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A new trend in Japan's asset management business toward a shift from saving to investment

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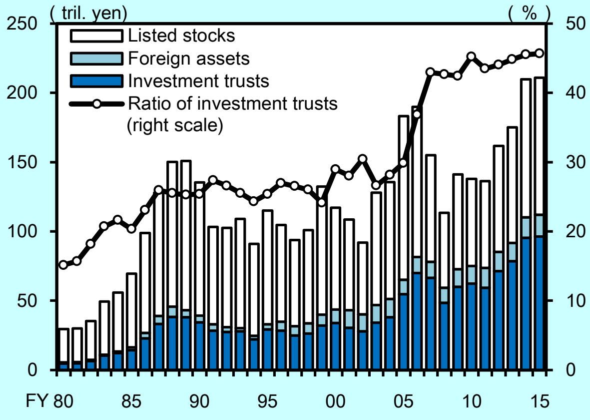
Japan's asset management business has reached a turning point. Looking at the investment trust market, the market share had been dominated by monthly dividend-paying funds, in which regular income could be expected. But recently, in response to diversification in households' asset-building needs, various types of products that meet households' preference for total return have been developed and the amount invested in those products is growing. Of these products, so-called engagement funds are gaining attention as one of the financial products that meet the medium- to long-term asset-building needs of households. The funds are a type of active management funds, aimed at improving corporate value through repeated dialogue with invested firms from a medium- to long-term perspective. Those active management funds are expected to contribute to strengthening equity governance, which has been comparatively weak.

Introduction

Japan's households have been increasing their holdings of risk assets along with a recovery in market prices after the Lehman shock and a shift from saving to investment. The share of risk assets in households' financial assets has recently increased to the 12-13 percent level from around 7 percent in the 2000s. This trend has mainly been led by investment trusts. The investment trust assets under management are approaching 100 trillion yen, and their ratio to households' risk assets has also increased to almost 50 percent from slightly below 30 percent in the early 2000s (Chart 1). Until a few years ago, the investment trusts were products preferred as an investment vehicle for retirement allowances, and therefore investors were mainly in higher age groups. At that time, monthly dividend-paying public bond trusts, which could be expected to be safe and higher-yielding than bank deposits, were a standard product. Recently, however, there is a growing demand for investment trusts not only among older age groups but also among asset-building age groups such as people in their 30s and 40s, in response to diversification in households' asset-building needs.

Looking at households' investment behavior, as the low interest rate environment becomes prolonged, an inflow of funds has continued into indexed trusts, which are low-cost investment funds linked to stock indices. Also, increased attention has been paid to active management funds, including value- and growth-type trusts investing in undervalued and growth stocks, respectively. In parallel with these changes on the investor side, the sell-side securities firms have refrained from focusing on sales of monthly dividend-paying funds and from encouraging customers to buy and sell their trusts frequently. Instead, those firms have put more importance on an increase in the investment trust assets under management and the use of discretionary investment

[Chart 1] Households' risk asset holdings



Note: "Ratio of investment trusts" indicates the percentage of investment trusts to risk asset holdings. The latest data are as of end-2015.
Source: Bank of Japan.

services, whereby an asset management firm manages investment assets on behalf of its customers. The changes on both the investor and sell sides within the asset management industry symbolize a recent shift from saving to investment. This paper provides an overview of such a new trend in Japan's asset management industry and considers the resulting changes in corporate finance.

