ETFs and REITs in Japan: Innovation and Steps for the Future Growth

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1. Investment Trusts in Japan and the Emergence of ETF, REIT Markets

1) Investment Trust Market in Japan: History of Regulatory Reform

In Japan, although the Exchange Traded Fund (ETF) market and the Real Estate Investment Trust (REIT) market both emerged in 2001, each has a different story of how it came into being. The speed of growth of the two markets has also differed. However, both ETFs and REITs are collective investment schemes traded in public securities market, and resulted from innovations in investment trusts.

Like mutual funds in the U.S., an investment trust in Japan is a collective investment scheme in which professionals manage pooled fund under a pre-determined investment policy. However, unlike mutual funds in the U.S., Japanese investment trusts are not structured as corporations, but as contracts (trusts). Investment trusts in Japan mainly invested in securities. Further, because of the strict regulatory separation between commercial banks and investment banks, beneficial securities in investment trusts are sold only by broker-dealers and usually managed by the asset management firms that the affiliates of the broker-dealers. As a result, investment trusts were not widely introduced to individual investors. At the same time, there was not an environment in which the fund managers compete and grow on the merit of their investment performances and the popularity among the investors.

Historically, the share of the investment trusts in the financial assets of individuals in Japan had not been much smaller than that of the mutual funds in the financial assets of individuals in the U.S. However, the gap between the two has been expanding since the 1980's. The assets of mutual funds in the U.S. have grown rapidly due to the long-term increase in equity prices, the introduction of defined contribution pension plans and the increased participation of the baby-boom generation in the securities markets. The growth helped develop an investment management industry in which independent management firms compete on the basis of investment strategies and performances in the U.S. while the growth of investment trust market in Japan remained limited. It resulted in the further widening the gap between the share of mutual funds in the financial assets of individuals in the U.S. and that of investment trusts in Japan where the distribution was limited.

During the major restructuring effort of the financial system through deregulation in Japan (Big Bang Program), the government believed that it was crucial to expand and grow the investment trust market to revive the depressed securities market. The government realized that the concentration of household assets in bank deposits and postal savings (a deposit scheme run by the Japanese Postal Service) prevented the capital market from maturing. It was expected that investment trusts would be the driving force in the diversification of household assets as well as the growth of capital markets.

The Japanese government undertook major restructurings of the investment trust system in 1995 and 1998. At these times, the government's first priority was to ease regulations on investment trust management companies, while maintaining securities as the main investment choice. As a result of these restructurings, many foreign management companies entered the Japanese market for the first time and helped develop a highly competitive fund management industry. At the same time, allowing the banks to sell investment trusts in their branches contributed greatly to the growth of the industry. It encouraged the individual investors who had deposited majority of their assets at the banks and had not previously been interested in asset management to buy investment trusts.

On the other hand, the amendment of the Investment Trust Act 1998 introduced privately-placed investment trusts and corporate-type investment trusts, and bolstered requirements for disclosure. Privately-placed investment trusts, which are used for two to forty nine accredited investors, have been used by corporate pensions, regional banks and credit unions, and assets in such private trusts are increasing. Investment corporations were finally established in Japan after several attempts to introduce such company-type funds based on foreign models. Although investment corporations have a governance mechanism similar to that of corporations (e.g., operating officers, unit holders meetings, etc.), asset management companies did not use investment corporations at all until the emergence of REITs, because investment corporations were required to have independent directors and the administrative costs were high. To this day, most securities investment trusts are still contract-type, and most investment corporations are REITs.

The 2000 amendment to the Investment Trust Act was intended to form a new framework for financial services regulations. Traditionally, Japanese financial services regulations were created on a product-by-product basis. The amendment intended to change this framework and to create rules to encompass a wide variety of assets. The amendment also reorganized regulations according to function with regard to collective investment schemes in which assets are gathered from investors and administered and managed by professionals.

The Financial Council, an advisory body to the Japanese Financial Services Agency, established a "Working Group for Collective Investment Schemes" in its First Group to discuss issues relating to investment trusts for ten months and on December 21, 1999, issued a report outlining the government directive for amending the Investment Trust Act. The draft of the 2000 Amendment, which was approved by the Cabinet on March 17, 2000, largely reflected the content of the Financial Council's report.

Important amendments in the 2000 include: (1) expansion of investment choices; (2) regulations on investment trust managers (e.g., strengthening of fiduciary duties, prohibition of conflicts of interest, etc.); (3) establishing investment trusts which trust banks that are fiduciaries of certain assets could manage for themselves. The expansion of investment choices in particular was epoch-making because it completely reformed the Japanese investment trust system. Along with this amendment, the name of the Act was changed from "Securities Investment Trust and Securities Investment Trust Corporation Act" to "Investment Trust and Investment Corporation Act."

2) Impact of Institutional Reform

It is widely believed that the combined easing of regulations and expansion of sales channels contributed to increased activity in the investment trust market in Japan. Simultaneous to the approval of the sales of investment trusts in bank branches, the world-wide IT boom played a role in invigorating the equity market in Japan. As a result, investment trusts became popular among individual investors and in June, 2000, net assets of publicly-offered investment trusts exceeded 60 trillion yen at an all-time high. Then, with the end of the IT boom and prolonged loan problems of the banks, the stock market in Japan fell into doldrums again and net asset of investment trusts started to decline once again. However, even during the time of market fluctuation, the assets of publicly-offered investment trusts (including ETFs) continued to grow. Since the third quarter of 1999, net cash flow (sales - redemptions - exchanges) of publicly-offered investment trusts increased for twenty eight consecutive quarters. And since the second quarter of 2005, cash inflow has been particularly rapid.

Competition among asset management companies accelerated and the sales channels continued to be diversified and more open. By May 2005, all of the regional banks and second-tier regional banks (total of 111) registered to conduct securities brokerage business, mostly to sell investment trusts. In addition, 36 credit unions and 28 life/casualty insurance companies conduct such businesses. It is particularly notable that net assets of investment trusts sold by banks and other financial institutions are about 22.9 trillion yen while net assets of investment trusts sold by broker-dealers are about 22.8 trillion yen as of June 2006.

In 2001, defined contribution (DC) pension plans were introduced in Japan. As of May 2006, about 1.93 million people were enrolled in company-type defined contribution plan offered by employers(established in October 2001) and about 65,000 people were enrolled in individual-type defined contribution plans which are offered to employees whose employers do not have an employee pension plan (established in April 2002). As of March 2006, net assets of company-type DC plans were about 2.2 trillion yen and net assets of individual-type DC plans are 1,100 million yen. The research by Nomura Institute of Capital Markets Research shows that about 30% of these assets are invested in investment trusts. On the other hand, as of end of 2005, net assets of DC pension plans (e.g. 401 (k), 403 (b), 457, etc.) in the U.S. are 3.7 trillion dollars and about 48% (about 1.78 trillion dollars) are invested in mutual funds. About 60% of the shareholders of mutual funds initially purchased them through DC plans. Currently, the DC pension plan market in Japan is much smaller than that in the U.S. However, DC plans are expected to contribute to the expansion of investment trusts as they continue to grow with the additional reforms to the pension system (e.g., increased contribution limits, introduction of DC plans for government workers, etc.).

The entry of Japan Post into the investment trusts market is expected to have a major impact. Following the enactment of “Act Governing the Certain Businesses that Can Be Provided by Japan Post” in December 2004, Japan Post began the sales of investment trusts at its 575 post offices throughout the nation in October 2005. Net assets of investment trusts sold as of the end of June 2006 stood at 226.3 billion yen. Although the level of postal savings at Japan Post, which is scheduled to be privatized in the fall of 2007, has been declining for several years, the total savings still stood at 196 trillion yen as of July 2006 which rivals the total deposit of 250 trillion yen at the top three mega banks (Mitsubishi UFJ, Mizuho, Sumitomo Mitsui). Japan Post has 25,000 post offices which is more than the combined number (23,000) of the branches of banks, credit unions and credit associations. Individuals with limited knowledge of investing are expected to gain exposure to investment trusts through increased education and marketing efforts of Japan Post which has until now limited the number of post offices selling investment trusts in order to ensure the customers thoroughly understand the product they are buying. Japan Post now plans to expand the sales network of investment trusts to 1,500 post offices by March, 2009 through enhanced training program for the sales staff and it is expected to contribute significantly to the growth of the investment trusts market.

3) Introduction of ETF and REIT

In 2006, net assets of investment trusts in Japan exceeded 58 trillion yen and currently approaching the record level of 60 trillion yen. While there appears to be a boom in investment trusts, as of the end of 2005, the size of the investment trust market in Japan was still only 5% to 6% of the size of that of the mutual fund market in the U.S. The share of investment trusts in the financial assets of households in Japan was 3.4%, while that of the mutual funds in the U.S. was 13.2%.

The investment trust market in Japan is still a small part of the overall economy, despite a relatively strong growth seen this year, investment trusts are not yet widely accepted among individual investors. There are many factors contributing to this situation, such as the recent poor performance of the Japanese stock market, difficulty in managing bond investments trusts due to the historical low interest rates, negative returns experienced by several money market funds in 2001, complicated forms of disclosure (e.g., prospectus), and issues with the tax treatment of investment gains. While in the U.S., various investment strategies such as indexing as well as innovative products have been developed as the size of the mutual fund market and asset management industry continued to grow, Japan struggled to attract investors to the securities markets. Japanese government envisioned reforming investment trust market as a way to attract money to the securities markets and as part of the reform effort, new instruments such as ETFs and REITs were created to turn investment trusts into more attractive means of asset management.

2. ETF

1) Development of the ETF market in the U.S.

(1) Diversification of ETFs

ETFs (Exchange Traded Funds) are in general index funds traded on securities exchanges. The first ETF in the U.S. was SPDRS (S&P Depository Receipts "Spiders") which was listed on the American Stock Exchange (AMEX). Then, DIAMONDS (Diamonds Trust Series I "Diamonds"), QQQQ (NASDAQ 100 Index Tracking Stock "Cubes") and others followed.

In the 1990's, the ETF market in the U.S. developed mainly through the funds tracking broad-based stock indexes represented by the three mentioned above. Taking advantage of exchange traded feature, proprietary trading departments of the investment banks and institutional investors such as hedge funds frequently used ETFs for short-term trading as well as hedging tools. On the other hand, individual investors seldom invested in ETFs. In those days, SPDRS and QQQQ dominated the ETF market in terms of the asset size and the daily trading volume.

Since 2000, the U.S. ETF market has experienced a rapid expansion and as of May 2006, there were 227 ETFs in the U.S. with the net asset of 324.6 billion dollars. The marked expansion has been due to the continuous development of the new types of ETFs which enabled the new ways to use ETFs and to attract the new classes of investors.

Diversification of ETFs began in the late 1990s starting with regional and country diversification, followed by sector diversification and investment style diversification. In 2000 alone, fifty new ETFs were launched. Barclays Global Investors (BGI), for example, aggressively developed new ETFs including those with different investment styles and set the trend for the rapid growth in the market. BGI expanded quickly and became the top provider of ETFs rivaling State Street Global Advisers (SSgA), the manager of SPDR.

BGI introduced a bond-price-index-linked ETF in July 2002 putting an end to the notion that ETFs are linked to stock prices. The diversification in the asset class of ETFs began in the U.S. and at the end of 2003, with the listing of TIPS-Bond-linked ETF (iShares, Lehman TIPS Bond) on the New York Stock Exchange, ETFs began to be viewed as inflation hedging tool.

With the recent worldwide increase in energy commodity prices, there has been a race to develop commodity ETFs. The streetTRACKS Gold Shares, which was listed on the NYSE in November 2004, triggered the race. The strretTRACK is a gold ETF linked to the portfolio of gold bullion HSBC stores and manages in the underground vault in London. As of April 2006, the net assets exceeded 700 million dollars and gained popularity in the U.S. BGI followed by listing its own gold ETF (iShares COMEX Gold Trust) in January 2005 and a silver ETF (iShares Silver Trust) in April 2006. Also in February 2006, Deutsche Bank sponsored commodity-price-index-linked ETF, DB Commodity Index Tracking Fund was introduced.

With the diversification of the products, market share of ETFs linked to broad-based-stock-indexes (e.g., S&P 500, Dow Jones Industrial Average) has declined from above 80% to 70% and instead, the shares of ETFs linked to sector-stock-indexes, foreign-stock-indexes or bond-price-indexes have gradually been rising. Regional and market diversification in ETFs is also becoming prominent. The ETFs linked to foreign stock indexes (e.g., MSCI EAFE Index, MSCI Japan Index, MSCI Emerging Markets Index) set up by Morgan Stanley Capital International (MSCI) rank high in the asset size. Although the expense ratio of these international-stock-index-linked ETFs is higher than other ETFs, they have gained popularity. In other words, these ETFs that are dollar denominated and traded during the trading hour in the U.S. markets are being recognized as a tool for international diversification by the investors.

In the U.S., ETFs were developed, in a way, as part of the competitive strategies of stock exchanges. For instance, the American Stock Exchange (AMEX), once thrived with the initial public offerings of the new companies that did not meet the listing standard of New York Stock Exchange (NYSE), was losing the listings to Nasdaq Stock Market. In order to revive itself as a stock exchange, AMEX developed its own ETFs and aggressively promoted them to institutional investors.

As the ETF market grew rapidly, other stock exchanges started to list ETFs and trade existing ETFs listed on AMEX through unlisted trade privilege. The NYSE has been particularly aggressive in listing ETFs and the number of ETFs listed on NYSE increased from three in 2003 to 101 in August, 2005. Further, NYSE has been the exchange for BGI since it agreed to move 61 iShares ETFs listings there in July 2005. (BGI listed 40 iShares on NYSE in November 2005 and will move remaining 21 iShares to NYSE in 2006 and 2007.) NASDAQ lists four ETFs including QQQQ (former ticker is QQQ) which moved the listing from AMEX. As a result of increased competition, AMEX is losing ground but it continues to list newly developed ETFs by sponsors other than the big two (BGI and State Street).

(2) Acceptance by Individual Investors

Among the reasons for the rapid growth of the ETF market in the U.S., an especially notable is the influx of money from individual investors. Originally, ETF investors were mostly institutional investors. Initially, ETFs were mainly utilized for a transition trade by proprietary trading desks at broker-dealers and or by hedge funds hedging price risks of stocks through short-selling ETFs.

At the same time, ETF's benefits for individual investors have also been emphasized. First of all, minimum investment unit for ETFs is one share and SPDRS share can be purchased at around 120 dollars and QQQ at around 35 dollars. Also, ETFs can be traded throughout the day on the exchanges at the market price and therefore, have greater flexibility in trading and transparency in price than the mutual funds that are priced once a day at the close of the market. Moreover, ETFs have lower management costs, even though the brokerage commissions are charged at sale. They are also tax efficient. Like index funds, ETFs seldom realize or distribute capital gains because they do not change the composition of the stocks in the portfolio frequently. Individual trades by shareholders do not affect other shareholders because ETFs trade the share of the fund and not the individual stocks in the portfolio. Lastly, the dividends issued by companies in the portfolio could be an incentive for some individual investors to invest in ETFs.

In the1990's, neither financial advisors in financial institutions nor independent financial planners were active in marketing ETFs. The ETF's structure had to be explained to clients and fees were relatively low, so there was little incentive for them to recommend ETFs. Financial advisers receive not only front load fees but also agent fees paid from fund's assets in the form of 12b-1 fee when they sell actively-managed mutual funds. On the other hand, with ETFs, they only receive fees only once at the time of sale.

However, there have been some changes in the environment surrounding asset management industry in the U.S. ETFs have benefited from well-publicized scandals with improper trading practices in mutual funds which surfaced in 2003. Certain mutual funds were accused of allowing hedge funds and other privileged investors to engage in market timing and late trading which were generally discouraged or prohibited to regular investors. With ETFs, such impropriety could not occur. At the same time, no incentive compensation can be exchanged between management companies and sales companies, another issue mutual funds had faced. The transparency and low costs of ETFs have attracted attention of the investors who lost confidence in the mutual funds.

At the same time, the players in the ETF market began emphasizing education as well as bolstering advertisement and marketing efforts targeting individual investors as well as financial advisers. AMEX, the central market for ETFs, and the two largest ETF management companies (BGI and SSgA) have been most active in such efforts.

Moreover, emphasis on the assets management services for individual investors shifted from recommending individual stocks or mutual fund to portfolio management and asset allocation based on each investor's attributes and risk tolerance. This shift contributed to the wider acceptance of ETFs by individual investors. Because ETFs reflect average risk and return characteristics of each asset class, it is useful for analyzing and formulating asset allocation. Further, with the diversification of the products since 2000, diversification of portfolio by investment style and sector as well as country can be achieved while continuing to benefit from low management costs. Some financial institutions began providing services to create a portfolio composed of multiple ETFs within the wrap and separately managed accounts (SMA) which charge fees based on the asset under management.

The data indicating the ETF market share of individual investors is not available in the U.S. Moreover, because of the large number of funds, it is likely that the shares of retail investors vary greatly among ETFs. However, in general, retail investors are gaining presence in the ETF market in the U.S and at the same time, the ETF market is maturing through a virtuous cycle created by the continuing diversification of products and the expansion of the market.

2) Structure of ETF

ETF is a kind of index fund, which is managed by linking to a specific stock index. However, while index funds are open-ended and can accept investor's request for redemption or exchange anytime at a price based on the net asset, ETFs are basically closed-end funds whose shares are listed and traded on stock exchanges.

Although ETFs are closed-end funds, they often purchase underlying stocks in the portfolio and set up separate funds or make redemptions using the stocks. Such process is called "in-kind creation/redemption" of ETF. For example, management companies collect "a basket of stocks" that are linked to specific index (TOPIX, Nikkei stock index 300, Nikkei Stock Average, S&P/TOPIX150) from institutional investors and broker-dealers (called "authorized participants") holding a large number of stocks or brokerage houses, and in turn, issue beneficial securities in the stock index-linked investment trusts (ETF beneficial Securities) that are traded in the markets.

