THE JAPANESE ASSET MANAGEMENT INDUSTRY: IMPLICATIONS for FOSTERING ASSET MANAGEMENT and CAPITAL MARKETS in ASIA

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EXECUTIVE SUMMARY

This paper analyzes the Japanese asset management industry (AMI) and seeks to make policy recommendations for the asset management markets of ASEAN+3 countries using insights from the Japanese, European and United States experiences. While it is true that there exists a huge gap in the current states of AMI in Japan and Southeast Asian (SE Asia) countries, the fact that Japan is the leader in the region’s AMI implies that the Japanese experience can and does offer a rich source of information and lessons for SE Asian countries’ strategy and policy in developing their individual AMI. The depth of familiarity with asset management practices and the level of asset management knowledge in Europe and the United States, and the lessons drawn from them by Japan are also highlighted in this study.

AMI in JAPAN

The core attraction of asset management is the usefulness of its tools in diversifying portfolios, offering more investment choices and increasing the savings base. It is this essence on which AMI development strategies in Japan (as in other countries) are anchored. It may not be as well developed as its European and US counterparts, but the Japanese AMI is impressively taking serious steps to further its expansion and progress.

Japan’s investment trust industry boomed in the late 1980’s, went through a stormy patch in the 1990’s, and has since been clearing its way out of the woodwork. After shedding the recession mentality of the 90’s, investor confidence has been restored, reassuring Tokyo’s position as a major international financial center.

The preference for safety over returns was the predominant market sentiment in the 1990’s, resulting to fewer funds and fewer institutional investors. It was against this backdrop that the business gravitated toward major firms with established investment advisory terms. Investment advisory is generally more independent than the investment trust industry. Investment advisory clients tend to be far larger, more knowledgeable investors, and hence more likely to invest for the medium-to-long term. This provides a solid capital base for a fund.

The market is currently undergoing a ‘savings-to-investment’ shift and the industry’s optimism is reflected by the increasing number (and popularity) of investment trusts –
products characterized as funds pooled from a large number of investors and designed to be invested in securities or other cash-flow generating assets (e.g., real estate) under the management of persons or entities other than the investors. Profits from investment trusts are allocated among investors in proportion to the amount they have invested. Investment trusts fulfill a key economic role for both the investing public and the market in general by financing business corporations, channeling the investment public’s funds into the securities market and facilitating the formulation of fair prices for securities. Although widely regarded as representative collective investment vehicles and offering widespread financial tools for individuals, investment trusts tend to contain more short-term capital, be more sell-side oriented, and focuses on more fashionable investment products. Since investors are typically keen on making quick returns, there is the odd tendency for well performing funds to be sold.

Circumstances which lent support to the establishment of the existing investment trusts date back to 1948, when the Securities and Exchange Law, modeled after the U.S. legal framework of securities transaction, was enacted. Further, the Securities Investment Trust Law was put into effect, providing legal ground for the type of investment trusts now in operation in Japan. It is worth mentioning that investment trusts in Japan were established to meet the changing requirements of government policy, and the circumstances leading to their birth were drastically different from those which gave birth to the investment trusts of Europe and the U.S., which were caused primarily by the spontaneous outgrowth of economic development.

Since then, the industry has implemented a variety of reforms, the most noteworthy of which were those in 1989 and 1992; and reforms in the line of the Japanese Financial Big Bang of late 20th century to the dawn of 21st century. The government took reform measures in 1995 to relax regulations and toughen disclosure requirements, and carried out a sweeping amendment of the Securities Investment Trust Law in 1998 and 2000. These reform measures are often referred to as “Big Bang” of the Japanese investment trust system, whose main objective was to shift Japanese financial system away from the indirect system of banks’ arms and towards a more direct financing system.

In 1999, the Financial System Council (FSC) set up by the Ministry of Finance (MoF) categorized collective investment schemes into two types, that is, asset securitization and asset management. Asset securitization is a scheme under which the specified assets are securitized and separated from a corporation. Asset management, on the other hand, is a
scheme under which funds from public investors are pooled and invested in various assets by professional fund managers, and the income generating from the investment management of funds are shared by investors.

The Securities and Investment Trust Law was partially revised and later renamed as the Law for Investment Trusts and Investment Companies. This amendment was part of a government program to streamline related laws, a step preliminary to the enactment of a Financial Service Law. By virtue of this amendment, the targets of investments were extended beyond securities and the way for introduction of the real estate investment trust was paved. In 2001, the Financial Services Agency (FSA) put into action the Program for Structural Reform of Securities Markets, allowing individual investors to play a major role. In 2002, the FSA set the Program for Promoting the Reform of Securities Markets into motion.

Investment trusts are large-scale financial products with a balance worth about 54 trillion yen, over 4000 deals and a wide range of characteristics. The most common type of investment trust product is the publicly offered contractual type, which accounts for more than 70% of trusts.

The biggest problem confronting investment trust institutions centers on the issue of low transparency and poor disclosure of investment trusts, which are relatively complicated, time-consuming and cost inefficient. Although some improvements were made in 2002, basic difficulties still existed and further measures aimed at simplification were taken in 2004. Disappointingly, the system is still not user-friendly. Other issues of concern include: (1) the high costs (accounting, administrative, sales maintenance and governance) of investment trust companies; (2) the question of performance of investment trusts; (3) insufficient indices to measure the performance of investment trusts; (4) lack of distribution channels for increasing the size of the market’ and (5) investors’ tendency to be quite risk-averse and their general lack of knowledge.

Resolving the disclosure problem necessitates a paradigm shift in order to lead policymakers to examine alternative ways of disclosure, and consider a system of semi-disclosure or indirect disclosure. For coping with the problems on operational procedures, information and sales of investment trusts must be tackled along with reforms in the system aspects. Currently, there is not enough data accumulated on track records or performances. Promoting the accumulation of data on performances must be given due attention. It is also important for
operating companies to be active in efforts concerning investment trusts that are targeted towards individuals. In this regard, the contribution of pension schemes can be studied for its feasibility in expanding the market. Strengthening the operating capabilities of management companies is, needless to say, one of the key factors of success. It is also important to promote product diversification alongside investor education to minimize poor investment behavior, trim off excess risk adversity and keep the market receptive to growth and expansion. Finally, we have to consider the role of investment trusts in contributing to pensions, especially with an ageing society. Pensions are key to the expansion of the investment trust market and should be the focus of deregulatory efforts, in expanding their role in the pensions market.

AMI in EUROPE

The market in Europe is at a far more advanced stage than in Japan. Europe has 29000 funds and there are 8000 in the US. Currently, there are more than €10 trillion under management. The European experience in asset management is rich in history and suggestive of key areas critical to AMI development in ASEAN+3 countries, although some of these areas of improvement might be inapplicable to the Asian context. This is so because current reforms in Europe are very much market oriented and occurs almost autonomously. On the other hand, the needs of the ASEAN+3 markets are both market- and legislative (policy) oriented.

Despite Europe’s AMI status of development, a number of deficiencies still exist within the system. Regulatory systems, which are crucial for fostering well functioning firms and nursing investor confidence, have yet to fully mature. There is lack of governance and regulation and competition is relatively insufficient. Addressing these problems will boost benefits to investors, who would then have wider choices among new product types. There are major implications for the banking system. In general, banks will benefit through the spread of investment trusts, although the situation becomes more complex when sales networks are taken into consideration, since the commission fee creates an incentive for banks to encourage the quick sale of rising investment trust funds, rather than to engage in longer term investments. As such, construction of sales networks is critical to creating a well functioning market. Banks also have an interest in promoting deposits when interest rates are high, since spreads typically widen. Imperfections aside, for a developing capital market, the banking system provides the best means of distribution. The possibility of deepening markets
by promoting alternative investment such as hedge funds is one promising area of consideration.

There are massive economies of scale to be had through merger (valued approximately at €6bn) provided cross-border impediments can be resolved. In Europe, removal of cross border impediments would provide the average investor with a 9% gain in returns. The European Asset Management Association (EAMA) assessed the effect of capital requirements on investment firms and found that there would be benefits in areas such as offsetting risk and investor protection, although high capital requirements would damage competition and damage small business.

Transparency remains an issue. Investors must be able to broadly discern what is going on with their funds. Injecting this type of market discipline not only elevates management standards but increases investor confidence as well, bringing more funds into the market. Promoting transparency can produce very powerful effects within a burgeoning market and can serve as a catalyst to a self-fuelling growth phase.

Information disclosure is crucial- in the European Union (EU), there are discrepancies between member states. There is also an absence of a general code of conduct for financial advisers. Having a general code of conduct would allow the system to be far more Europe centric, rather than confined to individual nations. Obviously, this brings with it competitive benefits and greater transparency. The same concepts apply for ASEAN and as much as it is possible, policies should aim to engender such standards.

Tax and pension issues must be addressed. In the EU, national discrimination exists between domestic and offshore funds, and this hampers investment. Pension funds are also critical to the growth and nature of the asset management industry. In Germany, dominance in the pension industry by insurance products and insurance firms has hampered diversification.

Finally, the promotion of investor education is crucial in any market, be it the EU or Japan or SE Asia. This may be accomplished using the regular routes of general public marketing campaigns, along the lines of Japan’s ‘savings to investments’ program, but other avenues must be explored as well. Investor education help proliferate knowledge and interest about investment products and asset markets.
AMI in the UNITED STATES

In the US, the AMI consists of a wide array of services, with retirement saving being conducted through the social security system, insurance plans, retirement plans and individual programs. Private sector saving largely consists of mutual funds, three quarters of which are owned by households. Mutual funds began to take off in 1981, with the introduction of IRAs (Individual Retirement Accounts), which invested heavily in mutual funds. Growth in the 1980s and 1990s came on the back of sustained stock market growth and occasional bubbles, such as the internet boom.

A marked growth in the market has been displayed, particularly since 2003. This has been due, for the most part, to an ageing US society and the concomitant rising demand has resulted to the entrance of a number of more complex and sophisticated products.

Reform has been a major issue in recent years. The Bush administration has been pushing reforms toward private pension management, with individual participation. This fits with a republican approach to small government and individual provision, although it serves to remove from government the burden of an ageing society. In the area of governance, the Securities and Exchange Commission (SEC) found a number of problems including breach of trust and agency problems. In distribution channels, fees paid to underwriters were raised, permitting higher payments to brokers. Of course, this detracted from the overall performance of the fund as there was a general focus on commission over quality. Moreover, there were breaches in terms of fees- institutional investors were charged less than retail customers and certain customers were offered market timing and late trading services, which cost the industry 2 per cent annually.

The reforms implemented included efforts by the SEC to make the industry more independent from boardrooms. Companies were also required to disclose important information on the considerations behind a management contract. Fines, penalties and punishments were also imposed and enacted. Some individuals were subject to disciplinary action by the SEC, pour encourager les autres and to ensure that reforms were taken seriously. There was a general strengthening of oversight with regard to mutual funds, in terms of regulatory functions, compliance and ethics. Furthermore, there were heightened efforts toward improving disclosure at a reasonable cost, along with improvement of fees and the eradication of illegal
and favouritist trading arrangements, under SEC pressure.

The US is a good example of how the world’s most advanced asset management market can be subject to a number of severe problems, most of which arise from the clash of interests between profits for management companies and returns for investors. This should serve to illustrate the importance of establishing a watertight legal framework and ensuring sufficient transparency and oversight.

Aside from the legal regulatory and transparency approaches to AMI, the implications of developments in the US market for ASEAN+3 suggest that focus be placed on pension-orientated asset management. In targeting this individual area, perhaps tax incentives could be used to encourage fund allocation. The scandals that rocked the asset management industry in the past few years seriously undermined investor confidence. As a response, there was an increasing focus on fees, management and sales practices. In less developed markets, with little established practice, there should be a number of loopholes for firms to exploit. It is crucial that in recommending policy, we think carefully about the dangers of an imperfect legislative framework among ASEAN nations.

An EMPIRICAL ANALYSIS on MUTUAL FUND and INVESTMENT TRUST MARKETS in the U.S. and JAPAN

This section examines the general features and trends in savings in both countries and explores the portfolio selection among stocks, bonds, mutual funds and investment trusts for both countries.

In general, savings is the function of Income. If income in any household increases, savings is expected to also accrue. Intuitive analyses suggest that income is an important factor affecting savings. On the other hand, the important factors that affect portfolio selection among stocks, bonds, mutual funds and investment trusts are the combination of risk and return. Given a certain level of risk, we prefer the asset with high return.

The number of choices for investors is another factor affecting portfolio selection. Investment choice expands the utility of investors leaving them better off. An increase in the variety of mutual funds and investment trusts raise the amount of money
invested to these types of assets.

Empirical results confirm that market performance (stock price change) has some impact on net cash inflow and the amount of assets of mutual funds and investment trusts in both countries. Risks in stock market, however, have different effect on net cash inflow and the amount of assets of mutual funds and investment trusts in both countries. Focusing on stock funds and investment trusts, risks in stock market reduce net cash inflow in the U.S., but risks raise net cash inflow in Japan. This difference might imply that investors in both counties have different utility levels for mutual funds and investment trusts. Investors in Japan treat investment trusts as the tool to diversify their assets and investment trusts can be the substitute for individual stock. However, investors in the U.S. draw up their funds from stock funds when the stock market is turbulent. This tendency suggests that stock funds and individual stock are complementary goods.

Interesting results are also obtained. An Increase in the number of the types of mutual funds and investment trusts raise the net cash inflow into mutual fund and investment trust market, with some exception such as Japanese stock investment trusts, U.S. stock and bond mutual funds. It might be said that the variety of mutual funds and investment trusts have positive impact on mutual funds’ and investment trusts’ demand. From these findings, it could be said that the more the variety of mutual funds and investment trusts are provided, the higher investors’ utility goes up. The rise in the variety of mutual funds and investment trusts works on the increase in investors’ welfare. This is because the supply of the wider variety of mutual funds and investment trusts provide richer opportunity to investors in both counties to construct desirable portfolio.

AMI in ASIA
(China, Indonesia, Malaysia, the Philippines and Thailand)

The Asian asset management industry (with regards to China, Indonesia, Malaysia, The Philippines and Thailand) generally suffers from a lack of sufficient capital markets and an excessive dependence on the banking sector, factors which were also identified as major causes behind the Asian Financial Crisis (AFC). While there exist huge pools of capital within the ASEAN nations, it is difficult for firms to mobilize long term domestic resources. Hence, current efforts to develop individual capital markets are geared towards capital markets integration. In recent years, there has been impressive growth within investment
trusts throughout the majority of the ASEAN+3 landscape, and moves toward tighter legislation, with China having the highest net assets among the group in 2004.

Among the South East Asian nations, Malaysia and Thailand have the most developed investment trust industries, with Malaysia boasting of the highest level of market penetration and the most diversified and sophisticated fund products. In terms of bonds, China has a small market relative to its GDP. Government bonds dominate most markets in Asia, with only Malaysia offering a balanced mix of government and corporate bond products.

Notwithstanding its growth potentials, the industry suffers from a number of problems. First is poor (and sometimes excessive) regulation. Second, taxes are also acting as a deterrent to investment, as are excessive fees and charges, which vary greatly between funds and countries, although in some countries, this is not a major impediment. Third, while there are decent distribution networks, there is a general lack of investor education and interest. Responsibility lies with the industry players themselves to educate the investing public, which has other associated problems.

Of course, the proliferation of investment trusts is also tied to the condition of securities markets. If there are a number of stocks and bonds to choose from, this allows the creation of a wide range of investment products. China has the largest markets in absolute terms, although it is weak in size in terms of GDP and moreover, the stock market has generally been poorly performing. The Philippines and Indonesia have also had poor stock markets, although Malaysia and Thailand are far more advanced.
INTRODUCTION

Asset management is currently at a very promising stage in Asia. There has been a marked development in recent years, with individual countries progressing at different speeds. For example, China has witnessed rapid growth since 2000, whereas Malaysia, whose framework has been in place since 1959, has only experienced a rapid maturity of its markets in recent years.

What is most noteworthy is that all these recent development have been largely market-led. There have been a number of efforts by government toward tighter legislation and the creation of a more favorable investment environment, but much has come from investors and managers realizing the potential for returns. Of course, it is difficult to say that any development could be fully autonomous. The major factor behind an improving investment environment has been economic growth among the ASEAN nations and a commitment to reform in the wake of the AFC.

This paper brings to light the development of Japan’s asset management industry (Chapters 1 & 2), highlighting milestones, lessons, and areas of vulnerability and reforms, which other expanding Asian economies could study and adapt in the process of helping nurture towards maturity their own AMI. The experiences of Europe and the US (Chapter 3), especially in comparison to Japan, draws attention to the weight of having well functioning legal regulatory frameworks and underscores the essentials of transparency and aiming for high standards of disclosure.

The major drive for market-oriented development is coming from the proliferation of new financial products on the market, which allows individuals to better find products that suit their own risk-return parameters. In closely matching their ideal balance, individuals will derive a greater utility out of investment trusts and as such, funds will flow into the market. This in turn will have secondary effects, as markets will become more liquid and less risky. Combined with better stock markets, economic growth and an overall improvement in the investment environment, the investment trust business is poised to experience marked growth. Furthermore, from a marketing perspective, increased availability of investment instruments will create a perception amongst investors that investment trusts are a normal constituent of any household’s portfolio. This will foster an investment environment far more predisposed
toward asset management and in turn, the market will be the driver for investor education.

It is crucial that in developing solid markets for financial products, investors understand, to a sufficient level, the good that they are buying. In doing so, they are able to make judgments about quality and investment performance, facilitating the survival and proliferation of high performance funds, which will have externalities on investor confidence in future investment trust markets. We are currently experiencing a shift of this kind in Japan. However, Asia as a whole still has a very low penetration rate into the investment trust industry, with few investment trusts currently being offered on the market. There is a lack of both sufficient products and distribution channels.

In terms of aggressively promoting new products and develop suitable markets, this report seeks to identify what policy is required, based on empirical evidence (Chapter 4). There is a detailed discussion regarding disclosure to investors, the required legislation and concerns over investor protection. As with any major market reform (involving an overhaul of the legal system, strengthening distribution networks, offering tax incentives, streamlining system of fees and commission), these developments will take time, but arguably now is the correct juncture to implement major structural changes, essentially due to the fact that economic growth in the ASEAN nations, along with Japan, China and Korea should be fully harnessed as a catalyst for stock market improvement, investor involvement and ultimately the development of the asset management industry (Chapter 5).
1.1 REINFORCING MARKET ECONOMIES IN ASIA WITH AN ASSET MANAGEMENT STRUCTURE

The Rise of the Asian Manufacturing Industry and the Financial Economy

The development of Asia’s manufacturing industry has been quite remarkable. Through the years, it has managed to achieve economies of scale and tremendous quality improvements, resulting to low-cost outputs that are internationally competitive. Bolstered by strong demand, Asian export volumes are booming. Domestically and within the region, shipments of Asian manufactured goods are rapidly increasing. Judging by the performance of its manufacturing economies, it can be said that Asian nations are doing an impressive job.

Unfortunately, the same cannot be said of the state of affairs of the Asian financial economy. Based on the monetary economy, the Asian financial system is still described as having characteristically low level of capital reserves, compared to their developed counterparts in the United States and Europe (hereinafter alternatively referred to as ‘the West’). At its core, the Asian financial system is still largely an ‘indirect’ system where the (real) production sector is linked to the financial sector via traditional banking conduits, largely in the form of bank loans to industry and bank deposits from investors. In the West, the real and financial sectors are linked by a ‘direct’ financial system, whereby funds are raised by issuing equity (stocks) and bonds, instead of the banks’ loan channels. In terms of directly procuring funds from investors in the capital markets, the Asian direct financial system remain relatively underdeveloped.

Globalization and the Asian Financial System

With the spread of market economics, the widening clout of liberalization and the birth of globalization in the Twentieth Century, the principle of competitiveness grew in stature and has become the mantra of the developing world. In terms of international capital movement, as a result of the evolution of information systems, progress in financial engineering, capital growth and globalization, capital is able to move around the world quickly, efficiently and in large quantities. Asia has benefited from these market-oriented developments in major ways,
but the region has also developed a number of vulnerabilities, particularly in its weak area – the financial system. The 1997 Asian Financial Crisis (AFC), which left countries in the region in a serious state of financial stress and monetary disarray, is one glaring example.

Despite the speed with which globalization is worming its way into Asia, its influence on the financial and industrial sectors has been uneven. Owing to the construction of global networks, the financial world has become more influenced by the globalization of information and technology than the industrial economy. There is also a marked difference in the impact of globalization on the financial markets in the West and in Asia. Unlike the West (where high levels of capital funds, competitiveness, networks and financial acumen provide the backbone to its financial economy), in Asia, only a handful of national financial markets have come about. Among Asian countries, individual country financial systems differ in their current state of development, and while they maybe relatively competitive, it’s only within the domestic and Asian spheres at best. Since the financial infrastructure in the West is quicker to respond to globalization and adapts faster to technological change compared to Asia, the financial development gap between these regions is widening, particularly in the area of fashionable financial products, which are focused toward financial technology.

To diminish this gap, the Asian market has instituted reforms and struggled to be accustomed to the order of international capital mobility. Crisis-causing events such as sudden significant currency exchange movements, stock market slumps and bank runs called for serious strengthening of the region’s financial monetary and regulatory frameworks. Since the 1997 AFC, strengthening the financial economy has been a major priority in Asia.

**Encouraging the Shift to a Direct Financial System**

As economies develop, financial needs grow and diversify. In addition to investments offering a safe yet low rates of return, there is also a demand for a variety of investments offering different risk-return profiles. In this environment, the indirect financial system found in less developed economies (including Asia) is no longer capable of adequately corresponding to the needs of the market. For example, during the long recession in Japan, banks tightened credit, and the supply of capital to the industrial sector dwindled. As a result, a number of businesses went bankrupt, and the economic contraction was exacerbated. This was a typical example of how the indirect financial system did not work efficiently.
In the West, the importance of the direct financial system has been increasing through the years. With strong economic performance and steady growth in capital reserves, there is a growing demand for suitable markets, underwriting services, sales capabilities and asset management. Moreover, direct financial markets are much more capable of adapting to the evolution of information, the progress of financial acumen, the growth of funds, and the progress of globalization.

Given this scenario of rapidly increasing pace of world business and the degree of difference between the financial systems in the West and in Asia, the path Asia must take in order to effectively compete with Western financial industries will require suitable preparation, well-designed frameworks and an efficiently organized financial system.

**Asset Management, the New Wing of the Financial Economy**

As an economy gradually shifts from indirect to a direct financial system, the rationale for an asset management industry (AMI) begins to form and take root. Within the process of economic growth, the AMI fulfils the intended role of increasing accumulated wealth. It is also a useful tool in contributing to wealthy societies and in answering the needs of ageing societies. In the United Kingdom and Holland, growing levels of capital reserves stressed the importance of asset management. Within Europe and the United States, AMI is developing at a remarkable pace.

This development is inevitably linked to the preparations being put into effect by Western countries to adequately deal with the problems of an ageing society. Individual countries are placing limits on their social security systems and are encouraging people to accumulate assets by amending policies in order to encourage individual saving. AMI is engaged in making use of accumulated funds and increasing reserves, two elements of particular importance in ageing societies.

Asia is not at all oblivious to these AMI trends and occurrences in the West. Asian societies are also becoming older and see themselves in same way as Western nations in forecasting the same problem. Responding early and having ample preparation in terms of AMI-related frameworks and strategies are prudent and smart moves for Asia.
1.2 THE PRESENT STATE OF THE JAPANESE ASSET MANAGEMENT BUSINESS

In Japan, using AMI as a viable means of providing for the needs of an ageing society is a concept that has yet to be fully appreciated. In an economy where AMI is focused around securities, banks, trust banks, and insurance (life and non-life), the ideal purpose of AMI may only be achieved if asset management begins to assume one of the leading roles in the financial system. This lead role, however, may only be taken on if the asset management business is essentially INDEPENDENT, both from an industry and a company basis. Although AMI in Japan is more readily identified with pension management, the symbiotic relationship of firms in the AMI business prevent them from being independent.

The Diffusion of Asset Management from the West to the Rest of the World

The West has a long history of asset management, beginning with the asset management model used by the East India Company in the 17th Century. Two hundred years later, securities investments became the center of attention and the full-scale management firms began to develop. The business used commercial and industrial capital as a basis for fund accumulation and originally started in Britain (which enacted the Investment Service Law) and Holland, and afterwards expanding into Switzerland, France and Germany. Eventually, asset management reached the vast and asset rich United States, and from the 19th century onwards began to develop.

Beginning the 1900’s, specialist management companies began to proliferate in the United States. In 1940, the Investment Company Law was enacted. In Japan, the asset management business is lagging behind the West. The creation of a suitable legislative framework was also somewhat slow to take effect. Legal developments have taken the form of the Investment Trust Law (1951) and the Investment Advisory Law (1986).

