Crisis cannot Undermine the Growing Role for Mutual Funds in Japan's Asset Management Sector

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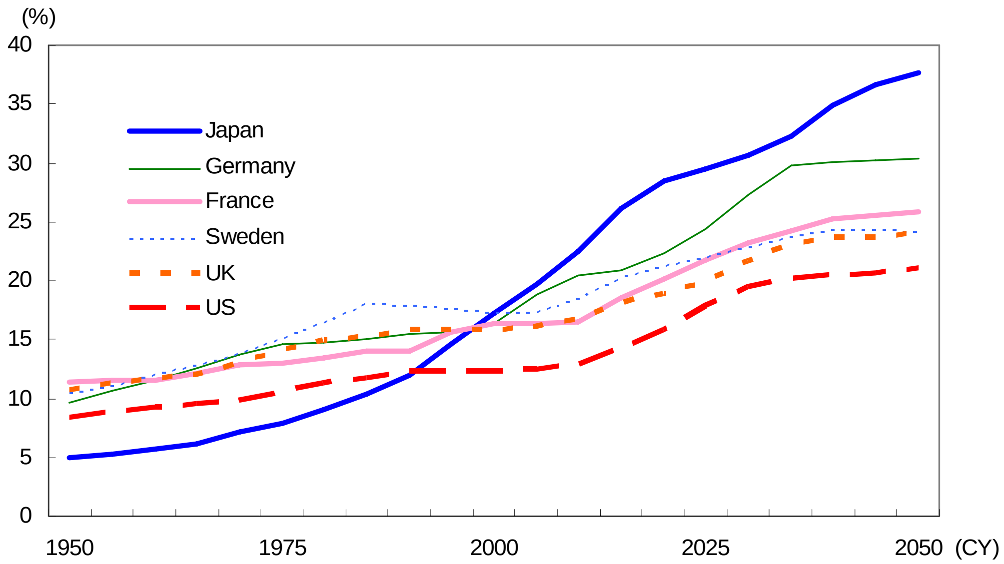
I. Japan's population ages to unprecedented levels

It is impossible to ignore the impact from societal aging when considering the outlook for individual investor services in Japan.

Japan's population has been aging faster than that of other advanced countries and now has the world's oldest population (Figure 1). It is only expected to take Japan 25 years, from 1985 until 2010, for its "old-age population ratio" (the percentage of the total population aged 65 or older) to increase from 10% to 20%, for example, whereas the next fastest aging advanced country, Germany, is expected to take 55 years.

In addition, while this old-age population ratio is forecast to level out at around 20-25% in other advanced countries, in Japan alone it is expected to keep rising, to just under 40% by 2050.

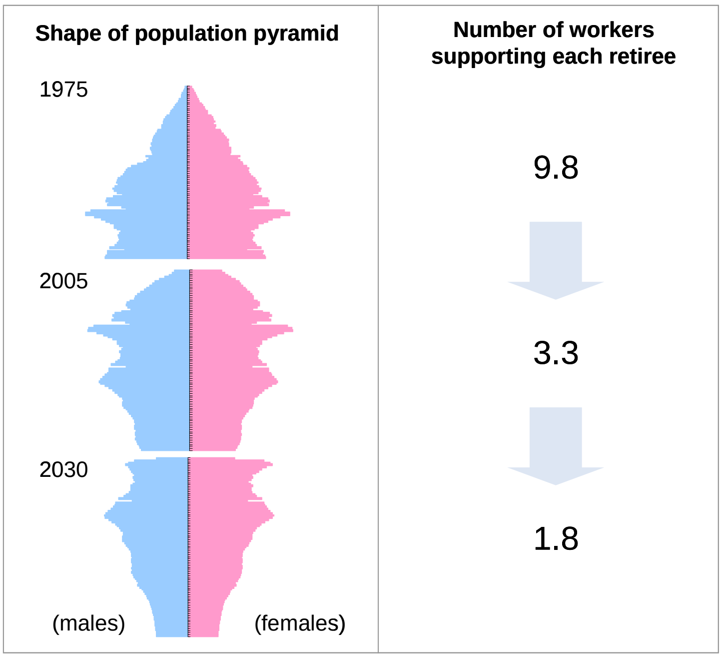
Figure 1: Old-age populaion raio in each country



