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Special Edition

Japan's Asset Management Business 2008 (Summary)

Nomura Research Institute, Ltd.

Japanese investor trends

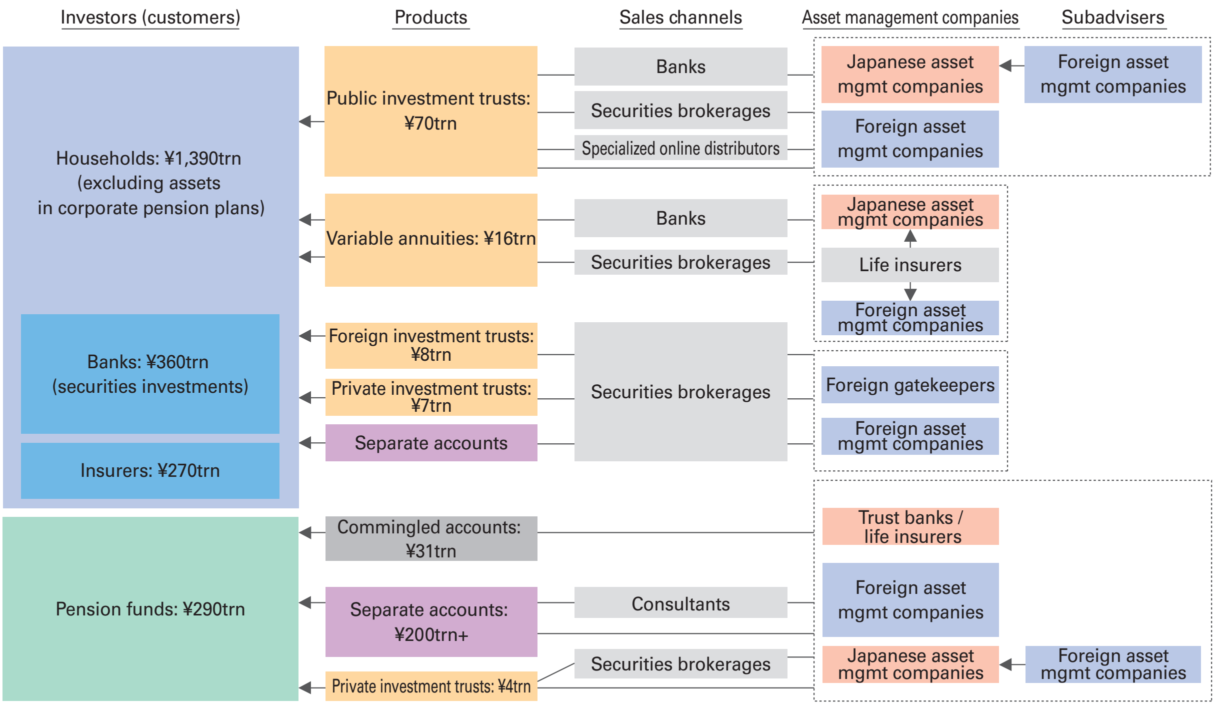
Japanese investors are still a huge potential market

In FY07, the Japanese asset management business was hard-hit by the global equity market slump triggered by the subprime mortgage crisis. Nonetheless, Japan's asset management market still has huge growth potential.

Exhibit 1 provides an overview of the market broken down in terms of investors, products, distribution channels, and asset managers. It shows in simple terms which types of asset managers manage money for which types of investors, how investor assets are allocated, and how the money flows are intermediated.

In Japan, asset management companies mainly serve three types of clients: retail investors (households), corporations including financial institutions, and pension funds. These investors hold financial assets totaling an estimated ¥1,680trn, adjusted to take into account that financial institutions' securities portfolios are basically funded with retail customers' deposits, Meanwhile, asset management companies' assets under management (AUM) total some ¥351trn[1], meaning that a mere 21% of Japanese investors' financial assets are professionally managed. Even excluding the estimated portion of cash

Exhibit 1. Overview of Japan's asset management business



Source: NRI, based on data from various sources holdings earmarked for living expenses and portion of insurance assets that represent subsistence security instead of investable savings, the pool of assets that potentially could be allocated to investment products exceeds ¥700trn in our estimation. The Japanese asset management business still has substantial scope for growth.

Currently, asset management companies' clientele predominantly comprises wholesale clients (financial institutions, pension funds) as opposed to retail clients (individuals). Wholesale clients account for ¥265trn or roughly 75% of asset management companies' total AUM. In terms of latent growth potential, however, the retail market is larger than the wholesale market. It is also more lucrative. Asset management companies derive a disproportionate (over 40%) share of their asset management revenues from the retail market, mainly investment trusts with relatively high management fees.

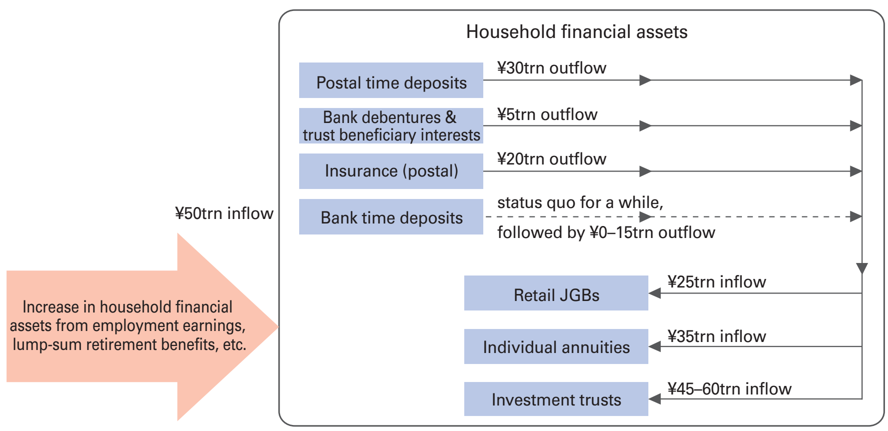
Households: shift from saving to investing continues

Japanese households' financial asset holdings total some ¥1,390trn, down ¥60trn from FY06-end but nonetheless a massive hoard. Households hold over 70% of their financial assets in the form of cash, bank deposits, and insurance products (excluding annuities). Their allocation to risk-bearing assets is still small. Moreover, inflows to the investment trust market slowed in FY07 in the wake of the downturn in securities markets and effectuation of the Financial Instruments and Exchange Law. Meanwhile, bank time deposits have recently resumed growing. This confluence of trends has provoked concern that households have ceased reallocating assets from savings to investment products.

