NRI

Japan's Asset Management Business 2017/2018

Nomura Research Institute, Ltd.

FOREWORD

Can Japan's asset management industry meet the public's expectations?

The Japanese asset management industry's AUM increased by ¥30trn during FY2016. Fresh asset inflows, however, were limited to ETF purchases by the BOJ and banks' investments in private funds. Such private fund inflows have slowed in FY2017. While the asset management industry's growth has thus ostensibly downshifted, we find that, beneath the surface, fundamental conditions are falling into place for asset management services to become more broadly entrenched in Japanese society.

In the public investment trust market, investment trusts are being used less as a source of dividend income and more as a vehicle for generating stable long-term returns. For asset management companies, offering top-notch investment products suitable for inclusion in portfolios whose objective is steady capital appreciation will become increasingly important. In the market for funds offered to banks, AUM growth has slowed somewhat but will likely reaccelerate as banks make further progress in upgrading their risk management. Asset management companies could better serve their bank clients through such means as providing detailed data that afford look-through visibility to underlying fund holdings while otherwise offering support based on their extensive portfolio management expertise, including helping banks to manage in-house securities portfolios. In the pension market segment, competition will likely intensify further as pension funds, particularly public ones, diversify their investment universes and revamp their fee structures for external managers, setting the stage for asset managers to compete based more on their portfolio management capabilities.

The changes mentioned above have long been on the asset management industry's wish list. So far, however, they have not fully taken root as clear trends. Asset management companies need to take action to ensure that incipient changes develop into full-fledged trends. This report aims to highlight signs of change through various innovative analyses. We hope to refine such analyses through discussion. We warmly welcome candid feedback from readers.

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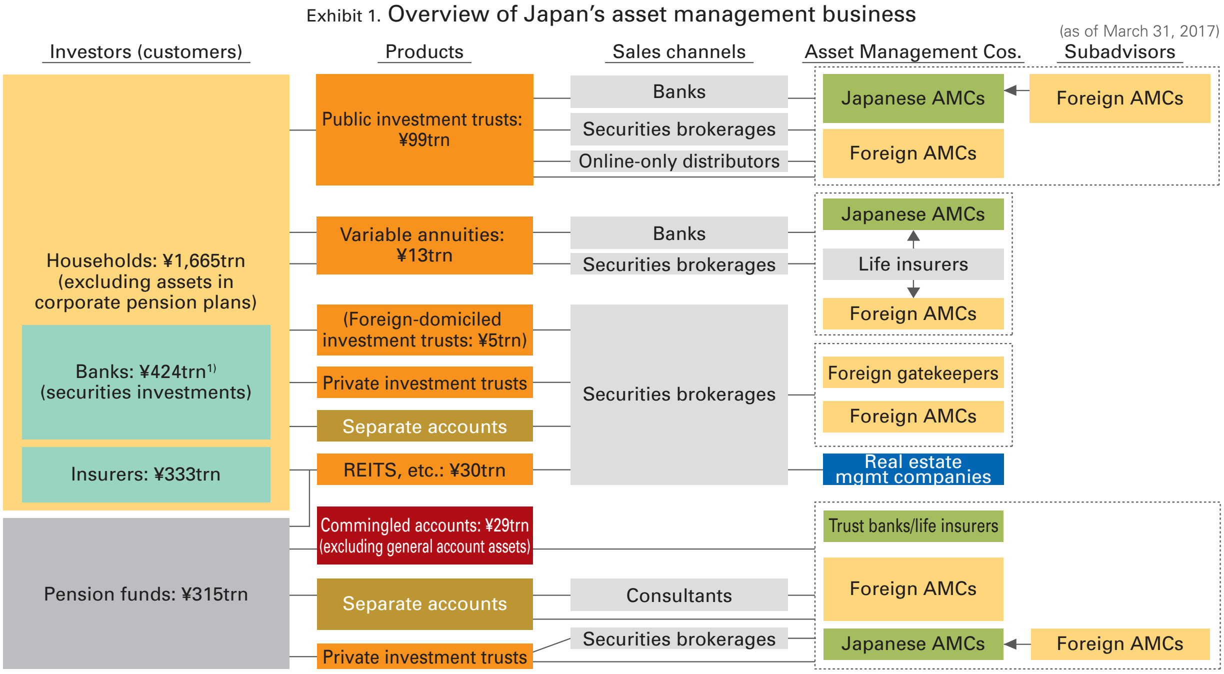
CHAPTER 1 Japanese investor trends

Resumed growth in financial assets

The Japanese asset management industry resumed growing in FY2016 after its previous multiyear growth streak stalled in FY2015. Its renewed growth was driven primarily by banks continuing to invest in securities via funds, albeit at a slower pace than in the past. Nonetheless, the asset management industry is faced with a challenging environment. While public investment trusts are experiencing a slowdown in asset inflows, dividend distributions have yet to come down much from their peak level. Investment trust AUM are at an all-time high but with fund distributors struggling to come up with business models that comply with the FSA's *Principles for Customer-Oriented Business Conduct*, investment trust sales could remain volatile. One bright spot is that eligibility for individual defined contribution (iDeCo) retirement accounts has been expanded to encompass civil servants et al., enlarging the pool of potential investment trust investors. This development bodes favorably for steady growth in investment trust assets.

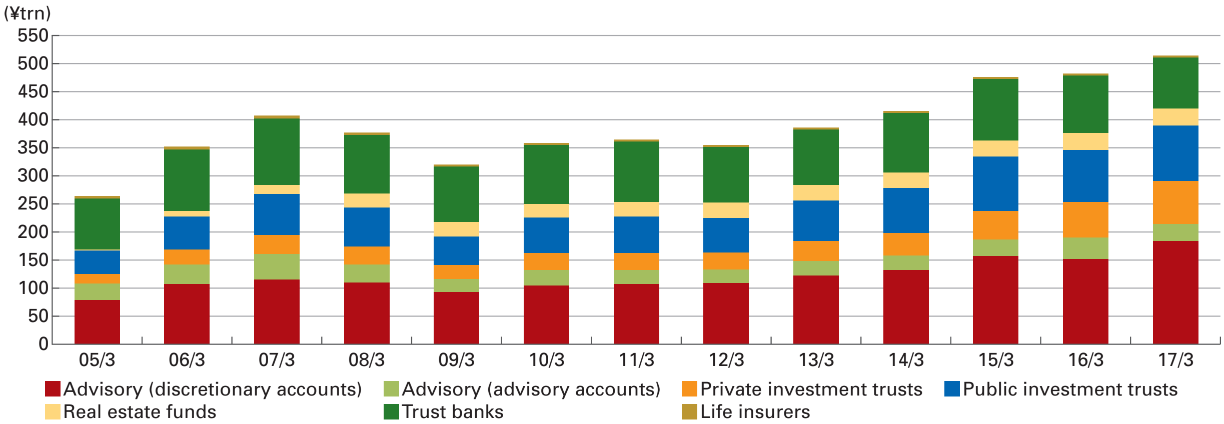
Exhibit 1 presents a simplified overview of the Japanese asset management market at March 31, 2017, in terms of products and players, the latter comprising investors, asset managers and distributors. It shows which types of asset managers manage money for which investor classes, how

Exhibit 1. Overview of Japan's asset management business



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

Exhibit 2. AMCs' AUM



Note: Life insurer AUM are DB pension asset mandates and do not include general-account assets with guaranteed returns.
Source: NRI, based on Investment Trusts Association of Japan and Japan Securities Investment Advisers Association data and financial statements in AMCs' business reports submitted to the FSA and Ministry of Finance's Kanto Local Finance Bureau

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 institutions' securities portfolios are largely funded with retail customers' deposits, Japanese investors' financial asset holdings at March 31, 2017, totaled an estimated ¥1,970trn, a ¥114trn year-on-year increase almost entirely attributable to the household sector. Specifically, household financial assets accounted for ¥104trn of the ¥114trn increase while pension assets accounted for the ¥10trn remainder.

The ¥1,970trn of total financial assets' professionally managed subtotal was ¥514trn[1], up ¥32trn from a year earlier and above the ¥500trn mark for the first time ever. With professionally managed assets' share of total financial assets approaching 30%, AMCs' presence should continue to expand.

Developments among households, pension funds and financial institutions

Household financial assets at March 31, 2017, totaled roughly ¥1,655trn, a ¥104trn increase from a year earlier. Their composition has remained largely unchanged, with bank deposits and insurance products accounting for nearly 80% of the total.

Although the postwar baby boomers' retirement wave has already crested, we expect new retirees' lump-sum retirement benefits, together with working households' monthly savings from wages, to remain a key funding source for household financial asset holdings. We estimate that over the next five years such retirement benefits and savings will flow into financial assets at a rate of ¥20trn annually, augmented by an additional ¥3trn of proceeds from sales of households' existing equity and other asset holdings. Of these ¥23trn of total annual financial asset inflows, we estimate that roughly 80%, around ¥18trn, will end up in bank accounts or insurance products and the remainder, a bit over ¥5trn, will flow into risk assets, mainly equity investment trusts. Investment trust outflows in the form of dividend distributions have recently started to gradually decrease after running as high as ¥5trn annually. Their prospective rate of descent is hard to predict, but if they were to hypothetically fall to 50% of their current level, our estimate of annual investment trust inflows over the next five years would be to ¥3trn once dividend distributions are netted out. In addition to these net inflows, we estimate based on NRI survey data that NISA (Nippon Individual Savings Accounts) inflows will amount to nearly ¥3trn annually until 2014-vintage NISAs' tax exemption on investment returns expires in two years. For the subsequent three years of our five-year forecast horizon, we assume that NISA inflows and outflows will roughly negate each other. We estimate that nearly 70% of the NISA inflows will be invested in equity investment trusts, in which case average annual investment trust inflows via NISAs over the next five years would approach ¥1trn. Inclusive of these NISA-intermediated inflows plus an estimated ¥500bn of additional investment trust inflows via defined contribution retirement accounts, we estimate total investment trust net-inflows over the next five years at around ¥4-5trn per year. Although NISAs and defined contribution retirement plans have substantial potential, they are unlikely to drive much market growth for quite a while.

