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Will Japanese asset management companies embrace front-office outsourcing?

Nomura Research Institute, Ltd.

A recent NRI study revealed major differences in cost structures between investment trust and investment advisory businesses, with front-office operations accounting for a much smaller share of total costs in the former than in the latter. In the investment trust business, which has promising growth prospects, front-office outsourcing could be a viable management strategy for asset management companies based in Japan.

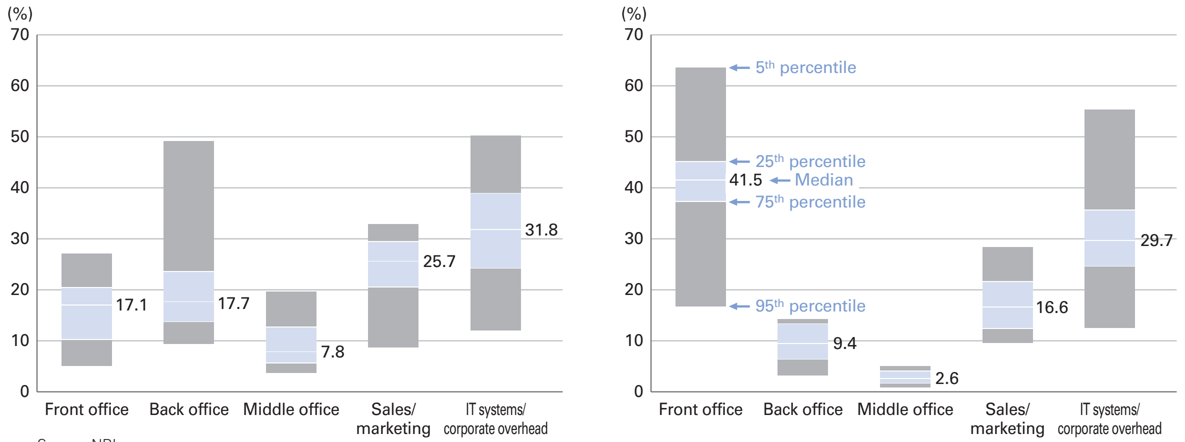
Japan's asset management industry encompasses two main businesses: investment trusts and investment advisory services. The former involves offering pooled investment funds for retail investors; the latter, managing segregated accounts for institutional investors. In Japan, these two businesses have vastly different cost structures, as revealed by a recent NRI project[1].

In investment trust business, front office accounts for less than 20% of total costs

The graphs below compare the cost structures of the investment trust business (left graph) and investment advisory business (right graph). The graphs show how asset management companies' total costs are broken down by organizational function. The bars show the distribution of each organizational function's share of total costs at the asset management companies that participated in the project. For example, in the investment trust business (left graph), sales and marketing's share of total costs (second bar from the right) ranges from around 10% to over 30% at the participating companies.

The biggest difference in cost structure between the investment trust and investment advisory businesses is front-office (i.e., portfolio management, research, and trading) costs' magnitude. In the investment advisory business (right graph), front-office operations' median share of total costs is around 40%, the highest median value among the five organizational functions. In the investment trust business, by contrast, front-office costs' median share of total costs is slightly over 17%. When we likewise analyzed data from fiscal 2003, we found that front-office operations accounted for 33% of investment trusts' total costs, meaning that their share of total costs has declined by roughly half over the past five years. In the investment trust business, the two organizational functions that account for the largest median shares of total costs are sales/marketing and back-office operations

Exhibit. Cost structure of investment trust (left graph) and investment advisory (right graph) businesses



Source: NRI

at 26% and 18%, respectively. In the investment advisory business, sales/marketing and back-office operations' median shares of total costs are respectively 17% and 9%, both nine percentage points below the corresponding median values for the investment trust business.

