NRI

Japan's Asset Management Business 2014/2015

Nomura Research Institute, Ltd.

FOREWORD

Can asset management companies adapt to changes afoot?

The past year has been one of major changes for Japan's asset management industry. In the retail market segment, NISAs (Nippon Individual Savings Accounts) made their advent in January 2014. In the pension market segment, public pension funds have started to reform their asset management practices. They have substantially revised their asset allocations and are slated to undertake governance reforms to remake themselves as asset management organizations worthy of the public's trust. Meanwhile, the composition of financial institutions' investment securities holdings has started to change in response to the Bank of Japan's unconventional monetary easing policies.

Against such a backdrop, asset management industry performance data for FY2013 were generally more positive than in the recent past. Asset management companies' assets under management (AUM) finally surpassed their FY2007 peak. Revenues and operating margins also are re-approaching their previous peaks. Asset management companies have started expanding their workforces, particularly their sales forces.

The various reforms and changes currently underway are likely to have a major impact on the asset management industry's modus operandi and investment strategies. One example is equity market reforms' impact on Japanese equity investment strategies. Amid a growing emphasis on dialogue between asset management companies and their investee companies, equity price formation and investment strategies favored by clients could change substantially, potentially leading to changes in asset management companies' equity investment processes. If investment trust distributors succeed in their efforts to transition to an AUM-based fee model, such an outcome would have a major impact on asset management companies. According to our most recent survey, many asset management companies expect such a change in fund distributors' fee model to have wide-ranging effects, including changes in investment trust investors' product preferences, expansion of the investor class and changes in relationships between fund distributors and their affiliated asset management companies.

While new trends have currently yet to decisively emerge, the possibility of gradual change drastically transforming the asset management industry's landscape over the next five years cannot be ruled out. In the report that follows, we carefully analyze such small changes in the aim of gauging how the asset management business will evolve going forward. We hope to improve our analysis through discussion with readers.

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November 2014

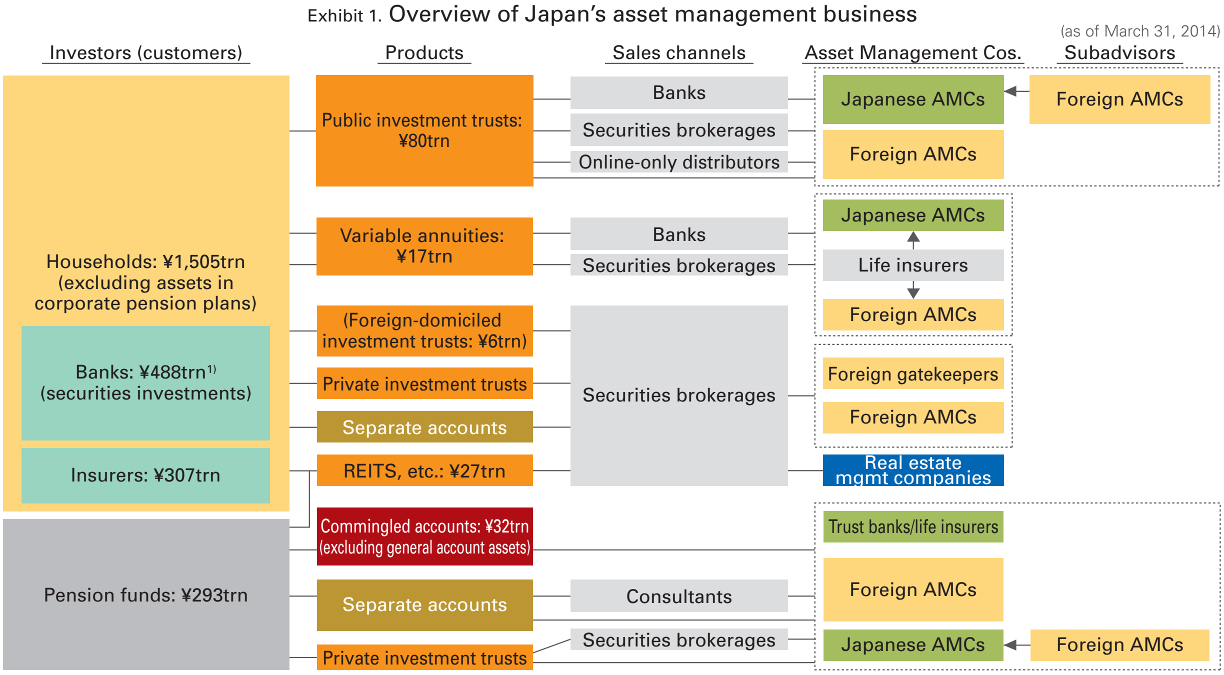
CHAPTER 1 Japanese investor trends

Continued growth in financial assets

Japan's asset management business experienced major changes in 2014. In the retail market segment, Nippon Individual Savings Accounts (NISA), which provide tax-exempt treatment of investment returns, became available in 2014. NISAs have gotten off to a relatively successful start. As of end-June, six months after NISAs' advent, assets held in NISAs totaled some ¥1.6trn, about ¥1trn of which was invested in investment trusts. Meanwhile, public pension funds are set to substantially increase their equity allocations and further diversify their portfolios in anticipation of a transition from deflation to an inflationary economic environment. Such changes are expected to have a major impact on the asset management business.

First, we present an overview of the Japanese asset management business as of FY2013-end. Exhibit 1 provides a simplified big-picture view of the Japanese asset management market at March 31, 2014, in terms of investors, products, asset managers and distribution channels. It shows 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 (AMCs) 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

Exhibit 1. Overview of Japan's asset management business



Note 1: Excludes Norinchukin Bank and Zenkyoren.
Source: NRI, based on data from various sources

institutions' securities portfolios are largely funded with retail customers' deposits, Japanese investors' financial asset holdings as of March 31, 2014, totaled an estimated ¥1,798trn, a year-on-year increase of ¥75trn. Of this ¥75trn increase, household financial assets accounted for ¥59trn, pension assets for the remaining ¥16trn.

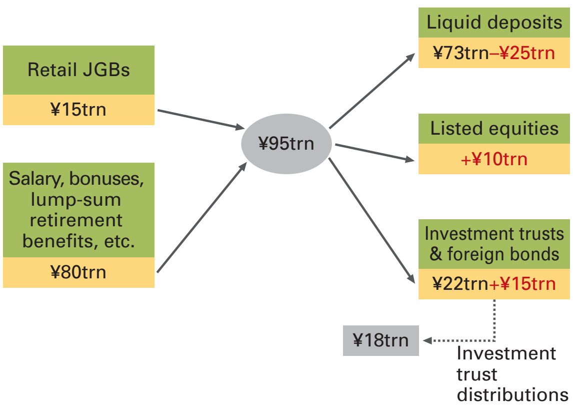
Approximately 22% (¥391trn[1)]) of the total stock of financial assets is managed by asset managers. Assets under management (AUM) have finally surpassed their March 2008 peak after stagnating some 20% below their peak level for several years.

NISAs expected to drive growth in households' investment trust holdings

Household financial assets at March 31, 2014, totaled roughly ¥1,505trn, a ¥59trn increase from a year earlier. Their composition remained largely unchanged during FY2013, with bank deposits and insurance products accounting for nearly 80% of the total.

Exhibit 2 presents our estimates of changes in household financial holdings over the next five years based on historical data. We estimate that over the next five years households will invest about ¥80trn in financial assets using funds from lump-sum retirement benefits (net of home mortgage repayments), bonuses, salaries and other income sources. Assuming that interest rates remain below 1%, we estimate households will redeem ¥15trn of retail JGB holdings. Based on historical trends, we expect households to deposit most of their incoming investable funds into bank accounts. We estimate that households will deposit ¥73trn into bank accounts and invest ¥22trn in risk assets such as investment trusts and foreign bonds over the next five years. However, these flows into risk assets will be partially offset by investment trust outflows in the form of dividend distributions. While we expect investment trust distributions to decrease going forward, they are currently still running at a fairly high level. We estimate cumulative investment trust distributions over the next five years at around ¥18trn. Net of these distributions, projected inflows to investment trusts and foreign bonds are only about ¥4trn.

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



Note: The numbers in red are forecasts of NISAs' impact on household asset allocations.
Source: NRI

NISAs will have a major impact on inflows of household assets into risk-bearing products. Although NISAs are off to a relatively successful start as noted above, they were in existence for only three months as of FY2013-end. While future NISA inflows are therefore hard to predict based on FY2013-end data, we project NISA inflows of roughly ¥25trn over the next five years based on our own survey data. If 60% of this ¥25trn is invested in investment trusts, ¥15trn would flow into investment trusts through NISAs. Investment trust AUM currently total around ¥80trn. If NISA inflows are funded with bank deposits, the projected ¥15trn in NISA-intermediated investment trust inflows would increase total investment trust AUM to the vicinity of ¥100trn even after outflows from dividend distributions are taken into account. NRI surveys have found that about half of individuals that began investing for the first time because NISAs became available are younger adults between the ages of 20 and 39. With the government likely to continually enhance NISAs' benefits going forward, NISAs should help expand the risk-asset investor class and contribute to growth in household's risk-assets holdings.

Banks are reducing JGB holdings, further diversifying investment portfolios

Pension funds, Japan's largest institutional investors, ended FY2013 with an estimated ¥293trn of assets. Of this total, public pension schemes accounted for roughly ¥184trn, an ¥8trn year-on-year increase. Corporate and other private pension funds accounted for the remaining ¥109trn, likewise an ¥8trn year-on-year increase. Public pension funds are projected to continue to draw down their pension reserves in the wake of growth in their benefit outlays. However, these net outflows will be largely offset by inflows of assets from Employees' Pension Funds (EPF) that will dissolve and transfer their assets and liabilities to the government over the next five years in response to EPF program reforms. Consequently, the Government Pension Investment Fund (GPIF), which manages the Employees' Pension Insurance Scheme's pension reserves, is unlikely to experience much of a net drawdown in assets for the time being. Defined-benefit (DB) corporate pension plan assets are projected to decrease.

Financial institutions' investment securities holdings totaled about ¥795trn at March 31, 2014. Of this total, banks (ex Japan Post Bank) accounted for ¥255trn, *shinkin* banks and credit unions for ¥67trn, Japan Post Bank for ¥166trn, life insurers (ex Japan Post Insurance) for ¥216trn, Japan Post Insurance for ¥69trn, and nonlife insurers for ¥22trn.

Banks substantially reduced their investment securities holdings in FY2013 in response to the effects of the BOJ's quantitative and qualitative easing (QQE) program launched in April 2013. JGBs accounted for most of this reduction. Banks are facing an increasingly adverse earnings environment amid Japan's persistent low-interest-rate environment partly attributable to QQE. Against such a backdrop, banks are strengthening their asset management capabilities. Banks are likely to diversify into non-JGB assets in pursuit of profit opportunities while continuing to limit their interest-rate risk exposure to the JGB market. Banks aim to internationally diversify their securities portfolios. Regional financial institutions have been increasingly investing in foreign securities through funds such as private investment trusts. Banks, even the major ones, are counting heavily on AMCs' research, analytical, portfolio management, and administrative capabilities to help them internationally diversify their investments. AMCs can improve their chances of winning whole-portfolio management mandates from banks by pitching investment ideas that not only offer high returns but also are in accord with the banks' investment policies.

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 general-account assets with guaranteed returns (e.g., fixed-amount insurance, fixed annuities).

CHAPTER 2

Current state of asset management business

1 Current state of asset management business

We estimate the Japanese asset management market's size at ¥415trn in AUM terms (including foreign clients' assets) as of March 31, 2014, and ¥808bn in terms of management fee revenues.

