUM.

Shift toward passive management is afoot

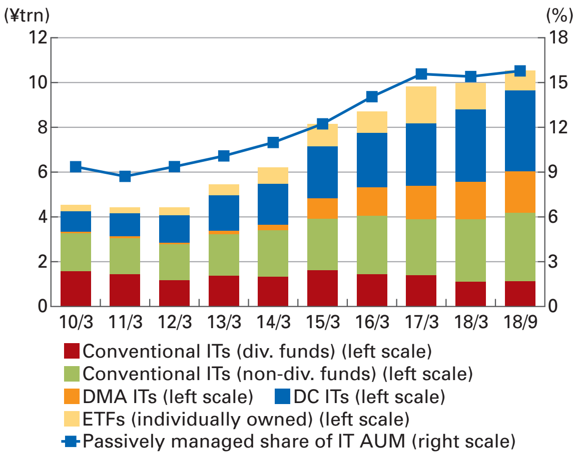
As diversified investment continues to become more popular, the passively managed share of investment trust AUM is expected to grow. As noted by Brinson et al. in their seminal *Determinants of Portfolio Performance* paper, investment performance is 90% determined by asset allocation. In other words, selection of a best-in-class fund within a single asset class would influence only 10% of overall portfolio performance. Accordingly, if interest in cross-asset diversification grows, retail investors may increasingly prefer passively managed investment trusts over actively managed ones.

Passively managed investment trust AUM have indeed been growing in recent years. Between March 2011 and September 2018, individually owned passive investment trust AUM grew from a mere ¥4.4trn to ¥10.5trn or from 8.7% to 15.8% of total individually owned open-end equity investment trust AUMs (Exhibit 19). With individual investors expected to increasingly adopt a diversified investment mindset, this growth trend will likely continue. The trend toward passive management seen overseas and in Japanese pension fund investment appears to now be spreading to Japanese investment trusts also.

Growth in passively managed share of AUM will compress margins

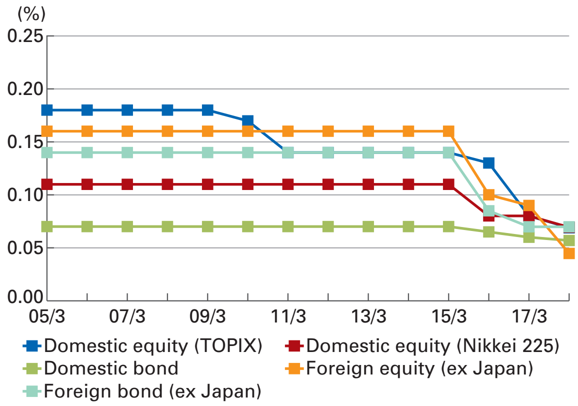
Index funds' management fee rates (AMCs' share of trust fee rates), the biggest cost factor for passively managed investment trust investors, have fallen substantially over the past few years. Exhibit 20 plots the lowest management fee rates for five categories of index funds. It shows that the lowest fee rates have come down sharply since 2015. Their declines are due to not only the emergence of new lower-fee investment trusts but also reductions in incumbent investment trusts' management fees in response to the new entrants' cut-rate pricing. The lowest index fund management fees are currently in the vicinity of or even below 10bps across all major asset classes. Investment trusts that charge the lowest or near-lowest management fees are available only from online brokers or as special offerings of

Exhibit 19. Passively managed investment trust AUM (individually owned share)



Note: Passively managed investment trusts include balanced investment trusts comprising multiple passively managed funds. DMA ITs: investment trusts distributed exclusively in the discretionary managed account channel. DC ITs: investment trusts distributed exclusively in the DC plan channel.
Source: NRI, based largely on Investment Trusts Association of Japan and Japan Securities Depository Center data

Exhibit 20. Lowest-fee public index funds' management fee rates



Note: "Management fee" means the investment trust sponsor's share of investment trust fees. Survey sample excluded investment trusts offered exclusively through the DMA or DC plan channel.
Source: NRI

fund distributors with face-to-face sales channels. Though not available to all customers of every fund distributor, they are definitely having an industry-wide impact. Weighted-average annualized fee rates that represent effective management fee rates charged on total investment trust AUM have now fallen to the 16-25bps range for index funds in major asset classes.

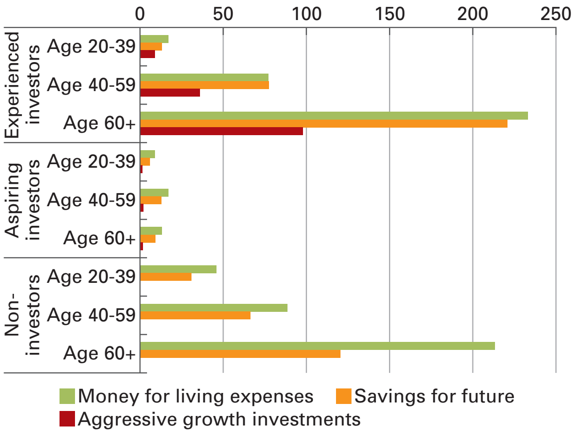
Actively managed investment trusts, by contrast, have a wider variety of categories (e.g., quant, judgmental) and, unlike index funds, lack uniformity, making them difficult to compare. Though consequently unable to granularly analyze actively managed investment trusts' fees, we can at least say that their management fee rates have not declined like passively managed funds'. Whether actively managed investment trusts' management fee rates will decline going forward remains to be seen. However, irrespective of actively managed investment trusts' management fees' future direction, the passively managed share of Japan's retail investment trust market will surely increase and, as it does, the overall average fee rate should progressively decline.

