NRI

# Japan's Asset Management Business 2021-22




Nomura Research Institute

# Foreword

The ranks of Japanese retail investors are growing, mainly in the younger segment of the age spectrum. Moreover, they seem to be growing quite rapidly. According to an online survey by Insight Signal, our advertising effectiveness measurement service, investors' prevalence in Japan's adult population increased from 35% to 43% between August 2018 and May 2021. In the 20-39 age group in particular, investor prevalence increased nearly 15 percentage points over the same timeframe. These percentages may be inflated by online sample bias, but Japan's investor class is undeniably growing at an unprecedented pace since the advent of *Tsumitate* NISAs and expansion of iDeCo eligibility.

The Japanese asset management industry's AUM has recently resumed growing, driven largely by equity price appreciation in the US and other major overseas markets since mid-2020. If this growth trend persists, the Japanese asset management industry's aggregate operating revenues are on track to grow 20% in FY2021. Retail investors, a growing number of whom practice yen cost averaging, are expected to be a source of stable medium/long-term capital inflows to the asset management industry. However, asset management companies' management should not allow themselves to be lulled into complacency by such a favorable business environment. Asset management companies face competitive threats from various quarters. For example, brokers and other fund distributors are strengthening their customer-facing asset management capabilities. Additionally, FinTech companies are targeting the asset management market with customized micro-investing services. Such new entrants will encroach upon incumbent asset management companies' service domain. The asset management industry is entering a challenging phase in which management acumen vis-à-vis deciding which emergent growth opportunities to pursue will determine whether individual asset management companies grow or shrink.

This report aims to provide points of reference for thinking about the asset management business's future path. Its intended audience includes the senior management and marketing/sales planning staff of both asset management companies and financial product distributors. With new players entering the fray as the Japanese public's ongoing transformation from savers into investors accelerates, the asset management business is expected to play an increasingly important role going forward. We hope this report adds to your understanding of Japan's evolving asset management industry.

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CHAPTER 1

# Japanese investor trends

## Asset management industry's growing AUM

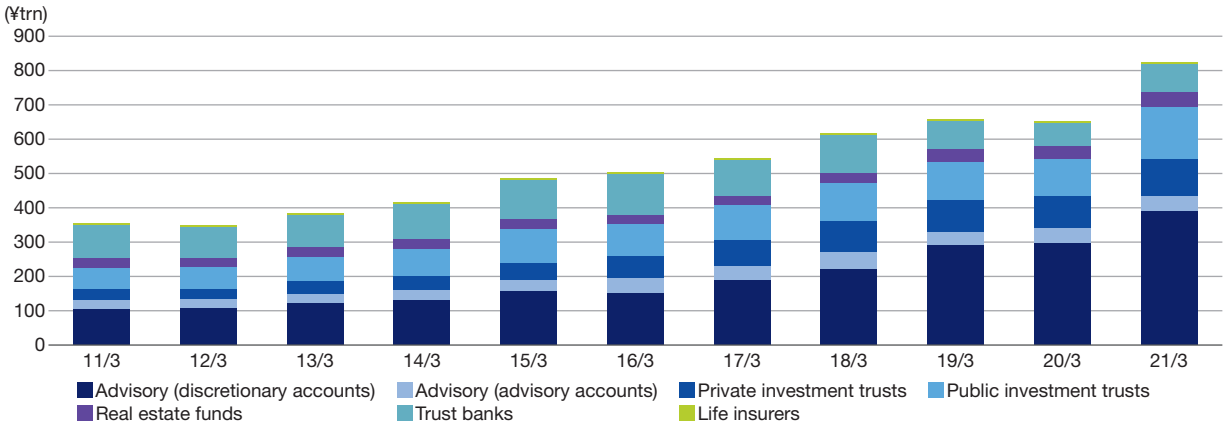
Japanese asset management companies (AMCs) collectively ended FY2020 with estimated AUM of ¥825trn[1)], a ¥174trn or 26% increase from a year earlier (Exhibit 1). The big jump in AUM was driven mostly by asset prices' rebound from their pandemic-induced drawdown at the end of FY2019. Notwithstanding the transient drawdown in March 2020, AMCs' AUM have grown relatively steadily over the nine years through FY2020 at a pace that equates to a CAGR of roughly 10%.

The AUM subtotal in discretionary investment advisory accounts grew particularly sharply in FY2020, increasing by more than ¥89trn to end the fiscal year at ¥387trn, a 260% increase from March 2012. However, much of this nine-year increase was attributable to a handful of financial groups transferring pre-existing AUM to affiliated investment advisory firms. Public investment trust AUM also grew markedly in FY2020, increasing by ¥45trn, which was split nearly equally between ETFs (¥23trn) and non-ETF investment trusts (¥22trn). Public investment trust (ex ETF) AUM consequently ended the fiscal year at a new all-time peak for the first time in six years. Trust banks and private investment trusts also saw their respective AUM grow more than ¥10trn in FY2020. AUM grew across all categories of managers/funds in FY2020.

## End-investor AUM have grown at nine-year CAGR of 8%

The AUM data plotted in Exhibit 1 are significantly inflated by double-counting of certain assets. For example, a private investment trust's inflows via a public fund of funds (FoF) are counted as an increase in AUM for both the private investment trust and FoF. Other examples of such double-counting include corporate pension assets invested in private funds for

Exhibit 1. **AMCs' AUM**




Note: Life insurers' AUM are DB pension asset mandates.
Source: NRI, based largely on Japan Investment Trust Association (JITA) and Japan Investment Advisers Association (JIAA) data and AMCs' business reports

nontaxable institutional investors under a discretionary investment advisory agreement and pension assets discretionarily managed by an affiliated asset advisory firm or invested in a private investment trust under a pension trust agreement. AMCs typically earn lower fees on such nested AUM because investors are generally not willing to pay higher total asset management fees just because their assets are invested in products that involve multiple layers of managers. AUM counted from the end-investor's standpoint therefore present a more accurate picture of AMCs' aggregate revenue base.

Like AMCs' aggregate AUM plotted in Exhibit 1, AUM counted from the end-investor's standpoint[2)] are in a growth trend dating back to their post-GFC trough at FY2011-end (Exhibit 2). Although they have not grown as much as AMCs' aggregate AUM, they still doubled over this nine-year period (equivalent to a roughly 8% CAGR).

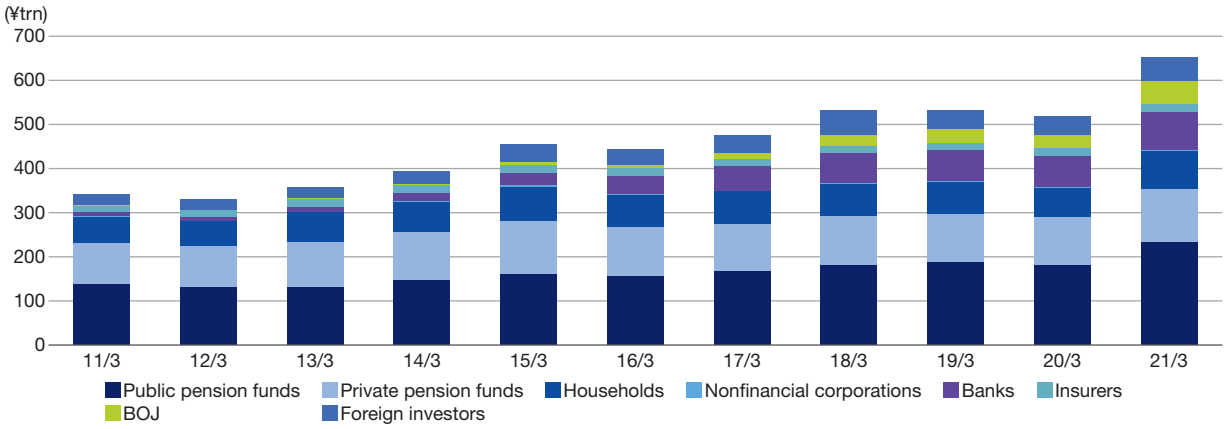
Of their growth since FY2011-end, assets managed on behalf of public pension funds accounted for the largest share, increasing by ¥103trn. Assets managed on behalf of banks (depository financial institutions) and the BOJ increased ¥75trn and ¥51trn, respectively, while assets managed on behalf of overseas investors, private pension funds and retail investors increased a more modest ¥30trn or so apiece.

## Pension funds, banks and households

Public pension funds have been increasingly outsourcing management of assets to AMCs in response to changes in their policy portfolios' asset allocations and re-nationalization of the substitutional portion of Employee Pension Funds' assets and liabilities, but these two drivers have already run their course. Public pension funds are no longer planning to award incremental mandates to AMCs at the same rate they have over the past decade.

In the private pension space, rules governing corporate defined contribution (DC) plans are set to become more conducive to growth in such plans' AUM. At companies with both DC and defined benefit (DB) plans, DC plan contributions are currently capped at a uniform ¥27,500/month, but the government has decided to change this limit to ¥55,000/month less the amount of any DB plan contribution. This change will increase the DC plan contribution limit at many companies that have both DC and DB plans, likely leading to increased contributions to corporate DC plans and, in turn, faster growth in DC plan assets. However, such a pickup in DC plan assets' growth rate would presumably come at the expense of growth in DB plan assets. We doubt overall corporate pension assets will grow much beyond their current level. Favorable regulatory changes are likewise pending for individual DC (iDeCo) plans, a type of

Exhibit 2. **Investor assets managed by AMCs**




Note: Public pension fund assets exclude internally managed assets.
Source: NRI, based largely on JITA, JIAA and BOJ data and AMCs' business reports

non-corporate private retirement plan. Specifically, the age limit on iDeCo enrollment will be raised and restrictions on iDeCo participation by corporate DC plan participants will be eased, both effective from 2022. These changes will definitely spur growth in iDeCo AUM, although with iDeCo plans basically funded solely by participants' monthly contributions, such growth will inevitably be gradual.

Within banks' securities portfolios, fund investments have dramatically increased in importance since the BOJ launched its large-scale JGB purchases. While banks are no longer ramping up fund investments as rapidly as they were a few years ago, they have continued to add to their fund holdings year after year. Regional banks in particular are increasingly outsourcing asset management to discretionary managers and utilizing investment advisory services in response to pressure from regulatory authorities that want banks without adequate portfolio management or risk management capabilities to take advantage of external asset managers' expertise. Financial institutions remain a key market segment for AMCs.

Households entrust assets to professional managers mainly by buying public investment trusts or opening fund wrap accounts. Securities investment's public image has been changing as more and more people realize the importance of long-term investing and asset diversification. This trend will undoubtedly drive growth in households' professionally managed assets. In fact, open-end public investment trust (ex ETF) AUM surpassed its previous all-time peak for the first time six years in FY2020. In the first half of FY2021, net inflows to public investment trusts approached their pre-GFC run rate. Meanwhile, the passively managed share of public investment trust AUM is rapidly increasing. This shift toward passive management is all but certain to continue irrespective how fast or slowly retail investors increase their professionally managed asset holdings going forward. However, passive funds' growing popularity among retail investors does not necessarily mean that active funds in aggregate will shrink. High-quality active funds could still regain favor in the retail market.

Another investor that warrants mention in addition to those discussed above is a new university endowment fund set up by the Japanese government. The fund is scheduled to launch at the end of FY2021 with ¥4.5trn of AUM and a 65% allocation to global equities. It is slated to be seeded with an additional ¥5.5trn within a few years. Its assets are to be managed by external managers.