Pension funds, Japan's largest institutional investors, collectively had an estimated ¥315trn of assets as of March 31, 2017. Public pension funds' share of this total was ¥207trn, with corporate and other private pension funds accounting for the remaining ¥108trn. Relative to a year earlier, the former increased by ¥12trn while the latter decreased by ¥2trn. The resultant ¥10trn net increase in total pension assets was mainly attributable to improved capital market returns. Meanwhile, the Government Pension Investment Fund (GPIF) experienced asset inflows due to dissolution of companies' Employees' Pension Funds (EPFs) and re-nationalization of a portion of their assets. The GPIF, having inaugurated a new management committee with a collective decision-making model from October 2017, will likely proceed with further investment reforms, including increased portfolio allocations to alternative assets and adoption of a full-fledged performance-based compensation scheme for external managers. The GPIF's external managers can look forward to earning high management fees if they deliver high returns like in the past.

Financial institutions' investment securities holdings at March 31, 2017, totaled about ¥758trn, a ¥20trn decrease from a year earlier. Of this total, banks (ex Japan Post Bank) accounted for ¥218trn, *shinkin* banks and credit unions for ¥68trn, Japan Post Bank for ¥139trn, life insurers for ¥310trn (Japan Post Insurance's share of which was ¥64trn) and nonlife insurers for ¥24trn.

Amid Japan's ultra-low interest rate environment and the Bank of Japan's ongoing massive JGB purchases, financial institutions have a strong need to diversify their investment securities portfolios into higher-yielding assets. They will presumably continue investing in "other securities," mainly fund products and foreign securities, but with the FSA stepping up oversight of financial institutions' risk management of securities portfolios, conditions are no longer conducive to continued steady growth in other securities holdings. That said, Japan Post Bank and Japan Post Insurance continue to upgrade their securities portfolio management capabilities. Financial institutions will likely remain strategically important clients for AMCs.

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

In this chapter, we look at the state of AMCs' business based on various data, including proprietary surveys (we define AMCs as firms specializing in investment trust management and/or investment advisory services).

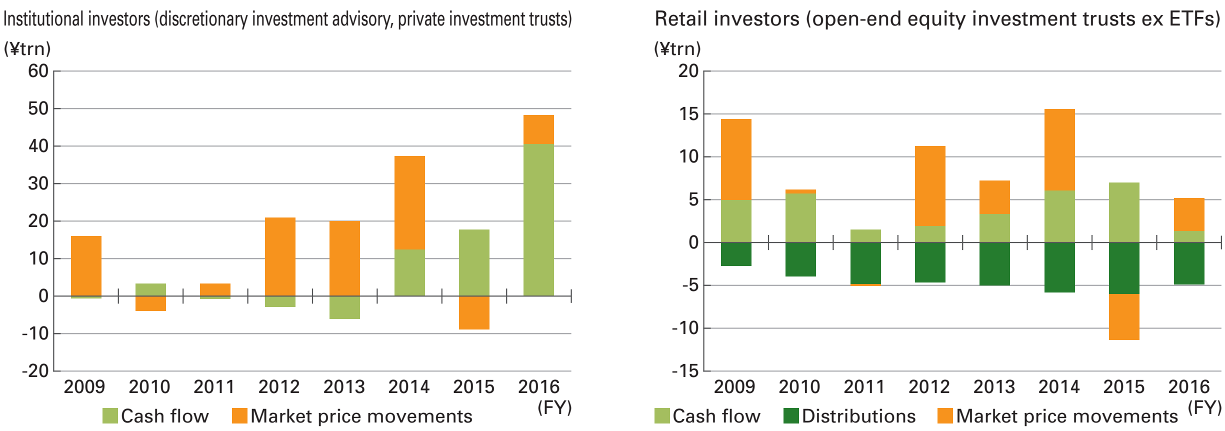
Revenues down 5% in FY2016

Exhibit 3 plots annual changes in AMCs' AUM disaggregated by causative factor. First, in the institutional market segment (leftward graph: total of discretionary investment advisory AUM and private investment trust AUM), asset price appreciation, mainly in domestic and overseas equity markets, added some ¥8trn to AMCs' AUM in FY2016.

Meanwhile, net inflows of new assets boosted AMCs' AUM by whopping ¥41trn, ¥29trn of which flowed into discretionary investment advisory accounts. However, nearly all (about ¥27trn[2)]) of these ¥29trn of inflows stem from consolidation and functional reorganization of major Japanese financial and insurance groups' affiliated AMCs. Certain public pension funds, most notably Mutual Aid Associations, outsourced management of more of their assets to external managers again in FY2016. Such outsourcing generated asset inflows for some AMCs but these inflows were largely offset by continued redemptions and mild outflows of private, mostly corporate, pension assets. On balance, the pension segment as a whole did not contribute much to AMCs' asset net-inflows in FY2016.

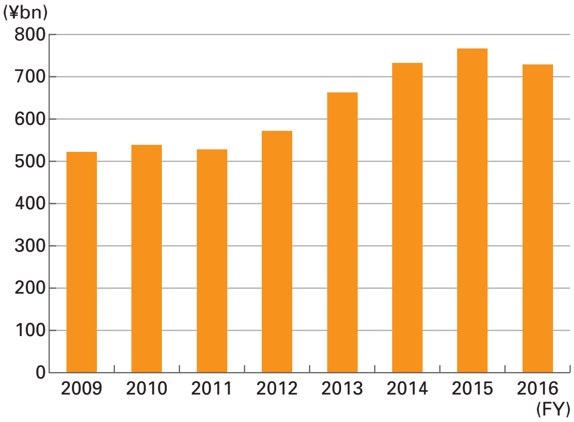
Private investment trusts, a product mainly for financial institutions, saw net inflows of roughly ¥12trn in FY2016. Outsourcing of portfolio management by financial institutions to AMCs via private investment

Exhibit 3. Changes in AUM broken down by causative factor



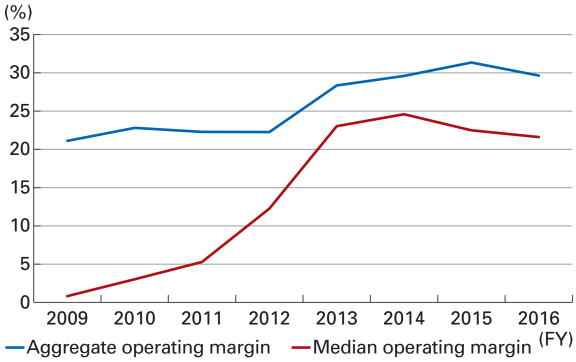
Source: NRI, based largely on data from the Investment Trusts Association of Japan, Japan Securities Investment Advisers Association and NRI Fundmark

Exhibit 4. AMCs' aggregate management fee revenues



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

Exhibit 5. AMCs' operating margins



Note: The above graph plots operating margin data for domestic public investment trust sponsors (number of AMCs in data sample varies among fiscal years). Aggregate operating margin is calculated as the aggregate operating profits of the AMCs in the sample divided by their aggregate net operating revenues.
Source: NRI, based on AMCs' business reports

trusts has been growing rapidly in recent years. Although private investment trust net-inflows were about ¥2.5trn lower in FY2016 than in FY2015, their previous growth trend essentially remained intact.

In the retail market segment (rightward graph: open-end public equity investment trust (ex ETF) AUM), asset price appreciation accounted for roughly ¥4trn of AUM growth in FY2016. Retail investment trusts' inflows from sales of new units exceeded redemptions by a mere ¥1trn in FY2016. Retail investment trust inflows had been robust until FY15 but have since slowed precipitously. Adjusted to factor in some ¥5trn of distributions of investment returns, retail investment trusts collectively experienced a net outflow of assets in FY2016. Even inclusive of incremental AUM stemming from asset price appreciation, growth in retail investment trust AUM (net assets) was essentially nil. Retail investment trust distributions decreased in absolute terms for the first time in a while, down about ¥1trn from FY2015. With retail investment trust AUM largely unchanged year on year at fiscal year-end, this decrease in distributions was due to a reduction in the overall investment trust market's average distribution yield[3], which has fallen below 8% from around 10% as of March 31, 2016.

Exhibit 4 plots the asset management industry's aggregate management fee revenues. Based on data available at time of this writing, we estimate FY2016 management fee revenues at ¥730bn, down about 5% from FY2015's all-time record level to approximate parity with revenues' FY2014 level. The decline in revenues was largely attributable to a decrease in annual-average investment trust AUM. While private investment trust AUM grew more than 20% in FY2016, AUM in public investment trusts (defined the same as in Exhibit 3) decreased about 7%. Revenue growth in other segments was insufficient to fully offset the decrease in public investment trust revenues.

Exhibit 5 plots operating margins of domestic AMCs (limited to those that manage public investment trusts). In FY2016, the AMCs in our survey sample had an aggregate operating margin of 30% (calculated by dividing their aggregate operating profits by their aggregate revenues) and median operating margin of 23%, both down 1ppt from FY2015 (based, like Exhibit 4, on data available at the time of this writing).

2 Outlook for asset management business

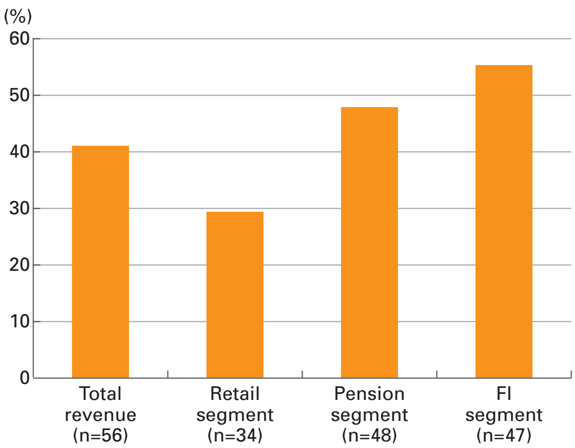
AMCs' revenue decline and margin shrinkage in FY2016 appears to signal a reversal of their revenue and profit growth trends from FY2012 through FY2015. The revenue downturn was of course mainly due to a decrease in (average-annual) AUM, which in turn reflects capital market trends. Japan's major capital markets' average valuations in FY2017 through the time of this writing were mostly 10-15% higher than in the year-earlier period. If these valuation gains are sustained, AMCs' revenues and profit should grow in FY2017.

However, AMCs have business strategies aimed at capturing asset inflows irrespective of market factors. We annually survey AMCs' management (*NRI Survey of Asset Management Companies' Management Priorities*[4)]) to ascertain the asset management industry's consensus outlook and latest business conditions. The remainder of this chapter looks at how AMCs perceive their near-term business environment and what they are doing in response, as revealed by survey responses.

