The Sun Also Rises

Growth Strategies for Japanese Asset Managers

May 2010

- **Japanese fund managers can strengthen their competitive positioning at home and abroad by making three key changes in their business models:**
  — Streamlining mutual fund economics by managing fewer, larger funds
  — Reducing home bias focused on domestic securities
  — Improving incentive alignment structures

- **Japan's fund management industry is less profitable than others worldwide,** providing 20% operating margins on an asset-weighted basis, compared to 31% in the US and 40% in Europe.

- **Approximately 80% of Japanese mutual funds do not generate enough fee income to cover operating costs,** reflecting a marketplace lacking efficiency in packaging and distribution.

- **Roughly 45% of Japan's mutual fund revenue goes to pay subadvisors.**

- **Japanese firms have gathered fewer assets from non-Japanese clients in recent years,** instead focusing on local institutional accounts with shrinking fees.

- **Implementing more merit pay and long-term incentives may help boost performance and retain key talent.** Nearly 75% of Japanese fund manager compensation is salary, compared to 50% in the US.

- **A number of strategic enhancements could quickly improve profitability among Japan's fund managers, including:**
  — A more rigorous product development process
  — Expanding product arrays to include regional equity
  — Creating better alignment structures for management

Introduction

Japanese asset management firms face three key competitive challenges that currently make them less profitable than their counterparts in other countries:

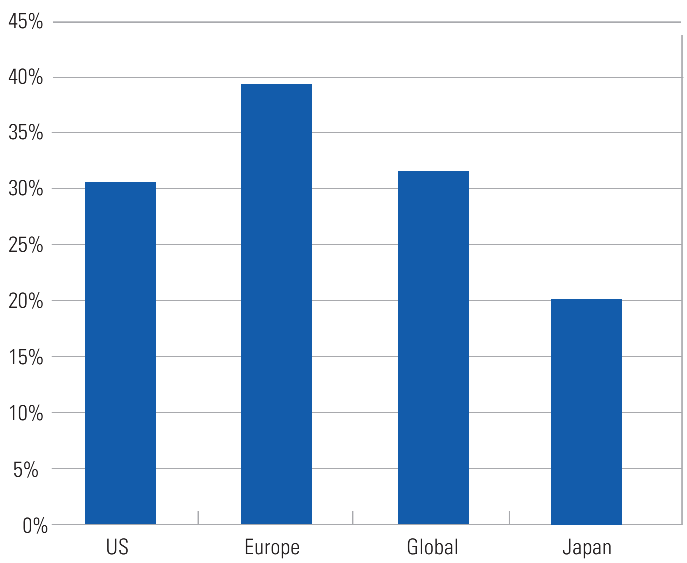
1. An inefficient and fragmented mutual fund marketplace saddles Japanese fund managers with higher client acquisition, subadvisory and other related distribution costs than their peers worldwide, with many Japanese firms running mutual fund complexes as loss leaders.
2. A focus on domestic products, and proclivity to use foreign firms as subadvisors, not only prevents them from addressing the growing component of Japanese portfolios, but also keeps them from gaining new assets from overseas clients.
3. Most importantly, many Japanese asset managers lack flexible and competitive incentive alignment structures, making it difficult to adjust compensation in a crisis or share earnings with employees during a boom—two ways other fund managers worldwide have bolstered profitability.

The current profitability gap between Japanese fund managers and their foreign counterparts is significant. A comparison of profit margins posted by fund managers worldwide during the 2008 fiscal year, the most recent for which data is currently available across the countries measured, reveals that on an asset-weighted average, Japanese fund managers—including subsidiaries of global asset managers active in Japan—are roughly a third less profitable than their peers in the US or Europe.

Japanese managers can bridge their profitability gap. With proper attention paid to product development, a shift toward regional investment processes, and better compensation and alignment systems, Japanese fund managers can become more competitive and start steadily improving their profit margins.

