

# lakkyara

2009

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**Special Edition**

**Japan's Asset Management Business 2009  
(Summary)**

## Japanese investor trends

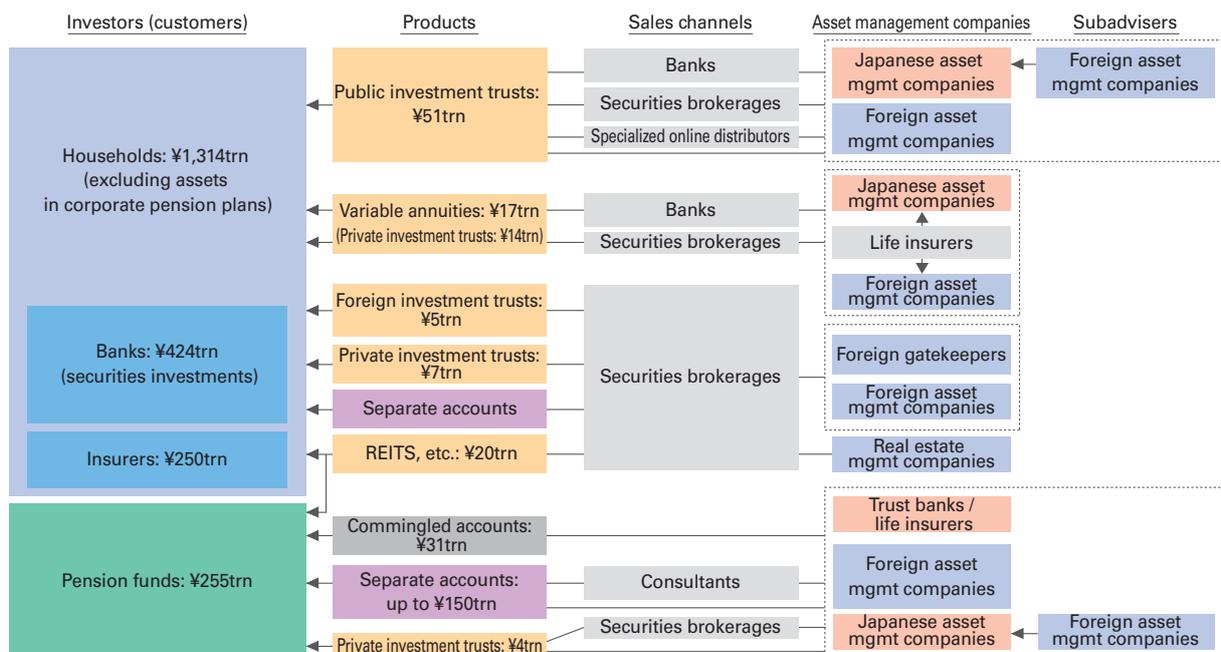
### Japanese investors still a largely untapped market

Exhibit 1 provides an overview of the Japanese asset management market as of March 31, 2009. It depicts the market in terms of investors, products, distribution channels, and asset managers to offer a simplified picture of which types of asset managers manage money for which investor classes, how investor assets are allocated, and how asset flows are intermediated. Asset management companies in Japan mainly serve three types of clients: retail investors (households), corporations including financial institutions, and pension funds. All told, Japanese investors hold an estimated ¥1,570trn in financial assets (adjusted to take into account that financial institutions' securities portfolios are largely funded with

retail customers' deposits). Relative to a year earlier, this total is down ¥110trn or 6.5%, a relatively mild decline in comparison to the US, where the corresponding decrease in financial asset holdings exceeded 15%.

Of these total assets, only ¥300trn<sup>1)</sup>, a mere 19%, is under management by asset management companies. In FY08 (year ended March 2009), the asset management industry had an abysmal year as a result of the unprecedentedly severe financial crisis. Assets under management (AUM) consequently shrank for a second consecutive fiscal year due to market factors. Nonetheless, Japan still has a huge pool of assets yet to be tapped by asset managers. Japan's asset management industry thus still has tremendous growth potential.

Exhibit 1. Overview of Japan's asset management business



Source: NRI, based on data from various sources

## Chapter 1: Japanese investor trends

Of asset management companies' AUM, wholesale (i.e., financial institution and pension) assets account for ¥214trn or approximately 70%. The remaining 30% or ¥87trn are retail (household) assets. Revenue-wise, however, retail investors account for nearly half of asset management revenues, even including those of trust banks that predominantly serve the wholesale market. This disproportionality reflects that retail assets are heavily concentrated in investment trusts with relatively high management fees. The retail market has more growth potential than the wholesale market. Revenues from the retail market are on track to surpass 50% of total asset management revenues in FY09.

### Household assets still flowing into investment products

Japanese households ended FY08 with financial assets (excluding corporate pension assets) of approximately ¥1,310trn, down ¥76trn from a year earlier but still a huge hoard. Over 70% of household financial assets continue to be held in the form of cash, bank deposits, and insurance products (excluding annuities).

In terms of household investment activity, there is a general perception that the trend from saving to investing has changed since October 2007, when the subprime mortgage crisis started to reverberate. This perception is corroborated by the fact that equity investment trusts

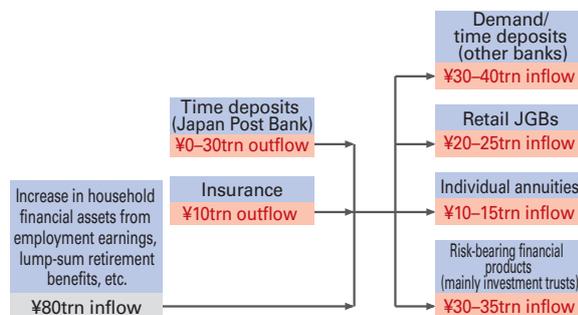
experienced a net outflow of funds for the first time since 2000 in the fourth quarter of 2008. To ascertain whether households' asset reallocation trend has indeed changed, we projected changes in household financial assets over a roughly 5-year horizon based on data (Exhibit 2).

