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Has J-SOX had any impact other than dampening investment trust sales?

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Investment trust inflows have fallen sharply since last summer in response to subprime woes and the J-SOX law's advent. Meanwhile, previously out-of-favor fund categories have seen a pickup in sales, suggesting that investment trust distributors may be reforming their sales processes as intended by J-SOX.

Investment trust inflows down sharply under the weight of J-SOX and market downturn

Until last August, monthly net inflows[1)] to open-end equity investment trusts were consistently running in the vicinity of ¥1.5 trillion, not even counting ETFs. In September and October, monthly net inflows fell to around ¥600 billion, less than half of their previous level. This drop was attributed to investment trust distributors, particularly banks, implementing more rigorous sales procedures from early September to comply with the then-pending Financial Instruments and Exchange Act, more commonly known as the Japanese Sarbanes-Oxley (J-SOX) law, which took effect on 30 September 2007.

Once the subprime mortgage crisis began to reverberate through financial markets in earnest, investment trust inflows fell further. In January 2008, open-end equity investment trusts' average return was -9.1%, their worst monthly performance since banks began selling investment trusts in December 1998. Moreover, monthly returns were negative in five of the six major categories of investment trusts[2)], the sole exception being domestic bond funds. Since January, net inflows to open-end equity investment trusts (ex ETFs) shrank further, falling to a monthly rate of ¥300 billion, partly reflecting poor investment performance across a broad range of investment trusts. In sum, investment trust net inflows are down some 80% from their level through last August.

Inflows have shifted in favor of foreign bond and emerging market funds

Amid the sharp falloff in investment trust inflows, fund categories' popularity rankings also have shifted. The exhibit below lists the top five and bottom five fund categories (based on the NRI Fundmark classification scheme) in terms of change in net inflows over the six months through February 2008 relative to the preceding six months.

The fund category that experienced the largest decline in net inflows was foreign hybrid (balanced), a category that includes many asset allocation funds. Other categories that saw major declines in net inflows (or swings from net inflows to net outflows) include foreign equity (global) and

Exhibit. Changes in net inflows to investment trusts

Top 5 fund categories in terms of change in net inflows

(¥bn)

		07/03 ～07/08 (A)	07/09 ～08/02 (B)	Changes in net inflows to investment trusts (B-A)
1	Foreign bond (global)	964.7	1,809.8	845.1
2	Foreign equity (emerging)	83.2	270.8	187.5
3	Foreign bond (Asian/Oceanian currency)	-0.2	104.4	104.6
4	Foreign bond (emerging)	336.3	364.7	28.4
5	Foreign equity (North America)	-51.0	-26.4	24.6

Bottom 5 fund categories in terms of change in net inflows

(¥bn)

		07/03 ～07/08 (A)	07/09 ～08/02 (B)	Changes in net inflows to investment trusts (B-A)
1	Foreign hybrid (balanced)	3,903.1	284.4	-3,618.7
2	Foreign equity (global)	2,175.1	143.7	-2,031.4
3	Foreign hybrid (REIT)	715.0	-295.9	-1,010.9
4	Foreign equity (Asia/Oceania)	588.4	-69.1	-657.5
5	Foreign equity (Europe)	371.5	-32.6	-404.1

Note: Net inflows = gross inflows - redemptions. Source: NRI Fundmark foreign hybrid (REIT). All three of these categories were popular with investors from 2006 through early to mid-2007 and all experienced declines in semiannual net inflows of at least ¥1 trillion.

In contrast, the fund categories that saw major increases in net inflows (or decreases in net outflows) include foreign bond (global), foreign bond (Asian/Oceanian currency), foreign bond (emerging) and foreign equity (emerging). Of these, foreign bond (global) was the most popular fund category until 2005. From 2006, its popularity waned as balanced funds, REITs, and foreign equity funds gained favor among investors. Recently, however, the foreign bond (global) category has seen a resurgence in inflows. With inflows into the overall investment trust complex on the decline, the volume of inflows into Australian bond funds, emerging market bond funds, and emerging market equity funds is impressive in relative terms. Popular fund categories collectively span a broader investment universe than ever before.

Emerging market funds are prominent even in the bank channel

The funds that have recently gained popularity (e.g., foreign bond funds, emerging market funds, Asian/Oceanian currency funds) have traditionally been marketed chiefly by securities firms. Recently, however, banks have also started to actively market such funds. For example, of 10 emerging market bond funds with net inflows in excess of ¥4 billion in January and February 2008, four are sold primarily through banks. In the emerging market equity fund category, banks accounted for an estimated 40% or more of the January and February sales of four of 15 funds with net inflows in excess of ¥4 billion in those two months. Moreover, the emerging market equity fund with the most net inflows in January and February is sold exclusively via the bank channel. We have heard from knowledgeable sources that more banks apparently plan to offer emerging market bond and/or equity funds.

J-SOX's impact to date is not all bad

Investment trusts that invest in emerging markets have favorable prospects for high returns over a long-term horizon, but they pose a high risk of large temporary losses. Unlike the global bond funds and diversified funds that have accounted for the bulk of investment trust sales in recent years, emerging market funds are not suitable for all investors. That such funds are nonetheless now being sold through banks suggests that banks' sales processes have started to change. In other words, banks' recent record of emerging market fund sales can be construed as evidence that banks have adopted a sales approach that involves carefully screening customers and educating them on investment trust products' risk and return profiles. Whether this change is substantive or merely superficial is open to debate, but promoting such a sales approach that places priority on customer education was J-SOX's aim vis-à-vis investment trust distributors. J-SOX was undoubtedly one catalyst behind recent changes in how banks sell investment trust products. In fact, some of the most successful distributors of emerging market funds have adopted the most proactive approaches to ascertaining customers' needs in response to J-SOX's advent.

It will likely take a while longer to substantiate a correlation between sales approach and sales results. While J-SOX has been widely criticized for having an adverse impact on investment trust sales, its emergent positive impact cannot be overlooked.

Note

1) Net inflows: gross inflows - redemptions.

2) The major investment trust categories' rates of return in January 2008 were -10.6% for domestic equity, -16.2% for foreign equity, -4.5% for foreign bond, -9.4% for domestic hybrid, and -8.5% for foreign hybrid.

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