

Japan's
**Asset Management
Business**
2010/2011

CHAPTER 1 **Japanese investor trends**

CHAPTER 2 **Current state of asset management
business and asset management firms'
management priorities**

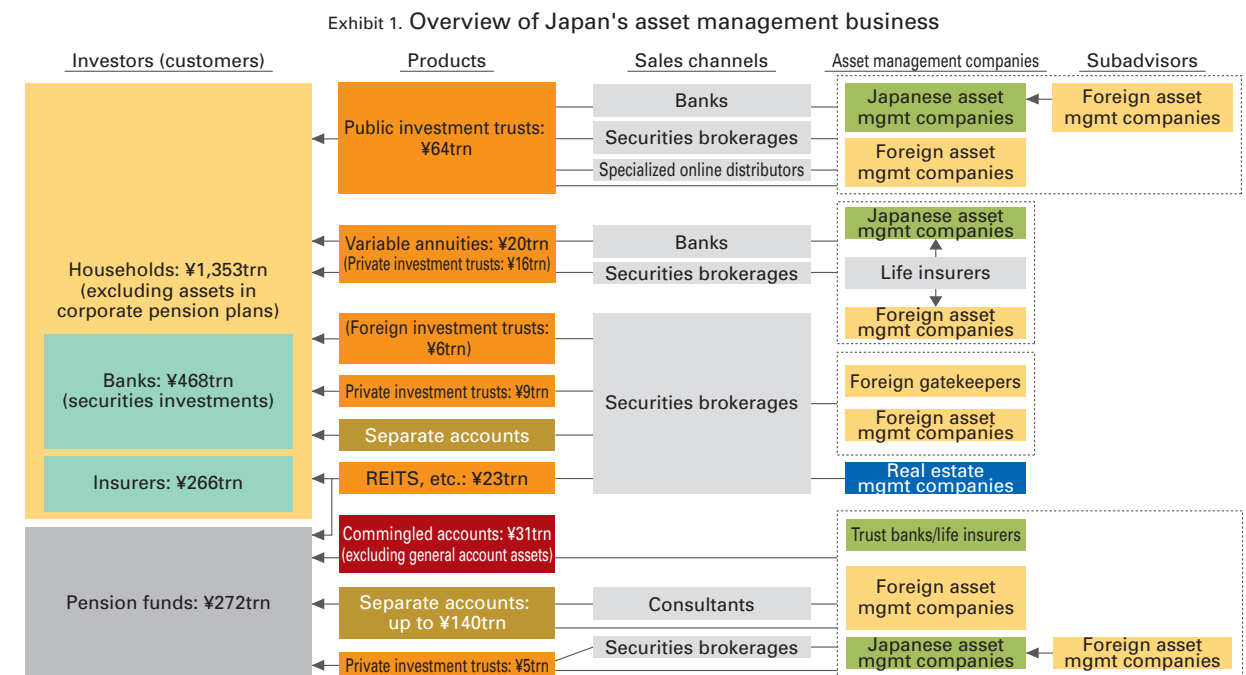
CHAPTER 3 **Market trends and product strategies by
client segment**

No major changes in composition of financial asset holdings

Overall, the Japanese asset management market witnessed no major changes in FY2009 (year ended March 2010) from the previous fiscal year, aside from asset growth driven largely by equity market recovery. Exhibit 1 provides an overview of the Japanese asset management market as of March 31, 2010. It depicts the market in terms of investors, products, distribution channels, and asset managers to provide a simplified picture of which types of asset managers manage money for which investor classes, how investor assets are allocated, and how asset flows are intermediated. Asset management companies in Japan mainly serve three types of clients: retail investors (households),

corporations including financial institutions, and pension funds. Japanese investors' financial asset holdings total an estimated ¥1,625trn (adjusted to take into account that financial institutions' securities portfolios are largely funded with retail customers' deposits), an increase of some ¥56trn from a year earlier. Of this ¥56trn, household assets accounted for ¥39trn and pension fund assets accounted for the remaining ¥17trn. With household financial assets mainly held in the form of bank deposits and other safe assets, total household assets have not changed much over the past several years despite the recent financial crisis.

Of the ¥1,625trn in total assets, ¥344trn¹⁾ or roughly 20% is under management by asset management



Source: NRI, based on data from various sources

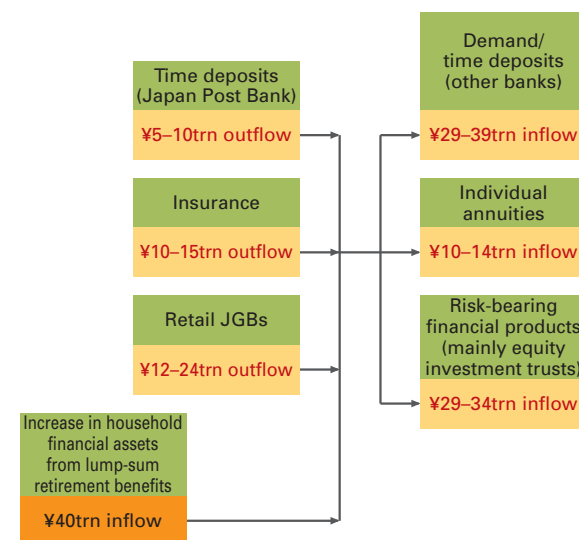
companies. This percentage also has remained relatively constant over the past five years. Although investment trusts have favorable prospects for robust growth driven by new inflows of household financial assets, their growth rate is currently subdued, partly because capital markets continue to languish. The asset management industry consequently remains in a growth lull.

In the Japanese asset management industry's FY2009 management revenues were split almost evenly between investment advisory revenues (mainly from pension funds) and investment trust revenues (mainly from retail investors). With retail demand for high-yield products projected to remain strong, investment trusts capable of meeting this demand still have substantial growth potential. The share of revenues derived from investment trusts is therefore virtually certain to increase going forward.

Household assets: resurgence in investment trust inflows

Japanese households ended FY2009 with financial assets of approximately ¥1,353trn, an increase of 3% or ¥39trn from a year earlier. Most of the

Exhibit 2. Projected household-sector asset in/outflows by investment product (5-year horizon)



Source: NRI

increase was attributable to growth in holdings of equities and investment trusts. Bank deposits and insurance products (excluding annuities) still account for over 70% of household financial assets, although holdings of insurance products are in decline. Household bank deposits were nearly unchanged from a year earlier.

To gauge the outlook for household financial asset flows, we projected changes in household financial asset holdings over a five-year horizon based on data. First, we estimate that over the next five years households will see inflows of lump-sum retirement benefits, a key source of funding of financial asset holdings, of approximately ¥40trn net of home mortgage repayments upon retirement. Relative to recent years, we lowered this estimate to reflect that number of new retirees will begin to decrease as the baby boomers' mass retirement runs its course.

We project ¥5-10trn in outflows from maturing Japan Post Bank time deposits. With Japan Post Bank taking action to stanch these outflows over the past year or two, we expect them to decrease somewhat relative to previous years. We project outflows from insurance products of ¥10-15trn. Retail JGBs, hitherto a recipient of asset inflows, will begin to reach maturity from 2011. Assuming that interest rates remain in the vicinity of their current low levels, we do not see much prospect of rollover demand. We project outflows from retail JGBs of ¥12-24trn, although actual flows will depend largely on interest rate levels.

We expect non-Japan Post Bank deposits, individual annuities, and risk-bearing investment products to experience inflows over the next five years. For bank deposits, we project continued inflows of ¥29-39trn. We project inflows of ¥10-14trn into individual annuities, mainly fixed annuities. Lastly, we project inflows of ¥29-34trn into risk-bearing products such as equity investment trusts. The consensus outlook for investment trust inflows appeared to be

pessimistic following their steep decline in FY2008, but inflows rebounded in FY2009. This trend is likely to continue for while. We believe that investment trust inflows are in a recovery trend.

Banks expanded their securities holdings but continue to place priority on safety

Pension funds, the largest institutional investors, held an estimated ¥272trn in assets at end-March 2010. Of this total, public pension assets accounted for ¥179trn, an ¥8trn increase from a year earlier. Corporate pension plans accounted for the remaining ¥93trn, up ¥9trn from a year earlier. Growth in pension assets was largely attributable to equity market recovery. With net outflows from the Employees' Pension Insurance Scheme, the predominant public pension plan, projected to increase in FY2010 relative to FY2009, pension assets have little if any growth prospects even on an aggregate basis.

Financial institutions' securities investments totaled approximately ¥734trn at end-March 2010. Of this total, banks (ex Japan Post Bank) accounted for some ¥230trn, *shinkin* banks and credit unions for ¥60trn, Japan Post Bank for ¥180trn, life insurers (ex Japan Post Insurance) for ¥165trn, Japan Post Insurance for ¥80trn, and nonlife insurers for ¥20trn.

