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Index fund cost comparison between Japanese DC and DB plans

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NOTE

1) Per Japan's Pension Fund Association (FY17 data).

2) As used herein, "costs" exclude redemption fees charged when investment trust units are sold. Redemption fees are not counted as a cost because they compensate for expenses incurred to liquidate assets and are retained as trust assets. Funds that charge a redemption fee therefore do not necessarily underperform funds with no redemption fee over the holding period from purchase through sale (although a redemption fee reduces investment returns from the standpoint of investors who sold their units, it improves (or does not detract from) returns for the other investors who continue to own the same fund).

Executive Summary

Defined contribution (DC) pension plans have long had a reputation for being more expensive than defined benefit (DB) plans in terms of asset management fees. Today, however, DC plans in Japan are approaching cost-wise parity with DB plans, at least for passively managed assets, by virtue of participant-friendly regulatory policies that have driven down index fund fees in DC plans.

DC plans have reputation for higher management fees than DB plans

In Japan, investment advisors, trust banks and other asset managers charge 30bp¹⁾ (0.3%) per year on average for managing pension assets. In contrast, public investment trusts marketed primarily to retail investors commonly charge trust fees (total fund management and account servicing fees) in excess of 150bp per year, often in addition to a sales load. DC pension plans that offer investment products to individual investors have consequently had a reputation for being costlier than corporate DB pension plans in terms of asset management fees, not only in Japan but globally. For example, the 2012 OECD Roadmap for the Good Design of Defined Contribution Pension Plans stressed the importance of ensuring that low-cost investment products are available in DC plans through competition or other means.

Contrary to this widespread perception of DC plans, a recent NRI study of management fees charged by index funds found that most of such investment trusts offered in DC plans charge fees largely equivalent to those charged by funds that manage DB plan assets. Index funds in Japan account for 70% of the investment trust AUM in DC plans and roughly half of Japanese DB plans' AUM.

Not much difference in index fund fees between DC and DB plans

With virtually all Japanese DCIO (defined contribution investment only) investment trusts being no-load funds, the costs²⁾ that DC plan participants incur for buying, holding and selling investment trusts are essentially limited to trust fees. We investigated the breakdown of DCIO investment trust AUM by current trust fee level.

3) The lowest DCIO TOPIX index fund trust fee rate has since decreased as a result of existing funds lowering their fee rates to below the previously lowest fee rate in their asset class and new funds being established with a lower fee rate than any pre-existing fund.

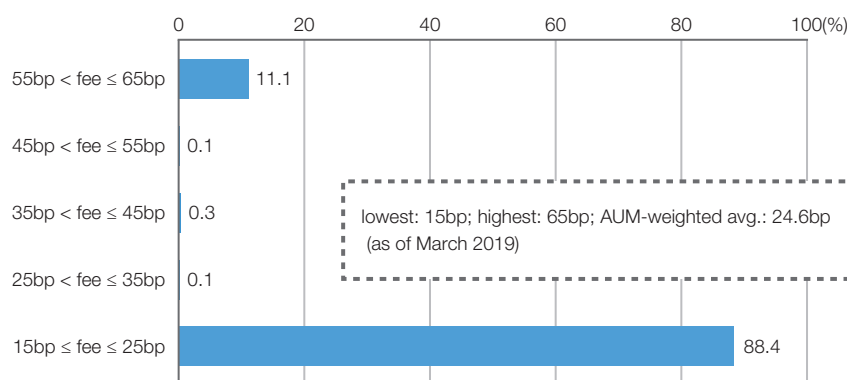
Among DCIO investment trusts, the breakdown of TOPIX index funds' AUM is plotted by trust fee level in Exhibit 1. As of March 2019, there were 28 such funds. They were charging trust fees ranging from 15bp³⁾ to 65bp and averaging 24.6bp on an AUM-weighted basis. Of their total AUM, 88.4% was in funds charging between 15bp and 25bp, the lowest fee tier in Exhibit 1.

