Raising assets in Japan

Japan is host to some of the largest pools of institutional investment assets in the world. It ought to be a magnet for asset managers of all kinds, and especially for the alternative investment managers that are garnering substantial shares of institutional assets in North America and Europe. Yet Japan has proved an exceptionally challenging market to penetrate, for reasons which range from the cultural to the structural. However, there are now signs that Japans institutional investors are opening their portfolios to foreign and alternative assets. How should alternative managers approach this opportunity?

Japan is an attractive market for any fund manager. According to a recent survey by PwC of foreign investment by pension funds around the world,[1] Japanese retirement assets total ¥182.4 trillion. That figure makes the Japanese pension fund market one of the largest in the world. Japanese households have another ¥1,500 trillion in savings, and both banks (¥500 trillion) and insurance companies (¥300 trillion) also command large pools of assets. But Japanese investors are not an easy group to access for fund managers based outside Japan, and they have proved especially difficult for alternative asset managers in general, and hedge fund managers in particular.

Some of the reasons for that are obvious but hard to surmount, such as language and culture. In fact, it is possible to distribute fund management products in Japan, but success rests on meeting a number of unusual demands. The first is to be exceptionally patient. It can take anywhere between one and three years to secure an allocation. Actually raising assets will necessitate regular visits to Japan, and frequent communication with investors and potential investors between visits.

An essential prerequisite for securing an allocation is a track record of at least three years, preferably in one of the strategies Japanese investors prefer, such as multi-strategy, global macro, credit, or CTA. These strategies are popular because they complement the domestic exposures institutions have as a matter of course. It is also helpful to have powerful testimonials to hand, in the shape of an entrenched client base of geographically and institutionally diversified investors.

It is also vital to understand and work with the gatekeepers to Japanese institutional assets. In Japan these are principally the five trust banks, the fund of fund and multi manger investment teams within institutions, the top tier prime brokers, domestic fund managers and securities brokers who have longstanding relationships with the domestic pension funds and the few independent consultancy groups. Importantly, the gatekeepers do not generally include the global investment consultants which govern access to institutional money in Europe and North America. In Japan, these groups do have institutional relationships, but the main focus is on monitoring local asset managers for allocations from their non-Japanese clients.

[1] PwC and Alfi, *Beyond their Borders: Evolution of foreign investment by pension funds,* September 2015.

For fund managers looking to raise assets in Japan, on the other hand, the most important gatekeepers are the trust banks. They, above all, are the intermediaries best placed to explain an investment strategy to their existing institutional clients. Their role is akin to that of a fiduciary, charged with ensuring any managers of Japanese assets have the substance, skill and capacity to look after Japanese savings. It follows that fund managers dealing with trust banks should be well-prepared. They can expect to answer more questions about who they are, what they do, and how they do it, than they will encounter anywhere else.

One effect of this search by the most powerful Japanese intermediaries for fund managers whose strategies they can understand and whose people they can trust is an institutionalised preference for recognized brand names. This preference is obvious in the global asset management businesses which have secured allocations, but a liking for instantly recognisable brand-names extends to service providers, such as prime brokers, fund administrators and custodians. In fact, it is not unknown for managers entering Japan with an existing fund to create a separate vehicle or share class supported by separate service providers with brand recognition in Japan.

Naturally, this makes it harder for lesser–known managers to build a following in Japan, because they lack both the instant brand recognition and in most cases the support of the blue chip service providers as well. But it is worthwhile even for mid-sized managers to persist, because the difficulty fund managers face in penetrating the market also means it is both less crowded and rich in potential for growth.

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That said, size does matter in Japan. Any investment strategy seeking to raise assets there needs a certain scale. Allocations from Japanese institutional investors tend to be smaller in size than those from similar investors in the United States and Europe, but these are still generous by hedge fund standards. An initial direct allocation is never less than $50-100 million. Smaller allocations are possible only if an investment is intermediated by a trust bank capable of aggregating a large number of investments.

An effective local placement agent to translate ideas and documents - such as a domestic pension consultant, most of them linked to the securities houses - is essential for managers seeking larger, segregated mandates. Any fund manager setting up a domestic fund, on the other hand, requires a locally authorised investment manager, since it entails setting up a local fund supported by a local fund administrator, which can then be distributed by the Japanese banks and securities houses. The domestic fund can invest in offshore fund vehicles domiciled in the Cayman Islands, Dublin or Luxembourg, but the domestic presence is indispensable.

Japanese institutions also have a distinct preference for liquidity, in terms of asset classes as well as redemption terms, and for transparency into how investments are made and managed. This is an aspect of a relatively conservative approach to investment, especially on the part of the pension funds. Most retirement schemes are still defined benefit plans, making them reluctant to incur losses of the kind which might end up on the balance sheet of the public or private sector plan sponsor. This can enhance the appeal of alternative investments, on grounds of non-correlation, but it is important for foreign fund managers not to treat the Japanese institutional market as a monolith.

