Japan's Asset Management Business 2023/24

Nomura Research Institute

Foreword

Steady progress has been made on the shift from savings to wealth formation that has been promoted jointly by the Japanese authorities and the financial industry. In a nationwide 2022 survey conducted by NRI that asked 10,000 people about their financial activity, household situation, and assets, fully 32% of respondents—roughly one in three—said they had invested money before. This trend is also confirmed by the sustained large inflows to publicly offered investment trusts starting in FY2021. Momentum is almost certain to pick up further when the new NISA framework takes effect in 2024, and it is clear that the public investment trust business offers the greatest potential for long-term growth.

However, there has also been a rapid migration to passive investment strategies as active investment trusts have been unable to present a compelling value proposition to retail investors. There are mounting concerns about whether the industry can keep fees at a sustainable level, and it would appear that a key success factor for the sector will be its ability to demonstrate the value of active investment trusts via improved investment capabilities.

The government intends to present a plan for drastic reform of the asset management business by the end of the year as part of its efforts to transform Japan into an “asset management nation” and mobilize the country’s huge capital stock. This is truly a time for change, and the future balance of power within the industry may hinge on the business strategies adopted going forward. As foreign companies enter the market and competition intensifies, asset management firms will have to do more to provide value and enhance the efficiency of their operations. And that is not all. Financial groups may also need to alter the role of their asset management divisions. If Japan’s asset management business is to continue growing, the industry will need to view this reform period as an opportune time to undertake new challenges.

This report aims to provide points of reference for thinking about the future direction of the asset management business. Its intended audience includes the senior management and marketing/sales planning staff of asset management companies and financial product distributors along with the business planning staff of financial groups. The asset management business is expected to play an increasingly important role as the transition from saving to wealth formation accelerates, and we hope this report adds to readers’ understanding of Japan’s evolving asset management industry.

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CHAPTER 1

Japanese investor trends

Gradual growth in AUM continues

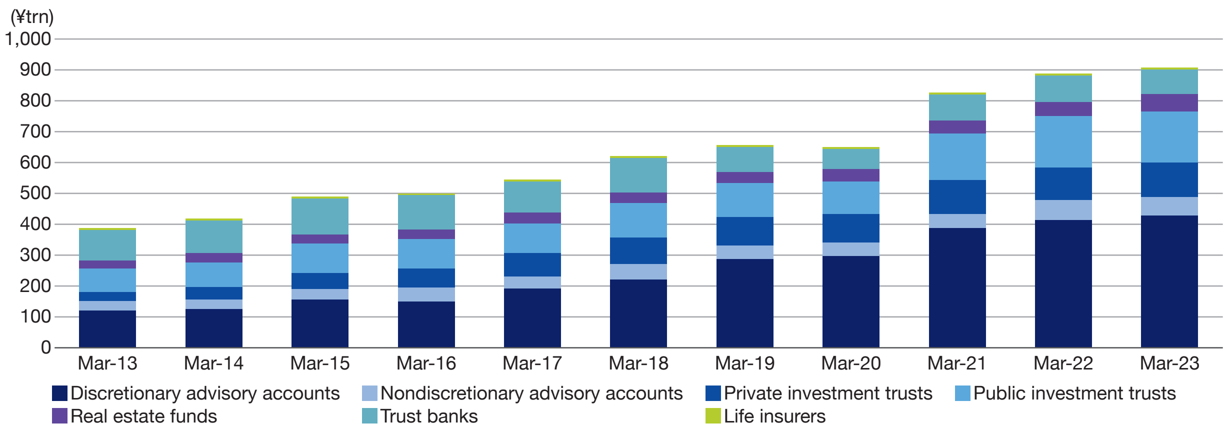
Japanese asset management companies (AMCs) ended FY2022 (March 2023) with estimated AUM of ¥909trn[1], representing an increase of ¥21trn or 2% over the year before (Exhibit 1). This was the second lowest growth rate in the last ten years and was attributable to the poor performance of both domestic and overseas bond markets in response to monetary tightening and changes to monetary policy. Although the return delivered by foreign equities was positive, it was down sharply from a figure in excess of 20% the previous fiscal year.

AUM in discretionary investment advisory accounts grew ¥12trn YoY to ¥427trn. The 3% increase was probably attributable to a high percentage of (foreign and domestic) equity investments, which enjoyed relatively high returns. AUM in such accounts have grown 260% over the past ten years for a CAGR of 14%, but this increase is due partly to financial groups transferring existing assets to affiliated investment advisory firms. Such reshuffling continued in FY2022, with a leading life insurer shifting some ¥2trn in AUM to an affiliated advisory firm.

AUM in public investment trusts, the second largest vehicle, increased by only ¥3trn in FY2022, but the smallness of the gain was due largely to market price movements. Cash inflows did not decline, and the Japanese public's shift from savings to wealth formation continued.

The yen's decline after March 2023 has lifted the prices of foreign-currency assets, and domestic equities have also appreciated substantially. As a result, we estimate that AUM in discretionary and nondiscretionary investment advisory accounts, public investment trusts, and trust banks were up about 10% at the end of June 2023 from the end of March.

Exhibit 1. **AUM at asset management companies**



Note: Life insurers' AUM represent DB pension assets in special accounts.
Source: NRI, based on Japan Investment Trust Association (JITA) and Japan Investment Advisers Association (JIAA) data and financial reports of AMCs

End-investor AUM have grown at CAGR of 7% for last ten years

We now look at funds entrusted to Japanese AMCs by customers. It should be noted that the AUM data in Exhibit 1 are significantly inflated by double-counting of certain assets. For example, cash inflows to a public fund of funds (FoF) that has holdings in private investment trusts are counted as an increase in AUM for both the FoF and the private investment trusts. Other examples include corporate pension assets that are (1) invested in private funds for nontaxable institutional investors under a discretionary investment advisory agreement or (2) discretionarily managed primarily by an affiliated investment 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 not willing to pay higher management fees simply because their capital is being invested by multiple layers of managers. Counting AUM from the end-investor's standpoint therefore presents a more accurate picture of the aggregate revenue base for AMCs.

Exhibit 2 shows growth in AUM counted from the standpoint of the end-investor[2)]. Like total AUM, AUM counted in this way have been growing since the post-GFC trough at the end of FY2011. However, they have increased only 90% during the ten years through end-FY2022 (for a CAGR of roughly 7%), compared with a 140% increase (9% CAGR) in total AUM over the same period.

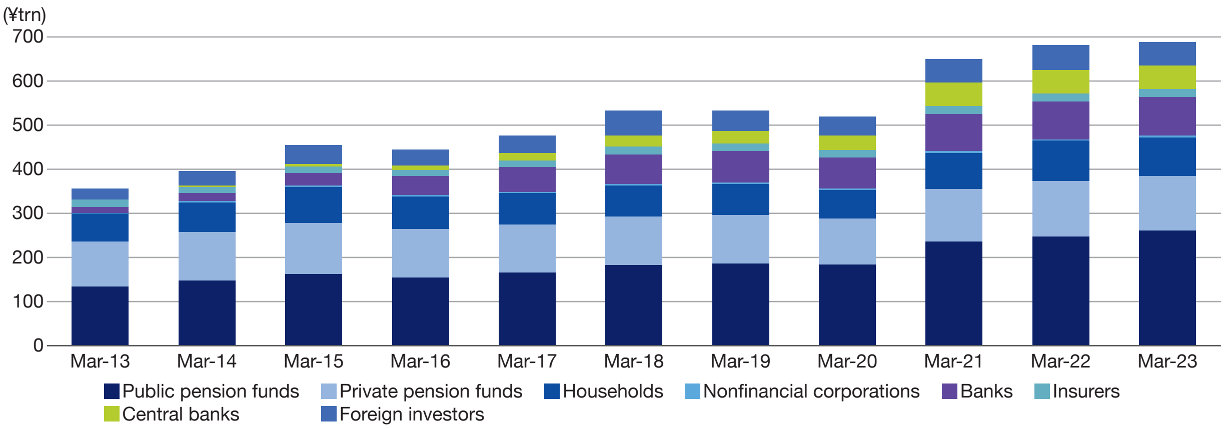
The biggest contributor to AUM growth over the past ten years was assets managed on behalf of public pension funds, which increased ¥126trn. Assets managed on behalf of banks (depository financial institutions) and the Bank of Japan increased ¥75trn and ¥52trn, respectively, whereas assets managed on behalf of overseas investors, private pension funds and retail investors grew at a slower pace, expanding by ¥20–30trn each during the same period.

