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Household asset allocation trends

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With ¥1,533trn in financial assets, Japanese households are gradually increasing their allocation to risk assets. How will the new J-SOX law, in full effect since September, affect household asset selection?

Ongoing shift from saving to investment

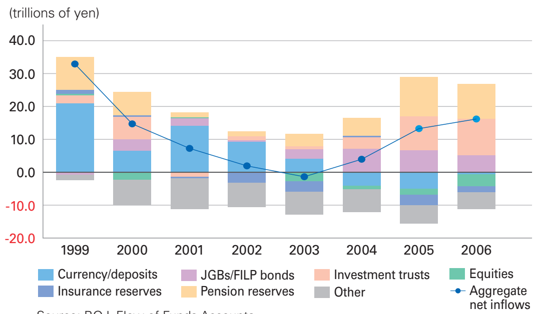
According to the Bank of Japan's Flow of Funds Accounts, Japanese households ended March 2007 with total financial assets of ¥1,533trn, an all-time record for a fiscal year-end. Of this total, cash and bank deposits accounted for ¥770trn (50.2%), reflecting Japanese households' conservative approach to asset allocation. However, cash and deposits' share of household financial assets has been progressively declining in recent years, offset by a rising allocation to risk assets, particularly moderately risky assets such as investment trusts, annuities, and JGBs[1].

This shift from saving to investment is seen as a long-term trend. We reexamine it below from the standpoint of the BOJ's Flow of Funds Accounts and other pertinent data.

Flow-of-funds analysis

Financial asset balances are partly a function of changes in market value. To factor out the impact of fluctuations in market value, we focus on flows of funds among asset classes (Exhibit 1). Flow-of-funds data show how households allocate funds among asset classes in light of assets' risk/return profiles.

Exhibit 1. Fund flows by asset class



Source: BOJ, Flow of Funds Accounts

In FY06, households reallocated substantial funds to investment trusts, pensions, and JGBs, as shown in Exhibit 1. Investment trusts in particular were recipients of ¥10.8trn in inflows, an all-time record. On the opposite side of the ledger, equities, for example, experienced outflows of ¥3.3trn. Although equities account for a larger share (7.1%) of households' total financial assets than investment trusts, households pulled money out of individual equities in FY06.

Like investment trusts, pension funds saw inflows of ¥11.1trn[2], while JGBs and FILP (Fiscal Investment and Loan Program) bonds experienced inflows of ¥5.2trn.

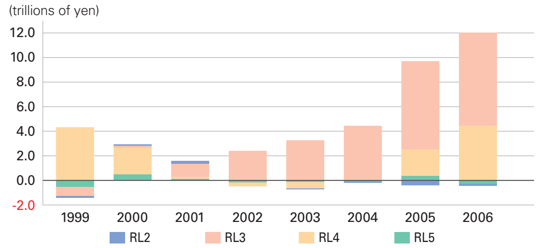
Risk assets' growing prevalence among household financial asset holdings

Investment trusts' share of households' total financial assets ended FY06 at an all-time high of 4.5%. Investment trusts have thus already achieved a certain stature as a financial asset that households can readily purchase at their discretion. Closer analysis, however, reveals a shift in households' preferences vis-à-vis investment trusts.

Investment trusts differ widely in their risk attributes depending on the underlying assets in which they invest. Using NRI's Fundmark/RL[3] risk classification hierarchy for investment trusts, we calculated open-ended equity investment trusts' money flows by risk category (Exhibit 2).

Exhibit 2 shows that investment trusts in the moderate-risk RL3 category have historically captured the bulk of investment trust inflows, but inflows to the relatively high-risk RL4 category have increased markedly in recent years, jumping to ¥2.3trn in FY05 before nearly doubling to ¥4.5trn in FY06[4,5].

Exhibit 2. Open-ended equity investment trust in/outflows by risk category

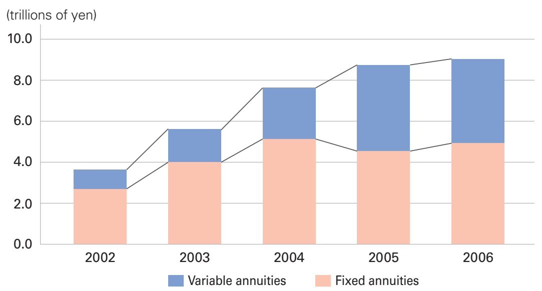


Note: The above data do not coincide with the investment trust data in Exhibit 1 because they encompass corporate investment trust holdings also.