First, inflows of fresh funding from lump-sum retirement benefits will total an estimated ¥80trn over the next five years as a result of an increase in workers reaching the mandatory retirement age over the next five years. Outflows of maturing time deposits from Japan Post Bank have nearly ceased by virtue of aggressive retention activity by the bank since its privatization, but the outflows may resume as a result of the recently elected Democratic Party of Japan government's policies. Up to ¥30trn of funds could be reallocated from Japan Post Bank time deposits to investment products over the next five years. Additionally, we estimate that some ¥10trn will flow out of Japan Post Insurance products over the same timeframe.

Banks other than Japan Post Bank are likely to see continued inflows (¥30-40trn) into time deposits in response to incentives such as premium introductory rates. Another ¥20-25trn is likely to flow into retail JGBs. A major shift in asset flows has occurred in the individual annuity market, where inflows to variable annuities have fallen substantially following suspension of sales of variable annuities with minimum guaranteed value. Fixed annuities are likely to henceforth account for a majority of inflows into individual annuities (¥10-15trn).

Lastly, in terms of risk-bearing products such as equity investment trusts, inflows into investment trusts have undeniably fallen sharply since October 2007, but direct investment in individual foreign bond issues is growing. On balance, inflows to risk-bearing financial products have not fallen drastically. The trend toward reallocation of household financial assets from savings to investment products remains intact. We estimate that some ¥30-35trn will flow into risk-bearing financial assets, mainly equity investment trusts, over the next five years.

Exhibit 2. Projected household-sector asset in/outflows by investment product (5-year horizon)



Source: NRI

## Institutional investors have little near-term prospect of AUM growth

Pension funds, the largest institutional investors, ended FY08 with an estimated ¥255trn in assets. Of this total, public pension assets accounted for ¥170trn, a decrease of ¥20trn from a year earlier, while corporate pension plans accounted for ¥74trn, down ¥14trn. Although the pension market is huge, it does not have much prospect of asset growth, given that benefit payouts, particularly public pension benefits, are projected to exceed incoming receipts for the foreseeable future as a result of demographic aging.

Financial institutions' securities investments at FY08-end totaled roughly ¥675trn, including ¥195trn at banks (ex Japan Post Bank), ¥170trn at Japan Post Bank, ¥60trn at *shinkin* banks and credit unions, ¥150trn at life insurers (ex Japan Post Insurance), ¥80trn at Japan Post Insurances, and ¥20 at nonlife insurers.

Excluding Japan Post Bank, Banks' securities investments grew 4% from a year earlier. Meanwhile, the composition of their investment securities holdings changed, with JGBs' share of the total rising to 50% and bonds' share increasing to 70% while equities and "other securities" respective shares declined. These "other securities" include investment trusts and hedge funds in addition to foreign securities. Within the "other securities" category, holdings of products other than foreign securities (e.g., funds) decreased particularly sharply. This decline was most pronounced at regional banks and second-tier regional banks. This shift in the composition of financial institutions' investment securities holdings, including the increased allocation to JGBs, reflects an increased preference for safety. However, with domestic demand for loans stagnant or shrinking, security investment's importance to bank earnings is likely to increase or at least remain undiminished.

## Current state of asset management business and asset management firms' management priorities

### 1 Challenging times for the asset management industry

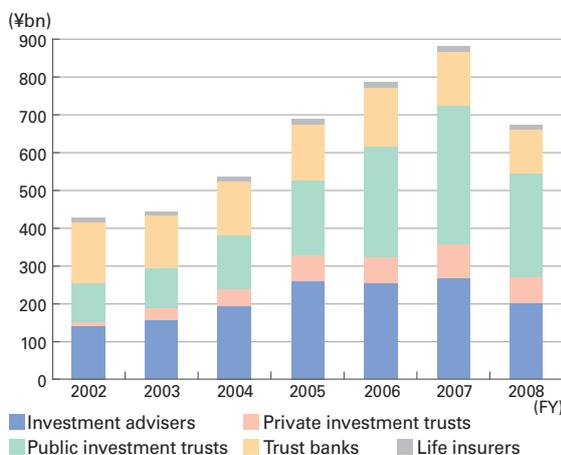
In our estimate, Japan's asset management industry earned management revenues of approximately ¥678bn in FY08 on AUM of roughly ¥315trn (including foreign clients' assets) as of end-March 2009. On a year-on-year basis, AUM and management revenues respectively declined ¥62trn (16%) and ¥208bn (23%). In percentage terms, both of these declines are the largest on record dating back to FY02 (Exhibit 3). They are chiefly attributable to large declines in asset values in the second half of FY08 as a result of the financial crisis. Of total AUM, specialized asset management firms, namely investment advisers and investment trust companies, respectively account for ¥116trn (37%) and ¥76trn (24%). Below we look at these asset management companies' status in FY08.

### Large declines in both AUM and management revenues

Asset management companies ended FY08 with AUM of ¥192trn, a ¥52trn decrease from a year earlier and the second consecutive major annual decline. Exhibit 4 plots annual changes in AUM broken down by causative factor. In FY08, asset price declines (market factor) due to the impact of the financial crisis wiped out ¥46trn of AUM value. The client factor, which represents net inflows of funds, contributed positively to AUM growth, but its contribution includes the impact of conversion of some mandates for management of public pension assets from trust agreements to discretionary investment agreements. Adjusted to factor out these conversions, net inflows were negligible for both investment trust companies and investment advisers.