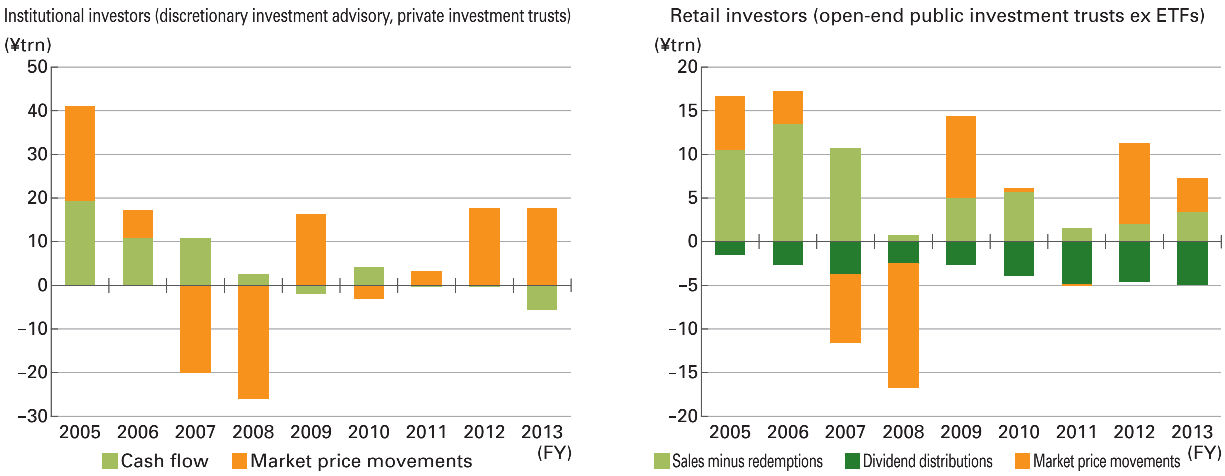
Below we look at the state of the asset management business and challenges facing AMCs, defined as investment trust and investment advisory firms excluding trust banks and life insurers.

Asset management business is recovering

Exhibit 3 plots annual changes in AMCs' AUM disaggregated by causative factor. First, in the institutional market segment (left graph: discretionary investment advisory AUM and private investment trust AUM combined), AMCs' AUM increased by ¥11.7trn in FY2013. This increase was the net result of a ¥5.8trn net outflow of assets and a ¥17.5trn increase in AUM stemming from continued, albeit mild, asset price appreciation driven by yen depreciation and equity market gains dating back to year-end 2012. The ¥5.8trn outflow was presumably largely attributable to EPFs that are preparing to dissolve and turn their assets and liabilities over to the government. They liquidated risk assets in response to improvement in market conditions or moved assets from investment advisors to trust banks in a shift toward passive management in the aim of tracking the GPIF's investment performance more closely.

In the retail market segment (right graph: open-end public investment trust AUM), AMCs' AUM increased by ¥3.9trn due to changes in asset prices and by an additional ¥3.4trn due to net inflows (sales

Exhibit 3. Changes in AUM broken down by causative factor



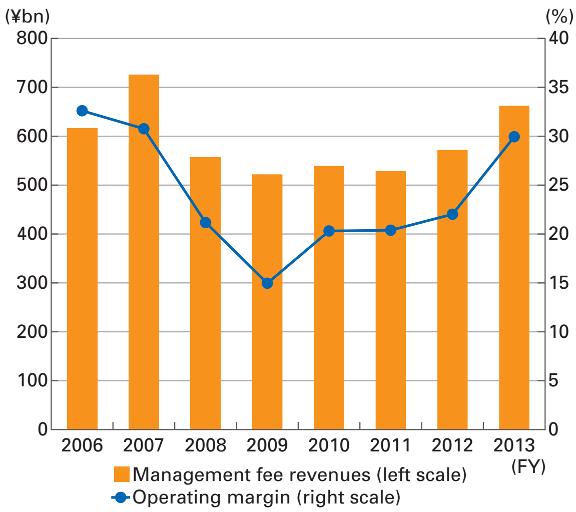
Note: Adjusted to reflect M&A and assets switched between contractual modalities.
Source: NRI, based largely on data from the Investment Trusts Association of Japan, Japan Securities Investment Advisers Association and NRI Fundmark data

minus redemptions). Gross sales before deduction of redemptions totaled ¥32trn, an all-time record. Meanwhile, redemptions likewise set a new all-time record of ¥28trn in FY2013. Investment trust sales net of redemptions were nearly zero in 2008, when the global financial crisis erupted, and have subsequently been tracking at a low level. Additionally, investment trust outflows in the form of dividend distributions were around ¥5trn in FY2013. Net of these outflows, AMCs' AUM increased by only ¥2.2trn inclusive of asset price appreciation.

We estimate AMCs' aggregate FY2013 management fee revenues at roughly ¥660bn and their adjusted operating margin at 30% based on data available at the time of this writing. Both increased substantially from FY2012 and have recovered to the vicinity of their respective FY2006-07 peaks (Exhibit 4).

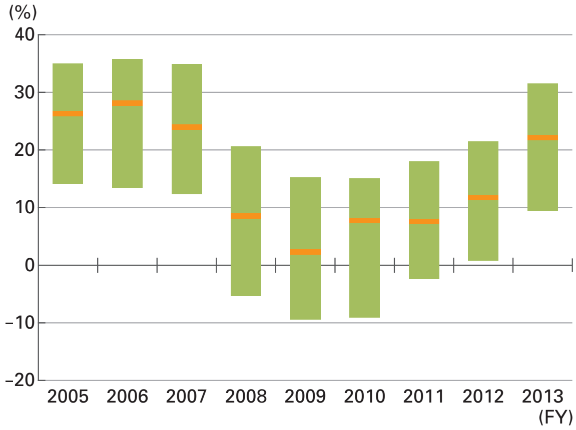
Exhibit 5 plots AMCs' operating margins as 25th-to-75th-percentile ranges. The FY2013 data were derived from a sample of 56 mostly large AMCs for which the requisite information was available at the time of this writing. In FY2013, the median operating margin recovered to 22%, near its level preceding the global financial crisis.

Exhibit 4. AMCs' aggregate management fee revenues and operating margin



Source: NRI, based on AMCs' business reports and data from the Investment Trusts Association of Japan and Japan Securities Investment Advisers Association

Exhibit 5. Dispersion of AMCs' operating margins



Note: The above graph plots operating margins of AMCs for which the requisite data were available. The FY2013 operating margin data were derived from a sample of only 56 AMCs for which the requisite data were available at the time of this writing. Operating margin was calculated as the ratio of operating income to operating revenues net of agency fees. Green bars represent the 25th-to-75th-percentile range of respondent AMCs' operating margins. Red lines indicate median values.
Source: NRI based on data from AMCs' regulatory filings and business reports

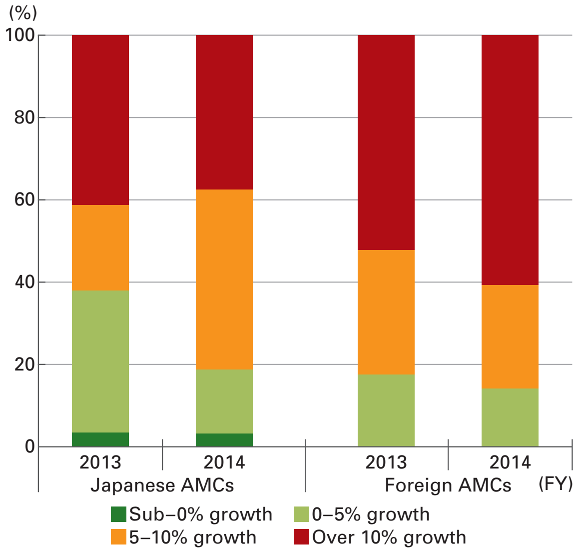
Improved revenue outlook; growing optimism toward domestic equities

We conduct an annual survey of AMCs (*NRI Survey of Asset Management Companies' Management Priorities*) to ascertain current conditions in the asset management business and AMCs' consensus outlook[2]. Based on the survey responses, we gauge AMCs' outlook for the asset management business going forward. We distribute the survey questionnaires to AMCs in July with an early-September deadline for responses.

Exhibit 6 plots the breakdown of survey respondents' projections of their annual revenue growth rates over the next 3-5 years in comparison to the corresponding data from the previous year's survey. Japanese AMCs' revenue growth projections were somewhat more optimistic in 2014 than in 2013, with the percentage of Japanese respondents projecting annual revenue growth of 5-10% doubling between the two years.

Exhibit 7 presents breakdowns of survey respondents' revenue growth forecasts by market segment. Revenue forecasts are somewhat more

Exhibit 6. Breakdown of respondent AMCs' revenue growth forecasts (disaggregated by nationality)

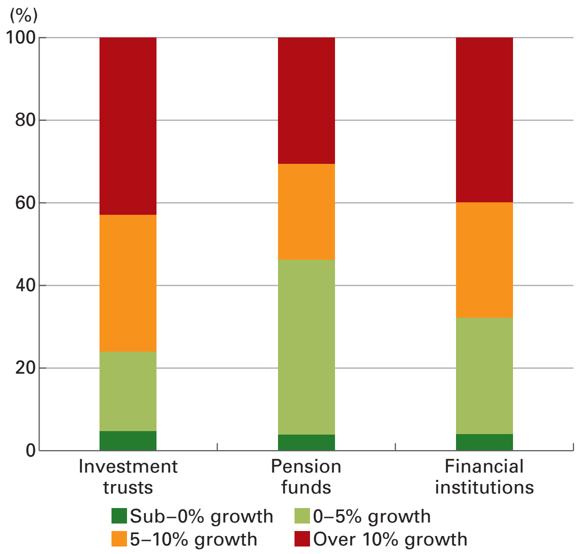


Source: NRI *Survey of Asset Management Companies' Management Priorities*

cautious in the pension segment than in the other market segments. Nearly half of the respondents project annual revenue growth of 5% or less (or negative growth) in the pension segment. Many respondents seem to expect their pension businesses to shrink. The investment trust business, by contrast, has the best revenue growth prospects in the survey respondents' opinion. About 40% of respondents project annual revenue growth of at least 10% in their investment trust businesses while an additional 30% project annual revenue growth in the 5-10% range. Such a bullish outlook apparently reflects a favorable business environment for investment trusts, including the recent advent of NISAs, growth in defined-contribution (DC) pension plans' prevalence, and fund distributors' ongoing business model reforms (discussed further below). Many survey respondents are optimistic about revenue growth prospects in the financial institution segment also. With the BOJ in the midst of monetary easing, AMCs apparently expect banks and life insurers to further diversify their portfolios' sources of investment returns.

