NRI

Japan's Asset Management Business 2013/2014

Nomura Research Institute, Ltd.

FOREWORD

Shift from price competition to value competition, from short-term trading to long-term asset building

Japan's asset management industry appears to be at a turning point, about to exit a protracted stagnation phase dating back more than five years to the global financial crisis. The industry is starting to undergo a shift from price competition to value competition in the institutional market segment and from short-term trading to long-term asset building in the retail market segment.

In the institutional segment, Prime Minister Shinzo Abe's government is pursuing reforms aimed at transforming public pension funds, key clients of the asset management industry, from unsophisticated administrators to professional asset managers. Public pension funds may end up shedding their fixation with historical returns and low management fees and start to pay fair prices for superior investment products that offer real value. Additionally, with subadvisory arrangements becoming increasingly prevalent even in the institutional market segment, Japanese asset management companies face competition even from foreign rivals with no physical presence in Japan. The institutional market segment appears to be heading into a new era of value competition. Asset management companies are unlikely to survive this new era unless they offer distinctive, top-notch investment products.

In the retail market segment, the pending advent of Nippon Individual Savings Accounts (NISAs) could be the long-awaited catalyst that turns investment trusts into long-term asset-building products for Japan's retail public. NISA rules essentially prohibit short-term trading. Additionally, surveys indicate that NISAs are highly popular among not only the elderly, hitherto the investment trust industry's main customers, but also younger generations. NISAs are designed to induce demographic groups that have historically not been part of the investor class to become long-term investors. If NISAs prompt retail financial institutions to adopt an advisory business model and strengthen their commitment to investment trusts as a core product offering, the investment trust business may enter a new phase that is complete departure from the past. Because the elderly will still be the investment trust industry's core customers, investment trusts' existing income orientation will likely persist, but if investment products targeting long-term total returns become available and deliver high absolute returns, investment trusts should grow as a key component of individual investors' financial asset portfolios. Asset management companies have a duty to offer such products.

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November 2013

CHAPTER *1*

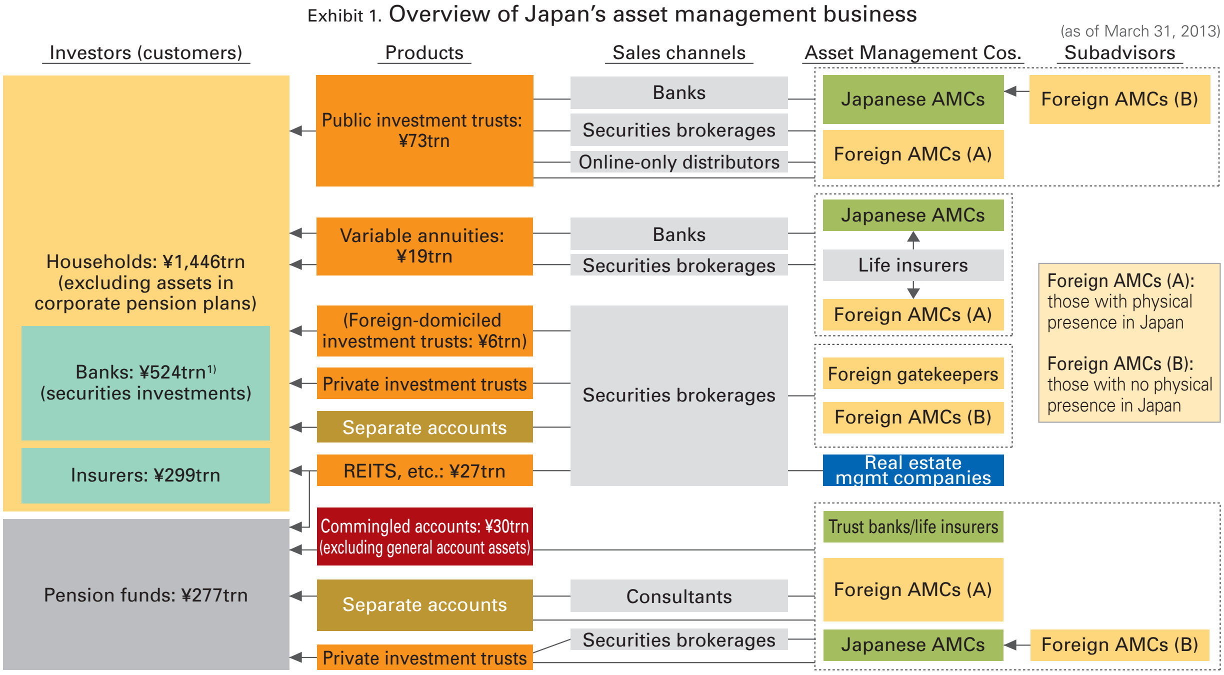
Japanese investor trends

Financial assets have recovered to their pre-crisis level

In FY2012 (year ended March 2013), Japan's total financial assets increased by ¥72trn to end the fiscal year at ¥1,723trn, near their level immediately preceding the 2008 financial crisis. Most of this increase was attributable to equity market appreciation and yen depreciation since the Liberal Democratic Party (LDP) regained power in late December 2012. As of FY2012-end, Japan's asset management market remained largely unchanged from the previous several years. From FY2013, however, the asset management market may undergo major changes due to the advent of new tax-advantaged accounts aimed at promoting securities investment among individual investors and possible changes in banks' hitherto JGB-centric investment securities portfolios in response to the BOJ's unconventional monetary easing.

We begin with an overview of the Japanese asset management business as of FY2012-end. Exhibit 1 provides a simplified big-picture view of the Japanese asset management market at March 31, 2013, in terms of its participants (investors and asset managers), products, and distribution channels. It shows which types of asset managers manage money for which investor classes, how investor assets are allocated, and how asset flows are intermediated.

Exhibit 1. Overview of Japan's asset management business



Note 1: Excludes Norinchukin Bank and Zenkyoren.
Source: NRI, based on data from various sources

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Asset management companies (AMCs) in Japan mainly serve three types of clients: retail investors (households), corporations including financial institutions, and pension funds. Adjusted to take into account that financial institutions' securities portfolios are largely funded with retail customers' deposits, Japanese investors' financial asset holdings as of March 31, 2013, totaled an estimated ¥1,723trn, a ¥72trn increase from a year earlier. This ¥72trn breaks down to a ¥55trn increase in household financial assets and ¥17trn increase in pension fund assets.

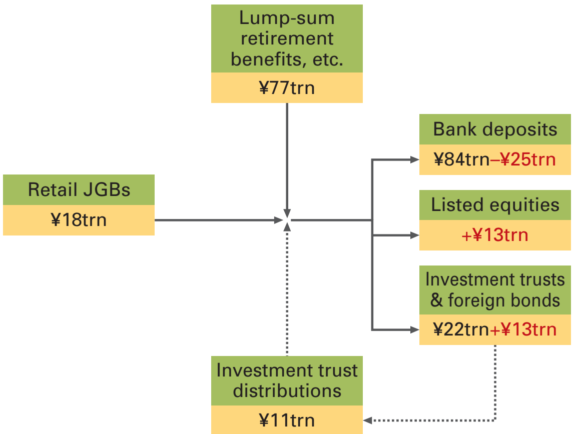
Of the total stock of financial assets, ¥367trn[1] or roughly 20% is managed by asset managers. Assets under management (AUM) are finally re-approaching their March 2008 peak after stagnating some 20% below their peak level for several years.

Household sector: NISAs' advent likely to fuel growth in investment trust AUM

Household financial assets at March 31, 2012, totaled roughly ¥1,446trn, a ¥55trn year-on-year increase. Their composition remained nearly unchanged from a year earlier, with bank deposits and insurance products accounting for about 80% of the total.

To gauge the outlook for household financial assets,

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



Note: The numbers in red are forecasts of NISAs' impact on household asset allocations.
Source: NRI

we modeled asset flows over the next five years based on historical data (Exhibit 2). We estimate that over the next five years households will receive bonuses and lump-sum retirement benefits, key funding sources for household financial assets, of ¥77trn net of home mortgage repayments upon retirement. We estimate households will redeem ¥18trn of retail JGB holdings, assuming that the 10-year JGB yield remains at its current level below 1%. Based on historical trends, we expect households to deposit most of their incoming investable funds into bank accounts. We estimate that households will deposit a net ¥84trn in bank accounts over the next five years. In terms of risk assets, we expect households to invest an additional ¥22trn in investment trusts and foreign bonds. However, these inflows into risk assets will be partially offset by outflows from investment trusts in the form of dividend distributions. We expect investment trust distributions to decline from their current level on the assumption that investment trusts will refrain from paying distributions in excess of their total returns. We project investment trust distributions of around ¥11trn over the next five years. Net of these distributions, estimated investment trust inflows over the next five years are reduced to ¥11trn.