In response to such concerns, we looked at household asset allocation trends from a moderately long-term perspective. First, the six years through FY07 saw uninterrupted outflows of assets from postal (currently Japan Post Bank) time deposits, bank debentures, loan trusts, and postal (currently Japan Post Insurance) life insurance. These outflows plus new savings collectively funded annual inflows of roughly ¥29trn spread among a number of asset classes, including cash and demand deposits, retail JGBs, individual annuities, and equity investment trusts. As noted above, bank time deposits also have been experiencing net inflows for the past three years.

Based on these historical trends, Exhibit 2 projects household asset reallocation trends over the next five years. Inflows to cash and demand deposits have recently turned downward. Additionally, banks have been using "teaser" interest rates to induce recent retirees to deposit

Exhibit 2. Projected household-sector asset flows into/from investment products (5-year horizon)



Source: NRI

their lump-sum retirement benefits into time deposits, but the teaser rates are short-term, typically expiring in three months or so. These funds are consequently prone to reallocation to other products, most likely investment products in our view. Factoring in new inflows of funds (e.g., lump-sum retirement benefits) to the household sector, we project that over the next five years households will invest an incremental ¥25trn in retail JGBs, over ¥35trn in individual annuities, and ¥45–60trn in equity investment trusts. From this longer-term perspective, the trend toward reallocation of household financial assets from savings to investment products remains intact in our view.

Financial institutions are increasingly investing in securities

The biggest class of wholesale investors is pension funds, with estimated assets of ¥290trn as of March 2008. Of this total, public pension assets account for ¥200trn, unchanged from a year earlier. Corporate pension funds account for the remaining ¥90trn, down ¥10trn from a year earlier. Of total pension assets, an estimated ¥203trn is managed by asset management firms. The pension market is huge, but with Japan's population shrinking and the baby boomers retiring, its prospects for asset growth are limited.

Meanwhile, securities investment is playing an increasingly important role for banks, insurers, and other financial institutions. Banks ended FY07 with securities holdings of ¥188trn, a ¥12trn decrease from a year earlier. Although banks' ratio of securities holdings to deposits decreased modestly in FY07, it remains high at 31% for domestic banks in aggregate. In terms of the composition of their securities holdings, banks increased their allocations to corporate bonds and "other securities" (i.e., foreign securities, investment trust, hedge funds, etc.) again in FY07. Banks thus continue to pursue investment returns through high-yield products. With the economy now in the midst of a slowdown, banks' loan-to-deposit ratios are unlikely to rise much over the next few years. Securities investment is therefore likely to assume even greater importance as a profit source for banks.

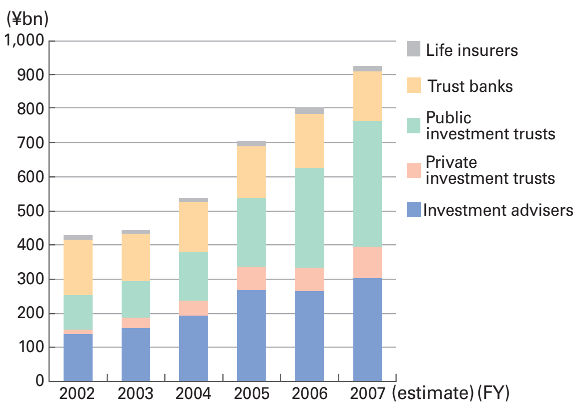
Among individual financial institutions, two that are particularly noteworthy as major investors are Japan Post Bank and Japan Post Insurance, with combined security holdings of ¥260trn as of end-March 2008. At the time of their privatization, both unveiled management plans that discuss their future securities portfolio management plans. Both plans emphasize risk diversification and upgrading of portfolio management capabilities. Looking ahead, we expect JP Bank and JP Insurance to progressively diversify their securities portfolios away from investment in bonds predominantly held to maturity and to outsource asset management involving asset classes and investment strategies in which they lack sufficient in-house expertise. JP Bank and JP Insurance have the potential to emerge as major clients for asset management companies.

Current state of asset management business and asset management firms' management priorities

1 Japanese asset management business has hit a lull

In our estimate, Japan's asset management industry earned FY07 management revenues of approximately ¥922bn on AUM of roughly ¥374trn (including foreign clients' assets) as of end-March 2008. Relative to a year earlier, AUM ended FY07 down ¥38trn (9.2%), but management revenues increased ¥122bn (15.3%) in FY07 to another all-time record (Exhibit 3). The majority of the industry's AUM is managed by specialized asset management firms–i.e., investment advisers and investment trust companies, which respectively account for 40% (¥151trn) and 27% (¥102trn) of total AUM. Below we look at how these asset management companies fared in FY07.