A transformation of Japan's asset management business

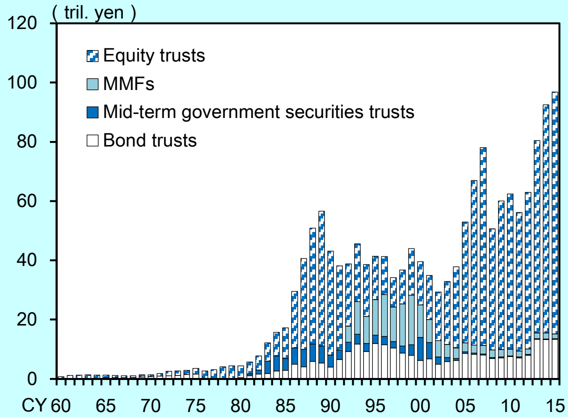
A short history of investment trusts

The history of Japan's investment trusts stretches back to the establishment of the Securities Investment Trust Act in 1951. At that time, Japan's economy faced an urgent need to secure funds for receiving shares released from the dissolution of business conglomerates after the war, and a possible option to solve this issue was the utilization of households' funds. Against this background, the early investment trusts appeared. The investment trusts were a unit-type equity trust that makes a one-time public offering and terminates in the short term, and were designed similar to bank deposits in order to lower the psychological barrier of households who had not been accustomed to equity investment. This product design is unique to Japan, reflecting Japan's households' strong preference for dividends. This approach to product design was followed by medium-term government securities trusts in the 1980s, money management funds (MMFs) in the 1990s, and monthly dividend-paying funds in the 2000s.

In the 1980s, the total assets under management broke through the 10 trillion yen mark, driven by the medium-term government securities trusts and spot-type equity trusts, which is a unit-type trust that makes public offering as needed (Chart 2). The medium-term government securities trusts achieved popularity for both their profitability on par with 1-year deposits and their convenience on par with ordinary deposits that can be made and withdrawn at any time, encouraging households to invest in securities. Furthermore, in 1986, when the regulatory limit on the establishment of investment trusts was removed, sales of spot-type equity trusts started to sharply increase as stock prices followed an increasing trend, driving the expansion of the investment trust market in the late 1980s.

Later, the collapse of the asset bubble deteriorated the asset management performance of equity trusts, leading to the departure of investors from the market

[Chart 2] Investment trust assets under management



Source: Investment Trusts Association.

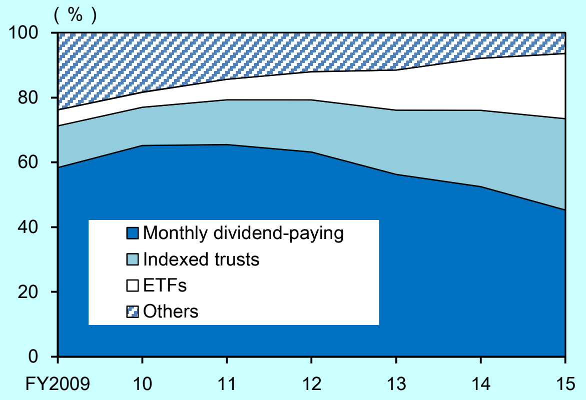
and a significant reduction in the assets under management. At the time, the outflow of investment funds was received by MMFs that appeared in 1992. The MMFs broke through the 10 trillion yen mark a year after they emerged, becoming one of the big products that underpinned the investment trust market in the 1990s. In 2001, when the U.S. Enron bonds defaulted, however, the MMFs that invested in the bonds broke the buck, triggering a rapid outflow of funds from households who put importance on safety. Sluggish investment returns under the prolonged low interest rate environment also contributed to a reduction in the MMF assets under management.

In place of the MMFs, equity trusts once again led the expansion of the investment trust market. Since the start of sales of exchange-traded funds (ETFs) and real estate investment trusts (REITs) as well as the amendment of the Investment Trust Act in 2008, the lineup available has expanded to various products, including securities, real estate, and commodities, that meet households' diverse investment needs. Furthermore, equity trusts investing in foreign bonds attracted funds from households expecting higher yields than domestic bond trusts, and the amount invested in the equity trusts has steadily increased.

Stronger preference for total return

As mentioned above, Japan's investment trusts originally appeared as a replacement product for bank deposits, and many products have been introduced to meet the investment needs of households expecting regular income. Of these products, monthly dividend-paying funds were widely accepted by households with a preference for dividends because, as their name suggests, those funds provide dividends every month, and they accounted for the majority of the total investment trust assets under management until a few years ago (Chart 3). Partly due to households' preference for dividends, securities firms selling investment trusts seem to have encouraged customers to frequently buy and sell investment trusts that had been designed to provide a high return of dividends. Furthermore, asset management firms managing investment trusts developed highly thematic products, including currency selection-type funds, which are suitable for sales focused on the frequent or short-term customer trading.