Excluding Japan Post Bank, banks' securities investments grew ¥37trn or nearly 20% from a year earlier. This increase stemmed predominantly from a ¥35trn increase in their JGB holdings. For a second consecutive year, banks continued to favor safe assets. Banks reduced their holdings of "other securities," which include foreign securities and fund products (e.g., investment trusts, hedge funds). The reduction was chiefly attributable to a decrease in foreign securities holdings in contrast to FY2008, when banks substantially reduced their fund holdings. We estimate that their fund holdings held steady in FY2009. If loan growth remains anemic, securities investment will continue to grow in importance

for banks. For the time being, however, banks' preference for safety is likely to persist.

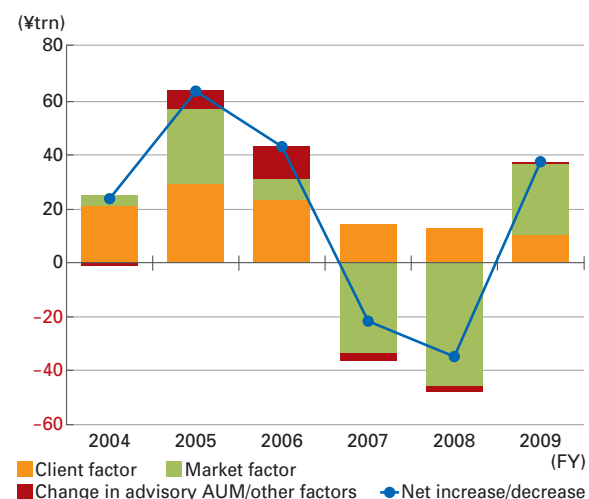
1) With respect to trusts and life insurers, this total includes only assets managed on behalf of pension/annuity customers. In the case of life insurers in particular, the total includes only special account balances, not assets in general accounts with guaranteed returns (e.g., fixed-amount insurance,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

1 Continued shrinkage in asset management industry's profit margins

By our estimate, Japan's asset management industry earned FY2009 management revenues of approximately ¥653.1bn on ¥355trn of assets under management (AUM) (including foreign clients' assets) as of end-March 2010. Relative to FY2008, the industry's revenues decreased ¥42bn (6%) despite a ¥40trn (13%) increase in ending AUM. In FY2009, AUM recovered by virtue of the market's rebound off its March 2009 bottom, but yearly average AUM fell short of its FY2008 level. Revenues consequently declined for a second consecutive year for the first time ever.

Below we look at how specialized asset management companies (investment trust and investment advisory firms excluding trust banks and life insurers) fared in FY2009 and the challenges they face.

Exhibit 3. Changes in AUM broken down by causative factor



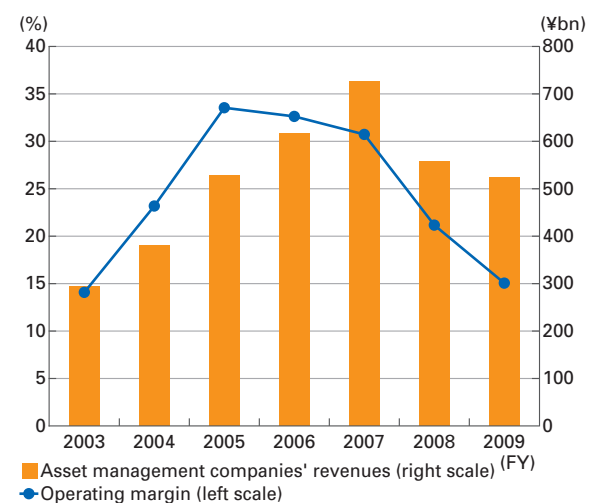
Note: Adjusted for M&A and divestments to the extent possible.
Source: NRI, based on data from the Investment Trusts Association of Japan and Japan Securities Investment Advisers Association

Continued margin compression as earnings fall for a second consecutive year

Exhibit 3 plots annual changes in these asset management companies' AUM broken down by causative factor. In FY2009, their AUM increased ¥37trn, of which ¥26trn (70%) was attributable to the market factor (asset price appreciation). The client factor (net inflows of assets from clients) accounted for roughly ¥10trn of the increase, but this ¥10trn included about ¥6trn of new discretionary investment contracts converted from existing pension trust contracts²⁾. Investment trust therefore accounted for nearly all of FY2009's actual net inflows.

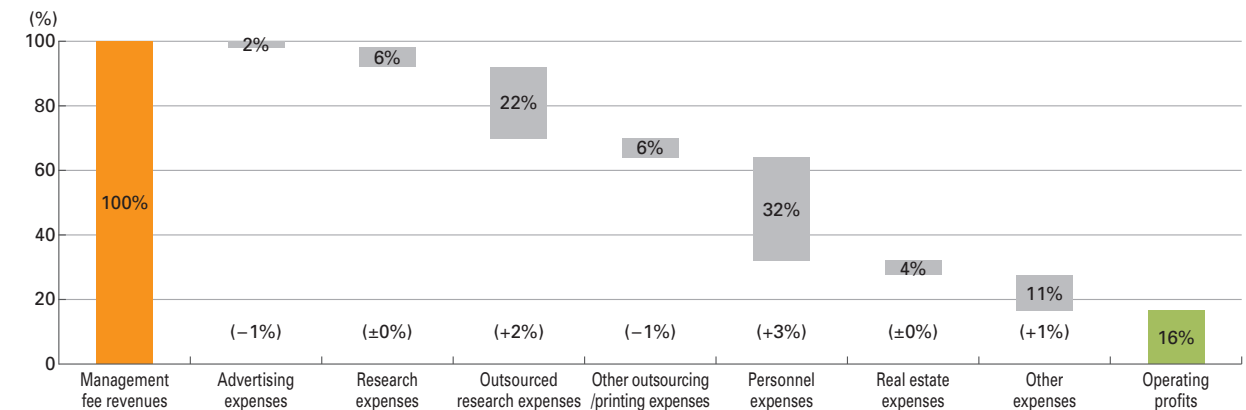
We estimate asset management companies' FY2009 management revenues at ¥525bn, a ¥31bn (8%) decrease from FY2008 (Exhibit 4). Management

Exhibit 4. Asset management companies' aggregate management fee revenues and operating margin



Note: Data are for specialized asset management companies exclusive of trust banks, life insurers, etc.
Source: NRI, based on asset management companies' business reports and data from the Investment Trusts Association of Japan and Japan Securities Investment Advisers Association

Exhibit 5. Asset management companies' aggregate cost structure



Note: Management fee revenues are net of investment trust account management fees paid to distributors. Numbers in parentheses are changes in the expense item's share of management fee revenues relative to the previous fiscal year (in percentage points).
Source: NRI, based on asset management companies' business reports and regulatory filings

revenues continue to decline in both the investment trust and investment advisory businesses, down 9% to ¥310bn in the former and down 2% to ¥215bn in the latter.

Operating margins also decreased substantially. Asset management companies' aggregate operating margin fell to around 15% in FY2009, down from a peak of over 30%. Aggregate operating margin has fallen back to near its level of FY2003, when AUM and management revenues were about 40% below their current levels. The profit margin decline was presumably attributable to the major drop in revenues due to deterioration in the investment environment and cessation of asset inflows after asset management companies had enlarged their staffs and otherwise augmented their management resources in the aim of business expansion.

Rigid cost structures

The sharp contraction in profit margin triggered by a slump in revenues reflects that asset management companies have rigid cost structures. Exhibit 5 plots various expenses as a percentage of the FY2009 management revenues of some 60 asset management companies for which FY2009 income statement data were available at the time of this writing (and which had an aggregate operating margin of 16% in FY2009). The biggest expenses

were personnel expenses (32% of revenues) and outsourced research expenses (22% of revenues). Personnel expenses are the cost of procuring human resources, asset management companies' most important management resource. Outsourced research expenses include investment advisory fees paid to external asset managers and allocated costs charged by foreign-owned asset management companies' overseas parents.

Exhibit 5 also notes the changes in each expense item's share of revenues relative to FY2008 (when the aggregate operating margin of the companies in the data sample was 20%). Personnel expenses and outsourced research expenses respectively increased as a percentage of revenues by three and two percentage points. These two expense items thus accounted for the entire decrease in operating margin in FY2009. These two expenses that together account for a majority of total expenses are largely fixed costs. Asset management companies have little flexibility to reduce these expenses in response to a decline in management revenues. They have consequently been unable to avoid margin compression.

