The Next Evolution in Asset Management in Japan

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Creating shared values

Over the past several years, I have consistently been calling for financial institutions to do business with a customer-first approach. If companies continue to provide high-quality products and services that satisfy customers’ needs, their corporate value will be enhanced. This principle applies not only to the financial services industry but to most industries.

In the asset management industry, if investment managers and product sellers keep their customers happy by providing better financial products and services that help to build up customers’ assets, their reputation will no doubt rise, paving the way for medium- to long-term prosperity.

Michael Porter and Mark Kramer called this process “creating shared value.” If financial institutions create shared values with their customers, that will also contribute to the sustainable growth of the national economy and the development of the financial market.

In reality, however, many companies are seeking their own benefits with little regard for customers’ interests. This trend is conspicuous particularly in the asset management industry.

Wise investment is essential for sustainable growth of the national wealth. For tips on how to invest wisely, individual investors can turn to a book co-authored by Burton Malkiel and Charles Ellis, two of the world’s most reputed thinkers in the asset management world.

1 This provisional translation was published on June 15, 2017.
First, Malkiel and Ellis urge investors to recognize that reinvesting investment gains (thereby generating compounded yields) is the key to making sure to build savings, albeit gradually. Second, they recommend focusing on making investment steadily without being distracted by market fluctuations. They also encourage investors to diversify investments by asset class and choose low-cost index funds, which track broad market indexes.

**Investment trust funds fit for the installment-type NISA**

The installment-type NISA (*Nippon Individual Savings Account*), which will be launched next January, is an investment tax-break scheme suited for individuals to build up their assets through approaches which should meet the recommendations by Malkiel and Ellis. We at the Financial Services Agency (JFSA) established a working group of asset management experts tasked with identifying investment trust funds that are fit for investment through the installment-type NISA.

Of the more than 5,400 publicly-offered stock investment trust funds available in Japan, around 380 are stock index funds. When selecting candidates for investment through the installment-type NISA, the working group excluded funds which pay out monthly dividends, leveraged funds and funds whose trust period is short, which means they are not fit for long-term investments. The working group further whittled down the list of candidates by picking funds for which no sales commission fee is charged (no load funds) and for which the trust fee is lower than a certain threshold. As a result, less than 50 investment trust funds remained on the list of candidates.

Malkiel and Ellis argue that index funds generally deliver a higher return than actively managed funds.

In the United States, there is a large base of investors who follow the principle of making investment decisions in light of the fundamental value of companies, a situation which enhances market efficiency. As a result, indexing works as an effective strategy. However, in Japan, actively managed stock investment funds that are at least 10 years old, which total around 280, bring an average annual return of a paltry 1.4% after deduction of the trust fees. On top of that, the return is negative for a third of the total. Over the past 10 years, the Nikkei average rose approximately 3%. From this, we may say that Japanese stocks are no exception to the theory argued by Malkiel and Ellis: index funds generally deliver a higher return than actively managed funds.
To select funds fit for the installment-type NISA from among actively managed funds in Japan, which total just over 2,700, the working group set several criteria, including: recording a net fund inflow during two-thirds of the period since the fund establishment; charging no sales commission fee; and having a trust fee lower than a certain threshold rate. As a result, the list of candidates was narrowed down to only five funds. This outcome is disappointing. I am looking forward to the day when in Japan as well, more investors will focus on the fundamental value of companies when investing in stocks and more actively managed funds fit for long-term investment will become available.

The upshot of the working group’s finding is that a total of just around 50 funds, or less than 1% of the more than 5,400 publicly-offered stock investment funds, can be regarded as fit for investment through the installment-type NISA.

However, the story is quite different when the same criteria is applied to the U.S. asset management market. Of the top 10 U.S. stock mutual funds—mutual funds are equivalents of investment trust funds in Japan—in terms of the outstanding balance, eight meet the NISA-friendly criteria. In Japan, of the top 30 stock investment trust funds in terms of the outstanding balance, only one, which is ranked 29th, meets the criteria.