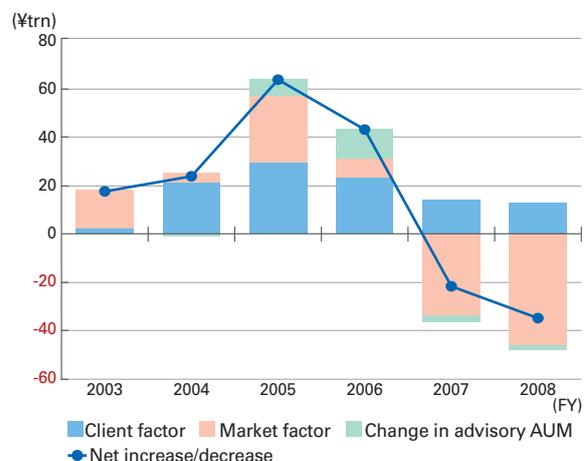
We estimate asset management companies' FY08 management revenues at ¥543bn, a decrease of ¥185bn

Exhibit 3. Asset management companies' aggregate management revenues



Source: NRI

Exhibit 4. Changes in AUM broken down by causative factors



Source: NRI, based on data from the Investment Trusts Association of Japan and Japan Securities Investment Advisers Association

(25%) from FY07. This decline was asset management companies' first major decline in management revenues, which had been consistently growing in recent years. Their revenue growth was previously driven by AUM growth attributable to the client factor, but asset price declines had a huge adverse impact in FY08.

Operating margins<sup>2)</sup> also fell substantially. In aggregate, estimated operating margin decreased 10 percentage points from 31% in FY07 to 21% in FY08. One major factor behind this margin compression was apparently personnel expenses. In comparison to FY07, personnel expenses increased as a percentage of revenues by approximately 7 percentage points. Although personnel expenses did not increase in absolute terms, asset management companies were apparently unable to cut personnel expenses, which are predominantly fixed costs, fast enough to keep them from rising as a share of shrinking revenues.

### Profitability gap between investment trust and advisory businesses widened

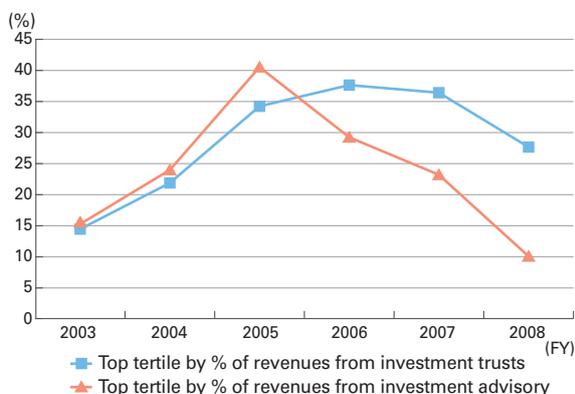
While asset management companies' overall operating margin fell substantially in FY08, operating margins in fact diverged sharply between asset management companies that are predominantly in the investment trust business and those predominantly in the investment advisory business. Exhibit 5 plots average operating margins for the

top tertile (third) of asset management companies ranked by their investment trust management revenues' share of total revenues in each fiscal year and the top tertile ranked by investment advisory revenues' share of total revenues. The graph is distinguished by an inversion of the two groups' profit margins between FY05 and FY06, with the investment trust group's profit margin rising above that of the investment advisory group. The investment trust group subsequently maintained a relatively high profit margin.

One reason for this divergence is a difference in earnings growth rates. A comparison of management revenue growth rates between the investment trust and investment advisory businesses reveals that investment trusts' management revenues grew steadily until FY07 by virtue of cash inflows, while the investment advisory business's management revenues have stagnated in recent years. Consequently, the split between investment trust and investment advisory businesses' respective shares of total management revenues, which was roughly 50:50 until FY05, shifted to 63:37 in favor of the investment trust business by FY07 and remained unchanged in FY08.

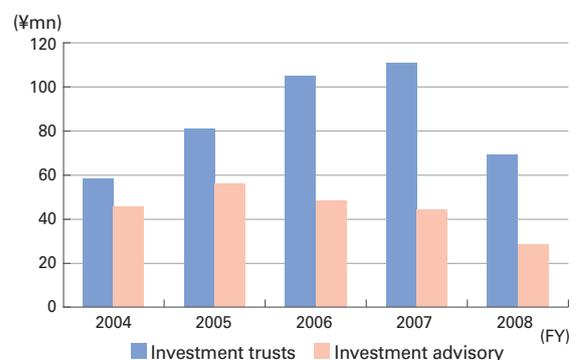
Earnings stagnation in the investment advisory business was attributable to pension funds, the largest investment advisory clients. Public pension assets' share of investment advisory companies' pension assets under contract has grown since FY07. Although the amount of public pension assets under contract is large, investment advisory companies have substantially discounted their management fee rate on account of asset size. Moreover,

Exhibit 5. Operating margins by main business



Source: NRI, based on data from funds' regulatory filings and asset management companies' business reports, websites, publicly released financial statements, etc.

Exhibit 6. Revenues per employee



Source: NRI, based on data from funds' regulatory filings and asset management companies' business reports, websites, publicly released financial statements, etc.

pension assets have limited growth prospects, largely because of demographic aging.

Another difference between the investment trust and investment advisory businesses is efficiency. In the investment trust business, revenues per employee grew annually in tandem with total revenues until FY07 (Exhibit 6). In the investment advisory business, by contrast, revenues per employee have been declining since FY05. In other words, investment advisory companies have apparently increased headcounts despite an absence of revenue growth. The investment advisory business can accordingly be said to be in a recession dating back to even before the financial crisis.

### Investment trust business's distinctive characteristics

While the investment trust business is more profitable than the investment advisory business as noted above, one major reason for this differential in terms of revenues is that investment trusts generally charge higher management fee rates than investment advisers. Another important point is that investment advisory companies discount their fee rates as contract value increases, as already mentioned. Investment trusts, however, charge a flat-rate management fee regardless of how many investment units they sell. In

other words, their revenues grow as a linear function of their sales. Sales growth was a major contributing factor to growth in investment trusts' aggregate profitability.