However, future inflows into risk assets will be heavily influenced by the success of tax-exempt Nippon Individual Savings Accounts (NISA) to be introduced in 2014. Based on NRI survey data, we project that some ¥25trn will newly flow into listed equities and investment trusts through NISAs over the next five years. If this ¥25trn is split evenly between listed equities and investment trusts, the latter would see incremental inflows of ¥13trn. In sum, even taking into account outflows in the form of dividend distributions, we project that net investment trust inflows, including those that flow through NISAs, will total nearly ¥25trn over the next five years. If our projection prove accurate, total investment trust AUM, currently around ¥70trn, will approach ¥100trn in five years. Much of households' NISA investments in equities or equity investment trusts will likely be funded with bank deposits. Inflows to liquid deposits consequently may decrease going forward. NISAs are likely to spur a reallocation from safe assets to risk assets and increase investment trust ownership among younger generations.

Banks are likely to diversify away from JGBs

Pension funds, Japan's largest institutional investors, had an estimated ¥277trn in assets at March 31, 2013. Of this total, public pension schemes accounted for roughly ¥176trn, a ¥9trn increase from a year earlier. Corporate pension funds accounted for the remaining ¥101trn, an ¥8trn year-on-year increase. However, the Employees' Pension Insurance Scheme, the predominant public pension program, continues to draw down its reserves. Its benefit outlays exceeded inflows from contributions by roughly ¥4trn in FY2012 and are projected to do so again in FY2013 by nearly ¥5trn. These drawdowns are expected to continue for several more years. Even in the corporate pension sector, defined-benefit (DB) pension assets are expected to decrease as Employees' Pension Funds (EPFs) are dissolved or re-nationalized in response to institutional changes.

Financial institutions' investment securities holdings totaled roughly ¥822trn at March 31, 2013. Banks (ex Japan Post Bank) accounted for ¥285trn of this total, *shinkin* banks and credit unions for ¥67trn, Japan Post Bank for ¥172trn, life insurers (ex Japan Post Insurance) for ¥206trn, Japan Post Insurance for ¥73trn, and nonlife insurers for ¥21trn.

From AMCs' standpoint, financial institutions are a minor revenue source in comparison to pension funds because they invest mostly in JGBs and predominantly manage their investment securities portfolios internally. With banks' loan books still stagnant, securities investment remains as important as ever to financial institutions, but their JGB-centric investment policies have reached an inflection point in the wake of the BOJ's large-scale JGB purchases and a growing probability of rising interest rates. Banks will undoubtedly diversify into non-JGB securities going forward. Their holdings of "other securities" (i.e., foreign securities and domestic securities other than JGBs, municipal and corporate bonds, and equities) increased in FY2012. While foreign bonds accounted for most of this growth, banks' fund holdings also increased. Banks have shifted to a strategy of expanding their investment universe to enhance their investment returns. Such unconventional assets are one option for banks to capture capital gains through tactical trading. For AMCs and fund distributors, advising banks on asset selection and timing of asset sales will likely become very important in terms of building and maintaining business relationships with banks.

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).

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CHAPTER 2

Asset management business's current state and asset management firms' management priorities

1 Current state of asset management business

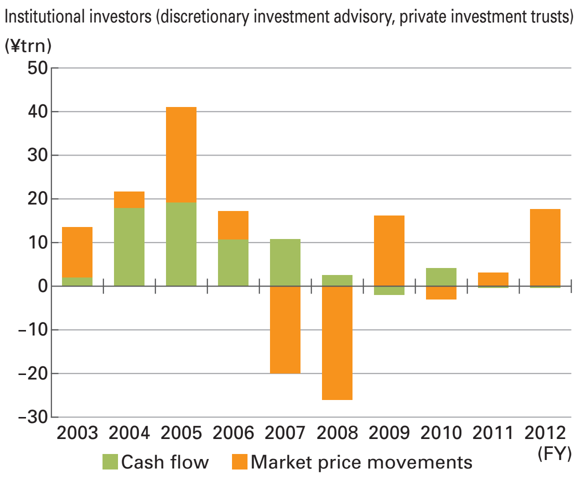
We estimate the Japanese asset management market's size as of March 31, 2013, at ¥387trn in terms of AUM (including foreign clients' assets) and ¥722bn in terms of management fee revenues.

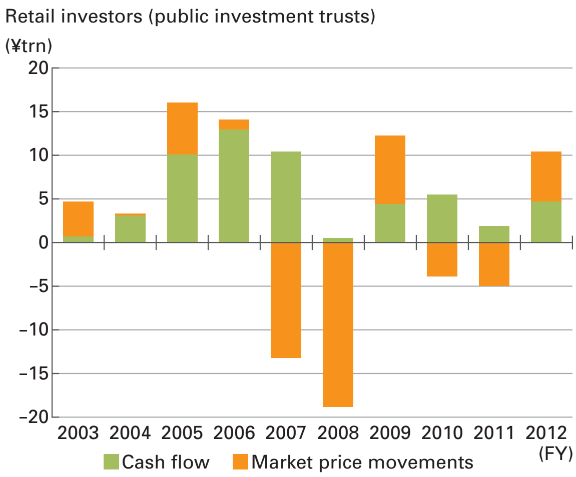
Below we look at the state of the asset management business and challenges facing asset management companies (AMCs), defined as investment trust and investment advisory firms excluding trust banks and life insurers.

Asset management business remains in stasis

Exhibit 3 plots annual changes in AMCs' AUM in recent fiscal years, disaggregated by causative factor. In FY2012, assets rose in market value from November in particular by virtue of equity market appreciation and yen depreciation triggered by the LDP's return to power. AMCs' AUM consequently increased by ¥17.6trn in the institutional market segment (discretionary investment advisory AUM and private investment trust AUM combined) and ¥5.7trn in the retail market segment (public investment trust AUM). In the institutional segment, AMCs saw virtually no net inflows again in FY2012. In the retail segment, gross inflows to public investment trusts were a hefty ¥68.8trn, the most since FY2008, but net inflows were a mere ¥4.7trn, largely due to redemptions to lock in profits in the wake of the equity market rally. Additionally, open-end equity investment trusts distributed aggregate dividends of roughly ¥4.7trn. Adjusted to factor in dividend distributions, net inflows to public investment trusts were essentially zero in our estimation. The reality of FY2012 is that, despite

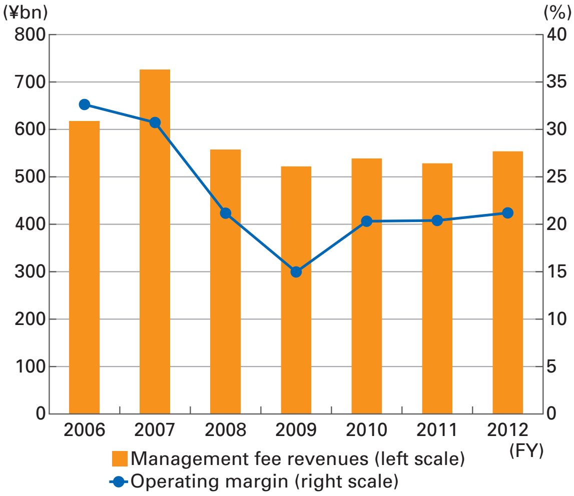
Exhibit 3. Changes in AUM broken down by causative factor





Note: Adjusted to reflect M&A and assets switched between contractual modalities.
Source: NRI, based largely on data from the Investment Trusts Association of Japan and Japan Securities Investment Advisers Association

Exhibit 4. AMCs' aggregate management fee revenues and operating margin



Source: NRI, based on AMCs' business reports and data from the Investment Trusts Association of Japan and Japan Securities Investment Advisers Association

the market rally, AMCs did not benefit from significant asset inflows.

We estimate AMCs' aggregate FY2012 management fee revenues at ¥552.7bn and their adjusted operating margin at 21.1% based on data available at the time of this writing. Both management fee revenues and operating margin appear to have improved, albeit modestly, on a year-on-year basis, but they remain well below their respective FY2007 and FY2006 peaks (Exhibit 4).

Exhibit 5 plots AMC operating margins' distribution for FY2006-12. The FY2012 data were derived from a sample of 26 mostly large AMCs for which the requisite information was available at the time of this writing. The median FY2012 operating margin was 14%.

