Japan's Asset Management Business 2006

Nomura Research Institute

Preface

Following a difficult period in the 1990s when persistent expectations of growth were let down by a poor investment environment, Japan's asset management industry is now undergoing a robust expansion on the back of a more favorable regulatory climate, changing investor behavior, and a recovering economy. Both revenues, totaling some 660 billion yen in the year ended March 2006, and assets under management, at 343 trillion yen, are up more than 50% in the last five years. There have also been major changes in the mix of providers and the range of services offered as banks begin to sell investment products—foreign asset management companies, for example, have lifted their market share significantly. Asset managers in Japan are now at a critical junction and need to reassess the perceived benefits of the market and review their strategies for the future.

This report was compiled to provide an overview of the asset management business in Japan based on an objective analysis of available data. Our primary goal was to offer a starting point for the consideration of future developments in the industry. The intended readership includes executives at asset managers and financial product distributors as well as those tasked with developing marketing and sales strategies.

As the shift from savings to investment accelerates, we expect asset management to play an increasingly important role in Japan's economy. We hope this report will contribute to a better understanding of emerging trends in the industry.

Shin Kusunoki
Nomura Research Institute, Ltd.
October 2006

About Nomura Research Institute

Since its inception more than 40 years ago, the Nomura Research Institute, Ltd. (NRI) has strived to push the boundaries and explore new horizons by proposing corporate strategies, making policy proposals, and developing and managing advanced systems. Our strength lies in our ability to provide total solutions for clients. With a full range of integrated services, we are able to enhance corporate value by anticipating problems, working towards their resolution, and implementing specific solutions.

Japan's Asset Management Business
2006

I

Business Environment for Asset Management Firms

1. Conditions for Japan’s Asset Management Industry Remain Favorable –Assets Under Management, Revenue, and Margins at Record Highs

Record revenue and assets under management

According to NRI estimates, assets under management in Japan at the end of March 2006 totaled approximately 343 trillion yen, while revenues for fiscal year 2005 amounted to some 660 billion yen, setting new records for the second straight year (trends in assets under management and revenue are shown in Figures I-1 and I-2[1]). Assets under management rose by around 30 percent, while revenues increased by 22 percent.

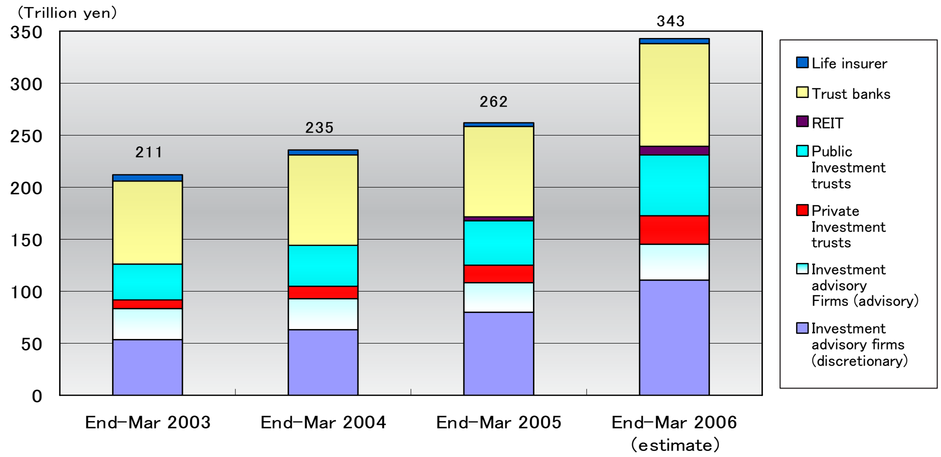
The main players in Japan’s growing asset management market are trust banks, life insurers, and the asset management firms that manage investment advisory accounts and establish investment trusts. Asset management firms have greatly increased their market presence in recent years. Of the 343 trillion yen in assets, investment advisory accounts account for 143 trillion yen (42%) and investment trusts for 90 trillion yen (26%), for a combined two-thirds share of the market. Growth in assets under management (37%) and revenues (31%) at these management firms far outpaced that of the market as a whole. The following section examines the current status of asset management firms.

[1] Fiscal 2005 figures for trust banks and life insurance companies are not yet available, so we assumed the same results as for fiscal 2004. We also used fiscal 2004 investment advisory fees to estimate fiscal 2005 investment trust revenues.

Asset management firms are growing

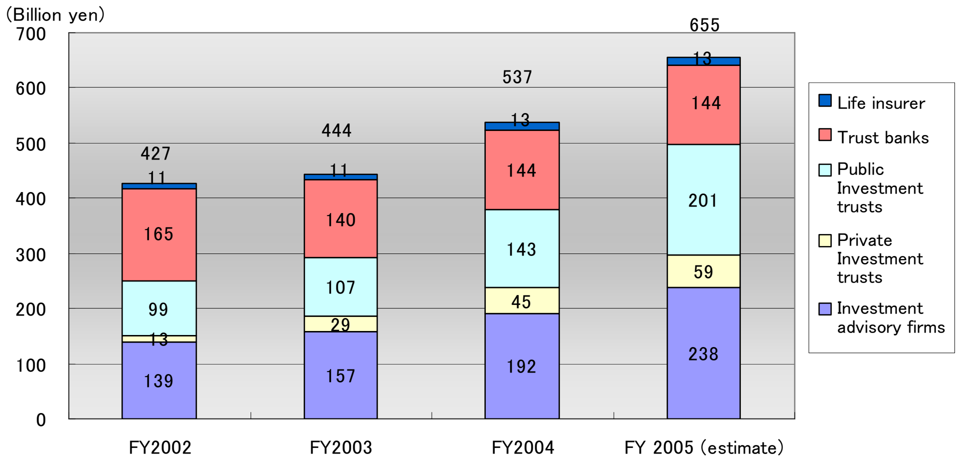
At the end of fiscal year 2005, the value of assets managed by asset management firms had increased by about 63 trillion yen year-on-year to 233 trillion yen, while revenues rose by 120 billion yen to around 500 billion yen. About half the increase in assets under management, or 30 trillion yen, can be attributed to an inflow of new funds from clients. This figure compares with 23 trillion yen in fiscal year 2004 and appears to be growing steadily. The 500 billion yen in revenues includes 200 billion yen from investment trusts for individual investors, 60 billion yen from private investment trusts, and about 240 billion yen from advisory fees charged to pension funds and other institutional investors.

Figure I-1 Assets Managed by Asset Management Firms



Note: Figures for life insurance companies include only special accounts and not general accounts with guaranteed returns.
Source: Compiled by NRI based on income statements submitted by asset management companies to the Financial Services Agency and the Ministry of Finance, and materials published by the Investment Trusts Association and the Japan Securities Investment Advisers Association.

Figure I-2 Management Revenues of Asset Management Firms

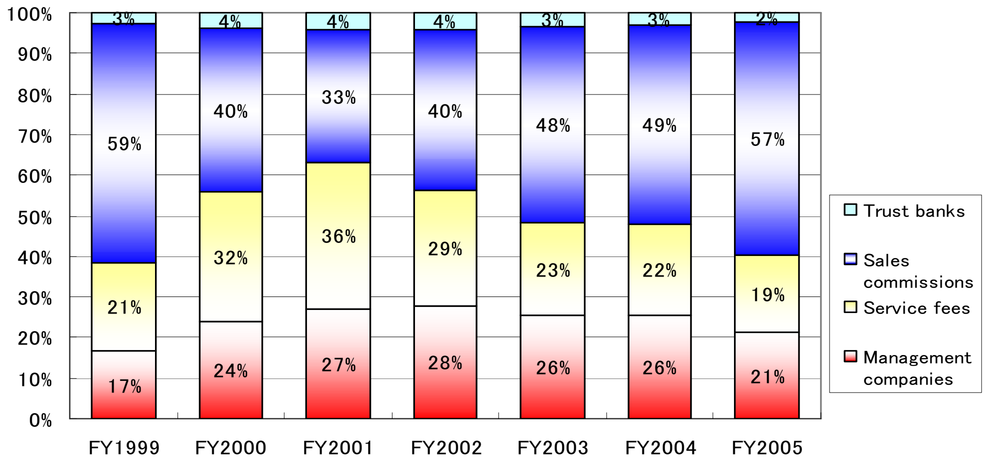


Note: Figures for life insurance companies include only special accounts and not general accounts with guaranteed returns.
Source: Compiled by NRI based on income statements submitted by asset management companies to the Financial Services Agency and the Ministry of Finance, and materials published by the Investment Trusts Association and the Japan Securities Investment Advisers Association.

Revenues from investment advisory services reflect favorable conditions in the Japanese stock market. Revenues have increased by more than 20 percent per year since fiscal year 2004. Both corporate pension funds and public funds, including the postal savings and postal life insurance programs, have lifted their investments in Japanese equities during this period. In addition, more foreign investors are delegating asset management duties to Japanese firms.

Revenues from public investment trusts total 200 billion yen, while sales and service fees charged by distributors amount to more than 700 billion yen. When revenues from private funds are added, total investment trust revenues are nearly 1 trillion yen, underlining the growing importance of this market. Another characteristic of this market is that distributors earn a significant portion of the fees charged to clients. Figure I-3 provides a breakdown of revenues for companies in this field. In fiscal year 2005, sales commissions and service fees charged to clients by distributors constituted almost 80 percent of total revenue, with asset management firms earning the remaining 20 percent[2].

Figure I-3 Breakdown of Public Investment Trust Revenues



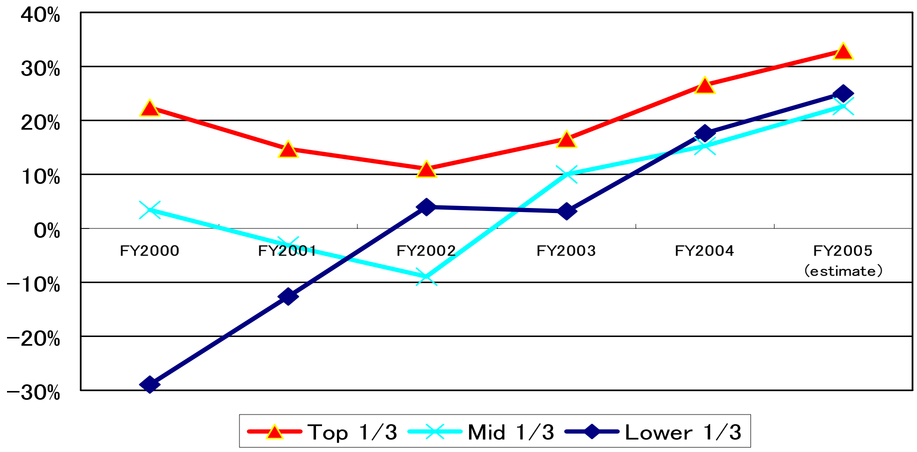
Source: Compiled by NRI based on NRI Fundmark data.

2 In the US, management companies and distributors are said to earn equal shares of total revenues.

Profit margins now on a par with those of Europe and the US

Profit margins[3] in the asset management industry have grown steadily since fiscal year 2004. Figure I-4 ranks about 80 asset management firms[4] with funds in excess of 100 billion yen into three groups based on asset size and also plots profit margins for each fiscal year since 2000. Even middle- and lower-tier asset management firms have seen profit margins turn positive since fiscal year 2003, with margins exceeding an estimated 20 percent in fiscal 2005. Overall, the asset management industry appears to have posted an average profit margin of more than 30 percent[5] in fiscal year 2005, placing it on a par with its counterparts in Europe and the US.

Figure I-4 Profit Margins at Asset Management Firms by Asset Size



Source: Compiled by NRI based on income statements submitted by asset management companies to the Financial Services Agency and the Ministry of Finance.

3 Defined as operating profit divided by net revenue.
4 These companies are responsible for more than 99% of all assets under management at investment trust and investment advisory companies.
5 Average weighted by assets under management.

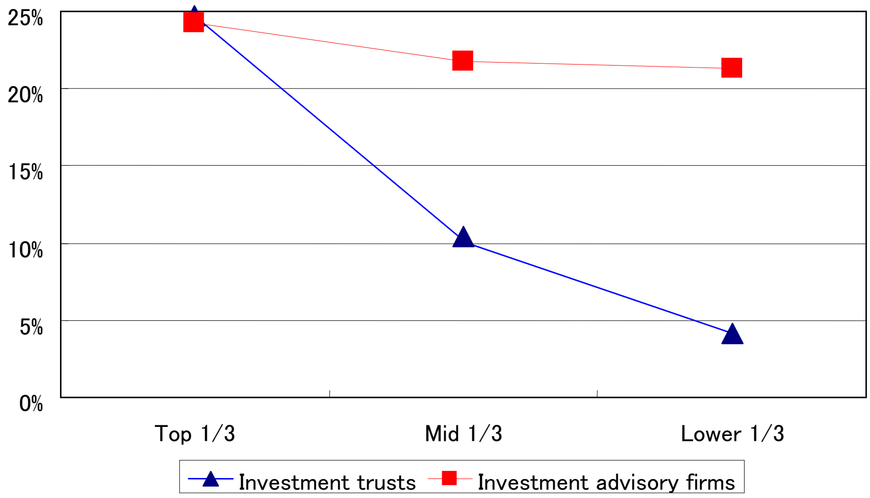
2. Investment Trust and Investment Advisory Business Characteristics Drive Margin Differentials –Profits Vary Widely at Small and Mid-sized Asset Management Firms

Profits vary widely

While Japanese asset management firms still manage very few assets compared with their counterparts in Europe and US, their margins are nearly as high. At relatively small companies, however, profitability still varies significantly at investment trust and investment advisory businesses. Like Figure I-4, Figure I-5 ranks management companies based on asset size (fiscal year 2004 data), with firms grouped into three categories. Companies in each group are classified into two categories: those for which investment trust revenues are high relative to investment advisory income, and vice versa. We then calculated the average profit margin for each group[6].

Companies in the top tier report the same level of profitability from the investment trust and investment advisory businesses. But at companies with fewer assets under management, those focusing on investment trusts tend to have lower margins, while those concentrating on investment advisory services exhibit little variance in profitability regardless of how many assets they manage.

Figure I-5 Profit Margins by Asset Size and Type of Business (Fiscal 2004)



Source: Compiled by NRI based on income statements submitted by asset management companies to the Financial Services Agency and the Ministry of Finance.

6 The top tier includes firms managing assets of more than 2 trillion yen, the middle tier those with assets of 500 billion to 2 trillion yen, and the bottom tier those with assets of less than 500 billion yen, based on data at end-March 2005.

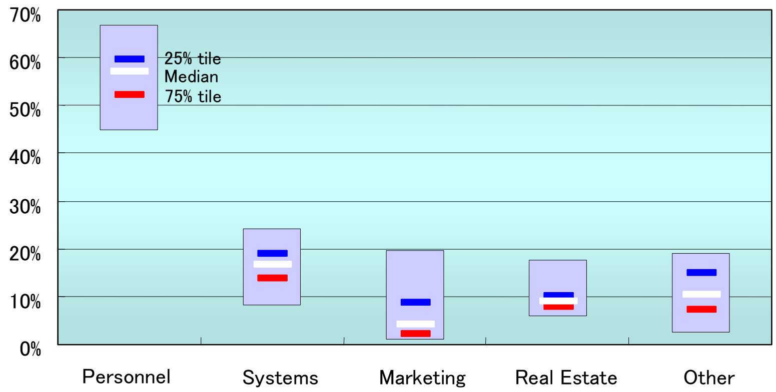
Cost structures vary greatly

■ Cost structure by expense items

Profit margins vary greatly with the amount of assets under management and the type of business because the investment trust and investment advisory businesses have significantly different cost structures. These differences can be confirmed by classifying asset manager cost structures, either by expense items, such as personnel costs and systems costs, or by function—namely front, middle, and back office costs[7]. Figure I-6 sets total costs for each asset management company to 100%, with expense items—including costs for personnel, systems, marketing, real estate, and other items—indicated as a ratio.

On the median, personnel costs constitute about 60 percent of total costs. Similarly, personnel costs constitute more than 60 percent of total costs at most US and European asset management firms. Clearly, the asset management business is highly reliant on individual talent, and this characteristic extends to cost structures as well. Other expenses include systems (about 20%), real estate (about 10%), and marketing and other costs (about 10%). Systems costs for Japanese firms are rather high relative to European and American companies, but this may be due to differences in depreciation rules, as accounting practices vary from country to country in this respect.

Figure I-6 Cost Structure at Japanese Asset Management Firms



Source: Compiled from data acquired in the "Multi-Client Project Concerning Efficiency of Asset Management Firms" conducted by NRI in 2003 and 2004.

[7] Cost structure data calculated based on the "Multi-Client Project Concerning the Efficiency of Asset Management Firms" implemented by NRI in fiscal 2003 and 2004.

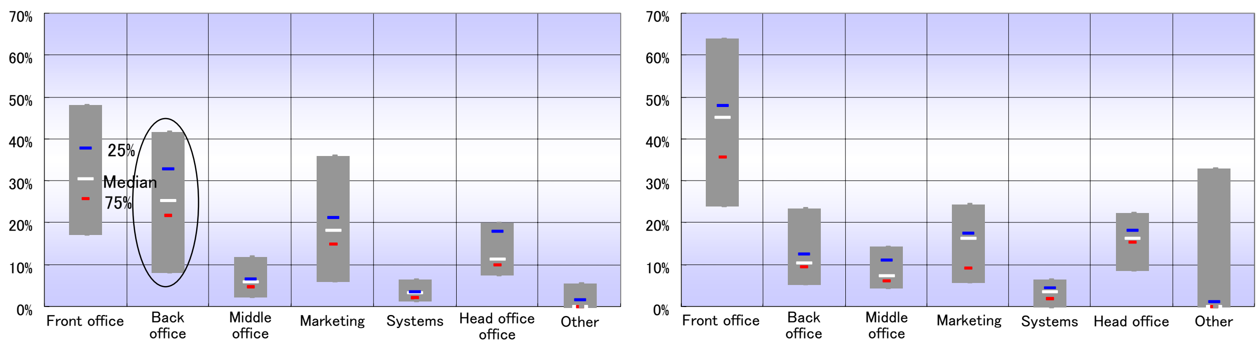
■ Cost structure by function

Figure I-7 breaks down total costs into front office, middle office,[8] and back office functions, with costs incurred for various functions expressed as a ratio and indicated on a bar graph. A longer bar indicates a greater variance in costs.