Bullish growth expectations persist; outlook largely unchanged

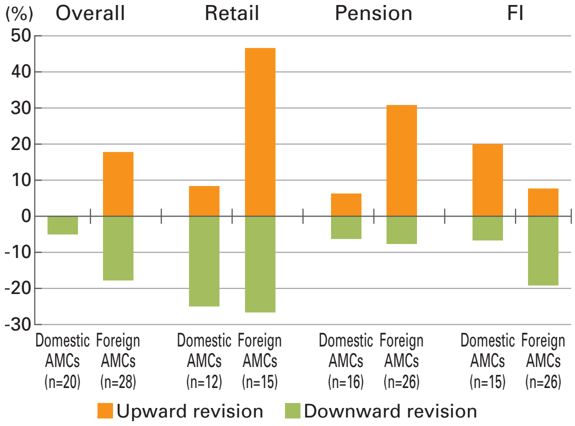
First, in terms of AMCs' overall revenue outlook, Exhibit 6 plots the percentages of survey respondents forecasting revenue growth (due to asset net inflows, excluding revenue growth driven by AUM growth due to asset price appreciation) in excess of 10% over the next 3-5 years on a company-wide basis and by business line (investor segment). Some 40% of the respondents expect their total revenues to grow more than 10%. The investor segment in which the most respondents are forecasting revenue growth of over 10% is the financial institution segment, followed in descending order by the pension and retail segments.

Exhibit 6. Percentage of survey respondents forecasting revenue growth in excess of 10% over next 3-5 years



Note: FI: financial institution
Source: NRI *Survey of Asset Management Companies' Management Priorities*

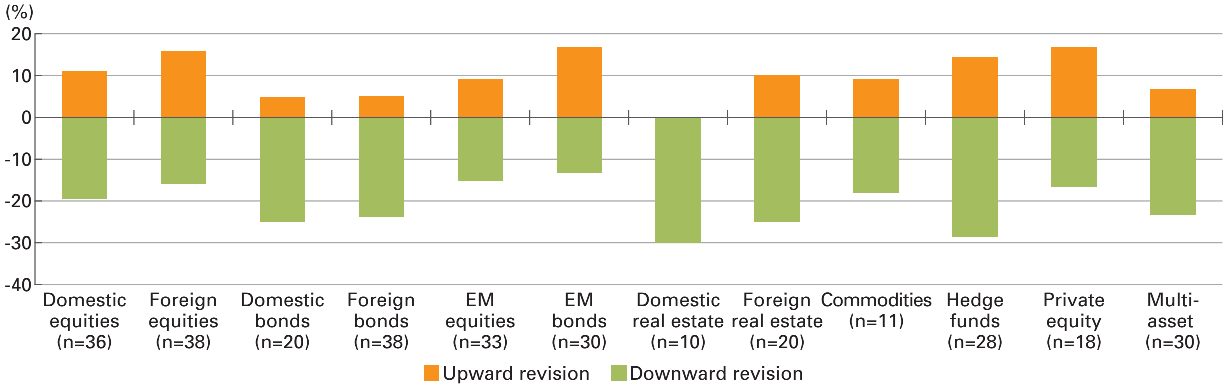
Exhibit 7. Percentage of survey respondents that revised their revenue growth forecasts in 2017 relative to 2016 (overall and by business segment)



Note: Data samples are limited to AMCs that participated in survey in both 2016 and 2017. FI: financial institution segment.
Source: NRI *Survey of Asset Management Companies' Management Priorities*

Figure 7 compares revenue forecasts between our latest and previous year's surveys by plotting percentages of upwardly and downwardly revised revenue forecasts among respondents that participated in both surveys. Nearly all domestic-AMC respondents and around 60% of the foreign-AMC respondents left their company-wide revenue forecasts unchanged from the previous year. The remaining roughly 40% of foreign-AMC respondents were almost evenly split between upward and downward revisions. Notwithstanding this divergence in outlook among a sizable minority of foreign AMCs, the overall revenue outlook generally remained unchanged from the preceding year. By investor segment, many more foreign than domestic respondents raised their revenue forecasts for the retail and pension segments. In the financial institution segment, the vast majority of respondents left their forecasts unchanged, but more domestic than foreign

Exhibit 8. Percentage of survey respondents that revised their asset in/outflow forecasts in 2017 relative to 2016 (by asset class)



Note: Data samples are limited to AMCs that participated in survey in both 2016 and 2017.
Source: NRI *Survey of Asset Management Companies' Management Priorities*

respondents raised their forecasts.

The asset management industry's growth in recent years has been largely driven by a series of favorable changes in the industry's external environment (e.g., establishment/expansion of programs to promote household wealth accumulation, adoption of more sophisticated asset management practices by public pension funds, suppression of domestic interest rates, bullish equity market performance). However, these developments' positive impact is already factored into AMCs' revenue forecasts. Nothing new happened over the past year that materially changed the revenue outlook.

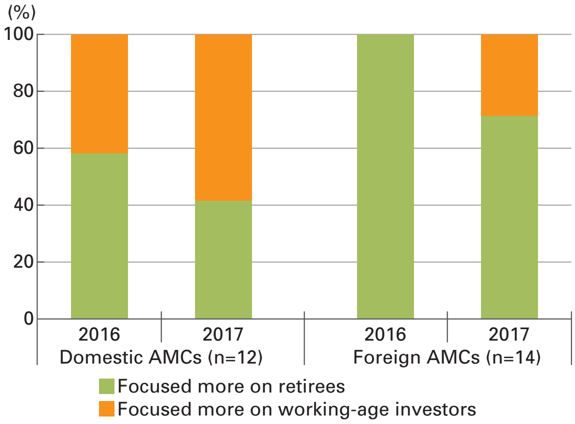
Exhibit 8 plots, by asset class, percentages of survey respondents that revised their asset inflow forecasts upward or downward relative to their previous-year forecasts. Overall, somewhat more respondents revised their forecasts downward than upward. Downward revisions outweighed upward revisions most prominently in the domestic bond, foreign bond and domestic real estate asset classes, likely reflecting these asset classes' recent performance and lofty valuations amid the current interest rate environment as well as the fact that the GPIF finished revamping its foreign bond manager structure in 2015. The top-ranked asset classes in terms of upwardly revised inflow forecasts were foreign equities, emerging market bonds and private equity. In comparison to previous surveys, however, upward revisions did not markedly outweigh downward revisions in these three asset classes. Indeed, these asset classes' forecast revisions were roughly evenly split between up and down. Such a split in opinion is another indication of an absence of major changes in the external environment over the past year[5].

AMCs focusing more on working-age investors in retail investment trust business; foreign AMCs shifting their institutional businesses strategies toward major investors

Our survey inquired about AMCs' priorities in each investor segment. The survey results shed light on how such priorities are changing.

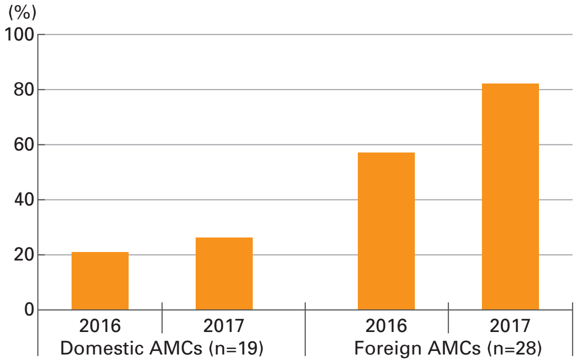
First, Exhibit 9 shows the breakdown of respondents (limited to those that manage public investment trusts) between those that cater more to retirees than to working-age investors in their retail investment trust businesses and those that do the opposite. Public investment trust investors today are mainly retirees but the working-age demographic is expected to emerge as another important retail investor subclass, given the advent and expansion of NISAs, defined-contribution (DC) retirement plans and other such wealth accumulation vehicles for the working-age

Exhibit 9. Breakdown of survey respondents by their prioritization of retirees vs. working-age investors in retail investment trust business



Note: Data samples are limited to AMCs that participated in survey in both 2016 and 2017.
Source: NRI *Survey of Asset Management Companies' Management Priorities*

Exhibit 11. Percentage of survey respondents placing priority on targeting megabanks and other major financial institutions as clients

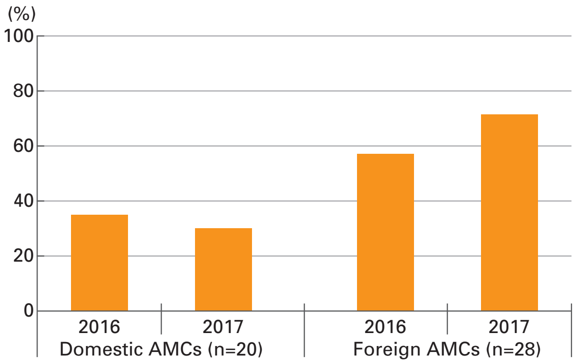


Note: Data samples are limited to AMCs that participated in survey in both 2016 and 2017. The graph plots percentages of respondents that selected "cultivating clients among megabanks and other major financial institutions" as one of their priorities. Respondents were permitted to select up to three priorities from a list of 12 choices.
Source: NRI *Survey of Asset Management Companies' Management Priorities*

population and the wealth that today's elderly will bequeath to younger generations.

According to Exhibit 9, respondents that place priority on targeting working-age investors have increased among both domestic and foreign AMCs in comparison to last year. Many have decided that, for example, the *Tsumitate* NISA (new NISAs with a lower annual contribution limit but longer-term tax exemption than regular NISAs) and DC plan market segments are low-margin businesses because the

Exhibit 10. Percentage of survey respondents placing priority on targeting large clients in the pension business



Note: Data samples are limited to AMCs that participated in survey in both 2016 and 2017. The graph plots percentages of respondents that selected "intensifying sales efforts targeted at large clients" as one of their priorities. Respondents were permitted to select up to three priorities from a list of 12 choices.
Source: NRI *Survey of Asset Management Companies' Management Priorities*

funds offered in NISAs and DC accounts are mostly simple, low-cost ones and asset inflows via such accounts are modest. Nonetheless, a majority of domestic respondents and even a couple of foreign respondents are already targeting working-age investors on a priority basis[6].

In the pension business, the percentage of foreign AMCs focusing primarily on public and other large pension funds increased in the latest survey (Exhibit 10). A similar increase was observed in the financial institution market segment also. That is, more foreign AMCs are focusing predominantly on major financial institutions such as megabanks and life insurers (Exhibit 11). The percentage of respondents reporting that they focus on regional banks and other local financial institutions decreased among both domestic and foreign AMCs. While it is only natural for foreign AMCs to concentrate their sales and marketing efforts on large financial institutions to which they can gain direct access and from which they stand to win sizable mandates, their pursuit of such large financial institutions as clients has intensified.