In practice, Japanese institutional investors divide into four classes. There are pension funds (which are tax-exempt, and free to buy funds or mutual funds domiciled anywhere in the world); financial institutions such as regional and local banks (which prefer offshore or domestic unit and investment trusts to the corporate form of most conventional mutual funds, since these have to be added to the balance sheet, and they rely heavily on the trust banks to recommend suitable fund managers); insurance companies (whose appetite for non-Japanese managers has diminished since their enthusiastic allocations at the turn of the century were hit badly by the subsequent rise in the value of the Yen); and retail investors (which can buy locally promoted domestic funds domiciled in Japan only).

These considerations make Japanese pension funds the most suitable investors for alternative assets. However, they have so far shown a limited interest. According to the PwC survey, they are massively under-invested in alternatives (less than 1 per cent of total assets) by comparison with their counterparts in the United States (29 per cent), Canada (31 per cent), the

United Kingdom (31 per cent) and the Netherlands (16 per cent). Even by comparison with other pension markets in Asia, such as Australia (16 per cent) and Korea (10 per cent), Japanese pension funds have retained a surprisingly large exposure to conventional fixed income investments, and an unusually limited exposure to alternative investment strategies.

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This bias is contrary to the behavior of pensions elsewhere in the world. The PwC survey found that, globally speaking, pension funds have since 2008 shifted allocations decisively from bonds to equities, and especially into alternative asset classes. Taken as a whole, the global pension fund industry more than doubled its allocation to alternatives over six years, from $4.4 trillion in 2008 to $9.7 trillion in 2014. Alternatives now make up more than a quarter (26 per cent) of total global pension fund allocations.

Globally, pension funds are also more willing to invest abroad. According to PwC, the cross-border allocations of pension funds based in OECD countries, excluding the United States, increased to 21 per cent in 2014. In making that transition, non-Japanese pension funds have also found mutual funds an ideal vehicle, chiefly because of their regulated status and guarantee of liquidity. At the end of last year, a third of global pension fund assets were held in the form of investment funds. Yet only 93 UCITS funds are distributed in Japan at the moment, despite the prolonged and extensive Japanese trust bank investment in Luxembourg and increasingly in Ireland.

But if UCITS funds are a minority pursuit in Japan, funds structured to comply with the Alternative Investment Fund Managers Directive (AIFMD) have yet to secure any degree of brand recognition at all. This may change as Japanese investors come to appreciate the regulatory protection AIFMD offers investors – after all, UCITS took decades to establish itself as a global brand, and is only now becoming popular with European pension funds – but AIFMD-compliant funds are also uncomfortable for non-Japanese managers to offer. This is because even a dedicated fund or share class or feeder fund purchased exclusively by Japanese investors would still require the European based manager to report to European regulators.

To date Cayman-domiciled alternative funds have proved more acceptable to Japanese institutional investors than AIFMD-compliant funds, largely because of their tax-efficiency. Bermuda is also an acceptable domicile and for the same reason. But there is no fundamental issue of taxation or regulation that prevents Japanese investors – especially pension funds, which are tax-exempt, endorsing virtually any domicile, on or offshore. A lack of familiarity with a domicile is the main obstacle, which in turns reflects the relatively limited scale of investment outside Japan so far and the concentration in familiar domiciles.

However, evidence of a substantial change in attitude towards investment outside Japan is accumulating. Under the twin pressures of deteriorating demographics and a high debt-to-GDP ratio, Japanese institutional investment behavior is definitely changing. A systematic reallocation of institutional assets is now under way in Japan. It represents a major opportunity for hedge fund managers pursuing strategies other than equity long/short. It is also an opportunity for private equity managers, especially if they use vehicles (such as funds of private equity funds managed from Japan) or pursue strategies (such as real estate, industrials or digital technology) that currently appeal to Japanese institutions.

One way of measuring the scale of that opportunity is to study the current asset allocation of Japanese pension funds. The PwC survey found that a majority of Japanese retirement assets are still invested in bonds (58 per cent). Though allocations have shifted to equities (up from 17 per cent of the whole in 2008 to 39 per cent in 2014), this still means that 97 per cent of assets are invested in conventional asset classes. In fact, considered as a proportion of the market capitalization of listed equities in Japan, even 39 per cent amounts to no more than an eighth of the value available. That is another reminder of how large the opportunities created by a less conservative approach might be.