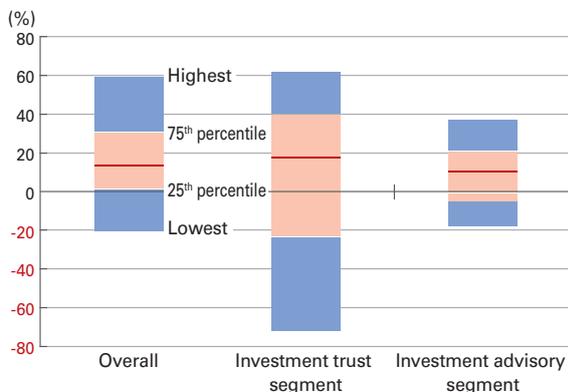
To shed light on the profitability of individual asset management companies, Exhibit 7 plots the distribution of operating margins broken down by business segment (investment trust and investment advisory) at asset management companies that participated in an NRI benchmarking survey<sup>3)</sup>. Profit margins vary over a wider range in the investment trust segment than in the investment advisory segment. In FY08, profit margins were substantially negative in quite a few companies' investment trust segments. This reflects the investment trust business's cost structure, which differs from that of the investment advisory business.

Exhibit 8 shows the cost structures of the asset management companies that participated in the aforementioned survey, broken down between their investment trust and investment advisory segments. It shows that back-office and marketing operations account for a much higher share of total costs in the investment trust segment than in the investment advisory segment. Investment trusts are sold mainly to the public through distributors. Investment trusts consequently incur substantial costs for distributor support, preparation of sales materials for investors, calculation of NAVs, and other such needs.

These expenses are largely essential regardless of how little AUM an investment trust has. Consequently, until an investment trust accumulates sufficient AUM, essential costs outweigh revenues, preventing it from earning a profit. Once AUM exceeds the breakeven threshold, however, profit growth subsequently tends to far outstrip AUM growth. In the investment trust business, profit margins differ widely as a function of AUM size. Japanese investment trusts have a higher overall profit margin than the investment advisory business by virtue of AUM growth stemming from continued asset inflows that have enabled them to earn revenues sufficient to absorb their costs.

Investment trusts' high back-office expenses are also partly attributable to a peculiarity of the Japanese investment trust market. Namely, there is an extremely

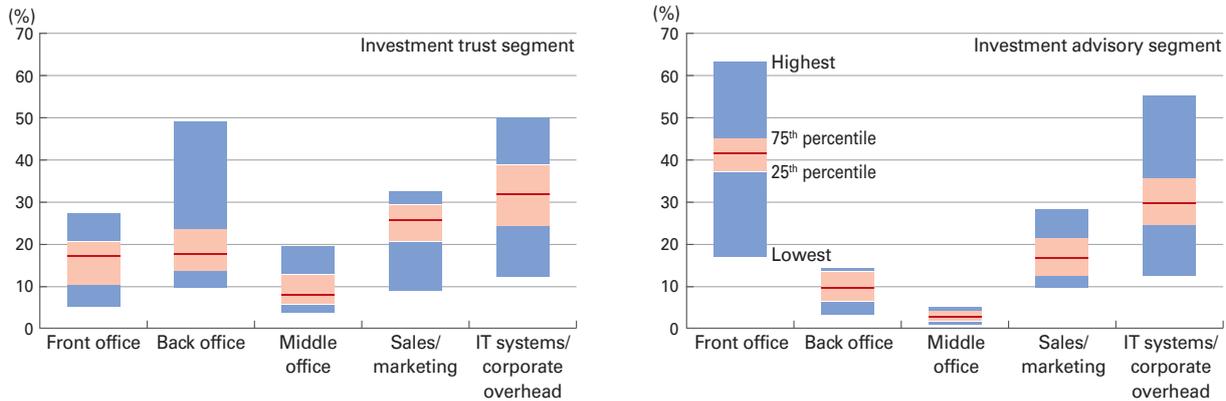
Exhibit 7. Operating margins by segment



Note: Red lines indicate median values. For the segment data, companies with the highest and lowest operating margins were excluded.

Source: NRI Asset Management Company Benchmarking Survey (FY09)

Exhibit 8. Cost structures by segment



Note: Red lines indicate median values.  
Source: NRI Asset Management Company Benchmarking Survey (FY09)

large number of investment trusts with very little AUM. Among publicly offered open-end equity investment trusts, an extremely small number of funds account for a huge share of total revenues. Only 20% of open-end equity funds have revenues in excess of average expenses per fund (estimated at approximately ¥42mn). The other 80% are unprofitable. These unprofitable funds also incur the aforementioned unavoidable costs (e.g., NAV calculation, report preparation). Their cost burden presumably boosts investment trust companies' overall costs. If investment trusts can find a way to convert such operating costs to a revenue-dependent variable basis, they should be able to cut costs.

Another distinguishing characteristic of investment trusts' cost structure is low front-office costs (e.g., for portfolio management, research). Front office operations form the nucleus of the investment advisory business, where the front office accounts for the largest share of total costs. In the investment trust segment, however, the median value of the front office's share of total costs is less than half of the corresponding value for the investment advisory segment (Exhibit 8). This differential reflects that in recent years most of the best-selling investment trusts have been funds that invest in foreign assets and funds of funds. Many such investment trusts outsource portfolio management to foreign asset managers. The Japanese investment trust industry is increasingly embracing

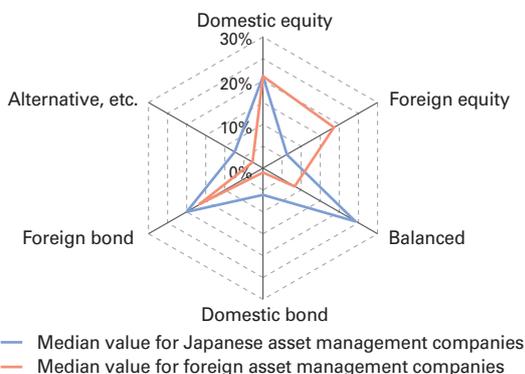
outsourcing in lieu of developing investment products in house. Investment trusts are focusing their management resources on marketing. Japanese asset management companies' portfolio management capabilities predominantly revolve around Japanese equities, resulting in a mismatch between their skills and the most popular investment trust products. Front-office outsourcing could be one viable business model for the Japanese asset management business.

