Progress Report on Enhancing Asset Management Business 2022 (Summary)

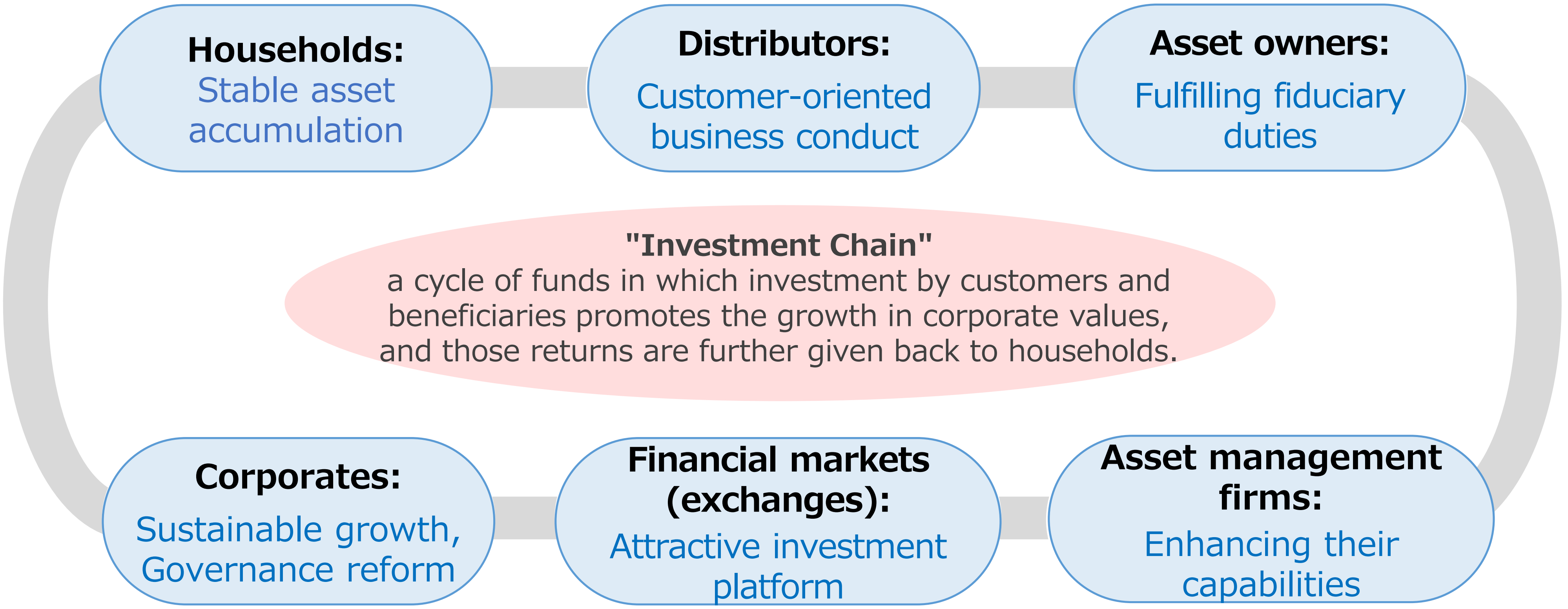
May 2022

金融庁
Financial Services Agency

Contents

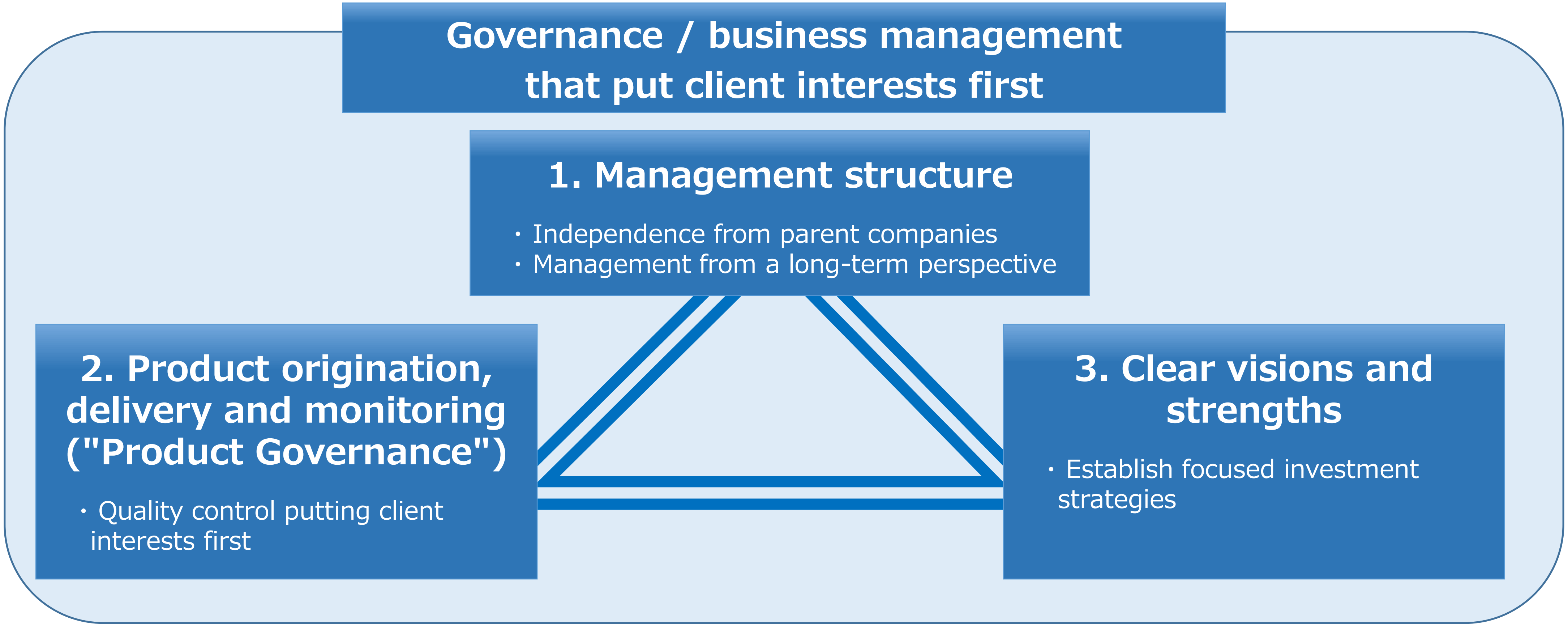
For a better functioning Investment Chain

◆ In order to respond to various changes in the economy and society and to realize sustainable economic growth, it is important that each participant in the Investment Chain fulfills its expected role to achieve a virtuous cycle of funds.



Governance and business management that put client interests first

- Asset management firms shall establish their stable revenue base supported by customers by delivering good investment performance in the long run. It is essential for them to develop an organizational structure and to implement initiatives that give top priority to client interests.
- For that purpose, the FSA considers the following three pillars are important: (1) Management structure, (2) Product origination, delivery and monitoring ("Product Governance"), and (3) Clear visions and strengths. We will encourage the firms to take effective initiatives through further dialogues with them, aiming at achieving more competitive environment.



1. Management structure

(1) Ensuring the independence from parent companies and implementing an effective control framework

- **The management** of a firm shall **ensure independence from parent companies** and **implement an effective control framework** from a viewpoint of customers.
- It is necessary for **each committee in a firm to regularly review whether its business is operated for the best interest of clients**.

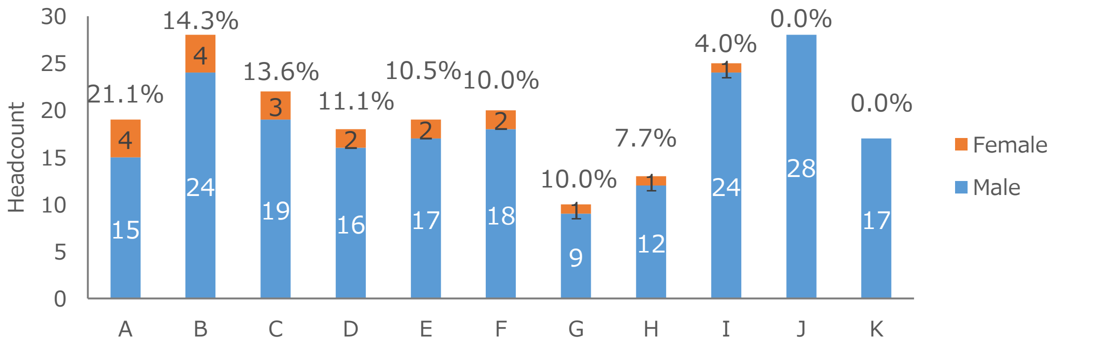
Cases	• Directors are appointed by a nomination committee independent from its parent group, and an internal talent, rather than a transferee, is promoted to a CEO.
	• Those with investment management experience outside of its parent group are appointed for directors.

(2) Executives with expertise in investment management in the long run

- In order to **establish a management structure that puts client interests first and strengthens investment management capabilities**, it is necessary to have executives with enough expertise, experience, and willingness to engage in investment business.

Cases	• In several firms, top management with strong investment management experience tend to have a longer tenure.
	• To diversify human resources, a firm not only has quantitative targets on the ratio of women in managers, but also promotes women to participate in selective training programs.

