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Retail investor asset management trends

Nomura Research Institute, Ltd.

Households are beginning to allocate assets to investment-type products, heralding a change in their attitude towards investing. But they continue to prefer conservative, low-risk investments. If financial institutions are to persuade individuals to purchase products with higher risk/return profiles, they need to take a longer-term approach to asset management services.

Investment-type products such as foreign-currency deposits, equity investment trusts, individual equities, and foreign securities accounted for 11% of outstanding household financial assets at the end of March 2006, twice the level of several years ago.[1)] This statistic would seem to remove any doubt that there has been a shift of personal assets from savings to investment. In this report, however, we try to examine objectively whether the practice of investing has taken root among individuals in Japan.

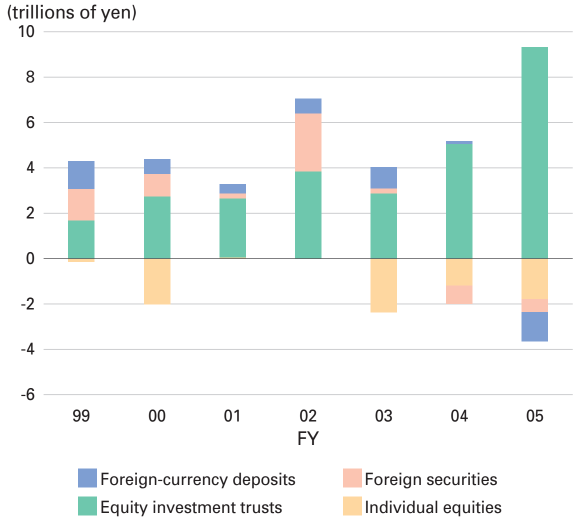
Fund inflows concentrated in relatively low-risk products

When looking at changes in individual investor behavior from a macroeconomic perspective, the typical approach is to focus on changes in the share of outstanding household financial assets represented by investment-type products. But to determine whether individuals are actually allocating assets to investments, we need to examine fund inflows and outflows, which are unaffected by fluctuations in market value.

Exhibit 1 shows inflows and outflows for various investment-type products. Individual equities saw three straight years of net outflows starting in FY03, in spite of rising share prices and reports that retail investors were actively participating in the stock market. When viewed in aggregate, retail investors were actually net sellers of equities during this period.

The one asset category seeing a steady inflow of funds was equity investment trusts. These funds received minimum net inflows of almost 3 trillion yen in every year since FY00, with inflows surpassing the 5 trillion yen mark in FY04. And in FY05, when post offices joined securities companies and banks as authorized sellers of investment trusts, net inflows amounted to nearly 10 trillion yen.

Exhibit 1. Fund inflows and outflows to investment-type products



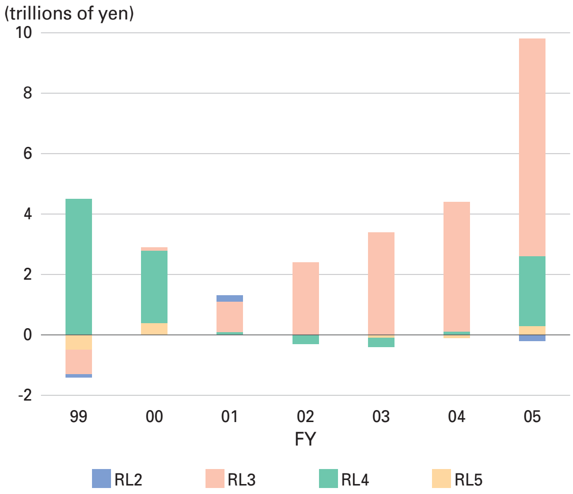
Source: NRI, from Bank of Japan *Flow of Funds Accounts*

We interpret these data as saying that, on a flow-of-funds basis, households remain hesitant to purchase volatile individual equities, but have actively invested in equity investment trusts, which are characterized by smaller price swings.

Fund investments center on low-risk products

Because of a quirk in Japan's securities taxation law, not all funds labeled "equity investment trusts" actually invest in equities. Some, for example, invest only in domestic or foreign bonds. Consequently, risk levels vary substantially from fund to fund. We used NRI's proprietary five-stage risk classification[2] to estimate inflows and outflows to funds with varying degrees of risk (Exhibit 2). Inflows were greatest to the intermediate risk classification, RL3, which includes global bond funds and balanced funds. The next higher risk classification, RL4, which contains Japanese and global equity funds, saw only sporadic net inflows. In general, therefore, high-risk funds have had relatively small inflows, with most funds allocated to relatively low-risk funds.

Exhibit 2. Net fund flows into open-end equity investment trusts by risk classification



Note: Results are not consistent with those of Exhibit 1 because the data include inflows from corporate investors.
Source: NRI

Funds offering periodic distributions also popular

When equity investment trusts are classified by the frequency of their dividend distributions, products offering periodic distributions have seen a net inflow of funds. In the three years from FY03 to FY05, these funds accounted for more than 80% of fund inflows and outflows to all equity investment trusts.

In a sense, these funds provide automatic and periodic cash conversions. The individuals who buy them tend to be less sensitive to price fluctuations than investors in ordinary funds. Put another way, they do not feel that their investments involve significant risk.

In summary, household financial assets are beginning to flow into equity investment trusts and other investment-type products. But most of the inflows into equity funds are to medium-risk funds and funds that mitigate investors' awareness of price fluctuation risk. In short, household attitudes towards asset management remain conservative.

Providers of asset management services need longer-term perspective

The majority of personal financial assets in Japan belong to retirees, and the investment conservatism observed among households can be attributed largely to attitudes among this group. Many financial institutions are now trying to convince older customers of the need to incorporate risky investments in their asset management planning. But as noted above, the number of individuals purchasing such products does not appear to be increasing. Risk tolerance is not something that is formed overnight. It comes only from years of study and experience starting early in life.

If financial institutions are to convince retirees of the need to invest, they will need to devote more resources to asset management services tailored to customers in different stages of life, including the younger generation. Naturally, such efforts should not be expected to produce immediate results. Financial institutions need to view asset management services as a long-term investment and not simply as a source of short-term profits.

Note

1) Our source was the Bank of Japan's *Flow of Funds Accounts*. Equity investment trusts held by individuals are NRI estimates.

2) Funds are ranked from RL1 to RL5 in order of ascending risk. Products rated RL1 effectively ensure stability of principal and yield, and therefore do not include any equity funds. Funds ranked RL2, including most domestic bond funds and currency-hedged global bond funds, have annualized risk of less than 5%. RL3 denotes annualized risk of 5–15%; RL4, annualized risk of 15–30%; and RL5, annualized risk of more than 30%. R5 includes so-called bull/bear funds and funds investing in emerging market equities.

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