Investment Trust Distribution in Japan: Japan Post and Banks

Toshio Taki

I. Introduction

More than a year has passed since the post office began selling investment trusts on 3 October 2005.[1] The sales, which began with five different products sold by 575 post office branches, expanded to nine different products (Figure 1) sold by 605 branches in June 2006, and further to 1,155 branches in October.

Cumulative sales during the one-year period ended end-September 2006 totaled ¥359.7 billion, and the total net assets of all funds sold stood at ¥360.4 billion at end-September. Assets increased further to ¥483.5 billion by end-November. As explained below, the pace of sales is picking up, approaching the end-March 2007 target of ¥643 billion, which appears to be a realistic target.

The sale of investment trusts is expected to turn into a fee-based business for the Post Office Company and the Postal Savings Bank, two of the entities that will result from the privatization and splitting up of Japan Post scheduled for October 2007.[2] With the current postal savings business now dealing with the asset management issues arising from the huge amount of assets it controls, the growth in commission income is an important topic, including from the perspective of ensuring that the privatization process goes smoothly. Also, as we explain later, around the time that the post office began selling investment trusts, retail sales by the banks, another factor behind the rapid growth in the investment trust market in recent years, were also undergoing change. In this paper, we draw upon data on the post office's sales trends to examine the future development potential of the post office channel and to look for clues to help predict the direction that the overall investment trust market may take.

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1 For trends when sales began, see Toshio Taki, The sale of Investment Trusts by the Post Office, Capital Market Review, Winter 2006 issue.

2 On 1 October 2007, Japan Post will be split up into a holding company (Japan Postal Services Holding Company) and four operating companies (Post Office Company, Postal Service Company, Postal Savings Bank, and Postal Life Insurance Company).

Figure 1 Overview of funds sold by the post office

	Fund name	Contractor	Type product	Benchmark index	Sales commission (including tax)	Trust fees (including tax)	Settlement (distribution) month	Fund allocations	Actual distributions
October 2005 Sales start	Nomura Global 6 Assets Diversified Fund (Stable)	Nomura Asset Management	Equity fund (Balanced)	NOMURA-BPI, Six indices, including TOPIX	1.575%	0.651%	January, March, May, July, September, November	Bonds 70% (domestic 60%, foreign 10%), equity 20% (domestic 5%, foreign 15%), REIT 10% (domestic 5%, foreign 5%)	January, March, May, July, September 2006 ¥20 November 2006 ¥30
	Nomura Global 6 Assets Diversified Fund (Income)	Nomura Asset Management	Equity fund (Balanced)	NOMURA-BPI, Six indices, including TOPIX	1.575%	0.725%	January, March, May, July, September, November	Bonds 70% (domestic 20%, foreign 50%), equity 20% (domestic 5%, foreign 15%), REIT 10% (domestic 5%, foreign 5%)	January, March, May, July, 2006 ¥50 September, November 2006 ¥60
	Nomura Global 6 Assets Diversified Fund (Growth)	Nomura Asset Management	Equity fund (Global equity)	NOMURA-BPI, Six indices, including TOPIX	1.575%	0.798%	January, March, May, July, September, November	Bonds 20% (domestic 10%, foreign 10%), equity 70% (domestic 35%, foreign 35%), REIT 10% (domestic 5%, foreign 5%)	January, March, May, July, September 2006 ¥20 November 2006 ¥100
	Daiwa Stock Index 225 Fund	Daiwa Asset Management	Equity fund (Indexed)	Nikkei average	2.1%	0.546%	September	Targets investment results linked to the Nikkei average (Nikkei 225)	September 2006 ¥40
	Goldman Sachs Japanese Equity Index Plus	Goldman Sachs Asset Management	Equity fund Domestic equity	TOPIX	2.625%	1.05%	March, September	Aims to consistently achieve returns above the benchmark while tracking the TOPIX	March 2006 ¥800 September 2006 ¥60
June 2006 Sales start	Nikko Five Continents Bond Fund	Nikko Asset Management	Equity fund Balanced	Citigroup World Government Bond Index	2.1%	1.05%	Monthly	80% industrialized and 20% emerging market Targets investment results linked to bond indices	August, September 2006 ¥35 October 2006 ¥40
	Nikko Five Continents Equity Fund	Nikko Asset Management	Equity fund Global equity	MSCI - Kokusai and Emerging	2.1%	1.155%	February, May, August, November	80% industrialized and 20% emerging market Targets investment results linked to equity indices	August 2006 ¥150
	DIAM World REIT Index fund	DLIBJ Asset Management	Equity fund Fund of Funds	S&P Citigroup Global REIT Index	2.625%	0.8925%	Monthly	Invests in REITs in countries worldwide, including Japan Targets investment results linked to the benchmark	October 2006 ¥45
	Sumitomo Trust Japanese Equity SRI Fund	STB Asset Management	Equity fund Domestic equity	TOPIX	3.15%	1.68%	June	Targets investment results that outperform the TOPIX	No results (First settlement in June 2007)

Source: Nomura Institute of Capital Markets Research, based on materials for each fund

II. Sales trends at the post office

1. Stepped growth in sales

When it began sales in October 2005, the post office's plan was to develop its own sales force internally, rather than hire investment trust sales expertise from the outside. Some of those involved were concerned, however, that such an approach may lead to insufficient sales capabilities. In fact, when sales first began there were reports that it was taking two to three hours for each sale,[3] and there were questions at the time over whether the sales pace would ever actually grow.

Looking at the monthly sales figures since then (Figure 2), although sales were under ¥10 billion for the first several months, they have exceeded ¥20 billion since December 2005, and there have been a number of months since April 2006 in which sales were over ¥40 billion. Given that the number of branches making the sales did

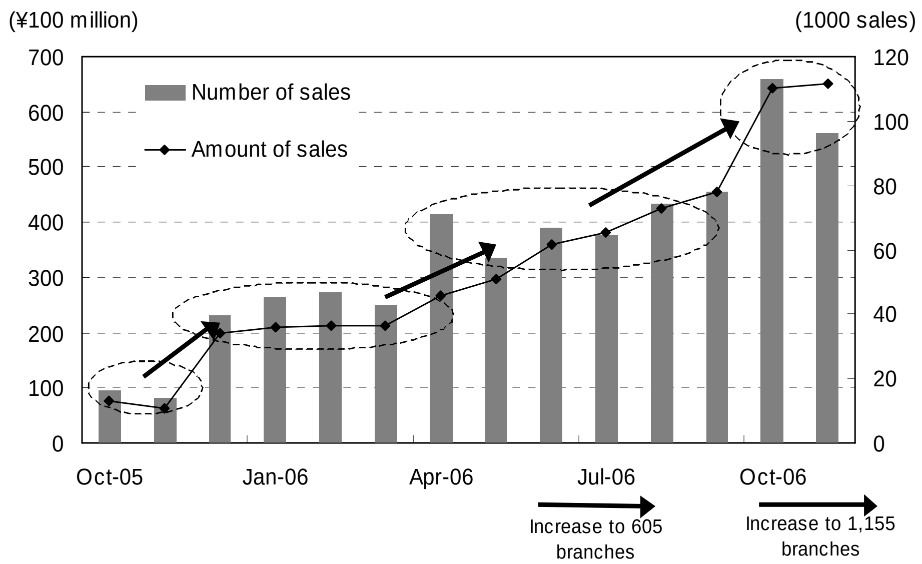
3 See articles in *Nihon Keizai Shimbun*, 23 October 2005, p. 13, and *Nikkei Business*, 23 October 2006 pp. 34-35.

not increase much over this period, it is likely that the sales generating capability per branch grew by four to five times its initial level. Sales grew further to ¥65.9 billion in October 2006, when there was a substantial increase in the number of branches selling investment trusts. We see room for further growth stemming from improvements in sales capability at the branches that have just started selling.

