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Individual investors seeking greater diversification

Nomura Research Institute, Ltd.

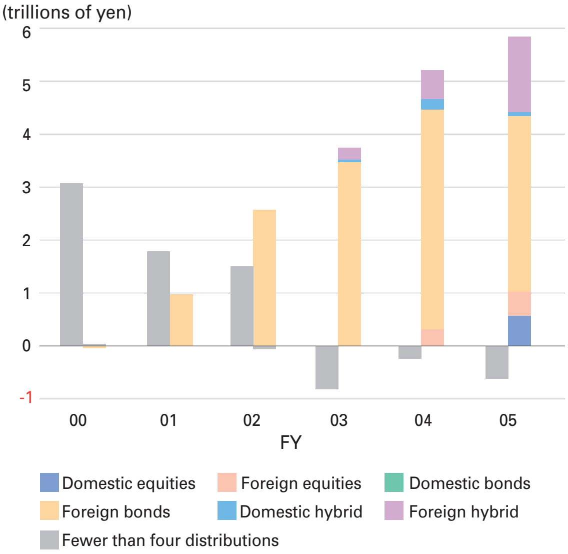
A growing number of funds are offering more frequent distributions for retired investors. Especially popular are diversified investment trusts able to invest in three asset classes: stocks, bonds, and real estate. Such funds reduce risk through diversification while offering yields on a par with foreign bond funds.

More funds offering multiple distributions

With a rising age of eligibility for corporate pension benefits, falling benefits, and an aging population, individuals in Japan increasingly need to take responsibility for funding their own retirements. Investment trusts offering at least four distributions a year—typically monthly distributions—are attracting more money from retirees who seek to apply the distributions to living expenses.

Exhibit 1 illustrates inflows and outflows at funds offering multiple distributions between FY00 and FY05. The gray bars on the left represent investment trusts making fewer than four distributions each year. These funds have experienced a net outflow of funds since FY03. The color-coded bars on the right show net inflows and outflows at funds offering at least four distributions a year. Here, net inflows have steadily risen. A breakdown of these funds by asset class shows that the previous dominance of foreign bond funds is gradually giving way to a more diversified investment approach.

Exhibit 1. Fund inflows and outflows by annual distribution frequency and fund type



Note: Figures for FY05 are through December 31, 2005.

Greater diversification at multiple-distribution investment trusts

From FY01 to FY03 nearly all of the multiple-distribution funds were foreign bond funds sold mainly through banks and paying monthly dividends.

Most of these funds offered high yields but no currency hedges and were therefore characterized by significant currency risk. With speculation on the timing of an end to quantitative easing in the air for some time, there is now a heightened risk of yen appreciation. Rising expectations of an earnings recovery are helping the stock market to emerge from its long slump, and there are more offerings in the REIT market as well.

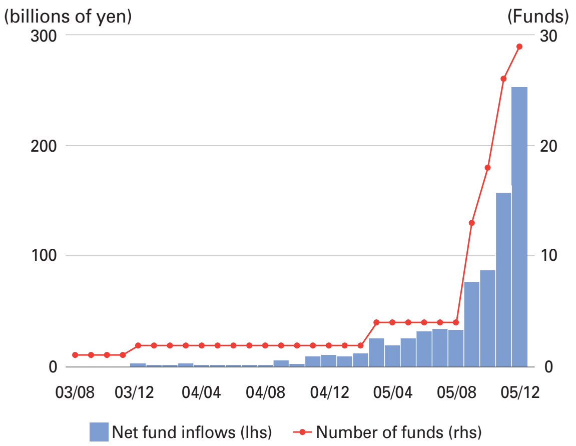
Reflecting this increase in the relative attractiveness of assets other than foreign bonds, multiple-distribution investment trusts investing in these assets have been increasingly popular since FY04. Examples include funds specializing in high-yield stocks, REITs investing in domestic and foreign real estate, and three-asset diversified funds[1] able to invest in stocks, bonds, and real estate. As inflows have diversified with the emergence of new multiple-distribution funds, three-asset diversified funds, considered part of the "overseas hybrid" fund class, have shown especially robust growth.