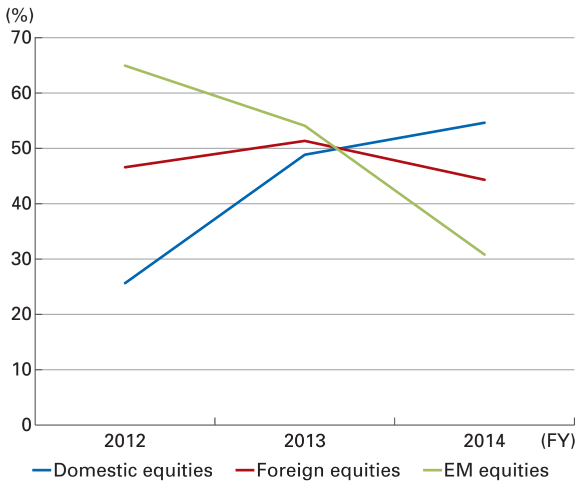
Exhibit 8 plots in time-series format the percentages of AMCs projecting 3-5 year AUM growth rates of at least 10% per annum for their domestic, foreign and emerging-market equity products based on 2012-14 survey data. Emerging-market equities, which were previously expected to be in strong demand by virtue of emerging-market economies' perceived growth prospects, have performed poorly in recent years. In response, the percentage of survey respondents projecting EM-equity AUM growth of at least 10% from asset inflows decreased for the past two years, falling to around 30% in 2014. Emerging-market

Exhibit 7. Breakdown of respondent AMCs' revenue growth forecasts (by business segment)



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

Exhibit 8. Percentages of respondent AMCs projecting double-digit AUM growth due to asset inflows (Japanese and foreign equity investments)



Note: Percentage of respondents that project AUM growth of 10% or more due to asset inflows over the next 3–5 years.
Source: NRI *Survey of Asset Management Companies' Management Priorities*

equities have been replaced by domestic equities as the equity asset class with the best prospects of strong inflows. In the 2014 survey, more than half of the respondents project domestic equity AUM growth of 10% or more from asset inflows.

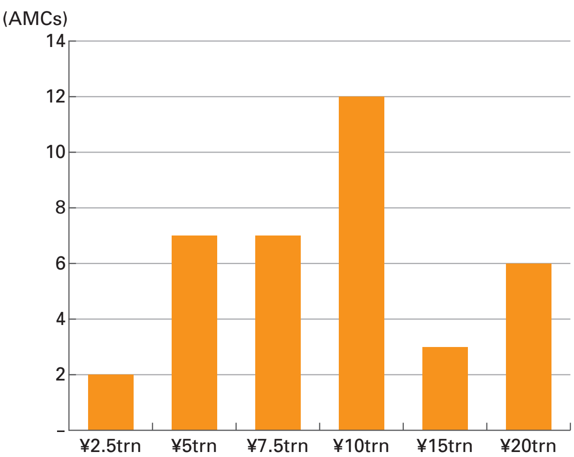
2 Anticipated quantitative and qualitative changes in the investment trust business

NISA outlook

NISAs are new tax-advantaged investment accounts that became available from 2014. They have an annual contribution limit of ¥1mn. Capital gains and dividends (distributions) from assets held in a NISA are tax-exempt for a maximum of five years from the initial investment date. NISAs are gaining popularity, with 7.27mn NISAs opened and ¥1.56trn of assets purchased in NISAs as of June 30, 2014. Of these purchases, investment trusts account for about ¥1trn, about twice as much as listed equities' share[3].

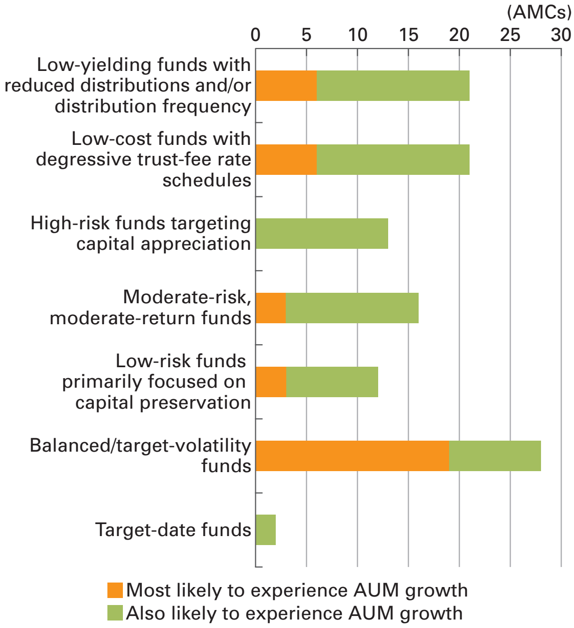
Our survey asked respondents for their forecast of total investment trust holdings in NISAs as of December 31, 2019, five years after NISAs' inception. The distribution of respondents' forecasts is presented in Exhibit 9. While the forecasts are spread over a fairly wide range, the most popular response was "around ¥10trn," selected by 12 respondents (32% of those who answered the question). Six respondents (16%) expect NISA investment trust holdings to be "over ¥20trn" at year-end 2019. If NISA investment trust holdings reach ¥10trn, the resultant increase in equity investment trust AUM would be around 20% of equity investment trusts' total AUM at present. AMCs appear to be bullish on NISAs.

Exhibit 9. Forecasts of NISA investment trust holdings at December 31, 2019



Note: Survey responses of 42 investment trust sponsors.
Source: NRI *Survey of Asset Management Companies' Management Priorities*

Exhibit 10. Types of funds expected to experience AUM growth due to asset inflows via NISAs



Note: Survey responses of 42 investment trust sponsors.
Source: NRI *Survey of Asset Management Companies' Management Priorities*

Additionally, many survey respondents cited balanced funds and target-volatility funds as fund categories likely to experience AUM growth as a result of inflows from NISAs (Exhibit 10). Investors cannot rebalance their holdings within their NISAs. Once an asset held in a NISA is sold, the sales proceeds must be withdrawn from the NISA. Funds suitable for long-term investing consequently could see strong demand from NISA holders.

Impact of changes in fund sales policies

As noted above, investment trust inflows (sales) and outflows (e.g., redemptions) are both running at high levels. The average holding period for Japanese public investment trusts is said to be around two years. Investment trusts are thus shorter-term investment vehicles in Japan than in other developed countries. One reason that has long been cited for Japanese investment trust investors' short average holding period is that fund distributors encourage their customers to engage in short-term trading (account churning). Fund distributors have a strong incentive to encourage fund switching in the aim of earning sales commissions.

In recent years, however, financial regulatory authorities intent on changing such practices have started to apply strong pressure on fund distributors. Following are two examples of the regulatory authorities' tactics.

- In a March 7, 2014, revision of Comprehensive Guidelines for Supervision of Financial Instrument Dealers, the Financial Services Agency (FSA) added a new checkpoint regarding sales personnel evaluations. From a supervisory standpoint, the new guidance instructs examiners to make sure that fund distributors' evaluations of their sales personnel are not based too heavily on revenues (e.g., sales commissions). Another new supervisory checkpoint included in a September 17, 2014, revision of the same guidelines instructs examiners to ascertain whether sales personnel disclose their sales commission rates to customers and explain reductions in the sales commission rate for each year that a fund is held.

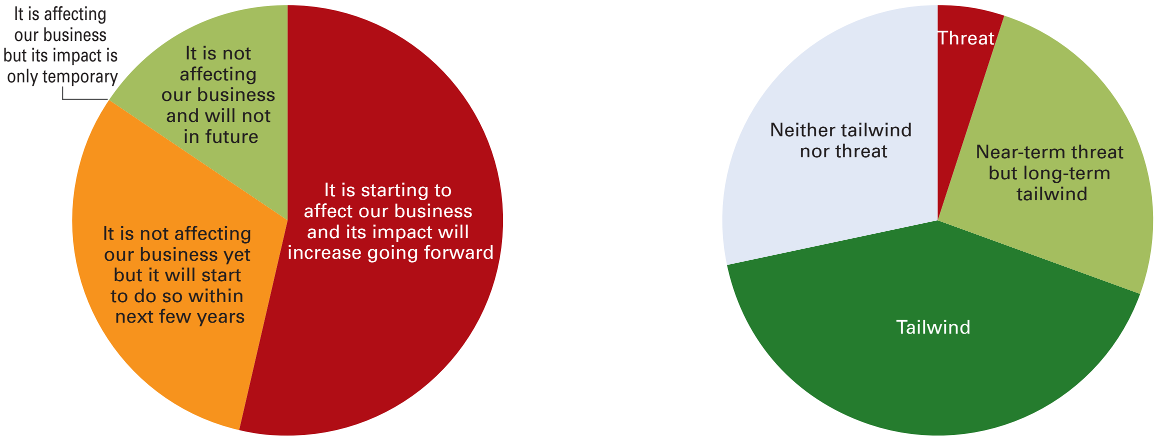
- The FSA's Financial Monitoring Report, released on July 4, 2014, presented findings from financial monitoring examinations that corroborated the hypothesis that one reason why wealth-building through investment has not taken root among Japanese households is that financial institutions have an incentive to pursue sales commission revenues from fund switching by their customers.

Together with introduction of NISAs, such actions by regulators are aimed at spurring fund distributors to reorient their revenue models from commissions based on trading activity to fees based on customers' fund holdings. Fund distributors have already started to switch from sales targets to asset-gathering targets. Some fund distributors, mainly major ones, aim to expand their wrap (discretionary investment) account businesses. Additionally, in evaluating sales personnel's performance, fund distributors are increasingly placing more priority on growth in customer assets than in sales totals.

In terms of how these changes will affect AMCs' business, Exhibit 11 presents a summary of investment trust sponsors' survey responses to questions on these changes' effects on their business. In response to a question on whether the change in distributors' sales policies is affecting their business, 54% of respondents (21 respondents) reported that "it is starting to affect our business and its impact will increase going forward" while 31% (12 respondents) reported "it is not affecting our business yet but it will start to do so within next few years" (Exhibit 11, left graph). None of the respondents chose "it is affecting our business but its impact is temporary" as their response. Six respondents selected "it is not affecting our business and will not in the future" as their response, but most of them have atypical business models (e.g., unusually close ties with affiliated fund distributors). The aforementioned change in fund distributors' sales policies is generally being taken very seriously by AMCs. It is already materially affecting AMCs' businesses or is expected to do so.

Exhibit 11's right graph presents the breakdown of respondents' responses to a question about whether the impact of this change is positive or negative. The preponderant response, selected by 16 respondents (41%), was that the change is a "tailwind." Ten respondents (25%) perceive the change to be a "near-term threat but long-term tailwind." These 10 respondents, a mix of both Japanese and foreign

Exhibit 11. Impact of change in fund distributors' sales policies



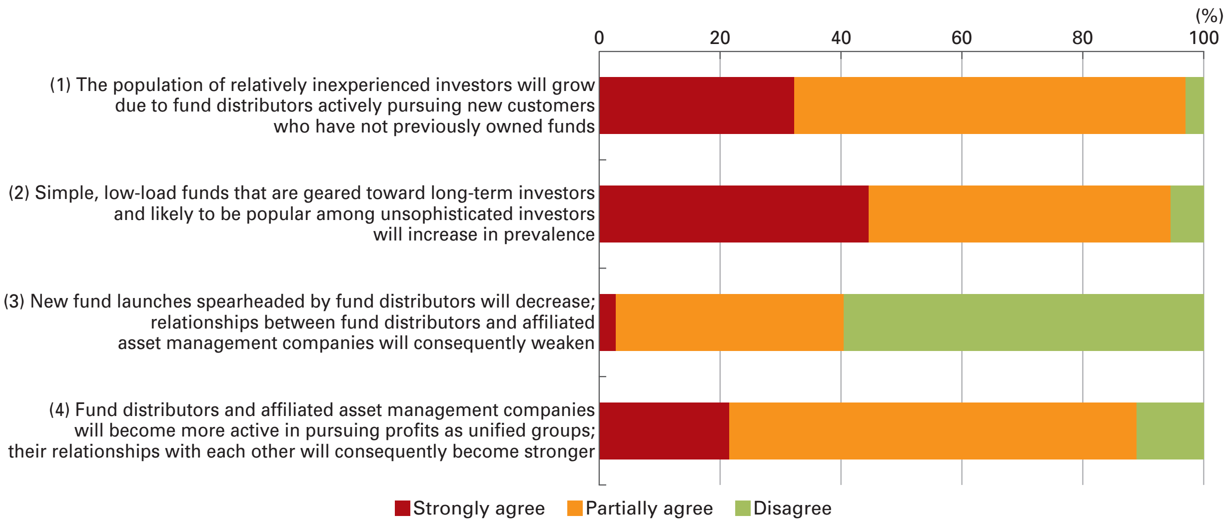
Note: Survey responses of 42 investment trust sponsors.
Source: NRI *Survey of Asset Management Companies' Management Priorities*

companies, were mostly AMCs with substantial public investment trust AUM. For major investment trust sponsors that have been successful in gathering assets, the change in sales policies has seemingly prompted a reassessment of their existing business models and organizational structures' effectiveness.