Revenue outlook unchanged

We conduct an annual survey of AMCs (*NRI Survey of Asset Management Companies' Management Priorities*) to ascertain their consensus outlook for the asset management business[2)]. Following is an update on their outlook based on our latest survey data.

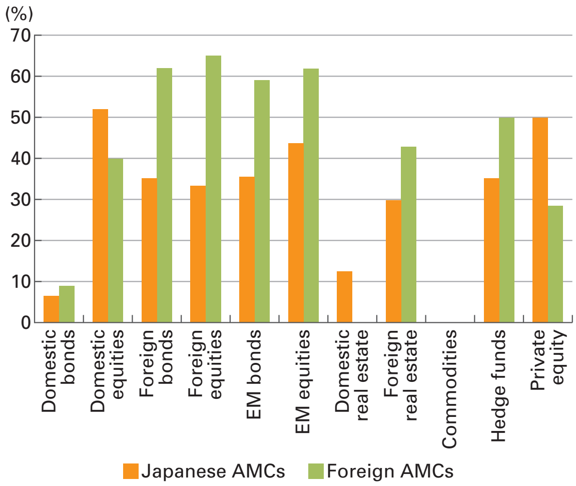
First, Exhibit 6 plots the percentages of survey respondents that expect to experience annual AUM growth attributable to net asset inflows of 10% or more over the next 3–5 years, broken down by asset class. Like last year, many AMCs expect net asset inflows equivalent to at least 10% of AUM in foreign and emerging-market asset classes.

The asset class with the biggest change in outlook

Exhibit 5. Dispersion of AMCs' operating margins

Note: FY2006-11 operating margin data were derived from a sample of 62 AMCs for which the requisite data were available. FY2012 operating margin data were derived from a sample of only 26 AMCs for which the requisite data were available at the time of this writing. Operating margin was calculated as the ratio of operating income to operating revenues net of agency fees. Green bars indicate the range of operating margins of companies ranked in the second and third quartiles. Red lines indicate median values.
Source: NRI based on data from AMCs' regulatory filings and business reports

Exhibit 6. Percentage of respondent AMCs projecting AUM growth of 10% or more by asset class (disaggregated by nationality)



Note: Percentages of respondents that project AUM growth of 10% or more due to asset inflows over the next 3–5 years.
Source: NRI *Survey of Asset Management Companies' Management Priorities*

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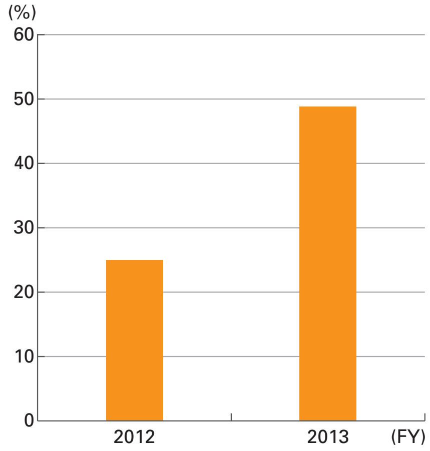
Exhibit 7. Percentage of respondent AMCs projecting AUM growth of 10% or more in domestic equity asset class (FY2012 vs. FY2013)

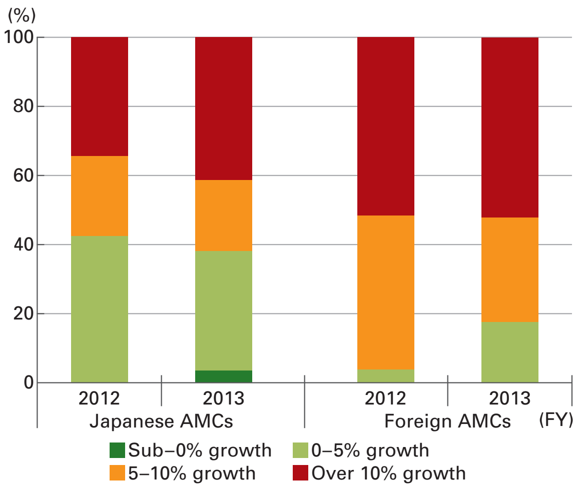


Source: NRI *Survey of Asset Management Companies' Management Priorities*

between last year and this year was domestic equities. In recent years through last year, about one-quarter of all respondents were projecting strong AUM growth in the domestic equity asset class, but this percentage doubled this year (Exhibit 7). This increase presumably reflects strong expectations that the Abe Government's reflationary economic policies will succeed. Exhibit 6 also reveals that Japanese AMCs in particular are more optimistic in their outlook for inflows to domestic equity products than for inflows to foreign asset classes.

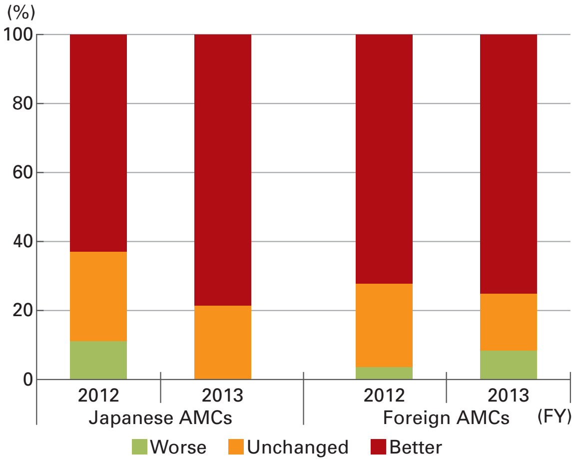
Next, Exhibit 8 plots the breakdown of annual revenue

Exhibit 8. Breakdown of respondent AMCs' revenue growth forecasts (disaggregated by nationality)



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

Exhibit 9. Respondent AMCs' operating margin forecasts



Note: Percentages of respondents that respectively expect their operating margins to be better, worse, and unchanged in 3–5 years.
Source: NRI *Survey of Asset Management Companies' Management Priorities*

growth rates projected by survey respondents over the next 3–5 years in comparison to the corresponding 2012 data. Relative to 2012, AMCs' revenue outlook was a bit more cautious but largely unchanged.

However, AMCs that mainly manage or subadvise retail investment trusts have a more optimistic revenue outlook in 2013 than in 2012. Conversely, AMCs mainly involved in the pension business tend to have a more cautious outlook in 2013 than in 2012. Retail investors do in fact have a number of incentives to invest in equities or other risk assets, including NISAs' pending advent and the government and BOJ's reflationary policies. In the institutional segment, by contrast, anticipated near-term changes (e.g., Employees' Pension Funds' de facto demise, upgrading of the Government Pension Investment Fund (GPIF) and other public pension funds' asset management capabilities) are not entirely positive for AMCs.

The survey inquired about AMCs' outlook for operating margins also (Exhibit 9). The percentage that expects their operating margins to improve over the next 3–5 years increased to around 80% among Japanese AMCs but was largely unchanged among foreign AMCs. The increase in the percentage of

Japanese AMCs' projecting improvement in operating margins despite virtually no change revenue growth projections (Exhibit 8) suggests that Japanese AMCs may be planning some type of cost-cutting initiatives.

2 Management methods differ from standpoint of external resource utilization

AMCs have long outsourced certain core business processes. It is common knowledge that AMCs often outsource front-office functions to other AMCs (subadvisors) and that public investment trusts in particular include many such externally managed products (advisory products). Additionally, outsourcing of other (e.g., back-office) functions to third parties, so-called business process outsourcing (BPO), is also becoming increasingly common.

Below we examine the current state of such utilization of external resources.

Advisory products' prevalence and multiplex relationships between distributors and sub-managers

One method of utilizing external resources that has been common among Japanese AMCs for quite a while is outsourcing of the portfolio management function itself. Typically, Japanese AMCs outsource front-office functions, the nucleus of portfolio management operations, to third-party AMCs without a Japanese branch while performing other functions, including structuring investment vehicles for domestic investors and conducting marketing, in-house.

