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Fund management outsourcing by investment trusts

Nomura Research Institute, Ltd.

As the fund business expands, more investment trust companies are hiring outside advisors to manage funds. For managers without a Japanese investment trust license, outsourcing offers a promising entry to the retail management business.

Investment trust companies on course to report record revenues in FY05

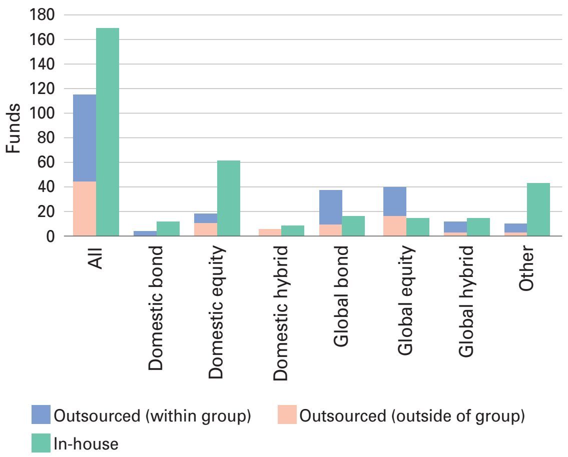
Assets in publicly offered open-end investment trusts have risen for 13 straight months starting in November 2004, in part because a rising market lifted the value of trust units. Investment trust assets totaled approximately 36 trillion yen at the end of November 2005 and were on course to set a new record. Benefiting from this environment, investment trust companies report that management fees are running at an annualized rate of 178 billion yen and are expected to eclipse the previous peak of 146 billion yen, recorded in FY00.[1)] The number of funds on offer also turned up in March 2005, reversing a gradual slide that began in May 2002. This turnaround reflects the expansion strategies adopted by many investment trust companies.

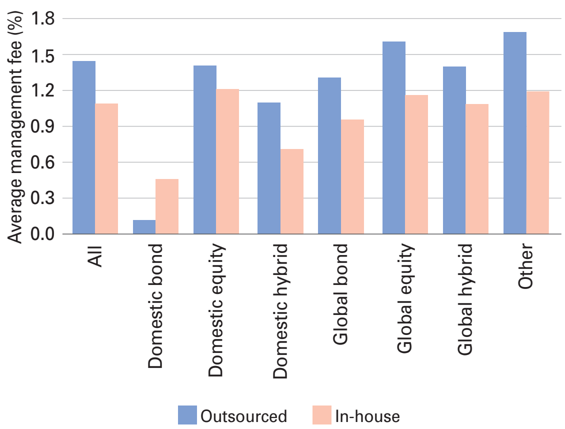
As the business expands, more investment trust companies are outsourcing fund management. Investment trust companies relegated at least some of fund management to outside advisors at 115, or about 40%, of the 285 open-end trusts set up in the two years through October 2005 (see left graph in Exhibit).[2)]

Fund management outsourcing market

At investment trusts, compensation for outside advisors is normally paid from the fund to the investment trust company, with a portion then remitted to the outside advisor. The advisor's fee is sometimes not even disclosed in the prospectus, making it difficult to ascertain the level of such fees. However, the average trust management fee differs by about 40bp for funds managed in-house and those for which management is outsourced (see right graph in Exhibit). As the fee received by the investment trust company itself tends to be lower for externally managed funds, it stands to reason that the fee paid to outside advisors most likely averages more than 40bp. At funds that provide such information, fees generally

Exhibit. Management outsourcing by fund category





Data as of end-October 2005.

fall within the range of 40–90bp. Given that 40% of outstanding investment trusts are now managed by outside advisors, even if we assume a low average fee of 40bp, this translates to annual revenues of 54.4 billion yen (= 34 trillion yen x 40% x 40bp), or about 30% of all fees paid to investment trust companies.

Fund management is generally outsourced in one of two ways: either another group firm manages the funds or an outside advisor is hired. An independent manager seeking to expand its business must focus on the second market. If we assume that outside advisors account for the same 40% of outstanding fund assets and charge an average fee of at least 40bp, the market would be worth about half of 54 billion yen, or some 20–30 billion yen.

Fund characteristics

Under what circumstances is fund management relegated to outside firms? A closer examination of fund characteristics reveals two types of needs: those of the investment trust companies that establish the funds and those of the outside advisors themselves.

When looking at the former, dividing funds by asset class facilitates the identification of fund characteristics. Among global equity funds, funds investing in high-yield stocks and stocks in emerging markets like China, India, and Eastern Europe—which have been especially popular—often employ outside advisors. Among global bond funds, those investing in high-yield bonds with relatively high credit risk tend to use outside advisors. While there is nothing particularly new about these assets, risk management increasingly requires sophisticated research capabilities. All of the so-called global hybrid funds that invest in foreign real estate investment trusts (REITs) employ outside advisors. High-yield bonds and REITs have seen strong demand in recent years as investors seek higher yields. Finally, in the domestic equity fund category, some of the SRI funds, an area said to require independent research capabilities, have turned to outside advisors.

In summary, relatively few Japanese management firms have substantial experience investing in assets requiring independent management experience. Many investment trust companies and fund distributors are therefore willing to pay outside advisors to help them develop products capable of satisfying increasingly diverse investor needs.

One need that outside advisors have is for so-called "shell funds." Here, the fund is managed by the outside advisor, and the investment trust company itself makes no investment decisions—in effect, it lends the legal "shell" of the investment trust to the advisor. This type of arrangement is currently used by some small- and mid-cap domestic equity funds managed by independent Japanese firms established relatively recently. Japan has a reputation for being a difficult place to set up a new investment trust company because of highs costs and a variety of other issues. In contrast, it is comparatively easy to set up an investment advisory firm. As such, we think more funds may take this route to gain access to the retail asset management market.

Retail asset management needs growing more complex

Two themes common to many of the funds outsourcing management are a focus on relatively new asset categories and proprietary investment techniques. This situation reflects the increasingly complex investment needs of individual investors in Japan. For management companies with their own investment styles, outsourcing opportunities are likely to grow.

Note

1) We estimated first-half management fees based on the average management fees paid to public, open-end investment trusts and actual assets under management in the first half of FY05. This amount was then doubled to obtain an estimate for the full fiscal year.

2) There are a number of ways in which fund management can be entrusted to an outside advisor. For example, the advisor may provide data and other advice to the investment trust company, which then makes the investment decisions on its own, or the advisor may handle everything from the selection of investments to the execution of trades. In this report, however, all such arrangements are grouped together under the blanket term of "management outsourcing."

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