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Key to renewed growth in asset management business is an Asian focus

Nomura Research Institute, Ltd.

With asset management companies still beset by an adverse operating environment and Japanese equities losing relative appeal, the Japanese asset management industry seems mired in stagnation. Japanese asset management companies must pursue opportunities for renewed growth by reorienting their business models and reevaluating Japanese companies from the standpoint of dynamically growing Asia, while also applying know-how cultivated in institutional businesses to the investment trust business.

Asset management business environment has yet to recover

In the year to March 31, 2010, Japanese asset management companies' assets under management (AUM) grew an estimated nearly 10% by virtue of recovery in global equity markets. However, the Japanese asset management industry saw little if any new inflows from pension funds, other institutional investors, or retail investors. The asset management industry has yet to embark on recovery.

Although asset management companies ended fiscal 2009 with more AUM than a year earlier, their yearly average AUM was lower in fiscal 2009 than in fiscal 2008, reflecting a large decline in AUM amid the market meltdown ensuing from Lehman Brothers' bankruptcy. As a result, their asset management revenues, which are linked to average AUM, apparently decreased year on year in fiscal 2009. The asset management industry has not yet emerged from its post-crisis slump[1)].

Among publicly offered investment trusts, high-yield bond funds that offer a foreign currency overlay with a choice of high-yielding currencies such as the Brazilian real sold briskly in the securities brokerage channel in fiscal 2009. Investment trust distributors' sales commissions surpassed ¥500 billion, recovering to nearly 80% of their peak level. The flipside of this heavy sales volume is that many investors have recently been redeeming investment trust units within a year of purchase. The average holding period of investment trust units sold through the brokerage channel has fallen below two years. Despite a spike in investment trust sales, the AUM derived from such sales subsequently fell rapidly, preventing average AUM from stabilizing. Asset management revenues consequently did not grow much.

Medium-term management challenges

In addition to such recent developments, Japanese asset management companies face two serious medium-term challenges. First, the business of managing money for institutional investors, mainly pension funds, no longer has much growth potential. Second, Japanese equities' investment appeal is diminishing.

First, Japanese pension funds have little prospect of future growth in AUM. For the past five years, the Government Pension Investment Fund's self-managed AUM have on average increased more than ¥10 trillion annually, but this growth ended in fiscal 2008, when the GPIF finished redeeming all assets previously on deposit with the Fiscal Loan Fund. Going forward, the GPIF's self-managed AUM is projected to gradually decrease. Mutual aid associations likewise are projected to experience net outflows of assets as Japan's population progressively ages. The outlook for corporate pensions is partly dependent on the extent to which international accounting standards are adopted, but as companies' pension risk rises, corporate pension plans could be downsized or derisked through increased diversification entailing reduction of equity allocations. With pension funds' AUM unlikely to grow much and their equity allocations likely to decrease, asset management revenues also are at risk of declining (whether they do decline will depend on the asset classes into which pension funds diversify).

Another vexing problem for asset management companies in Japan, with its limited prospects of rapid economic growth, is that Japanese equities are losing appeal relative to other countries' equity markets. Historically, Japanese asset management companies have developed investment products that predominantly revolve around Japanese equities and Japanese bonds. As economic globalization progresses, differentiation of equities by company nationality is becoming less meaningful. Institutional investors are increasingly awarding mandates for global equities as a unified asset class, with no distinction between Japanese and foreign equities. Japanese equities' share of global equity market capitalization has already fallen below 10%. There are concerns that Japanese pension funds may reduce Japanese equities' weighting within their equity allocations.

Rethinking the asset management business from an Asian perspective

For asset management companies that serve institutional investors, one potential way to pursue renewed growth is to deemphasize Japan and rebuild their Japanese asset management businesses with a broad Asian orientation. Emerging market equities' share of global equity market capitalization is projected to increase in proportion to the GDP growth rate differential between emerging market economies and the rest of the world. With Asian equities accounting for nearly 60% of the "global emerging market equity" asset class, strong expertise in Asian equities should confer a major competitive advantage. Japanese asset management companies have ample opportunity to gain an advantage over competitors, not in relatively highly efficient US and European equity markets but in Asian equity markets, which are considered relatively inefficient and are also geographically near Japan. Asian equity is currently an asset class in which no asset management companies stand out as exceptional performers. The pecking order among asset management companies in Asian equity markets will likely be determined by the extent to which companies henceforth develop local asset management capabilities. If Japanese asset management companies can adequately shift the focus of their front-office operations from Japan to Asia, they should improve their prospects of capturing foreign clients.

Additionally, despite the Japanese equity market's limited growth prospects as noted above, many individual Japanese companies are highly profitable. Japanese companies' elemental manufacturing technologies are still highly acclaimed overseas. Japanese asset management companies thus have ample potential to deliver high returns to clients through bottom-up stockpicking. Asset management companies should seriously consider differentiating themselves from competitors by improving their ability to evaluate Japanese companies that are taking advantage of their close proximity to rapidly growing Asian economies.

Meanwhile, asset management companies need to also revamp their business strategies in the Japanese investment trust market, which still has substantial growth potential from the standpoint of retail investors' untapped pool of investable financial assets. Over the past five years, Japanese asset management companies have predominantly focused their new product development efforts on high-yield and frequent-distribution investment trusts targeted at retirees seeking to supplement their public pension benefits. Going forward, asset management companies must also develop investment trust products aimed at enabling working-age investors to build wealth over the long term. It is important for asset management companies to cultivate long-selling products suitable for long-term investors by developing products that capitalize on the expertise they have acquired serving institutional investors. One such product might be stable-growth funds that pursue diversified investment in many sources of return. Such funds have recently been gaining popularity among major US and European pension funds.

If retail investors embrace diversified investment in a broad range of sources of return, asset management companies would have to offer a diverse lineup of products with as many sources of return as possible. It would not be feasible for any single asset management company to offer a complete lineup of such products. To meet retail investors' needs, asset management companies would likely have to add passively managed products, including ETFs, to their product lineups. Unless Japanese investment trust distributors shift away from their existing business model dependent on sales commissions, major growth in low-commission products' AUM may be a low-probability scenario. Nonetheless, diversified investment is essential to household wealth-building. The ability to structure products with broad capital market coverage will accordingly increase in importance. Asset management companies will eventually have to diversify their product offerings, even at the risk of reduced asset management fees.

The Japanese asset management industry seems to be deeply mired in stagnation as its previous growth prospects have dried up. Yet it still has substantial opportunity to dynamically grow by taking advantage of its geographic proximity to Asia and capitalizing on the asset management know-how it has amassed in Japanese asset classes on behalf of institutional investor clients.

Note

1) Even on a global-ex-Japan basis, the asset management industry's asset management revenues are estimated to have declined in 2009 relative to 2008.

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