Exhibit 10. Percentage of Japanese AMCs that offer only advisory products (by asset class)

	For retail investors	For pension funds
Domestic bonds	0.0%	14.3%
Domestic equities	6.3%	21.1%
Foreign bonds	7.7%	31.3%
Foreign equities	26.7%	35.3%
EM bonds (USD-denominated)	72.7%	88.9%
EM bonds (local currency)		87.5%
Non-Japan Asian bonds	38.5%	N/A
EM equities	44.4%	42.9%
High-yield bonds	91.7%	71.4%
Bank loans	N/A	85.7%

Note: Percentages of AMCs with product offerings in the listed asset classes that offer only subadvisory products.
Source: NRI *Survey of Asset Management Companies' Management Priorities*

Exhibit 10 tabulates by asset class the percentages of Japanese AMCs that offer only advisory products based on our latest annual AMC survey data. For example, over 90% of Japanese AMCs in our survey sample use subadvisors to manage their high-yield bond funds for retail investors. Advisory products account for large shares of Japanese AMCs' product offerings in foreign and emerging-market asset classes. Foreign AMCs often re-outsource portfolio management to an overseas parent or other affiliate. They consequently utilize third-party sub-managers to a lesser extent than Japanese AMCs.

According to a 2013 NRI survey on advisory products, major Japanese asset managers, including trust banks, have been beefing up their capabilities for recruiting and evaluating prospective sub-managers, monitoring sub-managers' performance, and reporting in liaison with sub-managers.

Additionally, relationships between Japanese asset managers and sub-managers are becoming increasingly multiplex, with the former sometimes utilizing multiple sub-managers in a single asset class and the latter partnering with multiple domestic asset managers for distribution of their products. Moreover, even foreign AMCs with Japanese branches are increasingly partnering with unaffiliated Japanese asset managers to expand their sales channels.

BPO likely to increase in prevalence

Another method of utilizing external resources is BPO. Our latest annual AMC survey inquired about current and planned BPO utilization. First, the breakdown of survey responses on the current state of BPO utilization and plans to use BPO in the future is shown in Exhibit 11. Ninety percent of foreign AMCs are

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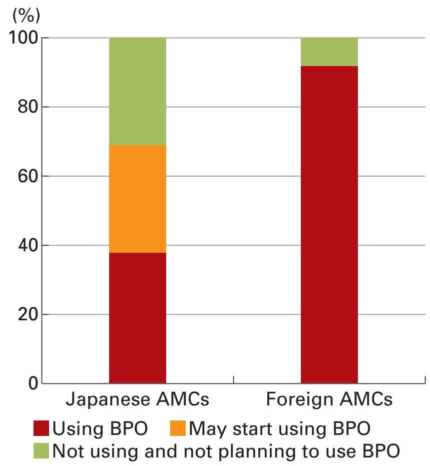
Exhibit 11. BPO utilization among AMCs



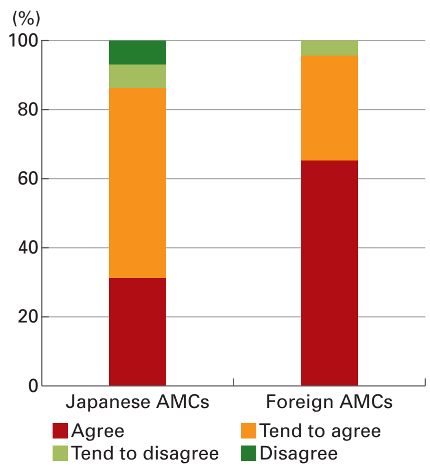
Source: NRI *Survey of Asset Management Companies' Management Priorities*

currently utilizing BPO versus only about one-third of Japanese AMCs.

Notably, another one third of Japanese AMCs, mostly mid-sized and large companies, are looking into utilizing BPO. BPO utilization is thus likely to become more prevalent among Japanese AMCs also. Japanese AMCs' profit margin forecasts (Exhibit 9) may reflect such plans to utilize BPO.

The difference in the extent of current BPO utilization between Japanese and foreign AMCs may be attributable to differences in BPO's perceived effectiveness as a management tool. Exhibit 12 shows the extent to which survey respondents agree that BPO is one of the most effective management tools. Only about one third of Japanese respondents agreed versus two-thirds of the foreign respondents. Japanese AMCs seem to have a stronger DIY mentality than foreign AMCs, but many Japanese AMCs are in fact currently taking steps toward utilizing BPO.

Exhibit 12. Responses to survey question "Do you agree that BPO is one of the most effective management tools?"



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

Exhibit 13. Risks of not using BPO (top-ranked risks)

Rank	Risk
1	Further operational dependency on key personnel (key-man risk)
2	Risk of future IT/operating cost increases
3	Risk of personnel expenses becoming fixed costs
4	Inability to accommodate new business expansion
5	Risk of inability to hire or train needed personnel

Note: Survey respondents were presented with a list of major risks and asked to choose up to three risks. The above risks are the five most-cited risks. Respondents already using BPO were instructed to answer the question as if they were hypothetically not using BPO.
Source: NRI *Survey of Asset Management Companies' Management Priorities*

Our survey also inquired about the perceived risks of not utilizing BPO (Exhibit 13). The major risks cited by survey respondents include operational dependency on key personnel (key-man risk), cost increases, and personnel expenses becoming a fixed-cost burden. The flipside of these risks is the expected (or actually realized) benefits of utilizing BPO. Aversion to such risks is apparently motivating many AMCs to utilize BPO.

3 What are AMCs' core functions?

In managing portfolios, AMCs are utilizing affiliated companies' resources in their home countries (in the case of foreign AMCs) and unaffiliated AMCs as subadvisors (in the case of Japanese AMCs) as discussed above. Meanwhile, both Japanese and foreign AMCs are pursuing BPO utilization for standardizable business processes. If AMCs thoroughly embrace such a management model, Japan-based AMCs' remaining functions would be limited to

- Product planning,

- Marketing and reporting to domestic investors and distributors, and
- Monitoring of outsourced functions.

In fact, some foreign AMCs' Japanese branches are essentially engaged solely in marketing.

For Japanese AMCs, the significance of outsourcing of portfolio management appears to differ from that of BPO in many cases. BPO is seen as an irreversible decision to conduct non-core business processes with a flexible cost structure while avoiding key man risk. The same is not necessarily true of outsourcing of portfolio management. AMCs consider portfolio management to be a source of added value and would ideally prefer to keep it in-house, but many AMCs see outsourcing as an expedient means of swiftly meeting investors' increasingly diverse needs or augmenting their own uncompetitive products. AMCs presumably would naturally prefer to offer internally managed products instead of relying on sub-managers if their in-house fund managers were capable of achieving competitive market performance.

However, now that AMCs are able to flexibly outsource business processes through BPO or subadvisory arrangements, they should reassess the sources of added-value that they provide. While it may be natural to assume that portfolio management is a source of added-value, building competitive portfolio management capabilities has never been easy for Japanese AMCs in the face of stiff competition, particularly in foreign asset classes, from top overseas managers of products imported to Japan. Japanese AMCs need to diligently apply themselves to formulating and developing clear-cut investment philosophies and processes in which they have conviction as a means of capturing returns.

Alternatively, choosing to offer Japanese clients products managed by top-performing external managers as a source of added value could also be a viable management decision.

After an AMC has thus clarified its sources of added-value, it needs to formulate a medium/long-term growth story by (1) identifying and acquiring the capabilities that its existing core organizational units should possess, (2) deciding on the businesses in which it will use subadvisors and those in which it will use in-house managers, and (3) deciding which non-core business processes to outsource and which to keep in-house.

2) NRI has conducted this survey annually since FY2007. In 2013, NRI distributed the survey questionnaires in July–September and received valid responses from 55 AMCs (31 Japanese, 24 foreign).

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CHAPTER 3

Market trends and product strategies by client segment

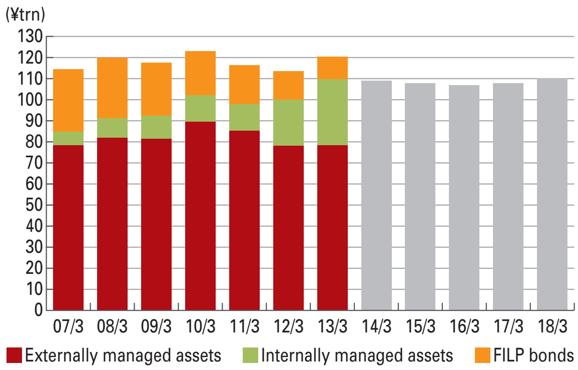
1 Pension business

AUM grew in FY2012 for the first time in three years

Japanese pension assets increased in FY2012 for the first time three years, ending the fiscal year at an estimated ¥277trn, a ¥17trn year-on-year increase. Of this total, public pension schemes (National Pension, Employees' Pension Insurance, and Mutual Aid Associations) accounted for some 64% or ¥176trn, a ¥9trn increase from a year earlier. Corporate pension plans and other pension schemes (National Pension Funds and Small-scale Enterprise Mutual Aid System) accounted for the remaining ¥101trn, an increase of ¥8trn from a year earlier.

