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Meeting retirees' income needs is an important mission for investment trusts

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Executive Summary

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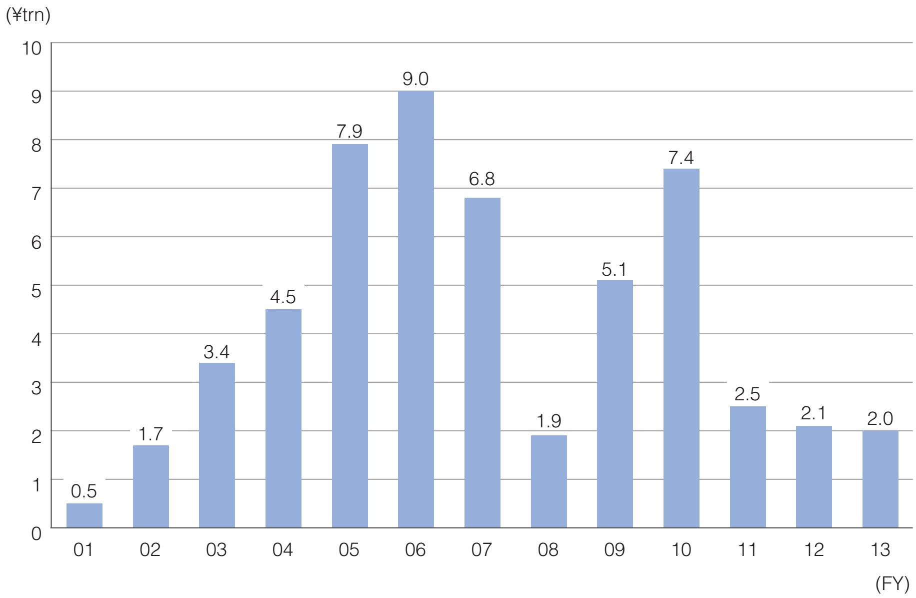
With high-yielding funds' popularity waning, Japan's investment trust industry must develop new products to meet retirees' need for recurring income.

Inflows to monthly income funds have slowed. Even the high-yielding ones are having difficulty attracting inflows. With the rankings of top-selling funds currently still dominated by monthly income funds and high-yielding funds in particular, the foregoing may seem hard to believe but it is inarguably substantiated by data.

Downshift in inflows to monthly income funds

In fiscal 2013, sales of open-end equity investment trusts (excluding ETFs; likewise below) grew 24% year-on-year to ¥31.6 trillion, surpassing ¥30 trillion for the first time ever. Their growth was driven largely by investment trusts other than monthly income funds, including many domestic and foreign equity funds. Excluding monthly income funds, open-end investment trust sales doubled year on year to ¥13.2 trillion in fiscal 2013.

Exhibit 1. Monthly income funds' net inflows



N o t e: Net inflows = sales of new units - redemptions
Source: NRI

Sales of monthly income funds, by contrast, decreased ¥600 billion year on year to ¥18.5 trillion in fiscal 2013. Although still high in absolute terms, monthly income fund sales have ceased growing at their previously rapid pace in recent years. Moreover, their net inflows (sales net of redemptions) in fiscal 2013 were only ¥2.0 trillion, lower than in any year since fiscal 2003 except fiscal 2008, when markets were roiled by Lehman Brothers' bankruptcy (Exhibit 1). In sum, inflows to monthly income funds have clearly slowed.

High-yielding funds' popularity is waning

Monthly income funds' sales were previously said to vary among funds as a function of their distribution yields. Recently, however, even high-yielding funds have experienced a decline in inflows. Exhibit 2(A) plots monthly income funds' net inflows by quintile ranked in descending order of distribution yield. The top (first) quintile's semiannual net-inflows exceeded ¥3 trillion in fiscal 2010 and the first half of fiscal 2011. From around September 2011 onward, the top quintile's net inflows fell to less than half of their previous level. This collapse is even more pronounced when these net inflows are adjusted to factor in distributions (Exhibit 2(B)). When distributions are factored in, the top quintile of monthly income funds has been experiencing net outflows since the second half of fiscal 2011. The higher a fund's yield, the larger its distributions. Large distributions weigh heavily on net in/outflows.

Why have inflows to high-yielding fund slowed? The top quintile of monthly income funds includes many currency overlay funds, foreign REIT funds, and emerging market bond funds. Around 2011, many funds in these categories experienced NAV declines even as their NAVs appreciated when adjusted by adding back distributions to the NAV. In other words, many such funds paid distributions in excess of investment returns. The situation was seen as a problem by regulatory authorities[1)] and the media[2)]. Fund distributors consequently became more cautious in selling high-yielding funds and retail investors became less eager to buy them.

NOTE

1) Annual Supervisory Policy for Financial Instrument Business Operators, etc., for Program Year 2011 (Financial Services Agency; August 26, 2011).

2) "Twenty Funds with Sustainable Distributions" (Diamond Zai; April 2012) (in Japanese).

