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Fund wrap services likely to gain popularity

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Executive Summary

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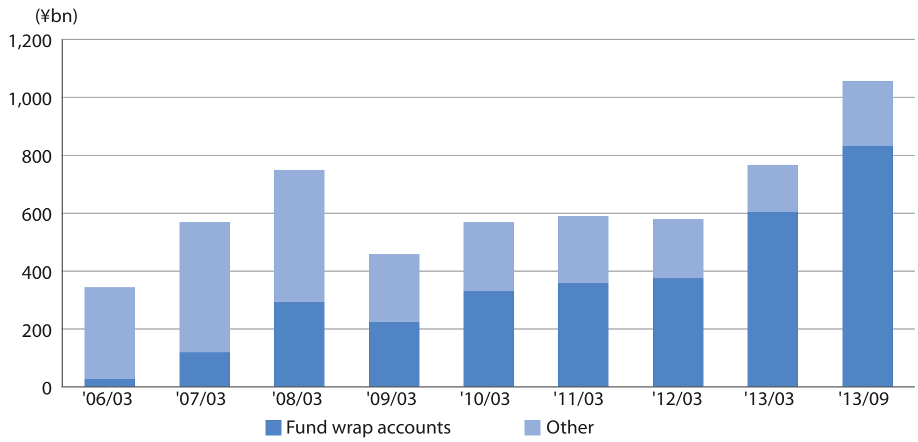
Assets in fund wrap accounts are growing rapidly even as overall investment trust AUM stagnate. Business models with AUM-based revenue streams like the fund wrap model tend to be seen as less profitable than the conventional investment trust sales model. In actuality, however, fund wrap services compare favorably with conventional investment trust sales in terms of profitability. Additionally, fund wrap services mostly offer moderate-risk products to customers who dislike making investment decisions themselves. They accordingly have a large pool of potential customers.

Although Japanese investment trust sales set an all-time semiannual record in the first half of fiscal 2013, investment trust assets barely increased. While sales of open-end equity investment trusts (ex ETFs) grew to ¥17.5 trillion in the first half, their assets under management (AUM) grew a mere ¥420 billion (1%) from six months earlier as sales growth was offset by increased redemptions. An exception to this general trend was fund wrap services, which experienced rapid AUM growth.

What is a fund wrap?

A fund wrap is an asset management service that invests in investment trusts. It is essentially equivalent to a wrap account or separately managed account. Financial institutions that provide fund wrap services set investment goals in consultation with the customer, determine individualized investment policies (e.g., risk tolerance) and the amount to be invested to realize the customer's goals, execute buy and sell orders, and administer the customer's account. Additionally, they periodically report to customers about investment performance and earn fees in proportion to AUM. Even in the regular investment trust sales process, financial institutions provide advice to customers, but the customer is the one who decides on the specific product in which to invest. With fund wrap accounts, by contrast, the financial institution makes such decisions in accord with investment policies determined through consultation with the customer. In Japan, wrap accounts date back to April 2004, when the Investment Advisor Business Act was amended to permit securities brokers and other financial institutions to offer discretionary investment management services. After stagnating in the aftermath of the global financial crisis, total wrap account AUM surpassed

Exhibit . Wrap account AUM



Source: NRI, based on Japan Investment Advisers Association and Fundmark data

their previous peak (¥750 billion) in March 2013 and grew to over ¥1 trillion over the following six months (see graph). The driving force behind this growth was fund wrap services. Fund wrap services have experienced nearly uninterrupted AUM growth since their inception. Their AUM doubled in the year through September 2013. As a result, fund wrap AUM now account for 80% of total wrap account AUM. Because wrap accounts are an investment advisory service, they are offered by a limited number of large and mid-sized brokerages and major commercial banks and trust banks that have staff specializing in wrap account services. Additionally, even fund wrap accounts, which have relatively low minimum investment requirements in comparison to other wrap accounts, typically require a hefty minimum investment of ¥5 million. There is consequently a general perception that most wrap account customers are highly knowledgeable and experienced investors, but many financial institutions are marketing fund wrap accounts as a service for people who want to invest but are indecisive or unskilled at selecting specific investments.