[Chart 3] Equity trusts by investment type



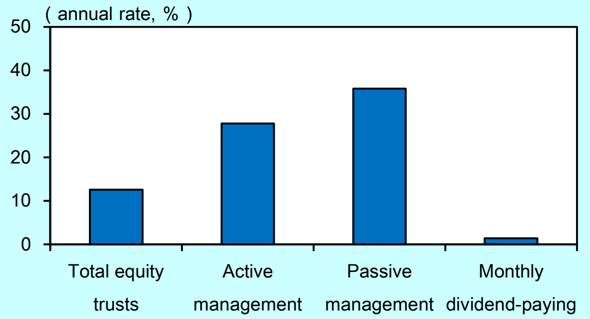
Note: Data are percentages of each investment type to publicly-offered equity trust assets under management.
Source: Investment Trusts Association.

This business model of asset management has been changing recently. Firstly, on the household side, there are increasing calls for a total return that covers not only short-term dividends but also long-term capital gains on the back of a prolonged low interest rate environment and a less attractive return on bank deposits. Furthermore, on the sell side, securities firms have refrained from encouraging sales focused on frequent customer trading, and instead focused on accumulating customers' assets in custody, aimed at earning so-called stock revenue such as trust fees. In terms of institutional aspects, the introduction of the Nippon Individual Savings Account (NISA), which is a tax-free system for small-amount investment, has also propelled the behavior of households' with a preference for total return.

A new trend in asset management

In response to the series of transformation, another change has come about on the side of asset management firms. Specifically, asset management firms have shifted their focus to developing products suitable for long-term asset-building needs in place of monthly dividend-paying funds. Of these newly developed products, there are indexed trusts and other passive management funds aimed at tracking benchmark stock indices (Chart 4). There are also active management funds, which seek capital gains on stocks by taking higher risk, such as value- and growth-type trusts.

[Chart 4] Growth in amounts invested by investment type



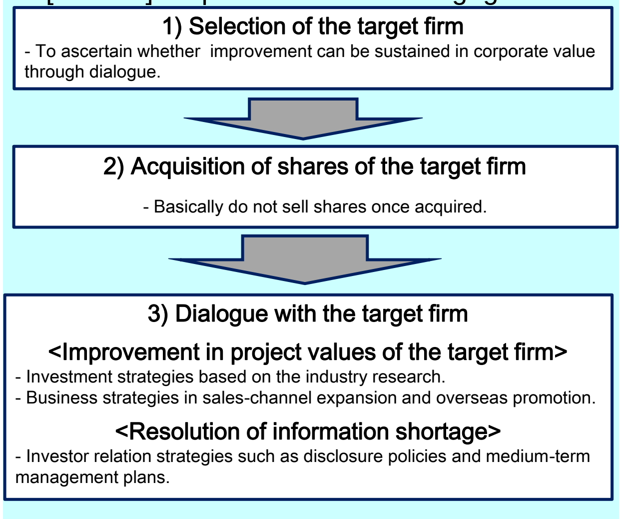
Note: Data are annualized rates of growth of assets under management from 2012 to April 2016, based on the funds search engine offered by the Association. "Active management" indicates funds matched to keywords of *absolute return*, *long term*, or *corporate value*. "Passive management" indicates funds matched to keywords of *indexed*.
Source: Investment Trusts Association.

In particular, a type of active management funds called engagement funds are recently gaining much attention. [1] The approach of engagement funds involves the idea of stockholder engagement, i.e., seeking medium- to long-term improvement in business of invested firms through repeated dialogue with corporate managers, and is aimed at correcting undervalued stock prices from a medium- to long-term perspective. Against this background, those funds have been regarded as products suitable for households with a preference for total return. Compared to pioneering markets such as the U.K., the scale of funds dedicated to stockholder engagement is still small in Japan: the amounts outstanding for individual investors and institutional investors are tens of billion yen and hundreds of billion yen, respectively. However, partly due to the establishment in 2014 of the Principles for Responsible Institutional Investors, Japan's stewardship code, the activities of stockholder engagement have been gaining momentum among asset management firms and other institutional investors.