With a long history of practical experience, the West accumulated useful lessons with regards to good practice, creating a solid legislative framework that improved investment theory along with its practice and application, and honed the evaluation of management performance. More importantly, great progress was made in learning how to preserve competitiveness. As a result, Western AMI became much more powerful. What Japan did was to follow the Western lead.
Securities Firms Taking the Lead in Japan

In 1951, the Investment Trust Law was brought into effect. The investment trust business began to evolve through the sales networks of securities companies, which sold investment trusts mainly designed for individual investors. Raising capital for the industry then became the first priority for investment trusts. Since the point of contact with the investors was at the sale of securities, the system inevitably became very sales-concentrated. Key factors regarding product planning and fund establishment were largely dictated by ease of sale. The industry did not pay much attention to the competencies of managers and needs of investors. Examining industry weaknesses were likewise relegated to the backburner. As a result, while the Japanese investment trust business was expected to be a powerful tool in increasing the wealth of individuals (the outstanding balance as of October 2005 stood at ¥49 trillion, or US$462 billion), it failed to gain sufficient trust among investors whose preference were tilted in favor of bank deposits.

Table 1-1. Householders Financial Assets Within Leading Countries 2004

<table>
<thead>
<tr>
<th></th>
<th>Japan</th>
<th>U.S.A.</th>
<th>U.K.</th>
<th>Germany</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(100mil Y) component rate (%)</td>
<td>(100mil Y) component rate (%)</td>
<td>(100mil Y) component rate (%)</td>
<td>(100mil Y) component rate (%)</td>
</tr>
<tr>
<td>change rate</td>
<td>1USD= 104.21JPY</td>
<td>1£= 199.81JPY</td>
<td>1EURO= 141.61JPY</td>
<td></td>
</tr>
<tr>
<td>cash</td>
<td>1990E 58.6</td>
<td>2004E 7,881,961 55.4</td>
<td>2004E 4,849,829 12.7</td>
<td>2004E 1,714,769 27.0</td>
</tr>
<tr>
<td>deposit</td>
<td>1990E 23.0</td>
<td>2004E 30.7</td>
<td>2004E 30.7</td>
<td></td>
</tr>
<tr>
<td>insurance</td>
<td>1990E 30.7</td>
<td>2004E 30.7</td>
<td></td>
<td></td>
</tr>
<tr>
<td>trust+pension</td>
<td>1990E 27.1</td>
<td>2004E 12,161,098 31.8</td>
<td>2004E 3,333,630 52.4</td>
<td>2004E 1,802,685 31.3</td>
</tr>
<tr>
<td>bond</td>
<td>1990E 27.1</td>
<td>2004E 12,161,098 31.8</td>
<td>2004E 3,333,630 52.4</td>
<td>2004E 1,802,685 31.3</td>
</tr>
<tr>
<td>stock</td>
<td>1990E 27.1</td>
<td>2004E 12,161,098 31.8</td>
<td>2004E 3,333,630 52.4</td>
<td>2004E 1,802,685 31.3</td>
</tr>
<tr>
<td>Investment</td>
<td>1990E 27.1</td>
<td>2004E 12,161,098 31.8</td>
<td>2004E 3,333,630 52.4</td>
<td>2004E 1,802,685 31.3</td>
</tr>
<tr>
<td>stock+trust</td>
<td>1990E 27.1</td>
<td>2004E 12,161,098 31.8</td>
<td>2004E 3,333,630 52.4</td>
<td>2004E 1,802,685 31.3</td>
</tr>
<tr>
<td>others</td>
<td>1990E -</td>
<td>2004E 4,649,642 25.2</td>
<td>2004E 1,714,769 27.0</td>
<td>2004E 657,070 11.4</td>
</tr>
<tr>
<td>total</td>
<td>1990E 100.0</td>
<td>2004E 14,244,917 100.0</td>
<td>2004E 100.0</td>
<td>2004E 100.0</td>
</tr>
</tbody>
</table>
In the 1970s, Japanese stocks began to take centre stage. Following their Western counterparts, Japanese investment advisory companies, most of which focused on the securities industry, became more and more established. Securities companies created their own networks in both foreign and domestic spheres, in line with the needs of institutional investors, and one by one formed investment advisory companies. This was how they came to be the pioneers of the Japanese investment advisory business. Due to competition with foreign management companies and customers who were mainly pension clients, the link to the securities industry was weakened. There was no solid financial base hence a multitude of companies were still dependent on their parent companies. In March 2005, the total assets of investment advisory companies amounted to ¥79 trillion, or US$687 billion.

### New Entrants to the Industry and the Issue of Independence

The latter half of the 1980s witnessed the birth of the bubble economy. The market was awash with funds, majority of which came through individuals and corporations. The needs for asset management rapidly expanded, which was attributable not only to growth in equity markets backed by economic expansion, but also to growth in government, public groups, business related bond issuances and the subsequent activities in the bond market. This expansion increased the number of industry entrants, i.e. trust banks, life insurance and non-life insurance funds. As a group, banks established investment advisory companies. Furthermore, well established foreign companies created asset management firms in Japan to pursue Japanese business. In the latter half of the 1980s, especially specified monetary

### Table 1-2. Investment Advisory Contracts in Japan

<table>
<thead>
<tr>
<th>Year-Month</th>
<th>Domestic Client amount 100mil Yen (%)</th>
<th>Domestic entrusted amount 100mil Yen (%)</th>
<th>Overseas Client amount 100mil Yen (%)</th>
<th>Total (domestic + overseas) amount 100mil Yen (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1992-03</td>
<td>216,575 (62)</td>
<td>140,773 (38)</td>
<td>131,521 (38)</td>
<td>378,096 (100)</td>
</tr>
<tr>
<td>1993-03</td>
<td>208,412 (58)</td>
<td>131,806 (42)</td>
<td>153,852 (42)</td>
<td>362,264 (100)</td>
</tr>
<tr>
<td>1994-03</td>
<td>213,301 (54)</td>
<td>137,345 (46)</td>
<td>180,518 (46)</td>
<td>393,819 (100)</td>
</tr>
<tr>
<td>1995-03</td>
<td>213,215 (56)</td>
<td>138,180 (44)</td>
<td>169,186 (44)</td>
<td>382,401 (100)</td>
</tr>
<tr>
<td>1996-03</td>
<td>238,907 (52)</td>
<td>149,285 (48)</td>
<td>218,900 (48)</td>
<td>457,807 (100)</td>
</tr>
<tr>
<td>1997-03</td>
<td>318,884 (57)</td>
<td>213,970 (43)</td>
<td>240,941 (43)</td>
<td>559,825 (100)</td>
</tr>
<tr>
<td>1998-03</td>
<td>374,025 (62)</td>
<td>260,005 (38)</td>
<td>233,335 (38)</td>
<td>607,360 (100)</td>
</tr>
<tr>
<td>1999-03</td>
<td>519,078 (73)</td>
<td>300,680 (27)</td>
<td>194,639 (27)</td>
<td>713,717 (100)</td>
</tr>
<tr>
<td>2000-03</td>
<td>648,120 (71)</td>
<td>368,787 (29)</td>
<td>258,528 (29)</td>
<td>966,448 (100)</td>
</tr>
<tr>
<td>2001-03</td>
<td>733,245 (81)</td>
<td>323,331 (19)</td>
<td>177,401 (19)</td>
<td>910,646 (100)</td>
</tr>
<tr>
<td>2002-03</td>
<td>745,231 (84)</td>
<td>473,346 (16)</td>
<td>142,515 (16)</td>
<td>887,471 (100)</td>
</tr>
<tr>
<td>2003-03</td>
<td>706,032 (84)</td>
<td>462,862 (16)</td>
<td>130,750 (16)</td>
<td>863,681 (100)</td>
</tr>
<tr>
<td>2004-03</td>
<td>756,779 (81)</td>
<td>520,741 (19)</td>
<td>172,827 (19)</td>
<td>931,605 (100)</td>
</tr>
<tr>
<td>2005-03</td>
<td>874,783 (81)</td>
<td>646,205 (19)</td>
<td>204,359 (19)</td>
<td>1,370,347 (100)</td>
</tr>
</tbody>
</table>

**Resource:** The Investment Advisory Association
accounts (so called ‘tokkin’ accounts) associated with high revenues were put to use in an environment of rising Japanese stocks and in turn, investment advisory companies created substantial profits. In the midst of all this, the Investment Advisory Act was put into effect in 1986.

The 1990s heralded the collapse of the bubble, and witnessed the sudden decrease in tokkin funds, which are non-long term capital. Individual investors began to flood out of investment trusts after suffering huge losses from the stock market. The pension industry was deregulated, hence sifting out a large number of asset management companies. What remained were powerful investment advisory firms, involved in the securities, bank, trust bank, life and non-life insurance, and foreign firm related sectors. Defined contribution pension investment trusts were introduced, and it was assumed that the investment trust sales route was expanding. As such, major financial groups set up investment trust management companies as their subsidiaries. Powerful asset management companies involved in banking, insurance and foreign funds, which have both investment advisory and investment trust capabilities, entered into the investment trust management. This structure involving interwoven investment trust and investment advisory companies prevented the firms from operating independently of each other. Furthermore, owing to economies in management resources, many capital management companies began to cooperate far more with foreign capital firms in order to better manage foreign capital markets.
1.3 THE PURPOSE OF THE ASSET MANAGEMENT INDUSTRY

1.3.1 Efficient Management of Japan’s Financial Assets

Japanese household financial assets are second only to America in size, worth over ¥1,400 trillion. This is more than double the figures for the United Kingdom and Germany. The Japanese financial system is also highly concentrated on deposits, which represent 55% of assets. This is far greater than the corresponding figures of 13% in the US and 36% in Germany. However, in terms of securities investments (comprising of bonds, securities and investment trusts), Japan lags behind, accounting for only 13%, compared to the US (36%), Germany (33%) and the UK (17%).

Table 1-3. Comparison of the Outstanding Investment Trust Balances in Leading Countries

<table>
<thead>
<tr>
<th>Year/E</th>
<th>Japan (100 mil Yen)</th>
<th>U.S. (100 mil US$)</th>
<th>U.K. (100 mil £)</th>
<th>Germany (PO + special fund 100 mil EURO)</th>
<th>France (Corporate type + contract type 100 mil EURO)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990/E</td>
<td>459,939</td>
<td>10,652</td>
<td>463</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>1991/E</td>
<td>414,738</td>
<td>13,932</td>
<td>544</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>1992/E</td>
<td>433,005</td>
<td>16,426</td>
<td>633</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>1993/E</td>
<td>507,375</td>
<td>20,701</td>
<td>947</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>1994/E</td>
<td>434,083</td>
<td>21,554</td>
<td>918</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>1995/E</td>
<td>479,571</td>
<td>28,113</td>
<td>1125</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>1996/E</td>
<td>486,680</td>
<td>35,258</td>
<td>1317</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>1997/E</td>
<td>406,495</td>
<td>44,682</td>
<td>1574</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>1998/E</td>
<td>427,393</td>
<td>55,252</td>
<td>1824</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>1999/E</td>
<td>513,536</td>
<td>68,463</td>
<td>2532</td>
<td>7,661</td>
<td>6,517</td>
</tr>
<tr>
<td>2000/E</td>
<td>493,992</td>
<td>69,647</td>
<td>2610</td>
<td>8,212</td>
<td>7,721</td>
</tr>
<tr>
<td>2001/E</td>
<td>452,807</td>
<td>69,750</td>
<td>2357</td>
<td>8,143</td>
<td>8,002</td>
</tr>
<tr>
<td>2002/E</td>
<td>360,160</td>
<td>63,916</td>
<td>1945</td>
<td>7,627</td>
<td>8,102</td>
</tr>
<tr>
<td>2003/E</td>
<td>374,356</td>
<td>74,141</td>
<td>2410</td>
<td>8,417</td>
<td>9,093</td>
</tr>
<tr>
<td>2004/E</td>
<td>409,967</td>
<td>81,069</td>
<td>2754</td>
<td>8,991</td>
<td>10,085</td>
</tr>
<tr>
<td>2005/E</td>
<td>487,996</td>
<td>85,889</td>
<td>3245</td>
<td>9,861</td>
<td>11,876</td>
</tr>
</tbody>
</table>

Source: Investment Trust Association FUND MANAGEMENT Spring 2006

In increasing Japan’s ¥1400 trillion capital base, asset management must graduate from its current supporting role and begin to assume lead roles in shaping Japan’s future financial landscape. Related companies’ and clients’ comprehension of the issues at hand along with an understanding of the improvement of financial issues, should be encouraged as much as possible. The resolution of current financial issues and the implementation of reforms to
better the business environment will help hasten the growth of AMI.

1.3.2 Adding Value and Strength to the Tokyo Market

In an era of increasing globalization within the economy and financial markets, Japan stands to gain from following the Western markets’ remarkable ability to adapt to the changing times. A shift toward a direct financial system will underscore the strength of the Tokyo market, especially in the light of it being a prime financial influence among the financial infrastructures of Asia. Under a direct financial system, investors are connected to the issuer through the market and the market offers an entry point into asset management. Essentially, this means that the investor and the issuer are free to choose any world market, in which case Tokyo must be ready to reposition itself as a global financial base.

Fortunately for the Tokyo market, it is endowed with a number of favorable conditions. Firstly, major investors, issuers and managers are closely positioned to one another. Secondly, markets are sufficiently liquid. Thirdly, geographical conditions are ideal. Tokyo is a key strategic base, especially since expectations point toward a distinct Asian regional market. Together with the quest to be one of the world’s three main financial centers (accompanying New York and London), the successful achievement of requisite reforms will be beneficial to the development of the Japanese Asset Management Industry.

1.3.3 Diversifying Portfolio Instruments and Professional Investment Specialization in Response to Diversified Investment Needs

Globalized financial engineering, along with computerization, inevitably pushes the market to shift towards a more ‘direct’ system of finance. This change brings with it an expansion of market offerings, in terms of the types of investment products, types of investor and the types of investment specialists to manage and handle investment placements. The market then becomes a host to a more diversified system, offering a wider spectrum of risk and return parameters. But in order for expanded investment tools to be efficient vehicles of capital generation, the nature of such tools must be well understood by investors in order for them to make appropriate and informed judgments regarding their choice of portfolio placement. In this sense, the entry of more diverse, complex and high quality investment instruments corollarily brings with it an increased demand for investment management specialists. It is in this context that the role of the AMI professionals and specialists begin to take shape. Rather than worry about their investments, more investors will choose to pay the fees of an
investment specialist. As it is, a rising number of investors believe that entrusting their money to professional investment specialists is worth the expense, on the expectation that such placements are likely to yield more efficient (hence profitable) results.

The demand for investment products naturally gravitates towards products that are viable both in terms of cost and efficiency. These products are, in many cases, limited. The implication for investment professionals is that while diversified demand is making them hone their management skills, they do so only within a limited sphere. Competition has, in fact, been so intense that it is spreading even among related management companies. Another implication has to do with the way investment specialists cater to investor needs. It is essential that along with a core understanding of the rudiments of risk-return tableaux and full comprehension of the amendments within asset management, investment professionals maintain direct communication with clients and diligently report investment performance and results.

The shift to a more ‘direct’ system has recently given birth to a number of securitized paper assets that have been put into circulation, in addition to the traditional stocks, bonds and short term assets. Securitized papers such as Asset Backed Securities (ABS), Certificate Debt Obligation (CDO), Residential Mortgage Backed Securities (RMBS), Commercial Mortgage Backed Securities (CMBS) and Real Estate Investment Trusts (REIT) have been put onto the market. Furthermore, off the back of existing assets, every kind of derivative, exchange and commodity-related good is now available. After the current reexamination of the Investment Services Act, a number of new products will also be put onto the market.
### 1.4 A COMPARISON BETWEEN INVESTMENT TRUST COMPANIES AND INVESTMENT ADVISORY COMPANIES

Table 1-4. Comparison of Japanese Investment Trusts and Investment Advisory

<table>
<thead>
<tr>
<th>Comparison of Japanese Investment Trusts and Investment Advisory</th>
<th>12/2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Related Law, Issue Year</td>
<td>Investment Trust Law 1951</td>
</tr>
<tr>
<td>Contract Amount (2005/03)</td>
<td>Public Investment Trusts ¥42 tr</td>
</tr>
<tr>
<td>Main Investor</td>
<td>Mainly Individuals</td>
</tr>
<tr>
<td>Level of Sophistication</td>
<td>Low, Medium</td>
</tr>
<tr>
<td>Advisor to Investor</td>
<td>Mainly Sales Company, Salesmen</td>
</tr>
<tr>
<td>Contact to Investor</td>
<td>Indirect, Through Sales Company</td>
</tr>
<tr>
<td>Characteristics and Stability of Fund</td>
<td>Low stability</td>
</tr>
<tr>
<td>Factor of Decision Making</td>
<td>Sales power, Planning of product</td>
</tr>
<tr>
<td>Performance and Balance</td>
<td>Weak Co-relation</td>
</tr>
<tr>
<td>Issues of Concern for the Investor</td>
<td>Essentially Results Only</td>
</tr>
<tr>
<td>Structure of Management, Investment</td>
<td>Investor is Uninterested</td>
</tr>
<tr>
<td>philosophy, Investment Style</td>
<td></td>
</tr>
<tr>
<td>Target of Investment</td>
<td>Almost Solely Absolute Return</td>
</tr>
<tr>
<td>Characteristics of Fund</td>
<td>Variety of Client, Individual Characteristics</td>
</tr>
<tr>
<td>Comparison Between Funds</td>
<td>Difficult to Compare due to Individuality and</td>
</tr>
<tr>
<td>Fee Structure</td>
<td>Purchase Commission Charge and Fund</td>
</tr>
<tr>
<td></td>
<td>Incentive Fee.</td>
</tr>
</tbody>
</table>

Table 1-4 above compares the Japanese investment trust and investment advisory businesses on several grounds. The comparison presents relatively distinct results for each type of investment business. For example, the clients of investment trusts are mostly individual persons, whereas the clients of investment advisory firms are primarily institutional investors such as pension funds. Individual investors tend to exhibit middle-to-low level of sophistication, in terms of investment knowledge and attitude. As such, they are neither too keen on the entire investment process nor on the contents of the fund. On the other hand, institutional investors (which constitute a large part of the investment advisory business), have deeper levels of understanding of the investment process, and are as focused on the end result as on the investment plan and content.

In investment trust, capital stability tends to be rather low since the removal of money is
rather easy. The business is also more predisposed towards sales, which is the controlling element in the relationship between investors and managers. On the other hand, within investment advisory, investment contracts tend to be longer term in nature and are not easily broken (particularly within the realm of pensions), and even foreign clients keep their money within the funds for the entire period. In this sense, it takes consultants a long time to examine and judge the merits of a project, since to get any solid results, at least three years’ worth of data needs to be analyzed. Nurturing the investor-manager relationship is therefore crucial, and to achieve this throughout a sufficiently long contract period would critically depend on the reliability of both parties.

Investment products in investment trust firms are largely influenced by sales. The point of contact with the investor is likewise initiated and maintained through sales. The process of planning products is centered to those that can easily be sold. Sales companies tend to prefer topical products, fashionable products, and new funds, as they are easy to sell. On the other hand, investment advisory firms tend to concentrate on more fundamental products, which happen to be limited in variety. In analyzing products, actual results’ data are thoroughly considered and greater focus is placed on the production of fundamental results than the planning of new products. Investment advisory firms also engage themselves more in explanation of contracts, management and the staging of reports. This is particularly true with pensions where asset management autonomy and independence are required.

Recently, the retail sales outlet of banks related to investment trusts have been rapidly increasing. There are enormous bank deposits being transferred into investment trusts, which are subject to high sales commission and other investment remuneration, hence it is not uncommon to find banks becoming the main source of investment sales. Postal savings balances are entering the sales force of investment trusts. The huge sales potential has expanded the sales route of investment trusts. No longer is it simply limited to security companies; it is also spreading to banks, postal savings, life insurance and non-life insurance.

The process of evaluating investments also differs for these two groups. In general, investment trusts are difficult to evaluate for a number of reasons. Firstly, the multitude of financial products managed within a fund makes it difficult to establish a common standard. Funds lack any real longevity element because of their short-term nature, making it difficult to give a general appropriate advice regarding investment direction. Secondly, there is the
persistent propensity for high-performance funds to be sold more often relative to other types of funds. Thirdly, in most cases, the non-existence of funds’ track records makes it difficult to establish a suitable benchmark, which would have been instrumental in helping establish a credible system of valuation. On the other hand, for investment advisory companies, the longer-term nature of the funds (i.e. pensions) make it possible for assets in different classes to be compared as regards performance and return.

Despite the differences in the investment systems for investment trust and investment advisory, both have benefited from the recent demand from domestic and overseas clients to adopt standards of asset management similar to those offered in the West. Such calls are significantly contributing to the improvement of investment advisory within the field of asset management. In the light of adhering to greater transparency and standard checks from pension clients and consultants, investment advisory companies have been required to meet certain standards in submitting presentations, contracts and asset management, reports, as well as making available some level of information explaining the investment philosophy, investment characteristics and investment processes at work.

On the profit arena, investment trust is generally more profitable than investment advisory. Profit guarantee is important in investment trust, hence highlighting the importance of sales. For investment advisory firms, fixed costs are low but variable costs are high, so therefore profits are smaller. Another reason for low profits is that investment advisory fees are low and the industry has a highly competitive fee structure. Entry barriers to the industry are also low and therefore business competition is strong.

Recently, investment advisory has, in many cases, been entering and merging with the investment trust business. The exchange between the investment trust and investment advisory culture is currently increasing. Originally, within the asset management industry, Japan’s investment trusts enjoyed a longer history and managed more resources than investment advisory. With the cultural exchange between the industries, the chance for reform is regarded as being vastly significant for the asset management industry. The introduction of higher remuneration (i.e. fees) based on good performance is also beneficial for the industry. A system rewarding favorable performance with high profits encourages an improvement of investment ability and a similar improvement in customers’ investment results, through which, the Japanese asset management industry will be developed.
1.5 SOME ISSUES CONFRONTING THE JAPANESE ASSET MANAGEMENT INDUSTRY

**Gap in Future Business Prospects.** Although the investment advisory business started late compared to investment trust, its investment balance vastly exceed that of the investment trust business. The increasing pressure to be able to compete with Western pension companies has forced the Japanese investment advisory business to undertake major improvements. For investment trust, the balance of assets is not increasing as expected.

**Low Profitability.** Low profitability makes it difficult for firms to be independent, an essential ingredient to long-term efficiency and sustainability of asset management firms. Since firms’ profitability is low, they are finding it hard to become independent.

**Business Structure and Management.** The management of investment trust has largely been characterized by sales firms, who have largely dictated the direction of asset management with regard to sales. Compared to the stiff competition with Western firms faced by investment advisory firms, within the field of investment trusts, Western competition has been insufficient. To prepare for the genuine competition from Western management firms, an improvement is required in both the perception and structure and also the content of management. In the interest of investor protection, sales and investment management companies should ideally be distanced from each other. Recently, trust sales attributed to banks and the post office are expected to utilize their higher independence in distinguishing themselves from their competitors.

**Kind of Investors.** There is a need for better-educated investors to improve investor standards. If investors’ understanding, judgment and selection capabilities are nurtured, high quality investment trusts maybe cultivated, with low quality trusts going to the wall. For this reason alone, educating investors is an important issue.

Asset management faces more problems with investment trust, compared to investment advisory. The management model of investment advisory firms is becoming more and more improved by the introduction of the defined contribution pensions system, and through the merger with investment advisory services. On the other hand, investment trust is largely inexperienced in terms of direct competition with Western firms. Improvement, in terms of
the quality of asset management and content are still issues for future discussion. With a gradual separation of sales firms and an improvement in the quality of investment trust investors, management companies should experience improvement in both investment and content.
1.6 NEW DEVELOPMENTS IN THE ASSET MANAGEMENT INDUSTRY

The Japanese asset management industry is undergoing significant changes, most notable of which are the following:

First, there’s an expansion in investment trusts’ sales routes. Since 1998, it has become legal to sell investment trust products through the banking system. Retail sales were legalized against a background of huge network and huge assets, the increase being far beyond that of securities companies.

Second, since 2005, postal savings’ funds and network moved into investment trust. Although in the past, the sales route has largely been conducted within the networks of security companies, a delicate network is taking effect all over the country. As a result, growth in the volume of investment trust sales, the division of investment trust companies and the trend toward independence for individual firms are all likely developments within the industry. The industry will also experience the spread of investment trust and efforts to popularize investment management. It is also expected that a class of unsatisfied investment trust customers will be moving into investment advisory.

Third, investment products are being diversified. Until now, one of the reasons for the sluggish shift from an indirect to a direct financial system has been the lack of adequate financial products. In addressing this problem, improvements on existing products, a number of alternative products, securitized goods, and a wide range of goods associated with the introduction of investment service laws are expected to enter the market.

Fourth, investments in foreign funds are increasing. Although this involves taking currency risk, the funds feature a monthly dividend, and balances have been rapidly increasing. We are seeing a huge increase in these types of funds and this phenomenon seems to be the overriding force in the shift from deposits to investments. In meeting the needs of dividend scheme customers, large scale investment schemes began to proliferate in a short space of time. In this sense, if the needs of investors are addressed, the huge potential will be realized for a shift from deposits to investments.

Fifth, we are seeing a change in the form of investments and the diversification of activity. Technically, up to now, it has been assumed that there are far more potential customers for the
investment advisory business, who would be able to enter were the minimum size of the fund much smaller. As such, Separate Managed Accounts (SMAs) already exist for rather wealthy individuals in the US, although these investors are generally smaller than investment advisory clients. Furthermore, within the sphere of investment trusts, they are distinguishing themselves from public contribution investment trusts and to that extent, are successful in limiting people to private placement investment trusts. In 1998, private placement investment trusts were introduced and in a very short space of time, ¥20 trillion of funds flowed in. In this way, owing to the diversification of investment forms, capital shifted towards investment.

