NRI

Japan's Asset Management Business 2020/2021

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Nomura Research Institute

Foreword

The Japanese asset management industry has grown since the BOJ embarked on ultra-accommodative monetary policy in response to former prime minister Abe's call for bold monetary easing to vanquish deflation. Its operating profits have nearly tripled by virtue of asset inflows coupled with sustained asset price appreciation. Of the investor segments the industry serves, the one that has contributed least to its AUM growth of recent years is retail investors. While pension funds, banks and other institutional investors have been divesting JGBs and reinvesting the proceeds with asset management companies, households have not shifted much of their assets out of savings deposits into investment trusts or other investment products. However, the Japanese public's saving habits are showing signs of change, with more and more people starting to invest in risk markets in regular installments. The notion of securities investment as a means of long-term wealth-building is becoming mainstream. Retail investors are beyond any doubt the market segment with the most long-term growth potential.

In June 2020, Japan's FSA published a progress report on building a better asset management industry. The report asserted that asset management companies must win customers' trust and loyalty by delivering good investment returns over the medium/long term. It candidly admitted that Japanese investment trusts have a history of subpar returns beyond the short term. Japanese investment trusts have indeed focused primarily on short-term returns. Asset management companies will not be able to shift to a longer-term focus without reforming their relationships with the fund distributors that sell their products to investors. As the FSA noted, the only thing asset management companies can do on their own is to change how they themselves operate and such change is merely one prerequisite to gaining customers' loyalty and trust. That said, preserving the status quo is no longer an option. Customer needs are already migrating to medium/long-term investment horizons.

A 1956 economic whitepaper published by the erstwhile Economic Planning Agency famously declared that the era of reaping the low-hanging fruit of economic growth driven by postwar reconstruction was over. It stressed that the economy needed to be modernized and the process would entail pain. The ensuing industrial restructuring proved successful, setting the stage for the Japanese economy's dramatic growth over subsequent decades. The asset management industry today stands at an analogous crossroads. To solidify its foundations for the future, it urgently needs to reform how it does business even in the face of strong resistance.

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CHAPTER 1

Japanese investor trends

Asset management industry's AUM remains in growth trend

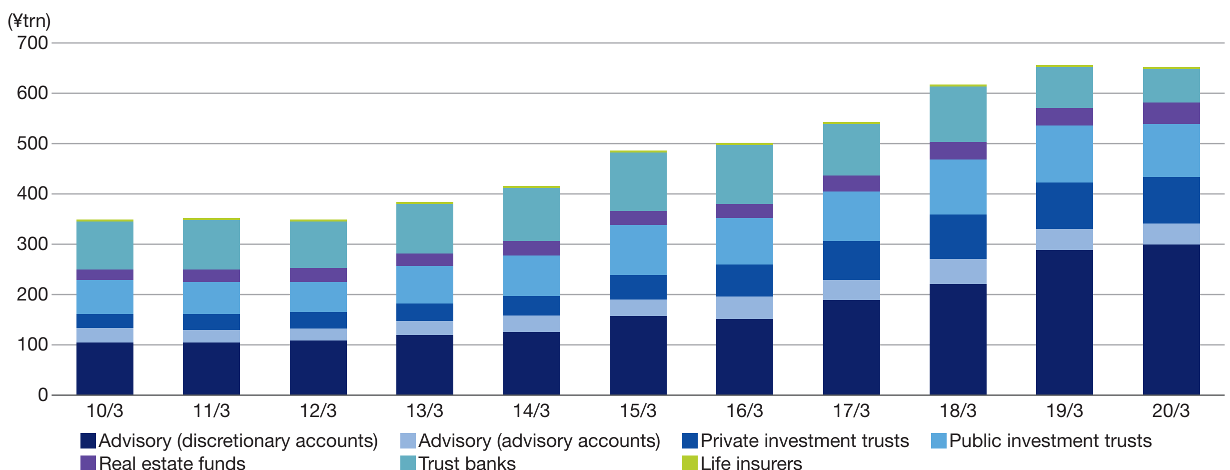
Japanese asset management companies (AMCs) collectively ended FY2019 with estimated AUM of ¥651trn[1)], a ¥3trn decrease from a year earlier (Exhibit 1). Prior to FY2019, AMCs' AUM had grown uninterruptedly for seven straight fiscal years, increasing a cumulative 90% from their post-GFC trough at FY2011-end. Their FY2019 decrease was largely attributable to asset price declines in February-March 2020 in response to the COVID-19 pandemic. The setback proved to be brief, with AMCs' AUM bouncing back to the vicinity of ¥700trn by mid-2020 to keep their long-term growth trend intact.

The AUM subtotal managed in discretionary investment advisory accounts has grown particularly rapidly in recent years. It increased by over ¥10trn to just shy of ¥300trn in FY2019 and by a cumulative 180% over the eight years through March 2020. However, this growth partly reflects reshuffling of pre-existing AUM to affiliated AMCs within banking and insurance groups. Private investment trust AUM also have grown markedly, increasing by ¥2trn in FY2019 and more than tripling over the eight years through March 2020. Trust banks and public investment trusts, by contrast, saw their AUM shrink materially in FY2019. In trust banks' case, the shrinkage was due to the aforementioned intragroup reshuffling of AUM. Public investment trusts, however, lost AUM in non-ETF investment trusts.

End-investor AUM down for second straight year

The AUM data plotted in Exhibit 1 are significantly inflated by double-counting of certain assets. For example, a private investment trust's inflows via a public fund of funds (FoF) are counted as an increase

Exhibit 1. AMCs' AUM



Note: Life insurers' AUM are DB pension asset mandates.
Source: NRI, based largely on Japan Investment Trust Association (JITA) and Japan Investment Advisers Association (JIAA) data and AMCs' business reports

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in AUM for both the private investment trust and FoF. Other examples of such double-counting include corporate pension assets invested in private funds for tax-exempt qualified institutional investors under a discretionary investment advisory agreement and pension assets discretionarily managed by an affiliated asset advisory firm or invested in a private investment trust under a pension trust agreement. AMCs typically earn lower fees on such nested AUM because investors are generally not willing to pay higher total asset management fees just because their assets are invested in products that involve multiple layers of managers. AUM counted from the end-investor's standpoint therefore present a more accurate picture of AMCs' aggregate revenue base.

AUM counted from the end-investor's standpoint[2)] grew a cumulative 60% over the six years through March 2018 (Exhibit 2), a smaller increase than that of AMCs' aggregate AUM over the same timeframe (Exhibit 1). Their growth over these six years was largely attributable to increases of over ¥50trn apiece in assets managed on behalf of public pension funds and banks (depository financial institutions). Assets managed on behalf of overseas investors and central banks also increased substantially. Retail investors' professionally managed assets increased by ¥15trn, a modest increment relative to other investor categories.

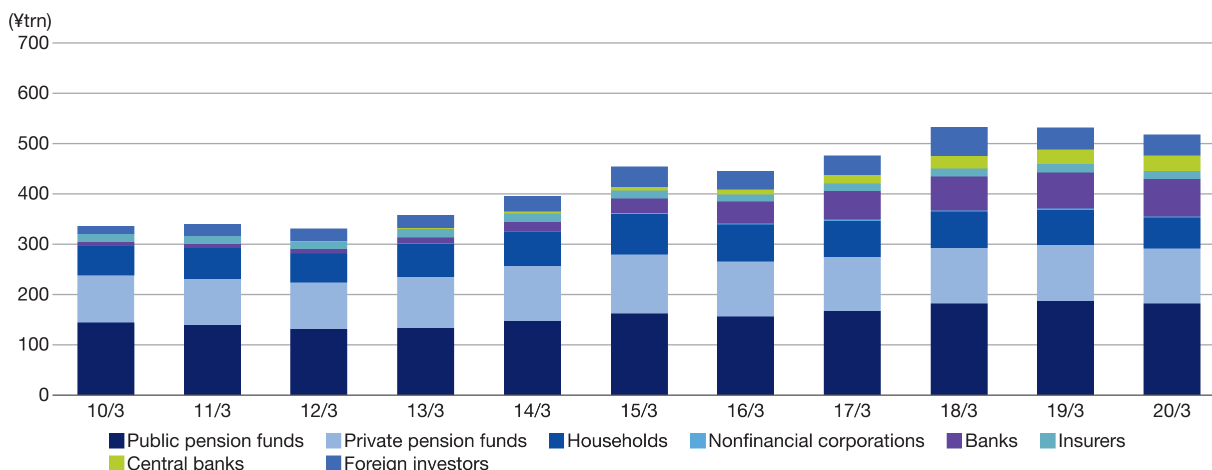
More recently, AUM counted from an end-investor standpoint decreased in FY2018-19. While externally managed bank and central bank assets continued to grow in FY2018-19, pension assets leveled off and assets managed on behalf of households and overseas investors decreased by more than ¥10trn. The asset management industry's fee pool has consequently not grown as much as its AUM and has even shrunk a bit since FY2018.

Pension funds, banks and households

Public pension funds have been increasingly outsourcing management of assets to AMCs in response to changes in their policy portfolios' asset allocations and re-nationalization of the substitutional portion of Employee Pension Funds' assets and liabilities. These two drivers have now run their course, likely setting the stage for slower growth public pension funds' externally managed assets going forward.

In the private pension space, conditions are becoming increasingly conducive to growth in AUM in corporate defined contribution (DC) plans. At companies with both DC and defined benefit (DB) plans, DC plan contributions are currently capped at a uniform ¥27,500/month, but this limit is slated to become variable as a function of DB plan

Exhibit 2. **Investor assets managed by AMCs**



Note: Public pension fund assets exclude internally managed assets.
Source: NRI, based largely on JITA, JIAA and BOJ data and AMCs' business reports

contribution amounts (i.e., DC plan contributions would be limited to ¥55,000/month less the amount of any DB plan contribution). If the limit is adjusted as planned, DC plan contribution limits would increase at most companies with both DC and DB plans, in which case corporate DC plan assets' growth rate should accelerate. Faster growth in DC plan assets, however, would presumably be accompanied by commensurately slower growth in DB plan assets. We doubt overall corporate pension assets will grow much beyond their current level. An increase in the contribution limit for individual DC (iDeCo) plans, a type of non-corporate private retirement plan, is also planned. Additionally, eligibility for iDeCo plans is slated to be expanded to individuals enrolled in a corporate DC plan. iDeCo plan assets are consequently certain to grow, but at a slow pace reflecting that iDeCo plans are basically funded solely by participants' monthly contributions.

Among banks, regional banks may increasingly outsource asset management to discretionary managers and utilize investment advisory services at the behest of regulatory authorities. The authorities are prodding regional banks with subpar portfolio or risk management capabilities to make use of external asset managers' expertise.