It is possible to exchange beneficial securities with in-kind stock portfolios, just as it is possible to receive ETF beneficial securities by contributing in-kind stocks. In investment-in-kind ETF, the stocks and cash are not exchanged for selling and buying of the investment trusts in the fund. Instead, "ETF beneficial securities" and the "basket of stocks" are exchanged between management companies and institutional investors/authorized participants.

Under such management structure, ETFs may have arbitrage opportunity with the actual stocks, therefore, the net asset value of ETFs and the trading prices of ETFs seldom differ widely. Moreover, unlike traditional mutual funds, in-kind type ETFs could significantly reduce the cost of trading stock in the market, therefore, limiting the compensation level of the trusts low.

3) Emergence of ETF in Japan

The Nikkei 300 Index Fund, which was listed in May 1995, is characterized as the first ETF in Japan. When this ETF was listed, the Japanese government revised rules related to the basic functions of ETFs (e.g., legal provisions related to exchange of ETF beneficial securities and in-kind stock portfolio, tax law provisions which treat ETF shares the same as stocks). However, these new rules could only be applied to investment trusts linked to the Nikkei 300 index and not to ETFs linking to other indexes.

At the time, the Nikkei 300 Index, which began publication in October 1993, was a relatively new index. Against the backdrop of criticism arguing that the swollen trade of Nikkei 225 futures negatively impacted the stock market, the Nikkei 300 was developed as an alternative to the Nikkei 225. In a sense, Nikkei 300 linked ETF was a "political" tool to promote popular use of the new index. The Japanese government's decision to limit the stock index that could be linked to ETF was an indirect cause in preventing the diversification of ETF products in Japan. In fact, a series of redemptions significantly decreased the net assets of ETFs and the new sales hovered at a low level, partly because of the lack of recognition among investors of the Nikkei 300 index.

On the other hand, in 2000, the amendment of the Investment Trust Act had a provision stating "An investment trust (excluding the securities investment trusts which government deems not to have the potential to harm beneficiaries) must be a money trust." (Section 5-3) The Japanese government made this provision based on the concern that investors could be harmed if in-kind type real estate investment trusts were to be formed with real estate and assets other than money. As a result of this provision, in-kind type ETF, which was a mainstream in the U.S., could not be formed.

In Japan, ETFs received much attention in 2001. At the time, the stock market was notably depressed with increasing dissolution of cross-shareholding between banks and companies. Although Nikkei 225 index was more than 20,000 yen as of the end of March 2000, it was below 14,000 yen as of the beginning of 2001, and it was below 13,000 yen as of the end of February 2000. Many people were worried that shares held by banks would bring massive capital losses, then, Japanese financial system would face a serious problem if the depression of stock prices continued. Because of this concern, since February 2001, the ruling government parties (Liberal Democratic Party, New Conservative Party and New Komeito) drew up and released a package for revitalizing the securities market, and at the Economic Policy Ministerial Meeting of the Japanese government, drew up an emergency economic package. These packages proposed introducing ETFs as part of a structural change in the securities market, as well as lifting a ban on treasury stocks, early establishment of a draft of the Defined Contribution Pension Act and the reform of the securities settlement system.

The reason why ETFs were listed as part of package for revitalizing security market was that the government expected that ETFs would contribute to the expansion of the investor base and the revitalization of securities markets. It was also expected that ETFs could be utilized as purchasing scheme of stocks held by financial institutions, while setting a limitation of share holdings by banks.

Hong Kong government initiated a scheme which was composed of using ETF and purchasing stocks with public funds before Japan did. When interest rates were rising just after Asian currency crisis in 1997, in response to the speculators driving down stock prices by massive shorting of stock index futures, the Hong Kong government intervened by buying stocks in the open market in August 1998. In December of that year, the Exchange Investment Fund Limited (EFIL) was established to manage the stocks the government purchased in August. EFIL initially sought to minimize the impact on market by managing those stocks in ETFs and formed the Tracker Fund (TraHK) which was a Hang-Seng-Index-linked ETF. State Street Global Advisers (SSgA) was involved in the development, marketing and management of TraHK, thus making management mechanisms of TraHK similar to those of the in-kind investment ETF in the U.S. Although the market intervention by the Hong Kong government continues to be a topic of contention, TraHK is widely viewed as having had positive effects such as increasing the interest of retail investors in the stock markets.

Japanese government released an emergency economic package on April 6, 2001. The government expected to protect the health of banks by limiting price fluctuation risks of the stocks held by banks to the level manageable by their risk management ability. It also expected that reduction of cross-shareholding would promote structural changes and revitalization of stock market. On the other hand, the government was concerned that massive stock selling by banks would affect the demand and supply as well as the price formation in the stock market which would be a cause of instability in the financial system and the overall economy. Therefore, the emergency economic package proposed the framework for the stock trading scheme as: (1) to establish an organization that acquires stocks from the banks with the contribution from the banks and others, (2) to purchase stocks from the banks at market price, (3) to choose stocks for purchase with the possibility of forming ETFs in mind, and (4) to utilize ETFs, investment trusts and defined contribution pension plans for the disposition of the stocks acquired by the purchasing organization.

Acting on the emergency economic package, in June 2001, Japanese government undertook a major reform of the Investment Trust Act, which triggered the expansion of ETF market in Japan, by defining in-kind contribution ETF as securities investment trust which meets the requirements below and provided for the exemption of Article 5-3 of Investment Trust Act.

(1) In order to align the volatility of asset per contribution to that of the broad based stock index, the fund invests in the stocks comprising the index.

(2) When investors accept invitations to subscription from the trust, they will receive beneficial securities which represent the composition ratio based on the number of shares of each stock in the investment portfolio.

(3) The beneficial securities are listed on securities exchanges or over-the-counter market. The exchange of beneficial securities and the stocks represented in the beneficial securities is conducted according to the rules of the Cabinet.

At the same times, the government amended the rules governing tax treatment of the newly formed ETFs to follow that of the shares in Nikkei 300 ETFs. It should be noted that Financial Service Agency designated, by announcement, Nikkei Index (Nikkei 225 Index), Tokyo Stock Exchange Stock Price Index (TOPIX), Nikkei 300 Index and TOPIX S&P150 as indexes which in-kind contribution ETFs can be linked.

Similar to the rules adopted when Nikkei 300 ETF was introduced, the government limited the indexes which ETF can be linked. Financial Service Agency explained the reason for such limitation as: "To maintain the balance in the price formation and to prevent price manipulation, we determined that the indexes which ETFs can be linked should be composed of a considerable number of stocks, should not excessively be affected by the price movement of certain stocks, and should be widely accepted by investors (e.g. the futures are traded on the stocks)." These rules prevented innovations in the products which are experienced in the ETF market in the U.S. Unlike the U.S. where ETFs are strategically developed by a stock exchange (AMEX), management companies developed their own ETFs that are linked to the same broad based index and listed on the stock exchanges in Japan. With the ETFs closely tracking the indexes, funds did not compete on the merit of management skills and the existence of multiple similar ETFs limited the asset growth potential of each ETF. Despite the surprising result of lowering the management costs below the level in the U.S., the rules were not effective in promoting

ETFs to investors. At the same time, the regulation did not encourage market players to increase investor participation in the market through innovative use of ETFs.

4) Growth of Japanese ETF Market and Issues

The ETF market in Japan in 2006 is the second largest following the U.S. in the world. However, net asset of ETF market in Japan is about 35 billion dollars which is about one tenth of the market in the U.S. is about 335 billion dollars (converted at 1 dollar = 115 yen).

Net asset of Japanese ETF was 1.5 trillion yen a year after the market was formed in July 2001, it increased to 2.5 trillion one and half years later and in September 2003, reached 3.2 trillion yen. However, since September 2003, growth of the net asset slowed. Although the net asset increased just before 2005, it was mainly the result of the rise in the stock index. After the late 2003, redemption of ETF increased. The reason behind the increase is believed to be the increase of exchange transactions in which institutional investors bring their ETF shares to management companies and exchange them into the baskets of underlying stocks.

In other words, when ETF market was initially formed, ETF was utilized for means of dissolving cross shareholding by financial institutions or as a vehicle to switch stocks in the portfolio. This drove the expansion of ETF market for a while, but later, it is highly likely that financial institutions exchanged their ETF shares with the stocks in light of the lack of diversification in the market and the investor base.

Another problem is that the number of ETF listings has been declining. Of the 19 ETFs listed in July 2002, five delisted by September 2005 and the total stood at 14(11 ETFs on Tokyo Stock Exchange; 2 ETFs on Osaka Stock Exchange; Nikkei 300 Index Fund on 5 stock exchanges). First, iShares S&P/TOPIX150 (former description code: 1315) delisted on January 9, 2004 and iShares TOPIX (former description code: 1307) delisted on September 10, 2004. Daiwa ETF-TOPIX Transport Machine (former description code: 1611) delisted on August 27, 2005. Nomura TOPIX Transport Machine ETF (former description code: 1614) delisted on September 3, 2005. At Osaka Stock Exchange, FTSE Japan Index Fund (former description code: 1616) delisted on August 31, 2004. In all the cases, the reason for delisting was that the number of investors (beneficiaries) did not exceed the minimum standard for continued listing at the Tokyo and Osaka Stock Exchanges within one year of listing and since then the number fell below the requirement. For investors, choices of ETF are smaller.

Considering market liquidity, the trend is that trading volume and trading values of ETFs have been increasing. However, analyzing the trading value in each fund, which is dominated by the ETFs linked to Nikkei 225 Index or TOPIX which are broad-based indexes, the trading volume and value of ETFs linked to sector indexes(bank, electronics) or TOPIX Core 30 Index are small. On the other hand, there is a gap in the trading value among ETFs linked to identical stock indexes. Further, according to the analysis based on the average bid/offer spread or average depth (sales volume per minute of trading hours) by Nomura Securities Quantitative Research Center, there is also a gap in the liquidity among ETFs linked to identical stock indexes.

Although the ETF market in Japan seems to have been steadily growing for the last 5 years, product innovation, diversification of investor base and liquidity in the market have not sufficiently developed. Therefore, there is still not a sign of explosive growth and expansion which was seen in the ETF market in the U.S. after 2000.

On the other hand, lower expense ratio of ETFs is one of the advantages for investors in Japan. Ironically, the existence of multiple ETFs linked to identical indexes brought on the price competition among management companies. The share of sales of ETF based on each investor segment, the share of individual investors started to rise around October 2005, and now it is nearing the share of foreign investors. The recovery of stock market contributed to this trend. Further, there is a possibility that individual investors have finally began to appreciate the benefits of ETFs five years after the market was formed. At the same time, broker-dealers, especially internet brokers, are aggressively promoting ETFs.

There is a possibility that the influx of individual investors mentioned above will lead to an explosive expansion of ETF market in Japan. However, considering differences in attitudes toward asset management between Japanese individual investors and those in the U.S. as well as the differences of market environments, there is a possibility that the U.S. style rapid expansion of ETF market will not be seen in the near future in Japan. Learning from the experiences of the U.S., several measures could be taken for accelerating the growth of ETF market in Japan.

The first is to list diversified ETFs and to continue diversifying products. If the variety of sector ETFs (currently only two are listed) as well as the ETFs linked to total market value and ETFs based on investment style and regions are listed, different ETFs could be combined (e.g. diversified international investment, long/short trade, core/satellite management) as an investment strategy. Expanded use of ETFs and the expansion of asset classes (e.g. bond ETF, inflation-protected bond ETF, commodity ETF) as well as listing the enhanced-index-linked ETFs (e.g. ETF linking a stock index composed of stocks of companies continually increasing dividends) and fundamentals-index-linked ETFs will contribute to the increase in the popularity of ETFs among hedge funds as well as individual investors.

In Japan, increased understanding among the investors of ETFs through the sales of diversified foreign ETFs may stimulate product innovation. Currently, when ETFs listed abroad are sold in Japan, the foreign management companies issuing the ETFs must comply with the filing requirements in Japan which impose heavy cost on them. However, it is reported that Financial Service Agency recently decided to abolish the filing requirement in 2007. In December 2005, Japanese government eased regulations to allow disclosure in English of the financial statements and prospectuses of foreign ETFs. Further relaxation of the regulations is expected to follow in the future including a new rule that will make it easy for Japanese individual investors to buy foreign ETFs.

The second possible measure to accelerate the growth of Japanese ETF market is to promote diversified ETFs to individual investors. Securities exchanges, broker-dealers, management companies along with the Institute for Securities Education & Public Relations (of Japan Securities Dealers Association) are making efforts to promote ETFs in Japan. However, they seem to emphasize only the basic elements of the ETFs that ETFs are investment trust linked to indexes representing broad markets or specific industries and are traded on the exchanges like stocks. Few people understand the differences among index funds, investment trusts and ETFs. Unlike the U.S. where BGI publishes educational materials for individual investors as well as financial advisors through its website, iShares.com., no organization with the similar role as BGI exists in Japan.

The third possible measure is to diversify distribution channels. Around 2005, broker-dealers started to offer Separately Managed Account (SMA) to retail investors in Japan. In SMAs and wrap accounts which offer asset allocation, ETFs can be an effective tool to diversify assets in the portfolio with low liquidity, for example. While the investors in the U.S. are familiar with such benefits of ETFs, they are seldom used in the defined contribution pension plans. The main reason for this is that the plan administrators are hesitant to make changes to the current investment trust platform or investment choices which largely consist of mutual funds. Japan could learn from this experience in the U.S. and aggressively promote the use of ETFs in defined contribution pension plans, for example.

3. REIT

1) Development of REITs in the U.S.

(1) What is a REIT?

In the U.S., a REIT (Real Estate Investment Trust) means a legal body which fulfills requirements prescribed in Internal Revenue Act. A REIT fulfilling the requirements can deduct dividends from annual corporate income, if it distributes over 90% of annual taxable income, which does not include capital gains. Therefore, investors can avoid double taxation. However, the reality of REIT is more than a mere passive securitization vehicle. Most REITs are corporations founded under the corporate laws of the states where they were incorporated. As a result of an amendment to the law in 1986, REITs do not need to outsource management. Therefore, as an organization, a REIT in the U.S. is a "company" while a J-REIT is a "fund." REIT shares listed on exchanges are nothing but listed securities. Publicly-traded REITs are regulated by Federal Securities Regulations and all the other regulations governing the trades of securities.

The literal Japanese translation of Investment Trust is a securities investment fund which is similar to a mutual fund in the U.S., therefore, the Japanese market participants as well as the government officials may have understood a REIT to be a type of mutual fund. Such perception may have contributed to the Japanese government's efforts to amend the Investment Trust Act to allow the creation of J-REIT, although it is difficult to ascertain. It should be noted that a REIT in the U.S. is not a mutual fund established under the Investment Company Act of 1940 and does not have the same structure as J-REIT established by the Investment Trust Act in Japan.

(2) From Foundation to 1986

In the U.S., the REIT was established in 1960 with the purpose of giving small investors opportunities to invest in large-scale, profit-earning real estates. At that time, the U.S. Congress believed that the best way for retail investors to invest in commercial real estates was through pooling of funds. Therefore, Congress adopted a corporation-type investment trust which avoided double taxation on the dividends.

Initially, although REITs were allowed to "own" real estates, they were not allowed to operate or manage actual properties. In that sense, REITs were passive investment vehicles. The REITs were operated by outside management companies which received the compensation, but did not necessarily have an incentive to maximize shareholder values of the REITs. Therefore, the REITs were not highly regarded by investors.

Moreover, the property tax system of the time had a negative effect on the development of the REIT market. In those days, investors were allowed to aggregate the losses in real-estate investment with income from other source, therefore, investors had an incentive to raise debt leverage and to realize losses on the book by recording interest costs and capital depreciation. During the real-estate boom of the 1980s, limited partnerships were frequently used because of their tax advantages. On the other hand, the REITs were not allowed to aggregate profit and loss and investors did not consider them to be advantageous as an investment tool.

(3) The Tax Reform in 1986

The Tax Reform Act of 1986 included two important reforms which greatly changed both the real estate and the REIT markets. One reform was to limit, in a significant way, the aggregation of profit and loss between real estate income and other income. This reform raised competitive advantages of REITs to real estate investment. Another important reform was to enhance the function of the REITs by letting them operate and manage real estates. As a result, the Self-managed REIT or Internally-managed REIT appeared, and investors and managers came to share a mutual interest.

The effect of the tax reform gradually surfaced around 1990 when the U.S. real-estate boom came to a turning point. The investments in and loans to the real estate market rapidly declined as the Savings and Loan crisis, which surfaced around 1982, deepend and the quality of real estate loans continued to deteriorate as a result of excessive lending by commercial banks..

(4) IPO Boom in REITs (1990-1994)

During the time of tightening of credit, the U.S. REIT market underwent three major changes. The first was the growth of initial public offerings (IPOs) of REITs. The IPO boom in the REIT market was not brought on by a flood of new ventures going public. Rather, many of the unlisted real estate companies, which had been financed by partnerships, facing the need to raise capital in the stock markets, became REITs in order to go public. During the commercial real estate boom at the end of the 1980s, mini permanent loans with 5-7 year terms were popular, reflecting an optimistic forecast for real-estate market and the loose standards of the lenders. When the loans became due from 1990 to1993, property values declined contrary to the initial expectations. Financial institutions did not allow refinancing, and as a result, many realty investment firms and developers faced cash-flow problems. For such investors, going public with the existing portfolio was an alternative to refinancing. On the other hand, investors who had purchased large number of commercial real estate properties from life insurance companies or Resolution Trust Corporations (RTC) (formed by the government to handle the assets of the failed S&Ls) at a bargain price wished to liquidate their holdings by listing stocks on the markets. For those investors, IPO of REITs was a way to raise capital for further growth or to realize return on their investments.