Exhibit 3. Asset management companies' aggregate management revenues



Source: NRI, based on asset management companies' income statements filed with the Financial Services Agency and Ministry of Finance, and data published by the Investment Trusts Association and Japan Securities Investment Advisers Association

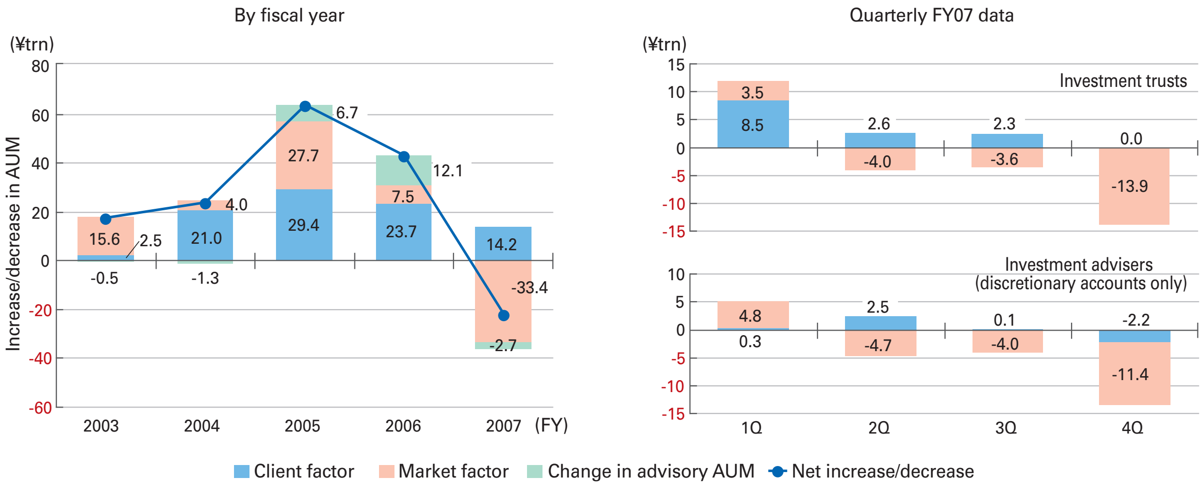
Management revenues increased sharply despite decline in AUM

Asset management companies ended FY07 with AUM of ¥253trn, a ¥22trn decrease from FY06-end following five consecutive years of brisk growth in AUM. In Exhibit 4, the leftward graph plots the past five fiscal years' annual changes in AUM broken down by causative factor. The client factor (net in/outflows of funds) and market factor (change in market values) both contributed positively to AUM growth every year through FY06. In FY07, however, the market factor detracted from AUM by a hefty ¥33trn, even as the client factor remained a net positive. On balance, the former outweighed the latter, resulting in a net decrease in AUM.

Exhibit 4's rightward graph plots the same FY07 data on a quarterly basis, broken down between investment trusts and investment advisers. In Q1, both factors' respective contributions to AUM growth were still positive, with the client factor contributing substantially to AUM growth for investment trusts in particular. The market factor's contribution subsequently turned negative for the remaining three quarters in the wake of the emergence of subprime mortgage problems. Meanwhile, net inflows from clients also declined, likely in response to market turbulence. In Q4, even investment trusts ended up experiencing a loss of assets from the client factor.

Asset management revenues, by contrast, still continued to grow briskly. We estimate that investment trusts and investment advisers respectively earned FY07 management revenues of approximately ¥460bn and ¥300bn, collectively exceeding their FY06 aggregate revenues by over ¥130bn. Japanese asset management companies achieved an aggregate operating margin of 31%, putting them on a par with their US and European counterparts in terms of profitability. Additionally, investment trusts accounted for a 60% share of investment management

Exhibit 4. Changes in AUM broken down by causative factors



Source: NRI, based on data from the Investment Trusts Association of Japan and Japan Securities Investment Advisers Association

firms' total management revenues, substantially outearning investment advisers for a second consecutive year after doing so for the first time ever in FY06.

How did management revenues manage to grow even as AUM decreased in FY07? Management revenues are a function of two factors: the average management-fee rate charged against AUM and the average AUM balance during the fiscal year. Management-fee rates did not rise much in aggregate in FY07. This factor accounted for not even 20% of management revenues' FY07 growth. The predominant factor was growth in AUM's average balance. Although AUM ended FY07 below their year-earlier level, their FY07-average balance was boosted by substantial net inflows early in the fiscal year (Exhibit 4, rightward graph).

Investment trusts, however, experienced a net outflow of assets in Q4, as noted above. Although investment trusts' average management-fee rate has continued to rise in the wake of a shift in assets from bond funds to equity funds, it no longer has much upside potential in our view. The investment advisory business is likewise faced with stagnant management-fee rates and sluggish inflows. In the event of protracted market turmoil, asset management companies could see a downturn in management revenues.

Investment trusts and investment advisers differ in their business models

Within Japan's asset management industry, the lineup of players and degree of concentration of AUM differ substantially by market segment (e.g., public investment trusts, discretionary portfolio management). In the public investment trust business, assets tend to be highly concentrated among the largest asset management companies by AUM. In FY07, the top three asset management companies by AUM accounted for 46% of public investment trust assets while the top ten accounted for 76%. Of the top ten, seven are Japanese asset management companies. It is important for investment trust sponsors to provide sales support to their distributors that deal directly with retail customers. Large asset management companies with the wherewithal to provide such support have been gaining market share.

In the discretionary portfolio management business, AUM is less concentrated among the top-ranked firms. The top ten firms by AUM account for 50% of total AUM. Discretionary portfolio management is a business in which even small asset management firms can carve out a viable niche by offering distinctive asset management products and services.

By nationality, the asset management industry's total AUM is split roughly 50:50 between Japanese and foreign firms. Foreign firms predominate in the investment advisory business with a 60% share of AUM, while Japanese firms dominate the public investment trust business with over 70% of AUM. However, these percentages do not take into account the subadvisory business, where foreign firms play a key role in managing overseas assets. Relative to their collective share of AUM, foreign asset management companies account for a disproportionately large share of management revenues in both the investment trust and investment advisory businesses. In the investment trust business, foreign firms' outsized share of revenues likely reflects that they predominantly offer equity funds, whereas Japanese firms typically have a broader range of offerings, including bond funds. In the investment advisory business, it presumably reflects that foreign firms place priority on offering products with a heavy weighting of foreign securities and high management fees.

