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Growth of the asset management business in Asia

Nomura Research Institute, Ltd.

Summary

For asset management companies, Asia is a very strategically important region as a home to both investors and assets in which to invest. Japanese asset management companies' future success at expanding globally depends on the extent to which they can become highly competitive as Asian asset managers.

Globalization of the asset management business and Asia

This paper discusses the current state of the asset management business in Asia, business opportunities and barriers to entry for foreign asset management companies, and the asset management capabilities required for Japanese asset management companies to achieve growth in non-Japan Asia[1)].

Globalization of the asset management business

Asset management is a business that channels investors' funds into assets via investment products. Globalization of the asset management business accordingly has two dimensions: investors and assets. That is, asset management companies can globalize by providing investment products to foreign investors and/or by offering foreign-asset investment products.

Exhibit 1 is a conceptual diagram of geographic expansion of asset management companies' business, with investors represented on the vertical axis and investment assets represented on the horizontal axis. Typically, local (i.e., locally owned) asset management companies in each region mainly provide local-asset investment products to local investors. Investors everywhere tend to invest more of their wealth in local assets denominated in their home currency than in foreign assets[2)]. Consequently, even if local asset management companies' portfolio management capabilities

Exhibit 1. Asset management companies' geographic coverage of investors and assets (conceptual diagram)

Investors \ Assets		Developed Countries			Emerging Markets	
			Asia			
		North America, Western Europe	Japan	Singapore, Hong Kong	China, Korea, Taiwan, etc.	. . .
North America, Western Europe		Local AM companies		Global AM companies		
Asia	Japan	← A	Local (Japanese) AM companies	B →		
	Singapore, Hong Kong			Local AM companies		
	China, Korea, Taiwan, etc.				Local AM companies	
⋮						Local AM companies

Note: Global asset management companies' scope of operations covers the entire grid above.
Source: NRI

are limited to local assets, they generally do not miss out on business opportunities as a result. Indeed, many local asset management companies enjoy a competitive advantage by virtue of favorable access to local investors established through capital tie-ups or other relationships with distributors.

In contrast, some major US- or European-based asset management companies conduct business globally, with access to both foreign investors and foreign assets. These companies have the capability to provide investors anywhere in the world with investment products representing a worldwide array of assets. In comparison to local asset management companies, global asset management companies' strength is their ability to provide investment products that allow investors in the regions in which they operate to invest in foreign assets. Global asset management companies are often at a disadvantage to local asset management companies in terms of meeting the needs of local investors with home country bias, but as local investors in a given geographic market gain sophistication and internationally diversify their investment portfolios, global asset management companies tend to steadily gain prominence in that market.

The above is a basic picture of the global asset management business and it holds true for Japan also. Japanese asset management companies have established domestic marketing channels and expanded their businesses mainly by providing domestic equity and bond investment products to Japanese investors. The difference between Japan and other regions is that demand from domestic investors for foreign assets has been growing notably in recent years as a result of a persistently adverse domestic investment environment. In response, Japanese asset management companies have adopted a strategy of specializing in marketing and product development while effectively outsourcing portfolio management by hiring global asset managers as subadvisors (Arrow A in Exhibit 1). Currently, some 45% of management fees collected by publicly offered mutual funds sold in Japan are paid to external subadvisors[3]. Additionally, Japanese asset management companies are increasingly utilizing subadvisors for foreign-asset investment products offered to pension funds also.