(Figure 1) Female executives of large asset management firms (as of April 2022)



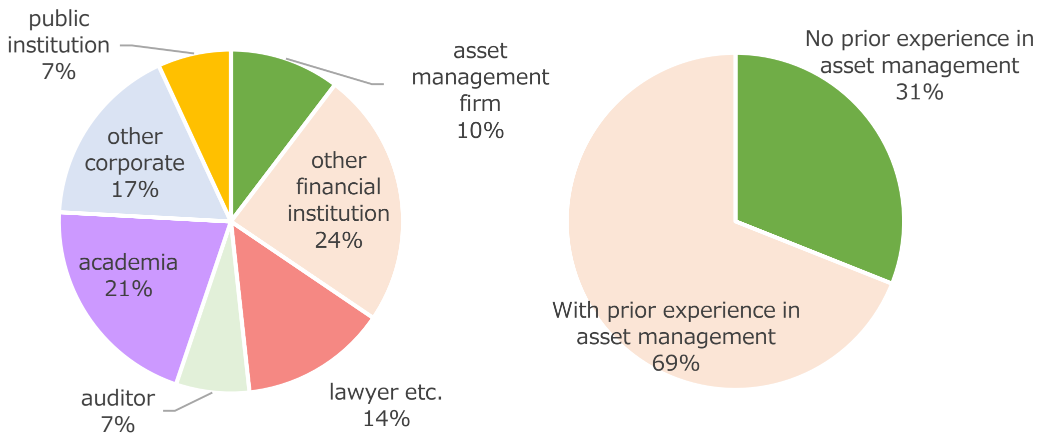
Sources: Prepared by the FSA based on websites of each firm

(3) Roles expected for independent directors

- While the **desirable attributes of independent directors** in asset management firms may vary with different perspectives by firms, we expect that **personnel with enough knowledge and experience in the asset management business are to be appointed as independent directors**.
- Independent directors whose expertise is different from that of asset management would require appropriate support by a firm.

Cases	• There is a case in a firm where independent directors regularly discuss plans of its management structure with the management of the parent company (such as inviting the president from outside of the group). There is another case where an independent director from academia gives advice on evaluation methods of individual funds.
	• Some opine as "management of an asset management firm is fairly specialized, and a background of investment practice is necessary for independent directors."
	• Regarding the provision of information to independent directors, some firms say: "It is extremely useful to have a dedicated department or person to support directors, such as providing information necessary for discussions at the board of directors, etc." and "It is necessary to provide information depending on the expertise and background of independent directors."

(Figure 2) Independent directors of large asset management firms by backgrounds (as of March 2022)



Sources: Prepared by the FSA based on data submitted by each firm

2. Product origination, delivery and monitoring ("Product Governance")

(1) Sharpe ratio of active funds

- Publicly offered active funds managed by **firms with a small number of funds tend to achieve good performance** by focusing resources on their flagship funds, while the performance of firms managing more than 100 funds tends to vary, having funds with a negative Sharpe ratio.

(2) "Alpha" of actively managed Japanese equity funds

- In order to quantitatively evaluate the added value of active Japanese equity funds, we have statistically estimated the excess return ("alpha") of 444 funds against passive investments by time-series regression analysis. As a result, estimated alpha of 32 funds are negative and statistically significant. Most of the 32 funds are managed by large firms, while none of them is by small firms. Of the 32 funds, approximately 70% (23 funds) have a poor track record of more than 20 years since their inception.

  * In particular, for those with t-value less than -4, the probability that a true alpha might be positive is estimated to be only 0.01% or less. All of these funds have existed for long time, around 20 years. This fact suggests that there could be serious problems in the product governance framework of the firms managing these funds with poor performance. It is necessary for the management of the firms to improve the organization's monitoring system as soon as possible.

- In general, clients invest in actively managed funds with the expectation for excess returns over passive investments. A fund with a negative alpha indicates that it does not meet such expectation. **The product lineup of most major firms includes funds with a negative alpha over the medium to long term.** We consider this is **an issue of the quality control framework**.

(3) Trust fee levels for actively managed Japanese stock funds

- The statistical results also show that while **more than 80% of the 444 active funds** have generated excess returns before deducting costs over passive investment to a certain extent, **such performance may be offset by costs and not delivered to clients as added value.**

- Based on the relation between pre-cost alpha and trust fee levels of the 444 active funds, it can be inferred that trust fees are, in general, set by only looking at peer levels, and **performance expectation for each fund at its origination may not be taken into consideration when a trust fee level is set, and the fee level is not reviewed after the inception.**

(Table 1) Characteristics of funds with negative alpha (bottom 15 funds)

Years since inception	Net assets (JPY 100mil., Feb 2022)	Estimated alpha (annualized)	t-value
7.6	1.7	-8.9%	-2.51
10.3	6.2	-3.9%	-2.17
21.5	8.8	-3.3%	-4.03
23.8	27.8	-3.2%	-4.62
20.3	5.7	-2.7%	-3.59
26.4	21.7	-2.7%	-2.37
21.0	67.3	-2.6%	-4.72
22.7	5.0	-2.5%	-3.94
15.8	20.1	-2.4%	-2.76
17.3	14.3	-2.2%	-4.18
20.2	23.7	-2.0%	-2.95
18.4	11.6	-2.0%	-4.89
20.4	6.0	-1.9%	-2.51
16.6	22.9	-1.9%	-2.36
22.5	35.4	-1.9%	-2.48

Sources: Estimated by the FSA based on data from QUICK, Nomura Securities (Russell/Nomura Japan Stock Indices), and the Bank of Japan

2. Product origination, delivery and monitoring ("Product Governance")

(4) Establish an effective product governance framework that puts client interests first

- Given that some of the major asset management companies' funds are **underperforming over the mid-to-long term**, **the effectiveness of their product governance framework is likely to be compromised**.

Cases	• A performance review process relies only on fund performance data before deducting costs. Fund performance after deducting costs is not systematically shared and verified during the review process.
	• While the unit price of a fund is calculated by including dividend reinvestment, ex-dividend TOPIX is used as its benchmark, resulting that reasonable comparison is not made.
	• Insufficient coordination among divisions related to reviews. For example, a risk management division that conducts performance verification applies only short-term thresholds (e.g. 1 to 3 years) and failed to flag performance deterioration of funds in the long-term since their inceptions.
	• In a value stock fund which actively manages only 30% of its portfolio, even though the remaining 70% is passively managed, it sets a trust fee level as high as that of other funds that actively manage 100% of its portfolio. As a result, the excess return after deducting costs since inception is significantly negative.

- **It is important to ensure effective product governance for all funds. It is necessary for a firm to have a systematic approach to verify, from a long-term perspective,** whether a fund management process envisioned at its origination has been implemented and whether returns commensurate with cost levels have been achieved.
- If it is found to be difficult to continue managing a fund as anticipated at its inception, it is **necessary to consider measures including reviewing the cost level or redeeming the fund early**.
- **The management of a firm is required** to know the actual performance of their own funds and **to take responsibility for constructing an effective verification process** in their organization, such as clear authorization structure of each department for product governance.

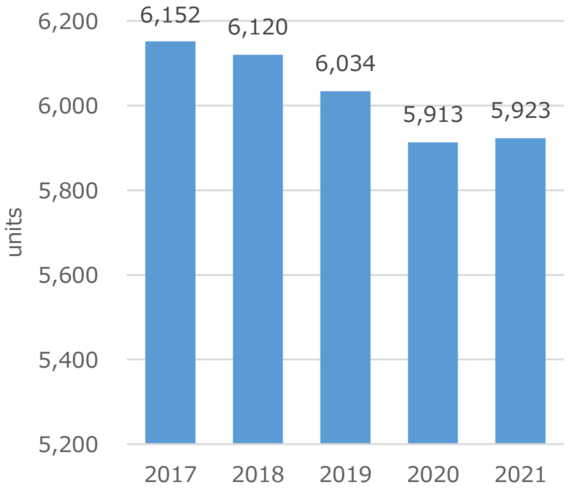
(5) Product origination and early redemption that put client interests first

- While some firms try avoiding a rampancy of small funds by carrying out early redemptions of small funds that could cause disadvantages to clients, we found some issues in their selection criteria of funds to be early redeemed.

Cases	• Investment performance (after deducting costs) is not taken into account in the criteria for selecting funds to be early redeemed.
	• A committee discussing early redemption of a fund is operated separately from a fund performance review process, and for example, some options such as early redemption are not considered as a measure for a fund performing poorly for a long time.

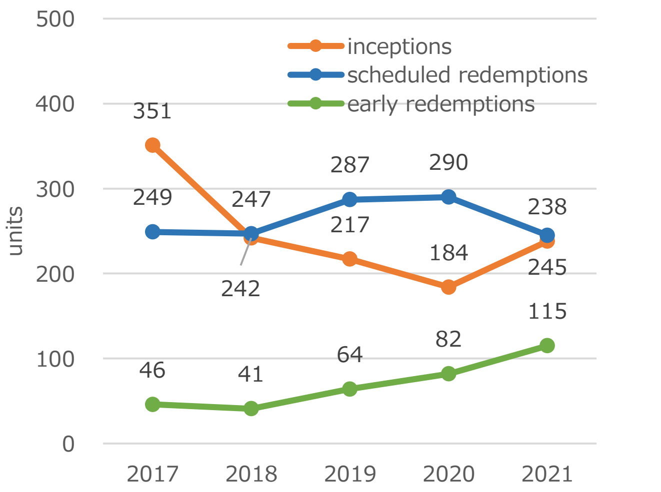
- In order to effectively apply product governance for all funds they manage, asset management firms are required to develop a control framework adequate to cover their own funds.