Getting back on growth path

Despite its growth potential, Japan's asset management industry has recently been showing signs of stagnation, including a downshift in asset inflows. To achieve growth in such an environment, AMCs must figure out how to increase their competitiveness in the face of inexorable qualitative changes in investment flows, including an emerging interest in investing among working-age novices, increasingly sophisticated public pension fund management and regulatory reforms targeted at financial institutions. If AMCs intend to pursue long-term growth, they need not take their existing competitiveness as a given but should instead develop whatever level of competitiveness they require to realize their management vision. The resultant improvement in their customers' investment experience should help AMCs to not only gain new customers themselves but also expand the industry's overall pool of customers.

The visibility that AMCs currently enjoy with respect to impending changes in the external environment affords a good opportunity for them to accurately reassess their environment, rethink their current and future positioning and update their long-term business strategies.

2) This ¥27trn includes an estimated ¥15trn of GPIF and other public pension fund mandates transferred by Mizuho Trust & Banking to Asset Management One plus an estimated ¥12trn of AUM that Mizuho Trust & Banking turned over to Asset Management One.
3) Calculated as trailing-12-month distributions divided by net assets.
4) NRI has conducted this survey annually since FY2007, most recently in September 2017. The 2017 survey's sample of valid responses encompassed 61 AMCs (32 Japanese, 29 foreign) that collectively account for 76% of the Japanese asset management industry's total AUM.
5) See the third chapter's fourth section for information on absolute demand levels on a product-by-product basis.
6) However, such foreign AMCs did not upwardly revise their revenue forecasts for their investment trust businesses. While over 40% of foreign respondents revised their investment trust revenue forecasts upward as shown in Exhibit 7, nearly all that did so are in the subgroup that is placing priority on retirees in Exhibit 9.

CHAPTER 3

Market trends and product strategies by client segment

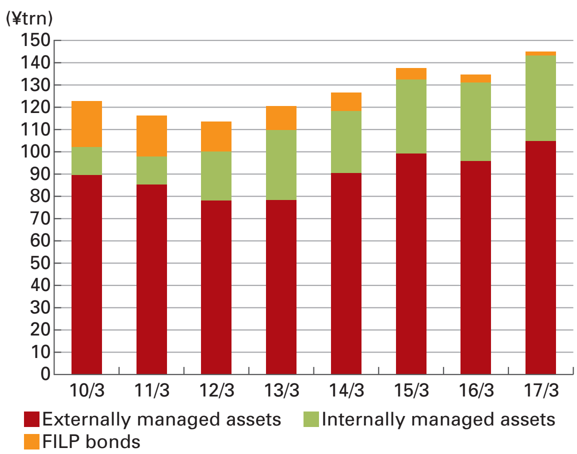
1 Pension business

Pension assets bounce back to level of two years earlier

Japanese pension assets at March 31, 2017, totaled an estimated ¥315trn, up ¥10trn year on year to approximate parity with their level of two years earlier. Of this ¥315trn total, public pension schemes (National Pension, Employees' Pension Insurance and Mutual Aid Associations) accounted for ¥207trn, a ¥12trn year-on-year increase that boosted public pension schemes' share of total pension assets to around 66%. Corporate pension plans and other pension schemes (National Pension Funds and the Small-scale Enterprise Mutual Aid System) accounted for the remaining ¥108trn, a ¥2trn decrease from a year earlier.

Since employee pension benefits were standardized across all public pension schemes about two years ago, the GPIF manages National Pension reserves and the portion of Employees' Pension Insurance reserves earmarked for benefits payable to private-sector employees. Meanwhile, Mutual Aid Associations manage pension reserves for benefits payable to their respective constituencies, including civil servants and private school employees.

Exhibit 12. GPIF's AUM

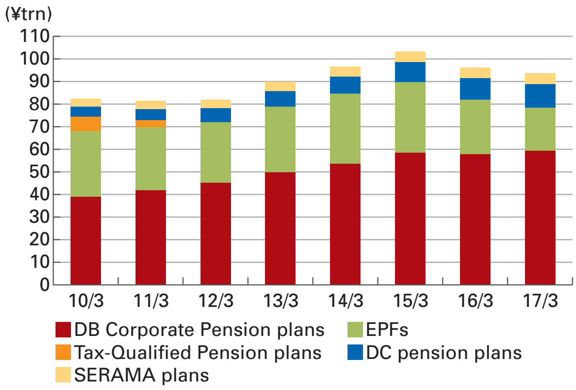


Source: NRI, based on GPIF annual reports

The GPIF's AUM at March 31, 2017, were roughly ¥145trn, a ¥10trn increase from a year earlier (Exhibit 12). Its AUM growth was presumably partly attributable to increased asset inflows from dissolution of EPFs and re-nationalization of the substitutional portion of EPF assets in addition to a +5.9% investment return in FY2016. The GPIF's AUM outsourced to external managers exceeded ¥100trn for the first time ever in FY2016, increasing roughly ¥9trn to ¥105trn at fiscal year-end. Meanwhile, its assets managed in-house continued to grow, ending the fiscal year at ¥38trn, up a modest ¥3trn year on year. The GPIF's actual asset allocation at March 31, 2017, was 33% domestic bonds, 24% domestic equities, 14% foreign bonds, 24% foreign equities and 5% short-term assets, approximately in line with its model portfolio allocations for Employees' Pension Insurance reserves (35% domestic bonds, 25% domestic equities, 15% foreign bonds and 25% foreign equities). Mutual Aid Associations' pension AUM at March 31, 2017, totaled approximately ¥54trn, a ¥1trn year-on-year increase. Reserves for Employees' Pension Insurance benefits accounted for more than half (¥29trn) of this total.

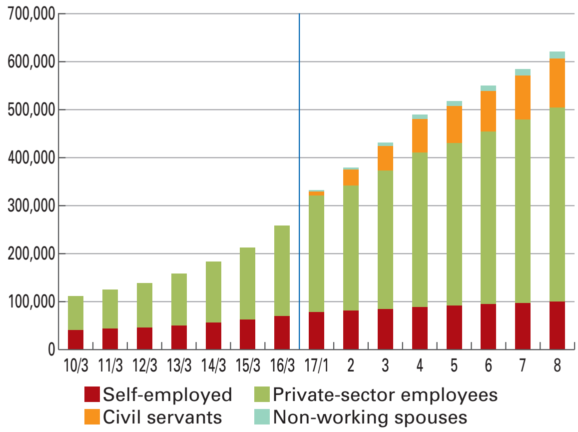
Corporate pension assets at March 31, 2017, totaled

Exhibit 13. Corporate pension assets



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

Exhibit 14. Individual DC (iDeCo) plan enrollment



Source: Ministry of Health, Labor and Welfare and National Pension Fund Association

roughly ¥95trn, a ¥2trn year-on-year decrease (Exhibit 13). Defined-benefit (DB) pension plans' share of this total was ¥79trn, a nearly ¥4trn reduction from a year earlier. Despite presumably positive investment returns, total corporate pension assets continued to decrease for a second straight fiscal year in the wake of continued dissolution of EPFs and re-nationalization of the substitutional portion of EPF assets. In FY2016, 110 EPFs were dissolved and 36 were converted into other types of plans, leaving 110 still in existence at fiscal year-end. The remaining EPFs ended FY2016 with ¥19trn in assets and 1.39mn participants, down ¥5trn and 1.15mn from a year earlier. In the first five months of FY2017, an additional 43 EPFs were dissolved, reducing the remaining EPF population to 67. DB Corporate Pension plans (non-EPF DB plans) ended FY2016 with assets of ¥59trn, a year-on-year increase of barely over ¥1trn. While the number of contractual DB Corporate Pension plans has been decreasing, 86 new fund-type plans were established in FY2016, increasing the total number of DB Corporate Pension plans to 705 as of April 1, 2017.

Corporate DC pension plans ended FY2016 with over 5.9mn members and total assets of ¥10.5trn, a year-on-year increase of nearly ¥1trn. DC plans are growing briskly in both number and enrollment but not fast enough to offset the ongoing decline in DB plans, particularly EPFs. Effective from January 2017, a major DC pension reform expanded iDeCo (individual DC retirement) account eligibility to civil servants, non-working spouses and even employees at companies with corporate pension plans. Nearly everyone under age 60 is now eligible to open an iDeCo account. iDeCo enrollment had previously been growing continuously since the program's inception, but since eligibility was expanded iDeCo enrollment has more than doubled from around 300,000 at December 31, 2016, to 620,000 at August 31, 2017 (Exhibit 14). iDeCo accounts' growing popularity has been fueled by various advertising and promotional campaigns. iDeCo assets at March 31, 2017, totaled ¥1.4trn, a ¥160bn increase from a year earlier. Going forward, however, iDeCo assets' growth curve will likely steepen in the wake of continued contributions by participants and accumulation of investment returns.

2 Securities investment by banks

Banks reduce their investment securities holdings for fourth straight year

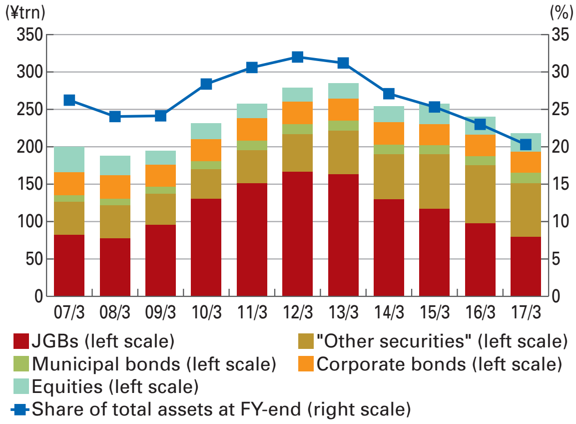
According to Japan Bankers Association (JBA) data, Japanese banks ended FY2016 with investment securities holdings totaling ¥218trn[7)], a ¥23trn decrease from a year earlier. Their investment securities' share of their total assets likewise declined, down 9.4 points to 20%. Banks have reduced their securities holdings for four consecutive years since the BOJ launched quantitative and qualitative easing (QQE) in April 2013. QQE was intended to spur banks to reallocate assets from JGBs to risk assets, particularly loans, but banks subsequently continued to accumulate excess reserves on deposit at the BOJ instead of lending out those funds or investing them in securities in accord with QQE's intent. In response, the BOJ adopted a negative interest rate policy[8] (NIRP) in February 2016, subjecting a portion of banks' excess reserves to negative interest charges of 0.1% per annum once the reserves exceed a certain threshold. Despite this deterrent, banks' deposits receivable have since continued to increase. In FY2016, they grew a whopping ¥36trn to ¥202trn at fiscal year-end. Such growth was attributable to not only city banks but regional banks also. City banks ended FY2016 with deposits receivable of ¥138trn (up ¥22trn year on year); regional banks with ¥31trn (up ¥9trn); second-tier regional banks with ¥6trn (up ¥1.2trn); and trust banks with ¥26trn (up ¥3trn). However, with excess reserves now approaching the threshold at which the BOJ will start charging negative interest, banks are unlikely to keep accumulating excess reserves.