Sixth, with demand for investment trusts growing, demand from pensions came in. Up to this point, along with defined benefit pension schemes, the new defined contribution pension plan took effect in Japan.

Lastly, in the investment advisory business, an incentive fee schedule rewarding good results and profits is being put into effect. Small-scale investment companies and hedge funds are certainly focusing on this structure, but in fact, major companies are also becoming more predisposed toward this schedule. If there is a profit improvement for the asset management company, there will be an expansion in firms offering the highest quality service. Moreover, this structure will also bring huge profits to the clients and eventually expand the asset management business.
2.1 OVERVIEW OF JAPANESE INVESTMENT TRUSTS BUSINESS

Asset management is a business enveloping investment trusts, corporate pension funds, insurance asset management, and investment advisory services, along with newly introduced securities accounts such as wraparound account provided by retail securities firms. Among these, investment trusts are most worthy of discussion because they are regarded as representative collective investment vehicles and widespread financial tools for individuals.

2.1.1 Defining Investment Trusts

Investment trusts are products designed to invest in the funds pooled from a large number of investors in securities or other cash-flow generating assets (such as real estate) primarily under the management of persons or entities other than the investors and distribute the profits raised by the investments among investors in proportion to the amount they invested. To investors, investment trusts offer a number of advantages, i.e. participation in a variety of assets with a small amount of funds whereby investors may enjoy economies of scale, efficient diversification of investments, and well-informed decisions and sophisticated investment techniques.

In general, it can be stated that investment trusts are financial service entities engaged in the business of investing funds on behalf of an unspecified number of individual beneficiaries who enjoy equal rights. Those who are engaged in the business of investment trusts are subject to a certain measure of legal and administrative control, although the degree of such control may vary from country to country.

In Japan, the overall framework of the investment trust system is defined by the Law Concerning Investment Trusts and Investment Corporations. Furthermore, rules governing the offering and selling beneficiary certificates of investment trusts and the investment of funds have been established by the Securities and Exchange Law, and the Investment Trust Association, a public-interest corporation under the Civil Code has also established its own rules and regulations to protect investors. Investment trusts provide an important vehicle of saving for, and perform the function of investing on behalf of, the investing public. At the same time, they play an economic role in facilitating the financing of business corporations.
by channeling funds of the investing public to the securities market. As institutional investors, investment trusts are expected to contribute to the formation of fair prices of securities on the securities market.

### 2.1.2 Classification of Investment Trust Fund

In Japan, there are several types of investment trust funds in accordance with legal forms and investing instruments (Figure 2-1).

**(a) Contractual Type vs. Corporate Type**

The contractual type of investment trust is one in which an investment trust management company (*Trustor*) and a trust company (*Trustee*) enter into a trust agreement, and the profits arising from investment management are delivered to investors (*Beneficiaries*). The *Trustor* is responsible for giving investment management instructions of the trust properties. The *Trustee*, usually a bank engaging in trust business, is responsible for the administration and safekeeping of trust properties. Prior to the 1998 amendment to the Law, only this type was permitted and is still dominant in Japanese markets.

On the other hand, the corporate type is one in which an investment company invests in assets, and issues investment certificates (*shares*). Investors obtain the position as shareholders by holding investment certificates and receive the profits arising from the investment management. The 1998 amendment incarnated to form this type, while the 2000 amendment permitted it to invest in real estates and other assets.

**(b) Open-End Type and Closed-End Type**

This classification depends on the acceptance of the investor’s request regarding redemption. Most contractual types are open-end type, whereas most corporate types are closed-end type.

**(c) Public Offering and Private Placement**

The 1998 amendment defined Public Offering as *any solicitation for purchasing a newly issued beneficiary certificates to a large number of persons except for the Private Placement to Qualified Institutional Investor (QII)*. The Cabinet Order defined ‘large number of persons’ as 50 persons or more. After April 2004, QIIs were excluded from 50 persons in the
calculation, if they number 250 or less. QII is defined as any investor who has expertise and experience in investing securities as defined by the Cabinet Order, which may be a securities firm, an investment trust management company, an investment company, a bank, an insurance company, a pension fund, a business company with certain securities investments and so forth.

The 1998 amendment defined two types of Private Placement. One is Qualified Institutional Investor Private Placement which refers to any solicitation for purchasing a newly issued beneficiary certificates only to QIIs. The other is General Investor Private Placement which refers to any solicitation for purchasing a newly issued beneficiary certificates not falling within the focus of the public offering and the QII private placement.

(d) Trustor Instruction Type and Non-Trustor Instruction Type

The trustor instruction type is a dominant contractual type of investment trust in current Japan. The non-trustor instruction type is one in which the investment trust management company is not involved; rather, the trust company manages the trust properties and acts concurrently as a trustee. The trust agreement is concluded between the trustee and each investor in accordance with a single trust deed (see Figures 2-2 and 2-3). Only the trustor instruction type is permitted to invest mainly in securities whereas the non-trustor instruction type invests mainly in specified assets such as real estates.

(e) Securities Investment Trusts and Investment Trusts Other Than Securities Investment Trusts

The securities investment trusts (the most dominant since the post-war period) are investment trusts managed by an investment management company that invest more than 50% of the fund’s assets in securities.*

The ‘investment trust other than securities investment trust’ is not a legal terminology. Its formation is attributable to the 2000 amendment which expanded investing assets of investment trusts from only securities to ‘specified assets’, i.e. securities, rights related to securities derivative transactions, real estates, rights to lease real estates, rights of superficies, money claims, promissory notes, rights related to financial derivative transactions, money

* Securities are defined by the Securities and Exchange Law.
trusts and interests in anonymous associations and so on.

Securities investment trusts are permitted only for the trustor instruction type, while ‘investment trust other than securities investment trust’ is permitted for both trustor instruction type and non-trustor instruction type.

(f) Securities Investment Companies and Investment Companies Other Than Securities Investment Companies

A securities investment company is any company established in accordance with the Law, with the purpose of managing its own assets by investing them mainly in securities. The 1998 amendment that allowed the formation of the corporate type of investment trust limited main investment objectives only to investment in securities. The 2000 amendment expanded these investment objectives by changing labels: from a securities investment company to just an investment company. But customarily, investment companies investing in securities are still called ‘securities investment companies’ for convenience sake. Examples of these types are those investing mainly in stocks of venture businesses.

The phrase ‘investment companies other than securities investment companies’ is also used as a business custom. It is not a legal terminology as is the case with ‘investment trusts other than securities investment trusts’.
2.2 PUBLICLY OFFERED SECURITIES INVESTMENT TRUST

Although there exists a variety of types of investment trusts currently, the fact is that the publicly offered securities investment trusts remain the Japanese mainstream. Generally, securities investment trusts are classified into two types, depending on how the trust deed sets forth the portfolio structure: one is *stock investment trust type* and the other is *bond investment trust type*. Stock investment trusts are funds invested in stock certificates or equity securities.†

2.2.1 Classification

**Stock Investment Trusts**

**Unit Type** is one that investors may purchase only during the subscription period at the initial launching, since no inflow of funds arises after the subscription period. **Open type** is one which investors are usually may purchase not only during the subscription period but also thereafter.

Up until the 1980s, the unit trust type was the dominant of the two, representing more than 80% of total net assets of stock investment trusts. But after the '90s, its share declined to only about 6% due to the new investment views prevailing in the industry.

Main examples of stock investment trusts are *Exchange Traded Fund (ETF)*, *Monthly Distribution Balanced Fund*, and *Funds of Funds (FOF)*.

The *Exchange Traded Fund* invests in only those stocks that comprise the specific stock index, and its component ratio of each portfolio stock at market prices is designed to correspond to the component ratio of that stock index. It provides a linkage between a fund’s performance and the specific stock index. The beneficiary certificates of the ETF are listed on the stock exchanges. This was introduced in March 2001 in accordance with the recommendation of the ruling parties as one of the urgent economic measures. At present, sixteen ETFs are listed on the Tokyo Stock Exchange and the Osaka Stock Exchange (see Table 2-4).

† Even those funds invested mainly in bonds are classified stock investment trusts when the funds are invested in stocks or equity securities (although the amount of the investments is negligibly small).
Monthly Distribution Balanced Fund is characterized by a balance in managing between stocks and bonds, or by weighing relatively heavily on bonds investment. It distributes profits monthly, and has grown remarkably in recent years.

Funds of Funds invest in other investment trusts or investment companies, which became available through the Association’s self-regulation in 1999. Various FOF such as the life cycle funds for the defined contribution plan and the FOF investing in the REIT has been growing remarkably.

Bond Investment Trusts

The total net assets of bond investment trusts once exceeded those of stock investment trusts. But due to the taxation reasons and the long-lasting low interest rate in Japan, newly established bond investment trusts have decreased. Examples of bond investment trusts are Long-Term Bond Investment Trust, Medium-Term Government Securities Fund, Free Financial Fund, Money Reserve Fund (MRF), and Money Management Fund (MMF).

2.2.2 Investment Management of Publicly Offered Securities Investment Trusts

Generally, securities as investment objectives of the publicly offered investment trusts are those defined by the Securities and Exchange Law. Furthermore, the Association stipulates self-regulation on the permissible investment objectives. Securities include (1) all stocks including subscription right certificates and subscription warrant certificates listed on the stock exchanges and the OTC markets; (2) bonds and debentures such as government bonds, municipal bonds, government-guaranteed bonds, and corporate bonds; and (3) commercial papers, foreign certificates of deposit, beneficiary certificates of loan credit trusts, beneficiary rights of housing loan claims trusts and so forth.

On the other hand, financial instruments include (1) securitized products of which market prices are available, other than those defined as securities by the Securities and Exchange Law; (2) mortgage-backed securities of which market prices are available; (3) money claims; (4) promissory notes other than CPs and discounted bill; (5) beneficiary rights in trusts; (6) interests in anonymous associations; (7) beneficiary rights in money trusts other than those defined as securities by the Securities and Exchange Law, of which purpose is to invest mainly in interests in anonymous associations; (8) deposits, designated money trusts, call
loans, domestic CDs and discounted bills; (9) Real estates; (10) Rights to lease real estates; and (11) right of superificies.

Transactions related to securities investment include (a) utilization of derivatives such as futures and options; (b) utilization of margin transactions; (c) borrowing of stocks; (d) securities lending; (e) bond repurchase transactions; (f) borrowing and short sales of bonds; (g) Japanese type repos, called ‘gensaki’; (h) cash lending; (i) money borrowing; (j) foreign currency forward contracts; and (k) when-issued transactions.

2.2.3 Quantitative Investment Limits

For stocks issued by the same company, the limit is not exceeding 50% of the total number of outstanding stocks of the same issuing company. The quantitative investment limit of securities of investment trusts issued by other management companies is not more than 5% of a fund’s total net assets. In addition, the combined net assets of the single acquired investment trust held by all funds managed by the same investment trust management company may not exceed 50% of the total net assets of the acquired investment trust.

2.2.4 Calculation of Net-Asset Value Per Share

Net-asset value per share of each publicly offered securities investment trust is calculated and made public daily. This value equals the total market value of the trust property per beneficiary certificate, and is determined by dividing the total net assets by the outstanding number of beneficiary certificates. In calculating the net-asset value per share, portfolio securities and other financial instruments held by a fund are valued in accordance with proper and reasonable values. The Investment Trusts Association sets forth the rules for the method of valuation related to portfolio securities and derivatives. Conversion into Japanese yen of foreign currency-denominated assets is made on the basis of the average price of the telegraphic transfer selling and buying spot rate for customers on the day of calculation, in principle, as announced by the Bank of Tokyo-Mitsubishi. For the spot rates not announced by the BOTM, Citibank’s rates are used. For the futures rates, the BOTM’s are used. For those not announced by the BOTM, Goldman Sachs Securities are used.
2.3 FEES AND EXPENSES OF SECURITIES INVESTMENT TRUSTS

2.3.1 Fees Paid Directly by Investors

Sales Charges. Investors pay to distributing companies such as securities companies and banks sales charges when they purchase investment trusts. Sales charges vary from one fund to another.

Generally, many stock investment trusts levy sales charges, while most bond investment trusts do not (called ‘no load funds’). In the case of no load funds, an amount corresponding to sales charges is paid to distributing companies as the agent fee out of the trust remunerations. Also some funds charge no front-end load at the time of purchase, but charge the back-end load at the time of redemption.

Redemption fees are charged to the canceling beneficiaries of investment trusts. Many (but not all) funds have adopted the charging of redemption fee. Redemption fees are calculated by multiplying the net asset value per share on the day of redemption by a certain percentage.

They differ from sales charges in that the fees go to funds, not to distributing companies or investment trust management companies. In this sense, redemption fees benefit remaining investors as they are retained in the trust properties and taken into the consideration for the calculation of net asset value per share.

2.3.2 Fees Born by the Fund and Deducted from Its Assets (Table 2-5)

Trust Remunerations. The annual rate of a trust remuneration is predetermined as a percentage of a fund’s total net assets, and the trust remuneration is deducted daily from a fund’s assets when calculating the net asset value per share. Investment trust management companies receive the trust remuneration for the trustor (i.e. management fee) at each accounting period as the compensation for the management of trust properties. Trust companies (banks) receive the trust remuneration for the trustee at each accounting period as the compensation for the safekeeping and administration of the trust properties. Distributing companies receive the agent fee from the investment trust management companies out of their trust remunerations for the trustors for covering these costs such as the expenses for paying profit distributions and money at redemptions as well as the postages for mailing financial reports.

Transaction costs incurred by transactions of portfolio securities such as brokerage fees are also deducted from a fund’s assets each time they occur.
Miscellaneous expenses such as taxes on fund’s assets, various expenses for handling trust business, interests arising from payments by a trustee instead of a fund and audit fees for a fund’s financial statements are also deducted from fund’s assets. Some funds deduct also preparation costs for disclosure materials.
2.4 BRIEF HISTORY OF INVESTMENT TRUSTS IN JAPAN

In Japan, some funds analogous to the investment trusts existed as early as 1937. These tools took the form of an investment association organized under the Civil Law through the instrumentality of a securities company. The main purpose of this scheme was to invest funds furnished by subscribers in securities and to distribute the profits among their members. However, their similarity to the organization and operation of trust companies, then already functioning, raised some room for doubt on the legitimacy of the association, and they were finally dissolved in 1940.

In 1941, another undertaking satisfying all the requirements of investment trusts and modeling after the British unit trust came into operation. By the following year, five securities companies undertook to manage funds, with each employing trust companies as trustees. Profits accruing on these funds were distributed among its subscribing members. In legal terms, this was a specified money trust, which found its legal ground in the Civil Law, the Trust Law and the Trust Business Law. Although this type of investment trusts had grown steadily, due to confusion following the defeat in World War II, further issuance had to be terminated in August 1945. These were liquidated, but were able to refund money to their member investors in excess of their original investment on average. Thereafter, they wound up business in February 1950.

Publicly offered securities investment trusts of contractual type, the dominant type at present, were first established in 1951. Circumstances which lent support to the establishment of the existing investment trusts date back to April 1948, when the Securities and Exchange Law, modeled after the U.S legal framework of securities transaction, was enacted. At that time, the securities market suffered from a glut of new issues which far exceeded demands caused by the dissolution of ‘Zaibatsu’ (gigantic industrial and financial conglomerates), and the payments of property taxes in kind. Stock prices plummeted and the trading on the stock market dived to its lowest level. A number of business establishments were asphyxiated by great difficulties in raising funds urgently needed for revitalization of operations and reconstruction of production facilities. To address the situation, business sectors concerned and government authorities held repeated discussions to explore the possibility of utilizing the investment trust system in parallel with the policy to popularize securities investment.
These efforts finally bore fruit as the enactment of a special law on investment trust, when the *Securities Investment Trust Law* was put into effect. This new law provided the legal ground for the type of investment trusts now in operation in Japan. Drawing on the experiences which pre-war investment trusts had accumulated, the new investment trusts were of the contractual type.

It is worth mentioned that investment trusts in Japan were established to meet the changing requirements of government policy, and the circumstances leading to their birth were drastically different from those which gave birth to the investment trusts of Europe and the U.S, where they were spontaneous outgrowth of economic development.
2.5 GROWTH AND DEVELOPMENT OF SECURITIES INVESTMENT TRUSTS

The Securities and Investment Trust Law was amended in 1953 to change from a registering system to a licensing system. Prior to the amendment, any company desiring to act as an investment trust management company was permitted to enter the business only by registration to the Ministry of Finance, if it was a stock corporation with capital of over ¥50 million and met certain requirements. This change to the licensing system came from the concern that the Ministry could not refuse the registration, even if the applicant was not qualified. The amendment also empowered the supervisory function of the Ministry.

Japan’s economy came under a recession of serious proportions after 1964. Under the impact, a debilitating dullness hung heavily over the stock market and stock prices plunged into alarming levels. The securities industry had to severe difficulties due to the long stagnant stock market, and one of the leading securities firms went bankrupt. Securities held in the portfolio of securities investment trusts were no exceptions to this precipitous downturn of the market, and the net-asset value of some of the investment trusts fell far short of the original investment, taking a heavy toll of new subscriptions. Adding insult to injury, cancellation figures of existing funds increased, drastically whittling the total net assets of investment trusts.

Facing such distress, the investment trust industry searched relentlessly for remedies to improve the ailing system and the management of individual investment trusts. In November 1966, the Investment Trusts Association came forward with a three-point recommendation that emphasized (1) the establishment of an independent management system for individual management companies; (2) strengthening of self-regulation by the industry; and (3) improvement of the unit type investment trust system.

In a parallel move, the Ministry put the-existing Securities Investment Trust Law through a thorough examination which realized the enactment of the law called Partially Amending the Securities Investment Trust Law in August 1967. This law added, among other things, a provision defining the management company’s fiduciary duties to the beneficiary and a provision relating to the Investment Trusts Association.

Even after the new law enactment, investment trust system has had a number of specific
issues to be improved further. Owing to improvements and the subsequent efforts by concerned sectors, coupled with the upward trend in the stock market, total net assets of securities investment trusts have continued to grow. Particularly, the Medium-Term Government Securities Fund launched in 1980 contributed a great deal to vitalizing the securities investment trust market. The fund’s features such as convenience similar to bank deposit and expectation for higher yield met the needs of wide range of investors. Upward trend of stock prices and expansion of trade volume after 1985 especially accelerated the growth of stock investment trusts as well. Total net assets of securities investment trusts exceeded 50 trillion yen in 1988.

The liberalization and internationalization of the Japanese financial markets made rapid progress. This also meant substantial change of the circumstances surrounding investment trusts. A Study Group on Investment Trusts, which was a private advisory body to the Director General of the Securities Bureau of the Ministry of Finance, was formed in October 1988 to review a wide range of issues on investment trusts, including arguments of new entries into the investment trust business. The Group submitted a recommendation in the next year which focused on various needs such as the need to (1) further diversify the products; (2) introduce measures into unit-type investment trusts for stabilizing the size of the fund throughout the entire trust term; (3) improve the disclosure requirements; (4) augment the independence of investment trust management companies; (5) allow qualified domestic and foreign companies entry into the investment trust management business.

Based on these recommendations, the investment trusts industry implemented a variety of improvements related to the investment trust system. The Ministry announced the Guidelines for Licensing Investment Trust Management Companies in December 1989, making clear interpretation on related laws and regulations, with foresight, to the new entry by foreign and domestic companies. The Guideline made it possible for foreign affiliated investment management companies to enter into the investment trust business in Japan. As a result, five foreign affiliated investment trust management companies have received licenses and have started their business.

The Ministry relaxed the Guideline in April 1992 and six bank affiliated investment trust companies and one life insurance company affiliated investment trust management company were established by domestic investment advisory companies as sponsors. Moreover,
discretionary investment advisory companies were permitted in January 1995 to concurrently engage in the investment trust management business by obtaining the license of an investment trust management company. In accordance with this, thirteen foreign affiliated companies, three domestic bank affiliated companies, two domestic insurance affiliated companies entered the investment trust business.

Further in 1996, investment trust management companies were permitted to share directors, personnel and offices with the investment advisory companies, as far as these companies are established by foreign investment advisory companies which entered Japanese markets in the form of branches. Two foreign affiliated companies obtained licenses according this new measure.

**Features of Recent Development**

After total net assets of investment trust reached a record high of ¥58.6 trillion at the end of December 1989, the figure decreased considerably, compounded by the net outflow of money and the devaluation of portfolio stocks. This was caused by the stagnant stock market after the burst of the bubble economy since 1990. As the market remained sluggish, the government took reform measures in 1995 to relax regulations and toughen disclosure requirements, and carried out a sweeping amendment of basic law in December 1998 and November 2000. These reform measures are often referred to as the “Big Bang” of Japanese investment trust system.

The 1998 amendment was designed to make the law consistent with the *Financial Systems Reform Law* that was enforced the same year. The number of articles of the amended law increased sevenfold, and its name was changed to *The Law Concerning Securities Investment Trusts and Securities Investment Corporations*. By this amendment, entering into an investment trust of the company type was authorized, in addition to the investment trust of the contractual type. It also increased the channels of distribution of their beneficiary certificates, which is the over-the-counter sale of investment trusts certificates by banking institutions. The amendment further authorized investment trust management companies to commission other institutions to instruct the investment of their assets.

In December 1999, Financial System Council set up by the Ministry announced the study results and recommendations on the legislative framework of the financial system for 21st...
The Council categorized Collective Investment Schemes into two types: (1) asset securitization and (2) asset management. The former is a scheme under which the specified assets are securitized and separated from a corporation. The latter is a scheme under which funds from public investors are pooled and invested in various assets by professional fund managers, and the income generated from the investment management of funds are shared by investors.

The Ministry submitted the bill to revise the Law along the line with the recommendations to the Diet, thereafter it was passed in May 2000. The Law was renamed the *Law for Investment Trusts and Investment Companies*, namely it deleted the word “Securities.”

This amendment was part of a government program to streamline related laws as a step preliminary to the enactment of a *Financial Service Law*. By virtue of this amendment, the targets of investments were extended beyond securities and the way for introduction of the real estate investment trust was paved. Also, the system of investment trust of the new contractual type was established, under which trust banks are authorized to collect funds for their own investing purpose and invest them in assets without going through investment trust management companies. Fiduciary duty of a diligent manager, namely a duty of a manager to carry out instructions for the investment of investment trust assets with care as a good fiduciary to the beneficiaries, was added to the Code of Conduct.
2.6 LATE FINANCIAL BIG BANG AND INVESTMENT TRUSTS BUSINESS

In sum, the principal objective of the Big Bang was to shift Japanese financial system to a more direct financing system utilizing markets from the indirect system on banks’ arms. The Big Bang can be divided into two terms, namely from the declaration of the Big Bang in 1996 to mini crash of IT bubble economy in 2000 as the first term, and from more concrete and comprehensive reforms launched in 2001 to today as the late term. Although the stock market had slumped because of several adverse events such as the economic stagnation occurred in 2000 after the burst of the IT bubble, the 9/11 terrorists attacks on the U.S and the U.S. invasion of Iraq in 2003, it has been regaining a forward momentum since mid-2003.

In August 2001, the Financial Services Agency (FSA) issued a policy statement entitled *Program for Structural Reform of Securities Markets: Toward the Creation of Securities Market Wherein Individual Investors Play a Major Role.* The program aimed to carry out structural reforms in the securities market to encourage a wide range of investors and promote market deepening through direct financing. It likewise called for the removal of factors impeding the participation of individual investors and the institutionalization of factors encouraging individual investor participation.

Furthermore in August 2002, the FSA issued a policy statement entitled *Program for Promoting the Reform of Securities Markets.* This program was anchored on the view that it is necessary to build a financial system that encourages a shift to direct financing, and to establish efficient and competitive securities markets supportive of a vital economy.

The FSA has carried out a series of reform measures. It introduced the minimum capital requirement for establishing a securities firm, defined the role of principal shareholders, introduced a sale agency system, changed the system of discretionary trading account transactions, instituted provisions encouraging small investment, authorized the opening of joint branches by banks and securities firms, and has taken steps to improve the securities settlement system.
2.7 THE CURRENT CONDITION OF MUTUAL FUND INVESTMENT

In Japan, the 1951 Securities Investment Trust Law laid out the basic structure of mutual fund investment. For the next half a century, mutual fund investment meant securities investment trusts. With the revision of the law in 2000, real estate and other items came to be included as part of investment instruments, but although the word investment trust is now used, it is still the case that securities investment trusts account for the dominant proportion. The investment trust system has undergone numerous reforms in the past 50 years and the “Big Bang” reform is again especially significant.

Investment trusts are large-scale financial products with a balance of about 54 trillion yen, over 4000 deals and a wide range of characteristics. The most common type of product is the publicly offered contractual type, which accounts for more than 70% of trusts. Within this type, more than half are securities investment trusts. However, privately offered trusts and some new types of product have been increasing in recent years. Households hold approximately 60% of investment trusts. This is a product targeting individuals and has much recognition as a financial product, but it accounts for only 2% of the overall financial assets held by individuals.

