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Asset management companies need to redesign their organizations in response to changes in their business environment

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Executive Summary

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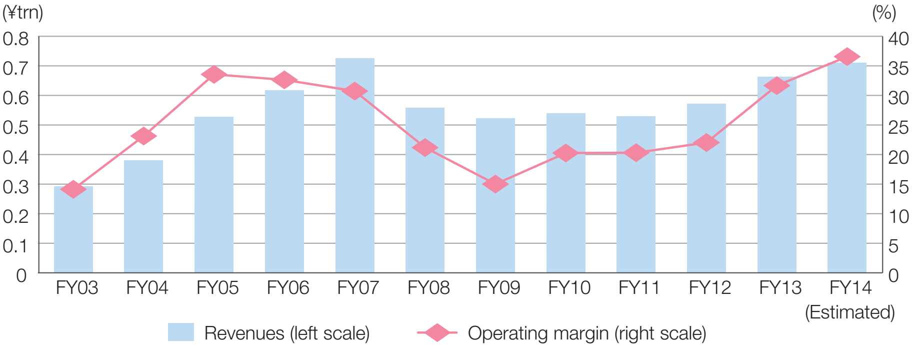
The Japanese asset management industry faces big changes in its business environment, including business model reforms by investment trust distributors and growth in public pension funds' in-house expertise. In response to such changes, asset management companies need to boldly reorganize themselves and revamp their investment processes.

In FY2014, Japan's asset management companies[1] are on track to earn revenues of over ¥700 billion, just shy of their FY2007 record. Meanwhile, their FY2014 operating margin is projected to exceed 35% (see graph). Japan's asset management industry appears to finally be poised for dynamic growth following protracted stagnation since the global financial crisis. However, the recovery in revenues and profit margins since FY2012 is more attributable to yen depreciation and equity market gains in response to Abenomics than to asset management companies' own efforts.

Major changes in business environment are in the offing

The Japanese asset management industry's business environment is likely to change dramatically from FY2015 onward. Investment trusts continue to experience brisk asset inflows from retail investors, partly by virtue of the advent of NISAs[2] in 2014. Asset inflows into NISAs are projected to total ¥5 trillion over the next five years[3]. With some 60% of this total expected to be invested in investment trusts, nearly ¥3 trillion could flow into investment trusts via NISAs.

Exhibit: Management revenues and operating margin



Source: NRI, based on various data sources

NOTE

[1] As used herein, "asset management companies" are companies engaged exclusively in investment trust and/or investment advisory businesses, excluding trust banks and insurers.

[2] Nippon Individual Saving Accounts are tax-free investment accounts modeled after the UK's Individual Savings Accounts (ISAs).

[3] Based on a 2014 NRI online survey of individual investors.

Over the past three years, however, investment trusts have paid out dividend distributions in excess of their net asset inflows. Adjusted to factor out changes in NAVs due to changes in market prices, investment trusts' assets under management (AUM) have not increased over the past three years. Money continues to flow into high-yielding investment trusts. If this trend continues, the asset management industry may not be able to achieve sustainable growth.

One catalyst that could change the investment trust business's focus on high-yielding funds is fund distributors' business model reforms. Distributors' main source of revenues in the investment trust business has hitherto been sales commissions derived from customers' fund switching. Recently, however, a number of major distributors have started to shift to an AUM-based revenue model, the focus of which is building up existing funds' AUM and earning revenues mainly from fees charged as a percentage of AUM. This change could have far-reaching impact. For example, high-yielding funds may be supplanted as best-selling funds by balanced funds that achieve stable growth in assets but yield less than the current best-selling funds. Another possibility is that fund distributors will focus more on advising customers about their portfolio allocations and demand that asset management companies offer distinctive funds compatible with their investment recommendations in every asset class.

The pension business, the core institutional market segment, is also likely to undergo major changes. Public pension funds have already increased their equity allocations substantially. Additionally, they are gaining discernment by expanding their in-house asset management staffs and increasingly awarding mandates to asset managers with distinctive investment styles in individual asset classes. Public pension funds also need to further diversify their asset holdings. Their demand for investment products that generate stable cash flows, including relatively illiquid assets, will undoubtedly increase. Additionally, public pension funds are likely to increasingly compensate external managers with performance-based fees instead of flat-rate fees. Public pension funds will surely become more important as a major revenue pool for asset management companies.

How should asset management companies respond to such changes?

Asset management companies have not yet fully adapted to such major changes in their business environment. Fund distributors' retail business model reforms will likely not only rewrite the list of top-selling funds as mentioned above but also change the nature of the support services that asset management companies provide to distributors. For example, asset management companies may put know-how cultivated in the institutional market segment to use in the retail market segment. Such know-how that could play an important role in developing new retail products and/or advising fund distributors include various investment advisory services already provided to pension funds, methods of constructing portfolios that are robust against changes in the investment environment[4], investment techniques that adjust portfolio risk in response to changes in customers' risk tolerances and various smart-beta strategies that outperform their benchmarks.

Pension funds and retail investors both seek absolute returns. They both also seek stable cash flows within the parameters of a limited risk tolerance. Application of institutional market know-how to the retail market segment is likely to become extremely important going forward. The time has come for asset management companies to reassess and optimize their internal resource allocations.

How must asset management companies change in response to growth in pension fund clients' in-house expertise? While consistency of investment returns is of course a key criterion for evaluating asset managers, even more important is replicability of investment processes. In other words, investment processes should be transparent enough to give clients confidence that a manager's outstanding historical returns will continue. Maintaining outstanding investment performance on a continuous basis is difficult, but the key to retaining clients when performance slumps is investment process transparency, the ability to clearly explain the types of environments in which an investment process works and does not work. Additionally, with nearly all major public pension funds having signed on to Japan's Stewardship Code[5], public pension funds are increasingly questioning external managers in detail about matters such as the content of their dialogue with investee companies and their reasons for owning specific stocks. Their vetting of external managers' investment processes could become even more detailed. Asset management companies must recognize the importance of investment processes' cogency and replicability in terms of capturing and retaining highly discerning clients.

Clients' growing in-house expertise means that clients will upgrade their risk management themselves. They will control diversification of the investment styles represented in their portfolios. In addition to delivering high returns, investment products must also possess unique attributes that contribute to portfolio diversification and differentiate the manager from rivals.

[4] A typical example of such methods is risk-parity portfolio construction.

[5] Japan's Stewardship Code, unveiled in February 2014, is a set of guidelines that encourage institutional investors to constructively engage with investee companies in the aim of enhancing the companies' value.

To adapt to future changes in the business environment, asset management companies should once again ascertain the skill set demanded by clients and check whether their human resources are appropriately deployed. Another essential point is to review current investment product offerings' viability as core products going forward. It would be a big mistake for asset management companies to assume that their businesses' recent growth trajectory will persist just because earnings have recovered over the past several years. Asset management companies need to recognize that discontinuous change is currently occurring. The time has come to rethink business strategies.

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