Of total public pension plan assets, the Employees' Pension Insurance and National Pension programs account for over 70% or ¥126trn, nearly all of which is managed by the GPIF. At March 31, 2012, the GPIF had AUM of ¥120trn, a ¥7trn year-on-year increase by virtue of a 10.2% investment return in FY2012 (Exhibit 14). However, its AUM outsourced to external managers ended FY2012 roughly unchanged year on year at approximately ¥79trn as a result of a major increase in internally managed assets to ensure adequate liquidity to meet benefit obligations. The GPIF drew down its reserves by ¥4trn in FY2012 and is slated to draw down nearly ¥5trn of additional reserves in FY2013. With benefit expenses projected to exceed pension contributions for the foreseeable future, the GPIF's reserve drawdowns are expected to continue.

Exhibit 14. GPIF's AUM (actual and forecasted)

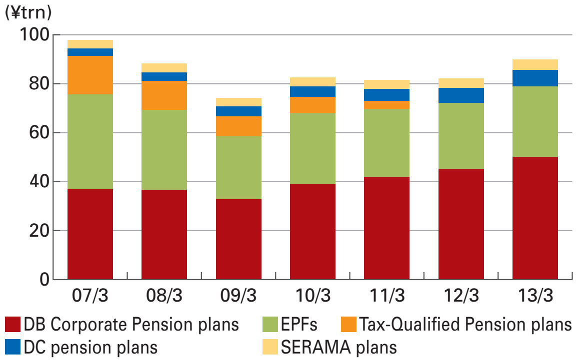


Note: Data for FY2013 and beyond are NRI forecasts based on the Ministry of Health, Labor and Welfare's 2009 actuarial valuation.
Source: NRI, based on GPIF's *Review of Operations in FY2012* and Ministry of Health, Labor and Welfare's 2009 Actuarial Valuation Report

Signs of change are afoot in the public pension sector. In August 2013, the government formed a committee of experts to discuss reforming public pension fund governance and transforming public pension funds into more professional organizations. If such reforms are implemented, public pension funds may increase their allocations to alternative assets to further diversify their portfolios and maximize after-cost returns. In such an event, they may outsource more of their assets to distinctive AMCs.

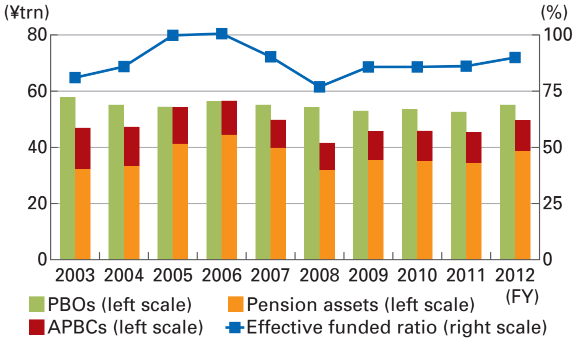
Corporate pension assets at March 31, 2013, totaled roughly ¥90trn, an ¥8trn increase from a year earlier (Exhibit 15). Among DB plans, DB Corporate Pension plans saw their assets increase by ¥5trn to ¥50trn at FY2012-end but they decreased in number to 14,700, down 300 from a year earlier. It was the first decrease in the number of DB Corporate Pension plans since their inception in Japan. EPFs continued to decrease in number in FY2012 even as their assets grew by ¥3trn to ¥29trn at March 31, 2013.

Exhibit 15. Corporate pension assets



Note: SERAMA: Smaller Enterprise Retirement Allowance Mutual Aid
Source: Trust Companies Association of Japan, Life Insurance Association of Japan, Federation of Pension Plan Administrators, and Organization for Workers' Retirement Allowance Mutual Aid

Exhibit 16. Corporate pension plans' overall funded status



Note: The above data pertain to Tokyo Stock Exchange 1st Section-listed companies with Japanese GAAP-compliant financial reporting. PBOs are net of prepaid pension expenses. Effective funded ratio = (pension assets + APBCs)/PBOs
Source: NRI, based on Nikkei Digital Media data

In June 2013, the government drastically amended the law that governs EPFs in the aim of spurring their dissolution or conversion to another type of corporate pension plan such as a DB Corporate Pension plan. Some 80% of existing EPF assets is expected to eventually be offloaded to the government (*daiko-henjo*) and managed by the GPIF. DB pension assets are consequently likely to decrease substantially going forward.

Defined contribution (DC) corporate pension plan assets at March 31, 2013, totaled ¥6.8trn, a ¥0.8trn increase from a year earlier. However, growth in both DC plans and DC plan participants was sluggish. Changes to the EPF scheme and accounting standards may spur future growth in DC pension plans.

Pending accounting change is fueling concern about pension risk among sponsor companies

Exhibit 16 shows the funded status for Tokyo Stock Exchange (TSE) 1st Section-listed companies' pension plans under Japanese accounting standards for postretirement benefits. In FY2012, the companies' pension assets grew ¥4.1trn by virtue of equity market appreciation and yen depreciation. At the same time, however, pension benefit obligations (PBOs) likewise increased by ¥2.5trn. The companies' effective funded ratio improved in FY2012, albeit only to around 90%.

An accounting standard mandating that PBOs be valued using a market bond yield as of fiscal year-end has been in effect since FY2009, but many companies continued to use their previous discount rates because they were not required to switch to a market discount rate unless the switch would result in a change in their PBOs of 10% or more (materiality threshold). The PBO increase in FY2012 was the result of many companies lowering the discount rate they used to value their PBOs in response to a decline in long-term bond yields beyond the materiality threshold. Of 1,520 TSE 1st Section-listed companies, 680 lowered their discount rates in FY2012.

A new accounting standard for postretirement benefits is slated to take effect from FY2013. The biggest change that will result from the new accounting standard is that companies will have to recognize the full amount of their net pension liabilities (PBOs in excess of pension assets) on their consolidated balance sheets. As a result, hitherto unrecognized benefit obligations (e.g., unrecognized actuarial losses) will be recognized as liabilities, likely resulting in a keener awareness of benefit obligations. In response, corporate pension plan administrators are likely to become more interested in LDI (liability driven investment) and similar solutions, strategies focused on delivering absolute returns while limiting downside risks, and asset classes that contribute to diversification of risk sources.

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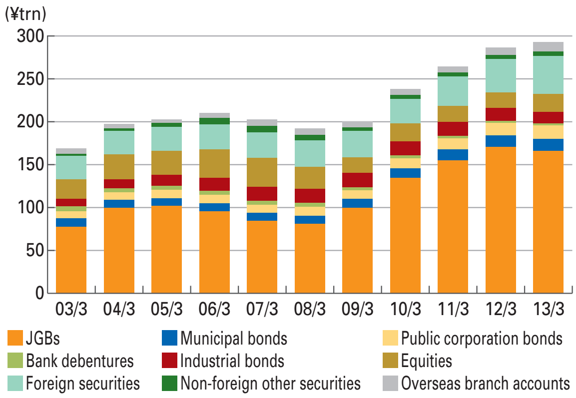
2 Securities investment by banks

Banks' investment securities holdings continue to grow

Japanese banks[3] ended FY2012 with aggregate investment securities holdings of ¥285trn per Japan Bankers Association data. During FY2012, their investment securities holdings increased by ¥6.3trn, a mere one-third of the previous fiscal year's increase. Investment securities' share of total bank assets at fiscal year-end was 31%, down 1ppt from the previous fiscal year-end's 32% share, its highest level of the past decade. Among the various types of banks, city banks' investment securities holdings at FY2012-end totaled ¥166trn, roughly unchanged from a year earlier. The lack of growth in city banks' investment securities holdings reflects a recent pickup in lending (mainly to overseas borrowers) and a change in JGB investment strategies (e.g., reduction of JGB holdings) in response to the BOJ's new monetary policy. In contrast, regional banks and second-tier regional banks' investment securities holdings continued growing in FY2012, with the former's increasing by ¥4.2trn to ¥75trn and the latter's increasing by ¥0.7trn to ¥16trn at FY2012-end[4].