The number of new accounts opened (Figure 3) started out at below 10,000 per month, but has consistently been over 20,000 since the start of 2006, reaching a total of 208,000 accounts at end-September 2006 and 267,000 accounts at end-November. The number of sales per account (excluding automatic collection savings) was initially about two, and is now over four. These numbers suggest that the average customer started out buying multiple investment trusts and then became a repeat buyer.

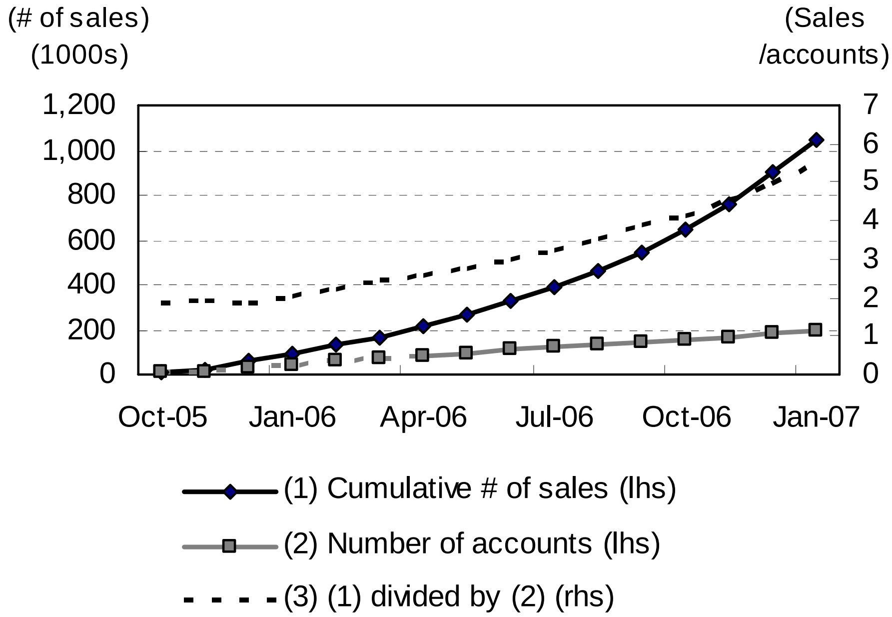
Since June 2006, growth has been particularly sharp for automatic collection savings (Figure 4), up to a total of 99,000 accounts as of end-November 2006, 37% of the total. More recently, more than half of the new accounts being opened are collection savings.

Figure 2 Increase in sales



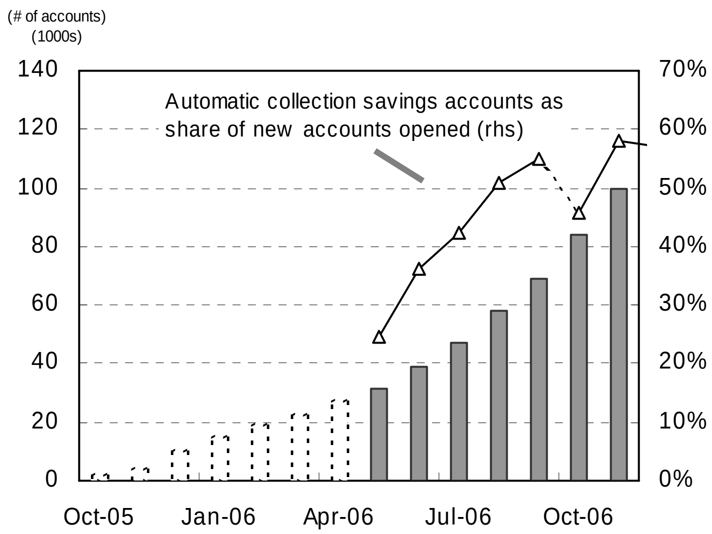
Note: Does not include automatic collection savings.
Source: Nomura Institute of Capital Markets Research, based on Japan Post data.

Figure 3 Number of investment trust accounts and cumulative number of sales



Note: Does not include automatic collection savings.
Source: Nomura Institute of Capital Markets Research, based on Japan Post data.

Figure 4 Number of automatic collection savings accounts



Note: Number of accounts since April 06 and shares are estimates
Source: Nomura Institute of Capital Markets Research, based on Japan Post data.

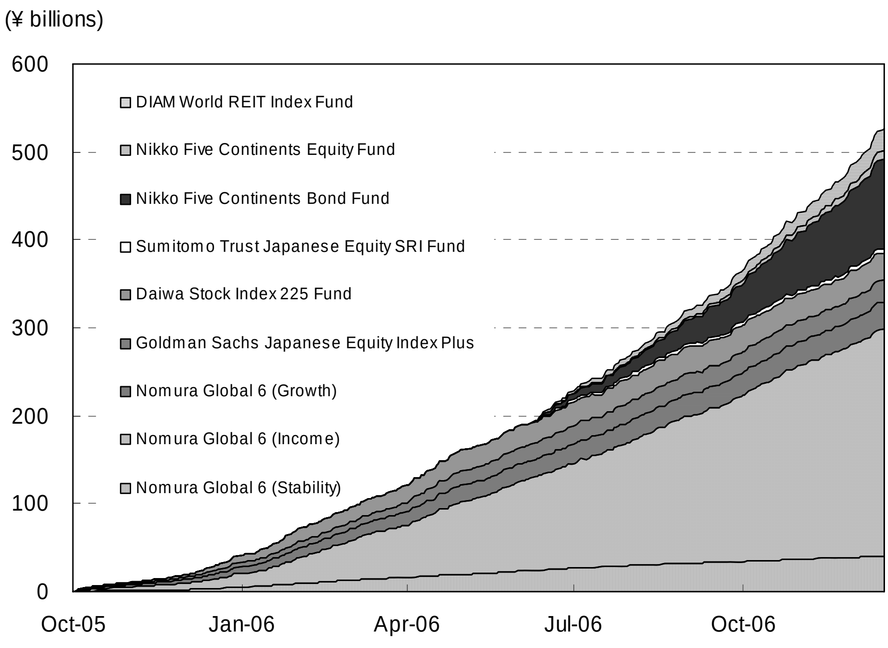
2. Trends for each fund

A look at the net assets of each investment trust (Figure 5) shows that the three variations of the Balanced Fund (Stable, Income, and Growth) combined account for 64% of the total. The Income Balance Fund, which invests 50% of its assets in foreign bonds, has shown particularly strong growth, and now has over ¥240 billion in assets. The Foreign Bond Fund, which was launched in June 2006, has also grown impressively, and is now the second largest fund. Based on where the assets are invested, those funds focused on foreign bonds are quite popular.

Breaking down the products sold between April and November 2006 by the frequency of their distributions (Figure 6), funds paying a monthly or bi-monthly distribution accounted for 82% of sales. This focus on multi-distribution funds is also probably worth noting.

These two features probably also explain why the monthly distribution foreign bond funds, the core product sold through retail banking channels (and the driver of growth in the investment trust market in recent years), have been so popular.[4] Outstanding assets held in that type of fund stood at ¥15.2 trillion as of end-October 2006. This represents 24.2%[5] of the market for publicly offered investment trusts, and

Figure 5 Net assets outstanding



Source: Nomura Institute of Capital Markets Research, based on Bloomberg data.

4 One point of difference is that the foreign bond funds focused on the government bonds of OECD countries have driven growth through the bank's retail channels, while 20% of the post office's Foreign Bond Fund is allocated in emerging markets.