Pension funds, banks and households

Within public pension funds, a look at the components of AUM growth at the Government Pension Investment Fund (GPIF) shows that deposits received (cash inflows) have roughly equaled redemptions and payments to the national pension special account (cash outflows) since FY2019. The conservative scenario in the Fund's latest financial condition report ("financial verification results") assumes net cash inflows of about ¥1trn a year, which suggests we cannot expect inflows to continue at historical levels.

Among private pension plans, DB corporate pensions are not expected to receive substantial cash inflows

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



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

going forward. However, the government is trying to improve corporate pension governance and strengthen related frameworks as part of efforts to transform Japan into an “asset management nation” and mobilize the country’s capital stock. This raises the possibility of major developments such as the consolidation of corporate pension programs. Attention may also start to focus on outsourced CIO (OCIO) solutions.

In DC pension plans, which include individual plans, inflows are expected to continue at around the current level of around ¥1trn a year since participants who are still paying in heavily outnumber those who have reached the age of eligibility. Reforms aimed at boosting fund inflows are projected to continue: the age cap on new participants in individual plans was raised to 65 in 2022, and a further increase to 70 is currently being considered.

Banks have dramatically expanded their fund investments since the BOJ launched its quantitative and qualitative easing program, although these investments have lost some of their former momentum now that monetary policy is under review. Nevertheless, banks have built up their securities investment organizations and are expected to continue making such investments, including outsourcing to AMCs.

Public investment trusts, which are purchased mainly by retail investors, are thought to have the highest growth potential. Investment trust ownership is growing as the public image of securities investment has evolved and more people—especially the young—come to realize the importance of long-term investing and asset diversification. The government is providing institutional support for this shift and plans to make Nippon Individual Savings Accounts (NISAs), a tax-free investment account for individuals, permanent while more than doubling the lifetime investment limit to ¥18mn. These changes will undoubtedly drive long-term growth in household holdings of investment trusts. Against this backdrop, the passively managed share of investment trust AUM is rapidly increasing. With passive investing now broadly viewed by retail investors as the best way to invest for the long term, the shift toward passive management is all but certain to continue.

However, passive funds already account for 55% of all AUM in public investment trusts. This may be one reason why the authorities—who until now looked favorably on the migration into passive funds—are starting to take a fresh look at the value offered by actively managed investment trusts. The question is whether the industry can demonstrate to retail investors the value of actively managed investment trusts as a long-term portfolio component.

1) Trusts and life insurers’ share of this total only includes assets managed on behalf of pension fund clients. Life insurers’ portion only includes special accounts and not general-account assets with guaranteed returns such as fixed-amount insurance and fixed annuities. In addition, the total is not adjusted to correct for double-counting due to, e.g., public investment trusts’ ownership of private investment funds or investment trusts’ partial outsourcing of asset management to subadvisors.

2) The Exhibit counts customer funds entrusted to AMCs only when it is the customers themselves who primarily bear the risk of fluctuations in value.

CHAPTER 2

Current state of asset management business

1 Current state of asset management business

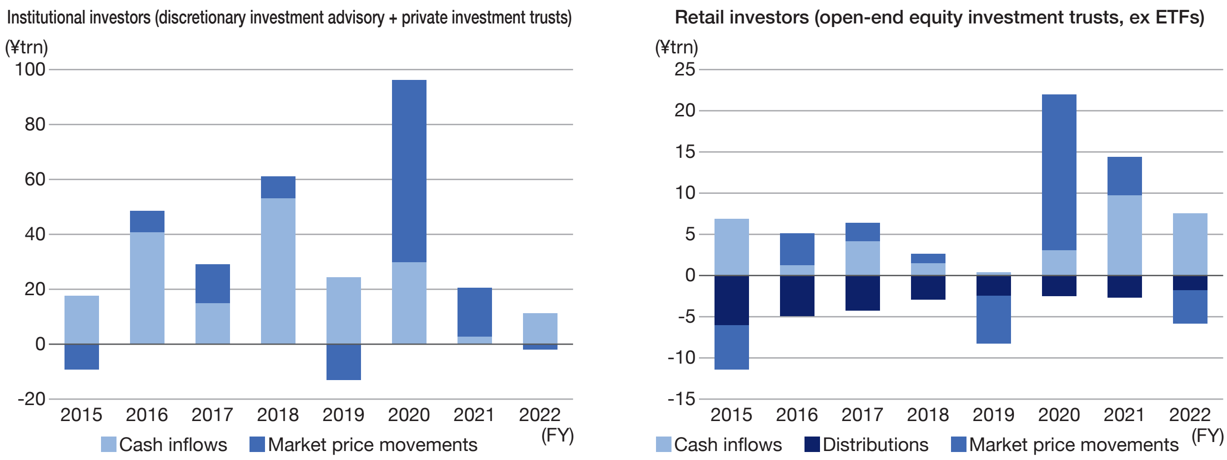
This chapter surveys the business environment for AMCs, defined as firms specializing in investment trust management and/or investment advisory services, using proprietary survey results and other data.

Revenues rise slightly to new all-time high

Exhibit 3 analyzes the components of AUM growth at AMCs over time. In the institutional market segment, asset price movements reduced AUM by about ¥1.8trn in FY2022, while net cash inflows boosted them by some ¥11trn. Of the net cash inflows, an estimated ¥2trn came from the transfer of an investment function within the asset management operation of a domestic financial group[3]. When this amount is excluded, effective cash inflows amounted to about ¥9trn. Private investment trusts, where financial companies have continued to invest the proceeds of JGB redemptions, saw net inflows of around ¥4trn in FY2022 but in FY2023 have experienced net cash outflows of about ¥500bn through the end of August. Depending on future developments in monetary policy and interest rates, a turning point may be approaching.

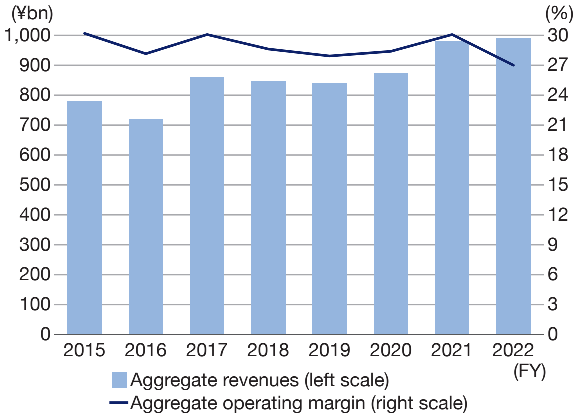
In the retail market segment, AUM declined ¥4.1trn due to asset price movements but received a ¥7.5trn boost from net cash inflows. After ¥1.8trn in dividend distributions are excluded, effective cash inflows amounted to about ¥5.7trn. Effective net inflows were negative from FY2016 onward but then turned slightly positive in FY2020 and have been heavily positive since FY2021. Dividend distributions peaked in FY2015 and have been declining ever since. As a result, the aggregate distribution yield for open-end equity investment trusts (ex ETFs) has fallen to around 2% from a high of about 10% at the end of FY2015[4].

Exhibit 3. Components of AUM growth, FY2015–2022



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

Exhibit 4. **Aggregate revenues and operating margins at AMCs**



Note: Aggregate operating margin is only for domestic public investment trust sponsors (number of AMCs in sample varies by fiscal year) and is defined as aggregate operating profit of AMCs in sample divided by aggregate net revenues.
Source: NRI, based on JITA and JIAA data

We next looked at the operating revenues and operating margins of AMCs (Exhibit 4). Based on data available at the time of this writing, we estimate the asset management industry's aggregate FY2022 revenues at a record ¥990bn, up slightly from ¥980bn in FY2021, which was also a record. Revenues were nearly flat for four years starting in FY2017, and the main driver of revenue growth since FY2021 has been an increase in retail segment AUM.

