Japan's
Asset Management Business
2011/2012

Nomura Research Institute, Ltd.

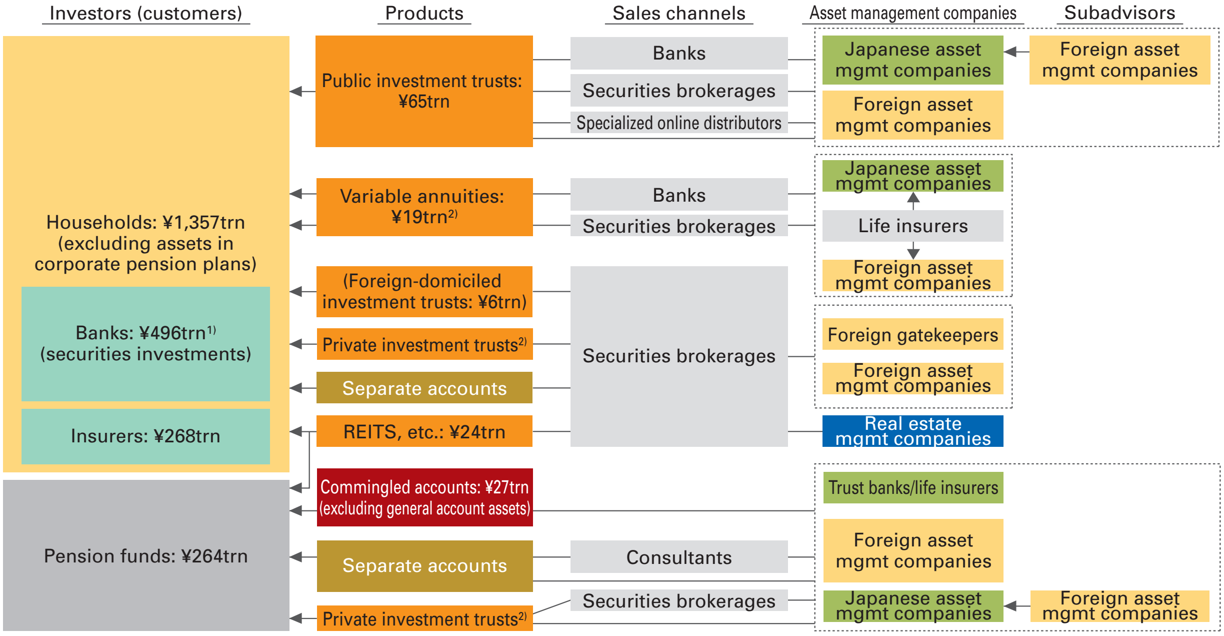
CHAPTER 1

Japanese investor trends

Financial assets: large potential but still little growth in managed assets

Overall, the Japanese asset management market exhibited little change for a third consecutive year in FY2010 (year ended March 2011). The Japanese asset management business is in a stagnation phase. Exhibit 1 provides an overview of the Japanese asset management market as of March 31, 2011. It depicts the market in terms of investors, products, distribution channels, and asset managers to provide a simplified picture of which types of asset managers manage money for which investor classes, how investor assets are allocated, and how asset flows are intermediated. Asset management companies in Japan mainly serve three types of clients: retail investors (households), corporations including financial institutions, and pension funds. Adjusted to take into account that financial institutions' securities portfolios are largely funded with retail customers' deposits, Japanese investors' financial asset holdings as of March 31, 2011, totaled an estimated ¥1,620trn, some ¥5trn less than a year earlier. This decrease was the net result of an ¥8trn reduction in pension fund assets offset by a ¥4trn increase in household financial assets. Household financial assets predominantly comprise bank deposits and other safe assets. Total household financial assets consequently have not fluctuated much over the past five years despite the recent financial crisis.

Exhibit 1. Overview of Japan's asset management business



Note 1: Excludes Norinchukin Bank and Zenkyoren.
Note 2: Private investment trust assets total ¥30trn, including investment trust assets backing variable annuities.
Source: NRI, based on data from various sources

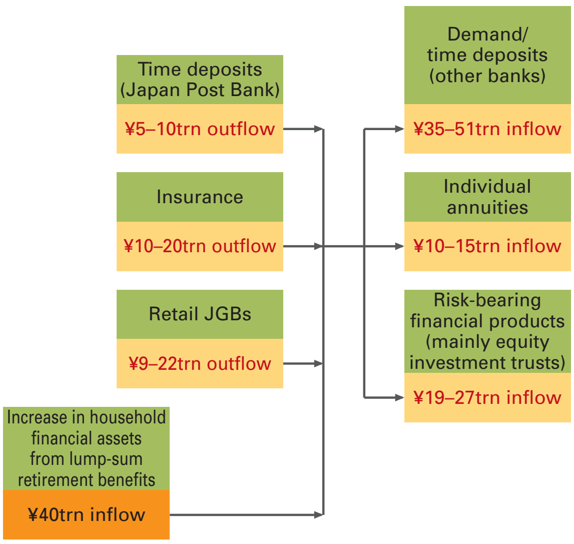
Of the total stock of financial assets, ¥340trn[1] or roughly 20% is under management by asset management companies. This percentage has likewise held relatively steady over the past five years. Although investment trusts have promising growth prospects as investment vehicles for household financial assets, they have failed to live up to growth expectations, partly because of heavy uncertainty in capital markets. Going forward, the Japanese asset management industry needs growth strategies that target not only domestic but also overseas customers.

Household assets: lackluster investment trust inflows

As of March 31, 2011, Japanese households held financial assets of approximately ¥1,357trn, an increase of a mere ¥4trn from a year earlier. Household financial assets' composition was largely unchanged from a year earlier, with bank deposits and insurance products continuing to account for over 70% of the total.

Looking ahead over a five-year horizon, we estimate that households will receive a cumulative total of some ¥40trn in lump-sum retirement benefits net of home mortgage repayments upon retirement (Exhibit 2). Now that the postwar baby-boom generation's mass retirement has ended, lump-sum retirement benefits, a key source of funding for investments in financial assets, are about to embark on a declining trend due to a progressive decrease in the number of new retirees.

Exhibit 2. Projected household-sector asset in/outflows by investment product (5-year horizon)



Source: NRI

We project ¥5–10trn in continued outflows from maturing Japan Post Bank time deposits over the next five years. In the past year or two, these outflows have slowed to an annual rate of ¥1–2trn. We expect them to maintain this run rate. With Japan Post Insurance's book of business continuing to shrink, we project ¥10–20trn in outflows from insurance products over the next five years. Net inflows into retail JGBs tend to be largely a function of interest rates. Assuming that interest rates remain low, we project ¥9–22trn in outflows from retail JGBs over the next five years, depending on actual interest rate levels.

In total, we estimate that households will have ¥64–92trn of investable funds from lump-sum retirement benefits and proceeds from redemption of other assets. Based on recent trends, we estimate that more than half of these funds, ¥35–51trn, will flow into ordinary bank deposits. We estimate that another ¥10–15trn will flow into individual annuities. We expect the remaining ¥19–27trn to flow into risk-bearing products, mainly equity investment trusts. Investment trust inflows have rebounded after falling sharply in response to the 2008 financial crisis, but they have yet to regain much growth momentum. Given recent concerns about a European crisis and other risks, we assume that investment trust inflows' recent trend will persist. On this basis, we estimate that risk-bearing products will capture slightly less than 30% of households' total incoming funds available for investment.

Financial institution market segment has growth potential

Pension funds, Japan's largest institutional investors, ended March 2011 with an estimated ¥264trn in assets. Public pension schemes' share of this total was about 65% or approximately ¥171trn, a ¥7trn decrease from a year earlier. Corporate pension plans accounted for the remaining ¥92trn, down ¥1trn from a year earlier. The sizable decrease in public pension assets is largely attributable to a FY2010 net outflow of some ¥6trn from the Employees' Pension Insurance Scheme, the predominant public pension program, which began drawing down its reserves in FY2009. With inflows to pension funds, including corporate pension plans, projected to continue to gradually decline, aggregate pension fund assets will likewise progressively decrease.

Financial institutions' securities investments totaled approximately ¥764trn at March 31, 2011. Of this total, banks (ex Japan Post Bank) accounted for some ¥258trn, *shinkin* banks and credit unions for ¥63trn, Japan Post Bank for ¥175trn, life insurers (ex Japan Post Insurance) for ¥171trn, Japan Post Insurance for ¥77trn, and nonlife insurers for ¥20trn.