5 This is the share of the total net assets of publicly offered investment trusts sold through all channels. See Figure 21 for details. Currently, monthly distribution funds investing in foreign bonds are typically established as stock investment trusts. The share those funds allocate to publicly offered stock investment trusts is 30.7% and the share to open-ended stock investment trusts is 31.4%.

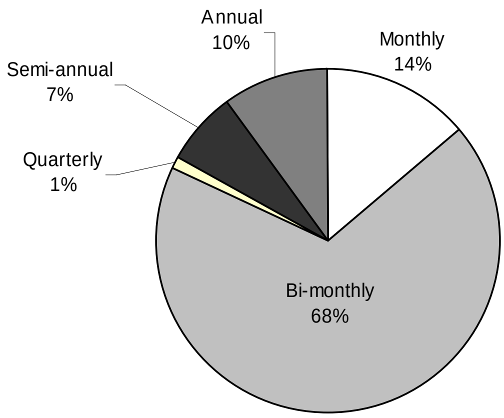
31.2% of open end stock investment trusts. Products with similar characteristics have probably been well received by beginning investors at the post office, as well.

Even more interesting, however, is probably the fact that the majority of the post office's sales were made after explaining to the customer the features of the balanced funds. A major reason for this, besides the fact that investments in foreign bonds are more lucrative than domestic savings, is that the sales personnel were obligated to educate investors, and explain that their investments would be diversified into various asset classes, including foreign equities and REITs.

Monthly sales are over ¥20 billion for the Income Balance fund and the Foreign Bond Fund, but under ¥1 billion for the three domestic equity funds. One possible reason for this is that the size of each sale is becoming smaller. Comparing the average size of each sale (Figure 7), the foreign bond fund averaged over ¥1 million per sale, the Income Balance Fund over ¥600,000, and the Global REIT Fund less than ¥500,000, whereas the three domestic equity funds all averaged below ¥100,000.[6]

Although the size of each sale is getting smaller, the number of sales itself is not that low. Domestic equity funds only accounted for 3% of the total sales value of all products in November, but they accounted for 21% of the total number of sales deals. As explained in the next paragraph, it will be interesting to see if the fact that share prices have performed relatively well since the sales began will result in domestic equity funds becoming more popular among investors.

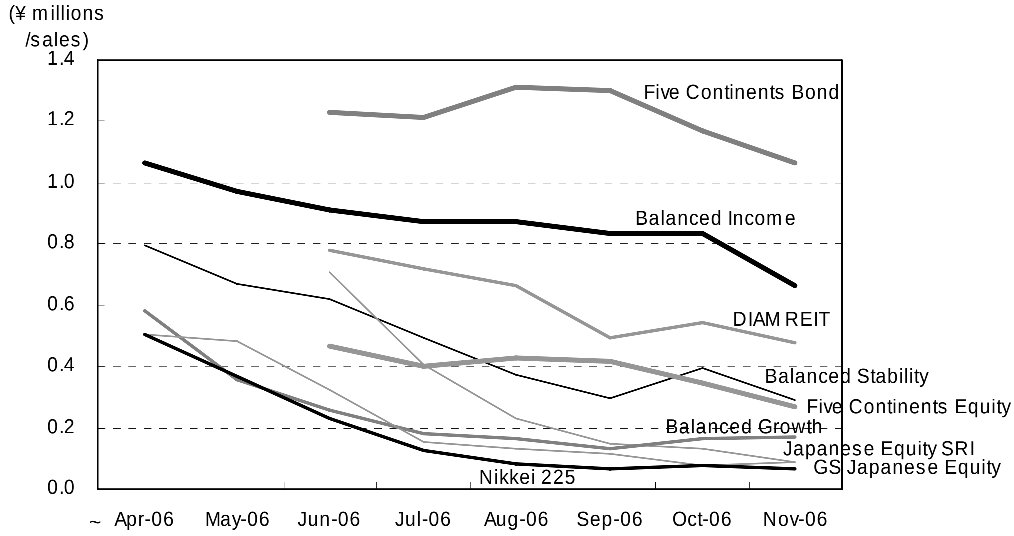
Figure 6 Share of sales by frequency of distributions



Note: For sales made in April-November 2006
Source: Nomura Institute of Capital Markets Research, based on Japan Post data.

[6] The impact from automatic collection savings is excluded when calculating the average amount of each sale.

Figure 7 Amount per sale for each fund



Note: Does not include automatic collection savings.
Source: Nomura Institute of Capital Markets Research, based on Japan Post data.

3. Net asset values

Figure 8 compares the performance of each fund, categorized by when they were introduced, based on NAV and actual distributions.

The fund with the best one-year performance of those funds for which sales began on 3 October 2005 was the Daiwa Nikkei 225 Index Fund. The second best was the Goldman Sachs Japanese Equity Index Plus, which uses the TOPIX as its benchmark.

Looking at the performance of the stock indices during this period, the TOPIX appreciated by more than 25% over a six-month stretch (the Nikkei average was up by more than 30%), and then fell by 22.3% (the Nikkei declined 23.5%) from 7 April until 13 June. Share prices then started a recovery in mid-June, and the TOPIX wound up increasing 14.1% and the Nikkei average 19.2% during the one-year period from when sales began. Thus the return on domestic equity funds, although subject to considerable volatility during the one-year period, wound up being helped by the favorable performance of the stock market.

As for the performance of the Balanced Funds, the Income version outperformed the Growth version from May 2006. During the one-year period from the start of sales, the yen weakened 4.2% against the dollar and 9.5% against the euro (based on BOJ figures); as a result the Income version, which was 70% invested in foreign currency-denominated assets, outperformed the Growth version, which only allocated 50% of its assets in non-yen instruments.

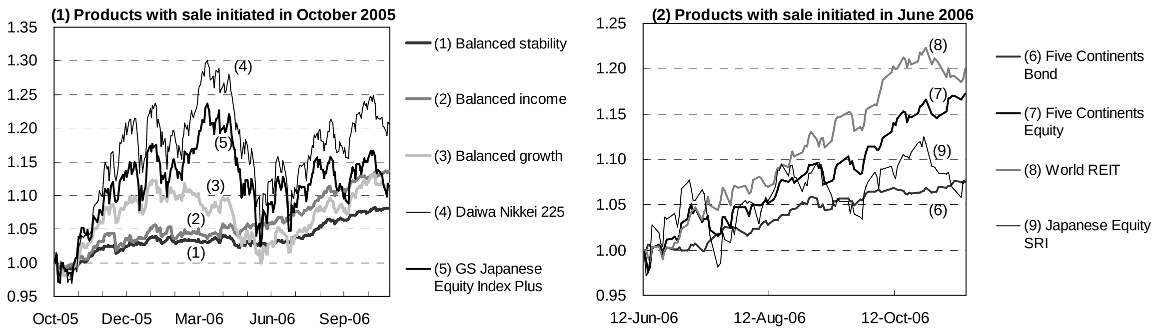
The Income Balanced Fund thus achieved growth in total assets amid stable fluctuations in its NAV and a favorable market environment. On the other hand, although domestic equity funds were blessed with a strong market overall, there was market downturn right around the time that the post office was expanding its sales, and as a result the size of each sale has remained small.

Comparing the performance of the four funds that were introduced on 12 June 2006, the Global REIT Fund generated a return of 15.6% from the establishment date until end-September 2006. This can be attributed to both the effects of yen depreciation as well as to the 11.1% appreciation during that same period of the fund's underlying index, the S&P Citigroup Global REIT Index.

In contrast, the Foreign Bond Fund, which ranks second in total assets despite a late start, has generated relatively low returns in the 3 1/2 months since its inception.