Banks' investment security holdings decreased in FY2016 across all categories of banks. City banks reduced theirs by ¥15trn to ¥102trn; regional banks by ¥3trn to ¥76trn; second-tier regional banks by ¥800bn to ¥16trn; and trust banks by ¥3.7trn to ¥21trn[9].

Banks pare down their JGB and "other securities" holdings

Of banks total investment securities holdings at March 31, 2017 (Exhibit 15), JGBs accounted for ¥80trn, ¥18trn less than a year earlier. This ¥18trn decrease reduced JGBs' share of banks' securities holdings to a 10-year low of 37%. Behind JGBs, the second-biggest reduction was in "other securities[10]" holdings, which decreased ¥5.7trn in FY2016 to ¥71trn at fiscal year-end. In place of the divested JGBs and "other securities," banks increased their municipal bond and

Exhibit 15. Japanese banks' investment securities holdings by asset class



Source: NRI, based on JBA's *Financial Statements of All Banks*

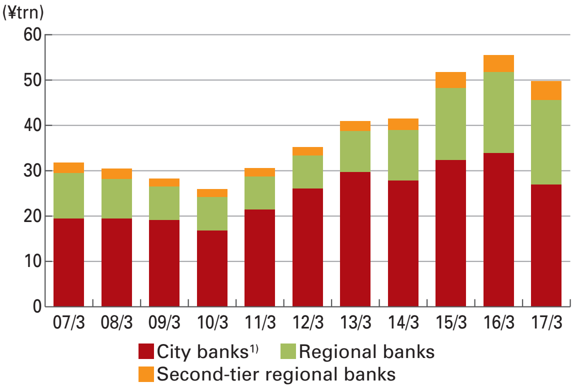
equity holdings in FY2016, the former by ¥1.2trn year to ¥14trn and the latter by ¥900bn to ¥25trn. The growth in municipal bond holdings was the result of not only local financial institutions but even city banks subscribing to municipal bond offerings to capture minuscule yield premia over JGBs. The growth in banks' equity holdings was attributable to the equity market rally in the second half of FY2016.

"Other securities" trading patterns differed among the various types of banks. While city banks reduced their "other securities" holdings by a big ¥6.4trn to ¥35trn in FY2016, regional banks increased theirs by roughly ¥1trn to ¥19trn. Second-tier regional banks followed suit, increasing their "other securities" holdings by some ¥400bn to ¥4trn.

Continued growth in non-foreign "other securities"

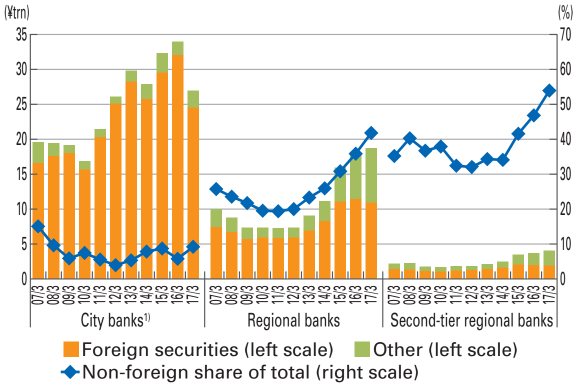
Since the BOJ launched QQE, banks have been diversifying into assets offering higher yields than JGBs do. Such yield seeking led them to purchase "other securities" (e.g., funds, foreign securities). In FY2016, however, banks reduced their "other securities" holdings for the first time in years, as noted above (Exhibit 16). According to the BOJ's *Domestic Bank Assets and Liabilities*, banks held ¥61trn of "other securities" (excluding securities held in foreign branch accounts) at March 31, 2017, having reduced

Exhibit 16. "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 17. Year-to-year changes in "other securities" holdings by bank type



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*

such holdings by a hefty ¥6.8trn during FY2016.

More specifically, they substantially reduced their foreign securities holdings while continuing to increase their holdings of non-foreign "other securities" (e.g., funds[11], hedge funds, structured bonds). Their foreign securities holdings ended FY2016 at ¥46trn, down ¥10trn from a year earlier. This large reduction was the result of banks offloading foreign bonds in response to the backup in US yields in the second half of FY2016. Meanwhile, banks increased their non-foreign "other securities" holdings by ¥3trn to ¥15trn as of FY2016-end. For banks, investment in non-foreign "other securities" has become an important tool for diversifying their securities portfolios and enhancing their earnings.

Non-foreign "other securities" holdings increased across all types of banks (Exhibit 17). City banks reduced their overall "other securities" in FY2016 by ¥7trn to ¥27trn, foreign securities' share of which was ¥24trn, a big year-on-year decrease of ¥7.5trn. Meanwhile, city banks increased their non-foreign "other securities" holdings, albeit by a mere ¥500bn, to ¥2.5trn. Regional banks ended FY2016 with "other securities" holdings of ¥19trn, ¥11trn of which were foreign securities. While regional banks reduced their foreign securities holdings by ¥500bn in FY2016, their non-foreign "other securities" holdings increased by ¥1.5trn for second straight year to end FY2016 at ¥7.8trn. Regional banks have apparently been becoming increasingly active investors in funds and other such products recently. Second-tier regional banks ended FY2016 with ¥4trn of "other securities" holdings, a majority of which were non-foreign. Their foreign securities holdings remained unchanged in FY2016 at ¥1.9trn while their non-foreign "other securities" holdings increased ¥500bn to ¥2.2trn. With few management resources (e.g., staff, investment know-how) allocated to securities investment in comparison to the megabanks, regional banks and second-tier regional banks have been becoming increasingly dependent on investment in non-foreign "other securities" year after year.

According to the BOJ[12], products in which Japanese banks are now investing include equity funds, real estate funds, laddered bond funds (overseas rates products) and structured bonds. Some banks invest exclusively in ETFs to avoid the hassle of complying with look-through requirements, but many banks prefer private funds to better navigate constraints such as capital adequacy regulations (e.g., double-gearing restrictions) and their own investment policies.

Banks' securities investment activity in FY2017

In FY2017, holdings of "other securities," particularly foreign ones, have resumed growing across all categories of banks. Banks are again accumulating foreign securities after ridding their portfolios of unrealized losses on foreign securities positions. For city banks and major regional banks that are active overseas lenders, one key objective of investing in foreign bonds is foreign-currency liquidity management.

Banks' non-foreign "other securities" holdings remained roughly unchanged in size from April 2017 until July, when city banks substantially added to their holdings. They did so partly in pursuit of even modestly higher investment returns amid an increasingly adverse banking environment. Another motivation for increasing investments in products such as equity funds was to hedge growing foreign bond holdings.

One regulatory reform that will affect banks' securities investment programs is a new set of requirements for managing interest rate risk in banking books effective from the end of FY2017. Once this reform takes effect, internationally active banks will have to quantify hypothetical changes in the economic value of their equity and net interest income on a currency-by-currency basis in response to prescribed interest rate shocks scenarios and disclose the resultant amounts together with their regulatory capital. Japanese banks subject to only domestic regulatory standards will also have to comply with the same requirements, albeit from the end of FY2018. In preparation, Japanese banks are already analyzing how the new requirements will affect their interest-rate risk taking and deciding how to adjust their policies accordingly. Japanese banks' securities portfolios have always been sensitive to interest rate risk, given their outsized JGB allocations. The pending regulatory tightening is expected to induce banks to exercise more restraint vis-à-vis interest rate risk. Banks may become more cautious about investing in long-term bonds and/or assets denominated in foreign currencies.

What should banks do to stabilize investment returns?

With banks' loan books growing slowly amid a protracted low interest rate environment, securities investment's importance to banks as an earnings source is unlikely to change much. Banks are therefore likely to continue investing in "other securities," particularly non-foreign ones, to stabilize their overall earnings.

Banks that have stepped up their risk-taking through securities investment are facing pressure from regulators to commensurately upgrade their risk management when investing in high-risk assets[13]. After rapidly diversifying their securities portfolios over the past five years or so, banks now face the imperative of implementing controls tailored to their securities portfolios' risk profiles. At all but the largest banks, risk management has yet to catch up with diversification of securities portfolios' risk profiles in the wake of growth in banks' "other securities" holdings. Risk management deficiencies are a potential source of instability in banks' securities investment returns. In other words, banks lack the expertise to maximize opportunities to profit from securities investment.

One factor cited as a major reason for banks' underdeveloped investment capabilities is inadequate understanding of securities investment risks among banks' top management. Very few C-suite executives at Japanese banks, including major ones, have any asset management experience. In today's chronically low interest rate environment, banks have come to keenly recognize the importance of having a well-balanced mix of earnings from both lending and securities investment instead of prioritizing one over the other. Recruiting outside directors to strengthen securities investment capabilities from the top down should help to stabilize earnings going forward.

Cultivating human resources with expertise in portfolio management is an urgent task for Japanese banks, especially regional banks. Banks should approach this task from a long-term perspective, as such human resource development obviously takes considerable time. In the meantime, banks must devise short-term measures to compensate for human resource deficiencies. For example, they could proactively computerize back-office securities investment functions currently still performed manually or with Excel spreadsheets at many banks. The resultant improvement in efficiency would enable banks to manage bigger portfolios at their existing staffing level and devote more man-hours to high-value-added functions such as investment analysis and valuation.

Another option when in-house expertise in certain portfolio management functions is lacking is to outsource those functions to qualified outsiders. Some regional banks have recently been teaming up to jointly acquire equity stakes in AMCs. While pooling of assets offers the benefit of economies of scale, banks' top management needs to ensure effective governance with respect to outsourced asset management mandates.

Yet another option is for banks to centralize securities investment operations within their respective groups[14]. The latest amendment of the Banking Act allows banks to consolidate common or duplicative operations within a single group. Banks could realize economies of scale and deploy their human resources more efficiently by consolidating their groups' asset management operations into one group company.