Asia's growing prominence

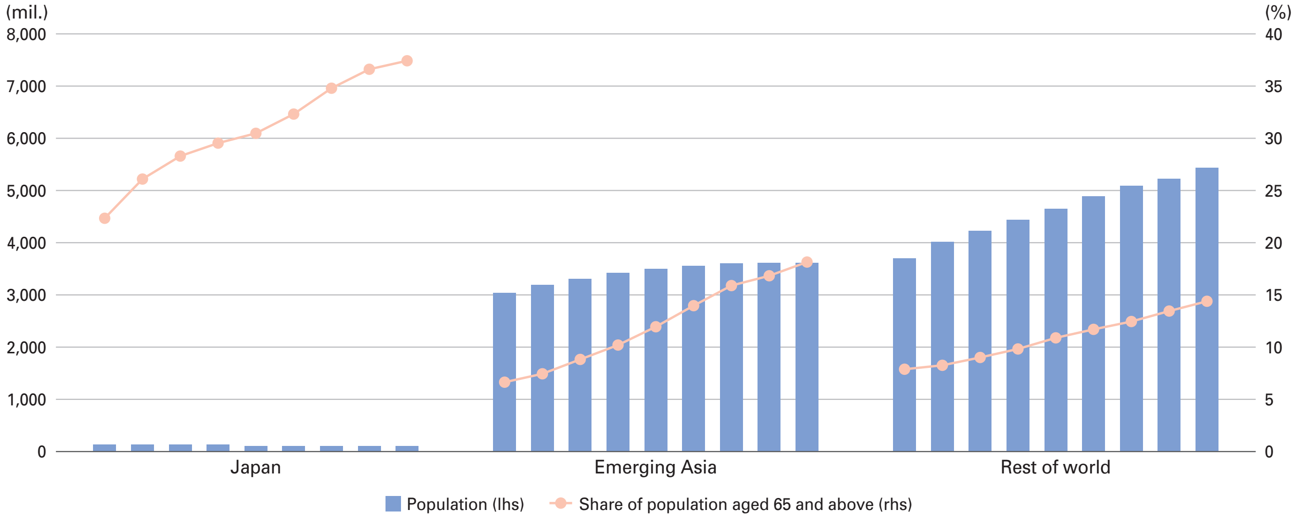
Among the regions in Exhibit 1, Asia ex Japan (AEJ) is the most dynamically growing region in the world in terms of both investment funding and assets in which to invest.

Major AEJ countries' growing prominence is evident from a couple of basic metrics. First, major AEJ countries' population is projected to continue growing, albeit at a gradually diminishing rate. At the same time, the percentage of the population aged 65 and above is projected to increase faster in AEJ than elsewhere in the world ex Japan (Exhibit 2). This implies accumulation of financial assets and a growing need for post-retirement income security through pension funds and individual efforts to accumulate savings.

In terms of GDP, AEJ's share of global GDP is projected to grow to approximately 20% over the five years to 2015 (Exhibit 3). At that point, AEJ would be at approximate parity with North America and Europe in terms of GDP. In this respect, AEJ stands in stark contrast to Japan, whose share of global GDP has been steadily declining since peaking in the vicinity of 20% in the mid-1990s. AEJ should provide markets with many investment opportunities through wide-ranging equity and debt issuance driven by corporate and sovereign funding needs.

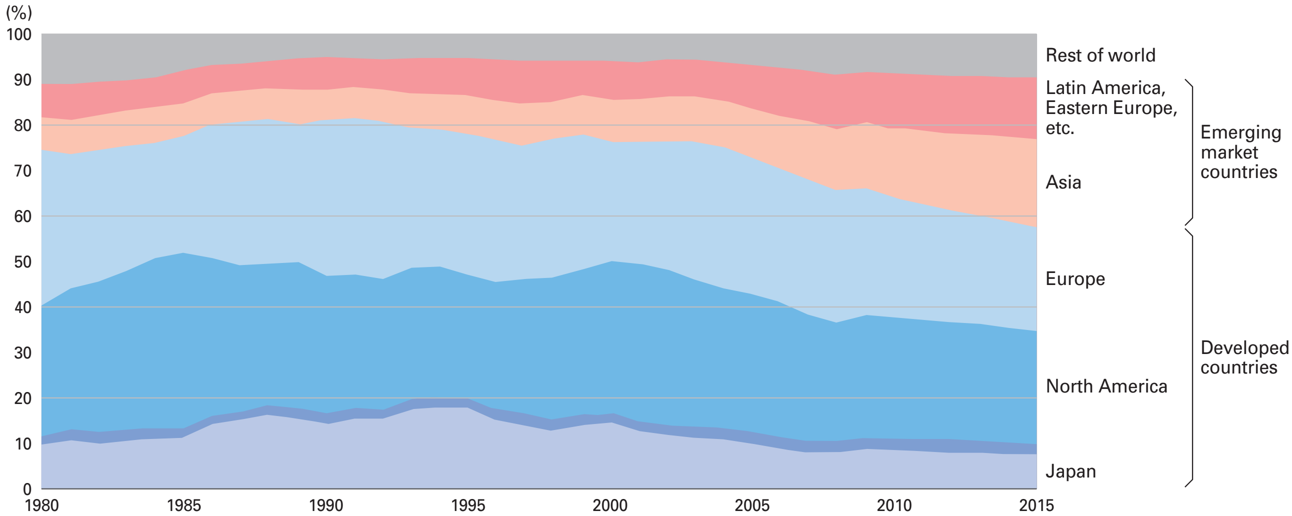
Asia's emergence has the potential to dramatically change the global asset management business's competitive landscape. Following is an overview of the Asian asset management business in terms of investors and assets in which to invest.