In the past, only securities companies could sell investment trusts. In 1993 direct sales by consignment companies, and (in 1998) over-the-counter sales by financial institutions were legalized. Financial institutions that were given the green light for over-the-counter sales in 1998 quickly increased their share of sales and now account for more than 30% of sales of publicly offered investment trusts. This trend is especially notable for stock investment trusts. Financial institutions now account for 45% of sales, catching up with securities companies. However, though the periodic distribution type is categorized as a stock investment trust, it is, in effect, a foreign bond investment trust. The combined share of publicly and privately offered trusts by financial institutions is 40%, out of which stock investment trusts account for 51%. Internet transactions increased in 2000, stayed about the same for the next three years, then started to increase rapidly from 2003. On the other hand, sales by consignment companies are on the decline (Table 2-6). Although efforts were made to increase sales through direct sales, the result has not been as good as was hoped for. Looking at the situation from another angle, it can be said that the demand for this route of sales is decreasing relative to the period before it was legalized due to the fact that sales through
financial institutions, which are the sales arms of consignment companies, and through the
Internet have increased.

Although various measures have been implemented in the field of system reform (i.e.
diversification of products, expansion of sales routes, etc.), sales of investment trusts have not
increased in any considerable way. By international comparison, from the end of 1998 to the
end of 2003, net assets of investment trusts increased by 1.3% in the United States, 1.4% in
the United Kingdom, by 1.8% in France, by 1.5% in Germany, whereas the figure was 0.9%
in Japan. Looking at the balance of investment trusts at the end of March 2004, the United
States had the highest balance, followed by France, Luxembourg, Australia, Italy and the
United Kingdom. Japan was in 9th place with one twentieth of the United States (see Table
2-5). In comparison with the size of its economy and finance, Japan’s investment trust
balance is very small in international terms. In the last few years, sales of investment trust
have flattened out. Although net assets of publicly offered investment trusts are recovering,
growth is still weak and less than the peak level by over 30 percent (Table 2-6).

Another observable trend is the rapid increase of privately offered investment trusts. Sales
increased directly after the introduction of privately offered investment trusts in 1998, but the
upward trend has clearly risen steeply since 2000. The total of net assets increased by seven
times in the last five years and the number of deals grew 6 times (Table 2-8). Sales routes
targeting individuals have increased, and maturing of privately offered trusts has met the
needs of institutional investors and corporate investors to a considerable degree.
2.8 INDIVIDUAL CONSUMERS AND SECURITIES INVESTMENT

Individual investors, which accounts for half of investment trust holdings, are not very familiar with securities investment. The weight of securities in households’ asset portfolio is still relatively low at about 14 percent, and only about 3 percent of households own investment trusts. Historically, Japanese have invested very little in securities, but in the late 1980s during the bubble years, 22.3% of the financial assets of individuals consisted of securities, which closely matched the figure in the United States. At that time, about 5% of households owned investment trusts.

Looking at the trends of individuals’ financial asset holdings since then, the weight of securities has halved while insurance grew by more than 1.5 times (Table 2-9). This implies current fewer tendencies to invest based on one’s own judgment while extra long-term savings-type indirect management, which depends on third parties, has increased. It is true, on the other hand, that it was extremely difficult to achieve a return worth the risks from the 90s onwards, what with the low performance of the stock market and extremely low interest rates. It was logical to invest assets in low-risk instruments, such as savings, even if they yielded low returns. The figures indicate that consumers chose no-risk, low return instead of high-risk, high-loss rate asset management.

The reason behind the low interest for securities is not only because of the system. In Japan, there was very high confidence and dependency in the Japanese style indirect financing where financial intermediaries carried the burden temporarily but was borne by the government in the end. This and the dismal performance of direct financial markets were major reasons.

Investment trust sales have been increasing recently. The popular types of trusts are those with diversified investment with the major portion being sovereign bonds of major countries and distributing profits regularly; those that invest partly in bonds with high credit ratings, short-term instruments, etc. to secure stable outcome and the rest in options and indexes; and those that guarantee a minimum capital return.

Since the mid 90s, the key element in making a choice about savings and investment is safety, and concern for profitability is declining. There is some fluctuation in the concern for
liquidity but it is, on average, about 30 percent.

There was a time, in the mid 80s, when there was a sudden high premium for profitability. Even in more recent years, around 2001, profitability became the focus while safety standards were deteriorating. These two periods coincide with the stock market boom of the bubble years and the high stock prices of the Internet and IT boom years. It is clear that there is a correlation between the savings and investment priorities of individuals and market tendencies --- if the market is bullish, then priority for profitability rises while interest in safety declines. In view of the fact that there has not been much success in raising interest in market investment although various infrastructure improvements have been made in the past, it is clear that attraction of investment trusts, especially stock investment trusts, depends a lot on the situation in the stock market.

The other important aspect is knowledge about investment. Individuals tend to think that they possess only a limited knowledge, if any, of finance and economics. Some feel they have some knowledge about deposits, insurance and related products, but more than 70% feel that they hardly have any about securities. When the overall economy is doing well and the performance of the stock market is high, an individual can achieve reasonable results even by making unstudied decisions and simply passively following the flow of the environment. But when the market is truly volatile and increasingly lacking in transparency, accurate and broad knowledge are necessary in making balanced and informed choices. In this regard, focusing on the concept of the financial consumer and spreading basic investment knowledge related to that concept seem a timely and reasonable idea.

Figures in Table 2-10 closely reflect where Japan stands in international comparison. It is well known that securities and investment trust holding ratios are very high in the United States. But even compared to Britain or to Germany, where previously lack of securities market development was pointed out, securities holdings by Japanese individuals are very low.
2.9 AN EVALUATION OF SOME SALIENT ASPECTS OF THE COLLECTIVE INVESTMENT BUSINESS IN JAPAN

2.9.1 Causes of the Limited Growth of Investment Trusts

Due to the streamlining of system infrastructure and deregulation, investment trusts targeting corporations and institutional investors have grown considerably, especially the privately offered trusts. This is because privately offered trusts are lower in cost and disclosure is simpler, compared to publicly offered trusts. However, privately offered corporate type trusts are still rare. This invites the conclusion that the setback lies in the trusts aimed at individual investors.

(a) Key Problems with regard to Institutional System

The biggest problem with regard to institutional system is the disclosure of publicly offered investment trusts. Disclosure on investment trust issuance was made in the beneficiary certificate catalogue in accordance with the Investment Trust Law before the application of the 1998 Investment Trust Law. Its enforcement made it obligatory to provide securities notification in accordance with the Securities and Exchange Law, a prospectus in advance or at the time of transaction, and audit by public accountants. The new arrangement contributes to the transparency of the products but at the same time, increases the maintenance and management cost per fund. Consequently, consignment companies prematurely redeemed small-scale funds and others that had low profitability before the end of 2000 when the grace period to move to the new system ended.

Continuous disclosure is carried out on a double-track of distributing the management report to beneficiaries in accordance with the Investment Trust Law and making the securities report available in accordance with the Securities and Exchange Law.

Disclosure on investment trust has been quite complicated, time- and cost-consuming. Furthermore, thick and highly detailed prospectuses contained information that was mostly understandable for general investors. Most investors simply did not read them. Since April 2001, distribution of prospectuses and management reports through the Internet and other IT methods became legal. However, information was not provided in a user-friendly way and the process had to be simplified later.

Some improvements were made to prospectuses in 2002, such as clarifying the disclosure
items, encouraging the use of words that were easy to understand and using charts and figures. However, basic difficulties still existed such as the fact that prospectuses were 80 to 100 pages long and considerable patience and effort were necessary to read the documents through on a computer screen. It took much time and cost to print it all out on a home-use printer. Also, prospectuses have to be distributed to existing investors and individual distribution is necessary even if there is more than one investor in the same household, and a complete summary of the information in a prospectus has to be included in sales information materials. All this led to cumbersomeness and inefficiency.

Simplification measures regarding disclosure were taken in December 2004. Prospectuses were split into two versions, one that must be distributed before or after transaction and one that is distributed on demand of investors. An exemption was made from the obligation of duplicate issuance with the condition of agreeing to non-issuance. Description of sales material was made less rigid by stating that it “may not use expressions that are false or invite misunderstanding” instead of “may not use expressions that falsify, contradict or omit the contents of prospectus.” However, instead of these changes producing simplified administration, it not only failed to produce its intended contribution; in some cases, it even increased labor and cost burdens. Deregulation concerning prospectuses at the end of 2004 forced a large-scale system reform in order to administer the distribution of on-demand prospectuses to investors. Delivered prospectuses and on-demand prospectuses were allowed combined publication. However, such publication meant that there were many duplications and producing the material became more cumbersome. In the end, the deregulation increased costs.

Even though considerable improvements and simplifications have been made, the system is still not user-friendly. For example, even though prospectuses were divided into two categories, so long as there is the distribution half, there is not much difference from the compliance perspective, and combined publication seems to require more labor and cost than under the previous arrangement. The increased cost will have to be ultimately carried by investors. The issuing disclosure under the Securities and Exchange Law assumes a specific offering time frame and is alien to the open-ended type of investment trust. In the case of a fund of funds, funds used in the scheme have different maturities. In addition, it is difficult to calculate the number of funds and related costs.
In any case, there should be a difference in the way disclosures are made between stocks and bonds on one hand and investment trusts on the other. This is because stocks are market based, direct financing product, and bonds are securities in the traditional sense under the Securities and Exchange Law, whereas an investment trusts is a market based, indirect financing product under group investment scheme.

Furthermore, even though this may seem a technical issue, price evaluation of some specified assets is also a problem. There is a rule based on the Investment Trust Law that directs a consignment company to employ such specialists as lawyers, accountants and real estate appraisers when specified assets that are not securities listed at the exchange are acquired or transferred. This rule, in effect, is restricting investment trust operations as it makes it more difficult to invest in securitized products such as trust beneficiary rights.

(b) Factors Obstructing the Incentives of Intermediaries

When there are factors that obstruct the incentives of consignment companies or sales companies (mainly securities companies and banks), which assume the responsibility of structuring and selling investment funds, they will restrict the growth of investment funds.

Currently, costs related to accounting administration, system costs of trust management and network for sales companies and outsourcing are burdensome, thereby limiting the establishment of investment trust companies. There is also extra labor and cost involved as both consignment companies and the trustees have to calculate standard prices. Apparently, one of the reasons why the number of ETFs is not increasing is because fees for index funds are higher and there is relatively little incentive in terms of profitability to deal in ETFs.

As regards corporate type investment trusts of securities, inhibiting factors include cumbersome procedures, high cost involved in establishing an investment company and the costs involved in maintaining the governance system needed to manage the company (investors general meeting). There are also more basic questions as to the absolute superiority of corporate style investment trusts.

(c) The Question of Performance

The overall performance of investment trusts, especially stock investment trusts, since the 90s has not been commendable. Since there is not enough data to make an accurate comparison
the picture is murky, but it seems the outcome of active investment trust operation was not as good as that of index investment trust operation. Since stocks and bonds (which are the raw materials of investment trusts), were influenced by the sluggish stock market and low interest rates, it would have been difficult to expect high performance in the overall investment trust business. However, investors are paying a premium to take advantage of the asset mix structured by professionals, and they must humbly accept customers’ dissatisfaction with lower than index performance.

Indices to measure the performance of investment trust funds have not been developed. Comprehensively compiled historical data that can be viewed easily is lacking. A tool to verify the comparison between the present and the past has not been developed satisfactorily. This is not just inconvenient but also creates a problem in trying to understand how well investment trusts are performing. As can be seen in the recent popularity of alternative investments, Japanese individual investors tend to regard performance as more important than benchmarks. This may also have had a delaying effect on the development of operational indices.

(d) Distribution System and Approach

There is a clear division of labor between consignment companies (which deal with operation) and sales companies (securities companies) with regard to the contractual type of trusts, which are the main stream of investment trusts in Japan. This is aimed at ensuring transparency of operation and avoiding the conflict of interest that could occur by combining structuring and sales. However, consignment companies have historically been subsidiaries of securities companies dealing in sales, and this organizational framework has sometimes invited contradictions. When there was friction between the parent securities company (which wants to give priority to sales) and the subsidiary (a consignment company), which focuses on medium to long-term operations, the interest of the former tended to take precedence. Under these circumstances, it is undeniable that inadequate explanations by sales companies, a sales approach that used short-term carry-over, and the loss incurred by customers, presumably as a result of such actions, have resulted in a sense that there is a lack of transparency in the investment trust business as a whole. However, these problems have been much reduced by regulating the dealings between consignment and securities companies, strengthening compliance procedures, a shift of focus in sales to place more emphasis on the profit for customers, etc.
Investors, on the other hand, had a tendency to purchase products without adequate knowledge, such as assuming that MMF guaranteed initial capital and misunderstanding the nature of investment trusts that included derivatives. There seem to be not a few cases where investors do not even read the prospectus --- granted that it has the kind of problems that have been pointed out ---- although it is the source of basic information about the product. There are other problems, such as the mindset that all is well as long as the standard price is good or the yield for a period rises and the failure to see investment trusts in the framework of the overall situation of the markets.

The rapidly increasing participation of financial institutions in the dealing of investment trusts should also be studied. In view of the fact that the market size of investment trusts is still way smaller than what it was at its peak and that there is imbalance in the sales of one product to another, fluctuation of sales by varying institutions seems only to be just a competition for a bigger share of the same pie. The aim of allowing more institutions to join in the trusts market was to increase the size of the market but the current situation falls short of expectation. It is necessary to put more effort into creating more demand and to spread the market base.

(e) Investors’ Lack of Knowledge and the Tendency to Choose Safety

As Chart 2-15 shows, investors’ lack of knowledge about investment trusts seems to be a reason for their passivity toward the product. General investors are possibly alienated by the huge number of publicly offered investment trusts and by the range of characteristics of those products. Prospectuses are thick and difficult to read, and most investors do not have even the basic knowledge about stocks and bonds, let alone about derivatives. It is also possible that although risk factors are explained to them, not enough financial literacy has been developed for them to make a judgment on their own. Another factor that is making investment trusts unattractive to investors could be that historically, there has not been enough understanding of the basic function about the organizational division between operation, management and sales of the contractual type of investment trusts.

The other reasons are the absence of capital guarantee and price fluctuation. From these numbers it is clear that individual investors in Japan have a very strong tendency to safety and hardly have the approach of aiming for adequate return with the risk profile in view. However, it must not be forgotten that the bullish market was behind the rapid increase of
investment trust sales in the 80s. Between 1980 and 1989, the net assets of investment trusts increased nine-fold from ¥6 trillion to ¥58 trillion, out of which stock investment trusts shot up from ¥4 trillion to ¥45 trillion, an increase of 11 times. The total market price of listed stocks increased 8 times from ¥80 trillion to ¥630 trillion in the same period. It is true that Japanese individual investors have been risk averse for the last ten years or so, but in view of the relationship between the market tendency and investors’ prioritization, it is a priori to conclude the underlining factor to be the wish for capital guarantee.

Since the beginning of 2000, foreign denominated assets as a ratio of individuals’ financial assets have been on the rise. Between 2000 and 2004, foreign denominated financial assets doubled, and foreign denominated investment trusts increased by 50 percent. This is partly a reflection of low domestic interest rates and the low performance of stock markets, but is likely to be also evidence of increasing accessibility to foreign markets for individuals and their pursuit of better interest rates on both domestic and international markets and their readiness to accept assets involving risks.

2.9.2 Measures to Stimulate Interest in Investment Trusts

Several measures concerning structure and operational procedures can be taken to develop investment trusts further, and especially to increase interest among individual investors. Many of them are extensions of the various methods taken so far.

Many of the issues related to the system have been dealt with. Evidence of this progress is the fact that more than 30% of the existing total net assets of investment trusts is accounted for by privately offered investment trusts, ETFs, J-REITs, and corporate type investment trusts, all of which were introduced after the 1998 reform. There are still unresolved issues concerning the system and it must be remembered that there are substantive problems that have been alluded to over the years and yet have not been solved, which indicates the difficulty of the problems.

Measures to be taken concerning the Structure

The most important issue regarding the system is disclosure. In order to develop an accurate understanding of investment trusts, it is necessary to re-examine the basic concept of investment trust disclosure. There is no disagreement that detailed and accurate information disclosure is important but the means of disclosure is the issue. If there is an attitude of
producing a voluminous prospectus as a result of pursuing legal accuracy and being content by the fact of distribution, necessary information will not reach the investors. This will be against the spirit of the system. The same problem exists for operational reports. According to a study done by the Investment Trust Association, 53% of the researched investors of investment trusts replied that they had not read the operational report in 2004. In addition, 34% answered that although they read the report they could not understand it well. This means that operational reports are meaningless for nearly 90% of investors. Some operational reports exceed 200 pages because for a fund of funds, all securities holdings within more than 20 funds in which a fund of funds invests in have to be disclosed.

In addition, if excessive importance is attached to the accuracy of detailed points, time, labor and cost will be overwhelming, and will kill the incentives of the intermediaries, as well as result in higher investment costs. The costs are worthwhile if investors read the prospectus, but the reality is otherwise (Chart 2-17). In the past, efforts have been made to disclose information accurately, quickly and in detail but in a way that is understandable and investor-friendly so as to meet the presupposed self-discipline rule of investors. However, the pursuit of detail and accuracy basically contradict the pursuit of easiness with which general investors can understand. The same problem regarding disclosure is experienced in the United States, and although various measures have been tried, there is an inevitable sense of self-contradiction.

Consequently, it seems necessary to change the thinking on disclosure for investment trusts and examine a completely new way of disclosure (perhaps semi-disclosure) by focusing on the unique characteristics of a market oriented indirect financing instrument.

It will be valuable to consider indirect disclosure or its substitution instead of direct disclosure, which is applied under the current Securities and Exchange Law to corporate type securities incorporated into investment trusts, since investment trusts use schemes with other vehicles as intermediaries. For example, a neutral investment trust evaluation organization could be established along with the existing rating companies (or developed out of existing organizations), and in the case of publicly offered investment trusts, evaluation on their investment worthiness by multiple organizations could substitute for detailed and lengthy direct disclosure. This will mean that detailed disclosure based on such laws as the Securities Exchange Law and Investment Trust Law will be made by operating companies to these
evaluation organizations (which will result in considerable disclosure), and investors will use the assessment provided by multiple evaluation companies as their investment material. The evaluation companies will take over the responsibility of disclosure on publicly offered investment trusts vis-à-vis investors. If in this case, such a disclosure process is used in parallel with the traditional direct disclosure to investors as final assurance, there will again be the problem of duplication which should be avoided while considering genuine investor protection and fair treatment.

Under the new disclosure scheme, the responsibility for inaccurate direct disclosure will rest initially between operating companies and evaluation organizations. It is necessary to determine the legal aspects of the powers and responsibilities of evaluation companies, the responsibility of such companies towards investors, civil responsibility for compensation, how to evaluate losses, and the burden of proof in such instances. Regulations concerning sales and soliciting should be dealt with separately.

Along with the prospectus, the necessity for financial reports, which are produced under the current Securities and Exchange Law, should be reviewed as well. They are important from the auditing point of view but have the same problems as the prospectus from the point of view of disclosing the content of management. Continued disclosure should be consolidated with the management report, which is required by the Investment Trust Law. When consolidating the disclosure of trust management into management reports, there should be an additional consideration to simplify and make them easier to read. Perhaps the way to deal in the future with the disclosure of investment trusts, which are market oriented indirect financial products, is to have it covered under the Financial Services Law.

2.9.3 Coping with Problems on Operational Procedures

Problems related to operational procedures are inhibiting individual investors from being more interested in investment trusts. Various issues related to the operation, information and sales of investment trusts, such as those discussed must be tackled along with reforms in the system aspect.

Promoting the Accumulation of Data on Performances

Currently, there is not enough data accumulated on the track record or performances that
could be used by investors for investment judgment. This should be corrected as soon as possible. The Investment Trust Association should further intensify its information dissemination work. Another area to look at is the use of the Internet, which has become common among individual investors. From the autumn of 2000 to the spring of 2003, purchase of investment trusts through the Internet was about 3% of the total commissioned underwriting. But the share has shown rapid increase since then, and for the first half of 2004, it has risen to 11.3%. This indicates that the websites related to investment trusts must be well structured.

Investors’ relations (IR) activities run by securities companies are a good source of reference to improve information output on investment trusts. It is also important for operating companies to be active in IR efforts at least concerning investment trusts that are targeted towards individuals.

**Strengthening the Operating Capabilities of Management Companies**

Improvement of performances by management companies is a prerequisite for investment trusts to develop in numbers and to become more popular. Unless management capabilities are enhanced, improvements made to the structure and practical procedures will not be effective. It is not certain whether Japanese investors are completely risk averse, as mentioned above. If a befitting return can be expected there, they are likely to take the necessary risk. It is not too much to say that the low level of activity in the investment trust market after the burst of the economy can be attributed to the miserable operation outcome. Well performing investment trusts can easily expand their sales when matched with improvement in information disclosure and reassessment of evaluation standards.

**Diversification of Products**

Investment trust products have diversified in recent years but the following two things need to be considered in the future.

First is the development and improvement of investment trusts suited for life plans of individual customers. The labor market is now much more liquid with the population aging rapidly and with the matrimonial age becoming higher, the pension system is changing and the Japanese are forced to be more self-responsible in planning their life. Although American style personal financial planning (PFP) cannot be applied directly due to differences in the
two societies, such as the tax system, the notion of PFP should be adopted urgently. Investment trust business should consider how to provide products that meet the criteria of PFP. Such a development may also help increase interest in investment trusts.

Some of the products that can be developed are extra-long-term investment trusts that cope with the changing stages of life, medium to long-term trusts aiming at asset accumulation for retirement, and at securing education funds for children. There do exist investment trusts that deal with such objectives, but products that meet such individual necessities will increase in the future. Product development to match the changing needs of the time must come hand in hand with diversification of operation and advancement of operational methods.

The second issue is coping with globalization. There have been a number of investment trusts that invest in overseas securities but recent high interest in emerging investment trusts and BRICs (Brazil, Russia, India, China) investment trusts indicate an increasing tendency of Japanese investors to pursue higher returns. Globalization has a considerable impact on the operational management of individual assets, which amount to 1400 trillion yen, as well as on portfolio diversification. Due to the shrinkage of overseas operation of Japanese institutions since the 90s, they are unable to cope adequately with such new developments. The management companies will have to strengthen cooperation with foreign companies with a strong record if they are to take advantage of globalization as well as to further improve their own operational regime.

**Education to Promote Investment Trusts**

The biggest reason why individuals are not acquainted with investment trusts is the lack of knowledge, which means that education is crucial to spread an accurate understanding of investment trusts. The Financial Services Agency, the Bank of Japan, various federations of securities companies, and major securities companies have been providing extensive and coordinated investor education, mainly on stocks. As regards investment trusts, the Investment Trust Association and individual securities companies have been active in educating and enlightening investors. However, because investment trusts are more complicated than stocks, the spread of knowledge on the subject has been relatively slow. Institutions, especially those financial institutions that have succeeded in winning a major share of sales, should be seriously involved in investor education.
Possible Contribution of Investment Trusts to Pension Schemes

The development of pension schemes has contributed to the increase in investment trust transactions in the United States. The overall economic performance has been positive and the stock and bond markets have been firm, and with the baby boomers (which account for 30% of the population) now preparing for retirement, 401Ks and IRAs have increased their balance by investing into mutual funds. Mutual funds, which are owned by employer-sponsored 401Ks and IRAs, amount to 2.5 trillion yen and account for 35% of the total mutual fund balance.

Diversification of products occurred in the United States in the 90s, and in Japan, with the reform of the corporate pension system, fixed contribution type pensions were introduced. There are still many parts of the system that can be improved and although the total value of pensions had not been increasing rapidly, it has picked up speed with deregulation in recent years.

With increasing emphasis on individual responsibility with one’s life plan, demands for product diversification will surely strengthen with pensions. Subscribers to a corporate type of fixed contribution pension at the end of November 2004 were more than 1.02 million and the number of participating corporations was 3,300. Subscribers to the individual type of fixed contribution pension were 370 thousand at about the same point in time. The upper limit of corporate contribution per year is 276 thousand yen, about one fifth of that in the United States. Deregulation, including an increase in the limit, is necessary.

The pension system, especially organizing and developing fixed contribution type pensions, which demand individual investment judgment, is the key to expanding the investment trust market.
Figure 2-1. Types of Funds

- Open-end type
  - Contractual type (investment trust)
  - Public offering
  - Investment trust managed by investment trust
  - Investment trust managed by trustee
  - Investment trust other than securities

- Closed-end type
  - Same as publicly offered

Figure 2-2. Investment Trusts Managed by Investment Trust Company

- Investors/Beneficiaries
  - Investor
    - Trust Agreement
      - Distributor Companies
        - Trust Agreement
          - Trust Agreement

- Main Investment Objects
  - Real Estates
  - Beneficiary rights in trusts etc.