Investment trust market's growth potential

If the image of investment trusts as a stable investment vehicle takes root as retail investors increasingly become aware of diversified investment, the investment trust market could grow substantially.

As we noted in last year's edition of this publication, investment trusts have historically been regarded as a short-term trading vehicle. Even among experienced investors, investment trusts have a strong image as a speculative product, not a means of saving for the future. In a 2015 NRI survey, we asked individuals to classify their financial asset holdings into three buckets: money for near-term living expenses, savings for the future and aggressive growth investments. We then classified the respondents into three experience-based categories–experienced investors, aspiring investors and non-investors with no interest in

Exhibit 21. Distribution of household financial assets (excluding pension plans and life insurance)



Source: Estimates based on 2015 NRI survey of individuals' investment activity and BOJ *Flow of Funds* data

investing–and into three age brackets within each category. Lastly, we estimated the breakdown of assets in each bucket by experience-based category and, within each category, by age bracket (Exhibit 21).

We found that experienced investors across all age brackets had twice as much savings for the future as aggressive growth investments, the latter of which accounted for only 20% of their financial assets. In aggregate, the experienced investors had an estimated ¥310trn of savings for the future versus about ¥140trn of aggressive growth investments. The 60-and-older age group alone holds over ¥200trn of savings for the future. Meanwhile, individuals own some ¥180trn of equity and investment trust holdings. These holdings presumably consist predominantly of the experienced investors' aggressive growth investments with only ¥40trn of their savings for the future thrown in.

If investment trusts come to be seen as an investment vehicle that delivers stable returns over the long term, they should gain widespread recognition as a product in which to invest money saved for the future. If so, experienced investors, particularly those in the 40-59 and 60-and-older age brackets, would likely shift more of their ¥310trn of savings for the future into investment trusts. Additionally, as investment trusts shed their existing image as a high-risk product, some aspiring investors and non-investors may successively start investing in investment trusts to build wealth. In such an event, a portion of these two groups' ¥240trn of savings for the future would also likely flow into the investment trust market.

More business opportunities for investment trust sponsors

Apart from a small minority of experienced investors who possess sufficient financial knowledge and investment experience, ordinary retail investors require appropriate advice when they start investing and periodically thereafter to realize stable medium- to long-term returns. Most do not have clear investment objectives to which they are personally committed, except perhaps short-term ones. Even if retail investors did set long-term investment objectives, many are prone to abandon their chosen investment strategy in response to short-term market volatility.

Meanwhile, fund distributors face an imperative to migrate to business models that generate revenue from appropriate and timely advice provided to customers. As a cross-asset diversification mindset becomes more common and the passively managed share of investment trust AUM increases, fund distributors are expected to experience steeper earnings declines than investment trust sponsors. If customers own suitable balanced funds, rebalancing would take place within the funds, reducing the frequency of their investment trust trades. The trend toward passively managed investment trusts is therefore expected to reduce not only account servicing fees, which are fund distributors' share of trust fees, but also sales commissions. In light of retail investors' latent needs, fund distributors will have to migrate to advisory business models sooner or later. Many financial institutions are already aware of this reality, but concerns about near-term profits have deterred all but a few from actually switching to an advisory model. Recently, however, banks' investment trust businesses are starting to be seen in a new light throughout banks' organizations, not just in their investment trust sales departments. For example, some banks are discussing campaigns to encourage depositors to shift money from their bank accounts into investment trusts out of a need for banks to better adapt to their operating environment. Presented with a golden opportunity to revamp their investment trust business models, banks now have more incentive than ever to proactively make the switch to an advisory model.

If fund distributors place more priority on advising customers, the resultant change in their sales personnel's role would mean that the nature of the sales support that investment trust sponsors have been intensively providing to regional financial institutions and other sales channels would likely also have to change. Specifically, sales personnel would turn their attention to conferring with customers to agree on suitable investment rules and monitoring customers' portfolios in accord with those investment rules instead of focusing predominantly on assessments of the market environment or the attributes of individual products from which customers' portfolios are constructed. Other forms of sales support likely to be in demand include training in how to construct portfolios in accord with agreed-upon investment rules.

If fund distributors provide not only advice but also services such as fund wrap accounts to help their customers realize stable returns, investment trust sponsors' role may expand further. Fund wrap providers require portfolio management expertise to appropriately re-position customers' portfolios in a timely manner, but regional and other smaller financial institutions lack sufficient resources to acquire all such requisite expertise on their own. They need to partner with AMCs. Investment trust sponsors could conceivably fulfill the investment advisory function for fund wrap providers. While a number of investment trust sponsors already offer low-fee index funds that are integral to fund wrap services, they could also help fund distributors launch fund wrap services by fulfilling a range of other functions, from proposal of portfolios tailored to customers' investment objectives to fund management. Some regional financial institutions have already partnered with specialized fund wrap providers. In many cases, these providers are robo-advisory platforms that tend to be targeted at mass-market demographics. Services targeted at upper-middle-class and/or high-net-worth customers are still fairly rare. Fund wrap services catering to the affluent will likely become much more common going forward.