Mechanism of stockholder engagement

In general, stockholder engagement conducted by engagement funds is made up of the following three steps: 1) selection of the target firm, 2) acquisition of shares of the target firm, and 3) dialogue with the target firm (Chart 5).

In the first step of *1) selection of the target firm*, it is important to ascertain whether sustained improvement in corporate value through dialogue can be expected. Looking at the selection process, it is the same as other active management funds: undervalued stocks are listed based on analysis of firms' financial



[Chart 5] Steps of stockholder engagement

data, and capital gains are sought. There is, however, a difference between engagement funds and other active management funds in terms of investment strategies. In Japan, active management funds have mainly focused on relative value strategies in assessing whether individual stocks are undervalued or overvalued based on comparisons with industry peers or the whole stock market. On the other hand, engagement funds focus on absolute value strategies in assessing whether individual stocks are undervalued or overvalued based on comparisons with their fair value. Furthermore, in selection, emphasis is placed on whether or not corporate managers of the target firm are open to dialogue with fund managers, and their own indicators and qualitative information are used. This is another characteristic unique to engagement funds.

An asset management firm narrows down candidate firms to only a few based on its own selection criteria. This is because it must have enough funds to increase its stockholding ratio to a certain level as well as a large enough number of fund managers to enable repeated dialogue with the target firms. The situations of engagement funds are different from those of major institutional investors, including life insurance firms, which have enough business resources to maintain dialogue with a large number of target firms at the same time. The firms that eventually remain after the selection process are often small- and medium-sized firms rather than large firms that are in the scope of research by analysts at major securities firms.

The next step is *2) acquisition of shares of the target firm*. In contrast with activist funds that immediately sell off stocks once stock prices reach their target level, engagement funds basically adopt buy-and-hold strategies and do not sell shares once they are acquired. There are only a few exceptions where stocks are sold when stockholder engagement is no longer expected to be effective, such as when the target firms drastically change their management policies or continued dialogue with the target firms becomes difficult.[2]

The content of *3) dialogue with the target firm* is considerably varied. Many cases in Japan have covered topics related to the whole business such as improving project values of the target firms and resolving mispricing of stocks caused by a shortage of information available to market participants. Specifically, these include a wide range of topics as follows: investment strategies based on research on the industry to which the target firms belong, business strategies in the event of expansion of sales channels and overseas promotion, and support for making investor relation strategies such as disclosure policies and medium-term management plans. As in overseas engagement funds, there is also expected to be an increase in the number of funds focusing on ESG investment, which takes environmental, social, and governance issues into consideration.

For any stockholder engagement to function effectively, a long-term relationship with the target firms is vital. In this respect, engagement funds send an important signal to the target firms through long-term equity investment as well as proposal and dialogue from a medium- to long-term perspective. Especially in Japan's case, there are more proposals to revise management plans that will take at least several years to fulfill the goal, rather than proposals for short-term results, such as to change dividend policies and to replace corporate managers. This is partly attributed to the fact that firms seem not to have a favorable impression of activist funds due to their experience. In contrast with overseas engagement funds, which often take strong actions by exercising voting rights or jointly engaging with other funds, Japan's stockholder engagement has a tendency to opt for face-to-face dialogue with corporate managers. The Japanese style of avoiding hostile relations and building friendly relationships is also a factor enabling long-term equity investment.

