Japan's Asset Management Business 2022/23

Nomura Research Institute

Foreword

Public investment trusts are at the forefront of the Japanese asset management industry's ongoing evolution. Retail investors' concept of investment trusts has been changing substantially. The Japan Securities Dealers Association's triennial *National Survey on Securities Investment* asks investment trust owners why they buy investment trusts. The percentage who do so "as a long-term investment" increased from 41% to 54% between 2012 and 2021. Other responses that also have increased notably in prevalence over the same timeframe include "so I can be diversified" and "because I can yen cost average." The asset management industry and regulatory authorities have long been collaboratively promoting long-term, diversified, recurrent investing as a promising investment trust use case for the masses. This message appears to have resonated with the public.

This major conceptual change is affecting the investment trust market. Its impacts include ongoing money flows into passive investment trusts and certain types of active investment trusts, including multi-asset and global equity funds, as covered in this report. These inflows have showed the asset management industry that changes in peoples' conceptions of products and services give rise to big demand responses.

Given investment trusts' versatility, other such conceptual changes may be in store. For example, just as investment trusts are used by workers to save for retirement, they can be used equally well to save for children's education or help fund retirees' living expenses. Investment trusts offer value across the generational spectrum. That said, not everyone is receptive to messages promoting investing more broadly across generations. For the idea of investment trusts as a universal investment vehicle to gain acceptance throughout society, it is important to further increase societal trust in investment trusts. From such a perspective, the industry should more proactively embrace the significance of the investment trust governance upgrades sought by regulators today.

This report aims to provide points of reference for thinking about the asset management business's future path. Its intended audience includes the senior management and marketing/sales planning staff of both asset management companies and financial product distributors. As the Japanese public's ongoing transformation from savers into investors accelerates, the asset management business is expected to play an increasingly important role going forward. We hope this report adds to your understanding of Japan's evolving asset management industry.

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CHAPTER 1

Japanese investor trends

AUM growth continued in FY21

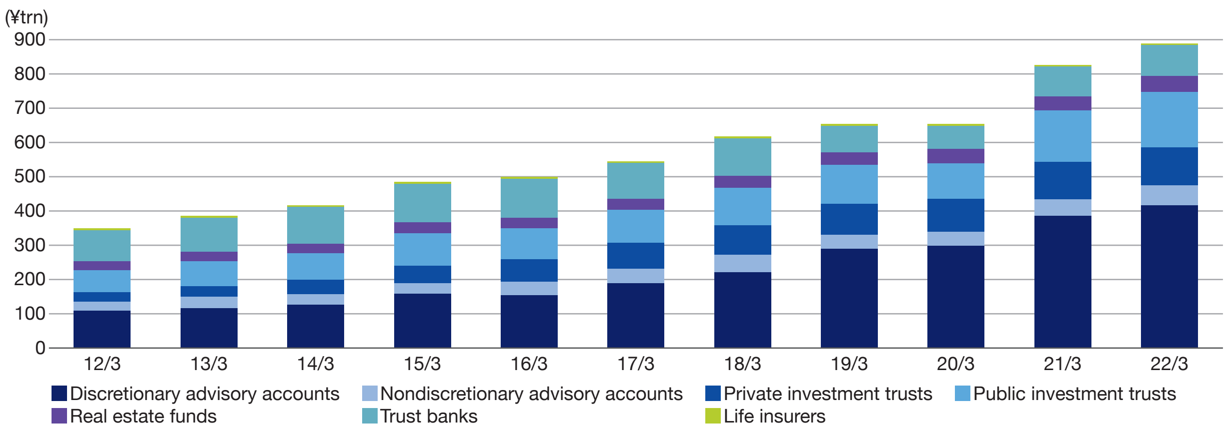
Japanese asset management companies (AMCs) collectively ended FY2021 with estimated AUM of ¥888trn[1], an increase of ¥63trn or 8% from a year earlier (Exhibit 1). Their aggregate AUM have grown in all but one of the 10 years through FY2021, the exception being FY2019, when AUM shrank in the wake of asset price depreciation triggered by the COVID-19 outbreak. FY21 AUM growth was largely in line with the industry's trailing 10-year AUM CAGR of roughly 10%.

By product, the biggest driver of FY21 AUM growth was discretionary investment advisory accounts. AUM in such accounts increased YoY by more than ¥28trn to ¥415trn, up 290% from 10 years earlier. However, this 290% increase was partly attributable to a handful of financial groups transferring pre-existing AUM to affiliated investment advisory firms. Such asset reshuffling continued in FY2021, with a major financial institution transferring some ¥5trn of AUM, together with some staff, to an affiliated advisory firm.

Public investment trust AUM also continued to grow briskly in FY2021, increasing by ¥12trn. One change from recent years, however, is that ETF AUM increased by only ¥1trn, reflecting that the BOJ dialed down its ETF purchases to ¥560bn, a 90% YoY reduction. Non-ETF funds thus accounted for ¥11trn of the ¥12trn increase in public investment trust AUM, ending FY21 with all-time record AUM for a second straight fiscal year.

Non-discretionary advisory accounts also saw substantial AUM growth in FY21. Their AUM increased ¥14trn, though ¥4trn of which was attributable to the aforementioned reshuffling of existing AUM between major financial institutions and their affiliated advisory firms.

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

End-investor AUM growth tracking at trailing ten-year CAGR of 7%

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 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 nontaxable institutional investors under a discretionary investment advisory agreement or discretionarily managed primarily by an affiliated investment 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 capital is invested in structures 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.

Like AMCs' total AUM plotted in Exhibit 1, AUM counted from the end-investor's standpoint[2)] are in a growth trend dating back to their post-GFC trough at FY2011-end (Exhibit 2). While they have not grown as much as AMCs' aggregate AUM, they still increased 110% over this ten-year period (equivalent to a roughly 7% CAGR).

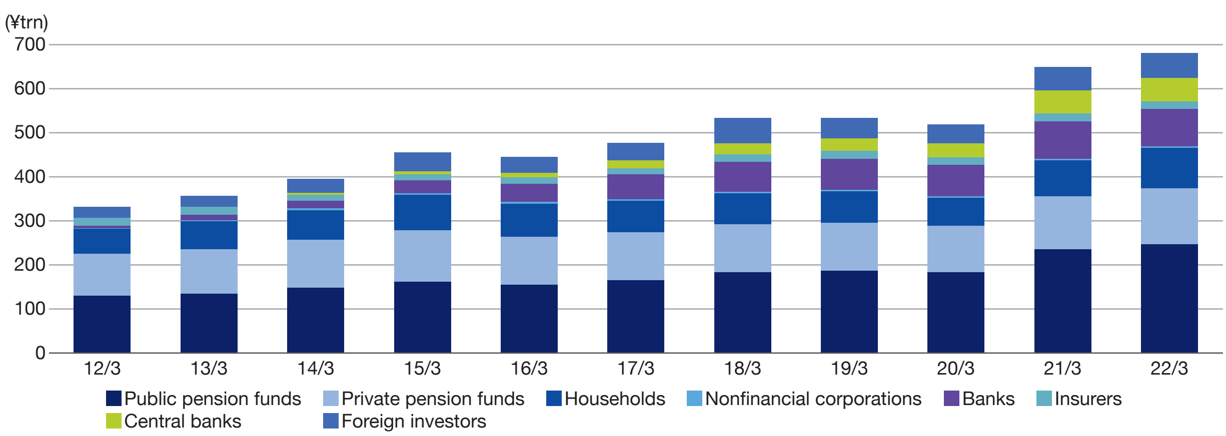
The biggest contributor to this 110% growth was assets managed on behalf of public pension funds, which increased ¥117trn over the 10 years. Meanwhile, assets managed on behalf of banks (depository financial institutions) and central banks increased ¥77trn and ¥51trn, respectively, whereas assets managed on behalf of overseas investors, private pension funds and retail investors grew at a slower pace, increasing about ¥30trn apiece over the same timeframe.

Pension funds, banks and households

Public pension funds have been increasingly outsourcing management of assets to AMCs over the past decade in response to changes in their policy portfolios' asset allocations and re-nationalization of the substitutional portion of Employee Pension Funds' assets and liabilities, but these two trends have already run their course. Public pension funds are no longer planning to award incremental mandates to AMCs at the same rate they have over the past decade.

In the private pension space, rules governing corporate defined contribution (DC) plans are set to become more conducive to AUM growth in such plans. At companies with both DC and defined benefit (DB) plans, DC plan contributions are currently capped at a uniform ¥27,500/month, but effective

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

December 2024 this limit is set to change to ¥55,000/month less the amount of any DB plan contribution. This change will increase the DC plan contribution limit at many companies with both DC and DB plans, likely leading to increased contributions to corporate DC plans and, in turn, faster growth in DC plan assets. However, such a pickup in DC plan assets' growth rate would presumably come at the expense of growth in DB plan assets. We doubt overall corporate pension assets will grow much beyond their current level. Additionally, the age limit on enrollment in individual DC (iDeCo) retirement plans was raised from May 2022. While these rule changes will definitely spur growth in private pension assets, the growth will likely be gradual given that private retirement plans are basically funded solely by participants' monthly contributions.

Within banks' securities portfolios, fund investments have dramatically increased in importance since the BOJ embarked on its large-scale JGB purchases. Although banks are no longer ramping up their fund investments as aggressively as a few years ago, they have continued to add to their fund holdings year after year. Many banks have long been investing in investment trusts, mainly privately offered ones. Some regional banks even use discretionary managers, among other investment advisory services. Financial institutions remain a key clientele for AMCs.

Households outsource management of their assets mainly by buying public investment trusts or opening fund wrap accounts. Securities investment's public image has been changing as investment trust ownership grows and more and more people realize the importance of long-term investing and asset diversification. Additionally, the government has signaled that it intends to radically expand Nippon Individual Savings Accounts (NISAs), a tax-advantaged investment vehicle for individuals. These developments will undoubtedly drive growth in households' professionally managed asset holdings. Against such a backdrop, the passively managed share of public investment trust AUM is rapidly increasing. With passive investing now broadly recognized by retail investors as the smartest way to invest for the long term, the shift toward passive management is all but certain to continue.

However, passive funds' growing popularity among retail investors does not necessarily mean actively managed investment trust AUM will shrink. Among active investment trusts, global equity and multi-asset funds with good track records are gaining popularity and starting to enjoy sustained asset inflows.

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., private funds' ownership of public investment trusts 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.

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.