Households entrust assets to professional managers mainly by buying public investment trusts or opening fund wrap accounts. With securities investment's public image improving as discussed below, households' professionally managed assets will definitely grow over the long term. Over the next 5-6 years, however, the extent to which more favorable public sentiment toward securities investment drives AUM growth remains to be seen. Households have recently been increasing their collective asset allocation to passive funds. This trend seems virtually certain to continue regardless of how much growth in the professionally managed share of household assets accelerates going forward. However, households' growing preference for passive management does not necessarily mean that active funds in aggregate will shrink. Depending on how fund distributors respond, high-quality active funds may regain favor in the retail market.

1) Trusts and life insurers' share of this total includes only assets managed on behalf of pension fund clients. Life insurers' share includes only special-account balances, not general-account assets with guaranteed returns (e.g., fixed-amount insurance, fixed annuities). The total is not adjusted to correct for double-counting due to, e.g., public investment trusts' ownership of private funds or investment trusts' partial outsourcing of asset management to subadvisors.

2) These AUM are counted from the standpoint of the end-investor (the party that primarily bears the risk of changes in asset values). For example, if a public investment trust invests in a private investment trust, the public investment trust would be the private investment trust's investor but the risk of changes in the private investment trust's NAV would be borne by the public investment trust's investors. The public investment trust's holdings in the private investment trust would therefore not be counted as public investment trust AUM in Exhibit 2.

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CHAPTER 2

Current state of asset management business

1 Current state of asset management business

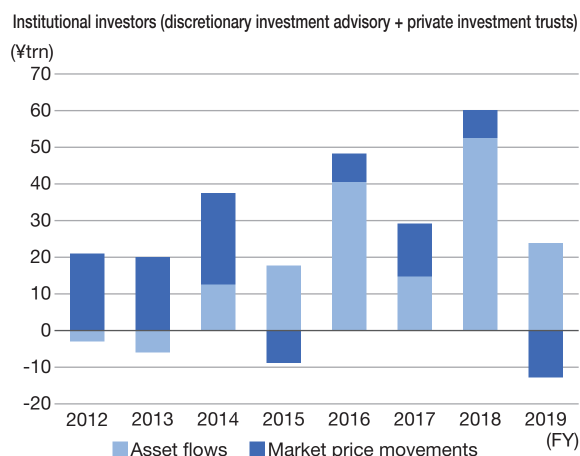
Using various data, including proprietary surveys, this chapter looks at how AMCs, defined as firms specializing in investment trust management and/or investment advisory services, are faring in their businesses.

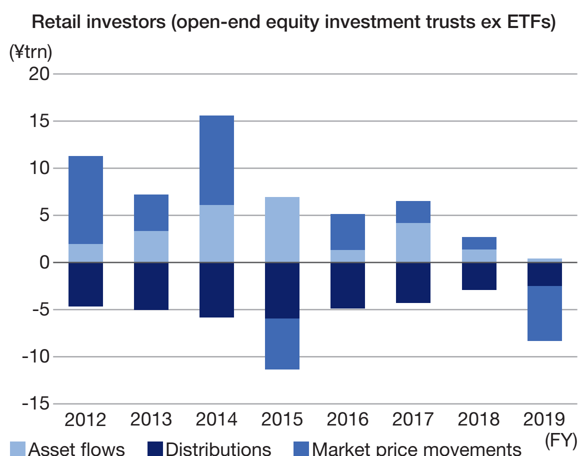
Continued margin compression

Exhibit 3 plots annual changes in AMCs' AUM disaggregated by causative factor. First, in the institutional market segment (left graph: total of discretionary investment advisory AUM and private investment trust AUM), asset price movements detracted from AMCs' AUM in FY2019 by ¥12.7trn, the biggest such decrement since FY2010. The AUM erosion was due to a pandemic-induced plunge in asset prices in the fiscal fourth quarter. Meanwhile, net inflows of new assets boosted AMCs' AUM by hefty ¥23.8trn. However, ¥16.4trn of the ¥23.8trn was attributable to intragroup reshuffling of AUM. Adjusted to factor out the reshuffled AUM, net inflows were ¥7.4trn. Net inflows ex reshuffled AUM plummeted from ¥14.8trn in FY2017 to ¥2.5trn in FY2018 before rebounding to ¥7.4trn in FY2019 (the portion of net inflows due to intragroup AUM reshuffling was ¥50trn in FY2018).

Discretionary investment advisory accounts' share of total FY2019 net inflows was ¥18trn or ¥1.6trn when adjusted to factor out reshuffled AUM (¥16.4trn). Excluding the reshuffled AUM, discretionary investment advisory accounts' asset flows flipped from a net outflow in FY2018 to a small net inflow in FY2019. Private investment trusts have seen rapid growth in net inflows in recent years. Their FY2019 net inflows totaled ¥5.6trn, a modest increase from FY2018's ¥3.6trn, which was down sharply from ¥11trn in FY2017. The downshift in net inflows since FY2017 reflects financial regulators' concerns that financial

Exhibit 3. **Changes in AUM disaggregated by causative factor**





Source: NRI, based largely on JITA, JIAA and NRI Fundmark data

institutions, the main investors in private investment trusts, are not upgrading their risk management fast enough to keep abreast of growth in their risk asset holdings. Amid the prevailing low-rate environment, however, private investment trusts remain in demand among financial institutions as a repository for proceeds from maturing JGB holdings. Despite the pullback in asset prices triggered by the pandemic, financial institutions' private investment trusts holdings surpassed ¥100trn by four months later.

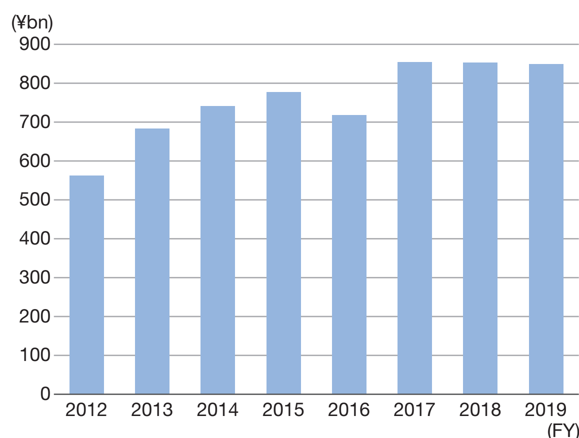
In the retail investor segment (right graph: open-end public equity investment trust (ex ETF) AUM), asset price movements detracted from AUM by a sizable ¥5.8trn, likewise as a consequence of the pandemic. Net inflows added ¥800bn to AUM in the fourth quarter but only ¥400bn on a full-year basis. After dividend distributions, which totaled ¥2.5trn, retail investment trusts experienced a fourth consecutive annual net outflow in FY2019. Together, the net outflow and price impact reduced open-end public equity investment trust AUM (net assets) by ¥8trn in FY2019.

Based on data available at the time of this writing, we estimate the asset management industry's aggregate FY2019 management fee revenues at ¥849.8bn, nearly unchanged from their all-time record FY2017 level for a second straight year (Exhibit 4).

Exhibit 5 plots operating margins of domestic AMCs that manage public investment trusts (likewise based on data available at the time of this writing). The aggregate operating margin of the AMCs in our survey sample was down for a second straight year at 28.8% in FY2019.

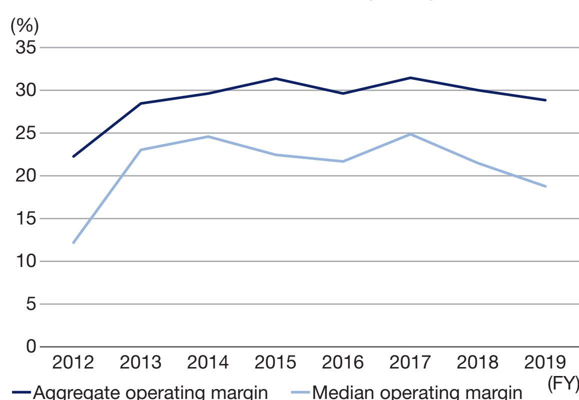
The margin compression was mainly attributable to growth in payroll expenses coupled with a slight reduction in revenues due largely to AUM migration to passive funds. The increase in payroll expenses presumably reflects a recent trend toward consolidation of financial groups' asset management staff in their asset management subsidiaries.

Exhibit 4. **AMCs' aggregate management fee revenues**



Source: NRI, based on JITA and JIAA data

Exhibit 5. **AMCs' operating margins**



Note: Graph plots operating margin data for domestic public investment trust sponsors (number of AMCs in data sample varies by fiscal year). Aggregate operating margin is aggregate operating profits of the AMCs in the sample divided by their aggregate net operating revenues.
Source: NRI, based on JITA data

2 Outlook for asset management business

At NRI, we annually survey AMCs' management (*NRI Survey of Asset Management Companies' Management Priorities*[3]) 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 as revealed by survey responses.

Mounting growth expectations vis-à-vis retail segment

First, in terms of AMCs' overall revenue outlook,

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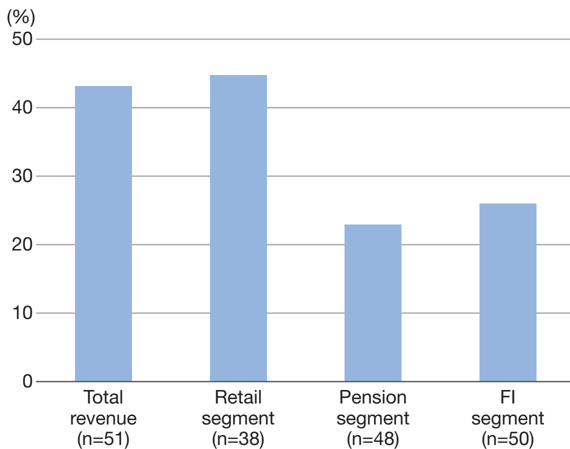
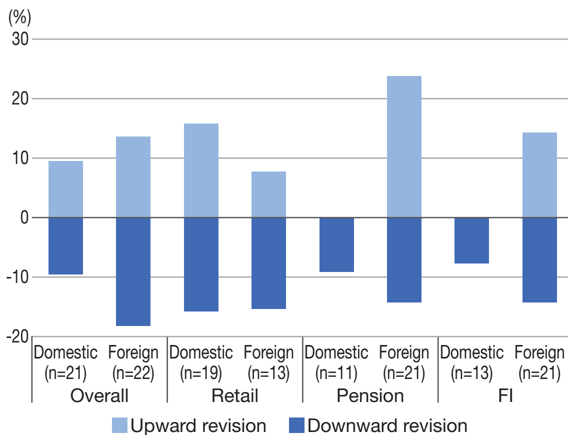
Exhibit 6. **Percentage of survey respondents forecasting revenue growth of at least 50% over next five years**