Qualitative changes in clientele and strengthening of relationships with affiliates

Additionally, our survey queried respondents on their opinion of the likelihood of some 20 specific scenarios that could occur as a result of the change in fund distributors' sales policies. The breakdowns of responses for four of these scenarios are presented in Exhibit 12. Many respondents agreed that the first two scenarios are likely to occur. The first scenario is that the population of relatively inexperienced investors will grow due to fund distributors actively pursuing new customers who have not previously owned funds. The second is that simple (and therefore low-cost) low-load funds designed to appeal to inexperienced

Exhibit 12. Effects of change in fund distributors' sales policies (respondents' assessment of hypothetical scenarios)



Note: Survey responses of 42 investment trust sponsors.
Source: NRI *Survey of Asset Management Companies' Management Priorities*

investors will increase in prevalence. Thirty-two percent and 45% of respondents strongly agreed with the first and second scenarios, respectively.

The change in fund distributors' sales policies could also have some type of impact on relationships between AMCs and fund distributors affiliated with each other. The third and fourth scenarios are a pair of opposite scenarios regarding relationships between affiliates. The third scenario is that new product development and new fund launches spearheaded by fund distributors will decrease, resulting in weaker relationships between the distributors and affiliated asset management companies that have previously been sponsoring funds conceived by the distributors. The fourth scenario is that relationships between fund distributors and affiliated asset management companies will become stronger in pursuit of group-wide profits, including account servicing fees. Based on the survey responses, AMCs overwhelmingly consider the fourth scenario (stronger ties between affiliates) to be more likely than the third scenario.

In particular, many foreign AMCs without close ties to distribution channels in Japan appear to be concerned about fund distributors strengthening their relationships with affiliated AMCs. Some of these foreign AMCs are revising their sales-channel strategies.

The asset management business's competitive landscape could change dramatically as result of changes at fund distributors.

2) NRI has conducted this survey annually since FY2007. In 2014, NRI distributed the survey questionnaires in July–September and received valid responses from 66 AMCs (37 Japanese, 29 foreign).
3) "Research on the Use of NISA Accounts," Financial Services Agency.

CHAPTER 3 Market trends and product strategies by client segment

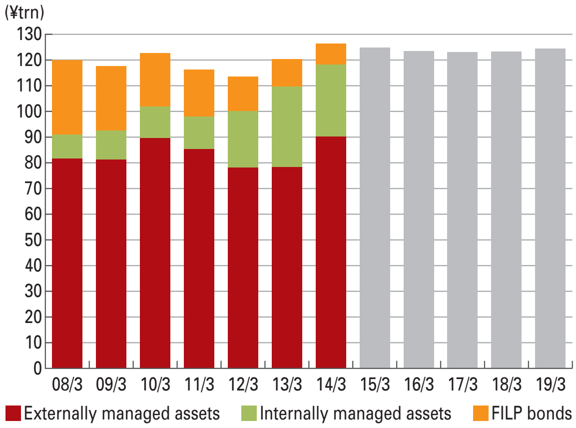
1 Pension business

Second consecutive year of growth in pension AUM

Japanese pension assets grew for a second consecutive year to end FY2013 at an estimated ¥293trn, a ¥16trn increase from a year earlier. Of this total, public pension schemes (National Pension, Employees' Pension Insurance, and Mutual Aid Associations) accounted for some 64% or ¥184trn, an ¥8trn year-on-year increase. Corporate pension plans and other pension schemes (National Pension Funds and Small-scale Enterprise Mutual Aid System) accounted for the remainder of ¥109trn, a year-on-year increase of ¥8trn.

The Employees' Pension Insurance and National Pension programs account for over 70% or ¥132trn of total public pension assets. Nearly all of their assets are managed by the GPIF. The GPIF's AUM at March 31, 2014, was ¥127trn, a ¥6trn increase from year earlier (Exhibit 13). The GPIF earned an 8.6% return on its AUM in FY2013. Although it fell short of achieving a double-digit return for a second straight fiscal year, it still earned a hefty positive return. The GPIF increased its AUM outsourced to external managers in FY2013 by some ¥12trn to a near-record level of ¥90trn. The GPIF continue to redeem assets to the tune of ¥2.5trn in FY2013, but this drawdown was overshadowed by asset growth attributable to investment returns. In FY2014, the GPIF plans to redeem some ¥5trn of assets.

Exhibit 13. GPIF's AUM (actual and forecasted)



Note: Data for FY2014 and beyond are NRI forecasts based on the Ministry of Health, Labor and Welfare's 2014 actuarial valuation (using reference-case economic assumptions).
Source: NRI, based on GPIF's *Review of Operations in FY2013*, Ministry of Health, Labor and Welfare's 2014 Actuarial Valuation Report, and Federation of National Public Service Personnel Mutual Aid Associations' Actuarial Revaluation Results

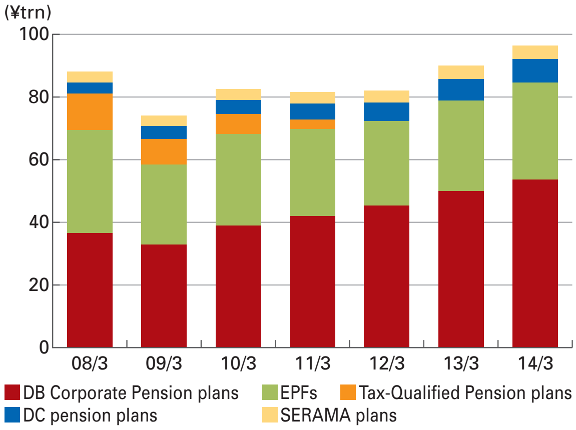
Public pension programs underwent an actuarial valuation in 2014 for the first time in five years. The gray bars in Exhibit 13 represent forecasts of the GPIF's AUM in each of the next five fiscal years based on the results of the 2014 actuarial valuation. We project that its AUM will remain roughly flat over this timeframe. While the GPIF is expected to continue to redeem invested assets for a while longer to meet benefit obligations, a large portion of EPFs' assets are expected to be turned over to the government as dissolution of EPFs and re-nationalization of their assets and liabilities progresses from FY2014 (discussed below). Taking into account this prospective influx of assets, we expect GPIF's AUM to remain flat over the next several years.

Employee pension benefits are slated to be standardized across all public pension schemes from October 2015, whereupon even public employees will be covered by Employees' Pension Insurance. Mutual Aid Associations and the Promotion and Mutual Aid Corporation for Private Schools of Japan will continue to collect pension insurance premiums and administer pension benefits as usual. Part of Mutual Aid Associations' pension reserves (the "common purse" portion) is to be integrated into the Employees' Pension Insurance Scheme's pension reserves. The remainder of their pension reserves is earmarked to fund occupation-specific pension benefits. Under current plans, the common-purse portion of Mutual Aid Associations' pension reserves will apparently be around ¥26trn, more than 50% of their total reserves. These common-purse pension reserves will be managed by the Federation of National Public Service Personnel Mutual Aid Associations, Pension Fund Association for Local Government Officials, and Promotion and Mutual Aid Corporation for Private Schools of Japan. As managers, these three entities, together with the GPIF, will formulate a model portfolio in accord with public pension fund guidelines. Each entity will set its own investment policies.

In terms of management of public pension reserves, the GPIF in particular is set to undergo major changes, largely in response to an expert panel's recommendations. These changes are detailed below.

Corporate pension assets at March 31, 2014, totaled roughly ¥97trn, a ¥7trn year-on-year increase (Exhibit 14). Among DB plans, DB Corporate Pension plans' assets increased by some ¥4trn to ¥54trn at fiscal year-end. DB Corporate Pension plans continued to decrease in number in FY2013, as did their total number of participants. EPFs' assets likewise increased, rising ¥2trn to ¥31trn at fiscal year-end, but they are projected to decrease substantially going forward. A new law essentially abolishing EPFs took effect in April 2014. The law provides incentives to dissolve EPFs within five years of its effective date. Any EPFs still in existence in April 2019 will then be

Exhibit 14. Corporate pension assets



Note: SERAMA: Smaller Enterprise Retirement Allowance Mutual Aid
Source: Trust Companies Association of Japan, Federation of Pension Plan Administrators, and Organization for Workers' Retirement Allowance Mutual Aid

subject to stricter regulation and monitoring. The vast majority of EPFs are consequently likely to dissolve and turn their assets over to the government by April 2019. Around 80% of EPFs' assets are expected to be transferred to the government to be managed by the GPIF. As of September 30, 2014, over 60% of existing EPFs have received tentative permission to dissolve and allow the government to take over their assets and liabilities. Very few of these ETFs plan to convert into DB Corporate Pension plans. DB plans' assets are consequently likely to decrease substantially.

DC corporate pension plan assets at March 31, 2014, totaled ¥7.5trn, a ¥700bn increase from a year earlier. Although not growing dramatically, DC pension plans have been steadily gaining prominence. Individual DC pension plan assets have grown to ¥900bn, just shy of ¥1trn. Effective from October 2014, contribution limits for DC corporate pension plans were raised (to ¥55,000/per month for participants without another employer-sponsored pension plan and ¥27,500/month for those who participate in another employer-sponsored plan). The extent to which DC pension plans gain prevalence in the wake of the EPF reforms discussed above and changes in accounting standards will be a focal point going forward.

GPIF reforms' impact on asset management business

Management of public pension assets is currently being reformed at the GPIF in three ways: revision of the GPIF's policy asset mix, further diversification of asset holdings (e.g., the GPIF has recently started investing in infrastructure), and governance reforms (reform of independent administrative agencies). Following is an explanation of these reforms from the standpoint of their prospective impact on the asset management business.

In October 2014, the GPIF revised its policy asset mix as shown in Exhibit 15. With interest rates expected to rise, the GPIF roughly doubled its total equity allocation from 24% to 50% to achieve its target return equivalent to the wage inflation rate plus 170 basis points.

To further diversify its asset holdings, the GPIF started investing in infrastructure assets from early 2014. It plans to invest ¥270bn in infrastructure over the next five years. Diversified investment is essential for the GPIF to outperform its policy asset mix while remaining within its risk budget. The GPIF plans to start investing in various assets, including to a limited extent illiquid assets such as real estate and private equity. Its maximum allocation to illiquid assets is likely to be limited to around 5% of total assets, equivalent to over ¥6trn. The GPIF could become a major revenue source for the AMCs to which it awards such alternative asset mandates.

Exhibit 15. **GPIF's revised policy asset mix**

	Previous	New
Domestic bonds	60%	35%
Foreign bonds	11%	15%
Domestic equities	12%	25%
Foreign equities	12%	25%
Cash	5%	

Source: GPIF, "Adoption of New Policy Asset Mix," (October 31, 2014)

Governance reforms' impact on the asset management business will largely depend on whether the GPIF remains an independent administrative agency or becomes an entity independent of the government like the BOJ. In June 2014, the Diet passed a bill amending the Act on General Rules for Independent Administrative Agencies (effective from April 1, 2015). Under the amended law, the GPIF will be able to increase its staffing budget, although the government will subsequently retain budgeting authority over the GPIF. The GPIF will consequently most likely not be able to substantially increase its staffing or revamp its compensation scheme for external managers. Governance reforms' impact on the asset management business in comparison to the status quo is therefore likely to be modest.