(Figure 3) Number of publicly offered funds (as of the end of each year)



Source: Investment Trusts Association, Japan

(Figure 4) Number of newly originated publicly offered funds and those early redeemed



Sources: QUICK, data submitted from asset management firms, etc.

(1) Setting focused investment strategies

- Each asset management firm must **focus on its core competencies, manage creatively in its areas of focus, differentiate itself from others, and realize its vision through competitive strengths.**

Cases	• Aiming at in-house management of all products in order to commit to long-term investment goals, a firm raises internal resources for management of foreign investment products.
	• To become a globally active asset management firm, a firm acquires new foreign institutional investors by strengthening sales and marketing functions overseas.
	• After building a track record by the successful management of FOFs suitable for regular investments, a firm newly launches an in-house fund focusing on engagement dialogues with investee companies.
	• While achieving good performance and high growth in AUM as a fund manager and also the founder of a firm, it renovates its organizational structure in order for a succession of investment capabilities.

(2) Due-diligence of outsourced investment managers

- Approximately a half (56 out of 100) of large, actively managed publicly offered equity funds are outsourced to external fund managers.
- Most of active U.S. equity funds, which often use outsourced investment managers, are unable to beat passive investments.
- The FSA has found several cases where domestic asset management firms failed to perform its duty of care in the processes of due-diligence & monitoring of funds outsourced to overseas managers.
- **Firms should carefully choose, monitor and manage external investment managers retained for outsourced funds or FOFs.**
- We do not preclude outsourcing of asset management itself and its utilization could be considered as one of the business models to meet clients' needs. However, given the importance of duty of care as asset management firms in selecting and managing external investment managers, **it is necessary to develop and manage products that reassure clients in the long term.**

(3) Compensation structure

- Each firm introduces or revises its own evaluation and compensation systems that are more strongly linked to investment performance.

Cases	• A firm introduces an incentive remuneration system for fund managers (deferred payment linked with long-term performance). The parent company allows the firm to introduce the system different from others in the group.
	• A firm stops considering AUM size and gross fee incomes for the evaluation of a manager's bonus, as those outcomes do not necessarily reflect a manager's skills and effort.
	• A firm outsources performance evaluation of fund managers to a 3rd-party specialized in performance evaluation of funds, including peer reviews.

- **In order to motivate officers and employees in a way aligned with the best interest of clients, a firm shall devise a performance evaluation framework consistent with client interests.**

(4) Initiatives to improve efficiency in asset management operations

- Each firm implements tools such as digital technologies to improve operational efficiency of asset management activities.

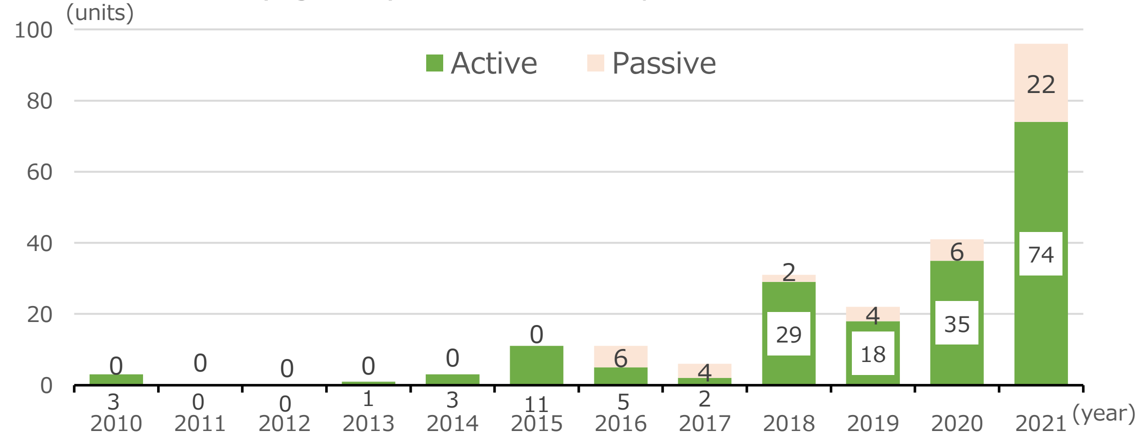
Cases	• A firm develops artificial intelligence (AI) models to quickly detect outliers in financial markets and apply them to investment management.
	• For the calculation of the net asset value per unit, a pilot fund that adopts a single-person calculation model by a trustee or a manager is newly set up for a trial basis.

- We look forward to further progress in research and developments in the use of AI and digitalization aimed at strengthening investment capabilities and reducing costs.

Background

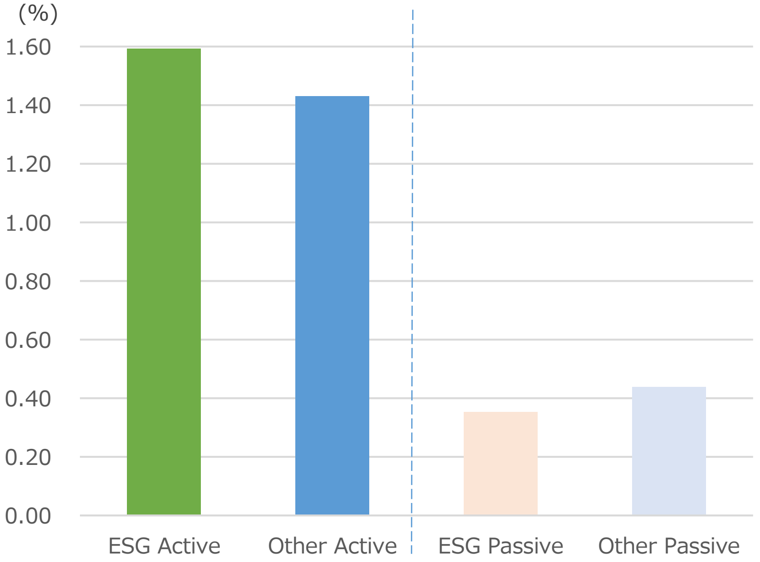
- According to the FSA's survey of ESG funds (37 firms, 225 funds) as of the end of October 2021, the number of newly established ESG funds is increasing and net assets tend to concentrate in a couple of very large ESG funds.
- The average trust fee ratio of active ESG funds is higher than that of other active funds, while that of passive ESG funds is lower than that of other passive funds. This is mainly because most of passive ESG funds have been established recently, when costs of passive funds in general have become cheaper.
- 37% of ESG funds have a scheduled maturity of 10 years or less. In light of the mid-to-long-term perspective required for ESG funds, it is necessary for firms to reasonably explain such short maturities.

(Figure 5) Number of newly established funds

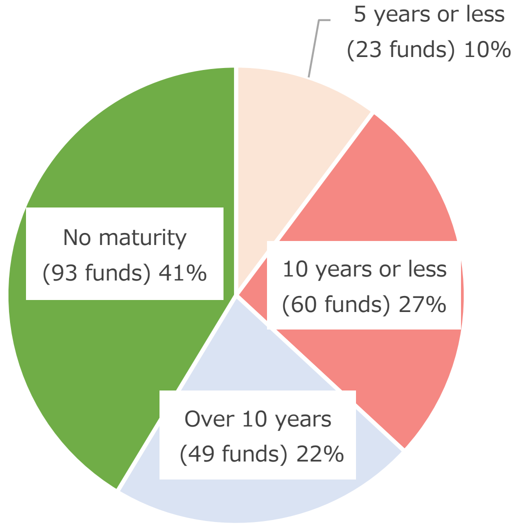


(Figure 6) Distribution of total net assets

(Figure 7) Comparison of average trust fees between ESG funds and other funds



(Figure 8) Ratio by maturity



Notes: Figure 5 is based on data extracted from QUICK database. Numbers for October 2021 and earlier include funds reported by firms.
Sources: All subsequent graphs on "II." unless otherwise noted are prepared by FSA. Also based on data as of October 31, 2021.

Practices of asset management firms (1)

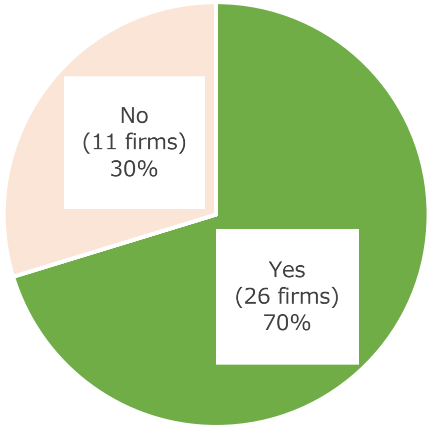
1. Overarching principle

- Many asset management firms believe that taking ESG into account in the investment process ("ESG integration") leads to the identification of previously unappreciated investment opportunities and risks, and may favorably affect the long-term performance of portfolios.
- In cases where a firm states, for example, "ESG factors are taken into account" in disclosure or other marketing materials about the characteristics and investment process of ESG funds, **its investment approach and process should be further strengthened on a continuous basis, and clear explanations and disclosures should be made in a consistent manner based on the investment processes so that investors can make appropriate investment decisions**.