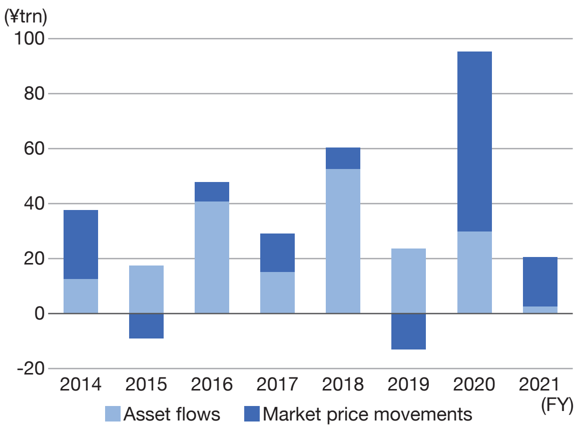
AMCs' revenues hit new all-time record

Exhibit 3 plots annual changes in AMCs' AUM disaggregated by causative factor. In the institutional market segment, asset price movements added some ¥18trn to AMCs' AUM in FY2021, mainly by virtue of favorable global equity market performance. Net inflows of new assets added roughly ¥2.3trn to AMCs' AUM, but this net ¥2.3trn included an estimated ¥5trn inflow stemming from reorganization of a domestic financial group's asset management operations[3]. Adjusted to exclude this ¥5trn, the ¥2.3trn net inflow would be a ¥2.7trn net outflow. Private investment trusts, a product that caters to institutional investors, saw another net inflow of assets in FY2021 as outsourced asset management solutions remained in demand among financial institutions, a key clientele for AMCs. However, private investment trusts' FY2021 net inflow decreased to ¥3.4trn from ¥6.6trn in FY2020, a nearly 50% reduction.

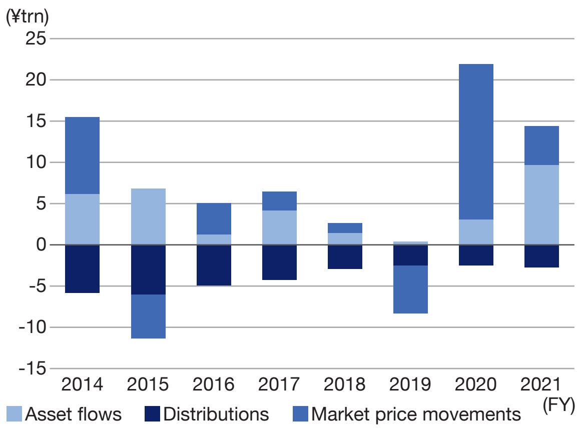
In the retail market segment, AMCs' AUM grew roughly ¥11.8trn as a net result of a ¥9.7trn net inflow of new assets, a ¥2.7trn outflow in the form of dividend distributions and ¥4.8trn of AUM growth attributable to asset, mainly global equity, price appreciation. After experiencing net outflows (inclusive of dividend distributions) for four straight years through FY2019, retail flows turned positive in FY2020 to the tune of ¥600bn. The FY2021 net inflow of ¥7trn after distributions was AMCs' biggest net inflow from retail investors since FY2007, back in

Exhibit 3. Changes in AUM disaggregated by causative factor

Institutional market segment (discretionary investment advisory + private investment trusts)



Retail market segment (open-end equity investment trusts ex ETFs)

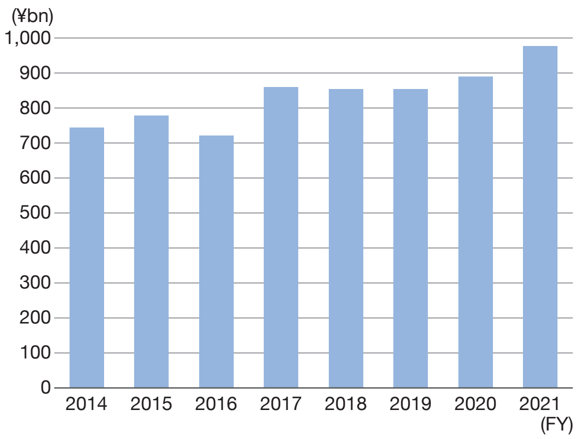


Source: NRI, based largely on JITA, JIAA and NRI Fundmark data the pre-GFC era. The aggregate distribution yield[4] for open-end equity investment trusts (ex ETFs) has fallen below 3% from its FY2015 peak of around 10%.

Based on data available at the time of this writing, we estimate the asset management industry's aggregate FY2021 management fee revenues at ¥970bn, a new all-time record following four straight years of flattish revenues (Exhibit 4). FY2021 revenue growth was presumably driven by (average) AUM growth in the retail segment. In FY2022 to date, however, AUM have been reduced by deterioration in market conditions. If such headwinds persist, revenue will likely decline in FY2022.

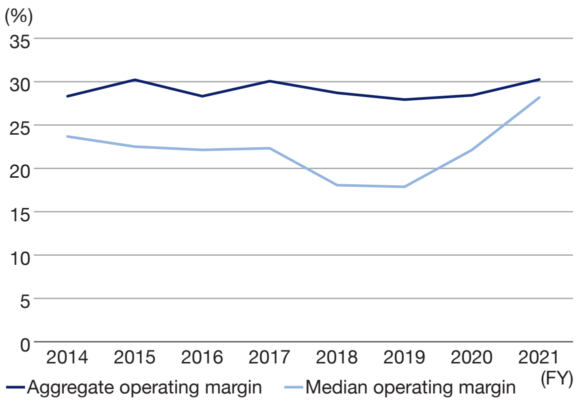
Exhibit 5 plots the aggregate operating margin[5] of surveyed Japanese AMCs that sponsor public investment trusts (likewise based on data available at the time of this writing). Our survey sample's aggregate operating margin exceeded 30% in FY2021, matching its FY2015 and FY2017 peaks. Despite all-time record revenues, aggregate operating margin failed to surpass these peaks as a result of two factors: an increase in advisory fees paid to subadvisors and growth in operating expenses. Many Japanese AMCs outsource management of foreign equity portfolios to subadvisors. With foreign equity funds' AUM growing, operating revenue should continue to grow, but operating margins will likely be compressed by increased operating expenses.

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 (the number of AMCs in the 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

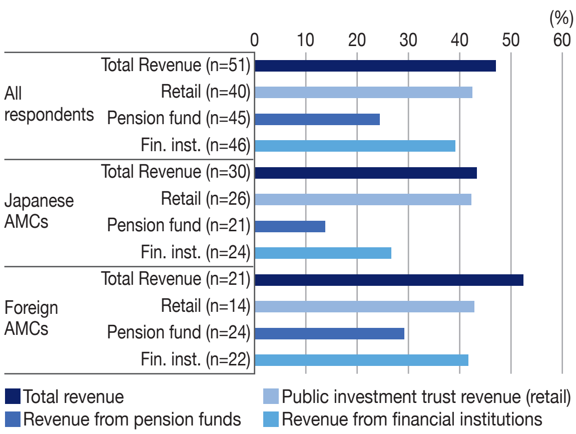
2 Outlook for asset management business

At NRI, we annually survey AMCs' management (*NRI Survey of Asset Management Companies' Management Priorities*[6]) 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 their survey responses.

AMCs still bullish on retail segment's growth prospects

Exhibit 6 plots the percentages of survey respondents

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

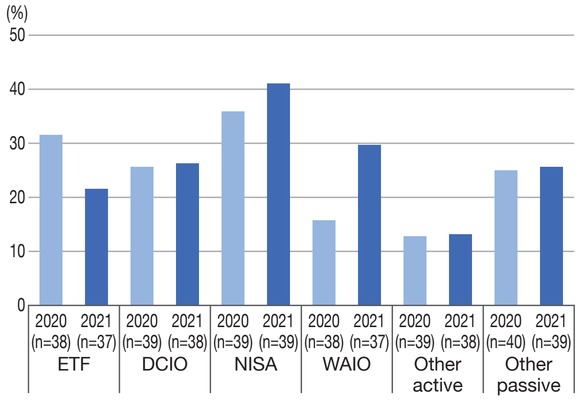


Source: NRI *Survey of Asset Management Companies' Management Priorities*

forecasting cumulative revenue growth of at least 50% over the next five years on a company-wide basis and by business line (investor segment). Some 50% of all respondents are projecting an increase in their total revenue of at least 50% over the next five years. For a fourth straight year, the investor segment in which the most respondents are forecasting such revenue growth is retail, followed in descending order by the financial institution and pension fund segments. The retail segment's continued hold on the top ranking reflects not only robust asset inflows in FY2021 but presumably also expectations of accelerated growth in investment trust ownership driven by expansion of programs intended to promote household wealth formation. The order in which the three investor segments are ranked is the same between Japanese and foreign respondents, but Japanese respondents' revenue growth expectations are skewed more toward retail while foreign respondents are more bullish than their Japanese counterparts on the pension and financial institution segments' revenue growth prospects. This difference in outlook between the two subsamples may reflect that many foreign AMCs derive a larger share of their revenues from pension funds and financial institutions.

Within the retail segment, the investor segment with the best revenue growth prospects in the eyes of our survey respondents, Exhibit 7 plots, by public investment trust category, the percentages of respondents projecting cumulative AUM growth of at least 50% due to asset inflows over the next five years. The category in which the highest percentage (over 40%) of respondents is projecting such AUM growth is investment trusts tailored to NISAs and *Tsumitate* NISAs (NISAs with a lower annual contribution limit but longer-term tax exemption than regular NISAs). In fact, investment trust holdings in NISAs and *Tsumitate* NISAs respectively grew 22% and a whopping 138% in 2021 to end the year at ¥5.9trn and ¥1.7trn, respectively[7]. Investment trusts offered in *Tsumitate* NISAs are mostly simple, low-cost funds. Meanwhile, *Tsumitate* NISAs'

Exhibit 7. **Percentage of survey respondents forecasting at least 50% AUM growth due to asset inflows over next five years (by public investment trust category)**



