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A new approach for beleaguered investment trust marketers

Nomura Research Institute, Ltd.

Assets have recently started to flow out of income-oriented investment trusts, a key driving force behind the shift from saving to investment in recent years. These outflows reflect structural factors in addition to the recent market downturn. To overcome this challenge, investment trust distributors should go back to the basics of investment product sales by rethinking investment needs and objectives from the customer's standpoint.

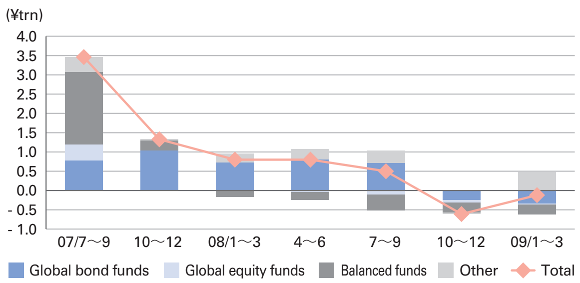
Open-end equity investment trusts that pay frequent distributions have seen a steady decline in asset inflows, which ultimately turned into net outflows from the second half of 2008. Given that such income-oriented investment trusts were a key driving force behind the shift from saving to investment in recent years, the recent reversal of their asset flows has major implications in terms of the investment trust business. To surmount this challenge, banks and securities brokerages should change their approach to retail asset management services, as discussed below.

Retail investment trust sales trends

Over the seven years through FY02, asset inflows into income-oriented investment trusts totaled over ¥43trn, of which open-end investment trusts accounted for 90%. On a quarterly basis, inflows to income-oriented investment trusts peaked at nearly ¥6trn in 2007 Q1. By 2007 Q4, quarterly inflows to income-oriented investment trusts had plummeted to ¥1.3trn and they subsequently continued to gradually decrease (Exhibit 1). In 2008 Q4, income-oriented investment trusts experienced a net outflow of roughly ¥600bn. In 2009, income-oriented investment trusts have continued to experience net outflows. Analysis of income-oriented investment trusts' asset flows by major fund category reveals that global equity funds and balanced funds had started to experience net outflows as early as FY07. Of the major categories of income-oriented investment trusts, global bond funds continued to enjoy net inflows the longest, but they too began to experience net outflows following Lehman Bros' collapse.

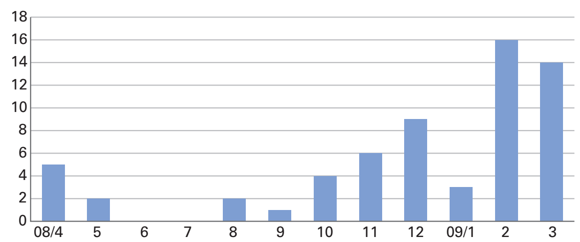
One catalyst behind the reversal of these income-oriented investment trusts' asset flows, in addition to foreign currency depreciation against the yen and steep declines in funds' NAVs, was that many funds cut their distributions. Exhibit 2 plots the number of funds that cut their distributions among those that were previously paying stable monthly distributions[1). It shows that the number of funds that reduced their distributions increased from last October, which coincides with the reversal of income-oriented funds' net asset flows from inward to outward. Distribution cuts apparently spurred outflows from income-oriented investment trusts, which had been popular among investors seeking periodic cash income.

Exhibit 1. Income-oriented investment trusts' asset in/outflows



Source: NRI Fundmark

Exhibit 2. Number of investment trusts that cut their distributions after previously paying stable monthly distributions



Note: Investment trusts have previously paid stable distributions are funds that paid a constant distribution for 12 consecutive months through the month before they cut their distribution.
Source: NRI Fundmark

Income-oriented investment trusts' shrinking supply-demand gap

Even if funds had not reduced their distributions or suffered declines in NAV, sales of income-oriented investment trusts would have eventually slowed anyway. The biggest factor behind income-oriented funds' popularity was a need for periodic income to offset shortfalls in pension benefits. The supply of income-oriented investment trusts has grown to near-parity with demand motivated by the need to supplement inadequate pension benefits.