As the shift from active to passive management continues to progress, AMCs will find it increasingly difficult to differentiate themselves with portfolio management acumen in individual asset classes. They thus have an incentive to expand their asset management services to include, for example, formulation and implementation of personalized investment rules for customers. Business opportunities are expanding even for AMCs.

4 Product market trends by investor segment

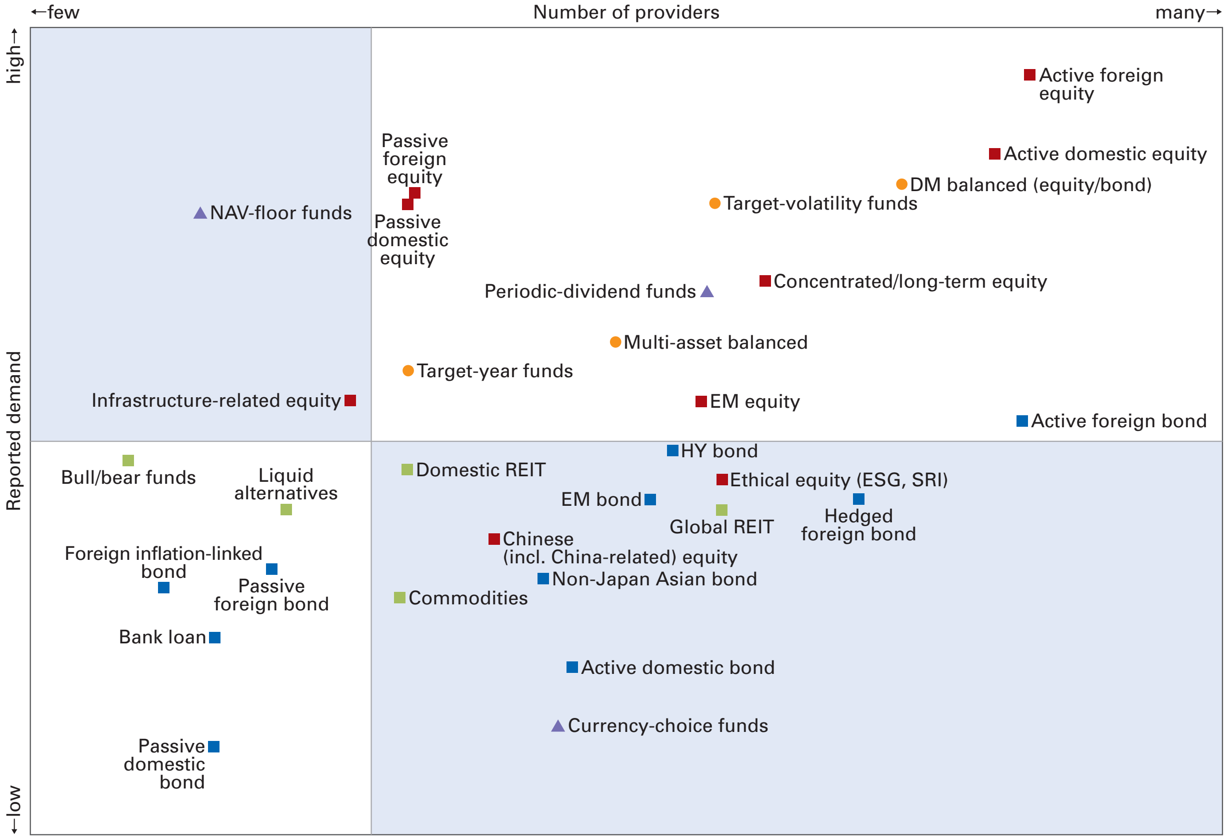
We have created product opportunity maps for three investor segments (retail, pension funds, and financial institutions) based on data from our *Survey of Asset Management Companies' Management Priorities*. These maps plot the strength of investor demand for various products (as assessed by AMCs) against 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 competitively disadvantaged products (poorly demanded products offered by many providers (lower right quadrant)). Exhibit 22 presents our product opportunity maps for a subset of products.

First, in the retail investor segment, the top-ranked product on the demand scale is actively managed foreign equity funds for a second consecutive year. Of actively managed foreign equity funds newly launched in FY2017, the most popular are mainly thematic funds related to technologies such as AI, IoT, FinTech, robotics, vehicular automation and EVs. The second highest ranked product on the demand scale is actively managed domestic equity funds, which climbed in the rankings relative to last year. Other products highly ranked on the demand scale both this year and last year include target-volatility funds, broadly defined balanced funds including funds with a redemption floor (i.e., guaranteed minimum NAV at redemption), and passively managed equity funds, both domestic and foreign. Foreign bond funds, by contrast, were generally ranked lower on the demand scale this year than last year, much lower in the case of hedged foreign bond and high-yield bond funds in particular. Foreign bond funds' lower rankings were presumably mainly attributable to poor investment performance in the wake of rising US interest rates. After sinking in the rankings for several consecutive years through last year, periodic-dividend funds maintained a ranking on a par with last year. They are still in relatively high demand.