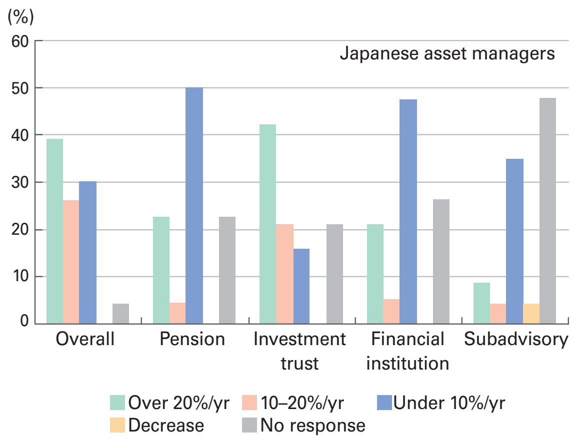
2 Future outlook and management priorities

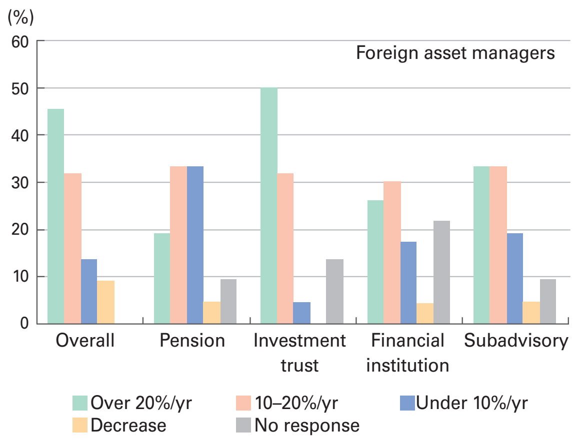
With the asset management industry's hitherto brisk growth trend seemingly at an inflection point, how do asset managers themselves see the state of their business? We conducted a survey of top executives of major asset management companies in June 2008 as a follow-up to our 2007 survey.

Asset managers' outlook remains bullish

Exhibit 5 plots the distribution of survey respondents' projected annual growth rates for their own companies' AUM over the next 3–5 years by market segment (e.g., investment trusts, pension funds), with Japanese and foreign asset managers' responses plotted separately. In terms of overall AUM growth, the most common response was "over 20% per annum" for both Japanese and foreign respondents. Among Japanese respondents, 65% projected annual growth of 10% or more; for foreign respondents, the corresponding percentage was 77%. Over two-thirds of asset management companies still project double-digit growth. A major difference between our 2007 and 2008 survey results is that there is no longer much of a divergence in AUM growth forecasts between foreign and Japanese respondents. In the 2007 survey, foreign respondents were extremely bullish in their AUM growth projections, but their bullishness moderated somewhat in 2008. Japanese respondents' growth projections were largely unchanged in 2008. The divergence in outlook between Japanese and foreign respondents consequently narrowed.

Exhibit 5. Projected AUM growth rates over next 3–5 years





Source: NRI *Survey of Asset Management Companies' Management Priorities (2008)*

The market segment with the highest projected growth rate is investment trusts. Nearly half of respondents project investment trust AUM growth in excess of 20% per annum. Although investment trust sales slumped in the latter half of FY07, asset managers apparently anticipate continued growth in investment trusts as the investment product most likely to benefit from inflows of household financial assets. Like the consensus outlook for AUM growth, respondents' outlook for profitability is also bullish. Some 60% of respondents expect profit margins (factoring in costs) to "improve from current levels." In terms of staffing, around 45% of both Japanese and foreign respondents plan to expand their workforces by at least 10% over the coming 3–5 years. Foreign respondents' hiring plans, which were notably bullish in the 2007 survey, were somewhat more restrained this year, but Japanese respondents' hiring plans are somewhat more ambitious this year than last, resulting in convergence in hiring plans between the two groups. Both plan to expand their marketing staffs in particular.

Recruiting and retaining personnel is a key priority

It goes without saying that human resources are a crucial factor for asset management companies. A majority of respondents cited "staff development (augmentation)," particularly in their asset management and back-office operations, as an utmost management priority, presumably because these operations' success depends predominantly on their staff's skills. For back-office operations, 90% of respondents cited staff development as their top priority. Currently, asset management companies apparently aim to strengthen their in-house resources instead of outsourcing operations.

In terms of employee compensation, high percentages of respondents cited improvement in compensation schemes as a top priority in asset management and marketing operations. For middle- and back-office operations, by contrast, sizable percentages of respondents, particularly among Japanese firms, cited reducing workload and improving status as top priorities, suggesting that an implicit hierarchy exists among organizational functions in Japanese asset management companies. Such issues need to be addressed despite the difficulty of changing an entrenched corporate culture.

In terms of hiring, foreign firms generally remained focused on hiring experienced personnel that require little or no training while Japanese firms highly prefer to hire young personnel and train them in-house. This year's survey, however, is distinguished by an increase in the percentage of Japanese respondents seeking to hire experienced marketing personnel on a priority basis.

Changes in investment trust marketing

Our survey queried respondents from various angles about their management priorities by organizational function. One area in which we saw a major change from last year's survey is investment trust marketing. Asked what type of numerical targets they set, about 40% of respondents reported that they place top priority on growth in AUM while a roughly equal percentage places top priority on growth in inflows of new assets. This latter percentage increased from last year's survey. Asset management companies are apparently now placing precedence on reviving growth in inflows in response to the large falloff in investment trust sales in the latter half of FY07.

Another change in investment trust marketing is sales channels' relative priority. In the 2007 survey, an extremely high percentage of respondents considered city and regional banks to be their key sales channel. In the 2008 survey, however, respondents generally placed much higher importance on securities brokerages as a sales channel. This shift presumably reflects that since mid-FY07, investment trust sales through securities brokerages have continued to grow, whereas sales through the bank channel have fallen precipitously in response to the Financial Instruments and Exchange Law coupled with the market slump.