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 from previous year (overall and by business segment)**

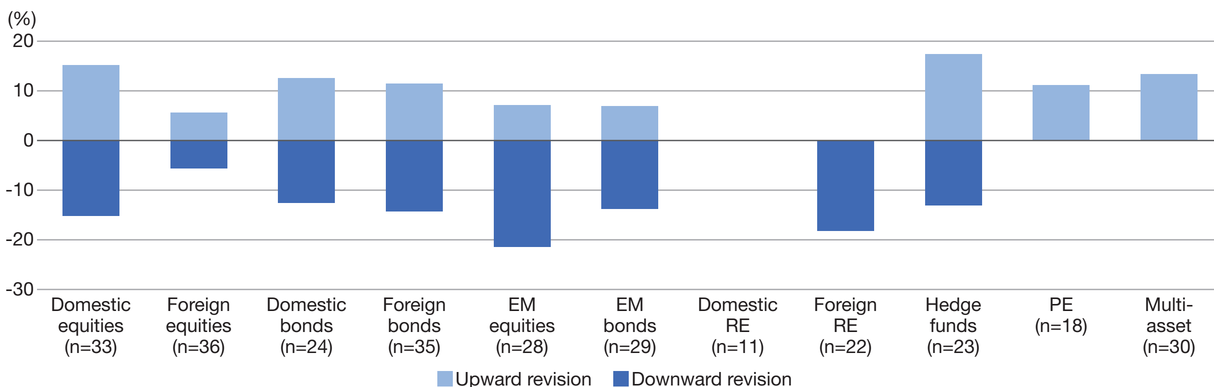


Note: Data samples are limited to AMCs that participated in survey in both 2019 and 2020. FI: financial institution segment.
Source: NRI *Survey of Asset Management Companies' Management Priorities*

Exhibit 6 plots the percentages of survey respondents forecasting cumulative revenue growth of at least 50% over the next five years on a company-wide basis and by business line (investor segment). For a third year in a row, some 40% of the respondents expect their total revenues to grow at least 50% over the next five years. Like in FY2018, the investor segment in which the most respondents are forecasting five-year revenue growth of at least 50% is the retail segment, followed in descending order by the financial institution and pension segments. In our FY2016-17 surveys, the financial institution segment was the favorite in terms of revenue growth prospects. In our latest survey, the percentage of respondents forecasting five-year revenue growth of at least 50% increased slightly in the retail sector while decreasing slightly in the other two segments, widening the growth expectations gap between the retail and other segments relative to FY2018.

Exhibit 7 compares revenue forecasts between our latest and previous surveys by plotting percentages of upwardly and downwardly revised revenue forecasts among respondents that participated in both years' surveys. In our latest survey, many respondents left their revenue forecasts unchanged on both a company-wide and segment-by-segment basis. In contrast to FY2018, when many companies lowered their forecasts for the financial institution segment, revenue outlooks were more static in the latest survey.

Exhibit 8. **Percentage of survey respondents that revised their asset in/outflow forecasts from previous year (by asset class)**



Note: Data samples are limited to AMCs that participated in survey in both 2019 and 2020. Numbers in parentheses are subsample sizes.
Source: NRI *Survey of Asset Management Companies' Management Priorities*

Exhibit 8 plots, by asset class, the percentages of survey respondents that raised or lowered their asset inflow forecasts from FY2018. Here as well, many respondents left their forecasts unchanged. One point that stands out is an absence of downward revisions to forecasts for private equity and multi-asset products, implying that sentiment toward these asset classes is universally upbeat. Multi-asset strategies that tactically adjust allocations in response to market conditions are now seen as more promising products than in FY2018.

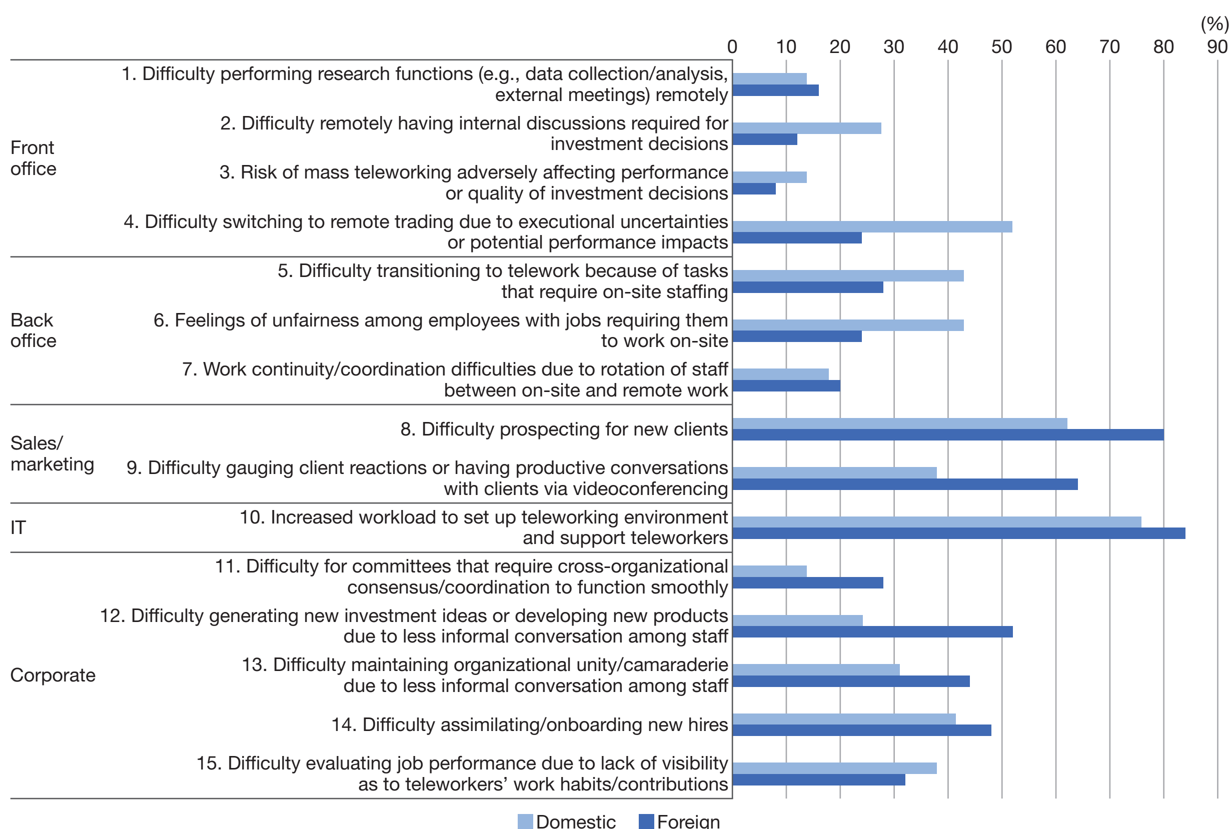
3 Operational challenges amid pandemic

Japanese AMCs are confronting various challenges as they navigate the pandemic and formulate post-pandemic growth strategies. Our survey results offer insight into what they perceive to be the biggest challenges facing them. Exhibit 9 shows the extent to which the respondents see various issues as problems across five functions: front office, back office, sales/marketing, IT and corporate.

The areas with the strongest consensus were IT and sales/marketing. Some 80% of respondents reported that increased workloads for IT staff are a concern. Even after teleworking environments had been set up in response to the pandemic and teleworkers' technical support needs had subsided, IT staff still have long to-do lists that include automating business processes and going paperless. To swiftly deal with IT workloads likely to continue growing, AMCs may need to hire more staff or experiment with outsourcing.

In sales/marketing, lead generation in particular is widely seen as a challenge. In the changed business environment wrought by the pandemic, remote sales interactions have become the norm. This new normal has not posed major problems in terms of serving customers with which AMCs have pre-existing relationships, but AMCs are encountering difficulties

Exhibit 9. Operational challenges encountered during pandemic



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

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in building relationships of trust with new customers through exclusively online contacts. Instead of relying solely on "push" sales strategies, adopting "pull" strategies like beefing up online content to expand points of contact with prospective customers may be the key to acquiring new customers going forward.

In terms of corporate functions, many AMCs, particularly foreign ones, reported difficulty generating new investment ideas and developing new products because of internal communication deficiencies. Such difficulties pose a threat to the added value that accrues from differentiation from competitors. More than a few respondents expressed the view that in-person communication is essential to creative endeavors, like business development and planning, in any industry, not only asset management. AMCs should first try to promote better online communication. If such efforts fail to pay off, AMCs may have to orchestrate opportunities for in-person communication after the pandemic has died down. Another challenge cited by many respondents is integrating new hires into their respective teams and getting them up to speed on company culture and job-specific knowledge. This challenge can be addressed through such means as promoting online communication among colleagues and developing off-the-job educational programs. To address challenges posed by HR performance evaluations in a teleworking environment, AMCs may need to clarify/granularize job descriptions and establish or update KPIs and other evaluation criteria.

In the front office, many mostly Japanese respondents feel that trading operations are not conducive to teleworking. Traders' telework rate is in fact low according to the survey's quantitative data. Although trading can be done remotely, many traders presumably prefer to work at their office from the standpoint of efficiency and reliability. Some respondents reported that they are considering splitting trading staff between their office and a disaster recovery site. Outsourcing is another option but we doubt many AMCs would immediately resort to it, considering that trading is a source of added value and that AMCs benefit from maintaining relationships with brokers. Among other front office functions, few respondents reported difficulties with portfolio management and research, telework rates for both of which are high. AMCs are seemingly confident that any adverse effects of teleworking on investment decisions or investment performance can be mitigated by establishing processes, delineating roles and instilling the firm's investment philosophy in all front-office personnel.

Urgent back-office challenges include key-man risk with respect to certain business processes and the continued existence of paper-dependent processes. Potential solutions to such challenges include automation, migration to paperless operations and use of outsourcing.

Now is the time for AMCs to figure out how to adapt their businesses to the impending post-pandemic new normal. AMCs are unlikely to be forced to rethink their approach to their core function of portfolio management revolving around investment decision-making. Company cultures and investment philosophies cultivated in in-person settings, however, may be hard to perpetuate in a teleworking environment, though not many AMCs seem to realize it yet. AMCs' management should perhaps acknowledge the risk of drifting away from customer-centric business practices as a result of their company culture or investment philosophy becoming diluted over time. New ways to strengthen employee engagement will be essential in the post-pandemic new normal.

3) NRI has conducted this survey annually since FY2007, most recently in August-September 2020. The 2020 survey yielded valid responses from 55 AMCs (28 Japanese, 27 foreign) that collectively account for 73% of the Japanese asset management industry's total AUM.

