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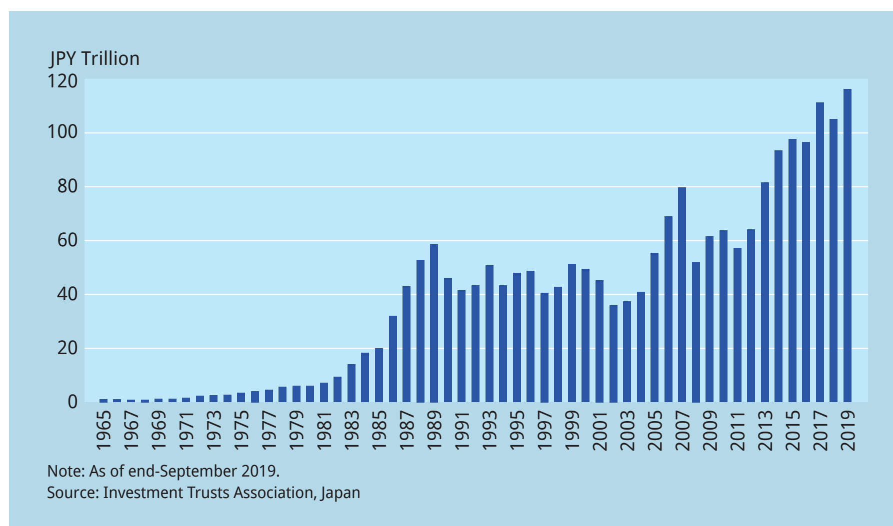
Investment Trusts Industry in Japan

Japan's Investment Trust Market

Investment trusts have existed in Japan since before the Second World War, but the foundations of today's investment trust market were laid in the 1950s. The Securities Investment Trust Act (the predecessor of today's Act on Investment Trusts and Investment Corporations, hereafter the "Investment Trust Act") was enacted in 1951 to establish investment trusts as a receptacle for the large supply of equity stocks created by the postwar dismantling of Japan's *zaibatsu* (family-owned business conglomerates) and by stock's use as payment in kind for property tax. The act was also seen as one means for promoting the democratization of securities investment in Japan. In addition, investment management companies entered into contracts with trust banks to oversee their assets under management (AUM) and protect investors. The act's enactment led Japan's four major securities companies to register as securities investment trust management companies. In 1957, the Securities Investment Trusts Association (now called the Investment Trusts Association, Japan) was established. In 1959, the Ordinance for Enforcement of the Securities Investment Trust Act was revised, requiring investment trust management companies to be separate entities from securities companies. As a result, Japan's four major securities companies spun off their investment trust businesses into separate companies. This can be considered as laying the foundation for today's investment trust industry in Japan.

Over the next 60 years, investment trusts in Japan have weathered several setbacks in the external environment, such as the slump following the bursting of Japan's economic bubble in the 1990s and a steep dropoff during the global financial crisis, and continued to expand, with the outstanding balance of AUM invested in publicly offered investment trusts reaching JPY 126.3 trillion as of end-September 2019 (Figure 1). As of end-June 2019, households' assets invested in investment trusts amounted to JPY 70.3 trillion, or just 3.8% of total household financial assets. While Japanese households' investment in investment trusts has expanded, its share of total household financial assets is much smaller than in the U.S., where households' investment in mutual funds (including Money Market Funds (MMFs)) as of end-June 2019 totaled USD 9.8 trillion, or 11.6% of total

Figure 1: Outstanding Balance of Publicly Offered Investment Trusts



Note: As of end-September 2019.
Source: Investment Trusts Association, Japan

U.S. household financial assets. This data indicates that investment trusts are not considered a core tool for asset formation by Japanese households, which can be considered a major issue for Japan's investment trust industry.

With Japan's birthrate declining and population aging at a rapid pace unseen elsewhere in the world, the importance of investment trusts as a repository for households' stock of financial assets should only increase. Many Asian countries are expected to face similar challenges in the future, as their birthrates decline and populations age. It may therefore be useful to look back at the history of the development of Japan's investment trust industry, its successful initiatives, and issues remaining to be resolved.

