Effective allocation of local capital could be a significant catalyst for Japan

Another tool to spur growth and end deflation

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In 2013, the Nikkei 225 stock index surged by approximately 57%[1] representing the largest single year percentage increase in more than 40 years. Market participants are quick to point out that the primary beneficiaries of this surge were foreign investors, as evidenced by the net foreign capital inflows of approximately US$145BN. Broadly speaking, local retail investors and pension/quasi-pension plans did not participate in these out-sized gains.

1 *Mogi, Chikako and Hirokawa, Takashi, 'Takenaka touts Nikkei surge', The Japan Times, 9 January 2014*

There are key macro-economic signs suggesting continued growth in Japan, including signs of inflation and inflation expectations, low unemployment and indications of wage increases.

While these positive signs are welcomed, there is no shortage of skeptics regarding Japan's ability to continue on its current path. One factor skeptics point to is the lack of true structural reforms, the third arrow[2] of Prime Minister Abe's so-called Abenomics, since Prime Minister Abe's administration took office in December 2012.To assist with identifying structural reforms in the capital markets, the Panel for Vitalising Financial and Capital Markets (the 'Panel') was established by the Financial Services Agency and the Ministry of Finance and whose recommendations are designed 'to make Japanese financial and capital markets more attractive.'

While detractors believe that the pace of change or even presentation of structural reform has not been fast enough, the more effective allocation of local capital, due to the sheer size of the potential new investment capital, will be a significant reform itself and could serve as a buffer against continued or advanced policies of the Bank of Japan (BoJ) and Japanese government

The Panel recently issued its recommendations, which identifies the following four areas that should be addressed with the goal of making Japan Asia's number one international financial center by 2020:

1. Establishing a positive cycle in which abundant financial assets held by households and public pensions are allocated more to funding for growing businesses (utilising 'inactive' funds)[3]
2. Realising Asia's growth potential, improving the market function of the Asian region, paving the way for integral growth of Japan and Asia (Supporting the development of financial infrastructures in Asian countries and fostering a necessary environment for Japanese financial institutions and companies to conduct business in Asia through cooperation between the FSA and relevant authorities)
3. Strengthening corporate competitiveness and promoting entrepreneurship
4. Developing human resources and establishing a better business environment

Allocation of capital – Current state

The current allocation of capital in Japan is not on par with global norms. It is not generating returns which create a positive cycle of reinvestment, growth and favorable sentiment.

Japanese household financial assets approximate ¥1,600 trillion (US$15.8 trillion)[4] and Japan's Government Pension Investment Fund's (GPIF) investment assets were approximately ¥128 trillion (US$1.27 trillion)[5]. According to fund flow statistics from the Bank of Japan, nearly 54% of Japanese household assets were allocated to cash and deposits and only 13% of households invested in stocks and mutual funds. Whereas, cash and deposits held by households in the United States and Europe is 13 and 36%, respectively[6] *(Fig. 1).*

2 Three arrows: 1) bold monetary policy, 2) flexible fiscal policy and 3) structural reforms The idea of three arrows comes from the story of the feudal warlord Mori Motonari, who taught his three sons that snapping a single arrow is easy, but snapping three arrows bound together is much harder. In other words, the power of three combined is mightier than that of a single

3 We've characterised this recommendation as 'Effective Allocation of Local Capital' and we will focus our attention on this topic for the remainder of the article

4 'Flow of Funds – Overview of Japan, U.S. and the Euro Area' – Research and Statistics Departments, Bank of Japan, 19 December 2013

5 Hodo, Chikafumi, 'Japan's public pension fund assets rise to record Y128.6 tril', Japan Today, 1 March 2014

6 'Flow of Funds – Overview of Japan, U.S. and the Euro Area' – Research and Statistics Departments, Bank of Japan, 19 December 2013

Figure 1: Distribution of household financial assets by country (Governmental Bulletin Online)