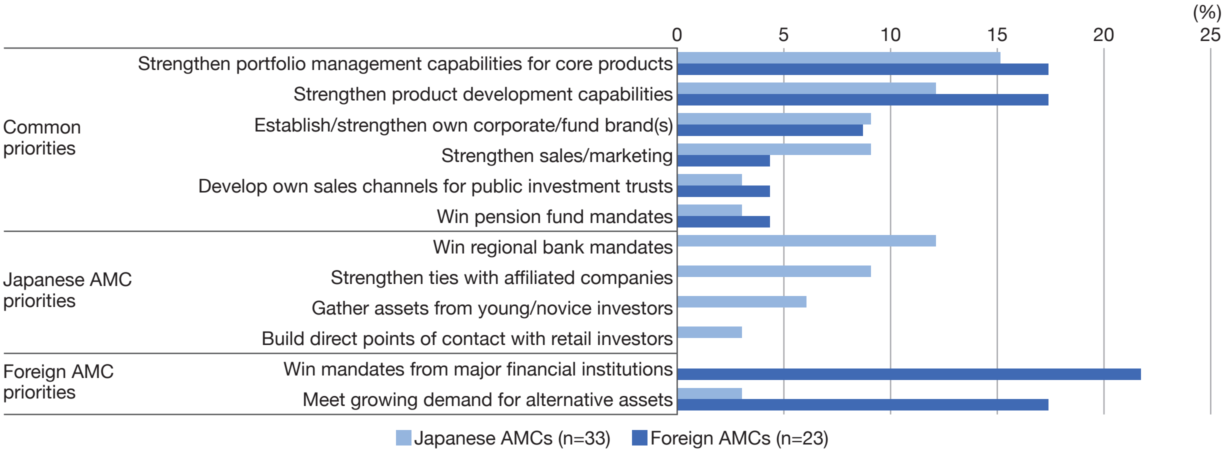
Note: NISA category includes funds for both regular and *Tsumitate* NISAs. DCIO: defined contribution investment only; WAIO: wrap account investment only (includes funds for non-wrap discretionary advisory accounts also)
Source: NRI *Survey of Asset Management Companies' Management Priorities*

lower contribution limit restrains asset inflows from *Tsumitate* NISAs into investment trusts. Investment trusts for *Tsumitate* NISAs are consequently not considered a lucrative business by many AMCs. Nonetheless, assets in *Tsumitate* NISAs are likely to steadily grow, partly by virtue of prospective increases in contribution limits. Many AMCs apparently expect growth in assets in NISAs and *Tsumitate* NISAs to accelerate. Behind NISAs and *Tsumitate* NISAs, the investment trust category with the second-best revenue growth outlook in our survey respondents' collective opinion is funds offered exclusively through discretionary advisory accounts. This category saw the biggest increase between 2020 and 2021 in the percentage of survey respondents projecting at least 50% AUM growth due to asset inflows over the next five years. The categories ranked third and fourth by perceived revenue growth potential are respectively DCIO (defined contribution investment only) funds and passive funds not otherwise categorized. The category with the worst revenue growth outlook per our survey is active investment trusts not otherwise categorized.

AMCs focusing more on alts, repriotizing in-house expansion

Our survey inquired also about AMCs' top priorities

Exhibit 8. **Survey respondents' top priorities to expand business or improve profitability over next five years**

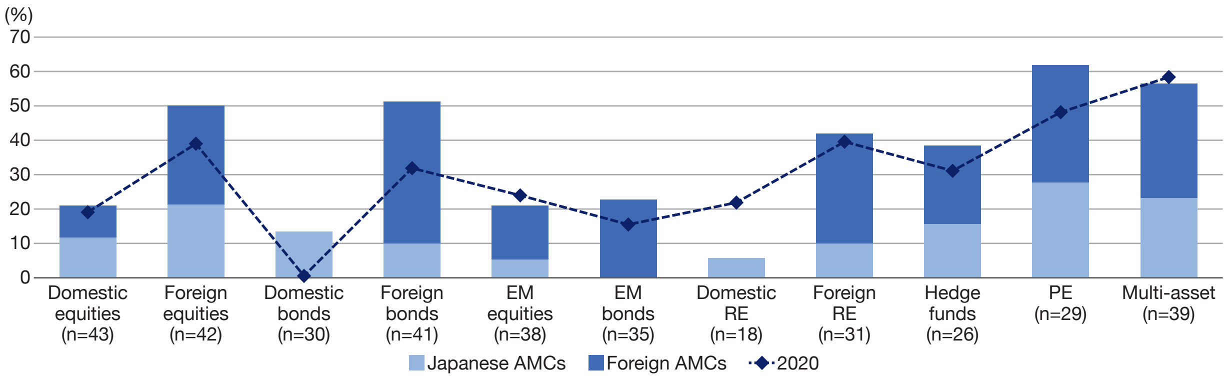


Note: Choices not selected by any respondents are omitted.
Source: NRI *Survey of Asset Management Companies' Management Priorities*

in terms of expanding their operations or improving profitability over the next five years (Exhibit 8). The most notable finding from this question is that sizable percentages of foreign respondents are placing priority on winning mandates from major financial institutions and meeting demand for alternative investments. Based on our survey results, we estimate that alternative assets' share of private investment trust AUM tripled from 3% to 9% between FY2019 and FY2021. Within the financial institution segment, foreign AMCs tend to focus on major financial institutions for two reasons. First, major financial institutions are directly accessible even to foreign AMCs without affiliated distributors. Second, they tend to award mandates large enough to be worthwhile for foreign AMCs to pursue. Additionally, the focus on major financial institutions implies that the foreign AMCs are confident they can provide differentiated investment strategies across a variety of asset classes, including alternative and foreign assets, in response to major financial institutions' diverse needs.

Exhibit 9 plots, by asset class, the percentages of survey respondents projecting cumulative AUM growth of at least 50% due to asset inflows over the next five years. The strategies on which the respondents are most bullish are, in descending order, private equity, multi-asset, foreign bonds and foreign equities. More than half of the respondents are projecting AUM growth of at least 50% in these four asset classes over the next five years. In all four except multi-asset, the percentages of respondents projecting at least 50% AUM growth are much higher

Exhibit 9. **Percentage of survey respondents forecasting at least 50% AUM growth due to asset inflows over next five years (by asset class)**



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

Exhibit 10. **Organizational functions where AMCs plan to add headcount within two years**

FY2016 survey

Rank	Organizational function
1	Investment trust sales/marketing (to distributors/investors)
2	Portfolio management (outsourced)
3	Institutional sales (to pension funds, financial institutions, etc.)
4	Investment/product strategy, project management
5	Reporting to investors/fund distributors
6	Risk management
7	Compliance, internal auditing, etc.
8	Planning (sales, products, etc.)
9	Investment advisory operations
10	IT system planning/development

(Lower-ranked choices)

FY2021 survey

Rank	Organizational function
1	Investment trust sales/marketing (to distributors/investors)
2	Institutional sales (to pension funds, financial institutions, etc.)
3	Portfolio management (in-house)
4	Investment/product strategy, project management
5	Research
6	IT system planning/development
7	Reporting to investors/fund distributors
8	Planning (sales, products, etc.)
9	Portfolio management (outsourced)
10	Trading

(Lower-ranked choices)

Note: Survey respondents were presented with a list of 20 organizational functions and asked which ones they planned to add staff to. Listed above are the top 10 ranked by percentage of respondents answering affirmatively.
Source: NRI *Survey of Asset Management Companies' Management Priorities*

in the latest survey than in the preceding one. Private equity supplanted multi-asset as the strategy with the highest percentage of respondents projecting at least 50% AUM growth, offering further evidence of growing demand for alternative assets. Between Japanese and foreign respondents, the latter are more bullish than the former on the AUM growth prospects of foreign asset classes, where foreign AMCs have long had an expertise advantage over Japanese AMCs. In the multi-asset and non-foreign alternative asset classes like private equity and hedge funds, the data in Exhibit 9 do not differ much between Japanese and foreign respondents. Many Japanese AMCs likewise expect to capture asset inflows in these asset classes.

Another survey question asked about where the respondents plan to increase or reduce headcount. Exhibit 10 ranks organizational functions by the percentage of respondents planning to increase headcount in that area within the next year or two. The rankings have changed substantially since five years earlier. Most notably, in-house portfolio management and research, neither of which ranked in the top 10 five years ago, respectively jumped up to the third and fifth spots while outsourced portfolio management dropped from second to ninth. These changes imply that AMCs are now placing more priority on establishing or expanding in-house portfolio management and research capabilities than they did in 2016. For example, some Japanese AMCs are presumably adding staff to internally manage active foreign equity and/or bond funds, both of which are in high demand among Japanese investors. Japanese AMCs with a strong propensity to outsource portfolio management should be able to improve their profit margins if they can expand their in-house portfolio management operations.

Building competitive portfolio management capabilities internally is not easy and requires investment in human resource and considerable time, but such capabilities could become a proprietary core competency. Formulating a medium/long-term growth strategy and agilely allocating human resources will inarguably continue to be keys to growth.

3) An estimated ¥5trn of AUM was transferred within the JA Group to Norinchukin Zenkyoren Asset Management.
4) Distribution yield was calculated as income distributions over the preceding 12 months divided by net assets.
5) Aggregate operating margin is calculated as aggregate operating profits divided by aggregate net operating revenues (i.e., operating revenues net of the portion of management fees paid to fund distributors for servicing customer accounts).
6) NRI has conducted this survey annually since FY2007, most recently in August 2022. The latest survey yielded valid responses from 58 AMCs (34 Japanese, 24 foreign) that collectively account for 78% of the Japanese asset management industry's total AUM.
7) Source: FSA statistics on NISAs and Junior NISAs

CHAPTER 3

Market trends and product strategies by client segment

1 Pension funds, life insurers, university endowment fund

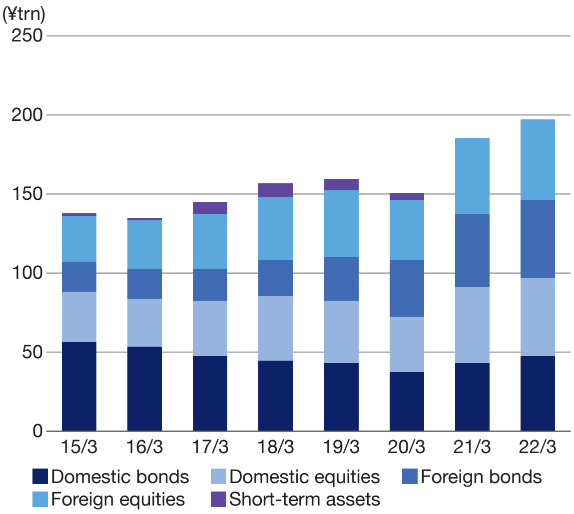
Pension funds continue to add to illiquid alt allocations

Major Japanese pension plans' reserves at March 31, 2022, totaled ¥388trn, a 4.3% YoY increase mostly attributable to the Government Pension Investment Fund (GPIF). The GPIF generated some ¥10trn of investment returns in FY2021, increasing its AUM 5.6% to ¥197trn at fiscal year-end (Exhibit 11). The GPIF adopted an updated policy portfolio with domestic bond, foreign bond, domestic equity and foreign equity allocations set at 25% apiece effective from FY2020. It has since been rebalancing its portfolio at least quarterly. Its actual allocations at March 31, 2022, roughly coincided with its policy portfolio allocations.

The GPIF's holdings of illiquid alternatives at March 31, 2022, were up some ¥800bn YoY at ¥2.2trn (1.1% of its reserves vs. a maximum allocation of 5%). Its alternative investments are classified into its policy portfolio's four asset classes based on their individual attributes. As of March 31, 2022, the GPIF had committed some ¥4trn (2.1% of reserves) to illiquid alternatives, a ¥1.1trn increase from a year earlier. It is expected to continue to seek out top managers to which to allocate more capital in the alts space. Mutual aid associations are likewise increasing their allocations to illiquid alts, albeit at a slower pace than the GPIF.