1) Trusts and life insurers' share of this total includes only assets managed on behalf of pension fund clients. Life insurers' share includes only special-account balances, not general-account assets with guaranteed returns (e.g., fixed-amount insurance, fixed annuities). The total is not adjusted to correct for double-counting due to, e.g., private funds' ownership of public investment trusts or investment trusts' partial outsourcing of asset management to subadvisors.
2) These AUM are counted from the standpoint of the end-investor (the party that primarily bears the risk of changes in asset values). For example, if a public investment trust invests in a private investment trust, the public investment trust would be the private investment trust's investor but the risk of changes in the private investment trust's NAV would be borne by the public investment trust's investors. The public investment trust's holdings in the private investment trust would therefore not be counted as public investment trust AUM in Exhibit 2.

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.

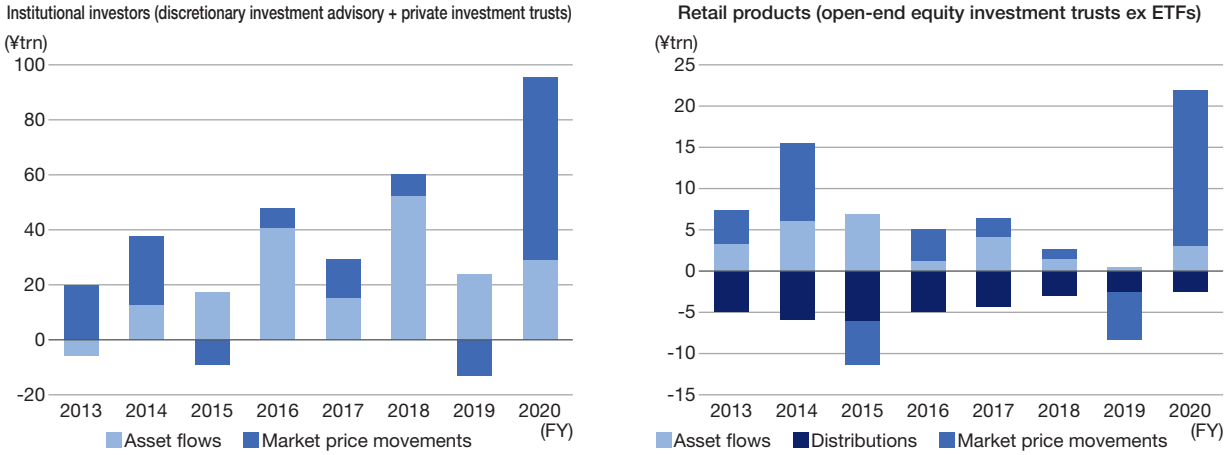
### Revenues and margins both flat

Exhibit 3 plots annual changes in AMCs' AUM disaggregated by causative factor. First, in the institutional market segment (left graph: total of discretionary investment advisory AUM and private investment trust AUM), asset price movements added some ¥66trn to AMCs' AUM in FY2020, mainly in the form of global equity price appreciation following the March 2020 market rout. The ¥66trn was by far the market price factor's biggest contribution to AUM growth over the past decade.

Meanwhile, net inflows of new assets added roughly ¥29trn, another large increment, to AMCs' AUM. Discretionary investment advisory products accounted for about ¥23trn of this ¥29trn. However, this ¥23trn included ¥34trn of inflows due to a major domestic trust bank joining the Japan Investment Advisers Association (JIAA) and to financial groups reshuffling existing AUM between affiliated companies[3)]. Absent this ¥34trn of inflows on paper, the ¥23trn net inflow to discretionary investment advisory products would have been an ¥11trn net outflow. By asset class, domestic and foreign equities accounted for much of the adjusted net outflow, presumably because public pension funds rebalanced their portfolios by selling equities and buying bonds into fiscal year-end in response to global equity market gains from April 2020 onward.

Private investment trusts, investors in which are mainly financial institutions, saw a net inflow of roughly ¥7trn. After growing rapidly in FY2016-18, net inflows

Exhibit 3. **Changes in AUM disaggregated by causative factor**




Source: NRI, based largely on JITA, JIAA and NRI Fundmark data

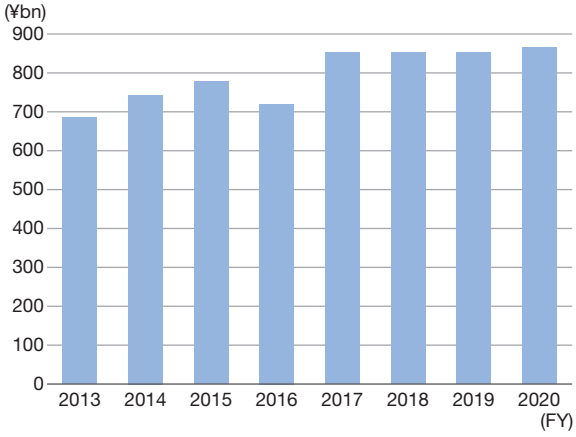
 

to private investment trusts slowed sharply in FY2019 in response to financial regulators' concerns about financial institutions' risk management. Subsequently, however, they have resumed growing, albeit gradually. Given the dearth of yield available in today's low-rate environment, private investment trusts remain mildly in demand as a reinvestment vehicle for proceeds from maturing JGB holdings.

In the retail investor segment (right graph: open-end public equity investment trust (ex ETF) AUM), AUM grew roughly ¥19trn as a net result of a ¥19trn increase in AUM due to asset price appreciation, a ¥3trn net inflow of new assets and a ¥2.5trn outflow in the form of dividend distributions.

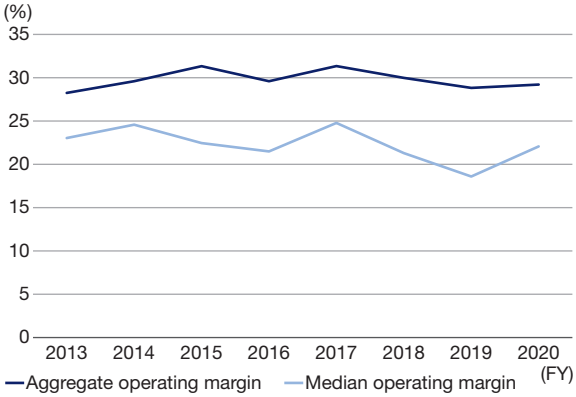
Based on data available at the time of this writing, we estimate the asset management industry's aggregate FY2020 management fee revenues at ¥867bn, nearly unchanged from their all-time record FY2017 level for a third straight year (Exhibit 4). Exhibit 5 plots operating margins of Japanese AMCs that manage public investment trusts (likewise based on data available at the time of this writing). The aggregate operating margin of the AMCs we surveyed (dark blue line in Exhibit 5) has been tracking in the vicinity of 30% since FY2014. While AUM increased in FY2020, revenues were flat, implying that management fee rates decreased on average.

Exhibit 4. **AMCs' aggregate management fee revenues**




Source: NRI, based on JITA and JIAA data

Exhibit 5. **AMCs' operating margins**




Note: Graph plots operating margin data for domestic public investment trust sponsors (number of AMCs in data sample varies by fiscal year). Aggregate operating margin is aggregate operating profits of the AMCs in the sample divided by their aggregate net operating revenues.
Source: NRI, based on JITA data

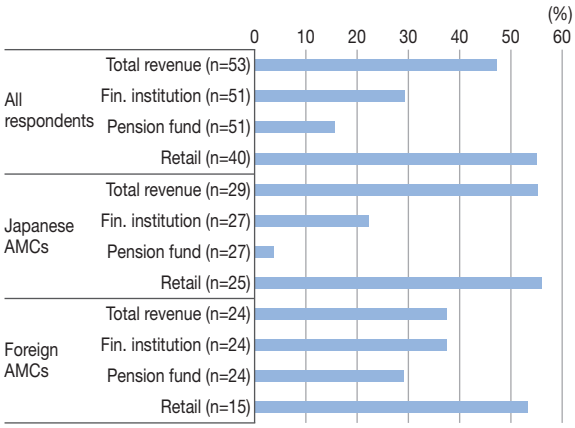
## 2 Outlook for asset management business

At NRI, we annually survey AMCs' management (*NRI Survey of Asset Management Companies' Management Priorities*[4]) 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 as revealed by survey responses.

### AMCs turn even more bullish on retail segment's growth prospects

First, in terms of AMCs' overall revenue outlook, Exhibit 6 plots the percentages of survey respondents

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

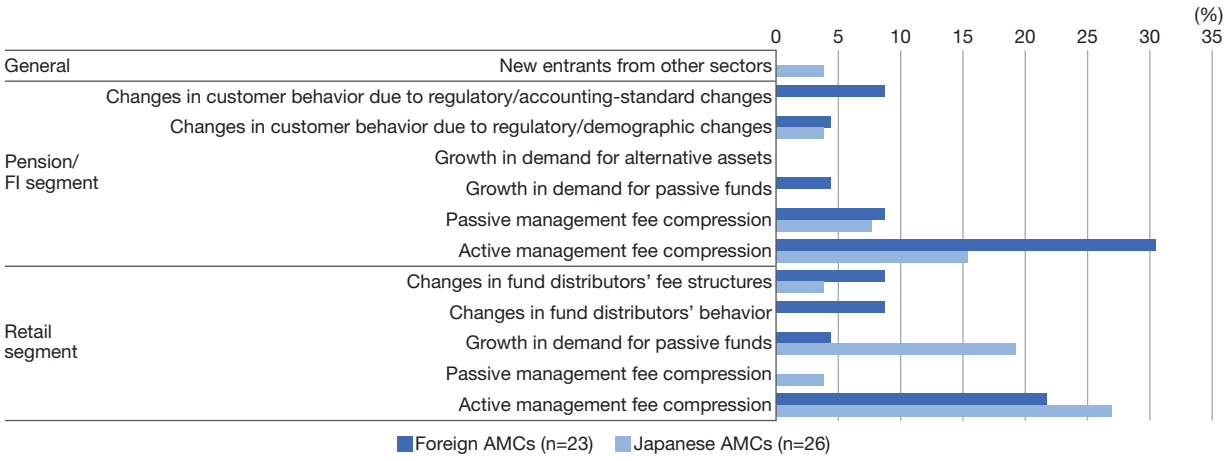



Source: NRI *Survey of Asset Management Companies' Management Priorities*

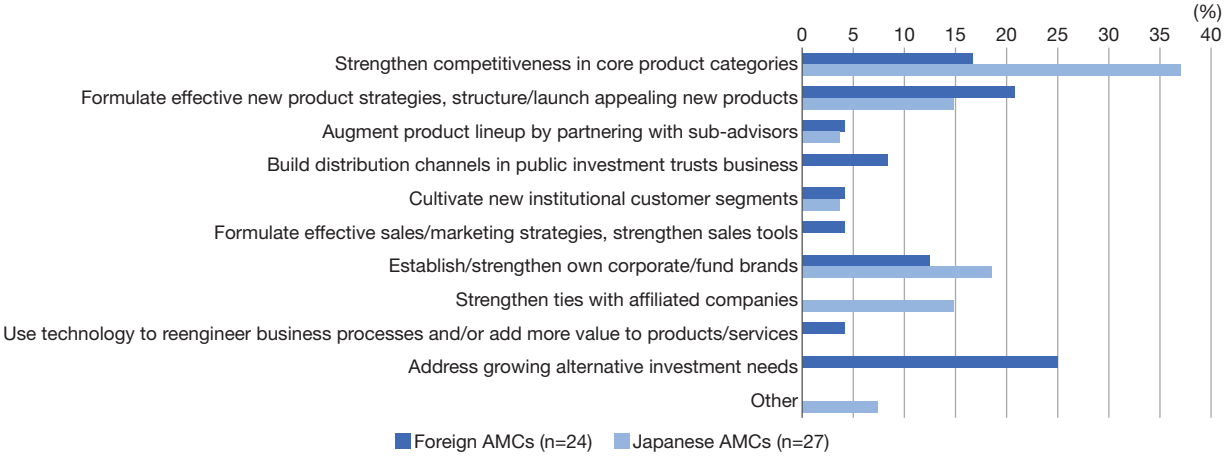
forecasting cumulative revenue growth of at least 50% over the next five years on a company-wide basis and by business line (investor segment). It also disaggregates the data between Japanese and foreign AMCs. In the latest survey, the respondents as a whole were moderately more bullish on the revenue outlook than in the previous survey, with 50% of them, up from around 40% for the prior several years, projecting cumulative total revenue growth of at least 50% over the next five years. For a third straight year, the investor segment in which the most respondents are forecasting five-year revenue growth of at least 50% is the retail segment, followed in descending order by the financial institution and pension fund segments. While the segments' respective rankings by revenue growth prospects were unchanged, dispersion in growth expectations among the segments increased, with the percentage of respondents projecting five-year revenue growth of at least 50% increasing in the retail segment and decreasing in the pension fund segment while remaining unchanged in the financial institution segment. Both domestic and foreign respondents were most bullish on the retail segment, though Japanese respondents were much more bullish on the retail segment than on the other two segments while foreign respondents were fairly bullish on the other two segments in addition to retail. This divergence in sentiment toward the pension fund and financial institution segments was evident in the respondents' answers to questions about the biggest potential threats they face (Exhibit 7) and their top priorities in terms of expanding their businesses and/or boosting profitability over the next five years

