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Using financial asset input-output tables to analyze retail investor trends

Nomura Research Institute, Ltd.

An analysis of household sector capital flows in FY04 reveals a decline in bank deposits offset by an increase in holdings of JGBs, investment trusts, and individual annuities. While this would seem to confirm a shift from savings to investment, households are actually opting away from risky investments, choosing instead to buy annuities and other low-risk products. We think this trend represents a business opportunity for financial institutions able to take on risk.

Financial asset input-output tables

NRI has compiled financial asset input-output tables since FY98 and just completed the FY04 edition. Compiled from the Bank of Japan's *Flow of Funds Accounts* and other sources, these tables provide a visual representation of inflows of household financial assets, currently valued at 1,400 trillion yen, into financial institutions. For instance, they show how household demand and time deposits flow into banks and the postal savings system. As a somewhat more complicated example, they show how household interests in corporate pension plans flow into the Employees' Pension Fund, tax-qualified pension plans, defined-benefit corporate pension plans, and so on, and how these funds are then entrusted to trust banks, life insurers, and investment advisors to be managed.

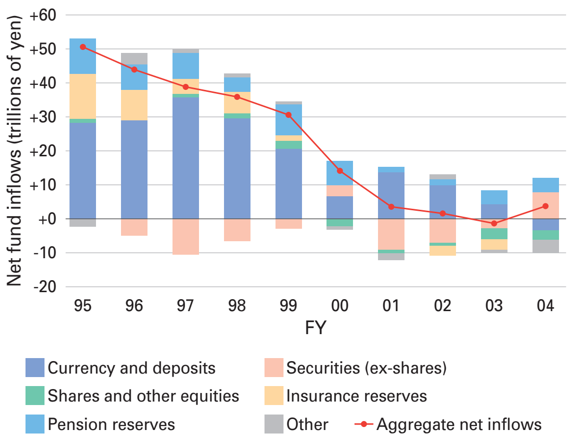
Currency and deposits accounted for 55% of all household financial assets in FY04, underscoring individuals' continued preference for safety. But an examination of changes in the balances—i.e., fund inflows and outflows—reveals subtle changes that are not evident in the end-of-period figures.

Fund flows portend turning point

Exhibit 1 illustrates household fund inflows and outflows over the last 10 years.[1)] The graph clearly reveals a number of changes in behavior in FY04.

For example, fund inflows to currency and deposits, which totaled nearly 30 trillion yen in FY95, dropped sharply over the last few years and actually turned negative in FY04. At the same time, there was a corresponding inflow of funds to securities (ex-shares) and to pension reserves. Securities (ex-shares) were characterized by net fund outflows in almost every year of the past decade, and inflows to pension reserves had been tapering off since FY01. In our view, the net inflows into both categories in FY04 portends a shift from savings to investment.

Exhibit 1. Household fund inflows and outflows



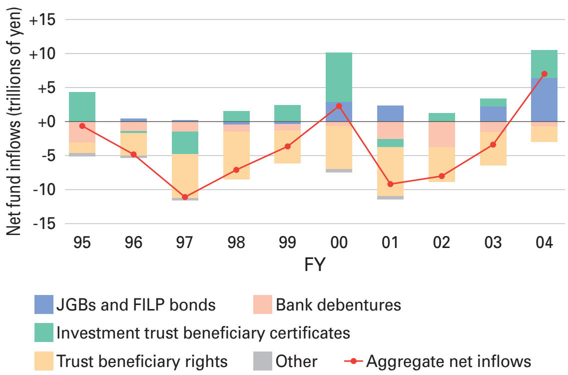
Source: NRI, based on Bank of Japan *Flow of Funds Accounts*

Households still reluctant to take on risk

In the rest of this report we take a closer look at FY04 inflows to securities (ex-shares) and pension reserves with the objective of determining the future potential of households as risk-takers.

Exhibit 2 provides a breakdown of net inflows to securities (ex-shares). JGBs and investment trusts registered net fund inflows in FY04. JGBs can be considered a low-risk product, while investment trusts are characterized by varying degrees of risk depending on fund type. We classified funds into five risk categories based on Fundmark risk classifications[2] and then calculated fund inflows and outflows for each category. The results are shown in Exhibit 3. Fund inflows were clearly concentrated in the intermediate risk category, RL3, with other categories experiencing negligible inflows or even net outflows. A majority of the funds in the RL3 category are pension-type investment trusts offering frequent dividend distributions.[3]

Exhibit 2. Fund inflows and outflows to securities (ex-shares)



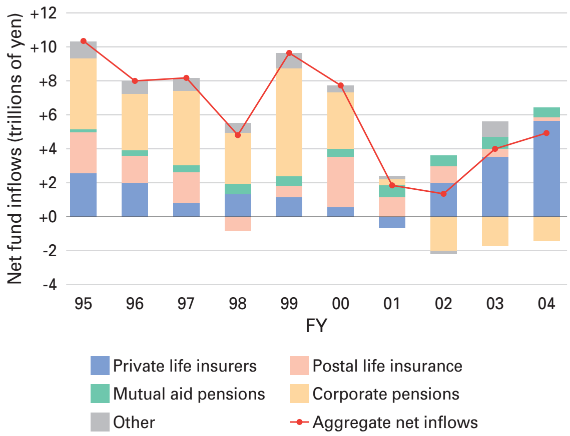
Source: NRI, based on Bank of Japan *Flow of Funds Accounts*

Exhibit 3. Fund inflows to investment trusts by risk classification

Risk category	RL1	RL2	RL3	RL4	RL5
Trillions of yen	-1.3	+0.0	+5.1	-0.1	+0.1

Exhibit 4 provides a breakdown of pension reserve inflows and outflows. FY04 was clearly dominated by net inflows to private life insurers—in other words, individual annuities. Individual annuities can be classified into fixed and variable annuities, and of the new policies purchased in FY04 the former outnumbered the latter by about two to one. Many of the variable annuities sold also feature a principal guarantee at the maturity date. In other words, households are opting for relatively low-risk products.

Exhibit 4. Fund inflows and outflows to pension reserves



Source: NRI, based on BOJ *Flow of Funds Accounts*

In summary, while households are moving away from savings deposits in search of higher yields, they are still reluctant to take on significant risk, tending instead towards low-risk products such as JGBs, pension-type investment trusts offering monthly distributions, and individual annuities.

Business opportunity for risk bearers

Another look at Exhibit 1 shows that fund inflows to households have fallen steadily as the population grows older. To the extent that significant new fund inflows cannot be expected, an increase in one asset category will require a decrease in another. The most likely scenario is for the 55% of household financial assets currently in currency and deposits to shift gradually into other products. But households are unlikely to select products with much higher risk profiles. And with growing concerns about the public pension system, we cannot rule out the possibility that Japanese households will *never* become risk bearers.

In this environment, there is likely to be a growing need for principal-guaranteed products, which can be delivered if financial institutions are willing to take on the risk that individual investors seek to avoid. We think institutions able to hedge or transfer such risk could retain a competitive advantage in such an environment.

Note

1) When pension funds elected to return the so-called voluntary portion of their assets to the government, this amount was treated as part of fund flows. Corporate pensions are included in the "pension reserves" item of Exhibit 1.

2) Funds are ranked from RL1 to RL5 in order of ascending risk. Products rated RL1 effectively ensure stability of principal and yield. RL2 indicates annualized risk of less than 5%; RL3, annualized risk of 5–15%; RL4, annualized risk of 15–30%; and RL5, annualized risk of more than 30%.

3) Funds making at least four distributions a year account for 99% of the assets in RL3 funds.

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