A final option is to aggressively recruit outsiders. Operating without sufficient expertise poses risks. It is important for banks to recruit senior executives who are capable of effective governance and fully accountable to top management instead of just hiring more junior staff.

3 Retail business

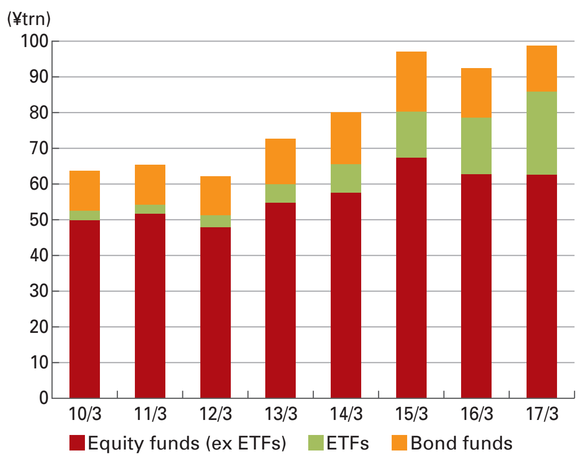
Investment trust market showing signs of inertia

Japanese public investment trust AUM totaled ¥98.8trn at March 31, 2017. Equity investment trusts accounted for ¥85.9trn of this total while bond investment trusts, including money reserve funds, accounted for the remaining ¥12.8trn (Exhibit 18). Equity investment trust AUM at March 31, 2017, was ¥7.4trn (9.4%) higher than a year earlier. With AUM growing nearly 10% in FY2016, the investment trust industry may seem to be thriving but it is actually closer to stagnating.

One reason we make this claim is that most AMCs have not experienced AUM growth anywhere near the reported 9.4% growth rate. Equity investment trust AUM growth in FY2016 was entirely attributable to ETFs, a subcategory of equity investment trusts. While ETF AUM grew ¥7.5trn in FY2016, other equity investment trusts' aggregate AUM shrank by ¥100bn. Moreover, ETFs' rapid AUM growth was driven predominantly by the BOJ's ETF purchases (¥5.6trn in FY2016). All investors other than the BOJ were collectively a net seller of ETFs by a ¥200bn margin. The ETFs traded in Japan are sponsored by a mere handful of AMCs.

Another factor contributing to the investment trust market's sense of stagnation is that optimism about the programs launched in recent years to promote investment has been steadily subsiding. After debuting in 2014, the tax-exempt NISA program has undergone a series of enhancements, including an increase in

Exhibit 18. Public equity investment trust AUM



Source: Japan Investment Trusts Association the annual contribution limit and the launch of Junior NISAs for minors and *Tsumitate* NISAs for those who want to invest in small, frequent installments. Additionally, individual DC (iDeCo) retirement account eligibility was expanded in 2017 to essentially anyone under age 60. While these programs' usership has been steadily growing as expected, it has become quite apparent that the programs will take a long time to have a noticeable impact on the investment trust market's size. Of the 10.77mn NISAs that had been opened as of March 2017, the percentage that actually hold investments is reportedly around 60%. Two-thirds of the ¥3trn annually invested in NISAs to date have flowed into equity investment trusts. Annual NISA investment trust outflows due to redemptions and distributions are estimated at around 20% of AUM. If such outflows' run rate remains largely unchanged, NISA-intermediated investment trust AUM would grow to nearly ¥6trn at year-end 2018 from ¥4.1trn at year-end 2016. From 2019, however, NISAs' aggregate investment trust holdings will likely plateau (disregarding changes in underlying assets' market prices) because NISAs' tax-exempt status is limited to a maximum of five years. NISA-intermediated investment trust AUM are unlikely to grow much going forward unless NISA usership dramatically increases, NISAs' tax-exempt period is extended or asset prices appreciate sharply.

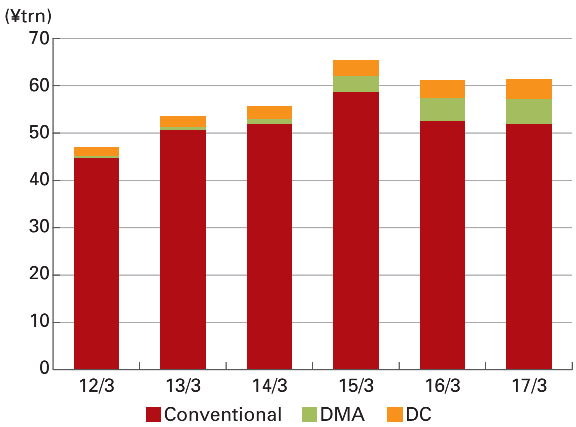
The same is true of DC pension plans. iDeCo account holders look likely to increase by nearly 500,000 in 2017 to reach 700,000-800,000 by year-end. Based on NRI survey data, however, we expect iDeCo enrollment growth to slow to around 100,000 new accounts per year from 2018. If so, total DC plan enrollment, including both iDeCo accounts and corporate DC plans, would be growing by about 500,000 participants annually. Annual DC plan contributions currently total around ¥1trn and are projected to increase some ¥70bn annually for the time being. Of total annual DC plan contributions, 40-45% flow into the investment trust market, implying that cumulative investment trust inflows via DC plans over the next five years would amount to only ¥2.8trn. Neither NISAs nor DC plans have a realistic chance of expanding the investment trust market much over the next few years.

With the overall investment trust market thus drifting toward stagnation, the asset management industry is hankering for a renewed growth scenario.

Internal change afoot in equity investment trust space

While the non-ETF equity investment trust space appears at first blush to be largely unchanged from a year earlier, changes are definitely occurring internally. One such change is ongoing diversification of distribution models. In addition to investment trusts offered through the conventional investment trust sales channel, non-ETF equity investment trusts also include investment trusts offered exclusively within DC pension plans (referred to below as DC investment trusts) and investment trusts offered exclusively through discretionary investment advisers (referred to below as DMA (discretionary managed account) investment trusts). Both DC and DMA investment trust AUM have been steadily growing (Exhibit 19, in which the DC investment trust data are limited to AUM in investment trusts offered exclusively within DC plans). DC investment trusts are currently experiencing net inflows of around ¥500bn annually.

Exhibit 19. Open-end equity investment trust (ex ETF) AUM by distribution channel



Source: NRI, based on Fundmark data

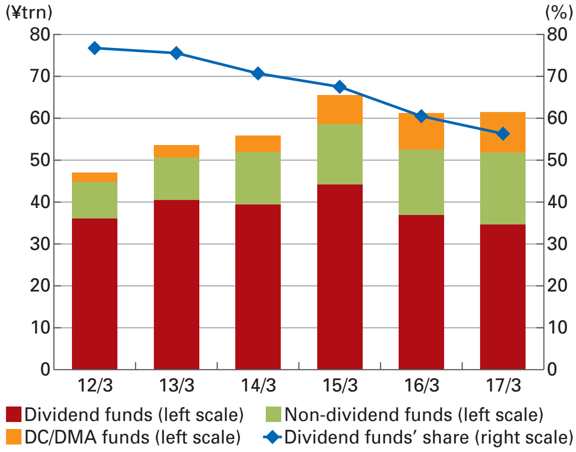
Such inflows are stable in size because a portion of DC plan contributions flow into investment trusts every month.

DMA services available to retail investors predominantly take the form of separately managed accounts (SMAs) or fund wrap accounts. Investment trusts offered in both types of accounts are mostly open-end equity investment trusts customized for such accounts. Although securities brokerages in Japan have been offering DMA services since 2004, the services did not gain much popularity until around FY2014, when DMA investment trusts saw asset inflows in excess of ¥2trn. Such inflows subsequently shrank to ¥350bn in FY2016 but they have resumed growing since April 2017 in the wake of an increase in providers of retail DMA services. As a value-added service related to investment trusts, fund distributors are increasingly focusing on maintaining ongoing contact with their customers after selling them investment trusts. This trend is expected to draw even more financial institutions into the DMA services market. Any such influx of market entrants would likely be accompanied by resumed growth in DMA investment trust inflows.

Dividend fund AUM shrinking

Another change within the investment trust complex is shrinkage in dividend funds' AUM. The decrease in conventional investment trust AUM in recent years shown in Exhibit 19 is primarily attributable to dividend funds (Exhibit 20). Dividend funds are investment trusts that pay out quarterly or more frequent distributions consisting mostly of investment returns. They grew in popularity from the early 2000s, mainly among retirees seeking regular income. Their AUM peaked in March 2015 in the vicinity of ¥45trn, three years after their share of non-ETF open-end equity investment trust AUM had peaked at nearly 80%. Over the two years since March 2015, dividend fund AUM decreased by some ¥10trn. Dividend funds' share of total open-end equity investment trust AUM has dropped almost to

Exhibit 20. Open-end equity investment trust (ex ETF) AUM



Source: NRI, based on Fundmark data

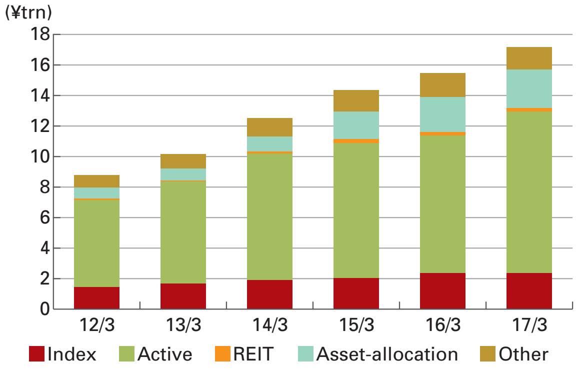
50% as of late. Their annual net inflows (sales minus redemptions) have diminished to a mere ¥500bn from a peak level of over ¥12trn. Meanwhile, their asset outflows due to dividend distributions have not decreased much, slowing to ¥4.7trn in FY2016 from a peak of ¥5.7trn in FY2015. In FY2017, dividend funds' asset outflows may exceed inflows. Their AUM will likely continue shrinking.

Growth in investment trust AUM outside of dividend funds

In contrast to dividend funds, other investment trusts' AUM are growing. Investment trust AUM outside of dividend funds stood at ¥17.3trn as of March 2017 and ¥20trn six months later, up from less than ¥9trn as of March 2012.

