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vol.28 (31.October.2007)

Special Edition

Japan's Asset Management Business 2007 (Summary)

Nomura Research Institute, Ltd.

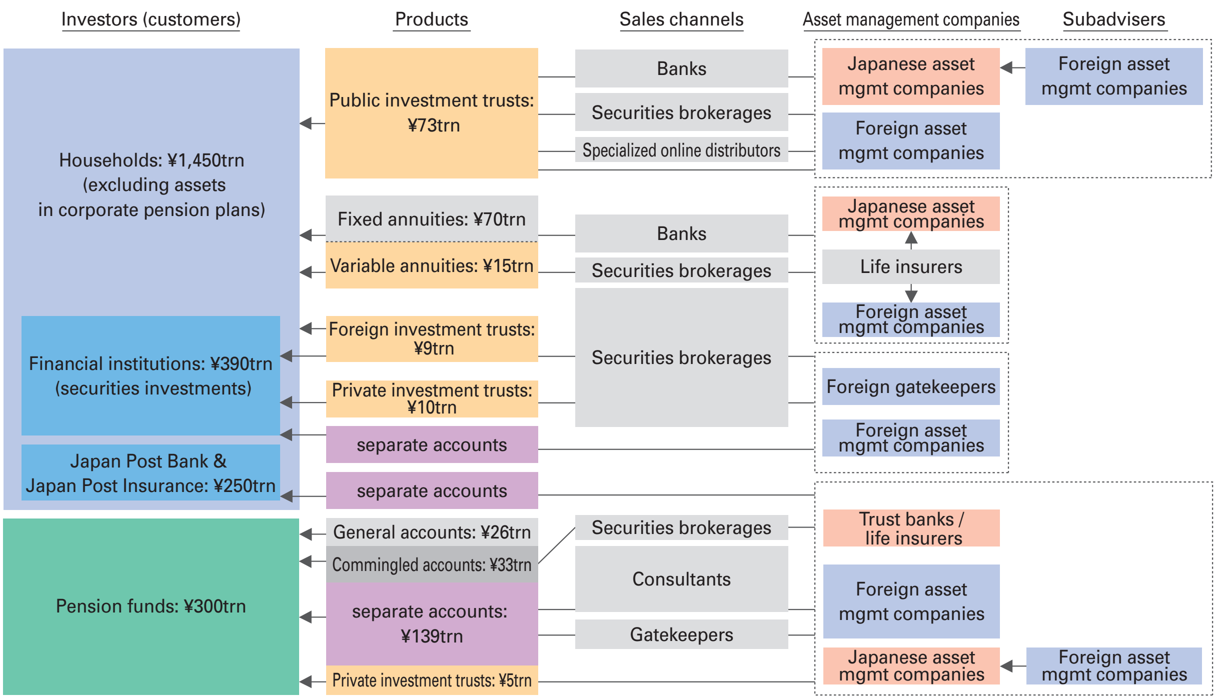
Japanese investor trends

Japanese investors have major potential

Japan's asset management market has grown substantially since the 1990s. Exhibits 1 provides an overview of the market broken down in terms of investors, products, distribution channels, and asset managers. It shows in simple terms which types of asset managers manage money for which types of investors, how investor assets are allocated, and how the money flows are intermediated.

In Japan, asset management companies mainly serve three types of clients: individual investors (households), corporations including financial institutions, and pension funds. Adjusted to take into account that financial institutions' securities portfolios are basically funded with retail customers' deposits, these investors' asset holdings total some ¥1,750trn. Meanwhile, asset management companies' assets under management (AUM) as of end-March 2007 totaled approximately ¥413trn[1)], including ¥40trn managed on behalf of overseas clients. That is, only about 20% of Japanese investors' assets are managed by asset management companies. In other words, Japan has a massive pool of assets yet to be tapped by asset management companies. We accordingly see enormous potential in the Japanese asset management business.

Exhibit 1. Overview of Japan's asset management business



Source: NRI, based on data from various sources

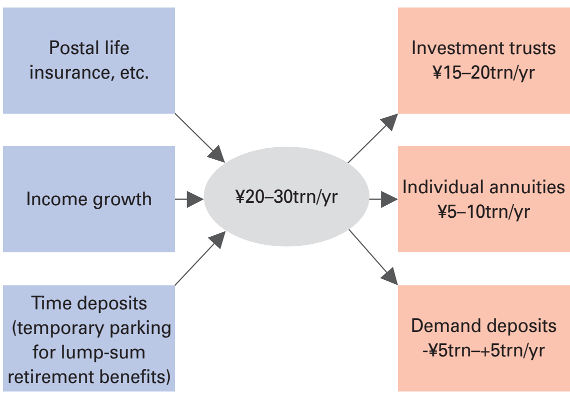
Of asset management companies' AUM, domestic clients account for ¥374trn, 75% of which are managed on behalf of wholesale clients (financial institutions, pension funds). Although the retail market is larger in terms of the pool of assets that can potentially be tapped, asset management companies' main clients are currently institutional investors, at least from the standpoint of AUM.

Households: Japan's largest asset holders

Japanese households have massive financial asset holdings totaling roughly ¥1,500trn, a renowned number often cited even overseas in the context of the Japanese asset management business's potential. However, households currently hold the bulk of their financial assets in the form of cash and bank deposits. Their allocation to risk-bearing assets is still small.