**Issues in investment trust funds in Japan**

I would not deny that some Japanese funds are delivering a respectable return even if they do not satisfy the NISA-friendly criteria. However, both we at the JFSA and the financial industry must take it seriously that so few investment trust funds can be recommended by asset management experts as useful for sustainable wealth growth for individual investors.

Why have investment products that do not seem to put customers first continued to be developed and sold for many years?

When I ask various asset management experts about the reason for this sorry state, I hear the same refrain. Most Japanese investment trust management companies are affiliated with companies selling the products. In terms of the amount of assets under management, as much as 82% of all investment trust funds are ones that have been established and are managed by affiliated investment trust management companies. That leads me to suspect that these affiliated companies are creating products which are convenient for sellers to rake in sales commission fees.
Of the products which have become popular in the past, most are complex theme-based funds, including double-decker funds that bundle high-return assets and high-yielding currencies, and are unsuitable for long-term holding. Such funds, by their nature, have a high turnover ratio, which means a fast cycle of sales and purchases bringing in sales commission fees to financial institutions frequently.

Have the business practices entrenched in the development and sales of investment trust products helped customers build up their assets in any way?

For the popular theme-based investment trust funds, the timing of sales and purchase is critically important. Of course, “buy low and sell high” should be the principle. However, it is difficult for even professional investors to consistently choose the right timing for sales and purchase. The poor performance of actively management funds that I mentioned earlier is evidence of that. The historical records of sales of stock investment funds to individuals also show that investors tend to snap up stock investment funds at market peaks.

For the top 10 investment trust funds in Japan as of February this year in terms of the net asset amount, the average sales commission fee was 3.1%, while the average trust fee was 1.5%. At a time when interest rates remain low around the world, it is not easy to achieve a sufficiently high return to earn profits after these costs are deducted. In Japan, the growth in financial assets owned by households over the past 20 years that is attributable to investment returns is 19%, a far cry from the growth of 132% in the United States. Probably, the blame for this huge disparity can be partly placed on the business practices entrenched in the development and sales of investment trust products in Japan.

**Principles for customer-oriented business conduct**

To change the status quo of the industry in Japan, the JFSA has developed and published *the Principles for Customer-Oriented Business Conduct* based on six months of debate by the Financial System Council.

To promote the sustainable growth of national wealth by helping the people build up their assets steadily, it is important that all financial institutions involved in the investment chain processes—sales, advisory service, product development, asset administration and asset management—recognize their own roles in the chain and commit themselves to a customer-first approach based on the Principles for Customer-Oriented Business Conduct.
However, in reality, as many financial institutions are not necessarily following these principles, it is hard to argue that they are contributing to the sustainable growth of national wealth.

Going forward, we expect financial institutions to develop, publish and implement effective measures in line with the principles. The seven principles, including appropriate management of conflicts of interest, clarification of fees, and accessible provision of critical information, lay down what financial institutions should do as a matter of course.

Rather than merely following the letter of the principles, financial institutions should act in accordance with their spirit: they should compete with each other to provide better financial services in pursuit of best practices.

I thought about what will happen if financial institutions uphold the principles and provide information in an accessible manner from the customer’s standpoint.

For example, financial institutions selling saving-type insurance products are now winning over customers by assuring them that the products meet their needs by combining death benefits and an investment return. However, if the sellers are to look at things from the customer’s standpoint, it is essential to provide a cost comparison between the purchase of a product bundling insurance and investment, and the purchase of insurance and investment products separately. This way, customers can make better investment decisions.

Meanwhile, many funds that pay out monthly dividends continue to be popular among customers. If financial institutions are to take a customer-first approach, they should explain that customers cannot enjoy the benefits of compound yields through the monthly dividend type. Investment trust funds whose prices have risen in the past few years are also popular. However, financial institutions should warn investors about the risk of ending up buying at peaks if they are to put customers’ interests first.

Furthermore, it is important to make sure that customers understand costs involved in investment trust funds, including the sales commission and trust fees. These costs should be indicated not merely in percentage terms but also in actual terms, such as what the costs are when a customer makes an investment of 100,000 yen.