Among non-dividend funds, asset allocation funds have experienced the most pronounced AUM growth (Exhibit 21). Over the five years through March 2017, their AUM has increased 250% to ¥2.5trn. Asset allocation funds invest in an assortment of asset classes. They were once one of the hardest types of funds for fund distributors to sell, partly because of the time required to explain all of the asset classes in which they invest to prospective customers. Recently, however, even fund distributors have come to view asset allocation funds as a good vehicle for delivering

Exhibit 21. Non-dividend-fund investment trust AUM by fund type



Note: The graph plots AUM in non-dividend-fund investment trusts excluding ETFs and DMA/DC investment trusts. The "Index" and "Active" categories include only funds that invest in a single conventional asset class (i.e., domestic equity, foreign equity, domestic bond or foreign bond).
Source: NRI, based on Fundmark data

stable investment returns to customers.

Another category of non-dividend funds that has recently experienced rapid AUM growth is index funds outside of the domestic equity asset class. Their aggregate AUM, though only ¥700bn as of March 2017, had tripled over the preceding five years.

Asset allocation funds and index funds are generally regarded as core portfolio building blocks for investors with a medium/long-term investment horizon. As dividend funds' popularity has waned, other types of investment trusts, particularly asset allocation funds and both domestic and foreign equity and bond index funds, have started to gain favor. This shift implies that retail investors' image of investment trusts is gradually changing. Specifically, retail investors now see investment trusts more as a vehicle for medium/long-term wealth accumulation and less as a source of income to cover current expenses.

Investment trust market has substantial potential

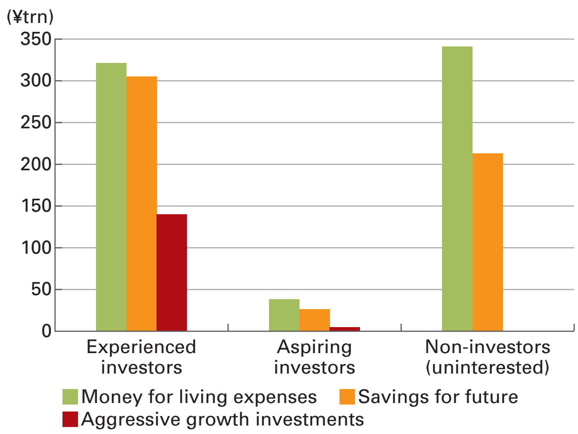
If the image of investment trusts as a vehicle for investing in DC plans, fund wrap accounts or other DMAs or as a core portfolio building block becomes entrenched in retail investors' minds, it could lead to expansion of the investment trust market.

Investment trusts have hitherto been generally regarded as a short-term trading vehicle. Even among experienced investors, investment trusts have a strong image as a speculative product, not a means of saving for the future, as was evident from rankings of best-selling investment trusts a couple of years ago. A 2015 NRI survey of retail investors asked its respondents to classify their financial asset holdings into three buckets: money for near-term living expenses, savings for the future and aggressive growth investments. We then classified the respondents into three categories based on their investment experience (experienced investors, aspiring investors and non-investors with no interest in investing) and estimated how much assets are in each bucket within each of the three experience-based categories (Exhibit 22).

By our estimate, experienced retail investors have some ¥140trn of aggressive growth investments in addition to ¥300trn saved for the future. Retail investors currently hold ¥200trn of investment products split roughly equally between listed equities and investment trusts. These investment holdings presumably correspond to the experienced investors' ¥140trn of aggressive growth investments plus a portion (¥60trn) of their savings for the future.

If investment trusts gain mass recognition as an

Exhibit 22. Household financial assets (excluding pensions and life insurance)



Source: Estimates based on 2015 NRI survey of individuals' investment activity and BOJ *Flow of Funds* data investment vehicle that delivers stable returns over the long term, the image of investment trusts as a product in which to invest money saved for the future should broadly take root. In such an event, a larger share of experienced investors' roughly ¥300trn of savings for the future may flow into the investment trust market. Experienced investors are not the only ones with savings. Aspiring investors and non-investors collectively have some ¥240trn of savings for the future. As investment trusts shed their existing image as a high-risk product, individuals in these other two categories could successively start to build wealth through investment trusts.

Investment trust business is under pressure to evolve

The extent to which investment trusts gain widespread recognition as investment vehicles that deliver stable long-term returns hinges largely on how many financial institutions adopt the approach of recommending portfolios customized to their customers' investment objectives and preferences. Only a tiny minority of the general public possesses enough financial knowledge to construct a balanced, diversified portfolio without professional assistance. If faced with a customer who wants to aggressively invest even in high-risk products in pursuit of high returns, a financial institution should mainly fulfill the role of identifying suitable products and explaining their risk/return profiles to the customer. If a customer is seeking more of a balance between safety and returns, the financial institution should ascertain the customer's risk tolerance and recommend a suitable portfolio. Additionally, as market conditions or customers' life stages change, financial institutions should recommend portfolio adjustments to maintain portfolio suitability.

If financial institutions start offering such services, they would need to change their business models because prevailing business models that rely mainly on sales commissions would give rise to timing mismatches between service delivery and receipt of compensation for that service. Given such mismatches, financial institutions would be unable to properly evaluate their performance internally or ultimately maintain an adequate level of service for customers. Many fund distributors are consequently likely to be forced to switch to an AUM-based fee model. As already mentioned, some fund distributors have started to offer DMA services such as wrap accounts as a channel for providing investment trusts. Those that do charge fees for such services based on customers' account balances. While such services are currently available from only a small minority of brokerages and banks, their availability is expected to continue to expand. Financial institutions should consider AUM-based fee structures even for non-DMA services. In such cases, they could ask AMCs to offer separate share classes to diversify their investment trust fee levels to accommodate fund distributors' fee structures.

Additionally, financial institutions need to seriously rethink their approach to retirees who own dividend funds for income. Like working-age investors, retirees with a long remaining life expectancy need to invest their assets to generate stable returns over the medium to long term. In recent years, the financial services industry has been intent on expanding the investor population, mainly among working-age generations. In Japan, the importance of promoting investment among younger generations goes without saying, but to change investment trusts' image among the working-age population who will become future investment trust customers, the industry must first change investment trusts' image among existing customers, namely retirees. Doing so makes sense business-wise also. Over 70% of the aforementioned experienced investors' ¥300trn of savings earmarked for the future is owned by senior citizens aged 60 and older. Capturing enough demand among retirees to sufficiently scale up a business should be easier than in younger age groups.

Serving retirees requires not only stable and efficient portfolio management but also systematic cash-flow generation. It requires financial institutions to coordinate asset management and customer account management functions, with the former tailoring asset allocations to customer age brackets and the latter facilitating conversion of invested assets into cash. In the US, some mutual fund sponsors offer retirement income funds, but the Japanese investment trust industry does not yet possess sufficient expertise with such funds. However, as the world's most aged society, Japan cannot afford to wait for other countries to set a precedent for it to follow. Japan's investment trust industry must rethink its approach to matters such as division of roles between AMCs and fund distributors and reporting to customers.

4 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 providers (upper left quadrant)) and competitively disadvantaged products (poorly demanded products offered by many providers (lower right quadrant)). Exhibit 23 presents our product opportunity maps for a subset of products.

First, in the retail investor segment, domestic and foreign REITs, last year's top-ranked products on the demand scale, are ranked much lower this year. REITs had been popular by virtue of high dividend yields. Since 2015, however, retail inflows to REITs have downshifted in the wake of a series of dividend cuts by major REITs, leading to the drop in REITs' demand rating. Periodic-dividend funds remain highly ranked on the demand scale, though their ranking has been sliding downward for several years, including 2017.

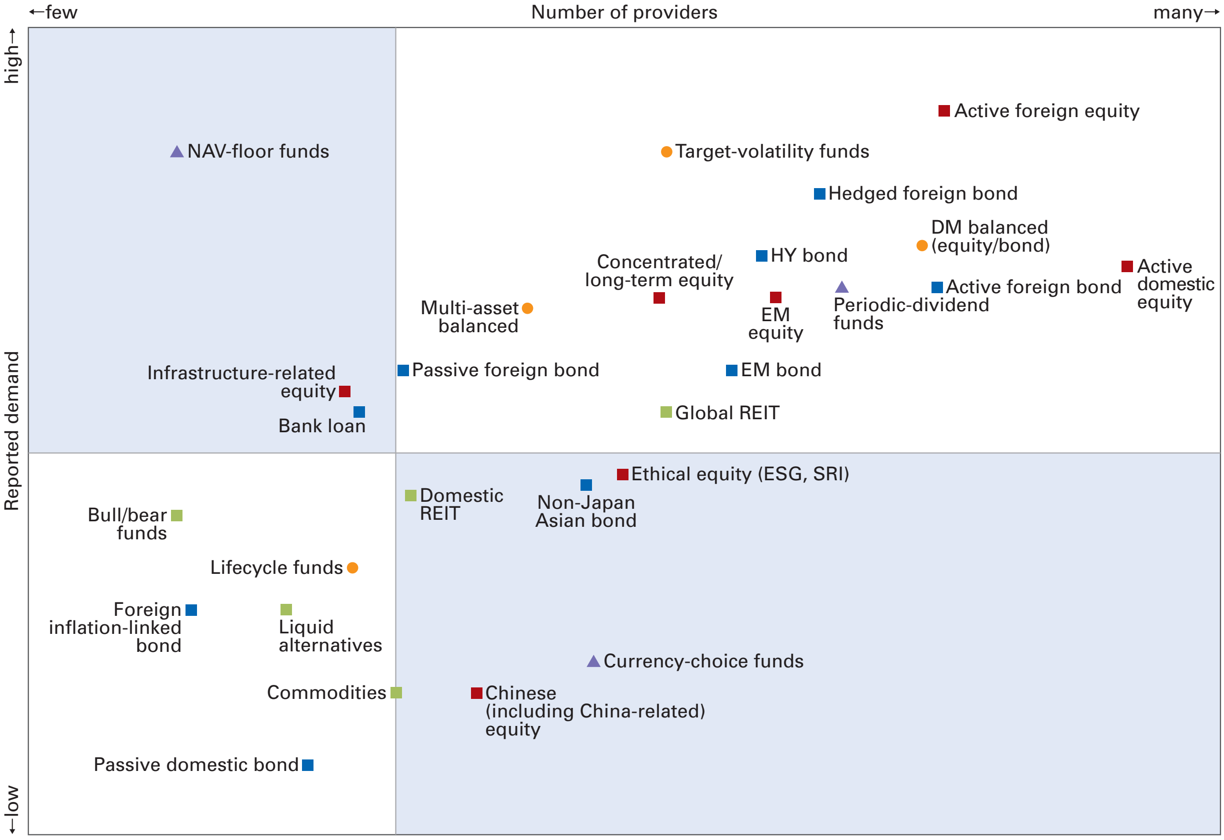
REITs have been supplanted by actively managed foreign equity funds as the top-ranked products on the retail demand scale. The types of foreign equity funds that are attracting the heaviest asset inflows include thematic funds and country/regional funds. One new product offering ranked near the top of the retail demand scale is funds with a redemption floor (i.e., guaranteed minimum NAV at redemption). Such funds are currently offered by only a few AMCs but they are expected to become more widely available. Retail demand for broadly defined balanced funds, including multi-asset balanced funds and target-volatility funds in addition to redemption-floor funds, is generally strong. Other asset classes enjoying strong retail demand include high-yield bonds and emerging market (EM) equities, both of which have performed well in recent years. Many AMCs apparently sense a general shift in demand from dividend-focused funds to funds that pursue capital appreciation.