All of the funds currently being sold got off to a favorable start owing to market conditions, and recorded almost no days in which their NAV closed below NAV at inception. There are concerns that sales might drop off during the opposite scenario of yen appreciation and share price weakness, but volatility in the best-selling funds' performance has been a relatively small, and the amount of sales should remain stable without much affect from market factors.

Figure 8 Change in NAV for each investment trust



Notes: (1) Fund establishment date normalized at 1. (2) Calculations based on reinvesting the distributions after deducting 10% dividend tax on the following business day.
Source: Nomura Institute of Capital Markets Research, based on Bloomberg data.

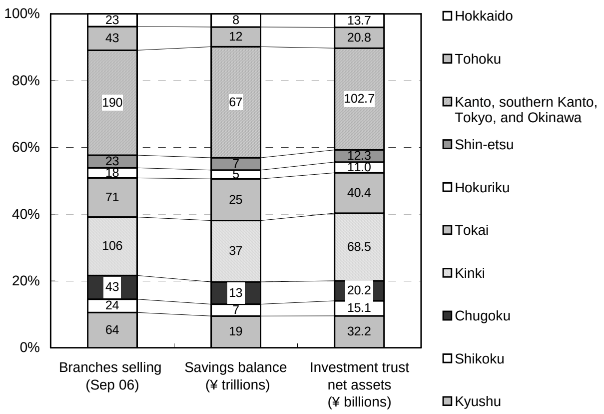
4. Characteristics of sales by region

The post office's ability to develop a customer base in those areas that have traditionally been neglected by securities firms and banks, meaning customers in rural rather than urban areas, has been seen as its strength as a distribution channel. Figure 9 shows a comparison among regions of number of post office branches handling sales and of share of bank deposits and estimated investment trust net assets. The net assets of the region comprising Kanto, southern Kanto, Tokyo, and Okinawa were the highest at ¥102.7 billion, 30.4% of the total, followed by the Kinki region with net assets of ¥68.4 billion (20.3%). Ranking the regions in terms of investment trust sales relative to deposit balances, using the ratio of the investment trust net asset share to the deposit share, shows Shikoku the highest at 1.239, followed by Hokuriku at 1.217. There were also regions where there has not been much growth in sales, with Chugoku the lowest at 0.892. Even among those regions thought to be stronger, this metric shows that regional gaps exist.

In the larger urban areas, where we expected sales to be a more difficult challenge because of the strong presence already established by the megabanks and the securities firms, that ratio was 0.918 in greater Tokyo (including Okinawa), but was 1.108 in the Kinki region, which likewise is heavily urban. This indicates that sales are not weak in all urban areas currently.

The number of post office branches selling investment trusts is expected to increase to 1,550 by the time of privatization in October 2007, which would mean that all normal branches would be handling sales by then (Figure 10). It should be interesting to see what type of specific regional characteristics emerge as the nexus of this growth shifts to more specialized branches.

Figure 9 Comparison among regions of number of PO branches selling funds, savings, and share of fund balance (as of end-September 2006)



	Net assets (¥ millions)	Investment trust share/ savings share	Investment trust share/share of selling branches	Net asset per branch (¥millions)
Hokkaido	13,741	1.028	1.073	215
Tohoku	20,823	1.058	0.870	257
Kanto, southern Kanto, Tokyo, and Okinawa	102,703	0.916	0.971	300
Shin-etsu	12,259	0.995	0.957	231
Hokuriku	10,952	1.217	1.093	332
Tokai	40,449	0.963	1.023	304
Kinki	68,489	1.108	1.160	401
Chugoku	20,154	0.892	0.842	234
Shikoku	15,140	1.259	1.133	244
Kyushu	32,184	1.009	0.903	248

Note: Savings balance is as of end-March 2006. Because there are no published figures on investment trust net asset for Kanto, southern Kanto, Tokyo or Okinawa, these figures are estimates obtained by subtracting the total for all other regions from the nationwide total (all estimates).

Source: Nomura Institute of Capital Markets Research, based on Japan Post data.

Figure 10 Comparison by region of number of selling PO branches and total number of PO branches

	# of selling PO branches			# of all PO branches (as of end-October 06)	
	06.9	06.10 ~	07.10 ~	Regular branches	Special branches
Hokkaido	23	64	N.A.	73	1,142
Tohoku	43	81		92	1,841
Kanto	86	168		182	2,212
Southern Kanto	44	67		75	880
Tokyo	55	96		114	1,395
Shin-etsu	23	53		60	919
Hokuriku	18	33		41	637
Tokai	71	133		145	1,903
Kinki	106	171		199	2,908
Chugoku	43	86		87	1,674
Shikoku	24	62		58	880
Kyushu	64	130		155	2,368
Okinawa	5	11		14	166
Total	605	1,155	1,550	1,295	18,925
(regular branches)	581	1,031	(All regular branches)		

Source: Nomura Institute of Capital Markets Research, based on various data.

III. The future of post office investment trusts

1. Comparing the size of different sales channels

A ranking of the different retail channels by the investment trust assets taken in as of end-September 2006 (Figure 11) lists Japan Post at number 14, on par with largest regional banks. Already eight years have passed since the prohibition on the retail sale of investment trusts by the banks was lifted in December 1998, and some second-tier players have begun to emerge over the past year.

We expect the post office's presence as a sales channel, both in terms of size and ability, to display even more unique characteristics moving forward.

The number of sales staff, which began at 4,700, is expected to increase to 12,000 by end-March 2007. Compared with the 76,000 registered persons[7] at all securities firms and the 1000 to 2000 investment trust sales personnel at each of the megabanks, we expect the impact of such a large number of new entrants a mere 18 months after starting sales to become quite noticeable over time. It should also be interesting to see what sort of new sales ideas and different approaches to building customer relationships never tried in other sales channels wind up emerging as a result of the fact that nearly all of these workers will be post office employees with no prior sales experience.[8]

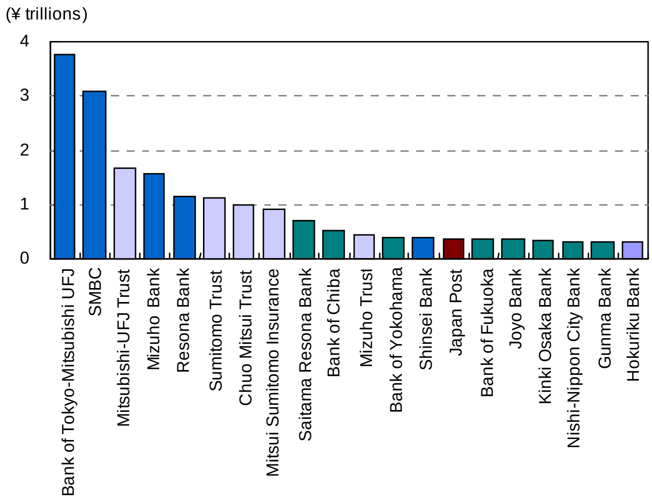
7 As of end-June 2006. Based on data published by the Japan Security Dealers Association.
8 When the post office's sales of investment trusts began, all sales were handled by post office employees, but as the amount of sales grew, the post office began hiring part-time sales staff with sales experience in private-sector financial institutions.

The 1,155 post office branches handling sales as of November 2006 is higher than the total of 894 domestic offices (including the bank, the securities firm, and the trust bank)[9] operated by the Mitsubishi UFJ Financial Group. Although the post office has fewer branches than do the regional financial institutions in their respective regions, the potential for it to build a nationwide sales infrastructure, including training and access to sales materials, as well as linkages with the various specialized branches scattered throughout Japan, is worth noting. The post office is already putting that nationwide network to use on a trial basis in Tokyo and in Kanagawa and Aichi prefectures, and is expected to do so throughout Japan by mid 2007.[10]

In addition, the post office plans to make the sales service for account holders that it began offering through a call center on 22 January 2007 available over the Internet from May 2007. This will give post office customers a level of access similar to that already offered by the securities firms. Thus the focus is not only on achieving a greater scale of operations but also on enhancing the sales infrastructure, which is currently a work in progress.