Financial institutions may be worried that if customers find out hard truths about investment, it will become difficult to sell their products, putting their business model in jeopardy.
But we should step back and think. So far, many financial institutions have continued to roll out products from which people with financial literacy stay away but which most ordinary people can be persuaded to pick without adequate understanding. They have focused on collecting fees with little regard for customers’ interests. As a result, customers find it difficult to build up their assets through investment. Does a business model like this deserve to be preserved in our society? Are managers of financial institutions which continue to develop and sell such products providing their employees with worthwhile jobs? Is this business model contributing to the enhancement of the enterprise value of financial institutions and groups over the medium to long term?

I heard an episode from a friend of mine. After his mother died, the friend went through her things to sort out what she left behind. He was surprised to find that she had purchased many high-risk, complex investment trust products that are hardly suitable for people living on pensions and savings. Over the past several years, I have heard similar stories over and over again. Perhaps, sales persons from financial institutions were not merely promoting their products to elderly people but were also doing some good by keeping their company when they were lonely. But what do financial institutions selling unsuitable products to the elderly look like in the eyes of their children? Is a sales practice like this helping to build relationships of trust between financial institutions and customers in the long haul?

Statistical data suggests otherwise. Over the six years from 2009 to 2015, the total outstanding balance of deposits at banks increased by 140 trillion yen from 589 trillion yen to 730 trillion yen, whereas the balance of investment trust funds sold by banks declined from 23 trillion yen to 22 trillion yen.

Over a longer term, the proportion of risk assets (e.g. stocks and investment trust funds) in household financial assets increased just a bit, from 13.2% in 1990 and in 1990 to 14.5% in 2015.

As a result, although Japan has the second largest household financial assets in the world, Japanese asset management companies are lagging far behind global rivals. Sumitomo Mitsui Trust Holdings, which is the largest asset management group in Japan, is in 33rd place in the global rankings in terms of the amount of assets under management. The firm’s amount of assets under management is a seventh of the figure for BlackRock, the world’s top asset manager. Until now, we have seen Japan’s asset management industry remain in a state that is unfavorable for everyone. For the people, increasing their wealth through investment has been difficult. For companies, risk money essential to growth has been in short supply. When it comes to the competitiveness of the financial industry, Japanese asset management companies have no presence on the global stage.
Are we content with this situation? Do we think that customers who have failed to gain a decent return from investment products are willing to make additional investments? Are they willing to continue transactions with financial institutions which have recommended disappointing products? Can financial institutions become more competitive in the global market if they stick with their present business model?

It is you, who are involved in asset management and investment product sales, that have the power to change the status quo. Doing business with a customer-first approach means making constant efforts to improve asset management expertise and better secure customers’ trust. Only when they continue such efforts can financial institutions raise their own fundamental enterprise value.

**Challenges for the JFSA**

We at the JFSA also need to do soul searching on our failure to change this less than ideal status quo. Since the JFSA’s establishment, we have been advocating the protection of investors as the centerpiece of our regulatory policies. In our financial inspection, we have set our sights on how approaches adopted by sales companies fit the specific characteristics of investors from the perspective of the principle of suitability. As a result, financial institutions have made some improvements to their sales methods and disclaimers attached to sales promotion materials, but these are nothing more than cosmetic changes. At the fundamental level, their business model has not shifted to a customer-first approach.

What’s important is creating an environment that enables customers to make the right choice. If that is done, companies providing products and services that truly meet customers’ needs can prosper. This is a principle that applies in all industries and in all countries across the world. Restaurants serving delicious food at affordable prices thrive, while those serving pricey food of poor quality are driven out of business. When it comes to financial products, it is difficult to evaluate the true quality or cost. However, we must strive to make it easier for investors to recognize the quality and cost of financial products and services. When we look for a restaurant in an unfamiliar place, for example, we can turn to a variety of information sources such as the Michelin and Zagat guides or word-of-mouth websites. In the financial world as well, it is desirable to develop a system that helps investors make choices from among the multitude of investment products by providing necessary information.
Another challenge is fostering financial literacy. If investors learn what kind of investment and asset diversification is desirable by age and by asset and income status, that will improve their ability to select products and services suited to their own needs. For us at the JFSA, it is imperative to develop an environment where the market mechanism functions appropriately. If the market mechanism works, financial institutions which possess outstanding asset management capability and which have a customer-first culture will flourish. Financial institutions which pay lip service to the principle of putting customers’ interests first but which fail to actually take any action will be driven out of the market. To enable the market force to prevail, the JFSA will do its utmost as the regulator of the Japanese market.