Exhibit 4 plots the aggregate operating margin (total operating profit divided by total net revenues) of surveyed Japanese AMCs that sponsor public investment trusts. The aggregate operating margin for companies in our survey was 27% in FY2022, off about 3%pt from the previous year. The lower margin is attributable to slightly higher revenues coupled with an increase in investment advisory fees paid to subadvisors and higher operating expenses.

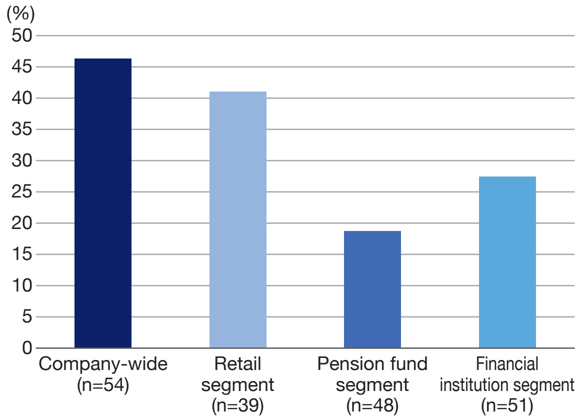
2 Outlook for asset management business

Each year NRI conducts a survey targeting the management of AMCs (*NRI Survey of Asset Management Companies' Management Priorities*[5]) to learn how the industry is doing and what the consensus outlook is. The remainder of this chapter looks at how AMCs view the near-term business environment, as indicated by their survey responses.

Revamped NISA program boosts growth prospects of retail segment

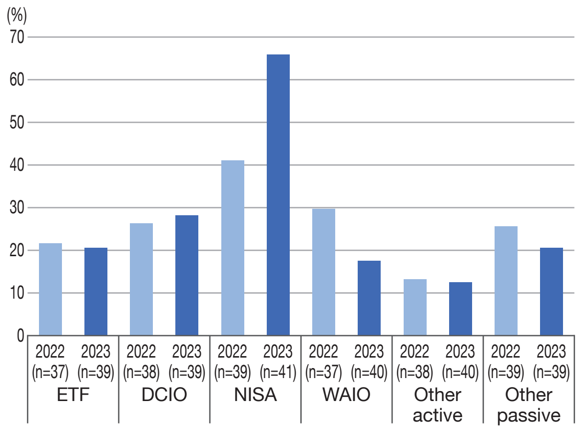
Exhibit 5 shows what percentage of survey respondents forecast cumulative revenue growth of at least 50% over the next five years either company-wide or in specific business lines (investor segments). Some 45% of all respondents project that firm-wide revenue will grow by at least 50% over the next five years. For a fifth straight year, the prospects

Exhibit 5. **Percentage of survey respondents forecasting at least 50% revenue growth over next five years**



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

Exhibit 6. **Percentage of survey respondents forecasting at least 50% AUM growth from cash inflows over next five years (by type of public investment trust)**



Note: DCIO refers to "defined contribution investment only" funds and WAIO to "wrap account investment only" funds.
Source: NRI *Survey of Asset Management Companies' Management Priorities*

were brightest for the retail segment, followed by the financial institution and pension fund segments. Retail's continued hold on the top ranking reflects robust asset inflows from FY2021 onward coupled with expectations of accelerated growth in investment trust ownership driven by new government incentives for household wealth formation, including the revamped NISA program.

The retail segment has been viewed as having as the best growth outlook ever since FY2018. We also examined individual business lines within the retail segment. Exhibit 6 divides public investment trusts into various categories and shows the percentage of respondents anticipating cumulative AUM growth of at least 50% due to cash inflows over the next five years. Investment trusts for NISAs had the highest score, with over 65% of respondents—substantially more than in the previous year—expecting AUM to grow by 50% or more. The steady increase in investment trust ownership under the current NISA framework has helped fuel expectations for the new program. Although the ban on active ETFs was lifted in FY2023, this does not appear to have boosted overall growth expectations for ETFs. That said, some respondents did say they planned to introduce active ETFs for foreign equities and foreign bonds, indicating the potential for a diversification of product lineups.

Expectations of AUM growth for "other active" and WAIO (wrap account investment only) investment trusts with their higher fees were tepid. As the shift to passive investing rapidly undermines revenues, AMCs need to find a business strategy that can improve investment capabilities and enhance the appeal of actively managed funds. This is also seen as a critical issue by the government as it attempts to transform Japan into an "asset management nation."

Exhibit 7 shows the percentage of respondents planning to increase headcount for various organizational functions within the next year or two. In-house portfolio management was ranked third, with about 40% of all companies seeking to bolster in-house investment operations and improve investment capabilities. This trend was especially evident among Japanese firms, with roughly 60% (the highest for any function) planning to increase headcount for in-house asset management. In addition to upgrading their domestic asset investment capabilities, these firms probably want to bring the outsourced management of foreign assets back in-house to save money. This needs to be a longer-term undertaking, as improvements in investment capabilities cannot be achieved overnight.

Exhibit 7. Areas where AMCs plan to add headcount within two years

Rank	Organizational function	% of respondents
1	Investment trust sales and marketing (to sales companies and investors)	45%
2	Institutional sales (to pension funds, financial institutions, etc.)	41%
3	Portfolio management (in-house)	39%
4	Investment and product strategy, project management	37%
5	Research (fundamental analysis)	30%
6	Planning (sales, products, etc.)	30%
7	IT system planning and development	29%
8	Compliance, internal auditing, etc.	25%
9	Investment trust accounting	23%
10	Reporting to customers and sales companies	23%

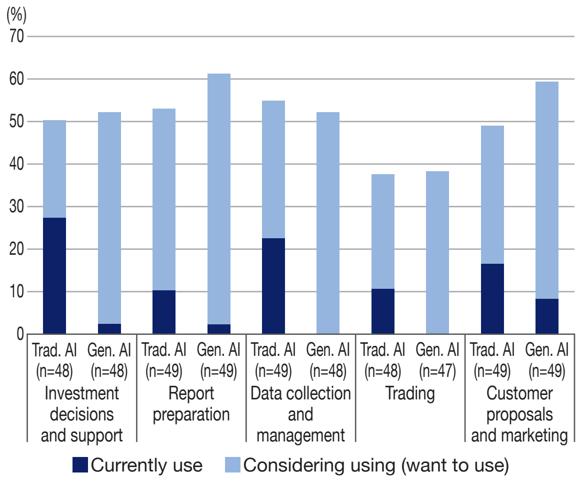
(Lower-ranked choices)

Note: Survey respondents were presented with a list of 20 organizational functions and asked where they planned to add staff. The table lists the top 10, which are color-coded by category.
Source: NRI *Survey of Asset Management Companies' Management Priorities*

Strong industry interest in AI

Generative AI has fueled interest in the use and potential use of AI in the asset management business. AI technologies can broadly be divided into traditional and generative AI. The former aims to automate specific processes, while the latter is used to generate new content[6]. Exhibit 8 summarizes the current and planned use of this technology in various applications. More than 50% of companies said they were either already using or planned to use both traditional and generative AI in nearly all of these applications.

Exhibit 8. **Current and planned use of AI**



Note: Trad. AI: traditional AI; Gen. AI: generative AI.
Source: NRI *Survey of Asset Management Companies' Management Priorities*

Roughly 20-30% of the companies surveyed already use traditional AI for "investment decisions and support" and "data collection and management." Some 80% of the 14 companies with at least ¥5trn in AUM said they currently use traditional AI for the former purpose. In other words, AI is already being widely used to automate specific processes.

Relatively few companies are using generative AI, in part because it has only recently attracted so much attention. But when we include those that are considering using it, the percentages are similar to those for traditional AI. The areas where AMCs were most likely to consider using the technology were "report preparation" and "customer proposals and marketing." As the latter corresponds to the areas ranked first and second in terms of expected headcount growth (see Exhibit 7), the use of AI here would probably be effective and is clearly worth considering. We expect more AMCs will mull the use of generative AI going forward given its ability to boost efficiency and, perhaps more importantly, add value.