Market trends by client segment and product strategies

1 Pension business

Public pension market: asset growth has stagnated

We estimate Japanese pension assets as of end-March 2008 at approximately ¥290bn, some ¥200bn or nearly two-thirds of which belong to public pension schemes (National Pension, Employees' Pension Insurance, and Mutual Aid Associations). The Employees' Pension Insurance program accounts for 70% of these public pension assets. Its assets, together with National Pension assets, have been managed by the Government Pension Investment Fund (GPIF) since FY01. The GPIF ended March 2008 with market-invested AUM of ¥91trn, a ¥6trn increase from a year earlier.

The GPIF's market-invested assets at FY07-end comprised about 60% domestic bonds, 15% domestic equities, and slightly over 20% foreign securities. During the course of FY07, the GPIF increased its asset allocation to domestic bonds by 10 percentage points (ppt) while conversely reducing its domestic and foreign equity allocation by 10ppt. Given the enormity of the GPIF's AUM, some 80% of its market-invested assets are passively managed. Such an investment style coupled with its economies of scale enables the GPIF to charge a miniscule management fee of 0.03% of assets.

The Employees' Pension Insurance program is scheduled to redeem the remainder of its assets deposited in the Fiscal Loan Fund by end-March 2009. Its former obligation to purchase FILP (Fiscal Investment and Loan Program) bonds expired in FY07. The GPIF's AUM has been steadily growing to date, but in light of the expiration of institutional arrangements (e.g., redemption of Fiscal Loan Fund deposits) and prevailing demographic trends (ie, societal aging, low birthrate), we see little prospect of major growth in the GPIF's AUM. Once the Fiscal Loan Fund deposits have been fully redeemed, growth in the GPIF's market-invested AUM is likely to slow to a modest pace, driven largely by redemption of FILP bond holdings.

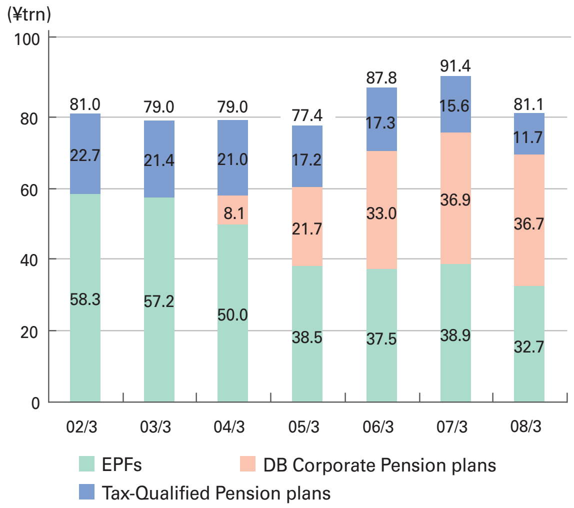
Corporate pension assets are predominantly held in defined benefit (DB) plans, which ended FY07 with assets of ¥81trn, down ¥10trn from a year earlier. Much of this decline is attributable to deterioration in the investment environment from mid-FY07. Corporate DB pension assets in aggregate earned a negative return in FY07 for the first time in five years.

Among corporate pension plans, Employees' Pension Funds (EPFs) saw a major plunge in assets, although the ongoing decline in the number of EPFs has slowed to a trickle, reflecting that renationalization of the so-called substitutional portion of EPF assets and liabilities (Daiko-Henjo) has largely run its course. DB Corporate Pension plans substantially increased in prevalence in FY07. We surmise that much of this increase stems from conversion of Tax-Qualified Pension plans into DB Corporate Pension plans. Despite DB Corporate Pension plans' numerical growth, their aggregate assets ended FY07 nearly unchanged from a year earlier. Nevertheless, FY07 was a watershed year in which DB Corporate Pension plans finally surpassed EPFs in asset-value terms to become the predominant type of corporate pension plan (Exhibit 6).

In aggregate, DB Corporate Pension plans and EPFs reduced their domestic and foreign equity allocation by some 6–8ppt and increased their bond allocation by an equivalent margin. EPFs are increasingly investing in alternative asset classes. In FY07, they increased their hedge fund allocation to over 6% of assets. Including other products in addition to hedge funds, EPFs had 10% of their assets allocated to alternative investments at FY07-end.

Tax-Qualified Pension plans, slated to be phased out of existence by end-March 2012, are in decline in both number and assets, but 33,000 of them with aggregate assets of ¥11.7trn remained in existence at end-March 2008. Of the Tax-Qualified plans that were converted to other types of pension plans in FY07, nearly 40% were absorbed into the Smaller Enterprise Retirement Allowance Mutual Aid program, 20% were converted to DB Corporate Pension plans, and slightly over 10% were converted to defined contribution (DC) pension plans (the relevant data on the remaining 30% are unavailable). The amount of assets converted from Tax-Qualified plans to other types of plans is unknown, but how conversion of the remaining Tax-Qualified plans unfolds over the final four years of phaseout process bears close monitoring.

Exhibit 6. Corporate DB pension plan assets



Source: Trust Companies Association of Japan, Life Insurance Association of Japan

Impact of revised accounting standard

In recent years, Japan's corporate pension plans have undergone major restructuring precipitated by adoption of a new Accounting Standard for Retirement Benefits in 2000. From a corporate accounting standpoint, Japanese companies have substantially reduced their pension obligations and expenses through the aforementioned renationalization of EPF assets and liabilities, conversion of existing plans to DC plans, and widespread adoption of cash-balance plans. In the process, they have also substantially reduced their risk exposure to pension liabilities.

The pension liabilities of companies listed on the Tokyo Stock Exchange's First Section have decreased from nearly ¥100trn in FY01 to below ¥80trn today. At the beginning of this decade, Japanese companies were saddled with substantially underfunded pension plans (e.g., due to unrecognized actuarial losses) in the wake of a "perfect storm" in the form of a decline in discount rates coinciding with an equity market downturn. This funding deficit also has since been nearly rectified. Due to the market downturn in FY07, amortization of unfunded liabilities is set to resume growing from FY08, but by virtue of pension restructuring to date, this upturn in amortization costs is not expected to have severe ramifications à la the perfect storm of the 1990s.