Product Diversification

From closed-end funds to open-end funds

The first investment trusts offered in Japan were closed-end funds. As noted earlier, Japan's postwar investment trust framework was created as a receptacle for a sudden increase in the supply of equity shares. To facilitate sales to individuals, new closed-end funds were established every month. For example, new funds with a two-year trust period and a one-month public-offering period were established each month. Japan's initial investment trusts were essentially limited-time savings products sold every month under the premise that stock prices would rise during that period. However, this model's premise became untenable after the collapse of Japan's bubble economy and stock market crash in 1990.*1

As a result, the investment fund market began to see increased issuance of open-end funds, which were already the mainstream in the U.S. and Europe. Open-end funds have fluctuating prices and accept new investments and withdrawals at any time. The number of open-end funds surpassed that of closed-end funds in 1999 and their AUM exceeded that of closed-end funds in 2003. Today, open-end funds account for about 90% of the outstanding balance of all investment trusts in Japan.

Introduction of real estate investment trusts

An amendment of the Investment Trust Act in 2000 removed the ban on real estate as an eligible asset for investment trusts, leading to the establishment of real estate investment trusts in Japan (J-REITs). J-REITs were established to provide small-lot investors with access to real estate investment and to increase the supply of risk money into the real estate market. J-REITs mainly take the form of an investment company (a corporate type investment trust) that lists on the securities exchange and operates a closed-end fund. By this structure, REITs can avoid fire-selling illiquid real estate assets in response to an increase in investor withdrawals, and investors can liquidate their holdings by selling their shares in stock exchanges. REITs must also distribute more than 90% of distributable income to investors as dividends, which are considered as an expense, thus reducing the REIT's taxable income.

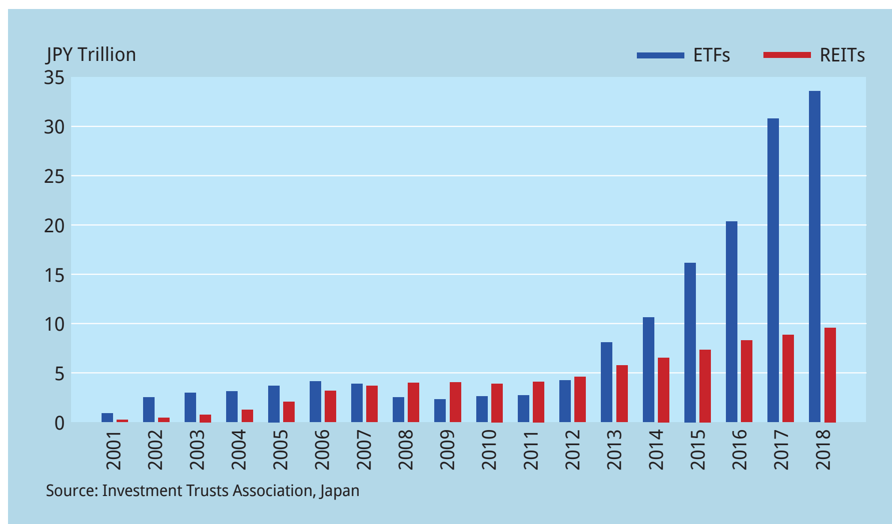
The J-REIT market began with the listing of two REITs on the Tokyo Stock Exchange. The market has since expanded, supported by the development of REIT indices, the establishment of REIT Exchange Traded Funds (ETFs), and the Bank of Japan's purchase of REITs as part of its quantitative easing policy since 2010. J-REITs' investments initially centered on office buildings and commercial facilities but have since diversified to include housing, logistics facilities, and more recently resort and healthcare facilities. In 2015, the J-REIT total market value surpassed that in Australia to become the world's second largest REIT market, after the U.S. market. As of end-2018, Japan had 61 listed J-REITs with a net asset value of JPY 9.6 trillion (Figure 2).

Introduction of ETFs

Japan's first ETFs appeared in 2001, when in-kind contribution type stock index–linked ETFs were listed on the Tokyo and Osaka stock exchanges.*2 The 2001 structural reform of Japan's securities market enacted as part of the Japanese government's emergency economic measures included revising ETF-related systems to promote long-term stable shareholding by individual investors. Since then, ETF offerings have become more diversified, with the listing of industry-specific ETFs followed by the lifting of the ban on commodity ETFs when the Investment Trust Act was amended in 2007 and the listing of leveraged ETFs and inverse ETFs in 2012. In addition, the Bank of Japan began purchasing ETFs in 2010.