There are also going to the challenges related to operating on such a scale and to making use of this infrastructure. It will probably remain important to maintain a support organization aimed at helping the sales staff improve their sales capabilities on an ongoing basis, of the kind seen during the initial year of sales. With future growth to be led by a broader class of employees at the smaller branches, we think the support organizations at Japan Post and the asset management companies will become even more important.

Figure 11 Ranking by net assets of publicly offered investment trusts sold by banks at retail (as of end-September 2006)



Source: Nomura Institute of Capital Markets Research, based on investment trust pension data from Japan Financial News and data from Japan Post.

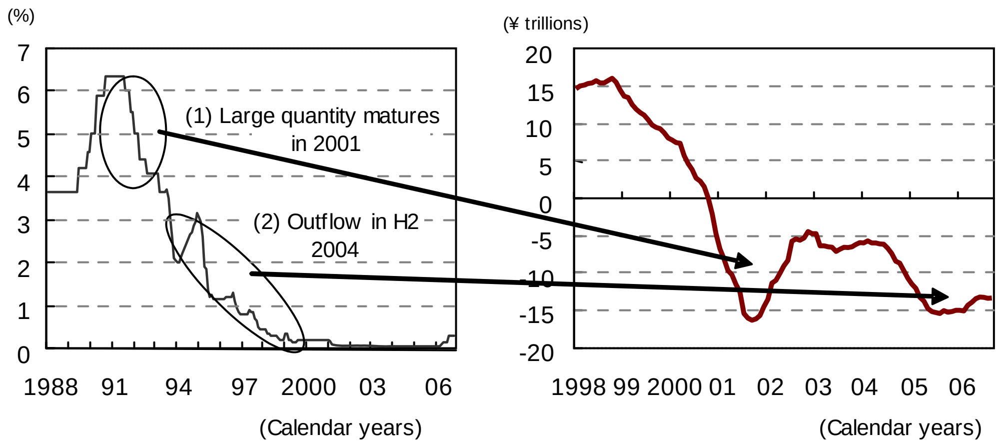
9 The total number of domestic locations (including subbranches and sales offices) listed on each company's website as of 15 November 2006.

10 *Nikkan Kogyo Shimbun*, *Yuusei Kousha*, *Toushi (sic) Hanbai no Hai Toriatsukaikyoku de mo Koukyaku Shoukai Saabisu* (Japan Post offers customer service even at branches that do not handle investment trust sales), 16 November 2006.

2. Ongoing exodus of funds from postal savings

An understanding of the large and ongoing exodus of funds from postal savings that has occurred over the past few years is critical to forecasting the future scale of the post office's investment trust business. Figure 12 shows the interest rate offered on the post office's Teigaku (fixed-amount) savings since the 1980s and recent changes in the overall postal savings balance. When interest rates began declining in the early 1990s, there was a huge shift of funds into Teigaku savings, which offered favorable terms at the time.[11] The large exodus of those funds when they reached their 10-year maturity in 2001 attracted attention at the time. This exodus slowed down temporarily in 2002, but began growing again in 2004 as the deposits taken in when interest rates began declining in 1994 started maturing, and this exodus was still continuing at an annual rate of ¥13 trillion as of end-November 2006. These funds, which flowed into JGBs for individual investors (retail JGBs), investment trusts retailed by the banks, and other investment assets, were part of the overall shift of household financial assets that has shown up in the macro data in recent years (Figure 13). This outflow of funds was probably also a major source of the funds used to purchase investment trusts at the post office.

Figure 12 Relationship between yields on Teigaku savings (3 years and higher) and the YoY change in postal savings balance



Source: Nomura Institute of Capital Markets Research, based on data from the Bank of Japan and Japan Post.

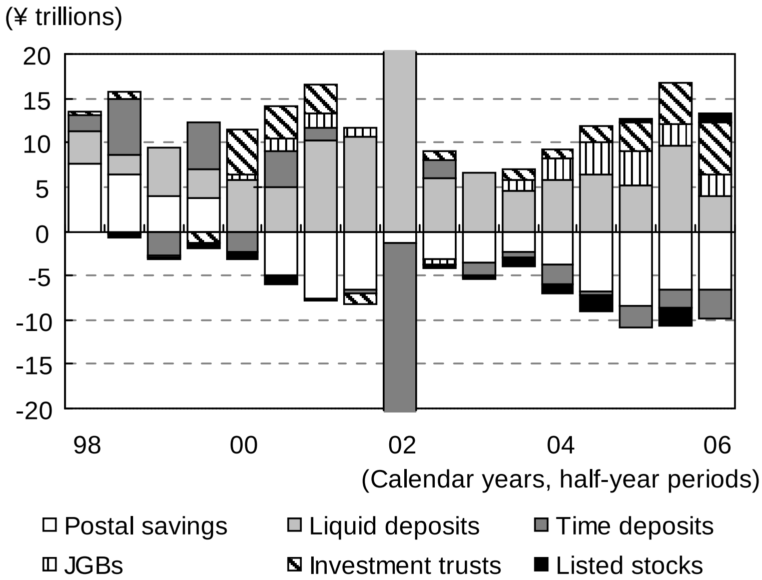
11 Teigaku savings can be redeemed anytime after the first six months and holder earns the same interest rate as when holding for the maximum term of 10 years, a valuable option to have when interest rates are declining. This method of setting the interest rate on Teigaku savings was changed in June 1993, such that (1) when the yield curve was upward sloping, the rate was set at 90-95% of the yield on three-year time deposits at the banks, but (2) when the yield curve was inverted, the yield was set at between 0.5% and 1.0% lower than the yield on the 10-year JGB. Since this lowered the attractiveness of Teigaku savings relative to other products, we think it has become less likely that expectations of lower interest rates will draw funds into Teigaku savings as occurred in 1990.

Assuming that the funds flowing out of postal savings were the sole source of funds for investment trust purchases, the rate of conversion was below 1% when sales began, but has recently increased to about 6%. When considering that the branches that recently began sales will gain more sales experience and that the post office has mechanisms, including linkages with branches not engaged in sales, to further develop its customer base, we think it realistic to expect this rate of conversion to surpass 10%.

We have estimated the future balance of post office investment trusts based on several scenarios. (1) For our status quo scenario, we assume that sales proceed at a rate that achieves the FY 2006 sales target (¥570 billion for the year), which would result in net assets of ¥2.9 trillion at end-FY 2010.

(2) Our second scenario uses the estimated balance of postal savings (Figure 14) announced by Japan Post[12] and assumes an average annual exodus of about ¥5 trillion, with an increase in the rate of conversion from FY 2007 to 10%, which would result in net assets of ¥2.6 trillion. (3) For our third scenario we assume that the rate of exodus stabilizes at the current rate of over ¥13 trillion, which would drive the postal savings balance at end-FY 2010 down to ¥139 trillion, and result in investment trust net assets of ¥6.0 trillion. These results are summarized in Figure 15.

Figure 13 Net inflow of funds for each financial asset



Notes: (1) Graph does not include variable annuities. (2) Change in H1 2002 from partial lifting of deposit insurance cap

Source: Nomura Institute of Capital Markets Research, based on the Bank of Japan's Flow of Funds data.

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[12] This is a forecast made in the outline of the Japan Post business succession plan announced by the Japan Postal Services Holding Company on 31 July 2006.