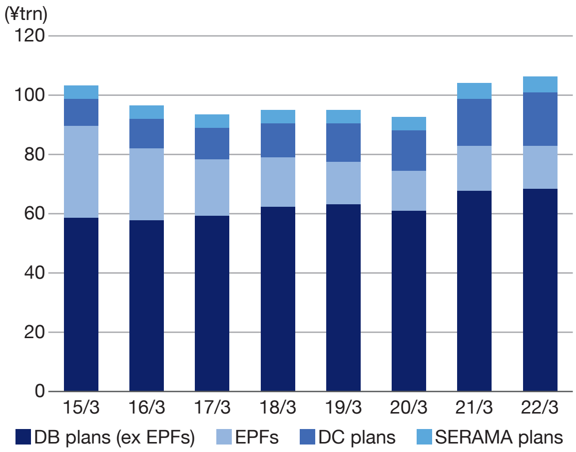
Corporate pension assets at March 31, 2022, totaled ¥106trn, a 1.9% increase from a year earlier (Exhibit 12). Of this total, DB pension plans accounted for ¥68trn, a 0.9% YoY increase. DB plan assets appreciated less than public pension assets

Exhibit 11. GPIF's AUM and asset allocation



Source: NRI, based on GPIF annual reports

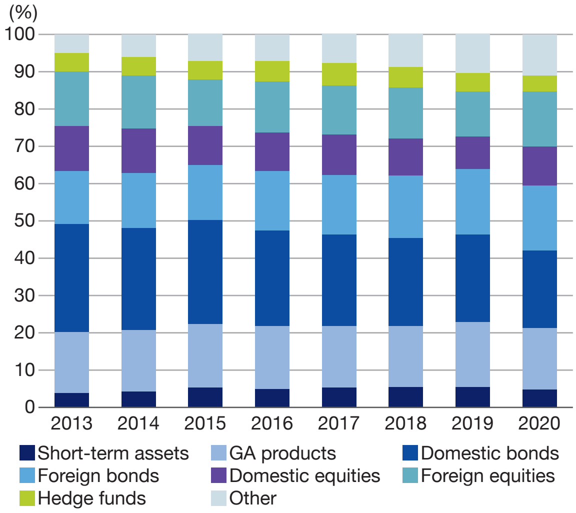
Exhibit 12. Corporate pension assets



Note: EPFs: Employee Pension Funds; SERAMA: Smaller Enterprise Retirement Allowance Mutual Aid

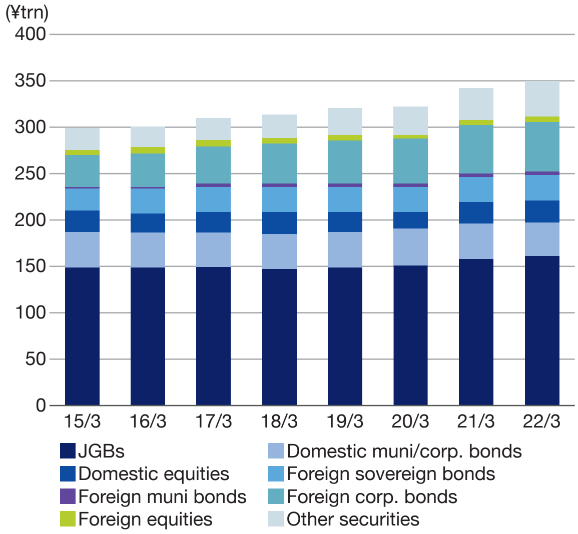
Source: NRI, based on data from Trust Companies Association of Japan and Organization for Workers' Retirement Allowance Mutual Aid

Exhibit 13. **Corporate DB pension fund asset allocations**



Note: GA: general account
Source: NRI, based on Pension Fund Association data

Exhibit 14. **Life insurers' investment securities holdings**



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

because corporate DB pension funds tend to have conservative asset allocations that target nominal returns of 2-3% on average. In recent years, DB pension funds have been gradually reallocating assets from low-yielding domestic bonds to foreign bonds and "other" assets (Exhibit 13). Corporate DB pension funds generally allocate their assets risk-aversely because most of them are well-funded at present. They seek to achieve their return targets by adopting idiosyncratic investment strategies within asset classes. They remain heavily interested in multi-asset strategies, ESG investing and illiquid alts, particularly private equity, private credit and foreign private real estate funds (discussed below).

Corporate DC plan AUM grew 8% in FY2021 to ¥18trn at fiscal year-end. In FY2020, contributions to corporate DC plans totaled ¥1.2trn. With some companies looking to migrate from DB to DC plans, corporate DC plan contributions are expected to continue to gradually grow.

Life insurers have started to phase in new solvency regime

Life insurers (42 companies per latest count, including Japan Post Insurance) collectively held investment securities with a carrying value of ¥350trn, a 1.9% YoY increase, on their balance sheets at March 31, 2022 (Exhibit 14). In recent years, they have been adding to their foreign securities holdings, much of which are corporate bonds. While their foreign corporate bond holdings grew a modest 2.9% to ¥55trn in FY2021, their holdings of foreign equities and foreign municipal bonds shot up 11.5% and 9.8% to ¥6trn and ¥4trn, respectively. Their "other" securities holdings, which include alternative investments, also grew in FY2021, up 8.8% to ¥38trn (inclusive of both domestic and foreign securities) at fiscal year-end. In the current low-rate, low-growth environment, life insurers, like pension funds, are turning to various alternative assets and overseas credit markets to both pursue higher-yielding investment opportunities and currency-match their policy reserves and potential insurance liabilities from an ALM standpoint. Major Japanese life insurers are committed to upgrading their intra-group asset management capabilities as a management priority. Most recently, they have been doing so through such means as shifting asset management functions to existing subsidiaries, establishing new asset management subsidiaries and expanding overseas subsidiaries' role in the upgrade process.

Japanese life insurers are slated to adopt new capital adequacy (economic-value-based solvency) rules from FY2025. Life insurers have started to extend the duration of their JGB holdings, which account for roughly half of their book value, by buying more ultra-long-dated JGBs in the aim of minimizing mismatches between their assets and insurance liabilities on an economic value basis.

University endowment fund is heavily counting on external managers

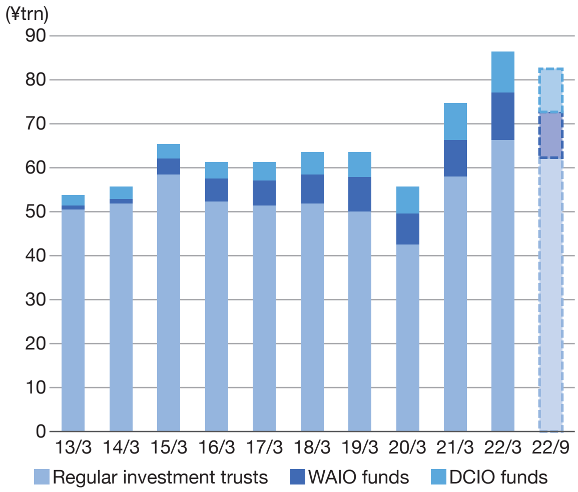
The Japan Science and Technology Agency (JST) launched a national university endowment fund in March 2021. It ended March 2021 with ¥5.1trn of assets, including short-term investments. By FY2022-end, it is scheduled to receive from the Fiscal Investment and Loan Program ¥4.9trn of additional funding, which would increase its endowment to the vicinity of ¥10trn. With the fund legally prohibited from internally managing its equity allocation, JST has started to award passive equity mandates, initially to one foreign AMC and one Japanese trust bank. JST is already soliciting proposals from external asset managers to manage multi-asset, private equity, private credit and active bond, including US credit, allocations. It is counting heavily on external asset managers.

2 Retail business

Equity investment trusts continue to gain assets through inflows

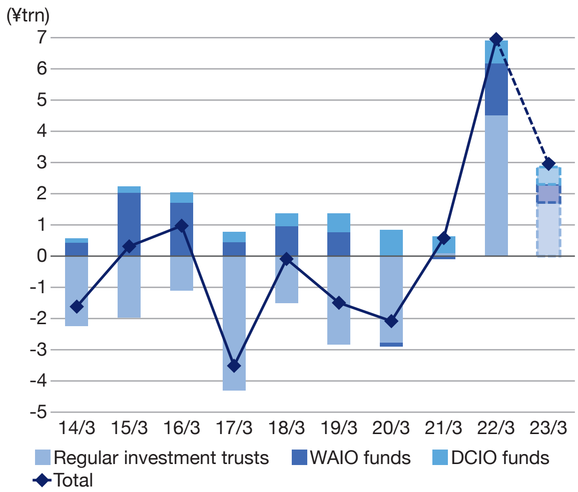
AUM in public open-end equity investment trusts ex ETFs (abbreviated below as "equity investment trusts") totaled ¥86.7trn at March 31, 2022 (Exhibit 15). The ¥86.7trn was an ¥11.8trn YoY increase and all-time record for a second consecutive year. By September 2022, equity investment trust AUM were down ¥4.2trn to ¥82.5trn in the wake of equity and bond price depreciation. AUM would have shrank even more if not for a ¥2.9trn net inflow during the six months through September (Exhibit

Exhibit 15. Open-end equity investment trust (ex ETF) AUM



Note: WAIO: wrap account investment only; DCIO: defined contribution investment only
Source: NRI

Exhibit 16. Open-end equity investment trust (ex ETF) net in/outflows



Note: In/outflows: purchases - redemptions - distributions; latest (23/3) data are flows for first half of FY2022 (non-annualized)
Source: NRI

16). Annualized, this ¥2.9trn net inflow equates to 80% of equity investment trusts' FY2021 net inflow. Additionally, equity investment trusts saw first-half net inflows across all three equity investment trust sales channels: DC retirement plans, fund wrap accounts and the regular sales channel. Most investment trusts offered through DC plans and wrap accounts are available exclusively in their respective channels (such investment trusts are referred to below as DCIO (DC investment only) and WAIO (wrap account investment only) funds). The outlook for equity investment trusts' asset flows is summarized by sales channel below.

First, DCIO funds continue to enjoy steady inflows year after year. Because DC plan participants make steady monthly contributions and mostly have a long-term investment horizon, they tend not to make short-term adjustments to their portfolios. Additionally, DC plans are still in the proliferation phase of their life cycle. With DC plan participation thus likely to keep growing, aggregate contributions should continue to increase for years to come. Corporate and individual DC plans combined have been gaining new participants at a rate of 700,000 per annum in recent years. Total participants have surpassed 10mn as of March 31, 2022. To further increase DC plan participation, the government is relaxing eligibility requirements. In 2022, it raised the age limit on individual (iDeCo) plan enrollment to 64 and eased restrictions on concurrent enrollment in both iDeCo and corporate plans. The limit on DC plan contributions by participants concurrently enrolled in a DB plan is slated to change by year-end 2024. The change is expected to allow many DB plan participants to contribute more to their DC plans. Given such pending deregulation intended to expand DC plan enrollment/assets, DCIO fund AUM are virtually certain to keep growing.