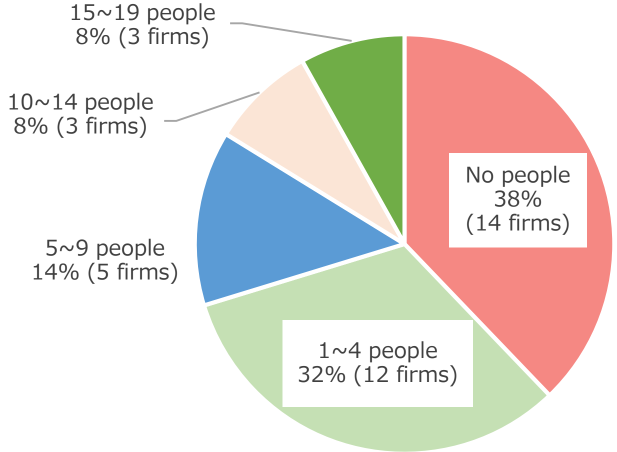
2. Organizational structure

- Some asset management firms established a department to promote ESG investment, but there are cases in which all of members are double-hatters with other non-ESG departments. Or some of other firms do not have a dedicated department/team or ESG specialists at all. **Firms shall put enough resources to implement ESG investment.**

(Figure 9) Whether there is a department or team dedicated to ESG



(Figure 10) ESG Experts



Notes: ESG experts are defined as full-time staff who spend 90% or more of their time on ESG-related tasks.

3. ESG integration

- Approximately 70% of asset management firms make efforts to identify material ESG factors that will affect future corporate value.
- Approximately 80% of asset management firms utilize their own ESG scores in their ESG assessments, but their designs vary widely.

<Advantages of ESG scores (opinions by each firm)>

- ✓ Useful as evidence for firms to understand ESG issues.
- ✓ In its own ESG integration, it functions as a common language for analysts, ESG experts, and fund managers to discuss.

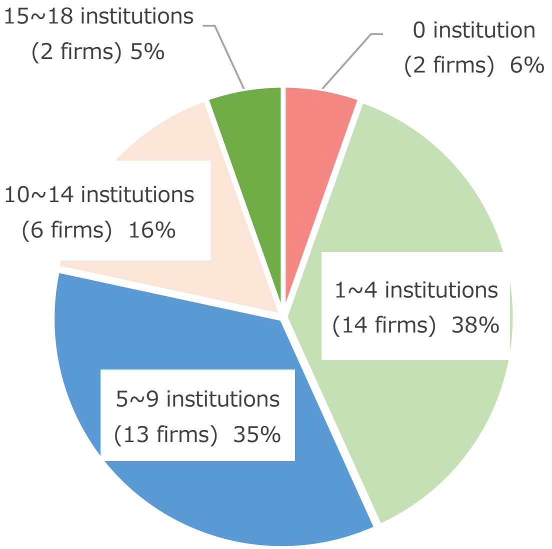
- **In order to effectively analyze and understand potential business opportunities and risks that may affect corporate values**, a firm should not solely rely on fund managers’ discretions **but also take systematic measures to ensure consistency and continuity as an organization**.

Practices of asset management firms (2)

4. ESG ratings and data product providers

- Many asset management firms use several ESG ratings and data product providers for corporate research and analysis.
- Although issues have been pointed out with regard to the transparency of evaluation methods and the quality of data, some asset management firms responded that they do not examine the appropriateness of the providers' ESG ratings because they use them only as a reference.
- Although the providers are continuously making efforts to improve the quality of service, **asset management firms using ESG evaluation and data should appropriately review the quality of service**.

(Figure 11)
Number of ESG ratings / data product providers used



(Table 2)
Top 5 ESG ratings and data product providers used by asset management firms

Institution	No. of firms
MSCI	23
Sustainalytics	23
ISS	20
Bloomberg	18
CDP	12

5. Stewardship activities

- We found many cases in which asset management firms sought to improve long-term corporate values with in-depth analysis of investee companies' ESG-related business opportunities and risks, as well as through regular dialogues and engagement.
- However, quality of stewardship activities vary with firms. Some consider strengthening engagement activities based on more detailed milestone management or having deep dialogues with investee companies whose issues have been centered on financial information analysis.

Milestone management
(example)

- Along with its investment strategy, **a firm should proactively conduct stewardship activities to achieve corporate value growths by improving ESG-related business opportunities and reducing risks identified at the time of investment**.

Practices of asset management firms (3)

6. Disclosure

- Some asset management firms do not adequately disclose their basic approach to ESG investment and their relevant initiatives in reports or other materials for investors.
- In many ESG funds, the description in their prospectus about how ESG factors are considered in the investment process is abstract.
- With regard to periodic disclosures of assets in ESG funds, many firms refer to the name of top 10 investees in a fund and their ESG related activities at best, in their monthly reports or investment reports.
- **In order for investors to correctly understand the details of investment products without misunderstanding and make appropriate investment decisions by comparing them with other products, appropriate information provision and disclosure should be promoted in a consistent manner that conforms to its investment process**.

*** The following examples are prepared by the FSA by disguising actual examples.**

<Prospectus>

abstract explanation

Characteristics

(1) Invest mainly in Japanese companies.
(2) Consider ESG factors for investment.

* In selecting companies for investment, we will invest in companies that we judge are expected to grow profits sustainably by taking into account the ESG perspective in qualitative assessment.

Investment methods

We aim to grow trust assets over the mid-to-long-term by investing in companies that we determine are expected to grow sustainably by taking into account ESG considerations in addition to traditional corporate evaluations in selecting investees.

Traditional corporate assessment
(profitability, cash flow, balance sheet position, etc.)

+

E S G

- Select companies with high overall evaluation from perspective of ESG as well as competitiveness, growth potential, management capabilities, and financial strength
- Avoid companies with little awareness of legal compliance and consideration for the environment and society

<Monthly reports>

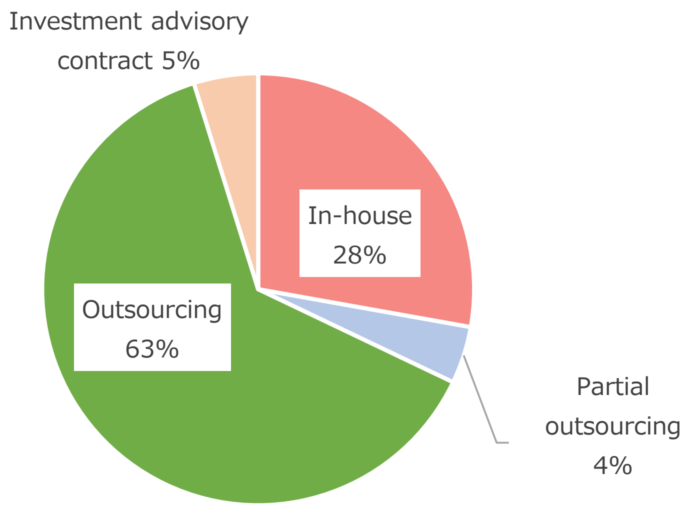
It is difficult to understand how investment based on investment processes that take ESG into account leads to the growth of assets (the purpose of the fund).

	Name of company	Industry	Ratio	Comments
1	AAA group	electrical equipment	4.9%	Making efforts to create sustainable social value from a long-term perspective in various business areas such as finance and electronics.
2	BBB HD	financial business	4.6%	A large company that appreciates its management ability to grow overseas business through M & A. We also expect further shareholder returns going forward.
3	CCC Transport	Transport	4.5%	A manufacturer providing products to railway companies around the world, offering a variety of products for locomotives and passenger cars.
4	DDD Energy	Utilities	4.3%	A utility holding company that provides electricity services in the United States and also sells natural gas.
5	EEE Group	financial business	4.0%	A financial group with growth potential through international operations. Strengthen stakeholder engagement functions by inviting external advisors.
6	FFF Service	Utilities	3.8%	A utility company that owns and operates an electricity transmission network in the UK and the US.

7. Outsourcing

- Approximately 70% of ESG funds subject to the survey outsourced all or part of their invest management.
- Some firms responded to us that they did not fully understand the ESG investment strategy of the outsourced investment managers or the status of engagement activities, saying "We do not specifically understand it" or "We guess engagement activities would be implemented as appropriate."
- **From the viewpoint of fulfilling the fiduciary responsibilities**, even when an outsourced manager is used, **it is necessary for a firm to confirm and understand the organization, strategy, performance, etc. of the outsourced investment managers on a regular basis and with enough details**, just as it does so with in-house investment.

(Figure 12) Ratio of outsourcing of investment management in active ESG funds



Supervisory expectations for asset management firms providing ESG funds

In cases where an asset management firm states, for example, "ESG factors are taken into account" as an explanation of the characteristics and investment process of ESG funds it provides, the FSA expects that the firm will improve the matters described in each of the following items.

1. Overarching principle

- The investment process and approach should be further strengthened on a continuous basis, and clear explanations and disclosures should be made in a consistent manner based on the investment process so that investors can make appropriate investment decisions.
  - ✓ While building the necessary organizational structure with sufficient human resources with expertise, the investment management firm should work to enhance its investment practice and ensure better disclosure so that it can clearly explain how it identifies and evaluates ESG factors that affect corporate value, how it uses them in portfolio decisions, and how it engages and exercises voting rights to improve ESG-related business opportunities and reduce business risks.
  - ✓ When considering ESG factors only as one element of corporate analysis, the firm should not emphasize ESG and sustainability in its disclosure documents to prevent investors from misleading as if the main characteristics of the funds are ESG (for example, a fund that identifies ESG factors as the source of excess returns and selects companies with a high ESG score, or a fund that aims to create environmental and social impact).