From asset management companies' standpoint, financial institutions constitute a less lucrative market segment than pension funds in terms of scale of revenues. Asset management companies consequently tend to assign relatively few asset management and sales staff to serving financial institutions. Most asset management mandates awarded by financial institutions have a one-year term. Their mandates are consequently regarded as short-term money. They also impose a growing accountability burden as a result of increasingly stringent regulation. Many asset management companies consequently fail to recognize financial institutions' importance and neglect to decisively position themselves within the financial institution market segment. One reason that asset management companies are reluctant to dedicate resources to the financial institution market segment is that financial institutions mostly award bond mandates, fee rates on which are relatively low. Nonetheless, the financial institution market segment has promising medium- to long-term growth prospects. Japanese financial institutions have enormous investment securities portfolios that are expected to continue growing. They need to also hire external managers for foreign bond mandates, which pay relatively high fee rates. Even amid financial institutions' ongoing downsizing of equity holdings, equity products also still have strong prospects if they are distinctive and have high expected returns. Viewed from such a standpoint, the financial institution market segment still has substantial growth potential. The time has come for asset management companies to develop strategies targeted at financial institutions.

1) With respect to trusts and life insurers, this total includes only assets managed on behalf of pension/annuity customers. In the case of life insurers in particular, the total includes only special account balances, not assets in general accounts with guaranteed returns (e.g., fixed-amount insurance, fixed annuities).

CHAPTER 2 Asset management business's current state and asset management firms' management priorities

1 Profit margins improved in FY2010

We estimate the Japanese asset management industry's FY2010 management revenues at ¥722.7bn and its assets under management (AUM) as of fiscal-year-end at ¥359trn (including foreign clients' assets), a ¥4trn increase from a year earlier. Relative to FY2009, management revenues were up 4% (¥26.1bn) by virtue of an increase in yearly average AUM but they failed to embark on a full-fledged recovery.

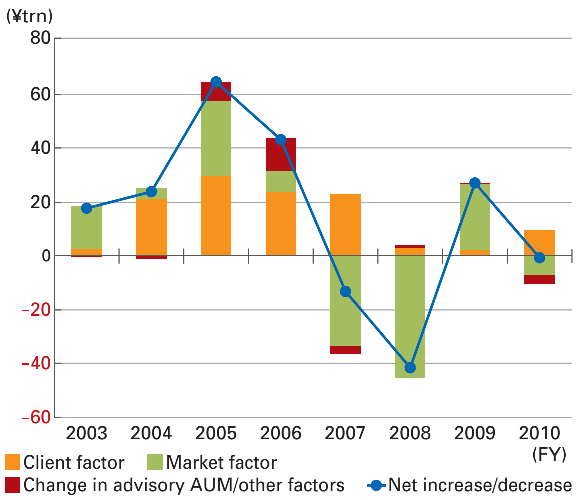
Below we look at how specialized asset management companies (investment trust and investment advisory firms excluding trust banks and life insurers) fared in FY2010 and the challenges they face.

Modest revenue growth, improved margins in FY2010

Exhibit 3 plots annual changes in these asset management companies' AUM disaggregated by causative factor. In FY2010, their aggregate AUM experienced a net decrease of approximately ¥1trn, ending the fiscal year nearly unchanged from a year earlier. The client factor (net inflows of assets from clients) contributed positively to AUM growth by approximately ¥9trn, but its contribution was nearly negated by the market factor (asset price changes), which detracted from AUM growth by ¥7trn.

The client factor's positive contribution was predominantly attributable to public investment trusts, which saw net inflows totaling roughly ¥6trn. After

Exhibit 3. Changes in AUM broken down by causative factor



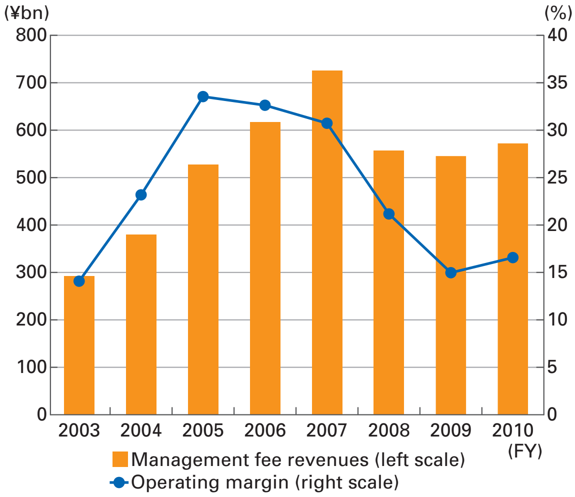
Note: Adjusted to the extent possible to reflect M&A and assets switched between contractual modalities.
Source: NRI, based largely on data from the Investment Trusts Association of Japan and Japan Securities Investment Advisers Association

coming to a halt in FY2008, public investment trust inflows exceeded ¥4trn in FY2009 and remained resurgent in FY2010.

Inflows to investment advisors, by contrast, essentially remained at a standstill. The data reported approximately ¥3trn in net inflows associated with discretionary management contracts, but these inflows were mostly attributable to mandates awarded to certain asset management companies by insurer-affiliated companies and growth in subadvisory mandates awarded by foreign-domiciled investment trusts, not to growth in mandates from domestic pension funds, investment advisors' core clients. As in FY2009, public investment trusts captured the vast majority of the Japanese asset management industry's asset inflows again in FY2010.

Asset management companies' FY2010 management revenues totaled an estimated ¥570bn, a roughly 5%

Exhibit 4. Asset management companies' aggregate management fee revenues and operating margin



Source: NRI, based largely on asset management companies' business reports and data from the Japan Securities Investment Advisers Association

increase from FY2009 (Exhibit 4). With AUM nearly unchanged in FY2010 as noted above, management revenues were roughly flat year on year. Aggregate operating margin, however, improved by a sizable 3.0 percentage points year on year to 18.0%. The factors behind this improvement are discussed below.

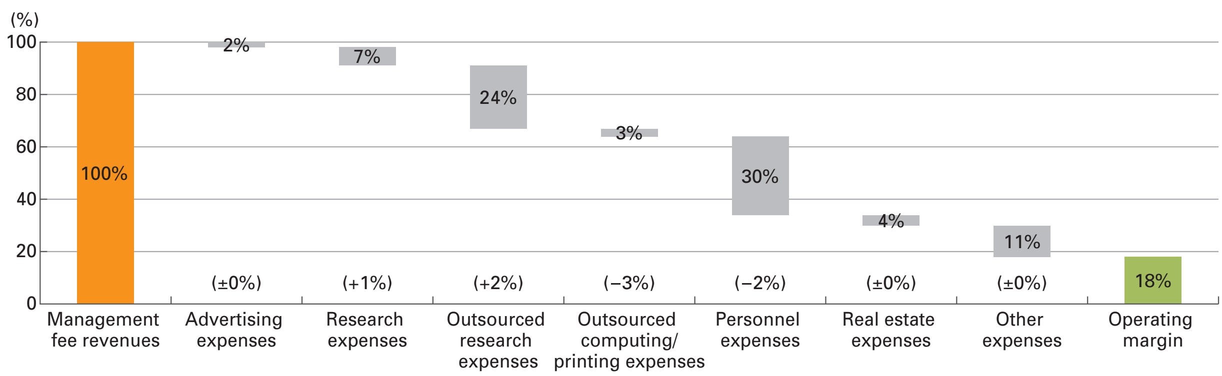
Changes in cost structures

Exhibit 5 shows the aggregate cost structure of 62 asset management companies for which FY2010 income statement data were available at the time of this writing. It does so by plotting expense line items as a percentage of management revenues. As in FY2009, the two biggest expenses in FY2010 were salaries and outsourced research (i.e., subadvisory fees paid to external asset managers and allocated costs charged by foreign asset management companies' overseas parents). However, several expenses' ratios to revenue changed in FY2010.

First, the ratio of personnel expenses to management revenues decreased by 2 percentage points. By nature, personnel expenses are predominantly fixed costs. Even in FY2009, when management revenues fell sharply in the wake of the financial crisis, asset management companies failed to flexibly reduce personnel expenses. In FY2010, however, personnel expenses' rigidity softened somewhat. When we queried individual companies about this change, we learned that some, mainly foreign, asset management companies substantially cut bonuses and/or top management's compensation.

The other major expense, outsourced research expenses, tends to increase as asset management companies offer more products that invest in foreign assets and other assets for which they lack in-house management expertise in Japan. In FY2010, outsourced research expenses' ratio to management revenues increased 2 percentage points, negating the reduction in personnel expenses. Growth in outsourced research expenses was common to both Japanese and foreign asset management companies. Several companies saw their outsourced research expenses increase from FY2009 by more than ¥1bn.