Second, WAIO funds collectively experienced a net inflow for the first time in two years in FY2021 as major banks and brokers started to refocus on wrap account services as part of multiyear initiatives to pivot to a recurring-revenue model. Such banks and brokers all aim to generate a consistent, if not necessarily large, stream of customer asset inflows every month. Even some non-majors have entered the fund wrap market, including financial institutions with strong online platforms or financial advisor networks and recently even regional banks (or their affiliated brokerages). Additionally, some AMCs are not only offering WAIO funds but also rolling out fund wrap services. Partly by virtue of such initiatives, the fund wrap channel is growing in terms of both AUM and total number of wrap accounts. Assets will likely continue to flow into investment trusts on a net basis via wrap accounts.

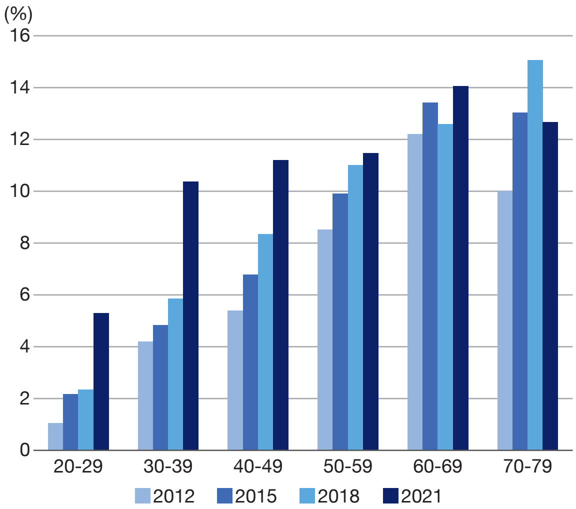
Lastly, the sales channel most readily associated with the investment trust business in the public's mind is banks and brokerages that sell investment trusts in their branches and online. We refer to investment trusts offered through this channel as regular investment trusts. Regular investment trusts collectively suffered net outflows for nine consecutive years through FY2019 before pulling in a meager net inflow in FY2020. In FY2021, regular investment trusts had another net inflow, this one ¥4.5trn. In the first half of FY2022, asset inflows downshifted from their FY2021 pace but still exceeded outflows by ¥1.7trn.

The main reason for the turnaround in net asset flows since FY2020 is that outflows from dividend funds have decreased. Total investment trust distributions, one form of asset outflow, are down 30% from their peak as a result of decreases in both dividend funds' AUM and their average distribution yield (total distributions divided by dividend fund AUM). Another factor behind the turnaround in flows is that certain types of regular investment trusts other than dividend funds have been consistently attracting net inflows. Such types include passive funds, inflows to which have been growing year after year as discussed below, and actively managed global equity and multi-asset funds.

Changes in composition of and motives behind investment trust ownership

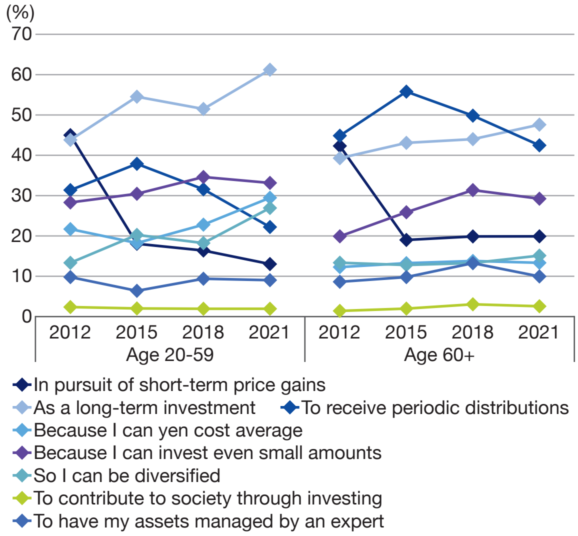
Recently resurgent investment trust inflows have been driven partly by rapid growth in investment trust ownership, mainly among younger Japanese. Exhibit 17 plots investment trust ownership data from a triennial survey conducted by the Japan Securities Dealers Association (JSDA). It shows that the percentage of Japanese who own investment trusts has been steadily increasing across all age brackets between 20 and 59 since 2012. Investment

Exhibit 17. **Percentage of Japanese who own investment trusts by age bracket**



Source: National Survey on Securities Investment (JSDA)

Exhibit 18. **Reasons for buying investment trusts**



Source: National Survey on Securities Investment (JSDA)

trusts ownership increased sharply in the 20-29, 30-39 and 40-49 age brackets between 2018 and 2021 in particular. In the over-59 age brackets, by contrast, no such growth trend is evident. The share of investment trust owners under age 60 has consequently increased to 55% as of 2021, up from 47% in 2018 and 40% in 2015. Additionally, the percentage of younger Japanese who do not yet own equities or investment trusts but recognize they need to do so has also risen rapidly in recent years[8]. This trend bodes favorably for continued growth in the under-60 age brackets' share of investment trust owners.

A second driver of the resurgence in investment trust inflows is changing attitudes among Japanese toward saving and investment, particularly investment trusts. Exhibit 18 summarizes investment trust owners' responses to a JSDA survey question about why they bought investment trusts. Over 60% of the 2021 survey's respondents under age 60 reported they had bought investment trusts "as a long-term investment." This percentage has been rising since 2012. Other responses that have sharply increased in prevalence since 2012 among respondents under 60 include "so I can be diversified" and "because I can yen cost average." In contrast, the percentage of respondents under 60 who bought investment trusts "in pursuit of short-term price gains" has decreased, falling to around 10% in the most recent survey.

Expectations vis-à-vis investment trusts have been changing even among investment trust owners in their 60s and 70s. Among 60-79 year-olds, one common reason for buying investment trusts is "to receive periodic distributions," but this reason's prevalence has been decreasing since peaking in 2015. In 2021, it was supplanted as the top response among 60-79 year-olds by "as a long-term investment," the response rate for which has increased in each of the surveys since 2012.

Such growth in investment trust ownership among younger Japanese and changes in expectations and perceptions toward investment trusts among investors of all ages are presumably largely ascribable to *Tsumitate* NISAs and/or iDeCo retirement accounts, eligibility for which has recently been expanded. These programs emphasize the benefits of long-term investing, diversification and yen cost averaging. As the population of *Tsumitate* NISA and iDeCo account holders has grown, people's image of investment trusts has changed. The Kishida Government has announced that it intends to further expand NISAs and iDeCo accounts as part of its flagship policy aimed at doubling Japanese households' asset-based income. If this policy is implemented as planned, recent changes in people's expectations toward investment trusts should continue to take root.

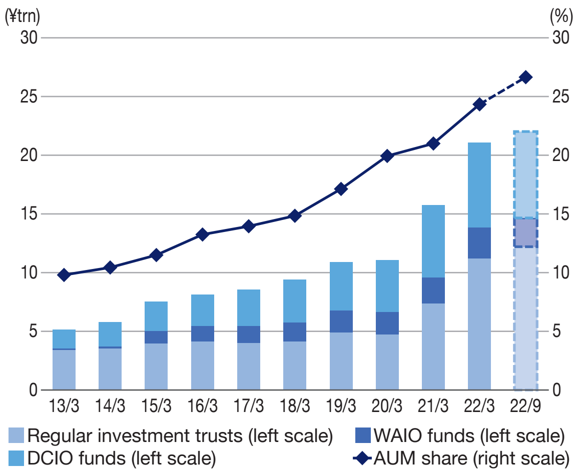
Changes in investment trusts ownership and expectations toward investment trusts are reshaping investment trust market

Such changes in investment trust ownership and public perceptions of investment trusts are rapidly transforming the investment trust market. One aspect of this transformation is a shift toward passively managed investment trusts. This shift reflects that the view that passive investment trusts outperform active investment trusts over the long term is broadly gaining credence among retail investors as they recognize the need for long-term investing.

The passive share of equity investment trust AUM has long been steadily rising. After ending FY2017 at 14.8%, it has gained upward momentum in the wake of growth in investment trust ownership, mainly among younger Japanese, since *Tsumitate* NISAs' 2018 advent (Exhibit 19). In the regular investment trust sales channel in particular, which includes *Tsumitate* NISAs, passive AUM have doubled between March 2018 and September 2022. Meanwhile, total passive investment trust AUM and the passive share of equity investment trust AUM have increased to ¥22trn and 26.6% as of September 2022, driven partly by growth in passive investment trust holdings in not only *Tsumitate* NISAs but also DC retirement accounts amid growth in DC plan participation.

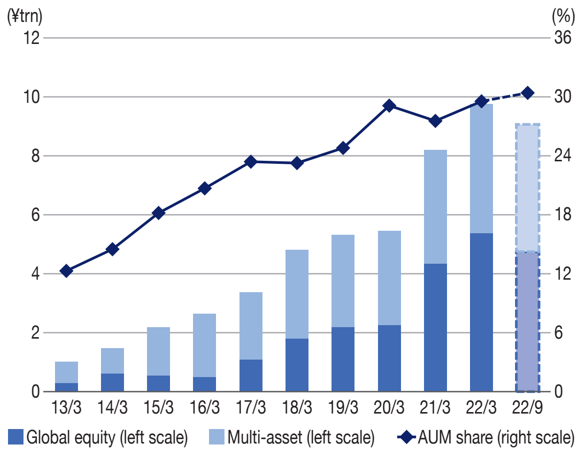
Additionally, with retail investors increasingly using investment trusts as a diversified investment vehicle, diversified active investment trusts ex dividend funds[9] have also been enjoying AUM growth. Such investment trusts consist largely of multi-asset funds[10] diversified across multiple asset classes globally and global equity funds that hold internationally diversified stock portfolios. Active investment trusts ex dividend funds have seen robust AUM growth, albeit not to the same extent as passive investment trusts. Specifically, their AUM have grown 260% over the 10 and a half years through September 2022, driven by thematic investment trusts that have successively gained popularity for a while in addition to multi-asset and global equity funds, which have attracted asset inflows in the hundreds of billions of yen every year since FY2017. By virtue of such inflows, multi-asset and global equity funds' aggregate AUM have grown to over ¥9trn as of September 2022, up from only ¥1trn in March 2013 (Exhibit 20).

Exhibit 19. **Passive investment trust AUM**



Note: AUM share is the passive share of total open-end equity investment trust (ex ETF) AUM.
Source: NRI

Exhibit 20. **Diversified active investment trust AUM**



Note: AUM share is diversified active funds' share of total actively managed investment trust (ex ETF, dividend fund and DCIO/WAIO fund) AUM. Multi-asset excludes balanced funds that use leverage.
Source: NRI

AMCs competing to provide more value to customers

In the passive investment trust space, AUM growth has been accompanied by intensification of price competition. Passive investment trusts that track the same index compete with each other by lowering their management fees. Such fee-cutting has substantially reduced passive investment trusts' average management fee. Price competition among active investment trust is currently less fierce but may intensify going forward for a couple of reasons.