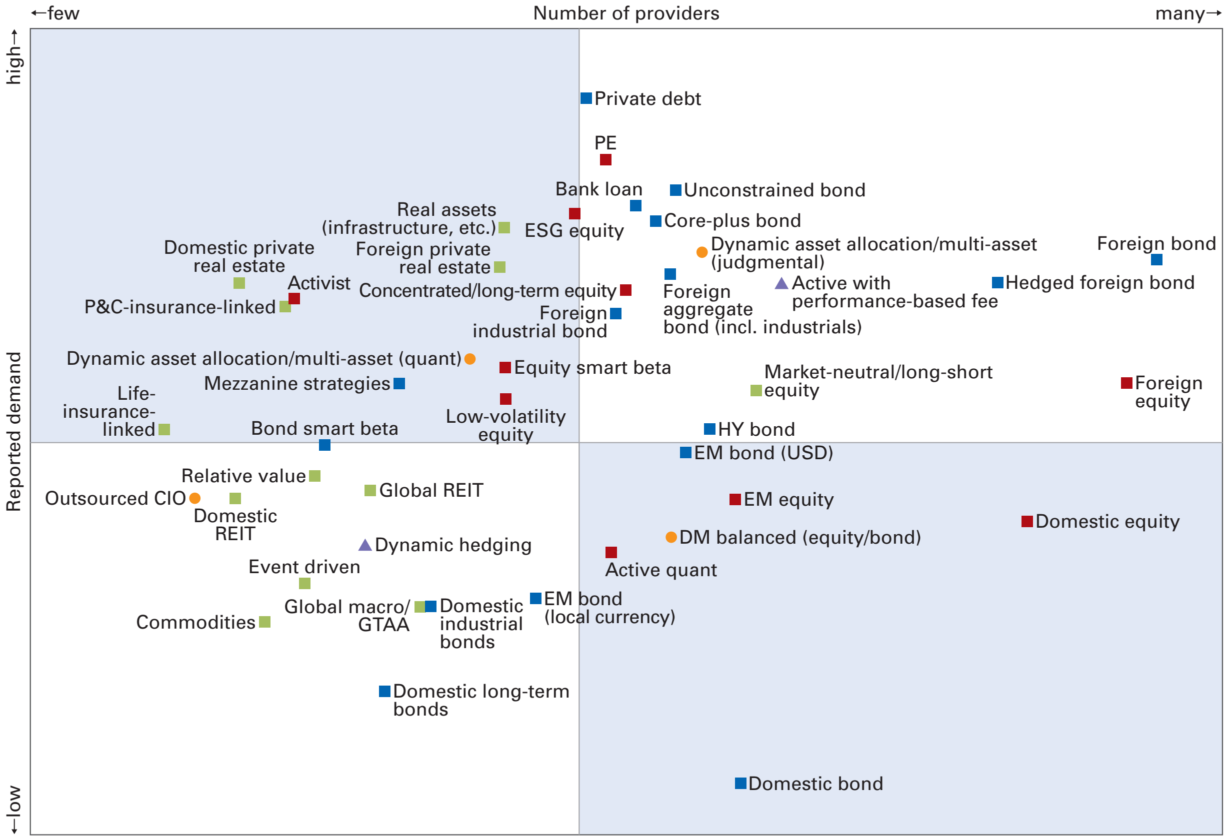
In the pension segment, like in the retail segment, foreign bond funds dropped in the demand-scale rankings in response to poor investment returns. The top-ranked products were private debt and private equity, presumably reflecting their relatively high expected returns and portfolio diversification benefits. Domestic and foreign private real estate (including REITs) and multi-asset strategies maintained high demand-scale ratings roughly unchanged from last year. Demand for ESG investment products was stronger in the pension segment than in the financial institution segment again this year, perhaps as a result of the GPIF's influence. Additionally, actively managed funds with performance-based management fees (a new product added from this year in response to the GPIF's newly adopted performance-based compensation scheme) also were relatively highly