Against such a backdrop, change is afoot. Over the past five years, households have been steadily reallocating financial assets out of postal savings accounts, loan trusts, bank debentures, and other such asset classes at an average rate of about ¥20trn per year. Including funds derived from endogenous growth in their financial asset holdings, households have been reallocating a total of ¥27trn annually to new investment vehicles, mainly investment trusts, individual annuities, and JGBs. Inflows into these three asset classes have been running at ¥23trn annually. Recently, inflows into investment trusts and individual annuities in particular have been growing. A major shift in behavior from saving to investment is unmistakably underway.

Exhibit 2. Projected household-sector money flows into/from investment products (5-year horizon)



Source: NRI

Looking ahead with a five-year horizon, we project cash inflows to the household sector of over ¥50trn in conjunction with the mass retirement of the postwar baby boom generation. Even if most of this money is temporarily parked in time deposits and other such savings vehicles, we expect much of it to ultimately flow into investment products such as individual annuities and investment trusts as a hedge against longevity risk or a source of income to cover living expenses. Meanwhile, banks aiming to increase their fee income while downsizing their balance sheets are increasingly pursuing sales of financial products to retail customers. With the supply and demand sides of the market thus in alignment in terms of their respective needs, such financial products are likely to experience inflows of some ¥20–30trn annually for at least the next five years (Exhibit 2).

Financial institutions are increasingly investing in securities

The biggest class of wholesale investor is pension funds. Public pension funds and corporate pension plans have assets of roughly ¥200trn and ¥100trn, respectively. An estimated ¥203trn of these assets are managed by asset management firms. The pension market is huge, but with Japan's population shrinking and the baby boomers retiring, it does not have much prospect of major growth in assets.

Banks, insurers, and other financial institutions are increasingly investing in securities. Banks in particular continue to increase their securities holdings as a percentage of their deposits. Banks ended FY06 with securities holdings of approximately ¥200trn. In the face of sluggish growth in corporate loans, banks are increasingly looking to their securities portfolios as a profit source.

This trend is evident in the composition of banks' securities holdings. Although bonds still account for 60% of their securities holdings, banks have modestly reduced their bond holdings, mainly JGBs, while increasing their holdings of so-called "other securities." These other securities include foreign securities and securities with the potential for high returns such as investment trusts and hedge funds (which are classified in the "other" subcategory of "other securities"). Holdings of "other other securities" have been growing in recent years, particularly among city banks and regional banks. We expect banks to continue to increase their investments in securities, particularly high-return products, to compensate for sluggish growth in corporate lending.

Also noteworthy is that the postal savings and life insurance programs were privatized in October 2007 as Japan Post Bank and Japan Post Insurance, respectively. Japan Post Bank already has security holdings in excess of ¥150trn as of end-March 2007. It may outsource management of a portion of its securities portfolio in the aim of increasing its holdings of products that offer both diversification and attractive returns, while strengthening its asset-liability management controls pursuant to the banking regulations that apply to all private banks. Japan Post Insurance also will surely place increased importance on asset management, given that it is expected to expand its offerings of individual annuities. Both will be highly attractive institutional investors in the eyes of asset management firms.

Current state of asset management business and asset management firms' management priorities

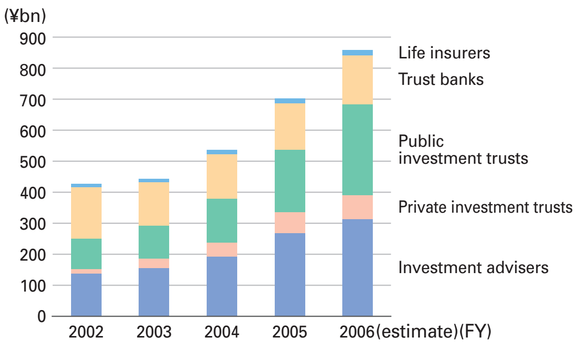
1 The Japanese asset management business should continue to grow robustly

In our estimate, Japan's asset management industry earned management revenues of approximately ¥860bn in FY06 and ended the fiscal year with some ¥413trn in AUM, setting all-time records on both counts for a second consecutive year (Exhibit 3). Relative to FY05, AUM and management revenues increased about 16% and 22%, respectively, in FY06. Specialized asset management firms –i.e., investment advisers and investment trust companies –account for 67% or ¥274trn of the industry's total AUM. More specifically, investment advisers account for ¥168trn (41%) and investment trust companies for ¥106trn (26%). Below we discuss the current status of these asset management companies' business and their management priorities.

FY06 was an historic year in which investment trusts' management revenues substantially surpassed investment advisory revenues for the first time. Including both public and private investment trusts, investment trust revenues totaled ¥370bn, exceeding investment advisory revenues by roughly ¥60bn. Although investment advisers surpass investment trusts in terms of AUM, the latter collected more revenues than the former by virtue of higher fees.

The asset management industry is faring well in terms of operating margins also. Based on a sample of 83 asset management firms with AUM of at least ¥100bn, operating margins have risen sharply in recent years. The 83 companies' aggregate operating margin rose above 30% in FY05 and held steady in FY06. Companies with more AUM tend to achieve higher profit margins by capitalizing on economies of scale, although this tendency is more pronounced in the investment trust business than the investment advisory business. In the investment trust business, which is distinguished by heavy fixed expenses for back-office operations and marketing, small companies' profit margins tend to be substantially lower than large companies'. In the investment advisory business, where companies need not incur heavy fixed costs and even small firms have the potential to be highly profitable if they can land clients by offering a distinctive asset management style, smaller firms could very well achieve higher profit margins than their larger competitors.