2. Organizational structure

- A firm should develop effective systems for ESG investment, including the establishment of a department responsible for strengthening the sustainability promotion framework, enhancing ESG investment methods, and applying ESG experts.

3. ESG Integration

- In order for ESG analysts and investment teams to accurately share the details and reasons of ESG evaluation of individual companies, and appropriately estimate corporate value and engage with companies, fund managers should not rely solely on their own judgment, but also should take systematic measures to ensure consistency and continuity as an organization.
  - ✓ In integrating ESG considerations, a framework for effectively analyzing and understanding potential business opportunities and risks that affect corporate value should be developed, such as by developing and enhancing an assessment framework that utilizes ESG scores, with the aim of identifying material ESG factors in investee companies.

4. ESG ratings and data product providers

- In order to conduct in-depth corporate research and analysis, appropriate verification of ESG ratings and data product providers should be conducted from the viewpoint of ensuring the accuracy and quality of ESG evaluations and individual data provided by the providers.
  - ✓ Organizational structure of ESG ratings and data product providers (number of staff, experience, ability to provide information according to customer needs, and compliance structure), the scope of the company subject to the survey, and the transparency and quality of the evaluation method should be verified in comparison with other ESG ratings and data product providers. Quality control should be actively performed through discussions with the providers, asking questions or suggesting what they should improve.
  - ✓ While disclosing its ESG initiatives (for example in sustainability reports), a firm should explain how to use and verify ESG ratings and data product providers to contribute to constructive dialogue with investee companies.

Supervisory expectations for asset management firms providing ESG funds

5. Stewardship Activities

- In accordance with its investment strategy, a firm should proactively conduct stewardship activities to achieve corporate value growths by improving ESG-related business opportunities and reducing business risks identified at the time of investment.
  - ✓ In cases where a firm positions climate change as an ESG issue to be addressed, FSA expects that the firm conducts engagement and exercise of voting rights in more active and continuous manner from the perspective of encouraging the transition to decarbonization, mainly in industries with large amounts of greenhouse gases.

6. Disclosure

- In order for investors to correctly understand the details of investment products without misunderstanding and make appropriate investment decisions by comparing them with other products, appropriate information provision and disclosure should be promoted in a consistent manner that conforms to its investment process.
  - ✓ A firm should strive to enhance disclosure of its policies and initiatives by, for example, explaining its basic ESG approach, ESG integration, engagement policies and specific examples, in its sustainability report or responsible investment report.
  - ✓ The characteristics and investment process of ESG funds should be adequately disclosed in the prospectus.
  - ✓ Where a firm invest in a company considering ESG factors based on the investment process described in the prospectus, efforts should be made to enhance disclosure, not only through investment reports and monthly reports, but also by using other documents, so that the firm can explain in detail "how the corporate value of investees is currently evaluated based on ESG factors" and "what engagement and voting rights are exercised toward improving the corporate value of investees based on ESG factors, as well as future policies."
  - ✓ In particular, when assigning names such as "ESG," "SDGs," and "impact" to the funds, it is necessary to explain and disclose more clearly how the products meet the characteristics implied by the names so that customers do not misunderstand the meaning of the names.

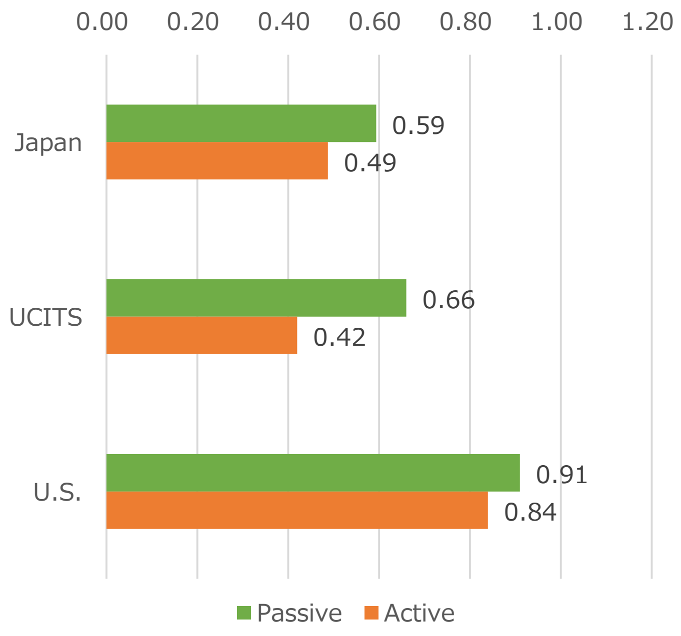
7. Outsourcing

- From the viewpoint of fulfilling fiduciary responsibilities, outsourced investment managers should be appropriately managed and accurate information should be provided to customers in accordance with the characteristics of products.
  - ✓ Even in cases where outsourcing including fund-of-funds type and investment advisory is used, as in the case of in-house investment, it is necessary to confirm and understand the outsourced managers' investment structure, investment strategies (investment methods and management methods) of invested assets, investment performance, etc., with appropriate frequency and depth.
  - ✓ A system for appropriate management of outsourced investment managers should be established.

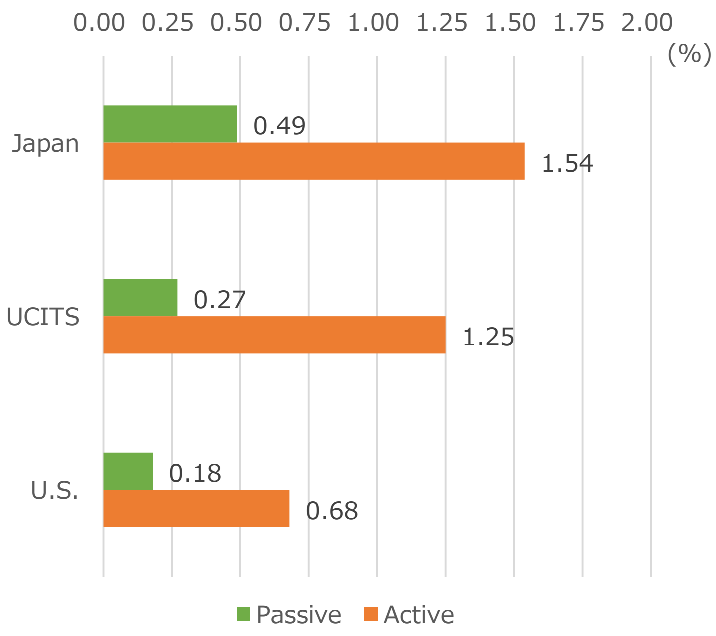
Global comparison of Sharpe ratios and expense ratios of mutual funds

- In a global comparison of mutual funds, **U.S. mutual funds have an advantage in both the Sharpe ratio and the expense ratio.**
- A comparison between passive funds and active funds reveals that **the Sharpe ratios of passive funds are higher than those of active funds in all of Japan, UCITS and the U.S., while the expense ratios of passive funds are lower than those of active funds in all of the three areas.**
- With respect to the active funds, U.S. mutual funds with an expense ratio of less than 1 percent account for the majority of active funds, while in Japan, funds with an expense ratio of 1%~2% account for the majority. On the other hand, the expense ratio of UCITS varies widely, reflecting the fact that UCITS funds tend to be originated and offered under different fee structures for various countries and regions in Europe.