In both the investment trust and investment advisory businesses, the front office, which actually develops investment products, accounts for the greatest portion of costs. But other costs vary significantly between the two businesses. Investment trust operations, for example, are characterized by back-office costs that are about the same as front-office costs (the back office is responsible for calculating net asset values and preparing necessary documentation). The back offices of Japanese asset managers account for a relatively high percentage of total costs relative to their European and US counterparts. At smaller management firms in particular, back-office functions sometimes exceed front-office costs, accounting for more than 40 percent of total costs. Smaller management companies are characterized by low margins despite relatively high management fees[9]. This is attributable to (1) higher back-office and marketing costs in comparison with the investment advisory business and (2) the need for a certain volume of business to cover high fixed costs. In contrast, top-tier firms with more than 2 trillion yen in assets under management enjoy margins on a par with those of investment advisory firms thanks to high management fees.

The investment advisory business is structured such that most costs are incurred by the front office. A skilled management team can therefore realize a profit from even a relatively small operation. Smaller asset managers with high margins tend to offer products that address specific customer needs, such as alternative investments. Many investment advisory companies actually act as sub-advisories[10] to cover non-investment-related costs.

Figure I-7 Cost Structure at Japanese Asset Management Firms by Function (Left: Investment Trust Business; Right: Investment Advisory Services)



Source: Compiled based on data from the "Multi-Client Project Concerning Efficiency of Asset Management Firms" conducted by NRI in 2003 and 2004.

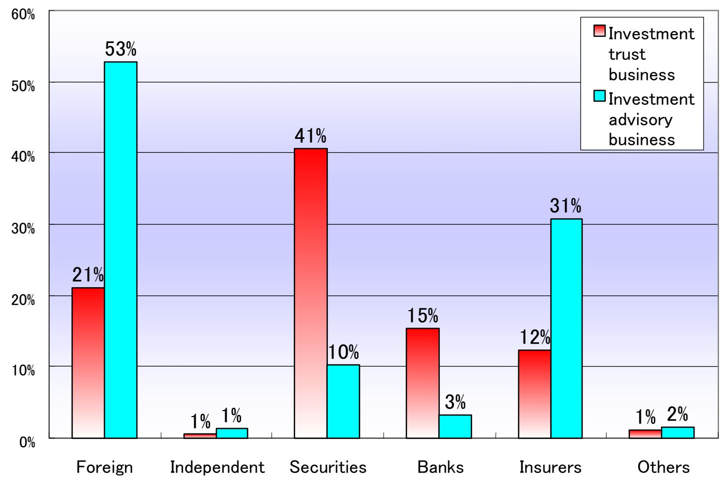
8 Front-office operations include portfolio management, research, and trading. Middle-office operations denote risk management.
9 In fiscal 2004, management fees averaged 0.52% at public investment trusts and 0.19% in the investment advisory business.
10 In a sub-advisory arrangement, advisory services are provided to another management company under the client firm's name.

3. Business Conditions at Asset Management Firms –Increased Presence of Foreign and Independent Managers

With the asset management industry as a whole posting record profits, we studied performance in individual segments. We looked at fiscal year 2004 results for six types of asset managers: foreign, independent, securities company affiliates, bank affiliates, insurance company affiliates, and others.

Foreign managers accounted for more than 50 percent of the investment advisory business in terms of assets under management, up 14 percentage points from 39 percent in fiscal year 2001 (Figure I-8). At the same time, their share of assets under management in the investment trust market grew from 12 percent to 21 percent. Within the investment trust business, asset managers affiliated with securities firms and having strong relationships with distributors still command a large share of the market, because distributors are often the parents of these firms. In the investment advisory business, however, foreign companies may have the larger share because independent advice plays a key role in pension funds' manager selection process.

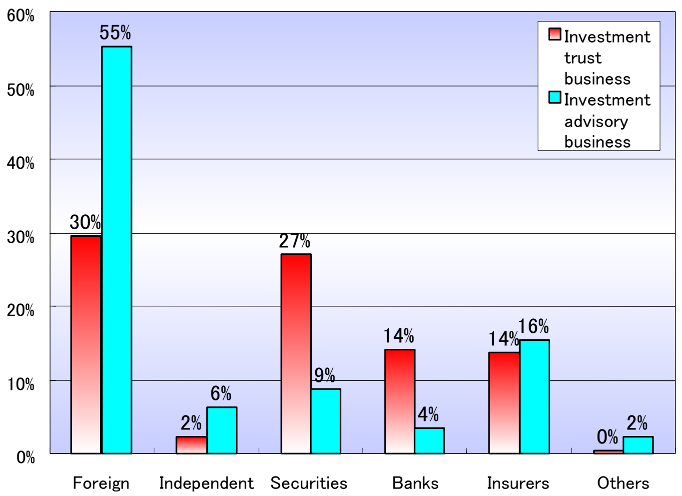
Figure I-8 Share of Assets Under Management by Manager Type (Fiscal 2004)



Source: Compiled by NRI based on income statements submitted by asset management Companies to the Financial Services Agency and the Ministry of Finance.

Figure I-9 shows shares of management revenues. Foreign firms' share of revenues is even higher relative to their asset size because they tend to manage funds with higher-than-average management fees, such as domestic and overseas equity funds.

Figure I-9 Share of Management Revenues by Manager Type (Fiscal 2004)

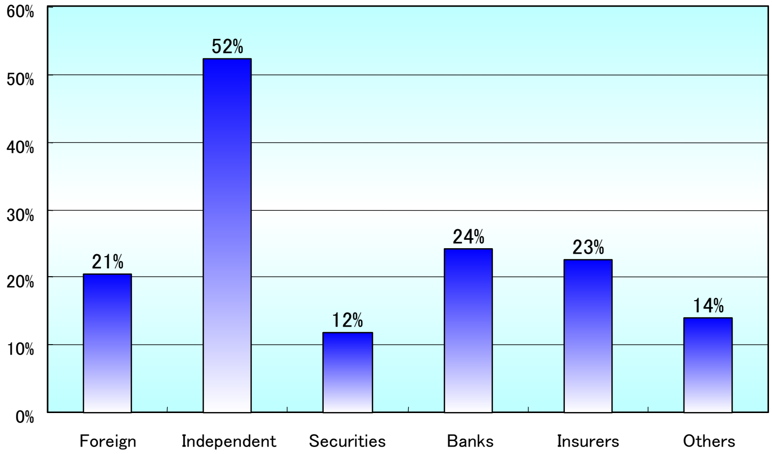


Source: Compiled by NRI based on income statements submitted by asset management companies to the Financial Services Agency and the Ministry of Finance.

Independent asset managers also have a larger share of revenue relative to their asset size, which we attribute to products with high management fees, such as equities and alternative investments. Since 2001, independent asset managers' share of revenue from investment advisory services has increased dramatically, from less than 1 percent to more than 6 percent. In contrast, managers affiliated with securities firms generate fairly low revenues relative to asset size. Moreover, their share of revenues has dropped from 30 percent to 18 percent since 2001 as assets invested in guaranteed-return bond funds have fallen sharply. The revenue share of advisory accounts at insurer-affiliated managers is less than half their share of assets because the parent firms (insurers) pay low management fees. Consequently, their share of revenues has fallen by more than 3 percentage points since fiscal 2001.

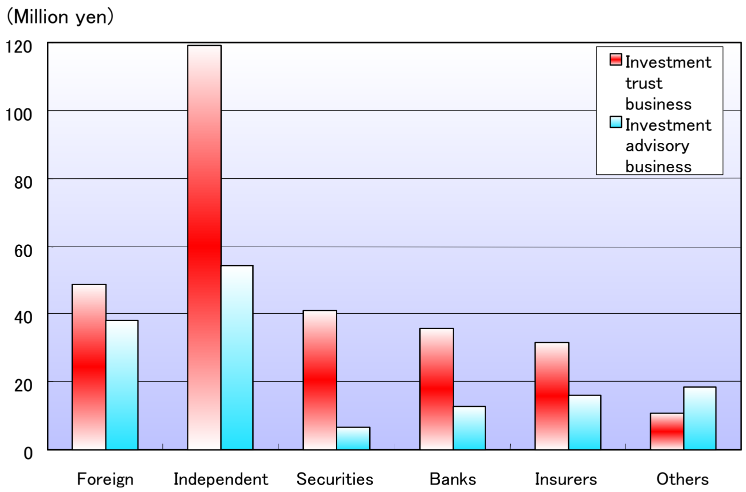
Figure I-10 compares profit margins. Margins at independent asset managers are extremely high despite the small scale of operations, exceeding 50 percent in fiscal year 2004. This is particularly remarkable in light of the fact that other asset management firms only generate profit margins of 20–30 percent. Figure I-11 clearly shows that management revenue per fund was much higher at independent asset managers than at other asset management firms. We attribute this to the fact that independent firms tend not to offer an excessive number of investment products, instead concentrating on a few distinctive products with high margins. Costs in the asset management business depend less on the size of assets under management than on the number and types of funds offered. If a company can generate large revenues with relatively few funds, cost efficiency will be extremely high. In addition to high management fees, high productivity per fund unit also boosts the profitability of independent asset managers.

Figure I-10 Profit Margins by Manager Type (Fiscal 2004)



Source: Compiled by NRI based on income statements submitted by asset management companies to the Financial Services Agency and the Ministry of Finance.

Figure I-11 Management Revenue per Fund by Manager Type (Fiscal 2004)



Source: Compiled by NRI based on income statements submitted by asset management companies to the Financial Services Agency and the Ministry of Finance.

4. Market Still Dominated by Large Institutional Investors –Looking to the Retail Market for Future Growth

Institutional investors account for 80 percent of assets under management

The preceding sections examined the Japanese asset management business from an asset manager's perspective. The following sections consider the business from the perspective of the clients and products. The clients of Japanese asset management firms can be divided into three main groups: pension funds, corporations (including financial institutions), and individual investors.

Figure I-12 illustrates the Japanese asset management industry from the perspectives of management companies, their products, and their clients. The right-hand side of the diagram shows that assets in the institutional market, represented by pension funds, total 273 trillion yen, or around 80 percent of the entire market, while the retail market is valued at about 70 trillion yen. Clearly, the institutional market is the main source of business[11].

Pension funds constitute a large portion of the institutional market and include the Government Pension Investment Fund (GPIF)[12], pension funds for public service employees, and corporate pension funds. Together they account for 246 trillion yen of assets. Trust banks and life insurance companies manage 92 trillion yen for pension funds, representing 37 percent of the market. Asset management firms manage the other 63 percent.

Other major customers include Japan Post and financial institutions. At the end of March 2005, Japan Post and financial institutions had delegated assets worth about 12.3 trillion yen and 15 trillion yen, respectively, to asset managers. Until 2003 Japan Post used only trust banks, but in 2004 it opened the door to asset management firms. By end-March 2005, Japan Post had delegated 930 billion yen in assets to these companies, and their share is rising each year. Other financial institutions delegate asset management responsibilities to both Japanese and foreign firms. A recent trend at financial institutions has been the use of hedge funds and other so-called absolute return funds. Banks and life insurance companies are the primary investors in hedge funds, having invested more than 5 trillion yen at end-March 2005.

11 This figure indicates the amount of assets for which management is outsourced and does not indicate the total amount of assets.

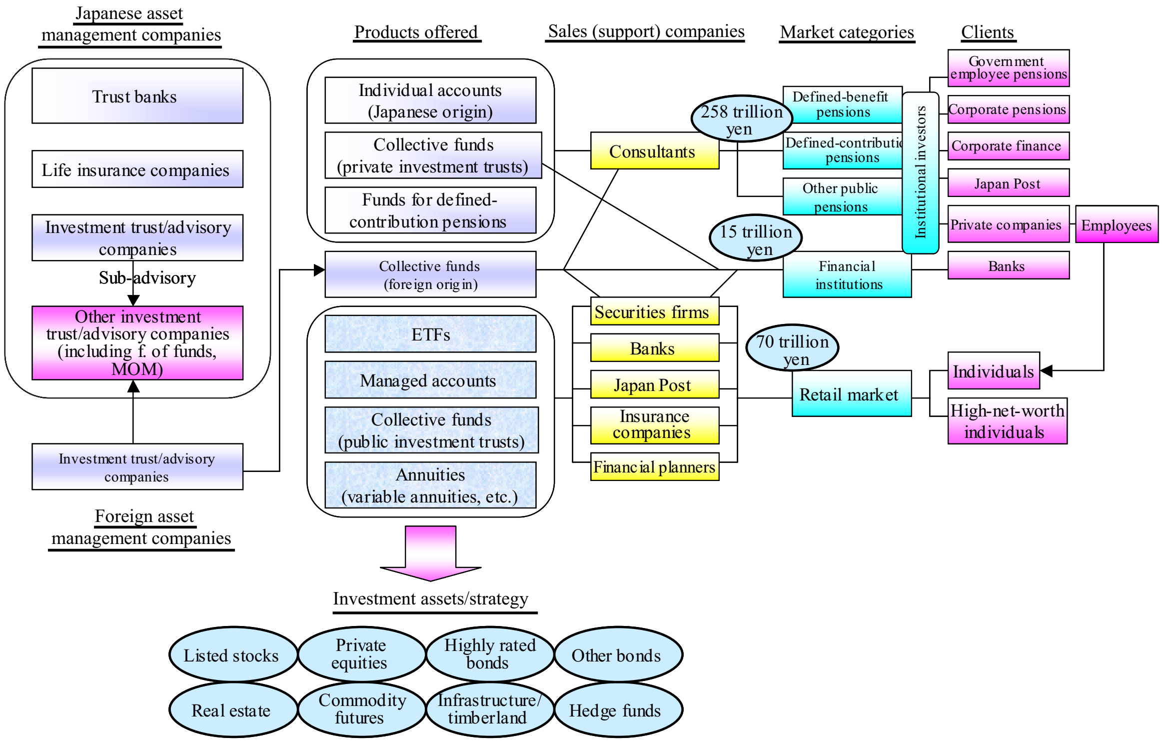
12 The world's largest pension fund, responsible for managing the accumulated funds of the Employees' Pension Insurance Scheme, which is a public pension scheme for salaried employees in the private sector. The current name was adopted in April 2006. It held about 100 trillion yen in assets at the end of 2005, including FILP bonds. Assets are expected to grow to 160 trillion yen by the end of fiscal 2008.

Industry looking to retail market for future growth

Institutional investors account for 80 percent of total assets under management. But they are not quite as dominant in terms of revenue, because the retail market has much higher management fees. When retail market revenues are defined to include public investment trusts and the variable annuity portion of private investment trusts, the retail market accounts for 35 percent of revenues, which is considerably higher than its 20 percent share of assets under management.

The retail market also has the edge from a growth standpoint. While the institutional market is expected to continue posting modest gains in assets and revenue, the retail market would seem to offer better prospects for growth, especially given the eagerness of Japan Post and regional banks to sell investment products to their clients. According to estimates by NRI based on Japan Post sales targets, asset management revenues from the retail market in fiscal year 2008 will increase by around 80 billion yen from the current level, representing a growth rate of about 40 percent. In contrast, revenue from the institutional market is projected to grow by somewhat more than 40 billion yen. The retail market's share of total revenues will rise to around 40 percent.

Figure I-12 Overview of Asset Management Business in Japan



Source: NRI.

The retail market vs. the institutional market

The retail market differs from the institutional market in that the end customers are individuals. But it also resembles the institutional market in many aspects—for example, the customers to whom asset management companies directly provide services are chiefly corporations. In the variable annuity market, for example, the ultimate customers are individuals, but asset managers provide products and services to life insurance companies. Similarly, while company employees are the end customers of defined contribution pension plans, the product is delivered to the personnel departments of sponsoring companies. Although there are a few exceptions, asset management firms seldom provide products directly to individual customers. Accordingly, the provision of services to companies cannot be ignored even in the retail market. The retail market and the institutional market together are known as the "Insti-vidual market"[13] in the US.

Sub-advisory business in the retail market

The retail market is more important than the institutional market because substantially higher asset growth is expected in the coming years. But targeting the new retail customer segment is not an easy task for asset management firms, which have traditionally specialized in managing the assets of pension funds and other institutional investors. The "sub-advisory business" provides an important strategic option for asset managers seeking to enter the retail market, because expansion requires relatively little investment.

This section focuses on four sub-advisory services: 1) investment trusts, 2) variable annuities, 3) managed accounts, and 4) multi-managers. We gauged their attractiveness as businesses based mainly on asset size and compensation received for services rendered. Total revenue from these four services is estimated at around 100 billion yen, which is quite attractive given that domestic asset managers reported total revenues of about 500 billion yen in fiscal year 2005.

■ Sub-advisory services for investment trusts

In response to individual investors' need for a wide range of more complex products, many domestic investment trusts have considered using sub-advisors. NRI estimates that about 16 percent of all public investment trusts are managed through sub-advisors.

The sub-advisor may be either an asset management firm affiliated with the investment trust company or a completely unrelated company. If the former is regarded as an example of in-house subcontracting, then only the latter is a true example of sub-advisory services. As the investment trust market expands and competition to develop new products intensifies among distributors and

[13] An amalgam of "Institutional" and "Individual."

asset managers, we expect demand for outsourcing to increase.

Estimated assets under management: 6 trillion yen (2005)
Estimated revenue: 20 to 30 billion yen per year (2005); this excludes "funds of funds" and "managers of managers."

■ Sub-advisory services for variable annuities

Variable annuities are a key product aimed at retirees. Like investment trusts, this segment is expected to grow rapidly.

When an insurance company offers a variable annuity product, it hires an investment advisor to manage the assets. In many cases, the insurance company will invest through special accounts in private investment trusts that are managed by an asset management company. This could be handled by sub-advisories.

Estimated assets under management: 10 trillion yen (March 2006)
Estimated revenue: 25 to 40 billion yen per year (March 2006)

■ Sub-advisory services for managed accounts (primarily SMAs)

"Separately managed accounts" (SMAs)[14] were first offered in April 2004 by Japan's leading securities firms. Later, medium-sized and smaller securities firms and trust banks also began to offer these products. While the market is still small, it is expected to grow as securities firms promote SMAs as an effective means of attracting the "mass affluent" segment of the retail market.

There are three types of SMA in the US: 1) the self-managed SMA, which is managed by an affiliate of the financial institution offering the SMA; 2) the outsourced SMA, which may also be managed by unaffiliated fund managers; and 3) the multi-style portfolio (MSP), which offers customers a number of model portfolios from various fund managers. In Japan, the efficient MSP type has become the most popular format. The major role of sub-advisories in this market is to structure the model portfolios.

Estimated assets under management (SMAs): 4–5 trillion yen (after 3 years)
Estimated revenue (SMAs): 10 billion yen per year (after 3 years)

[14] See sidebar titled "SMAs: From Product to Process."

■ Multi-manager services

The market for multi-manager services can be roughly divided into "funds of funds" and "managers of managers". The first fund of funds for the retail market was established as an investment trust in September 2000, and assets under management have grown steadily since then. Currently there are only a handful of manager of managers funds for the retail market in Japan.