Exhibit 1

International Comparison of Operating Profit Margins for Asset Managers Worldwide, 2008



Note: Global firms reporting end of calendar year; Japanese firms reporting end of fiscal year.
Sources: Casey Quirk, Nomura Research Institute

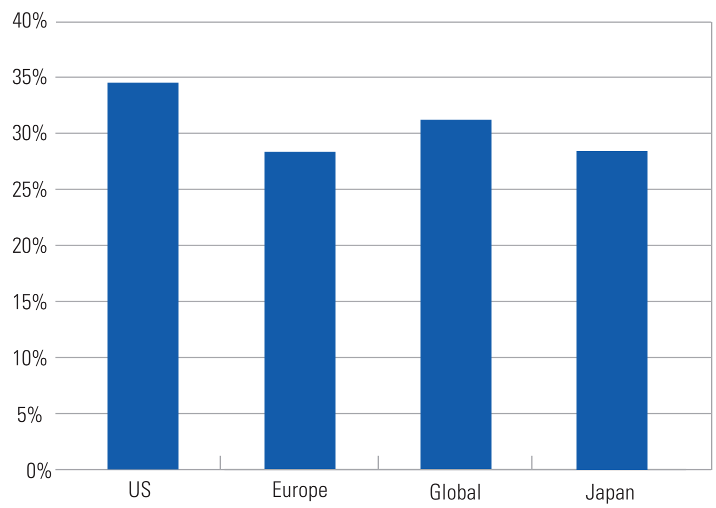
Operating margins in Japan are not only lower than in the US or Europe, they also vary more widely. While one-fourth of Japanese fund managers reported a loss during the year ending March 2009—admittedly in the darkest days of the recent financial crisis—another quarter posted margins comfortably above global medians of 32%. While it is difficult to ascribe success to any common denominators, those that suffered clearly did so because they failed to develop with at least one, if not all, of three core strategies.

Strategy 1: Streamlining Mutual Fund Economics

Domestic mutual funds represented more than 60% of the Japanese fund management industry's gross revenue at last measure, and with asset-weighted average operating margins of 30%, mutual fund-oriented firms are still more profitable than institutional-focused firms, where profit margins hovered around 10%. This is the opposite of most US firms, where institutional margins eclipse those of mutual fund firms. In addition, the range of profitability among Japanese mutual fund firms, is much higher, separating organizations into clear winners and losers.

Exhibit 2

International Comparison of Operating Margins for Mutual Fund-Focused Firms, 2008



Note: Global firms reporting end of calendar year; Japanese firms reporting end of fiscal year.
Sources: Casey Quirk, Nomura Research Institute

A far higher proportion of Japanese firms lose money selling mutual funds, due to a number of reasons:

- A need for subadvisors: Some 45% of Japanese gross mutual fund revenue goes to subadvisors, many of whom are foreign firms, some of which have no Japanese cost infrastructure to pay.
- High distribution tolls: Of the remaining revenue, distributors can take as much as 80% as a toll, with smaller fund complexes typically paying more for shelf space.
- Fragmented product issuance: approximately 80% of Japanese mutual funds do not generate enough fee revenue to cover allocated costs. This impacts both small and large Japanese mutual fund firms.