※In some cases, trust banks sell the trust managed type as a registered financial institution.
Figure 2-3. Investment Trusts Managed by Trustee

Table 2-4. Types of Indices of the ETF

<table>
<thead>
<tr>
<th>Type of Indices</th>
<th>Number of ETF</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Tokyo Stock Exchange</td>
</tr>
<tr>
<td>Nikkei 224</td>
<td>2</td>
</tr>
<tr>
<td>Nikkei 300</td>
<td>1</td>
</tr>
<tr>
<td>TOPIX</td>
<td>3</td>
</tr>
<tr>
<td>TOPIX Core 30</td>
<td>2</td>
</tr>
<tr>
<td>TOPIX Electric Appliance Equipment Index</td>
<td>2</td>
</tr>
<tr>
<td>TOPIX Transportation Equipment Index</td>
<td>2</td>
</tr>
<tr>
<td>TOPIX Bank Index</td>
<td>2</td>
</tr>
</tbody>
</table>
Table 2-5. Balance of Investment Trusts in the Top 10 Trust Holding Countries  
(end of December 2004)

<table>
<thead>
<tr>
<th>Country</th>
<th>Balance($bn)</th>
<th>Country</th>
<th>Balance($bn)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 United States</td>
<td>8,106</td>
<td>6 United Kingdom</td>
<td>492</td>
</tr>
<tr>
<td>2 Luxembourg</td>
<td>1,396</td>
<td>7 Ireland</td>
<td>467</td>
</tr>
<tr>
<td>3 France</td>
<td>1,370</td>
<td>8 Canada</td>
<td>413</td>
</tr>
<tr>
<td>4 Australia</td>
<td>635</td>
<td>9 Japan</td>
<td>399</td>
</tr>
<tr>
<td>5 Italy</td>
<td>511</td>
<td>10 Hong Kong</td>
<td>344</td>
</tr>
</tbody>
</table>

Source: Investment Trust Association

Table 2-6. Changes in the Net Asset Balance of Publicly Offered  
Securities Investment Trust (unit: million yen)

<table>
<thead>
<tr>
<th>End of Year</th>
<th>Stock Investment Trust</th>
<th>Public and Corporate Bond Investment Trust</th>
<th>MMF</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>4,029,252</td>
<td>2,022,659</td>
<td>-----</td>
<td>6,051,911</td>
</tr>
<tr>
<td>1981</td>
<td>4,006,258</td>
<td>3,223,140</td>
<td>-----</td>
<td>7,229,398</td>
</tr>
<tr>
<td>1985</td>
<td>10,378,692</td>
<td>9,593,552</td>
<td>-----</td>
<td>19,972,244</td>
</tr>
<tr>
<td>1989</td>
<td>45,549,417</td>
<td>13,099,856</td>
<td>-----</td>
<td>58,649,273</td>
</tr>
<tr>
<td>1990</td>
<td>35,072,210</td>
<td>10,921,751</td>
<td>-----</td>
<td>45,991,961</td>
</tr>
<tr>
<td>2000</td>
<td>14,610,532</td>
<td>23,817,597</td>
<td>10,971,097</td>
<td>49,399,222</td>
</tr>
<tr>
<td>2001</td>
<td>14,905,433</td>
<td>22,652,436</td>
<td>7,772,870</td>
<td>45,280,739</td>
</tr>
<tr>
<td>2002</td>
<td>16,372,841</td>
<td>14,121,634</td>
<td>5,521,559</td>
<td>36,016,038</td>
</tr>
<tr>
<td>2003</td>
<td>21,339,300</td>
<td>11,746,134</td>
<td>4,350,222</td>
<td>37,435,656</td>
</tr>
<tr>
<td>2004</td>
<td>27,435,268</td>
<td>9,955,276</td>
<td>3,606,208</td>
<td>40,996,752</td>
</tr>
<tr>
<td>2005(Nov.)</td>
<td>38,381,375</td>
<td>10,970,068</td>
<td>3,061,859</td>
<td>52,413,302</td>
</tr>
</tbody>
</table>

Source: Compiled from the Investment Trust Association Data
Table 2-7. Net Asset Balance of Contractual form of Publicly Offered Investment Trust  
(unit: yen in 100 million)

<table>
<thead>
<tr>
<th>Year and month</th>
<th>Securities companies</th>
<th>Banks and others</th>
<th>Direct sales</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Amount</td>
<td>%</td>
<td>Amount</td>
<td>%</td>
</tr>
<tr>
<td>1998.12</td>
<td>409,370</td>
<td>95.8</td>
<td>1,993</td>
<td>0.5</td>
</tr>
<tr>
<td>1999.12</td>
<td>463,769</td>
<td>90.4</td>
<td>27,965</td>
<td>5.4</td>
</tr>
<tr>
<td>2000.12</td>
<td>424,561</td>
<td>85.9</td>
<td>54,196</td>
<td>11.0</td>
</tr>
<tr>
<td>2001.12</td>
<td>363,074</td>
<td>80.2</td>
<td>77,371</td>
<td>17.1</td>
</tr>
<tr>
<td>2002.12</td>
<td>277,061</td>
<td>76.9</td>
<td>77,601</td>
<td>21.6</td>
</tr>
<tr>
<td>2003.12</td>
<td>269,596</td>
<td>72.0</td>
<td>102,372</td>
<td>27.4</td>
</tr>
<tr>
<td>2004.12</td>
<td>267,972</td>
<td>65.4</td>
<td>138,793</td>
<td>33.8</td>
</tr>
<tr>
<td>2005.11</td>
<td>321,772</td>
<td>61.4</td>
<td>199,087</td>
<td>38.0</td>
</tr>
</tbody>
</table>

*1. All data for publicly offered investment trusts and do not include privately offered ones.  
*2. Direct sales of publicly offered investment trusts for December 1998 include MMF.  
Source: Investment Trust Association

Table 2-8. Balance of Net Asset Balance and the Number of Deals of Privately Offered  
Securities Investment Trusts (unit: yen in 100 million / no. of deals)

<table>
<thead>
<tr>
<th>At the End of Year</th>
<th>Stock Trusts</th>
<th>Investment Trusts</th>
<th>Public and Bond Investment Trusts</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Net Assets</td>
<td>No. of Deals</td>
<td>Net Assets</td>
<td>No. of Deals</td>
</tr>
<tr>
<td>1999</td>
<td>12,408</td>
<td>74</td>
<td>3,072</td>
<td>22</td>
</tr>
<tr>
<td>2000</td>
<td>31,856</td>
<td>267</td>
<td>5,073</td>
<td>71</td>
</tr>
<tr>
<td>2001</td>
<td>50,450</td>
<td>519</td>
<td>10,616</td>
<td>149</td>
</tr>
<tr>
<td>2002</td>
<td>64,730</td>
<td>939</td>
<td>9,081</td>
<td>157</td>
</tr>
<tr>
<td>2004</td>
<td>133,419</td>
<td>1,396</td>
<td>9,138</td>
<td>171</td>
</tr>
<tr>
<td>2005(Nov.)</td>
<td>233,755</td>
<td>1,702</td>
<td>9,355</td>
<td>166</td>
</tr>
</tbody>
</table>

Source: Compiled from the Investment Trust Association materials
Table 2-9. Financial Asset Breakdown of Individuals  
(unit: %)

<table>
<thead>
<tr>
<th>End of Year</th>
<th>Stocks</th>
<th>Bonds</th>
<th>Investment Trusts</th>
<th>Cash /Deposits Payable on Demand</th>
<th>Fixed Deposit /Trusts</th>
<th>Insurance</th>
<th>Total Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>85</td>
<td>8.4</td>
<td>7.6</td>
<td>2.9</td>
<td>9.7</td>
<td>54.8</td>
<td>15.3</td>
<td>100.0</td>
</tr>
<tr>
<td>86</td>
<td>10.8</td>
<td>6.5</td>
<td>3.6</td>
<td>9.5</td>
<td>52.2</td>
<td>16.1</td>
<td>100.0</td>
</tr>
<tr>
<td>87</td>
<td>9.9</td>
<td>5.5</td>
<td>4.7</td>
<td>9.7</td>
<td>51.6</td>
<td>17.5</td>
<td>100.0</td>
</tr>
<tr>
<td>88</td>
<td>12.6</td>
<td>4.8</td>
<td>4.9</td>
<td>9.5</td>
<td>49.5</td>
<td>18.6</td>
<td>100.0</td>
</tr>
<tr>
<td>89</td>
<td>13.9</td>
<td>4.3</td>
<td>4.6</td>
<td>9.8</td>
<td>48.2</td>
<td>19.2</td>
<td>100.0</td>
</tr>
<tr>
<td>90</td>
<td>9.0</td>
<td>4.9</td>
<td>4.2</td>
<td>9.5</td>
<td>51.3</td>
<td>21.0</td>
<td>100.0</td>
</tr>
<tr>
<td>91</td>
<td>8.1</td>
<td>4.7</td>
<td>3.5</td>
<td>9.3</td>
<td>52.6</td>
<td>21.7</td>
<td>100.0</td>
</tr>
<tr>
<td>92</td>
<td>6.2</td>
<td>4.3</td>
<td>3.7</td>
<td>9.3</td>
<td>53.5</td>
<td>23.0</td>
<td>100.0</td>
</tr>
<tr>
<td>93</td>
<td>6.6</td>
<td>3.7</td>
<td>3.3</td>
<td>9.3</td>
<td>53.2</td>
<td>24.0</td>
<td>100.0</td>
</tr>
<tr>
<td>94</td>
<td>6.6</td>
<td>3.5</td>
<td>2.8</td>
<td>9.4</td>
<td>53.0</td>
<td>24.7</td>
<td>100.0</td>
</tr>
<tr>
<td>95</td>
<td>6.8</td>
<td>2.3</td>
<td>2.8</td>
<td>10.5</td>
<td>52.0</td>
<td>24.8</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Source: Bank of Japan, Asset Cyclical Account  
Stocks were calculated at current price. Figures for ‘87 and before include all stocks. Figures from ‘87 include only listed stocks.

Table 2-10. Financial Asset Holdings of Households in Major Countries (end of 2003)  
(unit: 100 million yen, %)

<table>
<thead>
<tr>
<th></th>
<th>Japan</th>
<th>United States</th>
<th>United Kingdom</th>
<th>Germany</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Amount</td>
<td>Ratio</td>
<td>Amount</td>
<td>Ratio</td>
</tr>
<tr>
<td>Cash/liquid deposits</td>
<td>2,377,595</td>
<td>16.9</td>
<td>319,156</td>
<td>0.9</td>
</tr>
<tr>
<td>Fixed deposits/savings deposits</td>
<td>5,499,902</td>
<td>39.1</td>
<td>4,259,372</td>
<td>11.6</td>
</tr>
<tr>
<td>Insurance/Trusts</td>
<td>2,630,040</td>
<td>18.7</td>
<td>2,065,694</td>
<td>5.6</td>
</tr>
<tr>
<td>Pensions</td>
<td>1,446,542</td>
<td>10.3</td>
<td>9,897,157</td>
<td>27.0</td>
</tr>
<tr>
<td>Bonds</td>
<td>222,336</td>
<td>1.6</td>
<td>2,353,097</td>
<td>6.4</td>
</tr>
<tr>
<td>Stocks</td>
<td>1,040,096</td>
<td>7.4</td>
<td>6,309,349</td>
<td>17.2</td>
</tr>
<tr>
<td>Investment Trusts</td>
<td>323,906</td>
<td>2.3</td>
<td>4,439,746</td>
<td>12.1</td>
</tr>
<tr>
<td>Others</td>
<td>521,597</td>
<td>3.7</td>
<td>7,031,273</td>
<td>19.2</td>
</tr>
<tr>
<td>Total</td>
<td>14,062,013</td>
<td>100</td>
<td>36,675,057</td>
<td>100.0</td>
</tr>
</tbody>
</table>

USA: Flow of Funds announced in June 2004 by the FRB  
UK: August 2004 Issue of Financial Statistics, ONS
CHAPTER 3:
THE ASSET MANAGEMENT INDUSTRY IN EUROPE AND USA

3.1 THE ASSET MANAGEMENT INDUSTRY IN EUROPE

Because of the vast regional differences between the European Union (EU) and Asia (as defined by this study), and the differences on a national level in terms of economic and financial institutions, scale, history, legal framework, current issues and general background of asset management in Europe and in Asia, a direct comparison is of no value here. For example, the major issue of current importance in Europe is the harmonization and unification of the industry, whereas in Asia the development of the industry in each country comprises a bundle of national concerns that are independent of other nations in the region.

Nevertheless, observation of the situation in Europe, where investment funds amount to more than €10 trillion (in pension funds, life insurance funds, investment funds, and other products), provides some insight on how to approach the subject of promoting a regional strategy for AMI development in Asia. In the following, emphasis is given to issues that while being of concern region-wide, are important at the national level, and matters such as the coordination of various entities (e.g., the European Central Bank and the Commission of European Securities Regulators, CESR), etc. are not specifically addressed. Similarly, specific issues that are more relevant in Europe than in Asia at this time are not taken up; these include, for example, adoption of common standards for prospectuses as a method of facilitating investors’ cross-border decisions and expanding their range of choice. Also, matters of universal concern, such as practices, regulations and systems for individual investors (including consumer protection measures) as opposed to institutional investors, are not given primary importance here.

The motivation of the ongoing efforts to harmonize, unify and coordinate national systems for fund management was originally driven by the broadest of political motives, and by the larger objective of creating a single wholesale market for capital (as described in the policy program known as the Financial Services Action Plan, or FSAP). Since then, however, support for this specific objective has increased in light of anticipated economic efficiencies. Initial undertakings under the FSAP were concentrated on raising capital and operating markets (the “sell side”), but structural change in the financial services sector led to inclusion
of asset management as a distinct sector deserving attention by the plan.

Key issues and subjects for asset management in Europe at this time are as follows. Needless to say, many more areas and activities are involved, for the consumers, for asset managers, for financial advisers, for regulators, and for the policymakers at the national and regional levels.

**Regulatory Environment.** Great challenges exist in making the environment of regulation functional and transparent, at the regional level in particular.

**Economic Efficiency (Economies of Scale).** Europe has 29,000 investment funds compared to 8,000 in the United States. As recently noted by the *European Pension and Investment News*, “A study last January by the independent Investment Industry Research Group found that removing scale inefficiencies in Europe’s fund market could generate savings of €6 billion, or 15 basis points in performance.”† The Investment Management Association found that if there were no impediments to cross-border trade in the asset management industry and the “European passport” available to funds was widely used, the gain accruing to the average investor would be on the order of 9% of the size of the portfolio, or €120,000.

The scale of the average fund, moreover, is relevant to the argument for seeking greater efficiency; the average net assets of a European fund amounts to €140 million (cf. €800 million in the US). Impediments to cross-border activity (see below) have been estimated to cost European investors from €2 to 6 billion in additional fees (annual base), as only about 15% of the 29,000 funds are truly “cross-border.” Facilitation of fund mergers would be one means of increasing the scale of funds, and efficiency in management.

Benefits could be expected to increase if recent growth of European investment fund assets is maintained, as those assets grew by €2 trillion from 1995 to 2000, while pension fund assets grew by more than a trillion euros. Simplification of the “notification” process is advocated by the Green Paper, released in August by the EU, and would contribute to reduction of cross-border barriers. Language and institutional matters are among the challenges to lowering cross-border barriers, and the need to service markets locally, as opposed to servicing them from a single center, is a reason that benefits of unification are slow in their

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realization.

**Promoting Cross-Border Activity.** Following on the UCITS Directive, an investment fund created in one EU member could be marketed in others. There are, nevertheless, formidable barriers to achieving this, and as the European Commission’s Commissioner Bolkestein commented, the present situation was “as if we are driving a Ferrari in second gear.” UCITS III has as one of its objectives promotion of effective cross-border activity. Or, it is also possible to take cross-border activity as being cross-border mergers and acquisitions of fund management companies. National differences include Germany’s legislation authorizing on-shore hedge funds, and the UK’s permitting domestic hedge funds to operate offshore and beyond regulatory oversight.

**Investment Company Governance and Regulation.** European industry leaders and regulators are well aware of events that have taken place in the United States that have harmed the reputation of the mutual funds industry, and this has increased the importance assigned to maintenance of confidence in the savings industry as a whole and in the governance of asset management firms. UCITS III has provided for a European passport for management companies, but there has been little progress in achieving a cosmopolitan industry because some countries insist that management companies and investment funds should be regulated by different agencies.

**Competition.** Benefits would be obtained by encouraging competition. Both the European Parliament and the UK’s Financial Services Authority have expressed the opinion that there is not enough competition, and it is generally recognized that legacies in domestic markets, and social inertia, are limiting competition in Europe. Benefits would be obtained by fund managers as they could more aggressive seek customers in foreign countries, and investors would benefit not only from the wider geographical range of choice but provided that requirements are met by access to new product types. Product development too would become more competitive against the background of a much larger, diversity-seeking demand.

**Implications for the Banking System.** In general, the banking system of a nation or region will benefit from an efficient system for management of investment funds, in various ways, but when banks are directly concerned with such management, and with the sale of funds, policy formulation and regulatory matters become increasingly complex.
Regulatory Capital Requirements. Imposition of capital requirements on investment companies would be influenced by factors including the legal nature of those companies, and the degree of their proximity or distance from banks. The key points here, as analyzed by the European Asset Management Association, are (1) systemic risk, (2) investor protection, and (3) legal of operational losses in the asset management industry. The EAMA cautions that high capital requirements would (1) damage competition within the region’s asset management industry, (2) damage the competitive position of the asset management industry, and (3) damage small business. In the latter case, a high capital requirement would raise the entry barrier, discouraging formation of small, niche-type asset management firms, and, second, would discourage coverage of smaller investment-target firms, considering that smaller asset management companies often specialize in investing in smaller companies that are publicly owned.

Distribution. Use of third-party distribution is necessary (as a cost issue) for sale of investment funds across borders, but this is being inhibited by issues such as limited expertise of financial advisers in some countries and structural power of domestic providers in others.\(^8\)

Soft Commissions and Unbundling of Services. Transparency and disclosure are desired not only for corporate management but also for execution services, and research, and the use of soft commissions and bundling of services, even if managed with the interests of the end investors in mind, presents an issue for consideration with regard to regulation. In this area, among others, European bodies are exchanging views with the SEC.

Investor Education and Protection. Mechanisms for educating and protecting retail investors in particular must be harmonized and improved.

Infrastructure. Standardization of the protocols used by infrastructure providers (e.g., transfer agents) should be done to simplify cross-border business.

Outsourcing. As a matter of corporate governance, practices of outsourcing of administrative work, which is growing in (at least) the United Kingdom, are deserving of scrutiny and establishment of regulatory and/or best-practices standards.

Eligible Assets. The UCITS Directive (fully, A Directive on Undertakings for Collective Investment in Transferable Securities, 1985) defined the single market for investment funds as being limited to conventional equity and bond products, but even after its revision in 2002 to include money market and fund of fund products, new product categories with high growth (demand) potential are still excluded. Definition of assets eligible for inclusion in investment funds is a matter of importance in every market; in Europe at this time there is concern regarding some newer products, that are complicated and high-risk in nature, and which are being sold as UCITS. In order to enable funds to diversify by investing in newer, more complex instruments as well as traditional instruments such as property (property funds), legislative changes are required. UCITS III, comprising the Management Directive and the Product Directive, seeks to expand the definition of transferable securities. At present, UCITS registered funds are biased in favor of investment in equities and bonds; it is expected that this will change over time.

Domestic-centered markets tend to discourage diversification by their nature, and this tends to depress risk-adjusted returns. Thus, the matter of eligible assets is related to reduction of barriers to cross-border investment in funds, which in turn is linked to competition in product development.

Alternative Investment Market - Hedge Funds. The alternative investment market, primarily hedge funds, must be considered as part of national or supranational policy planning for the asset management industry. Hedge funds are not currently regulated on an all-Europe basis. They manage an estimated €188 billion in Europe. Much of the management decisions are made in the United States, signifying interest in European changes on the part of industry there. Further, the outlook is for growth of European supply of funds to these vehicles. Risks and advantages of hedge fund activities are among the subjects under continuing study. The importance of hedge funds is growing in the sense that newer funds (in the UK, for example) have lower initial investment requirements, and while this broadens the investor base, also is reducing the difference between hedge funds and ordinary retail funds. Hedge funds have also received attention in that they were supporters of the failed effort by the Deutsche Börse to take over the London Stock Exchange.

Financial Advisers. A Europe-wide standard for qualification of financial advisers is needed for true internationalization or border elimination. Similarly, a uniform code of ethics is
desirable. Both the standard for qualification and the code could be defined in minimal, all-Europe terms, and individual EU members could add to or heighten them.

**Information.** Retail and institutional customers in all member states should be provided with equal access to good quality information in order that they can actually exercise their options in accessing the entire EU fund market, and acquire improved opportunities to manage their assets. The industry, moreover, must standardize and collect uniform statistics that must be made accessible to all.

**E-commerce.** Considerable momentum in the growth and development of the investment fund industry is being provided by the application of investment technology, including investor use of fixed-station (personal computer) and mobile (mobile phones) devices for obtaining information, making inquiries, arranging for transactions, making settlements, and managing personal accounts. Providers of financial services are aggressively expanding their use of IT to acquire and retain customers, making several issues matters of great importance. These issues include security, disclosure, and other matters. This subject differs in details but not in substance in nations in Europe and elsewhere where the financial markets are well developed.

**Taxation.** It is self-evident that the nature of taxation on investment fund transactions and profits is a matter of fundamental concern for policymakers. It may be among the most difficult areas to tackle when attention turns to growth and development of the asset management industry. In Europe at this time, in most nations hedge funds are taxed similarly to other investments (In France which with the U.K. is one of the two largest hedge fund markets in Europe, for example, hedge funds are taxed the same way as if they were UCITS mutual funds.), but tax regulations are hampering free cross-border investment in hedge funds. Thus, elimination of national discrimination between domestic funds and offshore funds is desirable.

**Fund Registration.** One-time registration, in the country of origin, should be recognized as sufficient for all EU member states.

**Pooling.** Fiscal, regulatory and commercial obstacles are inhibiting cross-border pooling of assets. The benefits of eliminating and reducing these obstacles include enabling asset
managers to leverage economies of scale and improve risk control, while multinational corporations with a variety of national corporate pension schemes could aggregate portfolios, also for economies of scale and improvement of risk management.

**Pension Fund Policy.** Fundamental to the growth and nature of the asset management industry of a given country is the situation of pension funds in that country. The situation varies widely. In Germany, pension funds have been dominated by insurance products and insurance companies, but recent moves are making it possible for greater diversification.
3.2 THE ASSET MANAGEMENT INDUSTRY IN THE UNITED STATES

Asset management in the US encompasses a wide range of services and a variety of entities that serve individuals, organizations made up of individual members, corporations (especially as employers) and others. For present purposes, the asset management industry can be taken as equivalent to the mutual fund industry, or investment companies, their services, functioning, performance, and regulation. As is true of peoples elsewhere, Americans save for a wide variety of reasons, including marriage, the education of children, home acquisition, and other reasons, including retirement. Saving for retirement is done through the Social Security system, insurance plans, employer-sponsored retirement plans, and individual programs (such as “Section 529” college savings funds). Much of savings done through private-sector mechanisms is in mutual funds (open-end management investment companies).

More than half of American households own, through retirement and non-retirement savings, about three-quarters of mutual fund assets (as of the end of 2003). The remainder, 23%, was owned by fiduciaries such as banks and other institutional investors. After 2002, the year of the first decline of net assets in mutual funds since their creation in 1940, assets increased 2.5% and passed the US$7.413 trillion level.

Growth of the industry has been driven by demographics, economic growth, increase in private-sector assets, innovation in the financial sector (such as creation of index funds and hedge funds), regulatory moves favoring growth and development, efforts of the industry through the Investment Company Institute as well as intermediaries such as stock exchanges, education and publicity, and other factors. Of special importance was the creation of the Individual Retirement Account by Congress in 1981. As of the end of 2004, IRAs held US$3.5 trillion and constituted the largest component of the retirement market (note that there are also variable annuity and other retirement programs). IRA assets invested in mutual funds amounted to US$1,292 billion or nearly half of mutual fund retirement assets (end of 2003). Defined contribution plans (401k plans) and other benefit plans collectively totaled US$1,395 billion.

The regulation of mutual funds is primarily by the Investment Company Act of 1940 and its subsequent revisions; other controlling legislation includes the Investment Advisers Act of 1940, Securities Act of 1933, Securities Exchange Act of 1934, relevant tax laws and “blue
sky” laws of each state.

By the end of the 1980s the number of funds, that had been about 525 a decade earlier, had grown to more than 2,900, accounting for $982 billion in assets. During the 1990s, influenced by the strong economy and strong stock market (including effects of the dot com bubble), the amount of assets in mutual funds rose rapidly, the number of funds increased (including 1,600 new general equity funds) and the names of some, such as the Fidelity Magellan Fund, became, literally, household expressions. During this decade, Morningstar, a company specializing in mutual fund information services, started to release “star ratings” of funds. Also, there was increased use of the Internet as a means of obtaining investment information as well as making investment decisions and transactions. Discount brokers contributed to increased investment in stocks and early in the decade the first large-scale discount broker, Charles Schwab, introduced Onestop, a kind of supermarket for funds. By this time, the industry offered investors a wide variety of instruments and techniques.

Mutual funds own about 25% of the shares of all US corporations (in 1995 it was 16.0%, in 1985 it was 5.2%).