Exhibit 3. Asset management companies' aggregate management revenues



Source: NRI, based on asset management companies' income statements filed with the Financial Services Agency and Ministry of Finance, and data published by the Investment Trusts Association and Japan Securities Investment Advisers Association

Japanese majors dominant in investment trusts, foreign firms in investment advisory business

While asset management companies in aggregate are reaping all-time record revenues, the roster of top companies differs substantially between the investment trust and investment advisory businesses. Exhibit 4 lists the top 10 investment trust companies and 10 investment advisers ranked by incremental AUM over the past four years. The shading denotes foreign asset managers.

Exhibit 4. Top-10 asset managers ranked by growth in AUM over past 4 years

Investment trusts

Manager	Increase in assets (¥bn) (Mar '03 – Mar '07)
Nomura Asset Mgmt	8,138.1
Mitsubishi UFJ Asset Mgmt	5,554.7
Kokusai Asset Mgmt	4,397.4
Nikko Asset Mgmt	3,470.5
Daiwa Asset Mgmt	3,184.3
DLIBJ Asset Mgmt	2,984.7
Sumitomo Mitsui Asset Mgmt	2,891.2
Pictet Asset Mgmt (Japan)	2,858.7
Fidelity Investments	2,611.1
State Street Global Advisors	1,795.9

Investment advisers

Manager	Increase in assets (¥bn) (Mar '03 – Mar '07)
Barclays Global Investors	10,998.3
State Street Global Advisors	4,973.3
Nomura Asset Mgmt	3,531.3
PIMCO	3,423.9
Morgan Stanley Asset Mgmt	2,888.9
AllianceBernstein	2,873.8
Tokio Marine Asset Mgmt	2,764.6
J.P. Morgan Asset Mgmt	2,631.9
Fidelity Investments	2,588.2
DLIBJ Asset Mgmt	2,234.1

Source: NRI, based on data published by the Investment Trusts Association and Japan Securities Investment Advisers Association

In the investment trust business, the companies that have achieved the most dramatic growth in AUM are major Japanese asset management companies with a high degree of name recognition and strong sales networks made up of affiliated companies. Such companies occupy the top seven slots. In the investment advisory business, by contrast, the top-ranked companies are foreign firms with strong capabilities in terms of managing assets denominated in foreign currencies. This marked difference in the top-ranked companies in each business reflects major differences in focus between the two businesses.

In the investment trust business, banks account for the majority of investment trust sales. Moreover, sales networks have broadened from the megabanks to regional banks and even post offices. Such distributors typically want in-depth sales support from the asset management company with respect to everything from information about the products being offered to sales methods. To achieve growth in AUM, asset management companies consequently must be large enough to be able to employ a sizable staff to support their distributors. Major Japanese asset management companies that meet this requirement have been gaining market share.

In contrast, investment advisers' main clients are pension funds. For investment advisers, success hinges upon having the asset management acumen that meets clients' needs. Most pension funds, particularly public ones, manage enormous sums of money. Most notably, the Employees' Pension Insurance scheme's assets invested in the markets have increased substantially in recent years. Because such investments are mainly passively managed, foreign investment advisers with strong passive-management capabilities have emerged as the top-ranked companies in terms of growth in AUM. Additionally, many pension funds have switched to new asset managers in response to poor performance of foreign-currency asset portfolios. Such manager changes appear to have caused large influxes of assets to foreign asset management firms skilled at managing foreign-currency assets. While Japanese asset management firms still command a higher share of the investment advisory market for domestic asset management, foreign companies have substantially increased their AUM over the past four years by capitalizing on their distinctive strengths as asset managers.

Division of labor between Japanese majors and foreign firms

Further evidence of such a difference in core competencies is that in the investment trust business, foreign asset management firms have collectively captured less than 30% of the market in terms of both AUM and management revenues. However, even in this market ostensibly dominated by Japanese companies, foreign asset management firms have in fact built a solid presence by capitalizing on their strong asset management capabilities. Specifically, they have done so in a subadvisory role. According to an NRI survey, foreign asset management firms act as subadvisers for over 30% of the AUM of public investment trusts managed by Japanese asset management companies. Including these assets, foreign asset management companies effectively manage roughly 50% of Japanese investment trusts' aggregate AUM. In sum, foreign asset management firms are making inroads into the Japanese market by focusing on core asset management functions, mainly management of foreign-currency assets, while leaving customer service to the major Japanese asset management companies.

The subadvisory business is broadening to encompass not only advising public funds and managing assets on their behalf but also offering other services such as providing funds for funds of funds, variable annuities, and separately managed accounts (SMAs). In our estimate, subadvisory fees total ¥120bn annually. Funds that allocate a large share of their assets to overseas asset classes are currently popular among retail investors. Many such funds outsource the actual management of such foreign assets to foreign asset management firms acting as subadvisers. We expect Japanese asset management companies to continue to outsource management of overseas assets to foreign asset managers as they supply their distributors with a mix of domestic- and foreign-asset products that meets Japanese investors' needs, together with sales support services.