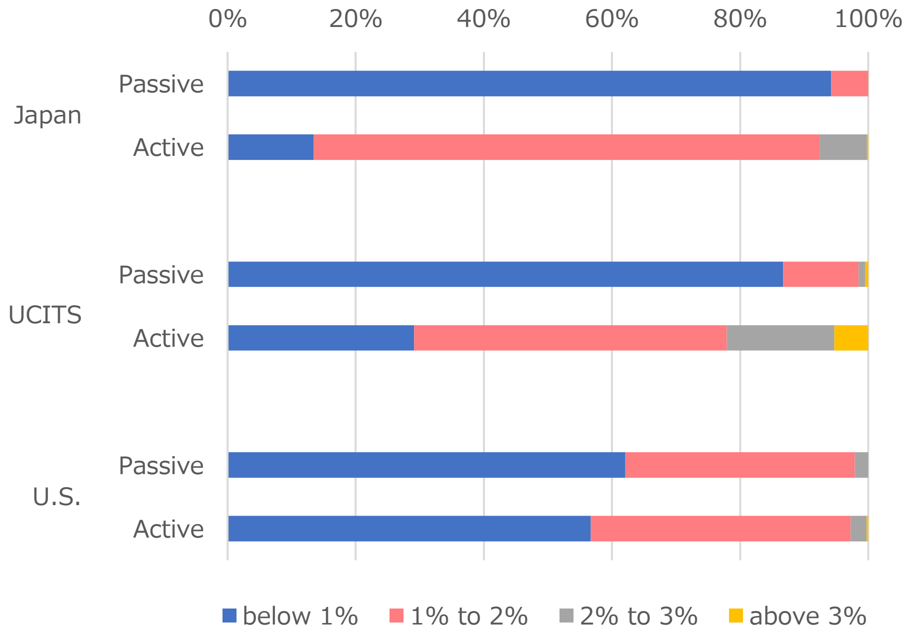
(Figure 13) Sharpe ratios



(Figure 14) Expense ratios



(Figure 15) Distribution of expense ratios of active funds



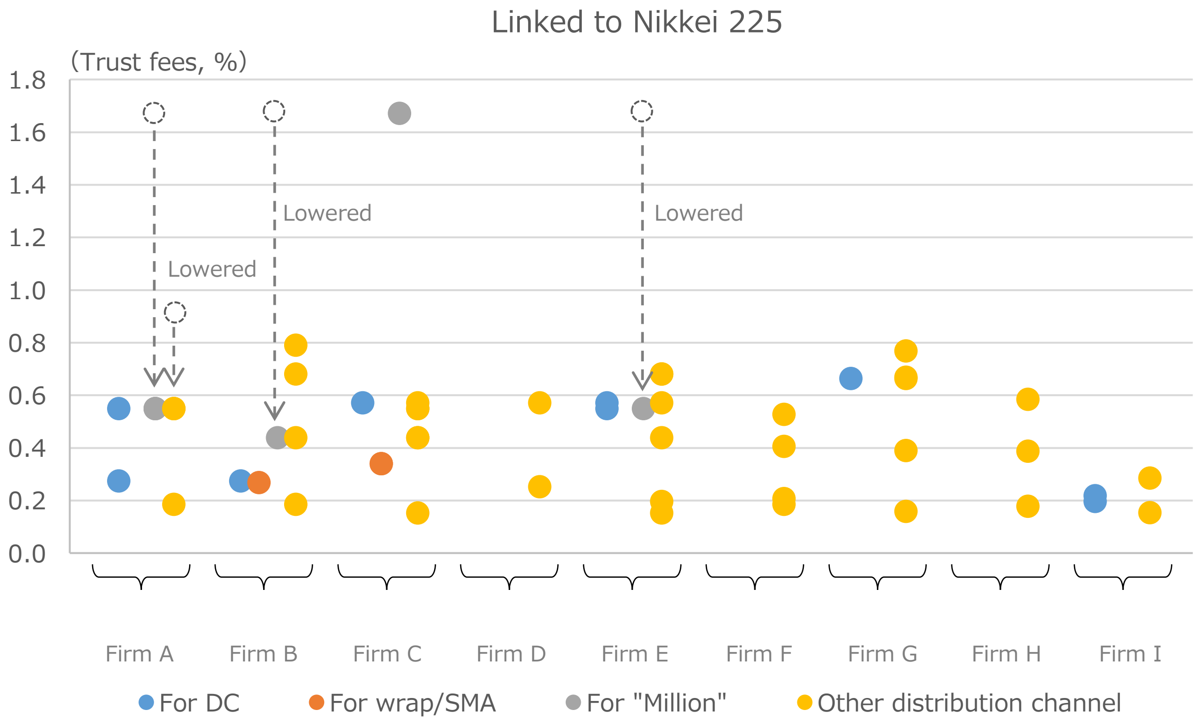
Notes: "Japan" mean publicly offered domestic investment trusts in Japan, "UCITS" means funds established and managed in accordance with EU laws and excludes ETFs etc., and "U.S." mean mutual based in the U.S. All funds in the sample are those that have been managed for at least five years as of the end of 2021. UCITS is a fund
Ratio numbers in Figure 13 and 14 are weighted averages calculated by the funds' balances at the end of December 2016. The distribution in Figure 15 is by numbers of units.
The "expense ratio" measures the ratio of management fees and other expenses to the average asset balance of a fund.

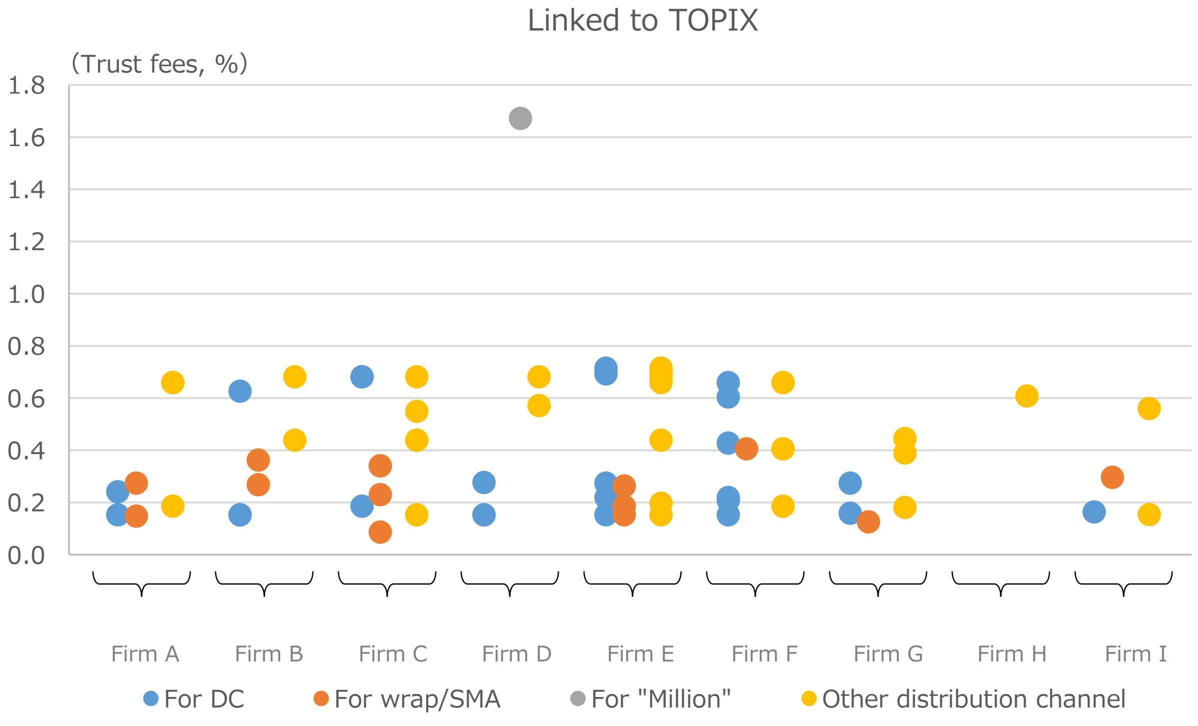
Sources: QUICK and Ibbotson Associates Japan

Fee dispersion among passive funds linked to same indices

- Among passive funds linked to an identical index, there is a dispersion in trust fee levels even within those managed by a single asset management firm and distributed through a single channel.
- **A couple of firms have lowered trust fees of some of their funds in order to eliminate the dispersion.** We heard from other firms that they were now engaged in negotiations with distributors to lower the fees to resolve the situation.
- **For the best interests of clients, the asset management industry as a whole, including not only asset managers but also distributors and trust banks, is expected to work together for reviews and corrections to appropriate trust fee levels.**

(Figure 16) Trust fee levels of index funds by each asset management firm and by distribution channel





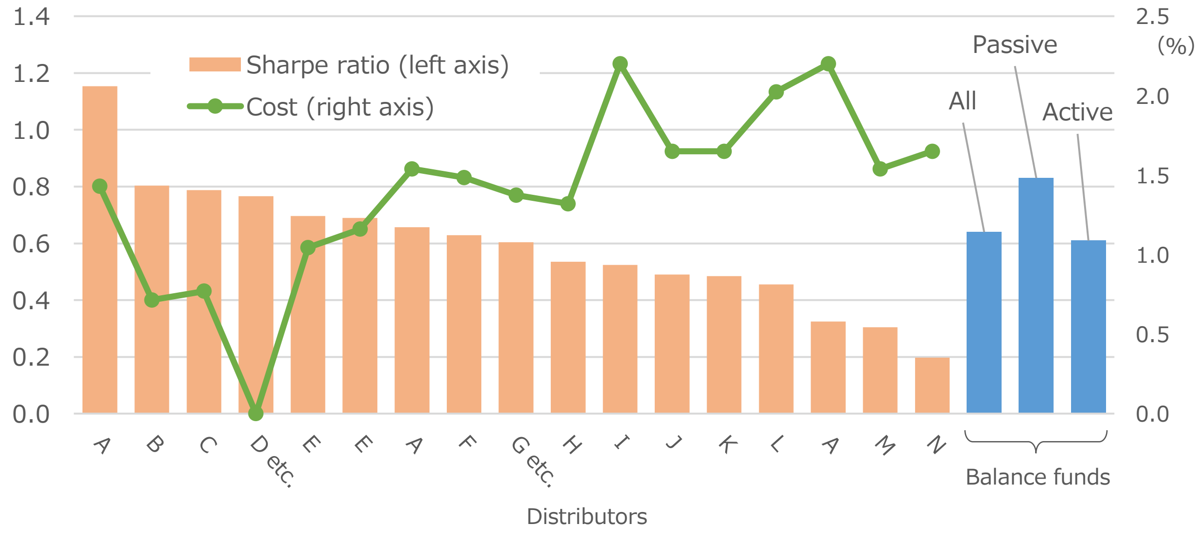
Notes: Refer domestic publicly offered open-type stock investment trusts that are indexed type (as of March 2022). "Lowered" means funds whose trust fees have been lowered since Oct 2020. "SMA" means "separately managed account". "Million" means installment investment methods from payrolls introduced by Japanese corporations in 1980s.

