lakyara

2007

Kyara, which means "precious" in ancient Japanese,
is an aromatic resin regarded as the highest quality of all agarwood.
"lakyara [la-kǽla]" aims to deliver the same quality as Kyara together with
NRI's endeavour for continuous excellence and innovation to provide
the most advanced and up-to-date information to our readers worldwide.

vol.21 (20.May.2007)

Signs of growth in sales of foreign ETFs

Nomura Research Institute, Ltd.

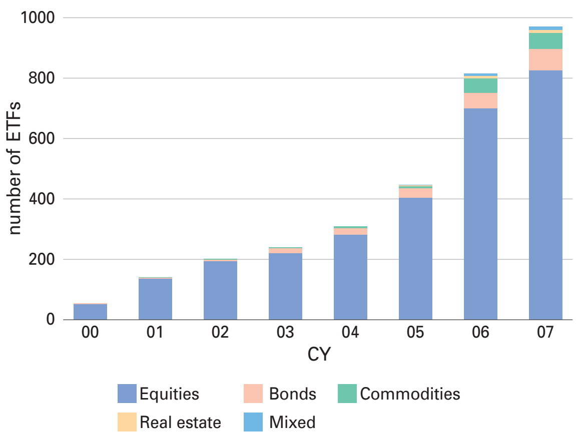
The enactment of the Financial Instruments and Exchange Law will likely lead to greater sales of foreign ETFs in Japan. As work on the necessary legal framework proceeds, financial institutions will need to prepare their sales organizations if they hope to increase sales.

ETFs offer investors wide range of asset classes

Exchange traded funds, or ETFs, are listed investment trusts whose price fluctuates in real time, like ordinary stocks. In Japan, they tend to be equated with equity investment trusts because all of the ETFs originated in Japan have been linked to stock indices. But other types of ETFs are available on global markets, and their number is increasing steadily (see Exhibits 1, 2[1]).

For investors, ETFs offer the benefits of low costs[2] and a market-average return. By combining domestic and foreign ETFs, local investors will be able to diversify across regions and asset classes, satisfying a broad range of needs. Japanese securities exchanges have also begun to sense the advantage of listing foreign ETFs and are moving ahead with preparations for their own ETF markets.[3] At present, however, only a handful of brokerages offer foreign ETFs to retail investors, and the number of products available remains limited.

Exhibit 1. Global ETFs by asset class



Source: Bloomberg

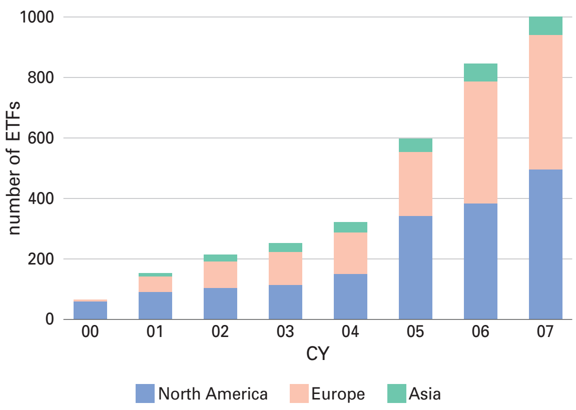
Selling foreign ETFs entails heavy administrative burden

There is a wide range of foreign ETFs that we think would appeal to Japanese investors. One reason why they are still sold in such limited quantities is the heavy administrative burden.

Under current Japanese regulations, companies issuing foreign ETFs must notify the Japanese authorities in writing. Continual disclosure is also required after the ETF is sold in the form of performance reports. Given the cost of translating the required information into Japanese and continuously updating it, it is not difficult to understand why only a small number of ETFs are considered for marketing in Japan.

Securities companies selling ETFs have two chief responsibilities: preparing a foreign securities prospectus[4] and issuing a performance report. The prospectus must include a number of items, and it is the sales firm's responsibility to collect and prepare the required information.