CHAPTER 3

Market trends and product strategies by client segment

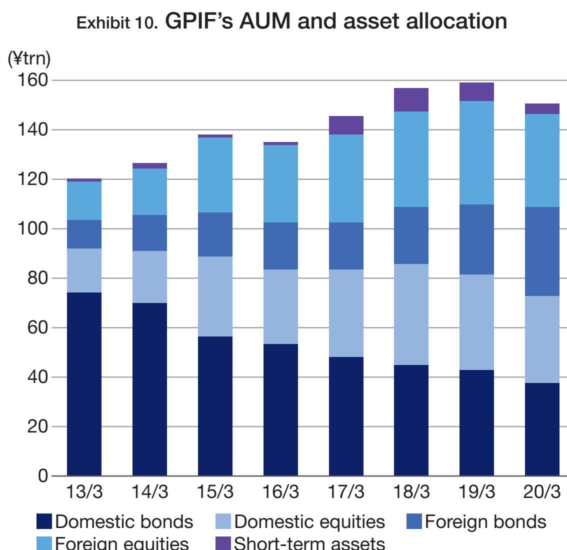
1 Pension business

Pension funds increasingly investing in alternatives

Japanese pension assets at March 31, 2020, totaled an estimated ¥311trn, a ¥14.1trn year-on-year decrease that snapped a three-year growth streak. The decrease was largely due to asset prices' pandemic-induced downturn in February-March.

The Government Pension Investment Fund (GPIF) ended FY2019 with AUM of ¥151trn, down 5.4% from a year earlier (Exhibit 10). By September, its AUM had recovered to ¥167.5trn. In March, the GPIF unveiled its policy portfolio for FY2020-24. Its updated policy portfolio reflects 2019 actuarial assessment results and input from the Social Security Council's asset management subcommittee. The policy portfolio sets the GPIF's domestic equity, domestic bond, foreign equity and foreign bond allocations at 25% each. The GPIF's actual portfolio already mirrors the policy portfolio's allocations pretty closely as a result of periodic rebalancing (Exhibit 10). In recent years, the GPIF has been investing increasingly actively in illiquid alternatives (infrastructure, real estate and private equity). Its illiquid alt holdings more than doubled in FY2019 to ¥940bn at fiscal year-end. They are classified into the policy portfolio's four asset classes based on their respective attributes. Additionally, following the standardization of employees' public pension benefits in 2016, mutual aid associations are required to adopt the GPIF policy portfolio's allocations with respect to their reserves earmarked to fund Employees' Pension Insurance benefits. They accordingly sync their model portfolio allocations with the GPIF's.

Exhibit 10. GPIF's AUM and asset allocation



Source: NRI, based on GPIF annual reports

Corporate pension assets at March 31, 2020, totaled ¥93trn, a 2.1% year-on-year decrease (Exhibit 11). Of this total, DB pension plans accounted for ¥61trn, a 3.0% year-on-year decrease. The decrease was DB plan assets' first ever. Through FY2018, DB plan assets had been in a growth trend fueled largely by Employees' Pension Funds (EPFs) converting to DB plans after returning the substitutional portion of their assets to the government. DB pension funds have continued to lower their assumed rates of return and to derisk through such means as reducing equity allocations. They were consequently not as hard-hit as the GPIF by the February-March asset price plunge. DB plans (including plans whose assets are

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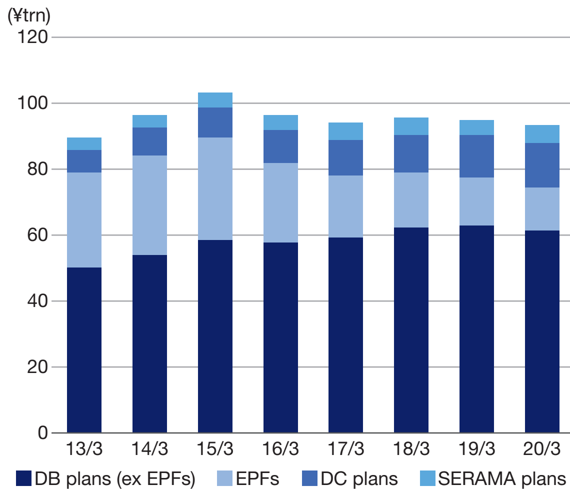
Exhibit 11. **Corporate pension assets**



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

managed by trust banks or Norinchukin Zenkyoren Asset Management) decreased in number to 12,579 at March 31, 2020, from 12,959 a year earlier amid continued conversions of small-scale contractual DB plans managed by life insurers into non-DB plans. Corporate DC plans, by contrast, saw their assets grow by ¥1trn in FY2019 to ¥14trn at fiscal year-end. DC plan sponsors and participants also continued to grow in number, driven partly by broader adoption of DC plans as a rollover destination for dissolved multi-employer EPFs' former participants.

The government has recently been working on policies to augment and popularize private pensions as a supplement to public pension benefits. One example is DB risk-mitigation contributions (tax-advantaged extra contributions that DB plan sponsors can make as a cushion against a future market crash), introduced in 2017. Nearly 400 risk-mitigation contributions have been made to date, indicating that at least some DB plan sponsors are committed to increasing their existing plans' sustainability. The contributions reduce the risk of failing to meet the minimum funding requirement, a risk that has been rising as super-long-dated bond yields have declined in recent years.

Additionally, the Social Security Council's subcommittee on corporate pensions and individual retirement plans is currently working on a plan to revise the corporate DC plan contribution limit (currently set at ¥55,000/month per participant if the employer does not also offer a DB plan and ¥27,500/month if the employer offers a DB plan also) the subcommittee has proposed resetting the maximum DC plan contribution at ¥55,000/month less any DB plan contribution. In other words, the DC plan contribution limit would increase if the employer contributes less than ¥27,500/month per employee to its DB plan. Employers contributing more than ¥27,500/month per employee to their DB plans (most such employers are large corporations) would have to reassess and potentially adjust the balance between their DB and DC plans. Some interest groups involved in the discussions are consequently advocating a cautious approach. For the time being, companies will likely continue to seek to optimize their pension plan mix between DB and DC in light of their respective circumstances and HR/financial strategies.

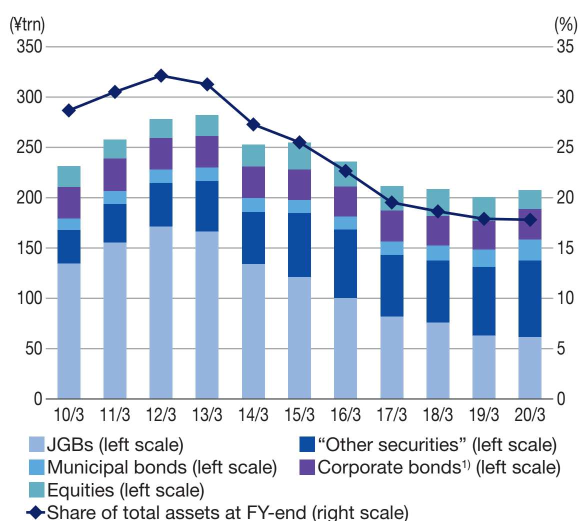
2 Securities investment by banks

City banks increased their investment securities holdings in FY2019

Japanese banks increased their investment securities holdings in FY2019 for the first time in five years, ending the fiscal year with aggregate holdings of ¥208trn, a ¥7trn increase from a year earlier. Investment securities' share of banks' total assets at March 31, 2020, was nearly unchanged year on year at 18% (Exhibit 12).

Of banks' aggregate investment securities holdings at March 31, 2020, city banks held ¥106trn, regional banks held ¥66trn and second-tier regional banks held ¥13trn for a total of ¥185trn[4]. City banks' holdings increased by ¥9trn in FY2019 while regional banks and second-tier regional banks' remained

Exhibit 12. **Japanese banks' investment securities holdings by asset class**



Note 1: Corporate bonds include short-term corporate debt instruments.
Source: NRI, based on BOJ's *Financial Institutions Accounts*

more or less unchanged.

Banks continue to diversify their securities portfolios

Since the BOJ embarked on quantitative and qualitative easing in April 2013, financial institutions have been diversifying their securities portfolios while cutting back on investing in JGBs. These trends persisted again in FY2019.

The largest component of banks' investment securities holdings is "other securities," a catchall category that mainly includes foreign securities and fund products. Banks' "other securities" holdings increased in FY2019 by ¥9trn to ¥77trn, roughly 40% of the aforementioned ¥185trn total. JGBs accounted for the second-largest share at ¥61trn followed by corporate bonds at ¥30trn.

For banks, JGBs serve as a liquidity adjustment valve for their core deposit-taking and lending operations. While JGBs consequently remain an important asset for banks, banks' JGB holdings have been shrinking for eight consecutive years through FY2019, when they were reduced by another ¥2trn. Municipal bonds account for a smaller share of banks' investment securities holdings than corporate bonds do. In FY2019, however, banks enlarged their municipal bond holdings ¥3trn to ¥21trn at fiscal year-end. The ¥3trn increase was second only to the increase in "other securities" holdings. Japanese banks are selectively investing in asset classes in which they can earn even a modest spread over JGBs.

Since April 2020, banks have turned cautious in their securities investment programs in response to the pandemic and the economic uncertainties it has spawned. Such caution has driven dramatic growth in their JGB holdings[5]. Between March 31 and August 31, 2020, banks' JGB holdings ballooned nearly 30% (¥18trn) to ¥79trn. Banks will likely maintain a cautious investment posture until the end of the pandemic is in sight.

In FY2019, city banks added to their holdings of "other securities," municipal bonds and JGBs in that order. Their "other securities" holdings increased by ¥8trn to reach parity with their JGB holdings at ¥41trn apiece.

Regional banks entered FY2019 with more "other securities" than JGBs. During FY2019, they increased their "other securities" holdings by ¥1trn to ¥19trn while trimming their JGB holdings by ¥2trn to ¥13.7trn, widening the gap between the two. Meanwhile, their municipal bond holdings surpassed their JGB holdings in FY2019, ending the fiscal year at ¥13.9trn, a ¥2trn increase from a year earlier.