Source: QUICK

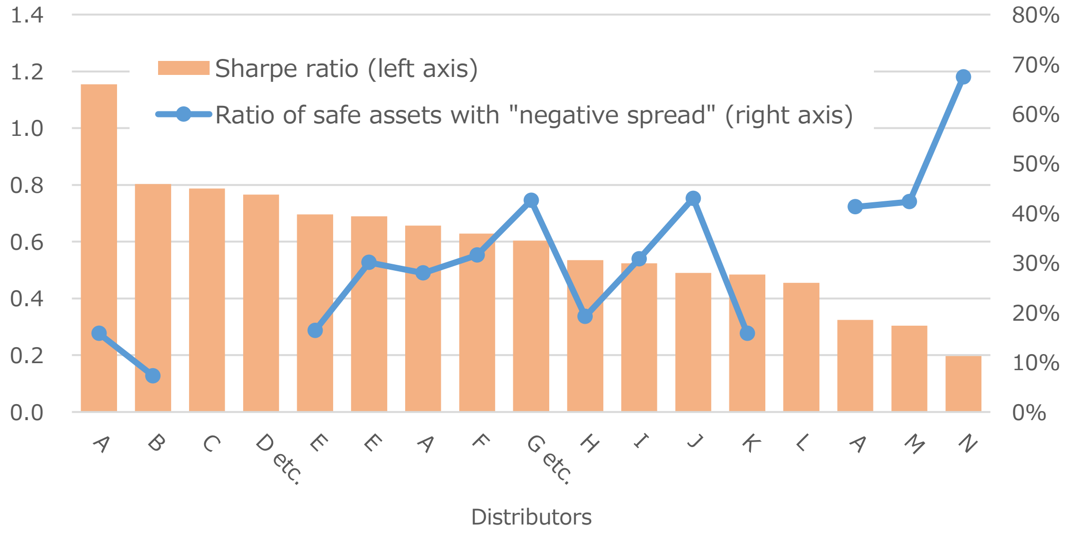
Fund wrap

- While many fund wraps performed positively in 2021, benefiting from a strong market environment, there is a gap in quality. Looking at the five year Sharpe ratios after deducting costs, many fund wraps still lag balance funds. Fund wraps with higher costs tend to perform worse.
- Because the cost of most of fund wraps is generally 1.5% per annum or higher, it is difficult for safe assets in fund wraps to achieve a return of more than 1.5% under the current low interest rate environment. As a result, **many fund wraps suffer from "negative spread" with respect to the portion of such safe assets. We see a relation that the ratio of safe assets tends to be higher in fund wraps with poorer performance.**
- It is natural for risk-averse customers to increase the allocation of safe assets, in general. However, there are multiple options of safe assets other than a fund wrap, so there is no need to use a high-cost fund wrap for that purpose. The “negative spread” of fund wraps would rather damage customers' assets. On the other hand, since fee income to distributors is proportional to asset size in fund wraps, it induces conflicts of interest that distributors would try bringing as much customers' assets, including safe assets, into fund wraps. **Regarding a fund wrap that charges expensive fees and has a high allocation of safe assets, distributors shall reconsider whether the product truly fits with customers' best interest.**

(Figure 17) Sharpe ratios of fund wraps (5 years)



(Figure 18) Ratios of safe assets with “negative spread” and Sharpe ratios



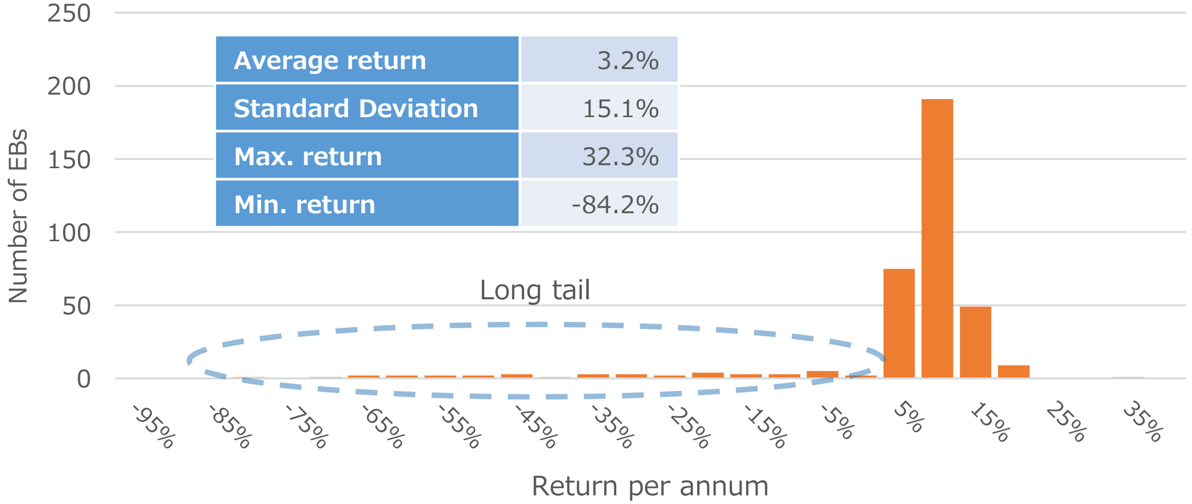
Notes: The reason why the same company name appears more than once is that one distributor may handle multiple fund wrap products.
There are three types of costs in fund wraps: (1) trust fees of funds wrapped, (2) fees for a fund wrap itself, and (3) investment management fees for a fund wrap itself. In this page, the total of (2) and (3) is referred to as "cost of fund wrap" or "cost." Some distributors ("Company D, etc." in Figure 17,18) set (2) and (3) at zero and indirectly receive remuneration from trust fees of funds wrapped. All of the Sharpe ratios for fund wraps in this slide are figures after deducting all of the costs from (1) to (3).

Source: QUICK

Structured notes

- Among structured notes sold to retail customers, EBs (bonds exchangeable to equities) accounts for a significant portion in sales. Because an EB is similar to a short position of a put option of an equity, it tends to incur large losses when share prices fall significantly. In our sample, there was a case where 80% of the principal was lost in only three months. Looking at the distribution of returns of the sample, although the frequency is small, the risk (standard deviation of the distribution) is relatively high due to the long tail of loss rate ("tail risk") (Figure 19).
- Compared to the long-term return-to-risk ratios of other asset classes, the returns on EBs are not high enough to justify their risk (Figure 20). **There is only little advantage to purchase EBs as a substitute for equity, because the return-to-risk ratio is inferior to that of equity, while both are highly correlated.**
- The real cost of EBs (difference between the principal and fair value) is estimated to be around 5-6% of the investment principal on average, based on industry interviews and other public information. However, since the realized maturity of EBs is as short as about 0.6 years, the real cost on an annualized basis is estimated to reach around 8-10%. Such a high real cost may have contributed to the poor return-to-risk ratio shown in Figure 20. From the viewpoint of distributors and dealers, EBs are an ideal product to effectively turn over customers' assets frequently and to earn high profits in a short period of time. **We expect each firm handling EBs and their industry association to enhance the disclosures of EBs to customers, for example, by voluntarily compiling and publishing data of returns and risks of structured notes on a regular basis and disclosing all of the real costs in Key Information Sheets.**

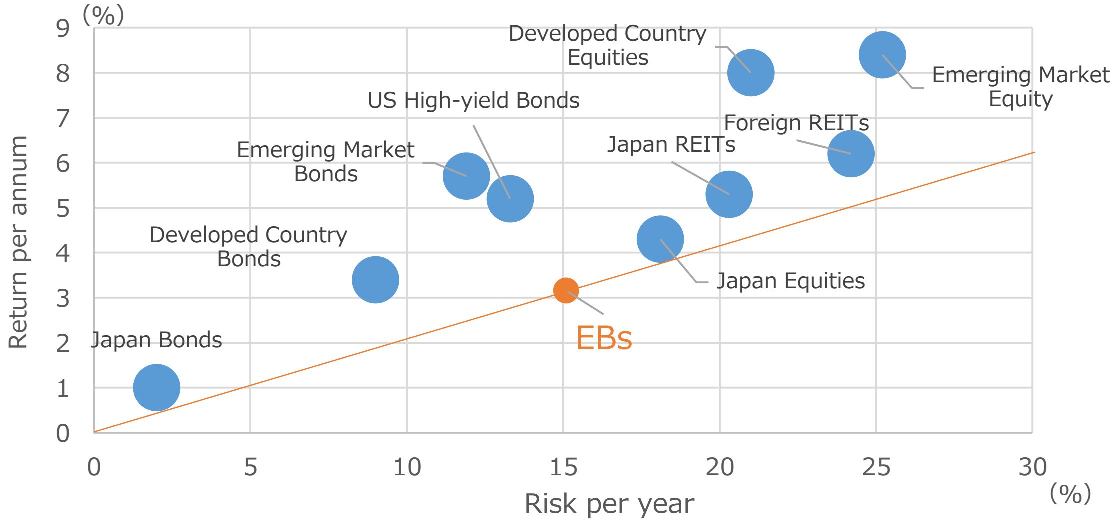
(Figure 19) Return distribution



Average return	3.2%
Standard Deviation	15.1%
Max. return	32.3%
Min. return	-84.2%

Note: Out of the total 856 EB reported by dealers as those sold to retail investors in April 2019, returns per annum are calculated for only fixed-income notes (364 notes). Regarding notes outstanding as of the end of 2021, then market prices are used for the calculation.
Source: Prepared by the FSA based on materials submitted by dealers