This product diversification has supported the expansion of Japan's ETF market, with the net asset value of listed ETFs surpassing JPY 10 trillion in 2014 and continuing to rise sharply thereafter. As of end-2018, 183 listed ETFs had a net asset value of JPY 33.6 trillion (Figure 2). ETFs have become a popular investment tool for investors because they can be bought and sold at market prices during market trading hours and, perhaps even more importantly, because of their low costs. However, it has also been pointed out that the Bank of Japan's purchases of ETFs, which began in 2010 and now total around JPY 6 trillion a year, may be causing market distortions.

Figure 2: Net Asset Value of REITs and ETFs in Japan



Source: Investment Trusts Association, Japan

Diversification of Sales Channels

Bank sales channel

In 1996, the government of then-Prime Minister Ryutaro Hashimoto unveiled its plan for the "Structural Reform of the Japanese Financial Market: Towards the Revival of the Tokyo Market by the Year 2001" and implemented what has been called "Japan's Financial Big Bang." This reform intended to promote more effective investment of Japanese households' financial assets, which at the time amounted to more than JPY 1,300 trillion, and make better use of those assets in the Japanese economy. One of the reforms was the lifting of the ban on direct over-the-counter sales of investment trusts by banks and insurance companies in 1998.*[3]

After the ban's lifting, bank sales of investment trusts were mostly at the major city banks, but over-the-counter sales gradually spread to Japan's regional financial institutions as well. Under the current ultra-low interest rate environment in Japan, banks are having difficulty generating income through traditional deposit and lending activities. Accordingly, expanding fee and commission income has become an important issue for the banks. Japanese banks therefore have been strengthening their investment-related services, with a focus on the sale of investment trusts. In 2005, post offices also began selling investment trusts.*[4]

Bank sales of investment trusts expanded steadily after the lifting of the ban on direct sales by banks, thanks in part to the high level of public confidence in the banks. However, bank sales of investment trusts have slowed since the global financial crisis (Figure 3). One reason for this slowdown may be that bank employees, which were relatively unfamiliar with capital at risk products, had trouble explaining the product to customers when faced with sudden market fluctuations.

Wrap accounts

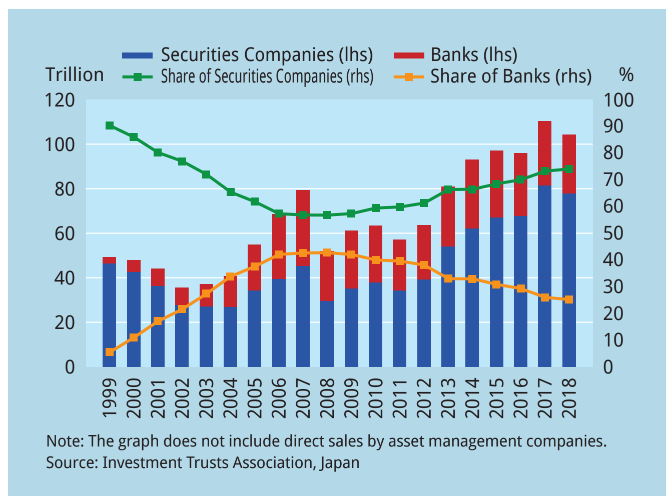
In recent years, wrap accounts have become an increasingly important channel for investment trust sales in Japan.*[5] Wrap accounts consist of a portfolio of multiple investment trusts provided to individual investors by securities companies and similar institutions that have registered as an investment adviser. Wrap accounts were first developed in the U.S.*[6] and later imported into Japan. In addition to traditional securities companies, wrap accounts now are provided to investors by trust banks, independent financial advisers (IFAs) and robo-advisers (see below). In most cases, wrap accounts serve as a platform enabling individual investors to access investment trusts managed by multiple third-party asset managers. Wrap accounts therefore provide asset management companies with a means for increasing fund inflows.