### FY08 revenue decline rates diverged between Japanese and foreign companies

How did FY08 earnings differ between Japanese and foreign asset management companies? Asset management companies' earnings differed substantially between the first and second halves of FY08. According to the aforementioned NRI benchmarking survey, asset management companies' overall profit margin in the fiscal first-half was flat year on year at around 30%. In the second half, however, the survey respondents' median profit margin was zero. This second-half decline in profitability was more severe for foreign asset management companies than for Japanese asset management companies.

One reason for this difference is that Japanese and foreign-affiliated asset management companies' product offerings generally differ. Exhibit 9 shows the breakdown of Japanese and foreign asset management companies' FY08 revenues by asset class. Whereas Japanese asset management companies' revenue mix was relatively evenly balanced between domestic equity, foreign bond, and balanced funds, foreign companies derived most of their revenues from domestic and foreign equity and foreign bond funds. The foreign asset management companies are thus more dependent on equities. In FY08, Japanese and foreign equity prices declined in a highly correlated manner. Meanwhile, the yen also appreciated sharply. With foreign asset management companies' AUM invested mainly in Japanese and foreign equities and foreign bonds, these two trends presumably largely account for the steeper decline in their revenues relative to their Japanese counterparts.

Exhibit 9. Product portfolios by asset class



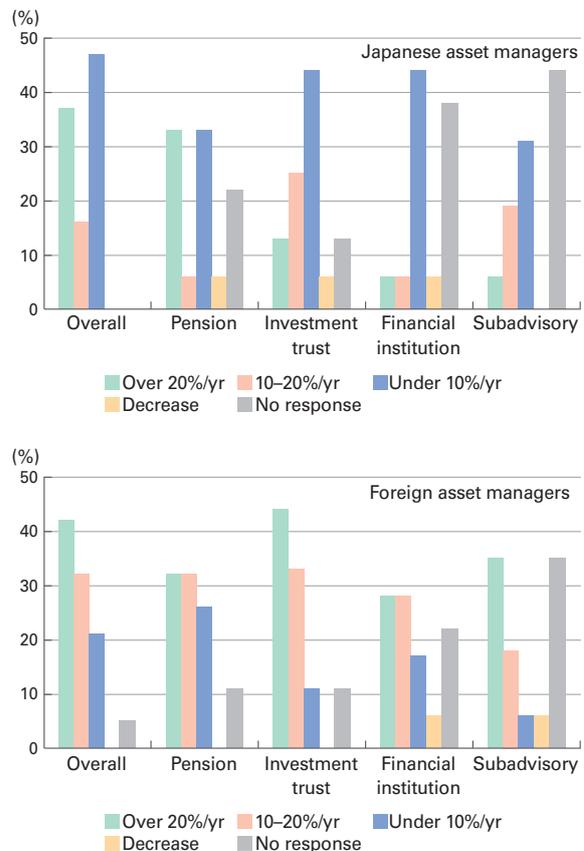
Note: We calculated asset management companies' respective revenue breakdowns by asset class and plotted the median revenue shares in the graph above. The plotted values consequently do not tally to 100%  
 Source: NRI Asset Management Company Benchmarking Survey (FY09)

## 2 Future outlook and management priorities

Amid such an environment, what is asset management executives' outlook for their business? An NRI survey conducted annually since 2007 sheds light on this question.

Asked about asset growth over the next 3-5 years, most survey respondents had a bullish outlook (Exhibit 10). About 50% of respondents at Japanese companies and some 70% of respondents at foreign companies anticipate asset growth of "10% per annum or more." Although these percentages of respondents were higher

Exhibit 10. Projected AUM growth rates over next 3-5 years



Source: NRI Survey of Asset Management Companies' Management Priorities (2009)

in the previous year, they nonetheless remain high. The survey respondents were bullish about prospects for growth in asset management revenues also. Sixty percent of respondents at Japanese companies and 80% of respondents at foreign companies project revenue growth of "10% or more." These percentages were unchanged from 2008.

By business line, many respondents project rapid growth in the pension business (particularly corporate pensions). They may perceive recent changes in the environment (e.g., declines in funded ratios, adoption of international accounting standards) to be a business opportunity. In the investment trust business, the percentage of respondents projecting growth of "10% or more" decreased substantially among Japanese companies. With investment trust sales through the bank channel down sharply, doubts have emerged about medium-term growth.

## Market trends and product strategies by client segment

### 1 Pension business

#### Pension market hit by major decline in assets

Japanese pension assets stood at an estimated ¥255trn at end-March 2009. Of this total, public pension schemes (National Pension, Employees' Pension Insurance, and Mutual Aid Associations) account for two-thirds or roughly ¥170trn (down ¥20trn from a year earlier). Seventy percent or some ¥120trn of these public pension assets belong to the Employees' Pension Insurance and National Pension programs.

Since FY01, Employees' Pension Insurance and National Pension assets have been heavily invested in market instruments by the Government Pension Investment Fund (GPIF). At end-March 2009, the GPIF had market-invested AUM of approximately ¥118trn, down modestly from a year earlier due to negative investment returns offset by fresh inflows of cash.

In FY08, the GPIF reduced its asset allocation to domestic and foreign equities and commensurately increased its allocation to domestic bond to end FY08 with two-thirds (67%) of its market-invested assets in domestic bonds. Given the enormity of the GPIF's AUM, most of its market-invested assets are passively managed. By virtue of its predominantly passive investment style and a recent consolidation of its network of asset custodians, the GPIF reduced its management fee in FY08 to 0.024% of AUM from 0.029% in FY07.