Exhibit 5. Asset management companies' aggregate cost structure



Note: Management fee revenues are net of (estimated) investment trust account management fees paid to distributors. Numbers in parentheses are changes in the expense item's share of management fee revenues relative to the previous fiscal year (in percentage points).
Source: NRI, based largely on data from the Investment Trusts Association of Japan and Japan Securities Investment Advisers Association

The expense line item that changed most dramatically was outsourced computing and printing expenses. Its ratio to management revenues decreased 3 percentage points, a 50% reduction from 6% in FY2009. Contacts with individual asset management companies revealed that many reduced printing costs in particular, mainly by virtue of a regulatory change that permits public investment trusts' prospectuses to be simplified and distributed in abridged form from FY2010. These cost savings should persist in FY2011 and beyond.

In sum, one distinguishing characteristic of FY2010 was that the asset management industry's overall operating margin improved largely due to a regulatory change in addition to companies' individual efforts to boost profitability.

With expected returns from domestic assets currently diminishing, expenditures on subadvisory and other such services are structurally unavoidable to some extent. However, the increase in FY2010 outsourced research expenses that negated a roughly equivalent reduction in personnel expenses suggests that the Japanese asset management industry, including both domestic and foreign companies, is at risk of being hollowed out as a result of the value-added of asset management itself shifting overseas. This situation looks unlikely to change much unless asset management companies restructure their businesses by capitalizing on their respective unique strengths.

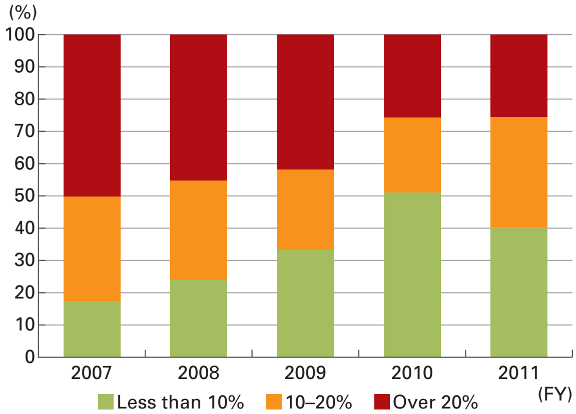
2 Business environment remains challenging

Next we look at asset management company executives' outlook and plans for their businesses based on NRI's 2011 Survey of Asset Management Companies' Management Priorities[2].

Outlook still downbeat

The survey annually asks respondents about their outlook for AUM growth (specifically, growth attributable to net asset inflows over the next 3–5 years, excluding the effect of changes in assets' market values). In the FY2011 survey, the percentage of respondents projecting AUM growth of 10% or more increased, albeit narrowly, after declining for the previous several years straight (Exhibit 6). However, while the percentage of respondents projecting AUM growth of 10–20% increased from FY2010, the percentage projecting growth of 20% or more remained as low as in FY2010. Asset management company executives remain downbeat in their outlook for the business environment.

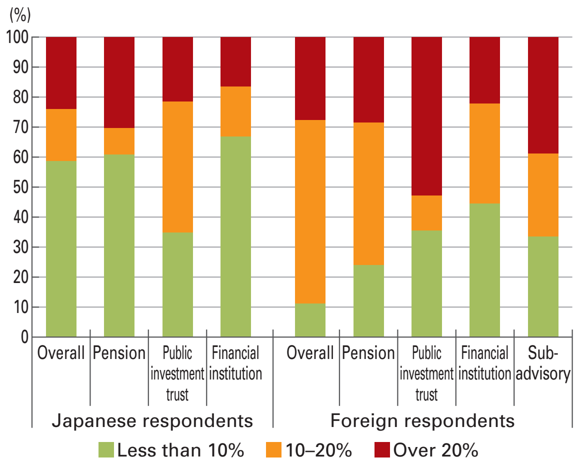
Exhibit 6. Projected AUM growth rates (whole-company basis)



Source: NRI *Survey of Asset Management Companies' Management Priorities*

Survey responses about the business outlook differ substantially by business segment and between Japanese and foreign asset management companies. Exhibit 7 presents survey respondents' outlook for asset inflows for each business segment, broken

Exhibit 7. Projected AUM growth by business (broken down between Japanese and foreign respondent-companies)



Source: NRI *Survey of Asset Management Companies' Management Priorities* (2011) down between Japanese and foreign companies.

First, 90% of respondents employed by foreign companies anticipate total AUM growth of 10% or more, whereas only 40% of Japanese respondents are equally optimistic. Foreign asset managers are thus generally bullish in their assessment of the business environment. Moreover, they are more bullish than their Japanese counterparts across all business segments.

The one business in which most Japanese asset management companies expect AUM growth of 10% or more is public investment trusts. In contrast, most foreign companies consider the subadvisory and pension businesses to have promising growth prospects in addition to the public investment trust business. Providing subadvisory services to domestically chartered investment trusts run by Japanese asset management companies is an important business for foreign asset management companies in the Japanese market. The difference in outlook between Japanese and foreign asset management companies reflects that demand for products in which the latter excel (e.g., emerging market assets) is growing among both retail and pension fund clients.

Foreign asset management companies have a relatively upbeat outlook even with respect to the financial institution market segment, which is regarded by both Japanese and foreign asset managers as the most difficult in which to gather assets.

Inflows to emerging market assets are a tailwind for foreign asset managers

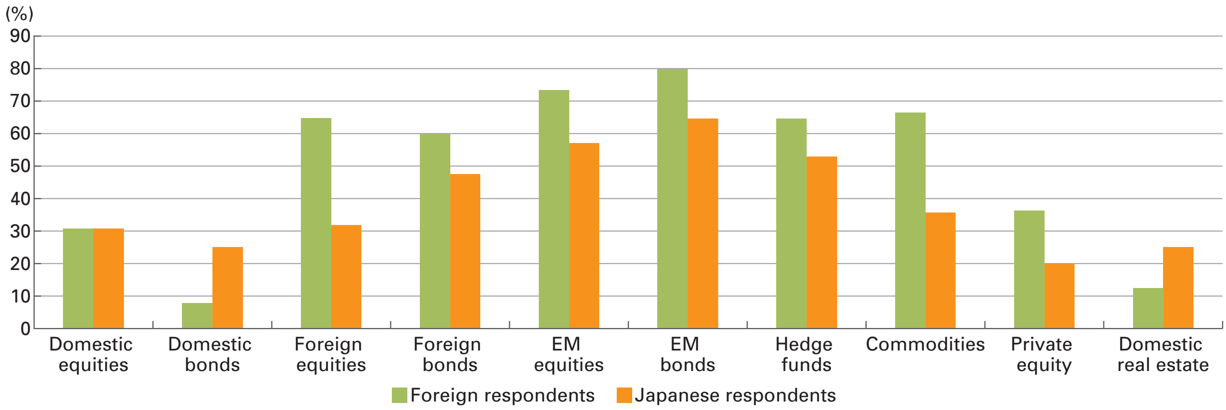
Exhibit 8 shows survey respondents' outlook for asset inflows by asset class, separated between Japanese and foreign asset management companies. The asset classes in which the largest percentages of respondents expect AUM growth of 10% or more are commodities and foreign, chiefly emerging market, assets. For foreign asset management companies in particular, AUM growth in these asset classes is expected to be a key driver of business growth.

Japanese asset management companies' outlook is more bullish than foreign asset management companies' in only two asset classes: domestic bonds and real estate. Domestic bonds, which are predominantly JGBs, may indeed be one of the few promising asset classes for Japanese asset management companies, given that not many foreign asset management companies are adequately staffed with domestic bond managers and that JGBs have recently been re-rated by the market in response to the US and European fiscal crises. By no means, however, do domestic bonds have much prospect of major asset inflows in comparison to other, most notably emerging market, asset classes.