JGBs continue to account for the lion's share of banks' investment securities holdings. According to BOJ data (which exclude foreign branch accounts), JGBs account for 59% (¥167trn), followed by "other securities"[5] with an 18% (¥50trn) share, domestic corporate bonds with an 11% (¥32trn) share, and domestic equities with a 7% (¥21trn) share. Banks' JGB holdings decreased by ¥4.4trn in FY2012 after having grown substantially every year since FY2009. Offsetting this decline, "other securities" holdings increased by ¥7trn, domestic equity holdings by ¥2trn, domestic public corporation bonds by ¥1.2trn, and domestic municipal bonds by ¥0.3trn, all relative FY2011-end. "Other securities" holdings grew particularly sharply as banks shifted more decisively toward strategies that expand their investment universes beyond conventional products to enhance their investment returns. Domestic corporate and municipal bonds are key earning assets for regional and second-tier regional banks that want to improve their investment returns but are heavily constrained in terms of management resources. Banks with large strategic equity holdings have been systematically reducing their holdings for a number of years and continued to divest strategic equity holdings in FY2012. The increase in banks' domestic equity holdings as of FY2012-end reflects renewed acquisition of equities as earning assets and elimination of unrealized losses on equity holdings in the wake of the fiscal-second-half equity market rally.

Exhibit 17. Japanese banks' investment securities holdings (by asset class)



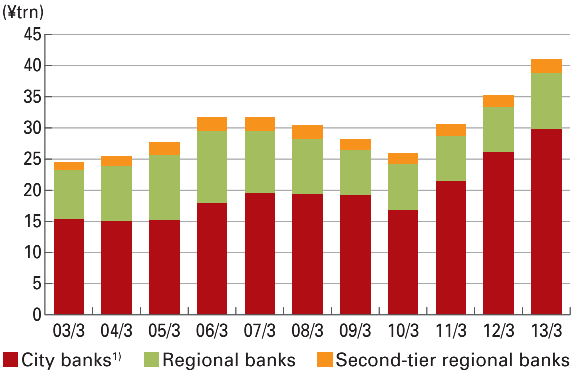
Note: Overseas branch accounts are city banks and regional banks' overseas branch accounts.
Source: NRI, based on BOJ's *Domestic Bank Assets and Liabilities*

"Other securities" holdings continue to grow

Banks' "other securities" holdings (excluding securities held in foreign branch accounts) grew for a third consecutive fiscal year to end FY2012 at ¥50trn, a ¥7trn year-on-year increase, per BOJ data. Of this total, foreign securities accounted for ¥44.2trn, a roughly ¥5trn increase from a year earlier. Non-foreign "other securities" holdings (e.g., funds, hedge funds, structured bonds) totaled ¥5.5trn at F2012-end, increasing by a hefty ¥1.3trn from a year earlier. They had previously been roughly flat since FY2008-end.

Among different types of banks (excluding foreign

Exhibit 18. "Other securities" holdings by bank type (excluding overseas branch accounts)

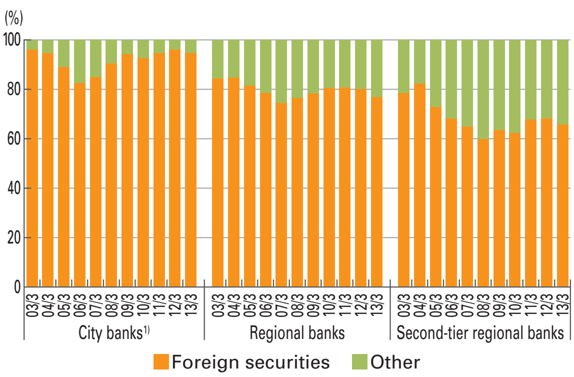


Note 1: City banks are Mizuho Bank, Bank of Tokyo-Mitsubishi UFJ, Sumitomo Mitsui Banking Corporation, Resona Bank, Mizuho Corporate Bank and Saitama Resona Bank.
Source: NRI, based on BOJ's *Domestic Bank Assets and Liabilities*

branch accounts), city banks' "other securities" holdings at FY2012-end totaled ¥29.8trn, a ¥3.7trn year-on-year increase. Regional banks' "other securities" holdings increased ¥1.7trn year on year to ¥9trn at fiscal year-end while second-tier regional banks' increased by ¥0.4trn to ¥2.2trn over the same timeframe[4] (Exhibit 18). Regional and second-tier regional banks' "other securities" holdings likewise increased substantially in FY2012 after previously fluctuating in a narrow range since FY2008-end. Growing enthusiasm for investing in "other securities" is an industry-wide trend, not limited to large banks.

The composition of banks' "other securities" holdings reveals differences in investment preferences among different types of banks (Exhibit 19). In city banks' case, foreign securities accounted for a whopping 95% share of "other securities" holdings at FY2012-end. While city banks have been stepping up investment in "other securities" since FY2011, they have been investing mainly in foreign bonds. Although foreign bonds include securitized products also, city banks' investment stance toward securitized products varies widely among individual banks. Non-foreign securities' share of city banks' "other securities" holdings had been declining for several years in a row before rising to 5% in FY2012. Against the backdrop of a low interest rate environment, city banks are starting to seek opportunities to increase investment in non-foreign "other securities". In comparison to city banks, regional and second-tier regional banks' "other securities" portfolios are not as concentrated in foreign securities. Foreign securities accounted for 77% of regional banks' and 66% of second-tier regional banks' "other securities" holdings at FY2012-end. The difference in foreign securities' portfolio allocations relative to city banks presumably reflects that in terms of enhancing investment returns, regional and second-tier regional banks are largely dependent on external asset managers' portfolio management know-how and analytical and risk-management capabilities, given their limited management resources in comparison to city banks. Like at city banks, non-foreign securities' share of "other securities" holdings has been rising at regional and second-tier regional banks also. Regional and second-tier regional banks may further intensify their efforts to improve investment returns through adroit utilization of external resources.

Exhibit 19. Composition of banks' "other securities" holdings



Note 1: City banks are Mizuho Bank, Bank of Tokyo-Mitsubishi UFJ, Sumitomo Mitsui Banking Corporation, Resona Bank, Mizuho Corporate Bank and Saitama Resona Bank.
Source: NRI, based on BOJ's *Domestic Bank Assets and Liabilities*

Securities investment trends in FY2013

In FY2012, banks exhibited an increased propensity to diversify their investment holdings in pursuit of higher returns. Many banks are pursuing diversified investment as an investment policy for FY2013. This trend is a decisive development. Banks of all sizes have adopted an investment stance of broadly investing in assets other than JGBs to boost returns while keeping JGB interest-rate risk within their risk tolerance parameters. One key factor behind this shift in banks' investment policies is the BOJ's new monetary policies. Due to

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the BOJ's unconventional monetary easing, banks encountered difficulty booking gains by selling JGBs at fiscal year-end. As a result, banks have started to look toward assets other than JGBs as investment vehicles from which they can capture capital gains through tactical trading. Banks that actively invest in "other securities" such as funds and foreign bonds treat such securities as a means of booking capital gains through tactical trading. Individual equities and ETFs are also regarded as trading vehicles for capturing capital gains. A wide range of banks from major banks to regional banks invest in ETFs by virtue of their transparency and liquidity. The number of banks interested in investing in ETFs has increased in response to ETFs' inclusion in the BOJ's asset purchasing program.

For investment products that banks have chosen to use as tactical trading vehicles (e.g., foreign bonds, funds, equities) effective holding periods will become shorter because banks intend to take profits on such positions when they have the opportunity to do so. After they have taken profits, they may not necessarily reinvest the sale proceeds in the same asset class. Instead, they intend to opportunistically invest in the asset class with the most promising return prospects at that time. Accordingly, for AMCs, distributors and other parties that sell investment products to banks, advising banks on when to sell the products, which asset class to reinvest the sale proceeds in, and other essential matters related to the banks' investment decisions will play an important role in maintaining business relationships with banks.

Since the global financial crisis, banks have been under pressure from financial regulatory authorities to implement risk management programs tailored to their investment holdings. In selecting assets, banks continue to place priority on safety, liquidity, and transparency. Unlike major banks, regional and second-tier regional banks have to invest on a smaller scale and be sensitive to even tiny yield differentials. This is one reason for private investment trusts' popularity in recent years. Product providers are likely to be increasingly called upon to provide detailed advice and recommendations in response to changes in the investment environment and financial institutions' needs. Given the need to develop the capability to provide such highly customized service, product providers may have to cut back on the number of clients they serve.