The second change was the emergence of investors for publicly traded REITs, responding to such refinancing and the exit strategy. Investors, trying to take advantage of the cyclical movement of the real estate prices and hunting for bargains, began to appreciate REITs for their high liquidity and the quality of governance. The number of investors including individual investors, mutual funds and pension funds gradually increased as the listings and the market value increased and provided higher liquidity.

The third change was the development of UPREIT (Umbrella Partnership REIT). Under this scheme, REITs, which are "parent companies", do not directly own real estates but acquire General Partnerships of Operating Partnership (OP) which are "subsidiaries." Limited Partners, who are owners of partnership or other interests, usually include former owners and/ or managers of the real estates. In other words, those who own the real estates through partnerships exchange their interest in the partnership with the shares in OP or the stocks of REIT. Due to the capital gains tax deferral in such exchange, transforming a partnership into a REIT and acquiring a limited partnership through a REIT became easier.

(5) Public Offerings and M&A (1995-1997)

After 1995, the main method of financing for REITs changed from IPOs to secondary public offerings. In 1997, 263.8 billion dollars (292 financing cases) were raised exclusively thorough secondary offering. A stable economy and low inflation and low interest rates contributed to the stable revenue and mergers and acquisitions in the REIT industry occurred at a brisk pace.

One of the contributing factors for the increased M&A activity in REITs was the segmentation of the REIT market. After the IPO boom in 1993-1994, the market was dominated by small and medium-sized REITs with the market value of around 150 million dollars, and the gap in the financing ability among publicly traded REITs gradually widened. Investors improved their understanding and investment analysis of the REITs. Moreover, the gaps in the performance among REIT stocks became more prevalent and smaller REITs that had questioned the costs and benefits of listing their stocks sought M&As. The benefits of M&A included cost reduction and realization of economies of scale which brought the significant increase in the cash flow at some REITs and attracted investors. These REITs that acquired management skills through M&As challenged the real estate operating companies with outdated management style and solidified their place in the real estate market.

(6) Maturing and Expanding Investor Base (1998 to present)

The Equity REIT Index compiled by the National Association of Real Estate Investment Trusts (NAREIT), the industry trade organization, declined 17.5% in 1998 after peaking at 3020.11 in December 1997 and declined 4.6% in 1999. [1] Various factors contributed to the bear market. The price of REIT stocks escalated by 1997 and there was a move to raise taxes on REITs. The securitized real estate market (e.g., commercial mortgage backed securities) was regarded pessimistically as a result of the Russian financial crisis and the collapse of the Long Term Capital Management, a hedge fund. The divergence of stock price movements of IT sector (New Economy) and other sectors (Old Economy) was also believed to be a factor.

From 2000 to 2005, in contrast, the NAREIT Equity REIT Index exceeded the S&P 500 index for six consecutive years. In addition to the booming real estate market in the U.S., there was an expansion of investor base. For example, pension funds, which had mainly invested directly in real estate, increased their real estate investment through REITs. Currently, GM pension plan, New York State Teachers Retirement Fund, CalPERS (California Public Employees' Retirement System), Florida State Board and others are believed to have invested over several hundred million to a billion dollars in REITs. REIT investments enable big pension plans to diversify their real estate holdings. Some small and middle-sized pension plans have started to investment in real estate only through REITs instead of trying to diversify real estate holdings through direct investment.

Moreover, foreign investors are increasing investments in the U.S. REITs. For example, ABP, a Dutch pension plan, has about 2,470 million dollars in REIT shares, comprised solely of the top five REITs in market value as of the end of September 2005. At the same time, after the amendment of the rules of the Investment Trust Association in 2004, Japanese investment trusts have started to invest in the U.S. REIT or Australian Listed Property Trusts (LPT), a similar real-estate investment vehicle in Australia, to meet the needs of investors looking for steady dividend income. As of end of 2005, the total net assets of Japanese investment trusts that bear the names such as “Global REIT” or “U.S. REIT” reached 1.1 trillion yen, more than a half of which is believed to be invested in U.S. REITs. Such inflow of capital both from domestic and international investors supported the long period of rising REIT stock prices in the U.S. The pace of growth in the aggregate market capitalization in the U.S. REIT market from 2002 to 2005 rivals that of the REIT boom of 1993-1997.

2) Emergence of J-REIT in Japan

[1] NAREIT Equity REIT Index is an index which is calculated by weighted average total market price of all publicly traded equity REITs.

The emergence of J-REIT in 2001 seems to have reflected two major trends in the Japanese financial market. One was the Japanese financial reform which included the reform of the investment trust system. Another was the securitization of real estates.

First, J-REIT emerged with the expectation that it would lead the product innovation. Stimulating the growth of asset management industry and the product innovation were two major purposes for reforming the investment trust system. The belief was that easing entrance and expanding sales channels would encourage competition in the management and sales and the introduction of private offering investment trusts would spur product innovation. With the emergence of J-REIT, many Japanese investors experienced for the first time investment trusts that investment in assets other than the stocks and bonds as well as the closed-end exchange-traded funds.

Secondly, it should be noted J-REIT market was created against the backdrop of the trend toward "securitization of finance" and "securitization of real estate." The securitization of financial assets and real estates can be defined as a shift from indirect financing to direct financing in the broad sense, and in the narrow sense as a shift toward pooling and packaging of the loans and real estate business revenues into securities. However, in the U.S., the trend was first seen in the residential mortgage-backed securities market expansion starting in the mid-1970s.

In Japan, until the early 1990s, securitization of real estate was only a concept for feasibility studies, because of the aggressive real estate lending by commercial banks and the continuous land price appreciation was not necessarily based on the cash flow income. For example, when securitization was considered as a means of disposing of the land former Japan Railways owned once, it had the special purpose of "concealing" the real estate transaction in order to prevent the price hike of the land properties in downtown Tokyo area. Further, concerning property investment products, Japan did not have any laws which provided necessary qualifications for fund-raisers and measures for investor protection, given that the products were sold to retail investors at large. On the other hand, although small-lot real estate products were sold through certain legal schemes (i.e. trust accounts in trust banks, stakes in foreign real estates) in the late 1980s, after that, values in many of them collapsed because of sharp declines in land prices after the real estate bubble burst or other liquidity issues. As a result, investors and financial institutions distrusted property-related investments. Although, under normal circumstances, Japan should have prepared for a fair and transparent market for property investment products sooner, institutional reform was likely delayed because there were adverse reactions to even mere discussion of the property investment market.

Later, the idea of securitization or liquidation of real estate to restructure corporate balance sheets came under spotlight through the experiences in Europe and the U.S. including the establishment of the Resolution Trust Corporation [RTC] in the U.S as a response to the loan problems in the 1990s. In the open and mature markets, securities markets could be leveraged to promote the revitalization of the market and restructuring of the companies in the event the liquidity crisis and loan problems arise in reaction to the real estate boom. Also in Japan, it was proposed that the opportunity to invest in real estate should be as freely available as it was in Europe and the U.S. to help revitalize the economy. However, Japanese tax rules prevented the creation of investment vehicles with securitized assets that could avoid double taxation.

The enactment of "Liquidation of Specified Assets by Special Purpose Company Act" (so called SPC Act; current "Asset Liquidation Act") in September 1998 provided for the creation and issuance of such investment vehicles as corporate bonds and preferred securities backed by leasing credit receivables or revenue from commercial real estate through the special purpose companies (SPCs). However, most securitized real estate products were privately offered to institutional investors and the secondary market for such products did not form.

J-REIT emerged as a securitization product and, like the SPC corporate bonds, had the same legal recognition as the securities under Securities Exchange Act. J-REIT can buy real estate from the companies in financial restructuring, therefore, promoting asset liquidation to the same extent as SPCs. Both REITs and SPCs were expected to promote the securitization of real estate and to end the dependency on the land-collateral loans.

3) Structure of J-REIT and Differences from US-REIT

As mentioned above, US-REIT refers to the status of a corporation with regard to tax laws. Japanese tax laws do not have any "eligibility requirements for REIT" as those of the U.S. , therefore, corporations can not choose the REIT status in their tax treatment. J-REIT is an investment trust in which the main investment asset is a real estate. Although the Investment Trust Act of Japan provided for the creation of investment trusts (contract-type investment trust) and investment corporations (company-type investment trust), currently, all of the listed J-REITs are structured as investment corporations. An investment corporation is formed for the purpose of managing assets by investing in specified assets.[2] An investment corporation entrusts its asset management to an investment trust management company. If the investment trust management company mainly manages real estate, it has to acquire a license as real estate brokerage agent and to get an authorization of discretionary transactions before it can be approved as an investment trust management company.[3]

Also, currently, all listed J-REITs are closed-end investment corporations. If funds that invest mainly in real estate are formed as open-end type, they could have trouble with meeting investors' request for redemptions due to the low liquidity of real estate. Therefore, all listed J-REITs are closed-end investment corporations and ensure liquidity of the investment securities by trading on the market instead of making redemptions.

An investment corporation issues investment securities, like a corporation issues stocks. An investor in investment securities can attend a unit-holders' meeting, similar to a shareholders' meeting. A closed-end investment corporation can issue investment corporation bonds, which are similar to corporate bonds, under issuance limits laid out in its constitution.[4] In reality, the Investment Trust Act does not include definitions for a property investment trust or a property investment corporation but allows an investment trust to include real estate into its specific assets. Rather, eligibility requirements as J-REIT are provided in listing standards of real estate investment trust markets (e.g., Tokyo Stock Exchange etc.).

As explained above, the current J-REIT system is much more complicated than the US-REIT

[2] *See* Art. 2, Sec. 19 of Investment Trust Act. Specific assets mean assets on which investment trusts can invest under a government order. For major instances, (a) security, (b) right in security-index futures trades, (c) right in security option, (d) right in foreign security future trades, (e) over-the-counter security index trades and other forward trades, (f) right in over-the-counter security option trades, (g) right in over-the-counter index trades and other swap trades, (h) real estate, leasehold right of real estate, surface right, (i) monetary claim, (j) promissory note, (k) right in financial future etc., (l) right in financial derivatives transaction, (m) beneficial interest in trust of money, security, monetary bond, real estate, surface right or leasehold right or real estate, (n) share of investment in silent partnership (Art. 3 of the enforcement order of Investment Trust Act).

[3] Although the Prime Minister (Financial Service Agency) approves investment trust management companies, the Minister of Land, Infrastructure and Transportation give a license of real estate brokerage agent and approve a discretionary transactions under Real Estate Transaction Act (Art. 6 and 9 of Investment Trust Act). Actually "a discretionary transaction" business by real estate agent was formed, when the J-REIT market started, by the amendment of related law of Investment Trust Act in order to allow to executing under full discretionary capability (so to speak blind fund management) at the stage when specific real estate is not decided.

[4] *See* Art. 139-2 of Investment Trust Act. This clause was added by the amendment of 2000.

system. In the U.S., the Internal Revenue Act provides a clear definition of REIT, content of funds and conditions for certain tax treatments. On the other hand, J-REIT system is not unified under a single law: the Investment Trust Act provides the structure of the vehicle; Tax law provides requirements for getting certain tax treatment; listing standards of securities exchanges provide asset requirement for treatment as a J-REIT. This situation means that J-REITS are difficult for investors to understand and also causes practical problems. For one, a person planning to found a J-REIT must get prior authorization or submit prior notification to various institutions.

Further, as mentioned above, the main difference between J-REIT and US-REIT is whether it utilizes outside management or inside management. J-REIT is a fund, therefore, it must entrust the custody of real estate registers, registration certificates and bank books, and must entrust business judgment regarding sales and management of real estate to investment trust managers. J-REIT is an investment trust, therefore, it ban only engage in asset management as its business. Additionally, the listing standards for J-REIT of Tokyo Stock Exchange requires that over 50% of the assets must be real estate currently yielding (or expected to yield) rental income. None of the J-REITs have thus far invested in development projects. J-REITs are, in fact, very passive investment scheme.

In the past, US-REITs were also passive property investment schemes. However, the amendment of the tax law in 1986 allowed internal management of REITs. Although differences between REITs and real estate operating companies (REOC) were nearly eliminated by the amendment, amendments which followed took into account REITs' status as active property investment corporations after the amendment of 1986. For example, the REIT Modernization ACT, which was enacted in 2001, allows a REIT to establish a Taxable REIT Subsidiary (TRS) in which the REIT can hold up to 100% of ownership. The act allows a REIT to supply a variety of services to tenants and so forth through a TRS governed by the REIT, while maintaining the exempt status of corporate tax. Further, the act reduced the dividend restriction from over 95% of taxable income to 90%, which was standard from the time the REIT system was established until 1980. This reduction allows a REIT to accumulate more earning retention than before. It can be said that US-REIT came closer to REOC. In Japan, listed REOCs (Mitsubishi Estate, Mitsui Fudosan, Sumitomo Realty & Development and so forth) have traditionally formed a main sector of the stock market, therefore, it is highly likely that differences between J-REIT and REOC were factored into the law and tax law when the J-REIT market was formed. It remains to be a topic of discussion how the difference in structure of a J-REIT from the US-REIT will affect the development of the market.

4) Expansion of the J-REIT Market and Contributing Factors

The J-REIT market was started when the Nippon Building Fund and Japan Real Estate, which are investment corporations, listed J-REITs on the Tokyo Stock Exchange (TSE) in September, 2001. At the time, the total market capitalization was about 260 billion yen, but as of August 2006, it reached 3.7 trillion yen with 37 listings.

It is believed that the expansion of the J-REIT market has been promoted by the following contributing factors:

(1) Dividend Yields and Yield Spreads

Corporate taxes are not imposed on an investment corporation if it distributes over 90% of divisible profit (including profit on the sale of real estate) in each fiscal period. This requirement brings high dividend yields of J-REITs. Relatively high dividend yields of J-REITs have attracted investors because the Japanese government maintained its low-interest rate policy and stock market slump continued through the summer of 2005. In fact, financial institutions and financial planners actively promoted J-REITs as suitable for the asset management needs of elderly investors because investors received dividends every month by investing in several J-REITs with different fiscal terms.

Nevertheless, just after J-REITs began to be listed on the TSE, the spread between the dividend yield of J-REITs and the yield of a 10-year government bond reached around 400 basis points. The reason for such high premium was that investors were afraid of the credit risk and were concerned about the marketability of J-REIT. The September 11th terrorist attacks in the U.S. and the bankruptcy filing by a major Japanese retailer, Mycal on September 14 were also believed to have contributed to the high premium. However, investors' confidence in J-REIT gradually increased since then and the corporations initially listed J-REITs began to release financial statements and steadily distribute dividends. Although the yield spread between J-REIT and the long-term interest is still 170-180 basis points, the average dividend yield in J-REITs sector has declined with the increase in the price of each investment unit.

(2) Conservative Debt Leverage

The average cost of the debt for J-REITs has been about 1%, benefiting from the low-interest rates. However, the average loan to value ratio is 30%-50%, a sign that most funds have maintained conservative financial policies. The reason for this is probably the lower risk of rising interest rates and to maintain borrowing capacity for future real estate acquisitions. Another reason is that management companies of J-REITs recognized that the investors preferred to keep the debt leverage low. As a result, the relative financial stability of J-REITs in comparison to privately offered real estate funds was emphasized.

On the other hand, when a J-REIT acquires additional real estate and expands its size, the J-REIT has to raise the capital. Fortunately, J-REITs were successful in raising capital and expanding through the additional acquisitions of real estates as their recognition in the market increased with the price of the investment units.

(3) Confidence in the Transparency and Profitability

Strong disclosure is one of the characteristics of J-REITs. The prospectuses provided to the investors explain in detail the investment policies of the investment corporations, therefore, investors can learn J-REIT's financial management policy such as "The corporation principally invests in real estates in operation and not in the development projects," "The corporation borrows only from accredited institutional investors and only up to one trillion yen." Management reports and other related documents disclose address, dimensions of rental property, book value, term-end valuation, operating rates, number of tenants, rent income for each fiscal period and other information for each real estate owned by the J-REIT. Planned and completed acquisitions of additional real estates are disclosed on the timely bases to analysts, rating agencies and other related parties. The information on the earthquake damages to the real estates owned by J-REITs and the changes in the level of debt are also disclosed on a timely basis. Considering traditional real-estate deals in which only a limited number of players had access to information, such disclosure practice of J-REITs are significantly open to the investors.

On the other hand, management companies of J-REITs announce expected amounts of dividends. So far, actual dividends have almost always exceeded expected amounts although this has been partly due to conservative announcements at each company. The transparency and profitability explained above gave investors a sense of security in the J-REIT market where dividends are one of the major factors attracting investors.

(4) Institutional Reform and Expansion of the Investor Base

Looking at the past trading behaviors by investor segment, banks and investment trusts emerge as the most aggressive buyers of J-REITs and have led the market. It is believed that there were two system reforms behind this result.

First, in December 2002, the Japanese Bankers Association issued an instruction which allowed bankers to allocate gain sales of J-REIT investment units into gross income, which is income from the main business. This change in the accounting system as well as the relatively high dividend yield of J-REITs attracted banks. Especially regional banks, which had sluggish loan growth and difficulties in managing their funds, started to invest in J-REIT actively. Also, because two of the J-REITs were added to the MSCI stock index in May 2005, institutional investors also started to recognize J-REIT as a valid investment choice.