Even under our status quo scenario, we expect the total net assets invested in postal investment trusts in five years to be roughly equivalent to that currently held by the megabanks. These estimates are based only on the outflow from postal savings, and if future improvements in sales capabilities result in the post office capturing a greater amount of outside funds, there is a possibility that this sales channel will grow even larger.

Based on our above estimates and the current product mix, we estimate the total earnings from sales commissions and trust fees (the sales company's portion) in FY 2010 would be ¥26.4 billion under the status-quo scenario (1), ¥30.4 billion under the ¥5 trillion-outflow scenario (2), and ¥54.6 billion under the ¥13 trillion-outflow scenario (3) (Figure 16). This is roughly equivalent to the total domestic securities-related fee and commission income earned by the megabanks.[13]

Figure 14 Business outlook for Postal Savings Bank and Post Office Company

Postal Savings Bank (Units: ¥ billions)

Fiscal years	2007	2008	2009	2010	2011
Recurring income	1,307	2,519	2,465	2,443	2,361
Recurring expenses	1,004	1,806	1,620	1,548	1,547
Recurring profit	303	713	845	895	814
Net profit	182	428	507	537	488
Quantity of funds (¥ trillions)	188.3	187.0	185.7	172.4	161.4

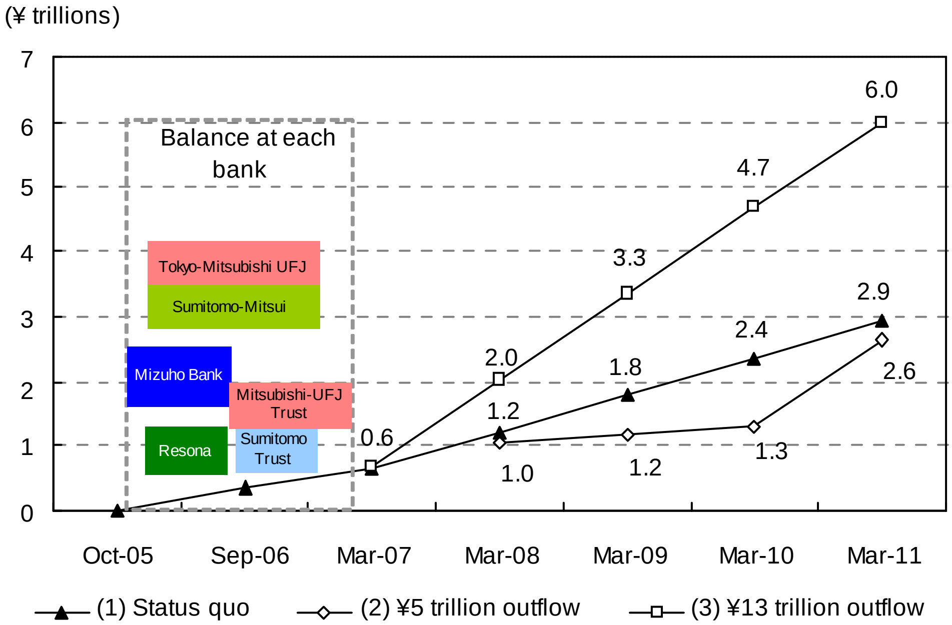
Post Office Company (Units: ¥ billions)

Fiscal years	2007	2008	2009	2010	2011
Recurring income	1,065	1,925	1,931	1,940	1,950
Recurring expenses	979	1,861	1,858	1,859	1,862
Recurring profit	86	63	74	81	88
Net profit	52	38	44	49	53

Source: Nomura Institute of Capital Markets Research, based on various data.

[13] The fee and commission income from the securities business reported for FY2005 was ¥67.4 billion for Bank of Tokyo-Mitsubishi UFJ, ¥44.9 billion for Mizuho Bank, and ¥23.2 billion for Sumitomo Mitsui Banking. In a speech given by Japan Post president Masaharu Ikuta on 27 August 2004, a figure of ¥190 billion was mentioned as the estimate made by the Cabinet Office's Postal Privatization Preparation Office for the profits earned by the post office for the contracted sale of investment trusts and other third-party products.

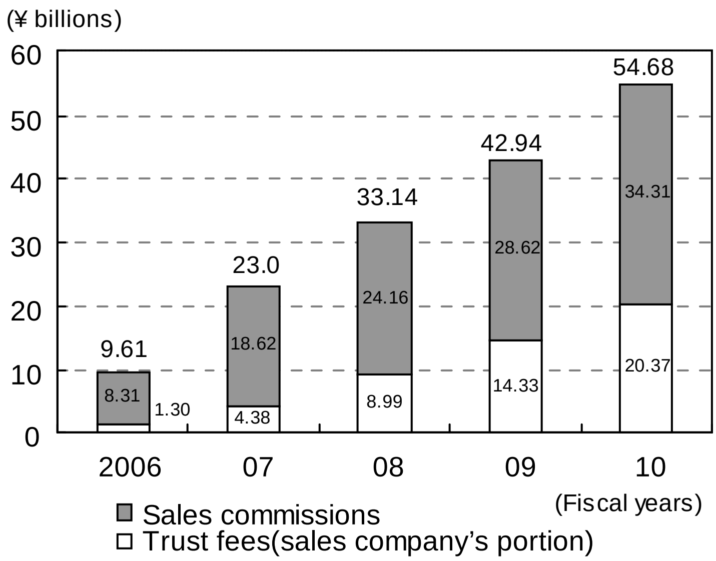
Figure 15 Post office forecast of investment trust balance



Note: Calculations based on 10% of outflow being invested into investment trusts from FY2007.

Source: Nomura Institute of Capital Markets Research, based on various data.

Figure 16 Estimated value of return related to investment trusts



Source: Nomura Institute of Capital Markets Research, based on various data.

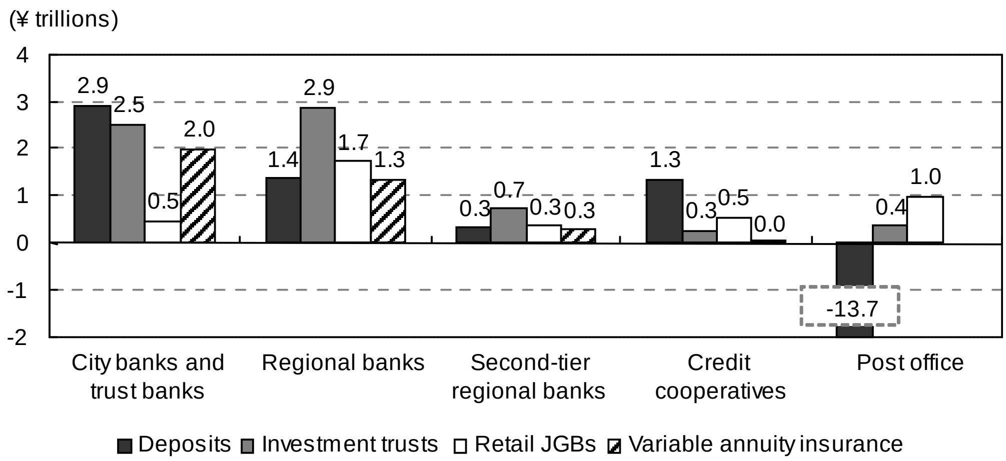
IV. Changes in the banks' retail sales market

1. Regional banks gain larger presence

As already noted, the outflow of funds from postal savings is a major source of funds in this shift of household financial assets into investment products. The biggest recipient of these funds seems to have been the investment trusts retailed by the banks. Changes in this market brought by the initiation of investment trust sales by the post office should be instructive in forecasting the direction that the post office's business in this area is likely to take.