3.2.1 Regulatory Infringement and Demand for Reform

The asset management industry in the US has been the object of increasing attention in recent years, for a number of reasons. The retirement of the baby boomer generation in the very near future is one. The widely reported efforts by the Bush Administration to reform the Social Security system is another reason, as the proposal is on one hand a reminder of the general subject of post-retirement income and life, and of the possibility that a substantial portion of assets now in the Social Security program will be managed privately, with a degree of participation by individuals. The failure of Long Term Capital Management in 1998, that was of such magnitude that the Federal government intervened, was followed by well-reported incidents in 2000, notable the collapse of the Tiger Fund and reorganization of the Quantum Fund (two large and well-known mutual funds), but in 2002 a number of scandals (disclosed as a result of efforts by the New York State Attorney General Eliot Spitzer) shook the mutual fund industry to its core. In the 78 years of the mutual fund industry, there had not been even one scandal of the magnitude and breadth of what was discovered. Some of the most respected, oldest, and largest companies were implicated. The result of the scandals was a
rush of regulatory efforts, and a sharp drop in popular confidence in the industry (among other changes). In addition to regulators’ moves, there were lawsuits, payment of well over US$1 billion in restitution to investors, great changes within investment companies, and substantial withdrawal of funds from investment companies implicated in the scandals. As a byproduct, further attention was focused on other aspects of fund management, such as fees, investment company management, and sales practices. Finally, the pressure of demographics has contributed to greater interest, among the public, the corporate sector, the financial sector, and the government, in the status of and outlook for unfunded pension accounts at employers. This latter development has come at the same time that many large employers have or have attempted to reduce retirement benefits, under the pressure of poor corporate performance or the imminent threat of bankruptcy.

The seeds of recent issues and reforms were sown in the 1990s, when many existing funds experienced high growth (inflow of funds, separate from appreciation), and fund sponsors became addicted to a high-margin, high-growth scenario. The industry itself changed, as stewardship was replaced by salesmanship. Investment companies increased their sales through third parties, and did less business directly with their end-investors. Investment companies came to be dominated by marketing, often to the neglect or overriding of fiduciary principles. Investment committees had been important in the past, but “portfolio managers” were made into celebrities. (In 1945, the new-born mutual fund industry had 49 equity funds, of which 47 were managed by committees; in 2004 there were 4,194 such funds, and 3,387 were controlled by a single portfolio manager.) The “exuberance” that propelled the stock market became as strong a presence in the financial sector as nitrogen is in the air. “Performance” funds rose in popularity and fund management grew more aggressive, holding periods grew shorter, and, coincidentally, “creative” accounting techniques (and fraud) became more widespread in some listed companies, including very large ones. Some fund managers engaged in practices that were inappropriate, or in violation of regulations (as had taken place in the past). Some of the practices had existed in the industry for years, but had not been recognized as problematic.

The activities that have attracted public and private attention, and have incited regulatory changes can be grouped in the following four areas: (1) governance, (2) advisory and

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customer services, (3) distribution, and (4) third parties and trading. The most important problem practices and violations have been as follows.

(1) Governance Problems

Some of the oldest and best-respected investment companies were not found to have committed abuses. Others, however, had serious governance deficiencies, as was discovered by New York and by SEC investigations. The problems that were discovered included breach of trust, and agency problems.

(2) Distribution

Fees that funds paid to their underwriters were raised; this was done to permit higher payments to brokers, and detracted from fund performance. Fund shareholders experienced higher costs when fund share sales were promoted as a means of meeting brokerage quotas (“directed brokerage”). This is deemed by the SEC to be an abuse of shareholder assets, and a conflict of interests. Distributors were paid for “shelf space” but this practice was not well informed to the investors who bought the funds. This practice, also called “revenue sharing,” has been widespread and common knowledge within the industry. The concern in this connection is that brokers could be encouraged to push funds on the basis of commissions rather than the qualities of the funds.

(3) Advisory and Customer Services

Investment managers employed soft-dollar payment (as components of commissions) for information feeds and research. This had been done earlier, but came to be more widely recognized as a way of making investors pay for a cost of doing business, and is one aspect of changes that were encouraged by reaction to revelations of abuses by investment companies.

Institutional investors were given better treatment than retail customers, by being charged lower advisory fees. There is, nevertheless, some justification for this discrimination, as handling regulated products could involve a cost increment such as that of managing a relatively volatile cash flow. Further, the timing of acquisition of a fund, and the channel through which it is distributed, would lead to a cost differential. When knowledge of this practice became a focal point of attention, moreover, it came shortly after the SEC took action to provide a level playing field for all equities investors, through the Fair Disclosure Act.
(4) Third Parties and Trading

Investment advisers engaged in market timing --- that per se was not illegal --- but favored certain customers by permitting them to trade frequently and beyond the required limits. This had the effect, to the detriment of those who held shares in the fund over the long term, of increasing transaction costs and lowering fund returns. A 2002 study by an American academic found that “market timing” (also called “short-term trading”) and “late trading” abuses resulted in a "cost to long-term shareholders ... as much as 2 percent annually."

Transactions were made for favored investors after the mutual fund had calculated the price of its shares (usually after the New York market closed); this made it possible for them to pay the fund share price for the day. Other investors were unable to use this advantage (‘late trading’, called by Spitzer, refers to betting on a horse race after the horses have crossed the finish line.'

Foreign investments were valued using closing prices in the foreign market even though those prices were no longer valid (a “fair value pricing” problem). This is also a late trading abuse, as Asian and European markets close after American markets.

3.2.2 Movement Toward Reform

The incidents and problems summarized above greatly increased the attention given to the mutual fund industry, its functioning, its governance, and its regulation. In addition to regulatory changes directly originating from the discovered abuses, interest in other reform or improvement subjects has risen. The effects of the revelations, and the subsequent lawsuits, hearings, judgments, rulings, and other reactions are continuing at this time. The following is a summary of major recommendations and changes, particularly those of the SEC (where some changes had been proposed prior to the unearthing of the scandals). It should be noted that other bodies, particularly the Investment Company Institute, that is the national organization of investment companies, and the National Association of Securities Dealers (NASD) have issued policy statements, guidelines, best-practice memoranda, have participated in Task Force studies, and so forth. Also, action at the level of States was not insignificant, although below mention is made primarily of New York. Pension trustees including State treasurers (being responsible for civil servant pension funds, and for college savings programs) similarly brought pressure to bear on regulators and investment companies.
Governance and Investment Company Management

(1) Governance

The SEC as matters of general policy expects that mutual fund boards will (1) be committed to their watchdog role, (2) serve as investor advocates, (3) use both the power of words and the vote for intelligent control of management, and hold management accountable for fund performance, and (4) contribute to the formation of regulatory policy and implementation of the policies.

In July 2005, the SEC voted to adopt governance regulations calling for 75% of a mutual fund’s directors, and the board chairman, to be independent. Management companies had, in the view of the SEC, been too sensitive to influence from fund boardrooms. Because of a controversy over the cost of compliance, and the matter of propriety in selecting a chairman, the ruling was subject to revision prior to the scheduled adoption in January 2006. The SEC has also proposed that independent directors meet in separate “executive sessions” at least quarterly, and that these directors are to be authorized to hire their own staff.

Investment companies are now required to indicate, in their annual reports, a discussion of what considerations were taken into account when the board voted on a management contract. Consumer advocacy groups had also called for requiring that independent directors stand for election, and that all board members be given a fiduciary responsibility with respect to fees.

(2) Fines, Penalties and Punishment

During the 18 months up to February 2005, the SEC had brought 61 cases related to mutual funds. Investment companies were made to give up US$1.4 billion in “disgorgements” and pay US$1 billion in penalties. This is apart from shareholder class-action suits. The amount of individual settlements ranged from US$2 million to US$140 million (average, US$56 million). Before 2003, however, settlements were typically less than US$20 million; thus, the seriousness of the problems, by this measure, is formidable.

By August 2003, fourteen fund groups had entered into settlements with either Federal or State regulators. A former vice chairman at another firm was sentenced to prison for illegal activities (an instance of an incidental discovery resulting from the inquiries). Twenty-four individuals were the objects of disciplinary action by the SEC. A number of other executives
lost their jobs.

(3) Regulatory Functions, Compliance and Ethics

The SEC has strengthened its own oversight function with regard to mutual funds. The SEC also has required investment companies to install a Chief Compliance Officer. This CCO must be hired by and directly report to the fund directors. All registered investment advisers have been required to adopt a code of ethics.

(4) Disclosure

An extensive study of mutual fund disclosure practices was undertaken by the SEC, with the objective of achieving an improvement of disclosure within reasonable cost boundaries. The SEC has made it mandatory for investment companies to make disclosures regarding market timing, fair value pricing, and other matters. Detailed disclosure of expenditures has now been made mandatory for inclusion in shareholder reports. The companies are also required to improve disclosure regarding portfolio managers and potential conflicts of interest.

Fund distributors now are required by the SEC to improve their disclosure (in fund prospectuses) regarding breakpoint, the predetermined contribution amount in a mutual fund, that when achieved, gives the investor eligibility for a reduction in sales charges. Each investment company using its own formula does the calculation of the breakpoint.

(5) Soft Dollars and Revenue Sharing

In October 2005 the SEC requested comments on its proposed guidance regarding soft dollars. Revenue sharing (shelf space deals) by broker-dealers with fund companies was among the subjects investigated by the authorities, and one firm had to agree as part of a settlement with the SEC to disclose revenue sharing counterparties and the amounts on the BD’s website. Subsequently, other companies made the same disclosure.

Distribution

(6) Directed Brokerage

The SEC in August 2004 banned directed brokerage. Investment companies had ceased to use this practice in advance of the SEC’s regulation. It is not clear whether other means of
providing compensation will be used in place of this, and whether they will be detected.

It is yet to be determined if broker-dealers are to deduct 12b-1 fees (collected to cover costs connected with the distribution of the fund's shares) from shareholder accounts, or include them in marketing costs, where they could not be identified.

**Advisory Services**

(7) Fees

The scandals did not involve abuses related to fees, but 10 of the 14 fund groups, in reaching a settlement with the New York Attorney General, agreed to cut fees by a total of $925 million over a period of 5 years. There are indications that in the initial year or so after the scandals became known there was extensive reduction of fees, in reaction no doubt to the sharp drop of investor confidence in the investment companies, and relatively few instances of increases in fees.

The observations†† made by John C. Bogle, the founder and former chairman of the Vanguard Group is relevant. Bogle has noted that equity funds have not returned as much as the stock market, over the long-term, and attributes as the main causes of this the amount spent on fund management, fund marketing, and turnover. The extremely high compensation packages provided to “star” portfolio managers, and high marketing costs of the 1990s, come to mind in this connection. Bogle sees as a desirable part of mutual funds' future a reduction of turnover rates, that could be accomplished relatively painlessly, a reduction of management fees, and of sales commissions, and reduction of operating and marketing costs (among other recommendations).

Investment adviser fees are required (by a 1982 court ruling) to comply with fees at other companies. This arrangement appears to promote escalation, and the basic principle for determining fees may come under scrutiny.

**Third Parties and Trading**

(8) Short-Term Trading

Although the SEC had wanted to have mutual funds charge a mandatory fee of 2% (a

†† Ibid.
redemption fee) for a fund sale made within 5 days of purchase, there has been criticism of this as being contrary to the interests of any investor who has to sell quickly for perfectly legitimate reasons. The rationale for imposition of the fee was the desire to prevent market timers from taking advantage of fund share price disparities by in-out (rapid-fire) trading. Implementation of this fee requirement, however, presents a problem for those investors and broker-dealers who use omnibus processing for mutual fund transactions, as such processing conceals the identities the individual shareholders who are selling or buying fund shares. The final rule called for the supply of information on shareholder identity and the relevant transactions by intermediaries that hold investor shares, if a fund requests such information. This affords flexibility to the funds to determine how to best prevent market timing.

(9) Late Trading

Prosecutors at the State and Federal levels have brought criminal charges against known violators who have engaged in late trading. The different jurisdictions involved mean that at times there will be a lack of consistency, arising from the legal and operational frameworks of the agencies involved. The SEC did not find that criminal charges were appropriate as market timing per se is not a matter of violation. The SEC did propose that all transactions had to be received by 4 p.m. Eastern time (“hard close”), but this would create a problem as pension plan managers, who are required to keep records, would then be obliged to place orders by 2 p.m. Eastern time, and operational and financial problems could result from this.

(10) Registration of Hedge Fund Advisors

By requiring registration of hedge fund advisers, the SEC expects to improve its own knowledge of the activities of those managers and the impact of their trades.

Other Issues Related to Mutual Funds

Investment companies, regulators and investors thus have spent several years wrestling with diverse and far-reaching changes. Apart from the above, the industry faces a number of issues and challenges. Outsourcing has increased as investment companies have sought to lower costs by paying others to do various tasks. Issues of security and reliability must be confronted. The development and acquisition of information technology, for compliance and cost control purposes, will continue to be important within the industry. Compliance costs including establishment and assuring good functioning of compliance infrastructure and systems are unavoidable.
CHAPTER 4:
EMPIRICAL ANALYSIS ON MUTUAL FUND AND INVESTMENT TRUST MARKETS IN THE U.S AND JAPAN

This chapter is provides an empirical analysis of the demand factors affecting mutual funds and investment trusts in the US and Japan markets. The first part of this chapter provides an overall review of savings patterns and related trends in the US and Japan. After examining the features of savings in both countries, the second part explores the portfolio selection among stock, bond, mutual funds and investment trusts.

4.1 INTUITIVE ANALYSIS ON SAVINGS MARKET FROM MACROECONOMICS VIEW

Features of Savings Trend in the U.S.

Household savings is a direct function of household income. To see this relationship, we use personal income and savings of households.‡‡ From Figure 4-1, we can see that disposable personal income is showing an uptrend. Until mid 80’s, personal savings changed much as income did. After this period, savings took on a decreasing trend and the saving rate also declined within the same period. This means savings, relative to income, has shrunk from then on. As revealed in subsequent sections, these tendencies are similar to those exhibited by Japan.

As in the historical trend in savings and income, the scatter diagram (Figure 4-2) here is showing similar shape to that of Japanese in the next section. Until 1992, the relations between savings and income did not change a lot. After 1992, savings relative to income has been declining and the same observation holds until now.

To verify the relations between the level of wealth and income, we use total net assets of mutual funds as the proxy of the level of wealth (Figure 4-3). This is because the share of mutual funds in household assets is relatively higher in the U.S. In this figure, we can see similar pattern in the relations between saving rate and level of wealth as in the Japanese case in the next section.

‡‡ Personal disposable income and personal savings data are from U.S. Department of Commerce.
Features of Japanese Savings Trend

Figure 4-4 shows Japan’s personal savings, personal income and saving rate from 1970 to 2003.§§ The saving rate is. In 1990s, Japanese disposable income stayed almost within same level because of the effect of bubble economy. In mid 70’s, the saving rate (obtained by dividing personal savings by personal income), increased and stayed at a relatively higher level. After the 70s, the saving rate went on a downtrend. However, since we are using flow data, the decrease in the saving rate does not simply mean the decline in the amount of savings.

The relations between personal income and savings are shown in the next scatter diagram (Figure 4-5). Especially before 1990, the personal income-savings relation was relatively stable. Just after 1990, personal savings declined dramatically while personal income did not vary significantly.

Figure 4-6 makes use of the total net assets of investment trusts in lieu of savings.*** The saving rate in any given year is steadily declining, while the net assets of investment trusts were growing until 1990. After the stock market bubble crashed in the late 1990s, the net assets of investment trusts remained steady. This same tendency can be seen in the U.S. The saving rate might have been declining in tandem with the maturation of the investment trust market, indicating an accumulation of wealth.

Lessons from the U.S. and Japanese Savings and Income Relations

It is easy to think that one of the important motives for saving is wealth accumulation in preparation for future uncertainties. High level of wealth is one of the possible reasons for the fall of saving rate accompanied by increasing income in recent years.††† Decreasing the risk in the future is also another possible reason for this situation. Seen from another standpoint, it is important to accumulate wealth during low wealth level era. For accumulating wealth, the supply of richer variety of financial products certainly helps.

§§ Personal income and personal savings are taken from SNA in Ministry of Internal Affairs and Communications.

*** In this part, we use investment trust data from the Investment Trusts Association Japan from 1970 to present.

4.2 EMPIRICAL STUDY ON THE DETERMINANTS OF DEMAND FOR MUTUAL FUNDS AND INVESTMENT TRUSTS

Data
Since our aim is to investigate the factors that affect demand for mutual funds and investment trusts, we utilize data representing variables that explore mutual funds’ and investment trusts’ demand. We use net cash flow to mutual fund and investment trust market, and the difference of total assets of funds and trusts from month to month ato represent demand for mutual funds and investment trusts. Total assets and returns of Japanese investment trusts are collected from “Daiwa Funds Universe Statistics,” which are provided by the Investment Trust Analysis Laboratory of Daiwa Institute of Research.‡‡‡ We collect total assets and net cash flow of U.S. mutual funds from “Trends in Mutual Fund Investing,” issued by the Investment Company Institute.

We choose stock market return, stock market volatility, risk-free interest rate and JPY/USD foreign exchange rate as the market factors. TOPIX and S&P 500 are used as proxy variables of stock market performance in Japanese and U.S. market respectively. The yields of 10-year Japanese government bond and the 10-year Treasury bond yields are also used as proxy of the risk-free interest rate. We compute monthly standard deviations from daily stock returns and use it as stock market volatility. Data on Japanese market are obtained from “Keizai Toukei Nenkan (Yearbook of Economic Statistics)” published by the Toyo Keizai Inc. The yields of 10-year Treasury bond are collected from FRED, an online database provided by the Federal Reserve Bank of St. Louis§§§. The S&P 500 comes from the web site of Standard and Poor’s****. The monthly data we use here cover from June 1998 to September 2005, and each time series contains 88 observations.

Overview of the U.S. Mutual Funds Market and the Japanese Investment Trusts Market
The important factors that affect portfolio selection among various types of mutual funds and investment trusts are the combination of risk and return. Given the level of risk, we prefer the asset with high return. The number of choices for investors is another factor affecting

‡‡‡ Since the statistics does not contain the net cash flow to investment trust market, we compute the cash flow from the following equation:

\[ a_{t+1} = (1 + r_t) a_t + f_t \]

where \( a_t \) is total assets of the funds, \( f_t \) is cash flow to investment trusts, \( r_t \) is return from investment trusts.

§§§ http://research.stlouisfed.org/fred2/

**** http://www.standardandpoors.com/
portfolio selection in various types of mutual funds and investment trusts. If the quantity of the types of mutual funds and investment trusts grows, the utility of the investor is better off. The increase in the variety of mutual funds and investment trusts pushes up the amount of money invested to this mutual funds and investment trusts, other things being equal.

In this section, we check out the relations between the candidates of the determinant that might affect the mutual fund and investment trust investment by looking at the graphs.

**Overview of the US Case**

Figure 4-7 confirms the features of cash flow into stock, bond and hybrid funds. From 1998 to the beginning of 2001, hybrid funds and stock funds moved opposite each other. Just after February 2001, these two funds moved parallel to each other. This tendency implies that these two funds might (structurally) have changed around the beginning of 2001. During the first half of the whole period, these two funds can be considered substitutable, and in the last half are complementary. Until 2002, the net assets of these three funds change similarly (Figure 4-8). Recently, the net assets of taxable bond funds are relatively increasing.

Hereafter, we try to explore the factors that affect demand of each funds through graphs. We use S&P500 as proxy of stock market performance (Figure 4-9). S&P500 and cash flow can be said to move proportionally. During the period, S&P500 stay at relatively high levels, and cash flow into stock funds tends to be also high. We cannot say any causality from this tendency at this moment. Strong demand of stock funds can raise the S&P500, or high performance of stock market attracts investors to these funds.

Bond yield might have some effect on cash flow into bond funds (Figure 4-10). High yield implies bond price is low. When the bond yield is low, cash flow can be high. This tendency might be confirmed from Figure 4-10, but this relationship has not been clear yet. Discussion from the econometric results will be conducted in the subsequent part.

The trends of the net assets of stock funds and S&P500 are similar. During the high level of S&P500, net assets of stock funds and cash flow into these funds are also high. During the period of stock market high performance, net assets of bond funds are decreasing (Figure 4-11). It is easy to image that stock and bond funds are serving as substitute.
As for hybrid funds, volatility of the stock market can be the factor that may affect cash flow into hybrid funds. During high-risk period in stock market, demand for hybrid funds is almost high. The investor of hybrid funds can be said as risk averse.

Net assets of hybrid funds are also low when the volatility of stock market is high (Figure 4-12). Cash flow and net assets of hybrid funds are increasing especially after the beginning of 2002 when risk had started to get lower.

Up to here, we learn that risk and return can be the important factors affecting the investment decision to mutual funds, and the weigh of these factors differ according to the different type of funds. These three types of mutual funds provide opportunities featuring a wide range of risk and return profiles. Hence, it is still beneficial to be supplied with a rich variety of mutual funds.

**Overview of the Japanese Case**

The Japanese case is not same as U.S. case; we cannot find clear structural break in the relation between the net cash flow of stock investment trusts and hybrid investment trusts. The net cash flows of hybrid and bond investment trusts move in the same manner (Figure 4-13), implying that these two investment trusts might be complementary products. The relation between these two investment trusts and stock investment trusts is different. From the figure, these investment trusts and stock investment trusts might be substitutable products.

Until mid-2002, the movement of all three investment trusts’ net assets looks much alike (Figure 4-14). From then on, net assets of bond investment trusts are increasing dramatically. As the net cash flow to bond investment trusts does not show this pattern, bond price and returns should be the main reason for this.

Total assets of stock investment trusts (Figure 4-15) are showing the same pattern as that of TOPIX (proxy of stock market performance). This tendency can be seen in U.S. case. Market performance is important candidate for the determinant of stock investment trusts demand.

In early period of our data, stock market performance and net assets of bond investment trusts
move in opposite direction. This tendency can be seen also in U.S. case. In later period, however, these two series do not seem to show any relations.

As for the cash flow into investment trusts market, in the early period of our data, stock market performance can be the determinant of investment decision to investment trusts. Recently however, market performance dose not co-move with cash flow.

Cash flow into hybrid investment trusts show an opposite moving pattern against stock market risk (Figure 4-18). To measure stock market risk, we use TOPIX volatility. This tendency also is quite same as that in the U.S. Hybrid investment trusts can be providing risk aversion tool of investment.

At the tail of our overview, we try to check the number of investment trusts in Japan (Figure 4-20), a number of which are showing stable movement. From this graph, we cannot find any clear impact of these numbers on the demand of investment trusts. In subsequent parts, we will explore the effect of this factor on the demand of investment trusts with econometrics analysis.

Test for Stationarity

It is well known that the regression model with nonstationary time series causes “spurious regression” and tends to lead us to incorrect interpretation of estimated results. Therefore, we need to test the stationarity of the data used in the analysis before we estimate the regression models on demand for mutual funds and investment trusts. Table 4-21 shows the result of the Augmented Dickey Fuller (ADF) test with constant term and no trend for U.S. data. In this case, null and alternative hypothesis are developed as follows:

\[ H_0 : y_t = \alpha + y_{t-1} + \varepsilon_t \]
\[ H_1 : y_t = \alpha + \beta y_{t-1} + \varepsilon_t, \quad \beta < 1 \]

where \( y_t \) is the time series to be tested and \( \varepsilon_t \) is white noise process. This means that the time series, \( y_t \), is nonstationary in null hypothesis; on the other hand, alternative hypothesis is equivalent to stationary.

Total net assets of U.S. stock, bond and hybrid mutual funds fail to reject the null hypothesis at 5% significant level, whereas the difference of those time series, \( (y_t - y_{t-1}) \), rejects the null
of unit root. Hence we conclude that these series are following I(1) process. The number of the funds of stock, bond and hybrid mutual funds in the United States is also following I(1) process. Log difference of S&P 500 and the yield of Treasury bond are considered as stationary process although the results for S&P 500 and the yield of treasury bond are showing nonstationarity. The null hypothesis of unit root in the volatility of S&P 500 is also rejected by the ADF test.

As for the total net assets of investment trusts in Japan, the ADF test results suggest that bond and hybrid investment trusts are I(2) process, whereas stock investment trusts is I(1) process(Table 4-22). However, the line graph of the difference of net assets in previous section shows that structural change has occurred at around the beginning of 2001: bond investment trusts has been showing an upward trend and the variance of stock investment trusts has been decreasing since then. Therefore, we try to conduct the Perron’s test for structural change in which null and alternative hypotheses are

\[ H_0: y_t = a_0 + y_{t-1} + \mu_t D_{p,t} + \epsilon_t \]
\[ H_1: y_t = a_0 + t + \mu_2 D_{L,t} + \epsilon_t \]

respectively, where, assuming that structural change has occurred at \( t = \tau + 1 \), \( D_{p,t}, D_{L,t} \) are dummy variables:

\[ D_{p,t} = \begin{cases} 1 & t = \tau + 1 \\ 0 & t \neq \tau + 1 \end{cases}, \quad D_{L,t} = \begin{cases} 1 & t > \tau \\ 0 & t \leq \tau \end{cases} \]

The null hypothesis in the test above means that \( y_t \) has unit root with structural change, whereas the alternative hypothesis means that \( y_t \) has trend stationary process with structural change.

Table 4-23 shows the result of the Perron’s test.†††† Since we need to decide the time structural change has occurred to perform the test, we assume that structural break occurred in October 2001, when the defined contribution pension plan system was introduced in Japan. The null of nonstationarity cannot be rejected for all series. Hence we conclude that the differences of total net assets of stock, bond and hybrid investment trust in Japan are trend

stationary with structural break.

