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Japanese asset management business in the eyes of global asset managers

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Executive Summary

In February and March, I met and discussed the asset management business with some 20 global asset management companies' CEOs. I learned about both their expectations for major potential opportunities and their risk concerns. To continue to grow, Japan's asset management industry must take action to surmount the risks on these CEOs' collective mind.

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The Japanese asset management industry appears to have achieved modest revenue growth in FY2015[1]. The main constraint on revenue growth was meager growth in assets under management (AUM). Although asset inflows from customers were robust in the fiscal first-half, the inflows were largely negated in the fiscal fourth-quarter by market price declines attributable mainly to yen appreciation and equity market losses. While the asset management industry is seen as having favorable prospects of rapid growth driven by Japanese households' transformation from savers to investors, it has recently slipped into a lull.

In February and March 2016, amid a flare-up in equity market volatility, I had the opportunity to talk about the Japanese asset management business with CEOs of global asset management companies around the world[2]. Japan's asset management industry, though much smaller than its European or US counterpart, is by far the largest in Asia[3]. The CEOs I met with remain committed to the Japanese market, but they expressed a number of concerns as discussed below. Their concerns reflect challenges facing the Japanese asset management industry.

Divergent business conditions and concerns about negative interest rates

In my conversations with the CEOs, I sensed that foreign asset management companies are split into two camps in terms of their success in the Japanese market. Specifically, a big gap in revenue growth rates has emerged between foreign asset managers that have won mandates from major Japanese banks and/or public pension funds and their peers that have not. For example, among those that have won large fund mandates from Japanese clients and, in turn, achieved

NOTE

1) Both investment trust and investment advisory revenues apparently grew at a single-digit rate.

2) The meetings took place between February 25 and March 15 in New York, Boston, London, Paris, Singapore and Hong Kong. The interviewees were global CEOs or chief executives of Japanese operations.

3) Based on my conversations with asset management company CEOs, I estimate that Japan accounts for a majority of asset management revenues in Asia as a whole.

major revenue growth, some reported having recently surpassed their peak revenues of the previous 10 years. In contrast, foreign asset managers that have failed to land such lucrative clients have seen their revenues stagnate.

In terms of the Japanese asset management environment, the CEOs were highly concerned about negative interest rates' impact on the asset management business. Such concern is perfectly understandable, given how barely precedented it is for any developed country ranked in the top five by GDP to have negative-yielding government bonds with maturities as long as 10 years. With customers still requiring positive returns from their investments, foreign asset management companies are paying close attention to how negative rates affect investors' allocations. About the only Japanese asset classes that currently offer potentially positive returns are equities and real estate. Foreign asset managers have a keen interest in the extent to which Japanese investors diversify into overseas assets, foreign asset managers' forte. One factor that militates against them doing so is that negative interest rates will not persist forever. Moreover, Japanese investors need courage to increase their foreign asset allocations while the yen is in an appreciation trend. Such circumstances call for asset management companies to offer enduringly viable solutions, unswayed by current conditions.

Expectations and apprehensions vis-à-vis bank market segment

Foreign asset management companies have high hopes of growing their businesses in the bank market segment. Faced with a dearth of prospective borrowers, banks have little choice but to rely more heavily on their securities portfolios to boost returns within acceptable risk limits. When diversifying their securities portfolios, banks are more likely to invest mainly in foreign bonds than in equities, given the latter's higher risk weights. Foreign bond investing is a core competency of many foreign asset management firms. When Japanese banks invest in foreign bonds, they will likely do so through foreign asset managers. Hence the CEOs' high hopes in the bank market segment.

Alongside such hopes, the CEOs also have doubts about their firms' prospects in the bank market segment. For example, the CEO of a foreign asset manager that has hosted a Japanese bank's employees as temporary trainees to help the bank upgrade its securities investment skillset admitted that he has no idea whether the trainee arrangement will lead to growth in his firm's AUM. Training clients' employees is an imposition for any asset management company. In some cases, it may also pose a risk of proprietary know-how being leaked to clients.

Another point raised by certain CEOs is that the regional bank market segment is harder to break into than other market segments in which asset managers market their services directly to clients (e.g., the pension fund segment). To succeed in the regional bank market segment, foreign asset managers must partner with Japanese financial institutions (e.g., megabanks, securities brokers) with strong customer connections. While regional banks will undoubtedly increase their fund holdings, particularly foreign fund holdings, many issues remain to be resolved for foreign asset management firms to build processes that will enable them to actually profit from growth in regional banks' foreign fund holdings.

Concerns and signs of change in investment trust business

Among the home-country CEOs of foreign asset managers active in the Japanese investment trust market, the biggest focal point was how retail investors' investment preferences will change going forward. For at least the past five years, the most popular funds in Japan have mostly been high-risk funds that take a variety of risks, including credit risk and currency risk, to provide high distribution yields. Foreign CEOs have been concerned that Japanese retail investors do not fully appreciate investment trusts' significance as a long-term wealth building vehicle. The rankings of top-selling funds have recently started to change.

For example, one new development is that some fund distributors have started offering discretionary investment management services in the form of so-called wrap accounts that hold portfolios comprising various funds that differ from those hitherto typically owned by retail investors[4]. Fund distributors are starting to independently select products for customers based on the customers' investment preferences. Their financial advisors are selecting a variety of products, depending on their skillsets and the type of input they receive from customers.

4) For example, one fund distributor offers a relatively low-risk portfolio with relatively large allocations to bond funds and passively managed funds. Others offer portfolios with outsized equity allocations or portfolios that include low-risk hedge funds.

However, with the funds offered in wrap accounts mostly managed by an asset manager affiliated with the fund distributor, foreign asset managers question how they can gain entry to the wrap account business. Low-cost investment products like ETFs will also likely become available in wrap accounts. Foreign asset managers face big challenges to cash in on changes in the rankings of fund products most popular among Japanese retail investors.

Another question is whether wrap accounts' current fee level is sustainable. The consensus among the CEOs with whom I met is that fund distributors and asset managers are able to charge their customers fees equivalent to 20-30% of the returns that their products deliver. Expected returns vary as a function of customers' investment preferences, making it difficult to specify a uniform level of expected returns, but most institutional investors in the world today expect to earn returns of 300-500 basis points above the inflation rate. Even if we assume 2% inflation, expected returns would be at most 5-7% in nominal terms. If fund distributors and asset managers were able to collectively charge their customers fees equivalent to 30% of the returns they can deliver to customers, their total fees (for both the distributor and asset manager) would be below 2% of AUM. This fee level differs somewhat from the current average fee level. Asset managers would thus be well advised to approach their fee levels from the standpoint of achieving stable long-term growth in customer assets.

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