Exhibit 7. **Biggest potential threats in eyes of survey respondents**




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

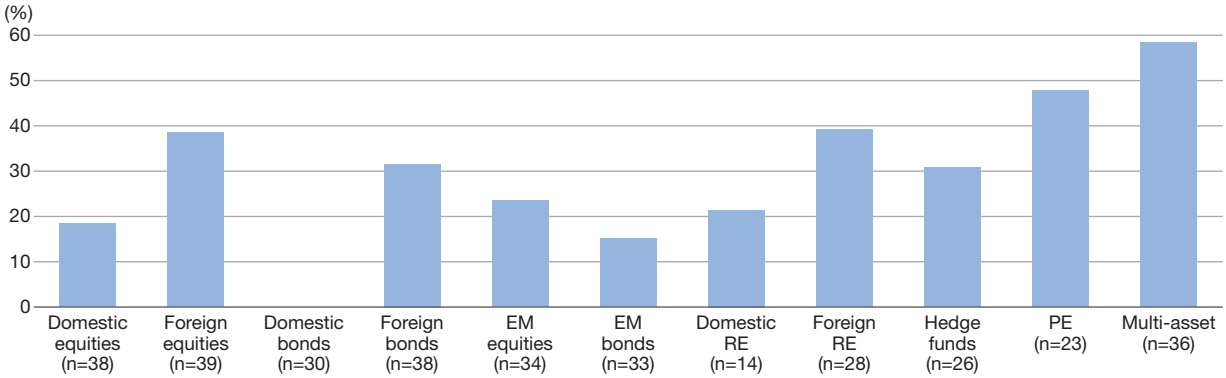
Exhibit 8. **Survey respondents' top priorities to expand business or improve profitability over next five years**




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

Exhibit 9. **Percentage of survey respondents forecasting at least 50% AUM growth due to asset inflows over next five years (by asset class)**




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

(Exhibit 8). In Exhibit 7, the biggest threat in the eyes of Japanese respondents is active management fee compression in the retail segment. Among foreign respondents, by contrast, the biggest perceived threat is active management fee compression in the pension fund and financial institution segments. In Exhibit 8, a plurality of foreign respondents place top priority on meeting growing demand for alternative investments, implying that they are committed to meeting the needs of pension funds and financial institutions. Meanwhile, more Japanese respondents than foreign respondents place priority on building closer ties with affiliated fund distributors and strengthen their brands to increase brand recognition among retail investors, implying that Japanese AMC place the most importance on expanding their retail businesses.

Exhibit 9 plots, by asset class, the percentages of survey respondents projecting cumulative AUM growth of at least 50% over the next five years in investment strategies that they offer. For a second year in a row, respondents were most bullish on private equity and multi-asset products. Demand for and expectations surrounding multi-asset strategies that tactically respond to changes in the market environment have been growing amid the pandemic. Their AUM are expected to grow rapidly again this year.

## 3 Operational challenges amid pandemic

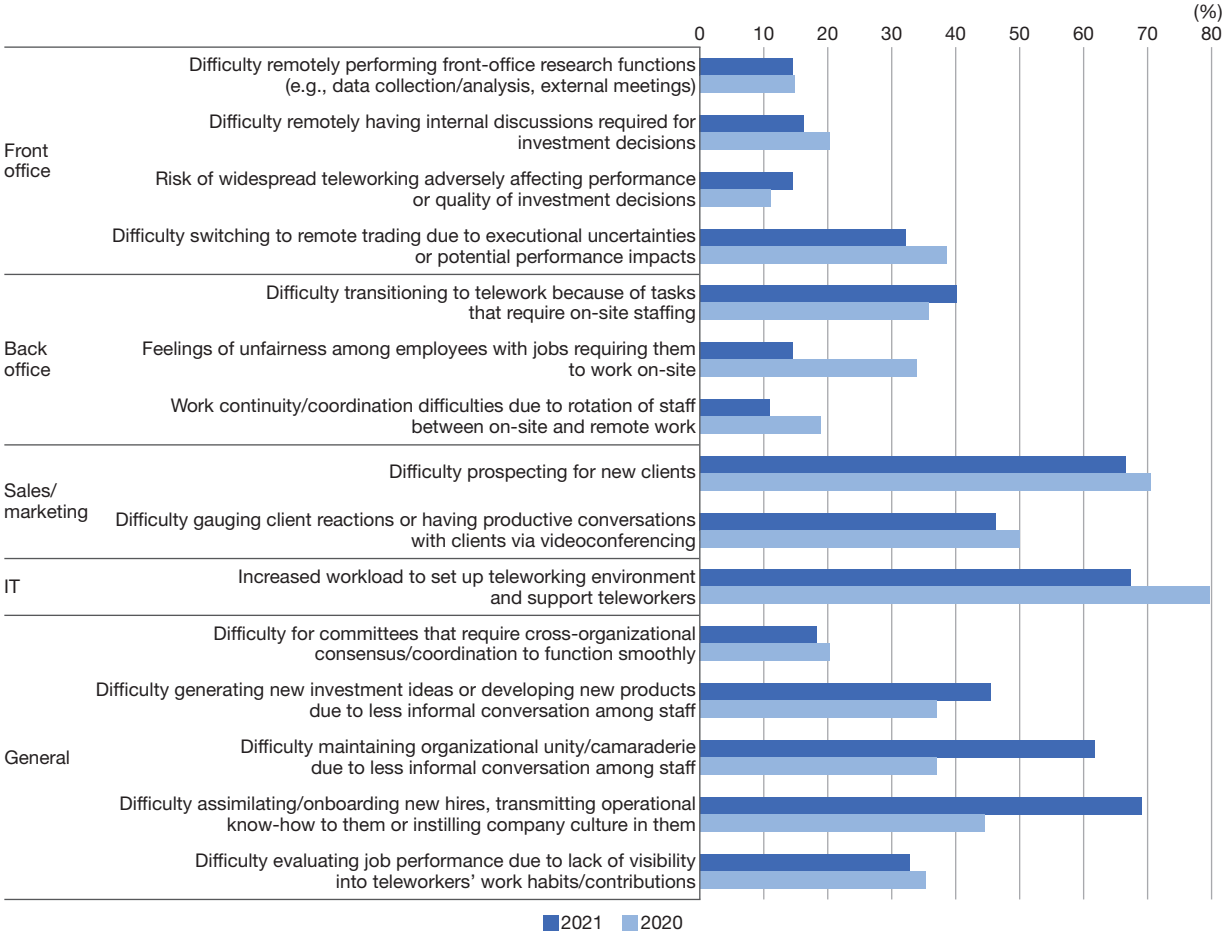
Japanese AMCs are confronting various challenges as they navigate the pandemic and formulate post-pandemic growth strategies. Our survey results offer insight into what they consider to be the biggest challenges facing them in comparison to the previous year. Exhibit 10 shows the extent to which the respondents see various issues as problems in five areas of their organizations.

In last year's survey, the most common problem cited by the respondents was increased workloads for IT staff. In the latest survey, a smaller but still large majority of respondents again cited increased IT workloads as a problem. While last year's urgent need to build a teleworking environment and provide IT support to teleworkers has subsided, IT staff apparently remain under pressure from growing workloads involving necessary but less urgent tasks such as migrating to paperless operations and automating business processes.

The area in which the second-most respondents reported challenges in last year's survey was sales/marketing. Slightly smaller percentages of respondents reported the same challenges this year. With remote interactions becoming the norm even in sales activities, many respondents are still struggling with lead generation in particular. AMCs need new

Exhibit 10. **Operational challenges encountered during pandemic**




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

strategies or tools for acquiring new customers, such as rolling out more content to increase points of contact with customers.

While quite a few of the problems cited in last year's survey are being resolved over time, problems related to internal communication have increased in prevalence. Specific difficulties cited by both a large percentage of respondents and more respondents than last year include instilling the company culture in new personnel, maintaining organizational unity/ camaraderie and generating new investment ideas or developing new products. It seems that company cultures and investment philosophies that AMCs have fostered within their offices are harder to maintain in a teleworking environment. Additionally, the difficulty AMCs are having with generating new investment ideas or developing new products could impair their ability to add value that differentiates them from competitors. The survey respondents collectively reported that a higher percentage of their staff are working in their offices this year than last year and many respondents intend to have even more of their employees return to the office once the pandemic is over. AMCs will likely need to gradually provide more opportunities for in-person communication to address problems they have not adequately rectified by promoting better online communication.

Amid ongoing changes in the business environment, most notably including management fee compression, it is crucial for AMCs to explicitly formulate growth strategies based on their strengths and value-additive drivers of differentiation. Even in the abnormal environment wrought by the pandemic, AMCs need to foster a climate conducive to generation of new

investment ideas, development of new products and wholehearted buy-in to their growth strategies, corporate cultures and investment philosophies across their entire organizations.

3) The trust bank was Mitsubishi UFJ Trust and Banking Corporation. When it joined the JIAA, discretionary investment advisory AUM increased by an estimated ¥20trn. The remaining ¥14trn was attributable to life insurers in the Nippon Life Group transferring a portion of their AUM to Nissay Asset Management.

4) NRI has conducted this survey annually since FY2007, most recently in August-September 2021. The 2021 survey yielded valid responses from 56 AMCs (32 Japanese, 24 foreign) that collectively account for 76% of the Japanese asset management industry's total AUM.

CHAPTER 3

# Market trends and product strategies by client segment

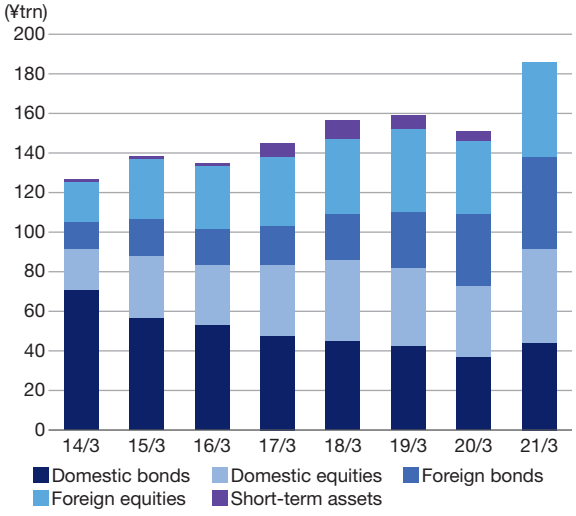
## 1 Pension funds, life insurers, university endowment fund

### Pension funds heavily reallocating from domestic bonds to illiquid alternatives

Major Japanese pension plans' reserves at March 31, 2021, totaled an estimated ¥369trn, an 18% increase from a year earlier, when capital markets were under tremendous stress from the initial COVID-19 outbreak.