Estimated assets under management: 7 trillion yen (March 2006)

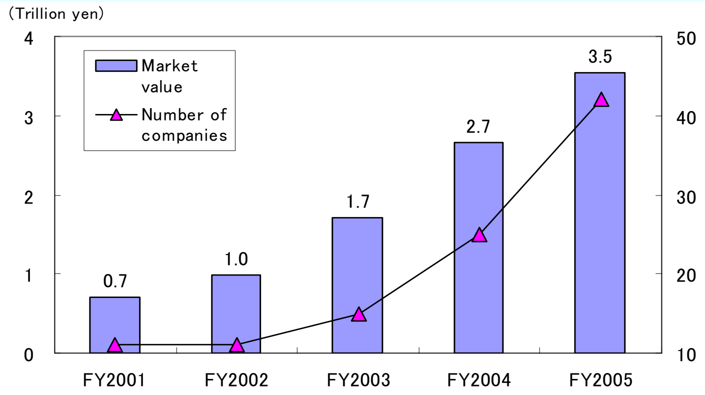
Estimated revenue: 25 to 35 billion yen per year (March 2006)

Sidebar

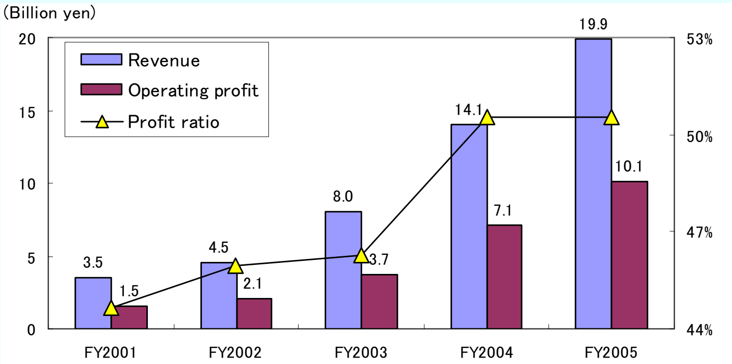
Overview of Japanese Real Estate Investment Trusts (J-REITs)

In the five years since September 2001, when the first real estate investment trust (REIT) was listed on the Tokyo Stock Exchange, the amount invested in REITs has continued to grow, exceeding 3.5 trillion yen at end-April 2006. A survey[15] has also estimated that the amount invested in privately placed real estate funds other than J-REITs exceeded 4.4 trillion yen at the end of 2005. We can therefore assume that more than 8 trillion yen has already been invested in real estate funds. There are now more than 40 asset managers specializing in managing J-REITs. As shown in the following figure, revenues at REIT asset managers amounted to some 20 billion yen in fiscal year 2005, and profits exceeded 10 billion yen. The former figure represents about 10 percent of total revenues for public mutual funds. Clearly, REITs have established a solid foothold in the market.

J-REIT Assets and Number of Asset Management Firms



Revenues and Operating Profits at J-REIT Managers



Source: Compiled by NRI based on operating results submitted by asset management companies to the Financial Services Agency and data from the Investment Trusts Association.

15 STB Research Institute Co., Ltd., "2005 Market Survey of Private Real Estate Funds," January 30, 2006.

II The Institutional Market

1. Growth Outlook for Pension Market –More Public Pension Assets To Be Invested in the Market; Sluggish Growth in Defined Benefit Plans

The institutional market for the asset management industry centers on pension funds[16]. At the end of March 2005, assets under management at public pension plans stood at around 200 trillion yen, while the corresponding figure for corporate pension plans, including defined contribution (DC) plans and the Smaller Enterprise Retirement Allowance Mutual Aid Scheme, was about 80 trillion yen, for a total of 280 trillion yen (Figure II-1)[17].

Figure II-1 Trends in Pension Assets

(Trillion yen)

Fiscal year	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Base date	95/3	96/3	97/3	98/3	99/3	00/3	01/3	02/3	03/3	04/3	05/3
Public pensions	151.4	161.5	171.4	179.0	186.5	192.7	196.5	198.0	196.9	197.0	197.4
National Pension	6.4	7.0	7.8	8.5	9.0	9.5	9.8	9.9	9.9	9.9	9.7
Employees' Pension Insurance	104.5	111.8	118.5	125.8	130.8	134.8	136.9	134.6	132.1	137.4	137.7
Mutual Aid Associations	40.5	42.8	45.1	44.8	46.7	48.5	49.8	50.6	49.3	49.7	50.1
National Public Service Personnel Mutual Aid Associations	9.2	9.6	10.1	7.9	8.1	8.3	8.6	8.6	8.7	8.7	8.7
Local Public Service Personnel Mutual Aid Associations	27.2	28.8	30.5	32.2	33.7	35.2	36.2	36.9	37.5	37.8	38.1
Pension Fund Association for Local Government Officials	***	***	***	***	***	12.5	13.0	13.4	13.7	14.0	14.2
Mutual Aid Corporation of Private School Personnel	2.3	2.4	2.6	2.7	2.8	2.9	3.0	3.1	3.1	3.2	3.2
Mutual Aid Association of Agriculture, Forestry and Fisheries Organization	1.8	1.9	1.9	2.0	2.0	2.0	2.0	2.0	na	na	na
Corporate pensions	58.0	62.4	66.4	70.9	74.3	79.7	83.5	84.1	82.2	82.6	81.6
Employees' Pension Funds	38.4	41.8	45.0	48.7	51.3	55.5	58.0	58.3	57.2	50.0	38.5
Pension Fund Association	2.4	2.7	3.0	3.4	3.9	4.6	4.7	5.4	5.7	7.9	9.9
Defined Benefit Corporate Pension plans	na	na	na	na	na	na	na	***	0.4	8.1	21.7
Tax-Qualified Pension plans	17.0	17.8	18.5	19.2	20.0	21.1	22.4	22.7	21.4	21.0	17.2
Defined-contribution pensions (corporate)	na	na	na	na	na	na	na	***	0.1	0.6	1.2
Smaller Enterprise Retirement Allowance Mutual Aid Scheme	2.6	2.8	2.9	3.0	3.1	3.1	3.1	3.1	3.0	3.0	3.1
National Pension Fund	0.4	0.6	0.8	1.0	1.1	1.4	1.4	1.5	1.4	1.8	2.1

Figures for the National Pension indicate the amount of assets in the national pension sub-account under the national pension special account, and do not include the basic pension sub-account.
Employees' Pension Insurance figures do not include funds managed by the Employees' Pension Fund.
Figures for the Smaller Enterprise Retirement Allowance Mutual Aid Scheme do not include pension plans for specific industries (construction, sake brewing and forestry mutual aid associations).
"na" = Plan is either terminated or has yet to be launched.
"***" = Information is either undisclosed or unavailable.
Source: Compiled by NRI based on "Annual statistics on social security", "Social insurance statistics", and materials published by the Japan National Pension Association, the Organization for Worker's Retirement Allowance Mutual Aid, the Liaison Committee for DC Pension Plans of the Ministry of Health, Labour and Welfare and the Trust Companies Association of Japan.

Over the next five years the pension market, including both public and corporate pensions, is about to undergo major changes. First, the amount of public pension assets invested in the market has been

16 See "Sidebar: Japan's Pension Systems—Overview and Recent Trends."
17 This amount includes assets for which management is not outsourced, such as FILP bonds underwritten using public pension funds.

expanding since all deposits in the Fiscal Loan Fund (formerly the Fiscal Investment and Loan Program, or FILP) are being returned to pension sub-accounts. Second, the termination of the Tax-Qualified Pension system at the end of fiscal 2011 is driving an outflow of pension plan funds to other types of plans. With corporations moving from defined-benefit (DB) to defined-contribution (DC) plans, the scheduled termination is expected to have a major impact on the corporate pension business in the future.

Taking these developments into account, NRI has estimated the future market scale and management fee revenues of the pension asset management business for public and corporate pension funds.

Estimating size of public pension business—growth in assets invested in the market

At the end of fiscal year 2004, public pension schemes (the National Pension, Employees' Pension Insurance, and Mutual Aid Associations) had assets totaling about 200 trillion yen. Of the institutions managing these funds, the largest is the GPIF (Government Pension Investment Fund), which manages assets for the Employees' Pension Insurance Scheme and the National Pension Scheme constituting about three-quarters of all public pension assets[18]. In the past, funds accumulated under the Employees' Pension Insurance Scheme and the National Pension Scheme were deposited in the Fiscal Loan Fund (formerly the Trust Fund Bureau). But this system was abolished in fiscal year 2001, and public pension funds are no longer required to deposit their assets in this fund. All existing deposits must be returned by the end of fiscal 2008, which will increase the amount of Employees' Pension Insurance Scheme and National Pension Scheme assets that are invested in the market. We estimated 1) the value of assets for which the GPIF will outsource management by the end of fiscal year 2008 and 2) the management fees that will be generated as a result.

Figure II-2 shows our findings. Between the end of fiscal year 2004 and the end of fiscal year 2008, we expect the value of assets being managed by the GPIF to nearly double from around 90 trillion yen to just under 170 trillion yen. Because the GPIF underwrites FILP (Fiscal Investment and Loan Program) bonds instead of making deposits, the entire amount will not be outsourced. But even after deducting the assets that will be managed in-house by GPIF, we expect outsourced assets to roughly double from 53 trillion yen at the end of fiscal year 2004 to 113 trillion yen four years later. Accordingly, we project fees revenue will more than double, from around 20 billion yen to 48 billion yen.

[18] At the end of March 2005, about half of the accumulated funds were deposited in the Fiscal Loan Fund instead of being managed by the GPIF. All of these deposits will be returned by the end of fiscal 2008 and will be managed by the GPIF (see the upper table in Figure II-2).

Figure II-2 GPIF Assets Under Management

(Trillion yen)

		05/3 (results)	06/3	07/3	08/3	09/3
Accumulated funds		163.3	174.7	171.4	168.7	166.5
	Deposited to Fiscal Loan Fund	75.7	56.8	37.9	18.9	0.0
	Managed by GPIF	87.6	117.9	133.6	149.8	166.5
Return of substitutional portion from Employees' Pension Funds (Daiko-Henjo)		0.0	0.2	0.4	0.7	0.9

Breakdown of GPIF Assets under Management

(Trillion yen)

	05/3 (results)	06/3	07/3	08/3	09/3
FILP bonds	28.6	33.7	36.7	39.7	42.7
Managed in-house	5.5	7.9	9.1	10.4	11.7
Managed by outside managers	53.1	76.5	88.1	100.4	113.0
Management fees (billion yen)	20.3	32.7	37.7	42.9	48.3

Source: Estimated by NRI.

Assumptions

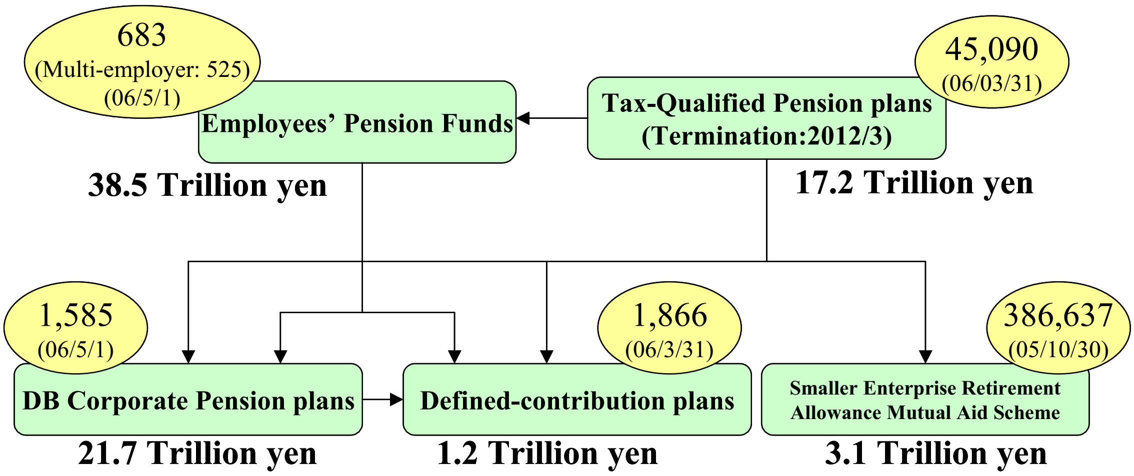
- For accumulated funds we used the projections of the fiscal year 2004 actuarial valuation.
- The outstanding amount of underwritten FILP bonds (underwriting began in fiscal year 2001) was estimated as follows: 2-year bonds, zero net increase (due to redemption + new underwriting); 5-year bonds, an increase of 2.1 trillion yen every year until fiscal year 2006, when the first redemptions are scheduled, and zero net increase subsequently; and 10-year bonds, an increase of 3 trillion yen each year. We did not consider 20-year bonds as few have been issued.
- Management fees estimates are based on 1) the estimated value of assets for which management will be outsourced and 2) the projected asset allocation.
- Management fees were assumed to remain unchanged.

One uncertainty for the public pension business is the issue of "unification." In Japan, there are four public pension schemes for employees: the Employees' Pension Insurance Scheme for private sector employees and three Mutual Aid Associations for government employees, local government employees, and private school employees, respectively. The four schemes are operated differently, and actuarial calculations are made separately. Contribution rates and benefits also differ between the Employees' Pension Insurance Scheme and the Mutual Aid Associations. All four schemes have agreed to be "unified". Although this issue is being discussed, it has yet to be determined whether it will entail simply financial consolidation or whether a single organization will actually be responsible for administering and managing assets for all employees. If plan management were consolidated—for example, by discontinuing the asset management responsibilities of the Mutual Aid Associations and combining them into the GPIF—then the number of companies to which asset management is outsourced would obviously fall, and the management fees for assets that would otherwise be managed by Mutual Aid Associations would probably fall, as would overall fees revenue. Given the current state of affairs in Japan, it seems highly unlikely that this sort of consolidation will occur. However, the basic policy for consolidation agreed on by the Cabinet in April stated that basic asset allocation would be the same for assets in the Employees' Pension Insurance Scheme and the shared portion of the assets of Mutual Aid Associations. This would have a particularly strong impact on asset management at Mutual Aid Associations.

Estimating size of corporate pension business—movement of funds out of Tax-Qualified Pension plans

At end-March 2005, assets held in corporate pension plans totaled some 82 trillion yen (Figure II-3). The main factor driving change in this market will be the termination of the Tax-Qualified Pension system, which is set to be completed by the end of fiscal 2011. Accordingly, we have estimated the value of pension assets and management fees for each plan by 2011.

Figure II-3 Current Number of Plans (Contracts) and Assets Under Management at Corporate Pension Funds



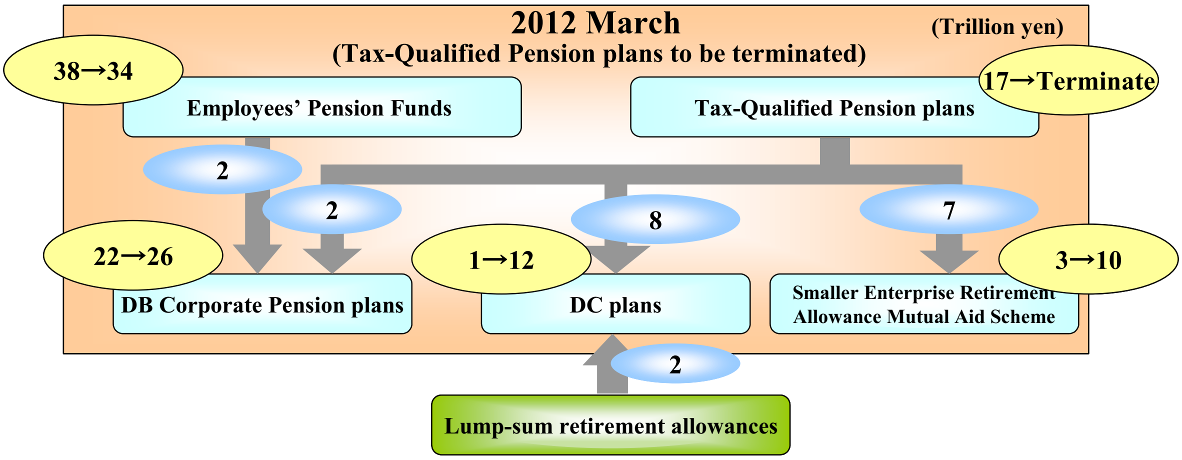
Assets as of end- March 2005.
Source: Compiled by NRI based on various materials.

Tax-Qualified Pension plans are in use not only at large enterprises but also at many small and medium-sized companies. We expect the type of scheme to be adopted after the termination of such plans will depend on the size of the business. To estimate asset value, we assumed that smaller businesses would migrate to the Smaller Enterprise Retirement Allowance Mutual Aid Scheme (established by the government for small businesses) and that somewhat larger companies would switch to defined-contribution (DC) plans. We also assumed that major corporations would adopt both DB Corporate Pension and DC plans (see "Assumptions Behind Estimates of Corporate Pension Market" for details of the assumptions used). This estimate suggests a major migration of assets, particularly into DC plans. On the other hand, inflows into DB Corporate Pension plans from Tax-Qualified Pension plans and Employees' Pension Funds will continue for some time, although we expect the magnitude of these inflows to remain small. A shift of assets in Employees' Pension Funds to DB Corporate Pension plans as the "substituitional portion" is returned to the government (*Daiko-Henjo*) is reducing assets in the Funds. Although this downward trend will continue, we expect the rate of decrease to settle into a fairly narrow range once asset migration peaks.

Figure II-4 shows our estimates of asset value and management fees for each plan at the end of fiscal year 2011 based on the above assumptions. DC plans will show the biggest increase, with assets increasing about ten-fold to about 12 trillion yen from some 1.2 trillion yen in fiscal year 2004. Management fees are also expected to increase 14-fold, from 2.8 billion yen to around 39 billion yen. Although DC plans cannot yet match DB plans in terms of asset size, we expect them to become a major presence in the corporate pension fund market. In addition, the Smaller Enterprise Retirement Allowance Mutual Aid Scheme, into which Tax-Qualified plan funds will flow in the same way as into DC plans, is expected to have assets roughly equivalent to those in DC plans. However, we project management fees generated from these funds will remain low.

We look for the assets of DB Corporate Pension plans to grow from about 22 trillion yen to 26 trillion yen, with management fees rising from 85 billion yen to 100 billion yen, an increase of about 20 percent. In contrast, although the assets in Employees' Pension Funds are falling, they are still worth 34 trillion yen and generate management fees of approximately 140 billion yen, making this the largest component of the corporate pension market. It is difficult to envision substantial growth for DB plans, which include Employees' Pension Funds and DB Corporate Pension plans. Nonetheless, we expect them to remain a major presence in the corporate pension market for some time even after the termination of the Tax-Qualified Pension system.