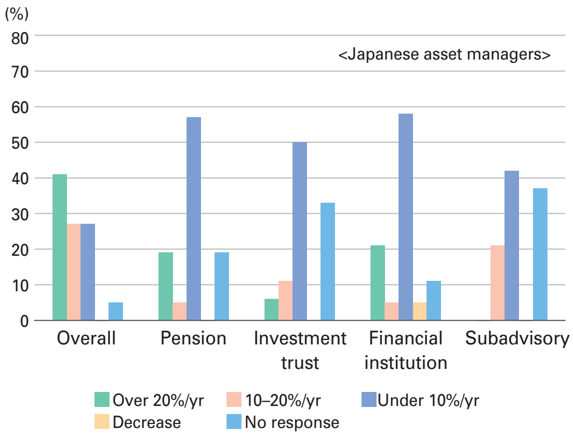
2 Future outlook and management priorities

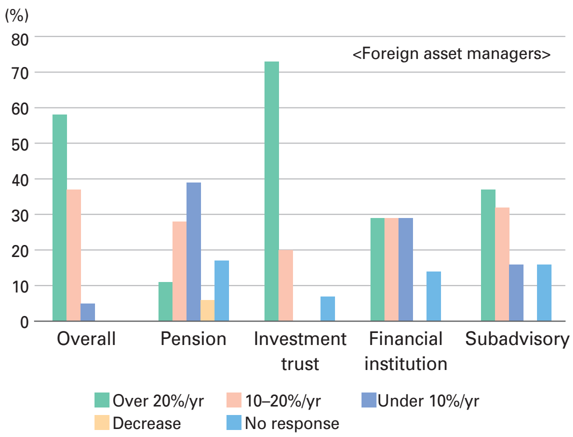
Amid the asset management industry's ongoing brisk growth, how do asset managers themselves perceive the outlook for their business? We conducted a survey of top executives of major asset management companies in June 2007 to ascertain their business outlook and management priorities.

Asset managers project major medium-term growth

Exhibit 5 plots the distribution of survey respondents' projected annual growth rates for their own AUM over the next 3–5 years by market segment (e.g., investment trusts, pension funds), with Japanese and foreign asset managers' responses plotted separately. Overall, the most common response was "over 20% per annum" for both Japanese and foreign respondents, indicating that many asset management executives anticipate continued robust growth in AUM over the medium term. However, the percentage of respondents with a bullish outlook

Exhibit 5. Projected AUM growth rates over next 3–5 years





Source: NRI *Survey of Asset Management Companies' Management Priorities (2007)* was higher among foreign companies than Japanese companies. Such a divergence was evident in all market segments except pension funds, revealing a major difference in outlook between Japanese and foreign asset managers.

In the investment trust segment in particular, over 70% among foreign respondents projected annual AUM growth of over 20% versus only about 40% of Japanese respondents who did likewise. A similar pattern was evident in the financial institution segment, where nearly 60% of foreign respondents projected double-digit growth rates versus less than 30% of Japanese respondents. In the subadvisory segment, nearly 40% of foreign respondents projected a growth rate of over 20% whereas nearly 40% of Japanese respondents did not even venture a projection, partly reflecting that the subadvisory business is dominated by foreign firms.

Foreign asset management companies have a bullish outlook for revenue growth also. When costs also are factored in, however, more Japanese respondents than foreign respondents project improvement in operating margins. We surmise that this difference reflects divergent expectations for growth in personnel expenses, which account for the bulk of asset management companies' costs. Nearly 70% of foreign respondents project double-digit headcount growth rates over the next 3–5 years versus only about 20% of Japanese respondents. Japanese asset management companies have modest hiring plans relative to projected growth in aggregate AUM. They apparently aim to boost profit margins through improvement in efficiency.

Management priorities by organizational function

Our survey asked questions from various angles about management priorities for various organizational functions. Below we summarize our key findings with respect to management priorities for the asset management, marketing, and IT functions, while highlighting differences between Japanese and foreign companies.

Priority for asset management function: HR development

In terms of the asset management function, "development (augmentation) of asset management staff" was a very important priority[2)] for both Japanese and foreign respondents. However, Japanese and foreign respondents differed in their specific approaches to this priority. Japanese asset management companies overwhelmingly indicated that their preferred approach is to hire young personnel and conduct long-term training programs as a key priority. By contrast, over 80% of foreign respondents primarily intend to hire experienced personnel that require little or no training. While this difference between Japanese and foreigners can be largely attributed to well-publicized cultural tendencies, more foreign asset management firms are recently opting to hire and train young personnel, although such companies are still in the minority. The view that Japanese asset management companies are the sole source of personnel for foreign competitors is a misconception.