However, in the event of more ambitious governance reforms that transform the GPIF into an entity completely independent of the government instead of an independent administrative agency, the reforms would likely have a major impact on the asset management industry. If granted independence from the government, the GPIF would likely switch to a performance-based compensation scheme for its in-house investment staff and promote adoption of performance-based compensation schemes by AMCs also. In such an event, management fees paid to AMCs capable of delivering excess returns would increase, likely resulting in a market environment in which the gap between top-tier and lower-tier AMCs is prone to widen.

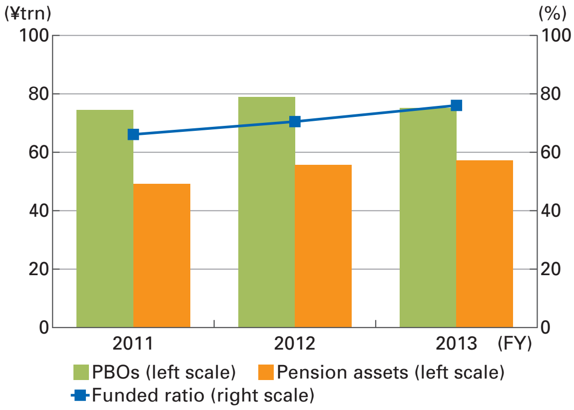
A key difference between Japanese public pension funds and their overseas counterparts is that they have already started to pay out benefits in excess of contributions. A large pension fund like the GPIF would have a major market impact if it were to sell assets to meet its benefit obligations. The GPIF consequently must pre-fund its benefit outlays. Its basic approach is to fund benefits with bond coupon income and proceeds from maturing bonds. A portion of its domestic bond holdings are already managed separately from other assets in a fund earmarked for meeting benefit obligations. This fund's assets will likely be increased going forward. Its assets will presumably be managed in-house, not by external managers. The fund's size is hard to predict because contributions and benefit payments tend to fluctuate greatly in response to changes in economic conditions, but our best guess is that it may be around ¥30-40trn.

It is not easy for a large public pension fund like the GPIF to outperform its policy asset mix. One way to potentially do so is to stably capture excess returns over the long term by better clarifying the roles that it wants each of its external managers to fulfill. If the GPIF were to adopt this approach, it would have an even stronger tendency to hire managers with highly distinctive investment strategies that are differentiated from and relatively uncorrelated with other AMCs' strategies. Additionally, mediocre active strategies are likely to be replaced by other (e.g., smart beta) strategies. More than ever before, the GPIF is likely to seek out external managers that develop unique investment strategies and can explain them in terms easily understandable to the client.

New accounting standard's impact is minor

The Accounting Standard for Retirement Benefits issued in May 2012 by the Accounting Standards Board of Japan (ASBJ) requires corporate pension plans' actuarial gains and losses (mainly liabilities arising from investment returns falling short of the assumed rate of return) unrecognized in nonconsolidated financial statements to be immediately recognized on the company's consolidated balance sheet. FY2013 was a first fiscal year in which immediate recognition of actuarial gains and losses was compulsory. Growth in liabilities as a result of this new accounting standard's adoption was a major concern for companies that sponsor pension plans with unrealized losses from investment of pension assets. However, the new accounting standard's impact proved to be minor by virtue of recent improvement in the investment environment.

Exhibit 16. Corporate pension plans' overall funded status

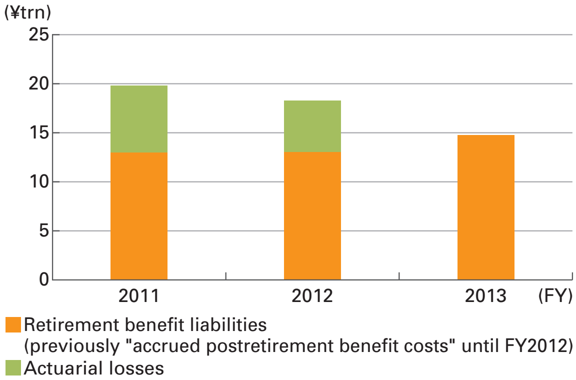


Note: The above data pertain to 1,685 TSE 1st Section-listed companies for which FY2011-13 financial statement data were available.
Source: NRI, based on Nikkei Digital Media data

To shed light on major pension-plan sponsors' accounting for retirement benefits, Exhibit 16 shows the funded status for Tokyo Stock Exchange (TSE) 1st Section-listed companies' pension assets, pension benefit obligations (PBOs), and their pension plans' funded status, which is the ratio of pension assets to PBOs, under the ASBJ's Accounting Standards for Retirement Benefits. Aggregate pension assets grew in FY2013, ending the fiscal year about ¥8trn above their level of two years earlier. Meanwhile, PBOs remained roughly unchanged. As a result, funded status improved substantially, rising to 76.1% from 66.0% two years earlier.

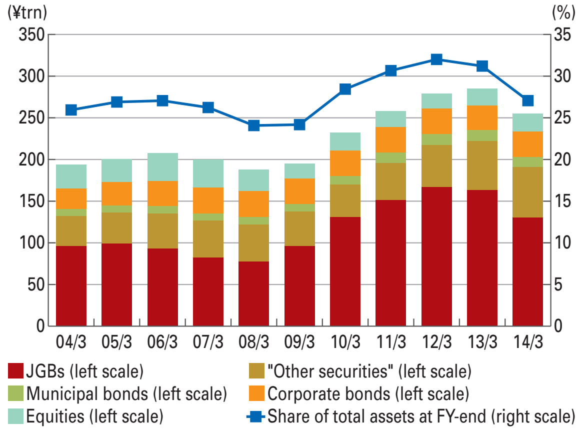
Next, we looked at recognized liabilities to gauge their impact on pension-plan sponsors' consolidated balance sheets. Exhibit 17 plots retirement benefit liabilities (previously called accrued postretirement benefit costs until FY2012) reported on consolidated balance sheets and unrecognized actuarial losses. In FY2013, ¥5.2trn of actuarial losses that were unrecognized in FY2012 should have been newly included in pension benefit liabilities as a result of the immediate recognition requirement. However, reported pension benefit liabilities were ¥14.8trn, only ¥2.9trn more than their FY2012 total. In other

Exhibit 17. Corporate pension plans' impact on their sponsors' consolidated balance sheets (reported pension liabilities)



Note: The above data pertain to 1,105 TSE 1st Section-listed companies with Japanese GAAP-compliant FY2011-13 financial statements.
Source: NRI, based on Nikkei Digital Media data

Exhibit 18. Japanese banks' investment securities holdings by asset class



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

words, unrecognized actuarial losses were reduced from ¥5.2trn in FY2012 to ¥2.9trn in FY2013 through amortization and/or offsetting actuarial gains. As a result, pension benefit liabilities did not increase that much in FY2013.

Although concerns about immediate recognition of actuarial losses ultimately proved unfounded by virtue of improvement in the investment environment, we doubt that the trend toward reducing corporate pension risk has changed. The number of workers entitled to receive benefits from corporate pension plans is in a downtrend, partly as a result of the EPF reforms discussed above. To promote accumulation of sufficient pension assets, the government should introduce a pension scheme to serve as a successor to EPFs or a scheme for sharing risks between companies and their employees.

2 Securities investment by banks

City banks sharply reduced their JGB holdings

After growing every year since 2008 in the wake of the financial crisis and ensuing global recession, Japanese banks' investment securities holdings decreased substantially in FY2013. According to Japan Bankers Association (JBA) data, Japanese banks[4] ended FY2013 with aggregate investment securities holdings of ¥255trn[5], a ¥30trn reduction from a year earlier. Investment securities' share of Japanese banks' total assets likewise decreased, down four percentage points to 27% (Exhibit 18). The large reduction in banks' investment securities holdings was triggered by the BOJ's unconventional monetary policy launched in April 2013.

Among the various types of banks, city banks reduced their investment securities holdings in FY2013 by a hefty ¥32trn to ¥134trn at fiscal year-end. JGBs accounted for ¥29trn of this ¥32trn reduction. Regional banks increased their investment securities holdings by ¥2trn to ¥77trn over the same timeframe. Second-tier regional banks ended FY2013 with their investment securities holdings unchanged from a year earlier at ¥16trn[6]. However, both regional banks and second-tier regional banks also reduced their JGB holdings in FY2013.

In terms of how the composition of city banks' assets changed in conjunction with the reduction in JGB holdings, deposits receivable[7] increased substantially as a replacement for divested JGBs. City banks collectively ended FY2013 with deposits receivable of ¥72trn, a year-on-year increase of ¥44trn. Their outstanding loans increased by ¥13trn over the same timeframe to ¥234trn at fiscal year-end. Overseas loans accounted for ¥10trn of this increase[8]. With interest rates gradually declining since the BOJ launched QQE, city banks have been stepping up overseas lending in pursuit of wider lending spreads than those available in Japan. Regional banks' outstanding loans increased by ¥5trn in FY2013. This increase was much larger than regional banks' net divestment of JGBs (¥1.2trn). Second-tier regional banks increased their outstanding loans by ¥1trn and reduced their JGB holdings by ¥1trn, leaving the balance between the two roughly unchanged. Factors behind FY2013's pickup in bank lending include not only QQE but also pressure on banks from financial regulators to build stable long-term revenue models.

Banks are diversifying their investment securities holdings

Despite the large reduction in banks' JGB holdings, JGBs still account for the largest share of banks' investment securities holdings. JGBs make up 51% (¥130trn) of banks' aggregate investment securities holdings, followed in descending order by "other securities"[9] at 23.5% (¥60trn), domestic corporate bonds at 12% (¥30trn) and domestic equities at 8.2% (¥21trn). While divesting JGBs, banks collectively increased their "other securities" holdings by ¥1.3trn, domestic equity holdings by ¥900bn and domestic corporate bond holdings by ¥400bn during FY2013. Among the different types of banks, growth in city banks' non-JGB securities holdings was limited solely to domestic equities. In contrast, regional banks increased their holdings of "other securities," domestic corporate bonds and domestic equities, in that order. Second-tier regional banks increased their holdings of domestic corporate bonds, "other securities" and municipal bonds, likewise in that order. To increase earnings from securities portfolios, banks have been expanding their investment universe beyond JGBs since FY2012, albeit to varying degrees until FY2013, when diversification in pursuit of higher returns became an industry-wide trend.

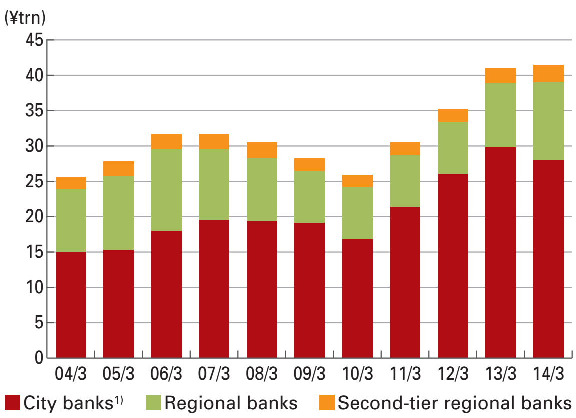
Unlike pension funds and insurers, banks invested in securities as a temporary parking place for loanable funds. Consequently, they tend to invest opportunistically in whatever asset class offers the highest expected return based on prevailing market conditions. In FY2013, banks actively invested in equities amid continuation of the equity bull market that began in FY2012.