3) Sumitomo Life transferred an estimated ¥2trn in AUM to an affiliated overseas investment advisory firm via Sumisei Asset Management for investment in foreign corporate bonds.
4) Distribution yield is defined as income distributions over the preceding 12 months divided by net assets.
5) NRI has conducted this survey annually since FY2007. The latest edition, carried out in August 2023 (FY2023), yielded valid responses from 56 AMCs (32 Japanese, 24 foreign) that collectively account for 77% of the Japanese asset management industry's total AUM.
6) Generative AI is defined as a system that learns patterns and relationships in a given dataset and creates new content based on that information.

CHAPTER 3

Market trends and product strategies by client segment

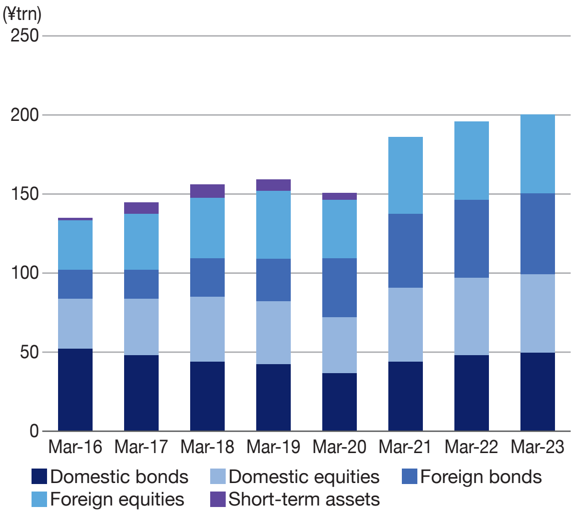
1 Pension funds continue to add to alternative assets

Major Japanese pension plans' reserves at the end of FY2022 (March 31, 2023) totaled an estimated ¥390trn, up ¥2trn YoY. This was the third consecutive annual gain since FY2020 and came amid sharply higher market volatility due to aggressive monetary tightening by the main central banks.

AUM at the Government Pension Investment Fund (GPIF), which is responsible for investing the reserves of Japan's national pension fund and the Employees' Pension Insurance assets of private-sector employees, grew ¥4trn YoY to ¥200trn (Exhibit 9). Although three straight down quarters left the Fund's return at -3.71% after Q3, a Q4 recovery lifted the full-year return to +1.50%, marking the third straight year of positive returns. The GPIF's basic portfolio has roughly equal allocations to domestic bonds, foreign bonds, domestic equities, and foreign equities. Its holdings of alternative assets increased some ¥680bn YoY to about ¥2.8trn in FY2022 due to further growth in contributions and the impact of the weak yen. Alternative assets accounted for just 1.38% of total reserves vs. a maximum allocation of 5%, and the wide gap between these two figures suggests further growth in such investments is likely. Despite the increase in AUM, management fees fell ¥5.0bn YoY to ¥30.2bn, reducing the fee ratio to a record low 1.5bp of average outstanding assets. This was the second consecutive year in which the fee ratio fell to a new low.

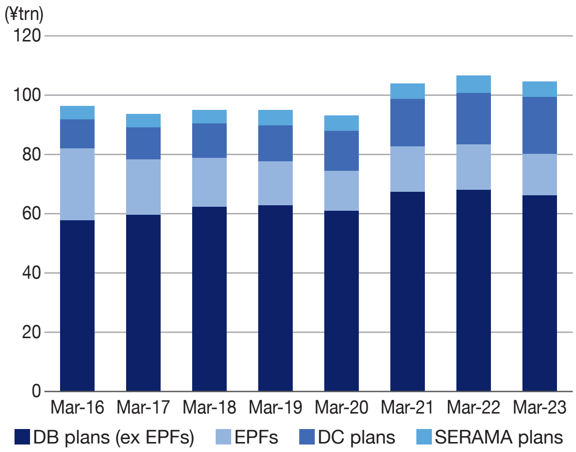
Corporate pension assets totaled ¥105trn at end-March 2023, down some ¥2trn YoY (Exhibit 10). DB pension plan and Employees' Pension Fund (EPF) assets fell by 3.1% and 3.7% YoY respectively due

Exhibit 9. GPIF AUM and asset allocation



Source: NRI, based on GPIF annual reports

Exhibit 10. Corporate pension AUM



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

to negative returns and a 2% decline in the number of participants (for both plans) to 9.24mn. Reserve ratios (as measured by pension accounting rules) increased despite the decline in pension fund assets, with even more companies reporting ratios in excess of 100%. In effect, the reduction in projected benefit obligations due to rising interest rates more than offset the shrinkage in pension assets. Consequently, these plans have not actively assumed more risk via asset allocation and are instead trying to achieve performance targets by adopting specific investment strategies within each asset class. There continues to be strong interest in private equity and credit, illiquid alternative assets such as foreign private real estate, and multi-asset strategies.

The government is seeking to improve governance and organizational structures at corporate pension plans and other asset owners as part of its plan to transform Japan into an "asset management nation." Corporate pension plans that are not large enough to justify hiring their own professional managers will probably consider such options as merging with larger pension plans or outsourcing the CIO function.

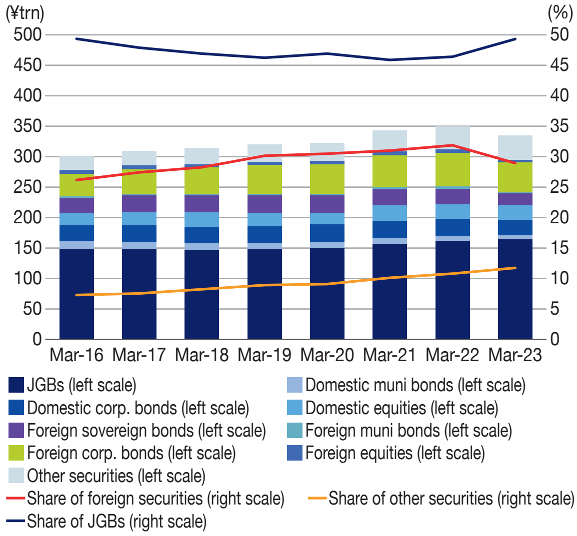
AUM in corporate DC plans grew 2% to ¥19trn at the end of FY2022. With only a small percentage of participants in corporate DC plans receiving benefits, we project net cash inflows will continue at around the current level of about ¥1trn a year.

2 Asset management at life insurers

Life insurers continue to outsource asset management

Life insurers collectively held investment securities worth ¥335trn at end-March 2023, down 4.2% on the year (Exhibit 11). A key reason for the decline was that holdings of foreign securities, which had risen significantly in recent years, dropped 17.8% to ¥74trn from ¥90trn a year earlier. This came in spite

Exhibit 11. Life insurer's investment securities holdings



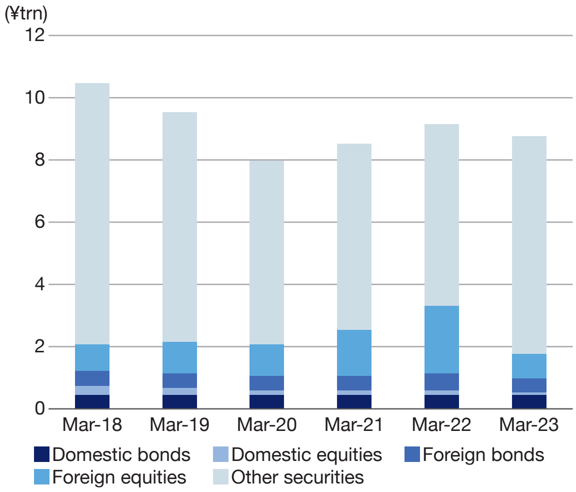
Source: NRI, based on Life Insurance Association of Japan data

of a weaker yen and was attributable largely to a steep drop in the market value of foreign-currency bonds amid surging interest rates in the US and other global markets. Meanwhile, holdings of JGBs and "other" securities—mostly externally managed investments—increased by ¥165trn (up 2% YoY) and ¥39trn (up 4.8%), respectively. Factors contributing to the growth in JGB holdings include the scheduled adoption of new capital adequacy (economic value-based solvency) rules in FY2025. The new regulations have prompted many life insurers to reduce the mismatch between their assets and insurance liabilities on an economic value basis by extending duration with larger holdings of super-long-term bonds. In today's low-rate, low-growth environment, there is strong demand for "other securities," which include alternative assets offering relatively high yields and a wide range of investment opportunities. "Other securities" as a percentage of total portfolio assets have grown steadily from around 7% in FY2017 to about 12% at present.