Exhibit 22. Product supply and demand maps by client segment

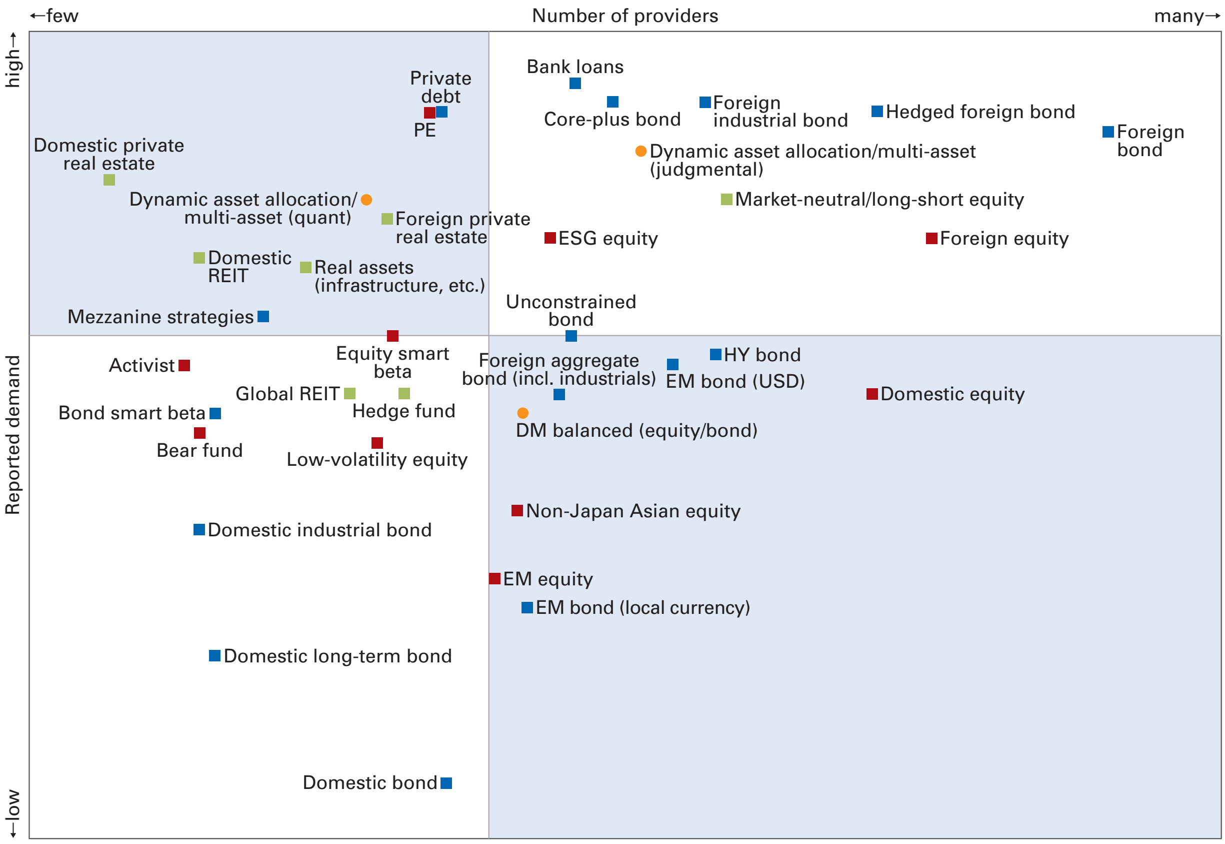
(a) Products for retail investors



(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*

ranked on the demand scale.

In the financial institution segment, foreign bond funds, last year's highest-ranked product on the demand scale, dropped to a lower ranking on a par with bank loans, private debt, private equity and multi-asset strategies this year. Their loss of favor was presumably partly attributable to the FSA's warning about risk exposure to foreign bonds in addition to foreign bonds' recent subpar returns. That said, with financial institutions still in yield-seeking mode, foreign bond products maintained relatively high rankings on the demand scale.

With growth in retail demand for long-term investment products and progressive diversification of institutional portfolios likely to continue, it is important for AMCs to pursue differentiation by formulating product strategies based on their respective competitive strengths.

5) November 2018 survey of mainly DB Corporate Pension funds conducted by Nomura Securities' Fiduciary Services Research Center. The survey had 202 respondents.
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) "Other securities" are foreign securities and domestic securities other than JGBs, corporate bonds, municipal bonds and equities.
9) Fund holdings reported by banks. Some financial institutions report fund holdings as the funds' underlying assets based on look-through information.
10) The report summarizes the results of FSA monitoring since FY2016 of 27 banks, mostly regional banks, and four bank holding companies suspected of taking too much risk in their securities investment programs relative to their risk-bearing capacity and risk-management capabilities.
11) Defined as the types of risk and total amount of risk that a bank or other company is well-advised to assume to achieve its business plan in light of its business model's distinctive characteristics (from FSA's July 2018, interim report on its monitoring of regional banks' securities investment programs).
12) From FSA's July 2018 interim report on its monitoring of regional banks' securities investment programs.

CHAPTER 4

Asset management industry's changing business environment

1 Digitalization in the asset management industry

Advancements in digital technology are expected to transform business models across various industries, including Japan's asset management industry. Digitalization initiatives may prove to be major determinants of AMCs' future growth and competitive standing.

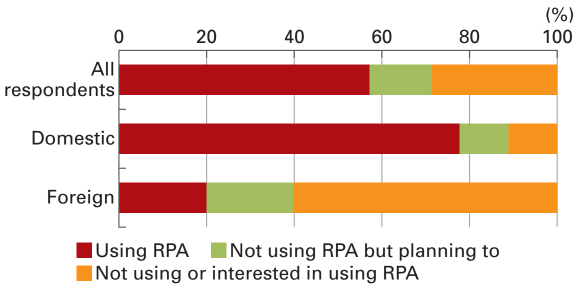
Current state of digitalization

Our most recent *Survey of Asset Management Companies' Management Priorities* inquired about how AMCs are currently utilizing digital technologies, particularly AI and robotic process automation (RPA), and challenges they have encountered in doing so. The following discussion of the survey's findings pertains to AMCs with at least ¥5trn of AUM as of March 31, 2018, on the assumption that larger companies are more likely to be relatively early adopters of technology.