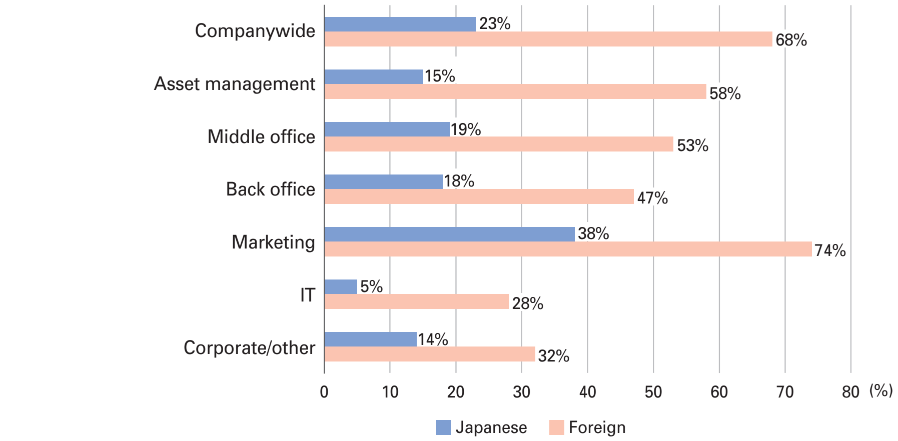
Strengthening the marketing function is a universal priority

Asset management companies aim to strengthen their marketing operations, as is evident from their hiring plans by organizational function. Foreign companies plan to dramatically expand their marketing staffs. Even among Japanese companies, which generally have less aggressive hiring plans, nearly 40% of respondents plan to increase their marketing staffs by at least 10% (Exhibit 6). Hiring plans are more ambitious for marketing operations than for any other function.

In terms of investment trust marketing, the top management priority differed between Japanese and foreign respondents (Exhibit 7). While Japanese companies cited "sales channel strategy" as their top priority, foreign companies cited "product strategy" as theirs. We see this difference in priorities as a strong reflection of the above-noted difference in focus between Japanese and foreign asset management companies.

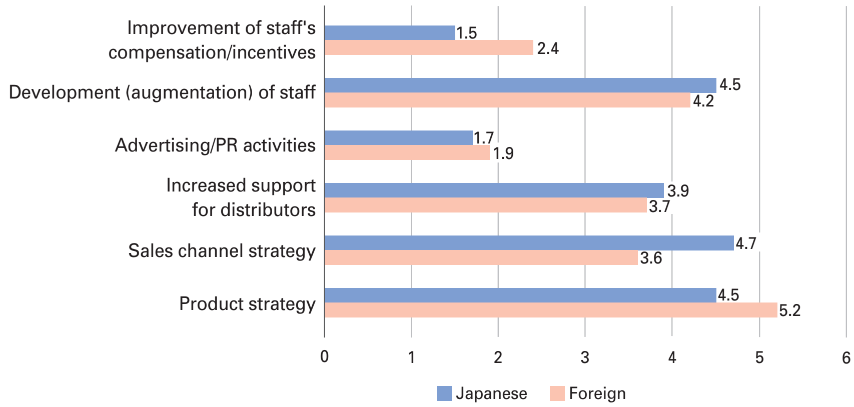
In the investment advisory marketing, the top management priority for both Japanese and foreign respondents was

Exhibit 6. Percentage of asset management firms that plan to increase staffing by 10% or more over next 3–5 years, by organizational function



Source: NRI *Survey of Asset Management Companies' Management Priorities (2007)*

Exhibit 7. Management priorities for investment trust marketing operations



Note: Survey respondents were asked to rank the above six choices in order of importance to their companies. The scores plotted above are weighted averages of the respondents' rankings. For example, if all respondents ranked the same choice as their top priority, its score would be "6".
Source: NRI *Survey of Asset Management Companies' Management Priorities (2007)*

"product strategy," but the two groups differed somewhat in terms of their preferred approach. Japanese companies place utmost priority on "product development based on recognition of customer portfolio attributes." Many foreign respondents likewise cited the same priority, but many also cited "specialization in our core competencies with respect to asset management." This difference also can be construed as a reflection of Japanese and foreign asset management companies' different orientations.

Highest IT priorities are asset management and back-office functions

The functions that were singled out as most important in terms of IT capabilities are asset management and back-office operations, followed by middle-office operations. The highest priority is back-office operations for Japanese companies and asset management operations for foreign companies.

Within the asset management function, the highest priority is, not surprisingly, "upgrading asset management support systems," followed by "upgrading trading systems" and "upgrading quant systems," although these last two are relatively low priorities. In the back office, upgrading systems for investment trusts was a higher priority than doing so for investment advisory services. The highest middle-office priority for both Japanese and foreign companies is "upgrading risk management systems." The next highest middle-office priorities, particularly for Japanese companies, are "installation of pre-execution compliance check systems" and "development of a high-quality, centrally managed, company-wide database."

Key asset management markets: pension and retail markets

1 Pension business

Public pension market: market-invested assets poised to grow over the next few years.

Japanese pension funds, which account for the lion's share of Japan's market for institutional asset management services, had assets of roughly ¥300trn at end-March 2006. Of this total, public pension schemes (National Pension, Employees' Pension Insurance, and Mutual Aid Associations) account for ¥202trn, 70% of which belongs to the Employees' Pension Insurance scheme. Since FY01, the Government Pension Investment Fund (GPIF) has been investing Employees' Pension Insurance assets in the market in earnest, together with National Pension assets. At FY06-end, ¥85trn in GPIF assets were invested in the market.

According to the GPIF's asset allocation as of FY06-end, domestic bonds account for slightly over 50% of market-invested assets, domestic equities account for slightly over 20%, and foreign securities account for the remainder. Given the enormity of the GPIF's AUM, some 80% of its market-invested assets are passively managed. GPIF's management fee is extremely low at 0.03% of assets, reflecting its predominantly passive investment style coupled with economies of scale.