2 Under pressure to restructure

NRI's 2010 Survey of Asset Management Companies'

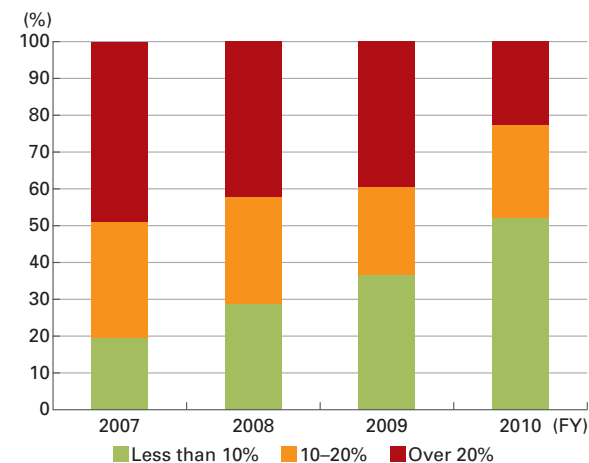
Management Priorities³⁾ sheds light on how asset management company executives are responding to such an adverse environment and on their outlook for the future.

Decreasingly optimistic outlook

The survey annually asks respondents about their outlook for AUM growth (more specifically, their outlook for net asset inflows over the next 3–5 years, excluding the effect of changes in assets' market values). The percentage of respondents that project AUM growth of 10% or more driven by asset inflows has been steadily declining in recent years. In 2010, the percentage of respondents projecting growth of 10% or more fell to approximate parity with the percentage projecting growth of less than 10% or negative growth (Exhibit 6).

Amid an environment in which market prices have little prospect of recovery and the asset management industry's asset inflows downshift or taper off as anticipated by many survey respondents, asset management companies will have to act more aggressively than they have in the past to expand their businesses. For example, from a product standpoint, asset management companies could attempt to capture clients from competitors by

Exhibit 6. Projected AUM growth rates



Note: The above graph plots the breakdown of survey respondents' projections of changes in their AUM due to net inflows over the next 3–5 years. Valid survey responses were received from some 40–50 companies each year.
Source: NRI Survey of Asset Management Companies' Management Priorities (2007–10)

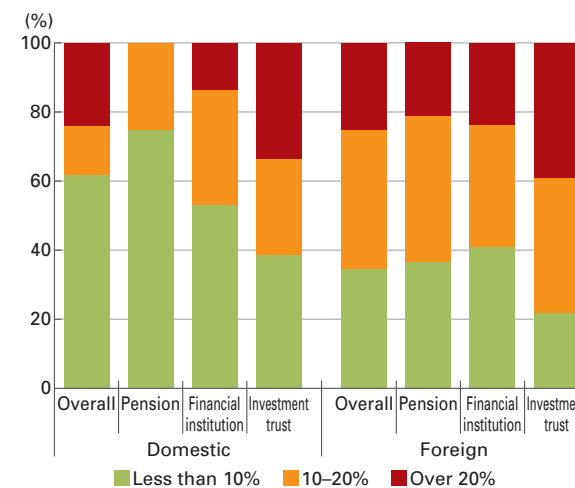
nimbly offering funds that meet retail investors' specific needs and unique products that are effective portfolio diversifiers and highly competitive in terms of performance, while averting outflows of existing clients' assets by establishing successor funds or substitute products. Such an approach should further revitalize the industry.

Major growth expectations pinned on emerging market assets

Comparison of Japanese and foreign asset management companies' survey responses reveals that a bullish growth outlook is more prevalent among foreign asset managers (Exhibit 7). In the 2010 survey, the percentage of foreign asset manager respondents forecasting AUM growth of 10% or more is roughly double the corresponding percentage of Japanese asset manager respondents. Foreign asset management companies apparently have more confidence than their Japanese counterparts in their prospects of successfully capturing asset inflows amid a slowdown in overall inflows.

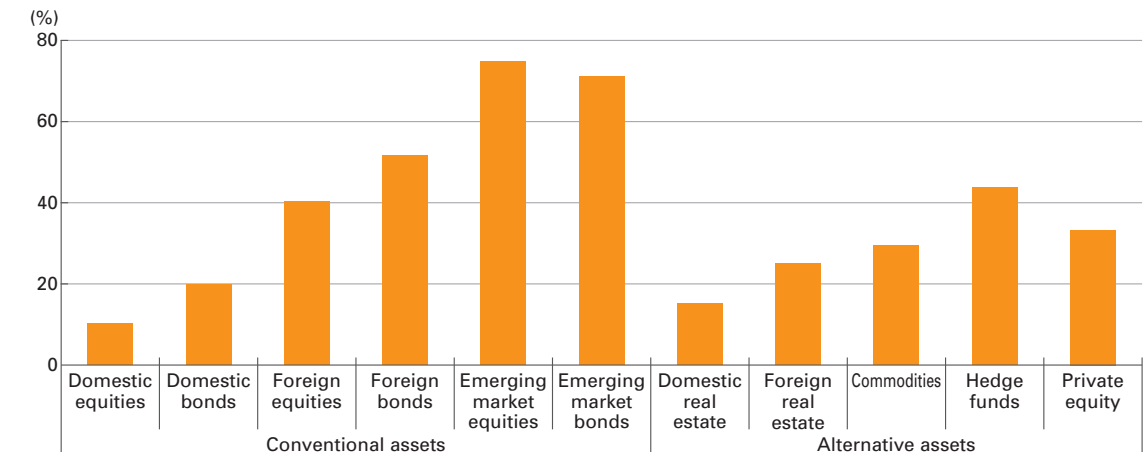
Why have foreign asset management companies maintained a more bullish business outlook than their Japanese counterparts? We surmise that the answer

Exhibit 7. Projected AUM growth (by responding companies' nationality and business)



Note: The above graph plots the breakdown of survey respondents' projections of changes in their AUM due to net inflows over the next 3–5 years.
Source: NRI Survey of Asset Management Companies' Management Priorities (2010)

Exhibit 8. Percentage of respondent companies projecting AUM growth of 10% or more by asset class



Note: The above graph plots percentages of survey respondents forecasting AUM growth of 10% or more over the next 3–5 years.
Source: NRI Survey of Asset Management Companies' Management Priorities (2010)

lies in differences in the two groups' respective strengths in terms of asset classes.

Survey respondents' assessment of prospects for AUM growth varied among asset classes. Exhibit 8 plots percentages of respondents that project AUM growth of 10% or more over the next 3–5 years by asset class. Among conventional asset classes, there is a clear hierarchy of growth expectations, with foreign AUM expected to outgrow domestic AUM and emerging market AUM expected to outgrow both domestic and foreign developed market AUM. Alternative asset classes such as real estate also are expected to see sizable AUM growth, albeit to a lesser extent than emerging market assets.

The most likely reason for foreign asset management companies' relatively bullish business outlooks is that they consider providing emerging market products and other investment products with favorable prospects for AUM growth to be one of their strengths. In contrast, most Japanese asset management companies' core strength is managing domestic equities, resulting in a mismatch between the products they are able to provide and asset classes with strong growth prospects. Japanese asset management companies may face major difficulties in their future efforts to capture asset inflows.

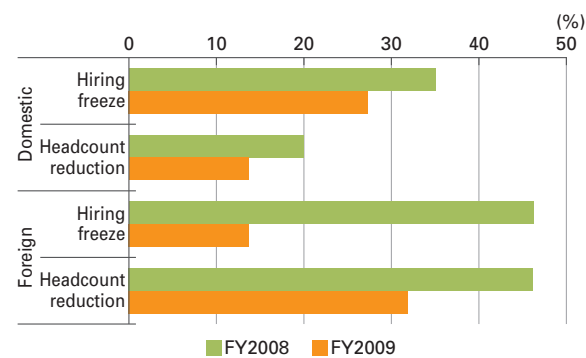
As is well known, many Japanese asset management companies that offer funds that invest in foreign assets essentially outsource management of such funds to foreign asset management companies serving as subadvisors. Hiring a subadvisor to rapidly roll out a new product to avoid missing out on a business opportunity can of course be a smart business decision from a short-term perspective. In such cases, however, erosion of profit margins due to paying management fees to the subadvisor is virtually unavoidable. Japanese asset management companies' ability to capture asset inflows and achieve earnings growth commensurate with the resultant AUM growth hinges upon whether they can develop strong in-house management capabilities in asset classes that will be future growth drivers.

Relaxation of personnel cost controls

As mentioned above, personnel expenses, asset management companies' biggest expense, are difficult to flexibly adjust in response to changes in management revenues. Our survey also asked about the status of respondents' measures to control personnel expenses.

