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Japanese asset management market still has appeal to new entrants

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The Japanese asset management business is beset by an adverse environment, but it still offers substantial opportunity to new entrants from overseas. Ample scope for growth still exists for new entrants that can meet the needs of investors periodically replacing underperforming asset managers and financial institutions' need for portfolio diversification.

In the first seven months of fiscal 2011, the Japanese asset management revenues from both investment trusts and institutional funds appear to be roughly flat, partly reflecting international capital markets' recent poor performance. Investment trusts are still seeing net inflows, but due to large dividend payouts, their assets under management (AUM) have barely grown. Among pension funds, the Government Pension Investment Fund's (GPIF) AUM decreased by over ¥6 trillion in fiscal 2010 and is projected to decline by a roughly equivalent margin in fiscal 2011. Pension assets have started to decrease in corporate pension plans also. Financial institutions' investment securities holdings are still in a strong growth trend, particularly among megabanks, but financial institutions are still investing predominantly in JGBs. They have yet to substantially increase their assets outsourced to external managers.

At first blush, the Japanese asset management business may seem to have little growth potential and no appeal, but it is still a potentially lucrative market from the standpoint of new entrants from overseas.

Three major market segments' size

What makes the Japanese market attractive from the standpoint of prospective new-entrant asset management companies? It offers substantial opportunity for new entrants to capture revenues from three investor classes: retail investors, pension funds, and financial institutions[1]. Revenues potentially available to new entrants from these investor segments can be estimated as follows.

The first and most important step is to estimate (1) asset inflows from each investor class (new assets) and (2) the percentage of assets that investors move from one asset manager to another (moved assets). Next, revenues can be estimated by multiplying projected new assets and moved assets by applicable management fee rates[2]. Although some may find fault with this simple estimation method, we used it to estimate revenues from the three investor classes as shown in the table below.

First, among retail investors, new retirees will annually receive an estimated ¥8 trillion in lump-sum retirement benefits for the next several years. A certain percentage of these funds will presumably be invested in high-yielding investment trusts and other such investment products. The asset management industry should accordingly see moderate inflows of new assets from retail investors[3]. Pension funds, which are projected to experience a decline in AUM going forward, have an established practice of replacing underperforming asset managers once every three years. Annual revenues available to new entrants by virtue of this practice total an

Exhibit. Estimated revenue available to new-entrant asset management companies, by client category

		Retail investors	Pension funds	Financial institutions
Existing investments[1]		¥64tn	¥80tn (corporate) ¥170tn (public)	¥36tn
New asset inflows[2]		¥5tn	¥0tn	¥4tn
Moved assets		¥0tn	¥21tn	¥9tn
Estimated management fee rates		0.60%	0.29% (corporate) 0.20% (public)	0.20%
Annual revenue	New assets	¥30bn	¥0bn	¥8bn
	Moved assets	¥0bn	¥30bn	¥18bn
Total revenue		¥30bn	¥30bn	¥26bn
Fiscal 2010 revenue[3]		¥310bn	¥330bn	¥60bn

Notes: 1. Financial institutions' existing investments figure is an estimate derived by summing their "other securities" holdings, foreign bond investments, etc.
2. Inflows from retail investors are an estimate of funds that will be invested in investment trusts from lump-sum retirement benefits, redemption of retail JGBs, etc.
3. Estimates based on Japan Securities Investment Advisers Association and Fundmark data
Source: NRI estimates based on data from various sources

estimated ¥30 billion, equivalent to the annual revenues that public investment trusts would earn on a ¥5 trillion inflow of assets. In the financial institution[4] segment, we estimated annual revenues available to new entrants at ¥26 billion. Many financial institutions review asset management mandates annually. For asset management companies that already have financial institution clients, the risk of asset redemption is high. Conversely, however, financial institutions' practice of annually reviewing asset management mandates presents a major opportunity for new entrants to win mandates.

These three estimates total ¥86 billion, more than 10% of the Japanese asset management industry's existing aggregate revenues of approximately ¥700 billion. This total would certainly differ if the underlying assumptions were changed, but Japan's asset management business is distinguished by sizable revenue potential for new entrants in all three market segments.

