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Cost transparency can improve investment trust business's efficiency

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Japanese investment trusts are, on average, small in terms of assets, giving them substantial scope for improvement in efficiency. With new funds likely to continue to proliferate, investment trust sponsors should apportion fixed expenses on a fund-by-fund basis to elucidate funds' stand-alone profitability. This should expedite early redemption or merger of investment trusts that have experienced large decreases in assets, thereby improving the investment trusts business's overall efficiency.

Japanese investment trusts tend to be small asset-wise

Between 2004 and 2007, Japanese investment trusts' share of household financial assets jumped from below 3% to 4.7% by virtue of diversification of investment trust offerings and augmentation of sales channels. Internationally, however, Japan lags behind the US and UK by a factor of eight and three, respectively, in terms of securities investment trust (mutual fund) holdings per capita. The Japanese investment trust market is therefore seen as having substantial growth potential.

To promote realization of this potential, the Investment Trusts Association of Japan (ITAJ) has convened panels of outside experts. In March 2008, it published a report[1)] on the current state of Japanese investment trusts, challenges facing the investment trust industry, proposed responses to these challenges, and a vision of the industry's future. According to the report's analysis, Japanese investment trusts are on average one-seventh the size of US mutual funds and one-half the size of UK investment trusts in terms of net assets (see table below).

In addition to asset management functions (e.g., stock selection, trading), the investment trust business entails substantial fixed costs unrelated to the amount of assets under management (AUM), including the cost of performance analysis, risk management, daily NAV calculation, and prospectus and management report preparation and distribution to investors and distributors' branch offices throughout Japan. Given such fixed expenses, small average fund size (i.e., AUM per fund) leads to low efficiency for the investment trust business in aggregate.

According to industry insiders, the conventional wisdom is that investment trusts must have AUM of at least ¥3bn to be sufficiently profitable on a stand-alone basis. Of investment trusts in existence for at least three years, those with less than ¥3bn in AUM currently number about 900, equivalent to 30% of all investment trusts[2)]. This implies that the investment trust industry has substantial potential for improvement in efficiency.

Exhibit. Japanese investment trusts are small in terms of net assets per fund (as of April 2008)

	IT/MF net assets (local currency) (trn)	IT/MF net assets (yen equivalent) (¥trn)	Population (millions)	IT/MF net assets per capita (yen equivalent) (¥mn)	Number of funds	Net assets per fund (yen equivalent) (¥bn)
US	$12.06	1,266	302	4.20	8,052	157.3
UK	£0.45	92	61	1.52	2,224	41.5
Japan	¥73.78	74	128	0.58	3,140	23.5

Note: (1) IT: investment trust, MF: mutual fund
(2) Includes only publicly offered securities investment trusts (mutual funds), not private-placement funds, REITs, ETFs, etc.
(3) Funds with multiple classes of shares (e.g., front-end load, back-end load) were counted as a single fund.
(4) Dollar and pound sterling values were respectively converted to yen at ¥105/$1 and ¥205/£1.
Source: Japan: Investment Trusts Association, Japan; US: Investment Company Institute; UK: Investment Management Association; and national population statistics

Factors behind Japanese investment trusts' small size

The aforementioned ITAJ report attributes Japanese investment trusts' small average size to a tendency for AUM to peak shortly after fund inception and subsequently diminish over time due to a lack of new inflows. Fund size (AUM) is consequently said to generally be an inverse function of fund age.

Such a pattern has long existed in Japan. It has been blamed on the investment trust industry's tendency to newly establish trendy, easily marketable funds and encourage investors to switch from older funds into new ones. In response to such criticism, some investment trust sponsors have been establishing and developing flagship funds with a long-term-growth mindset, modeled after US mutual funds with long track records of AUM growth. Nonetheless, the reality remains that many funds' AUM dwindle over time.