(Figure 20) Return-to-risk ratio

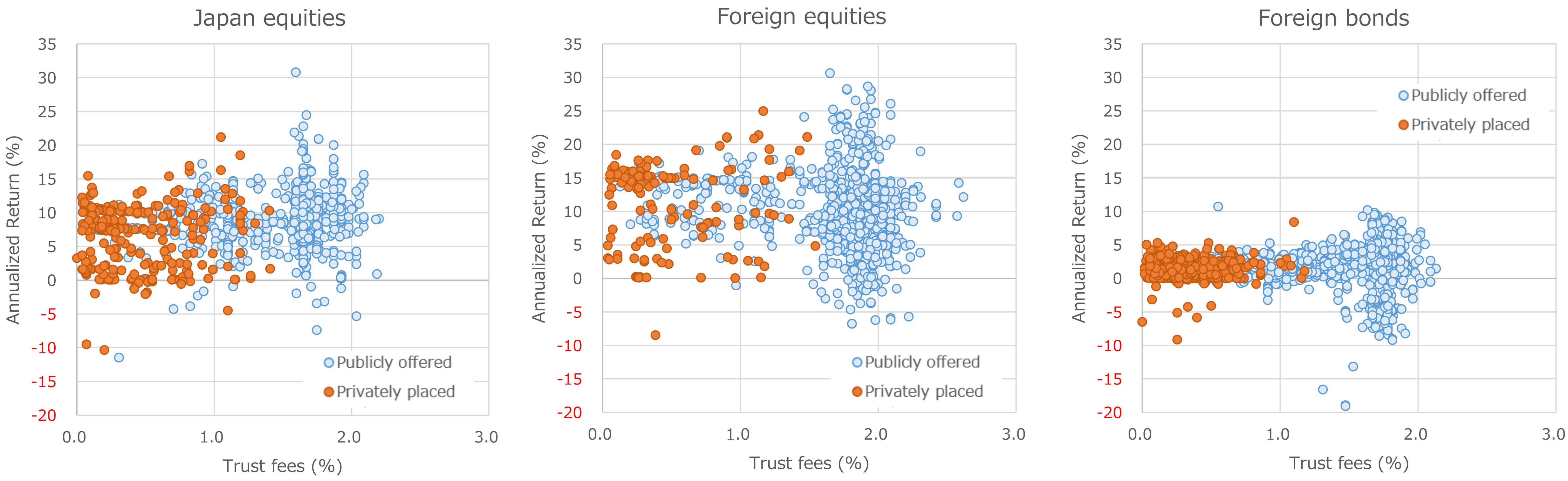


Note: The return and risk of EBs are calculated from the distribution in Figure 20, whereas the returns and risks of other asset classes are estimated from historical data from 2002 to 2021 (2006 to 2021 for Japan and Foreign REITs).
Source: Prepared by the FSA based on materials submitted by dealers and data from Ibbotson Associates Japan

Comparison between publicly offered funds and privately placed funds

- ◆ As of the end of 2021, the total amount of assets under management of Japanese asset management firms is more than 800 trillion yen. The total net assets of privately placed funds stood at approximately 110 trillion yen. In terms of the balance, privately placed funds are larger than publicly offered investment funds (excluding ETFs).
- ◆ Private placement funds for institutional investors offer products that are lower in cost than publicly offered funds, possibly because their customers are large institutional investors.
- ◆ There is a large gap in trust fee levels for all asset classes: domestic equities, foreign equities, and foreign bonds.

(Figure 21) Comparisons between publicly offered funds and privately placed funds by asset classes



Notes: Funds are plotted by annual returns and trust fees over the last five years by the end of 2021. Funds with track records less than 5 years are excluded.

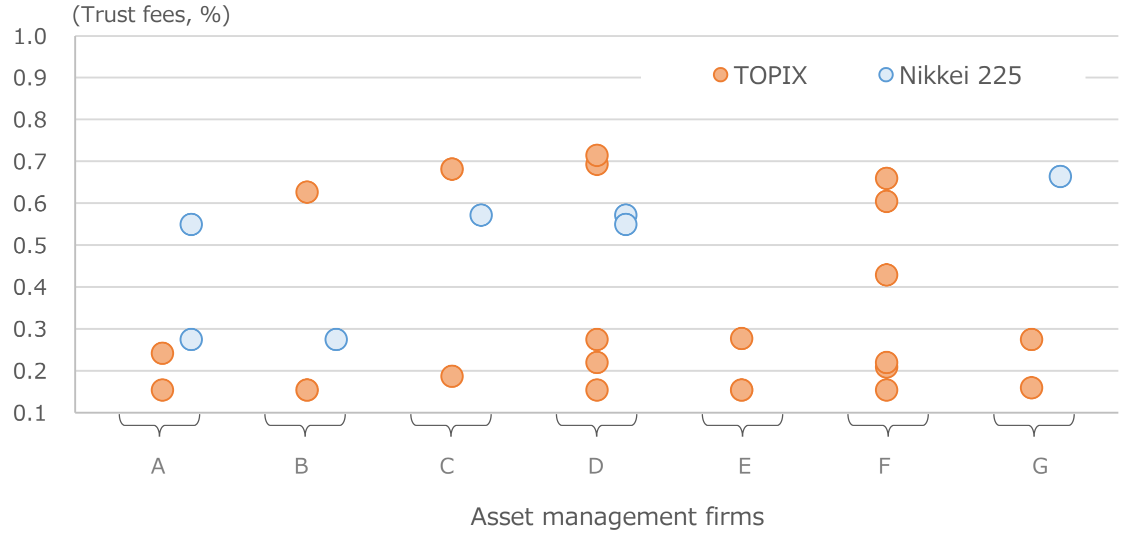
Source: Prepared by the Financial Services Agency based on data by QUICK and materials submitted by asset management firms having a large AuM of privately placed funds

Defined Benefit Corporate Pension (DB) / Defined Contribution Pension (DC)

- "Asset owners" in the investment chain means, in DBs, companies operating pensions and trustees (trust banks, life insurers, investment advisors, etc.) and, in DCs, participants. The companies and the financial institutions serving as agents play an important role in providing DC participants with access to the asset management industry.
- Regarding DBs, according to a commissioned survey*, **the issue of insufficient disclosure by Japanese corporate pensions compared with overseas pensions is pointed out to be improved first, and it is proposed that there is considerable room for Japanese corporate pensions to improve investment management capabilities by enhancing human resources and other resources, taking into account interests of not only participants but also other stakeholders, including shareholders who fund pensions.**

  *"Survey on the situation of corporate pensions" (Boston Consulting Group, published by the FSA on May 20, 2022)
- A dispersion in fee levels of index funds for DC remains large and show no signs of significant improvement. The following points are important for the growth of assets of participants who are the final beneficiaries of DC:
  - ✓ **Companies should pay close attention to the selection of investment products and provide investment education to DC participants.**
  - ✓ The financial institutions operating as agents for DC programs should provide enough information and educational support to the companies and participants on differences between DC's current product lineup and other more cost-efficient products.

(Figure 22) Trust fee levels of index funds for DC by asset management firms



Notes: Index funds for DC as of March 2022
Source: QUICK

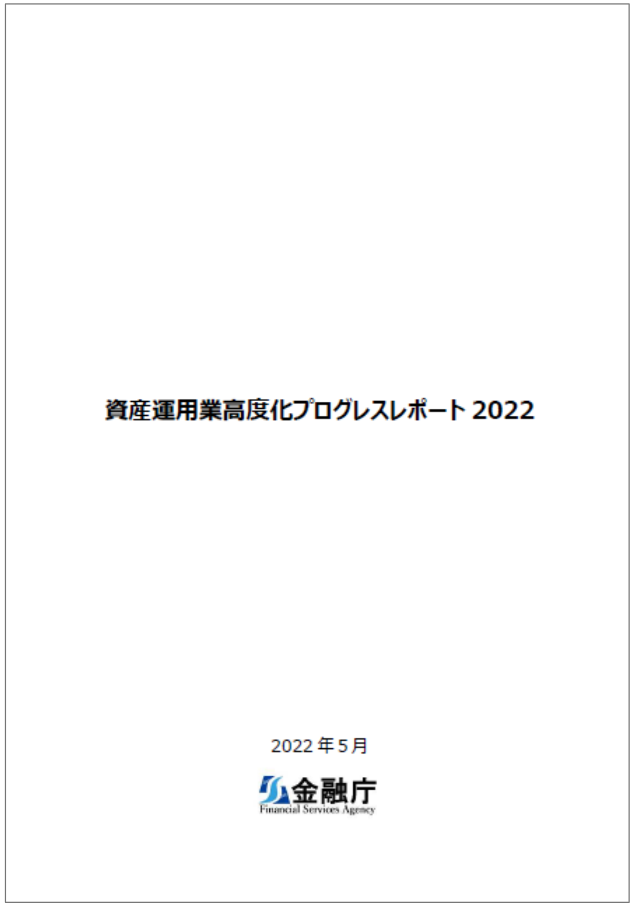
(Reference)

- Original Report : Progress Report on Enhancing the Asset Management Business 2022
  (Currently Japanese only. English version to be published soon.)

- Commissioned Survey : "Survey on the investment performance of asset managers in Japan"(Japanese only)

- Commissioned Survey : "Survey on the investment performance of asset managers in the U.S and Europe" (Japanese only)

- Commissioned Survey : "Survey on the situation of corporate pension funds in Japan" (Japanese only)


資産運用業高度化プログレスレポート 2022

2022 年 5 月

金融庁
Financial Services Agency

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