One extremely encouraging sign of change is the growing appetite to invest abroad. Indeed, the Japanese pension fund industry now hosts some of the most aggressive institutional investors outside domestic markets anywhere on Earth. Driven by low yields on Japan government bonds (JGBs) and a depreciating Yen, pension funds have increased their allocations to foreign markets from 16 per cent in 2008 to 32 per cent in 2014. That shift is equivalent to ¥57.81 trillion.

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There are no quantitative limits on Japanese portfolio investment abroad, or on particular asset classes or countries, so the only limits to continuing growth in foreign investment are the appetite of particular pension funds to invest abroad, and their degree of confidence that the gains they make will not be eroded by a surge in the value of the Yen. It is a telling commentary on the continuing institutional preoccupation with currency risk in Japan that one alternative investment strategy which is securing allocations is shorting the Yen.

Some less obvious developments are likely to feed the change in asset allocations by Japanese institutions. The Japanese pension fund market is a highly concentrated one, with no less than 92 per cent of total assets under the control of just one fund: the giant Government Pension Investment Fund (GPIF). This gives the GPIF bellwether status. So its declaration in October 2014 that it would trim its allocation to bonds to 50 per cent of its assets, and divide the balance evenly between domestic and foreign equities, is likely to encourage smaller pension funds to follow suit. Even the fixed income allocation of the GPIF is changing, with 15 per cent to be invested in non-Japanese instruments.

Although the GPIF is not empowered to invest in hedge funds, the change of investment strategy is nevertheless encouraging for non-Japanese fund managers. It is also unlikely to be reversed, following a recent change in the chief investment officer (CIO) at the GPIF. The successor to Tokihiko Shimizu is Hiromichi Mizuno, who previously worked at Coller Capital. More encouragingly still, Shimizu-san is now CIO at Japan Post Bank, which manages more in post office savings even than the GPIF commands on behalf of pensioners. Its previously unadventurous investment policy can now be expected to change as well, including a switch to alternatives, which are authorised as an allocation.

It would, however, be a serious error of judgment to enter the Japanese market armed with a sale pitch of a similar kind to that a manager would make to an American endowment or a European sovereign wealth fund. Investors of all kinds are resistant to being sold a product. Yet it is equally mistaken to design and deliver products based on suppositions about the investment objectives of Japanese investors.

The fund managers which have succeeded in Japan tend instead to take the time and trouble to ensure their target investors and their advisers understand the methodology and objectives of their firm and their strategy, so they can choose whether or not to support it in the light of their own needs and expectations. One reason Japanese pension funds are not heavy buyers of equity long-short strategies, for example, is that pension funds regard short-selling as likely to undermine the equity valuations of corporate Japan.

Once a manager is approved, however, Japanese investors are exceptionally loyal. Investment time horizons congregate around three to five years. This provides valuable stability and time for an alternative investment manager to make a strategy work, though Japanese investors do also expect a high degree of transparency. Managers of Japanese assets are expected to deliver weekly reports, usually in a bespoke format. They are also expected to visit their investors at least two or three times a year. Global brand-name managers have found it necessary to actually open an office in Japan.

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In this sense, Japanese investors are demanding. But they are also much more accommodating towards hedge fund fee structures than, say, Australian pension funds, chiefly because they are happy to accept management and performance fees for traded guarantees of liquidity without penalty. That said, growing sales of exchange-traded funds (ETFs) in Japan suggest that institutional tolerance for generous fee structures is dependent on the ability of managers to deliver alpha.

For now only in retail distribution are management and performance fees under serious downward pressure in Japan. This is mainly because so many other intermediaries – the domestic fund manager, the local distributors, the fund accountant, the transfer agent, the custodian and the offshore vehicle – are also eating into returns. However, hedge fund managers are unlikely to seek retail investors except through funds of funds vehicles, which insulate them from competition on fees.

What distributors of retail funds do have in common with their institutional counterparts is a ready appreciation of the value of liquidity. For this reason, liquid alternatives, whether structured as UCITS funds or '40 Act funds, are likely to prove attractive simply because they offer daily liquidity. Managers of these funds need to be mindful, however, of the interest Japanese regulators have taken in adaptations of institutional strategies to the retail market. Poorly performing capital guaranteed capital products, which were widely sold in the years ahead of the financial crisis, are not forgotten.

If regulators sensitive about retail investor protection sound familiar, it would be a mistake to assume that selling investment management expertise is ever the same in Japan as it is anywhere else. The Japanese institutional investment market is *sui generis*. Even brand-name managers which can satisfy the well-attested Japanese preference for liquid, transparent, non-equity strategies will take between 18 months and three years to secure their first investment.

Retaining an allocation will require regular visits, adaptation of reporting formats, and especially respect for deadlines, to ensure Japanese counterparts can always meet the expectations they face. In Japan, mistakes are easy to make, and recovering from them is hard, but the rewards – in terms of large, loyal and engaged investors – mean the risks and the costs are well worth incurring.

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