First, Exhibit 9 plots the percentage of respondents that froze hiring or downsized their staff in FY2009

Exhibit 9. Prevalence of personnel cost containment measures (FY2008–09)

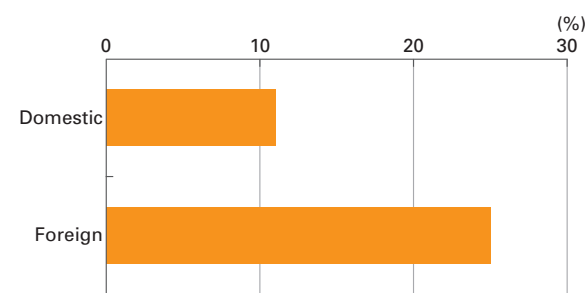


Source: NRI Survey of Asset Management Companies' Management Priorities (2009–10)

in comparison to FY2008, the year in which cost structure problems first emerged. For both hiring freezes and headcount reductions, the percentage of affirmative respondents decreased in FY2009 from FY2008, suggesting that asset management companies are emerging from crisis-response mode. However, there were major differences between Japanese and foreign asset management companies. Among foreign companies, the percentage that had frozen hiring and the percentage that had downsized staff both decreased substantially in FY2009. Among Japanese companies, by contrast, hiring freezes and downsizing were less prevalent to begin with, but the percentages of companies that implemented these measures decreased relatively modestly in FY2009. Japanese asset management companies still have a distinct tendency to curtail new hiring while maintaining existing headcounts.

Such an approach to personnel management cannot unequivocally be rejected. If AUM hypothetically recover to their level preceding the recent financial crisis, Japanese asset management companies could benefit from greater improvement in profit margins than their foreign counterparts by virtue of having a high degree of operating leverage. However, with investment demand for emerging market assets on the rise, Japanese asset management companies will likely face difficulty amassing AUM. In comparison to foreign asset management companies, relatively few Japanese asset management plan to aggressively

Exhibit 10. Percentage of respondent companies with plans to increase headcount by 10% or more over the next 3–5 years (FY2009)



Source: NRI Survey of Asset Management Companies' Management Priorities (2010)

expand their headcounts (Exhibit 10). This difference likely reflects the divergence in foreign and Japanese asset management companies' respective outlooks for business expansion.

Challenges facing Japanese asset management companies

Asset classes in which Japanese asset management companies have historically been at a competitive disadvantage, such as emerging market assets, are likely to attract the bulk of future investment inflows as discussed above. Japanese asset management companies will most likely trail their foreign competitors in terms of business expansion and improvement in profit margins.

In light of such, Japanese asset management companies should clearly place priority on strengthening their in-house capabilities vis-à-vis management of investment products in promising asset classes and restructuring in pursuit of this objective (e.g., rebuilding of asset management staff through reassignment of personnel, upgrading portfolio management processes).

Major HR or compensation scheme reforms are not necessarily required in our view. Companies unable to withstand anticipated near-term pressures on already squeezed profit margins will of course have no alternative but to variabilize and curtail personnel expenses. Most companies, however, will likely

switch to HR and compensation regimes that they deem to be optimal after reassessing how to do so in a manner that strengthens their organizational capabilities.

In comparison to foreign asset management companies, Japanese asset management companies face a much higher hurdle to restore their revenues and profit margins to previous levels. Nonetheless, challenging and achieving the priorities noted above are a prerequisite for the Japanese asset management industry to emerge from its state of crisis.

3 Investment trust business facing pressure to boost investor returns

Having discussed how asset management companies are addressing management challenges in the face of an anticipated slowdown in the industry's overall growth rate and qualitative changes in clients' investment preferences, we now look at the more fundamental, industry-wide issue of whether the asset management industry is delivering value-added to investors.

Among asset management businesses, the investment trust business is expected to grow substantially, as shown in Exhibit 7. Overall, however, investment trusts have not delivered satisfactory long-term returns to investors. We estimate that over the ten years through FY2009, open-end equity investment trust investors' total losses exceeded their total gains by ¥7.8trn, based on market values at the beginning and end of each fiscal year and intra-year money flows (i.e., purchases, redemptions, and dividend distributions). When commissions, fees, and capital gains taxes are taken into account, their actual net loss is even greater. Investors' rate of return is presumably a major determinant of customer satisfaction with investment trusts. Large losses tend to detract from customer satisfaction. Investor losses can be decomposed into three components. Analysis

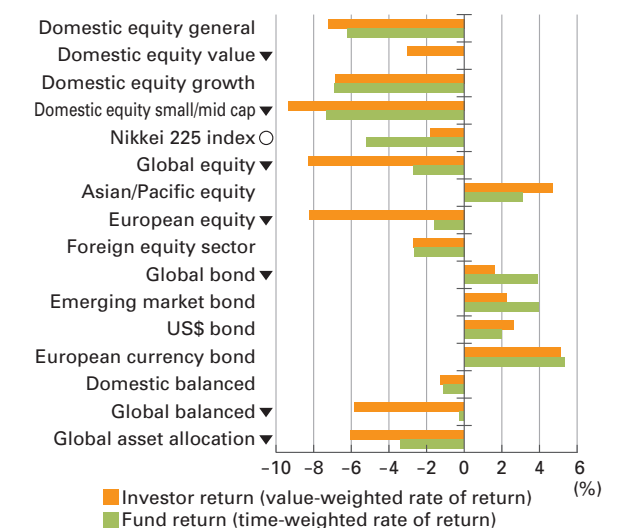
of these components can help identifying approaches to improving returns.

The first component is the market return (i.e., the portion of a fund's overall return that is attributable to the rate of return of the asset market in which the fund invests). If capital markets maintain a positive ROI over the long-term, this component would also be a positive. However, over 10 years through FY2009, a period that included multiple financial crises, losses attributable to the market return were particularly large.

The second component is the return attributable to the difference between the market return and the fund's rate of return. For some types of funds this spread was substantially negative. For example, general domestic equity funds average 10-year return was -55%, more than 10 percentage points below the dividend-inclusive return of the TOPIX, which is the benchmark for most such funds.

The third component is the return attributable to the difference between a fund's rate of return and the rate of return realized by its investors. Exhibit 11 compares funds' time-weighted returns with their

Exhibit 11. Fund returns vs. investor returns



Note: Measurement period: FY2000–09 inclusive. Rates of return are annualized.
 ○ : Investor return exceeded fund return by 2 percentage points or more
 ▼ : Investor return fell short of fund return by 2 percentage points or more
 Source: NRI

value-weighted returns, a proxy for investor returns, for 16 categories of open-end equity funds with AUM of ¥100bn or more. In most cases, the value-weighted return is lower than the time-weighted return. The value-weighted rate of return exceeded the time-weighted rate of return by two percentage points or more in only one fund category, Nikkei 225 index funds, whereas the time-weighted rate of return exceeded the value-weighted rate of return by two percentage points or more in six fund categories. Most notably, the value-weighted rate of return fell short of the time-weighted rate of return by a wide margin in the highly popular global bond, global equity, and global balanced (a global hybrid subcategory) fund categories, presumably reflecting that many investors buy such funds when their NAV is high and redeem them to cut losses after the NAV has declined. Consequently, even if a fund itself has a positive time-weighted return, its investors' actual returns could very well be negative.

The first and second of these components are returns that investment trust companies continuously endeavor to improve as their specialized domain. On a day-to-day basis, they take actions such as increasing their portfolio allocations to assets with high expected rates of return and developing investment strategies to generate alpha. However, they do not seem to have paid much heed to the fact that investor returns have often fallen well short of their funds' rates of return.

To boost investor returns, investors must properly time their fund purchases and redemptions. Investment trust companies consider such market timing to be difficult to do successfully, but is this really the case? We believe that focusing on the gap between investor returns and funds' rates of return as discussed above can contribute to improving investor returns. For example, by calculating investment returns by distributor or distribution channel on a daily basis, investment trust companies should be able to identify fund shortcomings from the customer's

perspective in real time. Additionally, if investor returns fall substantially short of the fund's rate of return, investment trust companies should check the rationality of investors' investment behavior and the appropriateness of their distributors' sales solicitations. By collecting such feedback down to the sales level, investment trust companies should be able to formulate measures to improve their customers' returns.

Over the past 10 years, Japan's investment trust industry ultimately did not serve retail investors well as asset managers, although a financial crisis likened to a hundred-year storm was partly to blame for poor returns. In the final analysis, it is difficult to increase customer satisfaction if investor returns are negative. Of course, this is not solely asset management companies' problem. To promote wider ownership of investment trusts, the investment trust industry must recognize that it is an industry-wide problem and adopt a full range of remedial measures.

2) Consequently, net inflows to investment advisors were de facto negative in FY2009 (for the first time ever on a fiscal year basis). Additionally, a similar conversion of existing contracts into discretionary management contracts occurred in FY2008 also. We estimate that actual net inflows to the investment advisory business were negligible in FY2008.