Exhibit 2. Comparison of population and elderly population share by region



Note: The above data are forecasts for 2010 and every subsequent fifth year through 2050. Emerging Asia is defined based on MSCI-constituent countries as of April 2010. "Rest of world" data are global data ex Japan, Singapore, Hong Kong, and Emerging Asia.
Source: UN Population Prospects

Exhibit 3. Global GDP broken down by region



Note: The above data are shares of nominal GDP based on current US-dollar-equivalent prices. Country classifications are based on MSCI-constituent countries as of April 2010.
Source: IMF World Economic Outlook: April 2010

Overview of Asian asset management market and business environment

This section briefly summarizes the business environment in Asian retail and institutional investment markets. The two markets differ vastly in terms of investment needs, largely reflecting differences in investor sophistication. They also differ substantially in terms of the investment products and organizational capabilities required of asset management companies. The two markets consequently have very different lineups of major players.

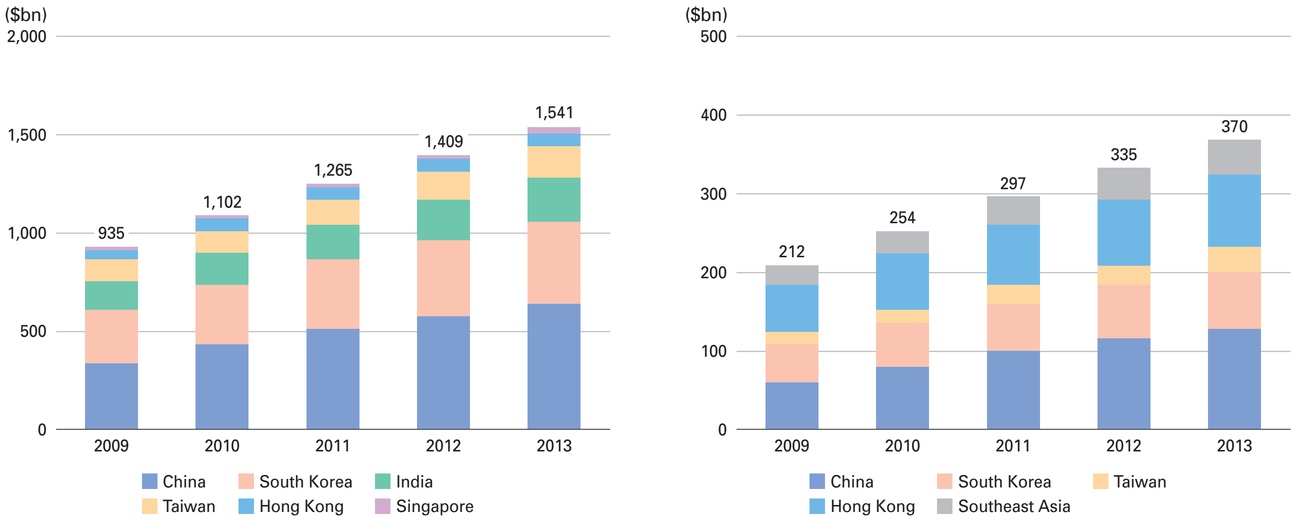
Retail market

The leftward graph in Exhibit 4 presents a forecast of growth in mutual fund assets-under-management (AUM) in AEJ countries. In 2009, mutual fund AUM in major AEJ countries totaled approximately US$940 billion. Among individual Asian countries, Japan is the largest mutual fund market with some US$520 billion in AUM, but the rest of Asia in aggregate is already a bigger mutual fund market than Japan. Additionally, including both market factors (growth in assets' market value) and customer factors (net fund inflows), the AEJ mutual fund market is projected to grow at a compound annual rate of 13% through 2013.

AEJ retail investors are often said to have a strong home country bias. Their home country bias reflects a lack of motivation to invest in foreign assets in light of an optimistic outlook for their home countries' economic growth rates and exchange rate trends[4]. There is consequently not much demand from AEJ retail investors for investment products that provide access to foreign assets, a market segment in which global asset management companies have a competitive advantage.

Additionally, to operate a fund management business in AEJ,

Exhibit 4. Projected growth in AEJ mutual fund market (left graph) and pension market (right graph) in terms of assets



Note: In billions of US dollars as of each calendar year-end. Data plotted in the rightward graph are addressable assets, not assets actually managed by outside managers. In the rightward graph, Southeast Asia includes Singapore, Malaysia, Thailand, Indonesia, etc.