One reason is that comparing investment trusts within a subset of those deemed suitable as long-term investments may become common among investors with a long-term orientation. If investment trust ownership continues increasing mostly among younger Japanese, one can easily imagine investment trust comparison services becoming more widely available online or through apps.

The second reason is that investment advisory services are now more likely to gain prevalence in Japan than in the past. The FSA is currently looking into easing restrictions on fund distributors' entry into investment advisory businesses. If such deregulation comes to fruition, more financial institutions would likely offer investment advisory services. Those entering the investment advisory business would presumably be more selective in assembling their investment trust offerings than they hitherto have been in their capacity as mere fund distributors. They may, for example, start caring more about the prospective performance of the investment trusts they offer to customers because investment advisory services generally have a fee structure where revenue growth directly hinges on growth in customer assets.

AMCs unable to offer funds appealing to customers and distributors consequently may not survive. The FSA's *Progress Report on Enhancing Asset Management Business 2022* warned that many funds do not deliver added value to customers. AMCs do not need to be reminded by regulators that they have to upgrade their portfolio management capabilities and set their fee rates appropriately to ensure their funds' competitiveness.

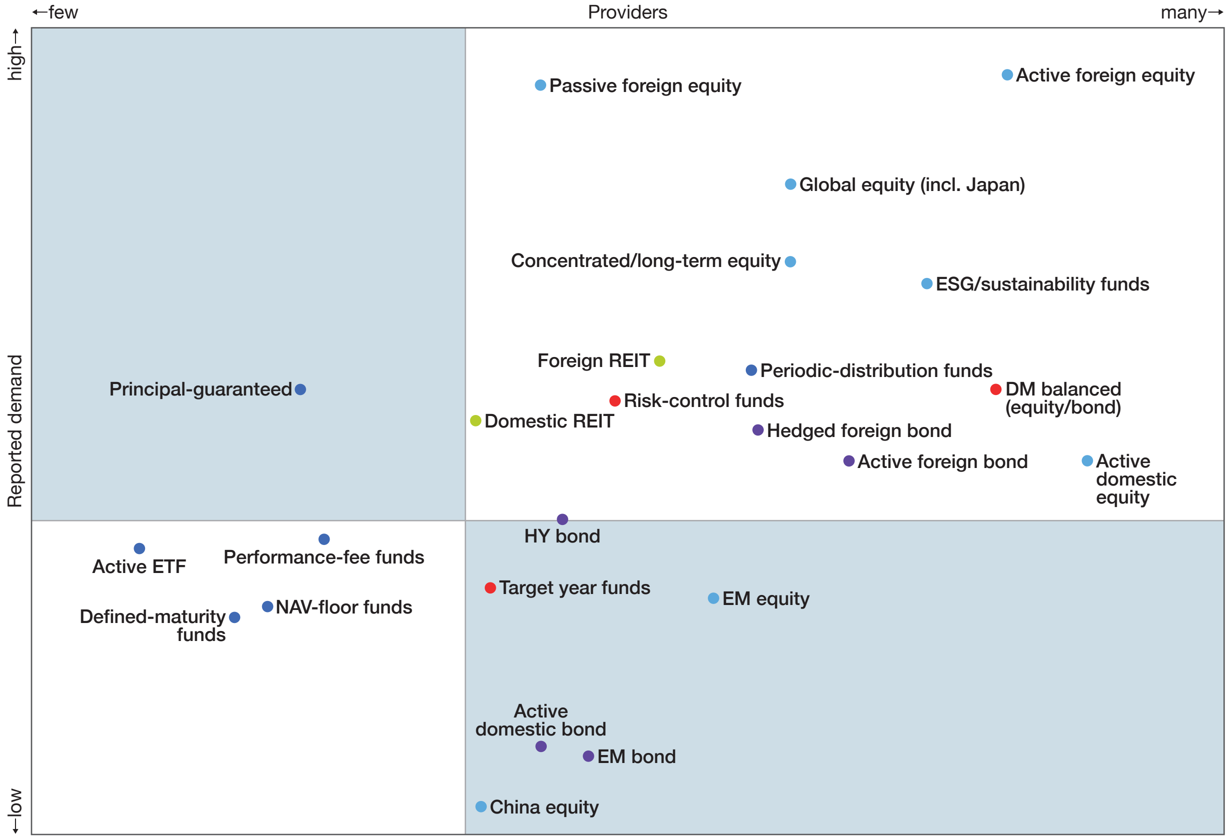
3 Product market trends by investor segment

We have created product opportunity maps for three investor segments (retail, pension funds, and financial institutions) based on data from our latest *Survey of Asset Management Companies' Management Priorities*, conducted in August 2022. 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 presents our product opportunity maps for a subset of products.

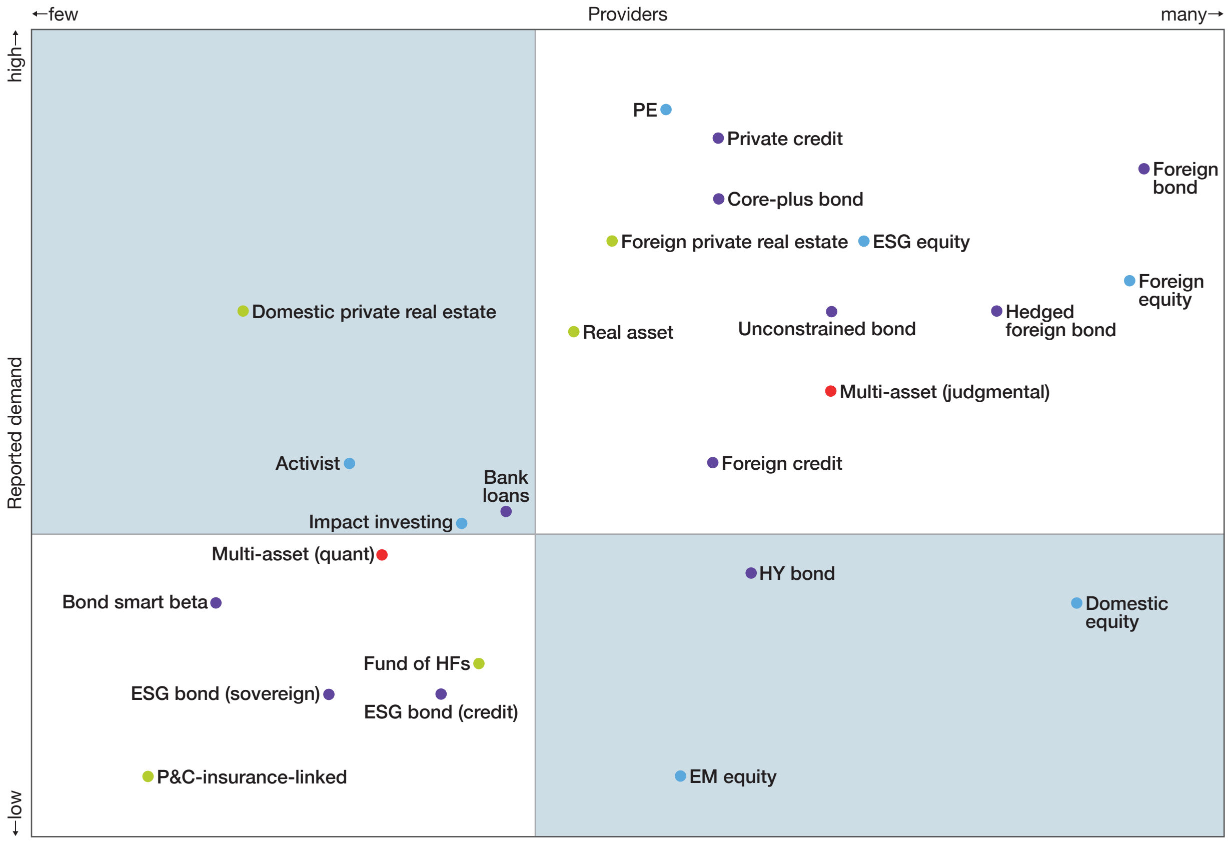
In the retail investor segment (Exhibit 21(a)), the products that rank highest on the demand scale are mostly foreign equity products for yet another consecutive year. Specific products that scored highest on the demand scale include active and passive foreign equity funds, concentrated equity funds with long-term investment horizons and ESG-themed equity funds. Their demand rankings are consistent with public investment trusts' actual fund flows. In the foreign equity asset class, active funds that have been attracting the heaviest inflows include growth stock funds, mainly those focused on healthcare and the US tech sector. Among passive foreign equity funds, those that track the S&P 500 and MSCI All Country World Index are enjoying continued inflows. Japanese equity funds, by contrast, remain lowly ranked on the demand

Exhibit 21. Product supply and demand maps by customer segment

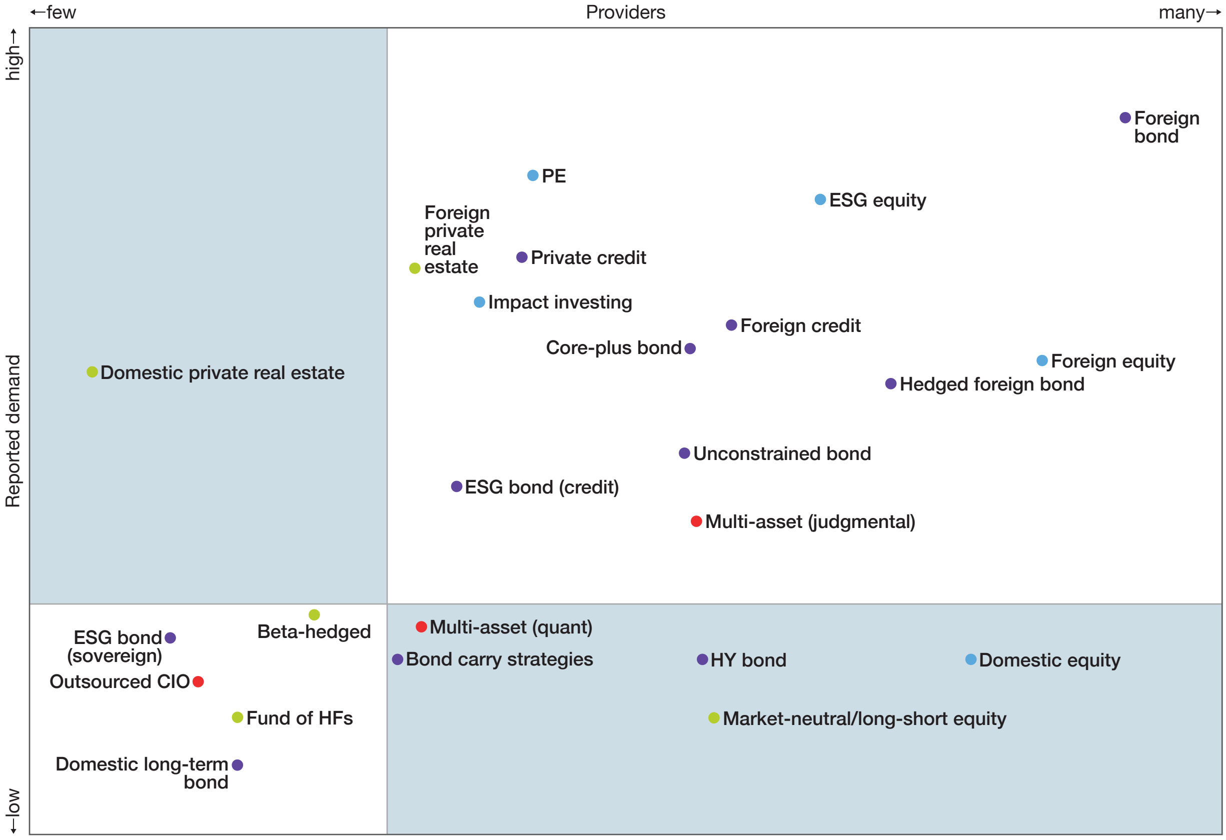
(a) Products for retail investors



(b) Products for pension funds



(c) Products for financial institutions



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

scale while EM and China-related equity products are ranked lower than in 2021.