Figure II-4 Estimated Size of Corporate Pension Funds



Estimated Size of Corporate Pension Funds

(Trillion yen)

	2005/03	2008/03	2012/03
Employees' Pension Funds	38.5	36.8	34.5
DB Corporate Pension plans	21.7	23.4	25.7
Corporate DC plans	1.2	5.7	11.7
Smaller Enterprise Retirement Allowance Mutual Aid Scheme	3.1	6.1	10.2
Tax-Qualified Pension plans	17.2	9.9	0.0

Source: NRI.

Estimated Management Fees from Corporate Pension Fund Management

(Billion yen)

	2005/03	2008/03	2012/03
Employees' Pension Funds	152.9	146.1	137.1
DB Corporate Pension plans	85.1	91.8	100.8
Corporate DC plans	2.8	15.6	38.9
Smaller Enterprise Retirement Allowance Mutual Aid Scheme	1.7	3.3	5.5
Total	242.4	256.8	282.3

* Tax-Qualified Pension plans are not included.
* These estimates only include investment trusts for DC plans.

Source: NRI.

Assumptions behind corporate pension market estimates

1. Estimates of market scale

- Projections of the migration of Employees' Pension Funds, DB Corporate Pension plans, Tax-Qualified Pension plans, and DC plans are based on past experiences, sponsors' prospective intentions, etc.
- Projections of the amount allocated to each asset class are based on estimated asset size and expected asset allocation ratios, with management fees calculated based on these results.

Past shifts among pension plans

Assumed Shift in Plan Assets

Employees' Pension Funds
We assume that **in the next five years, 40 percent of single/corporate group employer-type Funds will be shifted to DB Corporate Pension plans** (according to Newsletter on Pensions & Investment). We also assume that all multi-employer-type plans will remain as Employees' Pension Funds.

DB Corporate Pension plans
Shifts to DC pension plans are conceivable. However, **because there were almost no shifts of assets in the past, a similar trend is assumed for the future.**

Tax-Qualified Pension plans
We assume that all companies with these plans will move to other plans by March 2012 (no bankruptcies are assumed). **All small and medium enterprises having 300 or fewer employees will move to the Smaller Enterprise Retirement Allowance Mutual Aid Scheme. Relatively large enterprises with more than 300 employees will adopt DC plans.** **Those with assets of 20 billion yen or more will use both DC and DB Corporate Pension plans.**

DC Pension Plans
We consider only migration to this plan from other plans (we assume neither the termination of the DC plans nor migration to other plans).

* Lump-sum retirement allowances
With respect to migration from lump-sum retirement allowances to corporate pension plans, we assume only moves to DC pension plans for which past data are available.

Sponsors' prospective Intention to introduce other plans

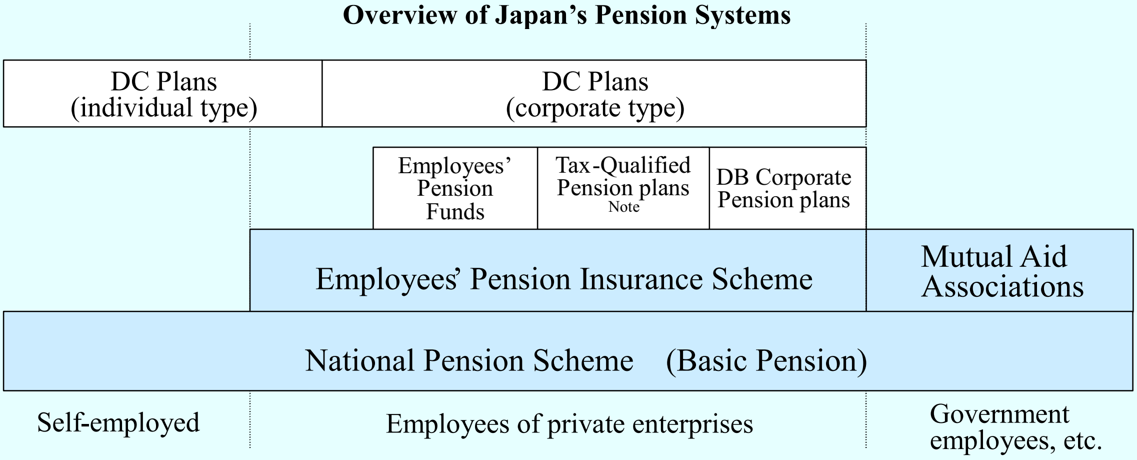
2. Estimates of defined-contribution (DC) pensions

- While migration to DC plans may occur from Employees' Pension Funds, DB Corporate Pension plans, Tax-Qualified Pension plans, and lump-sum retirement allowances, our estimates focus on the shift from Tax-Qualified Pension plans. We assumed that companies with more than 300 employees would adopt DC plans, and that those with large plans (assets of more than 20 billion yen) would also offer DB Corporate Pension plans.
- We looked at past-year data and previous trends to estimate growth in new DC plans (including the shift of assets from lump-sum retirement allowances).
- We project that investment trusts' share of DC assets will rise steadily until it reaches 48.9 percent at the end of March 2015 (the same proportion as that of US 401k assets in March 2005). The figure stood at 29.8 percent at end-March 2005, roughly equivalent to the corresponding figure for US 401k funds in 1995. While it is difficult to make simple comparisons with the US, we assumed Japan would lag behind the US by 10 years in this respect.
- We assumed no change in the legal framework for DC plans.

Sidebar

Japan’s Pension Systems—Overview and Recent Trends

Overview of Japan’s Pension Systems



Note: Tax- Qualified Pension plans are scheduled to be terminated at the end of March 2012.

1. Public pension system

There are basically three types of public pension plans (shaded in blue in the figure).

- National Pension Scheme (Basic Pension): Covers all members of the population aged 20–60 (although not shown in the figure, persons not employed by corporations, such as full-time homemakers, also participate in this plan). Benefits are dependent on the length of time a person contributes to the plan.
- Employees’ Pension Insurance Scheme: Covers employees of private companies. Benefits are proportional to the employee’s income.
- Mutual Aid Associations: Covers public employees and teachers, with benefits proportional to income. There are three Mutual Aid Associations, one each for 1) central government employees, 2) local government employees and 3) private school employees.

■ Management of public pension assets

While public pension schemes are basically managed on a pay-as-you-go basis, they have large reserves sufficient to cover almost five years of benefits. Management of assets in the Employees’ Pension Insurance Scheme and the National Pension Scheme is entrusted to the GPIF (Government Pension Investment Fund). Each Mutual Aid Association manages its own assets. It should be noted, however, that local branches manage a portion of the assets of the Mutual Aid Association for Local Government Employees.

Sidebar

2. Corporate pension system

■ Establishment of DB Corporate Pension system and termination of Tax-Qualified Pension system

Formerly, Japan's corporate pensions were provided as one of two defined-benefit (DB) plans: Employees' Pension Funds and Tax-Qualified Pension plans. The role of the former has been to provide benefits and manage assets for a part of the Employees' Pension Insurance Scheme that is a public pension plan for private employees (referred to as the "substituitonal portion") in addition to providing their own pension benefits. However, growth in the senior population and the economic slump have made asset management difficult. This led to a demand for new corporate pension systems that do not manage assets on behalf of the Employees' Pension Insurance Scheme and are regulated strictly as Employees' Pension Funds in terms of the protection of pension rights. As a result, the DB Corporate Pension system was established in 2001 and came into force in April 2002. It was also decided to terminate the Tax-Qualified Pension system at the end of fiscal year 2011.

■ Establishment of defined-contribution (DC) pension plans

The legislation allowing defined-contribution (DC) pension plans was enacted in 2001 and took effect in October 2001. In a corporate DC plan, the company makes contributions to individual pension accounts up to a specified maximum (Note) for each employee. Employees themselves cannot contribute to the scheme. In principle, a person may receive pension benefits starting at age 60 (with certain exceptions, early withdrawals and lump-sum payments are not permitted prior to this age). In addition to corporate DC plans, individual plans have been set up for employees working in companies without any corporate pension plans and also for self-employed persons. Individuals may contribute up to a specified maximum.

Note: Maximum monthly contribution under DC plans.

• Corporate plans	With other corporate pension plans: 23,000 yen
	Without other corporate pension plans: 46,000 yen
• Individual plans	Private company employees: 18,000 yen
	Self-employed: 68,000 yen

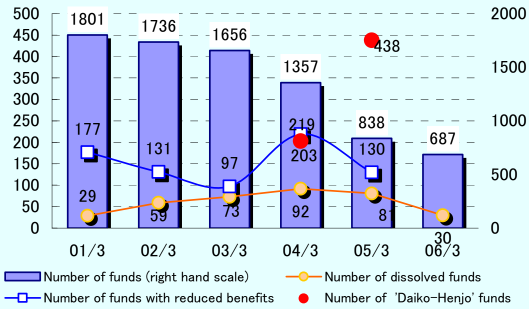
Sidebar

■ **Accelerated shift to new plans**

Since the establishment of DB Corporate Pension plans, an increasing number of Employees' Pension Funds are returning funds managed on behalf of the government to the Employees' Pension Insurance Scheme (*Daiko-Henjo*) and shifting to DB Corporate Pension or other plans. The number of Employees' Pension Funds has decreased as a result, and most of the remaining funds are multi-employer plans.

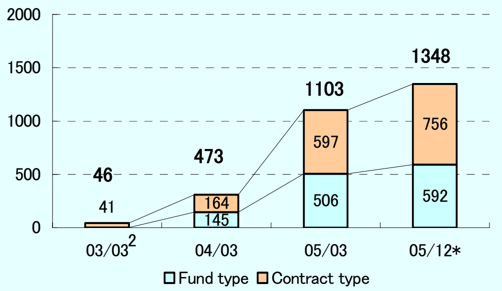
Because Tax-Qualified Pension plans have been adopted by a wide range of companies, both large and small, attention is increasingly focusing on the kind of pension plans these companies will adopt once existing plans are terminated. We project that small-scale companies will switch to the Smaller Enterprise Retirement Allowance Mutual Aid Scheme (established by the government for small businesses), while medium-sized and larger companies will mostly migrate to DC and DB Corporate Pension plans.

Employees' Pension Funds



Source: Compiled by NRI based on Pension Fund Association, *Basic Data Regarding Corporate Pensions* and other materials.

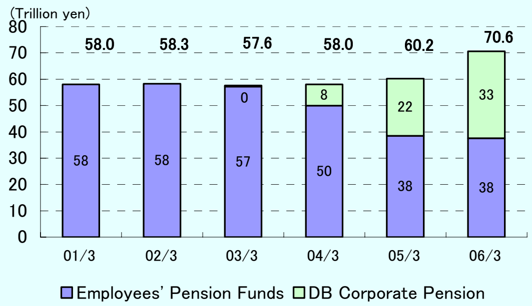
Number of DB Corporate Pension Plans



* Data are as of December 1, 2005

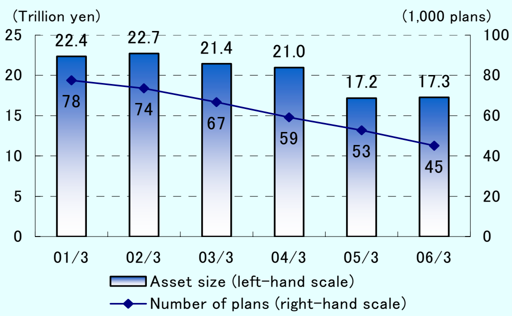
Source: Pension Fund Association, *Basic Data Regarding Corporate Pensions* and other materials.

Asset Size of Employees' Pension Funds and DB Corporate Pension Plans



Source: Trust Companies Association of Japan, Life Insurance Association of Japan.

Tax-Qualified Pension Plans - Asset Size and Number of Plans



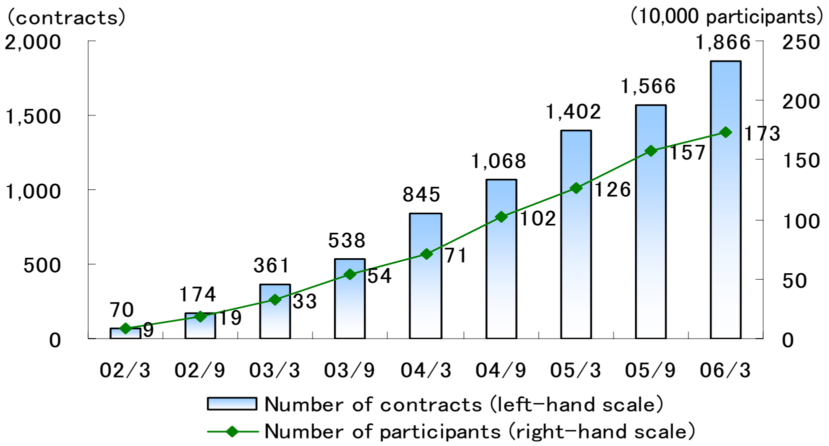
Source: Rating and Investment Information, Inc., *Newsletter on Pensions & Investment,* Trust Companies Association of Japan, Life Insurance Association of Japan.

2. DC Plans Growing Rapidly on Asset Migration from Tax-Qualified Pension Plans

Corporate DC plans have grown steadily since their establishment in October 2001. At the end of March 2006, there were about 1,900 pension contracts under this system with 1.7 million participants and 2.0 trillion yen in assets. The termination of Tax-Qualified Pension plans accounts for about 50 percent of the total asset migration from other corporate pension plans and the retirement allowance system, while newly established plans account for 30 percent(Figure II-7). DC plans are growing in popularity as a new type of corporate pension plan.

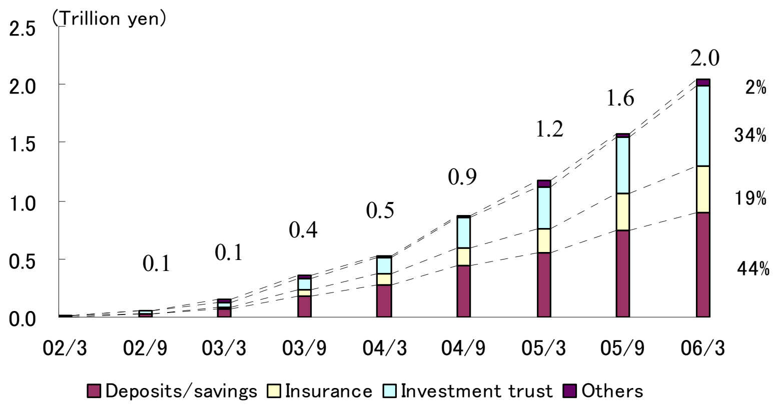
Such plans offer an average of 12 to 14 asset management products, a majority of which are investment trusts and other securities products. Although deposits still account for nearly 50 percent of fund assets, the recovery of the stock market in recent years has produced a modest uptrend in the share of assets invested in investment trusts.

Figure II-5 Corporate DC Plan Contracts and Participants



Source: Compiled by NRI based on Ministry of Health, Labour and Welfare data.

Figure II-6 Breakdown of DC Plan Assets



* Share of total assets in percent.
Source: Rating and Investment Information, Inc., *Newsletter on Pensions & Investment*.

Figure II-7 Funds Transferred from Other Plans (End of Month)

	02/5	02/7	02/8	02/12	03/2	03/5	03/8	03/12	04/2	04/5	04/9	04/11	05/2	05/10	Ratio (05/10)
Employees' Pension Funds	1	1	1	3	5	9	9	13	15	18	22	23	23	28	2%
DB Corporate Pension plans										1	3	3	3	6	0%
Tax-Qualified Pension plans	17	21	33	65	83	140	174	230	265	345	412	428	493	595	38%
Lump-sum retirement allowances	11	16	18	23	29	38	46	69	82	110	139	143	170	215	14%
Tax-Qualified Pension plans and Lump-sum retirement allowances	5	6	8	17	21	27	33	57	69	100	132	143	174	259	16%
None (newly established)	61	76	93	123	136	193	213	256	268	311	345	358	379	458	29%
Others	0	1	2	2	2	5	5	7	8	13	15	16	18	22	1%
Total	95	121	155	233	276	412	480	632	707	898	1068	1114	1260	1583	

Source: DC Liaison Committee, Ministry of Health, Labour and Welfare.

Management of DC plan investment trusts—most are passively managed funds

Most of the investment trusts used by DC pension funds have been set up exclusively for DC plans (referred to as "DC plan investment trusts" in this report). Below, we look at trends in these trusts.

At the end of December 2005, assets in DC plan investment trusts were valued at about 650 billion yen. The most common in terms of both the value and number of funds were funds investing in Japanese equities and funds investing in a combination of Japanese bonds and equities, also known as balanced funds. The value of assets flowing into such investment trusts continues to increase. Some 200 billion yen was invested in the first eight months of fiscal year 2005 (through November 2005), more than the amount for the entire preceding fiscal year(Figure II-9). Asset flows into equity funds were particularly strong.

Passively managed funds are still far more common than active funds, constituting 70 percent of total assets. In addition, the ratio of asset inflows to active funds has declined steadily since fiscal year 2002 (although the share of inflows to actively managed equity funds has increased modestly). It should be noted, however, that this tendency is attributable to the passive fund-dominated product lineup offered by some companies and does not necessarily reflect the preferences of individual plan participants.

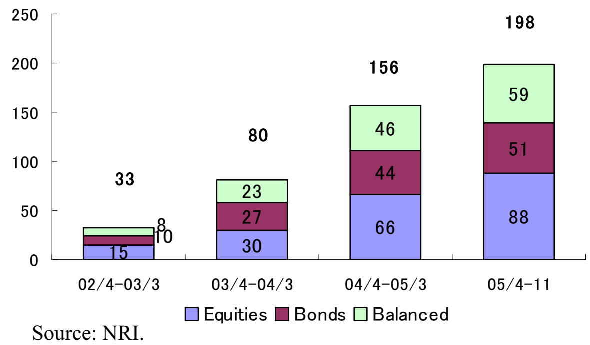
Figure II-8 Assets in DC Plan Investment Trusts (End-December 2005)

(Billion yen)

	Active		Passive		Total	
	Amount	Number of funds	Amount	Number of funds	Amount	Number of funds
Equity investment trusts						
Japanese equities	91.8	(54)	140.1	(34)	231.9	(88)
Foreign equities	15.5	(24)	53.8	(16)	69.4	(40)
Japanese bonds	11.0	(17)	60.2	(18)	71.2	(35)
Foreign bonds	9.6	(16)	67.4	(19)	77.0	(35)
Japanese balanced	19.7	(37)	108.4	(39)	128.1	(76)
Foreign balanced	19.0	(19)	31.5	(9)	50.5	(28)
Others					2.5	(4)
Subtotal					630.6	(306)
Bond investment trusts						
MMF					14.9	(1)
Total	166.6	(167)	461.5	(135)	645.6	(307)

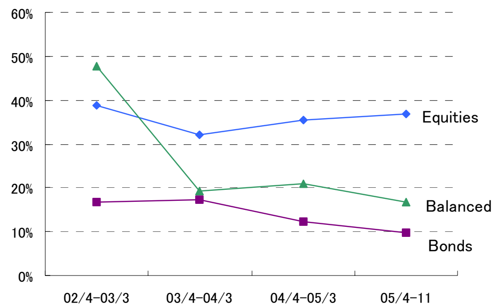
Source: Estimated by NRI after deduction of seed money

Figure II-9 Net Inflow of Funds to DC Plan Investment Trusts



Source: NRI.

