The Future of Japan’s Mutual Fund Industry
Overview of Japanese Mutual Funds

- Majority of mutual funds in Japan take form of the investment trusts, of which 97% are open-end.

*Note: “Stock Funds” means the investment trusts that are allowed to invest in stocks in their stipulation. Data is as of August, 2007. Source: The Investment Trusts Association, Japan
Investment Trusts are not structured as corporation but as contract.

**Structure of Investment Trusts**

- **Asset Manager**
- **Trustee**
- **Fund**
- **Distributor (securities firm, bank, etc.)**
- **Investors**
- **Accounting Firm**

- **Trust contract**
- **Direction of Investment**
- **Custody & Management**
- **Auditing**
- **Issuance of Beneficiary Securities**
- **Sales Contract**
- **Portfolio Investment**
- **Sales Amount**
- **Distribution**
- **New sales**
- **Redemption**

Source: NICMR
Market Share by Types of Asset Manager

- Japanese market is more concentrated than U.S. market.
  - Top 5 market share: US=38% vs. Japan=64%
  - HHI: US=400-500 vs. Japan=1,059

- Major asset managers are typically affiliated companies of large financial groups.

### Market Share by Types of Parent Company in Japan

<table>
<thead>
<tr>
<th>Types of Parent Company/Group</th>
<th>Number of Asset Managers</th>
<th>All Mutual Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Securities Firm</td>
<td>4</td>
<td>40.9</td>
</tr>
<tr>
<td>Banking</td>
<td>11</td>
<td>24.2</td>
</tr>
<tr>
<td>Insurance</td>
<td>7</td>
<td>2.2</td>
</tr>
<tr>
<td>Independent</td>
<td>17</td>
<td>1.3</td>
</tr>
<tr>
<td>Foreign Company</td>
<td>32</td>
<td>13.3</td>
</tr>
<tr>
<td>Total</td>
<td>71</td>
<td>82.0</td>
</tr>
</tbody>
</table>

(tril yen, marker share)

Source: The Investment Trusts Association, Japan., NICMR
Relative Market Size

- Japanese mutual fund industry ranks 8th globally, small market for the second largest economy.
- Does this mean potential for future growth?

Country Ranking of Mutual Fund Industry

<table>
<thead>
<tr>
<th>Rank</th>
<th>Country</th>
<th>Total Net Asset ($billions)</th>
<th>World Market Share</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>United States</td>
<td>10,414</td>
<td>47.8%</td>
</tr>
<tr>
<td>2</td>
<td>Luxembourg</td>
<td>2,188</td>
<td>10.1%</td>
</tr>
<tr>
<td>3</td>
<td>France</td>
<td>1,769</td>
<td>8.1%</td>
</tr>
<tr>
<td>4</td>
<td>Australia</td>
<td>864</td>
<td>4.0%</td>
</tr>
<tr>
<td>5</td>
<td>U.K.</td>
<td>787</td>
<td>3.6%</td>
</tr>
<tr>
<td>6</td>
<td>Ireland</td>
<td>768</td>
<td>3.5%</td>
</tr>
<tr>
<td>7</td>
<td>Hong Kong</td>
<td>631</td>
<td>2.9%</td>
</tr>
<tr>
<td>8</td>
<td>Japan</td>
<td>579</td>
<td>2.7%</td>
</tr>
<tr>
<td>9</td>
<td>Canada</td>
<td>566</td>
<td>2.6%</td>
</tr>
<tr>
<td>10</td>
<td>Italy</td>
<td>453</td>
<td>2.1%</td>
</tr>
</tbody>
</table>

Note: data as of December, 2006
Source: The Investment Company Institute, U.S.
Recent Growth of Japanese Mutual Fund Industry

- After 2003, the market has recovered mainly due to the increase in stock funds.

Net Assets of Investment Trusts by Investment Type

Source: The Investment Trusts Association, Japan
Driving Forces: Distribution Channels?

- Distribution channels of investment trusts have been expanded for these years.
- Seems to be reasonable to consider the expanded channels contributed to the recent growth of mutual funds.