Economic effects of long-term equity investment

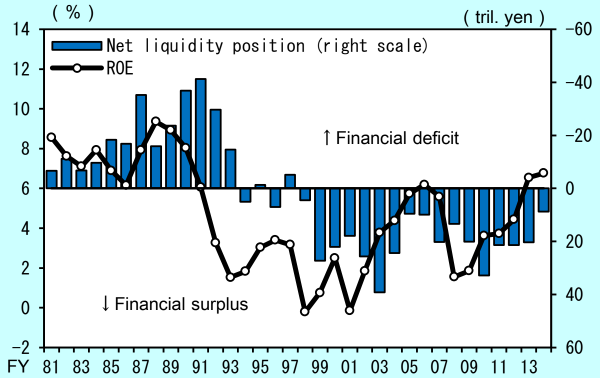
Recently, various types of passive management funds, including indexed trusts, and those of active management funds, including value- and growth-type trusts, have been developed and grown rapidly. Such efforts to expand outlets for long-term equity investment are gaining attention because of their potential impact not only on households' medium- to long-term asset building but also on corporate governance and price formation for invested firms' stocks.

Strengthening of equity governance

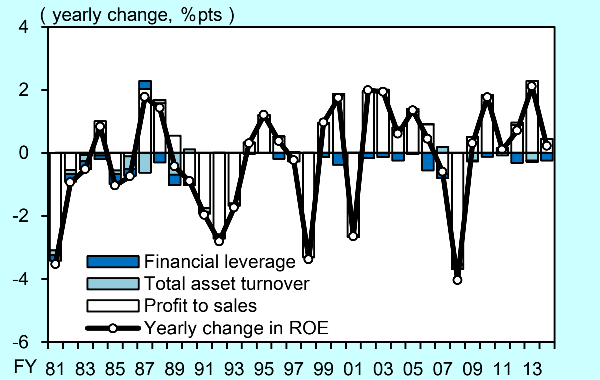
Capital efficiency in Japan's corporate sector has been lower than that in the U.S. corporate sector. Japan's return on equity (ROE) declined from an average level of 8 percent in the 1980s to around 5 percent in the 2000s along with the decline in earning capacity indicated by the profit-to-sales ratio (Chart 6 (1)). Although Japan's ROE has been rising in recent years, it has still been below the U.S. and European level of almost 15 percent. It has frequently been pointed out that one of the reasons behind the low ROE may be the weakening of debt governance through bank lending. The basis for this argument is that banks' incentive to be involved in corporate governance tends to remain weak due to an abundance of internal reserves in the corporate sector and a limited probability of default except for the period immediately after the Lehman shock.[3]

[Chart 6] ROE of the corporate sector

(1) ROE and net liquidity position



(2) Factors affecting fluctuations of ROE



Note: ROE, net income after taxes over total capital, is based on the Financial Statements of Corporations by Industry, and the net liquidity position is based on the Flow of Funds Accounts.
Sources: Ministry of Finance; Bank of Japan.

Under these circumstances, equity governance through the stock market is expected to complement debt governance. Whereas debt governance increases banks' incentive for monitoring when a firm is at risk of default, equity governance provides a constant incentive for stockholders to be actively involved in corporate governance because improvement in firms' capital efficiency is directly linked to stockholders' interest. In addition, the presence of friendly and stable stockholders has positive effects on firms that consider anti-takeover measures, providing an incentive for firms to actively engage in dialogue with stockholders.

Conventionally, Japan's stockholders mainly with a short-term investment horizon were somewhat hesitant to be involved in corporate governance. Furthermore, institutional investors with a long-term investment horizon were mainly passive in their investment and did not necessarily have sufficient involvement in corporate governance. The presence of stable stockholders active in their investment is expected to strengthen equity governance, which has been relatively weak.

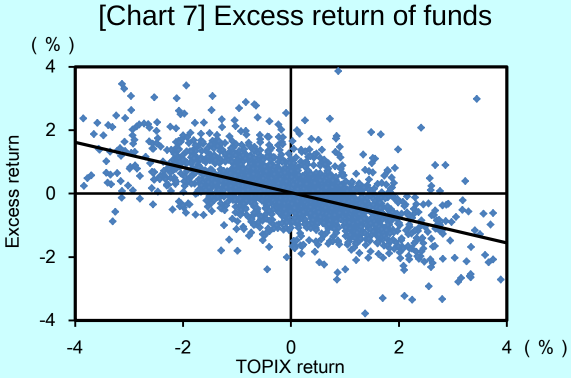
It should be noted that debt governance and equity governance have opposing views on firms' financial leverage in general. Under debt governance, banks require firms to lower their financial leverage to avoid default. On the other hand, under equity governance, stockholders require firms to increase their financial leverage to increase capital efficiency. In Japan's corporate sector, however, the low ROE is more attributable to the low earning capacity than the low financial leverage (Chart 6 (2)). This implies that there is room for improvement in capital efficiency by increasing earning capacity without the conflict of the above two forms of governance.