Figure II-10 Ratio of Fund Inflows to Active Funds



Source: NRI.

Figure II-11 summarizes the management fees charged for DC plan investment trusts. Compared with general investment trusts, passive funds charge much lower fees. Based on a simple average, fees are 0.15–0.25 percentage point lower for dedicated DC funds than for general investment trusts (the differential is particularly large for passively managed foreign equity funds). Based on a weighted average at the end of December 2005, the difference is even greater. Fees for actively managed funds are about the same.

Figure II-11 Management Fees for DC Plan Investment Trusts (December 2005)

(%)

		General			DC Plan investment trusts		
		Number of funds	Management fees		Number of funds	Management fees	
			Simple average	Weighted average		Simple average	Weighted average
Japanese equities	Active	225	1.48	1.47	58	1.32	1.30
	Passive	27	0.65	0.73	34	0.48	0.32
Foreign equities	Active	145	1.56	1.50	24	1.54	1.64
	Passive	8	0.80	0.84	16	0.55	0.36
Japanese bonds	Active	23	0.63	0.63	17	0.60	0.57
	Passive	6	0.46	0.46	18	0.30	0.20
Foreign bonds	Active	220	1.08	1.14	16	1.16	1.16
	Passive	6	0.75	0.99	19	0.48	0.38
Japanese balanced		102	1.04	0.98	76	0.80	0.47
Foreign balanced		158	1.27	1.27	28	1.04	0.59

Source: NRI.

Large growth potential seen for corporate DC plans

As described in Section II-1 ("Growth Outlook for Pension Market"), the termination of the Tax-Qualified Pension system at the end of fiscal year 2011 is expected to lead to a major shift of assets to DC plans, chiefly from medium-sized and larger Tax-Qualified Pension plans. Together with this shift, we expect assets in DC plans to grow from 1.2 trillion yen at the end of fiscal year 2004 to 3.6 trillion yen at the end of fiscal year 2007 and about 12 trillion yen at the end of fiscal year 2011. This will bring the portion of assets invested in investment trusts to more than 40 percent by the end of fiscal year 2011, with around 5 trillion yen invested. Management fees will therefore grow faster than total assets in DC plans. In fact, we expect fees to grow 14-fold, from 2.8 billion yen at the end of fiscal year 2004 to about 39 billion yen at the end of fiscal year 2011.

Figure II-12 Estimated Size of DC Pension Market

(Trillion yen)

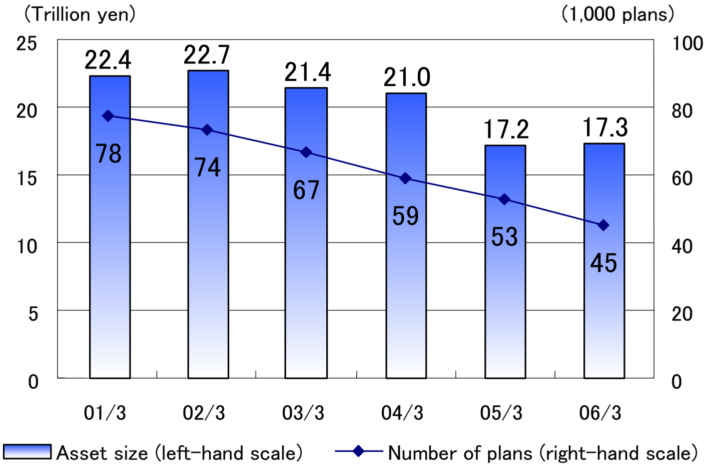
Amount shifted	2005/3	2008/3	2012/3
Inflows from Tax-Qualified Pension plans	—	3.6	8.4
Inflows from lump-sum retirement allowanc	—	0.5	1.1
Newly established	—	0.5	1.1
Assets in DC plans	1.2	5.7	11.7
Assets managed in investment trust	0.4	2.0	5.1
Investment trusts as % of total	29.8%	35.5%	43.2%
Management fees (billion yen)	2.8	15.6	38.9

Source: NRI.

This rapid growth in the DC pension market triggered by termination of the Tax-Qualified Pension system is expected to slow at the end of fiscal year 2011. Subsequently, however, we look for a review of corporate pension plans to drive a continued shift to DC plans and newly established plans, enabling sustained market growth.

Our estimates of the asset shift from Tax-Qualified Pension plans to DC plans assume that smaller companies with fewer than 300 employees will switch over to the Smaller Enterprise Retirement Allowance Mutual Aid Scheme, while larger enterprises will adopt DC plans. We also assume that large corporations with considerable assets will offer both DC and DB plans. In other words, we assume that most assets will be switched from DB to DC schemes. The value of assets in Tax-Qualified Pension plans has now fallen to 17 trillion yen, a majority of which is managed by life insurers and trust banks. For these firms, the shift from Tax-Qualified to DC plans means the loss of their traditional DB plan management business. Competition in investment advisory services for DB plans, with their limited growth prospects, is also expected to intensify.

Figure II-13 Tax-Qualified Pension Plans—Asset Size and Number of Plans



Source: Rating and Investment Information, Inc., *Newsletter on Pensions & Investment*, Trust Companies Association of Japan, Life Insurance Association of Japan.

Management of Tax-Qualified Pension Plan Funds (End-March 2006)

(Trillion yen)

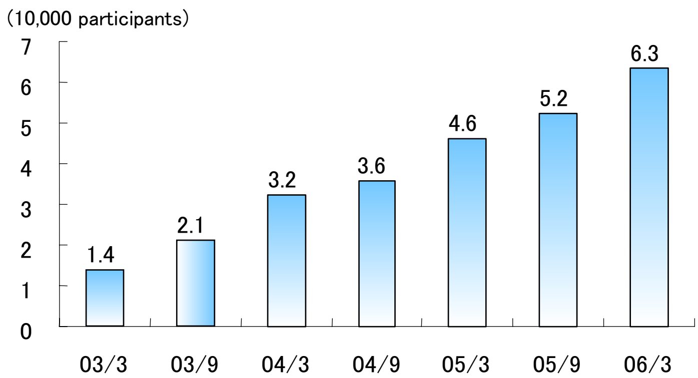
Asset manager	Number of plans	Asset size
Life insurance companies	37,725	6.8
Trust banks	6,938	10.1
JAFMAC*	427	0.3
Total	45,090	17.3

JAFMAC = Japan Federation of Mutual Aid Cooperatives

■ Steady growth foreseen for individual DC plans

Assets in individual DC plans totaled 50 billion yen at the end of fiscal 2004, and there were about 60,000 participants at the end of fiscal year 2005. Both assets and participants are steadily increasing. Many of the assets were transferred from corporate DC plans when participants left the sponsoring companies, with the amount contributed by individuals still relatively small. Depending on future changes in the legal framework, however, assets under management could grow sharply if individual DC plans become more popular as a retirement savings vehicle.

Figure II-14 Participants in Individual DC Plans



Source: Compiled by NRI based on data from Ministry of Health, Labour and Welfare.

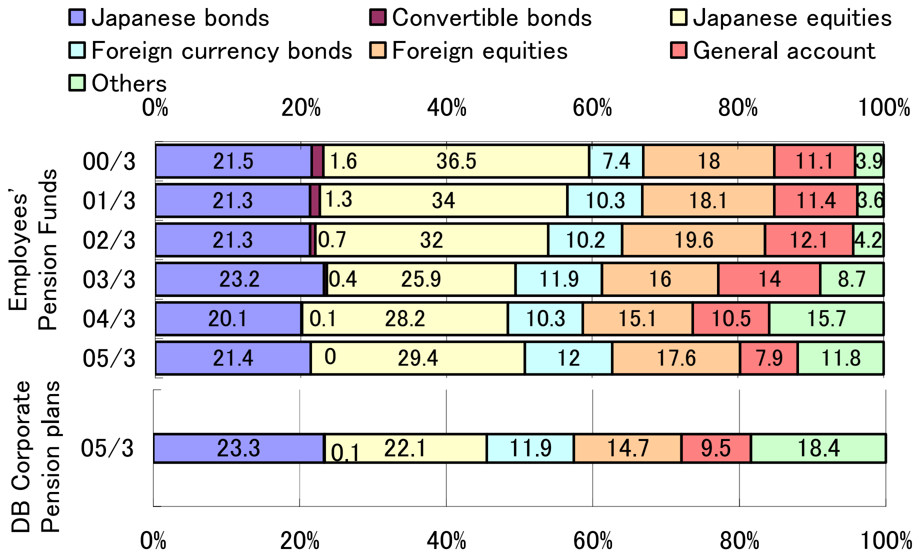
3. Pension Asset Management Focusing More on Non-traditional Investments

Corporate pension funds rely not only on traditional investments. Increasingly, they are starting to invest in non-traditional assets. The GPIF, the largest asset manager among public pension funds, principally takes a passive approach because of the huge amount of money it manages.

Corporate pension fund asset management—alternative investments grow

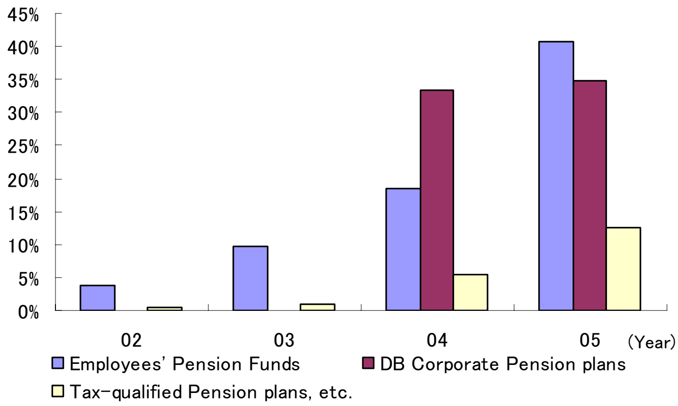
Figure II-15 shows changes in the asset allocation of Employees' Pension Funds over time. The ratio of Japanese equities has fallen substantially because of the stock market's decline from 2000 to 2002 and has yet to return to the level of fiscal year 2000. Meanwhile, the share of "Other" investments, including real estate and alternative investments, has increased. In other words, Employees' Pension Funds are increasingly turning to non-traditional investments. Although data are only available through the end of fiscal year 2004, this trend is accelerating among DB Corporate Pension plans. "Other" investments now represent 18.4 percent of total assets, approaching the figures for Japanese bonds and equities.

Figure II-15 Asset Allocation of Employees' Pension Funds and DB Corporate Pension Plans



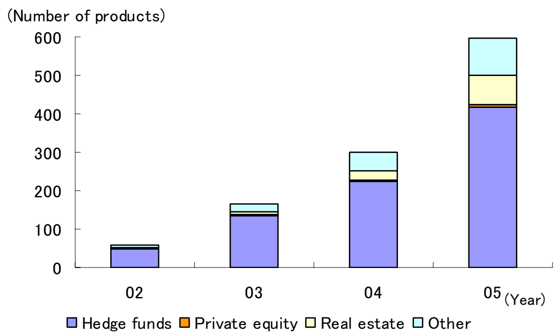
* "Others" include alternative investments, real estate, loans, etc.
Source: Pension Fund Association, *Survey on Actual Status of Asset Management* and *Basic Data Regarding Corporate Pensions*.

Figure II-16 Percentage of Corporate Pension Plans Employing Alternative Investments



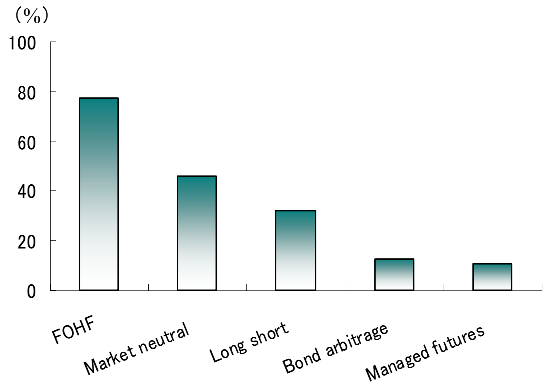
Source: Rating and Investment Information, Inc. , *Newsletter on Pensions & Investment.*

Figure II-17 Adoption of Alternative Products



Source: Rating and Investment Information, Inc., *Newsletter on Pensions & Investment.*

Figure II-18 Investments in Hedge Funds



Source: Daiwa Institute of Research Ltd. *Pension Newsletter (Alternative Investments)*, June 2005

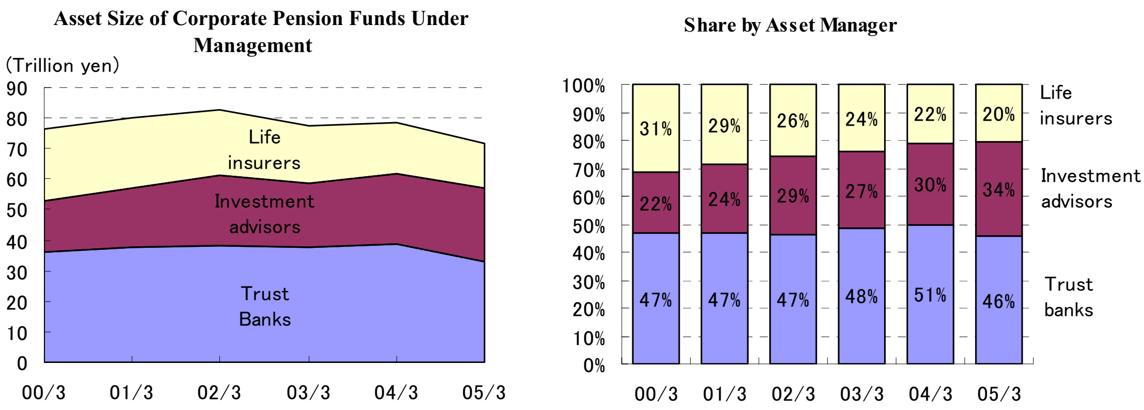
According to an annual survey conducted by *Newsletter on Pensions & Investment* magazine,[19] the year 2005 saw a large increase in the number of pension plans turning to alternative investments. Forty percent of Employees' Pension Funds and 35 percent of DB Corporate Pension plans answered that they had made such investments (Figure II-16). There also appears to be a tendency for larger funds to invest a greater proportion of their assets in alternative investments. While the vast majority of these alternative investments are in hedge funds, recent years have also seen an increase in real estate and other such investments. More than 60 percent of the investments in hedge funds are in funds of funds.

[19] The Survey on Pension Customers of Asset Management Firms was featured in the December 19, 2005 newsletter, while alternative investments were covered in the April 17, 2006 issue.

■ Use of asset management companies

An examination of trends in assets held by corporate pension plans (Employees' Pension Funds, DB Corporate Pension plans, and Tax-Qualified Pension plans) and managed by asset management firms shows that life insurers and trust banks are managing less in both absolute and relative (market share) terms. We think this trend is closely related to the shift away from Tax-Qualified Pension plans. Another reason for the decline is the fact that substantial amounts of funds managed by Employees' Pension Funds on behalf of the government were returned to the government (*Daiko-Henjo*) in fiscal year 2004, reducing the value of corporate pension plan assets managed by these institutions. In contrast, investment advisory companies have experienced a modest increase in both assets under management and market share in recent years.

Figure II-19 Assets Under Management by Manager Type



Source: Compiled by NRI based on Rating and Investment Information, Inc. *Newsletter on Pensions & Investment*

Figure II-20 shows historical trends in the number of asset managers used by Employees' Pension Funds according to asset size. Overall, the number of asset managers used has fallen, with smaller funds, in particular, using fewer asset managers. Smaller funds are also less likely to utilize investment advisory companies.

Figure II-20 Average Number of Contracted Management Companies by Asset Size (Employees' Pension Funds))

Asset size (billion yen)	1996	97	98	99	2000	01	02	03	04			
										Trust banks	Life insurance companies	Investment advisory companies
-3	6.3	6.0	5.5	5.0	4.9	4.7	4.8	4.1	3.3	1.6	1.6	0.0
3-5	7.3	7.0	6.6	6.3	6.0	5.8	5.6	5.1	4.9	2.5	2.3	0.2
5-10	7.5	7.3	7.0	6.6	6.6	6.3	6.2	5.4	5.1	2.5	2.3	0.4
10-20	7.8	7.8	7.6	7.4	7.3	6.9	6.8	6.2	5.9	3.0	1.8	1.2
20-30	9.4	9.0	8.9	8.3	8.4	8.2	8.3	7.1	7.0	3.3	1.6	2.2
30-50	10.6	10.9	10.8	10.1	10.4	10.3	10.2	8.5	8.6	3.3	1.8	3.4
50-	14.8	15.4	15.4	14.7	15.0	14.6	14.9	12.9	13.2	3.6	1.8	7.7
Total	8.4	8.4	8.3	8.2	8.1	7.8	7.6	6.9	6.8	2.8	1.9	2.0

Source: Pension Fund Association, *Corporate Pension Funds*.

Management fees tend to fall as a fund's asset value increases. There has been no major change in fees over the last ten years.