The Perron’s test is also performed for the net cash flow of investment trusts in Japan. Table 4-23 shows the result of the Perron’s test. While the net cash flow of bond investment trusts rejects nonstationarity, cash flow into stock and hybrid investment trusts cannot reject the null of unit root at 5% significant level. This suggests that money inflow into stock and hybrid investment trusts are nonstationary time series.

The number of Japanese investment trusts is following I(1) process. The market factors such as TOPIX and the yield of Japanese government bond is I(1) process, despite the log difference of these series are stationary. The volatility of TOPIX also rejected the null hypothesis for nonstationarity. These results are similar to the conclusion for U.S. market.

**Regression Models and Estimation Results**

In this section, we explore the market factors that affect investor demand for U.S. mutual funds and Japanese investment trusts statistically. The net cash flow to funds and investment trusts are considered as the investor demand. We also use the difference of net assets of funds and investment trusts as proxy variables for the investor demand. Since the previous section reveals that the market factors, such as the performance and volatility of stock and bond market, are important factors for the investor demand, we estimate the equation below:

\[
DEMAND_t = \alpha + \sum_{i=0}^{1} \lambda_i \Delta \text{STOCK}_{t-i} + \sum_{i=0}^{1} \eta_i \Delta \text{VOLA}_{t-i} + \sum_{i=0}^{1} \beta_i \Delta \text{BOND}_{t-i} + \sum_{i=0}^{1} \psi_i \Delta \text{DOLLAR}_{t-i} + \sum_{i=0}^{1} \nu_i \Delta \text{STOCK}_{t-i} + \sum_{i=0}^{1} \lambda_i \Delta \text{BOND}_{t-i} + \sum_{i=0}^{1} \rho_i \Delta \text{HYBRID}_{t-i}
\]

for U.S. market, where \( \Delta \text{STOCK}_t \) is the log difference of S&P 500, \( \text{VOLA}_t \) is the volatility of S&P 500, \( \Delta \text{BOND}_t \) is the log difference of the yield of 10-year treasury bond, \( \Delta \text{DOLLAR}_t \) is JPY/USD foreign exchange rate, \( \Delta \text{STOCK}_t, \Delta \text{BOND}_t, \Delta \text{HYBRID}_t \) are the differences of the number of stock, bond and hybrid mutual funds, respectively.

Because of the fact that the time series of Japanese investment trust market have structural change, we apply the following regression models to Japanese investment trust market.
\[ DEMAND_t = \alpha + \gamma t + \delta_1 D_{L,t} + \delta_2 D_{T,t} + \sum_{i=0}^{\infty} \lambda_i \Delta \text{STOCK}_{t-i} + \sum_{i=0}^{\infty} \eta_i \text{VOLA}_{t-i} + \sum_{i=0}^{\infty} \beta_i \Delta \text{BOND}_{t-i} \]
\[ + \sum_{i=0}^{\infty} \psi_i \Delta \text{DOLLAR}_{t-i} + \sum_{i=0}^{\infty} \nu_i \Delta \text{STOCK}_{t-i} + \sum_{i=0}^{\infty} \lambda_i \Delta \text{BOND}_{t-i} + \sum_{i=0}^{\infty} \rho_i \Delta \text{HYBRID}_{t-i} \]

where \( \Delta \text{STOCK}_t \) is the log difference of TOPIX, \( \text{VOLA}_t \) is the volatility of TOPIX, \( \Delta \text{BOND}_t \) is the log difference of the yield of 10-year Japanese government bond, \( D_{L,t} \) and \( D_{T,t} \) are dummy variables:

\[ D_{L,t} = \begin{cases} 1 & t > \tau \\ 0 & t \leq \tau \end{cases}, \quad D_{T,t} = \begin{cases} t - \tau & t > \tau \\ 0 & t \leq \tau \end{cases} \]

and \( \tau \) is the time when structural break has occurred, that is, October 2001.

The estimation results for U.S. and Japanese markets are presented in Table 4-24 and Table 4-25, respectively. Estimating all regression models, we apply \( j = 1 \) because we cannot find any clear evidence of Granger causality from market factors to investor demand for mutual funds and investment trusts.

The estimation results for net cash flow to U.S. and Japanese stock investment trusts show that stock market return is statistically significant at 1% level, which means that good performance of the stock market raises net cash flow to the mutual funds and investment trusts. This is consistent with the discussion in previous section. The first lags of the stock market return, however, are not significant in both countries. This implies that the investors in both countries invest in stock funds and investment trusts by looking at current market situation, not the past. The growth of the number of the stock funds and investment trusts may raise the cash flow to the investment trusts since the first lags of the number of stock funds and investment trusts are significant. The stock market volatility is not significant in all estimation results except for Japanese investment trust’s assets.

The dummy variables for the cash flow and the difference of net assets in Japanese stock investment trusts market are not significant at 5% level. From this result, we confirm that we cannot find structural change in these variables.
As for the cash flow to bond funds in the United States, the coefficients of $ΔLBOND_i$ and $ΔLBOND_{t-1}$ take negative value, and those are significant at 1% and 10% level respectively. This fact suggests that the bond appreciation causes an increase in the demand for bond funds. Since coefficient on $ΔNBOND_i$ is significantly positive at 10% level, an increase in the variety of bond funds raises the cash flow to the bond funds. This can be said to be similar to the relation between stock market and stock funds. The estimation results for the difference of bond funds’ assets resemble those findings.

Similarity of the estimation results between the cash flow into U.S. funds and Japanese investment trusts can be confirmed. That is, the coefficient on the log difference of 10-year Japanese government bond yield is significant and takes negative value, and increase in the number of bond investment trusts stimulate the demand for bond investment trusts. In addition to this, the $ΔLDOLLAR_{t-1}$ is significantly positive at 5% level, which implies that the depreciation of Japanese Yen causes the increase in cash flow to Japanese bond investment trusts.

The coefficients of $VOLA_i$ and $VOLA_{t-1}$ in the estimation result for the cash flow of hybrid funds in the U.S. is negative and significant. Hence, increase in the volatility of stock market reduces the demand for hybrid funds. On the other hand, these variables are not significant in the Japanese market, although the coefficients on the variables are negative. This implies that the nature of the demand for hybrid funds and investment trusts may be different in the U.S and Japan. The number of hybrid funds and investment trusts affects the funds’ cash flow positively in both countries.
Figure 4-1. Disposable Income, Savings and Saving Rate in the US

Disposable Income, Savings and Saving rate in the U.S.

Figure 4-2. Scatter Plot of Personal Savings and Personal Disposable Income in the US

Scatter Plot of Personal Savings and Disposable Personal Income in the U.S.
Figure 4-3. Personal Saving Rate and Total Net Assets of Mutual Funds in the US

Figure 4-4. Disposable Income, Savings and Saving Rate in Japan
Figure 4-5. Scatter Plot of Personal Disposable Income and Personal Savings in Japan

Figure 4-6. Personal Savings Rate and Total Net Assets of Investment Trusts in Japan
Figure 4-7. Cash Flows into Stock, Bond and Hybrid Funds

Cash Flows into Stock, Bond and Hybrid Funds (U.S. data)

- Stock and Bond Funds (Millions of Dollars)
- Hybrid Funds (Millions of Dollars)

Figure 4-8. Net Assets of Mutual Funds

Net Assets of Mutual Funds

Net Assets (Billions of Dollars)
Figure 4-9. Stock Market Performance and Net Cash Flow into Stock Funds

Figure 4-10. Net Assets of Taxable Bond Fund and Market Performance (US Data)
Figure 4-11. Cash Inflow and Volatility

Cash Inflow and Volatility: Hybrid (U.S. data)

Net Cash Flow
(Millions of Dollars)

Volatility

Figure 4-12. Net Assets of Hybrid Funds and Volatility

Net Assets of Hybrid Funds
(Billions of Dollars)

Volatility of S&P500

Net Assets of Hybrid Funds and Volatility: Hybrid (U.S. data)
Figure 4-13. Net Cash Flow of Investment Trusts in Japan

Figure 4-14. Net Assets of Investment Trusts (Japanese Data)
Figure 4-17. Cash Flow of Investment Trust Market and TOPIX

Figure 4-18. Volatility of TOPIX and Net Cash Flow of Hybrid Investment Trusts
Figure 4-19. JGB Yield and Net Cash Flow of Bond Investment Trusts

Figure 4-20. The Number of Investment Trusts Provided to Market
Table 4-21. Test statistics of ADF test for U.S. data

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<th></th>
<th>Market Factors</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>S&amp;P500 Volatility</td>
<td>yield of TB</td>
<td></td>
<td></td>
</tr>
<tr>
<td>no difference</td>
<td>-1.533</td>
<td>-4.528***</td>
<td>-1.474</td>
<td></td>
</tr>
<tr>
<td>log difference</td>
<td>-9.284***</td>
<td>---</td>
<td>-7.578***</td>
<td></td>
</tr>
<tr>
<td>No. of lags</td>
<td>0</td>
<td>0</td>
<td>1</td>
<td></td>
</tr>
</tbody>
</table>

*** Significant at 1% level
** Significant at 5% level
### Table 4-22 Test statistics of ADF test for Japanese data

<table>
<thead>
<tr>
<th></th>
<th>Stock</th>
<th>Bond</th>
<th>Hybrid</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Net Total Assets</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>No difference</td>
<td>-1.827</td>
<td>3.358</td>
<td>0.686</td>
</tr>
<tr>
<td>difference</td>
<td>-4.048***</td>
<td>-1.111</td>
<td>-0.789</td>
</tr>
<tr>
<td>No. of lags</td>
<td>1</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td><strong>Net Cash Flow</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>No difference</td>
<td>-2.954**</td>
<td>-0.674</td>
<td>-1.607</td>
</tr>
<tr>
<td>No. of lags</td>
<td>1</td>
<td>1</td>
<td>0</td>
</tr>
<tr>
<td><strong>Number of Trusts</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>No difference</td>
<td>-0.422</td>
<td>-1.002</td>
<td>-1.044</td>
</tr>
<tr>
<td>difference</td>
<td>-6.438***</td>
<td>-5.867***</td>
<td>-6.136***</td>
</tr>
<tr>
<td>No. of lags</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td><strong>Market Factors</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>TOPIX</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>No difference</td>
<td>-1.035</td>
<td>-6.523***</td>
<td>-2.636*</td>
</tr>
<tr>
<td>log difference</td>
<td>-4.791***</td>
<td>---</td>
<td>-7.698***</td>
</tr>
<tr>
<td>No. of lags</td>
<td>1</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

*** Significant at 1% level  
** Significant at 5% level  
• Significant at 10% level

### Table 4-23. Perron’s test statistics for Japanese data

<table>
<thead>
<tr>
<th></th>
<th>Stock</th>
<th>Bond</th>
<th>Hybrid</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Difference of Net Total Assets</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>test-statistic</td>
<td>-4.040**</td>
<td>-4.675***</td>
<td>-7.418***</td>
</tr>
<tr>
<td>No. of lags</td>
<td>1</td>
<td>1</td>
<td>0</td>
</tr>
<tr>
<td><strong>Net Cash Flow</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>test-statistic</td>
<td>-3.390</td>
<td>-4.135***</td>
<td>-2.732</td>
</tr>
<tr>
<td>No. of lags</td>
<td>1</td>
<td>1</td>
<td>1</td>
</tr>
</tbody>
</table>

*** Significant at 1% level  
** Significant at 5% level
| Table 4-24. Estimation Results for Demand of Mutual Funds in the U.S. |
|---------------------------------|---------|---------|---------|
| Stock                           | Bond    | Hybrid  |
| **Const.**                      | 21414.1 | 1268.08 | 2305.83 |
| (6114.89)***                    | (3158.36)| (1846.26)|
| **ΔLSTOCK**ₜ                  | 104838.8| -6060.84| -1264.83|
| (18891.44)***                  | (8513.36)| (1410.84)|
| **ΔLSTOCK**ₜ₋₁                | 2380.31 | -10505.53| -2125.59|
| (26756.87)                      | (10405.52)| (1569.43)|
| **VOLA**ₜ                      | -59372.75| -112241.1| -74934.02|
| (513615.30)                      | (160162.00)| (28452.40)|
| **VOLA**ₜ₋₁                    | -438547.6| 234348.6| -5182.01|
| (310221.50)                      | (155864.30)| (26197.70)|
| **ΔLBOND**ₜ                    | 18839.9 | -36194.47| 2456.81 |
| (16156.64)***                  | (9196.39)***| (1225.28)**|
| **ΔLBOND**ₜ₋₁                  | 30614.84| -14430.14| 300.88 |
| (18768.81)                      | (8562.52) | (1086.45)|
| **ΔLDOLLAR**ₜ                  | 23282.06| -7413.47| -2210.64|
| (43330.64)                      | (14205.98) | (2080.53)|
| **ΔLDOLLAR**ₜ₋₁                | -25683.48| -23621.29| -1163.25|
| (32832.55)                      | (12101.49) | (1778.52)|
| **ΔNSTOCK**ₜ                   | 161.5   | 134.12  | -6.31  |
| (156.05)                       | (76.62) | (11.36)| (0.37) |
| **ΔNSTOCK**ₜ₋₁                 | -88.83  | -62.75  | -10.62 |
| (158.52)                       | (79.50) | (13.12)| (0.39) |
| **ΔNBOND**ₜ                    | 4.61    | -0.43   | 0.74   |
| (0.94)***                      | (0.47) | (0.05)***| (1.21)**| (0.14)**|
| **ΔNBOND**ₜ₋₁                 | 2.18    | -0.09   | 0.31   |
| (0.72)***                      | (0.26) | (0.04)***| (1.22) | (0.15) | (0.05) |
| **ΔNHYBRID**ₜ                  | -2.95   | -17.23  | 1.76   |
| (55.13)                        | (20.32) | (3.67)| (0.01)**| (0.00) |
| **ΔNHYBRID**ₜ₋₁                | 76.46   | 24.6    | 0.91   |
| (43.24)                        | (23.00) | (2.95)| (0.01) | (0.00) |
| **R²**                         | 0.67    | 0.65    | 0.94   |
| **D.W.**                       | 1.95    | 2.22    | 0.85   |

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Table 4-25. The estimation results for demand of investment trust in Japan

<table>
<thead>
<tr>
<th></th>
<th>Net Cash Flow Difference of Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Stock</td>
</tr>
<tr>
<td><strong>Const.</strong></td>
<td>139372.4</td>
</tr>
<tr>
<td></td>
<td>(148074.80)</td>
</tr>
<tr>
<td><strong>t</strong></td>
<td>-1683.86</td>
</tr>
<tr>
<td></td>
<td>(3941.51)</td>
</tr>
<tr>
<td><strong>Dt</strong></td>
<td>-8822.77</td>
</tr>
<tr>
<td></td>
<td>(90046.53)</td>
</tr>
<tr>
<td><strong>ALSTOCK</strong></td>
<td>-656.67</td>
</tr>
<tr>
<td></td>
<td>(3841.51)</td>
</tr>
<tr>
<td><strong>VOLA</strong></td>
<td>4121257</td>
</tr>
<tr>
<td></td>
<td>(4292310.00)</td>
</tr>
<tr>
<td><strong>VOLA</strong>&lt;sub&gt;-1&lt;/sub&gt;</td>
<td>1481996</td>
</tr>
<tr>
<td></td>
<td>(5200487.00)</td>
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<tr>
<td><strong>ALBOND</strong></td>
<td>213609.9</td>
</tr>
<tr>
<td></td>
<td>(191363.00)</td>
</tr>
<tr>
<td><strong>ALBOND</strong>&lt;sub&gt;-1&lt;/sub&gt;</td>
<td>56216.16</td>
</tr>
<tr>
<td></td>
<td>(133461.20)</td>
</tr>
<tr>
<td><strong>ALDOLLAR</strong></td>
<td>-1214813</td>
</tr>
<tr>
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<td>(578935.40)</td>
</tr>
<tr>
<td><strong>ALDOLLAR</strong>&lt;sub&gt;-1&lt;/sub&gt;</td>
<td>-186818.4</td>
</tr>
<tr>
<td></td>
<td>(646329.80)</td>
</tr>
<tr>
<td><strong>ΔSTOCK</strong></td>
<td>2567.51</td>
</tr>
<tr>
<td></td>
<td>(1996.20)</td>
</tr>
<tr>
<td><strong>ΔSTOCK</strong>&lt;sub&gt;-1&lt;/sub&gt;</td>
<td>8303.86</td>
</tr>
<tr>
<td></td>
<td>(3965.38)</td>
</tr>
<tr>
<td><strong>ΔNBOND</strong></td>
<td>-12010.91</td>
</tr>
<tr>
<td></td>
<td>(3652.66)</td>
</tr>
<tr>
<td><strong>ΔNBOND</strong>&lt;sub&gt;-1&lt;/sub&gt;</td>
<td>-5563.37</td>
</tr>
<tr>
<td></td>
<td>(5633.33)</td>
</tr>
<tr>
<td><strong>ΔHYBRID</strong></td>
<td>14499.33</td>
</tr>
<tr>
<td></td>
<td>(4147.45)</td>
</tr>
<tr>
<td><strong>ΔHYBRID</strong>&lt;sub&gt;-1&lt;/sub&gt;</td>
<td>-22437.38</td>
</tr>
</tbody>
</table>

* *** significant at 1% level
** ** significant at 5% level
* * significant at 10 % level
<table>
<thead>
<tr>
<th></th>
<th>(7952.44)***</th>
<th>(1397.81)</th>
<th>(427.17)</th>
<th>(10157.96)*</th>
<th>(2339.12)</th>
<th>(455.25)</th>
</tr>
</thead>
<tbody>
<tr>
<td>$\bar{R}^2$</td>
<td>0.45</td>
<td>0.85</td>
<td>0.64</td>
<td>0.72</td>
<td>0.77</td>
<td>0.72</td>
</tr>
<tr>
<td>$D.W.$</td>
<td>2.13</td>
<td>2.46</td>
<td>2.15</td>
<td>2.05</td>
<td>2.12</td>
<td>1.98</td>
</tr>
</tbody>
</table>
CHAPTER 5:
ASSET MANAGEMENT INDUSTRY IN SELECTED ASIAN COUNTRIES

The lack of a robust capital market and the resulting excessive dependence on the banking sector are widely seen as major causes of the 1997 Asian financial crisis. Since then, Asian countries have strived to develop the domestic bond markets, and East Asian governments have worked closely together to develop the regional bond markets, already making meaningful progress toward that end. However, the capital markets in East Asia remain relatively underdeveloped, and financial infrastructures are not well established. Firms in the region, therefore, cannot efficiently mobilize domestic long-term resources despite the huge amounts of capital that the ASEAN+3 countries have at their disposal.

Institutional investors can play critical roles in the development of the capital markets by providing means of channeling savings into the capital markets with medium- and long-term investment horizons. In addition, they can help establish high standards for compliance, disclosure, and oversight of information, and help improve corporate governance of market participants. This report focuses on the asset management industry, particularly collective investment schemes with professionally managed intermediaries such as mutual funds and contractual investment trust funds.

This report covers the People’s Republic of China, Indonesia, Malaysia, the Philippines, and Thailand. The main objectives of the study are: (i) to analyze the background, historical growth, and current status of the asset management industry in each country; and (ii) to identify major impediments to the development of the asset management industry in each country.

This report is based on a desk review of information available in the public domain (publications and websites). The main sources of information, particularly industry statistics and regulations, were websites of government agencies regulating the asset management industry, the industry association, and industry players. Other sources of information include studies, reports, publications, press releases, and news archives found on the Internet.

Statistical data generally covered the period from 2000 to 2004. It should be noted, however,
that information for some topics and/or for some years are either incomplete, limited or not available.

Section 5.1 discusses the status of the asset management industries in the selected countries and provides essential information on asset growth, types of funds, distribution channels, and fees and expenses. Section 5.2 examines the major impediments to the development of the asset management industry in these countries. Section 5.3 offers some policy recommendations for the further development of the industry in the region.
5.1 State of the Asset management Industries in China, Indonesia, Malaysia, the Philippines and Thailand

The asset management industries in China, Indonesia, Malaysia, Philippines, and Thailand comprise fund management companies that are authorized by their respective regulators to manage the funds of corporations, charitable institutions, government agencies, private pension funds, mutual funds, unit trusts, insurance companies, and high net worth individuals. However, this report will focus only on asset managers of collective investment schemes.

Collective investment schemes or investment funds go by different names: securities investment funds in China; mutual funds in Indonesia; unit trusts in Malaysia; mutual funds, common trust funds, and unit investment trust funds in the Philippines; and mutual funds in Thailand. Whatever they are called, the basic nature of these funds remains the same – they issue shares or units to the general public and they invest the proceeds in various securities according to the funds’ investment objectives and policies.

5.1.1 History and Growth of Investment Funds

The investment fund industries in the selected countries are still in their infancy. In fact, the investment fund industry in most of the countries reviewed emerged only in the 1990s - China in 1997, Indonesia in 1996, Thailand in 1992, and the Philippines in 1991. Only Malaysia has an investment funds industry that dates back to 1959 although it was not until later in the 1980s that the unit trust industry in the country began to take off.

In most cases, the promulgation of new laws and regulations governing investment funds provided the impetus for the emergence of these industries. In China it was the issuance of the *Provisional Measures of the Administration of Securities Investment Funds* in 1997, in Indonesia it was the enactment of Act No. 8/1995 (*Capital Market Law*) while in Thailand it was the passage of the *Securities and Exchange Act* that precipitated the growth of investment funds in these countries. In the case of the Philippines, its *Investment Company Act* was enacted in 1960 but it was not until the promulgation of the *Rules and Regulations Governing Investment Companies* in 1989
that a mutual fund industry began to emerge.

As shown in Figure 5-1 below, all countries recorded impressive growth in the net assets of their respective investment funds from 2000 to 2004. Most obvious from the graph is the rapid increase in the net assets of investment funds in China from US$10 billion in 2000 to US$39 billion in 2004. Equally impressive, although less apparent, is that the net assets of Indonesia’s investment funds grew by nearly 20 times from only US$600,000 in 2000 to US$11 billion in 2004. However, the net assets of Indonesia’s mutual funds have gone down to less than US$4 billion in October 2005 as a result of massive redemptions.

![figure 5-1 growth in net assets of investment funds 2000 to 2004]

*Note: Year-end 2004 US$ exchange rates were used to eliminate the effects of currency movements*

In absolute terms, China had the highest net assets among the five countries with US$39 billion as of year-end 2004 (See Table 5-2). However, it also had the smallest NAV-to-Bonds Outstanding ratio and NAV-to-GDP ratio. Malaysia topped the NAV-to-GDP measure with 19.4% followed by Thailand with 10.4%. Thailand had the most number of funds with 523 funds while Indonesia recorded the highest 5-year NAV compounded annual growth rate with 83.7%. Indonesia and Thailand also had the highest NAV-to-Stock Market Capitalization ratios with figures of 15.3% and 15.1%, respectively. Meanwhile, the Philippines lags behind its Asian neighbors in
Based on the above indicators, Malaysia and Thailand appear to have the more developed investment fund industries among the five countries. They have the most number of funds and the highest NAV-to-GDP, NAV-to-Stock Market Capitalization, and NAV-to-Bonds Outstanding ratios. Indonesia also had a high NAV-to-Stock Market Capitalization ratio but this is primarily due to the low market capitalization of the Jakarta Stock Exchange. China, Indonesia, and the Philippines recorded higher 5-year annual growth rates in NAV but this is due in large part to their low net asset bases in 1999. The similar 15% CAGR in net assets recorded by Malaysia and Thailand, on the other hand, is a sign of a more mature industry.

5.1.2 Market Penetration

As a further measure of the level of development of the investment funds industries in the selected countries, the market penetration was estimated by dividing the number of investment fund accounts by the number of households in each country. The number of households that own at least one investment fund would have been a better measure but this information was not available. As shown in Table 5-3 below, Malaysia clearly had the deepest market penetration among the five countries with 182.5%. The rest had estimated market penetration levels of below 5%.