Second-tier regional banks have collectively owned more "other securities" than JGBs since FY2017-end, one year longer than regional banks have. While they have subsequently reduced their holdings of both JGBs and "other securities," they still hold more of the latter than the former. They ended FY2019 with JGB, "other securities" and corporate bond holdings of ¥2.8trn, ¥3.7trn and ¥3.2trn, respectively. Their corporate bond holdings have exceeded their JGB holdings since FY2018-end. In FY2019, second-tier regional banks increased their holdings of municipal

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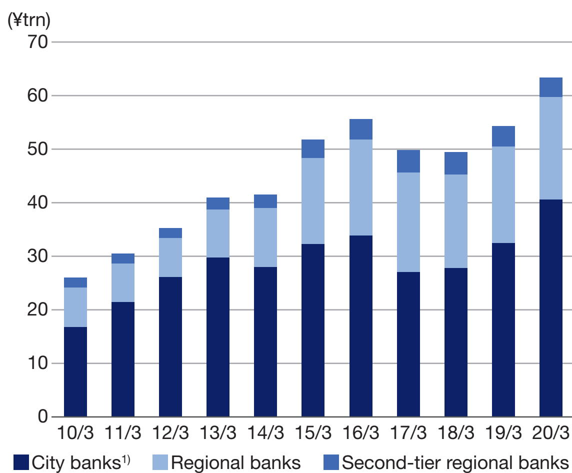
and non-financial corporate bonds only and both increases were minor.

Financially constrained regional banks[6] have a stronger propensity to invest in higher-yielding assets than major banks.

"Other securities" investment trends

With banks beset by an increasingly adverse earnings environment against a backdrop of chronically low interest rates, "other securities" continue to play an important role in their portfolios, as evidenced by their "other securities" holdings' ongoing growth. As already mentioned, city, regional and second-tier regional banks respectively owned ¥41trn, ¥19trn and ¥3.7trn of "other securities" at FY2019-end. City banks in particular have sharply ramped up their "other securities" holdings over the three years through March 2020. At second-tier regional banks, by contrast, "other securities" holdings have barely changed, edging downward slightly, over the same timeframe (Exhibit 13).

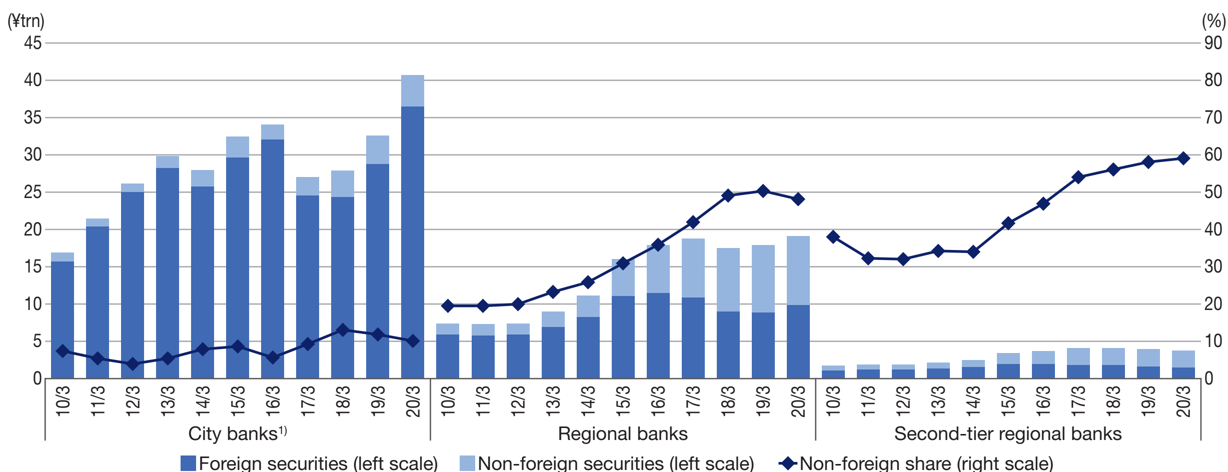
Exhibit 13. **"Other securities" holdings by bank type (excluding holdings in overseas branch accounts)**



Note 1: City banks are Mizuho Bank, MUFG Bank, Sumitomo Mitsui Banking Corporation, Resona Bank and Saitama Resona Bank.
Source: NRI, based on BOJ's *Financial Institutions Accounts*

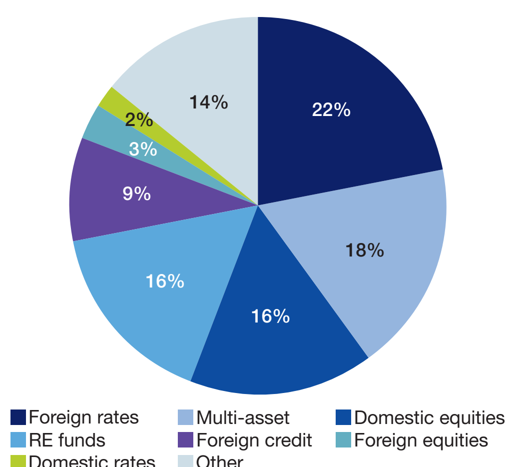
City banks' "other securities" holdings at March 31, 2020 consisted of ¥37trn of foreign securities holdings and ¥4trn of non-foreign securities (e.g., fund products[7]). City banks' foreign securities holdings increased substantially over the two years through March 2020. According to BOJ data, about half of major banks'[8] fund holdings are bear funds for hedging bond and strategic equity holdings[9]. At regional and second-tier regional banks, the non-foreign share of "other securities" holdings has increased substantially since FY2010 and FY2011, respectively. According to BOJ data, regional financial institutions[10] have been investing in multi-asset investment trusts in addition to domestic and foreign rate products, corporate bonds, REITs and foreign equities[9] (Exhibits 14-15).

Exhibit 14. **"Other securities" holdings by bank type and by foreign vs. non-foreign**



Note 1: City banks are Mizuho Bank, MUFG Bank, Sumitomo Mitsui Banking Corporation, Resona Bank and Saitama Resona Bank.
Source: NRI, based on BOJ's *Financial Institutions Accounts*

Exhibit 15. **Composition of regional banks'[1] investment trusts holdings (as of June 30, 2020)**



Note 1: Graph plots data for both regional banks and second-tier regional banks.
Source: BOJ's *Financial System Report* (October 2020)

Such differences between what city banks and regional banks are respectively investing in reflects differences in their respective portfolio management staffing and know-how. Regional and second-tier regional banks with much fewer portfolio management staff than major banks rely on external asset management expertise to help them diversify their portfolios. They accordingly favor fund investments. Even city banks utilize fund products when investing in markets in which they lack internal expertise and when they want access to specific fund managers' market views. For financial institutions of all sizes, fund products offer opportunities to gain information and know-how useful to their in-house investment programs (e.g., market views, risk analytics, investment know-how).

Investment trends by bank subsector

(1) City banks

Faced with an adverse earnings environment, major banks, including city banks, have been investing more actively in overseas credit products, particularly CLOs, over the past two years. According to a BOJ/FSA joint survey[11], major banks[12] at March 31, 2019, held ¥76trn of credit investments, some 40% of which were CLOs and high-yield bonds.

After regulatory capital requirements for securitized products were revised at the end of FY2018, major banks' CLO holdings shot up to ¥14trn over the next six months[13]. We attribute their dramatic growth to two factors. First, banks were granted a three-year transition period to implement the new regulatory capital requirements. Second, the major banks selectively invest in CLOs' AAA-rated tranches[11].

The FSA and BOJ plan to jointly conduct follow-up surveys in light of the possibility of major banks investing more aggressively if the investment environment improves[13].

Going forward, we expect city banks to make investment decisions with regard to securitized products, including CLOs, from the standpoint of not only the availability of returns commensurate with risk capital requirements but also the fit between their risk management regimes and the product's risk profile.

(2) Regional banks

In FY2019, the FSA changed how it monitors regional and second-tier regional banks' securities investments in one respect. Namely, it began to prod regional banks to not only upgrade their risk governance/management and portfolio management capabilities but also utilize external expertise to compensate for any in-house deficiencies. This change was prompted by concerns that regional banks may take excessive risks to maintain profits when reinvesting proceeds from the roughly 40% of their JGB and municipal bond holdings scheduled to mature over the three years through FY2021[14]. The FSA's stance has remained unchanged in FY2020 also.

In response, regional banks' investment behavior has been steadily changing. One such change is increased use of investment advisory services and discretionary management arrangements. The latter offers the added advantage of enabling regional banks to outsource their investment programs' back-office functions. Some providers have recently

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started offering peripheral support services like risk management and HR development in addition to investment advice. In response, AMCs have likewise started to place priority on ancillary support services in addition to offering fund products. Another change is that regional banks are increasingly teaming up with partners that possess investment know-how and/or financial resources to jointly invest in regional funds and private equity, among other asset classes. Some players like the SBI Group are seeking to partner with regional banks in comprehensive alliances not limited to securities investments.

While outsourcing of portfolio management functions is already benefiting some regional banks by generating more stable investment returns, it poses a new challenge for regional banks: risk governance. Regional banks' management faces a growing imperative to clearly articulate investment and risk management policies to external managers, closely monitor their compliance therewith and intervene when necessary.

ESG investing likely to become more prevalent in banking sector

Interest in ESG investing has been on the rise in Japan since the GPIF became a signatory to the UN's Principles for Responsible Investment in 2015. However, ESG investing is still in its infancy in Japan relative to Europe and the US. Japanese banks have been pursuing ESG investing as one SDG (Sustainable Development Goal) initiative but mostly in the context of societal contribution, not business strategy. In October 2010, however, ESG investing may have arrived at an inflection point when Prime Minister Suga officially announced a commitment to achieving net-zero greenhouse gas emissions, thereby turning Japan into a post-carbon society, by 2050. For banks, ESG investing is a key strategic tool to help their customers and society as a whole transition to a post-carbon world. It will likely grow in prevalence in pursuit of the national net-zero target.

3 Retail business

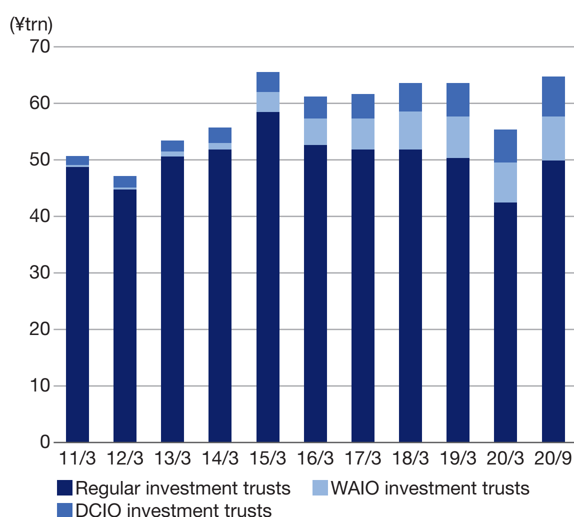
Changes afoot in equity investment trust distribution channels

AUM in public open-end equity investment trusts ex ETFs (abbreviated below as "equity investment trusts") has ranged between ¥60trn and ¥66trn since 2015, dropping materially below ¥60trn only twice: in summer 2016 and spring 2020. In both instances, equity investment trust AUM soon bounced back above ¥60trn. While overall equity investment trust AUM continues to trend sideways, their composition has changed significantly.