Special accounts in variable life and variable annuity business

We also looked at the special accounts for variable life (VL) and variable annuity (VA) products, which are an important market for AMCs. The special accounts

Exhibit 12. **Securities investments in variable insurance and annuity policies**



Source: NRI, based on life insurer data

for VL and VA at life insurers offering these products contained securities worth some ¥8.8trn at end-FY2022, down 4% YoY (Exhibit 12). Investments in private investment trusts ("other securities" in Exhibit 12) accounted for about 80% of this figure and were valued at around ¥7trn, up 20% YoY. Investments in private investment trusts were mostly flat from FY2019 to FY2021 but increased sharply in FY2022. We think the VL/VA business has significant growth potential given 1) policyholders' growing wealth formation needs and 2) the insured value upside of these products amid mounting concerns about inflation. We expect more life insurers will become active in the VL/VA space in an attempt to fill these needs.

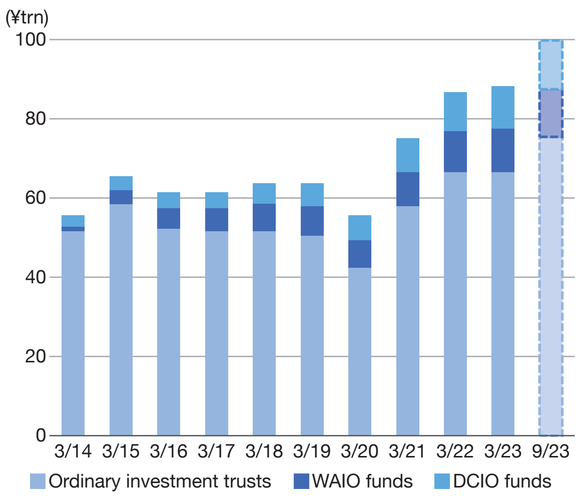
We next examined private investment trusts held in special accounts for currently marketed VL and VA products. The use of active, passive, and balanced investment strategies was divided fairly equally in terms of the number of funds, but active funds accounted for around 75% of total AUM, with balanced funds at about 15% and passively managed funds at about 10%. The most common asset category among the active funds was foreign equities, representing about 65% of the total. Products that allow policyholders to select the special account typically offer a wide range of choices (in some cases as many as 16). These special accounts therefore hold an increasingly wide range of private investment trusts, and this is a trend that is expected to continue. Life insurers providing VL and VA products do not limit the private investment trust managers they use to affiliated (group) companies but also use a broad range of managers outside their groups.

3 Retail business

Equity investment trusts continue to experience net fund inflows

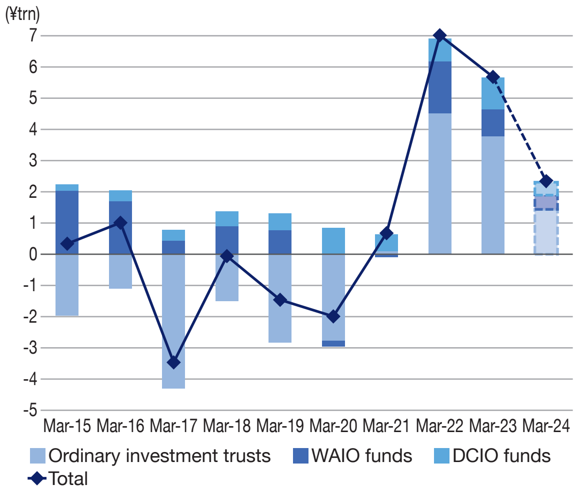
AUM in public open-end equity investment trusts ex ETFs ("equity investment trusts" below) totaled ¥88.2trn at end-March 2023 (Exhibit 13). AUM fell through the first three quarters of the year (Apr–Dec 2022) but staged a comeback in Q4 (Jan–Mar 2023) to post a ¥1.6trn increase for FY2022. Momentum has picked up in FY2023, with AUM rising to ¥99.7trn at end-September 2023. Factors contributing to the sustained growth in AUM since FY2020 include strong investment returns (10% for all equity investment trusts) and continued net fund inflows amounting to several trillions of yen each year. All three sales channels for equity investment

Exhibit 13. **AUM in open-end equity investment trusts (ex ETFs)**



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

Exhibit 14. **Net inflows to open-end equity investment trusts (ex ETFs)**



Note: Net inflows defined as purchases minus sales, redemptions and distributions; latest (24/3) data are for FY2023 H1 (non-annualized).
Source: NRI

trusts—DC pension plans, fund wrap accounts, and regular channels—have seen continued net inflows (Exhibit 14). Below we examine the outlook for equity investment trust fund inflows and outflows by sales channel.

Looking first at DC pension plans, most of the investment trusts offered through these plans are available exclusively via this channel and are referred to below as DCIO (DC investment only) investment trusts. DCIO funds have enjoyed steadily increasing inflows. Because DC plan participants make regular monthly contributions and typically have a long-term investment horizon, they tend not to make short-term adjustments to their portfolios. Additionally, DC plans are still in the adoption phase of their life cycle. With DC plan participation likely to keep growing, we anticipate further increases in total contributions. Corporate and individual DC plans in aggregate have been gaining new participants at a rate of 700,000 per annum in recent years. The number of participants is estimated to have surpassed 11mn at the end of June 2023, and DCIO funds experienced net cash inflows amounting to ¥1trn in FY2022. The government is also relaxing eligibility requirements to further boost DC plan participation. In May 2022 it raised the age limit on individual DC ("iDeCo") plan enrollment to 65 from 60, and the number of participants aged 60 and over increased by 80,000 in the 11 months through the end of March 2023. The authorities have also revealed plans to increase the age limit further to 70. Given the government's ongoing efforts to widen the scope of these plans, we are confident that DCIO funds will continue to see increased fund inflows and a gradual increase in the pace of AUM growth.

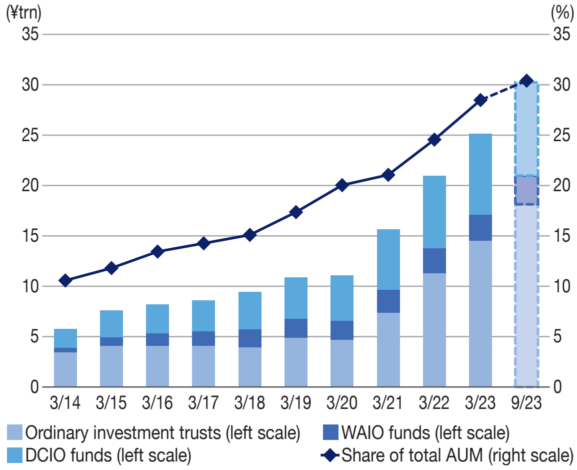
Turning next to fund wrap accounts, most of the investment trusts offered are available only through this channel and are known as WAIO investment trusts. WAIO funds have experienced net inflows every year since FY2014 (except for FY2019 and FY2020). If FY2023 inflows continue at the pace of the first half, they will amount to some ¥0.9trn for the full fiscal year, which ends in March 2024. Although some of the major securities companies and banks that offered these services from the beginning are seeing a slowdown in account growth, AUM per account have grown more than 30% in the last three years. Use of the mostly online fund wrap services provided by FinTech companies has also undergone rapid growth. AUM have more than tripled in the last three years and now exceed ¥1trn. Some investment trust companies are not only providing WAIO funds but have also begun offering their own wrap services in the past year or two via regional banks and smaller securities companies. As fund wrap services are still in the adoption phase, this channel is expected to see continued growth in both AUM and the number of accounts. Net inflows into investment trusts via wrap accounts will likely continue as a result.