Figure II-21 Management Fees Shown as a Percentage by Asset Size

(%)

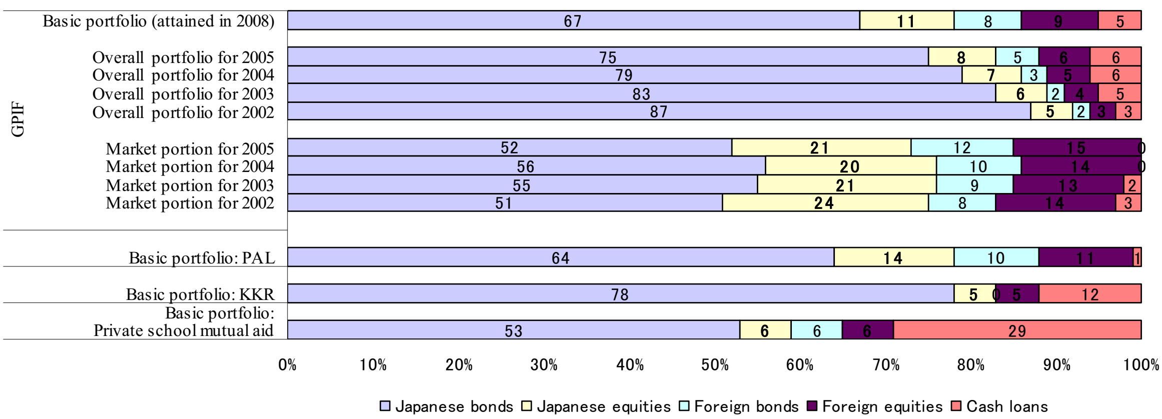
Asset size (billion yen)	1995	97	99	2001	02	03	04
Less than 2.5	0.43	0.41	0.44	0.41	0.40	0.44	0.42
2.5-5.0	0.40	0.39	0.43	0.41	0.39	0.43	0.43
5.0-7.5	0.39	0.38	0.44	0.40	0.38	0.41	0.42
7.5-10.0	0.38	0.35	0.41	0.39	0.37	0.40	0.42
10 - 25	0.38	0.34	0.40	0.37	0.35	0.38	0.37
25 - 50	0.35	0.32	0.38	0.35	0.32	0.34	0.32
50 - 75	0.33	0.29	0.39	0.33	0.29	0.32	0.32
75 -100	0.29	0.27	0.36	0.31	0.27	0.31	0.29
100 - 250	0.26	0.24	0.33	0.27	0.25	0.26	0.28
250 or over	0.23	0.20	0.28	0.23	0.20	0.23	0.26
Total	0.32	0.28	0.35	0.31	0.28	0.31	0.31

Source: Pension Fund Association, *Corporate Pension Funds*.

Asset allocation of major public pension funds—GPIF focuses on passive management with low management fees

Figure II-22 shows the basic portfolios of major organizations managing assets for public pension schemes (GPIF, Pension Fund Association for Local Government Officials, Federation of National Public Service Personnel Mutual Aid Associations, and Promotion and Mutual Aid Corporation for Private Schools of Japan). Because all but the last organization are required to invest in FILP or local government bonds, Japanese bonds represent a large share of their portfolios. At GPIF, funds returned from the Fiscal Loan Fund have been allocated to equities and other marketable securities, resulting in a gradual decline in the share of Japanese bonds. GPIF is scheduled to achieve its targeted basic portfolio by fiscal year 2008.

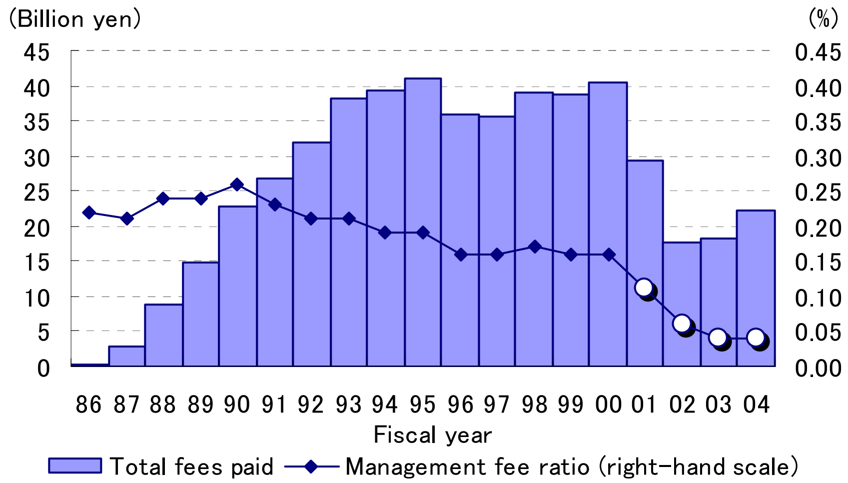
Figure II-22 Basic Portfolios of Major Public Pension Funds



Source: Compiled by NRI based on data from GPIF, Pension Fund Association for Local Government Officials (PAL), Federation of National Public Service Personnel Mutual Aid Associations (KKR), and Mutual Aid Corporations for Private Schools.

The GPIF, which manages a large pool of assets, focuses mainly on passive management. Actively managed funds are limited to about 20 percent of total assets, and management fees are fairly low.

Figure II-23 GPIF Management Fees



Source: Compiled by NRI based on GPIF data.

4. Financial Institutions Shift Towards Hedge Fund Investments –Growth To Continue with Investments in Funds of Funds

Over the last few years, financial institutions have boosted investments in securities to compensate for low margins in their lending operations. However, these investments have changed substantially. Ten years ago, government bonds accounted for around 25 percent of banks' total investments in securities. By fiscal year 2003, the ratio had doubled to 50 percent. This shift in asset allocation has created significant exposure to interest rate risk. Financial institutions' stock portfolios have fallen sharply with the termination of cross-shareholdings, making it difficult for banks to rely on higher stock prices to offset losses from rising interest rates. This creates a need for asset management techniques capable of boosting profits while minimizing risk. In other words, financial institutions require asset management methods that maximize profitability while providing some diversification against interest rate risk.

To this end, many financial institutions have been using money trusts, private investment trusts, and hedge funds offered by outside asset managers. This chapter examines the findings of a survey conducted to determine financial institutions' approach towards hedge fund investments, which have become played an increasingly large role in recent years.

Financial institution investments in hedge funds as revealed by AIMA-Japan survey

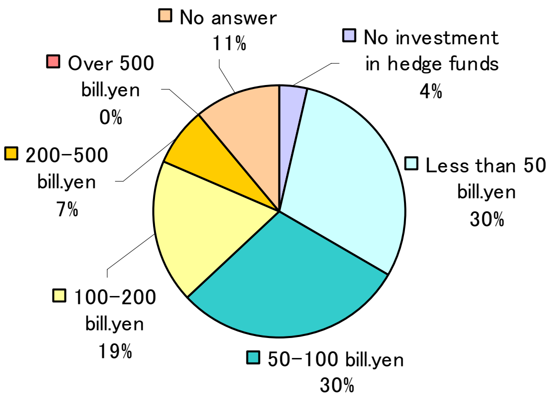
The Alternative Investment Management Association-Japan (AIMA-Japan) jointly conducted a questionnaire survey with NRI in July 2005. The survey targeted 31 major financial institutions that invest in hedge funds and received 27 responses. (Most were banks and insurers, but there were also three trading companies. We estimate that the respondents account for 60–70 percent of total hedge fund investments by financial institutions in Japan.) The survey revealed an average investment of about 100 billion yen, a focus on funds of funds, and a persistent strong interest in hedge fund investments among both life and non-life insurers.

■ Current investments in hedge funds—more than 2 trillion yen invested by 27 respondents

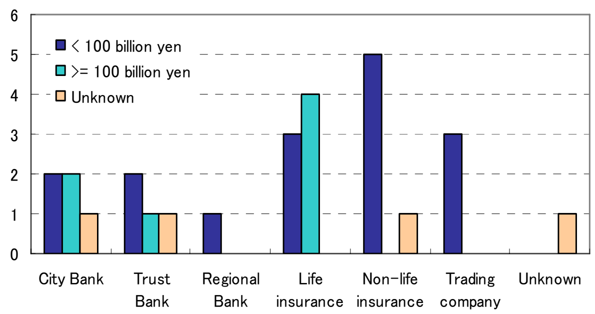
About one-fourth of the responding institutions had invested more than 100 billion yen in hedge funds, while 56 percent—more than half—had invested more than 50 billion yen. Investments by respondents totaled 2.25 trillion yen, with an average investment of about 100 billion yen.

When asked when they began investing in hedge funds, 24 institutions responded. Fourteen answered that they had first invested prior to 1999. Those investing for the first time in 1999 or later tended to have invested larger amounts.

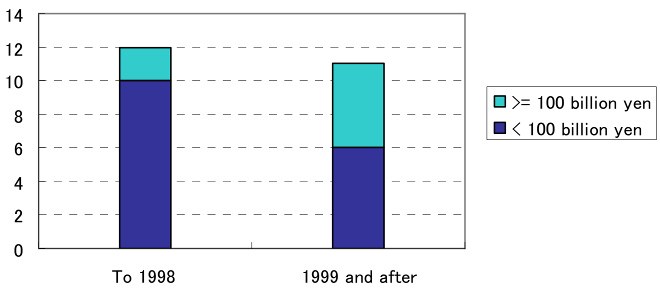
Figure II-25 Amount Currently Invested in Hedge Funds



Amount invested in hedge funds per sector and business category



Amount invested in hedge funds by date of first investment



■ Investments center on funds of funds

More than 50% of the respondents allocated at least 60% of their hedge fund investment to funds of funds, with only 12% investing in single funds exclusively. Clearly, funds of funds have become the main investment vehicle. Forty-nine percent of all respondents had invested in six or more funds of funds.

Looking at single-manager funds, 57% of respondents had invested in less than 15 funds, while 31% had invested in 21or more such funds.

Regardless of whether they invest in funds of funds or single-manager funds, a majority of financial institutions rely on foreign funds and/or managers.

When asked about the key factors in selecting funds of funds, respondents noted the emphasis on investment strategies, risk management, and management structure as well as past performance, risk levels, and disclosure and transparency.

Figure II-26 Funds of Funds as Portion of Total Hedge Fund Investment

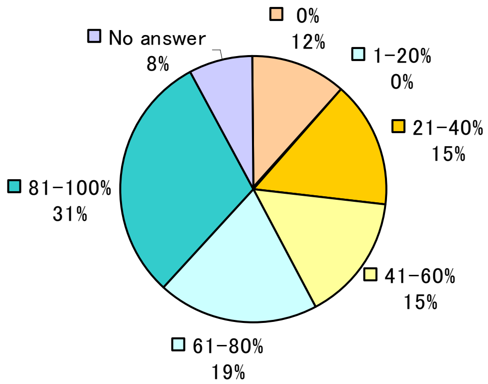
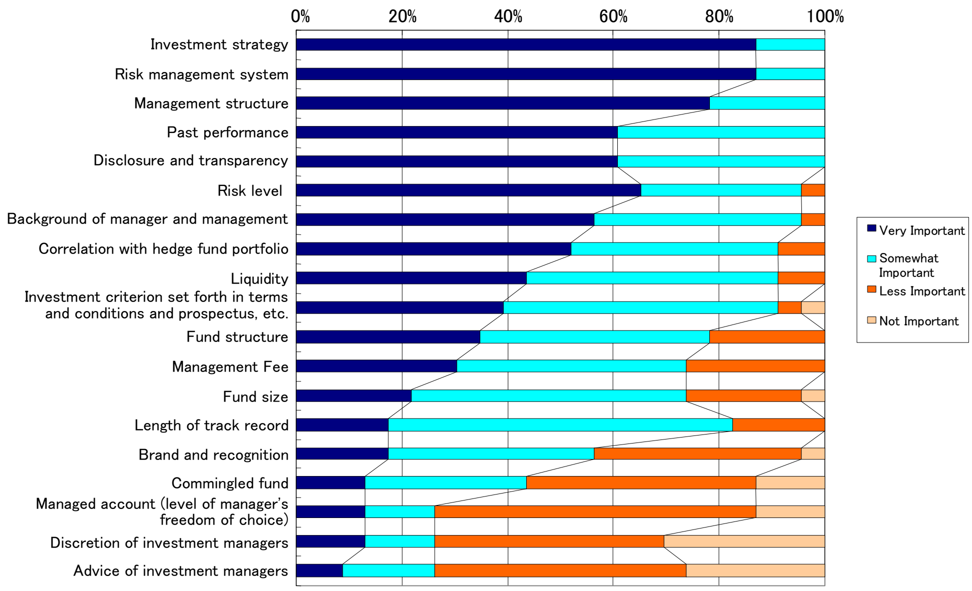


Figure II-27 Key Factors in Selecting New Funds of Funds

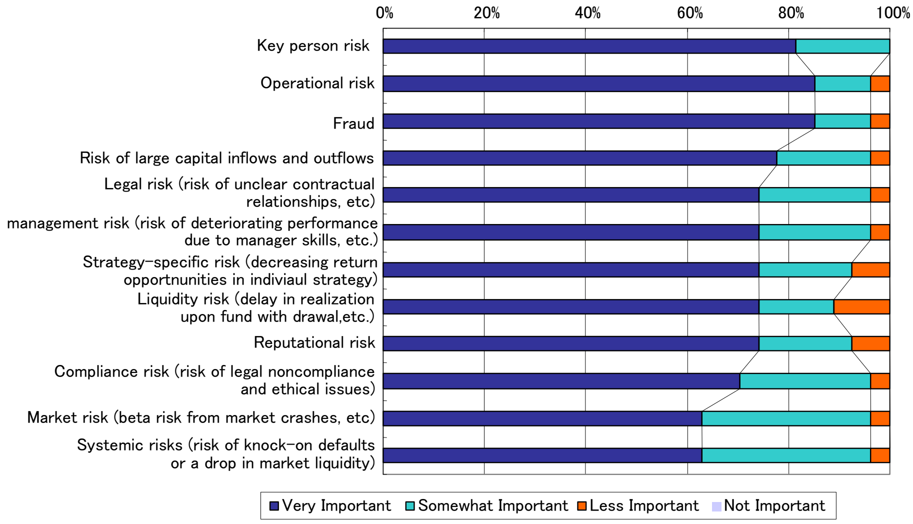


■ Risk management

Almost all respondents (95%) placed high importance on “absolute returns”, with around 60 percent aiming for returns of “3% to 7%”. The most common target return, noted by about 30% of the respondents, was “5% to 7%”. An overwhelming proportion of the respondents engage in monthly monitoring of hedge fund performance.

In terms of risk management, almost all institutions focused on items such as key person risk, operational risk, fraud, and legal risk. Nevertheless, other matters were also considered to be important, and all items received a relatively similar weighting.

Figure II-28 Risks of Hedge Fund Investment

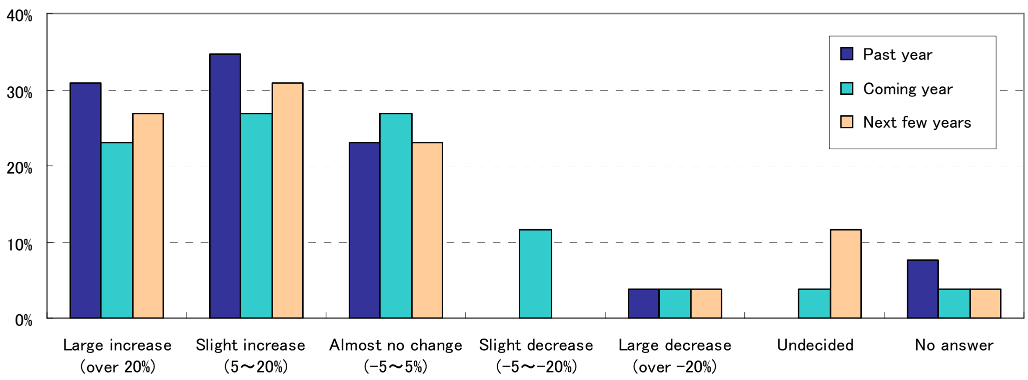


About 40 percent of respondents answered that four or more staff were responsible for managing hedge fund investments. However, only 15 percent of the respondents maintain full-time overseas staff despite the high share of investments delegated to foreign managers and funds.

■ Further growth seen for hedge fund investments

In the past year, two-thirds of respondents had increased investments by more than 5 percent. Approximately half the respondents—and life and non-life insurers in particular—planned to raise their investments by 5% or more in the coming year.

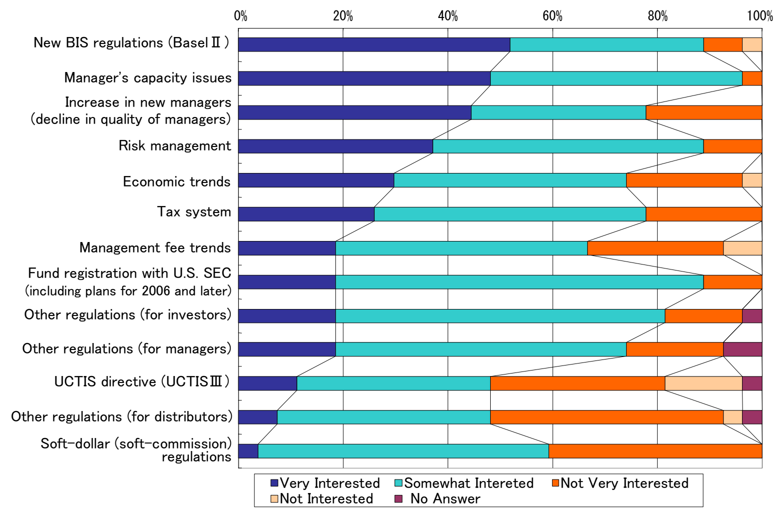
Figure II-29 Current and Future Investments in Hedge Funds



■ Recent concerns: new BIS regulations and capacity

When asked to name their greatest concerns about hedge funds, many respondents said they were worried about the new BIS regulations, capacity issues, and a deterioration of quality as more new managers enter the business. More attention is being focused on the new BIS regulations because detailed regulations relating to the risk weighting of hedge fund investments are now being drawn up.

Figure II-30 Issues of Greatest Concern



III Retail Market Financial Products

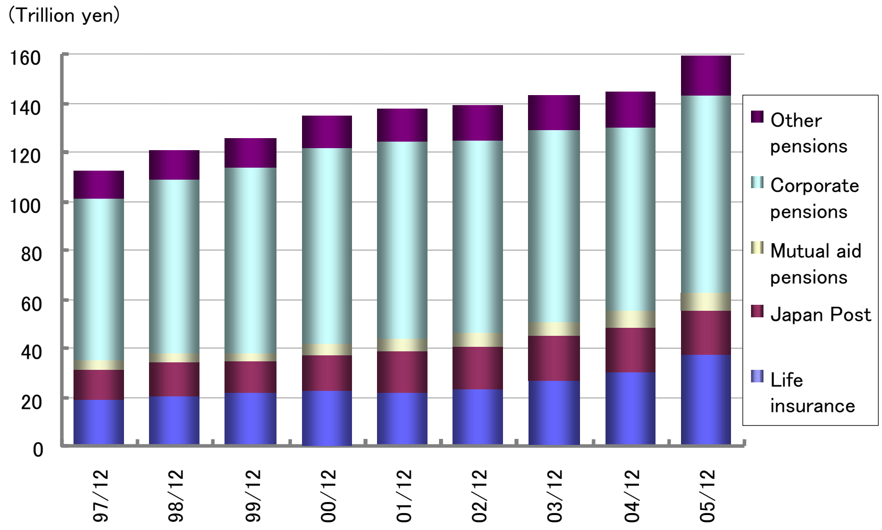
1. High Demand for Principal Guarantees and Cash Flow in Preparation for Retirement

Household financial assets in Japan exceeded 1,500 trillion yen at the end of December 2005. Financial institutions have tried to attract these assets by offering a range of financial products. But with about half of all such assets still "sleeping" in bank deposits, there remains considerable potential for further growth.