Mutual Aid Associations, the participants in which are civil servants and teachers, are each managed by multiple asset management entities. A pending plan to unify public pension schemes has major implications for investment of these Mutual Aid Association assets. The unification plan calls for public pension schemes for employees to be consolidated into the Employees' Pension Insurance scheme to standardize contribution rates and benefits for all employees, including civil servants. Under proposed legislation[3] submitted to the Diet (parliament) in April 2007, public pension schemes' asset management entities would not be consolidated but a common set of basic asset management policies, including asset allocation targets, would be prescribed for all public pension assets. If the asset allocation targets are modeled after those of the GPIF, the largest of the public-pension asset managers in terms of AUM, Mutual Aid Associations' asset allocations could conceivably converge with the GPIF basic portfolio's.

Meanwhile, Employees' Pension Insurance assets that were deposited into the Fiscal Loan Fund are to be refunded in their entirety by FY08 and the Employees' Pension Insurance scheme's obligation to purchase FILP (Fiscal Investment and Loan Program) bonds will expire in FY07. We project that the GPIF's AUM will consequently increase substantially within about two years and then grow at a moderate pace for the remainder of our five-year horizon.

Corporate pension market: benefiting from favorable investment environment

Corporate pension assets total roughly ¥98trn as of FY06-end. The corporate pension landscape has been changing dramatically in recent years in the wake of various institutional changes.

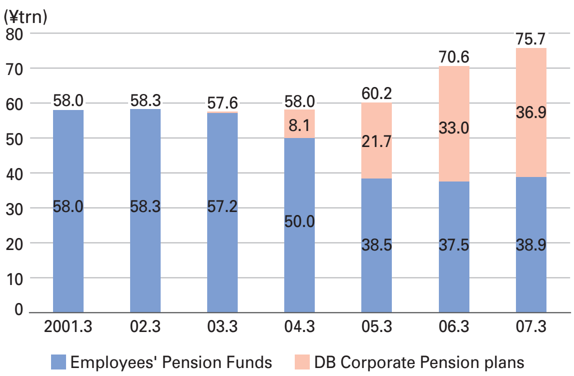
The number of Employees' Pension Funds, the most prevalent type of corporate pension fund in the 1990s, has decreased substantially as result of fund dissolutions and the return of the so-called "substitutional portion" of Employees' Pension Fund assets to the government (*Daiko-Henjo*). In place of the dissolved Employees' Pension Funds, Defined-Benefit (DB) Corporate Pension plans have increased sharply. DB Corporate Pension plan assets have grown to approximate parity with Employees' Pension Fund assets, partly by virtue of growth in DB Corporate Pension plans converted from Tax-Qualified Pension plans, which are slated to be phased out by end-March 2012 (Exhibit 8).

Meanwhile, defined-contribution (DC) corporate pension plans continue to steadily grow in prevalence. DC plans number approximately 2,300, with ¥2.8trn in assets and 2.2mn participants.

Looking ahead over the roughly five years until Tax-Qualified Pension plans are completely phased out, we expect the ongoing outflux of assets from Employees' Pension Funds to continue at a moderate pace. We expect assets from Employees' Pension Funds to flow into DB Corporate Pension plans, together with assets from Tax-Qualified Pension plans. We also anticipate a substantial influx of assets to DC plans from Tax-Qualified Pension plans.

DB pension plans' asset allocation to domestic and foreign equities has been increasing, reflecting equity markets' buoyant performance. The increased equity allocation was funded with a reduction in short-term money market instruments. Otherwise, DB pension plans' asset allocation has not changed much. The breakdown of DB pension assets by asset manager type has not changed much

Exhibit 8. Employees' Pension Fund and DB Corporate Pension plan assets



Source: NRI, based on Rating and Investment Information Inc.'s *Newsletter on Pensions & Investment* and data published by the Trust Companies Association of Japan and Life Insurance Association of Japan

for about three years, although investment advisers have modestly increased their share of AUM. Since FY03, corporate pension plans have generated quite high, albeit volatile, returns. This strong investment performance has led to a major improvement in pension finances also. Corporate pension plans can be said to have benefited from a favorable environment for the past few years.

DC pension plan participants' asset allocations remain heavily weighted toward savings deposits, insurance, and other principal-guaranteed products, but investment trusts' allocation has been steadily growing, recently reaching 35%.

2 Retail business

Japanese households hold roughly ¥1,500trn in financial assets as of end-March 2007. While cash and bank deposits still account for 50% of these assets, the past few years have witnessed heavy flows of household assets into investment trusts, individual annuities, JGBs, and other investment products[4], as discussed above.

Variable annuities account for a growing share of the individual annuity market

Japan's individual annuity market is still heavily weighted toward fixed annuities, but sales of variable annuities have been growing rapidly in recent years. Aggregate variable annuities in force have been growing briskly since banks began selling annuities in October 2002, ending FY06 at roughly ¥15trn, equivalent to one-fifth of aggregate fixed annuities in force.

In terms of product features, annuities with underlying pension funds guarantee or minimum total-payout guarantee in addition to a death benefit account for 50% of the market, reflecting strong demand for principal-guaranteed products. Additionally, some annuity products offer the prospect of a one-time payout three or more years after inception if investment returns exceed a prescribed target rate. Annuities' accumulation phases (i.e., the waiting period preceding payout of insurance benefits) have been getting progressively shorter.

