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Fund inflows from investment trust customers critical to asset manager growth

Nomura Research Institute, Ltd.

In FY06, for the second straight year, Japanese asset managers appear to have set new records for assets under management, investment revenues, and operating margins. Rising fund inflows from investment trust customers have driven growth in the asset management business in recent years. But with revenue growth still dependent on market trends, the outlook is fragile.

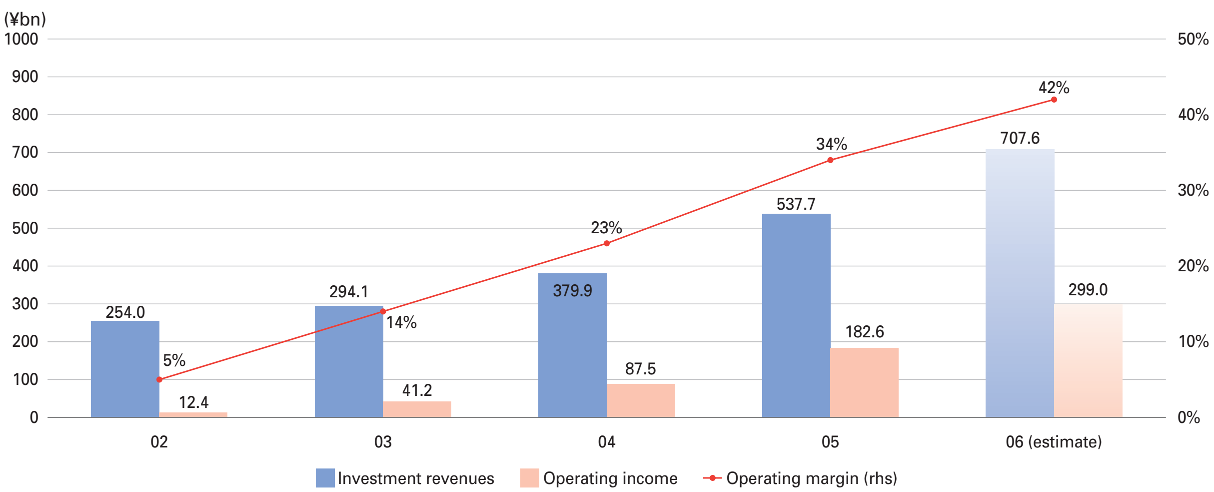
Record assets under management, income, and operating margins

We estimate that Japanese asset managers specializing in investment trusts and investment advisory services, ex trust banks and life insurers, set new records in FY06 for assets under management (270 trillion yen at end-March 2007[1]) and investment revenues (700 billion yen). Assets under management rose 17% over FY05, also a banner year, and investment revenues surged 30%.[2]

Exhibit 1 shows trends in asset manager revenues (which correspond to sales at non-financial companies), operating income, and operating margins since FY02. FY06 revenues were up some 200% compared with FY02, to 700 billion yen, while operating income of almost 300 billion yen translated to a sector-wide operating margin of more than 40%, according to our estimates. The situation is far different from several years ago, when many asset managers had yet to achieve the scale needed to achieve meaningful profitability. While Japanese asset managers remain relatively small, they now enjoy the highest profit margins in the world.[3]

FY06 was also a historic year in that it was the first time that investment trust revenues surpassed those from investment advisory services. When both publicly and privately offered investment trusts are taken into account, investment trust revenues totaled 380 billion yen in FY06, topping investment advisory revenues by 50 billion yen.[4] Over the past four years revenues from investment advisory services have increased at an annual pace of 24%, but those from investment trusts rose even faster, growing by 35% a year.

Exhibit 1. Revenues, operating income, and operating margins, FY02–06



Source: NRI, based on various materials

Rising investment balances responsible for two-thirds of revenue growth

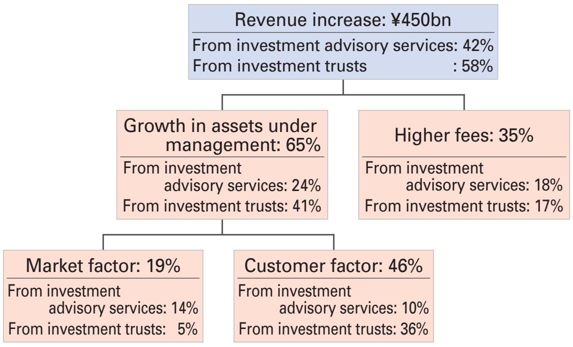
To identify the source of this rapid revenue growth, we performed a factor analysis. The results are shown in Exhibit 2. Investment trusts are responsible for about 60% of the growth in revenues, and investment advisory services for the remaining 40%.[5] Taking a different perspective and breaking revenue growth down into (1) higher assets under management and (2) increased management fees due to changes in the investments themselves (e.g., stocks or bonds), we found that the former was responsible for roughly two-thirds of the revenue gains, with the latter accounting for the remaining one-third.