The Government Pension Investment Fund (GPIF), which manages the Employees' Pension Insurance and Japanese National Pension schemes' respective reserves, ended FY2020 with AUM of ¥186trn, up 24% from a year earlier (Exhibit 11). Its FY2020 investment returns totaled an all-time record ¥38trn.

Exhibit 11. **GPIF's AUM and asset allocation**




Source: NRI, based on GPIF annual reports

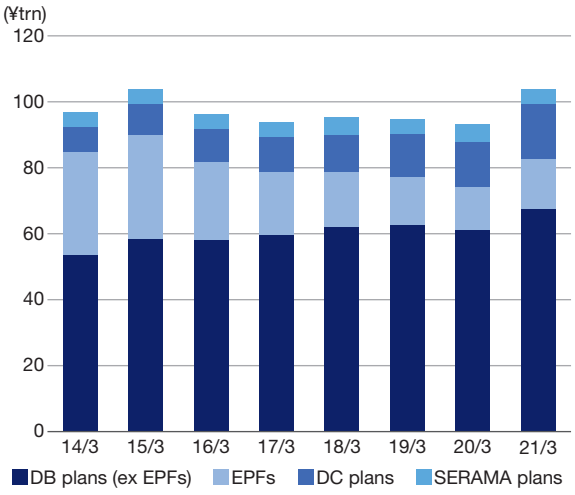
From FY2020, the GPIF adopted a new policy portfolio that equal-weights domestic bonds, foreign bonds, domestic equities and foreign equities at 25% apiece. It rebalanced its portfolio into approximate alignment with its policy portfolio allocations at FY2020-end. Additionally, mutual aid associations are required to adhere to the GPIF policy portfolio's allocations for any Employees' Pension Insurance reserves they manage. The new policy portfolio permits the GPIF and mutual aid associations to treat currency-hedged foreign bonds as part of their domestic bond allocation. The GPIF's passively managed domestic bond allocation already includes positions in currency-hedged index funds that hold US Treasuries, US MBS and euro-denominated DM sovereign bonds. The GPIF may be able to more flexibly incorporate currency-hedged foreign bonds into actively managed strategies also.

The GPIF's illiquid alternative investments at March 31, 2021, totaled roughly ¥1.3trn (0.7% of reserves vs. 5% maximum allocation), up about ¥400bn from a year earlier. Its alternative investments are classified into one of the policy portfolio's four asset classes based on their individual attributes. The GPIF has committed around ¥3trn (1.6% of reserves) to illiquid alternatives. It is expected to continue to seek out prime alternative investment opportunities from top managers. Mutual aid associations also are increasing their allocations to illiquid alternatives but at a slower pace than the GPIF is.

Corporate pension assets at March 31, 2021, totaled ¥104trn, a 12% year-on-year increase (Exhibit

Exhibit 12. **Corporate pension assets**



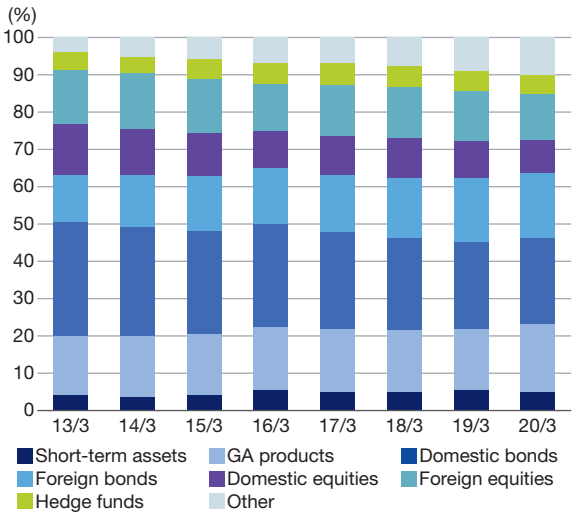

Note: EPFs: Employee Pension Funds; SERAMA: Smaller Enterprise Retirement Allowance Mutual Aid
Source: NRI, based on data from the Trust Companies Association of Japan and Organization for Workers' Retirement Allowance Mutual Aid

12). Of this total, DB pension plans accounted for ¥68trn, a 10% year-on-year increase. DB plan assets appreciated less than public pension assets because corporate DB pension funds tend to have conservative asset allocations that target nominal returns of 2-3% on average. As shown in Exhibit 13, they have been gradually reducing their allocations to low-yielding domestic bonds in recent years while increasing their allocations to foreign bonds and "other" assets (presumably including alternative investments that do not fall into either the equity or bond bucket). Corporate DB pension funds are generally risk-averse on the asset allocation level because they are mostly well-funded at present. They seek to achieve their return targets by their own idiosyncratic investment strategies. They remain heavily interested in alternative assets, ESG investing and multi-asset strategies (discussed below). Corporate DC plan AUM grew 20% in FY2020 to ¥16trn at fiscal year-end. Aggregate contributions to corporate DC plans have been running at over ¥1trn per year in recent years and are expected to continue to gradually increase.

## Life insurers are consolidating asset management capabilities within their groups

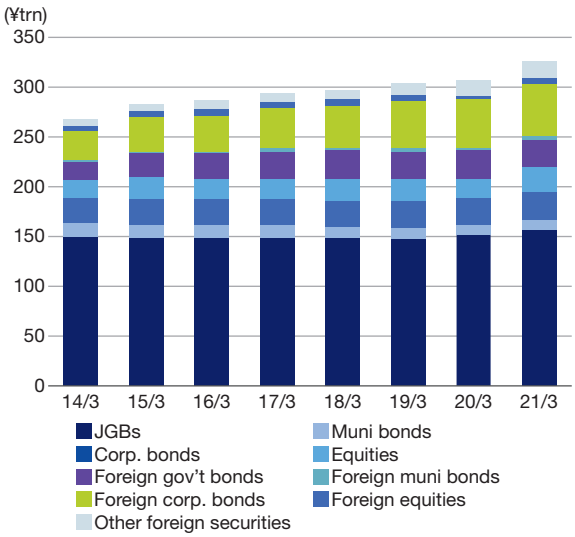
Life insurers (42 companies per latest count) collectively had investment securities with a carrying value of ¥343trn, a 7% year-on-year increase, on their balance sheets at FY2020-end (Exhibit 14). Their foreign securities holdings have been growing rapidly in recent years. In FY2020, they increased their holdings of foreign corporate bonds, equities and "other" securities (i.e., securities other than conventional equities and bonds, including fund investments) by 7%, 30% and 27% to ¥53trn, ¥5trn and ¥18trn, respectively. In the current low-rate, low-growth environment, life insurers, like pension funds,

Exhibit 13. **DB pension fund asset allocations**




Note: GA: general account
Source: NRI, based on Pension Fund Association data

Exhibit 14. **Life insurers' investment securities holdings**




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

are seeking higher-yielding investment opportunities in various alternative assets and overseas credit markets.

Major Japanese life insurers have long been committed to upgrading their portfolio management as a business strategy. Their affiliated AMCs have been playing an important role in this process. Most recently, life insurers have been consolidating asset management functions within their respective groups. In March 2021, Nippon Life, Japan's biggest life insurer, transplanted its previously in-house credit and alternative asset investment functions into its subsidiary Nissay Asset Management. As a result, Nissay Asset Management newly manages some ¥15trn of general-account assets in addition to preexisting separate-account (advisory) mandates. Other major life insurance groups may follow suit (such intragroup consolidation/upgrading of asset management functions is happening even among other financial groups outside of the insurance industry). They may even award asset management mandates to external managers through their affiliated AMCs.

## Overview of soon-to-be-launched ¥10trn university endowment fund

Besides pension funds and life insurers, the asset management industry has a keen interest in a public university endowment fund now being set up by the government and slated to be managed by the Japan Science and Technology Agency (JST). It will be endowed with public funds and commence long-term management of its endowment in FY2021. Its future investment returns are earmarked for increasing Japanese universities' competitiveness in scientific and technological research, including by cultivating more researchers. Initially, the fund will be endowed with ¥4.5trn in the form of ¥4trn of Fiscal Investment and Lending Program (FILP) funding plus a ¥500bn capital contribution from the government (budgeted basis[5]). The endowment is to be increased to ¥10trn within a few years. What is currently known or surmised about the fund is summed up in the following five points.

- The long-term expenditures to be funded by the fund's investment returns are estimated at ¥300bn per year. In light of its expenditure schedule and the current investment environment, the fund's initial (five-year) reference portfolio allocations are 65% global equities and 35% global bonds.

- JST will formulate a policy portfolio that seeks to maximize returns within the reference portfolio's risk budget and autonomously manage the fund's assets under the oversight of the Ministry of Education, Culture, Sports, Science and Technology, its parent agency.

- The fund's equity allocation will be managed mostly by external managers. Both its equity and bond allocations will generally consist of a mix of actively and passively managed products.

- The fund may invest in illiquid alternatives at JST's discretion.

- Before the fund goes live, JST will establish investment and oversight committees. It will also select external managers before starting to deploy capital.

JST has already recruited an executive from a private financial institution to head its asset management operations and named the investment and oversight committees' members also. It is now setting up and staffing its portfolio management operations. It is expected to expand its staff over time.

Much is still unknown about how the fund will actually invest its capital. Key questions that have yet to be decided include the following.

- How will the policy portfolio be structured? Will it

afford a high degree of discretionary latitude like the reference portfolio? Will it adhere to a traditional four-asset framework like the GPIF's model portfolio or will it be delineated another way?

- How will the lineup of external managers be configured? Will it be based on specialized niches à la public pension funds? Will the fund strategically partner with managers across multiple asset classes? To what extent will the fund internally manage bond allocations not required to be externally managed?

- How will external managers be selected? Will the fund use a manager registry (a system where the fund solicits investment performance reports on an ongoing basis and is free to select new managers and award mandates to them at any time) like public pension funds or will it award multiyear mandates on a set schedule? How will the fund structure long-term agreements with managers, including management fees and internal redemption criteria? How will the fund find illiquid alternative investment opportunities? Will the fund use consultants?

- What types of investment vehicles will the fund use? Will it use separately managed accounts or existing private investment trusts for nontaxable institutional investors or directly hold ETFs? What types of alternative assets will it invest in?

- How effectively will the fund's front and middle offices manage risk?

All of these questions will need to be addressed but some will be harder than others to reach a consensus on.

While the fund is slated to receive an additional ¥5.5trn of funding within the next few years, it cannot subsequently count on steady asset inflows like contributions to US universities' endowment funds. Additionally, the fund will be under pressure to fulfill its founding mission of funding initiatives to upgrade Japan's scientific and technological research capabilities and cultivate more researchers as early as possible. At some point, it may also have to repay the FILP funding that accounts for the lion's share of its initial capital. In sum, successfully operating the fund will entail formidable challenges and require a clear-eyed assessment of downside risks as an utmost priority.

It goes without saying that institutional investors' performance ultimately depends on bargaining power backed by the scale of their AUM and their governance capabilities. With ¥10trn already committed as seed funding, the fund will no doubt have considerable bargaining power vis-à-vis the asset management industry. Given its extremely short pre-launch timeline, the fund faces a lot of pressure. We hope JST at least comes up with a step-by-step approach to constructing a good-fit portfolio while devoting sufficient time to building a suitable governance regime, upgrading its organizational capabilities and gaining sophistication as an institutional investor.