Exhibit 2. Global ETFs by region



Sales firms must issue performance reports for all of the investment trusts they sell, and not just ETFs. In the case of ordinary investment trusts, compensation for this work is included in the fund fees, but ETFs have no such fees. The costs incurred are therefore borne entirely by the sales firm. Even so, some securities companies have chosen to offer foreign ETFs as a means of differentiating themselves from competitors, although the number of companies able to engage in such strategic sales efforts is probably limited in number. A number of online brokerages allow customers to purchase foreign ETFs, but their offerings tend to overlap, leaving Japanese retail investors with access to only a handful of funds.

FIEL to relax rules for foreign ETFs

There are substantial barriers to the domestic sale of foreign ETFs for both management and sales firms. Judging from the draft version of the Financial Instruments and Exchange Law recently released by the Financial Services Agency, we think the new law will substantially lighten the administrative burden. Specifically, the FIEL will eliminate the obligation (1) to notify Japanese authorities when offering foreign ETFs and (2) to issue performance reports. Although the former will be limited to ETFs linked to equity indices, it still represents a major step forward for the market, in our view.

We think this represents a business opportunity for fund managers providing ETFs and should enable them to market their products more flexibly in Japan. While sales firms will still be required to supply prospectuses for foreign ETFs, not having to issue performance reports will substantially reduce the time and money they must spend on paperwork. We think it will encourage financial institutions to take a more active role in the offering and sales of foreign ETFs going forward.

Financial institutions must also prepare for ETF sales

The new Financial Instruments and Exchange Law will enhance the growth of foreign ETFs in Japan. But as with other investment products, financial institutions will need to demonstrate to retail investors the unique advantages of these funds.

First, there is the issue of investment information. Online brokerages are a popular sales channel for foreign ETFs because of their low sales commissions. Their customers have called for increases in the number of funds offered. But even if online brokerages were to aggressively expand their product offerings, we think it would be difficult to boost sales to the independent investors who are their main customers unless they can provide sufficient information for these individuals to make investment decisions. Enhancing the range of news and market information available for Asia and emerging markets tops the list of areas requiring further work. And once the need to submit performance reports is eliminated, we think sales firms will need to consider creating systems to collect information from the fund managers issuing the ETFs in order to maintain the flow of information to investors.

In face-to-face sales channels, greater information will need to be complemented with improved sales techniques. The FEIL will make it possible for banks to offer wrap account services. We think that foreign ETFs would be an easy way to achieve global diversification in such accounts. The practice of advice-driven sales has only just begun in Japan, and financial institutions will need to establish systems to support these new sales methods.

The regulatory authorities and securities exchanges have begun to establish a legal framework for the sale of foreign ETFs. Now it is time for financial institutions themselves to prepare their sales organizations in order to receive maximum benefit from the sale of these funds.

Note

1) Figures in Exhibits 1 and 2 are cumulative. In Exhibit 2, “Asia” includes Australia and New Zealand, “Europe” includes Africa, and “North America” includes Canada.

2) The Tokyo Stock Exchange (TSE) website indicates that the majority of traditional investment trusts have annual fees of at least 0.6%, whereas the corresponding figure for ETFs is just 0.1–0.2%.

3) The Osaka Stock Exchange revamped its listing rules in March to enable the sale of (1) ETFs linked to overseas equity indices and (2) ETFs linked to interest rates and the price of gold. The TSE, prompted by its tie-up with the NYSE, is considering sanctioning the listing of commodity ETFs. As a result, a gold ETF may be listed as early as this summer.

4) A document summarizing information about the issuing company and securities for investors; required when selling any foreign security in Japan, including foreign stocks.

Author's Profile

Kazumi Tabata

Researcher
Financial Technology and Market Research Department

E-mail : kyara@nri.co.jp

Inquiries to : Financial Technology and Market Research Department
Nomura Research Institute, Ltd.
Marunouchi Kitaguchi Bldg.
1-6-5 Marunouchi, Chiyoda-ku, Tokyo 100-0005, Japan
E-mail : kyara@nri.co.jp

http://www.nri.co.jp/english/opinion/lakyara