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Developing Asian asset management capabilities is crucial for Japanese asset managers

Nomura Research Institute, Ltd.

Japanese equities' underperformance and changes in institutional investors' mandates are major threats that undermine Japanese asset managers' competitiveness. Japanese asset management companies are well advised to expand globally by developing Asian, including emerging market, asset management capabilities.

Asia is seen as a key region that will spearhead the asset management industry's future growth. Asset management companies are exhibiting a strong interest in expanding in Asia. Those that have set up shop in Singapore or Hong Kong include not only global (foreign-owned) companies with operations in Japan also but at least ten Japanese companies too.

Asset management companies can expand geographically in two ways. Namely, they can do so in terms of the location of (1) the assets in which they invest and/or (2) the clients they serve. Exhibit 1 shows differences in asset management companies' geographic business domains on a worldwide basis, including Asia. While global asset management companies operate on a worldwide basis in terms of both assets and clients, Japanese asset management companies mainly manage domestic assets for Japanese investors as their core competency, although they have expanded into domestically providing foreign-asset investment products by utilizing subadvisors (leftward arrow in Exhibit 1). Japanese asset management companies' operations in Asia can be characterized as oriented toward expansion of Asian asset management capabilities (rightward arrow) or gaining local clients (downward arrow).

Japanese asset managers are focusing on the institutional market

According to a January 2010 NRI survey of asset management industry trends in Asia, there is a consensus among Japanese asset management companies that breaking into the retail business in Asia is extremely difficult for them. The factors behind this perceived difficulty include inadequate local sales support staff to service key distribution channels (e.g., banks), regulatory restrictions on outbound investment, and a low degree of international diversification by local retail investors, who tend to have a strong home-country bias reflecting forex considerations or optimism regarding their own country's economic growth prospects. As a result, no Japanese asset management company is currently operating a retail business on its own in Asia. Instead, Japanese asset management companies are seeking opportunities to acquire minority stakes in local asset management companies or establish local joint ventures in the retail market.

The institutional business, by contrast, does not require much of a local presence. Japanese asset management companies are consequently focusing mainly on serving institutional investors in Asia. They typically do so by managing Japanese equities, a product to which they have historically devoted substantial human resources, or managing Asian equities while building asset management capabilities through a local presence.

Exhibit 1. Asset management companies' geographic coverage of investors and assets

Location of assets / Location of investors	Developed Countries			Emerging Markets	
		Asia			
	N. America, W. Europe	Japan	Singapore, Hong Kong	China, Korea, Taiwan, etc.	Russia, Brazil, etc.
N. America, W. Europe	Global AM companies		Institutional investors : strengthening of in-house sales capabilities		
Japan	Expansion through use of subadvisors (outsourcing)	Japanese AM companies	Expansion of in-house asset management operations		
Local Asia			Institutional investors : strengthening of in-house sales capabilities Retail : Gaining access to investors through JVs, etc. Local AM companies		

Source: NRI

Japanese equities' loss of stature and changing mandates

However, experts unanimously agree that Asian sovereign wealth funds and public pension funds are highly sophisticated investors on a par with US and European institutional investors. In pursuing mandates from such institutional investors, Japanese asset management companies face competition from global asset management companies.

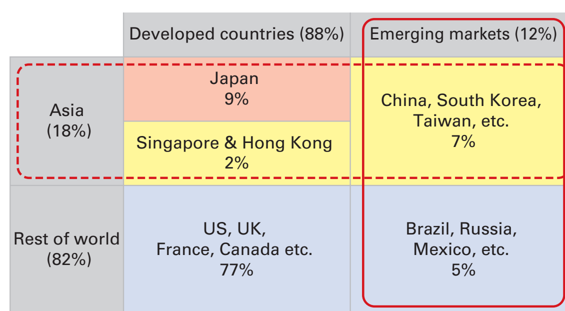
One factor that compounds Japanese asset management companies' difficulty winning mandates from institutional investors is that Japanese equities have declined in relative stature in the wake of their prolonged underperformance and the growing prevalence of emerging market investment. Exhibit 2 shows a representative international equity index's country weightings. Within the investment universe of developed-country equities, Japan accounts for a major share of Asian (or Asia/Pacific) equities. Japan's heavy weighting within developed Asia gave Japanese asset managers an advantage in terms of winning major mandates by virtue of their strength in managing Japanese equity portfolios.

Today, however, they are losing this advantage as emerging market investing gains prevalence. That is, when the investment universe is enlarged to pan-Asian equities inclusive of emerging markets, Japan's weighting is reduced to half of Asia's overall weighting, making it difficult for Japanese asset managers to win pan-Asian equity mandates with their competitive products. Moreover, Asian equity mandates often exclude Japanese equities altogether.

Additionally, some institutional investors have started to define mandates not geographically (e.g., Asian assets) but in terms of countries' stage of economic development (e.g., developed-country equities and emerging market equities). The rationale behind this trend is that developed countries' equity markets are highly efficient and therefore difficult to extract excess returns from. Some institutional investors are accordingly opting for a combination of passive management in developed markets and active management in emerging markets[1]. Amid such an environment, institutional investors that grant mandates to asset managers specializing in Japanese equities are likely limited to those with a certain critical mass of assets-under-management and staff dedicated to overseeing external asset managers.

In sum, Japanese equities' loss of stature and changes in how institutional investor grant mandates have the potential to deprive Japanese asset management companies of business opportunities.

Exhibit 2. Representative international equity index's country weightings



Source: NRI, based on MSCI Barra data current as of end-September 2009

Global expansion based on Asian asset management capabilities

Japanese asset management companies' future success essentially hinges on whether they can develop a high degree of competence in managing Asian assets. First, with Asia accounting for some 60% of emerging markets' index weighting, Japanese asset managers should develop the capability to offer competitive Asian asset products as a core competency in terms of managing both pan-Asian and emerging market equities. Additionally, given that such products are in demand among non-Japanese and non-Asian clients also (upward arrow in Exhibit 1), this capability is essential to expanding into the business domain of providing foreign-asset management products to overseas clients.

From such a perspective, Asian asset management capabilities are extremely valuable capabilities that Japanese asset management companies should develop posthaste. To do so, they may need to reallocate resources from management of domestic assets, where

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their resources are currently heavily concentrated, to management of Asian assets.

Building such asset management capabilities is difficult but not impossible. In fact, certain Japanese asset management companies have won awards from an influential fund rating agency for their Asian equity investment performance. Given Japanese equities' diminished stature and investment appeal, Japanese asset management companies are well advised to develop a high degree of Asian asset management capabilities and expand globally with such capabilities as a cornerstone.

Note

1) According to reports from survey interviewees, the Government of Singapore Investment Corporation (GIC) and Central Provident Fund (CPF) are good examples of such institutional investors. They have reportedly granted mandates for active management of emerging market equity portfolios and passive management of developed-country equity portfolios because of limited opportunities to capture excess returns in developed countries' equity markets.
Additionally, many relatively small-scale institutional investors do not systematically allocate assets by region or have the capability to select outstanding asset managers by region. Instead of splitting up their foreign asset management mandate geographically, such institutional investors tend to grant mandates split between developed countries and emerging markets or grant a single mandate for global equities.

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