Asset managers' recognition of the need to shift to so-called "fee-based model", where their fees are based on investors' AUM, has supported the growth of wrap accounts. Instead of the traditional model by which asset managers generate a commission for each trade conducted for their clients, wrap account fees are based on the total AUM of the client's portfolio and assume goal-based financial planning. Accordingly, increases in portfolio value benefit both the investor and the asset manager, thus aligning their interests. Japan's Financial Services Agency has positively evaluated this "fee-based model", which is now becoming increasingly popular among individual investors. Investment trust sales companies also are increasingly aware of the need to shift from conventional brokerage services that use a commission-based model to "fee-based model" that generate stable income as their clients' assets grow. Wrap accounts have therefore increased notably since 2015, with total AUM reaching JPY 8.8 trillion as of end-March 2019 (Figure 4).

New sales channels: Robo-advisers and IFAs

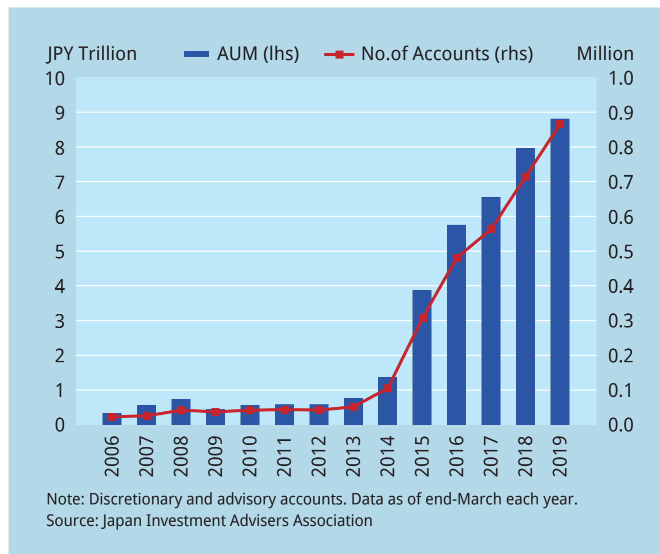
Recent years have seen the emergence of two new channels for investment trust sales – robo-advisers and IFAs. Robo-advisers are platforms that provide online discretionary investment services. Robo-advisers in Japan are modeled after the platforms developed in the U.S. and Europe. Online brokerage companies in Japan have expanded since the complete liberalization of stock trading commissions in 1999, but their expansion is limited because they essentially serve do-it-yourself

Figure 3: Sales of Publicly Offered Investment Trusts by Securities Companies and Banks and Each Channel's Share of Overall Sales



Note: The graph does not include direct sales by asset management companies.
Source: Investment Trusts Association, Japan

Figure 4: Wrap Account Numbers and AUM



Note: Discretionary and advisory accounts. Data as of end-March each year.
Source: Japan Investment Advisers Association

(DIY) investors capable of making all their own investment decisions. Robo-advisers provide investors with more in-depth support than that available from online brokers. Robo-advisers provide investors with an investment portfolio based on their answers to a questionnaire that asks about their risk tolerance, investment timeframe, and other investment-related topics. Portfolios mainly consist of low cost funds such as ETFs. This utilization of low cost funds, together with customer interface without human advisors, amounts to the most important feature of robo-advisers, which is to provide low-cost discretionary investment services. Robo-advisers are still in its infancy in Japan and have yet to achieve any widespread usage by Japanese investors. One possible reason for Japanese investors' hesitancy to use robo-advisers may be the lack of proactive recommendations in the online robo-adviser business model.

IFAs are companies and/or individuals who are not employees of traditional securities companies or other financial institutions and provide their clients with unbiased investment advice from an independent position. In Japan, IFAs are modeled after registered investment advisers (RIAs) in the U.S. and traditional IFAs in the U.K.. In the Japanese system, IFAs are registered financial products intermediary who are then entrusted to provide investment advice to clients by a financial instruments business operator, such as a securities company. Account management and compensation for losses are the responsibility of the securities company. Although IFAs are expected to be independent and neutral, the IFA role is still rather new and there remains wide differences in the sophistication and expertise of the practitioners.

Measures to Promote Greater Use of Investment Trusts: Preferential Tax Treatment

Defined contribution pensions

Japan introduced defined contribution (DC) pensions in 2001. Contributions to and investments made in DC pensions are tax exempt, with taxation occurring only when the individual receives the pension benefits. The individual establishes a personal account and gives instructions on how the funds are to be invested. In general, investment options include various investment trusts. DC pensions have therefore become another sales channel for investment trusts. The U.S. 401(k) plans and Individual Retirement Accounts (IRAs) that served as a reference point for Japan's DC pensions helped drive growth of the U.S. mutual fund market in the 1990s and stimulate investment education.