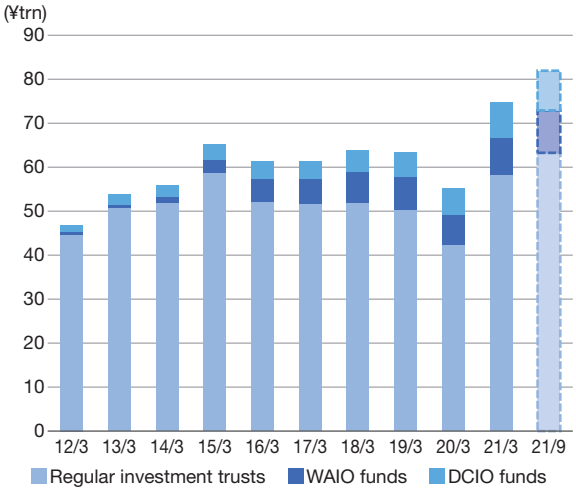
## 2 Retail business

### Big net inflow to equity investment trusts in FY2020

AUM in public open-end equity investment trusts ex ETFs (abbreviated below as "equity investment trusts") stood at ¥74.9trn as of March 31, 2021, surpassing their previous all-time peak for the first time in six years after dipping in FY2019 in response to the pandemic (Exhibit 15). Prior to FY2019, equity investment trust AUM ranged between ¥60trn and ¥66trn for five straight years. In FY2020, equity investment trusts' asset inflows exceeded outflows[6)] for the first time in five years. Their inflows accelerated in the first half of FY2021, boosting equity investment trust AUM to ¥81.9trn at September 30. Over 40% of

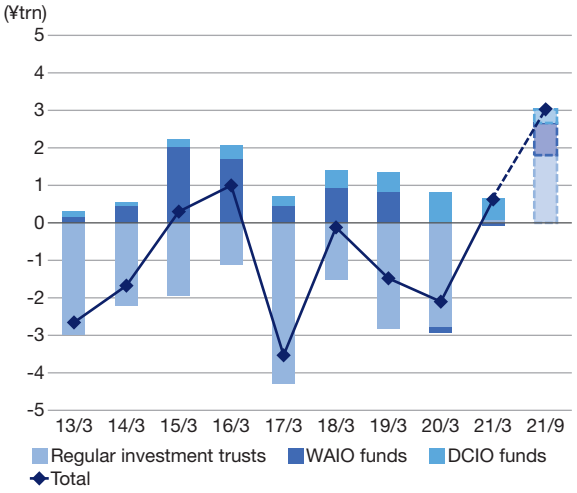
 

Exhibit 15. **Open-end equity investment trust (ex ETF) AUM**




Note: WAIO: wrap account investment only; DCIO: defined contribution investment only
Source: NRI

Exhibit 16. **Open-end equity investment trust (ex ETF) net in/outflows**




Note: In/outflows: purchases - redemptions - distributions; latest (21/9) data are half-yearly totals (non-annualized)
Source: NRI

the ¥7.1trn increase in AUM in the first six months of FY2021 was attributable to asset inflows. Net inflows' first-half run rate annualizes to ¥6trn, a level not seen since FY2007, the year preceding the Lehman bust. The recent surge in asset inflows has been driven by net inflows across all three types of equity investment trust distribution channels.

Investment trust sales channels are delineated based on the services provided by the fund distributors that interface with retail investors. The best-known channel is banks and brokerages that sell investment trusts in their branches and online. We refer to investment trusts offered through this channel as regular investment trusts. In FY2020, regular investment trusts inflows exceeded outflows, albeit barely, for the first time in 10 years. In FY2021, regular investment trusts had net inflows of ¥1.8trn in the first half alone (Exhibit 16).

One reason for the turnaround in regular investment trusts' asset flows is that total investment trust distributions, one form of asset outflow, are down some 40% from their peak level as a result of two factors. First, dividend fund AUM have been shrinking. Second, the average distribution yield (total distributions divided by dividend fund AUM) also has decreased.

A second reason is that among regular investment trusts other than dividend funds, foreign equity funds have been attracting net inflows for the past several years in a row. Global and North American equity funds in particular have enjoyed net inflows every year since FY2016. Some long-term investors are starting to increase their allocations to foreign equities as discussed below. This trend is conducive to ongoing net inflows to regular investment trusts.

The second distribution channel is fund wrap accounts. Most investment trusts currently available in wrap accounts are exclusive to the fund wrap channel (such investment trusts are referred to below as WAIO (wrap account investment only) funds). After two straight years of net outflows through FY2020, WAIO funds are seeing resumed net inflows in FY2021 as major banks and brokers have started to refocus on wrap account services as part of their plans to pivot to a recurring-revenue model. Even some non-major financial institutions are entering the fund wrap market, including financial institutions with a strong online platform or financial advisor network and, recently, regional banks (or their affiliated brokerages). Wrap-account AUM have been

steadily growing in tandem with the number of wrap accounts. Investment trust AUM in wrap accounts may fluctuate to some extent but it should basically keep growing.

The third distribution channel is DC retirement plans. Investment trusts offered through DC plans are mostly exclusive to the DC channel (such investment trusts are referred to below as DCIO (DC investment only) funds). DCIO funds continue to enjoy steady inflows from monthly contributions year after year. Because DC plan participants tend to have a long-term investment mindset, they rarely make short-term changes to their portfolios. With total participants in DC plans, including both corporate and individual plans, recently increasing by 700,000 annually, DC plan inflows are in a growth trend. Effective from 2022, the age limit on DC plan eligibility will be raised and restrictions on concurrent enrollment in both corporate and individual DC plans will be eased. Additionally, the limit on DB plan participants' DC plan contributions will be raised in 2023, enabling many DC plan participants to increase their contributions. Such pending deregulation virtually ensures continued steady growth in DCIO fund AUM.

## Rapid growth in passive share of investment trust AUM

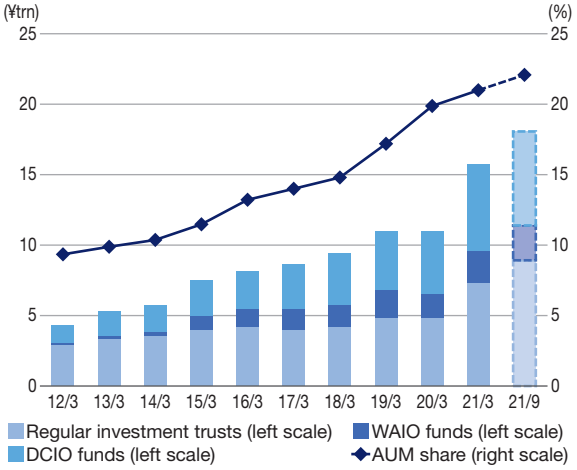
While equity investment trust AUM were languishing for six years before recently re-embarking on a growth trend in response to the factors discussed above, other developments have emerged that could materially impact the investment trust business going forward. One such development is a shift in demand toward passive investment trusts.

Over the six and a half years through September 2021, the passive share of equity investment trust AUM nearly doubled from 11.5% to 22.0%, driven by two factors, both of which remain at play prospectively (Exhibit 17).

One factor is that assets in DC plans, the investment trust distribution channel in which the passive share of AUM is highest, continue to grow. The passive share of DC plan AUM has been nearly constant in the vicinity of 75% for the past 10 years (Exhibit 18). Meanwhile, the DC plan channel's share of total investment trust AUM has more than doubled between March 2015 and through September 2021 (Exhibit 19).

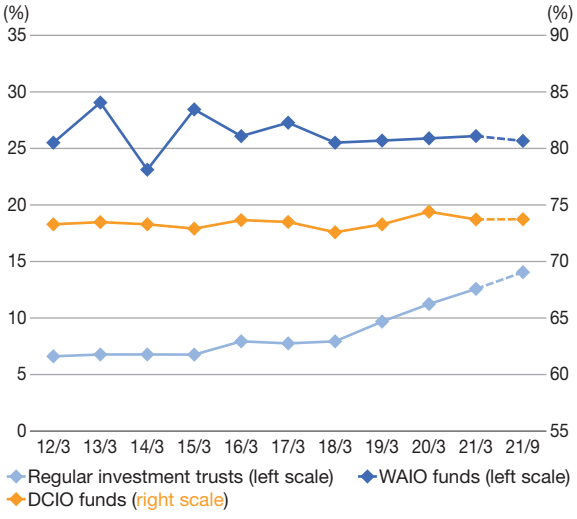
The second factor is that the passive share of regular investment trust AUM has been on the rise since 2018, increasing from 7.9% in March 2018 to 14.1%

Exhibit 17. **Passive investment trust AUM**




Note: AUM share is the passive share of total open-end equity investment trust (ex ETF) AUM.
Source: NRI

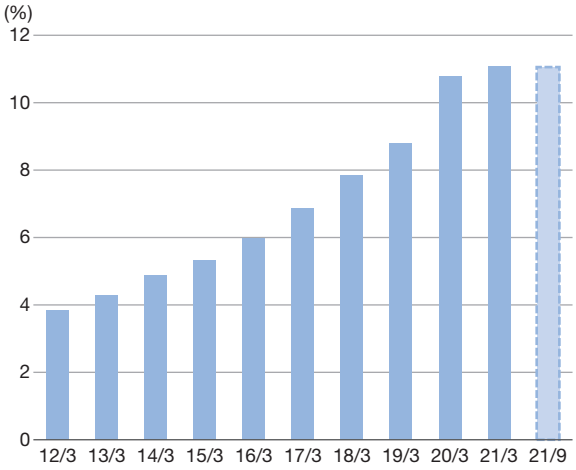
Exhibit 18. **Passive shares of regular, WAIO and DCIO investment trust AUM**




Source: NRI

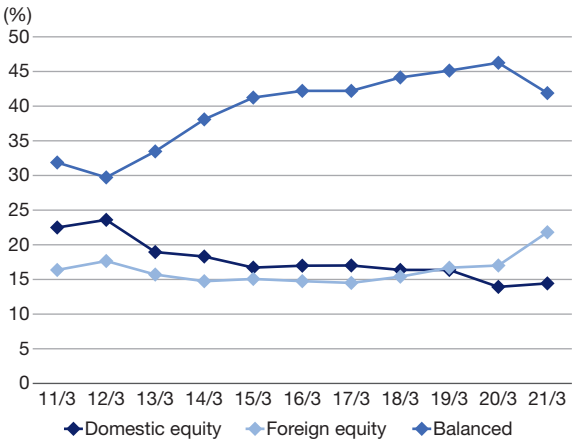
 

Exhibit 19. **DCIO funds' share of total investment trust AUM**




Note: DCIO funds' share of total open-end equity investment trust (ex ETF) AUM
Source: NRI

Exhibit 20. **Allocations of corporate DC plan contributions by fund category (excluding principal-guaranteed products)**




Note: Estimated based on purchases on the 25th of every month, the assumed monthly contribution date
Source: NRI

in September 2021 (Exhibit 18). Its sharp increase is indicative of a change in retail investors' perception of passive investment trusts' value as an investment vehicle. One undeniable catalyst behind this perceptual change is the 2018 advent of *Tsumitate* NISAs (Nippon Individual Savings Accounts with a lower annual contribution limit but longer-term tax exemption than regular NISAs). In 2020, some 40% of net inflows to passively managed regular investment trusts flowed through *Tsumitate* NISAs.

Passive investment trusts' average management fee rate (AMCs' share of trust fees) is in steep decline. Ten years ago, passive investment trusts' management fee was on average about 50% lower than active investment trusts'. Today it is 75% lower, having been driven down by intensification of competition. The ongoing rapid growth in the passive share of investment trust AUM has major implications for AMCs' revenues.

## Home-country bias weakening

Another development that will have a major impact on the investment trust business is that retail investors are increasingly investing in foreign equity investment trusts. In recent years foreign equity funds have been garnering net inflows not only in the regular investment trust space as we have already mentioned but in the DCIO fund space also.