Consumer attitudes are obviously an important consideration for financial institutions developing a product strategy. But consumer preferences can also be viewed from a macroscopic standpoint. According to the "Flow of Funds Accounts" data published by the Bank of Japan, three types of household financial assets have increased over the last few years: pension reserves, government bonds, and investment trusts (in order of increase).

An examination of pension reserves and their makeup shows that variable annuities for individuals, offered by private insurance companies, have grown considerably (Figure III-1). In the past, most variable annuity products featured a death benefit rider. Recently, however, products with a rider guaranteeing the underlying pension funds have become more popular. These trends suggest strong demand for principal guarantees as policyholders prepare for retirement.

Figure III-1 Breakdown of Pension Reserves

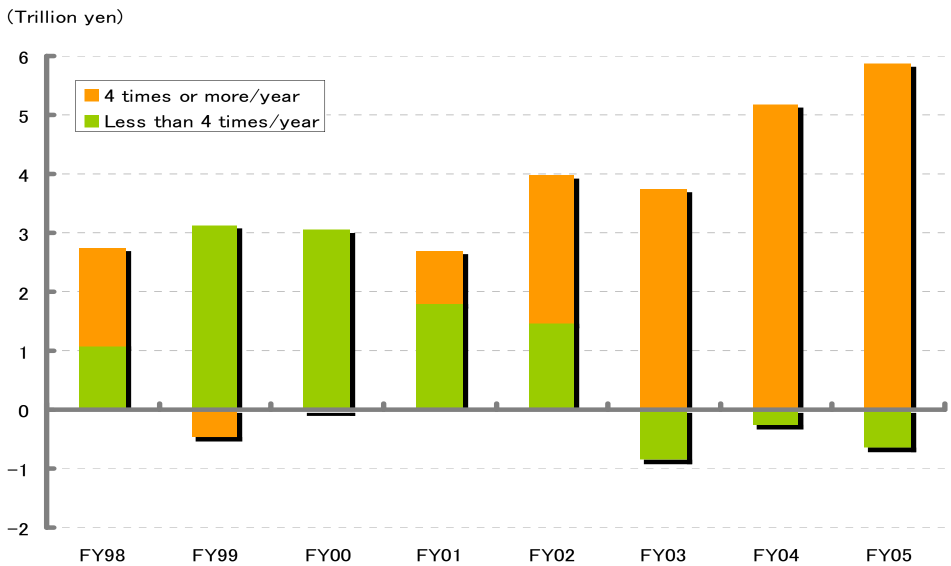


Source: Compiled by NRI based on Bank of Japan data.

Given the current low level of interest rates, we think consumers investing in government bonds mainly seek long-term, principal-guaranteed savings as opposed to a high rate of return or interest income.

Finally, we looked at the kinds of investment trusts being selected by customers, with a focus on investment risk and dividend payment frequency. Until 2002, funds continued to flow into relatively high-risk investment trusts investing mainly in equities. But this became an outflow in 2003. Meanwhile, medium-risk products, such as funds investing in foreign bonds and balanced funds investing in multiple asset classes, have been attracting more assets each year since 2001, evidence of a clear trend towards less risky investments. Funds paying dividends on at least a quarterly basis—including balanced funds and funds investing in high-yielding stocks, as well as the popular foreign bond funds—are also attracting substantial assets (Figure III-2). The growing preference for medium-risk products with frequent payouts is not driven by a desire for capital growth. Rather, investors seek stable cash inflows from investment gains, enabling them to fund their retirements without drawing down principal.

Figure III-2 Investment Trust Inflows and Outflows by Dividend Payment Frequency



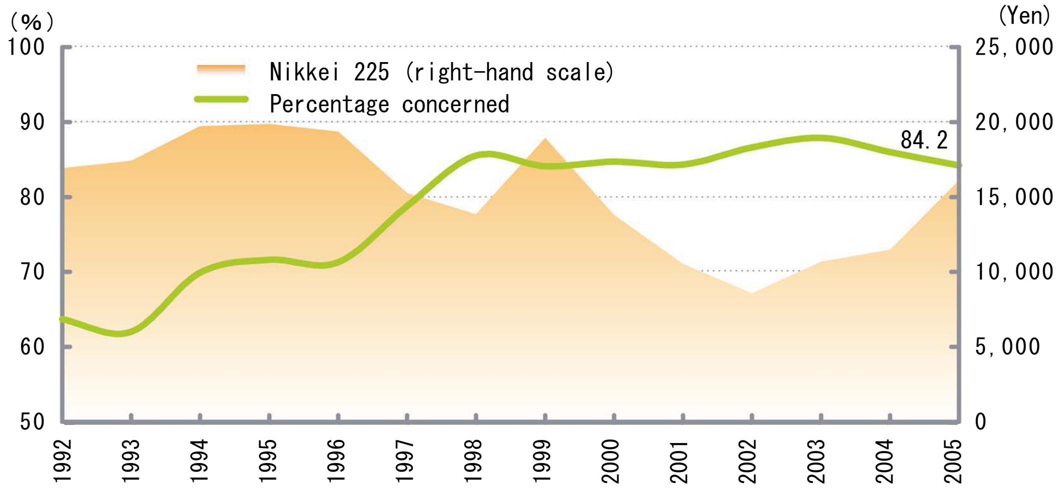
Note: Funds for which accounts are settled on a daily basis, such as MMF and MRF, are not included; figures for fiscal 2005 are through the end of November.
Source: Compiled by NRI based on Fundmark data.

■ Concerns over retirement

According to a survey conducted by the Bank of Japan, the fall in stock prices triggered by the collapse of the dot-com bubble in 2000 was accompanied by a widespread perception among individuals that the economy was struggling. But the subsequent upturn since 2003 has created a more sanguine view. In this way, individuals' awareness of short-term economic conditions tends to be influenced by recent market activity. According to a survey undertaken by the Central Council for Financial Services Information, however, worries about how to plan for retirement gradually began to surface in the 1990s. In the late 1990s, more than 80 percent of households were unsure about how they would provide for their retirement. Further, this percentage has remained high despite the recent economic upturn (Figure III-3).

The products offered by financial institutions reflect the behavior of individual investors. Sales of products that address cash flow and principal protection needs have been rising, and a broad range of such products is on offer. This growth indicates a desire among consumers to avoid "longevity risk". Given the concerns many households have about how to provide for their retirements, we expect demand for such products to remain strong for some time.

Figure III-3 Retirement Concerns Among Households Headed by Persons Under 60



Note: Nikkei 225 Average as of end-December each year.
Source: Compiled by NRI based on Central Council for Financial Services Information, *Public Opinion Survey on the Financial Assets of Households*.

Sidebar

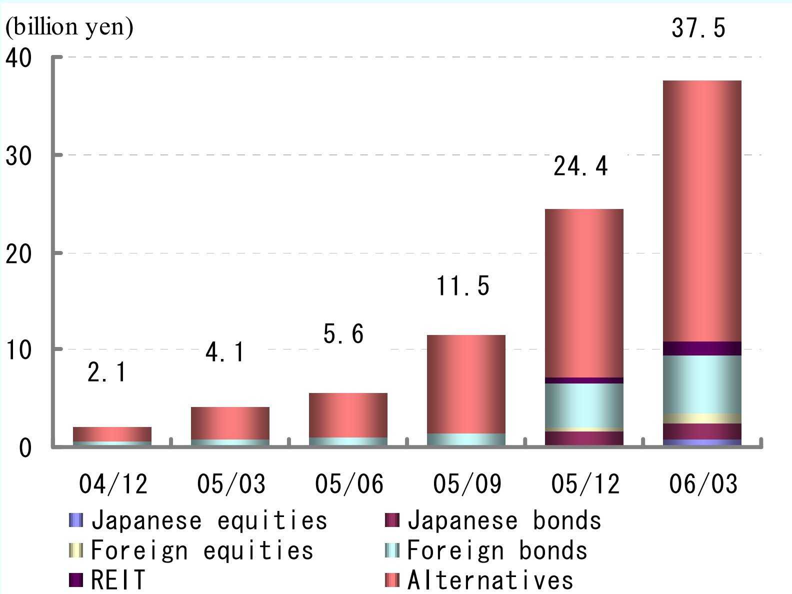
SMA (Separately Managed Account)—From Products to Processes

With the amendment of the Investment Advisory Law in April 2004, restrictions imposed on the discretionary investment advisory services offered by securities firms were greatly relaxed, allowing them to offer SMAs—so-called "wrap account" services. To take advantage of this opportunity, the major securities companies have either started to offer such products or are undertaking preliminary studies in preparation for doing so. Banks and trust banks are also offering these services.

SMAs target high-net-worth individuals, with required minimum investments ranging from 10 million yen to 300 million yen. The market is small because these services are still quite new. Nevertheless, assets in SMAs totaled some 340 billion yen at end-March 2006.

Because these products require relatively large investments compared with other products for individuals, the companies offering them have tried to make their services as appealing as possible. To this end, they offer a wide product lineup that includes hedge funds (see Figure below). Companies are also offering advice regarding asset allocation, etc. Through such efforts, companies aim to offer a complete range of services, from investment advice to reporting, rather than just selling financial products.

Alternative Investments Represent Major Portion of SMA Funds



Note: SMA funds are Japanese-based equity investment trusts offered exclusively to SMAs.
Source: Compiled by NRI based on Fundmark data.

Sidebar

Services offered in an SMA include the management of portfolios consisting of individual stocks or investment trusts. In the case of the former, most of the stocks are Japanese equities. Some financial institutions offer only investment trust portfolios, which are known as “investment trust wraps”.

Portfolio management services for SMAs in the US are divided into three types: (1) SMAs for which portfolios are created and managed by an affiliated asset management company; (2) SMAs that offer a selection of portfolios provided by an affiliated asset management company or unaffiliated managers; and (3) multi-style portfolios (MSP), in which an investor selects model portfolios offered by asset management companies and the securities firm actually manages the selected portfolio. The MSP is the most common type of SMA in Japan.

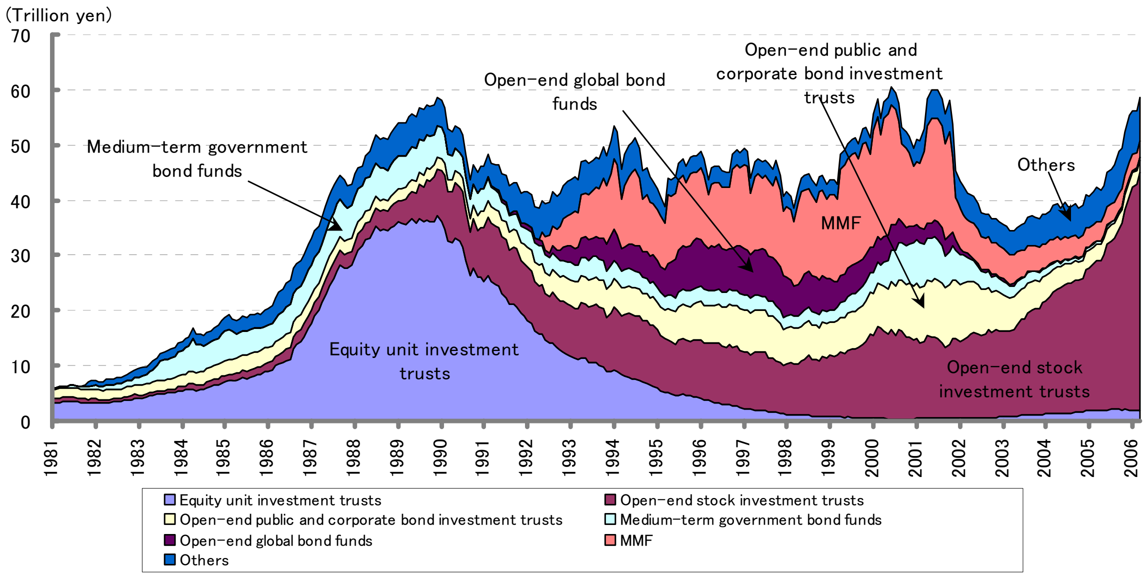
In a sense, SMAs have made it possible for individual investors to utilize asset management services that until now were offered only to pension funds and other institutional investors. We expect the market for asset management services to grow along with the need to hedge against “longevity risk”.

2. Changing Features of Consumer Financial Products –Focus on Investment Trusts and Variable Annuities

Market for Japanese-based public investment trusts—growing diversity and assets under management

Total assets in Japanese public investment trusts fell sharply in 2002 before recovering starting in 2003. Assets at the end of March 2006 amounted to some 58 trillion yen and are once more approaching an all-time high. Open-end equity investment trusts (Figure III-4), and especially actively managed foreign equity funds and foreign hybrid funds, have been mainly responsible for this increase.

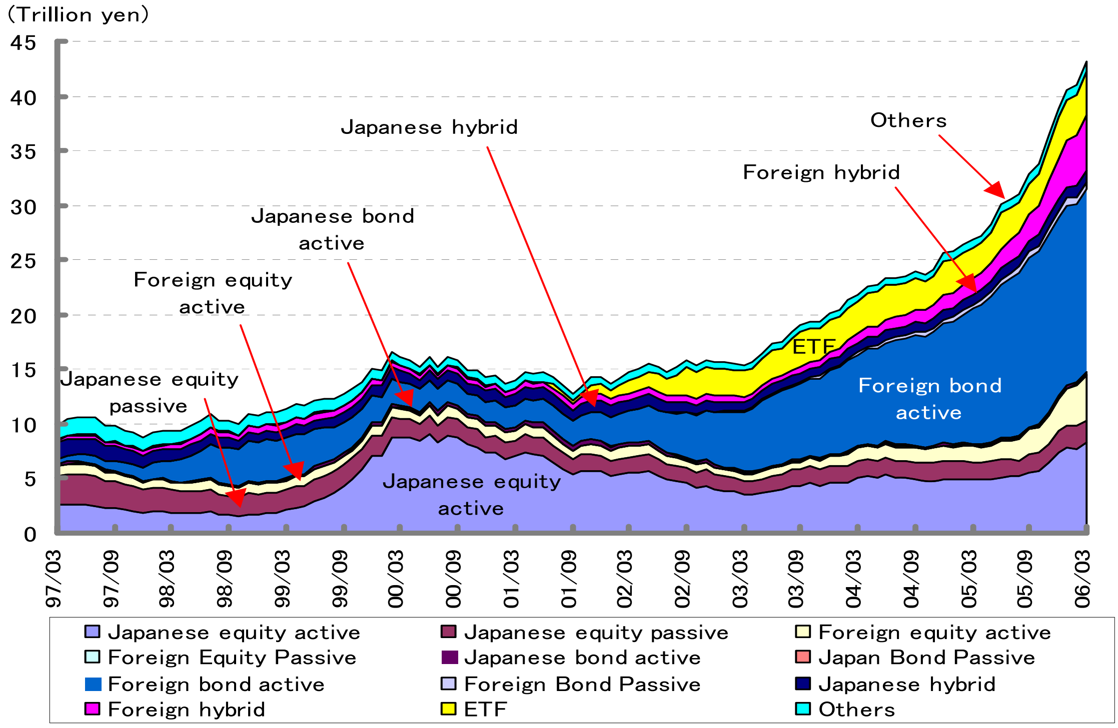
Figure III-4 Public Investment Trust Market in Japan



Source: Compiled by NRI based on data from Investment Trusts Association, Japan.

A ranking of open-end equity investment trust funds by quarterly net asset inflows shows that, through the third quarter of 2003, foreign bond funds such as the Global Sovereign Open Fund accounted for an overwhelming share of asset inflows. Since around September 2003, Japanese equities, Chinese equities, and real estate investment trust funds have also counted among the top-ranked funds. More recently, as Japanese equities have risen, top-ranked funds have included Japanese equity funds as well as foreign equity and foreign hybrid funds. These developments reflect the diversification of product offerings (Figure III-5).

Figure III-5 Open-end Equity Investment Trusts: Trends in Assets Under Management by Type



Source: Compiled by NRI based on Fundmark data.

Trends in investment trusts

■ Products offered in response to cash flow needs

An examination of net asset inflows and outflows from public equity investment trusts based on dividend frequency shows that inflows into funds paying out at least four times a year have increased every year since 2001, underlining individuals' strong need for cash flow (Figure III-2).

■ Products offered to address need for principal guarantee

- Since the second half of 2002, the number of so-called "limited risk" investment funds has been increasing. These products have been promoted based on the high yields achievable by distributing option premiums to investors. In recent years, however, the yield has fallen, making these products less attractive and causing growth in assets to slow.
- An examination of fund inflows and outflows by product risk shows that assets are now flowing out of high-risk products and into medium-risk products.

Sidebar

Increasing the Number of Japanese ETFs

The net assets of domestic exchange-traded funds (ETF) have increased every year since 2001 and stood at 3.7 trillion yen at the end of 2005, for an average annual increase of 56%. Although the total amount continues to rise, growth is slowing. Past growth was attributable to the use of ETFs as a tool for winding down corporate cross-shareholdings between 2000 and 2002, when the economy slowed and share prices fell. ETFs grew in Japan as a market for professional investors.

Net assets in US ETFs have increased every year since 1993 and totaled some 300 billion dollars (about 36 trillion yen, or ten times the assets in Japanese ETFs) at the end of 2005. Assets under management rose by 81 percent a year, with growth rates of 77 percent for domestic equities, 91 percent for global and foreign equities, and 59 percent for bonds. Both global and foreign equities posted remarkable rates of growth during this period, owing to the convenience of passive ETFs under fee-based services for individual investors seeking advice. In the US, therefore, ETFs developed as a retail product.

