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Individual investors' newfound cognizance of investment trust risk

Nomura Research Institute, Ltd.

Individual investors have hitherto favored investment trusts with high distribution yields, particularly foreign hybrid and foreign equity funds. Recently, however, they no longer select investment trusts on the basis of distribution yield alone, having apparently become more risk-conscious.

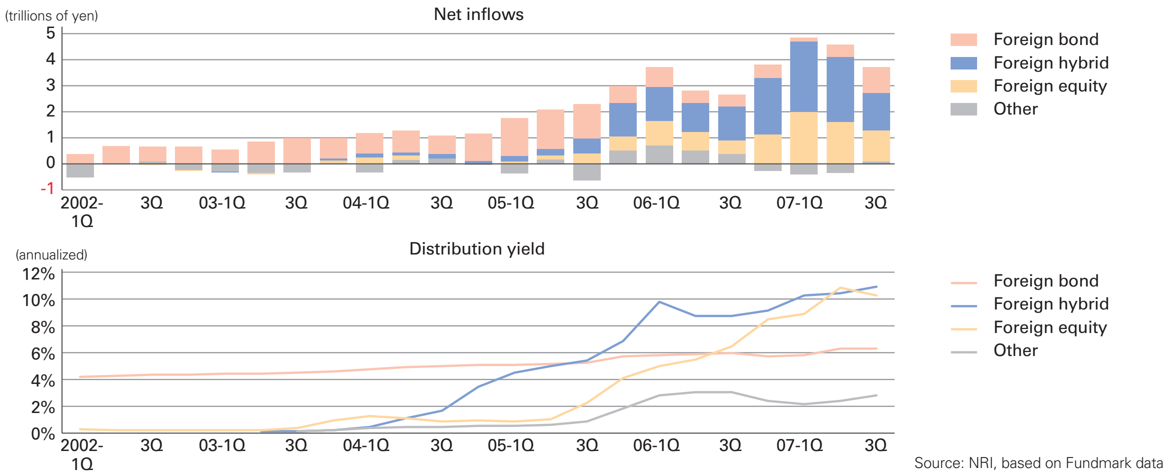
Open-end equity investment trusts enjoyed a steady influx of roughly ¥1 trillion per month for the past several years, until last July. Since then, inflows have slowed. This slowdown has been accompanied by changes in inflows' breakdown among fund types. Funds' popularity was previously said to be largely a function of their distribution yield. Indeed, historical data show a clear correlation between funds' popularity and distribution yield, but this correlation also has begun to change.

Investors' changing preferences vis-à-vis equity investment trusts

First, we look at how investment trust popularity rankings by fund type have changed since 2002, when open-end equity investment trusts began to experience asset growth in earnest. We use net inflows (sales less redemptions) as a proxy for popularity. In the exhibit below, the top graph plots quarterly inflows to open-end equity investment trusts, broken down by major fund type. In Japan, the equity investment trust category also includes funds that actually invest exclusively in foreign bonds and hold no equities[1].

The top graph shows that foreign bond funds captured the vast majority of inflows in 2002–04. From 2005, however, inflows to other types of funds began to gradually pick up. By 2005 Q4, foreign bond funds' share of total net inflows to open-end equity investment trusts (ex ETFs) had fallen below 30%. As foreign bond funds' share declined, the fund types that benefited from growth in their shares of net inflows were foreign equity funds and foreign hybrid funds, which include diversified funds that invest in multiple asset classes and funds that invest in foreign REITs. Inflows to these two types of funds subsequently continued to grow, while net inflows to foreign bond funds continued to diminish. By 2007 Q1, net inflows to foreign bond funds had fallen over 90% from their peak.

Exhibit. Open-end equity investment trust (ex ETFs) net inflows and distribution yields by fund type



Source: NRI, based on Fundmark data

Distribution yield is key determinant of fund popularity

The bottom graph plots distribution yield (cumulative distributions over preceding 12 months ÷ average NAV over same timeframe) by fund type. It shows that in 2002 foreign bond funds were paying a far higher distribution yield than other types of funds. This yield differential persisted for while. It began to change from the latter half of 2004, when foreign hybrid funds' distribution yield began to rise. By 2005 Q3, foreign hybrid funds were paying higher distribution yields than foreign bond funds. Foreign equity funds' distribution yield embarked on a similar uptrend with a lag of about one year, likewise eventually rising above foreign bond funds' distribution yield. Today, the distribution yields on both foreign hybrid and foreign equity funds are above 10% (annualized).

At first glance at the graphs of distribution yield and net inflows by fund type, the fund types' rankings by distribution yield appear to coincide almost perfectly with their rankings by net inflows. When one fund type overtakes another in the distribution yield rankings, the change appears to be immediately reflected in the net inflows rankings also.

The investment trust market's budding risk-consciousness

This correlation between distribution yield and net inflows began to show signs of change from 2007 Q2. Although foreign equity funds and foreign hybrid funds currently still pay far higher distribution yields than foreign bond funds, net inflows to foreign bond funds have resumed growing. As of Q3, foreign bond funds' net inflows had rebounded to approximate parity with those of foreign equity and foreign hybrid funds. Conversely, net inflows to foreign equity and foreign hybrid funds have been declining.

Needless to point out, investors weigh risk and return when making investment decisions. When many investors single-mindedly pursue investment returns in the form of periodic distributions as in today's investment trust market, there is a strong tendency to focus on distribution yield as a measure of return and to make investment decisions by weighing distribution yield against risk. If different fund types' relative shares of net inflows change in the absence of a coincident change in distribution yield differentials among those fund types, it is safe to assume that investor perceptions of the balance between distribution yield and risk have changed. Risk levels differ among fund types by design. For example, annualized risk is roughly 5% for foreign bond funds, approximately 8% for foreign hybrid funds, and over 10% for foreign equity funds. Previously, investors were apparently oblivious to these risk differentials. Any type of fund that paid an even slightly higher distribution yield than other types would immediately see a shift in inflows in its favor.

As of recently, investors no longer select funds solely on the basis of distribution yield. Even though foreign bond funds yield only about half as much as foreign hybrid and foreign equity funds, net inflows are now roughly evenly split among these three fund types, implying that investors have become more sensitive to risk than in the past.

The Financial Instruments and Exchange Law (FIEL), in effect since September, requires financial institutions to explain risks to customers when selling investment trusts. The investment trust market apparently started to become much more cognizant of investment trusts' risk in anticipation of the FIEL's effective date.

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Note

1) Japan's Investment Trusts Association defines "equity investment trusts" as investment trusts able to invest in equities. It is therefore possible for a fund that invests primarily in foreign bonds and has no equity investments to be registered as an equity investment trust.

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