The third ("regular") sales channel, which consists of banks and brokerages selling investment trusts at their branches and online, is probably the most readily associated with the investment trust business in the public mind. We refer to investment trusts offered through this channel as ordinary investment trusts. Ordinary investment trusts collectively suffered net outflows for nine consecutive years through FY2019 before attracting a small net inflow in FY2020. Net inflows have continued in the three years since then. In FY2023 H1 (Apr–Sep), net inflows were down on a YoY basis but still amounted to ¥1.4trn. Factors contributing to the turnaround since FY2020 include steady growth in inflows to passive investment trusts (see below) along with the fact that long years of outflows from dividend-oriented funds, which are common among active funds, have reduced the likelihood of further substantial outflows. The wave of redemptions from dividend-oriented funds has largely exhausted itself, and total investment trust distributions, which are a form of fund outflow, have fallen to 30% of their peak at these funds due to declines in AUM and average distribution yield (total distributions divided by AUM). Conditions should therefore be conducive to continued net fund inflows to ordinary investment trusts.

Passively managed funds see continued growth in AUM

Passively managed funds have garnered two-thirds of all net fund inflows to equity investment trusts in the two and a half years starting in FY2021, and their share of total equity investment trust AUM has increased sharply as a result. This share stood at 30.3% at end-September 2023, up nearly 20%pt from just 10.4% in FY2013 (Exhibit 15). Two sales channels are largely responsible for this dramatic shift to passive strategies.

Exhibit 15. AUM in passive investment trusts



Note: Share of AUM represents passively managed funds' share of total AUM in open-end equity investment trusts (ex ETFs).
Source: NRI

One is DC plans, many of which offer mainly passively managed investment trusts. Reflecting this, passive funds account for roughly 75% of all AUM in investment trusts chosen for DC plans. With the number of DC plan participants growing by hundreds of thousands each year, there have been sustained increases in both fund inflows and AUM, and the AUM in passive investment trusts offered via DC plans have expanded steadily as a result.

Also driving the rotation to passive investment strategies is the regular sales channel, i.e., everything other than DC plans and fund wrap accounts. Passive's share of total AUM in investment trusts sold via this channel grew from just 7.9% in FY2017 to 24.1% five and a half years later, in FY2023 H1. Contributing to this dramatic shift was increased awareness of the characteristics of passive funds among retail clients with relatively little investment experience. Government support in the form of *Tsumitate* NISAs and other programs has dramatically improved public recognition of passive investment strategies. As a result, passive funds in *Tsumitate* NISAs alone saw net inflows of ¥2.4trn in the five years from the beginning of 2018 to the end of 2022. Passive funds outside of *Tsumitate* NISAs attracted another ¥5.0trn in fund inflows over the same period.

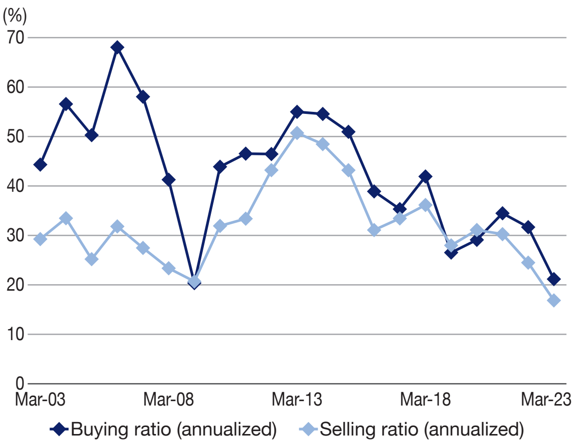
Since investors purchasing investment trusts via DC plans or the regular channel typically make monthly contributions, fund inflows to passive investment trusts tend to be stable and relatively immune to market fluctuations. Current trends might therefore continue even if securities markets experience some turbulence. If so, passively managed funds could come to account for half of all AUM in equity investment trusts (strictly speaking, public open-end equity investment trusts ex ETFs) five years from now.

Value of long-term holdings in active funds being questioned

Fund inflows to actively managed investment trusts will also need to increase if growth in investment trust AUM is to accelerate, but this is proving difficult in practice. Net fund inflows to active funds sold via the regular channel shrank from ¥1.7trn in FY2021 to just ¥0.4trn in FY22 and have fallen even further in FY2023. Exhibit 16 looks at historical fund purchases and sales as a percentage of AUM, expressing them as a buying ratio and a selling ratio. The graph shows that both the buying and selling ratios are at their lowest levels ever if we ignore periods when asset prices fell precipitously. The selling ratio spent many years above 30% but began a steady retreat after peaking in FY2012 and had dropped to 17% by FY2022. The buying ratio has also fallen to 21%. The current buying and selling ratios for active funds are close to those recorded around the Lehman shock (FY2008) and are very low given the absence of a sharp drop in asset prices.

Boosting fund inflows to investment trusts requires either a reduction in the selling ratio or an increase in the buying ratio. Since the selling ratio for active funds is already at an all-time low, it seems difficult to expect further declines. It is therefore important to find ways to raise the buying ratio.

Exhibit 16. **Buying and selling ratios for actively managed investment trusts (ex DCIO and WAIO funds)**



Note: Selling ratio includes redemptions as well as sales.
Source: NRI

When many investors bought investment trusts in the hope of short-term price appreciation, as was historically the case, it was possible to attract them with funds focused on specific themes. But now that the majority of investors seek the benefits of long-term investing, the industry faces a major challenge in trying to demonstrate the value of active investment trusts as a component in an individual investor's long-term portfolio.

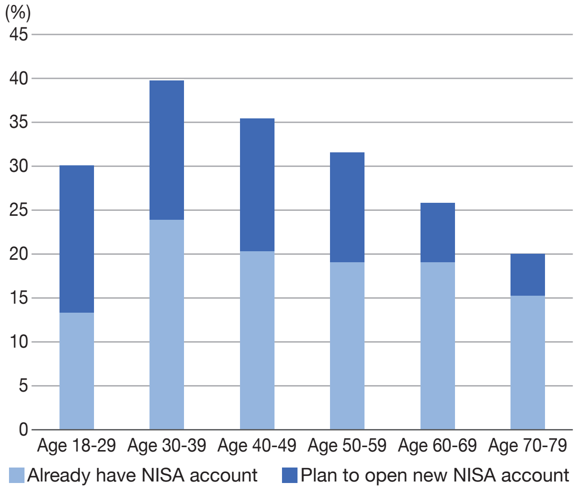
Adoption by seniors holds key to the growth of new NISAs

NISAs, which have had a major impact on fund inflows to equity investment trusts, will be made permanent when the program is relaunched in 2024. Changes include the following: (1) the length of the tax-free holding period will be extended indefinitely, (2) the annual cap on contributions will be increased, and (3) it will become possible for the same individual to use both a *Tsumitate* NISA with regular investments and a "growth investment" NISA. The tax-exempt lifetime limit on contributions will also be raised to ¥18mn. Since each person can as a rule have only one NISA account at one financial institution, institutions have launched campaigns to attract customers before their rivals do.

Retail investors have expressed strong interest in NISAs. An NRI survey conducted in March 2023 estimated that there are 11.6mn people in Japan who currently do not have a NISA account but would like to create an account under the new program. Those aged 18–49 were especially eager, with about 15% of people in this group saying they would like to open a NISA account (Exhibit 17).

People around retirement age were not as interested. In the survey, interest in opening a new NISA account began to drop among those in their 50s and fell to just 7% among those in their 60s. The government's initiative to double the nation's income from investments seeks to persuade seniors, who

Exhibit 17. **Current and future use of NISA accounts**



Source: NRI, based on March 2023 NRI survey regarding new NISA awareness and usage intention

hold the majority of the nation's savings, to achieve a more favorable asset allocation by investing, and it is hoped that the new NISA program will help drive this transition. The industry's ability to deliver services tailored to the needs of customers aged 60 and over, which include extending asset life and drawing down assets, will be critical to the future growth of NISAs. It will also have major implications for the investment trust market.

Column

Sales company fund lists could help rekindle interest in active investment trusts

As noted in the section above, low-cost passive funds have steadily grown their AUM via regular investments from customers with a long-term horizon. Meanwhile, the fact that active funds are viewed as having high costs and inferior performance after fees suggests the industry has failed to demonstrate their value to investors.

To make a case for the value of active funds, customers must be convinced that these funds can deliver good performance over the long run. Sales companies distributing products from a wide range of AMCs have an important role to play as "curators" of those funds.