Importance of meeting retirees' need for recurring income

High-yielding funds are probably unlikely to regain their former popularity because it does not make sense for investment trust companies that earn revenues based on AUM[3)] to increase funds' distributions if the distributions end up depleting the funds' assets. The same holds true for fund distributors, which have started to place more priority on AUM than on sales. Meanwhile, retail investors also are broadly recognizing

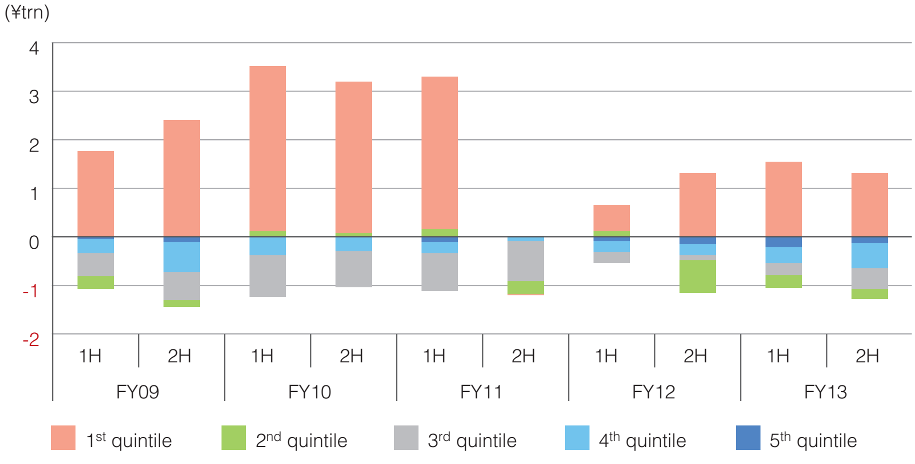
3) AUM: assets under management.

the disadvantage of funds that pay distributions in excess of investment returns on an ongoing basis.

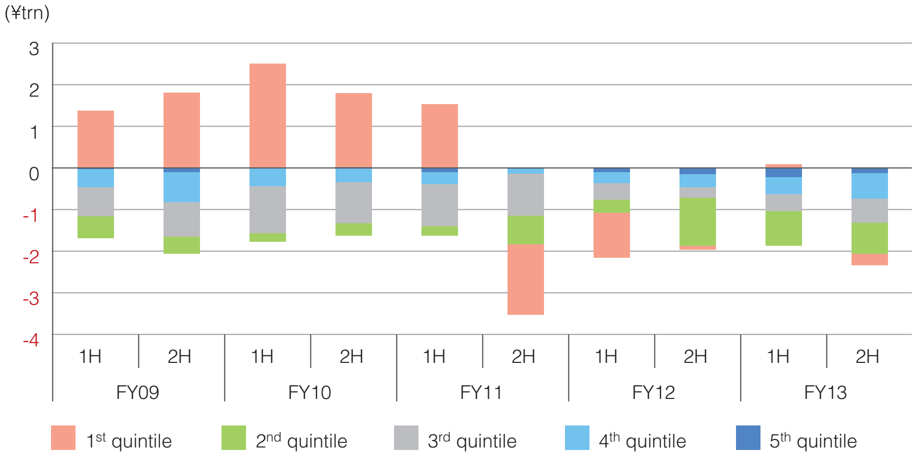
Nonetheless, retirees' need for recurring income will undoubtedly persist. From retirees' standpoint, ensuring that their assets generate income for the remainder of their lives is presumably even more of a priority than earning a larger income from their assets. If so, investment trust companies and fund distributors should promote cash-flow control to prevent depletion of customers' assets instead of solely emphasizing the amount of income returns as they hitherto have been doing.

Exhibit 2. Monthly income funds' net in/outflows (By quintile ranked by distribution yield)

(A) Net in/outflows not counting distributions



(B) Net in/outflows inclusive of distributions



Note: Funds in existence for more than six months were sorted into quintiles by distribution yield (the 1st quintile contains the highest-yielding funds).
Source: NRI

To better preserve customers' assets, asset managers should invest efficiently, diversifying across a broader range of asset classes while employing necessary risk controls, and stably distribute investment returns on a long-term basis. Fund distributors should educate customers on roughly how much income, including withdrawals of principal, they can earn from their assets without depleting them, after thoroughly ascertaining the customers' risk tolerance and asset holdings. In the investment execution stage, adjustments such as reinvestment of excess distributions or redemption of fund holdings to offset distribution shortfalls could be made to provide customers with their planned amount of income. If investment trust companies and fund distributors independently developed such services, they are unlikely to achieve the level of service desired by retirees. They should develop products and services collaboratively, with the investment trust company handling fund management and the distributor handling customer service and administrative functions.

While there has recently been much discussion[4)] about popularizing investment products among working-age generations, we must not lose sight of the importance of investment services for retirees highly dependent on investment income derived from their substantial financial asset holdings.

4) For example, recommendations published on June 12 by the Panel for Vitalizing Financial and Capital Markets noted the importance of "providing and popularizing investment products that take investors' life stage and risk profile into account" and recommended promoting defined contribution pension plans and Nippon Individual Savings Accounts targeted exclusively at working-age generations.

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