Source: NRI, based on Cerulli Associates data.

Exhibit 5. Top asset management companies by AUM in the AEJ mutual fund market

Rank	AM company	Domicile/ownership	AUM (in US$bn)
1	Mirae Asset	Korea	39.3
2	China AMC	China	36.1
3	Reliance Capital	India	25.1
4	Prudential Plc	Foreign-owned	24.8
5	Bosera	China	21.4
6	HDFC	India JV	20.8
7	E Fund	China	20.3
8	Harvest	China JV	19.9
9	ICICI Prudential	India JV	17.2
10	China Southern	China	16.9
11	UTI	India	16.3
12	Shinhan BNP Paribas	Korea JV	16.1
13	JP Morgan	Foreign-owned	16.0
15	GF Fund	China	14.3
15	Birla Sun Life	India	13.9

Note: Rankings are current as of October 2009.
Source: Strategic Insight SimFund GL

asset management companies must have a sizable local staff for two reasons. First, banks and other mutual fund distributors have strong bargaining power. Asset management companies must build relationships and secure distribution channels by intensively conducting marketing activities and providing various forms of support to distributors in the local language. Second, regulations regarding matters such as fund accounting and disclosures differ between countries. Asset management companies consequently need to conduct back-office operations locally. These requirements are similar to the barriers to entry that foreign asset management companies face when branching into the Japanese market.

For such reasons, foreign asset management companies tend to have difficulty gaining a competitive advantage in AEJ retail markets. Even if they set up shop locally, it typically takes a long time to cultivate distribution channels and ultimately achieve profitability. In fact, the top-15 asset management companies by mutual fund AUM are mostly local companies interspersed with a few foreign-owned companies and local-foreign JVs (Exhibit 5).

Institutional market

The rightward graph in Exhibit 4 plots projected growth in Asian countries' pension assets addressable by external asset managers[5]. In 2009, these addressable pension assets were estimated at US$210 billion. In Japan, the Government Pension Investment Fund (GPIF) and other public pension funds' externally managed assets and corporate pension plan assets totaled roughly US$200 billion. In Japan's case, these assets are actually externally managed at present. The Japanese total is consequently not directly comparable with AEJ countries' estimated addressable pension assets. In terms of potential, however, AEJ is already roughly on a par with Japan as a pension asset management market. The AEJ pension market is projected to grow at a compound annual rate of 15% through 2013, in contrast to the Japanese pension market, which has already reached maturity.