Second, the Investment Trusts Association of Japan classified REIT as a type of investment trust, in which the association had a voluntary regulation preventing each investor from investing over 5% of its net assets in a single investment trust. The association amended the regulation to treat a REIT almost the same as a listed stock. This amendment made it possible to form a REIT-specific investment trust in which the portfolio was composed of minimum of 10 to 15 REITs. As a result, financial institutions started to form investment trusts for individual investors which distributed dividends every month by investing in multiple REITs with different fiscal terms. [5]

5) The Significance and Effect of the Expansion of the J-REIT Market

Reviewing the history of real-estate deals in Japan, there was a tendency not to attach importance to “the ability to create a lasting and stable cash flow” which was a major feature of a real estate as a financial asset because it was strongly believed that real estate did not depreciate and was a scarce resource. As a result, commercial real estate was seldom traded as a financial asset; commercial real estate continued to be owned even if the owners did not need it any more; commercial real estate was traded only for acquiring capital gains through development or resale. Each transaction amount in such trades is big. Further, because limited investors or limited market participants possess detailed information in such strongly closed trades, transaction costs are high. Therefore, there is little opportunity for retail investors to be involved in such trades. Based on the inefficient real estate market, creation of a huge amount of credit was accomplished via land-collateral loans in the late 1980s. It is believed that the emergence of the bubble was largely influenced by the fact that land appraisal methods relied not on the discount cash flow model, but on comparisons with the similar properties. In the market environment where there were strong expectations for increases in the land prices, over-sized financing of land increased the price of surrounding land and enabled the owner of the land to borrow more and as a result, the pace of credit creation accelerated.

When the cycle reversed in the 1990s and land prices rapidly declined, the quality of bank loans deteriorated to a point that caused a crisis in the financial system. At the same time, real estate ownership was heavily concentrated among corporations and real-estate developers and there was no system for securitizing real estates. Therefore, when the loan problem emerged, it was not widely recognized how pervasive it was and remained largely unnoticed for many years.

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[5] This amendment of the voluntary regulation gave effect not only to J-REIT, as mentioned above, but also to investments in US-REIT or other similar foreign public real estate securities.

Although the J-REIT market has not solved all the problems mentioned above, it can be said that the J-REIT market has had significant impacts as follows:

(1) Opening Opportunities to Invest in Real Estate and Expansion of the Investor Base

The first significance of the emergence of the J-REIT is that it opened the door to investment in real estate for retail investors. J-REIT enabled diversified methods of asset management for individual investors and for domestic financial institutions which were puzzled over finding reasonable investment choices. Foreign investors also aggressively invest in J-REITs. The expansion of the market was also supported by the 4-6%dividend yields of J-REITs, while the Japanese government continued the zero-interest-rate policy. Further, many investors invested in J-REITs because they thought that Japanese economic recovery would put upward pressure on real-estate values. Expansion of the investor class in J-REITs indirectly activates trades of actual real estate. The total value of real estate that J-REITs have acquired is about 4 trillion yen. It can be said that the liquidity and efficiency of the real-estate market has been strengthened by the market participation of investors who have different ideas from those of traditional investors.

(2) Changes in Real Estate Valuation Methods

Second, J-REIT has influenced changes in real estate appraisal methods. Because a REIT is a financial product backed by operating real estate, its valuation methods are based on cash flow or earnings yield. It is likely that an extravagant appraisal will be adjusted in market. Further, the expected returns which investors seek in the J-REIT market had an effect on the entire real estate investment market and the appraisal methods for commercial real estate were changed to put greater importance on the cash flow and earnings yield.

In fact, so far, dividend yield has been the most important factor in determining the price of J-REIT investment units. Study results show that dividend announcements cause fluctuations in the stock prices of J-REITs .[6] It draws attention to how changes in the interest-rate environment and other changes affect J-REITs. However, considering experiences in US-REITs, it is believed that substantial positive yield spreads are not needed for the growth of the REIT market but, rather, total return is an important contributing factor for the growth of the REIT market. At the same time, the correlation coefficient of returns of the J-REITs listed earliest to TOPIX is about 0.16-0.17 based the performances of five years.

(3) Changes in Behaviors of Bank and REOC

Third, it is possible that the expansion of the REIT market has influenced the behaviors of the banks and existing real-estate development companies which triggered the real-estate bubble in Japan. Now, banks focus on project-based finances which are easily securitized, because it is highly risky for banks to increase commercial loans collateralized by low-liquidity real estate or vacant land properties which are not suitable for securitization. REOCs are also avoiding exposure to the asset price movement risk and instead altering their business model in which REOCs do not own assets and concentrates only on the management of the assets owned by others.

(4) Forming an Institutional Real-Estate Investment Market

[6] Kawagushi & Hisatake (2005) etc.

Because a J-REIT is a fund that distributes income gain from portfolios of operating real estate under a conservative financial strategy, it is possible to formulate the concept of an investment fund which is designed to exit through J-REIT market. To be more precise, the fund invests in development projects, properties with a high rate of vacancy, real estate collateralized for bad loans, and sells these assets to the J-REIT after the completion of construction, acquisition of tenants, adjustment of rights and obligations. Because such fund has a relatively high risk, the fund should raise capital through a private offering to a small number of investors and should set its debt leverage high.

In Japan, private real estate investment funds were actively formed as the trend of J-REIT market expansion became apparent. Foreign players (e.g., Morgan Stanley, Goldman Sachs, Secured Capital, CB Richard Ellis, etc.) and investment firms founded in Japan (e.g., Pacific Management, daVinci Advisors, Creed, etc.) became fund managers of private funds. Many of the funds sell real estate that they own to J-REITs. At the same time, there are examples in which a fund looking to unwind its real estate holdings succeeded by appointing the fund manager as the sponsor of the J-REIT. It is important that funds operate with the mandate to increase operating properties' cash flow and adding value, instead of profiting from real estate development and rising land prices like the late 1980s.

The market size of private real estate funds has rapidly grown in Japan, and, is estimated to be about 5.5 trillion yen as of the end of June 2006; which is bigger than the J-REIT market capitalization. [7] As mentioned above, it is believed that a cash flow crunch in private funds triggered the growth of the REIT market in the U.S. However, it can be said that the private real estate investment market is maturing, using the formation of a public real estate market as a trigger.

(5) Reduction of Risk Premium for Real Estate Investment

In order to estimate the real estate investment yields which investors require of J-REITs, the implied capitalization rate, which is calculated through dividing Net Operating Income (NOI) by the REIT's enterprise value (total market values of equities + securities deposits + net debt obligation), is useful. [8] It is believed that the gradual decrease in the capitalization rate shows the surge in popularity of J-REITs among investors, and encourages J-REITs to acquire real estates more aggressively.

The capitalization rate in overall commercial real estate market has decreased as the J-REIT market has expanded. Because there was no circumstance in which real estate was traded according to investment yields, it is very difficult to scrutinize the capitalization rate in real-estate deals. Therefore, adequate objective and quantitative analyses regarding the influence of the J-REIT market on the capitalization rate after 2001 or the comparisons with the bubble period do not exist. However, according to recent research, the gradual expansion of investment choices by investment funds including J-REITs is believed to have had an impact on the capitalization rate of studio apartments and suburban shopping centers, which deceased after the capitalization rate of office buildings in big cities decreased; the capitalization rate in Osaka, Nagoya and Fukuoka showed a downward tendency following Tokyo.

As explained above, it is believed that the emergence of the J-REIT improved transparency in Japanese real estate deals, and that the inflow of ample money into real estate funds (including J-REITs)

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[7] STB Research Institute, "Field Survey about Real Estate Private Fund" (July 26, 2006). According to this survey, the market size of private offering real estate funds had exceeded counterpart of J-REIT as of the end of 2004. Further, in 2006, Association of Real Estate Securitization also issued its first field survey about private offering fund which reported that the total number of the funds managed by its members (194 companies) was 430 and total investment assets of them was about 6.1 trillion yen (May 31, 2006).

[8] Net debt with interest is calculated by deducting cash equivalent from total debt with interest.

gradually reduced the risk premium for real estate investment in Japan.

(6) Real Estate Market Linked to Capital Market

In the past in Japan, the price of real estate was almost always determined by expectations of price increase unrelated to revenue from the real estate. Beyond the fact that real-estate appraisals based on income or earning yields did not take root in general, there was a tradition of corporations having many pieces of real estate for their own use. Securitization has progressed, and, as a result, discount cash flow and other appraisals methods based on income are now becoming a mainstream.

Moreover, because of the appearance of the J-REIT market, the capital market has an influence on the physical real estate market. More specifically, investors in J-REITs require expected earning yields which include a certain risk premium over other financial assets. The implied capitalization rate is an index which shows one standard of the market participants. The managers of J-REITs recognize the need to assure the earning yield of invested assets in order to distribute dividends according to the expected earning yields in the market. Therefore, it is natural for them to hesitate acquiring real estate at a price which excessively lowers earning yields.

Investment behaviors of J-REITs, which have already become key players the real estate market, have influences on behaviors of private real estate funds and other real estate investors. Therefore, the J-REIT market can prevent price formations from differing excessively from fundamentals and prevent speculation from overheating if the J-REIT market, which is a capital market, exercises healthy market mechanisms.

6) Issues in the Future

The J-REIT market steadily continues to expand and mature in both asset size and the investor base. Its influence on overall real estate investment market is more prevalent and therefore, one can conclude that the initial political intention of creating the REIT market has largely succeeded.

Concerning issues in the future, the first is to figure out how to cope with potential problems created by using outside management. Considering the structure of J-REITs, it is possible that managers' behaviors will conflict with investors' interests. For example, the management company (or its employee) of a J-REIT fund, where the management fee is based on the size of the outstanding asset, may be motivated to make investment decisions without enough due diligence. On the other hand, many of the management companies hired to manage the real estate portfolios by J-REITs are the subsidiaries of the asset management companies that manage assets and facilities. In both cases, there are potential conflicts of interests. Although such conflicts have not yet surfaced, because management companies operate under strict internal rules for trading and management, the rapid expansion of the J-REIT market is fueling such concerns.

Recently, some have pointed out that there is a risk that investment funds could rush to acquire assets, and then invest in illegal buildings (e.g., buildings for which seismic assessments were forged). For example, the Financial Service Agency prohibited JP Morgan Trust Bank and Shinsei Trust & Banking from accepting new contracts for 6 months (the former) and for 1 year (the latter) because they lacked the system to review the appraisals of the real estate that they manage and securitize.[9] Further, on July 21,

[9] Financial Service Agency announced the penalty on JP Morgan Trust Bank on April 5, 2006, and announced the penalty on Shinsei Trust & Banking on April 26, 2006.

2006, the Financial Service Agency prohibited Orix Asset Management, which is a management company and a subsidiary of Orix, from executing new management contracts for 3 months. The reason for the penalty was that Orix Asset Management improperly managed (e.g., omitting examinations at acquisition of real estate, etc.) assets entrusted by Orix Real Estate Investment, which was a J-REIT. Although there was a recent scandal involving the forged seismic assessments behind the tightening of regulations in Japan, the government has a growing interest in the compliance of J-REIT management as well as the disclosure of real estate-specific risks. In order for a J-REIT to become a financial product backed by full confidence of investors, further discussions from various angles may be required.

4. Conclusion

Both ETF and REIT are new collective investment schemes in which amateurs pool money and professionals manage it. Further, other common features to both schemes are as follows: They are instruments in which investors can invest not on sole security or real estate but on diversified portfolio and are listed on exchanges. In Japan, both ETF and REIT, of which concepts were imported from the U.S. market, were introduced with specific political purposes from the end of 1990s to 2001 when the demand for reform of securities market was becoming strong. However, both the ETF and the REIT made actually are different from counterparts in the U.S. The Japanese ETF is technically different from the U.S. counterpart in that an in-kind creation of ETF shares can be formed only when the ETF links to stock indexes specified by rules of Financial Service Agency. The J-REIT is rather fundamentally different from the U.S. counterpart in that the J-REIT has the outside management system, which the US-REIT wiped out in past times. However, in another respect, it is inevitable that both the Japanese ETF and the J-REIT are different from the U.S. counterparts because both of them were instruments created on the basis of Japanese investment trust related laws which had developed independently from counterparts in other countries. Nevertheless, comparing them each other on the points of style of corporation, public offering, listing, existence or nonexistence of outside management and so forth, the each collective investment scheme in Japan or in the U.S. has features which are subtly different from ones its counterpart does.

In Japan, both the ETF market and the J-REIT market have grown to have about 3-4 trillion yen in total market value in five years since their actual inception. Although they have grown rapidly and their market sizes are not small when compared internationally, their market sizes are about one tenth of the ETF market and the REIT market in the U.S. Moreover, the gap between the size of Japanese investment trust market and the size of the U.S. mutual fund market is even wider (Japan : the U.S. = 1:18). Observing the U.S. securities market in the past 10-20 years, the mutual fund market, which steadily increased assets, kept stride with the expansion of innovative products (e.g.. syndicate loan) and contributed to the growth of market for such products. In Japan also, the further growth of investment trust, which can be regarded as a representative of collective investment schemes, will likely encourage investors to increase understanding of the benefits of ETF and J-REIT which will lead to the widening of the investor base for such products. Concerning J-REIT, there has already been an example of that the expansion of investment trusts promoting the growth of the markets for other innovative products. Since Japan Post started to sell investment trusts in the autumn of 2005 in Japanese investment trust market, funds which allocate resources among the 3 major asset classes (equity, fixed income, real estate) in a balanced manner have been gaining popularity. The real estate allocations in such funds are composed of portfolios of J-REIT or foreign REIT. There has been a movement in which J-REIT is used as one asset class in a diversified portfolio. This trend will probably lead to the increase in investment by the retail investors in J-REIT.

It should be pointed out that ETF and REIT are used by many investors and financial institutions as investment tools for global diversification. For example, U.S.ETFs linked to international stock market index and several global REIT funds, which are sold in Japan, opened opportunities to invest in global stocks and real estates at relatively low cost even if the investment unit was small. On the other hand, as it can been seen that the movements to introduce REIT system are brisk in countries in Asia and Europe, the significances of ETF and REIT are globally acknowledged. The global recognition of ETF and REIT and the expansion of investor base will possibly have an impact on the ETF and the REIT markets in Japan and the U.S. How the globalization of ETF and REIT will affect the local markets and the price formation of the underlying individual assets would be the topic of future study.

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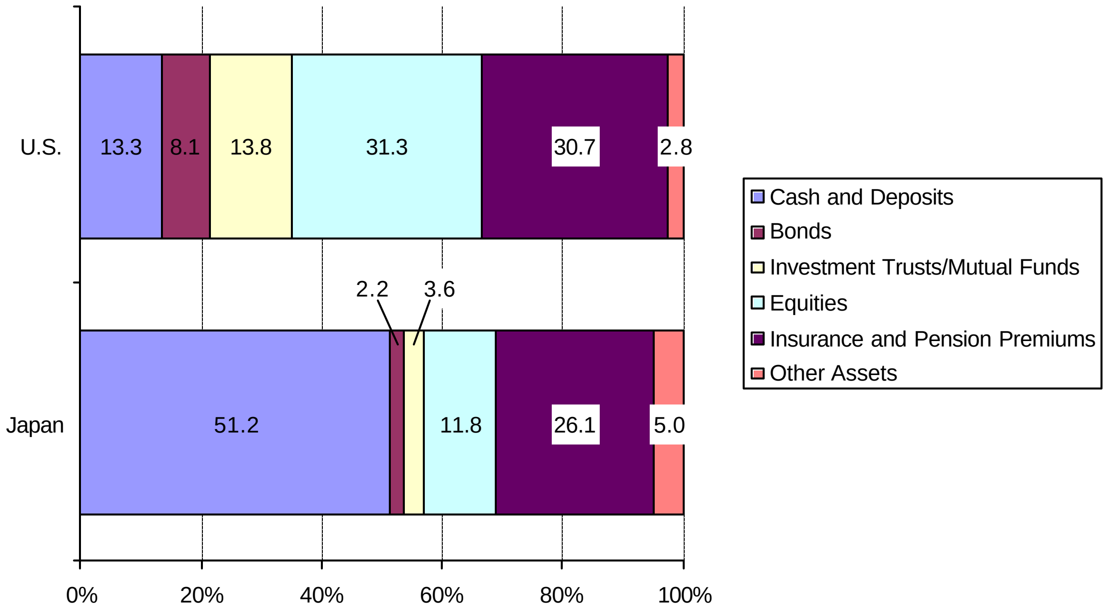
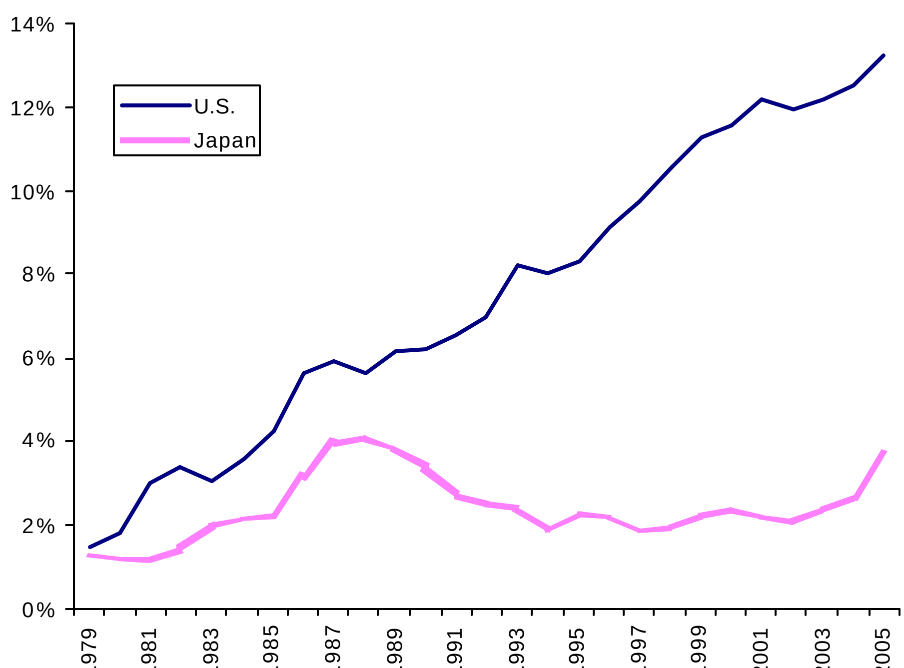
Figure 1-1 Household Asset Portfolio（as of end of March 2006）



Source: Nomura Institute of Capital Markets Research, based on data from the US Federal Reserve Bank and the Bank of Japan

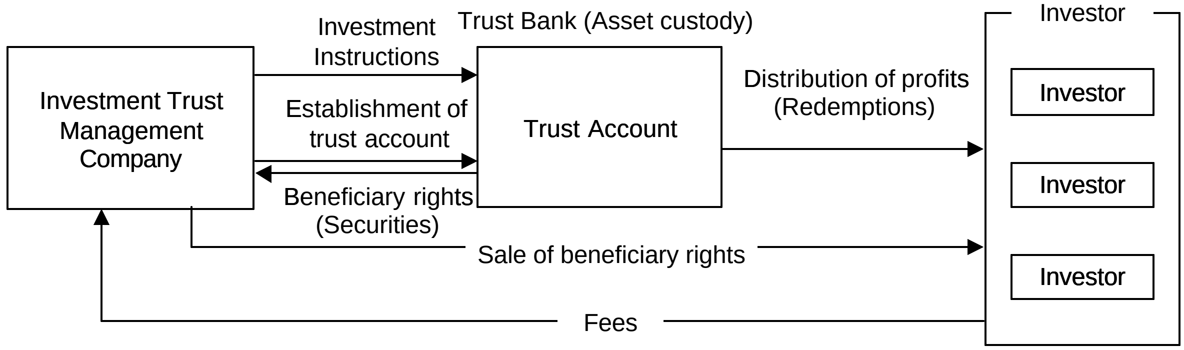
Figure 1-2 Rates of Investment Trusts in Household Financial Assets: Japan and the U.S.