One major change is in AUM mix by distribution channel. Investment trusts are available through DC retirement plans and wrap accounts in addition to banks and brokerages' in-person and online channels. AUM in investment trusts offered through DC plans and wrap accounts are growing rapidly.

In DC plans, investment trusts are offered to plan participants through a plan administrator. While plan administrators select which products to offer on a plan-by-plan basis, they have a fiduciary duty to act in plan participants' best interests. Consequently, investment trusts offered in DC plans are mostly low-fee funds, a large share of which are index funds. Additionally, DC plans' product lineup is generally limited to no more than 35 funds. Once selected, funds cannot easily be removed from the lineup. New products are therefore rarely added to a DC plan's fund lineup. Such stickiness differentiates investment trusts available only in DC plans from regular investment trusts. AUM in such DCIO (DC investment only) funds doubled from ¥3.5trn to ¥7.1trn over the five and a half years through September 2020 (Exhibit 16). Net inflows to DCIO funds are growing year after year, driven by growth in DC plan participants. They exceeded ¥800bn in FY2019. While corporate DC plan participants have been growing at a rate of

Exhibit 16. Public open-end equity investment trust (ex ETF) AUM



Note: WAIO: wrap account investment only; DCIO: DC investment only
Source: NRI

400,000 per year, growth in iDeCo plan participants accelerated from a mere 30,000-40,000 to 400,000 per year after iDeCo eligibility was expanded in 2017 to include employees of companies with pension plans, participants in mutual aid pension plans (e.g., public employees) and stay-at-home spouses in single-breadwinner households. As a result, DC plans, including both corporate and iDeCo, now have over 9.2mn participants in total.

Additional changes to DC plans are in the offing. In 2022, the maximum enrollment age will be raised by five years for both corporate and individual DC plans and new corporate DC plan enrollees will be able to conveniently opt in to an iDeCo account at the same time. Additionally, contribution limits for corporate and individual DC plans are slated to be adjusted to allow most participants to contribute more than currently permitted. The resultant increase in contributions per participant, coupled with growth in participants, will surely continue to drive steady growth in DCIO investment trust AUM.

With fund wrap services, the customer enters into an agreement with a discretionary investment manager (usually a broker or trust bank). The manager selects the product lineup. Although product additions and discontinuations are not uncommon, wrap accounts are like DC plans in that the product lineup is selected by a fiduciary. Perhaps for this reason, index funds account for a large share of investment trusts offered in wrap accounts, though not as large as their share of DCIO investment trusts. AUM in investment trusts available only in wrap accounts (labeled “WAIO funds” in Exhibit 16) more than sextupled from ¥1.2trn to ¥7.6trn over the five years through March 2019. Their growth rate subsequently slowed, with AUM remaining nearly unchanged at ¥7.8trn as of September 30, 2020. The slowdown is attributable to customer attrition at certain brokers and banks that had been focused on growing their fund wrap services since 2014. However, with new entrants still streaming into the fund wrap market even recently, the number of wrap accounts is steadily growing. AUM in investment trusts sold through wrap accounts may fluctuate to some extent but should remain in a growth trend.

Index fund AUM growing steadily

Another change in the composition of equity investment trust AUM is growth in index funds. Index fund AUM is increasing in the wake of growth in the prevalence of DC plans and wrap accounts, both of which tend to have index-fund-centric product lineups. Additionally, index funds are gaining share even in the market for regular investment trusts distributed through banks and brokers’ in-person and online channels.

Exhibit 17 plots index fund AUM and index funds’ share of total equity investment trust AUM. It shows a sharp acceleration in AUM growth since FY2018. One likely catalyst behind this growth spurt is the advent of *Tsumitate* NISAs (Nippon Individual Savings Accounts with a lower annual contribution limit but longer-term tax exemption than regular NISAs) in January 2018. Index funds account for roughly 80% of asset purchases in *Tsumitate* NISAs[15]. Conversely, *Tsumitate* NISAs’ estimated share of total index fund

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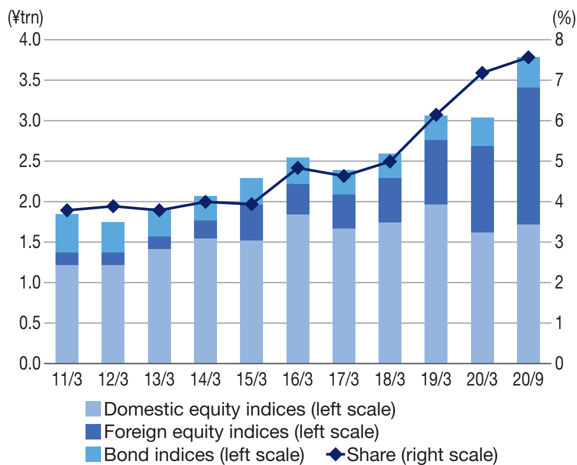
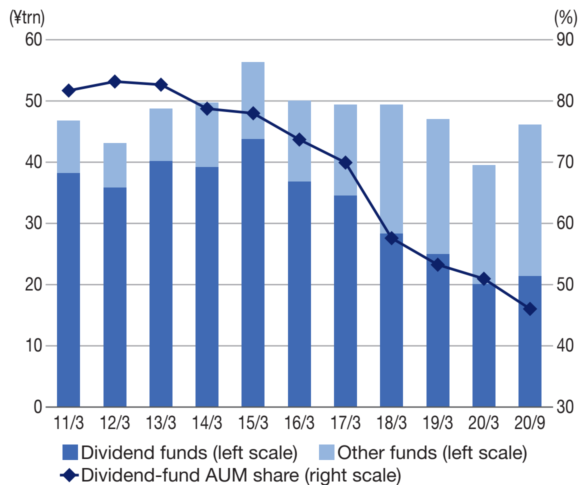
Exhibit 17. **Index fund (ex DCIO/WAIO investment trust) AUM**



Note: "Share" is index funds' share of investment trust (ex DCIO/WAIO investment trust) AUM.
Source: NRI

Exhibit 18. **Active fund (ex DCIO/WAIO investment trust) AUM**



Source: NRI

purchases has recently been running at 20%[16].

Among index funds, foreign equity index funds have recently been experiencing pronounced AUM growth that has brought them to AUM parity with their domestic counterparts. Among foreign equity index funds, the most popular are US and global equity funds, presumably reflecting US and global indices' outperformance. Over the 18 months through September 2020, foreign equity index funds saw net inflows of roughly ¥1trn, more than 30% of total net inflows to foreign equity funds[17], including actively managed ones, over the same timeframe. This data point is indicative of an ongoing shift in investor preference from active to passive.

Dividend fund AUM continues to shrink

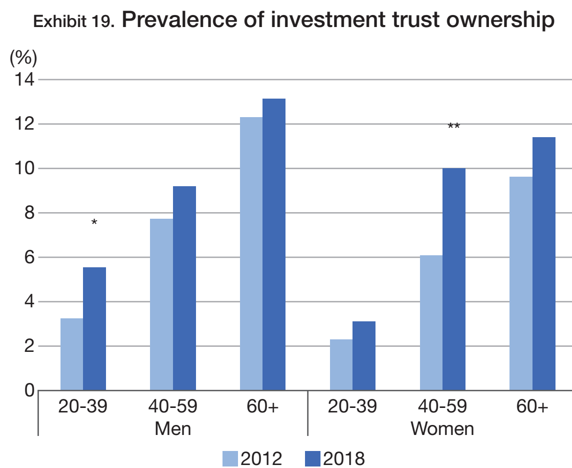
A third change in the composition of equity investment trust AUM is shrinkage in AUM in dividend funds (investment trusts that distribute dividends at least quarterly). Exhibit 18 shows the breakdown in active fund AUM (excluding funds available only in DC plans or wrap accounts) between dividend funds and non-dividend funds. In March 2012, dividend funds accounted for over 80% of total active fund AUM. Their share of active fund AUM has since declined for eight straight years to below 50% as of September 2020. The decline was particularly steep in FY2017, when dividend funds' AUM share dropped 12 percentage points. The FSA's *Principles for Customer-first Business Practices*, the final version of which was unveiled in March 2017 together with initiatives to promote their adoption, had flagged dividend funds' lopsided share of banks' investment trust sales as a concern. In response, fund distributors set out to rectify their fund sales' heavy skew toward dividend products by establishing and tracking KPIs. We doubt dividend fund AUM will resume growing anytime soon.

Meanwhile, actively managed non-dividend funds' AUM are growing, driven chiefly by inflows to funds that invest in global equities and tech stocks. However, few funds consistently attract net inflows on a sustained basis. Whether non-dividend funds in aggregate can maintain a stable AUM growth trajectory remains to be seen.

Securities investment increasingly seen as long-term wealth-building vehicle

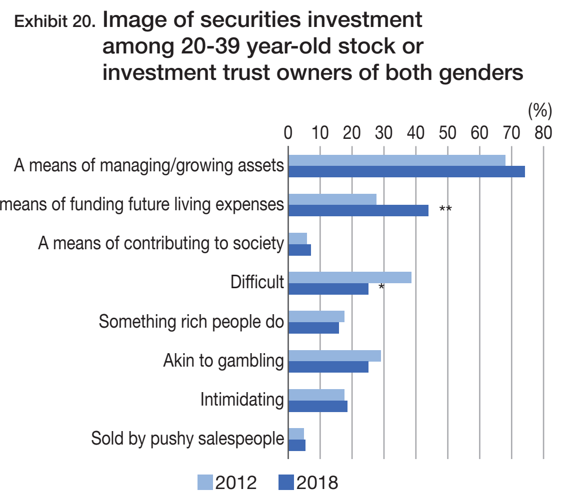
The above-discussed changes in the composition of equity investment trust AUM are largely attributable

Exhibit 19. **Prevalence of investment trust ownership**



Note: *p < .05; **p < .01, where the p-values are two-sided null hypothesis probabilities with respect to the difference between the 2012 and 2018 data points.
Source: NRI analysis of anonymized JSDA nationwide survey data (2012 and 2018)

Exhibit 20. **Image of securities investment among 20-39 year-old stock or investment trust owners of both genders**



Note: *p < .05; **p < .01, where the p-values are two-sided null hypothesis probabilities with respect to the difference between the 2012 and 2018 data points.
Source: NRI analysis of anonymized JSDA nationwide survey data (2012 and 2018)

to changes in customer demographics or attitudes. In terms of customer demographics, the Japan Securities Dealers Association's triennial nationwide survey on securities investment provides time-series data on investment trust ownership disaggregated by age group and gender (Exhibit 19). Over the six years through 2018, the percentage of survey respondents who own investment trusts increased sharply among men aged 20-39 and even more so among women aged 40-59. Investment trust ownership is higher among men than women across all age groups except 40-59, where investment trust ownership is equally if not more prevalent among women.