Profitability compares favorably with traditional investment trust business

Fund wrap services do not charge commissions on investment trust purchases and sales. Their fees are strictly a function of AUM. Fund wrap accounts typically charge total annual fees of around 1.4% of AUM. This total is split roughly 50:50 between administrative fees and investment advisory fees. In some cases, the investment advisory fee is linked to performance. In such cases, customers are charged a lower fee rate plus a percentage of any capital accretion attributable to investment returns[1]. Whichever fee arrangement is used, fund wrap providers also collect account servicing fees from investment trust sponsors. Account servicing

NOTE

1) With performance-based fees, the investment advisory fee rate is set at one-third to one-half of the rate for regular fund wrap accounts, plus 10-20% of capital accretion attributable to investment returns.

fees for investment trusts available in fund wrap accounts average around 0.16% per annum[2], below the corresponding fee rate for investment trusts in general. How do fund wrap accounts compare with the traditional investment trust business in terms of fees earned as a percentage of AUM? A financial institution with ¥100 billion of fund wrap AUM could earn ¥1.56 billion of annual fee revenues. In the traditional investment trust business, fee revenues vary as a function of customers' average holding period. Investment trusts' current average holding period has decreased to about two years at present. Given a two-year holding period, a financial institution with ¥100 billion of assets in conventional investment trust accounts would earn annual revenues of ¥1.8 billion, modestly more than the corresponding revenues from fund wrap accounts[3]. If the average holding period lengthens, the difference in revenues between the conventional investment trust business and fund wrap accounts would progressively shrink. Once the average holding period exceeds 2.5 years, financial institutions would earn higher revenues from fund wrap accounts than from the conventional investment trust business[4]. Fund wrap services' profitability thus compares favorably with that of the conventional investment trust business .

2) The administrative, investment advisory, and account-servicing fees are financial institutions' compensation. In total, these fees average 1.56% of AUM per annum.

3) In the conventional investment trust business, investment trust distributors earn average sales commissions of 2.6% and account servicing fees of 0.5% per annum. Given that the average investment trusts holding period is roughly two years, investment trust distributors would earn biennial revenues of ¥3.6 billion (¥1.8 billion per year) on ¥100 billion of investment trust account balances.

4) For example, if the average investment trusts holding period were three years, financial institutions would earn ¥4.1 billion of revenues over three years (¥1.37 billion per year) from the conventional investment trust business.

Large pool of potential customers

Investment trust that can be held in fund wrap accounts include not only equity, bond and REIT funds but also funds not widely available through conventional investment trust sales channels, such as commodity funds and hedge funds. This fact may convey the impression that fund wrap customers are mostly investors pursuing higher-risk, higher-return opportunities than those available from conventional investment trust sales channels, but in actuality the opposite is true. This is evident from just analyzing investment trusts available exclusively for fund wrap accounts. The (AUM-weighted) average annualized volatility of investment trusts that financial institutions offer to fund wrap customers is generally 9-12%. The average volatility of actual portfolios held in fund wrap accounts is presumably even lower by virtue of the covariance effect. Fund wrap account portfolios' average volatility is likely far lower than the average volatility of investment trusts sold through conventional sales channels[5]. This could imply that the pool of investors amenable to utilizing fund wrap accounts is large. According to NRI surveys, people interested in investing have a strong tendency to have a conservative investment approach. Most people's risk tolerance is moderate at best[6]. Since the global financial crisis, a small number of relatively highly risk-tolerant investors capable of making their own investment decisions have accounted for the bulk of investment trust purchasers. Although prospective fund wrap customers are limited to people with at least ¥5 million of investable

5) Calculated by the same methodology, open-end equity investment trusts' average annualized volatility was 18.0%.

6) See Exhibit 22 on page 17 of Japan's Asset Management Business 2012/13 (NRI): http://www.nri.com/global/opinion/jamb/JAMB2012.pdf.

capital, investors with relatively low risk tolerances and an aversion to making investment decisions constitute a large pool of potential fund wrap customers. Many financial institutions are seeking to switch to business models that generate revenues based on asset balances. Such business models are less conducive to conflicts of interest with customers, as regulatory authorities have repeatedly emphasized. Growth in fund wrap services may prompt financial institutions to shift more toward AUM-based fee structures.

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