Personnel cost containment

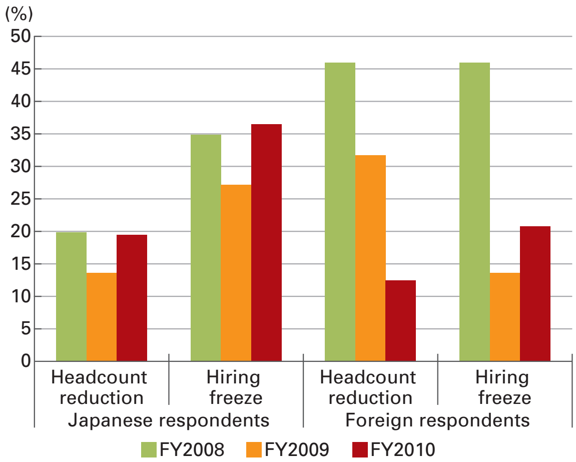
As seen in Exhibit 5, personnel expenses are asset

Exhibit 8. Percentage of respondent companies projecting AUM growth of 10% or more by asset class (broken down between Japanese and foreign respondents)



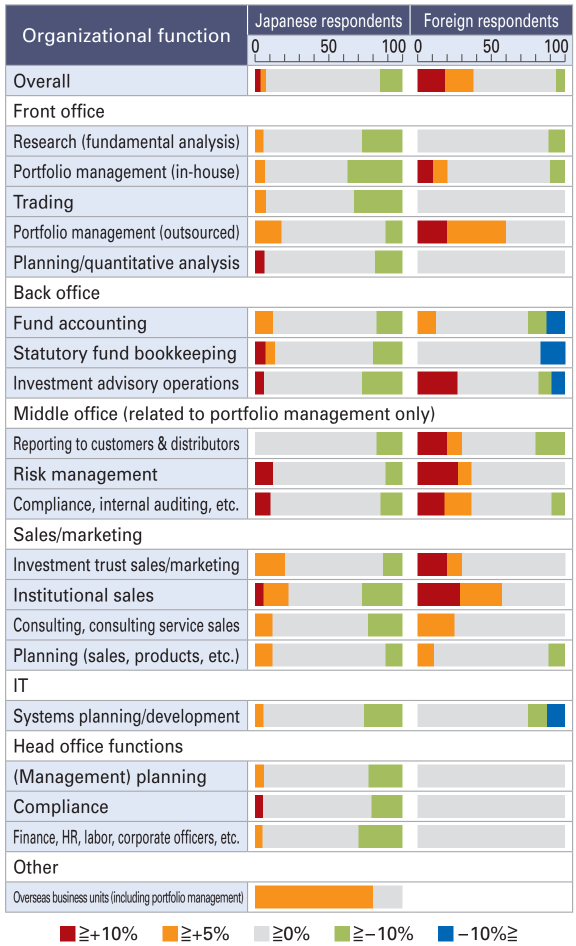
Source: NRI *Survey of Asset Management Companies' Management Priorities* (2011)

Exhibit 9. Prevalence of personnel cost-containment measures



Source: NRI *Survey of Asset Management Companies' Management Priorities*

Exhibit 10. Projected headcount adjustments by organizational function (broken down between Japanese and foreign respondents)



Note: Data for each organizational function were compiled from survey responses of companies that reported currently having at least one employee assigned to that organizational function.
Source: NRI *Survey of Asset Management Companies' Management Priorities* (2011)

management companies' biggest expense. Personnel cost control is a key management theme. Our survey queried respondents about personnel-cost control measures (i.e., headcount reductions and hiring freezes).

Exhibit 9 shows these measures' prevalence since FY2008, when cost structure strains first emerged. Neither measure's prevalence has changed much over the past three years among Japanese asset management companies. Among foreign asset management companies, by contrast, headcount reductions decreased over the past three years. Hiring freezes increased somewhat in prevalence among foreign asset managers in FY2010, but not by much relative to their FY2009 level, which was down sharply from FY2008. Foreign asset management companies are clearly quicker to adjust staff size than their Japanese counterparts. In FY2010, both headcount reductions and hiring freezes were roughly half as prevalent among foreign asset management companies as among Japanese companies. This is consistent with foreign asset management companies bullish business outlook discussed above.

Exhibit 10 shows how survey respondents plan to adjust staff size by organizational function. Foreign asset management companies' plans appear to be strategically targeted. For example, foreign firms generally plan to add staff to their front office, middle office, sales and marketing operations while somewhat reducing staff in organizational functions less integral to competitiveness, such as back-office operations. Such plans reflect their propensity to nimbly shift organizational priorities through such means as laying off, hiring, or reassigning personnel.

In contrast, Japanese asset management companies' staffing plans did not exhibit any such patterns. Instead, Japanese firms are generally projecting small decreases in headcount across all organizational functions, with the sole exception of overseas operations. Many asset management companies that already have overseas business units are planning to expand their overseas staff. For large Japanese asset management companies in particular, seeking new clients overseas is inevitable trend.

3 Japan's asset management market from the standpoint of new entrants

Although the Japanese asset management business has recently stagnated somewhat, it is still a potentially lucrative market from the standpoint of prospective new entrants from overseas. The Japanese market is attractive to prospective new entrants because it offers substantial opportunity to capture revenues from three investor classes: retail investors, pension funds, and financial institutions. We quantified revenues potentially available to new entrants from these investor segments through a two-step process. First, we estimated (1) asset inflows from each investor class (new assets) and (2) the percentage of assets that investors move from one asset manager to another (moved assets). Next, we estimated revenues by multiplying projected new assets and moved assets by applicable management fee rates[3]. While this estimation model is arguably simplistic, we used it to estimate revenues from the three investor classes as shown in Exhibit 11.

First, in the retail investor segment, new retirees will annually receive an estimated ¥8trn in lump-sum retirement benefits for the next several years. A certain percentage of these funds will presumably be invested in high-yielding investment trusts and other such investment products. The asset management industry should accordingly see moderate inflows of new assets

Exhibit 11. Estimated revenue available to new-entrant asset management companies, by client segment

		Retail investors	Pension funds	Financial institutions
Existing investments[1]		¥64trn	¥80trn (corporate) ¥170trn (public)	¥36trn
New asset inflows[2]		¥5trn	¥0trn	¥4trn
Moved assets		¥0trn	¥21trn	¥9trn
Estimated management fee rates		0.60%	0.29% (corporate) 0.20% (public)	0.20%
Annual revenue	New assets	¥30bn	¥0bn	¥8bn
	Moved assets	¥0bn	¥30bn	¥18bn
Total revenue		¥30bn	¥30bn	¥26bn
FY2010 revenue[3]		¥310bn	¥330bn	¥60bn

Note 1: Financial institutions' existing investments figure is an estimate derived by summing their "other securities" holdings, foreign bond investments, etc.
Note 2: Inflows from retail investors are an estimate of funds that will be invested in investment trusts from lump-sum retirement benefits, redemption of retail JGBs, etc.
Note 3: Estimates based on Japan Securities Investment Advisers Association and Fundmark data.
Source: NRI estimates based on data from various sources

from retail investors. Pension funds, which are projected to experience a decline in AUM going forward, have an established practice of replacing underperforming asset managers once every three years. Annual revenues available to new entrants by virtue of this practice total an estimated ¥30bn, equivalent to the annual revenues that public investment trusts would earn on a ¥5trn inflow of assets. In the financial institution[4] segment, we estimated annual revenues available to new entrants at ¥26bn. Many financial institutions review asset management mandates annually. For asset management companies that already have financial institution clients, the risk of asset redemption is high. Conversely, however, financial institutions' practice of annually reviewing asset management mandates presents a major opportunity for new entrants to win mandates.

These three estimates total ¥86bn, more than 10% of the Japanese asset management industry's existing aggregate revenues of approximately ¥700bn. This total would of course differ if the underlying assumptions were changed, but Japan's asset management business is nonetheless distinguished by sizable revenue potential for new entrants in all three market segments.

2) For five consecutive years since FY2007, NRI has conducted this survey of domestic and foreign asset management companies doing business in Japan. In 2011, NRI conducted the survey in August–September and received responses from 56 companies (32 Japanese, 24 foreign). The respondent companies account for 67% of the Japanese asset management industry's public investment trust AUM, 77% of private investment trust AUM, and 76% of investment advisory AUM as of March 31, 2011. In aggregate, the respondent companies have public investment trust AUM of ¥43trn, private investment trust AUM of ¥24trn, and investment advisory AUM of ¥91trn.
3) We estimated assets moved from one asset manager to another based on the assumption that (1) once every three years pension funds redeem assets invested with asset management companies with bottom-quartile performance and reinvest those assets with a new asset manager and (2) financial institutions do the same but on an annual basis. We used public investment trusts' current average management fee rate as the fee rate for retail investment trusts. We used Pension Fund Association survey data as the management fee rate for corporate pension plans. For non-GPIF public pensions, we estimated the management fee rate based on asset management companies' revenues. For GPIF, we estimated the management fee rate based on data published by GPIF. For financial institutions, we used the average management fee rate for bond mandates.
4) "Financial institutions" means "all banks" (mainly major banks and regional banks) as defined by Japanese Bankers Association statistics.