Japan's asset management business from the standpoint of risk

While Japan's asset management business appears to offer major revenue opportunities to new entrants, how does it rate in terms of risk, including costs? In the pension fund market segment, asset management companies conduct sales activities mainly through consultants even in Japan, obviating the need for a large sales force. Once an asset management company wins a pension fund mandate, the mandate is unlikely to be revoked for three years. During this three-year period, the asset management company faces little risk of a reduction in revenues from pension mandates. Pension funds are the lowest-risk clients for new entrants to Japan's asset management business, given that the cost and administrative burdens of operating in the pension fund market segment are relatively small and that revenue opportunities are large.

Public investment trusts, the primary product available to retail investors, have high redemption rates and sometimes experience precipitous declines in AUM soon after inception. Meanwhile, distributor support and fund administration costs remain largely unchanged even if AUM decreases. A decline in a fund's AUM consequently poses a risk of rendering the fund unprofitable. Foreign asset management companies, however, can lower costs through various means. For example, if a foreign asset management company provides a Japanese asset management company with foreign-domiciled funds that are then offered to retail investors in the form of a fund of funds, the foreign asset management company can enter the Japanese investment trust business without setting up shop in Japan.

Financial institutions generally award shorter-term mandates than pension funds and primarily invest in securities on which asset managers earn relatively low management fees. Many asset management companies consequently do not devote much resources to pursuing business from financial institutions. Based on the above estimates, however, financial institutions are important clients almost as lucrative as retail investors and pension funds in terms of revenue opportunities. While financial institutions are steadily reducing their strategic equity holdings in response to tightening of risk capital regulations, they are also diversifying their securities investments. Equity investment products that pursue high returns by assuming a high degree of active risk therefore should remain in demand by financial institutions to some extent. Managing assets for financial institutions can undeniably be an unstable business due to the frequency with which they move assets from one manager to another, but banks and life insurers' combined investment securities holdings total ¥800 trillion[5]. Asset management companies should regard financial institutions as a market with substantial potential if they are able to offer suitable investment products.

Incumbent asset management companies should focus on differentiation

Despite having seemingly little appeal at first blush, Japan's asset management market in fact has considerable appeal from the standpoint of foreign new entrants, as discussed above. The number of foreign asset management companies that are members of the Japan Securities Investment Advisers Association is nearly unchanged relative to five years ago[6], but there has been considerable turnover among foreign members in the interim. Foreign asset managers confident of their abilities will likely continue to enter the Japanese market.

From the standpoint of incumbent asset management companies, foreign asset management companies can gain access to Japanese investors from overseas by offering foreign-domiciled investment trusts. With many asset management companies that compete on the basis of past performance entering the market through such low-cost approaches, the key for incumbent asset management companies is to differentiate themselves through not only investment performance but also portfolio-wide investment advice and improvement in the quality of asset management services, including client support. It will become increasingly important for incumbent asset management companies to capitalize on their individual strengths and differentiate their services offered to clients.

Note

1) Japanese investors' financial assets total ¥1,620 trillion as of March 31, 2011. Of this total, only ¥340 trillion, a mere 20%, is managed by asset management companies.

2) We estimated assets moved from one asset manager to another based on the assumption that (1) once every three years pension funds redeem assets invested with asset management companies with bottom-quartile performance and reinvest those assets with a new asset manager and (2) financial institutions do the same but on an annual basis. We used public investment trusts' current average management fee rate as the fee rate for retail investment trusts. We used Pension Fund Association survey data as the management fee rate for corporate pension plans. For non-GPIF public pensions, we estimated the management fee rate based on asset management companies' revenues. For GPIF, we estimated the management fee rate based on data published by GPIF. For financial institutions, we used the average management fee rate for bonds.

3) We assumed ¥5 trillion in inflows from retail investors.

4) "Financial institutions" means "all banks" (mainly megabanks and regional banks) as defined by Japanese Bankers Association statistics.

5) Total includes Norinchukin Bank and agricultural cooperative banks.

6) The Japan Securities Investment Advisers Association's membership has increased sharply in recent years but the increase was attributable to growth in members that manage real estate and various other investments, in response to the Financial Instruments and Exchange Act's effectuation in 2007.

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