Among index funds in other asset classes (Exhibit 2), Japanese domestic bond funds' AUM-weighted average trust fee is even lower than TOPIX index funds' at 15.4bp, while foreign equity and foreign bond index funds are roughly on a par with TOPIX index funds in terms of their AUM-weighted average trust fees. Moreover, some 90% of AUM in all four asset classes is in DCIO index funds charging a trust fee within +10bp of the lowest trust fee in that asset class.

4) We used life insurers' data because trust banks, which manage the largest share of pension assets invested in index funds, do not disclose their fee rates.

For DB plans, comprehensive index fund management fee data are not available, so we compiled data for a subset of asset managers (life insurers⁴⁾) that publicly disclose their fund management fees. We ascertained each manager's lowest fee

Exhibit 1: Distribution of DCIO TOPIX index fund AUM by trust fee level



Source: NRI

Exhibit 2: DCIO index fund trust-fee levels (as of March 2019)

Asset class (index)	Lowest trust fee	AUM-weighted avg. trust fee	% of AUM in funds w/ fee w/in +10bp of lowest
Domestic equity (TOPIX)	15.0bp	24.6bp	88.4%
Domestic bond (Nomura-BPI)	10.0bp	15.4bp	95.0%
Foreign equity (MSCI Kokusai)	16.0bp	27.6bp	91.8%
Foreign bond (FTSE WGBI)	15.0bp	25.5bp	90.9%

Source: NRI

rate (the one charged on large pension mandates) by asset class. We found that their lowest index fund fee rates ranged from 10bp to 11bp for domestic equities, 7.5bp to 15bp for domestic bonds, 19bp to 21bp for foreign equities and 14.5 to 24bp for foreign bonds. By comparison, the lowest fee charged by DCIO index funds is about 5bp higher in the domestic equity asset class but more or less the same if not lower in the other three asset classes.

Although we cannot draw any definitive conclusions without more information on DB-plan funds' fees, fund fees do not seem to be materially higher in DC plans than in DB plans, at least for index funds.

Participant-friendly regulatory policies have driven down DC plan fees

One likely factor behind Japanese DCIO index funds' low trust fees is participant-friendly regulatory policies. As one example, regulators recently imposed on DC plan sponsors a duty to endeavor to evaluate their plan administrators at least every five years. Specifically, they must verify whether their plan administrators are acting solely in the plan participants' interests. Numerous administrators that select and offer investment products on behalf of DC plan sponsors have told me that they have since adopted a policy of offering index funds with the lowest trust fees in the industry irrespective of brand name. Such a preference for lowest-fee index funds has reportedly become particularly pronounced since 2015, when the aforementioned duty was first proposed⁵⁾. With index funds, whether a given fund is aligned with plan participants' interests is fairly obvious from its trust fee level. Plan administrators consequently no longer have any choice but to always offer the lowest-fee index funds.

⁵⁾ The duty became effective in May 2018.

Another factor that has helped to drive down trust fees is a regulatory change that has made it easier to discontinue investment products from a plan's product offerings. Previously, an investment product could not be discontinued without the unanimous consent of all plan participants who own that product. Since May 2018, however, this consent threshold has been lowered from unanimity to a two-thirds majority⁶⁾. Additionally, DC plan administrators have recently been clarifying procedures for discontinuing investment products. With hardly any products ever discontinued until recently, once a product was added to a plan's product lineup, it would remain in the lineup even if a substitute product more advantageous to participants were subsequently added. As a result, some 10% of DC plan AUM is invested in index funds that charge substantially higher fees than the lowest-

⁶⁾ In practice, plan administrators need only to confirm that no more than one-third of the owners are opposed to discontinuing the product.

fee funds, as shown in Exhibit 1. DCIO index funds' trust fees will presumably fall further as discontinuation of high-fee products becomes more common.

Amid the ongoing migration from DB to DC plans in the corporate pension space, it is becoming increasingly important for as many DC plan participants as possible to own cost-efficient products. With DCIO product offerings now largely identical to their DB-plan counterparts at least as far as index funds are concerned, the environment is becoming more conducive to DC plan adoption.

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