In the bond space, the product ranked highest on the demand scale is currency-hedged foreign bond funds. One notable change from FY2021 is that currency-unhedged foreign bonds are ranked higher, nearly at parity with currency-hedged bonds, reflecting the yen's sharp depreciation in 2022. Another, albeit directionally opposite, change from 2021 is a lower ranking, near the bottom of the demand scale, for EM bonds.

Balanced funds generally scored lower on the demand scale than in 2021. The survey respondents likely see retail investors as preferring to overweight foreign equities rather than hold a balanced portfolio diversified with low-yielding bonds. If interest rates stop rising, demand may shift back toward balanced funds with bond allocations. Among funds structured with distinctive features, periodic-distribution funds and principal-guaranteed funds are ranked highly on the demand scale. The latter are available from few AMCs.

Next, in the pension fund segment (Exhibit 21(b)), demand assessments are mixed in both the equity and bond asset classes. Among equity products, private equity (PE) and ESG strategies scored high on the demand scale while EM equities are ranked lower than in 2021, near the bottom of the demand scale, perhaps out of concern about a US recession and/or geopolitical risk. Impact investing strategies also are ranked low on the demand scale, possibly in response to a lack of clarity around fiduciary relationships.

Among bond products, private credit scored higher on the demand scale than in 2021 and unconstrained strategies maintained a relatively high demand ranking. Strategies focused on credit products like bank loans and high-yield bonds also maintained demand rankings largely unchanged from 2021 against a backdrop of recession concerns in a rising rate environment. Bond smart-beta strategies, by contrast, are ranked lower than in 2021.

Multi-asset strategies' rankings are presumably based on perceived demand from corporate pension funds because Japanese public pension funds have yet to allocate to any multi-asset strategy. Judgmental multi-asset strategies are still ranked higher than quant multi-asset strategies on the demand scale. Among illiquid alts, domestic and foreign private real estate products (including REITs) are ranked higher on the demand scale than in 2021. Real assets likewise scored higher on the demand scale than in 2021, likely reflecting global inflation.

In the financial institution segment (Exhibit 21(c)), products that remain in strong demand in survey respondents' assessment include foreign bond, currency-hedged foreign bond, foreign credit and core-plus bond strategies. Unlike pension funds, financial institutions are more interested in products that invest in specific sectors offering relatively high fixed returns than in diversified portfolios to be held over the long term. Recent private fund launches increasingly feature funds that invest in products such as Australian dollar bonds (e.g., commonwealth government bonds, semi-government bonds) and Canadian provincial bonds in addition to funds investing in products already popular with Japanese financial institutions, such as US treasuries, US municipal bonds, US mortgages and Danish covered bonds.

The equity products ranked highest on the demand scale are ESG strategies and PE. Impact investing strategies also have a high demand ranking in the financial institution segment, in contrast to the pension fund segment. Financial institutions are apparently keenly interested in investments that yield non-economic benefits in lieu of monetary returns. Judgmental multi-asset strategies are ranked higher than quant multi-asset strategies, like in the pension fund segment.

8) For example, this percentage rose among Japanese under age 60 from 16% to 23% between 2015 and 2021 while rising from 8% to only 9% among Japanese aged 60 and older.
9) Excluding DCIO and WAIO funds.
10) Excluding balanced funds that use leverage.

CHAPTER 4

Active management and product governance

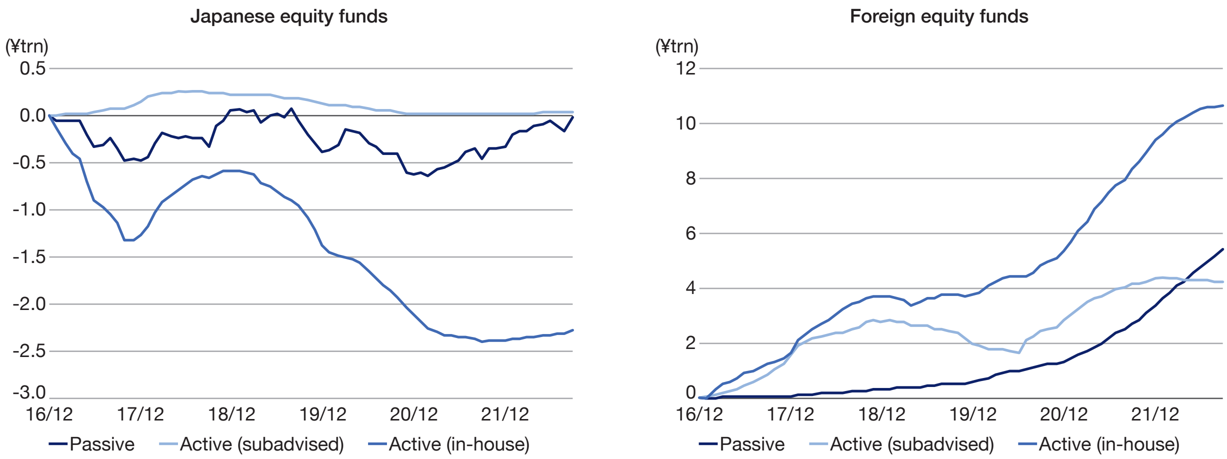
AMCs need effective product governance (product-by-product quality control focused on customer value) to win investors' trust and expand their businesses. Below we discuss product governance's importance, the current state of Japanese AMCs' product governance and practical lessons that can be gleaned from the UK's Assessment of Value framework for fund managers. First, we look at how Japanese AMCs are currently expanding process-based businesses such as passive fund management.

Public investment trusts: divergence in asset flows between domestic and foreign equity funds

Since 2017, Japan's public investment trust complex (open-end funds ex ETFs, DCIO funds and WAIO funds) has seen a distinct divergence in asset flows between domestic and foreign equity funds[11] (Exhibit 22). Among domestic equity investment trusts, those actively managed in-house by their sponsor have experienced some ¥2trn of net outflows since January 2017 while index fund flows have netted out to roughly zero over the same timeframe. Meanwhile, foreign equity investment trusts have enjoyed not only more than ¥10trn of net inflows to active funds, most of which are sponsored by foreign AMCs, but steady index fund inflows as well[12]. Subadvised foreign equity funds[13] offered by Japanese AMCs have garnered net inflows of over ¥4trn since 2017.

Such flows imply Japanese retail investors are counting heavily on foreign (mainly US) equities for beta and, to a lesser extent, alpha (excess returns or manager acumen) too. Conversely, they seem to have little faith in Japanese equities as a source of beta and to be losing confidence in Japanese equities' alpha prospects as well.

Exhibit 22. **Net inflows to public investment trusts (cumulative since 2017)**



Source: NRI Fundmark DL

Process-based business expansion

Management of index funds or subadvised funds can be called a process-based business. We use "process" to mean such funds provide portfolios constructed in accord with predetermined rules. In addition to index funds, other funds with a process-based business model include passively managed balanced funds, most notably target date funds, and smart beta strategies. Subadvised funds offered by Japanese AMCs with the intention of keeping the same subadvisor for the life of the fund also fit the process-based mold. In fact, many investment trusts in Japan include their subadvisor's name in their own names. Customers of such asset management services pay fees to an AMC to construct and manage portfolios in accord with rules agreed to in advance. In exchange, they receive the resultant returns. Because the AMC is merely following a rules-based process, it ultimately does not assume responsibility or have much motivation to make the customer's post-investment experience better.

In contrast to process-based businesses, outcome-oriented multi-asset strategies and traditional active funds that aim to deliver absolute returns or excess returns against a benchmark can be called product-based businesses[14)]. "Product" here means an asset management product that cannot be codified into a set of rules and outwardly resembles a black box. When investing in such a product, customers expect the manager to outperform. They accordingly tend to be willing to pay relatively high fees. In turn, the manager has an incentive to try to deliver better investment experiences to customers.

Given the obvious difficulty of differentiating rules-based processes, if the asset management industry leans too far in the direction of process-based businesses, price (i.e. fee) competition would ensue. Public index funds' asset flows are highly sensitive to price (e.g., management fee rate) signals. In light of the economies of scale and low switching costs in the public investment trust market, price competition is likely to progressively weed out undifferentiated asset management services, ultimately turning the market into an oligopoly.

In product-based businesses, AMCs seek some sort of unique differentiator or relative advantage through such means as generating investment ideas from research. Product-based businesses tend to be hard to replicate and have ample scope for differentiation. If an AMC is able to deliver positive investment returns after fees over the long term, customers should at some point collectively express confidence in its products in the form of net asset inflows. Although active management is subject to capacity constraints, active fund managers can ultimately grow their businesses by gaining customer loyalty with their intellectual property and/or brand.

Why product governance is necessary

The question of whether to provide customers with products or processes has historically been decided at the level of management strategy or company principles. With demand for process-based solutions growing in recent years, major AMCs are increasingly allocating resources to process-based businesses. What is required in terms of governance, however, differs somewhat between process-based and product-based businesses.

In the case of process-based businesses, customers minimally expect their chosen process to keep functioning effectively. AMCs consequently have to test and evaluate their processes' robustness retrospectively, identify risks to the processes' ongoing functionality and mitigate such risks.