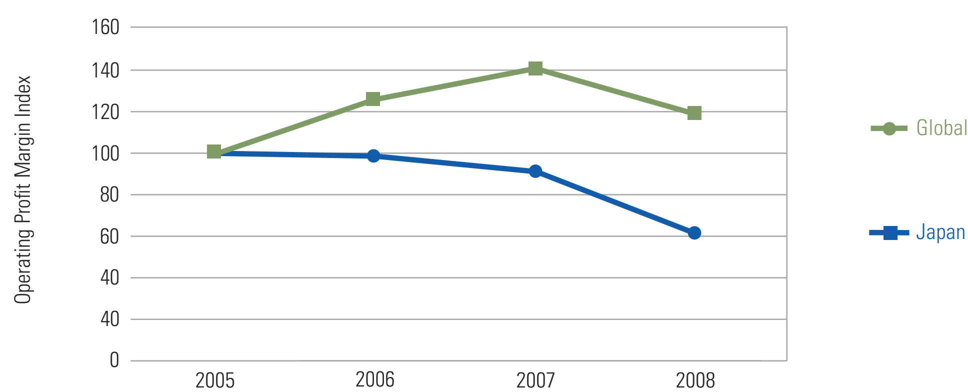
The lattermost point is critical. Without access to national multi-channel distribution—currently only awarded to large, proven players who have invested significantly in portfolio managers, or major fund-of-fund providers who further compress margins with assembly fees—Japanese fund managers have only two choices to prevent declining profitability. They can increase their exposure to Japan's institutional marketplace, but while fewer firms lose money here, growth is slowing and fees from domestic institutions are much lower. Their other option involves offering higher-margin products and services that non-Japanese clients will buy, potentially adding higher-margin revenue.

Strategy 2: Reducing Home Bias

Globalizing clients, and globalizing products to appeal to a broader universe of investors, also creates a key competitive advantage. Japanese firms have watched their asset-weighted average profit margin slump in the past few years, while firms with a truly global client base, often based in the US or Europe, have suffered less margin compression, even during the recent crisis.

Exhibit 3

Cumulative Operating Profit: Global and Japanese Fund Managers



Note: Global firms reporting end of calendar year; Japanese firms reporting end of fiscal year.
Sources: Casey Quirk, Nomura Research Institute

While many US and European firms have steadily increased the proportion of business they receive from non-domestic institutions, Japanese firms have watched it shrink during the last few years, with many realizing new business only from the government pension system, an institutional investor with notoriously low fees. Few Japanese firms offer global or foreign portfolios, and those that do heavily leverage subadvisors and offshore funds cross-registered from Dublin or Luxembourg.

Japanese firms need to build credible, and proprietary, regional equity and bond capabilities in order to improve margins. Most Japanese firms feel the costs of offering global equity portfolios—where competition is quite entrenched, and markets are already highly efficient—outweigh the benefits, but Asian equity and bond products present more attractive product development opportunities. Japanese firms also should focus on expanding into emerging markets portfolios: 60% of such securities are listed in Asia, Japan's neighborhood.

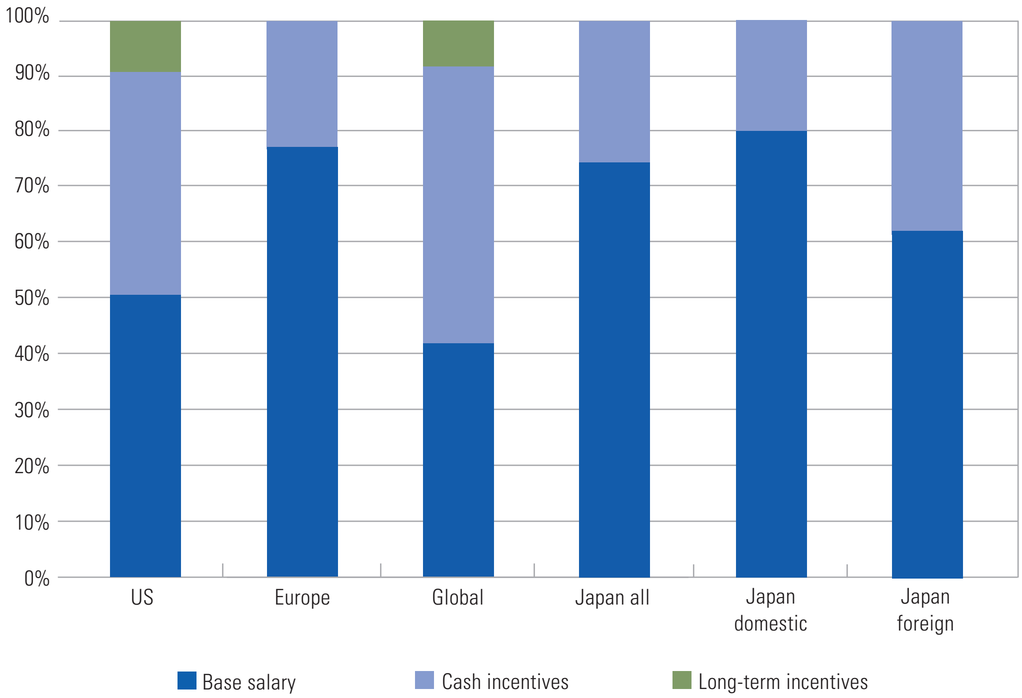
Offering Asian equity and bond products provide Japanese fund managers two advantages. First, they will be able to recapture margins from subadvisors and foreign firms in the higher-growth international and global equity and bond segments of Japan's investment marketplace, where fees also are generally higher. More importantly, if their products are truly competitive, they can win business outside Japan, where there is little demand for stand-alone Japanese products. This would have been particularly important during the crisis: while Japanese institutional investors fled to low-fee JGB (Japan Government Bonds) portfolios, other institutional investors, and many retail investors in Asia, kept purchasing international equity and bond products.