Notes: Old-age population ratio is the percentage of the total population aged 65 or older
Source: Nomura Institute of Capital Markets Research, based on data from the United Nations

This unprecedented societal aging taking place in Japan is having a major impact on, among other things, the functioning of public pensions. This is because public pensions in Japan are structured as pay-as-you-go systems, wherein the currently working generations are taxed to pay for the benefits of retirees. This could also be looked at as a society-wide allowance paid by children to their parents. Consequently, the retirement system becomes more difficult to operate when the working-age population declines relative to the population of retirees, and that is exactly what is now happening in Japan. In 1970, there were 9.8 workers for every retiree. That ratio had declined to 3.3 by 2005, and is expected to drop below 2.0 by 2030, only two decades from now (Figure 2).

Figure 2: Population continues to age



Notes: Working generation refers to the population aged 15-64, retired generation to the population aged 65 and over

Source: Nomura Institute of Capital Markets Research, based on data from the National Institute of Population and Social Security Research

II. Japan's public pension system still undergoing reforms

In response to these demographic changes, in the 1990s Japan's public pensions were modified by raising the age at which benefits begin (a phased-in increase from 60 to 65 years old), and there was further reform in 2004 with the introduction of a system for calculating benefits that capped future social insurance contributions and incorporated a sliding scale whereby benefits are automatically adjusted (effectively reduced) to reflect demographic changes. In anticipation of an actuarial review of the public pension system in 2009, there is an ongoing debate over securing a stable source of funds to pay for growing benefits, and there are likely to be further public pension reforms in the future if the population starts to age even faster.

A study group on pension reform established by the Nihon Keizai Shimbun proposed public pension reforms on two occasions, in January 2008 and again in December. Its proposals called for a) abolishing the pay-as-you-go approach for the basic pension portion, the foundation of the public pension system, and instead paying for it with funds collected from the consumption tax (in conjunction with raising the consumption tax rate to 6.5%), and b) shifting to individual savings accounts for a part of that portion funded by contributions commensurate with compensation (modeled after Sweden's public pension system). The fact that the Nihon Keizai Shimbun, one of Japan's most influential economic dailies, has proposed reforms that fundamentally differ from those currently being debated by the Japanese government could be seen as evidence that Japan's public pension system is in for some more hard knocks.

The Japanese government has its Council on Economic and Fiscal Policy (CEFP), an organization that taps expertise outside the government on key economic and fiscal policy issues, while remaining under the firm leadership of the Prime Minister. In February 2008, the CEFP established its Expert Committee on Structural Changes and the Japanese Economy to examine the qualitative changes in Japan's economy and consider the best economic structure for Japan. In its report released in July 2008, that expert committee noted that "... Japan has been slow to review and reform government expenditures and its social security system, despite its population distribution taking on the shape of an inverted pyramid, with a declining youth population supporting a growing population of seniors. ...as the population ages, income generated by assets becomes a more important component of income, and this makes it necessary to raise the return on financial assets. A major challenge remains the creation of a sustainable social security system that does not place too great of a burden on younger people and future generations." We think it worth noting that the committee acknowledges that the current public pension system, as well as the debate over reforming it, may be inadequate.