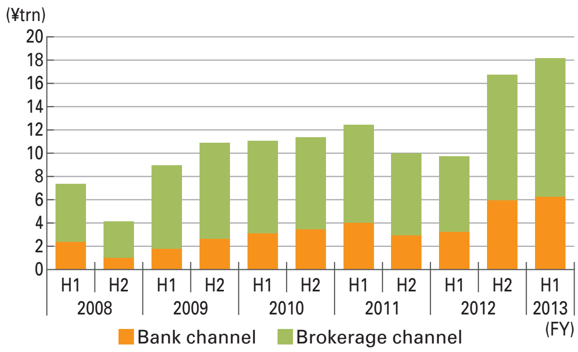
3 Retail business

All-time record investment trust sales for two consecutive semiannual periods

Investment trust sales have been recovering rapidly since the second half of FY2012. In the second half of FY2012 open-end equity investment trust sales (ex ETFs) hit an all-time record of ¥16.8trn, their first such record in six years (Exhibit 20). Investment trust sales have continued to grow in FY2013, surpassing ¥18trn in the fiscal first-half. Investment trust sales growth has been particularly pronounced in brokerage channel. In the first half of FY2013, investment trust sales via the brokerage channel exceeded their pre-crisis peak by 30%. In the bank channel as well, investment trust sales have resumed growing after several years of stagnation, recovering to 80% of their previous peak level in the first half of FY2013.

Various different types of funds have recently been selling briskly. While sales of foreign bond funds, which have hitherto accounted for roughly half of total equity investment trust sales, have of course

Exhibit 20. Open-end equity investment trust sales (ex ETFs)



Note: FY2013 H1 data are semi-annualized sales for the five months through August.
Source: NRI, based on Fundmark data

continued to grow, even domestic equity investment trust sales have resumed growing after languishing in recent years. Semiannual domestic equity investment trust sales increased to ¥3.9trn in the first half of FY2013 from ¥610bn in the year-earlier period. Meanwhile, sales of foreign equity and domestic REIT funds tripled over the same timeframe.

Net outflows continue

Equity investment trust AUM (ex ETFs) ended September 2013 at ¥54trn, a ¥9.2trn (21%) year-on-year increase. However, AUM have not increased as much as one would expect based on the robust sales data. Investment trust outflows due to redemptions have also remained at a high level.

Exhibit 21 plots net in/outflows to equity investment trusts (ex ETFs). It shows that rapid growth in equity investment trust sales in the second half of FY2012 was accompanied by growth in redemptions also. Additionally, dividend distributions, which were said to be high relative to AUM even before mid-FY2012, increased further in the second half. Consequently, despite all-time-record equity investment trust sales, outflows inclusive of dividend distributions exceeded inflows in the first half of FY2013 for a sixth consecutive semiannual period since the second half of FY2010.

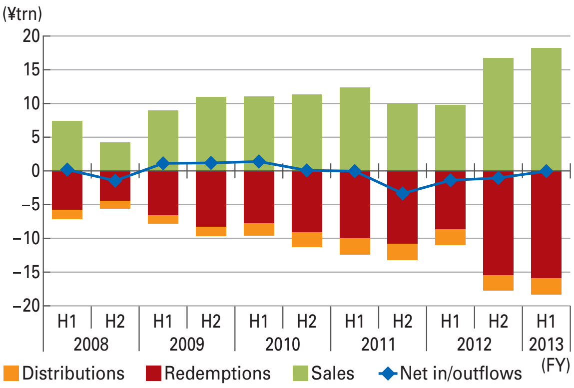
A big reason that net inflows have not turned positive as readily as in the past is a lack of growth in the number of investment trust owners. According to one research firm[6], the number of investment trust accounts at regional banks has fallen by more than 10% from its March 2010 peak. Mega-banks and trust banks are reportedly also experiencing similar attrition rates. Although the investment environment has improved dramatically, such improvement has not led to growth in the investment-trust investor population.

Pursuit of short-term efficiencies inhibits AUM growth

Investment trust sales commissions continue to rise. Exhibit 22 plots the sales-weighted-average pretax sales commission rate (based on maximum commission rates) for open-end equity investment trusts (ex ETFs). The average commission rate rose rapidly from FY2003, dipped around the time of the Lehman bust[7], and has resumed rising since FY2009. When disaggregated by fund type, average sales commission rates have generally not been rising. The weighted-average commission rate's rise has been driven by growth in sales of types of investment trusts that have always charged high sales loads.

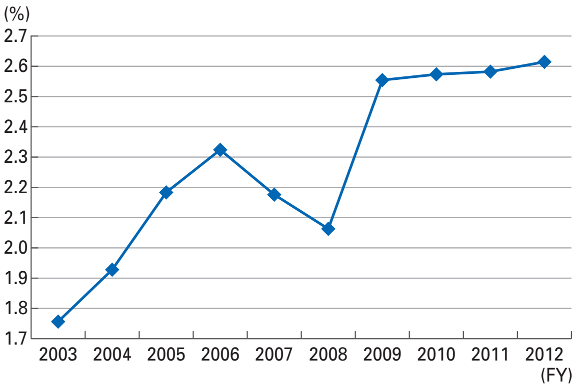
If a distributor sells mainly high-load funds, it can earn income efficiently, but not many investment trust investors are able to purchase such funds. The reason is that high-load funds are generally high risk. The pool of investors with a sufficiently high risk tolerance is limited. Additionally, even highly risk-tolerant investors

Exhibit 21. Open-end equity investment trust in/outflows (ex ETFs)



Note: FY2013 H1 data are semi-annualized sales for the five months through August.
Source: NRI, based on Fundmark data

Exhibit 22. Average sales load (open-end equity investment trusts)



Note: Sales-weighted average pretax sales load (maximum load)
Source: NRI, based on Fundmark data

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are unlikely to allocate much of their assets to high-risk funds. Focusing on selling high-load funds contributes to short-term earnings growth, but given high-load funds' limited pool of investors and investment capital, such a focus does not lead to medium-term business expansion. It is important to simultaneously pursue both short-term revenues and medium-term growth. For example, fund distributors should turn their attention to cultivating new customers, which is generally regarded as costly and inefficient. To win over hesitant investors, sales personnel should take the time to discuss investment planning with prospective customers instead of pressuring them to make an investment decision after merely explaining products and performing a cursory suitability check. While financial institutions may already be familiar with these approaches, they have not yet started to put them into practice. However, conditions are becoming conducive for them to actually do so, as discussed below.

NISAs likely to drive growth in new retail investors

NISAs (Nippon Individual Savings Accounts) will make their advent in 2014. NISAs will provide tax-exempt treatment of capital gains and dividend income from listed equities and equity investment trusts held in NISAs. Individuals will be permitted to invest up to ¥1mn annually in NISAs for 10 years through 2023. Once an eligible asset is purchased in a NISA, capital gains and dividends from the asset will be tax-exempt for maximum of five years. Investors will initially be limited to opening only one NISA at a single financial institution[8]. With financial institutions now rushing to sign up their existing customers, competition to capture NISA investors is fierce.

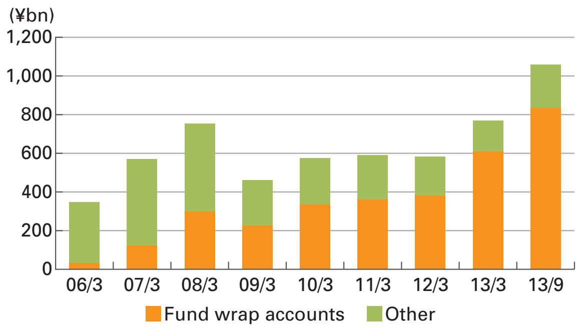
Public interest in NISAs is also running high. Based on an NRI survey conducted in July 2013, we estimate that 9.5mn people throughout Japan intend to use a NISA. When those who reported being "more likely than not" to use a NISA are included, the estimated pool of prospective NISA investors increases to 31mn. There was little variation among age groups or genders in survey respondents' reported propensity to use NISAs. Interest is high even among young adults and women with no previous investment experience. For financial institutions, NISAs' advent should be a good opportunity to increase the number of investment trust investors.

Individual advisory services bode well for growth

As a general rule, customers make investment decisions themselves when purchasing investment trusts that entail risk. Recently, however, financial institutions are increasingly offering individual advisory services whereby they make investment decisions on behalf of customers. Specific examples of such arrangements include separately managed accounts, wrap accounts, and fund wrap accounts. Among investment services in general, these advisory services still have a small footprint, but their AUM are steadily growing. After temporarily stagnating in the wake of the global financial crisis, overall wrap-account AUM surpassed their pre-crisis peak (¥750bn) in March 2013 and had risen over ¥1trn by six months later (Exhibit 23). AUM in fund wrap accounts have grown almost every year since financial crisis, doubling over the past year in particular. Fund wrap accounts consequently now account for 80% of total wrap-account AUM.