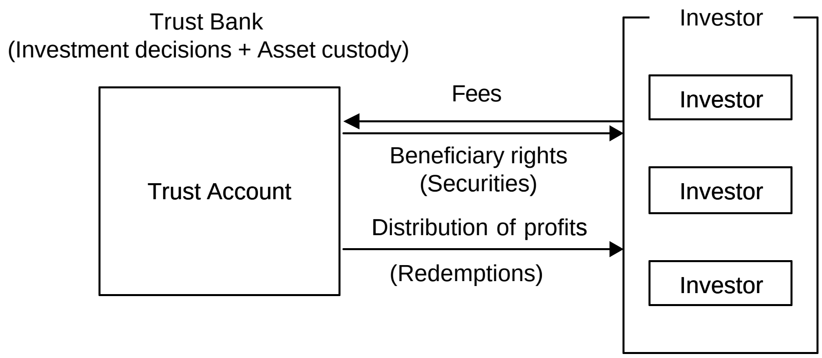
Note: Numbers of U.S. is as of end of each December; Numbers of Japan is as of end of each March.
Source: Nomura Institute of Capital Markets Research, based on data from FRB and Bank of Japan.

Figure 1-3 Types of Investment Trusts in Japan

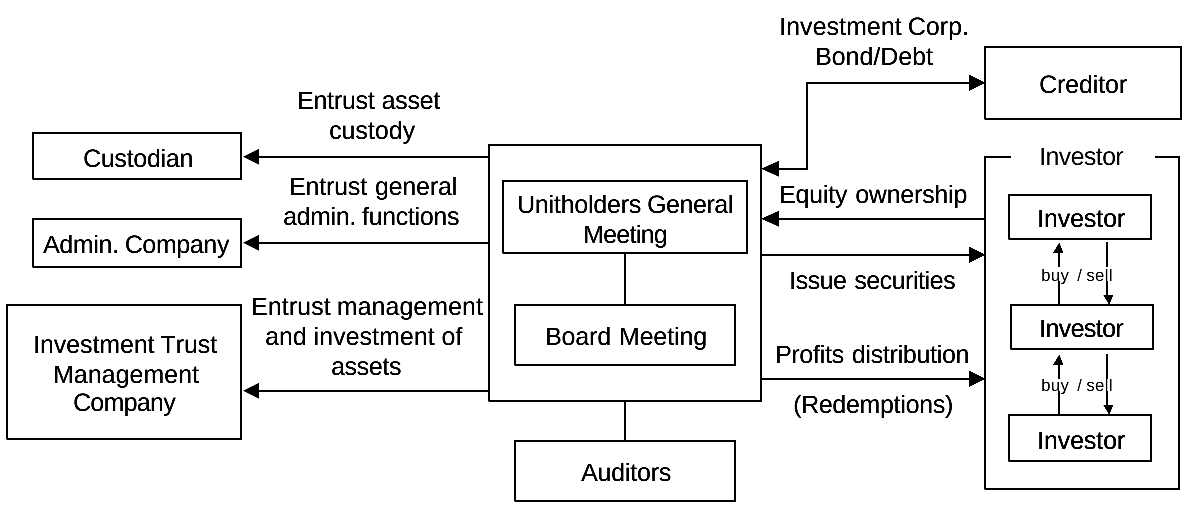
A: Non-discretionary Investment Trusts (Contractual-type)



B: Discretionary Investment Trusts (Contractual-type)

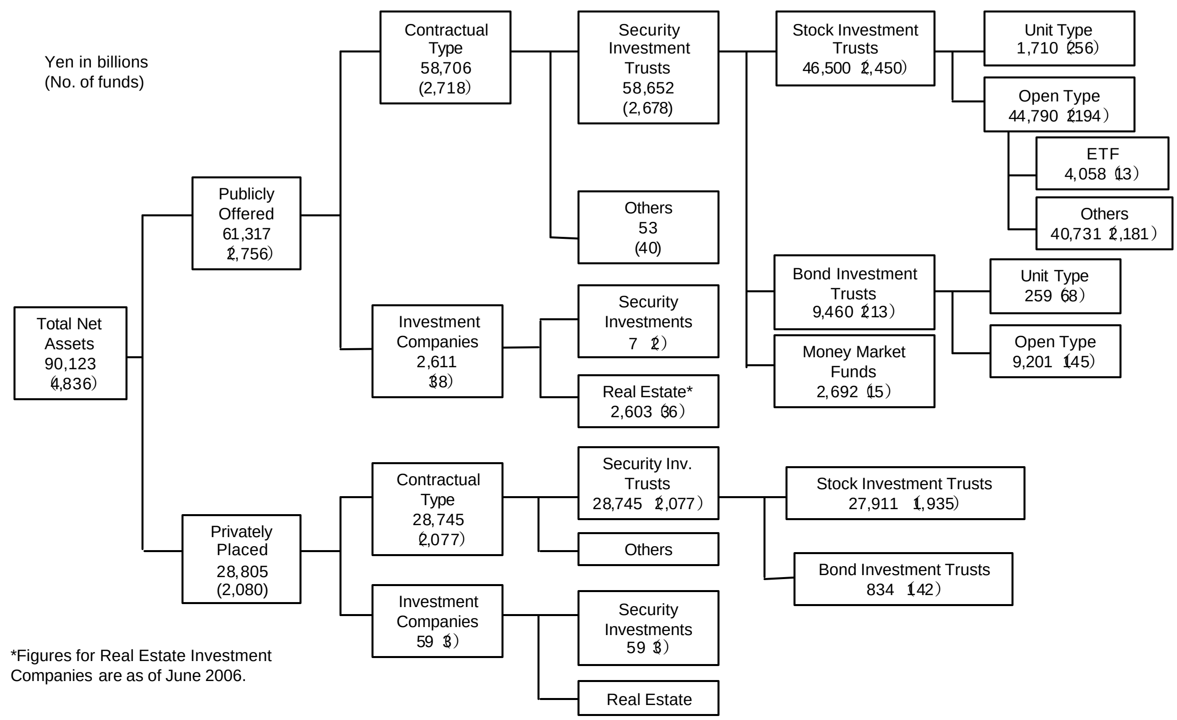


C: Investment Corporations (Corporate-type)



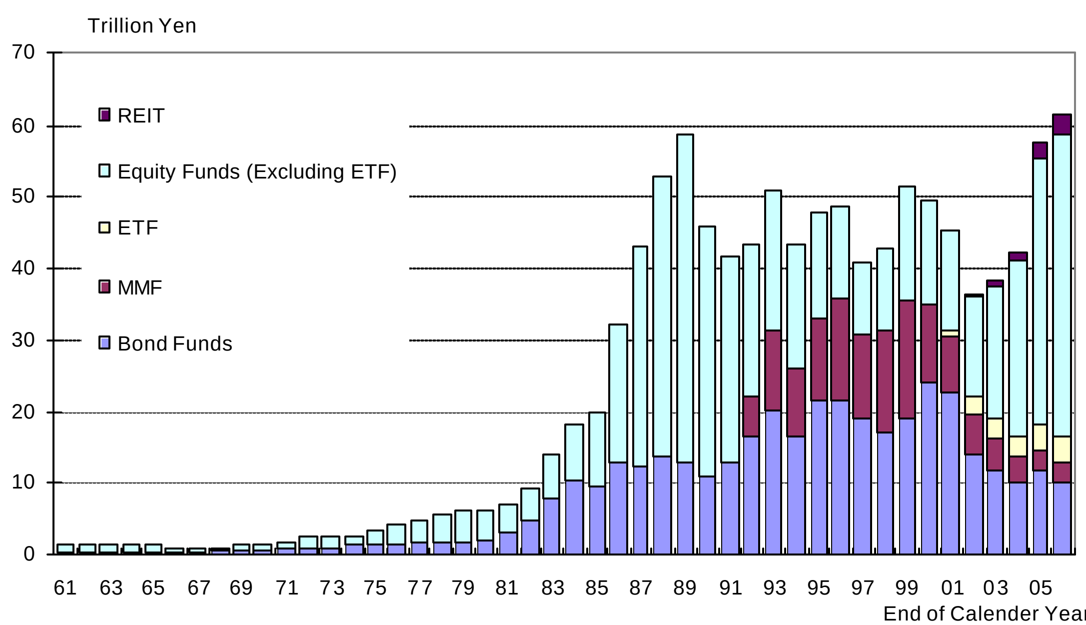
Source: Nomura Institute of Capital Markets Research, based on the Japanese Financial Services Agency

Figure 1-4 Investment Trusts in Japan: Net Assets and Number of Funds for Each Type
(As of end of July 2006)



Source: Investment Trust Association of Japan

Figure 1-5 Net Assets of Publicly-Offered Investment Trusts in Japan



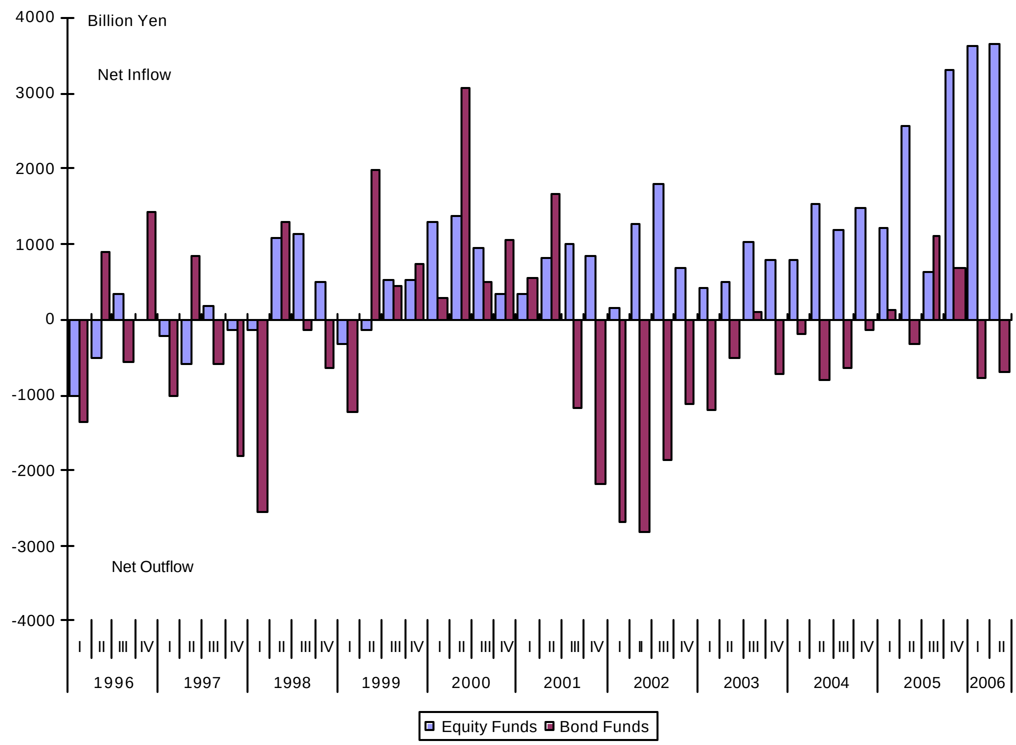
Note: Numbers of Year 2006 is as of end of June
Source: Investment Trust Association of Japan

Figure 1-6 Milestones in Investment Trust System Reform in Japan

1995	Japanese government eased regulations on entry for investment trust management companies (allowed to run investment trust business and investment advisory business simultaneously). The government also eased investment regulations on the use of derivatives.
December, 1998	The Japanese government enforced the Security Investment Trust Act, which was amended as part of financial reform. The government eased regulations on entry for investment trust management companies (changed to a business registry system), and introduced the private investment trust system and investment trust corporations. The government allowed banks and registered financial institutes other than security companies to sell investments trusts over the counter.
May, 2000	Japan enacted the “Investment Trust and Investment Trust Corporation Act” which allowed real estate investment trusts, the “Asset Liquidation Act” which simplified the foundation of Special Purpose Companies, the “Security Exchange Act” which allowed security exchanges to become corporations and allowed corporations to computerize disclosure systems, and “Financial Products Sales Act” which clarified the accountability of financial professionals to protect customers.
February 9, 2001	Ruling triparty set out “Intermediate Report on Measures for Revitalization of Security Market.”
April 6, 2001	Economic Policy Ministerial Meeting announced an emergency economic package which included development of exchange-traded funds (ETF).
April, 2001	With measuring unlisted bonds at fair value, long-term bond funds and midterm government bond funds changed from expectation distribution type to actual achievement distribution type.
June 6, 2001	In order to allow in-kind contribution type ETFs, the Japanese government amended the Investment Trust Act, the Enforcement Order of Income Tax Act, the Enforcement Order of Special Taxation Measures Act and other related tax systems.
June 19, 2001	The Tokyo Stock Exchange and the American Stock Exchange (AMEX) formed a strategic alliance regarding ETFs.
June 22, 2001	Japan enacted the Defined Contribution Pension Act.
July 13, 2001	The nation’s first stock-index-linked and in-kind contribution type exchange-traded funds (5 units) were listed on the Tokyo Stock Exchange and the Osaka Stock Exchange.
August 8, 2001	The Financial Services Agency announced the “Program for Structural Change of Security Market” which intended to enable individual investors to become major players in the securities market.
September 10, 2001	The Tokyo Stock Exchange listed 2 real estate investment trusts.
November 29, 2001	As a result of the failure of Enron Corp., the money market funds of of Nikko Asset Management, Japan Investment Trust Management, Sumisei Global Investment Trust and UFJ Partners Investment Trust fell below par.
April 1, 2002	Financial Service Agency issued an announcement which specified the Dow Jones Industrial Average, NASDAQ 100, MSCI JAPAN and FTSE Japan Index as stock indexes for ETFs.
May 20, 2003	The Tokyo Stock Exchange announced a reformed system which gave a one-year extension to the grace period related to numbers of beneficiaries. This was intended to prevent several ETFs from being delisted.
July 18, 2003	In accordance with the “Intermediate Report” by the Conference for Fostering Individual Investors, the Investment Trust Association amended a working rule in order to allow the establishment of funds-of-funds which incorporate real estate investment trusts.
December 16, 2003	The Tokyo Stock Exchange announced a draft amendment for delisting related to beneficiaries of ETFs. Under the former rule, ETFs having less than “500 beneficiaries” were delisted. However, under the new rule, ETFs having less than “100 beneficiaries” would be delisted. New rule was scheduled to be enforced as of beginning of February, 2004.
June 2, 2004	The Upper House passed a draft amendment to the Security Exchange Act. The draft allowed banks to run securities broking business, and introduced a surcharge system and simplified an investment trust prospectus system comprising of three parts.
October 3, 2005	Japan Post started to sell investment trusts at 575 post offices.
June 7, 2006	Japan enacted an amendment to the Security Exchange Act. According to this amendment, the current “Security Exchange Act” would be merged into the “Financial Instruments and Exchange Act (Investment Service Act).” The amendment organizes limited liability partnership and other funds as collective investment schemes. Further, the amendment deems interests in the collective schemes as securities, then, so that all securities regulation applies to them.