"Other securities" holdings continue to grow

According to the BOJ's Domestic Bank Assets and Liabilities, banks' "other securities" holdings (excluding securities held in foreign branch accounts) grew for a fourth consecutive fiscal year in FY2013, increasing by ¥2trn to end the fiscal year at ¥52trn. Of this total, foreign securities accounted for ¥45trn, a year-on-year increase of ¥800bn. Banks' non-foreign "other securities" holdings (e.g., funds, hedge funds, structured bonds) grew sharply for a second straight year, increasing by ¥1.4trn to ¥7trn at FY2013-end.

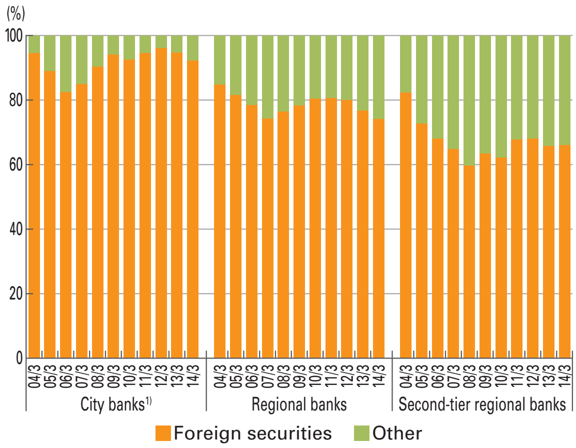
Among different types of banks, city banks reduced their "other securities" holdings in FY2013 while regional banks and second-tier regional banks stepped up their investments in "other securities," increasing their holdings at by a larger margin than in FY2012 (Exhibit 19). City banks ended FY2013

Exhibit 19. "Other securities" holdings by bank type (excluding overseas branch accounts)



Note 1: City banks are Mizuho Bank, Bank of Tokyo-Mitsubishi UFJ, Sumitomo Mitsui Banking Corporation, Resona Bank and Saitama Resona Bank.
Source: NRI, based on BOJ's *Domestic Bank Assets and Liabilities*

Exhibit 20. Composition of banks' "other securities" holdings



Note 1: City banks are Mizuho Bank, Bank of Tokyo-Mitsubishi UFJ, Sumitomo Mitsui Banking Corporation, Resona Bank and Saitama Resona Bank.
Source: NRI, based on BOJ's *Domestic Bank Assets and Liabilities*

with "other securities" holdings of ¥28trn, a ¥2trn reduction from a year earlier. Regional banks increased their "other securities" holdings by ¥2trn to ¥11trn over the same timeframe. Second-tier regional banks increased their "other securities" holdings by ¥300bn to ¥2.5trn.

Holdings of non-foreign "other securities" increased across all types of banks in FY2013 (Exhibit 20). Banks have been reshuffling their portfolios in pursuit of profit opportunities. City banks had been increasing their holdings of foreign securities, particularly foreign bonds, since March 2010. In FY2013, however, city banks reduced their foreign securities holdings while increasing the non-foreign share of their "other securities" holdings to 8%, a three-percentage-point increase from a year earlier. Among regional banks and second-tier regional banks, non-foreign securities' share of "other securities" holdings remained high at 26% and 34%, respectively, as of FY2013-end. Regional banks in particular substantially increased their non-foreign "other securities" holdings for a third consecutive year.

Outlook for securities investment among banks

Banks have historically regarded securities investment as temporary deployment of idle funds that would be better used to make loans. Since FY2012, however, banks have been focusing on securities investment as one core profit source and making more effort to revamp and strengthen their securities investment operations. Such efforts will presumably continue. Banks are likely to invest in a broader array of assets in pursuit of profit opportunities while continuing to reduce their exposure to interest rate risk in the JGB market. Banks aim to internationally diversify their investment portfolios in response to a dearth of profitable investment opportunities in Japan, where interest rates remain low.

Regional banks and second-tier regional banks, which have fewer management resources and less expertise than city banks, are constrained in their ability to invest directly in foreign equities and foreign bonds. Consequently, they mostly invest in foreign securities through funds. They favor private investment trusts because such trusts can be flexibly structured in several respects. First, private investment trusts can be tailored to banks' investment policies. Second, they are easier to manage because an investor's ownership interest tends to remain constant. Third, they can be structured to hedge foreign currency exposures.

AMCs' research, analytical and portfolio management capabilities are a decisive factor in banks' internationally diversified investment programs. Even major banks with in-house investment management staff heavily rely on AMCs' analytical capabilities in making asset-selection decisions. Complete analysis of everything from fundamentals to individual investment opportunities requires too much time and manpower for banks to do entirely in-house. Regional banks and second-tier regional banks are likely to utilize AMCs' expertise and know-how to an even greater extent than they have previously. In their dealings with banks, product providers are already becoming increasingly proactive in conducting consultative sales and pitching products that fully highlight their strengths.

When providers pitch products and provide investment advice, it is imperative for them to tailor their pitch or advice to banks' investment policies instead of focusing solely on high returns. Thorough familiarity with banks' investment policies (i.e., risk appetite) improves providers' prospects of winning whole-portfolio management mandates. Additionally, although banks are basically buy-and-hold investors in securities, AMCs must not forget that locking in profits through nimble trading in response to prevailing market conditions is also important. With the JGB market no longer conducive to such tactical trading, banks will be looking to book tactical trading profits on assets other than JGBs. To maintain and deepen business relationships with banks, AMCs must provide the banks with the advice and other information they need to make investment decisions, such as deciding when to sell an already purchased investment product and selecting new assets in which to reinvest sales proceeds.

Developments with respect to fund look-through requirements

When investing in funds, banks obtain from product providers the information that they need to conduct day-to-day risk management and calculate regulatory capital requirements. As a result of Basel II (which took effect in March 2007) and the subsequent global financial crisis, banks are now under strong pressure to thoroughly understand funds' investment strategies and asset holdings before investing in them. Fund distributors and AMCs have been diligently meeting banks' informational needs with respect to funds, but the workload involved in providing such information has recently been growing due to two factors. First, the granularity of information required by banks and the frequency with which they are required to obtain updated information have increased as a result of stricter regulations concerning banks' risk management and capital requirement calculations. Second, banks have been expanding their fund investments.

For example, in terms of calculating capital requirements, amended capital-adequacy-ratio regulations that took effect on March 31, 2014, for Japanese banks without international operations require the banks to ascertain whether funds' derivative positions were entered into through a central counterparty and to "look through" to funds' holdings of financial institutions' securities to comply with stricter regulations against double gearing. The Basel Committee on Banking Supervision's final standard on capital requirements for banks' equity investments in funds, published in December 2013 and scheduled to take effect in January 2017, imposes two additional requirements. First, when a bank invests in a fund, the fund's financial reporting must be no less frequent than the bank's[10]. Second, information required by the look-through approach must be verified by an independent third party, such as a securities depository, custodian bank or management company. Japan has already adopted more detailed look-through requirements than those in the Basel Committee's final standard. The extent to which Japan's existing regulations will be revised, if at all, is not yet known. However, if the Basel Committee's final standard is adopted in Japan without modification, it is likely to have a huge impact on the fund industry[11]. Information required to comply with look-through requirements has hitherto been provided to banks as one component of customer service, but the new information requirements may exceed the bounds of ordinary customer service.

Additionally, banks are under pressure from regulators to upgrade their day-to-day risk management also. From the standpoint of nimble risk management, global systemically important banks now need to compile and report data on an on-demand basis[12]. If banks upgrade their systems to calculate and report their risk exposures and capital requirements anytime, their upgraded systems may not be compatible with the methods that banks and AMCs currently use to collect and exchange data with each other.

In the European insurance industry, third-party vendors are already providing information collected from multiple asset managers and fund administrators for compliance with look-through requirements. Given the growing importance of fund investments in the context of banks' securities investment activities, the time has come even in Japan for banks, AMCs and fund distributors to jointly look into the feasibility of cooperatively developing shared infrastructure to improve the efficiency of fund-related data collection and enable timely exchange of such data.

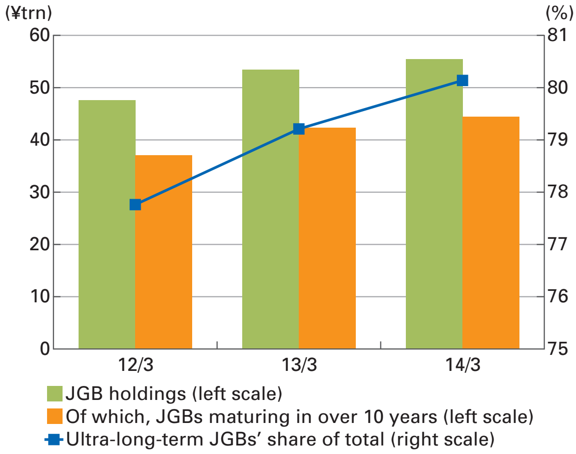
3 Life insurers' asset management operations

Life insurers have generally ceased investing in super-long JGBs

Japan's 43 life insurers' investment securities holdings at March 31, 2014, totaled ¥285trn, a year-on-year increase of ¥6.8trn, according to the Life Insurance Association of Japan. In FY2013, life insurers' investment securities holdings increased by only one-third as much as in FY2012. Investment securities' share of life insurers' total assets at FY2013-end was 81.3%, a 0.6-percentage-point increase from a year earlier. Life insurers' investment securities holdings continue to consist predominantly of JGBs. JGBs' share of the total is 53% (¥150trn), followed by foreign securities at 22% (¥61trn), corporate bonds at 9% (¥25trn) and equities at 6% (¥18trn).

The most notable change in life insurers' securities holdings was that hitherto rapidly growing JGB holdings increased by only ¥1.0trn in FY2013 while foreign securities holdings increased by ¥5.5trn. Although changes in the value of life insurers' securities holdings in FY2013 were largely attributable to market price movements, the near-cessation of growth in JGB holdings bears watching. One possible

Exhibit 21. Four major life insurers' JGB holdings and ultra-long-term JGBs' share their of



Source: NRI, based on four major insurers' financial statement data

reason for this downshift is that JGBs yielding enough to cover life insurers' assumed rates of return are limited to those with residual maturities of 15 years or longer. Another possible reason is that although policy-reserve-matching bonds and held-to-maturity bonds are not marked to market, life insurers would incur unrealized losses on such bonds when interest rates rise and consequently lose investment flexibility. The duration mismatch between life insurers' assets and liabilities has been reduced, but not completely eliminated, by continual purchases of super-long-term JGBs. The risk of a further decline in interest rates is limited. Life insurers could be starting to reposition their portfolios to hedge against upside interest-rate risk instead of downside interest-rate risk. We doubt that life insurers need to keep adding to their super-long-term JGB holdings to rectify duration mismatches. As of FY2013-end, JGBs with residual maturities of over 10 years accounted for more than 80% of the four major life insurers' JGB holdings (Exhibit 21). Life insurers have likely just about finished buying super-long-term JGBs to lengthen the duration of their assets.

Asset diversification is picking up

Life insurers' in-force business as of March 31, 2014, totaled ¥1,367trn, most of which was individual life insurance. If the composition of their in-force business remains more or less unchanged going forward, life insurers' policy of investing mainly in fixed-income assets matched to their policy reserves' duration in the aim of locking in ultra-long-term income streams is unlikely to change much.