Additionally, attitudes toward securities investment also are changing. Exhibit 20 plots JSDA survey data on the general image of securities investment in the eyes of respondents who actually invest in securities (data in Exhibit 20 are limited to a subset of respondents: 20-39 year-old men and women who own stocks or investment trusts). It compares responses between 2012 and 2018, an interval during which NISAs first became available (in January 2014). The most prevalent image of securities investment in both years was a "means of growing assets." The response with the biggest change in prevalence between 2012 and 2018 was the image of securities investment as a "means of funding future living expenses." While the image of securities investment as rapid-fire trading, which was not one of the choices in the JSDA survey question, may still be common, more and more people undeniably see securities investment as a means of building wealth over the long term. Such a trend was observed among stock and investment trust owners of both genders in other age groups also (i.e., 40-59, 60 and older) and even among people who do not own stocks or investment trusts. Public perceptions of investment are steadily changing.

Much hinges on quality in active management space

Securities investment's changing image is presumably changing customer expectations vis-à-vis asset management services. Securities investment's old image was conducive to expectations that investment trust sponsors and fund distributors' role is to identify investment strategies with currently high expected returns, launch funds that embody those strategies, pitch them to customers and, lastly, advise customers to sell those funds before their investment strategies' expected returns decreased. Under such a scenario, expected returns in the eyes of the customers who bought the funds would likely be considerably higher than the investment strategies' long-term expected

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returns. If public perceptions change to where securities investment is widely seen as a means of long-term wealth-building, expected returns in customers' eyes would be the long-term expected returns of the asset class in question, not transiently elevated expected returns. Customers would expect investment trusts to deliver stable investment performance, placing priority on long-term returns without seeking to profit from short-term variability in the underlying asset class's expected returns.

Such a change in customer expectations would have implications for asset management fee rates (trust fee rate and sales commission rate) also. Customers are willing to tolerate high fees in exchange for high short-term expected returns but not for lower expected returns. Additionally, a change in customer expectations would naturally be accompanied by a change in the types of investment trust that customers want to own. Given a choice between an index fund of uniform quality and an actively managed fund of variable quality, many investors would presumably prefer the former over the latter even if the latter's expected returns were somewhat better than the former's.

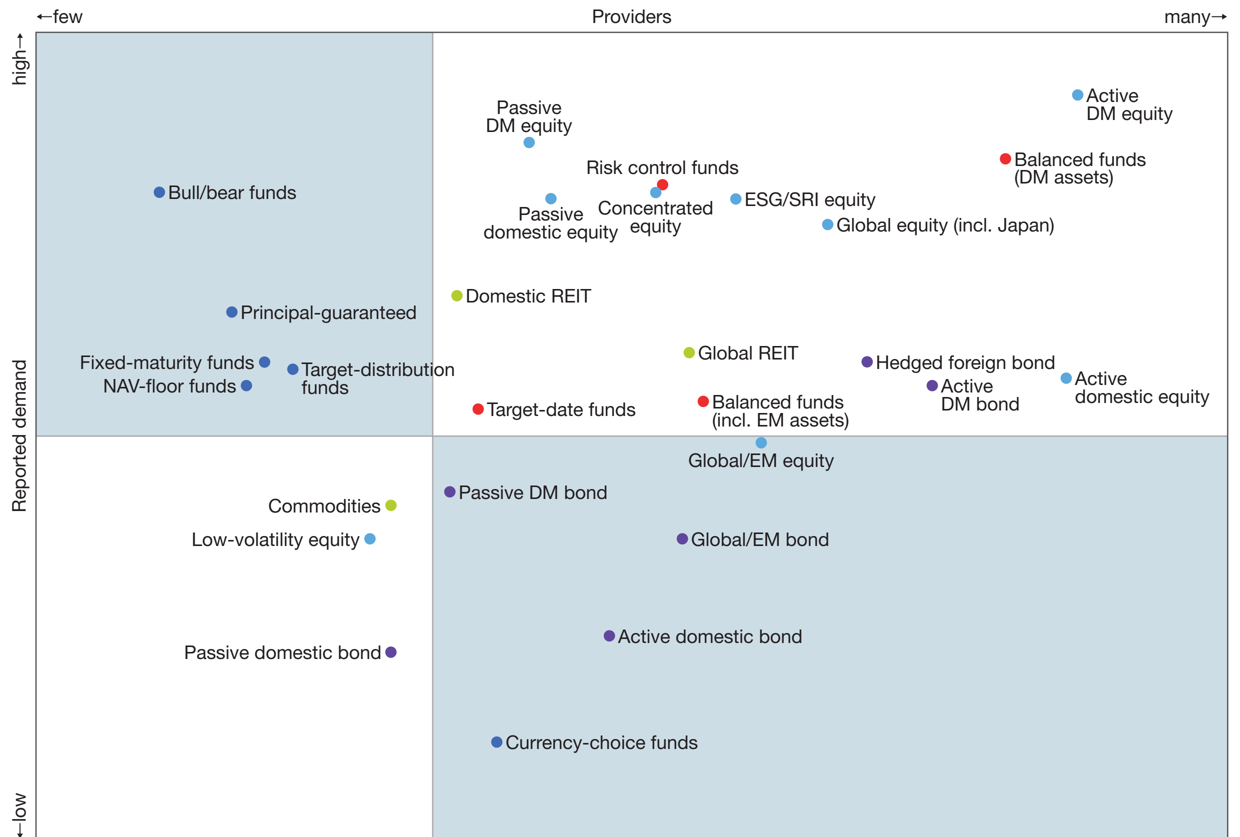
Index funds are in fact gaining AUM share even excluding funds available only in DC plans and wrap accounts. While their AUM share is currently growing slowly, one potential catalyst that could accelerate its growth is mass conversion of investment trust sales reps into fee-only financial advisors that, unlike conventional sales reps, charge the customer directly to avoid conflicts of interest. This fee model extends even to recurring fees. Instead of receiving account service fees (fund distributors' share of trust fees), fee-only advisors collect periodic fees, usually called management fees or service charges, directly from customers. If the fee-only model becomes popular in Japan, advisors should provide their customers with the lowest-priced option from among products of comparable quality, in which case index funds should continue to gain AUM share.

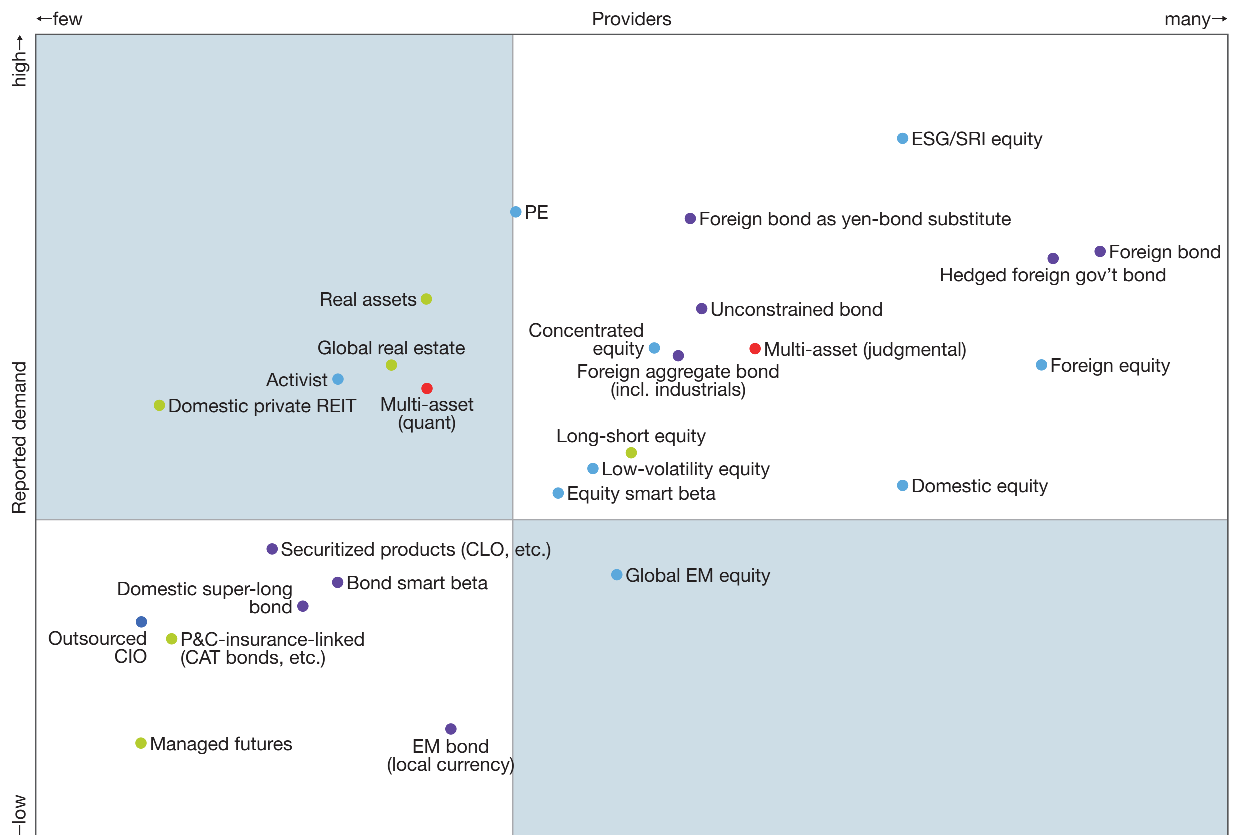
In the UK, where financial advisors have already switched to a fee-only model, investment trust AUM rapidly migrated from active to passive investment trusts. A similar shift could happen in Japan also, though perhaps not to the same extent as in the UK. Even if investment trust sales reps in Japan were to become fee-only advisors en masse, the Japanese financial advisory industry is unlikely to be predominantly made up of small-scale independent financial advisors like in the UK. A more realistic scenario in Japan is that major financial institutions would be the main driving force behind conversion of investment trust sales reps into fee-only advisors. If so, major financial institutions would likely focus on selecting high-quality funds to differentiate themselves from competitors. To do so, they may offer their customers a product lineup that includes at least a modicum of high-quality active funds instead of all passive funds. It is too early to predict whether Japan will follow in the UK's footsteps or chart a somewhat different path, but closet-indexing active funds are unlikely to survive in either case. From such a perspective, mass AUM migration from active to passive may present a lucrative opportunity for AMCs committed to being truly active managers.