One potential risk factor for corporate pension plans is that pension accounting rules are likely to be revised again in the next several years. US and international accounting standards aim to increase the reliability and transparency of pension asset and liability valuations. Japan's Accounting Standard for Retirement Benefits also is slated to be harmonized with international accounting standards. When this harmonization occurs, major problems are likely to emerge on the asset side of the ledger. Corporate pension assets are in a growth trend and not much of those assets are allocated to bonds able to serve as a hedge against interest-rate risk. If the new accounting rules were to hypothetically ban smoothing of discount rates or require immediate recognition of funding deficits, fluctuations in pension funding surpluses/deficits would immediately be reflected on corporate balance sheets. Such rule changes would likely give Japanese companies an incentive to adopt techniques to manage the risk of such fluctuations (e.g., liability-driven investment (LDI)).

2 Securities investment by banks

Japanese banks in aggregate ended FY07 with securities holdings of ¥188trn, a ¥12trn decrease from a year earlier. With demand for loans in the doldrums, banks are turning to securities investment as a key source of earnings. They consequently have been increasingly investing in products with the potential to generate high returns. This trend manifests as growth in banks' securities holdings classified as "other securities." As of FY07-end, Japanese banks' "other securities" holdings totaled ¥44trn, equivalent to nearly one-quarter (23.4%) of their total investment securities holdings (Exhibit 7).

We surveyed financial institutions about their securities investments in July 2008[2]. The survey results offer insight into the status of banks' investment in "other securities" (ie, funds, hedge funds, structured bonds, securitized products).

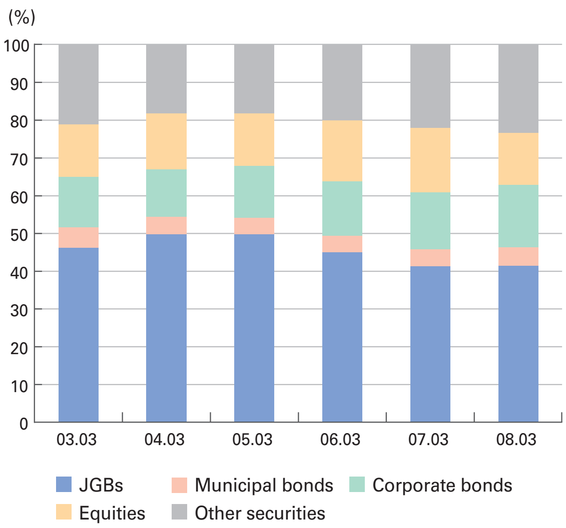
Banks' expanding investment universe

Financial institutions must prescribe internal regulations delineating the universe of investment products in which they may invest. Nearly all financial institutions may invest in JGBs, municipal bonds, and domestic corporate bonds, but many authorize investment in a diverse range of other securities also.

Among these other securities, some 60–70% of financial institutions of all types permit investment in fund products (including REITs and ETFs but excluding foreign equity funds). Actual asset allocations to funds vary widely among financial institutions, depending on their specific investment policies, but funds are one of the most popular investment products among financial institutions (Exhibit 8).

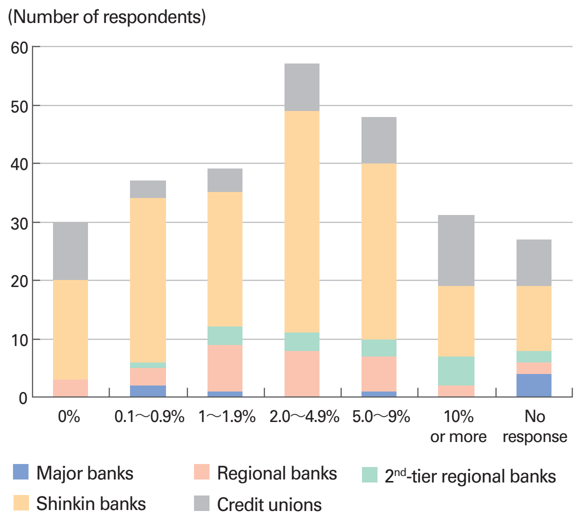
Hedge fund investment is more limited, reflecting the general complexity of hedge fund strategies. Only about 30% of financial institutions permit investment in hedge funds. Our survey revealed a tendency for hedge fund allocations to increase from regional banks downward in the hierarchy of financial institutions. Some smaller financial institutions are apparently investing in transparent

Exhibit 7. Japanese banks' aggregate securities portfolio allocations



Source: NRI, based on BOJ's *Assets and Liabilities of Financial Institutions, etc.*

Exhibit 8. Financial institutions' asset allocations to fund products



Source: NRI *Survey of Financial Institutions' Securities Portfolio Management Practices (2008)* or otherwise easily accessible hedge fund products as an extension of their fund investments.

Structured bonds are popular among regional banks and smaller financial institutions in particular. Actual structured-bond allocations are relatively high. Second-tier regional banks are particularly active investors in structured bonds.

Securitized products, by contrast, are largely shunned on account of the complexity of their structures and difficulty of assessing their risk. The percentage of financial institutions that have authorized investment in securitized products is consequently low. Moreover, there is a sizable gap between the percentage of financial institutions that have authorized investment in securitized products and the percentage that actually have assets invested in securitized products. Financial institutions have apparently largely divested their securitized product holdings in response to repercussions from the subprime mortgage crisis.

Prospective securities investment trends

Problems in the subprime mortgage market have impacted banks' securities investment policies. In our survey, over 40% of respondents reported that they had revised their investment policies after the subprime crisis erupted. Asked how they had done so, three-quarters of these respondents reported that they had altogether "ceased investing in products difficult to risk-assess." Such respondents apparently reawakened to the importance of investing based on an adequate assessment of the risks involved. In terms of position sizes, over 60% of respondents reported no recent changes in particular. Among respondents that had rebalanced their securities holdings, many had increased their holdings of JGBs and other conventional bonds. The most common products in which respondents had reduced their holdings were equities, funds, hedge funds, and securitized products.