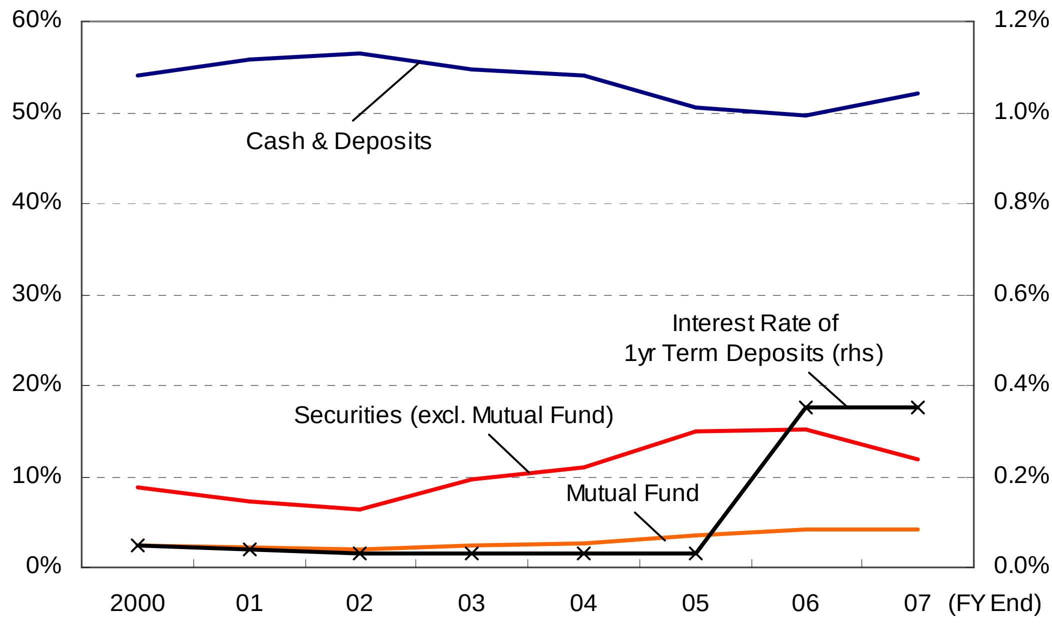
III. Asset management reconsidered and the growing role for mutual funds

A look at the average household budget of unemployed seniors shows a monthly deficit (spending in excess of income from pensions and other sources) of just under ¥50,000, an amount that winds up being covered by drawing down assets saved during working years. If changes to and the reform of public pensions continue, Japanese will need to take asset management much more seriously than they have in the past, and put time on their side by beginning in their youth, in order to ensure that they can provide for themselves in their old age.

The necessity and importance of this self-sufficiency for Japanese becomes that much greater as their average longevity increases. Longevity risk (the risk of outliving your assets) is starting to become a reality in Japan, where 65-year old males are expected on average to live 18 years longer, to age 83, and females 23 years longer, to age 88, the world's highest life expectancy. This rising trend in longevity brought by the dizzying pace of advancement in medical care and life sciences is likely to continue, given the possibility of more new drugs and innovative treatments being approved in the future.

The time has already come in Japan for people to start making arrangements while they are still working to provide for themselves in their old age, but doing this requires a willingness to rethink the traditional approach to asset management. Japanese households currently own financial assets valued at around ¥1,500 trillion, most of which (at least 50%) are still kept in cash and deposits, despite the consistently low yields earned (Figure 3). From April 2002 until March 2006, for example, the interest rate paid on a 1-year time deposit remained at only 0.03%. On the other hand, only 19% of household financial assets are invested in securities, namely stocks, bonds, and mutual funds. Logical and efficient asset management, where securities investments are generally expected to generate higher returns than bank deposits in the case of investments for which time can be put to use, i.e., investments made with a medium-to-long-term time horizon, has yet to catch on in Japan, and broadening its use has become an urgent issue.