In addition to pension funds, another major class of institutional investor in AEJ is sovereign wealth funds (SWFs). Of Asian SWFs' AUM, an estimated US$300 billion[6] was externally managed as of 2009.

These institutional investors are universally regarded as highly sophisticated. Most notably, they have in-house teams that manage traditional assets in their respective home countries or regions and reportedly seek to maintain or upgrade their in-house asset management capabilities through such means as dispatching personnel for training at external asset management companies and setting employee compensation at levels on a par with private asset management companies. Public pension funds, however, seem to be strongly inclined to build highly diversified portfolios, partly because they are under strong pressure to boost risk-adjusted returns due to rapid societal aging. Their penchant for diversification is in alignment with the asset management capabilities available from foreign asset management companies.

Additionally, the degree of localization required for asset management companies to serve institutional investors is quite low in comparison to the retail market. With assets highly concentrated in the hands of extremely few institutional investors made up of public pension funds and SWFs, asset management companies can conduct requisite marketing activities with few personnel. Moreover, from an operational standpoint, country-specific regulatory compliance requirements are low in comparison to the mutual fund market.

Due to a dearth of publicly available information, there is no systematic way to learn the identities of specific asset managers that have been awarded asset management mandates from such institutional investors. Based on available interviews and anecdotal information, however, AEJ SWFs and pension funds have apparently been awarding mandates to global asset management companies, given their need to rely on external management of foreign assets and other investment products in which they currently lack sufficient in-house expertise. Local asset management companies, which are a dominant presence in the mutual fund market, seem to have a limited presence in the institutional market.

Asian assets' growing heft

In this section, we shift focus to assets available for investment in Asia. Asia is also an attractive region from the standpoint of its pool of assets in which to invest. Globally, there is strong investment demand for Asian equities and bonds by virtue of their high growth potential (expected returns). For asset management companies, having expertise in Asian asset management is conducive to business opportunities vis-à-vis investors located not only in Asia but throughout the world.

Asia's stature among global equity and bond markets

Exhibit 6 shows the country weights of a global equity index widely used as a benchmark for global equity portfolios, including developed and emerging markets. By region, Asia/Pacific ex Japan accounts for an approximately 12% weight. AEJ ex Singapore and Hong Kong ("Emerging Asia") accounts for roughly 7% of the overall index.

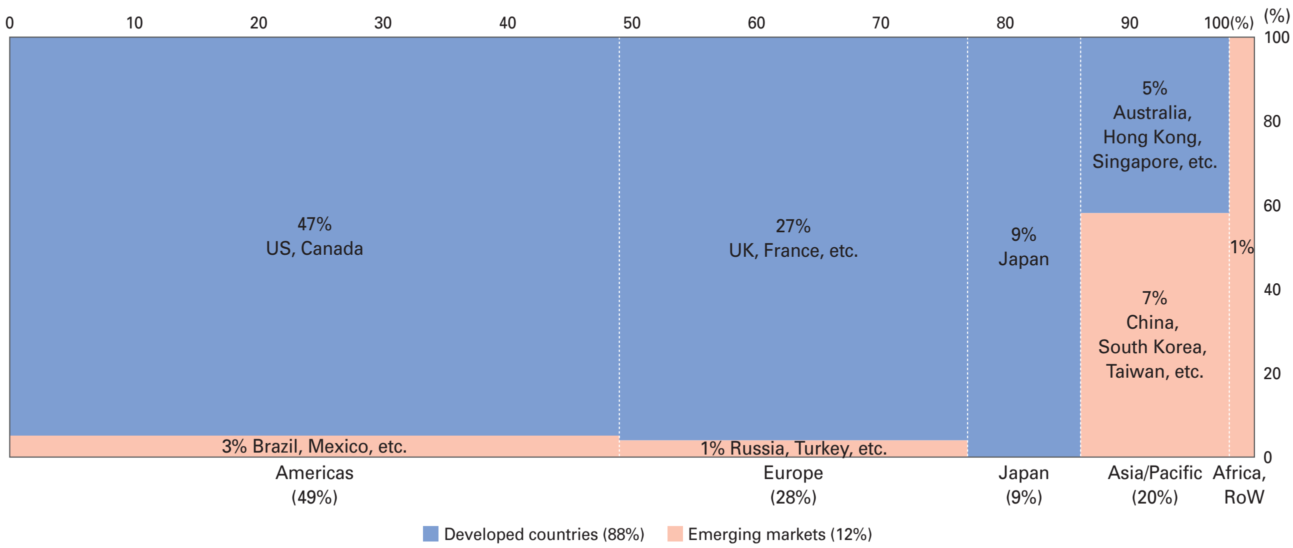
In comparison to metrics such as GDP or population, Emerging Asia's equity index weighting is still low. However, many Emerging Asian stocks are not yet eligible for inclusion in major equity indices from the standpoint of liquidity or other such criteria. Additionally, Emerging Asia is likely to see an increase in equity offerings, including IPOs. In light of such, Emerging Asia's weight in this global equity index is likely to increase in the future.