Effects on stock market fluctuations

It is well known that investment behaviors of investment trusts have a variety of effects on stock price formation according to their investment strategies.[4] For example, indexed trusts with passive management save on costs required for collecting and analyzing information on individual stocks, and trade those stocks to track a benchmark stock index. For this reason, market prices of stocks invested in by passive management funds are likely to reflect market factors rather than individual stock factors. As a result, investors can enjoy a market average return with low cost and low risk. Conversely, value- and growth-type trusts with active management collect and analyze information on individual stocks -- so-called information production -- and then make investment in undervalued stocks, the prices of which deviate from their fair value. For this reason, market prices of stocks invested in by active management funds are likely to reflect individual stock factors rather than market factors.

Chart 7 is a scatter diagram for engagement funds that are a type of active management funds, indicating a relationship between the return of TOPIX and the excess return of stock prices included in the funds over TOPIX -- i.e., a difference between the return of stocks included in the funds and the return of TOPIX. A positive excess return (depicted in the upper quadrants of the chart) indicates that the funds outperformed TOPIX, and a negative excess return (depicted in the lower quadrants of the chart) indicates that the funds underperformed TOPIX. The chart shows that the excess return of funds has a negative correlation with the TOPIX return. Prices of stocks invested in by the funds are likely to be delayed when the market is on an uptrend (depicted in the right quadrants of the chart), and therefore passive management funds offer relative advantages. On the other hand, the return on stocks invested in by the active management funds is likely to outperform when the market is on a downtrend, including the period immediately after the Lehman shock (depicted in the left quadrants of the chart). As mentioned above, active management funds emphasize individual stock factors, lowering the correlation between the prices of individual stocks invested in by these funds and movements of the whole market regardless of the performance of the market. It is expected that various types of investment strategies will make the stock market more susceptible to a variety of views.

[Chart 7] Excess return of funds



Note: The vertical axis indicates the excess return over TOPIX for stocks included in engagement funds, and the horizontal axis indicates the return of TOPIX. Both data are calculated on a daily basis. The sample period is from the beginning of 2007 until the end of 2015.
Source: Bloomberg.

Concluding Remarks

This paper has presented the transformation of Japan's asset management business, and provided an overview of recent investment behavior of households with a preference for total return, which have emerged along with a shift from saving to investment. In order to maintain such a shift, it is essential for financial products to be sufficiently widespread to meet households' diverse asset-building needs. In particular, products compatible with medium- to long-term improvement in corporate value are believed to be valid options considering households' strong preference for total return. Also, the number of institutional investors that have accepted Japan's stewardship code has gone beyond 200, and the activities of stockholder engagement have been gaining momentum. This progress is expected to strengthen financial intermediation by enabling households to invest in diverse assets and firms to raise funds from diverse and stable funding sources.

* Currently at the Financial Markets Department.

[1] See: Çelik, S., and M. Isaksson, "Institutional investors and ownership engagement," OECD Journal: Financial Market Trends, Vol. 2013/2, 2014.

[2] When stock prices are far above their theoretical prices, a fund manager may temporarily lower the share of his stockholdings based on his fiduciary duty to the end investors. For example, when stock prices of invested firms are substantially higher than target prices, indicating that those prices are expected to drop in the near future, the fund manager may sell off parts of his stockholdings based on the assumption that he will buy them back later.

[3] There has also been a weakening of debt governance through the banking system, partly due to banks deciding on policies to reduce their strategic stockholdings in response to the introduction of the Corporate Governance Code.

[4] See: Committee on Global Financial System, "Incentive structures in institutional asset management and their implications for financial markets," 2013.

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