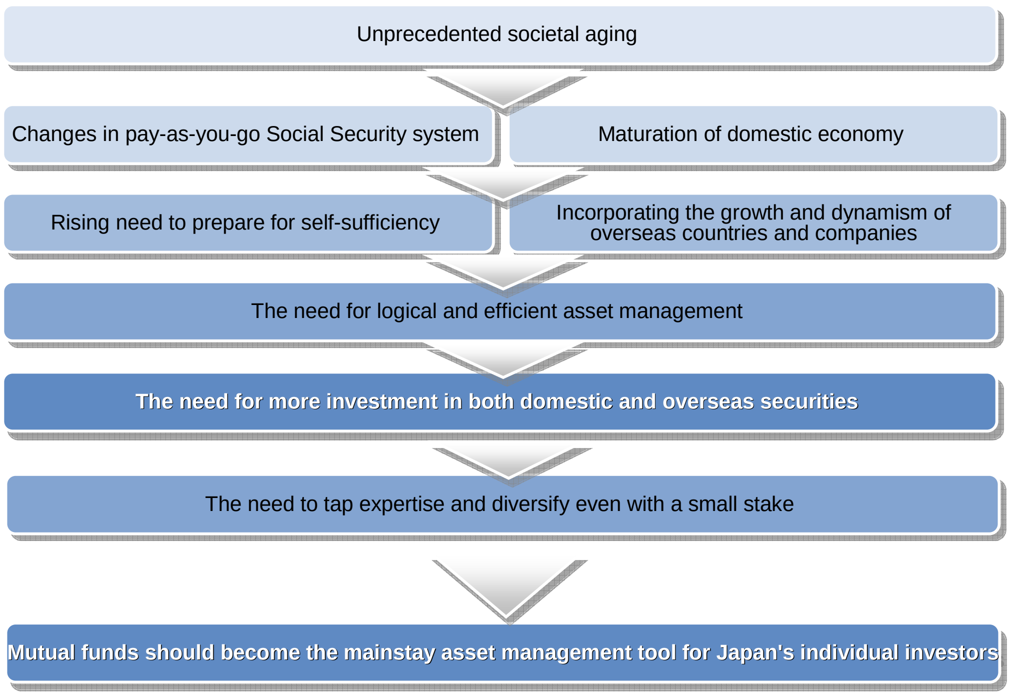
Figure 3: Composition of household financial assets in Japan (as of end-September 2008)



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

Nevertheless, given that the use of diversification to reduce portfolio price risk is a fundamental tenet of securities investment, mutual funds should play an especially important role as a vehicle for individuals to invest in securities. This is because the very nature of mutual funds makes it possible to diversify investments with only a small amount of funds, all the while getting access to specialized expertise and financial tools. Furthermore, with Japan's population not only aging but also having begun to decline, high domestic economic growth is becoming less likely, making it imperative to also invest in high-growth countries and companies overseas. Mutual funds, with their ability to offer expertise and diversification to small investors, should also become increasingly important vehicles for investing overseas (Figure 4). We do not think it would be an exaggeration to say that mutual funds should be the mainstay asset management tool for Japan's individual investors.

Figure 4: The importance of mutual funds in Japan



Source: Nomura Institute of Capital Markets Research

IV. Requirements for mutual funds to grow in Japan

The size of the mutual fund market (assets under management) is currently less than ¥100 trillion, an amount that accounts for less than 5% of the financial assets owned by individuals in Japan. What conditions need to be in place for the use of mutual funds to steadily increase, in step with increased efforts by the population to attain self-sufficiency in their old age? It is readily apparent that a national awareness of the negative impacts that societal aging is having on the public pension system, and the development of attractive mutual fund products and improved services, are necessary conditions. Equally important, in our opinion, is for the government to introduce more favorable investment-related tax breaks. Compared with the tax advantaged investment accounts offered in other advanced economies, including the Individual Retirement Accounts (IRAs) in the US and the Individual Savings Accounts (ISAs) in the UK, the individual-type defined contribution pension plans expected to serve roughly the same function in Japan offer considerably less attractive tax benefits, and substantially fewer individuals are eligible to enroll. The same is true when comparing Japan's corporate-type defined contribution pension plans with the 401(k) plans in the US. These are issues that the Japanese government urgently needs to address, in our opinion.