Investment trusts are predominantly invested in foreign assets

The reason that front-office operations' share of total costs has declined in the investment trust business is clearly apparent. Namely, foreign bond funds and other funds that invest predominantly in foreign assets and offer relatively high distribution yields in comparison to Japan's low interest rates have become the most popular investment trust products over the past five years. Many such funds outsource portfolio management to foreign asset managers considered to have special expertise in managing foreign assets. Such a major change in investment trusts' cost structure reflects that the portfolio management function has diminished in relative importance. Japanese investment trust companies now focus primarily on sales and support (e.g., preparing sales materials for fund distributors and retail customers) and compensate for front-office deficiencies by outsourcing.

Another interesting revelation from our study is the difference in profitability between the investment trust and investment advisory businesses. Five years ago, profit margins were lower in the investment trust business than in the investment advisory business, reflecting that investment trusts had high costs in their early years, when they did not yet have much assets under management (AUM). Our recent study, however, found that the investment trust business is now more profitable than the investment advisory business. Investment trusts' profit margins have improved by virtue of economies of scale[2] stemming from growth in AUM.

Turnkey outsourcing of front-office operations is also an option

With pension assets starting to be drawn down as the Japanese population progressively ages, pension funds, which account for most investment advisory clients, no longer have promising growth prospects. Meanwhile, with households still in the early stages of broadly diversifying their enormous financial asset holdings into investment products, the investment trust business is virtually certain to grow. Given investment trusts' favorable growth prospects and relatively high profit margins, concentrating management resources in investment trust operations seems to be an obvious management strategy for asset management companies, but is it the right choice?

As mentioned earlier, Japanese investment trust businesses tend to specialize in investment services, focusing primarily on product development and sales support without maintaining much of a front-office organization. To use an analogy from the semiconductor industry, Japanese asset management companies are shifting toward a "fabless[3]" model, where they design and market investment products but do not "manufacture" the products in-house. In the investment advisory business, by contrast, companies compete mainly by endeavoring to differentiate themselves based on the strength of their manufacturing (i.e., portfolio management) performance against a benchmark.

Many chief executives of major Japanese asset management companies apparently regard investment advisory services, which mainly involve managing pension assets, as their core business and *raison d'être* as asset managers. In their view, the proper strategy in the investment trust business is to increase earnings by adding product-development and marketing capabilities to leverage the portfolio management capabilities cultivated in the investment advisory business. They seem to feel at risk of an existential crisis without in-house "manufacturing" operations.

However, their portfolio management capabilities tend to be limited to domestic assets. Few Japanese asset management companies are endeavoring to extend their portfolio management capabilities to foreign assets. Even in the investment advisory business, Japanese asset managers have a strong tendency to outsource management of foreign assets. Additionally, investment products that incorporate high-yielding foreign assets are very likely to remain in favor among investors in rapidly aging Japan. Portfolio management capabilities developed in an investment advisory business do not necessarily have much applicability to investment trusts.

For companies that operate asset management businesses in Japan, enhancing one's competitive advantage based on portfolio management capabilities is contingent on improvement in the Japanese economy's growth potential and Japanese assets' expected returns. If such a scenario is unlikely, Japanese asset management companies should consider strengthening their competitiveness through outsourcing of front-office operations as one management strategy.

Note

1) The project was a multiclient study in which we analyzed asset management companies' efficiency based on fiscal 2008 revenue and cost data. Seventeen asset management companies participated in the study, including ten Japanese and seven foreign-affiliated companies.

2) In the investment advisory business, asset management fees are typically reduced as a percentage of AUM as AUM increases. In the investment trust business, however, management fee rates are generally not reduced much if at all. Investment trust managers' profitability consequently has a strong tendency to rapidly increase as AUM grows.

3) A fabless semiconductor company has no production facilities of its own. It designs and sells semiconductor devices but outsources their production to a semiconductor foundry. In other (e.g., high tech, apparel) industries that have experienced rapid change in their market environments, companies have historically tended to likewise divest production facilities and outsource production.

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