Exhibit 20 plots estimates of how DC plan participants' aggregate monthly contributions are distributed among the three most popular investment options, factoring out the impact of fund switching by a minority of participants. The graph disregards other investment options such as principal-guaranteed products like savings deposits. It shows that domestic equity investment trusts, previously the second most popular investment option behind balanced funds, have seen their share of inflows from monthly contributions gradually decrease 8.0 percentage points over the past 10 years while foreign equity funds' share increased 5.5 percentage points. In fact, even balanced funds have been reducing their collective allocation to domestic equities while increasing their allocation to foreign equities.

These data points imply that many DC plan participants have started to favor foreign equities over Japanese equities as long-term investments. While we have limited our analysis here to investment trusts in the DC channel, foreign equity funds are drawing heavy inflows even in the regular investment trust channel, implying that perceptions are broadly changing among retail investors in general.

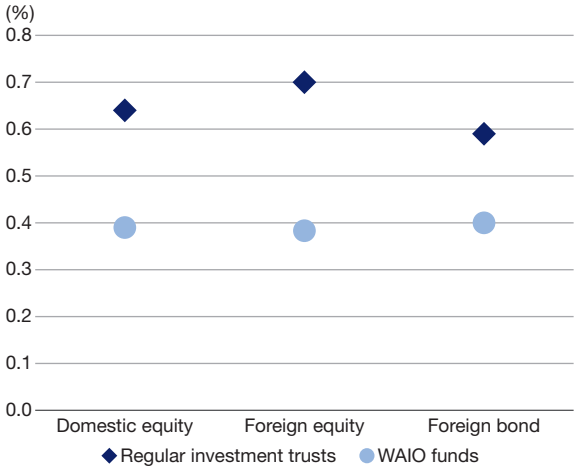
If so, the operating environment is set to become even more adverse for Japanese AMCs that have been relying on domestic equity products as a key revenue source amid the downtrend in active funds' AUM share.

## Growth in retail asset management services in which investment trust sponsors play little role

Discretionary investment advisory services such as fund wrap accounts constitute a growing market segment in which investment trust sponsors have little involvement. For the past several years, brokerages and banking groups, mostly larger ones, have been focusing on such services. Recently, major brokerages have been establishing chief investment offices in the aim of upgrading their discretionary investment advisory services.

If major financial institutions expand their discretionary investment advisory service offerings, investment trust sponsors' revenues may decrease even if those services funnel customer funds into investment trusts. The primary value-add of discretionary advisory services such as wrap accounts is efficient asset diversification, which is provided by the financial institution offering the service. Investment trust sponsors' main role is to merely manage assets in a designated asset class within certain active-risk constraints and explain their funds' performance in relatively simple terms. Largely because their role is so limited, investment trust managers charge lower management fees for WAIO funds than for regular investment trusts. Among actively managed domestic equity investment trusts, for example, WAIO funds' AUM-weighted average management fee is 39bps per annum versus regular investment trusts' corresponding average of 64bps (Exhibit 21). Consequently, if regular investment trusts lose AUM share to investment trusts offered exclusively through discretionary advisory services, investment trust sponsors' revenue would be reduced.

Exhibit 21. **Active investment trusts' average management fee rate**




Note: As of 3Q21. Average fee rates are AUM-weighted averages. Management fees are AMCs' share of investment trust fees.
Source: NRI

In fact, the investment trust industry is already experiencing such revenue erosion. As noted above, growth in WAIO fund AUM from FY2016 was accompanied by shrinkage in regular investment trust AUM. Meanwhile, total revenues from the public investment trust (ex ETF) business last peaked in FY2015 and have since gone five consecutive years without setting a new all-time record. With even regular investment trusts finally experiencing renewed net inflows since mid-FY2020 as already mentioned, the investment trust industry as a whole may no longer be at risk of a decline in revenues but the same cannot be said for individual investment trust sponsors.

## Boosting competitiveness by adapting to exogenous changes

In sum, three changes are afoot that will likely have a major impact on the investment trust business. For investment trust sponsors, each of these changes is a near-term threat with the potential to be an longer-term opportunity to pivot their business models.

The ongoing shift in demand toward passive management, while definitely a threat to active managers, means that retail customers are better able to gauge managers' performance by using

index performance as a benchmark. More and more retail investors may develop the ability to identify high-quality active funds. If active managers set management fees appropriately, they can offer actively managed options to investors who prefer passive investment trusts. To do so, they need to select distribution channels that are best suited to their investment capabilities and products' attributes. A distribution channel that charges fees in excess of the alpha that can be expected to be generated over the long term makes no economic sense. Managers must select distribution channels that leave enough alpha to entice customers.

Growing retail demand for foreign equity products is evident in DC plan participants' allocations of their contributions based on a long-term investment horizon. We doubt it is a passing fad. In response to such demand, Japanese AMCs will need to (1) build a lower-cost investment trust operating model utilizing passive funds and sub-advisory services and/or (2) strengthen their active-fund management capabilities. The latter is a challenge with which numerous Japanese AMCs have long been grappling. Greater effort to meet regular investors' investment needs also is crucial.

While major brokerages are taking steps to upgrade their discretionary investment advisory services, many smaller brokerages and regional banks have yet to roll out fund wrap products. Many financial institutions are currently working on revamping their investment trust businesses' fee structures from a customer-centric standpoint and switching to AUM-based fees as a major priority. They see discretionary investment advisory services as the key to accomplishing these objectives. One such service that many of them presumably intend to newly offer is fund wrap accounts. At the same time, many smaller financial institutions are also resource-constrained and likely lack confidence in their ability to launch a fund wrap service on their own. For these financial institutions, partnering with a specialized AMC to offer fund wrap services to customers is an attractive option. In fact, a number of financial institutions are already offering wrap accounts to retail customers through such an approach. Others will likely follow suit. Offering fund wrap services through alliances with regional banks and smaller brokerages could be a winning growth strategy for investment trust sponsors.

During Japanese public investment trusts' stagnation phase preceding their recently resumed growth trend, customers and fund distributors' needs changed materially. AMCs have arrived at an important juncture in terms of how they actually respond to such changes going forward.

## 3 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 latest *Survey of Asset Management Companies' Management Priorities*, conducted in August-September 2021. They 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 products that rank highest on the demand scale are mostly foreign equity products, including active and passive foreign equity funds, ESG equity products and concentrated equity funds with long-term investment horizons. These products' demand rankings are generally consistent with public investment trusts' actual fund flows. Within the DM equity asset class, the active

funds with the strongest inflows are those that invest in quality foreign growth stocks, mainly US large-cap tech names, and other growth-themed funds. In the passive foreign equity space, funds that track the S&P 500 and MSCI All Country World Index are seeing continued inflows. In contrast, Japanese, EM and China-related equity products have lower demand rankings than in 2020. The bond product ranked highest on the demand scale is currency-hedged foreign bond funds.

Among balanced funds, DM balanced funds and risk-control funds ranked relatively highly on the demand scale, albeit materially lower than in 2020. Many AMCs seem to recognize that retail investors generally prefer to overweight foreign equities than to hold a diversified balanced portfolio with a sizable allocation to low-yielding bonds. Principal-guaranteed funds and NAV-floor funds, both of which had respectably high rankings on the demand scale until last year, are ranked lower this year. Neither is offered by many AMCs.

In the pension fund segment, demand assessments are mixed. Equity products ranked highly on the demand scale included ESG investment strategies and private equity (PE) products. Low-volatility strategies, by contrast, are ranked near the bottom, presumably reflecting that some had failed to perform as defensively as expected when the market was under stress from the pandemic and that many pension funds have underperformed the subsequent market rally. In the fixed-income space, core-plus strategies and core-less absolute return products like unconstrained strategies are ranked higher on the demand scale than strategies specializing in a single market vertical like bank loans or high-yield bonds, reflecting the needs of corporate pension funds that want to be invested in strategies that flexibly adapt to market conditions instead of building diversified portfolios comprising a variety of sector-specific funds. Bond smart-beta strategies' demand ranking is higher than in 2020.

Multi-asset strategies' rankings are presumably based on perceived demand from corporate pension funds because no Japanese public pension fund has ever allocated to a multi-asset strategy. Quant multi-asset strategies are ranked much lower on the demand scale than in 2020 while judgmental multi-asset strategies' demand ranking remains high. Pension funds may be aware that some quant or rules-based multi-asset strategies have until recently performed poorly during the pandemic. Amid illiquid alternatives, domestic private real estate products (including REITs) are ranked lower on the demand scale than in 2020, likely because of uncertainties surrounding future office and retail occupancy rates in major metropolitan areas in which a large share of domestic private real estate funds' property holdings are located. Demand rankings for private credit and foreign private real estate funds remain high.

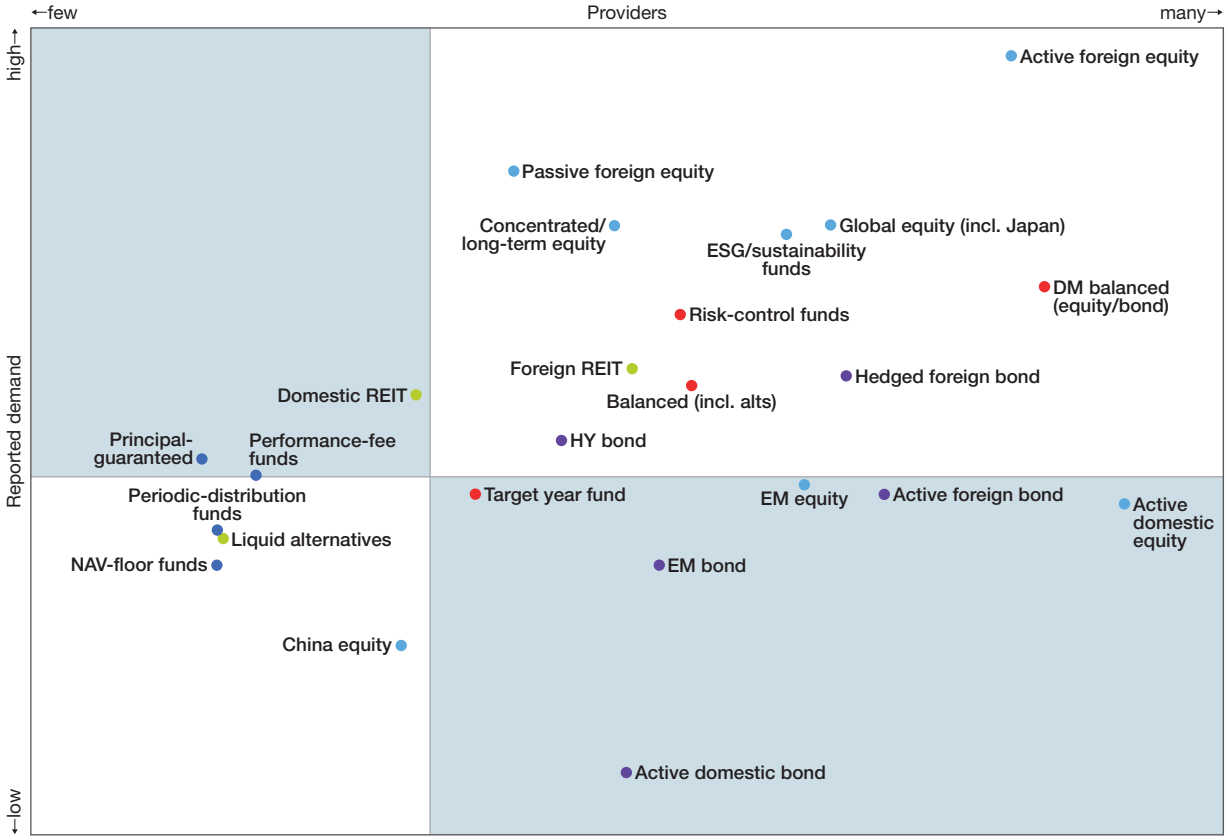
In the financial institution segment, investments that increase securities portfolios' yield are in strong demand. Regional financial institutions, for example, tend to favor foreign bond products that offer attractive yields in yen terms when reinvesting proceeds from maturing JGB holdings. Bond products with high demand rankings include foreign bonds, currency-hedged foreign bonds, foreign credit and core-plus strategies. AMCs continue to offer a wide variety of products to meet such demand, including US municipal bonds, mortgage bonds and IG bonds, Canadian provincial bonds, Australian dollar bonds and Danish covered bond strategies. In the equity space, ESG investments rank exceptionally high on the demand scale, even more so than last year.