4 Product market trends by investor 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* conducted in August-September 2020. They 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 21

Exhibit 21. **Product supply and demand maps by customer segment**





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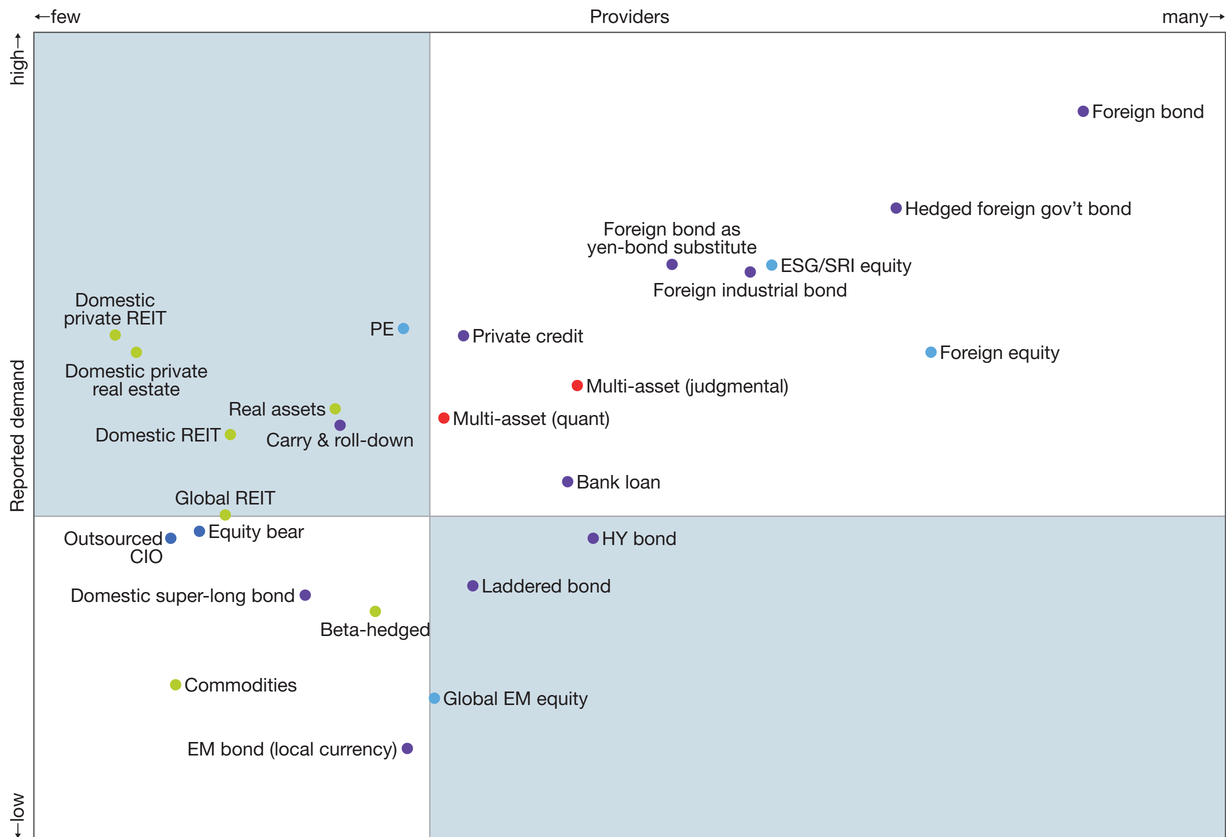
(c) Products for financial institutions



Note: The vertical scale is an indexed scale of the strength of demand from customers (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*

presents our product opportunity maps for a subset of products.

First, in the retail investor segment, the top-ranked products on the demand scale are DM equity and DM balanced funds. Other equity products highly ranked on the demand scale include both active and passive funds, the latter of which are often recommended as part of long-term portfolios for building wealth. The popular active funds include thematic, concentrated and ESG funds. These rankings are generally corroborated by public investment trusts' actual fund flows. Thematic funds launched relatively recently, including DM growth/tech stock funds and ESG funds, are experiencing particularly pronounced inflows. Balanced fund products that rank highly on the demand scale in addition to DM balanced funds include target-volatility funds and risk-control funds with a mandate to keep NAV above a specified level by adjusting their asset allocations. Actively managed balanced funds exhibited performance differentials as a function of how they navigated the market volatility of February-March. Some underperformers subsequently experienced net outflows.

Products that ranked lower on the demand scale in 2020 than in 2019 include domestic REITs and global EM equities, presumably reflecting uncertainty surrounding the pandemic's impact on those asset classes. Demand for principal-guaranteed products structured with the help of an investment bank's balance sheet likewise decreased somewhat from 2019 but remained at a high level.

In the pension segment, private equity, private credit and real assets (including infrastructure, timber and farmland) ranked highly on the demand scale, indicating that demand for illiquid alternatives remains

robust. However, demand for domestic and foreign private real estate funds and private REITS was much lower in 2020 than in 2019. Their loss of popularity among pension funds likely reflects poor forward visibility in addition to the NAV haircuts suffered by some real estate products due to reductions in income amid wide variability in the magnitude of the pandemic's impact among real estate subsectors and even individual properties.

Among public equity products, ESG and concentrated funds ranked highly on the demand scale. Public pension funds in particular are markedly ramping up ESG equity programs. In the fixed-income space, demand for hedged foreign bonds increased in the wake of a decrease in hedging costs since March. Multi-asset products and unconstrained bond funds also remain strongly in demand. Interest in multi-asset strategies seems to be higher among corporate pension funds than their public counterparts. Corporate pension funds on the whole are presumably maintaining a healthy funded status after having derisked. However, with some life insurers lowering guaranteed rates of return on general account products, pension funds are having more difficulty constructing portfolios with favorable prospects of stable returns. They are therefore likely to rely more heavily on managers' skill, including asset allocation acumen, and pursue numerous sources of return, including niche investment strategies, instead of doubling down on core-plus-alpha in traditional asset classes.

Financial institutions basically remain in yield-seeking mode and focused primarily on foreign bonds. Like in the other two segments, ESG funds were ranked higher on the demand scale in 2020 than in 2019. Bank loans and private credit were ranked lower, reflecting recent regulatory concerns about financial institutions' holdings of sub-investment grade foreign credit products. Demand for foreign private real estate funds decreased in response to the pandemic, like in the pension segment. Demand for domestic private REITs, by contrast, seems to have held firm. Outsourced CIO services ranked substantially higher, but still low in absolute terms, on the demand scale in 2020. In Japan, outsourced CIO services generally include a range of training programs in addition to multi-asset portfolio management services, rather than involving a broad discretionary asset management mandate. Demand may be emerging for services that upgrade securities portfolio management capabilities not limited to conventional alternative-yield products.

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4) The ¥23trn difference between the ¥185trn and the aforementioned ¥208trn total is trust banks' holdings.
5) Banks continue to invest in super long-dated JGBs per the BOJ's October 2020 *Financial System Report*.
6) Including second-tier regional banks.
7) Fund holdings reported by banks as funds. Some financial institutions report fund holdings as the funds' underlying assets based on look-through information.
8) The BOJ defines "major banks" as Mizuho Bank, MUFG Bank, Sumitomo Mitsui Banking Corporation, Resona Bank, Saitama Resona Bank, Mitsubishi UFJ Trust and Banking, Mizuho Trust and Banking, Sumitomo Mitsui Trust Bank, Shinsei Bank and Aozora Bank.
9) BOJ, *Financial System Report* (October 2019).
10) Regional financial institutions are defined as regional banks, second-tier regional banks and *shinkin* banks with reserves on deposit at the BOJ.
11) BOJ Review, *Developments in Overseas Credit Investments and Lending by Japanese Financial Institutions* (June 2020).
12) The survey defined "major banks" as Mizuho Bank, MUFG Bank, Sumitomo Mitsui Banking Corporation, Resona Bank, Saitama Resona Bank, Mitsubishi UFJ Trust and Banking, Mizuho Trust & Banking, Sumitomo Mitsui Trust Bank, SMBC Trust Bank, Shinsei Bank and Aozora Bank, Japan Post Bank and Norinchukin Bank.
13) Japan Financial News, *CLO Chosa wo Keizoku* (September, 11, 2020).
14) FSA, *Initiatives for User Oriented Financial Services in a New Era - Financial Services Policy: Assessments and Strategic Priorities 2019* (August 2019).
15) Index funds account for 76% (¥349.1bn) of the ¥457.8bn of cumulative asset purchases in *Tsumitate* NISAs as of June 30, 2020, per an FSA survey on NISA usage.
16) The FSA reported that index fund purchases in *Tsumitate* NISAs in the first six months of 2020 totaled ¥129.4bn, roughly 20% of the ¥642.9bn of total index fund purchases (excluding index funds available only in DC plans and wrap accounts) over the same timeframe.
17) Excluding funds available only in DC plans and wrap accounts.

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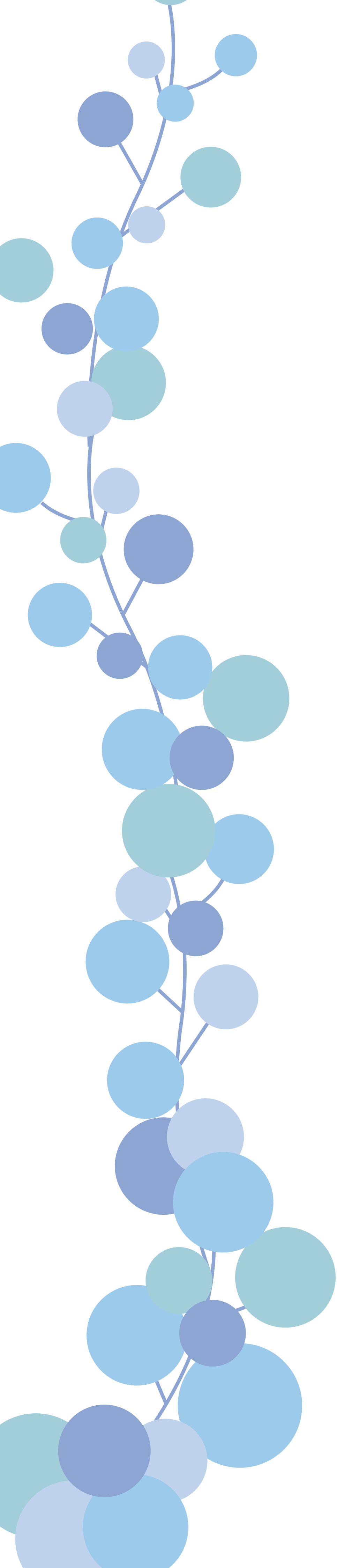

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