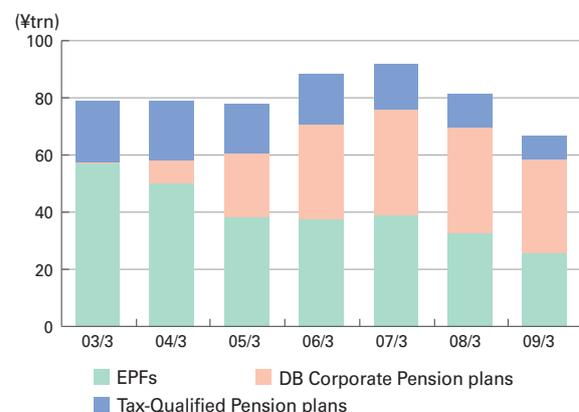
In FY08, the Employees' Pension Insurance program fully redeemed the remainder of its assets deposited in the Fiscal Loan Fund. Consequently, the GPIF's future investments in market investment instruments

will henceforth be funded by new pension contributions and redemptions of directly underwritten FILP (Fiscal Investment and Loan Program) bonds. However, annual pension benefit expenditures are expected to continue to exceed pension insurance premium receipts for at least the next few years as a result of demographic trends (i.e., societal aging, low birthrate). The GPIF is therefore expected to experience a continued net outflow of assets for the time being.

Among corporate pension plans, defined benefit (DB) plans ended FY08 with aggregate assets of ¥67trn, down roughly ¥15trn (18%) from a year earlier (Exhibit 11). Due to deterioration in the investment environment, corporate pension plans incurred even worse negative returns in FY08 than in FY07.

By type of plan, Employees' Pension Funds (EPFs) ended FY08 with aggregate assets of ¥26trn, a decrease of over 20% from a year earlier even though the number of EPFs remained nearly unchanged throughout the year. DB Corporate Pension plans increased substantially in number to over 5,000 in the wake of conversion of Tax-Qualified

Exhibit 11. Corporate DB pension plan assets



Source: Trust Companies Association of Japan, Life Insurance Association of Japan

Pension plans, which are in the process of being phased out. Despite DB Corporate Pension plans' numerical growth, their assets declined to ¥33trn.

While Tax-Qualified Pension plans are slated to be completely phased out by end-March 2012, 25,000 Tax-Qualified Pension plans with aggregate assets of ¥8trn were still in existence at FY08-end. Of the Tax-Qualified Pension plan conversions that took place in FY08, the percentage of conversions to DB Corporate Pension plans notably increased to 25% (approximately 10% of Tax-Qualified Pension plans converted in FY08 became defined contribution (DC) pension plans and one-third were absorbed into the Smaller Enterprise Retirement Allowance Mutual Aid program). This trend is expected to continue. The overall percentage of Tax-Qualified Pension plans converted to DB Corporate Pension plans is projected to end up around 15%. However, many such plans are likely to be small in scale. Perhaps few will be lucrative clients for asset management companies.

### Rising corporate pension risk

Since the adoption of postretirement benefit accounting in 2000, Japanese companies have endeavored to reduce their pension liabilities. The aggregate pension benefit obligations (PBOs) of companies listed on the Tokyo Stock Exchange's 1<sup>st</sup> Section (TSE1) have held steady in the vicinity of ¥70trn in recent years. Meanwhile, their pension assets, which had been in a growth trend until FY06, have fallen to ¥45trn as a result of two consecutive years of deterioration in investment performance from FY07. Their funded ratio (adjusted basis inclusive of reserves for retirement benefits), which had briefly recovered to nearly 100%, has fallen back below 80%. TSE1-listed companies have started to amortize this funding deficit from FY08. The amortization charges exceeded ¥1trn in FY08 and are projected to surpass ¥3trn in FY09.

The situation is likely to be compounded by reform of accounting standards. From FY09, smoothing of discount rates will be disallowed and short-term fluctuations in bond yields will have a direct impact on PBO valuation.

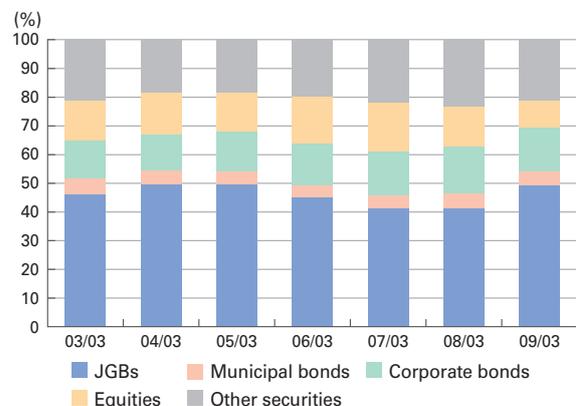
Additionally, reform of deferred recognition rules is also under consideration. The revised rules will almost certainly require instant recognition on corporate balance sheets of hitherto unrecognized pension funding deficits. If such a recognition policy were hypothetically in effect in FY08, unfunded pension liabilities on corporate balance sheets would have jumped to ¥29trn, nearly triple their reported level of ¥11trn. Whether deferred recognition is likewise disallowed on income statements remains to be seen but if it is, the resultant impact on corporate earnings would be even greater.

## 2 Securities investment by banks

### City bank and regional bank securities holdings diverged in FY08

Japanese banks in aggregate ended FY08 with securities holdings of ¥195trn, a ¥7trn increase from a year earlier. The composition of their securities holdings, however, changed substantially during the course of FY08. JGB holdings increased to account for half of banks' total securities holdings, while equities' share fell below 10% and "other securities" share also decreased after several consecutive years of growth (Exhibit 12). Banks'

Exhibit 12. Japanese banks' aggregate securities portfolio allocations



Source: NRI, based on Japanese Bankers Association's *Financial Statements of All Banks*

## Chapter 3: Market trends and product strategies by client segment

preference for safety apparently increased in response to the financial crisis, resulting in a reallocation of funds to JGBs and other assets with little credit risk. However, trends in securities holdings differed substantially between city banks and regional banks (including second-tier regional banks; ditto below).