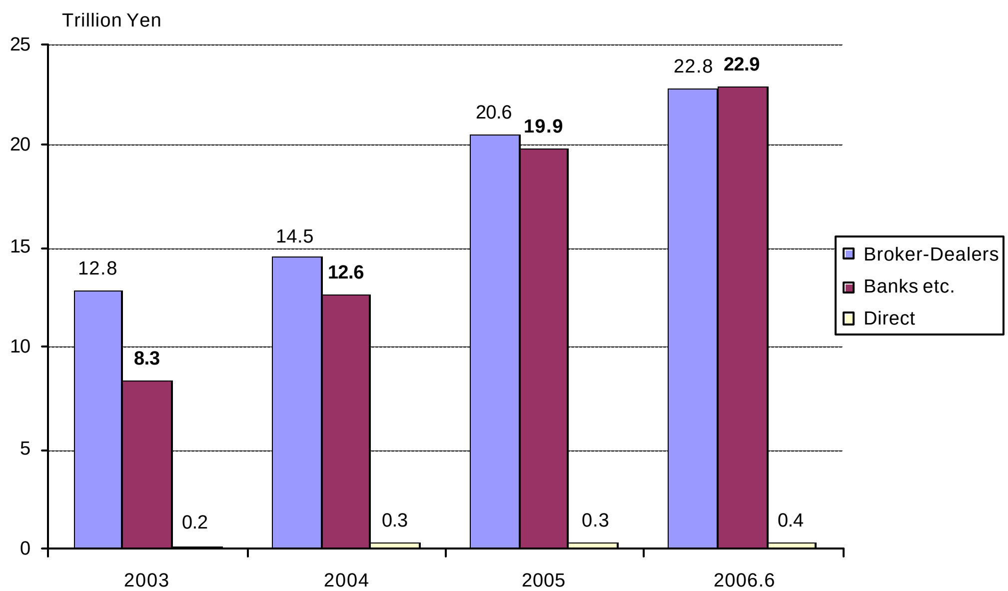
Source: Nomura Institute of Capital Markets Research

Figure 1-7 Changes in Net Fund Flows for Contractual-Type Public Investment Trusts
(Quarterly base: 1996-2nd quarter of 2006)



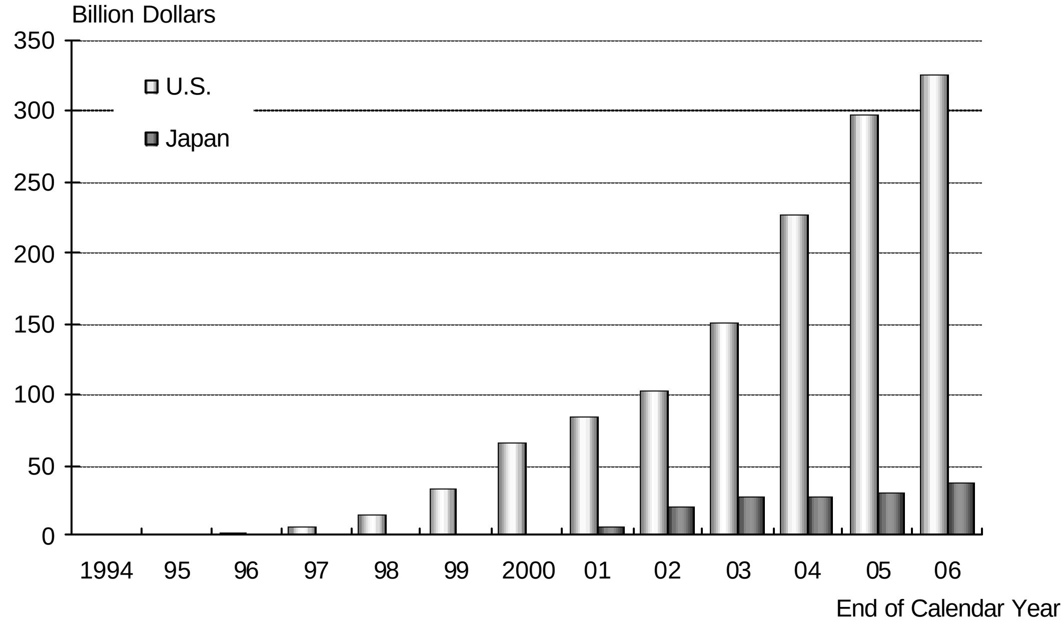
Source: Nomura Institute of Capital Markets Research, based on data from Investment Trust Association of Japan

Figure 1-8 Net Assets of Stock Investment Trusts by Distribution Channel



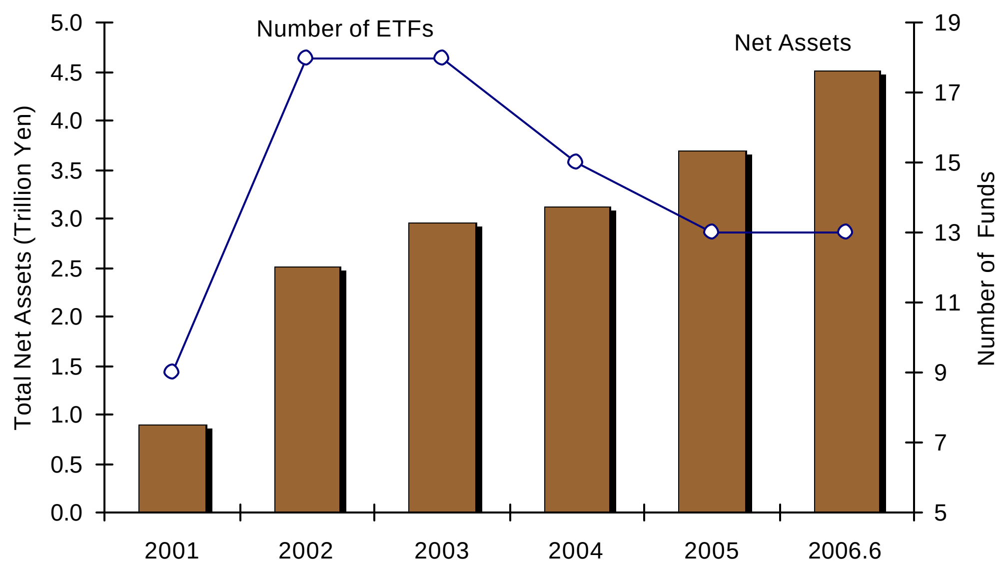
Source: Nomura Institute of Capital Markets Research, based on data from Investment Trust Association of Japan

Figure 2-1 Change of Net Assets of ETF: Comparison of Japan with the U.S.



Note: The number in 2006 is as of end of May. The net assets in Japanese ETF were converted into dollars by exchange rate at end of each year.
Source: Compiled by Nomura Institute of Capital Markets Research, based on data from ICI, Investment Trust Association of Japan

Figure 2-2 Change of Net Assets and Number of ETFs in Japan



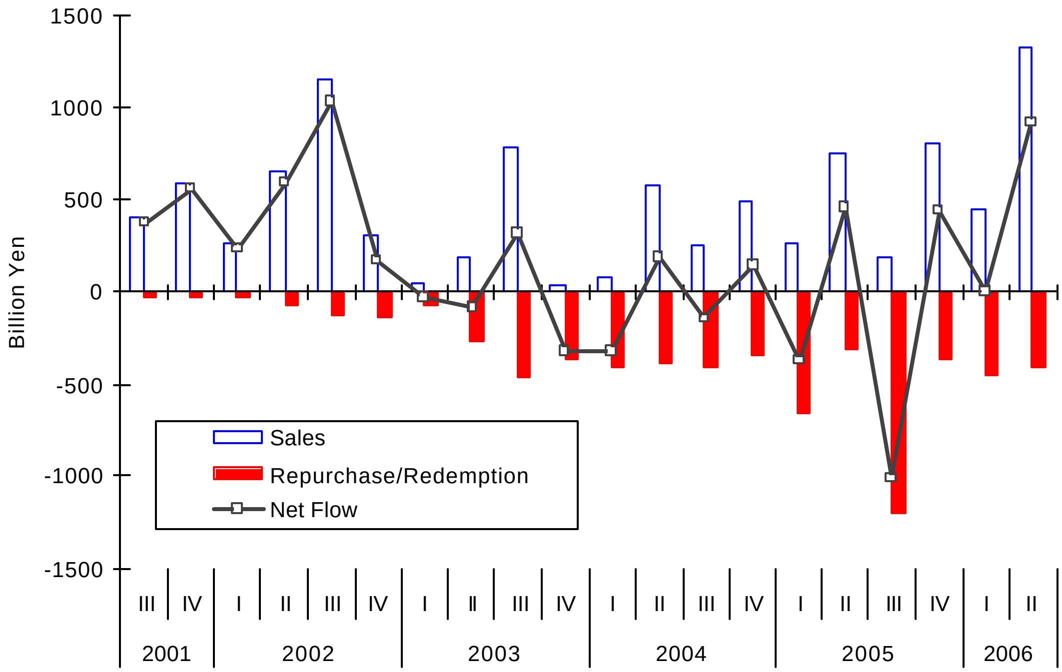
Note: This data does not include Nikkei 300 Stock Index linked ETF.
Source: Compiled by Nomura Institute of Capital Markets Research, based on data from Investment Trust Association of Japan

Figure 2-3 ETF in Japan: Summary (as of the end of June 2006)

Code	ETFs	Market	Index	Net Assets (Million Yen)	Manager	Inception
1305	Daiwa ETF-TOPIX	TSE	TOPIX	356,603	Daiwa Asset Management	2001/07/11
1306	Nomura ETF-TOPIX			987,568	Nomura Asset Management	2001/07/11
1308	Nikko ETF-TOPIX			717,186	Nikko Asset Management	2001/12/20
1310	Daiwa ETF-TOPIX Core 30		TOPIX Core 30	8,364	Daiwa Asset Management	2002/03/28
1311	Nomura TOPIX Core 30 ETF			4,972	Nomura Asset Management	2002/04/02
1329	iShares Nikkei 225		Nikkei 225	4,845	BGI	2001/09/04
1330	Nikko ETF 225			719,459	Nikko Asset Management	2001/07/09
1610	Daiwa ETF-TOPIX Electric Appliances		TOPIX Electric Appliances	2,181	Daiwa Asset Management	2002/03/28
1613	Nomura TOPIX Electric Appliances ETF			19,280	Nomura Asset Management	2002/04/02
1612	Daiwa ETF-TOPIX Banks		TOPIX Banks	4,652	Daiwa Asset Management	2002/03/28
1615	Nomura TOPIX Banks ETF			108,699	Nomura Asset Management	2002/04/02
1320	Daiwa ETF-Nikkei 225	OSE	Nikkei 225	440,021	Daiwa Asset Management	2001/07/09
1321	Nomura Nikkei 225 ETF			1,134,833	Nomura Asset Management	2001/07/09
1319	Nomura Nikkei 300 Index Fund	TSE, OSE, Nagoya, Fukuoka, Sapporo	Nikkei 300	22,573	Nomura Asset Management	1995/04/12

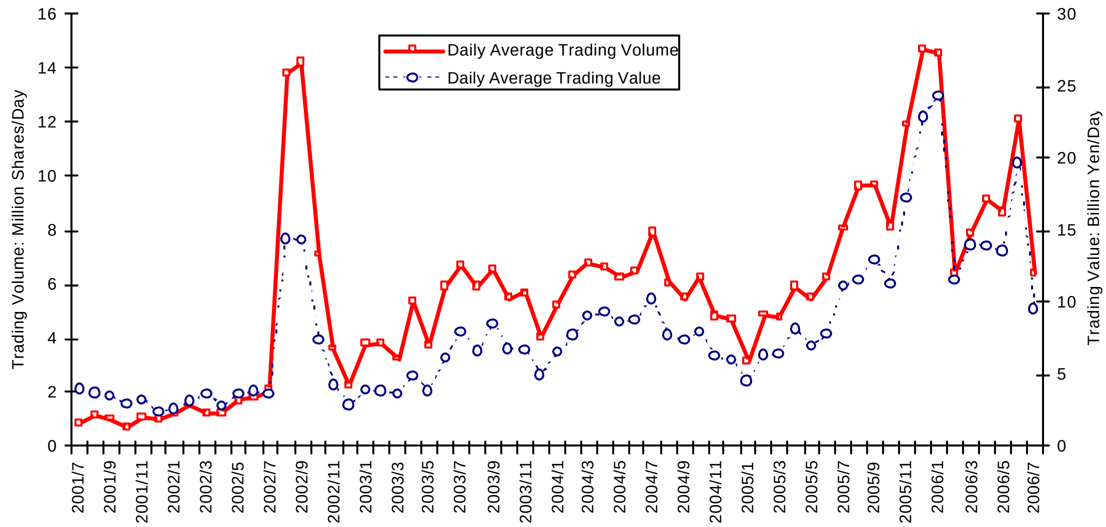
Source: Nomura Securities Co., Ltd., Bloomberg

Figure 2-4 ETF in Japan: Change of Setup and Cancellation (Quarterly Basis)



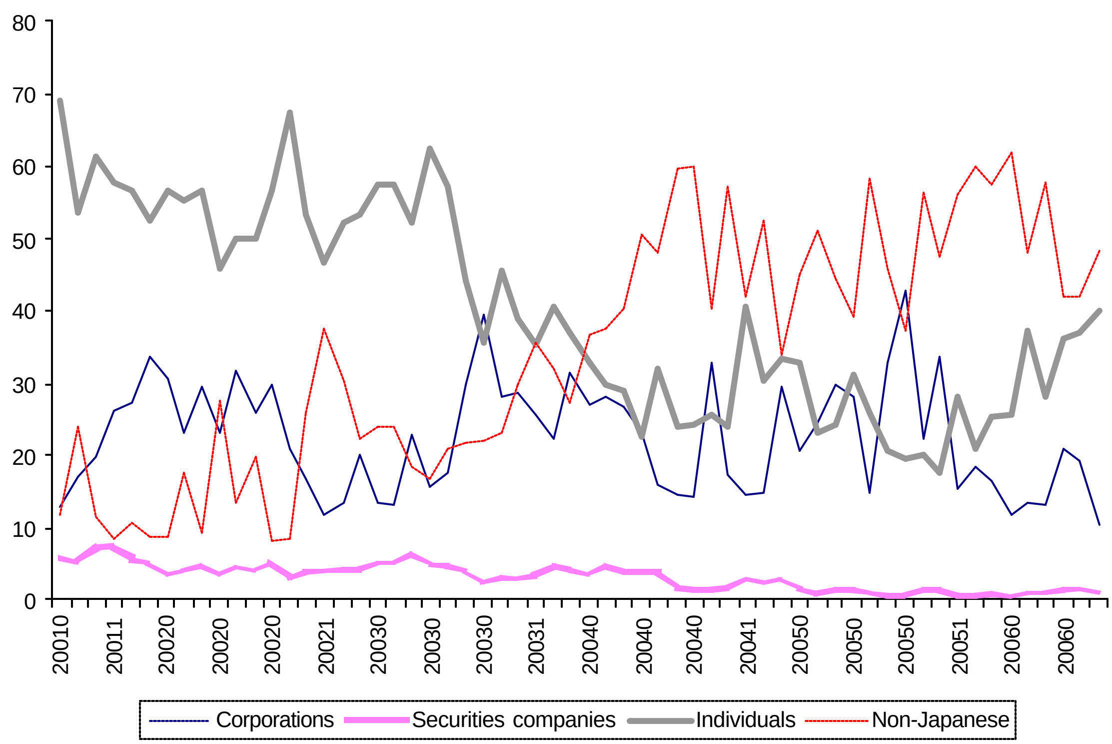
Source: Compiled by Nomura Institute of Capital Markets Research, based on data from Investment Trust Association of Japan

Figure 2-5 ETF listed on Tokyo Stock Exchange: Change of Trading Volume and Trading Value



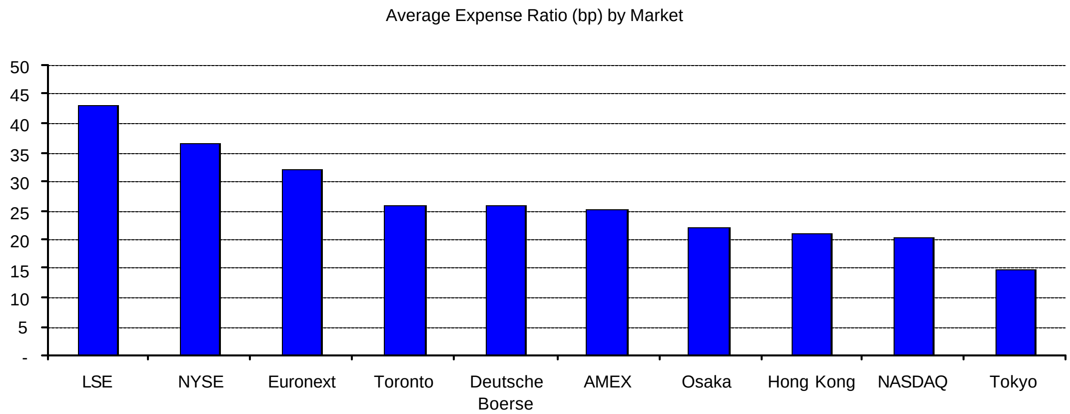
Source: Compiled by Nomura Institute of Capital Markets Research, based on data from Tokyo Stock Exchange.