In fact, inflows to income-oriented investment trusts began to decline in 2007 Q2, before distributions were cut or NAVs turned downward. Based on the assumptions in Exhibit 3, we estimate retirees' demand for income-oriented investment trusts at ¥48trn as of October 2007. At that time, income-oriented investment trusts had aggregate net assets of ¥44trn. From this perspective, demand for income-oriented investment trusts could be considered nearly satiated.

Back to basics of investment products sales

Even if income-oriented investment trusts no longer have much prospect of demand growth, the outlook for investment trust sales does not warrant pessimism. The elderly, for example, need to invest not only to supplement their pension benefits but presumably also to cover healthcare expenses. By meeting this need, investment trust distributors should be able to maintain their business's growth prospects.

According to a 2006 Cabinet Office survey on the elderly's standard of living, over 60% of respondents aged 60 and older reported that one reason that they invest their assets is to cover healthcare expenses in case they become ill or require long-term care. In contrast, less than 20% of respondents indicated that they invest to maintain their customary standard of living. Currently, however, not many elderly people see investment trusts as an investment vehicle for covering healthcare expenses. And even if they do, many elderly investors hold investment products that do not meet this investment objective, such as income-oriented investment trusts[2]. This inconsistency bespeaks the difficulty of determining investment objectives for oneself and the even greater difficulty of selecting investment products that meet one's objectives. If such is the case, banks and securities brokerages must place more priority on advising customers on how to clarify their investment objectives and helping them to select investment products that fit their objectives.

Investment trust distributors have hitherto focused on providing advice specifically related to selling investment trusts (e.g., determining asset allocations, selecting funds to achieve the desired asset allocation). However, they have been neglecting what could be called the basics of investment product sales, including clarification of the underlying investment objective. By getting back to basics, investment trust distributors should be able to now re-embark on a growth path.

Exhibit 3. Demand for income-oriented investment trusts

Demand for income-oriented investment trusts ¥48trn

= Households headed by someone aged 60 or older (excluding those with less than ¥10mn in financial assets) 13mn households*1 × Percentage of retirees risk-tolerant enough to own investment products approx. 40%*2 × { Living expense shortfall ¥63,000–76,000 /month*3 ×12 } ÷ Income-oriented investment trusts' average distribution yield (Oct 2007) 9.3%*4

Source: *1: Calculated with data from the Central Council for Financial Services Information. *2: NRI estimate, based largely on data from Figure 1 ("Post-Retirement Changes in the Mass-Affluent Class") in "Individuals' Lifecycle and Asset Allocation" (Kakuda, Yasuo; Securities Analyst Journal, October 2008). *3: 2004 National Survey of Family Income and Expenditures (Ministry of Internal Affairs and Communications). *4: NRI Fundmark

Note

1) As of end-September 2008, investment trusts paying monthly distributions (428 funds) had aggregate net assets of ¥29.5trn. Of this total, funds that paid a stable (i.e., constant) distribution for the preceding 12 consecutive months (204 funds) accounted for ¥19.5trn in net assets. That is, funds paying a stable distribution account for roughly two-thirds of income-oriented investment trusts' aggregate assets.

2) For example, according to a Fidelity Retirement Institute's survey on what retirees did with their lump-sum retirement benefits, many retirees that have invested to supplement their pension benefits own funds with a long-term investment orientation (e.g., Japanese equity funds). Conversely, many retirees that purchased investment trusts to fund large future expenditures selected income-oriented funds.

Author's Profile

Hisashi Kaneko

Senior Researcher
Department of Financial Markets and Technology studies

E-mail : kyara@nri.co.jp

Inquiries to : Department of Financial Markets and Technology studies
Nomura Research Institute, Ltd.
Marunouchi Kitaguchi Bldg.
1-6-5 Marunouchi, Chiyoda-ku, Tokyo 100-0005, Japan
E-mail : kyara@nri.co.jp

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