For product-based businesses, it is important for AMCs to assess how confident they are in each of their products' ability to prospectively generate alpha after fees. Products pose major information asymmetries, including black-box elements whose internals are inscrutable to outside observers. Information that reduces these asymmetries is highly valuable to customers in terms of helping them to act rationally. Additionally, AMCs must take steps to increase expected alpha through such means as allocating resources, building portfolio management teams and designing incentives.

To grow, product-based businesses in particular are more dependent on long-term relationships of trust with customers than process-based businesses are. AMCs with product-based businesses must practice product governance that imparts confidence to customers that their products' future performance is likely to meet the customers' expectations. If such product governance takes root, it should help to generate alpha opportunities. It might even reverse the erosion of retail investors' alpha expectations vis-à-vis Japanese equity funds, for example, while also increasing such funds' beta appeal.

Current state of product governance initiatives

Japanese AMCs are actively strengthening their product governance regimes. With the FSA increasingly prodding financial services providers to run their businesses more customer-centrically in recent years, AMCs have been forced to grapple with the challenge of winning customers' trust and rebuilding their revenue bases. AMCs now have to be keenly cognizant of customer value in the context of originating, providing and managing products. In other words, they have to figure out how to deliver cost-beneficial performance to customers over the long term, not just operate in accord with their respective groups' policies or fund distributors' wishes.

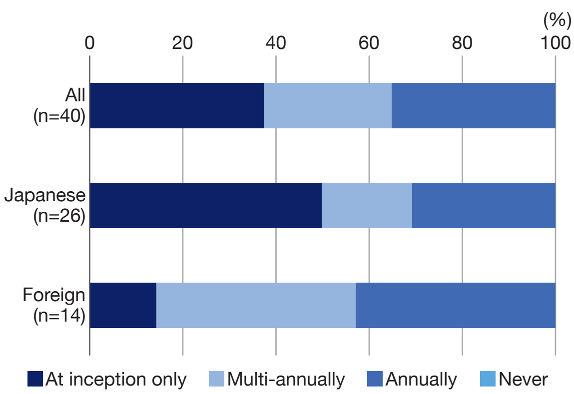
The key to implementing internal controls to ensure effective product governance is to make arrangements to (1) periodically assess customer value on a fund-by-fund basis and (2) enable senior management, including outside directors, to fulfill their responsibilities in the assessments.

(1) Periodic customer value assessments

Periodic reassessment of existing funds' customer value plays a crucial role in quality control at the individual fund level because how successfully a fund has been able to implement its original investment strategy and how cost-competitive it is in comparison to both rival and sibling funds are partly a function of the market environment and competitive landscape since the fund's launch. Additionally, ongoing quality control will become increasingly important to AMCs if they expect medium/long-term fund ownership to become more prevalent than in the past.

Exhibit 23 plots survey data on how frequently AMCs that manage public investment trusts assess the reasonableness of individual funds' trust fees. Nearly 40% of all respondents reported that they perform such an assessment only at fund inception. Only one third of respondents assess their funds' fees annually. Japanese AMCs appear less likely than foreign AMCs to have a periodic fee monitoring program, with half of the Japanese respondents reporting they assess fees only at fund inception. Quite a few Japanese AMCs are working on strengthening their post-launch monitoring regimes. Their progress bears watching going forward.

Exhibit 23. **Frequency of assessments of reasonableness of individual funds' trust fees**



Note: Sample is limited to AMCs that manage public investment trusts. No respondents chose "Never" as a response. Survey was conducted in August 2022.
Source: NRI *Survey of Asset Management Companies' Management Priorities*

(2) Senior management's role in product governance

To ensure the effectiveness of product governance, senior management must assess the adequacy of internal processes. Independent outside directors should fulfill a third-party oversight function in the product governance process.

Exhibit 24 presents survey data on senior management's role in product governance at AMCs that manage public investment trusts. It plots responses to two survey questions and disaggregates the response data based on how much public investment trust AUM the respondents have. The first survey question is whether senior management periodically assesses individual funds to decide whether each one should keep operating or be dissolved. The second is whether quantitative information on customer value is periodically reported to outside directors.

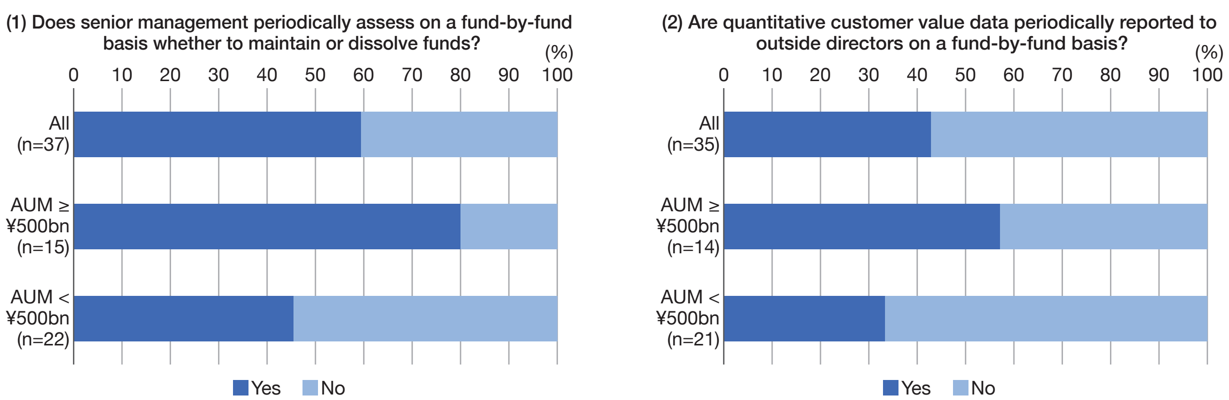
The first question was answered affirmatively by roughly 60% of all respondents; the second by some 40%. These affirmative response rates were higher among AMCs with ¥500bn or more of public investment trust AUM. Such AMCs have more products and therefore place more importance on product monitoring than AMCs with less than ¥500bn of AUM. The second question, however, was answered negatively by 40% of even the respondents with ¥500bn or more of public investment trust AUM. The asset management industry has more work to do in terms of creating an environment conducive to outside directors' full involvement in product governance.

What Japanese AMCs can learn from the UK's AoV mandate for fund managers

In addition to building such a product governance regime, it is important for AMCs to also formulate criteria based on cogent, coherent logic to assess whether their funds are providing sufficient customer value. Equally important is a corrective-action plan for funds deemed deficient in terms of customer value. In particular, AMCs need to cogently explain to not only end investors but also fund distributors and other stakeholders why they have decided to wind down, or cut their management fees on, funds that do not provide enough customer value in their assessment.

The FSA's 2022 progress report on the asset management industry identified deficiencies in (1) fund performance assessments, (2) cost assessments and (3) product governance regimes as impediments to product governance that places utmost precedence on customer interests (Exhibit 25, left column). The first two reflect that customer value is not adequately

Exhibit 24. **Senior management's role in product governance**



Note: Percentages of respondents that reported (1) their senior management do or do not periodically discuss/assess whether to continue operating or dissolve funds on a fund-by-fund basis and keep records of these decisions pursuant to internal regulations and (2) they do or do not quantify the added value that each product provides to customers and periodically report the data to outside directors pursuant to internal regulations. "AUM" is public investment trust AUM.
Source: NRI *Survey of Asset Management Companies' Management Priorities*

Exhibit 25. Features of UK's AoV program

Deficiencies identified by Japan's FSA	UK's AoV program
(1) Performance	
• Performance net of fees is not adequately monitored • Performance is monitored over short timeframes even for funds with poor long-term performance and no major corrective action is undertaken	Performance is assessed • net of all payments out of fund assets and • over an appropriate timescale
(2) Costs	
• Costs are compared only with similar rival products; differences in investment policies between products are overlooked • AMCs do not adequately consider resetting fees or whether to dissolve funds	• Costs are assessed from multiple angles, including profit margins, economies of scale and comparisons with both peers' and own funds • Funds are required to take corrective action when charges are deemed not justified
(3) Governance	
• Authority and responsibility for cross-organizational quality control are not clearly delineated, resulting in inadequate sharing of information with senior management, including outside directors • Senior management do not adequately recognize the need for an effective product governance regime	• Fund management company performs AoV; its governing body chair bears responsibility • Governing body's independent members provide input and challenge to value assessment process • Every fund annually discloses assessments and corrective action (by unit class)

Source: NRI

factored into fund assessment criteria.

In addressing these deficiencies, Japanese AMCs may find the UK's Assessment of Value (AoV) mandate to be instructive. Adopted in 2018, the AoV mandate involves three steps: value assessment, corrective action and disclosure. First, fund managers (including managers that outsource portfolio management) must annually assess whether the management and other fees charged by each of their funds are justified by the value provided to the fund's investors. Such value assessments must minimally factor in seven considerations, including fund performance, service quality and fee-rates charged by peers. Second, if a fund manager determines as a result of the value assessment that a fund's fees are not justified by the value provided to investors, the manager must take corrective action. Third, fund managers must annually disclose the content and outcomes of discussions of all factors considered in value assessments, comprehensive determinations of whether funds provided sufficient value, and any corrective action taken.

Exhibit 25's right column lists performance and cost assessment criteria and governance arrangements required by the UK's AoV mandate. A comparison of Exhibit 25's left and right columns reveals that the UK's AoV program nicely addresses the aforementioned product governance deficiencies flagged by the FSA.

For example, the UK requires fund performance to be assessed net of costs and over an appropriate timescale. Funds' costs must be assessed from various angles, including not only relative to similar rival funds but also relative to the fund manager's own products and services and to the cost of providing the service to which the charge relates. The extent to which the fund benefits from economies of scale must also be factored into the cost assessment.

Because the AoV mandate is principles-based regulation, compliance with it undeniably differs somewhat among UK fund managers[15)]. That said, how UK fund managers comply with the mandate could be highly instructive for Japanese AMCs that want to cogently and logically incorporate customer value in fund quality control.

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11) Foreign equity funds include global equity funds that invest in Japanese equities.

12) The asset flows are totals for funds not categorized as “special” by JITA. Active funds managed in-house are active funds sponsored by foreign AMCs or non-subadvised active funds sponsored by Japanese AMCs. However, they include funds de facto managed by external managers through fund-of-funds arrangements.

13) Subadvised active funds are funds sponsored by a Japanese AMC and managed by an external subadvisor.

14) Even when investment decision-making cannot be codified into a set of rules, there is no such thing as undisciplined investment decision-making among professional fund managers. Active management approaches are broadly categorized as either judgmental or quantitative. The former places priority on qualitative information; the latter is based on quantitative information. One commonality shared by the two approaches is they both require a balance between discipline and flexibility.

15) One common criticism of the UK's AoV mandate is that fund managers tend to be lenient in their value assessments because they are assessing their own funds. Another is even though fund managers disclose their value assessments in writing on a fund-by-fund basis, investors cannot use the assessments to compare funds between fund managers because assessment/presentation methods differ among managers.

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