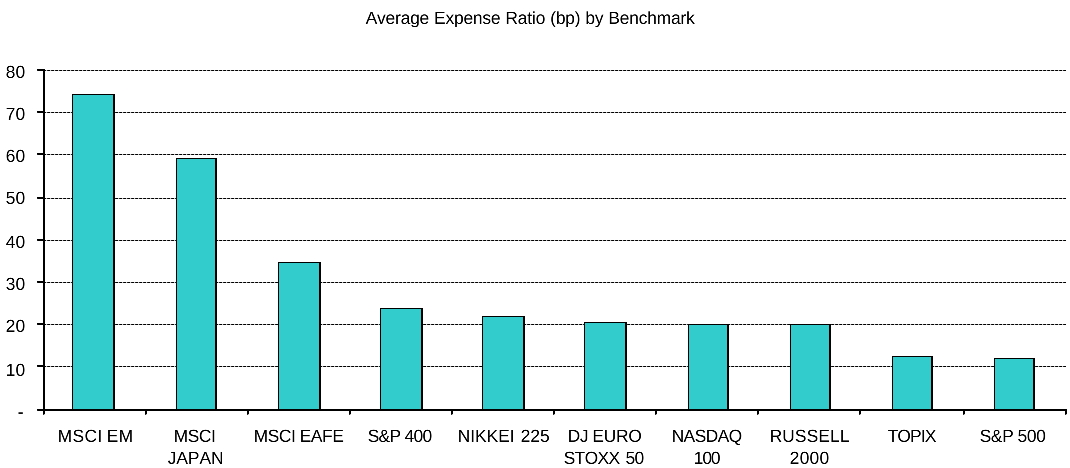
Figure 2-6 ETF in Japan: Change of Trading Value by Investor Type (% of Total)



Note: Aggregated values in Tokyo Stock Exchange and Osaka Stock Exchange.
Source: Compiled by Nomura Institute of Capital Markets Research, based on data from Tokyo Stock Exchange and Osaka Stock Exchange

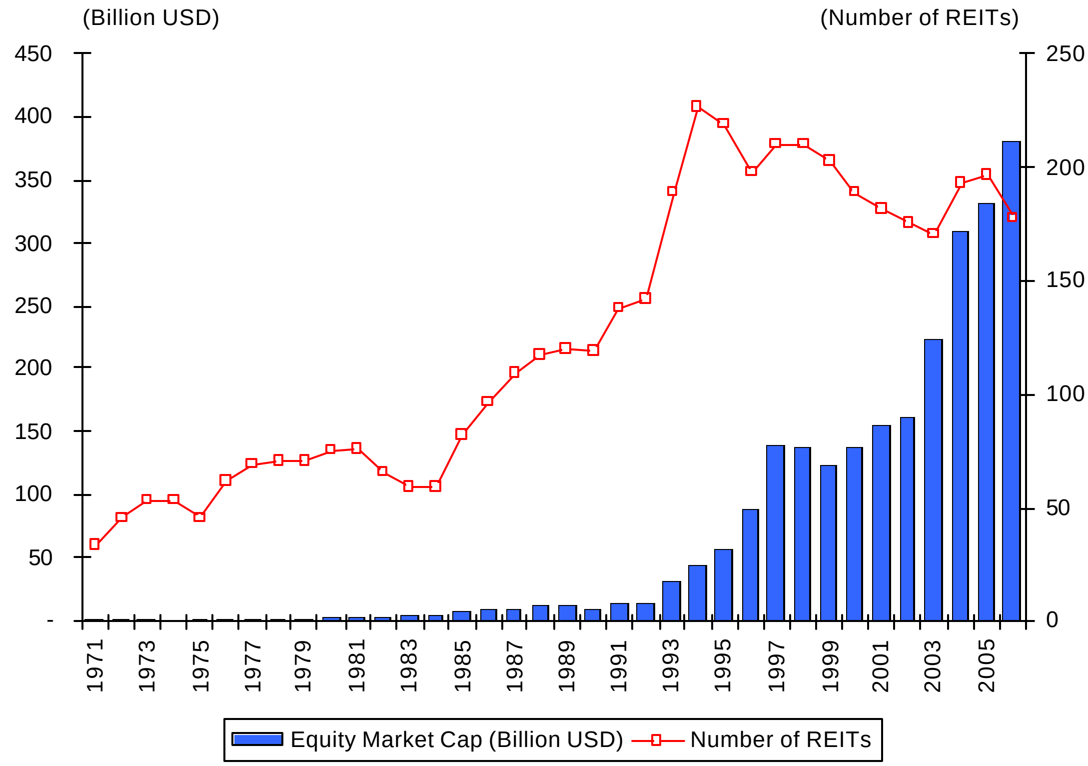
Figure 2-7 Global ETF Comparison by Expense Ratio (as of February 2006)





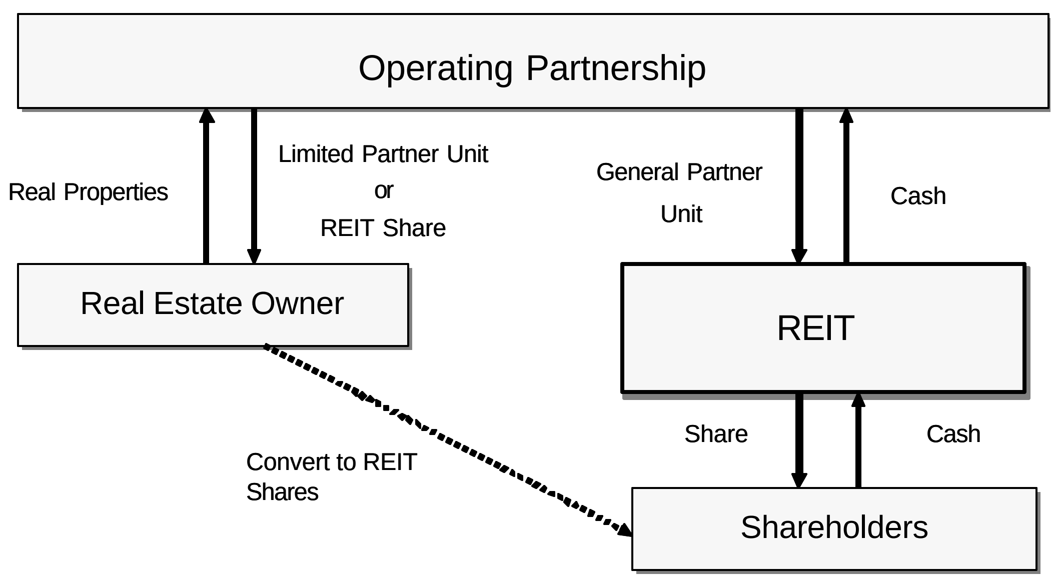
Note: Dual listing ETFs are calculated only on major market. Average is market-cap-weighted.
Source: Nomura Securities Co., Ltd.

Figure 3-1 Growth of the U.S. REIT



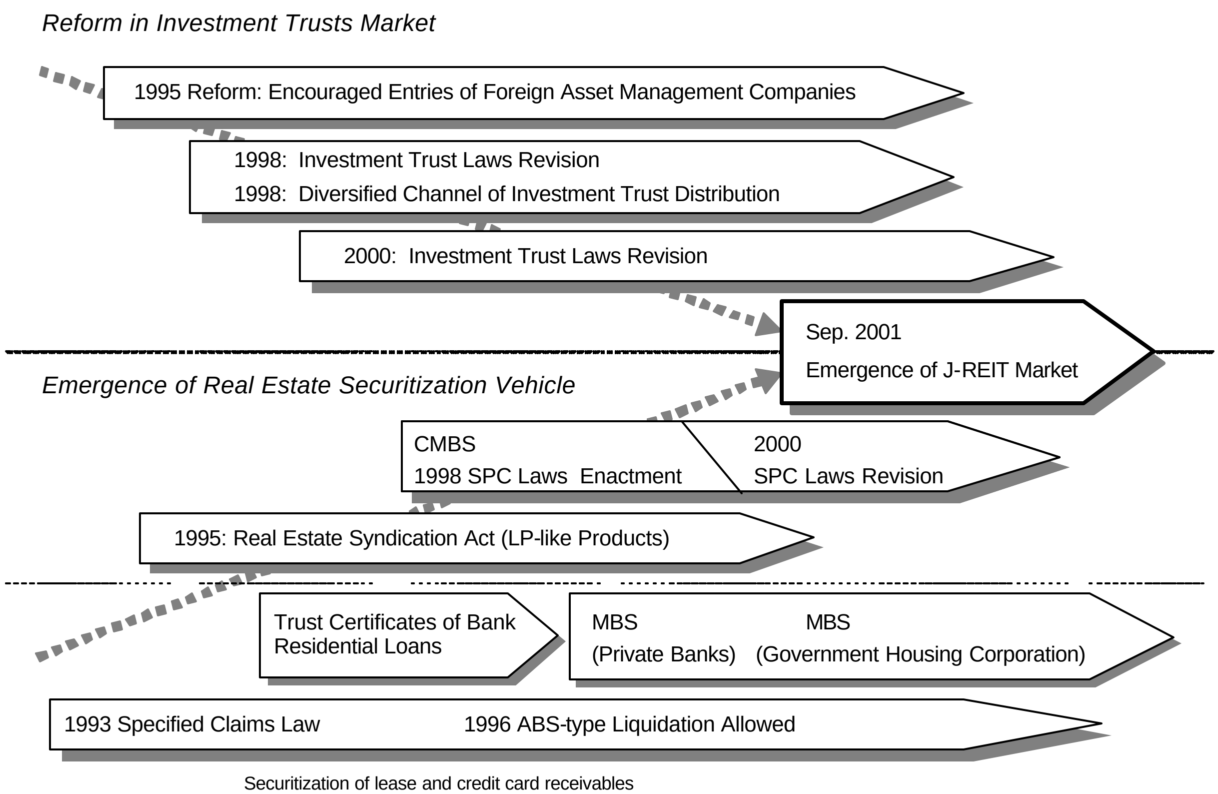
Note: The number in 2006 is as of the end of July 2006.
Source: NAREIT

Figure 3-2 Structure of UPREIT



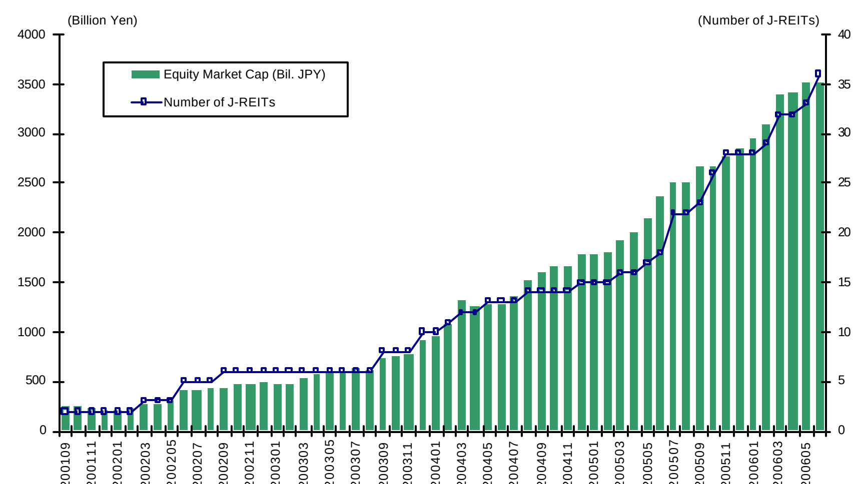
Source: Nomura Institute of Capital Markets Research

Figure 3-3 Trend of Capital Market in Japan and J-REIT



Source: Nomura Institute of Capital Markets Research

Figure 3-4 J-REIT: Change in Total Market Value and Number of Listed Funds



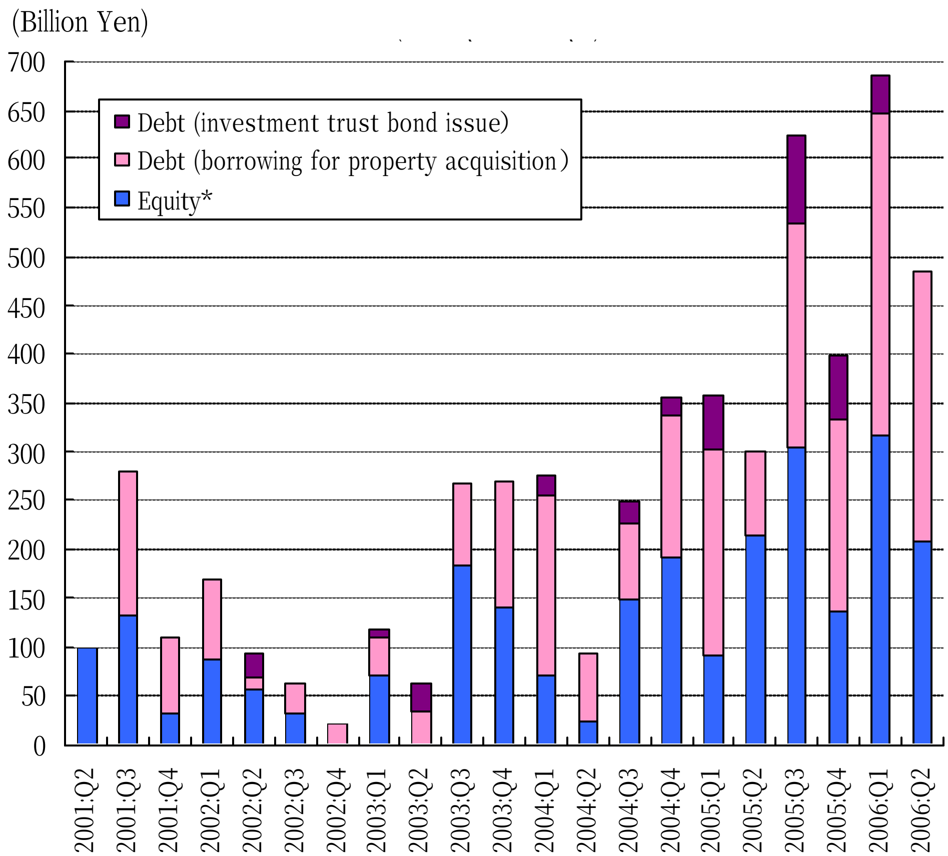
Source: Nomura Institute of Capital Markets Research, based on data from Bloomberg

Figure 3-5 List of Listed J-REIT

Code	Investment Corporation	Asset Type	Fund Manager	Listed	Equity Market Cap (Mil JPY, 8/17/06)
Tokyo Stock Exchange					
8951	Nippon Building Fund Inc. (NBF)	Office	Nippon Building Fund Management Ltd.	09/10/2001	574,040
8952	Japan Real Estate Investment Corporation	Office	Japan Real Estate Asset Management Co., Ltd.	09/10/2001	352,308
8953	Japan Retail Fund Investment Corporation	Retail	Mitsubishi Corp. - UBS Realty Inc.	03/12/2002	266,202
8954	ORIX JREIT Inc.	Diversified	ORIX Asset Management Corporation	06/12/2002	161,592
8955	Japan Prime Realty Investment Corporation	Office, Retail	Tokyo Realty Investment Manegement, Inc.	06/14/2002	183,380
8956	Premier Investment Corporation	Office, Residential	Premier Reit Advisor Co., Ltd.	09/10/2002	66,823
8957	TOKYU REIT,Inc.	Office, Retail	Tokyu Real Estate Investment Management Inc.	09/10/2003	142,787
8958	Global One Real Estate Investment Corp.	Office	Global Alliance Realty Co.,Ltd.	09/25/2003	75,636
8959	Nomura Real Estate Office Fund,Inc.	Office	Nomura Real Estate Asset Management Co.,LTD.	12/04/2003	239,047
8960	United Urban Investment Corporation	Diversified	Japan REIT Advisors Co.,Ltd.	12/22/2003	109,812
8961	MORI TRUST Sogo Reit,Inc.	Diversified	MORI TRUST Asset Management Co.,Ltd.	02/13/2004	164,800
8962	Nippon Residential Investment Corporation	Residential	Pacific Investment Advisors Corporation	03/02/2004	110,217
8964	Frontier Real Estate Investment Corporation	Retail	Frontier REIT Mangement Inc.	08/09/2004	94,723
8965	New City Residence Investment Corporation	Residential	CBRE RESIDENTIAL MANAGEMENT K.K.	12/15/2004	62,532
8966	CRESCENDO Investment Corporation	Office, Residential	Canal Investment Trust Co., Ltd.	03/08/2005	26,919
8967	Japan Logistics Fund,Inc.	Industrial	Mitsui & Co., Logistics Partners Ltd.	05/09/2005	93,133
8968	Fukuoka REIT Corporation	Office, Retail	Fukuoka Realty Corporation Limited	06/21/2005	80,544
8969	Prospect Residential Investment Corporation	Residential	Prospect Residential Advisors	07/12/2005	26,811
8970	Japan Single-residence REIT Inc.	Residential	Japan Single-residence Asset Management Corp.	07/13/2005	14,565
8972	Kenedix Realty Investment Corporation	Diversified	Kenedix REIT Management, Inc.	07/21/2005	92,787
8973	Joint Reit Investment Corporation	Retai, Residential	Joint Capital Partners Co.,Ltd.	07/28/2005	30,856
8974	eAsset Investment Corporation	Residential	Asset Realty Managers Co.,Ltd.	09/07/2005	30,861
8975	FC Residential Investment corporation	Residential, Hotel	Fund Creation REIT Advisers Co.,Ltd.	10/12/2005	14,453
8976	DA Office Investment Corporation	Office	K.K. daVinci Select	10/19/2005	49,500
8977	Hankyu REIT, Inc.	Office, Retail	Hankyu REIT Asset Management, Inc	10/26/2005	53,299
8978	Advance Residence Investment Corporation	Residential	AD Investment Management Co.,Ltd.	11/22/2005	21,652
8980	LCP Investment Corporation	Diversified	The LCP REIT Advisors Co.,Ltd.	05/23/2006	23,957
8981	Japan Hotel and Resort, Inc.	Hotel	Japan Hotel & Resort K.K.	02/15/2006	56,396
8982	Top REIT,Inc.	Diversified	Top REIT Asset Management Co.,Ltd.	03/01/2006	100,130
8983	CREED OFFICE Investment Corporation	Office	Creed REIT Advisors, Inc.	03/15/2006	42,369
8984	BLife Investment Corporation	Residential	MORIMOTO ASSET MANAGEMENT Co.,Ltd	03/22/2006	17,247
8985	Nippon Hotel Fund Investment Corporation	Hotel	Japan Hotel REIT Advisors Co.,Ltd.	06/14/2006	19,201
8986	re-plus residential investment inc.	Residential	re-plus REIT Management inc.	06/22/2006	26,095
8987	Japan Excellent, Inc.	Office	JAPAN EXCELLENT ASSET MANAGEMENT CO., LTD.	06/27/2006	77,510
3226	Nippon Accommodations Fund	Residential	Mitsui Fudosan Accommodations Fund Management Co.,Ltd	08/04/2006	64,053
Osaka Stock Exchange					
8963	TGR Investment Inc.	Office, Residential	GrowthREIT Advisors,Ltd.	05/17/2004	18,326
JASDAQ Stock Market					
8979	Starts Proceed Investment Corporation	Residential	Starts Asset Management Investment Trust Co.,Ltd	11/30/2005	7,007