Exhibit 17 is an estimate by investment product of the amount of funds that have flowed into the banks and the post office over the past year. Excluding the post office, the flow of funds into demand deposits and other deposits was ¥5.9 trillion, while a larger amount, ¥6.3 trillion, flowed into investment trusts. Also worth noting is that the regional banks sold more investment trusts and retail JGBs than did the city banks and trust banks. In contrast, the city banks and trust banks divided their sales focus between investment trusts and variable annuities, and were responsible for ¥2.0 trillion of the ¥3.6 trillion in variable annuities sold. These figures suggest that with the city banks and trust banks starting to focus more effort on variable annuities, the nexus of investment trust retailing is beginning to move toward the regional banks.

Figure 17 Inflow of funds into products for individuals by type institution



Notes: 1. Change is from October 2005 to September 2006 for post office and during FY2005 for other type institutions. 2. Individual deposit balances for city banks, regional banks, and second-tier regional banks are based on disclosures by each bank. Some figures include estimates. 3. Deposits at trust banks include trusts for individuals with guaranteed principle. 4. Figures for investment trusts are estimates based on subtracting the impact from share price changes from the investment trust pension data published by Japan Financial News. Includes corporate holdings. 5. Figures for retail JGBs estimated from Ministry of Finance data. 6. Figures on variable annuities based on data from the Kinzai Institute for Financial Affairs. Figures for city banks, trust banks and regional banks include some estimates.

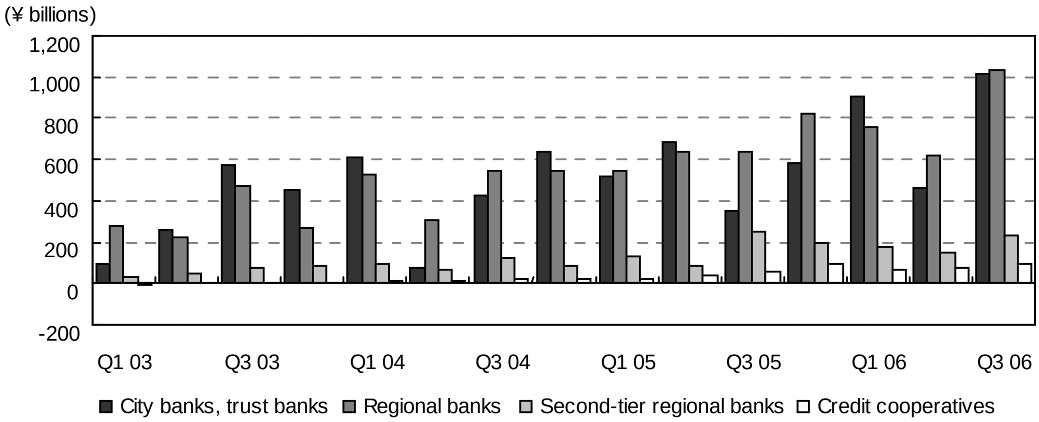
Source: Nomura Institute of Capital Markets Research, based on various data.

Figure 18 provides a further breakdown of this flow of funds into investment trusts noted above, outlining the estimated quarterly net inflow into publicly offered investment trusts. We can see from this figure that while the sales pace has steadily accelerated since 2003, aggregate sales by the regional banks began to surpass that of the city banks and trust banks around H2 2004. Sales weakened slightly In Q2 2006 as a result of the stock market downturn, but hit near-term highs in Q3. Although still a small portion of the overall pie, sales by second-tier regional banks and the credit cooperatives have been growing since Q3 2005.

The regional banks, second-tier regional banks, and credit cooperatives have thus become increasingly important players in the retailing of investment trusts. With the major battle increasingly looking like it is with these more regional financial institutions, which are more likely than the city banks and trust banks to have the same customers as the post office, there is a possibility that these regional players will start to develop products specifically targeted at the post office's business.

Such a response is already becoming evident in the survey of financial institutions taken by Japan Financial News aimed at gauging the impact of Japan Post's investment trust sales. Figure 19 summarizes the results of the surveys taken at end-March and end-September 2006. As of end-March 2006, six months after post office sales began, less than 20% of financial institutions thought that Japan Post represented a threat to their sale of investment trusts. In the survey taken after growth in those sales at end-September, however, a higher number of those regional banks and credit cooperatives perceived a threat, while the percentage of those perceiving synergistic benefits also increased.

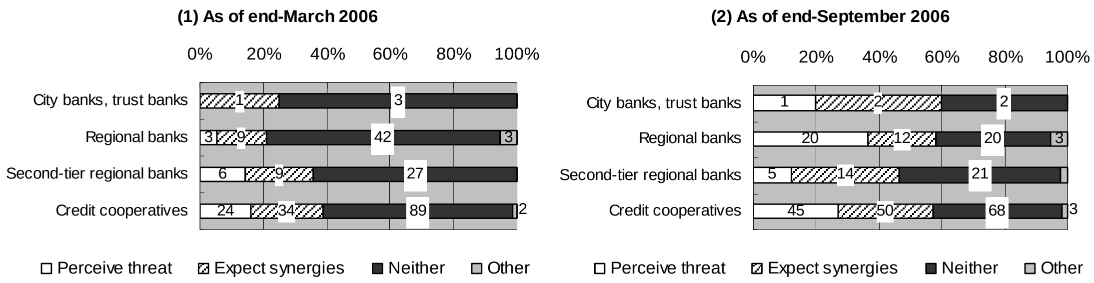
Figure 18 Net inflow of funds into investment trusts sold by banks, by type bank



Notes: 1. These are our own estimates of net inflows, subtracting the change in balances caused by share price and Forex changes from the outstanding retail sales of each type institution. 2. Because these figures include some private placements, they do not match with the data published by the Investment Trusts Association of Japan.

Source: Nomura Institute of Capital Markets Research, based on investment trust pension data from Japan Financial News and various other data.

Figure 19 Perception of Japan Post's investment trust sales at each type institution



Note: Figures noted in graph are the number of institutions giving that answer.
Source: Nomura Institute of Capital Markets Research, based on investment trust pension data from Japan Financial News.

2. Changes in the product preferences expressed in retail sales channels

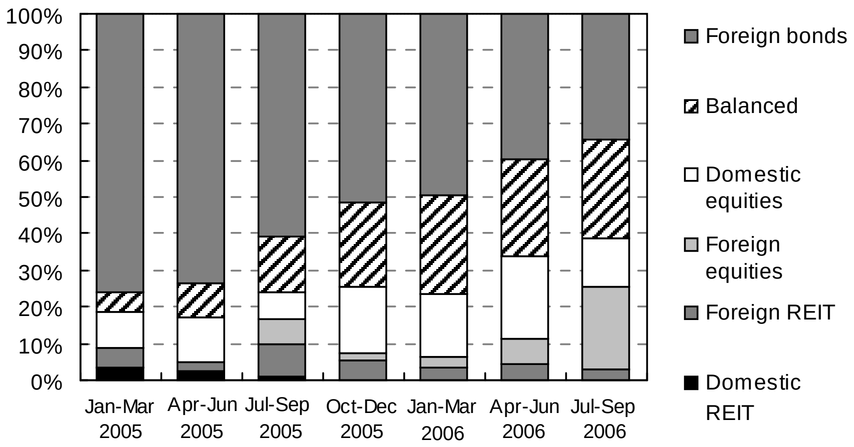
With the post office now being recognized as a competitor, we are starting to see changes in the selection of investment trust products sold by the banks. Figure 20 shows the banks and insurance companies' top 30 funds by sales amount classified by type investment, and the sales share of each. The proportion of foreign bond funds, which accounted for the majority of sales through the retail channel until H1 2005, began a steady decline in July-September 2005, right before the post office began selling investment trusts. Balanced funds and domestic equity funds, meanwhile, are accounting for an increasingly larger share, and most recently foreign equity funds have had a particularly strong presence.[14]

We can think of three factors originating in the post office that may explain these changes: an increase in awareness created by the post office's focus on the sale of its balance funds; the promotion of sales through retail channels of those products that were not selected by Japan Post; and the pursuit of sales strategies aimed at differentiation from the post office.

