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Have households become more conservative in their asset allocations?

Nomura Research Institute, Ltd.

Household financial assets declined sharply in FY07. At first blush, households appear to have become more conservative in their asset allocations, increasing their holdings of time deposits. But households still exhibit a robust risk appetite, particularly in their propensity to invest in foreign-currency products.

Household financial assets decreased substantially in FY07 (year ended March 2008). According to the Bank of Japan's Flow of Funds Accounts (preliminary data), household financial assets ended FY07 at ¥1,490trn, down ¥55trn from a year earlier, their largest one-year drop on record. While equity valuations were marked down by the equity market's decline in FY07, currency/deposits and JGB holdings ended March at record highs, leading some to conclude that households are reallocating assets back into safe financial products. In recent years, households have been increasing their asset allocation to investment products. Has this trend reversed?

Household financial assets flowing back into bank deposits

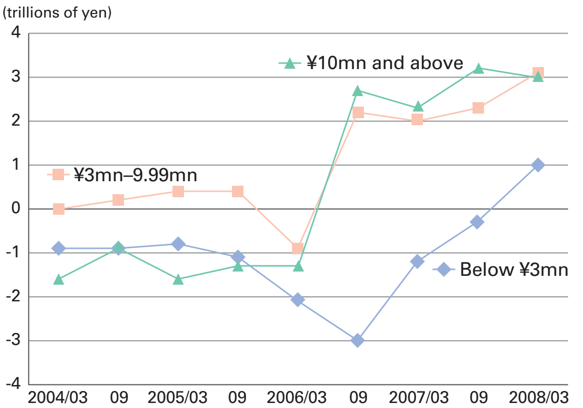
Within the currency/deposits asset class, time deposits in particular increased in FY07. Time deposits initially resumed growing in FY06 as some financial institutions saw inflows into time deposits, mainly from recent retirees. In FY07, inflows into time deposits began to broaden beyond the retiree demographic.

Exhibit 1 shows changes in personal time deposit balances at financial institutions other than Japan Post Bank, by deposit size broken down into three denominations: less than ¥3mn, ¥3mn or more but less than ¥10mn, and ¥10mn or more. It shows a pronounced divergence in net in/outflows between denominations. In FY06, time-deposit balances resumed growing in the two larger denominations but decreased by over ¥4trn in the sub-¥3mn denomination. We surmise that this dichotomy is related to “teaser” interest rates[1] that many financial institutions began offering to attract deposits from recent recipients of lump-sum retirement benefits. Considering that many financial institutions required minimum deposits of ¥5mn or more to qualify for these teaser rates, we mainly attribute time deposits’ growth in FY06 to such campaigns to attract deposits funded by retirement benefits[2].

If growth in time deposits was solely attributable to such campaigns, we would expect assets to be reallocated from time deposits into investment products (e.g., investment trusts) once the teaser interest rate expired (after around three months in most cases). In actuality, however, balances of the two larger denominations of time deposits did not decrease in FY07. Moreover, the balance of sub-¥3mn time deposits also started growing. We doubt that growth in the smaller time deposits is solely attributable to a single class of customers (i.e., recent retirees), leading us to conclude that a broader cross-section of individuals began transferring assets into time deposits.

In FY07, previously torrential inflows into investment trusts also began to exhibit change. Over the course of FY07, investment trusts' quarterly net-inflows progressively diminished from a hefty ¥6trn in Q1 to little more than ¥1trn in Q4.

Exhibit 1. Growth in time deposits (change from 6 months earlier)



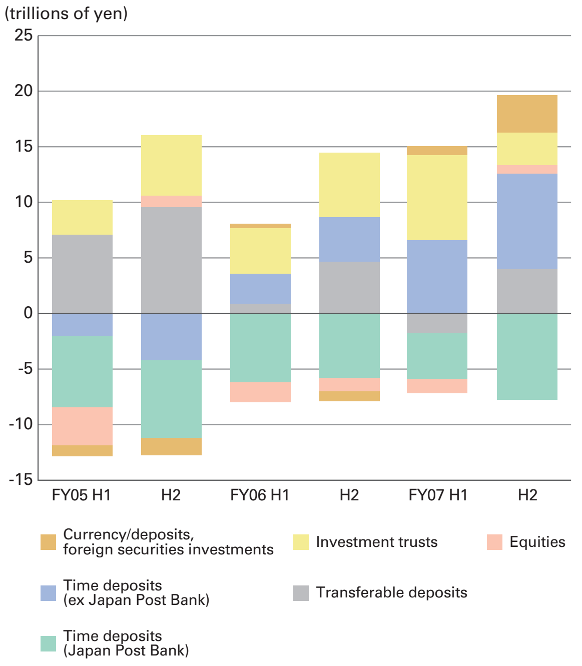
Source: Bank of Japan, Outstanding deposits by depositor (by amount)

Households are assuming currency and interest rate risks

While net inflows to the overall investment trust complex have been declining, net in/outflows vary by fund category. Foreign equity funds and balanced funds, holdings of which include REITs and foreign equities, have seen net inflows decline sharply or reverse into net outflows. Foreign bond funds, by contrast, are enjoying growth in net inflows. Aside from investment trusts, other risk-bearing financial products such as foreign-currency deposits and foreign-currency bonds[3] also have been experiencing growth in net inflows (Exhibit 2). Between FY07 H1 and H2, net inflows to foreign-currency deposits and foreign securities investments increased by some ¥3trn, offsetting more than half of the roughly ¥5trn decline in net inflows to investment trusts.

Such growth in money flows into foreign-currency bonds and deposits may lead many readers to conclude that individual investors are still pursuing high nominal yields without carefully weighing the associated risks. However,

Exhibit 2. In/outflows to/from major financial products marketed to individuals



Source: Bank of Japan, Flow of Funds Accounts

one could also argue that individuals are starting to exhibit some understanding of currency and interest rate risks as they endeavor to manage their assets. To wit, money flows into foreign-currency bonds and foreign-currency deposits during the later half of FY07 burgeoned in Q4 (Jan-Mar 2008) in particular. This upsurge coincided with progressive yen appreciation and rapid erosion of Japanese investors' returns from foreign-currency bond holdings. Many individual investors apparently saw the yen's appreciation as a high-probability opportunity to reap high returns, recognizing that exchange rates are prone to large swings.

With investment trust inflows, which have hitherto symbolized Japanese households' evolution from savers to investors, recently diminishing while inflows to time deposits have grown, households may appear to be becoming more conservative in their asset allocations. Upon closer examination, however, individuals do not necessarily seem to have become more risk averse, as noted above. On the contrary, they appear to be investing more actively in foreign-currency bonds and other such products with at least some understanding of currency and interest rate risks. The shift from saving to investing has by no means stalled.

Note

1) For example, one major bank offered retirees a 2% APR on 3-month time deposits (¥5mn minimum). This rate is an annualized 175bps above its regular 3-month time-deposit rate.

2) For more details, see "Are deposits making a comeback? –an analysis of BoJ flow-of-funds data–" (Yasuki Okai) in the August 2007 edition of this publication (http://www.nri.co.jp/english/opinion/lakyara/2007/pdf/lkr200725.pdf).

3) Such products are classified as foreign securities investments ("outward investments in securities") in the BOJ's Flow of Funds Accounts. In addition to foreign-currency bonds, such foreign securities investments also include foreign equities and other securities, although they are said to predominantly comprise foreign bonds.

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