In fact, growth in securities holdings was limited to city banks and trust banks. Regional banks reduced their securities holdings, albeit modestly. City banks substantially expanded their JGB holdings to increase their liquidity on hand. Their aggregate ratio of securities holdings to deposits also rose. Regional banks, by contrast, reduced their securities positions, mainly in the "other securities" category. They also aggressively booked impairment charges against their securities holdings. Regional banks' aggregate securities holdings and ratio of securities holdings to deposits consequently both declined. Banks' response to the financial crisis thus differed between bank categories.

### Appetite for fund products likely to diverge as a function of risk controls

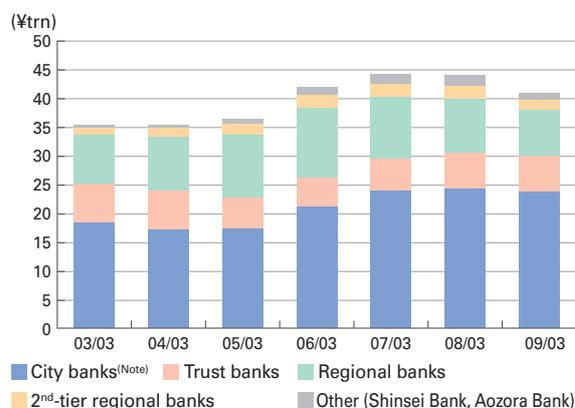
Among securities, fund investments are the most closely related to the asset management business. Banks' holdings of "other securities," which includes fund products, ended FY08 at roughly ¥40trn, of which ¥30trn was foreign securities. The remaining ¥10trn consisted largely of hedge funds, other funds, and securitized products. Of this ¥10trn, an estimated ¥5trn was fund investments, including hedge funds. While "other securities" holdings decreased roughly ¥3trn year on year, the vast majority of this decrease was attributable to holdings other than foreign securities. We estimate that fund investments accounted for half of the ¥3trn decrease.

Banks' appetite for fund investments, which decreased substantially in FY08, is likely to differ among bank categories and individual banks. In interview and questionnaire surveys<sup>4)</sup> conducted by NRI, many city bank respondents named funds/hedge funds and commodities as products in which they aim to invest in the future. Among regional financial institutions, many respondents

named bonds (e.g., JGBs, domestic corporate bonds) as future investment products. Fund investments were not highly ranked overall. Yet a minority of banks continue to invest in fund products even after the financial crisis triggered by Lehman Brothers' collapse. Many respondents reported that product transparency, information disclosure (e.g., products with "look through" visibility), and ease of risk management are key considerations in terms of investing in funds in the future.

In the wake of the recent financial crisis, banks are under increased regulatory pressure to upgrade their risk management of securities investments. Banks are therefore adopting a more cautious posture toward securities investment. With lending growth stagnating, securities investment returns will remain an important pillar of banks' earnings. Securities investment's profitability is likely to vary among banks depending on risk management capabilities. Major banks with relatively large portfolio management operations and even regional financial institutions that are building portfolio management capabilities could proactively invest in a broad range of investment vehicles that contribute to improvement in earnings. If the investment environment improves, investments in funds also may grow. Financial institutions without adequate portfolio management capabilities are likely to restrict their securities investments within the scope of their risk management capabilities for the time being.

Exhibit 13. Other securities holdings by type of bank



Note: City banks: Mizuho Bank, Bank of Tokyo-Mitsubishi UFJ, Resona Bank, Mizuho Corporate Bank, and Saitama Resona Bank

Source: NRI, based on Japanese Bankers Association's *Financial Statements of All Banks*

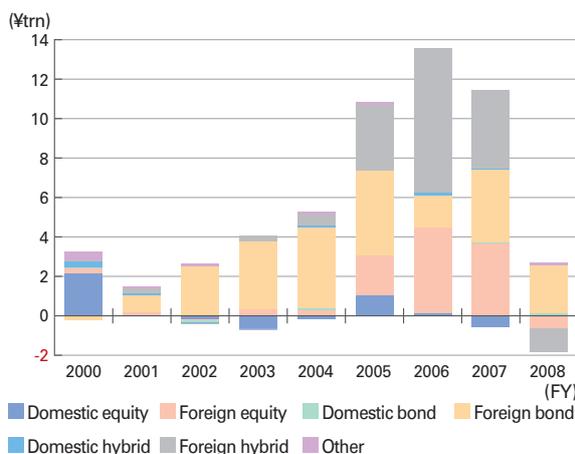
# 3 Retail business

## Foreign bond funds continue to attract inflows

Domestically chartered public investment trusts ended FY08 with aggregate assets of ¥51trn, down sharply from approximately ¥70trn a year earlier and their October 2007 peak of ¥82trn.

Open-end equity funds account for some 80% of total public investment trust assets. Most of their assets are concentrated in foreign equity, foreign bond, and foreign hybrid funds, all of which invest in foreign securities. In FY08, investment trusts continued to experience outflows in response to deterioration in market conditions. Outflows from foreign hybrid and foreign equity funds were particularly large. These outflows were largely attributable to the funds' distribution yields, which have declined from FY07 in the case of foreign hybrid funds and FY08 in the case of foreign equity funds. The decline in yields was accompanied by an outflux of assets. Foreign bond funds, by contrast, maintained their distributions even as their NAVs declined. Their distribution yields consequently rose and inflows into foreign bond funds continued.