Below we discuss the role of curated fund lists like those compiled by online brokerages in the US and the UK to help customers select funds. One example is the Wealth Shortlist published by Hargreaves Lansdown, the UK's largest online brokerage, for the last 20 years. Customers trust the list, which is said to influence investor decisions.

Three key characteristics contribute to the credibility of the Wealth Shortlist:

(1) Rigorous selection process

A rigorous process is used to determine which funds to include or remove. Funds are examined by a research team responsible for specific sectors. The final decision of whether to include or remove a fund is made based on a team vote following extensive quantitative and qualitative analysis. A governance structure has also been put in place, with a committee independent of the research team meeting quarterly to review the investment analysis process.

(2) Provision of information to customers

When a fund is included or removed or a fund manager is replaced, analysts provide investors with honest opinions based on their analysis of the event.

Reasons for removing funds from the list over the past three years have included the appointment of less experienced and less familiar new fund managers, room for improvement in the governance framework covering the investment process and risk management, and an occasional straying of the team from its investment mandate.

(3) Response to conflicts of interest

Hargreaves negotiates with AMCs to offer its customers discounted fund management fees. But if the existence (or size) of such discounts becomes a criterion for inclusion, this has the potential to create distortions in the list. In 2019, one of the funds on the predecessor to the Wealth Shortlist was suspended from trading, resulting in losses for many customers. This created mistrust toward the list as a whole, with some claiming the fund in question had remained on the list despite poor investment performance only because it offered a large discount.

Hargreaves subsequently implemented reforms in an attempt to restore confidence in the list. All of the funds in the list had previously offered discounts, the reforms led to the inclusion of funds not providing any discount. In addition, Hargreaves stopped placing as much emphasis on the discounts as it had in the past.

We think lists would have to demonstrate all three characteristics to persuade Japanese investors that they are a useful tool for selecting active investment trusts.

The presence of all three would minimize the likelihood of a low-quality list filled with whatever funds the sales company wanted to sell. If a sales company intends to include funds that are managed by affiliated AMCs or that pay high administrative fees to the sales company, the “conflicts of interest” criterion would require it to take measures to maintain the list’s credibility, including explaining how it maintained an unbiased selection process.

If more investors start to make use of fund lists, AMCs will have to respond accordingly. It is hoped that such lists, by encouraging AMCs to compete to provide high-quality funds that can deliver long-term value to customers, will help revitalize the market for active investment trusts.

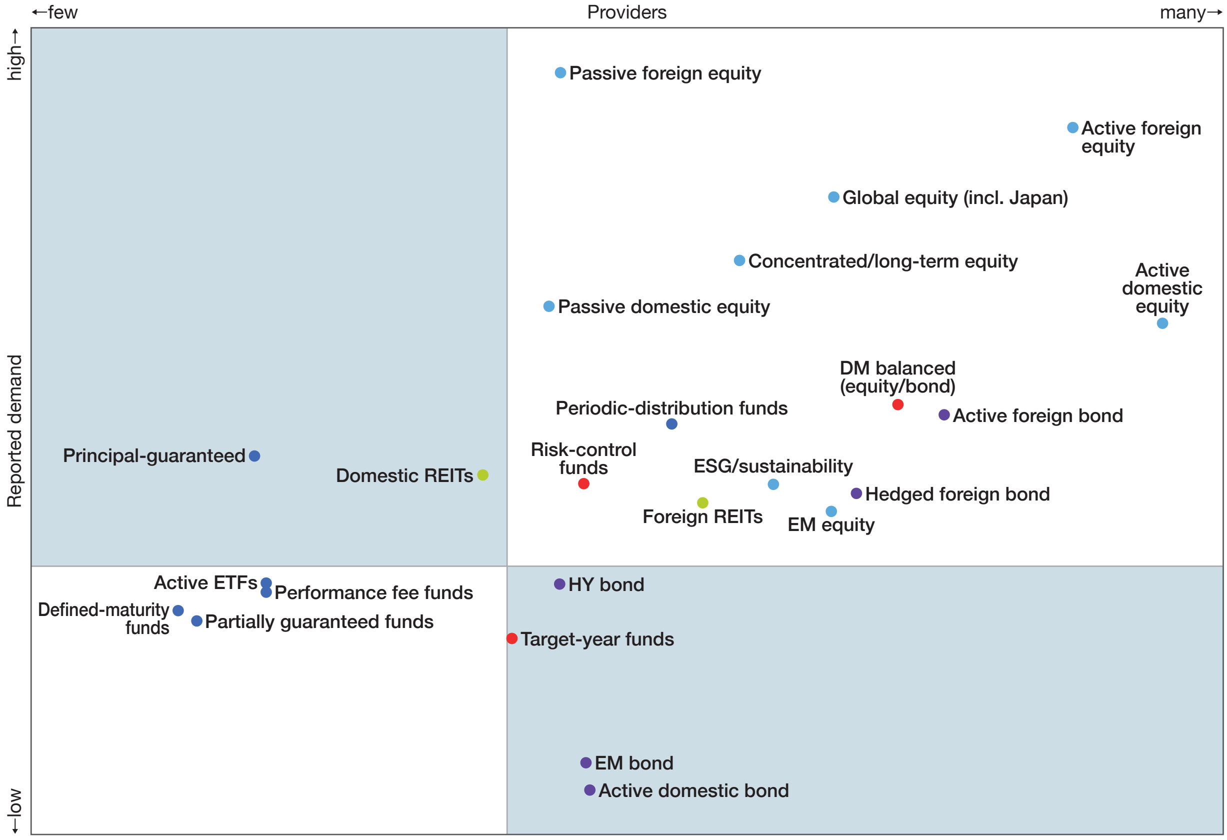
4 Investment product market trends by investor segment

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 2023. The maps show investment products characterized by strong demand (as assessed by AMCs) but limited supply (upper left quadrant) as well as those facing a tough competitive environment, with weaker demand and numerous providers (lower right quadrant). Exhibit 18 presents our product opportunity maps for a subset of products.

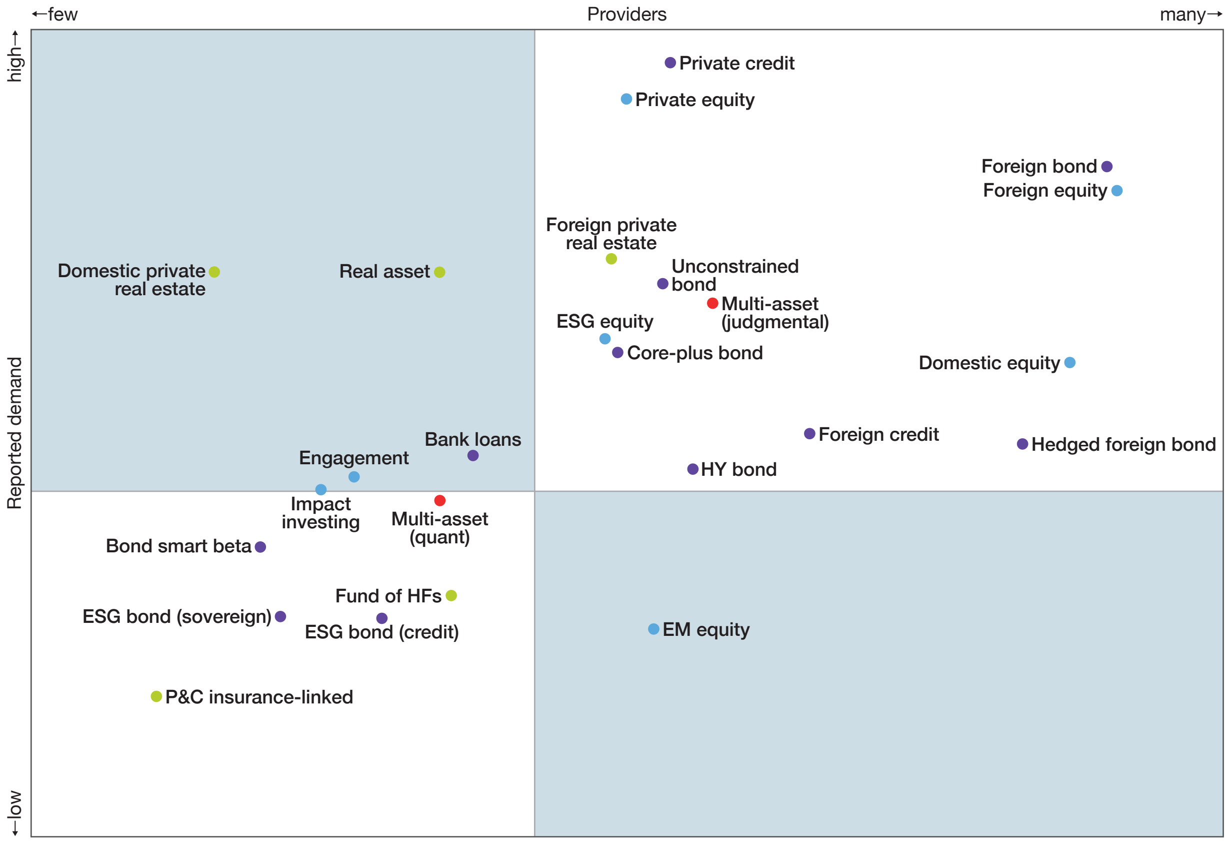
In the retail investor segment (Exhibit 18(a)), equity products continued to garner the highest demand scores. Products ranking high on the demand scale include active and passive foreign equity funds and concentrated equity funds with long-term investment horizons. Passive funds have become increasingly popular, with passive foreign equity funds taking over the top spot from the active foreign equity funds that topped the demand rankings for a number of years. This result is consistent with actual fund flows