Strategy 3: Improving Incentive Alignment Structures

Finally, and most importantly, two key differences separate Japanese fund managers from at least their American counterparts, if not others worldwide. First, compensation and benefits generally make up about 50% of the expense line at Japanese asset management firms—about the same ratio that remuneration comprises among European fund managers, but markedly less than the 65% posted by US firms and slightly higher from global fund management organizations. Secondly, nearly 75% of Japanese asset manager compensation is salary, again similar to Europe, but significantly more than the roughly 50% reported by American firms.

Exhibit 4

Compensation Expenses by Incentive Structure, 2008



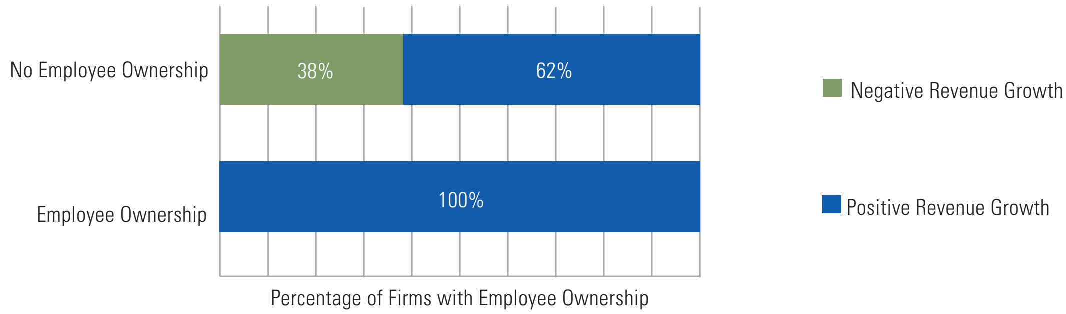
Note: Global firms reporting end of calendar year; Japanese firms reporting end of fiscal year.
Sources: Casey Quirk, Nomura Research Institute

Japan's salary-driven compensation culture makes it difficult for Japanese asset managers to offer incentive compensation systems that appear closer in line to those used among truly global fund management firms, as well as many investment managers in the United States. One can clearly see the cultural difference by comparing the salary-bonus ratio of Japanese fund managers with the local operations of global fund managers active in Japan. During the year ending March 2009, Japanese asset management revenues fell 25%. But Japanese fund managers could not reduce their compensation and benefits expenses as quickly as many of their American counterparts. Consequently, as a proportion of expenses, compensation rose by seven percentage points in Japan, while it fell four percentage points in the US.