Similar to Exhibit 6, Exhibit 7 shows the geographic breakdown of global bond issuance. The above comments about Emerging Asian equities apply equally to bonds also.

Emerging market investing's growing prevalence and Asia

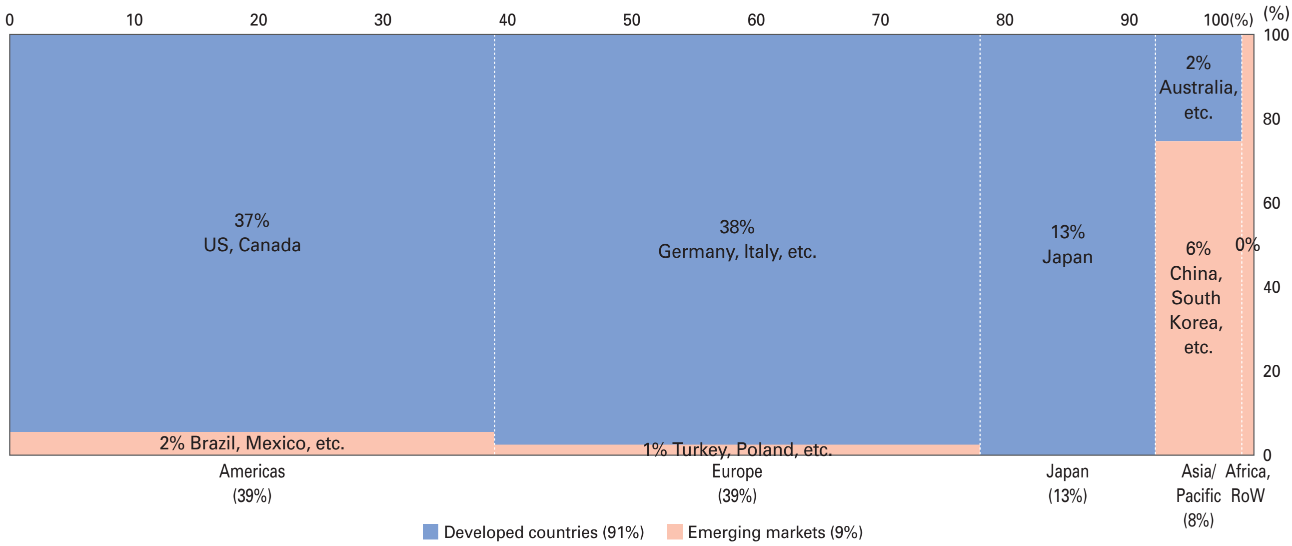
Historically, most internationally diversified investment strategies involved developed-country assets. In recent years, however, a strong interest in investing in emerging markets,

Exhibit 6. Global equity index's country weights



Note: Weights are estimates as of end-March 2010.
Source: NRI, based on MSCI Barra data

Exhibit 7. Global bond issuance broken down by region



Note: Countries are grouped into regions based on BIS classification scheme. Percentages are based on issuer's domicile and face value of issuance.
Source: NRI, based on BIS data

most notably the BRICs, has emerged among both retail and institutional investors.