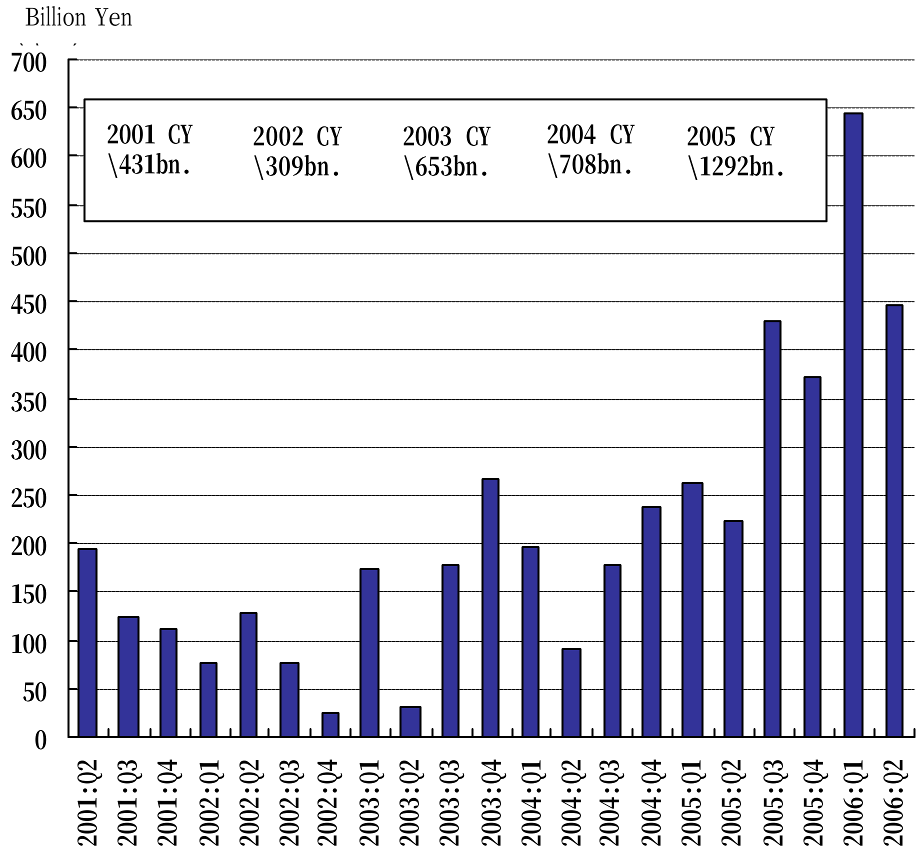
Source: Nomura Institute of Capital Markets Research, based on data of Japan Association for Real Estate Securitization

Figure 3-6 Debt and Equity Financing by J-REITs
(2001Q2-2006Q2)



Note: Equity data including the amount of private equity offered before IPO.
Source: Sumitomo Trust Bank Research Institute

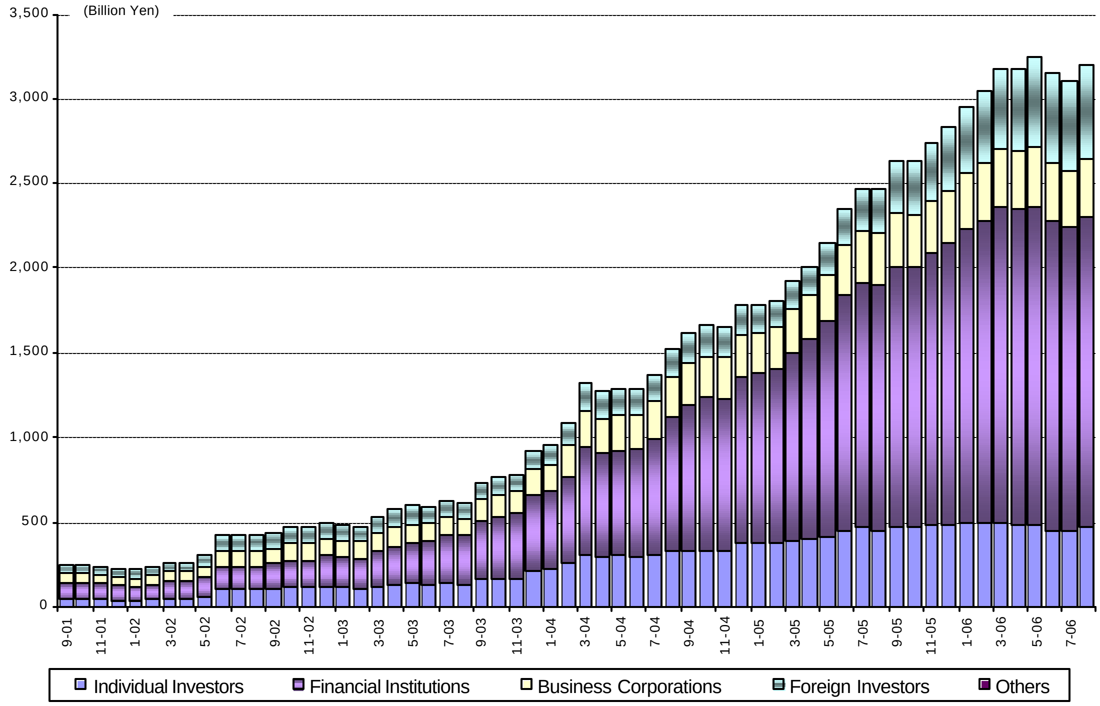
Figure 3-7 Property Acquisition by J-REITs
(2001Q2-2006Q2)



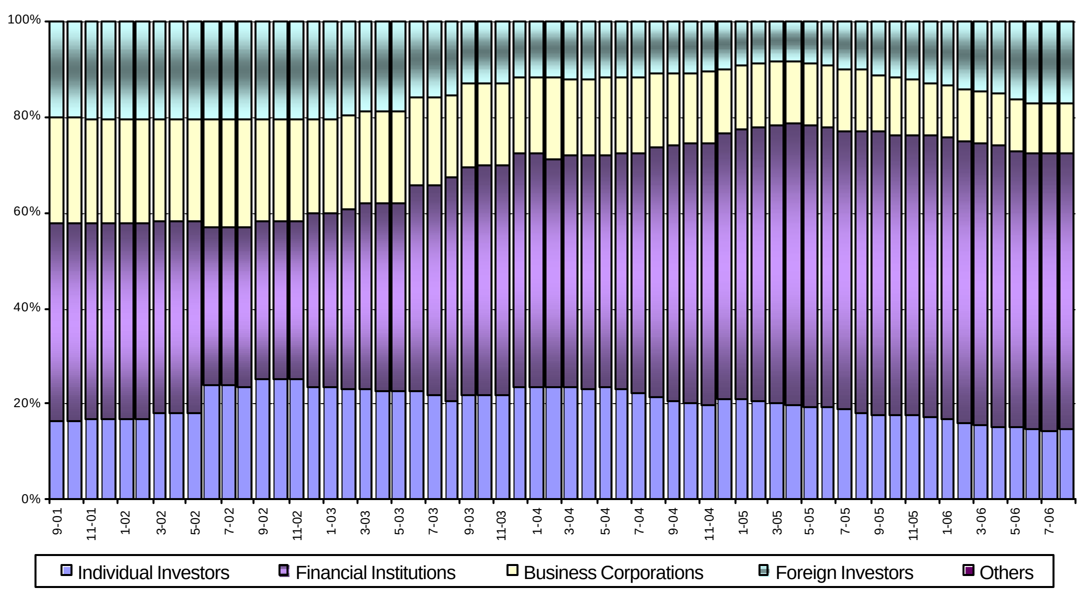
Source: Sumitomo Trust Bank Research Institute

Figure 3-8 Share Distribution of J-REIT Market by Investor Type

(Equity Market Capitalization)

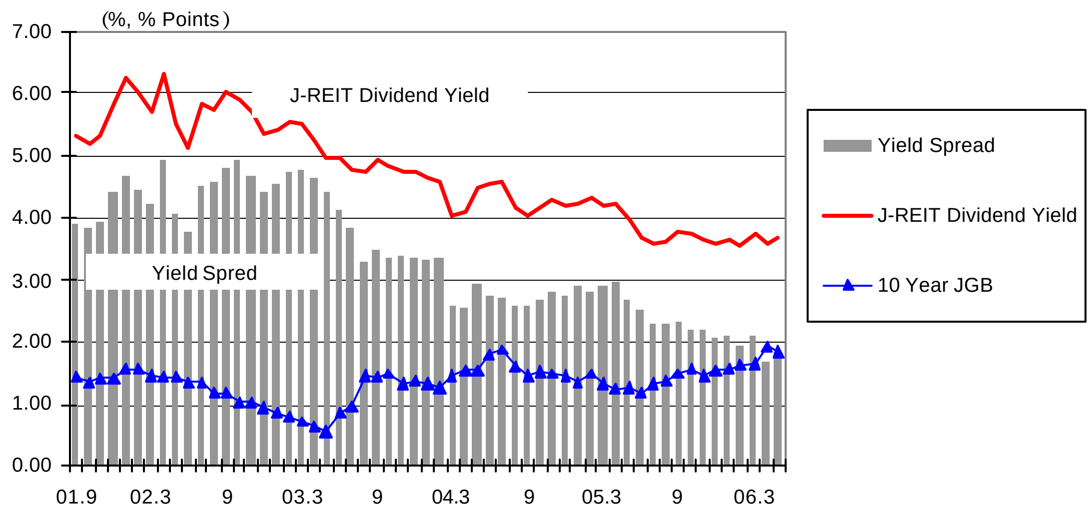


(% of Total)



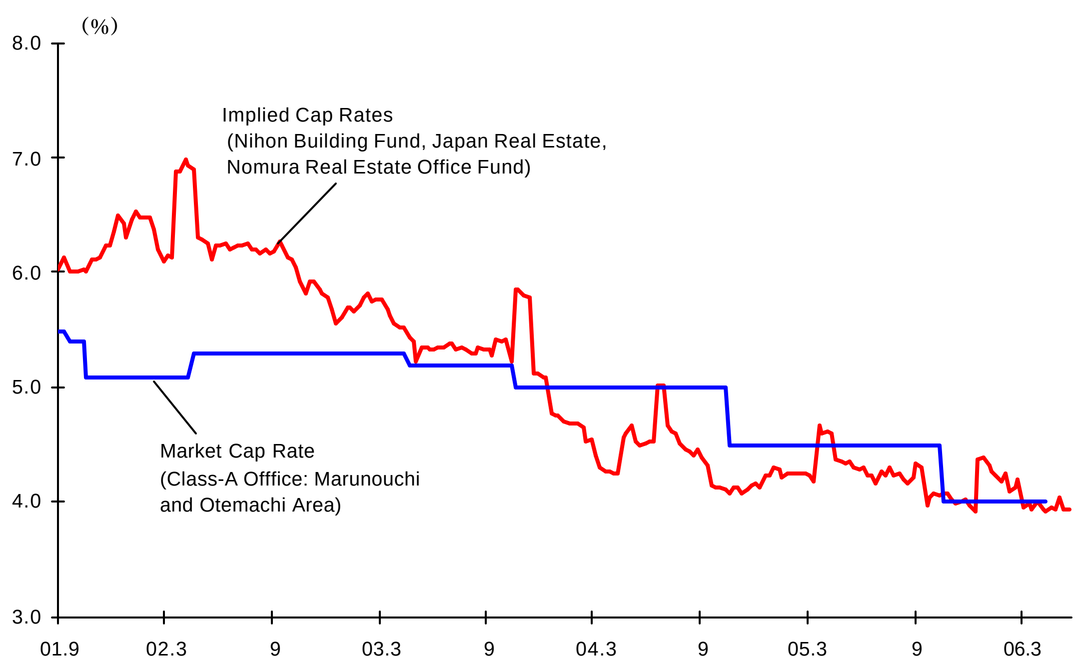
Source: Nomura Securities Co., Ltd.

Figure 3-9 Dividend Yield of J-REIT and Yield Spread



Note: Yield Spread = Dividend Yield of J-REIT – Interest Rate of 10 Year Government Bond
Source: Compiled by Nomura Securities Financial and Economic Research Center, from various data sources

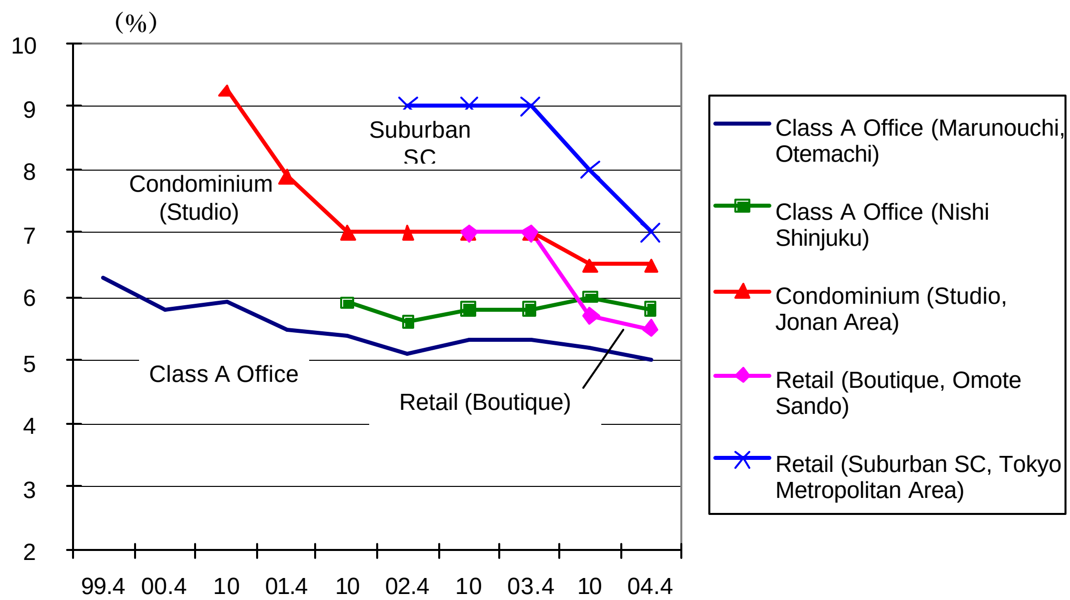
Figure 3-10 Implied Cap Rate of J-REIT and Market Cap Rate



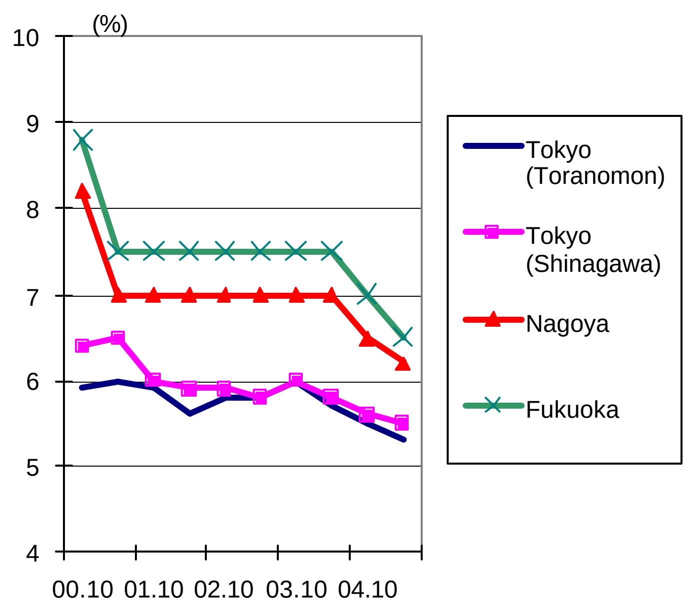
Source: Compiled by Nomura Securities Financial and Economic Research Center, from Japan Real Estate Institute, "Research about Real Estate Investors," CBRE, "Office Market Report," etc.

Figure 3-11 Change of Cap Rates in Japanese Commercial Real Estate Market

(By Property Type)



(By City or District)



Source: Compiled by Nomura Securities Financial and Economic Research Center, from Japan Real Estate Institute

Figure 4-1 Financial Instruments: Japan and the U.S.

Japan

	Market Size (Billion USD)	Corporate-type	Publicly Offered	Exchange Trade	Externally Managed	Tax Transparency
Investment Trust	510.0		○		○	○
Privately-placed Investment Trust	250.4				○	○
ETF	35.3		○	○	○	○
J-REIT	30.6	○	○	○	○	○
REOC	109.2	○	○	○		

1 USD = 115 JPY

U.S.

	Market Size (Billion USD)	vs. Japanese Market (Times)	Corporate-type	Publicly Offered	Exchange Trade	Externally Managed	Tax Transparency
Mutual Fund	9,328.5	18.3	○	○		○	○
Closed-end Fund	280.7	N/A	○	○	○	○	○
ETF	335.1	9.5	△	○	○	○	○
REIT	381.9	12.5	○	○	○		○
REOC	N/A	N/A	○	○	○		

Note: Market Size: Data of investment trust, private offering investment trust, Japanese ETF, Japanese REOC and the U.S. REIT is as of July 2006; Data of J-REIT, U.S. mutual fund, U.S. closed-end fund and the U.S. ETF is as of June 2006.
Source: The Investment Trust Association of Japan; Bloomberg; ICI; NAREIT