Looking ahead, the securities products in which at least 15% of survey respondents reported that they intend to increase their holdings were domestic equity funds, foreign bond funds, and ETFs. Many respondents had divested fund investments in response to losses stemming from deterioration in investment performance. Nonetheless, with financial institutions curtailing investment in foreign bonds, we see growing demand for fund products from the standpoint of portfolio diversification.

With the exception of a few major banks, the above-described trend toward avoidance of investments in products that pose difficulty in terms of risk assessment is likely to persist for a while. For financial institutions to build their securities investment operations into a key source of earnings, they must increase the sophistication of their risk management. Our survey found that many financial institutions are seeking external risk-management support (e.g., quantification of product-specific risks, price validation) for investments in funds and securitized products.

3 Retail business

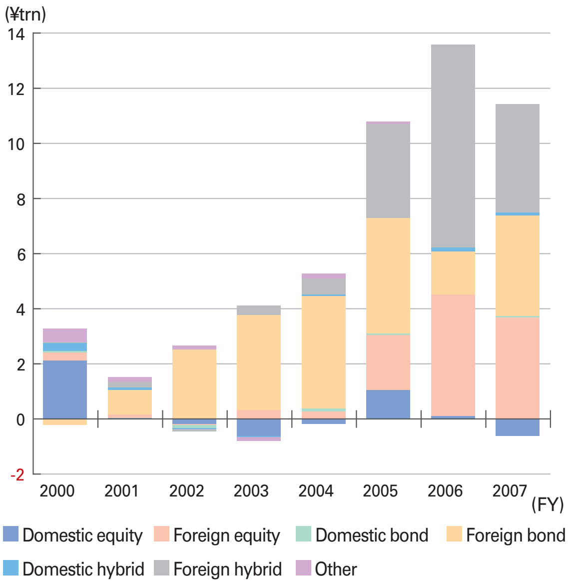
Resumed investment trust inflows to foreign bond funds

As of end-March 2008, Japanese households' financial assets stood at roughly ¥1,390trn, a decrease of ¥60trn from a year earlier. As of the same date, households' holdings of domestically chartered public investment trusts were approximately ¥70trn, down from their year-earlier balance of ¥73trn and their October 2007 peak of ¥82trn. The decline was the first substantial decrease in household investment trust holdings in many years.

Open-end equity funds[3] account for some 80% of total public investment trust assets. Those that invest in foreign securities are still the most popular among investors. Such funds comprise three types: foreign equity, foreign bond, and foreign hybrid. In FY07, net inflows exhibited divergent trends among these three types (Exhibit 9). While overall net inflows to open-end investment trusts decreased in FY07, foreign bond funds saw increased net inflows (+¥2.1trn) in a reversal of the previous fiscal year's decline in net inflows. In contrast, foreign hybrid funds experienced a major falloff in net inflows (-¥3.4trn) following a large increase in net inflows in FY06.

These types of funds that invest in foreign securities pay high distribution yields. Distribution yield is a key fund selection criterion. In FY06, foreign hybrid and foreign equity funds typically paid distribution yields in the vicinity of 10%, well above foreign bond funds' distribution yields. In FY07, however, foreign hybrid funds' distribution yields fell precipitously, reaching parity with foreign bond funds' yields by fiscal year-end. Since the emergence of subprime woes, retail investors' fund preference appears to have shifted from foreign hybrid to foreign bond funds, presumably partly in response to risk considerations also.

Exhibit 9. Investment trust in/outflows by fiscal year



Note: Excludes ETFs, funds with daily settlement arrangements, and bond investment trusts
Source: NRI, based on Fundmark data

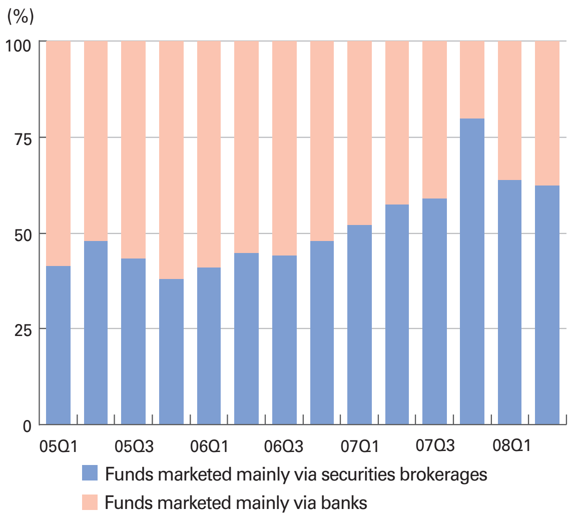
Securities brokerages regain stature as a sales channel

Revenues generated by the Japanese public investment trust business are split among asset management companies, distributors, and trust banks. Sales commissions earned by distributors account for the largest share, nearly 50% of total revenues in FY07. Distributors also collect a share of the trust fees as an account servicing fee. Including such servicing fees, distributors account for a 74% of total revenues. Distributors dominant share of industry revenues reflects their perennial leadership role within the investment trust market.

Since the ban on investment trust sales by banks was lifted, banks had been gaining stature as a sales channel year after year. Banks' investment trust sales operations are distinguished by a long-term commitment to continuously marketing the same fund offerings. Securities brokerages, by contrast, excel at developing new fund offerings in response to prevailing market conditions and intensively marketing them on a short-term basis. The stable market conditions that persisted for several years through mid-2007 were highly conducive to banks' investment trust sales model.