The pension and financial institution segments have much in common on the demand side, reflecting that the domestic interest rate environment constitutes a stiff headwind for both pension funds and financial institutions. With domestic bond yields suppressed to microscopic levels, foreign fixed-income products remain in strong demand among pension funds and financial institutions as a source of yield pickup and diversifier of yen interest rate risk. Other products that remain in strong demand include multi-asset and illiquid investment strategies, the latter of which include private equity, private debt and domestic and foreign private real estate funds (including REITs).

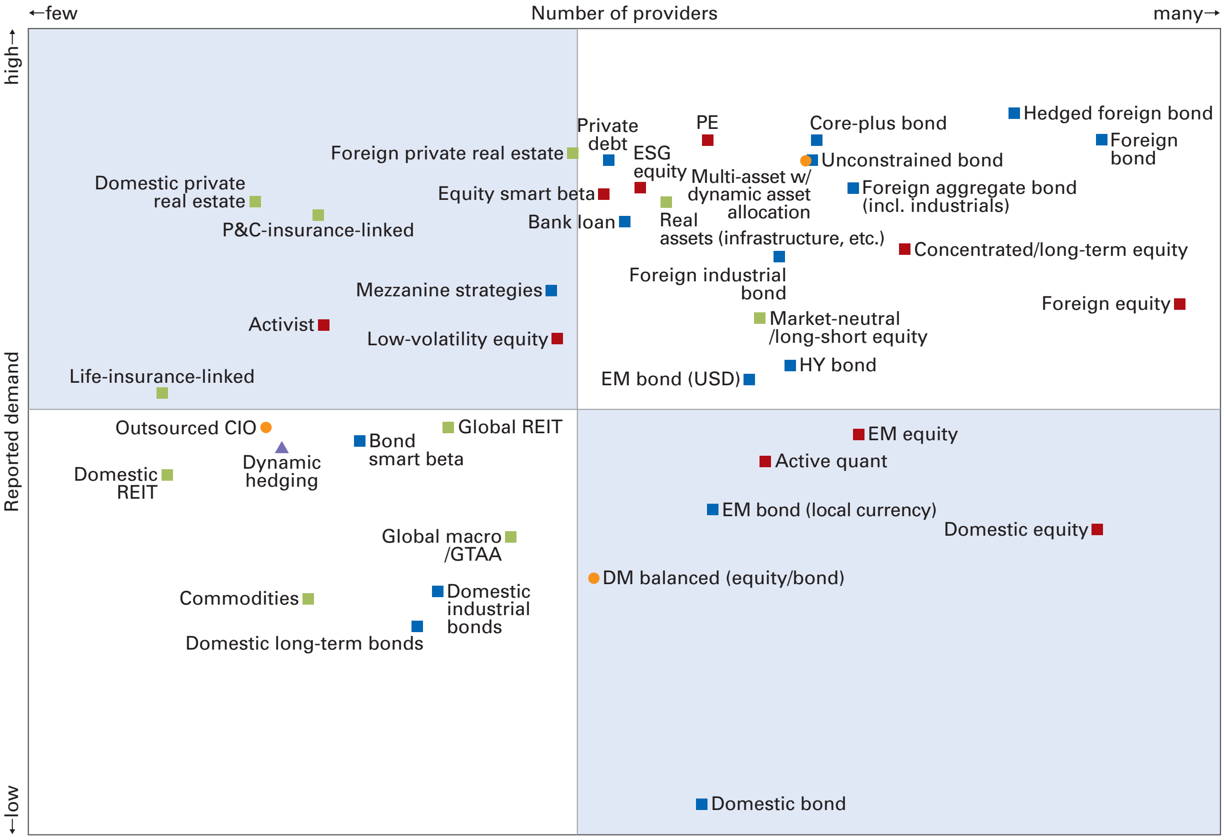
One difference between pension funds and financial institutions is that the latter's investment needs have a strong bias toward fixed-income products while pension fund demand encompasses a more diverse range of products, including ESG investments and securities linked to property and casualty (P&C) insurance. In 2017, the GPIF began passively investing

Exhibit 23. Product supply and demand maps by client segment

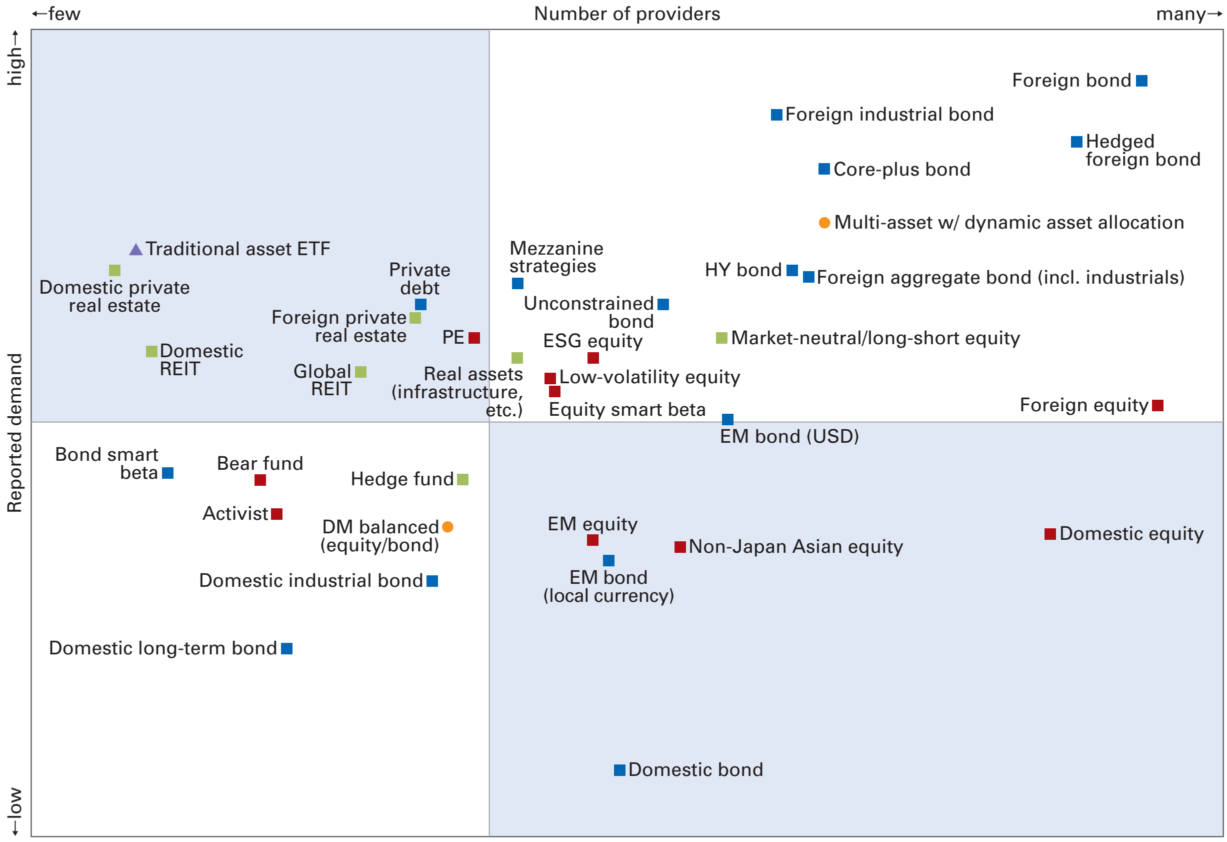
(a) Products for retail investors



(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*

in Japanese equity indices whose constituents are selected based partly on ESG assessments. The possibility of other public pension funds following suit may account for ESG products' high ranking on the demand scale. Strategies that invest in securities linked to P&C insurance are offered by AMCs affiliated with nonlife insurers. Together with real estate, such strategies have become a popular alternative investment among corporate pension funds.

The emergence of retail demand for long-term wealth accumulation products and institutional portfolios' progressive diversification are inexorable trends, not transient fads. AMCs' long-term growth prospects hinge largely on how well AMCs can align themselves with such long-term trends while building solid operational foundations that enable them to capitalize on their respective strengths.

7) JBA data includes overseas branch accounts.
8) As the name implies, NIRP is a central bank policy of setting a nominal policy rate below 0%.
9) The JBA total differs from the sum of the city bank, regional bank, second-tier regional bank and trust bank subtotals because it includes Shinsei Bank and Aozora Bank's securities holdings also.
10) "Other securities" are foreign securities and domestic securities other than JGBs, corporate bonds, municipal bonds and equities.
11) Fund holdings reported by banks. Some financial institutions report fund holdings as the funds' underlying assets based on look-through information.
12) BOJ, *Financial System Report (April 2017)*.
13) The FSA's *Strategic Directions and Priorities 2016-17*, published in October 2016, state that the FSA plans to monitor financial institutions' investment portfolios to ensure that Japanese financial institutions avoid concentrated exposures to specific asset classes/risks in light of the possibility of them making high-risk investments to boost their earnings in a low interest rate environment. The BOJ's *On-Site Examination Policy for Fiscal 2017* states that BOJ examiners will scrutinize whether financial institutions (1) appropriately identify and analyze their securities holdings and overall portfolios' risks by risk factor, (2) ensure that their risk management staff monitors market prices, risk exposures and compliance with risk limits with sufficient granularity as warranted by risk profiles and investment methods and (3) periodically review risk-measurement methods' adequacy and limitations through, e.g., backtesting, adjust those methods as necessary and stress-test their risk management frameworks.
14) A 2017 Banking Act amendment permits banks to centralize common and duplicative functions within a single group.

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