Judgmental multi-asset funds have a relatively high demand ranking, like in the pension fund segment. Outsourced CIO services rank lower on the demand scale than in 2020. Among alternative assets, domestic private real estate products have a materially lower demand ranking than in 2020, like in the pension fund segment. In absolute terms,

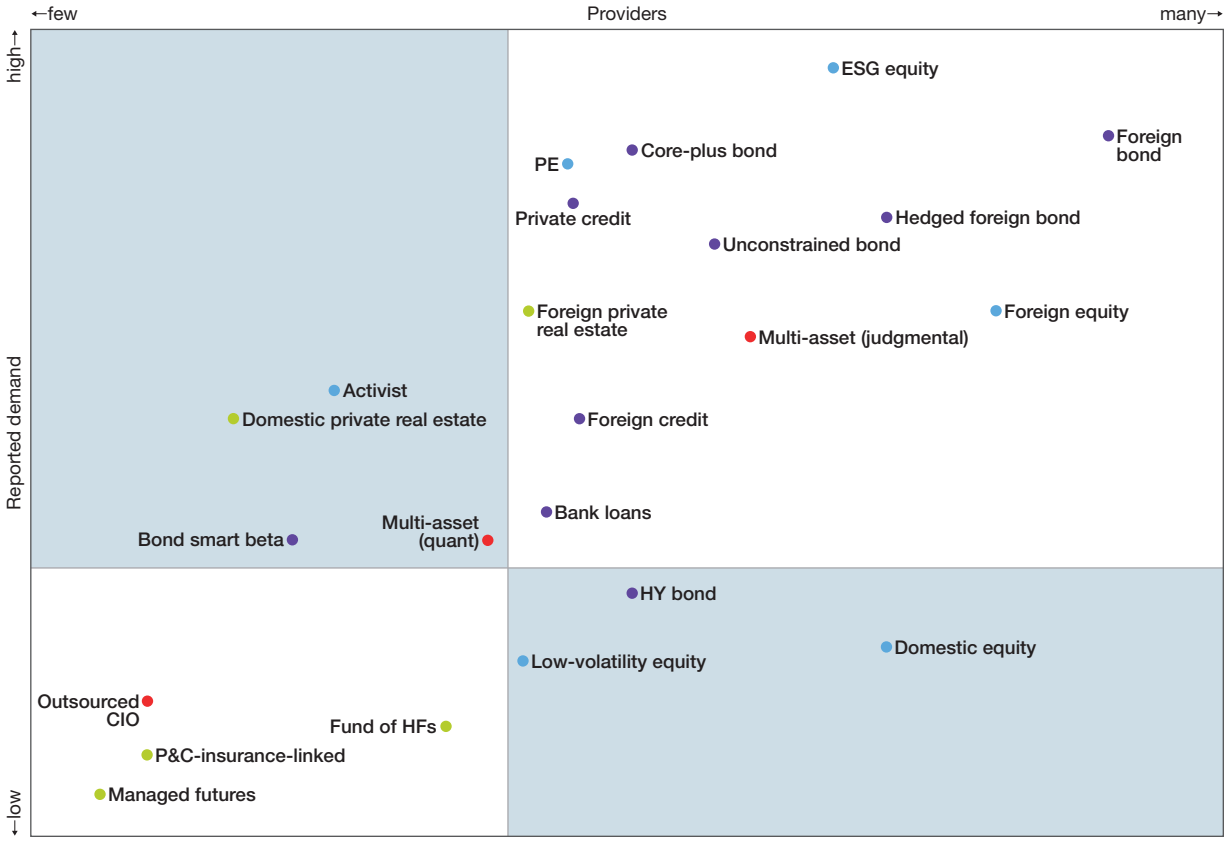
 

Exhibit 22. Product supply and demand maps by customer segment

(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 customers (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*

however, their demand ranking remains high, on a par with foreign private real estate products.

5) Per JST's Fourth Mid/Long-Term Plan.
6) In this section, we count investment trust distributions as asset outflows: net in/outflows = purchases – redemptions – distributions.

CHAPTER 4

# AMCs' cost structure

Lastly, we analyze AMCs' cost structure, focusing specifically on the breakdown between outsourcing and in-house execution of various essential business processes from a cost standpoint. Such insight into AMCs' actual cost structures should be of value to prospective new entrants to the asset management business as well as to incumbent AMCs that want to benchmark their cost structures against peers'. The data we use in our analysis are mainly operating and SG&A expenses reported on public investment trust management companies' income statements.

## AMCs' functions and costs thereof

In simple terms, AMCs' operations generally comprise three functions: (1) fund management, (2) IT/operations and (3) sales/marketing, all of which are essential to AMCs of all sizes irrespective of business model. These functions can be outsourced to one extent or another.

For example, Japanese AMCs sometimes outsource management of certain funds to global AMCs acting as a discretionary sub-advisor. Meanwhile, foreign AMCs offer products to Japanese investors by outsourcing fund management to an overseas affiliate pursuant to some type of transfer pricing arrangement.

AMCs outsource IT and operations functions to vendors such as IT service providers and trust banks or, in the case of certain foreign AMCs, to a shared service provider or an affiliated investment bank's back-office staff.

Outsourcing of sales and marketing functions may take the form of, for example, sub-advisorship of another AMC's investment product (e.g., management of another AMC's product for overseas investors, a reversal of the typical pattern of sub-advised Japanese products). However, the cost of such outsourcing is an opportunity cost (i.e., a reduction in the outsourcing AMC's management fee revenue) that cannot be quantified from the income statement. Additionally, such outsourcing itself is rare in the Japanese asset management industry. We have therefore chosen to focus on how AMCs strike a balance between outsourcing and in-house execution of fund management and IT/operations while disregarding sales/marketing.

The specific expense line items we analyzed are listed in Exhibit 23. Fund management outsourcing expenses include outsourced research expenses

Exhibit 23. **Expense line items included in in-house and outsourcing expenses**

| | (1) Fund management | (2) IT/operations |
|---|---|---|
| In-house expenses | Employee compensation: salaries/allowances, bonuses, benefits, other personnel expenses, etc.<br>Director/officer compensation: director/officer compensation, etc.<br>*Not including expenses related to severance/retirement benefits | |
| Outsourcing expenses | Fund management outsourcing expenses<br>Outsourced research expenses, trustee fees, sub-advisory fees paid, investment advisory fees paid, etc. | BPO expenses<br>NAV calculation expenses, BPO expenses, back-office outsourcing expenses, system usage fees, subcontracting expenses, etc. |

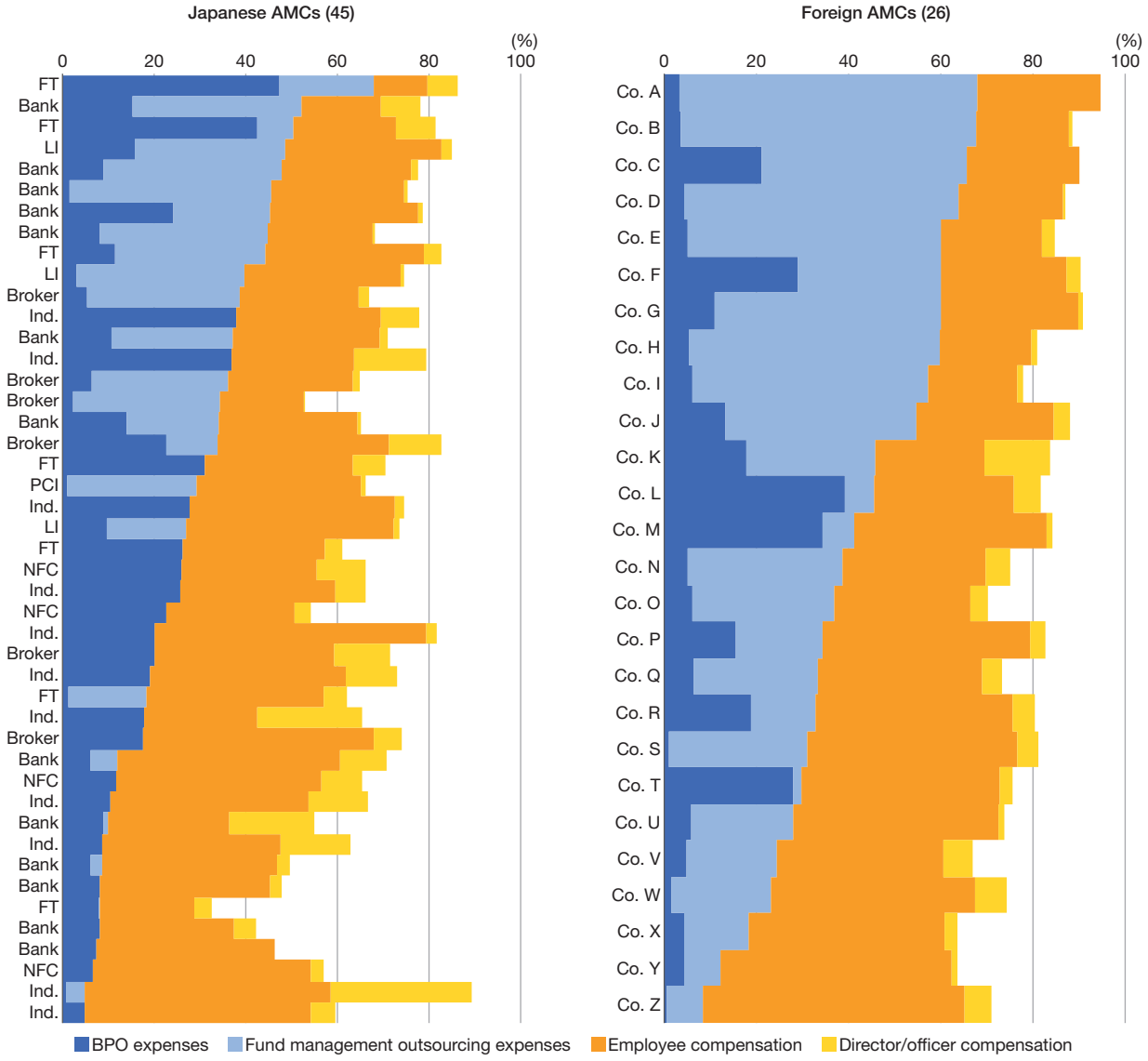
 

and management fees paid to external managers. IT/operations outsourcing expenses include outsourced NAV calculation, business process outsourcing (BPO) and back-office outsourcing expenses (collectively referred to below as BPO expenses). We use personnel expenses as a proxy for in-house execution expenses. Although personnel expenses cannot be disaggregated by organizational function, their totals can be ascertained from line items such as salaries and bonuses.