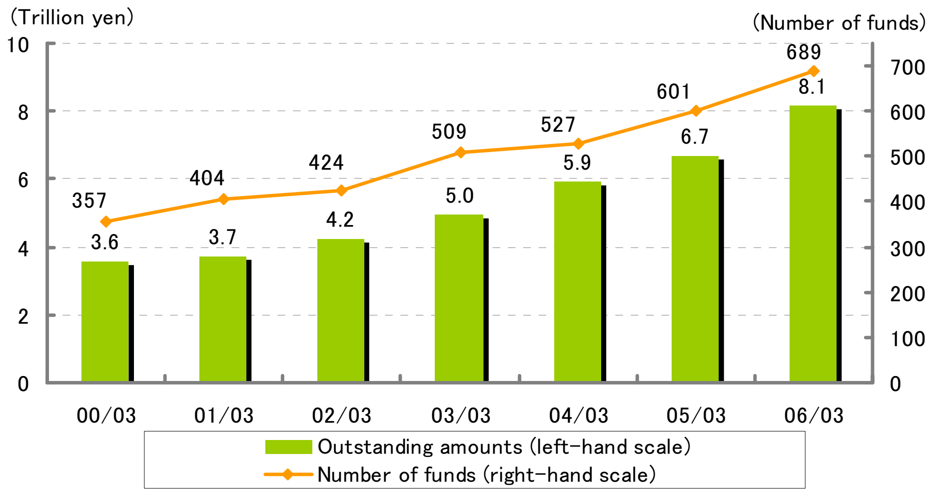
One reason for the expansion of ETFs in the US is the growth in fee-based services offering advice in response to strong demand from individual investors. There are three reasons for this trend: (1) ETFs are more suitable as a fee-based business for financial institutions, who cannot expect the same level of sales commissions from ETFs as from general investment trusts; (2) when a financial adviser recommends a portfolio to a customer, the emphasis is on asset allocation, with a tendency to emphasize passive products such as ETFs; (3) when an adviser proposes passively managed products, it is easier in terms of client loyalty and suitability rules to recommend ETFs than index investment trusts because fees are lower.

Taking the US market as an example, growth in the domestic ETF market depends on the popularity of ETFs among retail customers. In Japan, there are two major ETF-positive factors. One is that fee-based services for individuals continue to grow. Securities companies, in particular, are attempting to shift from conventional commission-based business models to fee-based models. The start of SMA services in April 2004 may have facilitated this shift. The second factor is the increased popularity of online trading by individual investors, which may increase the opportunities for use of ETFs. On the other hand, many financial institutions, such as major banks and securities firms, still rely on sales commissions. It may therefore take time for fee-based businesses to grow in Japan, and this is a concern for the future growth of the ETF market.

Market for foreign investment trusts growing by 13 percent a year

At the end of March 2006, assets invested in the 689 foreign investment trusts in Japan totaled some 8 trillion yen (Figure III-6). This is significant even when compared with the 58 trillion yen invested in Japanese public investment trusts. In terms of both assets under management and the number of funds, the market has almost doubled in size since the end of March 2000. During this period, assets under management have increased at an average rate of 13 percent per year.

Figure III-6 Growth of Foreign Investment Trusts



Source: Compiled by NRI based on Fundmark data.

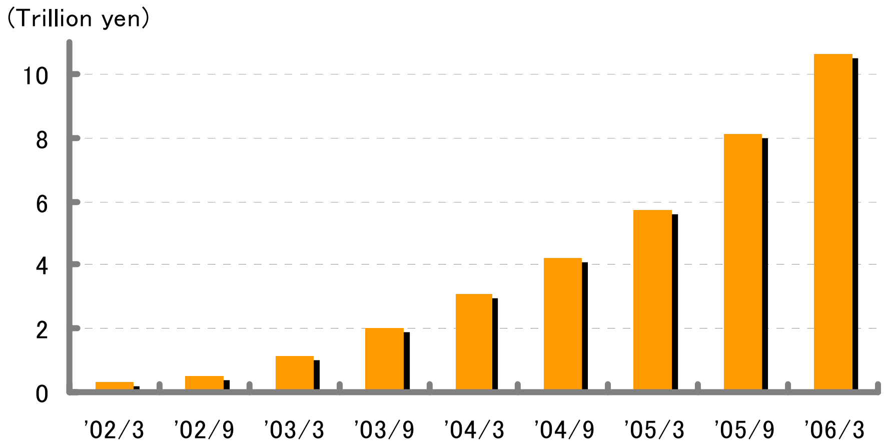
At the end of March 2006 fully 44 percent of all these funds focused on foreign bonds, echoing the trend for Japanese investment trusts. But these funds differ from Japanese investment trusts in several respects. While it is not surprising that there are fewer funds investing in Japanese equities, as many as 20% invest in non-traditional assets and use relatively new investment methods, compared with just 2 percent for Japanese investment trusts. Given that some 3,000 existing Japanese investment trusts use traditional management methods, it is difficult for foreign funds using similar techniques to differentiate their product. Distributors affiliated with securities firms are therefore offering foreign investment trust products using investment methods not previously available in Japan.

Under current legislation, when a foreign investment trust is sold in Japan, a local agent must handle administration on behalf of the overseas management company. All such agents must be licensed securities companies—i.e., members of the Japan Securities Dealers Association. However, the new Financial Instruments and Exchange Law set to be introduced in 2007 will allow companies other than securities firms, such as asset managers, to act as agents. We expect the market for foreign investment trusts to expand further as the number of agents increases.

Variable annuities for individuals are growing along with consumers' need to preserve principal

While the Japanese personal pension market consists mostly of fixed annuities, the last few years have seen substantial growth in variable annuities. Growth in fixed annuities has stagnated in terms of both total assets and the number of contracts, but variable annuities have posted double-digit growth since fiscal year 2002. Still, assets invested in variable annuities are just 10 percent of those in fixed annuities (Figure III-7).

Figure III-7　Growth in Variable Annuities



Source: Compiled by NRI based on data from life insurance companies.

A variable annuity possesses the characteristics of both an insurance product and an investment product. When first offered, variable annuities were viewed as investments with insurance—i.e., investment trusts with a simple insurance contract. In recent years, products with an enhanced insurance component have become increasingly popular as people become more aware of the insurance feature. This trend is exemplified by the growth in sales of products with principal protection in addition to a death benefit.

An examination of changes in the number of variable annuity products by rider type shows that so-called step-up products, in which the minimum guarantee of underlying pension reserves is regularly reviewed based on investment performance, were popular in the past. Today, however, the most common products are those carrying a principal guarantee. A look at changes in the number of products by investment type shows that while annuities that allowed customers to freely select their investment products were popular in the past, so-called balanced annuities, which invest fixed proportions in multiple assets, are now the most popular vehicles (Figure III-8).

Conditions at the insurance companies offering these products also seem to play a role. With principal-guaranteed products, the risk of principal loss is transferred to the insurance company.

Recently, as variable annuities have grown more popular, it has become more important to take into account risk from variable annuities with principal guarantee when calculating an insurer's solvency margin ratio. In addition to such regulatory impacts, the total risk incurred by insurers has also increased. To minimize any further increase in risk, insurance companies have shifted the focus of their sales to annuity products with balanced investments entailing less risk.

Figure III-8 Variable Annuities by Feature

	Product feature	Old products	Existing products	New products
Insurance conditions	Stepped-up death benefit	21	19	2
	Death benefit only	11	29	10
	Death benefit + principal protection	6	23	28
Investment	Selected by client (no equity allocation limits)	30	44	14
	Selected by client (equity allocation limits)	0	3	6
	Balanced fund	8	24	20

Note: Old products: Existed in July 2004, but sale was discontinued by September 2005.
Existing products: Existed in 2004 and were still available in September 2005.
New products: First sold in or after August 2004.
Source: Compiled by NRI based on data from insurance companies.

Personal pension trends

- Variable annuities

  Fixed annuities still account for far more assets, but growth in variable annuities has been notable. These products address the needs of individuals seeking a principal guarantee regardless of investment performance. Recently, variable annuities that begin distributing dividends as soon as the contract is purchased have also grown more popular because they satisfy the need some investors have for cash flow.

- Fixed annuities

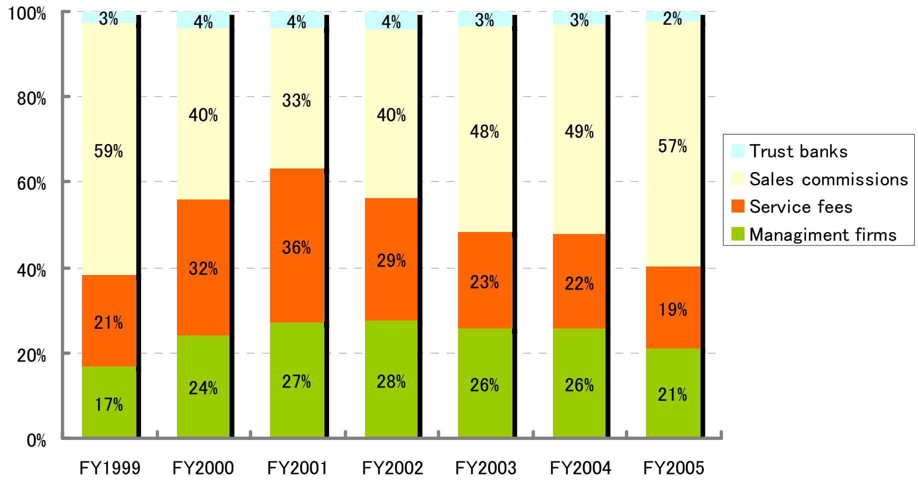
  These products provide principal protection by offering a guaranteed yield. Recently, new products that allow the customer to withdraw funds during the accumulation period have emerged in response to cash flow needs.

3. Distributors Increase Their Presence in the Investment Trust Business

Sales of public investment trusts by distribution channel—focus on regional financial institutions

When total revenue from Japan's public investment trusts business is broken down into trust banks, distributors, and asset managers, distributors account for the bulk of the total. Their revenues, consisting of sales commissions and service fees, represented 76 percent of total revenue in fiscal year 2005. Thus, it is fair to say that distributors dominate the investment trust market today.

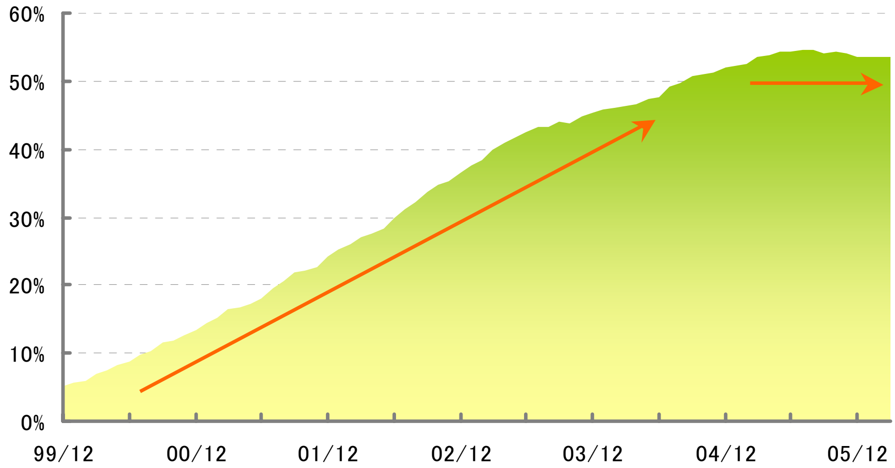
Figure III-9 Shares of Public Investment Trust Revenue



Note: Figures estimated by NRI based on outstanding investments, sales, and management fees of individual funds; when a single fund had a range of management fees and/or sales commissions, the maximum rate was used.
Source: Compiled by NRI based on Fundmark data.

In fiscal year 1999, when stock prices were rising rapidly in the dot-com bubble, distributors enjoyed an 80 percent share of revenue—roughly the same level as today. The majority of distributors then were securities companies. The situation is very different today. Since 1998, when banks were first allowed to sell investment trusts, banks' market share has increased dramatically. In 2005, bank sales of equity investment trusts exceeded those of securities companies (Figure III-10). Growth is slowing, however, and we expect roughly similar market shares for banks and securities companies going forward.

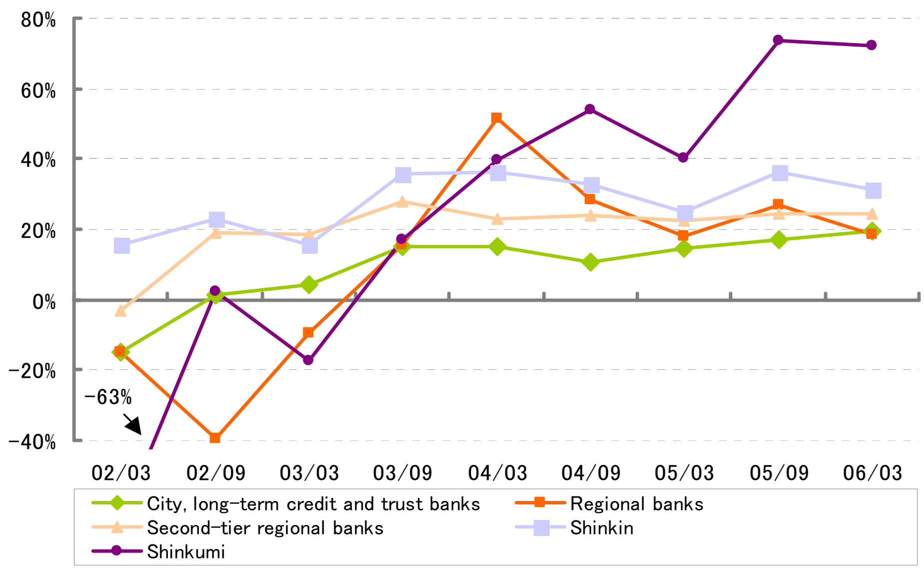
Figure III-10 Banks' Share of Public Equity Investment Trust Sales (ex-ETFs)



Source: Compiled by NRI based on data from Fundmark and Investment Trusts Association, Japan.

Attention is increasingly shifting to sales of investment trusts by regional financial institutions. First- and second-tier regional banks are both lifting their market share. In addition, sales by credit associations (*shinkin* banks) and credit cooperatives (*shinkumi* banks), while still accounting for only a small percentage of outstanding assets, are growing rapidly (Figure III-11).

Figure III-11 Six-month Change in Investment Trusts Held in Customer Accounts at Banks

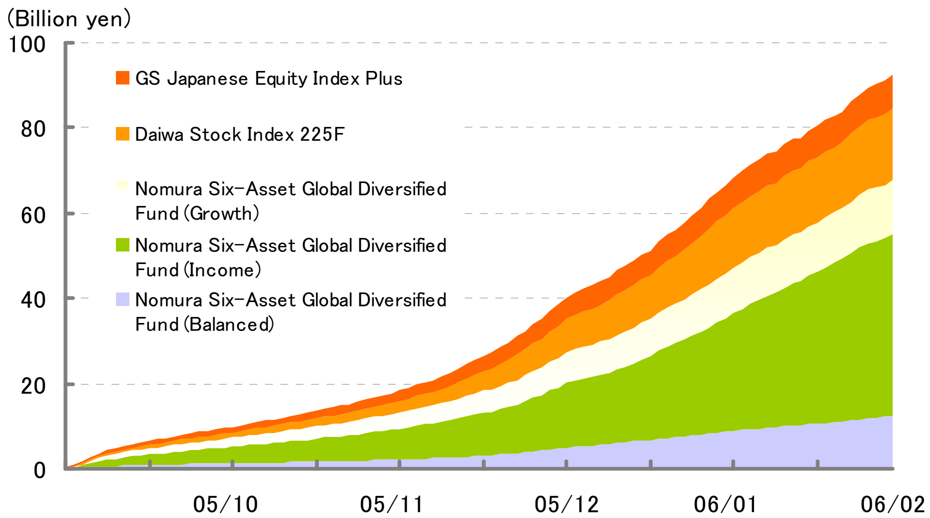


Source: Compiled by NRI based on Nikkin Toshin Nenkin Information.

Japan Post sales boosting sales by other distributors

Japan Post began offering investment trusts in October 2005, and sales began to rise sharply two months later (Figure III-12). Among the products offered, Nomura's Six-Asset Global Diversified Fund is the most popular.

Figure III-12 Outstanding Investment Trusts Sold by Japan Post

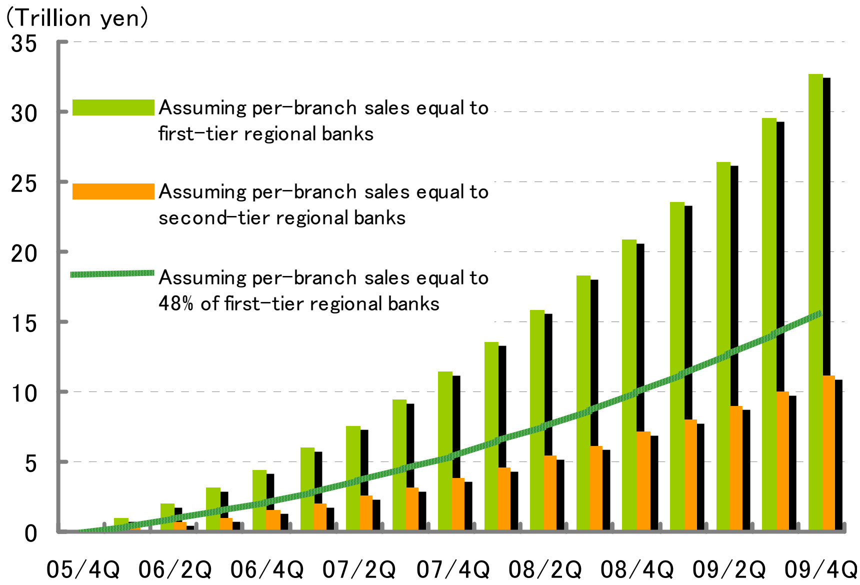


Source: Compiled by NRI based on Fundmark data.

Some financial institutions have expressed concerns about losing customers to Japan Post. But we think sales of investment trusts through post offices may actually lift sales of such investments in areas they have yet to penetrate. Since Japan Post began offering Nomura's Six-Asset Global Diversified Fund, for example, sales of similar balanced investment trusts have grown. Moreover, we find that in areas where city banks have been aggressively selling investment trusts in competition with regional banks, sales by the latter have actually increased as a ratio of deposits. We think rising sales by Japan Post may produce a similar effect.

We forecast that Japan Post will be selling as many investment trusts as top-ranked regional banks within four years (Figure III-14).

Figure III-13 Projected Investment Trust Sales by Japan Post



Source: Estimated by NRI based on data from Japan Post, Regional Banks Association of Japan, and Second Association of Regional Banks.

Assumptions

- The number of Japan Post branches selling investment trusts will increase from the current 575 to 1,500 four years from now.
- Our best-case scenario assumes that after four years a single Japan Post branch will sell as many investment trusts as a regional bank branch today.
- Our standard scenario assumes that after four years investment trust sales by a single Japan Post branch will equal 48 percent of those by a regional bank branch (each Japan Post branch holds deposits equal to 48 percent of an average regional bank branch).
- Our worst-case scenario assumes that after four years a single Japan Post office will sell as many investment trusts as a second-tier regional bank branch today.
- We forecast total sales of investment trusts by Japan Post four years from now based on these assumptions. Estimated sales were 30 trillion yen under our best-case scenario; 15 trillion yen under our standard scenario; and 10 trillion yen under our worst-case scenario.

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