However, with JGB market liquidity drying up in the wake of the BOJ's continued large-scale JGB purchases, life insurers will likely have a greater need to diversify their investments (e.g., into foreign bonds) even within the fixed-income asset class. In fact, life insurers started to experiment with different investment strategies in FY2013. For example, three of the four of major life insurers (the exception was Dai-ichi Life) stopped actively extending their JGB holdings' duration and stepped up their investments in foreign bonds and non-JGB domestic bonds. Meiji Yasuda Life in particular increased its holdings of relatively short-dated foreign bonds.

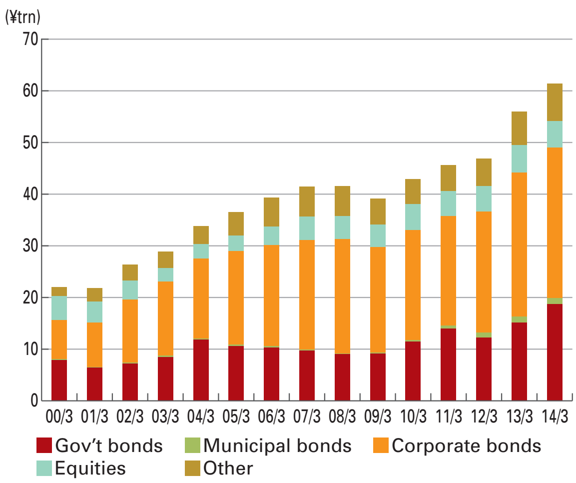
How to meet diversification needs vis-à-vis the risk of major economic fluctuations during existing insurance policies' terms is likely to be a key asset-management issue for life insurers going forward. In their investing activities, life insurers may place priority on downside protection against major, long-term market fluctuations while minimizing the risk of their financial statements being adversely affected by asset price movements by diversifying into assets with varying risk profiles and little mark-to-market impact (e.g., infrastructure, foreign credit) and keeping interest-rate risk contained within a tolerable range. In terms of foreign securities investment, life insurers have in fact been steadily diversifying their portfolios through such means as substantially increasing their holdings of corporate bonds and "other securities" and broadening their sovereign debt investment universe (Exhibit 22).

4 Retail business

Investment trusts see small net inflow by virtue of decreased redemptions

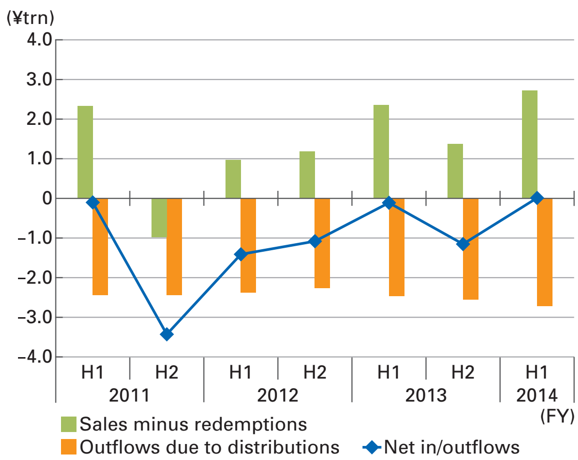
In the first half of FY2014, investment trusts in aggregate experienced a small net inflow (net of both redemptions and total dividend distributions) after seven consecutive semiannual periods of net outflows dating back to the second half of FY2010 (Exhibit 23). Investment trusts' dividend distributions totaled ¥2.7trn in the first half of FY2014, up from ¥2.2trn in the second half of FY2010. Meanwhile, net investment trust sales (sales net of redemptions), which have been steadily growing since bottoming in the second

Exhibit 22. Life insurers' foreign securities holdings



Source: NRI, based on Life Insurance Association of Japan data

Exhibit 23. Equity investment trust in/outflows (ex ETFs)



Note: Net in/outflows are sales net of redemptions and distributions.
Source: NRI, based on Fundmark data

half of FY2011, narrowly exceeded total dividend distributions in the first half of FY2014. Net inflows were not limited to any particular sales channel. Net in/outflows inclusive of dividend distributions turned positive across all sales channels, including not only brokerages, city banks and trust banks but also regional banks and second-tier regional banks.

However, this improvement was attributable to a decrease in redemptions, not sales growth. Sales decreased over the 12 months through September 30, 2014, but redemptions decreased by an even larger margin. This pattern was consistent across all sales channels. Sales decreased but redemptions decreased even more, resulting in net inflows via the brokerage channel and all bank channels, including city banks, trust banks, regional banks and second-tier regional banks. Given that the net inflows were not the result of proactive business initiatives, we doubt that net inflows will continue to grow robustly without sales promotion efforts.

Major fund distributors are starting to focus heavily on AUM growth

The decrease in redemptions across many fund distributors reflects a change in distributors' sales approach. With client assets stagnating in recent years despite growth in both investment trust sales and fund distributors' revenues, fund distributors themselves have started to recognize the investment trust business's limits in terms of growth potential. Additionally, regulators have been prodding fund distributors to change their business models through revised supervisory guidelines, among other means. To expand investment trusts' customer base, fund distributors have started to focus heavily on investment trust sales funded by inflows of fresh money instead of encouraging clients to switch from one fund to another. Regulators also have noted that fund distributors' sales mentality must be reformed for investment to take root among the general public as a means of wealth-building. Toward this end, regulators are talking about the need for fund distributors to shift the focus of their sales force incentives from sales commissions to expansion of clients' investment trust holdings.

Such a change in sales approach could result in a short-term decrease in revenues for many fund distributors because expansion of clients' fund holdings would require fund distributors to focus on cultivating new clients, a process that is generally costly and detrimental to sales force efficiency. Nonetheless, given fee businesses' continued importance going forward, financial institutions should be willing to tolerate a short-term dip in earnings while shifting their investment trust business model's primary focus to earning fees based on clients' account balances (e.g., account servicing fees) by increasing client assets over the medium term. Many major brokerages, city banks, trust banks and large regional banks that we have spoken to are starting to reorient their investment trust sales businesses toward asset gathering.

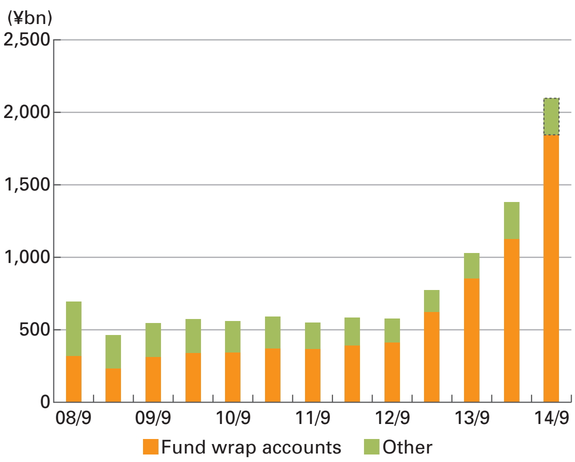
Wrap accounts are gaining favor

One service on which such financial institutions are focusing is wrap accounts. When clients purchase risk-bearing products, the general rule is that the clients themselves must make the investment decision. With wrap accounts, however, the client delegates decision-making authority to a financial institution. Financial institutions that offer wrap accounts confer with the client to identify the client's investment targets, set investment parameters (e.g., risk tolerance) to realize the targets, and determine the amount of money to be invested in the wrap account. The financial institution then executes orders on behalf of the client, manages the client's account and periodically reports to the client on investment performance. Even in a conventional investment trust sales setting, financial institutions provide investment advice to clients, but the decision on whether to invest in a specific product is always made by the client. With a wrap account, by contrast, investment decisions are made by the financial institution in accord with investment policies set through consultation with the client.

In Japan, wrap accounts date back to April 2004, when the Investment Advisory Business Act was amended to permit brokerages and other institutions to offer discretionary investment services. Since September 2012, total assets held in wrap accounts have been growing rapidly after stagnating for a while in the aftermath of the global financial crisis. Total wrap-account assets, which had previously been holding steady in the vicinity of ¥570bn, appear to have grown to over ¥2.1trn as of September 2014 (Exhibit 24). The driving force behind this growth is the fund wrap[13], a type of wrap account in which investments are limited to investment trusts. Since the fund wrap's advent, assets in fund-wrap accounts have grown nearly uninterruptedly to over ¥1.8trn, more than 80% of total wrap account assets, as of September 2014.

Financial institutions do not charge sales commissions on investment trust transactions in fund-wrap accounts. Fees are charged strictly based on the account balance. Fund-wrap accounts typically charge total fees of around 1.4% per annum, split

Exhibit 24. Wrap account AUM



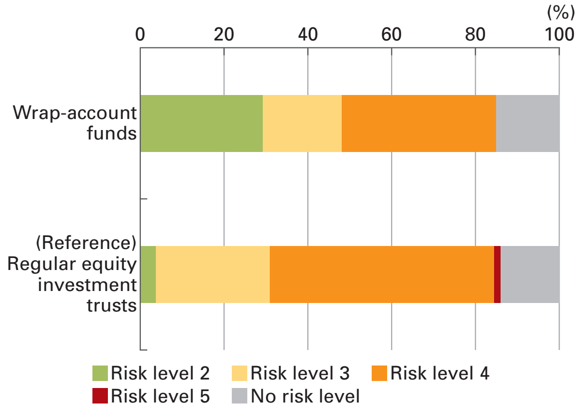
Source: Japan Investment Advisers Association. Fund-wrap AUM and September 2014 other AUM are NRI estimates.

roughly equally between an administration fee and investment advisory fee. The investment advisory fee is sometimes a variable, performance-based fee. In such cases, the base fee rate is set at a low level but a separate fee is charged on increases in account value attributable to investment returns[14]. Additionally, financial institutions earn investment trust account servicing fees on all investment trust accounts. The account servicing fees charged on investment trusts offered in fund-wrap accounts average around 0.15% per annum, which is lower than the corresponding fees charged on regular investment trusts[15].

How do fund-wrap accounts compare with conventional investment trust accounts in terms of profitability on an equivalent amount of client assets? With fund-wrap accounts, a financial institution can earn ¥1.55bn annually on client assets of ¥100bn. In the case of conventional investment trust accounts, the financial institution's earnings would vary as a function of its clients' average holding period. For example, given a short average holding period of around two years, in line with the industry average, the financial-institution could earn annual revenues of ¥1.95bn on conventional investment trust accounts[16], more than it could earn from fund wrap accounts with an equivalent ¥100bn of assets. As the assumed holding period increases in length, the revenue gap between the conventional investment trust accounts and fund-wrap accounts steadily shrinks. Once the average holding period reaches 2.9 years or longer, fund-wrap accounts generate more revenues than conventional investment trust accounts[17]. Fund-wrap accounts are ultimately not significantly less profitable for financial institutions than conventional accounts.

Fund-wrap accounts are offered with a choice of about five different investment styles. Most fund-wrap clients reportedly choose relatively conservative investment styles described with words such as "stable" or "moderate". This preference is immediately evident from the selection of investment trusts offered exclusively in fund-wrap accounts. Exhibit 25

Exhibit 25. Breakdown by risk level of AUM of funds offered exclusively in wrap accounts



Note: Data current as of August 30, 2014. Risk increases as the risk-level number increases.
Source: NRI, based on Fund market data

compares the breakdown of investment trust AUM by risk level between funds offered exclusively for fund-wrap accounts and the universe of regular equity investment trusts. Low-risk funds account for a larger share of the fund-wrap investment trust universe than the regular investment trust universe. According to past NRI surveys, most people, even those who are interested in investment, tend to have a highly conservative attitude toward investing and are willing to assume a moderate degree of risk at most. Many existing investors are willing to invest more money in a low-risk financial product than a higher-risk one. From such a standpoint, wrap accounts that offer low-risk investment trusts may attract more client assets.