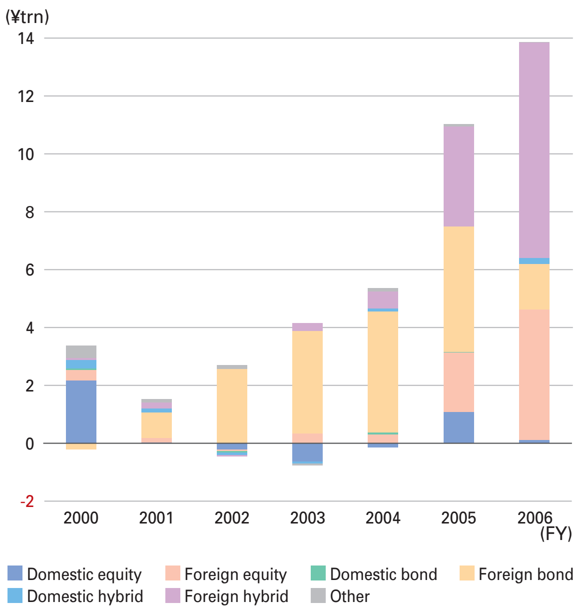
In terms of investment options, balanced products, which invest in a mix of asset classes, account for over 40% of the variable annuity market. Many variable annuity owners also opt for investment in actively managed portfolios of domestic stocks, foreign stocks, or foreign bonds.

Investment trust holdings are growing steadily amid shift in inflows

Japanese public investment trusts' assets have been in a growth trend since FY03, rising to approximately ¥73trn as of end-March 2007. Since FY05, foreign equity and foreign hybrid funds have been garnering large inflows of funds in the wake of a shift away from actively managed foreign bond funds, which had previously been the most popular product (Exhibit 9). In FY06, inflows to foreign bond funds were down sharply to ¥1.5trn, while foreign stock and foreign hybrid funds respectively saw total inflows of ¥4.4trn and ¥7.3trn, collectively accounting for the bulk of investment trust inflows.

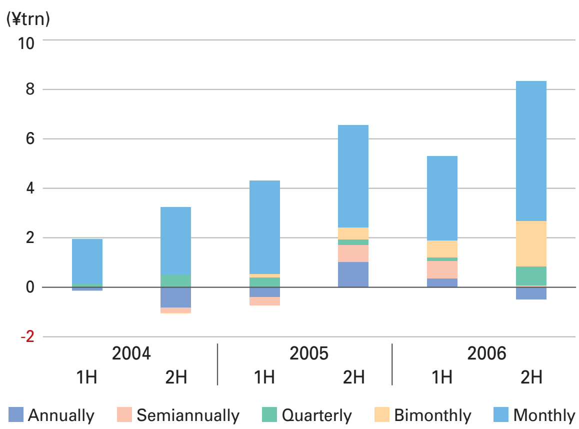
Foreign hybrid and foreign stock funds typically pay extremely high distribution yields, implying that the size of distributions is a key fund-selection criterion for investors. Another key criterion is apparently distribution frequency, given that funds with frequent distributions continue to experience heavy inflows. Recently, however, funds that pay bimonthly or quarterly distributions have been gaining popularity in addition to funds that pay monthly distributions (Exhibit 10).

Exhibit 9. Investment trust inflows/outflows by fiscal year



Note: Excludes ETFs, funds with daily settlement arrangements (e.g., MMFs), and bond investment trusts
Source: NRI, based on Fundmark data

Exhibit 10. Investment trust inflows/outflows by distribution frequency



Note: Excludes ETFs and funds with daily settlement arrangements (e.g., MMFs).
Semiannual periods are on a fiscal-year basis.
Source: NRI, based on Fundmark data

The popular types of investment trusts that invest in foreign assets–i.e., foreign bond, foreign hybrid, and foreign stock funds–charge higher management fees than other types of equity investment trusts. Specifically, their average management fee exceeds 0.6% of assets. Among open-end equity investment trusts, these three types account for the vast majority of aggregate management revenues. Their popularity presents ample opportunity for foreign asset management firms to also increase their revenues from subadvisory services.

Meanwhile, foreign investment trusts marketed in Japan are also gaining popularity. At end-March 2007, their aggregate assets stood at ¥8.5trn, equivalent to a respectable 12% of Japanese public investment trusts' ¥73trn in assets. Looking ahead, we expect foreign investment trusts' assets to remain in a growth trend despite a slowdown in their growth rate in FY06.

By investment style, foreign bond funds account for nearly half of foreign investment trust assets, similar to their share of Japanese investment trusts. However, foreign investment trusts' asset breakdown differs from that of Japanese investment trusts in that funds that invest in alternative asset classes or employ relatively novel investment approaches account for 30% of total assets. Such products' share of foreign investment trusts' assets is growing year by year. We consider the availability of such products to be one of foreign investment trusts' key attractions to investors.

