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Sub-advisory opportunities in retail finance

Nomura Research Institute, Ltd.

The sale of investment products to retail customers has become a key focus for financial institutions. As a result, management firms that traditionally dealt only with institutional investors now need to consider managing assets for individuals. This report examines opportunities in the sub-advisory business.

Sub-advisory services for the retail market

Banks, securities companies, and other financial institutions are marketing an increasingly wide array of financial products to retail investors in a bid to earn a larger share of Japan's more than 1,450 trillion yen in personal financial assets. This represents a major business opportunity for the management firms that develop such products. Although these firms traditionally dealt exclusively with institutional investors, it would be worthwhile for them to take another look at the market for retail services. In particular, they would do well to focus on sub-advisory services, which can be delivered with relatively little additional investment. This report compares the attractiveness of various opportunities in the Japanese market with an emphasis on market scale. Four products are examined: (1) investment trusts, (2) variable annuities, (3) managed accounts, and (4) multi-manager funds.

The investment trust market

Since laws were amended at the end of 1998 to allow banks to sell investment trusts, both the number of funds and the assets they manage have risen steadily. This growth has been driven by bank strategies for the expansion of fee-based businesses and the growing investment-related needs of retail customers.

Of the 285 public open-end equity investment trusts established over the last two years (excluding funds of funds and ETFs), 115, or about 40%, received investment advice from outside advisors, contracted the actual execution of trades to outside firms, or otherwise outsourced operations.[1] Sixty-nine of the 115 funds hired group companies, while the remaining 46 dealt with third-party managers and were therefore part of the market for sub-advisory services. We estimate that fund assets managed by outside advisors rose to about 6 trillion yen at the end of January 2006, equivalent to some 10% of the assets at all public investment trusts (we assumed, among other things, that previously established funds were equally likely to use sub-advisors). We also estimate that sub-advisors earn about 20–30 billion yen in management fees per year.[2]

The retail market for variable annuities

Banks receive larger sales commissions on variable annuities than on investment trusts of the same value. Accordingly, variable annuities have—along with investment trusts—become one of banks' two leading retail financial products since a sales ban was lifted in October 2002.

The value of variable annuities in force has roughly doubled each year since 2003, rising to more than 8 trillion yen at the end of September 2005, and further growth is expected. A similar amount has been invested in privately offered investment trusts managed by sub-advisors through the special accounts of insurance companies. Total fees earned by the sub-advisors managing these funds is estimated at 20–30 billion yen,[3] but this figure is likely to increase given the robust growth in assets.

The market for managed accounts

There are various types of managed accounts, but the product offering the most growth potential for providers of domestic sub-advisory services is the separately managed account, or SMA. Restrictions on discretionary investment management by securities companies were relaxed in April 2004, prompting them to offer, or to consider offering, SMA services to retail customers, and in particular to “mass affluent” clients, typically baby-boomers who have received retirement allowances. It has been reported that Nomura, Daiwa, Nikko, and Shinko managed a total of just 260 billion yen[4)] in such accounts at the end of 2005, in part because such services were first offered only recently. In contrast, SMA assets in the US have grown rapidly and now total some 80 trillion yen, or equivalent to about 7% of the US mutual fund market. If Japanese SMAs achieve a similar share over the next few years, we estimate that the SMA market would grow to 4–5 trillion yen, putting it on an equal footing with other sub-advisory markets.

There are three types of SMA in the United States: (1) the internally managed SMA, which is managed by an affiliate of the securities firm offering the product; (2) the externally managed SMA, which allows the client to select outside managers; and (3) the multi-strategy portfolio (MSP), which offers model portfolios created by a number of fund managers. In Japan, the relatively efficient MSP has been the most popular. The major role of sub-advisories in this market is to structure the model portfolios. Fees for such services tend to be less than those for discretionary investment. Still, assuming an average fee of 20bp, we forecast that annual compensation for such services will rise to about 10 billion yen over the next few years. If the second type of account, which entails discretionary investment management, including trade execution, becomes more popular, both average fees and total compensation could grow even more.

The market for multi-manager funds

Multi-manager funds can be broadly divided into funds of funds (FoFs) and managers of managers (MoMs). In Japan, however, there are almost no MoM products for the retail market.

The first retail FoF was established in September 2000. Since then both the number of funds and assets under management have grown steadily, with assets amounting to some 6 trillion yen at the end of 2005. Assuming an average fee of 40bp for the individual funds held by an FoF, we estimate that annual compensation in this market is about 20–30 billion yen a year.

All told, we estimate that sub-advisors currently earn about 100 billion yen in fees per year, clearly a significant figure even when compared with the 400 billion yen in management fees earned in FY04 by domestic investment trusts and investment advisors. In terms of assets outstanding and compensation, we think (1) investment trusts, (2) variable annuities, and (4) multi-manager funds offer equally attractive opportunities. The SMA market also deserves consideration for its future growth prospects.

Exhibit. Comparison of sub-advisory opportunities

	(1) Investment trusts	(2) Variable annuities	(3) Of which: SMAs	(4) Of which: FoFs
Assets/fees	○	○	*	○
Growth prospects	○	◎	◎	○

◎: highly attractive ○: attractive *: no rating because of short track record lakyara

Note

1) Analyzed from November 2003 to October 2005 using NRI database.

2) Not all fees paid to advisors are publicly disclosed. Our estimate assumes a management fee of 40bp, which is the average at a number of funds disclosing this ratio.

3) Private investment trusts generally do not disclose the fees paid for variable annuities. However, based on a comparison of all management-related expenses, which include management fees, and the management fees at public investment trusts of the same type, we estimate that fees at private investment trusts fall between 25bp and 40bp (assuming an average management fee of 50bp at public investment trusts and a discount of 20–50%).

4) Estimated SMA assets at these firms according to a Nihon Keizai Shimbun article dated 28 December 2005.

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