### Net Assets of Stock Funds by Distribution Channels

- **Direct Sales**
- **Bank, Insurance, and Post Office**
- **Securities firms**

Note: Sales at Post Offices began at October 2005.
Source: The Investment Trusts Association, Japan
Driving Forces: Product Innovation?

- Recently, balanced funds and fund-of-funds which primarily invest in foreign bonds and paying monthly dividends are growing rapidly.
  - Paying dividends monthly (bimonthly) reduces the performance of the funds, but they are growing.

Source: The Investment Trusts Association, Japan
Other Driving Forces

- Demographic factor.
  - Elderly people hold more mutual funds than younger people
  - Rapid aging is under way in Japan

- Favorable market conditions.
  - Upward trend of stock market and yen depreciation since 2003
  - Market conditions might be favorable to invest in equity and/or foreign assets
Challenges for Future: Pension reforms

- Potential positive effect of DC plan on the growth in investor base.
- Big differences in plan eligibility, contribution method and contribution amounts between US DC plans and Japanese ones.

**US-Japan Differences in Defined Contribution Pension Plans**

<table>
<thead>
<tr>
<th>Individual Status</th>
<th>U.S. IRA</th>
<th>Japan Individual DC Plan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Self-employed</td>
<td>☐</td>
<td>☐</td>
</tr>
<tr>
<td>Company employees</td>
<td></td>
<td></td>
</tr>
<tr>
<td>No corporate pension from employer</td>
<td>☐</td>
<td>☐</td>
</tr>
<tr>
<td>Have corporate pension from employer</td>
<td>☐</td>
<td>☐</td>
</tr>
<tr>
<td>Government employees</td>
<td>☐</td>
<td>☐</td>
</tr>
<tr>
<td>Spouse with no income</td>
<td>☐</td>
<td>☐</td>
</tr>
</tbody>
</table>

Source: NICMR
Challenges for Future: Increase competition

- Large financial groups have their own manufacturing and distribution channel.
- Many regional banks have close relationships with large financial group(s) through equity (cross-)holdings.
  - Different from the “open-architecture” system in U.S.
- Under these circumstances, how do distributors choose mutual funds to sell at their branches?
  - Hypothesis1: Large banks/securities firms tend to choose the funds of their affiliated asset manager
  - Hypothesis2: Regional banks tend to choose funds from financial groups that are their major shareholders.
Increase Competition: Empirical Results

- Investigate the patterns of fund choice behavior among distributors by a logit model.

\[ Pr (\text{Distributor}_i \text{ choose mutual fund}_j) = F_L (\text{group variables, control variables}_j) \]

- Results confirm preferential treatments are there.

**Result of Logit Model**

<table>
<thead>
<tr>
<th></th>
<th>Large Banks (10 firms)</th>
<th>Regional Banks (111 firms)</th>
<th>Securities Firms (18 firms)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Group variables</td>
<td>+</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>Commission variables</td>
<td>?</td>
<td>?</td>
<td>?</td>
</tr>
<tr>
<td>Size variables</td>
<td>+</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>Performance variables</td>
<td>?</td>
<td>?</td>
<td>?</td>
</tr>
<tr>
<td>Fund age variable</td>
<td>-</td>
<td>+</td>
<td>+</td>
</tr>
</tbody>
</table>

Note: Results are for balanced funds and fund of funds, as broadly categorized by the Investment Trusts Association, Japan. Source: NICMR
Other Challenges for Future

- Investor Education
- Rule for Fund Mergers
- Possible Competition with ETFs, SMAs in the Future
Demands for investment trusts have restored since 2003.

Behind the scene, structural forces and cyclical force at work.

- Without doubt, expanded distribution channels contributed to recent growth
- Demographic dynamics will support the market expansion for a while
- But, favorable market conditions have been at work, implying possible downturn in case of stock price decline and/or yen appreciation

For the future growth, need to consider the followings:
- Further reforms on the DC pension plan
- Keep eye on the development of the preferential treatment and its possible bad effect on competitiveness in the market
- Further Investor education, rule for fund mergers merit some attention