Exhibit 14. Investment trust in/outflows by fiscal year



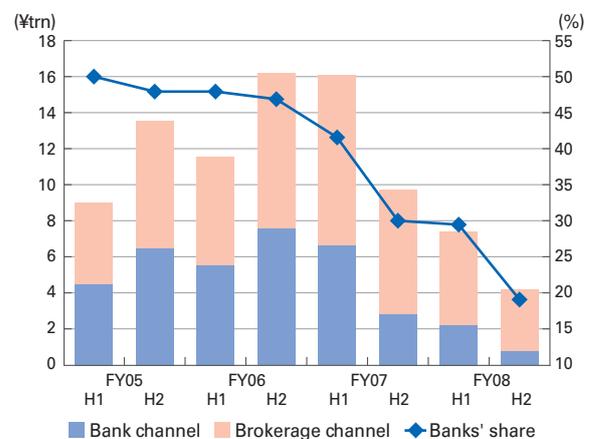
Note: Excludes ETFs, funds with daily settlement arrangements, and bond investment trusts  
Source: NRI, based on Fundmark data

## Changes in sales channels in response to falloff in investment trust sales

Investment trust sales have fallen sharply from the second half of FY07 and their decline accelerated in FY08. In the second half of FY08, sales of public equity investment trusts, which account for the majority of sales commission revenues, were approximately ¥4trn, down 75% from their peak level. This slump in investment trust sales has substantially reduced distributors' revenues related to investment trusts. It has also had a major impact on securities brokerages and banks' shares of investment trust sales. Since Lehman Brothers' collapse, many banks have reportedly virtually suspended sales activities targeted at new customers to concentrate on maintaining contact with existing customers. In the second half of FY08, banks' investment trust sales fell to 10% of their level in the first half of FY07. Securities brokerages, by contrast, have succeeded in halting the slide in their investment trust sales by rolling out new products (e.g., emerging market bond funds, currency-hedged funds) in rapid succession. Brokerages' investment trust sales were down to one-third of their peak level in the second half of FY08.

When viewed from the standpoint of investment trust assets, however, the situation is very different. The bank channel's share of investment trust assets has remained

Exhibit 15. Public equity investment trust sales (ex ETFs)



Source: NRI estimates based on data from Investment Trusts Association, Japan, Financial Affairs Weekly, and Fundmark

Chapter 3: Market trends by client segment and product strategies

stable at a somewhat above 50% for the past several years. This trend reflects that investment trust unit sold by brokerages have a high redemption rate. Over the past five years, brokerage-sold investment trust units' annualized redemption rate is 36%, double that of bank-sold units. From the standpoint of asset management companies, whose earnings vary as a function of their AUM, banks remain an important sales channel by virtue of their stable contribution to investment trust assets.

Additionally, banks' investment trust sales still have substantial upside potential. Since FY06, banks have been pursuing growth in time deposits by offering premium introductory rates in the aim of capturing recent retirees' lump-sum retirement benefits as deposits. Banks' time deposits have grown to ¥24trn, most of which are no longer accruing interest at the introductory rate. These funds may be awaiting more advantageous investment opportunities. They could conceivably flow into investment trusts or other such products if market performance improves.

In terms of timing, recovery in banks' investment trust sales is likely contingent upon further market gains and reduction of existing customers' unrealized losses. In sum, the market environment needs to become more conducive to recommending investment trusts to customers. We estimate that foreign hybrid funds and foreign equity funds have aggregate unrealized losses in excess of 20% as of end-June 2009. Such funds are unlikely to see resumed inflows for a while. Foreign bond funds, however, have already recovered to the vicinity of breakeven. Net inflows to foreign bond funds are likely to soon resume even via the bank channel.

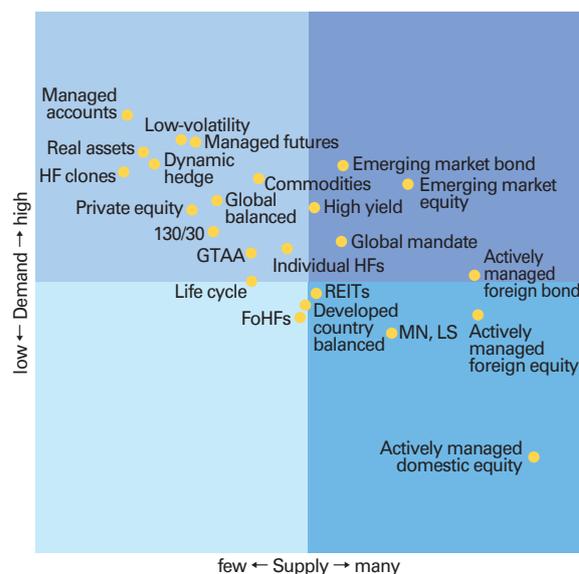
Although many asset management companies offer active management of domestic equities, investor demand for such products is low. Demand for long-short funds, funds of hedge funds, and other such products also has diminished due to deterioration in returns and high liquidity risk.

Products expected to enjoy strong demand from investors in general include emerging market equities and bonds. Demand for commodity products and high-yield bonds is strong among retail investors while managed futures and real assets are in demand among institutional investors, but the supply of such products is lagging behind demand. Additionally, in the wake of the recent financial crisis, demand is also strong for low-volatility investment strategies and equity investment products that incorporate risk management techniques (e.g., dynamic hedging). Asked what products are currently on the drawing board, many respondents indicated that they aim to offer such products that are in very short supply relative to demand.

## 4 Product trends and demand outlook by product

To ascertain what types of products asset management companies are currently offering to Japanese (retail, pension, and financial institution) investors and what kind of products investors are interested in, we analyzed data from the aforementioned questionnaire survey of asset management companies (Exhibit 16).

Exhibit 16. Supply-demand balance for products marketed to Japanese investors



Note: "Supply" (horizontal axis) is an indexed scale of the number of asset management companies that offer the above products. "Demand" (vertical axis) is an indexed scale of the number of asset management companies that perceive strong investor demand for the given product as a percentage of the number of asset management companies that offer that product.

Source: NRI

#### Note

1) With respect to trusts and insurers, this total includes only assets managed on behalf of pension/annuity customers. For life insurers in particular, the total includes only special account balances, not assets in general accounts with guaranteed returns (e.g., fixed-amount insurance, fixed annuities).

2) Operating margin: operating income ÷ net revenues (revenues net of sales commissions to distributors of public investment trusts)

3) In July 2009, NRI conducted an Asset Management Company Benchmarking Survey to identify deficiencies in terms of operating efficiency. Seventeen asset management companies, both Japanese and foreign, participated in the survey.

4) The survey was sent to 505 regional financial institutions throughout Japan. Responses were received from 258 of them (51.1% response rate).

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