Once the subprime crisis erupted, however, many asset classes were hurt by its repercussions, resulting in losses to most existing funds' net asset value. This turn of events made it difficult to consistently market the same funds. Banks' investment trust sales were consequently

Exhibit 10. Breakdown of investment trust inflows between funds marketed mainly via securities brokerages and funds marketed mainly via banks (top 50 funds ranked by inflows)



Source: NRI, based on Fundmark data

particularly hard-hit by the fallout from the subprime crisis. Conversely, securities brokerages, with their expertise in marketing newly launched funds, suffered little adverse impact. The share of investment trust inflows intermediated by securities brokerages ended up increasing in FY08 (Exhibit 10). By virtue of such market conditions, securities brokerages have been progressively regaining prominence as a sales channel.

However, it is risky to assume that securities brokerages will maintain their current large share of investment trust sales. Once the financial markets regain stable footing, banks are likely to find renewed success with their approach of consistently marketing the same funds. Additionally, banks are offering teaser rates to induce baby-boomer retirees to deposit lump-sum retirement benefits into time deposits. These deposits are very likely to eventually be invested in investment trusts. Overall, banks still have substantial potential as an investment trust sales channel in our view.

4 Product trends and demand outlook by product

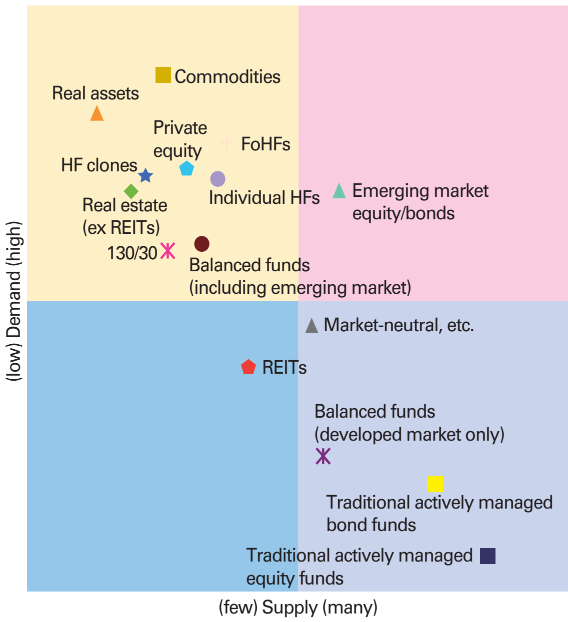
When we mapped out asset management companies' current product offerings to institutional investors by benchmark/investment style, we found that asset management companies in general have started to diversify, albeit gradually, their domestic and foreign bond and equity product offerings from a single major benchmark per asset class. Among actively managed domestic and foreign equity products, investors now have a wide range of investment styles to choose from amid a trend toward increasingly narrowly defined style mandates.

In terms of what types of products Japanese investors will invest in going forward, we analyzed the balance between the supply of representative investment products and demand from Japanese investors (retail, pension, and financial institution) based on the results of our aforementioned survey of asset management companies. In Exhibit 11, the horizontal axis represents supply. The farther to the right a product is plotted along the horizontal axis, the greater the number of respondent companies that offer that product to Japanese investors (data are plotted along the horizontal axis based on the number of companies offering, not the amount of assets invested in, the product). The vertical axis represents demand. It is an indexed scale of the number of respondents that perceive high demand from investors for a given product.

First, we found that among Japanese investors, there is universally little demand for conventional products such as traditional actively managed bond or equity funds and balanced funds that invest in developed markets. Demand for REIT products also appears to have declined amid the recent market downturn in the REIT sector.

In contrast, there is broad demand for products in non-traditional asset and style classes. Relatively illiquid asset classes such as real assets (e.g., physical commodities),

Exhibit 11. Supply-demand balance for products marketed to Japanese investors (retail, pension funds, and financial institutions)



Note: "Supply" (vertical axis) is an indexed scale of the number of asset management companies that offer the above products. "Demand" (horizontal axis) is an indexed scale of the number of asset management companies that perceive strong investor demand for the given product as a percentage of the number of asset management companies that offer that product.
Source: NRI *Survey of Financial Institutions' Securities Portfolio Management Practices (2008)*, based on 40 valid survey responses culled from a total sample of 50 respondents (26 Japanese firms and 24 foreign firms)

real estate, and private equity also have the potential to emerge as highly competitive market segments.

Demand for 130/30 funds[4)], which have gained widespread prevalence in the US, is relatively modest in Japan in comparison to other nontraditional investment styles. Survey respondents reported that Japanese investors tend to be less willing than their US counterparts to tolerate the risk of short positions or revise investment policies that prohibit short selling. Demand for hedge fund clones that have appeared on the market in recent years seems to be on a par with demand for funds of hedge funds and individual hedge funds. Many survey respondents currently anticipate demand for hedge fund clones from banks and other financial institutions.

Note

1) With respect to trusts and insurers, this total includes only assets managed on behalf of pension/annuity customers. With respect to life insurers in particular, the total includes only special account balances, not assets in general accounts with guaranteed returns (e.g., fixed-amount insurance, fixed annuities). Additionally, the total excludes some ¥23trn in assets managed on behalf of foreign investors.

2) The survey was sent to 533 domestic financial institutions, including major banks (e.g., megabanks, trust banks), regional banks, second-tier regional banks, shinkin banks, and local credit unions. Responses were received from 269 of them (50.5% response rate). The respondents comprised 8 major financial institutions (megabanks, trust banks), 32 regional banks, 17 second-tier regional banks, 159 shinkin banks, and 53 credit unions.

3) 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 invesments to be registered as an equity investment trust. Many funds investing primarily in foreign bonds have done so to take advantage of the lower tax rates levied on such funds.

4) "130/30" is a general term for a portfolio construction technique that incorporates a fixed allocation of short exposure. The typical 130/30 fund is authorized to maintain short exposure of around 30% of assets and increase long exposure up to 130% of assets by funding long positions with proceeds of short sales. Such funds are designed to maintain a beta in the vicinity of 1.0.

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