For example, emerging market equities have a 12% weight in the aforementioned global equity index (Exhibit 6). Given that Emerging Asia accounts for 7% of the index, some 60% of the index's emerging market equities are located in Asia.

Geographically, emerging market equities' inclusion substantially increases the prominence of Asia (or Asia/ Pacific). Inclusion of emerging market companies increases the Americas' index weighting from 47% to only 49% and Europe's from 27% to only 28%, but it more than doubles the Asia/Pacific region's weighting from 5% to 12%.

In sum, as emerging market equity investing gains prevalence, Asia will gain prominence within global equity indices.

Asset management products may be structured based on markets' degree of maturity (i.e., developed country vs. emerging market) or along geographic lines (e.g., North America, Europe, Asia/Pacific). Whichever the case, however, Emerging Asia is a force that cannot be ignored. For asset management companies, competitiveness in managing Emerging Asian assets could very well be a key determinant of business success.

Japanese asset management companies' current status and need for global expansion revolving around Asian asset management

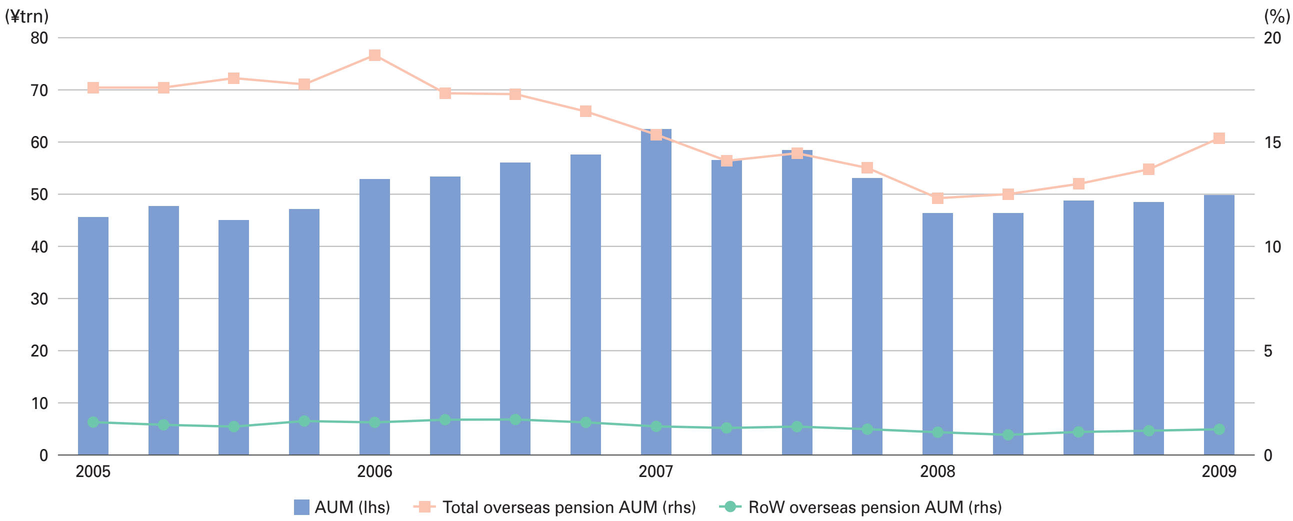
Some Japanese asset management companies are exhibiting a strong drive to expand their operations in Asia. We currently know of ten (as of April 2010) that have opened offices in Singapore or Hong Kong, possess AEJ asset research and portfolio management functions, and are conducting marketing activities targeted at local institutional investors.

However, due to the barriers to entry mentioned above, no Japanese asset management companies have branched into the AEJ retail markets. Additionally, in the institutional market (Exhibit 8), mandates from US, UK, and European pension funds account for a moderate share of Japanese asset management companies' AUM, but mandates from pension funds in the rest of the world, most notably including AEJ, account for a mere 1% of their total AUM and have shown no signs of growth in recent years. In short, Japanese asset management companies appear to have had little if any success to date in expanding their businesses by capturing asset inflows from investors in emerging AEJ countries.