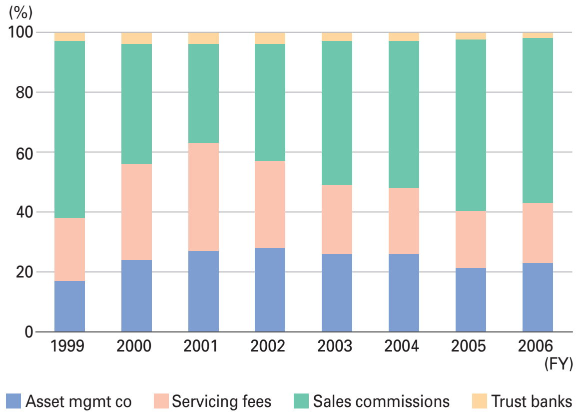
Investment trusts distribution channels: regional financial institutions and Japan Post Bank are key focal points

Revenues generated by the Japanese public investment trust business are split among asset management companies, distributors, and trust banks. Sales commissions earned by distributors account for the largest share, 55% of total revenues (Exhibit 11). Distributors also collect a share of the trust fees as a servicing fee. Including such servicing fees, distributors account for a whopping 75% of total revenues. Distributors' high share of industry revenues reflects that the balance of power in the investment trust market is tipped decisively in their favor.

The face of the investment trust distribution business has changed dramatically since the 1990s, when securities brokerages were the predominant force in the market. Today, banks play a very major role in investment trust distribution. Banks' share of equity investment trust sales (excluding ETFs) surpassed brokerages' share in 2005. Although growth in banks' share of such sales has since slowed, it has grown to 55% as of end-March 2007.

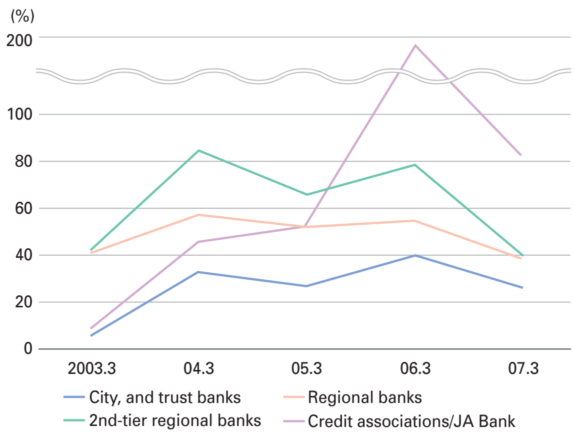
While banks have thus become the main distribution channel for investment trusts, regional financial institutions are currently playing a particularly key role. Regional banks (including second-tier regional banks; ditto below unless otherwise noted) have increased their share of banks'

Exhibit 11. Breakdown of public investment trust fee revenues



Note: (1) Figures are NRI estimates based on individual funds' assets, sales, and management fees. (2) In cases in which a fund's management fee and/or sales commission rate varies over a range, the maximum rate was used.
Source: NRI, based on Fundmark data

Exhibit 12. Investment trusts held in customer accounts at banks (YoY growth rates)

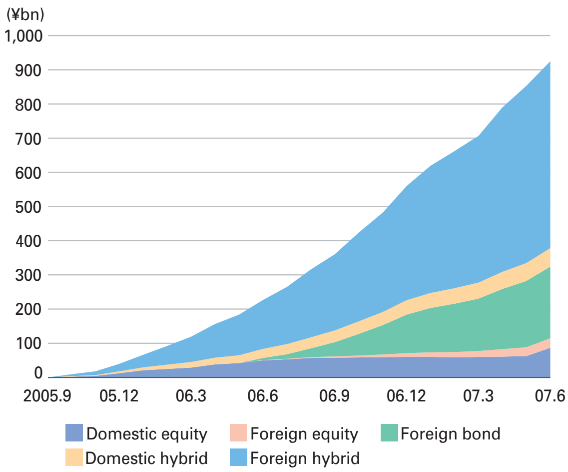


Source: NRI, based on data from *Nikkin Toshin Nenkin Joho* investment trust sales from 33% at FY03-end to 41% at FY06-end. Additionally, credit associations (shinkin banks) and JA Bank's combined investment trust sales have recently been growing at a rate approaching that of regional banks, although these institutions' share of sales is still low at 2.4% (Exhibit 12).

City banks' ratio of investment trust account balances to retail deposits ended FY06 at around 9%. By comparison, the corresponding ratio was about 7% for regional banks and 0.5% for credit associations and JA Bank combined. However, credit associations and JA Bank collectively rival regional banks in terms of aggregate retail deposits. If credit association and JA Bank customers reallocate just 1% of their assets from deposits to investment trusts, investment trust assets would grow by nearly ¥2trn. Credit associations and JA Bank have extremely promising potential as a sales channel if they develop the requisite sales infrastructure, including external support.

Another financial institution with major potential as an investment trust distributor is Japan Post Bank. It has been selling investment trusts since October 2005, before it was privatized, and has achieved stable growth in investment trust account balances. By product type, foreign hybrid and foreign bond funds with high distribution frequencies account for much of the investment trust balances in Japan Post Bank accounts. Japan Post Bank's investment trust sales should continue to grow, fueled partly by an anticipated increase in the number of post offices that sell investment trusts. Like credit associations and JA Bank, Japan Post Bank has a huge deposit base. If the pace of its customers' asset reallocation from deposits to investment trusts picks up, its investment trust account balances could grow substantially.

Exhibit 13. Outstanding balance of investment trusts sold by Japan Post Bank



Source: NRI, based on Fundmark data

Note

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

2) Respondents ranked the choices in order of priority. Higher priorities were assigned higher point scores and average point scores were calculated for each choice.

3) The proposed legislation is still under deliberation as of September 2007.

4) Corporate pension plans also have experienced large inflows of funds but we omitted these assets from our discussion of the retail business because the individual beneficiaries do not have discretionary control over such pension assets.

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