Regarding the benefits from the increased awareness created by the post office, although the banks have also long offered balance fund's for sale, considerable publicity was created when they were made into basic products that could also be purchased at the post office and, further, were positioned by the post office as its core product. It is possible that investors were reassured by the fact that even balanced funds, a complex product structured in a way that is difficult for beginners to understand, were aggressively sold in what could be termed a "beginner's" sales channel by emphasizing the advantages of investment diversification.

[14] In the rankings of the top selling funds at the banks and insurance companies published in the 4 December 2006 issue of Japan Financial News (for the July-September quarter), the Pictet Global Income Stock Fund (monthly distribution type) was in the top position, replacing the Global Sovereign Open (a monthly settlement fund from Kokusai Asset Management), which had long been the top-ranked fund.

Figure 20 Top 30 selling retail funds by type investment (share)



Note: 1. Excluding MMF and MRF. 2. Share of each type investment for top 30 selling funds by banks and insurance companies.
Source: Nomura Institute of Capital Markets Research, based on investment trust pension data from Japan Financial News.

Regarding the promotion of products that were not selected, there is a possibility that the banks changed their sales strategy to focus on the balanced funds not selected by Japan Post in 2005.[15] Many of the popular balanced funds offered by the banks are invested in three asset classes: stocks, bonds, and REITs.

It is conceivable that the banks, which generally deal with customers who own larger asset portfolios, shifted their focus toward selling higher risk equity funds to a different class of customers than that dealt with by the post office, as a strategy of differentiation. One fund that has experienced growth recently is the high-dividend Japanese equity fund, while sales have also been growing for a bond fund with redemption terms tied to share prices and a foreign equity fund that invests primarily in utility stocks.

It is probably too early to argue that these changes have resulted in a shift in sales strategy or changed the preferences of customers in the bank's retailing channel, which now totals over ¥26 trillion. Nevertheless, it is no longer the case that retailed investment trusts and foreign bond funds are one and the same, and product preferences in that channel are becoming increasingly diverse.

Changes in product preferences are becoming evident in the data covering all publicly offered investment trusts, including those sold through securities firms. A breakdown of open-end stock investment trusts from January 2005 until end-2006 (Figure 21) shows that while the overall balance was doubling, the balance of products classified as funds of funds,[16] including the balanced fund, grew 5x to ¥13.3

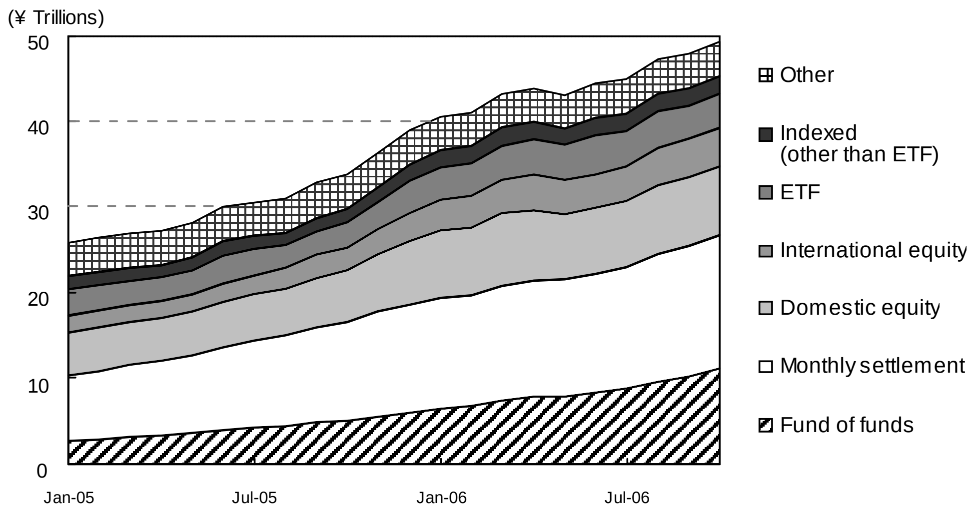
[15] See the *Nikkei Kin'yu Shimbun*, *Roku Shisan Fando Zokuzoku YuuChou no Madohan ni Taikou*?" (Will six asset funds continue to compete against postal savings' retail sales?), dated 16 November 2006.

[16] Among investment trusts classified as funds of funds, other product categories with large balances include global high-dividend equity and global REITs.

trillion from ¥2.6 trillion. This was a rapid increase compared with the balance of monthly settlement funds, which are primarily invested in foreign bonds and which grew by 2.1x, from ¥7.6 billion to ¥16.4 billion.

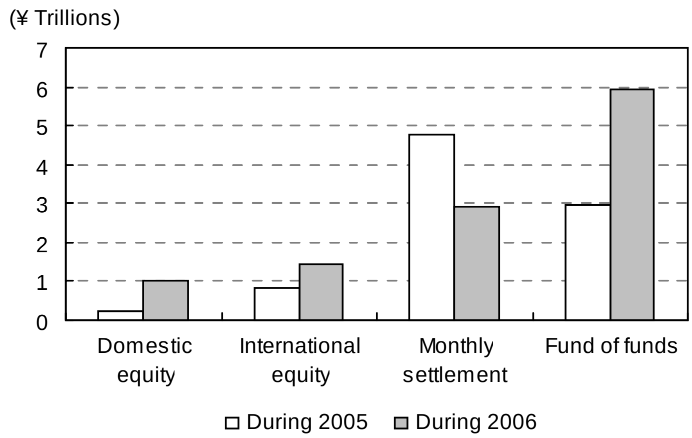
Furthermore, data on net inflows by type (amount sold less repurchases and redemptions) shows that 2006 inflows exceeded 2005 inflows for domestic bonds funds, global equity funds, and funds of funds. (Figure 22). In contrast, the inflow into monthly settlement funds was lower in 2006 than in 2005, despite growth in the investment trust market overall.

Figure 21 Net Assets of Equity Funds



Source: Nomura Institute of Capital Markets Research, based on data from the Investment Trusts Association of Japan.

Figure 22 Net Cash Inflow into Equity Funds



Note: Monthly distribution funds mostly comprise foreign bond funds.
Source: Nomura Institute of Capital Markets Research, based on data from the Investment Trusts Association of Japan.

V. Conclusion

We have shown in this report how the post office's sale of investment trusts have approached a cumulative balance as large as that of a megabank, while the nexus of growth in retail sales by the banks is shifting toward the regional banks. At the same time, the range of products sold is becoming more diverse.

These trends are a sign that the shift from savings to investments is gaining traction, and we may be in a transitional phase until households, which currently hold 51.6% of their financial assets in the form of cash and deposits, start allocating a larger percentage of their portfolios to riskier assets. Even for investment trusts, arguably an introductory product, sold through the bank retail market, which could be viewed as an introductory channel, we expect to see the development of more individualized products better tailored to customer needs.

Although the post office's sale of investment trusts has attracted attention for the source of income those sales will provide following privatization, it may be that the educational opportunities those sales will bring are of even greater significance for the individual investors who form the backbone of financial and capital markets. It is worthwhile to continue paying attention to both the volume of sales and product developments in the future.