3) For four consecutive years since FY2007, NRI has conducted this survey of domestic and foreign asset management companies doing business in Japan. In FY2010, NRI received survey responses from 44 companies. The respondent companies account for 60% of the Japanese asset management industry's total investment trust AUM and 51% of the industry's total investment advisory AUM as of end-March 2010.

CHAPTER 3

Market trends and product strategies by client segment

1 Pension business

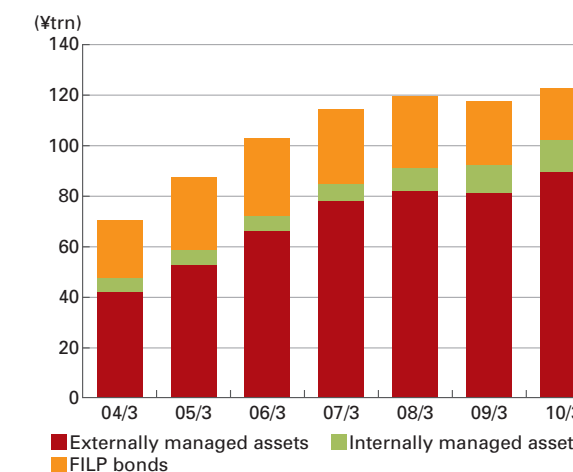
AUM grew by virtue of equity market appreciation

Japanese pension assets stood at an estimated ¥272trn at end-March 2010. Of this total, public pension schemes (National Pension, Employees' Pension Insurance, and Mutual Aid Associations) accounted for two-thirds or approximately ¥179trn, an ¥8trn increase from a year earlier. About 70% or ¥128trn of these public pension assets belong to the Employees' Pension Insurance and National Pension programs.

The vast majority of Employees' Pension Insurance and National Pension assets are managed by the Government Pension Investment Fund (GPIF). In FY2009, the GPIF earned a positive return on these assets for the first time in three years. Its fiscal-year-end AUM consequently increased by some ¥5trn relative to FY2008-end (Exhibit 12). In FY2009, pension insurance premium receipts were exceeded by pension benefit expenditures. In FY2010, this gap between inflows and outflows is projected to widen to a net outflow of more than ¥6trn.

The GPIF adjusted its allocation of assets net of directly underwritten FILP (Fiscal Investment and Loan Program) bonds by increasing its domestic and foreign equity allocation to nearly 30% and reducing its domestic bond allocation to slightly over 60%. Meanwhile, its average fee rate fell further,

Exhibit 12. GPIF's AUM

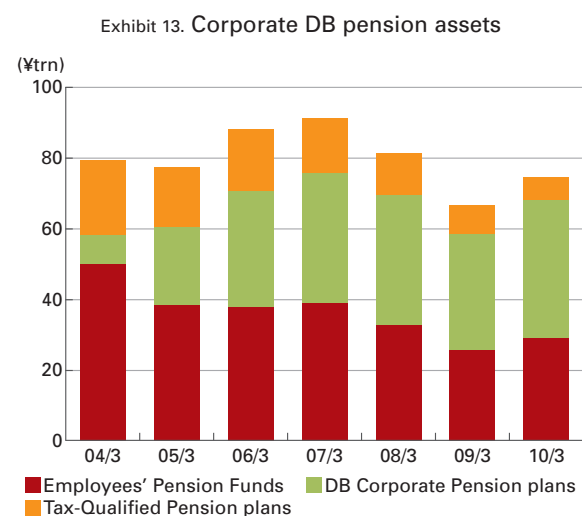


Source: NRI, based on GPIF's *Review of Operations in Fiscal 2009*

dropping to 0.021% of AUM. Although management fees increased, overall fees declined as a result of consolidation of assets in the hands of fewer custodians.

Among corporate pension plans, defined benefit (DB) plans ended FY2009 with aggregate assets of ¥74.4trn, an increase of approximately ¥8trn from a year earlier (Exhibit 13). The increase was largely attributable to strong domestic and overseas equity market performance. By type of plan, DB Corporate Pension plans increased in number by 48% to 7,400. DB Corporate Pension plans' share of total DB plan assets increased to over 50%. This growth is largely attributable to continued conversion of Tax-Qualified Pension plans to DB Corporate Pension plans.

Tax-Qualified Pension plans are slated to be completely phased out by March 31, 2012, but 17,000 such plans with aggregate assets of ¥6.4trn

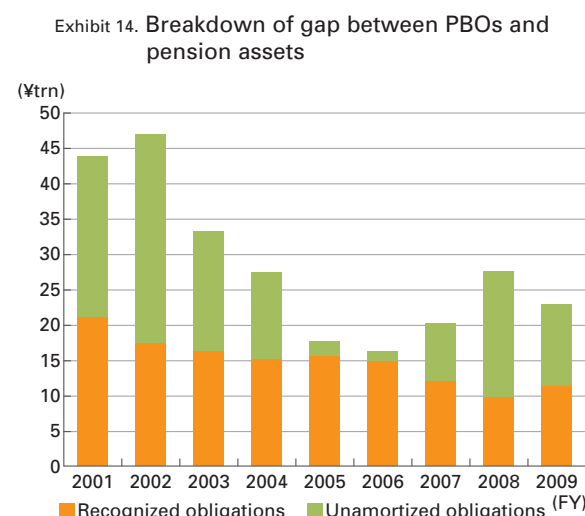


Source: NRI, based on data from Trust Companies Association of Japan and Life Insurance Association of Japan

were still in existence at end-March 2010. Of the Tax-Qualified Pension plans converted to other types of plans in FY2009, the percentage converted to DB Corporate Pension plans increased to nearly 30%. Defined contribution (DC) plans accounted for roughly 10% of conversions. Another one-third of converted Tax-Qualified Pension plans were absorbed into the Smaller Enterprise Retirement Allowance Mutual Aid program. The majority of Tax-Qualified Pension plans still in existence are small in size.

Corporate pension plans' growing impact on corporate earnings

Corporate pension plans' aggregate funding deficit decreased somewhat in FY2009 but its impact on corporate earnings is still substantial. Exhibit 14 plots the gap between pension benefit obligations (PBOs) and pension assets for Tokyo Stock Exchange 1st Section-listed companies in aggregate. This gap comprises two components: (1) obligations recognized on the balance sheet as liabilities, largely in the form of reserves for postretirement benefits, and (2) unrecognized liabilities that are not carried on the balance sheet and will be expensed as amortization. The former are in a declining trend as a result of pension plan restructuring through such means as adopting DC plans or offloading the so-called substitutional portion of EPF assets

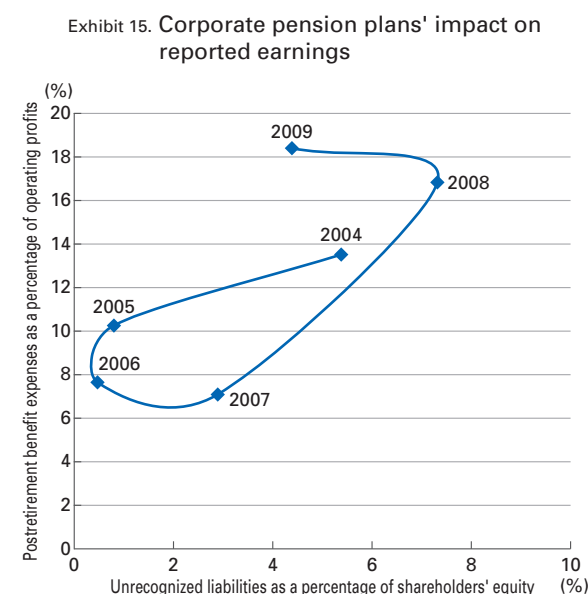


Source: NRI, based on Nikkei Media Marketing data

and liabilities to the government (*Daiko-Henjo*). Unrecognized obligations, by contrast, increased sharply in FY2007–08 after being reduced to nearly zero in FY2006.

The increase in unrecognized obligations reflects that unrecognized actuarial losses increased substantially as a result of two consecutive years of double-digit negative returns on pension assets in FY2007–08. Over this two-year period, unrecognized actuarial losses increased ¥16.5trn. Even at FY2009-end, these unrecognized losses, amortization of which increases pension benefit expenses, stood at some ¥12trn, posing concerns that they will continue to weigh heavily on reported earnings.

From a more detailed perspective, Exhibit 15 plots corporate pension plans' impact on reported earnings in terms of pension benefit expenses' magnitude relative to operating profits and unrecognized pension obligations' magnitude relative to shareholders' equity. In FY2008, both increased substantially in the wake of deterioration in the investment environment and poor earnings performance in companies' core businesses. In FY2009, pension obligations decreased as a percentage of shareholders' equity, largely as a result of amortization of unrecognized actuarial losses. Relative to operating profits, however, pension benefit expenses increased to an all-time high due to growth



Note: Unrecognized obligations plotted on the horizontal axis are total unrecognized obligations, not including any deferred tax assets or liabilities. Data plotted on the vertical axis are postretirement benefit expenses as a percentage of operating profits before deduction of postretirement benefit expenses.