**Challenges for the asset management industry**

So far, I have mainly discussed investment trust funds, but similar challenges can also be pointed out for investment management companies responsible for managing pension funds. For all players involved in investment management business, enhancing asset management expertise is a critical challenge. While strategy may vary from institution to institution, the path to better asset management expertise is the same for all institutions.

I have frequent opportunities to discuss with asset managers of global fame. They are not only familiar with economic and monetary policy affairs but are also collecting and analyzing information in a broad range of fields, including geopolitical risks and political situations around the world. They keep track of current trends in fund flows and investor behavior. To conduct advanced market analysis, some asset managers resort to cutting-edge technology, such as big data and AI.

Asset managers investing in individual stocks are devoting serious efforts to advanced analysis of the enterprise value of investment target companies and constructive dialogue with them in order to encourage efforts to enhance the value. To hone asset management expertise, it is also essential to develop the organizational infrastructure by training asset managers, by strengthening governance initiatives, such as eliminating conflicts of interest, and by creating an advanced risk management system commensurate with the investment profiles.

American and European asset managers I am familiar with keep close tabs on market trends throughout each day, all year around, and bet their own money on their investment decisions. While keeping track of the market constantly is an extremely stressful task, both mentally and physically, successful investment could bring significant rewards. For leading players in the American and European asset management industry, performance is everything, as is the case with top athletes in the world of sports.
In comparison, what is the situation of Japan’s asset management industry? Asset management companies are typically led by presidents appointed by their parent companies with not much regard for investment knowledge or experience. Portfolio managers give their loyalty to the financial group to which they belong ahead of their responsibility as asset managers. For them, would the focus of concern not be on how to live a quiet corporate life until retirement, rather than on how to achieve superior investment returns? Isn’t that the landscape we see in Japan’s asset management industry? In the world of sports, whether in baseball or football, teams are divided into different leagues with different levels of competition. However, in the world of asset management, players with different levels of skills compete in the same field—the marketplace is the only field of play. Unless Japanese financial institutions seriously set about enhancing their fundamental asset management capability, they will not only continue to fall short of being the best players on the global stage but also fail to fulfill the responsibility they owe to investors.

**Asset owners’ role**

As well as asset management companies, asset owners have an important role to play. For example, pension funds must fulfill the fiduciary duty to people who contribute funds to the pension system. Asset owners must identify the asset management companies which possess the capabilities best suited to be entrusted with investment funds. If a pension fund decides which asset management company should be given the investment mandate based on a historical relationship, rather than performance, the fund is failing to fulfill its fiduciary duty.

U.S. university funds and pension funds which boast superior investment performance over the medium to long term invariably have astute fund managers with a high level of asset management expertise. Japanese corporate pension funds should also elect fund managers with suitable professional skills and judgment from a wide field of candidates inside and outside of their own organization. Japan’s asset management industry can prosper only if both asset owners and asset managers enhance their fundamental capabilities and fulfill the fiduciary duty to ordinary people, who are the ultimate beneficiaries of investment services.
Conclusion

Japanese employees are competent and diligent. I believe that their potentials are as great as the potentials of employees anywhere in the world. Managers should manage and govern their organizations in ways that can fully unlock those potentials. If financial institutions cling to the business-as-usual way, Japan’s asset management industry will continue to languish, with no significant change occurring over the coming decades.

The Principles for Customer-Oriented Business Conduct should be useful for all financial institutions involved in the investment chain. Managers should set an example by seriously considering what their institutions should do to enhance the capabilities to fulfill duties from the perspective of a customer-first approach and by taking actions. Only then will financial institutions become more valuable organizations and better contribute to the development of Japan’s asset management industry and market and to the sustainable growth of the national wealth.

I am resolved to work with you to overcome the challenges so that Japan’s asset management industry can change and prosper. I very much look forward to working with you towards these goals.

Thank you for your kind attention.