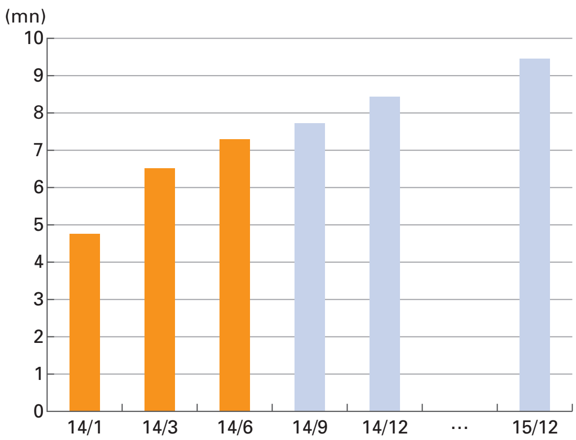
Being a discretionary investment service, wrap accounts require specialized staff. They are consequently offered by a limited number of financial institutions. Banks, with the exception of trust banks, are legally prohibited from directly offering wrap accounts. The megabanks indirectly offer wrap accounts by referring customers to affiliated brokerages. Even including such arrangements, very few financial institutions offer wrap account services. According to press reports, however, some regional banks, among other players, are preparing to launch wrap-account services by partnering with financial institutions with a track record as wrap-account providers. Given the emerging possibility of wrap accounts becoming available from a wider range of financial institutions, wrap-account assets are likely to continue growing.

Such a trend would have an impact even on financial institutions that do not offer wrap accounts. For example, it may become standard practice for financial institutions' sales staff to recommend multi-asset investment trusts to clients as core, long-term investment holdings.

NISAs are expanding the investor class

NISAs, available since January 2014, provide tax-exempt treatment of dividends (distributions) from and capital gains on listed equities and equity investment trusts. A total of 7.27mn NISAs were opened in the first six months of 2014. Based on NRI survey[18] data, we estimate that the number of NISAs subsequently grew to 7.70mn as of September 30, 2014, and may increase to 8.41mn by year-end 2014 (Exhibit 26). First-time investors prompted to start investing by NISAs' advent account for an estimated 20% of this total (1.88mn NISAs). Many of these first-time investors are between the ages of 20 and 39. With younger individuals accounting for half of the first-time investors that have opened NISAs to date, NISAs

Exhibit 26. Number of NISAs



Source: Data through June 2014 are numbers reported by National Tax Agency and FSA. Data from September 2014 onward are NRI estimates based largely on survey data.

have proven effective at cultivating new investor demographics to some extent.

The government intends to continually improve NISAs in the aim of promoting their widespread adoption. Tax reforms requested by the FSA in August 2014 included proposals to raise the annual NISA contribution limit to ¥1.2mn, allow minors under the age of 20 to also open NISAs (subject to an annual contribution limit of ¥800,000 and a restriction on withdrawals until age 18), and simplify the application process for opening a NISA by using national tax ID numbers. Additionally, from next year the government is slated to deliberate on extending the maximum duration of NISAs' tax exemption from five years at present and extending or completely revoking the current time limit on NISAs' existence.

NISAs are important for the investment trust business. Investment trusts accounted for two-thirds of asset purchases in NISAs through June 2014. Based on NRI survey data, we project that asset purchases in NISAs will reach some ¥5trn annually. If investment trusts' share of NISA asset purchases remains at two-thirds, more than ¥3trn of NISA contributions will flow into investment trusts annually. Because tax-exempt treatment of NISA holdings terminates once the holdings are sold, many individuals that hold or plan to hold investment trusts in their NISAs intend to do so for around five years. NISAs promise to be a conduit for continuous inflows of long-term capital to the investment trust market.

5 Product market trends by client segment

We have created product opportunity maps for three investor segments (retail, pension funds, and financial institutions) based on data from our Survey of Asset Management Companies' Management Priorities. These maps plot the strength of investor demand for various products (as assessed by AMCs) against the products' current availability (assessed based on the number of providers that offer each product). They are useful for identifying promising products (strongly demanded products offered by few companies (upper left quadrant)) and products facing intense competition (poorly demanded products offered by many companies (lower right quadrant)). Exhibit 27 presents our product opportunity maps for a subset of products.

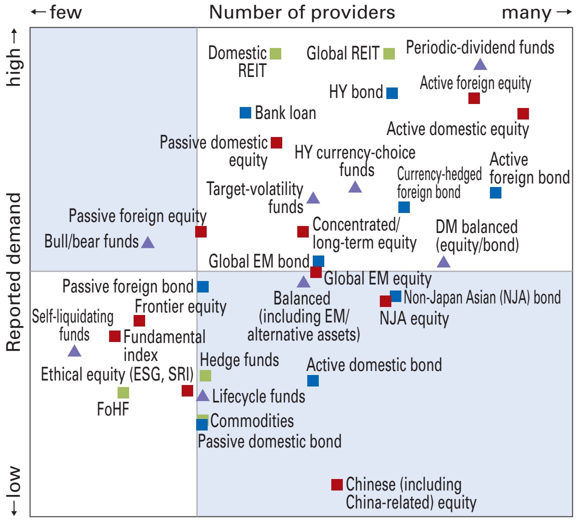
In the retail investor segment, domestic equities are seen as a strongly in-demand asset class (vertical axis) for a second consecutive year in the wake of recent improvement in the investment environment. Additionally, survey respondents reported strong demand for numerous high-yielding products (e.g., periodic-dividend funds, REITs, bank loans, high-yield bonds) also. High-yielding currency-choice funds also appear to still be strongly in demand. Demand for target-volatility funds, considered well-suited for NISAs, is also relatively strong. However, such products are generally already available from a considerable number of companies (horizontal axis). Hardly any products in the retail investor segment are rated as promising opportunities from the standpoint of their supply-demand balance.

In the pension fund segment, survey respondents reported that many bond products are strongly in demand, particularly those that utilize foreign bonds. Survey respondents' assessment of demand for equities was higher in 2014 than in 2013, though not as strong as demand among retail investors. From the standpoint of demand relative to supply, equity smart beta, low-volatility equity, real assets, private equity and real estate products look promising. Products rated at the low end of the demand scale include domestic long-term bonds, funds of hedge funds (FoHF), and commodities.

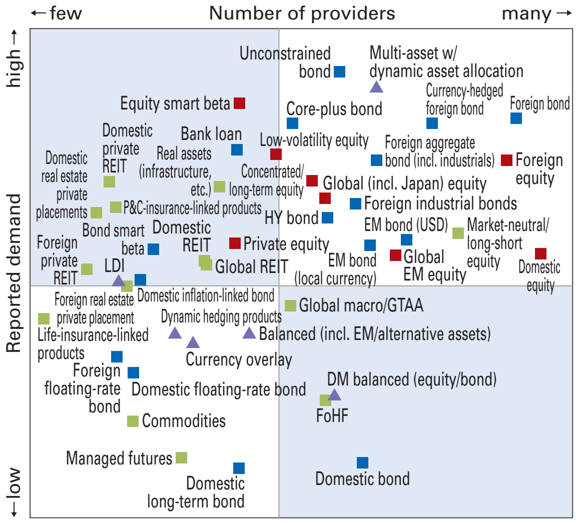
In the financial institution segment, foreign bond products remain strongly in demand in survey respondents' assessment. In contrast, demand

Exhibit 27. Product supply and demand maps by client segment

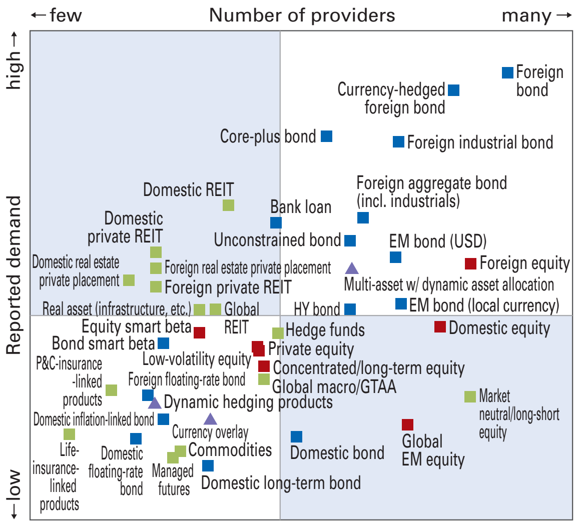
(a) Products for retail investors



(b) Products for pension funds



(c) Products for financial institutions



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

from financial institutions for equities and market-neutral products is generally low. From the standpoint of demand relative to supply, relatively promising products include domestic and foreign real estate products and core-plus bond funds, which are popular among pension funds also.

In sum, Japan's asset management industry currently does not have many products that can be called promising from the standpoint of their outward characteristics. AMCs must endeavor to clearly differentiate their products based on distinctive investment philosophies, processes and product attributes. To do so, they will need strong product planning capabilities that combine ideas from both asset management staff in contact with capital markets and sales staff in contact with clients and fund distributors.

4) JBA data covers 116 banks: five city banks, 64 regional banks, 41 second-tier regional banks, four trust banks, Shinsei Bank and Aozora Bank.
5) JBA data includes overseas branch accounts.
6) The JBA total of ¥255trn differs by ¥27trn from the sum of the city bank, regional bank, and second-tier regional bank subtotals because it includes trust banks, Shinsei Bank and Aozora Bank's securities holdings also.
7) Deposits receivable are deposits held at the BOJ, Japan Post Bank, and other financial institutions in addition to negotiable deposits receivable.
8) Per the BOJ's *Domestic Bank Assets and Liabilities*.
9) "Other securities" are foreign securities and domestic securities other than JGBs, corporate bonds, municipal bonds and equities.
10) The funds' financial statements are not required to be audited by an external auditor.
11) The final standard is partly intended to regulate shadow banking (i.e., funds) also.
12) Basel Committee on Banking Supervision, *Principles for Effective risk data aggregation and risk reporting*.
13) Wrap accounts include fund-wrap accounts, holdings in which are limited to investment trusts, and general wrap accounts in which one can invest in individual equities, etc. The latter are called SMAs (separately managed accounts) at many financial institutions that offer wrap accounts. While fund-wrap accounts can be opened with a ¥3-5mn deposit, SMAs require a deposit of ¥50-100mn.
14) Accounts that charge performance-based fees typically charge a base fee equivalent to one-third to one-half of a regular fund-wrap account's investment advisory fee plus 10-20% of any increase in account value attributable to investment returns.
15) Fees earned by financial institutions include an administration fee, investment advisory fee, and investment trust account servicing fee. On average, these three fees total 1.55% of fund-wrap account balances.
16) In conventional investment trust accounts, the fund distributor earns a sales commission averaging 2.72% and an account servicing fee of 0.59% (FY2013 average). Given the average holding period of around two years, fund distributors can biennially earn revenues of ¥3.9bn (¥1.95bn per annum) on ¥100bn of client assets.
17) For example, if the average investment-trust holding period were three years, financial institutions would triennially earn revenues of ¥4.5bn (¥1.5bn per annum) on ¥100bn of customer assets in conventional investment trust accounts.
18) Online survey conducted on September 27-28, 2014.

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Japan's
Asset Management Business
2014/2015

Date of Issue	December 24, 2014
Publication	Nomura Research Institute, Ltd., Marunouchi-kitaguchi-Bldg. 1-6-5 Marunouchi, Chiyoda-ku, Tokyo, Japan http://www.nri.com/global
Publisher	Yasuki Okai
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Japan's Asset Management Business 2014/2015

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