<table>
<thead>
<tr>
<th>Country</th>
<th>No. of Funds</th>
<th>NAV in US$ billion</th>
<th>5-Year NAV CAGR ('99-'04)</th>
<th>NAV as % of GDP</th>
<th>NAV as % of Stock Market</th>
<th>NAV as % of Bonds Outstanding</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>154</td>
<td>39.2</td>
<td>41.3%</td>
<td>2.4%</td>
<td>8.8%</td>
<td>6.2%</td>
</tr>
<tr>
<td>Indonesia</td>
<td>247</td>
<td>11.2</td>
<td>83.7%</td>
<td>4.5%</td>
<td>15.3%</td>
<td>22.6%</td>
</tr>
<tr>
<td>Malaysia</td>
<td>281</td>
<td>23.0</td>
<td>15.2%</td>
<td>19.4%</td>
<td>12.1%</td>
<td>24.1%</td>
</tr>
<tr>
<td>Philippines*</td>
<td>82</td>
<td>5.6</td>
<td>29.0%</td>
<td>6.5%</td>
<td>6.6%</td>
<td>21.8%</td>
</tr>
<tr>
<td>Thailand</td>
<td>523</td>
<td>17.5</td>
<td>14.7%</td>
<td>10.4%</td>
<td>15.1%</td>
<td>26.5%</td>
</tr>
</tbody>
</table>

* No. of funds includes 22 mutual funds and an estimated 60 common trust funds (no exact data available)
Table 5-3. Estimated Market Penetration of Investment Funds
As of Year-end 2004

<table>
<thead>
<tr>
<th>Country</th>
<th>No. of Accounts (million)</th>
<th>No. of Households (millions)</th>
<th>Estimated Market Penetration*</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>4.3</td>
<td>380.0</td>
<td>1.1%</td>
</tr>
<tr>
<td>Indonesia</td>
<td>0.3</td>
<td>50.0</td>
<td>0.6%</td>
</tr>
<tr>
<td>Malaysia</td>
<td>10.4</td>
<td>5.7</td>
<td>182.5%</td>
</tr>
<tr>
<td>Philippines</td>
<td>0.4</td>
<td>16.7</td>
<td>2.4%</td>
</tr>
<tr>
<td>Thailand</td>
<td>0.7</td>
<td>18.0</td>
<td>3.9%</td>
</tr>
</tbody>
</table>

*Actual market penetration could be significantly lower since investors have multiple accounts

TYPES OF FUNDS

By far, open-end funds are more popular than closed-funds in all the countries reviewed. This was to be expected though because of the superior liquidity feature of open-end funds. Nonetheless, Thailand and China still have a significant number of closed-end funds. The reason for this is that in China closed-end funds were the only funds that were allowed to be established from 1997 to 2000. But after the introduction of open-end funds in 2001, very few closed-end funds were created. In fact, none were established since 2002. As for Thailand, the closed-end funds are mostly special funds that were created to help resolve the problems of financial institutions affected by the Asian financial crisis.

Investment funds can also be classified according to the type of assets that they are primary invested in. The main categories are equity funds, bond funds, hybrid funds (including balanced and flexible portfolio funds), and money market funds. As shown in Table 2.3, equity funds are the dominant fund type in Malaysia and China, accounting for three-fourths of total net assets in these countries. On the other hand, funds in Indonesia and the Philippines are predominantly bond funds, accounting for 85% and 94%, respectively, of total net assets. In Thailand, flexible portfolio funds and special funds (funds to help resolve problems of financial institutions) are the preferred fund types.
Table 5-4. Market Shares of Different Fund Types  
As Percentage of Total Net Assets as of Year-end 2004

<table>
<thead>
<tr>
<th>Country</th>
<th>Equity Funds</th>
<th>Mixed or Hybrid Funds</th>
<th>Fixed Income Funds</th>
<th>Money Market Funds</th>
<th>Special Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>China*</td>
<td>76%</td>
<td>10%</td>
<td>12%</td>
<td>2%</td>
<td>0%</td>
</tr>
<tr>
<td>Indonesia</td>
<td>2%</td>
<td>4%</td>
<td>85%</td>
<td>9%</td>
<td>0%</td>
</tr>
<tr>
<td>Malaysia</td>
<td>75%</td>
<td>9%</td>
<td>14%</td>
<td>2%</td>
<td>0%</td>
</tr>
<tr>
<td>Philippines</td>
<td>2%</td>
<td>2%</td>
<td>92%</td>
<td>4%</td>
<td>0%</td>
</tr>
<tr>
<td>Thailand</td>
<td>15%</td>
<td>42%</td>
<td>17%</td>
<td>0%</td>
<td>26%</td>
</tr>
</tbody>
</table>

*As of year-end 2003

A majority of investment funds in the countries reviewed were general funds. Malaysia and Thailand, however, have more diversified and sophisticated fund products than the other countries.

5.1.3 Industry Players

Thailand, which had the most number of investment funds (523 funds as of end-2004), had the fewest number of asset management companies (AMCs) with seventeen (See Table 5-5). That’s an average of over 30 funds per AMC. In contrast, there were 34 AMCs in the Philippines managing 82 funds for an average of 2.4 funds per AMC. In terms of average assets under management (AUM), Thailand again topped this measure with an average AUM of US$1 billion per AMC, followed by China with US$871 million, and Malaysia with US$639 million. Of course, averages can be deceiving as the top AMCs would naturally have substantially more funds and more assets under management. Nevertheless, Table 5-5 below gives an indication of the general viability of engaging in the asset management business in the selected countries.

Invariably, domestic companies that are subsidiaries or affiliates of diversified financial institutions dominate the AMI in the selected countries. However, there are also a significant and growing number of asset management companies with foreign participation usually through joint ventures with domestic firms.

Except for the Philippines and China, there is at least one dominant government-
affiliated AMC in the countries reviewed: Permodalan Nasional Berhad in Malaysia, MFC Asset Management Public Co. in Thailand, and Danareksa Investment Management in Indonesia.

Table 5-5. Number of Asset Management Companies, Number of Funds and Assets Under Management As of Year-end 2004

<table>
<thead>
<tr>
<th>Country</th>
<th>No. of AMCs</th>
<th>No. of Funds</th>
<th>Ave. No. of Funds/AMC</th>
<th>NAV in US$ billion</th>
<th>Ave. AUM/AMC in US$ million</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>45</td>
<td>154</td>
<td>3.4</td>
<td>39.2</td>
<td>871.1</td>
</tr>
<tr>
<td>Indonesia</td>
<td>56</td>
<td>247</td>
<td>4.4</td>
<td>11.2</td>
<td>200.0</td>
</tr>
<tr>
<td>Malaysia</td>
<td>36</td>
<td>281</td>
<td>7.8</td>
<td>23.0</td>
<td>638.9</td>
</tr>
<tr>
<td>Philippines</td>
<td>34</td>
<td>82</td>
<td>2.4</td>
<td>5.6</td>
<td>164.7</td>
</tr>
<tr>
<td>Thailand</td>
<td>17</td>
<td>523</td>
<td>30.8</td>
<td>17.5</td>
<td>1,029.4</td>
</tr>
</tbody>
</table>

5.1.4  Distribution Channels

The distribution channels for most of the countries reviewed consisted of direct sales agents of the asset management company, accredited independent sales representatives, and financial institutions such as banks, finance companies, securities brokers/dealers, and post offices.

In most of the countries, banks have been an important third party distribution channel for investment funds as they accounted for more than 50% of total fund sales volume in China, Malaysia, Thailand, and Indonesia. The only exception is the Philippines where banks are not allowed to distribute mutual funds in their branch premises. As for common trusts funds and unit investment trust funds, they are distributed only by the banks that established them.

As of end-2004, persons involved in marketing and distributing investment funds numbered 32,017 in Malaysia; 7,031 in Indonesia; and 756 in the Philippines (excluding bank personnel marketing CTFs and UITFs since information is not available). No figures were readily available for Thailand and China.

Malaysia deserves special mention here as it probably has the most extensive
distribution network for investment funds among the countries reviewed. Aside from having a great number of persons dealing in unit trusts (PDUTs) as mentioned in the previous paragraph, Malaysia also has different types of institutions acting as institutional unit trust agents (IUTAs) including commercial banks, merchant banks, Islamic banks, finance companies, securities brokers/dealers, and other institutions. Most interesting is the fact that even unit trust management companies can apply as IUTAs and distribute funds of competitors.
5.2 Major Impediments to the Development of the Asset Management Industry

There are several factors that may impede the development of a country’s AMI. Some of these factors are examined below to determine if they are applicable to any of the selected countries. It should be noted, however, that the observations and conclusions in this section are the author’s personal assessment of the situation based on available information and may therefore need to be validated by industry practitioners and regulators.

5.2.1 Poor Regulation

A weak regulator and/or a poor regulatory framework can seriously impede the development of a country’s asset management industry. Although regulations are intended to primarily protect the interests of the investing public, they can sometimes be overly restrictive to the detriment of the industry. A weak regulator, on the other hand, can be indifferent to the problems of the industry and impotent in effecting necessary regulatory changes.

In general, the regulations governing investment funds in the selected countries contained adequate provisions on investor protection. These include: 1) provisions that help prevent conflict of interest situations; 2) provisions that ensure transparency and disclosure of pertinent information about the investment funds; and 3) provisions that help prevent exposure of investment funds to unnecessary risks.

An interesting observation in the study of the regulatory frameworks of the different countries is the manner in which the investment funds are established. In most countries, the promoters of the fund are allowed to accept subscriptions during an initial public offering. If they do not meet certain minimum requirements on the number of investors or amounts raised at the end of the offering period, the offering is considered a failure and the subscriptions received from investors are simply returned. In contrast, promoters of mutual funds in the Philippines are required to put up at least PHP50 million as paid-in capital for each fund that they establish. Moreover, they have to subscribe to at least 25% on any increase in authorized capital.
The Philippines is also unique in the region as it has two distinct types of investment funds being regulated by two government agencies – mutual funds are regulated by the Securities and Exchange Commission (SEC) while unit investment trust funds are regulated by the Bangko Sentral ng Pilipinas (BSP). The result is a regulatory framework that is not harmonized for the investment fund industry and an uneven playing field for the market players and investors.

5.2.2 High Taxes

High taxes on investment funds and/or their investors result in lower net returns and can therefore deter investments in investment funds.

A review of the taxation of investment funds and their investors in the selected countries revealed that taxation does not appear to be a hindrance to the growth of the investment fund industries in these countries. In fact, most countries afford tax incentives to investment funds and/or fund investors as shown in Table 5-6 below.
Table 5-6. Taxation of Investment Funds and Investors

<table>
<thead>
<tr>
<th>Country</th>
<th>Taxation of Investment Funds</th>
<th>Taxation of Fund Investors</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>Securities investment funds are exempt from both Business Tax and Enterprise Income Tax.</td>
<td>Distributions to individual investors are exempt from further individual income tax (as they have been withheld at the investee company level) while distributions to institutional investors are exempt from Enterprise Income Tax.</td>
</tr>
<tr>
<td>Indonesia</td>
<td>Investment funds in Indonesia are basically subject to the same taxes as any other type of investor in the country.</td>
<td>Capital gains and dividends received from contractual type funds (which are the most common type of fund in Indonesia) are exempt from income tax.</td>
</tr>
<tr>
<td>Malaysia</td>
<td>Unit trusts are allowed certain tax deductible expenses and exemptions. Tax allowable expenses comprise expenses wholly and exclusively incurred in the production of gross income.</td>
<td>Capital gains realized by unit holders upon the sale of units are not taxable. Distributions are classified as taxable distributions and non-taxable distributions.</td>
</tr>
<tr>
<td>Philippines</td>
<td>Investment funds in the Philippines are basically subject to the same taxes as other institutional investors in the country.</td>
<td>Gains realized upon redemption of shares in a mutual fund are exempt from income tax.</td>
</tr>
<tr>
<td>Thailand</td>
<td>Dividends, capital gains, and interest income received by the fund are all exempt from income tax.</td>
<td>For individual investors, capital gains realized upon redemption of mutual fund units are exempt from tax but dividends are subject to 10% withholding tax. For domestic corporate investors, capital gains are subject to 30% corporate income tax but dividend income received from mutual funds is 100% tax exempted for listed companies and 50% tax exempted for non-listed companies provided that shares are held for at least 3 months.</td>
</tr>
</tbody>
</table>

5.2.3 Excessive Fees and Charges

Excessive fees and charges can discourage prospective investors from investing in unit trusts as these obviously reduce their net returns. Shareholder/unitholder transaction fees consist of initial sales charges or front-end loads when buying into the fund and redemption fees or back-end loads when selling the shares/units back to the fund. Annual operating expenses, on the other hand, consist primarily of management fees and custodian/trustee fees. Other fund operating expenses are typically very minimal.

Table 3.2 summarizes the shareholder transaction fees and operating expenses of general equity funds and bond funds in the selected countries. It should be noted that the fees and expenses may vary greatly for each type of fund. For instance, some funds in the Philippines would give investors the several options for sales charges: a
5% front-end load but no back-end load, no front-end load but a declining back-end load depending on the length of investment, or a 1% front-end load and a 1% back-end load. The figures shown below represent either the average or the most common fees and expenses charged by the major players in each country.

As shown in Table 5-7, the annual operating expenses (annual expense ratio) of general investment funds in the different countries are more or less the same, with Indonesia and the Philippines incurring slightly higher operating expenses. Invariably, equity funds had higher expense ratios than bond funds. In comparison, the expense ratios of stock funds in the United States in 2003 averaged 1.2% while bond funds averaged 0.78%. Considering that the average sizes of investment funds in the selected Asian countries are smaller than U.S. mutual funds, the annual expense ratios of Asian funds may be deemed reasonable.

As for transaction fees, a glaring observation is that Malaysia AMCs charge rather high front-end loads for equity funds. On one hand, this may be viewed as excessive and may have discouraged investors from investing in Malaysian equity funds. On the other hand, high front-end loads may have also provided the necessary incentive for sales agents to aggressively market these funds. Furthermore, if investment funds are appropriately sold as a long-term investment, the entry costs can be distributed over the life of the investment.
Table 5-7. Fees and Expenses of General Equity and Bond Funds

<table>
<thead>
<tr>
<th>Country</th>
<th></th>
<th></th>
<th></th>
<th>Custodian/Trustee Fee</th>
<th>Annual Expense Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Front-end Load</td>
<td>Back-end Load</td>
<td>Management Fee</td>
<td></td>
<td></td>
</tr>
<tr>
<td>China</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity Fund</td>
<td>1.50%</td>
<td>0.50%</td>
<td>1.50%</td>
<td>0.25%</td>
<td>1.75%</td>
</tr>
<tr>
<td>Bond Fund</td>
<td>1.00%</td>
<td>0.50%</td>
<td>1.00%</td>
<td>0.10%</td>
<td>1.10%</td>
</tr>
<tr>
<td>Indonesia</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity Fund</td>
<td>2.00%</td>
<td>1.00%</td>
<td>2.00%</td>
<td>0.25%</td>
<td>2.25%</td>
</tr>
<tr>
<td>Bond Fund</td>
<td>1.00%</td>
<td>1.00%</td>
<td>1.00%</td>
<td>0.25%</td>
<td>1.25%</td>
</tr>
<tr>
<td>Malaysia</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity Fund</td>
<td>6.50%</td>
<td>1.50%</td>
<td>1.50%</td>
<td>0.10%</td>
<td>1.60%</td>
</tr>
<tr>
<td>Bond Fund</td>
<td>0.70%</td>
<td>1.50%</td>
<td>1.00%</td>
<td>0.07%</td>
<td>1.07%</td>
</tr>
<tr>
<td>Philippines</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity Fund</td>
<td>3.00%</td>
<td>2.00%</td>
<td>2.00%</td>
<td>0.10%</td>
<td>2.10%</td>
</tr>
<tr>
<td>Bond Fund</td>
<td>1.00%</td>
<td>2.00%</td>
<td>1.50%</td>
<td>0.05%</td>
<td>1.55%</td>
</tr>
<tr>
<td>Thailand</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity Fund</td>
<td>2.00%</td>
<td>0.25%</td>
<td>1.50%</td>
<td>0.25%</td>
<td>1.75%</td>
</tr>
<tr>
<td>Bond Fund</td>
<td>1.00%</td>
<td>0.25%</td>
<td>0.75%</td>
<td>0.20%</td>
<td>0.95%</td>
</tr>
</tbody>
</table>

5.2.4 Limited Distribution Channels

There is an old adage that “mutual funds (or unit trusts) are sold and not bought.” For this reason, distribution channels play a key role in the growth of the industry and should therefore be as broad as possible.

As noted in the previous chapter, most countries have extensive distribution channels for investment funds. Banks, in particular, have been essential sales outlets for investment funds in Malaysia, Thailand, China, and Indonesia. The only exception is the Philippines where mutual funds are sold primarily through a small number of SEC-licensed direct sales agents and accredited independent sales representatives. Meanwhile, Philippine unit investment trust funds are sold only through the banks that created them (i.e. no selling of third party funds) and are thus also limited in a sense.

Also worth mentioning is the recent decision of the China Securities Regulatory Commission to allow banks to establish their own fund management companies. It may be too early to tell but this may have an adverse effect on the distribution of
securities investment funds in China as banks might stop or lessen their distribution of non-proprietary funds.

5.2.5 Lack of Investor Education and Interest

Another factor that can impede the growth of a country’s investment fund industry is the lack of investor education. Retail financial products such as investment funds are inherently complex so it takes effort to educate investors on their advantages, disadvantages, risks and rewards, fees and expenses, subscription and redemption procedures, and other features.

It is primarily the responsibility of industry players to educate the investing public on investment funds but regulators and industry associations are also doing their share. However, without a market survey, it is difficult to assess the level of investor awareness and knowledge of investment funds in the selected countries. Market penetration, on the other hand, can be used to gauge not only the awareness level but also the acceptance of investment funds as an investment alternative. Based on the estimated market penetration in the selected countries as discussed in the precious chapter, it appears that Malaysia is way ahead of its Asian neighbors in promoting investment funds with a market penetration of 182.5%. The rest had penetration levels of less than 5%, indicating among other things a lack of investor education or interest on investment funds.

5.2.6 Limited Investment Outlets

The growth of a country’s investment fund industry is closely tied to the development and performance of its capital markets. For instance, if there are very few listed companies and bonds to choose from, this hinders the introduction of new funds, the development of new products, and meaningful diversification of investments.

In absolute terms, China had the biggest stock market with a market capitalization of US$447 billion as of year-end 2004 (see Table5-8). However, this represented only 27% of its year-end 2004 GDP and is the lowest in the group. Moreover, considering that the market capitalization of tradable shares is only one-third of the total market cap, the tradable market cap-to-GDP ratio is a measly 9%. In addition, although China
had the greatest number of listed companies, most of these are of poor quality so there is actually not that many investment grade stocks to choose from.

Other countries with underdeveloped stock markets are the Philippines and Indonesia. The Philippines had the fewest number of listed companies and the lowest turnover value in the group. According to some fund managers, there are only about 30 investment grade companies listed on the Philippine Stock Exchange. The Philippines had a rather high stock market cap-to-GDP ratio but this is due primarily to two foreign insurance companies (Sun Life and Manulife) that are listed on the PSE. Meanwhile, Indonesia had the second lowest turnover value, the second fewest listed companies, the lowest stock market capitalization, and the second lowest stock market cap-to-GDP ratio. It therefore does not come as a surprise that investment funds in these two countries are predominantly bond funds and that there are very few stock funds.

In contrast, Malaysia and Thailand have fairly developed stock markets. Malaysia in particular had the highest stock market cap-to-GDP ratio, the second highest stock market capitalization, and the second most number of listed companies. Likewise, Thailand had the second highest turnover value and decent numbers in the other measures. This has allowed AMCs in Malaysia and Thailand to introduce a sizeable number of not only general equity and mixed funds but also specialized funds.

<table>
<thead>
<tr>
<th>Country</th>
<th>Number of Listed Companies</th>
<th>Turnover Value US$ billion</th>
<th>Stock Market Capitalization US$ billion</th>
<th>Stock Market Cap as % of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>China*</td>
<td>1,373</td>
<td>511.3</td>
<td>447.5</td>
<td>27.1%</td>
</tr>
<tr>
<td>Indonesia</td>
<td>331</td>
<td>26.6</td>
<td>73.2</td>
<td>29.5%</td>
</tr>
<tr>
<td>Malaysia</td>
<td>963</td>
<td>56.7</td>
<td>190.0</td>
<td>160.6%</td>
</tr>
<tr>
<td>Philippines</td>
<td>235</td>
<td>3.7</td>
<td>84.7</td>
<td>98.4%</td>
</tr>
<tr>
<td>Thailand</td>
<td>439</td>
<td>128.6</td>
<td>115.8</td>
<td>68.8%</td>
</tr>
</tbody>
</table>

* Combined Shanghai and Shenzhen Stock Exchanges
As for the bond market, China once more topped the group in terms of the absolute amount of domestic bonds outstanding (See Table 5-9). But again, the size of its bond market is relatively small when compared to its economy. Another interesting observation is that only Malaysia has a balanced mix of government bonds and corporate bonds. The rest have bond markets dominated by government bonds. The situation is exceptionally bad in the Philippines where there are less than 10 corporate bond issuers. Malaysia was also the only country with a considerable bond market in relation to the economy.

Table 5-9. Bond Market (as of Year-end 2004)

<table>
<thead>
<tr>
<th>Country</th>
<th>Domestic Bonds Outstanding US$ billion</th>
<th>Gov't Bonds Outstanding US$ billion</th>
<th>Gov't Bonds as % of Total Bonds Outstanding</th>
<th>Domestic Bonds Outstanding as % of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>629.8</td>
<td>598.3</td>
<td>95.0%</td>
<td>38.2%</td>
</tr>
<tr>
<td>Indonesia</td>
<td>49.5</td>
<td>43.0</td>
<td>86.8%</td>
<td>20.0%</td>
</tr>
<tr>
<td>Malaysia</td>
<td>95.5</td>
<td>46.4</td>
<td>48.5%</td>
<td>80.7%</td>
</tr>
<tr>
<td>Philippines</td>
<td>25.6</td>
<td>25.3</td>
<td>98.8%</td>
<td>29.8%</td>
</tr>
<tr>
<td>Thailand</td>
<td>65.9</td>
<td>51.8</td>
<td>78.7%</td>
<td>39.1%</td>
</tr>
</tbody>
</table>

CONCLUSION

In summary, high taxes and excessive fees and expenses do not appear to be major impediments to the growth of the investment fund industries in the selected Asian countries. In fact, most countries even afforded tax incentives to investment funds and/or investors. Meanwhile, investment fund fees and expenses were quite reasonable.

Poor regulation and limited distribution channels were noted in the Philippines but not in the other countries although China may be limiting distribution channels for investment funds by recently allowing banks to establish their own fund management companies.

Lack of investor education and interest may be a major hindrance to the growth of investment funds based on low market penetration levels in all countries except Malaysia. Unfortunately, only a market survey can confirm this.
Finally, limited investment outlets appear to be a serious issue for most countries as their domestic capital markets have remained basically underdeveloped.
5.3. Policy Recommendations for the Development of the Asset Management Industry

The following policy recommendations are based solely on the author’s understanding of the current state of the asset management industries in the selected countries and the perceived impediments to their future development. Ideally, the author’s observations and conclusions should have been validated first by industry players and regulators especially since the study is only a desk review. However, this was not done due to time and budgetary constraints.

**CHINA**

The China Securities Regulatory Commission should reconsider its decision to allow banks to establish their own fund management companies as this could diminish the role of banks as a vital component of the investment fund industry’s distribution network. An added benefit of keeping banks out of the investment fund management business (but maintain its fund distribution function) is that it will help diversify the financial system and promote the development of the non-bank financial sector.

There is clearly a need to improve the quality of companies listed on the stock exchanges in order to expand the investment choices for investment funds and other investors. This could be achieved through stricter listing rules and regulations. The government should also consider providing incentives to companies that issue debt securities in order to promote the development of the corporate bond market.

**INDONESIA**

The laws and regulations governing investment funds in Indonesia could use some fine-tuning particularly in the area of investment restrictions. Too many specific prohibitions could unreasonably restrict the investment options for fund managers and retard product development. Emphasis should be put instead on the full and timely disclosure of all pertinent information about the fund especially on the risks involved in investing in different types of funds.

Indonesia needs to develop its capital markets and soon. As of year-end 2004, mutual funds already owned 45% of total outstanding corporate bonds. Likewise, the government bond
market is very limited and has not expanded since 2000. Finally, its stock market is one of the smallest in the region in absolute terms and in relation to the economy. The government should adopt a workable blueprint for capital market development similar to Malaysia’s Capital Market Masterplan.

MALAYSIA

There are no policy recommendations for Malaysia as the government appears to have successfully nurtured the growth and development of the unit trust industry. Although initial sales charges are rather high at 6.5%, a regulator-imposed limit may not be the best way to reduce transaction fees. Besides, the relatively high initial sales charges could be partly responsible for the widespread distribution of unit trusts in the country so placing a statutory limit on fees could be counterproductive.

PHILIPPINES

The main recommendation for the Philippines is for the government to unify and harmonize the regulatory framework for the investment fund industry. Banks could still be allowed to participate in the fund management business but the appropriate regulator for the industry is the Securities and Exchange Commission since this is basically a capital market activity. The law on investment funds should also be updated since the existing law is antiquated and not responsive to the needs of the industry.

There is also a need to expand the distribution channels for investment funds. Banks and other financial institutions should be permitted to sell mutual funds as their nationwide branch networks are ideal for the widespread distribution of retail financial products. This could be patterned after Malaysia’s institutional unit trust agent (IUTA) model where different types of financial institutions can apply for a license to distribute non-proprietary funds.

Finally, the Philippines has to develop its domestic equities and corporate bond markets. The adoption of a viable capital market masterplan is strongly suggested.

THAILAND

There are no policy recommendations for Thailand since, like Malaysia, the government has successfully nurtured the development of the fledgling mutual fund industry. The only factor
that was observed as a possible obstacle to the further development of the industry is the lack of investor awareness or interest in mutual funds. However, this is more the responsibility of the industry players than of the regulator.

OTHER RECOMMENDATIONS

To broaden investment alternatives for investment funds, especially for countries with underdeveloped capital markets, regulators could liberalize investments in foreign securities starting with those available in the region. This of course requires regional cooperation.

The governments should also consider the promotion of individual retirement accounts similar to the IRA in the United States as this has proven to be instrumental in the development of investment funds.
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