Although the investment of pension funds should focus on diversified investment that leads to asset accumulation over the long term, about half of Japan's DC pension assets are allocated to bank deposits and insurance products that focus on principal protection. Although employers have an obligation to provide employees with investment education and many financial institutions that serve as pension fund managers also provide investment education to plan participants, current asset allocation indicates that these efforts have not been very successful. In 2017, Japanese version of DC default fund was introduced to establish a default fund to be used when plan participants do not specify how their pension contributions should be invested. However, a survey conducted about a half year after the method was introduced revealed that 70% of pension funds were still using bank deposits and insurance products as their default investment products.

Since Japan's introduction of DC pensions in 2001, plan participants have steadily increased, with the total reaching 8.47 million as of end-June 2019. In 2017, eligibility for participation in individual DC plans, called iDeCo for short, was expanded to include non-employed stay-at-home spouses (male or female) and public employees.

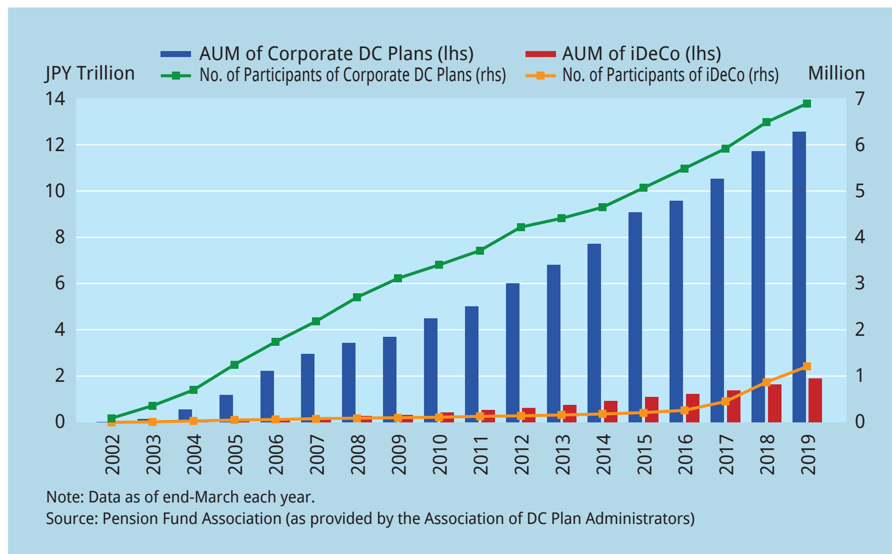
DC pension plan AUM totaled JPY 14.4 trillion as of end-March 2019 (Figure 5). This is a rather small figure compared with the JPY 77.5 trillion AUM in Japan's defined benefit (DB) pension plans,*[7] even when considering the relatively short history of DC plans. DC plan contribution limits have been gradually raised since DC plans were first introduced, and personal contributions to corporate DC plans were introduced in 2012. Nonetheless, further expansion of the DC system is desirable. The current contribution limit is too low and needs to be raised for DC plans to play an important role in asset formation for retirement.*[8]

NISA

In 2014, Japan introduced a small-lot tax-exempt investment system for individuals modeled after the U.K. Individual Savings Account (ISA). The Nippon ISA, or NISA, is intended to support household asset formation and strengthen the supply of growth money. Under NISA, individuals can invest up to JPY 1.2 million a year in stocks, investment trusts, and other financial products. Dividends and other distributions as well as gains from the sale or transfer of assets in the account are not taxed for the maximum account holding period of five years (which allows individuals to invest up to JPY 6 million in a NISA account). Accounts for NISA can be opened for a limited time, from 2014 to 2023.

Two derivative types of NISA have also been established. The first is the Junior

Figure 5: DC Pension Plans' AUM and Participant Numbers



Note: Data as of end-March each year.
Source: Pension Fund Association (as provided by the Association of DC Plan Administrators)

NISA, established in 2016 and modeled after the U.K. Junior ISA. The Junior NISA was created to support asset formation for children's future. Tax exemption and the five-year holding period for accounts opened by 2023 are the same as for general NISA. However, the accounts must be opened in the name of minors 19 years of age or younger, and the annual investment limit is JPY 800,000 (for a total investment of JPY 4 million over five years). In addition, in principle funds cannot be withdrawn from the account until the account holder is 18 years of age.