CHAPTER 3 Market trends by client segment

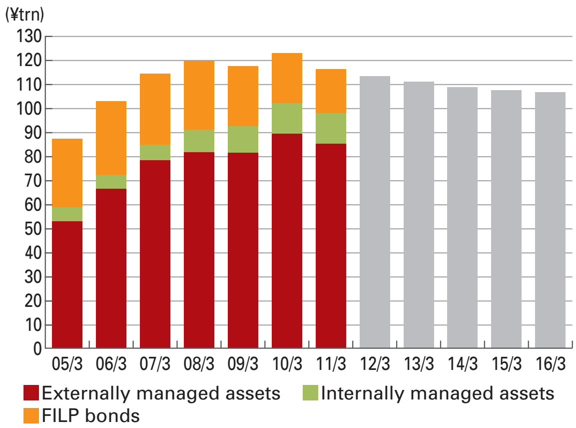
1 Pension business

AUM was reduced by growth in benefit payouts

Japanese pension assets totaled an estimated ¥264trn at March 31, 2011. Of this total, public pension schemes (National Pension, Employees' Pension Insurance, and Mutual Aid Associations) accounted for 65% or approximately ¥171trn, a ¥7trn decrease from a year earlier. Over 70% or ¥122trn of these public pension assets belong to the Employees' Pension Insurance and National Pension programs.

The vast majority of these two public pension schemes' assets are managed by the Government Pension Investment Fund (GPIF). At March 31, 2011, the GPIF had AUM of ¥116trn, down ¥6.5trn from a year earlier despite a near-zero, albeit negative, investment return. The decrease was attributable to a drawdown of the GPIF's pension reserves as a result of benefit expenditures exceeding receipts from pension insurance premiums. Even the official forecast issued in conjunction with the Ministry of Health, Labor and Welfare's FY2009 actuarial valuation of public pension schemes predicts that pension reserves will continue to be drawn down for the foreseeable future. Exhibit 12 plots a five-year forecast of the GPIF's AUM based on this official forecast. However, public pension reserves are slated to be drawn down by more than ¥6trn for a second consecutive year in FY2011. The GPIF's

Exhibit 12. GPIF's AUM (actual and forecasted)



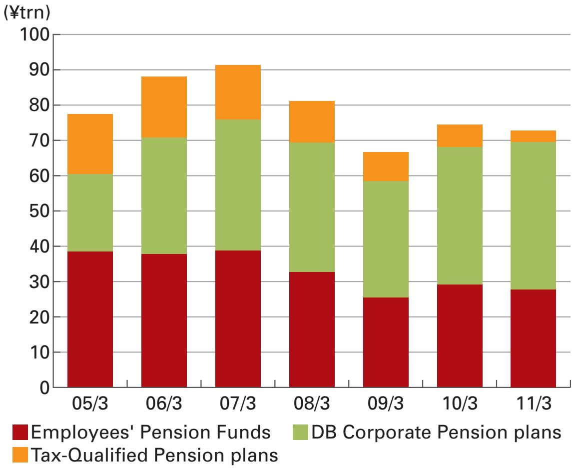
Note: Data for FY2011 and beyond are NRI forecasts based on the Ministry of Health, Labor and Welfare's FY2009 actuarial valuation.
Source: NRI, based on GPIF's *Review of Operations in Fiscal 2010* and Ministry of Health, Labor and Welfare's FY2009 Actuarial Valuation Report

AUM consequently may decrease by a larger margin than shown in the graph, unless the GPIF earns high investment returns.

The GPIF's allocations of managed assets (excluding directly underwritten FILP (Fiscal Investment and Loan Program) bonds) were roughly unchanged in FY2010, with 60% of assets allocated to domestic bonds and around 30% allocated to domestic and foreign equities. Its average fee rate was likewise unchanged from FY2009 at 0.021% of AUM, presumably reflecting that the GPIF did not change its asset allocation and has finished reducing the number of custodians that it uses.

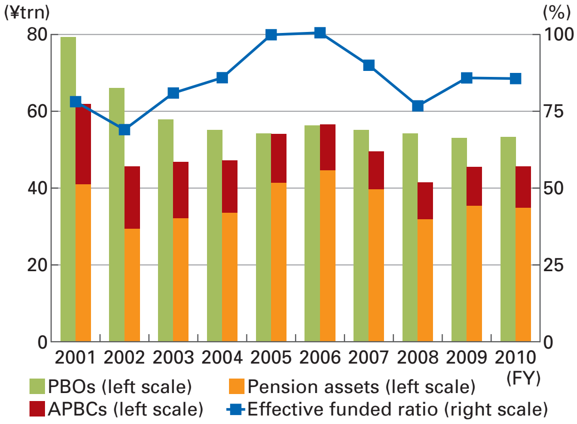
Among corporate pension plans, defined benefit (DB) plans ended FY2010 with aggregate assets of ¥73trn, an approximately ¥1.5trn decrease from a year earlier (Exhibit 13). By type of plan, DB Corporate Pension plans increased substantially in number to more than

Exhibit 13. Corporate DB pension assets



Source: Trust Companies Association of Japan, Life Insurance Association of Japan

Exhibit 14. Corporate pension plans' overall funded status



Note 1: The above data pertain to Tokyo Stock Exchange 1st Section-listed companies that have adopted Japanese GAAP-compliant pension accounting.
Note 2: PBOs are net of prepaid pension expenses. Effective funded ratio = (pension assets + APBCs)/PBOs
Source: NRI, based on Nikkei Media Marketing data

10,000, including both employer-administered and externally administered plans. Tax-Qualified Pension plans, which are in the process of being completely phased out by a deadline of March 31, 2012, saw their aggregate assets fall to ¥3trn. Many Tax-Qualified Pension plans are being converted to DB Corporate Pension plans or absorbed into the Smaller Enterprise Retirement Allowance Mutual Aid program, but quite a few others have apparently been simply terminated.

Defined contribution (DC) plans, which have been in existence in Japan for 10 years as of 2011, had aggregate assets of ¥5.5trn as of March 31, 2011. From 2012, participants in employer-sponsored DC plans (hitherto noncontributory) will be permitted to make "matching contributions[5)]" pursuant to the new Pension Security Assistance Act enacted in August 2011. The DC plan contribution limit will remain unchanged and matching contributions will be subject to certain restrictions. Most notably, they may not exceed employer-funded contributions. Nonetheless, matching contributions should help drive growth in DC plan assets to some extent.

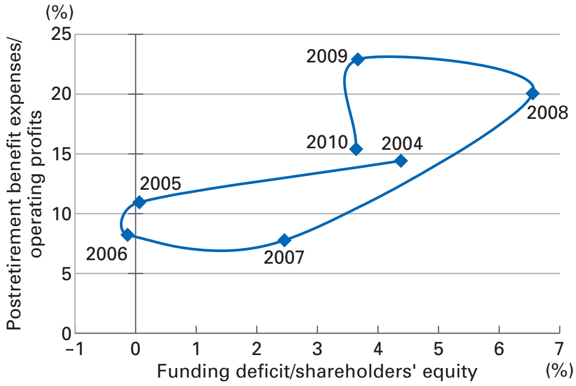
Corporate pension plans' financial burden leveled off in FY2010

Postretirement benefit plans continue to weigh heavily on corporate finances. Exhibit 14 plots pension benefit obligations (PBOs), pension assets, and accrued postretirement benefit costs (APBCs) recognized as on-balance-sheet liabilities for Tokyo Stock Exchange 1st Section-listed companies that have adopted Japanese GAAP-compliant pension accounting. It also plots the effective funded ratio, defined as the ratio of pension assets plus APBCs (which are recognized liabilities) to PBOs.

PBOs, which totaled nearly ¥80trn when the current postretirement benefit accounting standard was first adopted, decreased substantially over the next several years as a result of companies' switching to DC pension plans and offloading the so-called substitutional portion of Employees' Pension Fund (EPF) assets and liabilities to the government (*daiko-henjo*). Subsequently, however, PBOs have been holding relatively constant in the vicinity of ¥50trn. Pension assets fell to ¥32trn in FY2008, when financial markets were roiled by Lehman Brothers' collapse. Pension assets recovered modestly in FY2009 and were roughly flat in FY2010, ending the fiscal year at ¥35trn. The effective funded ratio consequently also remained virtually unchanged at around 85%. In other words, about 15% of PBOs remain unrecognized liabilities.

Postretirement benefit expenses decreased

Exhibit 15. Postretirement benefit plans' financial impact on sponsor companies



Note: The above data pertain to Tokyo Stock Exchange 1st Section-listed companies that have adopted Japanese GAAP-compliant pension accounting.
Source: NRI, based on Nikkei Media Marketing data

somewhat to ¥4.2trn in FY2010. The decrease was mainly attributable to an increase in expected returns on pension assets and a reduction in amortization of actuarial losses.

Exhibit 15 shows postretirement benefit plans' impact on corporate financial statements from two standpoints: (1) postretirement benefit expenses' magnitude relative to operating profits and (2) the pension funding deficit (unrecognized liabilities) relative to shareholders' equity.