Another noteworthy asset class is individual annuities. The volume of newly issued individual annuities are plotted on a face-value basis in Exhibit 3, which shows that variable annuities sales have grown dramatically in comparison to conventional fixed annuities. Indeed, variable annuity sales have recently grown to approximate parity with fixed annuities sales. On a stock basis, variable annuities' total outstanding balance has grown to roughly 20% of fixed annuities'.

While the shift from saving to investment has been ongoing for some time, Japanese households have hitherto had a strong preference for relatively low-risk assets[6]. The above-noted changes in risk preference vis-à-vis investment trusts and annuities suggest that Japanese households' risk preference is gradually shifting toward higher-risk assets.

Exhibit 3. Breakdown of new issuance of individual annuities by face value



Note: The Life Insurance Association of Japan

Will households' asset allocation continue to shift toward risk assets?

Will such a shift in households' asset allocation toward risk assets continue or even accelerate? In fact, this trend appears to have started to reverse, as exemplified by recent downturns in investment trust inflows and the number of newly launched investment trusts.One factor behind these declines is two new laws: the Financial Instruments and Exchange Law (the so-called J-SOX), which fully took effect in September, and the recently amended Law on Sales of Financial Products.

Both laws are intended to protect investors. They require that financial institutions verify financial products' suitability for customers and explicitly disclose the risk of principal loss when recommending various financial products, including investment trusts and variable annuities[7]. In response to these laws, financial institutions that sell financial products appear to be spending more time explaining product attributes during sales presentations to customers, revising their sales procedures to require signed acknowledgment of disclosures[8], and/or shying away from selling products that require complicated disclosures of multiple risks (e.g., hybrid investment trusts). For households, the impact of financial institutions' reluctance to sell such products may not necessarily be temporary.

Financial institutions have become an important distribution channel for investment products, reflecting that they have an inherent advantage over securities brokerages by virtue of their branch networks and custody of customer deposits, the funding source for financial product purchases. From the standpoint of improving investor convenience and expanding investment opportunities, financial institutions would better serve their customers by embracing a proactive approach to financial product sales.

Note

1) Since 1998, NRI has compiled financial asset input-output tables from the BOJ's Flow of Funds Accounts and several other data sources. These tables present an overview of how Japanese households and nonfinancial corporations' financial asset holdings are allocated among asset classes and asset management entities, and how financial asset flows are intermediated.

2) Pension reserves include both corporate pensions and individual annuities.

3) A risk-rating framework that classifies investment trusts into five risk categories, RL1 (least risky) to RL5 (most risky), based on the countries and types of securities in which they invest.

4) The RL4 category comprises investment trusts that mainly invest in domestic, North American, and Western European equities (without currency hedges) and/or emerging market bonds. The RL3 category comprises investment trusts that mainly invest in foreign bonds (without currency hedges) and/or foreign stocks (with currency hedges).

5) My colleague Tomohiro Ohana notes that (1) in selecting investment trust products, retail investors have historically placed primary importance on distribution yield (annual distribution / NAV) without much cognizance of risk, but (2) since CY07 Q3 they have started to also take risk into account when selecting investment trusts ("Individual investors' newfound cognizance of investment trust risk" (Financial IT Focus, November 2007)).

6) See Hisashi Kaneko, "Retail Investor asset management trends" (lakyara, December 2006) and Takahiro Tanaka, "Using financial asset input-output tables to analyze retail investor trends" (lakyara, December 2005).

7) Variable annuities are regulated pursuant to the Insurance Business Law, but their sale and recommendation falls within the purview of the Law on Sales of Financial Products.

8) Nihon Kinyu Shimbun, 7 October 2007, "J-SOX financial institution survey: 80% have changed how they sell investment trusts (e.g., by allotting time for risk disclosure, lowering sales targets)."

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