Some 60% of AMCs are using RPA

Exhibit 23 shows the state of RPA usage at AMCs. RPA is mainly used to improve operating efficiency and, in turn, reduce costs. Some 60% of all the AMCs in our survey sample are already using RPA. Japanese respondents are ahead of foreign respondents in terms of RPA adoption, with about 80% of the former using RPA versus only 20% of the latter.

Exhibit 23. RPA utilization status



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

Exhibit 24 list a number of challenges that the respondents have encountered in using RPA. The most common challenge, cited by around 60% of the respondents, was maintenance, administrative and/or operational issues. Many companies were apparently able to successfully set up RPA workflows at first but have since been having difficulty dealing with various issues that have arisen in RPA's day-to-

Exhibit 24. RPA utilization challenges

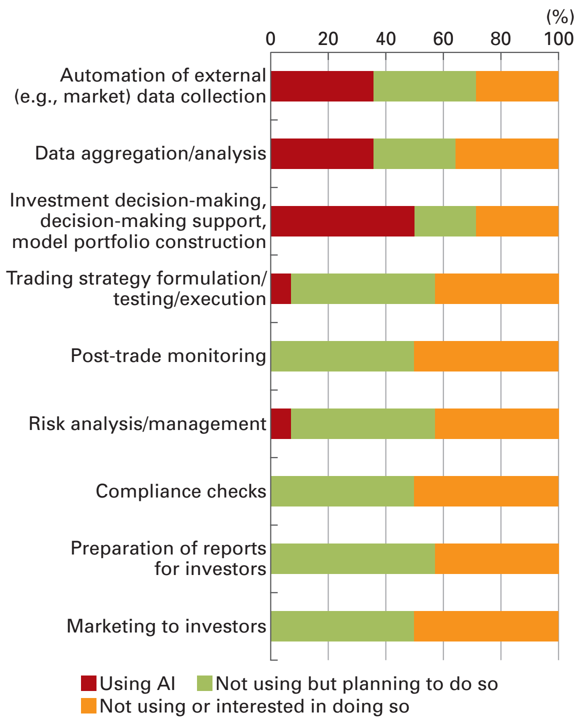
Note: Respondents were permitted to select up to three responses from the choices listed above and asked to designate one of them as their biggest challenge.
Source: NRI *Survey of Asset Management Companies' Management Priorities*

day use. The second-most common challenge, with a 46% response rate, was issues involved with system control decisions. Specifically, the respondents are perplexed about whether to treat RPA as an IT system (administered by the IT department) or to put user departments in charge of RPA administration. If treated as an IT system, RPA would require processes similar to existing system development processes, in which case speed and/or cost efficiencies would likely be sacrificed. On the other hand, RPA administration by user departments poses its own set of risks, including key man risk.

AMCs are initially using AI for tasks related to portfolio management

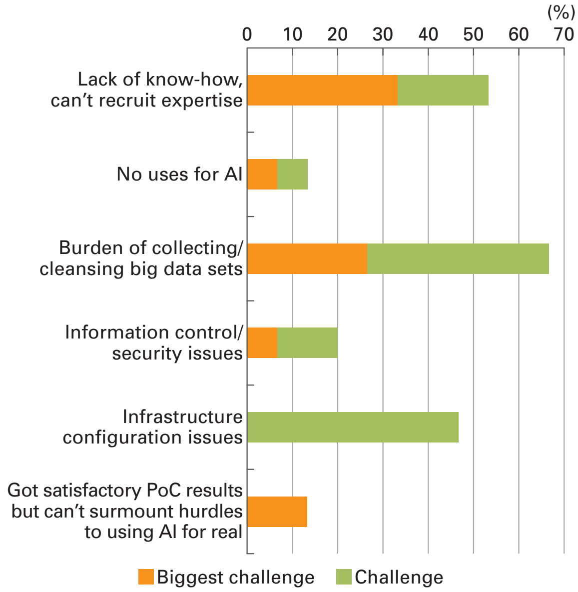
Exhibit 25 shows AMCs' AI utilization status. The business processes in which AI is most commonly used are investment decision-making, decision-making support and model portfolio construction. Fifty percent of the respondents are already using AI in one or more of these processes. More specifically, they are mainly using AI for extracting key information, including identifying attractive stocks, on a timely basis from public data such as news stories, securities filings and sell-side analyst reports. The next most common uses for AI are automation of external (e.g., market) data collection and data aggregation/analysis, both of which were selected by around 35% of respondents. Otherwise, however, AI is hardly used at all. In sum, AMCs are still at the stage of assembling training data for and starting to deploy AI in processes related to their core business of portfolio management. Meanwhile, for every one of the business processes listed in Exhibit 25, at least 50% of respondents are looking into deploying AI, implying that AMCs have a high degree of interest in AI.

Exhibit 25. AI utilization status



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

Exhibit 26. AI utilization challenges



Note: Respondents were permitted to select up to three responses from the choices listed above and asked to designate one of them as their biggest challenge.
Source: NRI *Survey of Asset Management Companies' Management Priorities*

Exhibit 26 lists a number of challenges to AI usage reported by the survey respondents. The most common, cited by roughly 70% of respondents, is the burden of collecting and cleansing big data sets to be input into AI programs. Tied for the next-most common challenges, both cited by roughly half of the respondents, were infrastructure configuration difficulties and lack of know-how and/or inability to recruit personnel with AI expertise.

