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Asset management business faces challenging times

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Asset management companies' FY08 revenues apparently fell some 20% from FY07. With the asset management industry undergoing consolidation led by foreign financial institutions, Japanese asset management companies face the challenge of offering solutions to clients while tightening cost controls.

In FY08, specialized asset management companies[1) apparently saw their revenues decline about 20% from FY07. Over the preceding five years, their revenues had roughly tripled while their aggregate operating margin rose above 30%. After years of nearly uninterrupted growth, the Japanese asset management business has reached a major turning point. Having rapidly increased headcounts in parallel with business expansion, the industry today can be likened to an army with overstretched supply lines, under bombardment. Below we look at the asset management business's prospects amid such an environment.

Asset management business in FY08

The steep drop in asset management companies' revenues in FY08 was mainly attributable to a large decline in assets under management (AUM). At end-March 2009, specialized asset management companies' AUM was down roughly ¥50 trillion (approximately 20%) from a year earlier. This decrease was predominantly due to declines in assets' market values. Investment trusts and investment advisers had both enjoyed continuous net inflows of funds from investors over the five years through September 2007. From October 2007, however, the inflows slowed to a trickle, a trend that continued through FY08. Public investment trusts, the most popular of which predominantly invest in foreign assets, were particularly hard-hit by sharp declines in AUM and revenues, largely as a result of yen appreciation. Their revenues were down over 25% in FY08. Some asset management companies that mainly manage investment trusts suffered revenue declines in excess of 40%.

With little prospect of fresh inflows from investors amid continued turmoil in capital markets, many Japanese asset management companies have resorted to cost-control measures. Some foreign asset management firms are cutting advertising expenditures and laying off investment trust sales support staff. Even among Japanese asset management companies, some are endeavoring to reduce expenses roughly 20% to pre-2007 levels to roll back rapid growth in expenses dating back to FY07. Cost-cutting targets appear to vary in magnitude among companies depending on whether their minimum management revenues are currently sufficient to cover costs, whether they have enough capital to remain in business despite incurring losses, and how much cost-cutting pressure they are under from their parent companies (or shareholders).

FY09 will be a year of consolidation

FY09 will very likely be another year of consolidation among foreign financial institutions. Such consolidation could conceivably involve divestitures of asset management subsidiaries. Among the foreign asset management companies with a presence in Japan, several will undoubtedly undergo drastic capital restructuring. From an investor's perspective, a change of ownership could adversely affect corporate culture or investment processes.

Consolidation among foreign competitors will likely have an impact on Japanese asset management companies also. Some Japanese asset management companies, mainly in the investment trust business, outsource management of foreign-currency assets to foreign asset managers. In such cases, a change in the foreign firm's portfolio management personnel would necessitate a reassessment of the outsourcing arrangement. Another conceivable scenario is mergers of asset management subsidiaries between Japanese megabanks and foreign financial institutions that have received capital injections from the megabanks.

The age-old question of where asset management fits within the finance business also may attract renewed interest. Globally, the trend in recent years has been toward divestiture of asset management operations by financial institutions other than life insurers. From the 1990s, financial groups embraced the idea that their business portfolios should include an asset management business to contribute to overall revenues and profits and offer customers high-value-added products adroitly developed through collaboration between sales and production (asset management) staffs. However, this strategy was undermined by conflicts of interest in the form of sales staff preferentially promoting in-house funds. Financial groups consequently began spinning off asset management subsidiaries in a trend that accelerated from 2005 in particular.

In Japan, by contrast, few financial institutions have divested asset management subsidiaries. Nonetheless, conflict-of-interest problems should be an important management concern in Japan also. At trust banks, for example, conflicts of interest could arise between the pension asset management department and the loan department that provides financing to pension plans' corporate sponsors[2]. Such conflicts are no small problem.

Aside from conflicts of interest, megabanks have another problem. Namely, they typically have multiple asset management subsidiaries and will likely have to consolidate their product lines. In Japan, asset management does not yet generate as much revenue as in the US or Europe. In the eyes of Japanese financial institutions' executives, divestiture of asset management subsidiaries may not be considered important enough to warrant management attention, but given the potential for conflicts of interest, megabanks will eventually have to reassess their asset management subsidiaries' role within their groups.

Proposing solutions to customers will be key in FY09

While the cost-cutting currently underway is important for ensuring asset management companies' survival, it could adversely affect customer service and is therefore not entirely welcome from the standpoint of investors and other stakeholders. In fact, investment trust distributors are apparently highly displeased with asset management companies that have substantially cut back on sales support staff.

Meanwhile, certain asset management companies see the current downturn as a golden opportunity to strategically strengthen their foundations. For example, one foreign asset management company has set a management target of increasing its personnel expenses, an asset management company's biggest expense item, to recruit high-caliber talent. This company has been recommending infrastructure and private equity investments, mainly to pension fund clients. With many hedge funds now dissolving, it reportedly has recently seen steady growth in accounts. With pension fund clients, there is typically a long delay between the initial recommendation of a product and the client's purchase of it. Sales activities consequently tend to produce results with a considerable lag. Additionally, many pension funds are desperately striving to ensure their continued viability in the face of precipitous drops in their funded ratios and prospective adoption of International Financial Reporting Standards. Amid such an adverse environment, clients are scrutinizing asset management companies' ability to provide reliable support and advice on an ongoing basis. How asset management companies respond to these challenging times may largely determine their future success or failure.

Retail investors also have been hard-hit by the financial crisis. Developing investment products able to provide stable income distributions with as little price volatility as possible should be one of asset management companies' missions. It is incumbent on the management of Japanese asset management companies to successfully navigate today's extremely challenging environment by supporting clients and formulating product strategies[3] conducive to long-term differentiation while continuing to cut costs to maintain operational viability.

Note

1) Excludes trust banks, life insurers, and asset management companies specializing in real estate.

2) Conceivable conflicts include a trust bank that lowers its pension fund management fee to earn interest income in its lending operations or, conversely, a pension fund that wants to redeem its assets managed by a trust bank due to poor investment performance but cannot do so because its corporate sponsor is dependent on the trust bank for financing.

3) With returns declining, cost pressures from clients are likely to intensify. If asset management companies fail to develop higher value-added products to compete with ETFs and other products that provide low-cost beta exposure to the equity market, further declines in their management fee income may be inevitable.

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