In FY2008, postretirement benefit expenses increased just as earnings from operations deteriorated. Postretirement benefit plans consequently detracted from FY2008 operating profits by some 20%. Meanwhile, the pension funding deficit also grew, imposing its heaviest-ever latent burden on shareholders' equity. In FY2009, the burden on shareholders' equity abated because many companies started to amortize their pension funding deficits, but this amortization increased postretirement benefit expenses commensurately, exerting greater downward pressure on operating profits.

In FY2010, amortization of funding deficits continued but decreased in amount while earnings from operations also improved. Postretirement benefit expenses' burden on operating profits consequently diminished. The aggregate funding deficit, however, was nearly unchanged from FY2009. The latent impact on shareholders' equity therefore remained undiminished.

After increasing sharply in FY2008, corporate pension plans' burden on companies' earnings and financial position has abated over the past two years. However, the risk assumed in investing pension assets is closely correlated with companies' core-business risks. If the pension asset investment environment worsens, companies' business environment would simultaneously worsen. In such an event, pension plans' financial impact on companies would increase like it did in FY2008.

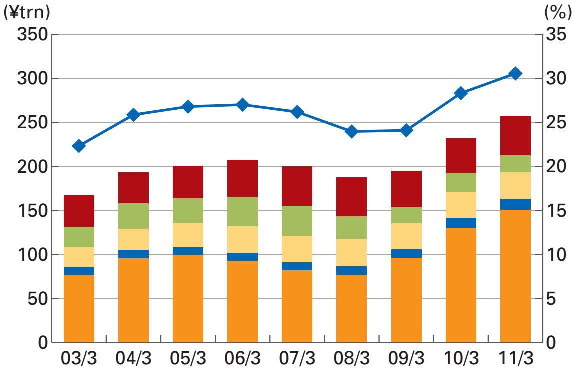
Companies previously had means, such as *daiko-henjo*, to alleviate postretirement benefit plans' burden on earnings. Currently, however, their options are limited. Companies will presumably look to asset management to relieve the burden through such means as improvement in risk-adjusted returns through further diversification or downside risk mitigation.

2 Securities investment by banks

Banks' investment securities holdings continue to grow

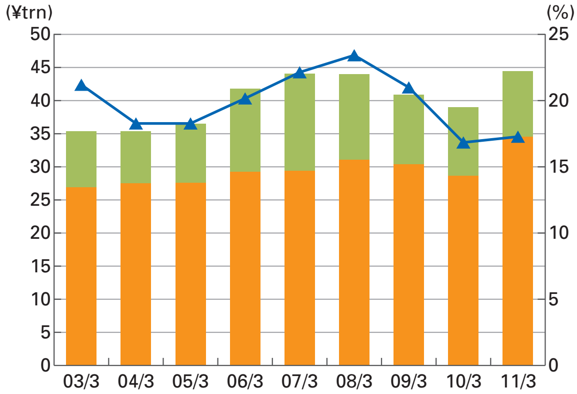
Japanese banks ended FY2010 with aggregate investment securities holdings of ¥258trn, a ¥26trn increase from a year earlier. Investment securities' share of total bank assets rose to 30.6%, its highest level of the past 10 years (Exhibit 16). JGBs account for the largest share of banks' investment securities holdings at 59% (¥151trn), followed in descending order by "other securities" at 17% (¥45trn), corporate bonds at 12% (¥30trn), and equities at 7% (¥19trn). Relative to FY2009, banks substantially increased their holdings of JGBs and "other securities". Meanwhile, they reduced their equity holdings again in

Exhibit 16. Japanese banks' investment securities holdings



Source: NRI, based on Japanese Bankers Association's *Financial Statements of All Banks*

Exhibit 17. Composition of banks' "other securities" holdings



Source: NRI, based on Japanese Bankers Association's *Financial Statements of All Banks* and Bank of Japan's *Domestic Bank Assets and Liabilities*

FY2010. For the past several years, all types of banks have been downsizing their strategic equity holdings.

As in FY2009, growth in investment securities holdings was most pronounced among major banks, whose securities holdings grew at a rate double to triple that of regional banks, second-tier regional banks, and trust banks' securities holdings. Growth in banks' securities holdings was driven by growth in deposits and a lack of growth in lending. Banks' outstanding domestic loans decreased from FY2009, reflecting sluggish corporate demand for funds. Corporate demand for funds spiked in the aftermath of the March 2011 earthquake and tsunami, but companies paid down their bank loans in the first half of FY2011 as the business outlook was increasingly clouded by yen appreciation and US and European financial market volatility. Loan growth has recently stagnated amid no sign of economic improvement while net lending margins have narrowed in the wake of a decline in loan rates. These two trends are a major source of earnings pressure for banks' securities investment.

Foreign securities investment is also growing

Banks "other securities" holdings as of March 31, 2011, were ¥44.5trn, a ¥6trn increase from a year earlier (Exhibit 17). The increase was their first since FY2006. Within the "other securities" category, foreign securities holdings increased ¥5.9trn year on year to ¥34.6trn, while other holdings (e.g., funds, hedge funds, structured bonds) decreased modestly to end FY2010 at ¥10trn.

By type of bank, major banks' "other securities" holdings grew a hefty 23% year on year to ¥25.9trn at March 31, 2011. Major banks apparently adopted a more aggressive investment posture in pursuit of earnings growth. Second-tier regional banks also increased their "other securities" holdings, albeit by only 5% to ¥1.8trn. Their first-tier counterparts, by contrast, continued to reduce their "other securities" holdings, ending FY2010 with ¥7.6trn, a 2% decrease from a year earlier. Regional banks' investment stance vis-à-vis "other securities" apparently differed widely among individual banks.

Banks' securities investment has reached an inflection point

Since 2007, NRI has repeatedly conducted surveys on securities investment by banks. We have found that banks can be broadly classified into two camps in terms of their investment behavior in response to the financial crisis triggered by US subprime mortgage woes in 2007 and the subsequent sovereign debt crisis. In one camp are banks that are pursuing broader diversification of their investment portfolios. In the other are banks that have become more aggressive in assuming interest rate risk. Major banks and trust banks are in the first category, while regional banks (including both first- and second-tier; likewise below unless otherwise noted) tend to be in the second[6].

Major banks have substantially increased their JGB holdings since the recent financial crisis, partly in response to stricter international regulations regarding liquidity. In the second half of FY2010, however, major banks started to invest more actively in various non-JGB assets to increase their investment returns, including funds, hedge funds, and foreign bonds. Major banks' holdings of foreign bonds in particular have grown dramatically. One key driver behind this growth is that with JGBs already accounting for nearly 70% of their investment securities holdings, interest rate risk constrains major banks from further expanding their JGB holdings. Going forward, major banks are likely to continue to strengthen their risk management (e.g., risk analysis/assessment) capabilities and maintain a policy of selecting investments from the standpoint of expected real returns, not superficial returns, and taking into account investment risks and associated costs. Additionally, hedge fund investments by banks may be subject to future restrictions, depending on the ultimate outcome of the ongoing tightening of regulation and oversight of shadow banking.

Regional banks, which are much more human-resource constrained than major banks, have been actively seeking to boost investment returns since FY2010 by extending their bond portfolios' duration while upgrading their methods of quantifying interest-rate risk in banking accounts. They have adopted core deposit models[7]. While regional banks are predominately investing in JGBs, some are simultaneously increasing their holdings of municipal, corporate, and/or foreign bonds. As noted above, banks have substantially increased their foreign securities holdings since March 31, 2010, but they vary widely in their individual investment stances toward foreign bonds, reflecting the uncertainties surrounding the US and European economies in recent years. Another reason behind such variation is that since the recent financial crisis banks have been under pressure from financial regulators to build risk management regimes suited to their investment holdings. With banks' securities investments recently under growing earnings pressure, regional banks find themselves in a predicament, given their human-resource constraints and inability to adequately develop portfolio management capabilities internally. Some regional banks are apparently using external third parties to provide expertise that they lack internally. For example, by utilizing investment advisory services or awarding discretionary portfolio management mandates, regional banks can supplement their in-house risk assessment and analysis capabilities and gain investment know-how among other benefits.

Like major banks, some regional banks are endeavoring to diversify into investment products such as funds and foreign bonds while upgrading their risk management. When selling investment products, distributors now provide detailed information on product attributes as a matter of course. In the current investment environment, asset management companies' research and analytical capabilities hold great promise as tools to help banks capture stable returns from securities investments.

All types of banks are reducing their equity holdings, but while downsizing strategic equity holdings, some banks are investing in ETFs or equity investment trusts or increasing their holdings of equities as a pure investment. As banks have increased bond allocations in their investment securities portfolios, they have recognized the importance of equities as an asset class inversely correlated with bonds. Asset management companies should not neglect banks' investment needs with respect to equities or equity-backed investment products.