## Balance between in-house and outsourcing expenses

Exhibit 24 shows the company-by-company breakdown between in-house expenses (personnel expenses) and outsourcing expenses (fund management outsourcing and BPO expenses) for 45 Japanese AMCs and 26 foreign AMCs[7] based on data from their most recent fiscal year (ended March 2021 in most cases)[8]. Outsourcing expenses' share of total non-labor expenses spans a wide range: from roughly 5% to 60% for Japanese AMCs and 10% to 65% for foreign AMCs. When personnel expenses are

Exhibit 24. **AMCs' cost structures**

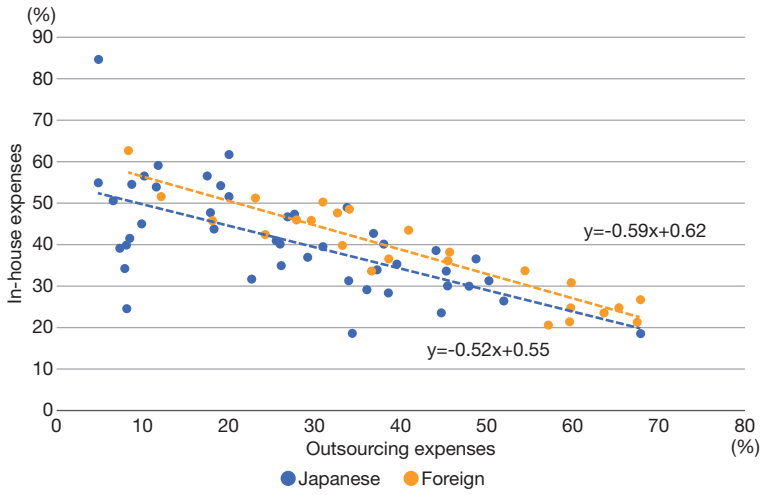



Note: The column to the left of the graph for Japanese AMCs contains the type of group to which the AMC belongs (FT: FinTech, LI: life insurer, PCI: property & casualty insurer, NFC: non-financial company, Ind.: independent (i.e., does not belong to a group)).
Source: NRI

added to outsourcing expenses, however, the resultant subtotals' share of total expenses span a narrower range of 50-80% for Japanese AMCs and 65-90% for foreign AMCs, implying that in-house expenses (personnel expenses) and outsourcing expenses are substitutes for each other.

Exhibit 25. **Scatter plot of AMCs' outsourcing and in-house expenses (FY2020)**




Source: NRI

Their substitutability is quantified in Exhibit 25. In the scatter plot, foreign AMCs' regression line is above Japanese AMCs', implying that foreign AMCs mostly have higher total expenses than Japanese AMCs. The dots representing Japanese AMCs are on average plotted lower, skewed more to the left and more dispersed than the foreign AMC dots. Their dispersion reflects that Japanese AMCs are more diverse than foreign AMCs in terms of how much they spend on expenses that do not fall into either the in-house or outsourcing expense category (e.g., research, advertising and real estate expenses).

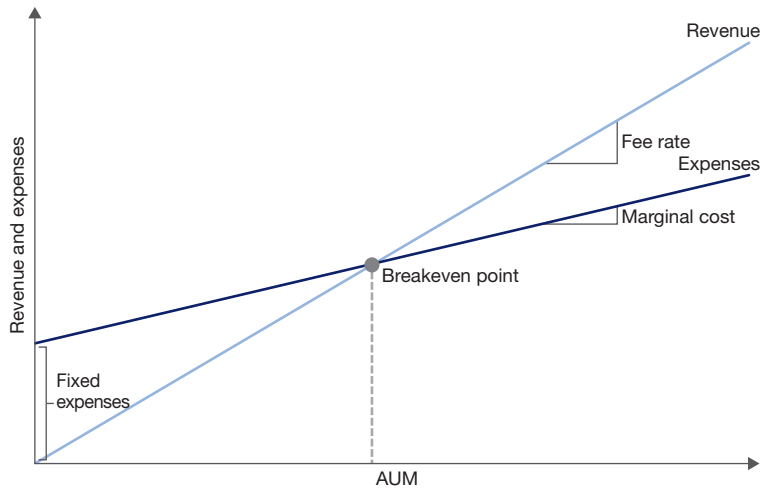
When in-house expenses are regressed on outsourcing expenses, the regression coefficient is -0.52 for Japanese AMCs and -0.59 for foreign AMCs. These coefficients imply that under normal circumstances, outsourcing expenses' share of total expenses would have to increase 17-20 percentage points to reduce in-house expenses' share by 10 percentage points.

Based on these cross-sectional correlation coefficients alone, one could conclude that the most effective way to reduce total costs is to minimize outsourcing. In Exhibit 24, the AMCs with lower ratios of outsourcing expenses to total expenses do indeed tend to have lower total expenses.

## Fixed vs. variable expenses

However, another point that must be taken into consideration is that in-house expenses (personnel expenses) are largely fixed expenses (expenses incurred even if AUM were zero). Fixed expenses raise a company's breakeven point or, put differently, increase its operating leverage (Exhibit 26). For a newly established AMC, for example, the higher its operating leverage, the longer it will take to reach profitability. Additionally, for AMCs subject

Exhibit 26. **Fixed/variable expense model**




Source: NRI

to downside risk to their revenues, operating leverage amplifies profit declines when AUM actually decreases. Conversely, once the breakeven point has been reached, an AMC with a higher proportion of in-house expenses should experience faster subsequent profit growth.

In contrast, outsourcing expenses are mostly variable expenses that increase or decrease in tandem with AUM. BPO expenses, for instance, are usually contractually set at a percentage of assets or management fee revenues. Even fund management outsourcing expenses are almost always contractually set at a percentage of the sub-advised fund's assets, not a fixed amount. Aggressive utilization of outsourcing reduces fixed expenses, increases marginal cost and, in turn, often lowers the company's breakeven point. On the flipside, however, aggressive outsourcing results in slower profit growth after the breakeven point has been reached.

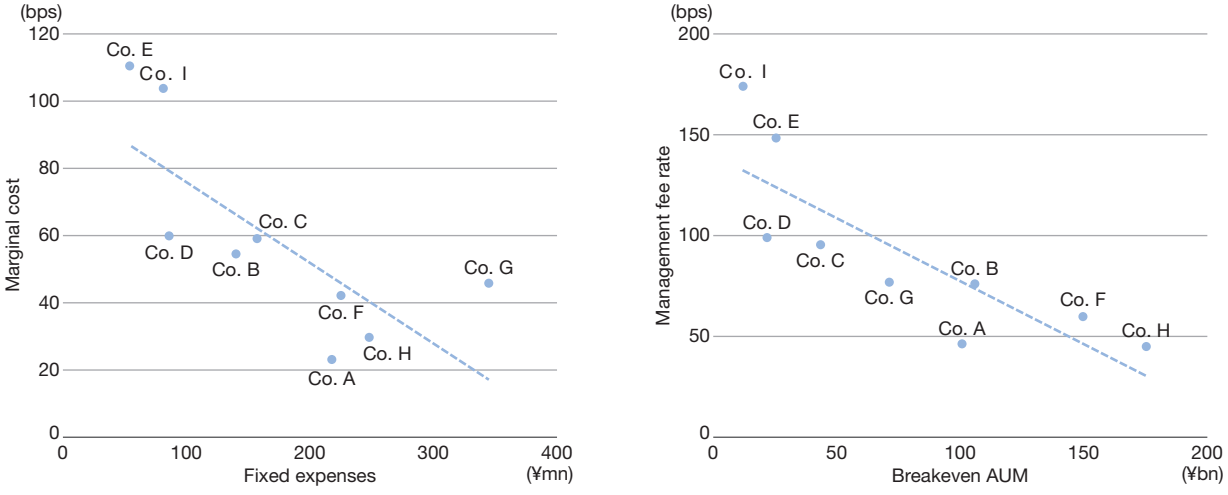
## Start-up AMC's costs

If we use time-series data for an individual AMC instead of cross-sectional data, we can construct a standard model that estimates the AMC's fixed and variable expenses, management fee rate and breakeven point like in Exhibit 26. However, the model's applicability would be limited to AMCs that have never undergone a major business model pivot. For example, an AMC that previously managed mostly active funds but has recently been shifting its business model more toward passive funds may experience a decline in management fee revenues despite growth in AUM. In such a case, the model's estimate of the AMC's management fee rate would be negative, in which case the AMC's breakeven point could not be correctly estimated. Nor could the model be applied to an AMC that derives a large share of its revenue from an institutional business with a sliding-scale fee that decreases as assets increase.

Using the model in Exhibit 26, we analyzed nine selected AMCs, all of which are relatively small, have been growing in recent years and derive most of their revenues from public investment trusts (Exhibit 27).

Exhibit 27's left graph shows that the nine AMCs' fixed expenses range from ¥50mn to ¥350mn. Companies with lower fixed expenses have higher marginal costs. Two of the companies have an estimated marginal cost in excess of 100bps. In the right graph, an AMC that offers mainly active strategies and charges an average management fee of around 100bps has breakeven point of roughly ¥50bn while another AMC that offers mainly passive funds and charges around 50bps has a breakeven point in the vicinity of ¥150bn. Companies E and I are boutique AMCs

Exhibit 27. **Scatter plots of marginal cost against fixed expenses and management fee rate against breakeven point**




Source: NRI

that offer distinctive investment strategies. On the opposite end of the spectrum, Companies F and H, both of which are affiliated with fund distributors, have been expanding their businesses with low-fee funds predicated on a vertically integrated business model.

## Building optimal business processes and cost structures

The optimal combination of in-house execution and outsourcing differs as a function of individual companies' business models. Important considerations that factor into optimizing the balance between the two include the company's average management fee rate on its own products, the expected growth rate of businesses that gather AUM, risks to the expected growth rate and the acceptable length of the company's profitability runway.

For new-entrant AMCs in particular, outsourcing is an effective means of achieving early profitability. The ability to easily outsource fund management and access standard IT/operations services through outsourcing is a key prerequisite to lowering barriers to entry to the asset management industry.

7) Requisite financial statement data were available for a total of 85 companies, of which we excluded nine companies (eight Japanese, one foreign) that do not disclose IT/operations outsourcing expenses, four companies (all foreign) that do not disclose fund management outsourcing expenses and one (Japanese) company that derives a majority of its revenue from a business other than asset management.

8) The percentages in Exhibit 24 are ratios of the expense line items to total operating and SG&A expenses (excluding investment trust fees paid to fund distributors for servicing customer accounts).

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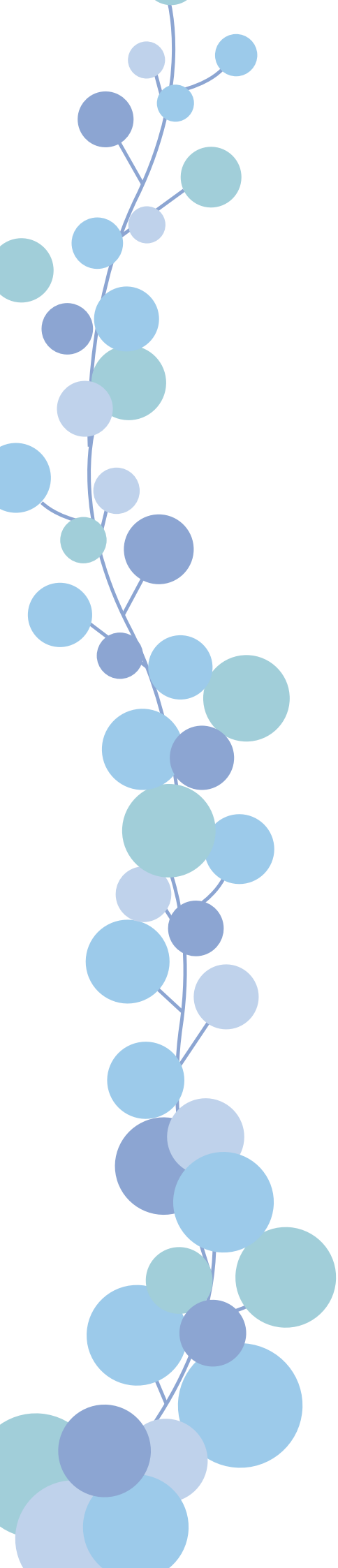

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