Additionally, performance-linked and long-term compensation is rare among Japanese fund managers, and only a handful offer employee ownership. There is mounting evidence that an incentive system linking profits and ownership directly to employee compensation is one of the more powerful, and sustainable, competitive advantages in global fund management. While some captive firms—investment managers wholly owned by a financial institution—have watched their revenues slump in absolute terms during the past five years, nearly no firm with a degree of employee ownership has.

Exhibit 5

Employee Ownership and Estimated Revenue Growth of Asset Management Subsidiaries, 2003-2008



Note: Sample includes firms majority controlled by a strategic or financial shareholder within an overall sample of 131 asset managers, mostly US-headquartered, with AUM >$1B
Source: Casey Quirk

Clearly, regulation and culture drives part of the compensation system at many Japanese fund managers, and admittedly many Japanese executives and portfolio managers prefer stable pay. Nevertheless, these incentive structures are less competitive than those at global fund managers, and consequently Japanese asset managers cannot compete for top investment, marketing and executive talent in the industry, once pitted against global competitors that provide greater total economic benefit to key people.

Conclusion

Japanese asset managers have a number of advantages their foreign counterparts can never replicate. They sit within the world's third-largest pool of professionally managed assets, and often enjoy favored terms within local retail and institutional infrastructure. By further refining their business models, Japanese fund managers can bolster earnings with a more diverse domestic revenue stream, coupled with a wider global clientele. Three key changes can address the challenges outlined above:

1. A more rigorous product development process can ensure Japanese firms launch mutual funds that stand a sizable chance of gaining and keeping enough assets to break even—rather than waste time on copycat, flavor-of-the-month products, in and out of which brokers will quickly churn clients.

2. Regional equity products, built to highlight a focused investment process that will attract professional buyers worldwide, will help Japanese fund managers secure footholds in faster-growing, more lucrative markets worldwide, rather than consign themselves to a take-away game in a shrinking, thin-margin marketplace for Japanese equities and bonds.

3. Finally, and perhaps most importantly, better alignment systems could help Japanese firms attract and retain the key talent necessary to make the first two changes. Such enhancements need not require radical changes, such as involving M&A or creating a public currency. Firms can build better long-term profit-sharing plans and pseudo-equity schemes that could replicate many of the advantages realized by key executives at competitive global fund managers.

Methodology Notes

Casey Quirk and the Nomura Research Institute combined data from a number of initiatives to underpin our conclusions regarding Japanese asset managers.

Casey Quirk gathered detailed financial and operating metrics from nearly 70 fund managers from the United States, Canada, and Europe as part of its annual performance benchmarking surveys, conducted in concert with compensation consultants McLagan and the *Institutional Investor* European Institute. All information, gathered during the second and third quarters of 2009, reflects the calendar year ending December 2008. The 2009 surveys are currently underway.

The Nomura Research Institute gathered detailed financial and operating metrics from nearly 100 Japanese asset management firms during the third quarter of 2009. Around half of these firms are the companies ultimately owned by foreign investment managers. The NRI then supplemented the survey findings with publicly available, but less granular, data regarding revenues, expenses, and earnings, collected from the Japanese Financial Supervisory Agency. All data reflects information available during the fiscal year ending March 2009.

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Nomura Research Institute (NRI) was established in 1965 as Japan's first private-sector think tank. NRI provides a wide range of navigation and solution services. Our navigation services include research, management consulting, and system consulting. NRI has conducted extensive surveys and other research regarding the asset management business in Japan. Our research spans a broad range of areas, including regulatory compliance, new portfolio management techniques, performance evaluation methods, governance, and the asset management business's institutional and retail environment.

NRI is also a global research partner of The Rotman ICPM (International Centre for Pension Management) of the University of Toronto, which strives to become a global catalyst for improving pension management. NRI dedicates to improve pension fund management in Japan through this activity.

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