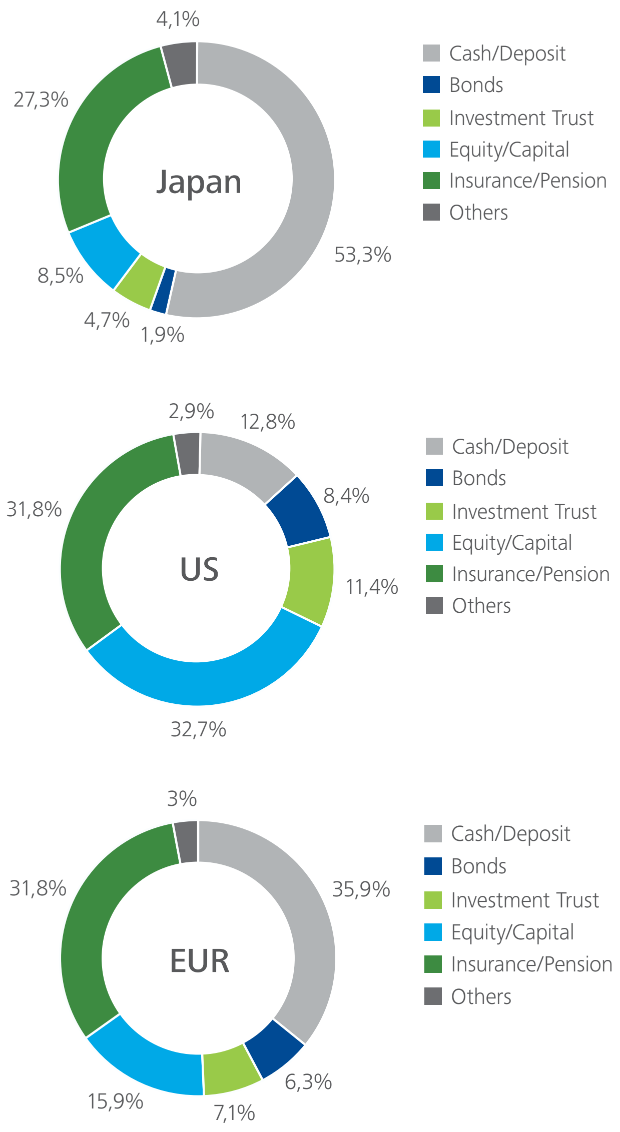


Figure 2: GPIF actual allocation (31 December 2013)

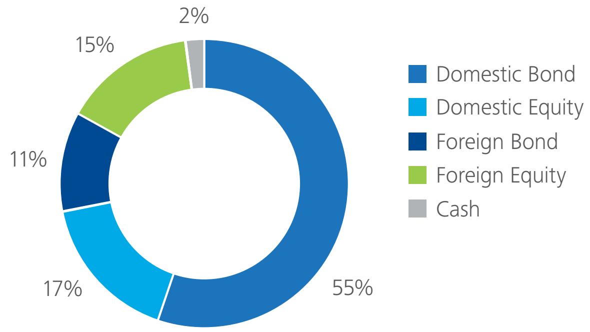
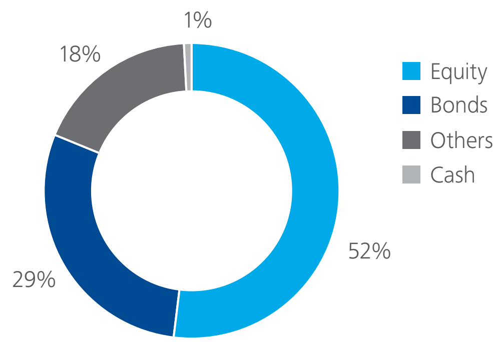


Figure 3: Global average allocation (Towers Watson study)



With respect to the GPIF's investment assets, as of December 2013, greater than 55%, or more than ¥70.5 trillion (US$697 billion), were allocated to domestic bonds[7]. For the period 1 April 2013 – 31 December 2013, these assets generated approximately ¥21 billion (US$208 million) in investment income. According to Towers Watson's 'Global Pension Assets Study 2014,' the average allocation for equities, bonds, other and cash is 52%, 29%, 18% and 1% respectively[8] *(Fig. 2/3).*

7 Government Pension Investment Fund, Japan
8 'Global Pension Assets Study, 2014', Tower Watson, January 2014

Steps toward effective allocation of local capital

The Introduction of Nippon Individual Savings Account (NISA)