Despite this trend, investment trust sponsors still continue to establish new funds targeting diverse investment needs. For example, among domestically marketed investment trusts, last year's top 10 by net asset inflows were all foreign bond, foreign equity, or foreign hybrid funds newly established since 2005. If the Japanese equity market continues to underperform its foreign counterparts and domestic interest rates remain ultra-low, investment trusts that invest in foreign assets are unlikely to wane in popularity. Indeed, investment trust sponsors are likely to launch various new foreign funds (e.g., regional or sector funds). Some say that promoting competition among asset management companies, including competition from new entrants such as direct marketers, is necessary to induce them to step up efforts to develop products and upgrade asset management capabilities. An increased influx of new entrants would be another factor conducive to proliferation of new funds.

Elucidation of stand-alone profitability as a catalyst for change

Even in the US, an advanced country in terms of mutual funds, new funds are established at a brisk pace. On an annual basis, however, the number of new funds tends to be roughly offset by fund liquidations and mergers. The total number of US mutual funds consequently tends to remain fairly constant. We largely attribute this pattern to US mutual funds sponsors' practice of charging funds' actual expenses against fund assets and disclosing itemized expenses (e.g., management fees, accounting expenses, custody expenses, prospectus printing costs, auditor fees) on a fund-by-fund basis. Investors are thus expressly informed of the heavy fixed-cost burden of funds with little AUM. In the case of funds that have little AUM because they are relatively new, asset management companies typically waive their management fees and/or explicitly bear other administrative costs to avoid saddling investors with excessively heavy fixed costs. However, funds that have experienced a progressive decline in AUM and have little prospect of future AUM growth are reportedly liquidated or merged into other funds in the interest of economic rationality.

In Japan, by contrast, investment trust sponsors typically charge fees as a fixed percentage of a fund's net assets. Consequently, if a fund has little AUM (i.e., below the breakeven-profitability threshold), its expenses are effectively borne by its sponsor (e.g., investment trust company, trust bank), albeit generally unbeknownst to fund investors. Moreover, the extent to which investment trust sponsors itemize and apportion fixed expenses on a fund-by-fund basis for managerial accounting purposes is questionable.

A small minority of investment trusts charge actual expenses (e.g., auditing fees, prospectus printing costs) as a miscellaneous fee[3], but they do not disclose an itemized breakdown. The details of such expenses consequently tend to be opaque to investors. Additionally, many fixed expenses (e.g., daily NAV calculation cost) continue to be paid out of general investment trust fees. In sum, investment trust sponsors undeniably appear to be lax in apportioning expenses.

Such a lack of transparency in terms of funds' stand-alone profitability may be one reason that average fund size is small in Japan and funds remain in existence long after experiencing major declines in AUM.

Historically, investment trusts could be prematurely terminated only by early redemption, but by virtue of a recent legislative amendment, they can now be merged[4)]. The industry has recently been formulating specific procedures for fund mergers. Although both early redemptions and mergers are time-consuming and costly, they are effective means to boost the investment trust business's overall efficiency. For investment trust sponsors to make appropriate decisions regarding early redemptions and mergers, it is important for their management to collectively adopt a scrutinizing mindset by apportioning fixed expenses to individual funds to ascertain the funds' stand-alone profitability, at least for managerial accounting purposes.

Note

1) The report discussed a broad range of issues (e.g., challenges facing asset management companies, REITs, investment trust distributors, disclosure, valuation services, promotional/educational and PR activities, commissions and management fees, maintenance of self-discipline in the investment trust industry, development of other infrastructure) and proposed solutions to them.

2) Per Morningstar data as of July 2008.

3) But because such fees are capped at a fixed percentage of assets (e.g., 5bps, 10bps), the investment trust sponsor still ends up bearing a sizable share of the expenses of investment trusts with little AUM.

4) For more details, see "Benefits of investment trust mergers" in the January 2007 edition of this publication (http://www.nri.co.jp/english/opinion/lakyara/2007/pdf/lkr200716.pdf).

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