Exhibit 18. Product supply/demand maps by customer segment

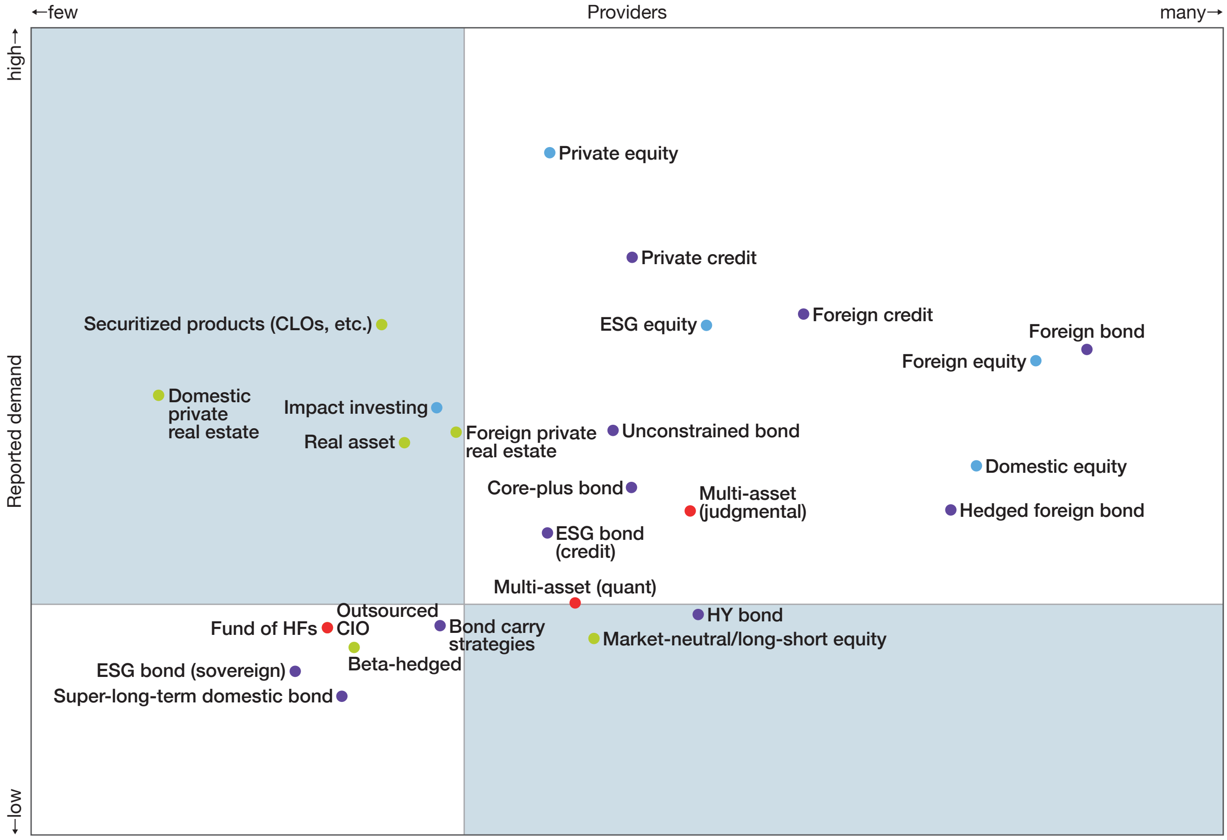
(a) Products for retail investors



(b) Products for pension funds



(c) Products for financial institutions



Note: Vertical axis is indexed and shows strength of demand from customers (based on AMC assessment of demand). Horizontal axis indicates number of AMCs offering each type of product and is indexed by number of providers and not by value.
Source: NRI, based on *Survey of Asset Management Companies' Management Priorities*

into public investment trusts, inasmuch as passively managed funds tracking the S&P 500, MSCI ACWI, and MSCI Kokusai indices have experienced sustained net fund inflows. Key changes since the previous fiscal year include a lower score for ESG-themed investments coupled with much higher scores for both active and passive domestic equity funds following a strong performance by the Japanese stock market. The improvement was especially pronounced for actively managed Japanese equity funds, demand for which had long been depressed.

In the bond space, actively managed foreign bond funds that did not hedge their forex exposure scored the highest on the demand scale. The demand score for these funds began improving last fiscal year as the yen fell sharply, and this year these funds managed to surpass hedged foreign bond funds. The score for emerging market (EM) bonds was low and mostly unchanged from the previous fiscal year.

The demand score for balanced funds holding developed market (DM) equities and bonds was higher this year. Of the funds structured with distinctive features, periodic-distribution funds and principal-guaranteed funds ranked highly on the demand scale, but there are few providers of the latter.

In the pension fund segment (Exhibit 18(b)), assessments for equity and bond funds were intermixed. Among bond products, private credit continued to score high on the demand scale and was ranked highest overall. The score for unconstrained strategies also remained relatively high. Meanwhile, the scores for core-plus bond funds and currency-hedged foreign bond funds fell sharply from last year in response to rising interest rates and higher hedging costs. Demand scores for funds specializing in credit products such as bank loans and high-yield bonds were largely unchanged.

Among equity products, private equity (PE) and foreign equity strategies continued to receive high demand scores, while the score for ESG strategies declined. Domestic equity funds also did better this year, perhaps in part because of their strong performance.

The rankings of multi-asset funds are presumably based on perceived demand from corporate pension funds because Japanese public pension funds have yet to allocate to these strategies. Judgmental strategies continued to outscore quant strategies. Among illiquid alternative assets, domestic and foreign private real estate funds (including private REITs) both ranked relatively high on the demand scale. Real assets continued to perform well, perhaps in reflection of global inflation.

The results for equities and bonds were also mixed in the financial institution segment (Exhibit 18(c)). In equities, private equity strategies ranked first with a modestly higher demand score than last year. Scores fell for ESG and impact investment strategies, although they were still relatively high. The comparatively high score for impact investing was something not observed in the pension segment. It would appear that financial institutions are more willing to make investments that yield non-economic benefits above and beyond their financial returns.

In the bond space, the demand score for foreign bond strategies remained relatively high but was down sharply from its category-leading result last year. The scores for private credit and foreign credit strategies remained high, while scores for core-plus bond and hedged foreign bond strategies declined, echoing the situation in the pension fund segment. In the multi-asset category, judgmental strategies received a relatively high score, as they did in the pension segment. Among illiquid alternative assets, the score for securitized product strategies (CLOs, etc.) rose sharply. The scores for both foreign and domestic private real estate (including private REITs) remained high, but foreign private real estate did not do as well as it did in the previous year.

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