Higher management fees were generally attributable to a shift to products carrying higher fees, such as equities and foreign securities. In the investment advisory business, for example, there was a significant increase in investments by pension and other funds in Japanese equities and foreign assets rather than Japanese bonds. In general, investment trusts in Japan are shifting from a product mix centered on domestic government and corporate bonds to one built around multiple-distribution foreign bond funds, global balanced funds, and global equity funds.

The two-thirds of revenue growth accounted for by growth in assets under management can be further broken down into a market factor (price) and a customer factor (fund inflows). Fund inflows from customers were responsible for some 70% (46% / 65%) of growth in assets. For investment trusts in particular, increased fund inflows from customers accounted for nearly 90% of the increase in assets under management. Factors making a significant contribution to asset growth included the growing number of sales points at banks and post offices and the development of products better suited to customer needs, such as multiple-distribution funds.

To determine whether the large recent revenue increases are sustainable, we looked at the factors that have driven revenue growth.

Exhibit 2. Factor analysis of revenue growth between FY02 and FY06

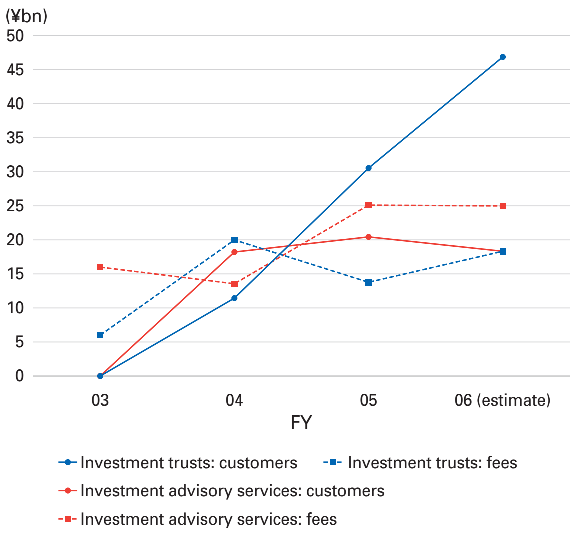


Source: NRI, based on various materials

Fund inflows have driven revenue growth for investment trusts

Exhibit 3 analyzes revenue growth by factor over the last four years.[6] The impact of customer fund inflows has grown steadily in the case of investment trusts. It was largely because of this factor that investment trust revenues surpassed those from investment advisory services in FY06.

Exhibit 3. Breakdown of asset manager revenue growth into management fee and customer factors



Source: NRI, based on various materials

Revenue growth in the investment advisory business attributable to customer fund inflows was comparatively low, trending roughly sideways since FY04. Revenues were almost flat in FY03 as companies returned the so-called substitutional portion (managed on behalf of the government) of pension plan assets to the government.[7)] In each of the following two years, however, there were fund inflows of more than 12 trillion yen, chiefly from public pension funds and overseas customers, adding some 20 billion yen a year in revenues. FY06 saw a similar increase in revenues, while fund inflows themselves amounted to just 5 trillion yen. With large net fund inflows unlikely in FY07 and beyond, we think the contribution of the customer factor in revenue growth will decline going forward.

While the contribution from higher management fees is relatively small for both investment trusts and investment advisory services, it is stable. One issue that will help to determine the sustainability of revenue increases is the extent to which companies can diversify assets under management into alternative investments.

As Exhibit 3 shows, the main driver of revenue growth in the industry has been fund inflows from investment trust customers. But with retail business heavily dependent on market trends, the outlook for revenue growth remains fragile.

Note

1) Does not include investment trust companies specializing in REITs.

2) FY06 figures are estimates based on FY05 data, our database of investment trust revenues in FY06, and assets for which advisory services were provided through end-FY06.

3) Typical operating margins at asset management firms in the US and Europe are said to be in the 30–35% range.

4) In FY05, revenues from investment trusts and investment advisory services were roughly equal.

5) Some investment trusts are privately offered funds designed for financial institutions and other institutional investors. As such, we estimate that there was relatively little difference in revenue growth between funds for individual and institutional investors.

6) Our estimates are for publicly offered investment trusts only. FY06 fee data for investment advisory services is not yet available, so we estimated revenue growth due to customer and market factors based on the assumption that revenue growth due to increased management fee would be unchanged from FY05.

7) This resulted in a large quantity of pension assets being transferred to the government, reducing the value of assets under management.

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