3 Retail business

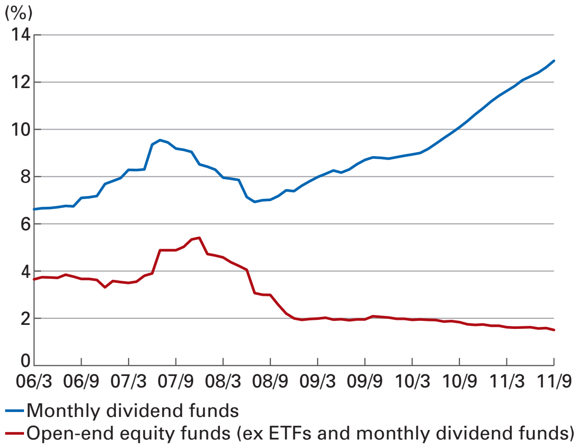
Continued inflows into high-yield, high-risk products

Domestically chartered public investment trusts' AUM as of March 31, 2011, totaled ¥65trn, a ¥1trn increase from a year earlier. As of September 30, 2011, however, their AUM had fallen to ¥58trn as a result of asset prices' intervening decline largely in response to European economic turmoil.

Open-end equity funds account for slightly over 80% of total public investment trust assets. For the past nearly ten years, open-end equity fund assets have been heavily concentrated in funds that invest in foreign securities—specifically, foreign equity, foreign bond, and foreign hybrid funds. Foreign bond funds have been the most popular of the three since FY2008, but foreign hybrid funds, mainly REITs, have also seen a surge in inflows since FY2010 (Exhibit 18).

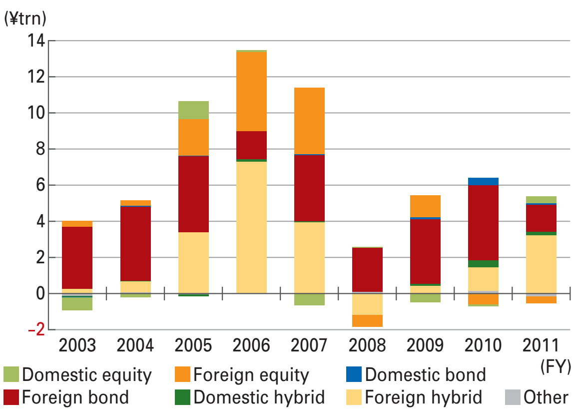
In terms of sales, equity investment trusts that pay high distribution yields remain highly popular. High-yield funds include many funds that invest in foreign securities. Yields differ substantially between funds that pay monthly distributions and funds that do not. This yield differential has progressively widened since FY2008 (Exhibit 19). Meanwhile, funds that do not pay monthly distributions have collectively experienced net outflows for four consecutive semiannual periods. Among funds that pay monthly distributions, relatively high-risk funds (e.g., currency-choice funds, Brazilian bond funds) have continued to experience net inflows.

Exhibit 19. Open-end equity investment trust (ex ETFs) distribution yields



Source: NRI

Exhibit 18. Open-end equity investment trust in/outflows



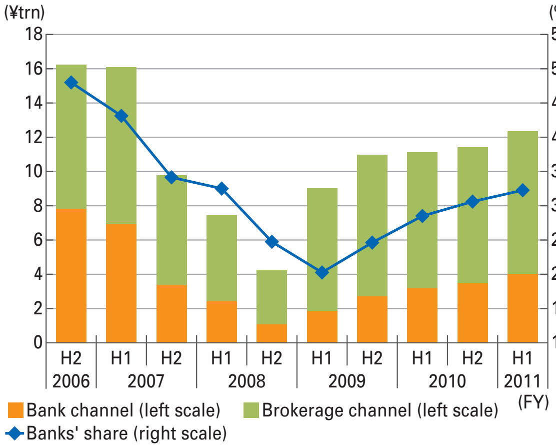
Note 1: FY2011 data are annualized fiscal-first-half data.
Note 2: Excludes ETFs, funds with daily settlement arrangements, and bond investment trusts.
Source: NRI, based on Fundmark data

Are such high-risk products truly what retail investors are currently seeking? According to an NRI survey[8) conducted in September 2010, individuals that invest in financial products in pursuit of double-digit expected returns account for less than 10% of retail investors, even among experienced investors. A majority of retail investors consider returns in the 2–5% range to be sufficient. Such investors prefer investment products that pose lower risk commensurate with such returns. Asset management companies should accordingly focus on offering lower-risk funds also, instead of concluding that most retail clients prefer high-yield funds. Such an approach should help expand their customer base to capture more first-time investment trust investors.

Regional banks hold the key to increasing the bank channel's share of investment trust sales

In terms of investment trust sales, brokerages

Exhibit 20. Open-end equity investment trust sales (ex ETFs)



Source: NRI, based on data from various sources

remain a stronger force than banks. In the first half of FY2011, brokerages' equity investment trust sales exceeded ¥8trn, more than 90% of their post-FY2000 semiannual peak level achieved in the first half of FY2007 (Exhibit 20). Relative to the year-earlier period, however, brokerages' equity investment trust sales grew a lackluster 5%. In contrast, banks' FY2011 first-half equity investment trust sales grew 25% year on year and their share of banks and brokerages' combined investment trust sales rebounded to one-third. However, banks' investment trust sales remained at less than half of their peak level reached in the second half of FY2006.

The key to recovery in banks' investment trust sales to their previous level is regional banks. Regional banks lag behind city banks and trust banks in terms of investment trust sales recovery. In the first half of FY2011, regional banks' investment trust sales were a mere one-third of their peak level. Regional banks' poor performance in the investment trust sales channel is attributable to a lack of effort to capture new investment trust customers since the post-Lehman market downturn. Since the second half of FY2007, the number of investment trust accounts at regional banks has barely increased. Regional banks should endeavor to capture new customers through such means as launching renewed sales efforts targeted at retiree customers that do not own investment trusts and pitching investment trusts to customers with maturing time deposits or retail JGBs.

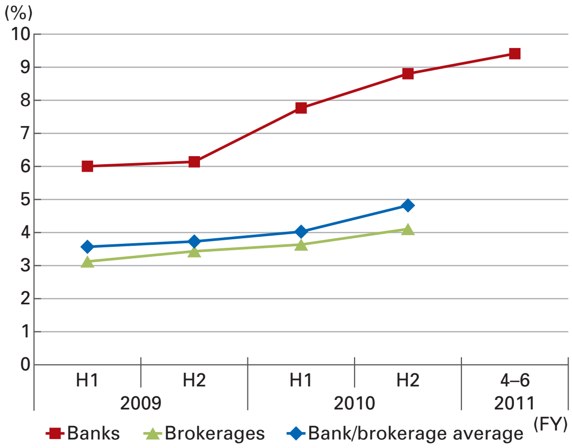
Lack of growth in banks' investment trust sales has significant implications for brokerages also. Brokerages reportedly have increased their sales by capturing new customers that first purchased investment trusts from a bank. If regional banks capture fewer new customers, brokerages could also experience a future downshift in investment trust sales.

Online share of investment trust sales is growing, particularly at regional banks

After falling sharply from the second half of FY2007, online sales of investment trusts have rebounded somewhat since FY2009. The online share of investment trust sales is rising faster at banks, particularly first-tier regional banks, than at brokerages. The online channel currently accounts for roughly 10% of first-tier regional banks' investment trust sales (Exhibit 21).

In the online channel, sales commissions are often discounted, particularly by banks. Ninety percent of first-tier regional banks that sell investment trusts online offer discounted sales commissions online. The average discount is 30%, but discounts generally

Exhibit 21. Online sales' share of total investment trust sales (ex ETFs and money reserve funds)



Source: NRI, based on data from Japan Securities Dealers Association and Kinzai/Quick Fund Databank tend to be larger at banks where online sales account for a large share of investment trust sales. Even some major banks discount sales commissions. Discounting may spread to brokerages at some point.

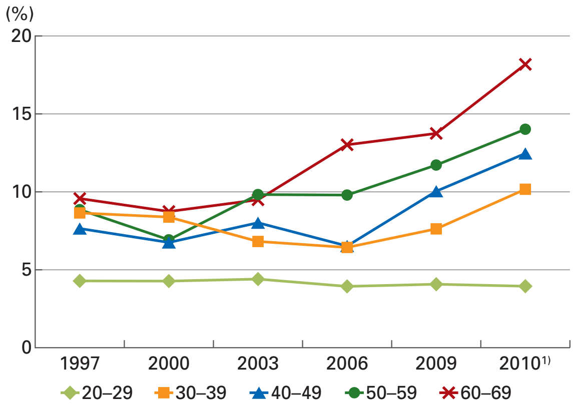
To ensure that the online sales channel does not fall prey to indiscriminate cut-rate competition, it is important for banks to clearly disclose to customers their commission levels and the services that customers receive in return for the commission. With this information, customers can make informed purchase decisions.