Digitalization outlook

How will Japanese AMCs' digitalization initiatives evolve going forward? With respect to RPA, many respondents seem to be at a stage where user departments are starting to use RPA locally but the aforementioned challenges have deterred the respondents from coordinating RPA implementation on a company-wide, cross-organizational basis through such means as establishing a new RPA-specific organizational unit or having the existing IT department take charge. However, if even a few manual tasks remain in an otherwise automated series of business processes, they would preclude major cost savings in most cases. AMCs wishing to substantially reduce costs through RPA likely need a designated organizational unit to cross-organizationally map out the business processes to be automated and promote RPA utilization.

AI will likely be used in marketing processes conducive to differentiation but not conducive to BPO (business process outsourcing). The first challenge is therefore likely to be collection of data to input into AI programs, as indicated by the survey results. AI used in marketing to investors would require two types of data: fund distributor sales support data (e.g., types of support previously provided, responses thereto, results) and investor data (e.g., investor attributes, funds owned, timing of purchases). The former are already available in existing archives such as CRM systems for fund distributors, though a more comprehensive set of detailed data would need to be assembled. Investor data would have to be collected from external sources such as allied fund distributors and/or information banks because AMCs generally do not keep investor records, particularly in the investment trust business. Alternatively, AMCs could also aggressively sell their investment trusts to investors themselves and collect detailed data. As AI utilization progresses in any realm, actively generating new data is essential to upgrading AI utilization.

Utilization of digital technologies will be a major determinant of future growth even in the asset management industry. Two indisputable keys to deploying digital technologies as a growth driver are business process reengineering and organizational restructuring that enables digitalization.

2 Fund liquidity risk management regulations

Globally growing interest in funds' liquidity risk management

Open-end funds' liquidity risk management is a growing regulatory concern internationally. In 2017, the Financial Stability Board (FSB) published policy recommendations that identified the liquidity mismatch between open-end funds' asset holdings and their investment units' daily redeemability as a structural vulnerability with the potential to threaten financial stability. In response, the International Organization of Securities Commissions (IOSCO) issued recommendations updating its 2013 Principles of Liquidity Risk Management for Collective Investment Schemes in 2018. On the national and regional levels as well, regulators are moving to adopt new regulations or guidance on funds' liquidity risk management[13].

In general, all investment trusts and other such funds invest mostly in highly liquid assets. Unlike banks, they usually do not fulfill a maturity transformation function by holding long-dated assets funded with short-term obligations. As long as funds can meet even mass redemptions by selling assets, they will not experience liquidity problems. However, if asset prices deviate from intrinsic value amid market stress, funds may no longer be able to meet redemptions without hurting their investors interests or sacrificing fairness.

One key factor behind mounting concern about funds' liquidity risk, in addition to globally growing investment trust AUM, is that funds have been increasingly investing in illiquid assets in pursuit of yield amid a low-interest-rate environment. In fact, a US high-yield bond fund froze redemptions for six months in response to mass redemption requests and ended up being liquidated after its performance deteriorated in 2015. In the UK, six open-end real estate funds were forced to suspend redemptions in 2016 in the aftermath of the Brexit referendum.

Best practices for fund liquidity risk management vary over time from the initial fund design stage through episodes of market stress. IOSCO's aforementioned 17 recommendations are split into three categories: design process recommendations, day-to-day liquidity management recommendations and contingency planning recommendations. The design process recommendations include formulation of liquidity risk management processes and establishment of internal standards for minimum liquidity levels. The day-to-day risk management recommendations include periodic assessment of the liquidity of assets held in funds' portfolios and continual liquidity stress-testing in accord with established liquidity management processes. The contingency planning recommendations include formulation of contingency plans in preparation for times of stress and testing to ensure that liquidity management tools (e.g., redemption restrictions/freezes) can be promptly deployed.

Stress testing has been gaining recognition as a particularly important component of liquidity risk management in recent years. IOSCO emphasizes that stress tests are an effective means of assessing fund liquidity risk and strategies for management thereof. The EU has already mandated liquidity risk stress-testing for alternative investment funds (e.g., hedge funds) and, as needed, for UCITS also. Additionally, the European Systemic Risk Board (ESRB) has asked the European Securities and Markets Authority to issue stress test guidance. Ninety-three percent of AMCs surveyed by the ESRB reported that they periodically stress-test all of their funds, though doubts remain about the adequacy of the scenarios used to stress-test certain funds.

In response to the FSB's aforementioned policy recommendations, regulatory authorities are currently looking into system-wide stress testing, which would involve analyzing market-wide liquidity risk and gauging illiquidity scenarios' impact on financial markets and the financial system in the aim of shedding light on the impact of large-scale asset sales by not only funds but various other investors also. However, with quite a few observers skeptical of its effectiveness as a regulatory tool given existing data and model limitations, system-wise stress testing seems unlikely to soon gain widespread prevalence. Historically, ordinary investment trusts have rarely if ever been systemic risk catalysts. In light of such, some in the asset management industry are highly skeptical of the FSB's claim that asset sales by investment trusts could unleash market-wide ripple effects severe enough to potentially threaten financial stability.