Source: NRI, based on Nikkei Media Marketing data

in amortization expenses.

Pension accounting's impact on reported earnings varies depending on the applicable accounting standards. Japanese accounting standards are in the midst of a transition to fair value accounting. For example, a rule requiring that PBOs be valued using a discount rate current as of fiscal year-end was adopted in FY2008 and immediate on-balance-sheet recognition of hitherto unrecognized pension obligations will be required from FY2011. Pension plans' impact on their sponsor company's earnings consequently may increase further. However, under International Financial Reporting Standards (IFRS), which Japanese companies will likely be required to adopt by FY2015, amortization of unrecognized actuarial losses is slated to bypass the income statement. Adoption of IFRS consequently may very well reduce the impact of short-term fluctuations in market yields relative to the status quo.

Companies that sponsor pension plans will likely increasingly reassess their costs and risk exposures based on the new accounting standards. If stricter standards are adopted, solutions such as liability-

driven investment that lessen pension plans' impact on the sponsoring company's earnings may gain favor, but prospective accounting standards' specific provisions currently remain uncertain. Companies may focus more on boosting their pension assets' risk-adjusted returns in light of losses incurred during the recent financial crisis or structural factors such as pension plans' increasing maturity. In such an event, companies could increasingly seek high-alpha or diversified-beta strategies to incorporate into their pension asset portfolios.

Securities investment by banks

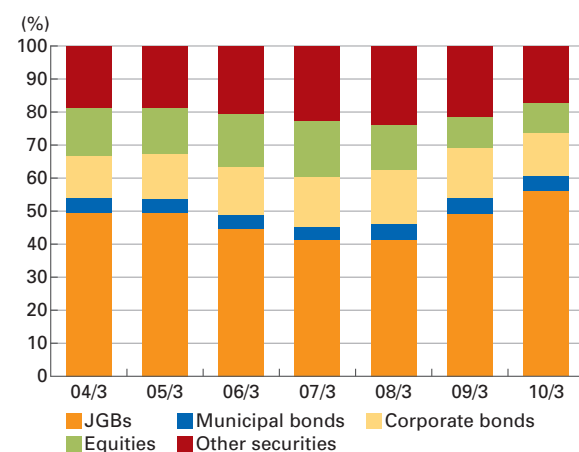
Continued growth in banks' investment securities holdings

Japanese banks ended FY2009 with aggregate investment securities holdings of ¥232trn, a ¥37trn increase from a year earlier. Even after the recent financial crisis, banks' investment securities holdings have continued to grow against a backdrop of growth in deposits and stagnant demand for loans. Investment securities' share of banks' total assets rose to 28.4%, a 10-year high. Major banks, which have seen their loan books shrink rapidly, have increased their investment securities holdings to a greater extent than regional banks, second-tier regional banks, and trust banks.

JGBs' share of banks' investment securities holdings increased to 56% at FY2009-end. Equities accounted for 9%, corporate bonds for 13%, and other securities for 17% (Exhibit 16).

Banks' JGB holdings grew a hefty ¥35trn in FY2009, reflecting a preference for safe assets. "Other securities" holdings ended FY2009 at ¥39trn, a ¥2trn decrease from a year earlier. Their share of banks' total investment securities holdings decreased four percentage points to 17%. For a second consecutive fiscal year, "other securities" holdings decreased across all categories

Exhibit 16. Japanese banks' aggregate securities portfolio allocations

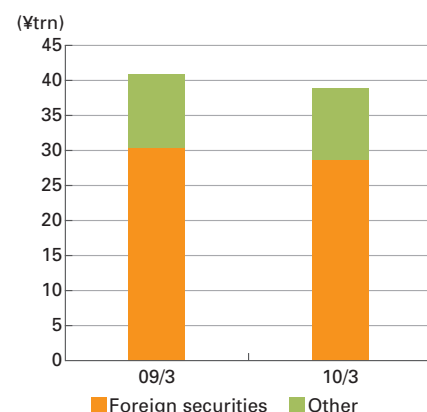


Source: NRI, based on Japanese Bankers Association's Financial Statements of All Banks and Fiscal 2009 Earnings of All Banks

of banks except trust banks. The decrease was attributable to a combination of divestitures, write-downs, and curtailment of new investments.

Within the "other securities" category, foreign securities holdings decreased ¥1.7trn to ¥29trn at FY2009-end, accounting for most of the overall decrease in "other securities" holdings. We surmise that the reduction was mainly attributable to divestment of foreign government bonds in response to escalation of sovereign risk triggered by the Greek fiscal crisis. Non-foreign "other securities" holdings (e.g., hedge funds, other non-foreign funds, domestic securitized products, structured bonds)

Exhibit 17. Breakdown of banks' "other securities" holdings



Source: NRI, based on Japanese Bankers Association's Financial Statements of All Banks, Bank of Japan's Domestic Bank Assets and Liabilities, and Financial Services Agency's Japanese Depository Financial Institutions' Holdings of Subprime Mortgage Products

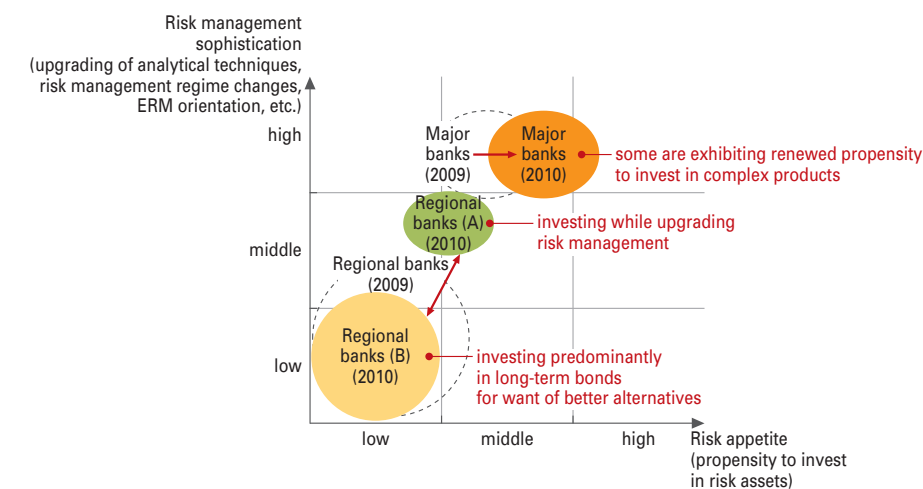
ended FY2009 roughly unchanged from a year earlier at ¥10trn. Divestment and write-downs of such securities holdings in response to the financial crisis seem to have nearly run their course.

Divergent securities investment trends driven by differences in risk management regimes

With demand for loans likely to remain depressed for a while, securities investment will perform increase in importance for banks. In the summer of 2010, NRI conducted an interview survey of major banks and regional banks to ascertain how they are approaching securities investment from the standpoint of portfolio management and risk management. The survey found that banks have generally been allocating a majority of their new investments to highly safe, highly liquid products such as JGBs, but it revealed two other interesting findings (Exhibit 18). First, some major banks have resumed investing in complex products (e.g., funds, securitizations). Second, a sophistication gap has emerged even among regional banks.

Among major banks, risk aversion has diminished somewhat in comparison to FY2009. Certain major banks, mainly megabanks, have resumed investing in funds and other complex products. Some of them are rigorously screening prospective fund investments by conducting more in-depth due diligence of fund managers based on not only quantitative but also qualitative criteria. Additionally, most major banks that have resumed investing in funds and other such products have upgraded their portfolio and risk management regimes. For example, one bank is endeavoring to boost returns and tighten controls through a more granular approach to profitability management. It is doing so in recognition that diversification of investment assets has diluted its product-specific expertise. This bank aims to strengthen its profitability management by setting return targets at the asset subclass level (e.g. hedge funds, commodities) and imposing stricter stop-loss discipline. From the standpoint of liquidity

Exhibit 18. Mapping of banks in terms of risk appetite and risk management sophistication



Source: NRI, based on interviews with bank employees

management, other banks aim to diversify their access to liquidity via fund redemptions by spacing redemption opportunities throughout the year instead of concentrating them in one timeframe.

Some regional banks also are upgrading their risk management despite having significantly less human resources than major banks. Quite a few regional banks have set up front-office operations in Tokyo to facilitate information-gathering while keeping their middle- and back-office operations in their home region. Several are endeavoring to strengthen coordination between the middle and front offices through such means as permanently stationing risk managers in the front office to promote information-sharing and keep a tight rein on the front office.