Historically, Japanese asset management companies have allocated most of their staff and other resources to Japanese equities and expanded their businesses by managing Japanese equity portfolios for US and European pension funds and other such institutional investors. This reflects that Japan has had a heavy weight in global equity indices, giving Japanese asset management companies an advantage in winning mandates for Japanese equity portfolio management in particular.

Currently, however, Japan's weight in global the global equity and bond markets is only 9% and 13%, respectively, as

Exhibit 8. Japanese asset management companies' AUM and overseas pension assets' share thereof



Note: All data are based on sum totals of discretionary investment mandates and advisory mandates. RoW (Rest of World) overseas pension AUM is total overseas pension AUM net of US, UK, and continental European pension AUM.
Source: NRI, based on Japan Securities Investment Advisers Association data

shown in Exhibits 6 and 7. Moreover, with emerging market investment gaining mainstream prevalence as discussed above, the value of Japanese asset management companies' domestic portfolio management capabilities is diminishing. Even within the Asia/Pacific region inclusive of Emerging Asia, Japan's index weight is already down to around 40%. Consequently, if Japanese asset management companies manage only domestic equity and bond portfolios, they will have difficulty meeting investor needs, including demand for emerging market asset management, with competitive products. Many Asian institutional investors exclude Japanese assets from their Asian portfolio management mandates. In such cases, Japanese asset management companies' domestic portfolio management capabilities are of no help.

Japan-domiciled assets' loss of stature within the Asia/Pacific region and Emerging Asia's ascent are expected to become even more pronounced going forward. Amid such an environment, institutional investors that continue to award investment mandates and select asset managers for Asia/Pacific developed markets or Japanese equities will likely be limited to those with a sizable scale of operations and staff dedicated to overseeing outside asset managers. We must conclude that Japanese asset management companies that limit their operations to domestic asset management and allocate vast resources to the domestic market will have difficulty expanding their businesses.

Japanese asset management companies' future success hinges largely on whether they can develop a high degree of expertise in managing Emerging Asian assets (Arrow B in Exhibit 1). By doing so, Japanese asset management companies should be able to effectively compete for investment mandates for global emerging markets or Asia/Pacific inclusive of Emerging Asia. Given that such asset management products are in demand among non-Japanese and non-Asian clients also, a high degree of Emerging Asian asset management expertise is also essential for Japanese asset management companies to operate in the "foreign/foreign" domain (i.e., managing foreign assets for overseas clients).

From such a perspective, Asian asset management capabilities are extremely valuable. Japanese asset management companies should develop such capabilities posthaste. To do so, they may have to reallocate resources, which are currently heavily concentrated in domestic asset management operations, to AEJ assets.

Building such capabilities will be difficult but not impossible. In fact, one Japanese asset management company has already won an award from a leading fund rating agency for its AEJ equity investment performance. With Japanese equities' international stature and investment appeal currently diminishing, Japanese asset management companies are well advised to expand globally with AEJ asset management capabilities as a core competency.

Note

1) This paper is based on interview surveys of Asian asset management companies (including global asset management companies and Japanese asset management companies) and research firms conducted by NRI in January 2010 and a survey of related literature. I would like to thank the CEOs, CIOs, and other decision makers that participated in our interview surveys.

2) This tendency is called home country bias.

3) Casey Quirk & NRI [2010]

4) Other frequently cited characteristics of AEJ markets include that (1) investors tend to hold "barbell" portfolios with the bulk of their financial assets held as bank deposits and a smaller portion invested in high-risk mutual funds, (2) mutual funds have high turnover rates stemming from a tendency toward short-termism among retail investors and top-selling funds change rapidly, and (3) direct investment in securities (i.e., not via mutual funds) is popular.

5) Of total investable assets, addressable assets are those that potentially could be entrusted to an outside manager for management.

6) Estimate based on SWF Institute and Greenwich Associates data.

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Author's Profile

Atsuo Urakabe

Researcher
Center for Financial Markets and Technology Research

E-mail : kyara@nri.co.jp

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

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