With individual advisory services, customers generally set their own investment goals in consultation with an investment advisor. The advisor then helps the customer to formulate a plan to achieve the goals, including investment policies and amounts to be

Exhibit 23. Wrap account AUM



Source: NRI, based on Japan Investment Advisers Association and Fundmark data invested. In terms of selection of specific products, the financial institution makes investment decisions in accord with the policies set through consultation with the customer and periodically reviews investment performance with the customer. Although the process is time-consuming, AUM per account average ¥15mn[9], substantially more than the typical investment trust sale[10]. Revenues per customer are consequently higher than average revenues per investment trust account[11]. Revenues per unit of AUM also compare favorably with regular investment trust accounts.

Individual advisory services that relieve the customer of the task of making investment decisions on individual securities (investment trusts) are targeted at customers who are indecisive or unskilled at investment decision-making. There is apparently a large number of such investors. Fund wraps' average risk is in fact quite low, perhaps due to the breadth of their customer pool. By our calculation, fund-wrap investment trusts have an average volatility of 11%[12], far below open-end equity investment trusts' average volatility (18%). Individual advisory services are currently available only from major brokerages and a few banks, but many financial institutions are watching the early entrants' progress with interest. If such services become widely available, investment services' customer base would broaden, likely leading to growth in the investment trust market also.

4 Product market trends by client segment

We have created product opportunity maps for three investor segments (retail, pension funds, and financial institutions) based on data from our Survey of Asset Management Companies' Management Priorities. These maps plot the strength of investor demand for various products (as assessed by AMCs) against the products' current availability (assessed based on the number of providers that offer each product). They are useful for identifying promising products (strongly demanded products offered by few companies (upper left quadrant)) and products facing intense competition (poorly demanded products offered by many companies (lower right quadrant)). Exhibit 24 presents our product opportunity maps for a subset of products.

In the retail investor segment, very few products are rated as promising opportunities from the standpoint of their supply-demand balance. Survey respondents reported that target-volatility funds, newly added to our product opportunity maps this year, are in strong demand as a product for NISA investors, but such funds are already offered by many AMCs. Major changes from previous surveys include increases in reported demand for domestic equities and foreign equities. On the flipside, reported demand for emerging market equities and China-related equities decreased substantially. These changes can be largely construed as a reflection of recent market performance.

In the pension fund segment, real assets and products linked to nonlife insurance policies are rated as promising asset classes. Multi-asset products and bank loans, both of which were rated as promising opportunities last year, migrated to the upper-right quadrant this year due to an increase in the number of companies offering the products. Products reported to be in strong demand are generally those that contribute to diversification of pension asset portfolios' risk sources, but this year's survey results suggest that AMCs have been expanding their offerings of such products, resulting in intensification of competition.

Among conventional asset classes, survey respondents reported stronger pension-fund demand for fixed-income products than equity products and for foreign assets than domestic assets. This pattern was evident in previous surveys also. There does not appear to be any change in response to the market environment. For example, pension fund demand for domestic equity products remains low while demand for emerging-market assets remains high. In this respect, pension funds' investment preferences differ from retail investors'.

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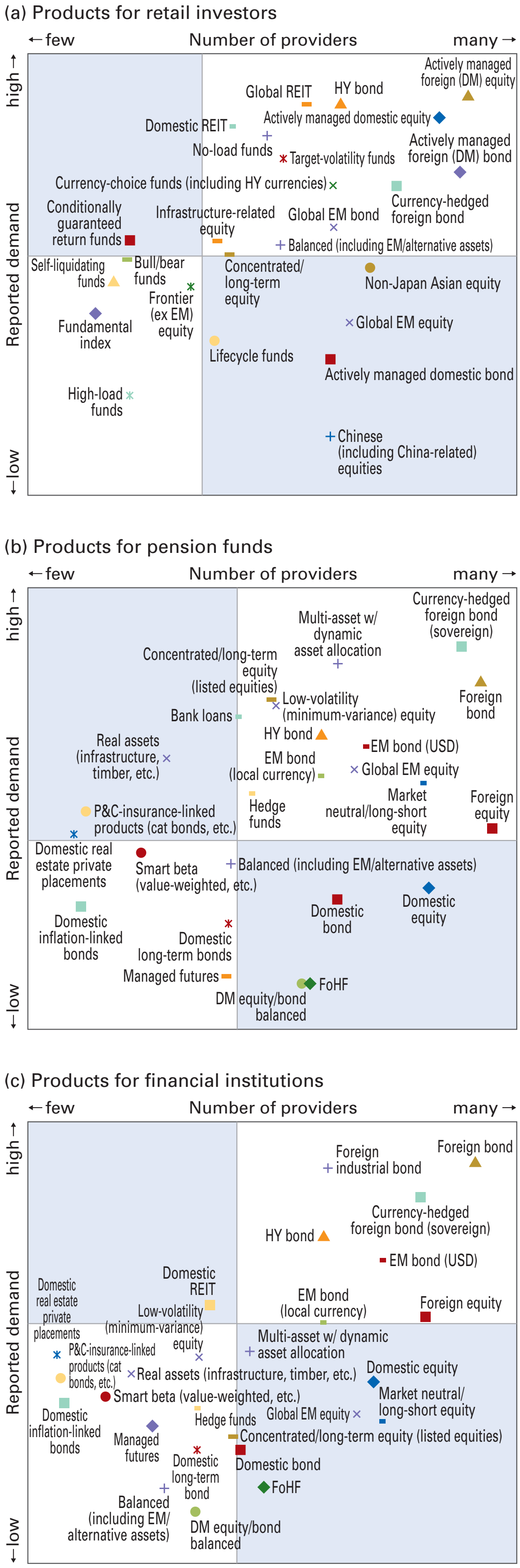
Exhibit 24. Product supply and demand maps by client segment



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

In the financial institution segment, like in the retail investor segment, very few products are rated as promising opportunities. Fixed-income products, particularly foreign bonds and foreign industrial bonds, were reported to be in relatively strong demand.

In sum, Japan's asset management industry currently has few promising products from the standpoint of their outward characteristics. One factor behind this dearth of promising products is that AMCs are increasingly utilizing subadvisors to offer new products that previously would not have been widely available. In such a business environment, AMCs must clearly differentiate their products from rival products in terms of attributes and performance.

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3) Including overseas branch accounts.
4) The difference between the grand total and the sum of the city bank, regional bank, and second-tier regional bank subtotals is attributable to other banks, mainly trust banks.
5) "Other securities" are foreign securities and domestic securities other than JGBs, corporate bonds, municipal bonds and equities.
6) Kinzai/Quick Fund Databank
7) While investment trust sales were falling sharply from the second half of FY2007 through FY2008, the sales-weighted average sales commission rate declined due to growth in sales of low-load index funds.
8) Under the current law, once individuals open a NISA, they cannot move the NISA to another financial institution until 2017. However, the government is considering a rule change to allow NISA investors to switch financial institutions.
9) Per Japan Investment Advisers Association data.
10) For regular investment trust sales, average investment trust holdings per customer are said to be around ¥10mn at major brokerages and ¥5mn at megabanks.
11) For example, investment trust sales commissions and account servicing fees earned by fund distributors average 2.6% and 0.5%, respectively. If a customer hypothetically invests ¥5mn in an investment trust and holds it for two years before selling, the distributor would collect ¥180,000 of revenues from the customer during those two years. Fund wrap accounts do not charge sales commissions, but the financial institution would earn $470,000 in revenues per fund wrap account over the same timeframe, assuming an average account balance of ¥15mn and account management fees of 1.56%, including a 0.16% account servicing fee collected from the investment trust sponsor.
12) This 11% is the AUM-weighted average volatility of investment trusts marketed exclusively to fund wrap accounts. For the top three financial institutions ranked by fund wrap AUM, average volatility ranges from around 10% to 12%. Because assets in actual fund wrap accounts are invested in multiple investment trusts, average volatility per fund wrap account is presumably even lower than investment trusts' average volatility due to the covariance effect.

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Japan's
Asset Management Business
2013/2014

Date of Issue December 16, 2013

Publication Nomura Research Institute, Ltd.,
Marunouchi-kitaguchi-Bldg. 1-6-5 Marunouchi,
Chiyoda-ku, Tokyo, Japan
http://www.nri.com/jp

Publisher Yasuki Okai

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