The other derivative NISA is the installment-type NISA, introduced in 2018. These accounts encourage long-term investment based on regular monthly contributions of a fixed amount. While annual investment is limited to JPY 400,000 (approximately JPY 33,000 yen per month), new contributions can be made from 2018 to 2037 and maximum holding period has been extended to 20 years. Eligible investment products are limited to low-cost investment trusts. For example, equity investment trusts must be no-load funds with management fees below a certain level (0.5% for investment trusts linked to a domestic equity index). In addition, monthly distributions are not allowed.

As of end-June 2019, the number of accounts for general NISA was about 13.09 million with cumulative contributions totaling JPY 17.6 trillion. While these figures are small relative to the potential market size, they represent steady growth over the five years since NISA was first introduced.

The future expansion of the NISA system as an asset-building tool that can be easily accessed by a wide range of people is highly desirable. The main impediment to further expansion is the current limited timeframe for this initiative. Users of the U.K. ISA expanded after the system was made permanent. Similarly, Japan's financial industry has been asking the nation's tax authority to make NISA a permanent system.

Japan's Experience a Useful Point of Reference

In recent years, the middle class in Asian countries has been expanding. As their financial assets expand, so will their need for effective investment instruments, including diversification into overseas investments. Expanding the supply of growth money to domestic and regional industries also will be important. Investment trusts can play a very important role as a tool to realize these goals. Expansion of investment trusts as major institutional investors also is important for the sophistication of Asian securities markets.

Asian countries also are expected to experience further aging of their populations. While Asian societies are still young and in a growth phase, it will be important for them to establish systems that support long-term, diversified, installment-type investments. Diversification of investment products and system reforms that include beneficial tax measures merit careful consideration as means to achieve this goal. Asian countries also will need to keep pace with the digitalization of financial services that is occurring in the more advanced economies of North America and Europe. The lack of legacy systems should facilitate rapid change in Asian countries.

Of course, while we refer to "Asian countries" as a single group, they are actually a highly diverse group of countries with many differences. Some Asian countries are already expanding the use of DC pension plans, while REITs and ETFs are already available in some countries. The key points for development of the investment trust market in each county therefore will be different. The strong and weak points to be found in Japan's experience should provide a useful reference for Asian countries.

Notes

*1 Sugita, Koji. Hossoku kara man 60-nen wo mukaeru Nihon no tōshi shintaku – sono kiseki genjō to kongo no kadai – (Japanese only, unofficial translation: Investment trusts in japan – a history of the first 60 years, current situation and future issues), May 18, 2011.

*2 Nikkei 300 Index Exchange Traded Fund was traded on the Tokyo and Osaka stock exchange since 1995, but the nature of these investment trusts was different from today's ETFs and transaction volume was smaller as they were not allowed to use in-kind contributions and additional fund establishment was limited.

*3 The ban on over-the-counter sales of investment trusts by investment trust management companies renting space at banks was lifted in 1997.

*4 Today, post offices sell financial products, including investment trusts, as a financial products intermediary for Japan Post Bank.

*5 Rather than being a sales channel similar to securities companies and banks, wrap accounts actually are a product or service provided by securities companies and other financial institutions. However, for the sake of convenience, they are treated as a sales channel in this article.

*6 In the U.S., "managed account" is a general term that includes wrap accounts and various other individual accounts such as "rep as advisors" and "rep as portfolio managers". Japan also has several types of managed accounts, which are collectively referred to as "wrap accounts" in this article.

*7 According to data as of end-March 2019 announced by the Investment Trusts Association, Japan and including pension plans managed by the investment trust industry, the life insurance industry, and the National Mutual Insurance Federation of Agricultural Associations (JA Kyosairen).

*8 For example, an employee participating in a corporate DB pension plan can contribute JPY 27,500 a month; individuals participating in an individual-type DC corporate plan can contribute JPY 20,000 a month; and participants in other corporate pension plans and public employees can contribute only JPY 12,000 a month.

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Tetsuya Kamiyama has been a Senior Analyst at Nomura Institute of Capital Markets Research (NICMR) since 2012. His main research coverage includes financial regulation and asset management.

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