Emergence of three-asset diversified funds

Investment trusts investing in more than one asset class are not a recent invention. For some time investors have been able to choose from four-asset diversified funds, which invest in domestic and foreign equities and bonds, and funds using tactical asset allocation (TAA) models. But these differ from three-asset funds in two main ways. First, three-asset fund portfolios incorporate real estate in addition to stocks and bonds. Second, these funds can offer more frequent dividend distributions by investing in high-yield issues and tapping the high yields of property holdings.[2)]

The first three-asset diversified fund was offered by Nikko Asset Management about two and a half years ago. At the end of 2005, this fund had more than 500 billion yen in assets, making it Japan's fifth-largest publicly offered equity investment trust. But such growth is only a recent phenomenon. As Exhibit 2 shows, there has been dramatic growth in both the number of funds and net inflows since September 2005. This corresponds roughly with Japan Post's announcement that it would begin selling Nomura's six-asset funds, which led to broadly increased awareness of three-asset diversified funds. Fund inflows in December 2005, the most recent month for which data are available, totaled 250 billion yen, eclipsing inflows to multiple-distribution foreign bond funds (199 billion yen) for the first time.

Exhibit 2. Three-asset diversified funds and net fund inflows

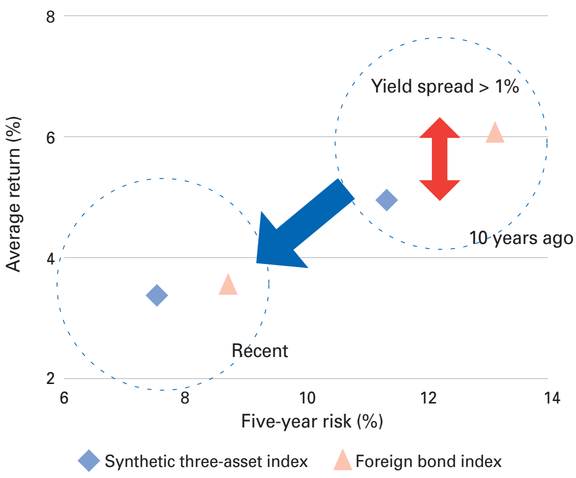


Risk/return characteristics of three-asset funds

We next examined the risk/return characteristics of three-asset diversified funds. Since these funds have insufficient track records to allow reliable analysis, we considered a hypothetical fund that invested 50% of its assets in foreign bonds and 25% each in domestic equities and foreign REITs.[3)] We also assumed the primary objective of holding multiple-distribution funds was to fund retirements and defined the return as income. We then calculated risk and average return on representative indices[4)] for each asset class for the 10-year period from January 1996 to December 2005.[5)]

Exhibit 3 shows risk and average return for the foreign bond index and our synthetic three-asset index at present and 10 years ago. The yield spread between the two indices, once more than 1%, has now almost disappeared. And of course from a risk perspective, diversifying across three assets translates to lower risk than investing exclusively in foreign bonds.

Exhibit 3. Foreign bond index versus synthetic three-asset index



Three-asset diversified funds offer investors the convenience of not having to buy separate funds for individual asset classes, enable them to check their asset allocations at any time, and free them from the need to rebalance their portfolios periodically. In short, they take advantage of the unique characteristics of investment trusts to enable diversification with even small investments.

Note

1) Unlike traditional "balanced funds" that invest in foreign and domestic stocks and bonds, three-asset diversified funds spread their assets across stocks, bonds, and real estate. This category also includes six-asset funds that invest in both foreign and domestic stocks, bonds, and real estate.

2) Whereas more than 85% of all three-asset diversified funds offer multiple distributions, the corresponding figure for traditional balanced funds is only about 10%.

3) Since domestic REITs have such short track records, we assumed the fund had invested in foreign REITs.

4) We used the Citigroup Global Government Index (ex-Japan), TOPIX, and the NAREIT Index for foreign bonds, domestic equities, and foreign REITs, respectively.

5) Risk was measured over a five-year period, and return was the average two-year yield.

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