While some regional banks are thus upgrading their capabilities, many others are apparently investing predominantly in long-dated bonds for want of a better alternative, without quantifying their own risk tolerance. Amid domestic interest rates' recent large decline, these regional banks have to resort to strategies such as extending their bond portfolios' duration and investing in foreign bonds that offer relatively wide spreads over domestic bonds to earn even modestly higher returns.

Securities investment, including fund investment,

programs are thus increasingly diverging among banks. How to strategically differentiate product and service offerings targeted at different segments of the bank market is likely to become more important for asset management companies.

In serving major banks with a healthy risk appetite, asset management companies should most importantly continue to offer high-quality funds, including funds managed by overseas managers. Instead of focusing solely on relative performance, major banks are likely to place priority on fund management acumen during times of market stress as a fund selection criterion. In serving regional banks that are starting to upgrade their securities investment capabilities, asset management companies should put more effort into offering products that place priority on liquidity and ease of management. Suitable products would include ETFs and managed accounts as investment vehicles and foreign bond funds, currency long/short funds, and managed commodity trading accounts as investment strategies. Risk weights will also be an important consideration from the standpoint of Basel capital adequacy regulations. Regional banks that are investing exclusively in long-term JGBs offer asset management companies relatively little prospect of fund sales. The fastest way to make inroads in this market segment may be through educational activities, including advice

regarding interest rate risk management and other investments' compatibility with bond portfolios, even if such an approach may seem circuitous.

3 Retail business

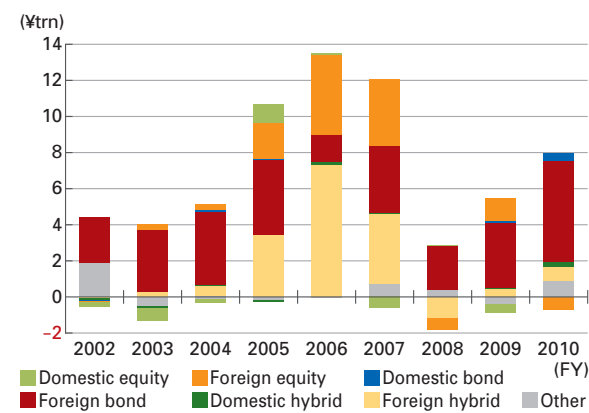
Continued inflows into high-yield products

Domestically chartered public investment trusts' AUM recovered to ¥64trn at FY2009-end from their year-earlier level of ¥51trn, which was nearly 40% below their peak level. In the first half of FY2010, their assets decreased slightly to ¥63trn at end-September.

Open-end equity funds account for slightly over 80% of total public investment trust assets. Most of their assets are still concentrated in funds that invest in foreign securities, namely foreign equity, foreign bond, and foreign hybrid funds. Of these three types, foreign bond funds, which have seen particularly heavy inflows since FY2008, accounted for a majority of inflows again in FY2009 (Exhibit 19).

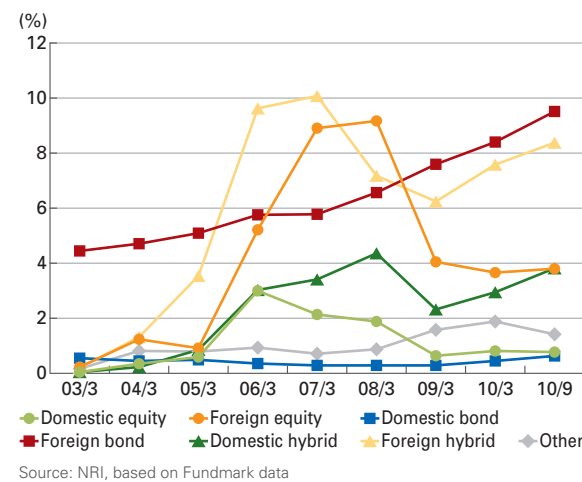
Foreign bond funds' popularity is attributable to their high distribution yields. Foreign bond funds' average distribution yield continues to rise, as shown in Exhibit 20. Inflows into foreign equity and foreign hybrid funds have been slow to recover in the wake of a steep

Exhibit 19. Open-end equity investment trust in/outflows (¥trn)



Note 1: FY2010 data are annualized fiscal-first-half data.
 Note 2: Excludes ETFs, funds with daily settlement arrangements, and bond investment trusts.
 Source: NRI, based on Fundmark data

Exhibit 20. Open-end equity investment trusts' distribution yields (%)



Source: NRI, based on Fundmark data

decline in their NAVs in FY2008 and a downturn in distribution yields.

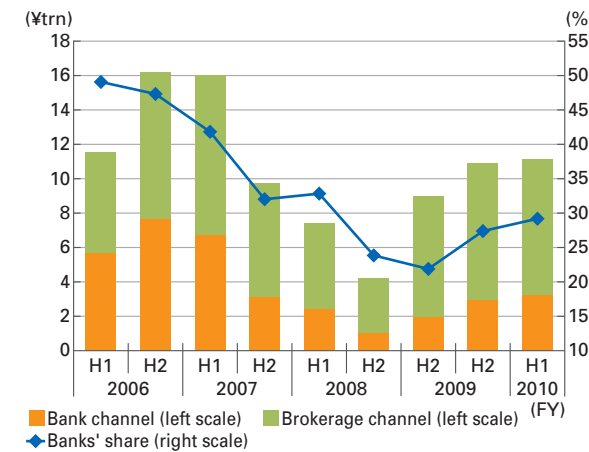
Inflows into foreign bond funds have continued in FY2010 also. Meanwhile, domestic bond funds, which pay an average distribution yield of not even 2%, experienced resumed net inflows in the first half of FY2010. Banks have apparently been pushing domestic bond funds as a product suitable for safety-oriented customers in the aftermath of the financial crisis.

Steady sales recovery in bank channel

Investment trust sales rebounded sharply in FY2009 after bottoming in the second half of FY2008 (Exhibit 21). FY2009 investment trust sales totaled ¥20trn, an increase of some 70% from ¥11.6trn in FY2008. This recovery was driven largely by sales growth in the brokerage channel. Brokerages' share of investment trust sales increased to 78% in the first half of FY2009. Investment trust sales via the brokerage channel have recovered to the vicinity of 85% of their peak level, reached in the second half of FY2007. Brokerages have succeeded in rolling out a succession of popular new products, including emerging market bond funds and multicurrency funds.

In the bank channel, by contrast, investment trust sales have been recovering more slowly than in the

Exhibit 21. Open-end equity investment trust sales (ex ETFs) (¥trn)



Note: FY2010 first-half (H1) sales data are provisional values.
 Source: NRI, based on data from various sources

brokerage channel. Banks' share of investment trust sales dipped to around 20% in the first half of FY2009 before rebounding to the vicinity of 30% in the second half. The bank channel has continued to steadily gain share in FY2010 also.

However, banks have been faring better from the standpoint of AUM, they key determinant of asset management companies' earnings. The bank channel still accounts for 51% of investment trust AUM, although its share has fallen for the past year or two. If banks' investment trust sales continue to recover, the recent decline in the bank channel's AUM share will eventually taper off and turn upward. The reason that the bank channel still accounts for a majority of investment trust AUM despite continuing to underperform the brokerage channel in terms of sales is that it has a dramatically lower redemption rate than the brokerage channel. The relative stability of bank-channel AUM indisputably makes banks an attractive sales channel in the eyes of asset management companies.

Recently, banks have joined brokerages in selling emerging market and multicurrency funds while also placing priority on selling funds that invest in low-risk domestic bonds as mentioned above. Despite investing mainly in bonds, these funds are set up

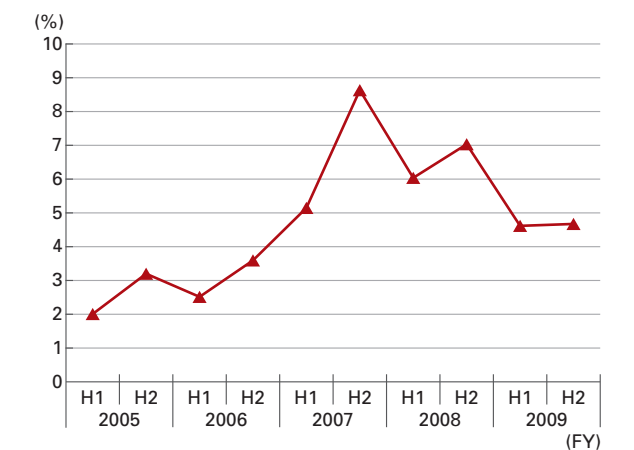
as equity funds because it is more tax-efficient to invest in JGBs through such a fund than to do so directly. Banks are apparently marketing such funds in anticipation of redemption of retail JGBs, which begin to mature from 2011 (approximately ¥28trn of them are scheduled to mature over the next five years).