The looming "2015 problem"

Now that the postwar baby boom generation has retired, the number of persons annually reaching the retirement age of 60 will decline sharply going forward. The population in the 60–79 (or 60–84) age group, which is the investment trust industry's main customer base, will peak around 2015. This looming decline in the elderly population is known as the "2015 problem".

If the investment trust market is to continue growing beyond 2015, it is important to first increase the investment trust ownership rate among the main customer base. Exhibit 22 plots investment trust ownership rates by age bracket. It shows that investment trust ownership among 60–69 year-olds has risen sharply since 2000. This growth trajectory's sustainability will be a key determinant of how successfully the investment trust industry surmounts the 2015 problem.

Exhibit 22. Percentage of investment trust owners among survey respondents by age bracket



Note 1: In the 2010 survey, the wording of the survey question differed from previous years, resulting in discontinuity in the data series.
Source: NRI Questionnaire Survey of 10,000 Consumers (1997, 2000, 2003, 2006, 2009, and 2010 Financial Editions)

Another key is cultivation of new customers among the working-age population, hitherto largely overlooked by the investment trust industry. Exhibit 22 suggests that since 2006 investment trust ownership has been growing among 30–59 year-olds also. People in this age range typically have relatively little money available to invest and therefore will not directly contribute much to the industry's profits, but they are an important demographic in terms of expanding investment trust ownership among future retirees. Investment needs within the 30–59 age group vary widely among age subgroups. Investment trust companies will have to formulate strategies that address age subgroups' respective needs. The industry should first focus on cultivating customers among 50–59 year-old near-retirees, a subgroup similar to their existing main customers.

4 Product market trends by client segment

Based on the results of our Survey of Asset Management Companies' Management Priorities, we mapped out investment product supply and demand by investor segment (pension funds, financial institutions, and retail investors) (Exhibits 23). Our maps plot the strength of investor demand for various products (as assessed by asset management companies) against the products' current availability. They are useful for identifying promising products (strongly demanded products offered by few companies (upper left quadrant)) and products beset by intense competition (poorly demanded products offered by many companies (lower right quadrant)).

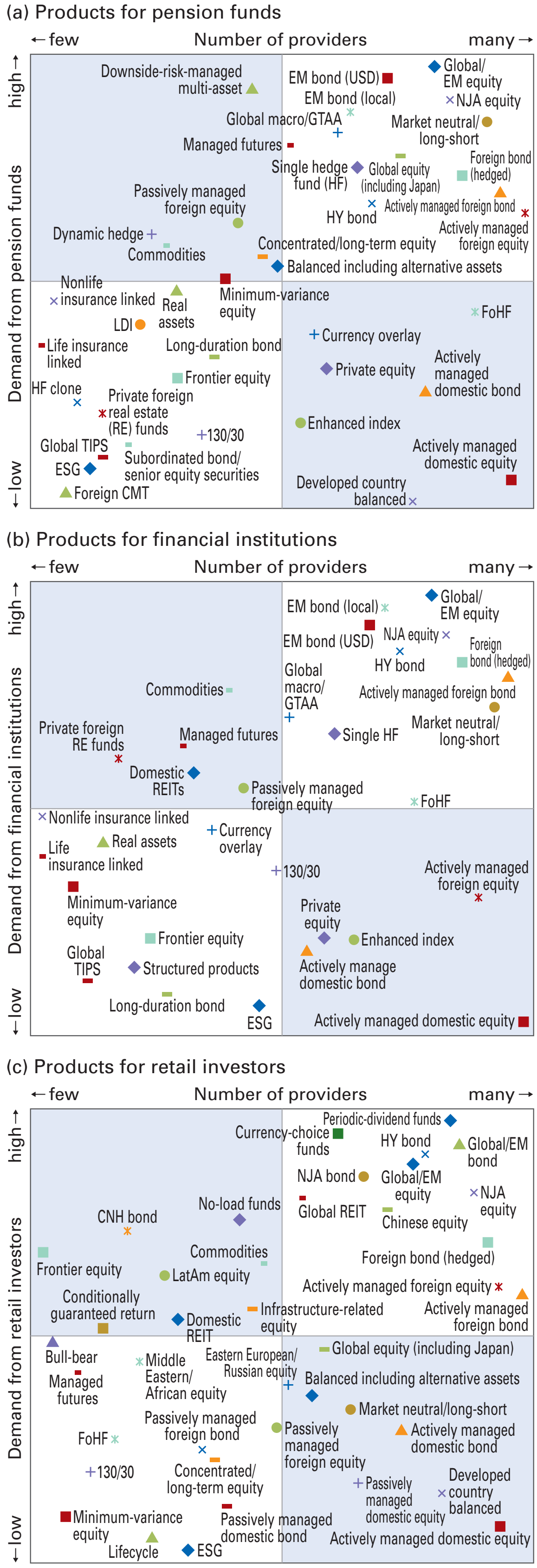
On all three supply and demand maps, conventional actively managed domestic equity funds and developed country balanced funds are in the lower right quadrant, meaning that these products are widely available despite weak investor demand. Additionally, emerging market equity and bond funds and non-Japan Asian (NJA) equity funds are in strong demand but already offered by many companies. Such products are facing increasingly intense competition.

First, the map for the pension fund segment has few products in its upper left quadrant, which is where promising products reside. The products in this quadrant include dynamic hedge products and downside-risk-managed multi-asset products, both of which are just inside the quadrant's borderline. These products incorporate relatively sophisticated risk management that utilizes derivatives or cross-asset-class portfolio management. Many asset management companies have apparently yet to offer such products even though they recognize that the products are in strong demand. Last year's map for the pension fund segment had more products in the upper left quadrant, but many of these products have moved to the upper right quadrant as a result of an increase in the number of companies offering them.

Products on the periphery of the upper left quadrant (products in moderate demand that are offered by few companies or products in strong demand that are offered by a moderate number of companies) meet needs specific to pension fund clients. They include insurance-linked products, which contribute to diversification of sources of return; LDI (liability-driven investment) products, which hedge against fluctuations in pension liabilities' value; commodities and real assets, which are inflation hedges; minimum-variance portfolio products and managed futures, which mitigate or hedge against equity risks; and concentrated/long-term equity investment products that seek to deliver absolute returns from equities.

On the map for the financial institution segment, products with high expected returns are clustered in

Exhibit 23. Maps of asset management product supply and demand by client segment



Note: The vertical scale is an indexed scale of the strength of demand from clients (based on asset management companies' assessment of demand). The horizontal scale represents the number of asset management companies that offer the product (scaled by number of providers not by value).
Source: NRI, based on *Survey of Asset Management Companies' Management Priorities*

the upper right quadrant. Investment products with relatively high expected returns (e.g., foreign bonds) and equity investment products with expected returns that are relatively uncorrelated with bond returns tend to be in strong demand among financial institutions. Such products' position on the map is consistent with the trends discussed above in the section on banks' securities investments. Products that are in strong demand but available from few providers include real estate funds and managed futures.

On the map for the retail client segment, the upper left quadrant features high-risk, high-return products that involve management of assets not encompassed by existing emerging market or NJA equity or bond funds. Specific products include CNH bonds (offshore bonds denominated in Chinese yuan), frontier equities, and Latin American equities, all of which were newly added choices in this year's survey. Similarly, Middle Eastern and African equities are on the periphery of the upper left quadrant. Also on the upper left quadrant's periphery are products that seek to deliver steady returns in any market environment, including bull-bear funds and conditionally guaranteed return funds.

Periodic (e.g., monthly) dividend funds and currency-choice funds are both in the upper right quadrant. Although still popular, such products have become widely available.

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5) In Japan, "matching contribution" refers to contributions made by DC plan participants, not employers.
6) Since FY2007, some major banks also have pursued a policy of investing predominantly in bonds (e.g., long-term JGBs, corporate bonds) while reducing investments in funds and other such products.
7) From the standpoint of upgrading asset-liability management (ALM), the proper approach is for a bank to analyze assets (e.g., loans) and liabilities (e.g., deposits) in detail and position its securities portfolio to match deposits' maturity structure and interest-rate risk profile. However, many core deposit models currently in use are not adequately tested to verify that they function properly in a rising interest rate environment also.
8) NRI Questionnaire Survey of 10,000 Consumers (Financial Edition).

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