US liquidity risk management regulations

Amid the recent international movement to upgrade funds' liquidity risk management, the US, which had unveiled the comprehensive risk management regulations before the FSB issued its recommendations, has revised those regulations before they even took effect.

In 2016, the US Securities and Exchange Commission (SEC) issued regulations requiring open-end funds (including ETFs but excluding money market funds) to establish liquidity risk management programs and comply with related reporting and disclosure requirements (Exhibit 27). The new regulations most notably require funds to classify the assets they hold into four buckets based on the estimated number of days it would take to convert them to cash under prevailing market conditions in compliance

Exhibit 27. US SEC's liquidity risk management regulations for mutual funds

Liquidity risk management program	Related disclosures/reporting
■ Implement liquidity risk management programs on fund-by-fund basis. (1) Assess, manage and periodically review funds' liquidity risk.	• Publish discussion of liquidity risk management programs' operation/ effectiveness over previous fiscal year in funds' shareholder reports.
(2) Classify portfolio holdings into four buckets (highly liquid, moderately liquid, less liquid and illiquid) based on their liquidity. ⇒ Implementation postponed six months; SEC is looking into switching to principles-based rules	• Report funds' liquidity classification data to SEC monthly on non-public basis. ⇒ Postponed six months • Disclose funds' overall liquidity classification ratios to investors quarterly. ⇒ Repealed
(3) Set a highly liquid investment minimum (HLIM: minimum ratio of highly liquid investments to net assets) for every fund (except funds that "primarily" hold highly liquid investments). ⇒ Postponed six months (4) Limit illiquid investments to maximum of 15% of net assets.	• Report HLIM data monthly to SEC on non-public basis. ⇒ Postponed six months • Report any breaches of HLIM or 15% cap on illiquid investments to SEC on non-public basis. ⇒ Implementation of reporting requirement for HLIM breaches postponed six months

Note: Blue font denotes changes made in 2018.
Source: NRI

disclosures with narrative reports to investors on the status of funds' liquidity risk management programs' operations in the previous fiscal year.

The liquidity classification requirements' implementation was postponed because AMCs were having difficulty complying with the requirements by their originally scheduled effective date. Most AMCs have to rely on service vendors for the market data and tools required for liquidity classification and reporting and their vendor selection processes are time-consuming. Additionally, the vendors themselves need time to prepare. The original liquidity classification reporting requirement's replacement with a watered-down requirement was in response to concerns that fund-by-fund liquidity risk disclosures in the form of four liquidity classification ratios were liable to be misunderstood by investors. The liquidity classifications would have been heavily influenced by the methods and assumptions used by the fund, but investors might very well take the reported risk classification ratios at face value without taking such influences into account.

In response to the Department of the Treasury's recommendation to transition to a principles-based liquidity classification scheme, the SEC intends to decide whether to do so based on data collected after its liquidity risk regulations have actually gone into effect. The US Investment Company Institute, which has been lobbying for principles-based regulations since before the SEC unveiled its regulations, has taken the position that the SEC's liquidity risk management program, regardless of whatever value it may have for internal control purposes, is too costly to implement and inadequate

with standards set by the SEC (see middle row of Exhibit 27's left column). This liquidity classification requirement was expected to be the basis for calculating funds' highly liquid and illiquid asset ratios (see bottom row of Exhibit 27's left column) and a uniform framework for both SEC oversight of funds' liquidity risk and reporting of funds' liquidity risk to investors.

The SEC changed its position on liquidity risk management in response to the Trump Administration's rollback of Dodd-Frank reforms. In October 2017, the US Department of the Treasury published a report recommending broad deregulation of the asset management industry. While acknowledging the importance of liquidity risk management programs, the report recommended delaying implementation of the SEC's detailed regulations, including the liquidity classification requirement, and replacing them with a principles-based approach on the grounds that their benefits would be outweighed by compliance costs. In response, the SEC decided in early 2018 to push back the liquidity classification requirements' effective date by six months[14], abandon public disclosure of fund assets' percentage breakdown by liquidity category on a fund-by-fund basis and replace such in terms of comparability of the data required to be disclosed to the SEC and reported to investors. Another criticism of the SEC's regulations is that they may impose an undue burden on AMCs that have implemented liquidity management programs of their own accord.

Implications for Japan

Awareness of liquidity risk management has grown in recent years even among Japanese AMCs. However, since the SEC announced the postponement of its pending liquidity classification requirement for mutual funds, interest in liquidity risk management in Japan appears to be waning in response to doubts about the near-term likelihood of Japan imposing strict regulations like the SEC's.

Even if the US's liquidity classification requirement ends up being revised, the SEC will presumably come out with principles-based regulations mandating high-quality liquidity risk management programs. The EU also is seeking to maintain a certain qualitative standards by issuing stress-testing guidance. The global regulatory push to ensure that funds have high-quality liquidity management programs is unlikely to abate. Even in Japan, there is a growing need for suitable liquidity risk management mechanisms, whether regulatorily imposed or voluntary, that reflect individual funds' respective attributes.

13) Most recently, the Monetary Authority of Singapore published guidelines that incorporate the FSB and IOSCO's recommendations in August 2018.

14) The original effective date was December 2018 for funds with assets of $1bn or more and June 2019 for funds with less than $1bn of assets.

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