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How long before investment trust inflows resume?

Nomura Research Institute, Ltd.

Investment trust returns have deteriorated precipitously as a result of recent asset price declines. Most investment trust investors now have unrealized losses on their holdings. Investment trusts are unlikely to see renewed inflows until existing investors' unrealized returns improve.

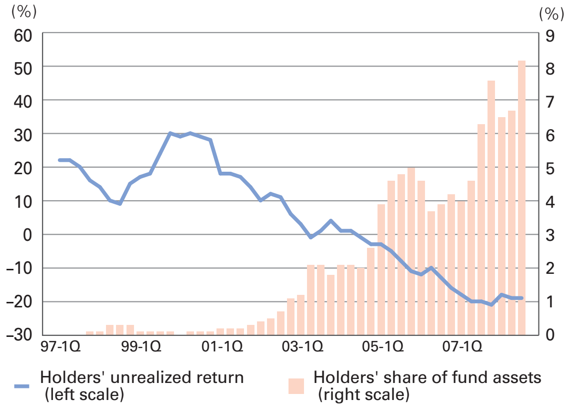
Open-end equity investment trusts' average return[1)] over the three months through October was -30%. For an individual stock, such a quarterly return would not be unusual, but given that open-end equity investment trusts are portfolio products and currently have a larger share of their aggregate assets invested in bonds than equities, a -30% quarterly return can be characterized as an extreme anomaly. Open-end equity investment trusts consequently experienced a net outflow of some ¥400bn in October.

In light of Japanese households' need to invest their assets, few would dispute that investment trust inflows from the household sector will someday resume. The question is how long retail investors that suffered losses from the recent market plunge will wait before they resume investing. Although this question unfortunately cannot be answered with certainty, we reviewed historical data to roughly gauge the timing of retail investors' prospective return to investment trust investing.

Most investment trust investors have unrealized losses

How large are investment trust investors' losses stemming from the recent market plunge? For any type of investment trust, we can ascertain investors' return to date if we know the timing of their purchases. In the case of global bond funds, for example, the line graph in Exhibit 1 plots existing investors' unrealized returns (inclusive of distributions) through October 2008 as a function of the quarter in which they invested. It shows that all investors that purchased this type of fund from September 2004 onward have unrealized losses on their holdings as of end-October. If we knew when existing investment trust holders purchased their investments, we could calculate their population distribution by rate of return. We cannot do so accurately, however, without detailed knowledge of all these investors' individual transactions. We therefore roughly estimated investors' unrealized returns based on a hypothetical model of investment trust redemptions[2)]. Based on this model, Exhibit 1's bar graph plots the estimated distribution of global bond fund assets by the timing of their holders' purchases. It reveals that existing holders that purchased their units since September 2004 account for some 80% of fund assets.

Exhibit 1. Investment trust holders' unrealized return and share of fund assets by date of purchase



Source: NRI estimates

Exhibit 2. Investment trust holders' average unrealized return by major fund type

	Average unrealized return	% of holders with unrealized gains
Foreign bond funds	-12%	14%
Nikkei 225 index funds	-37%	7%
General domestic equity funds	-44%	2%
Foreign equity funds	-38%	0%
Balanced funds	-32%	0%

Source: NRI estimates

We repeated the same exercise for other major types of investment trusts. Our estimates of existing holders' unrealized returns are tabulated in Exhibit 2. Even for global bond funds, where losses are relatively minor in comparison to other types of funds, existing holders' average unrealized return as of end-October was -12% and existing holders with unrealized losses accounted for over 85% of fund assets. Even taking into account that these estimates are based on an extremely simplified model of reality, we can reasonably conclude that holders of at least 80% of equity investment trust assets had unrealized losses on their holdings at end-October.

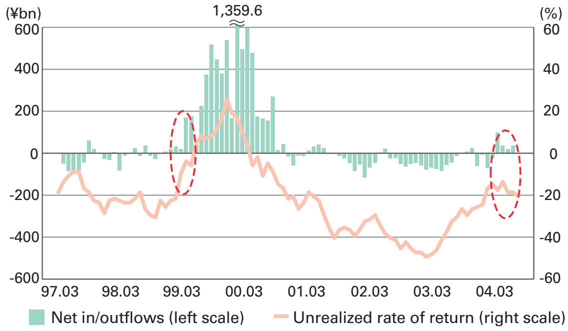
Recovery in inflows follows improvement in unrealized returns

What are the prerequisites for resumed growth in investment trust inflows? From investors' standpoint, convincing signs of market recovery are of course essential. The question is how long investors typically take to regain their risk appetite once a market rebound gets underway. Our contacts within investment trust sales channels report that even if the market rebounds, it is difficult to recommend a fund to new investors so long as the fund's existing investors have large unrealized losses. This anecdotal report is largely substantiated by macro data. Following Japanese equities' bear market bottoms in October 1998 and March 2003, inflows to domestic equity funds did not resume until the funds' unrealized returns had improved to the -20% – -15% range (Exhibit 3). Global bond funds' inflows resumed once unrealized returns improved to around -5% (Exhibit 4). While these examples may not be comprehensive, market recovery and a certain degree of improvement in existing investors' unrealized returns can be considered benchmarks for gauging the timing of investment trust inflows' resumption[3].

Investor care is crucial to restart investment trust inflows from households

Given the magnitude of existing investors' unrealized losses, most types of funds are unlikely to see resumed inflows by virtue of improvement in investors' unrealized returns any time soon. Today, many investment trust distributors are reportedly contacting customers with unrealized losses in excess of a certain level to explain the status of their funds' portfolio holdings. With retail investors starting to shy away from investment trusts, such investor care is of utmost importance to coax them back to investing in investment trusts.

Exhibit 3. General domestic equity funds' net in/outflows and existing holders' unrealized returns



Source: NRI Fundmark

Exhibit 4. Global bond funds' net in/outflows and existing holders' unrealized returns

Source: NRI Fundmark

Note

1) Based on NRI-FPI investment trust index data.

2) The model is conceptually similar to a moving average used to determine the unit price of inventory outflows. To illustrate with a specific example, assume that a newly established investment trust experiences redemptions of ¥300mn two days after its inception. Before deducting this ¥300mn, it has net assets of ¥3bn, of which ¥2bn date back to its inception date and the remaining ¥1bn to the day after its inception. In this case, we assume that two-thirds of the redeemed ¥3mn correspond to inflows received on the inception date and the remaining one third to inflows received the following day. By prorating redemptions in this manner, we modeled the composition of investment trust assets on a daily basis to arrive at Exhibit 1's estimated distributions of returns and assets by purchase date at end-October 2008.

3) For domestic equity funds' unrealized rate of return to improve to -20%, we estimate that the Nikkei 225 Average would have to recover to around ¥12,000. Similarly, we estimate that improvement in global bond funds' unrealized rate of return to -5% would require the euro/yen and dollar/yen rates to return to the vicinity of ¥136 and ¥106, respectively.

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