Online channel has favorable medium-term growth prospects

Online sales of investment trusts had been steadily growing through the second half of FY2007, when they accounted for nearly 9% of total investment trust sales, but they have since lost momentum (Exhibit 22). Online sales currently account for slightly below 5% of total investment trust sales, but their share will likely increase over the medium term, given online brokers and banks' stated intention of focusing more intensively on the online sales channel.

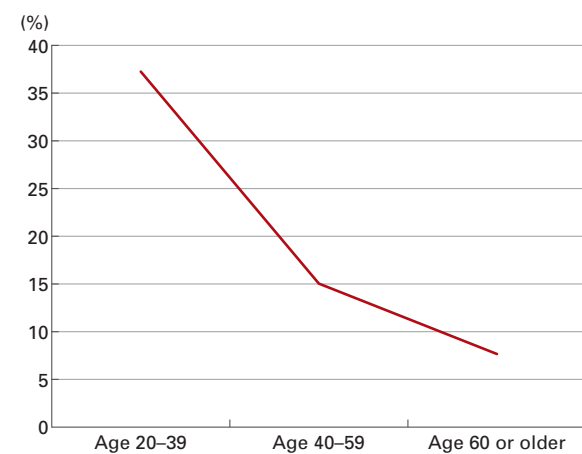
According to a 2010 Japan Securities Dealers Association survey, the experience of having purchased an investment trust online is much more prevalent among younger investors than older ones. Nonetheless, even in the 40–59 age bracket, 15% of survey respondents had purchased investment trusts online (Exhibit 23). Within 10 years, by which time much of this age group will have received lump-sum retirement benefit payouts, online sales' share of total

Exhibit 22. Online sales' share of total investment trust sales (%)



Source: NRI, based on data from Japan Securities Dealers Association and Financial Affairs Weekly

Exhibit 23. Percentage of survey respondents who have purchased investment trusts online



Source: Japan Securities Dealers Association's Report on Securities Investment Survey of Individual Investors (September 2010)

investment trust sales by value should conservatively reach 15%. In the interim, online trading is likely to increase in prevalence in the 50-59 age group, which hardly trades online at present. If so, the online channel's share of investment trust sales could increase to around 20% within 10 years.

Japanese ISAs and securities taxation going forward

The FY2010 tax reform act authorized the establishment of tax-free individual savings accounts (ISA) for listed stocks and equity investment trusts, effective from 2012. In 2012, the tax on listed equities and equity investment trusts is scheduled to be restored to 20% from its currently reduced level of 10%. According to official explanations, ISAs were intended as a substitute for this preferential tax rate.

In late August, however, the Financial Services Agency requested extension of the reduced tax rate on qualifying equity securities in the FY2011 tax reform bill. Given Japan's strained fiscal position, it remains to be seen whether ISAs will make their advent as currently scheduled and/or the reduced tax rate on equity securities will be extended again. The government's FY2011 tax reform proposal, which is normally unveiled in December, should shed light on

these questions.

Some managers and distributors are hesitant to embrace ISAs because of their early initial expiration date and their low contribution limits (up to ¥3mn over three years). Nonetheless, some asset management companies see ISAs as a promising opportunity to capture asset inflows from not only retirees but also currently employed investors. Against such a backdrop, asset management companies are planning to offer new investment products and modify their distributor support programs in preparation for ISAs' advent. Investment trust distributors are also likely to adjust their product offerings and seek to cultivate new customer demographics in response to ISAs' advent. ISAs present a prospective business opportunity for asset management companies. If ISAs are introduced as currently scheduled, they will likely garner substantial attention as a major theme within the asset management industry.

4 Market trends and product strategies by client segment

We mapped out investment product supply and demand by investor segment (pension funds and retail investors) based on the NRI Survey of Asset Management Companies' Management Priorities (Exhibits 24, 25). More specifically, we plotted the strength of investor demand (based on asset management companies' assessment) for various products offered by asset management companies against the products' current availability. The maps are useful for identifying promising products (strongly demanded products offered by few companies (upper left quadrant)) and products bogged down in intense competition (poorly demanded products offered by many companies (lower right quadrant)).

One commonality between the supply and demand map for pension funds and the map for retail investors is that investor demand for conventional actively managed domestic equity funds and developed

country balanced funds is quite low even though such products are offered by many companies. Additionally, emerging market equity and bond funds are in strong demand but they are already offered by many companies.

Promising products can be summed up by investor segment as follows.

(1) Supply and demand map for pension fund clients

What the promising products in the upper left quadrant of Exhibit 24 have in common is that they facilitate risk management. These products, which include dynamic hedging products, managed futures, low-volatility equity funds, and liability-driven investment (LDI) products, should help meet pension fund clients' risk management needs such as downside-risk hedging, diversification of risk sources, reduction of equity risk exposure, and containment of surplus risk.

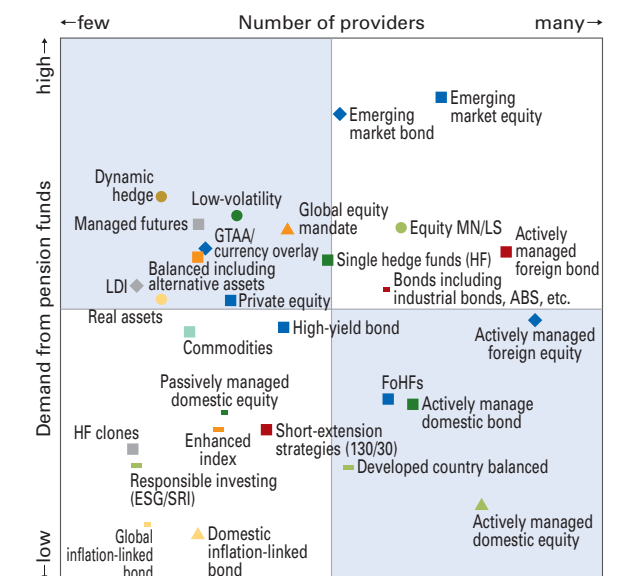
Single hedge funds were deemed more promising than general funds-of-funds, currently popular among Japanese pension funds. Among balanced funds, those that invest in a broader array of asset classes are seen as more promising than balanced funds that invest in developed countries only.

(2) Supply and demand map for retail clients

The supply and demand map for retail clients in Exhibit 25 is distinguished by a dearth of promising products in its upper left quadrant. These few products include multicurrency foreign bond funds (which typically invest in US high-yield bonds and offer a choice of several numeraire currencies) and infrastructure-related equities, but these products' status as promising products seems to be strongly influenced by recent sales trends. The sustainability of recent strong demand for such products remains to be seen. Retail clients tend to place priority on product attributes that differ from portfolio-management considerations such as risk management and asset classes. Success in the retail

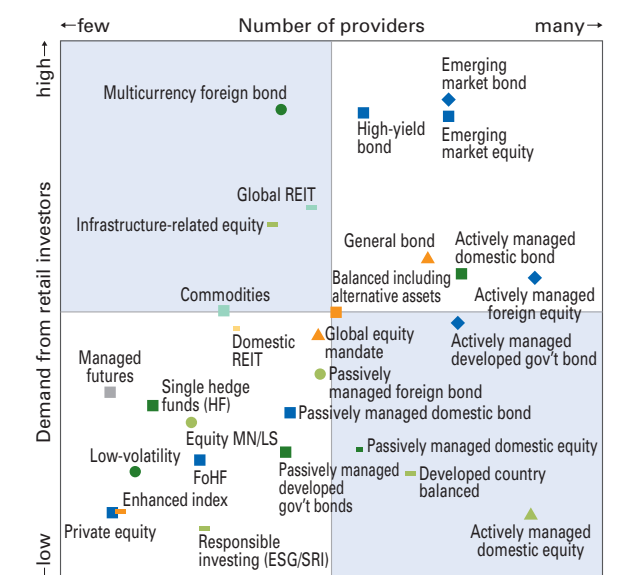
market segment hinges on the extent to which an asset management company, in cooperation with its distributors, can offer products attuned to currently popular themes or otherwise meet retail clients' unique needs.

Exhibit 24. Supply-demand map for pension fund clients



Note: The vertical scale is an indexed scale of the strength of demand from pension fund clients (based on asset management companies' assessment of demand). The horizontal scale represents the number of asset management companies that offer the product (scaled by number of providers not by value). Source: NRI, based on Survey of Asset Management Companies' Management Priorities (2010)

Exhibit 25. Supply-demand map for retail clients



Note: The vertical scale is an indexed scale of the strength of demand from retail clients (based on asset management companies' assessment of demand). The horizontal scale represents the number of asset management companies that offer the product (scaled by number of providers not by value). Source: NRI, based on Survey of Asset Management Companies' Management Priorities (2010)

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