The Japanese version of the United Kingdom's Individual Savings Account programme was introduced in January 2014. NISA is designed for residents of Japan 20 years of age or older and is meant to encourage medium-to-long term investment horizons. Given the tax advantaged status of the accounts, the NISA programme is an attempt to spur household financial assets to diversify away from cash and cash equivalents. Expanding the pool of equity investors in Japan may well attract additional capital raising activities in Japan, increase initial public offerings and increase financial assets available for general business growth. Additionally, if inflation targets are met, enhancing personal rates of return will be necessary to maintain or advance Japanese citizens' standard of living. The government's goal is to have ¥25 trillion (US$247 billion) moved from cash to NISA by 2020. Based upon the figures provided above, this would be a movement of only 3% of the assets currently held in cash.

According to the Japanese Securities Dealers Association (JSDA), at the end of January 2014, it was estimated that approximately 5.6 million NISA accounts had been opened[9] and, according to Nomura Research Institute, Ltd. (NRI)[10], the average NISA balance was ¥593,000 (US$5,900). Furthermore, NRI survey results indicate that approximately 70% of those funding NISA accounts are doing so with savings or current income, as opposed to proceeds from existing asset sales. Finally, NRI estimates that by year end, 8.65 million accounts will be opened[11].

If NRI's February survey results are representative, by December 2014, approximately ¥5.2 trillion (US$51 billion) will be invested via NISA accounts and approximately ¥3.6 trillion (US$36 billion) of that total would have been from existing savings or current income.

{http://fis.nri.co.jp/en/news/2014/02/20140213en.html}

There are several restrictions / limitations that may make it difficult for NISA to reach its full potential. For example:

- Tax-exempt status is limited to five years (UK ISA has no limit)
- NISA accounts can only be opened within a 10 year timeframe (ISA has no limit)
- Tax-free exemption only applies to a maximum of ¥5 million in total investment (again, ISA has no such restriction)
- Participants cannot aggregate any loss generated by their NISA account with profit generated in other accounts in which they hold assets. As such, if an investor is unable to realise profit in their NISA account, then the significance of maintaining the account will be diminished.

These current restrictions can be addressed and government officials have intimated that changes are possible in the future. The first concern was launching the NISA programme to the marketplace. As provided by the JSDA, there have been several adjustments and iterations to the UK ISA and, as a result, participation has increased since introduction in 1999[12]. In the UK, it is now estimated that 40% of households have ISA accounts.

9 *'NISA: Japan's new tax exemption scheme for investment by individuals', JSDA*
10 *'NRI conducts Nippon Individual Savings Account (NISA) Usage Survey, Findings Project 8.65mn NISA holders/applicants by year-end', Nomura Research Institute, 13 February 2014*
11 *ibid*
12 *'NISA: Japan's new tax exemption scheme for investment by individuals', JSDA*

Figure 4: Comparison with UK ISA[13]

	NISA (Japan)	ISA (United Kingdom)	
		ISA for stocks and other products	ISA for deposits
Scheme establishment	Started on 1 Jan. 2014. Accounts can be set up for 10 years (until 2023).	Started on 6 Apr. 1999. While originally planned to terminate in 10 years, perpetuated in 2008	
Eligible persons	Persons who live in Japan and are aged 20 or older (as of 1 Jan. of each year starting NISA)	Persons who live in the UK and are aged 18 or older	Persons who live in the UK and are aged 16 or older
Tax-exempt period	5 years	Permanent	
Tax-exempt products	Listed stocks, investment trusts, etc.	Stocks, bonds, investment trusts, insurance, bank deposits, etc. (It is not possible to repurchase another product unless proceeds received from the sale of the previously invested product are withdrawn from the ISA account.)	Bank deposits, MMF, etc.
Tax-exempt incomes	Dividends, coupons and capital gains	Interest (except for interest on bank deposits) Dividends, coupons and capital gains	Interest
Maximum yearly invest-ment amount	A maximum of ¥1 million (approx.US$10,000) (excluding commission payment)	A maximum of £11,520 (approx.US$18,800) including both types of ISA 1/ A maximum of £5,780 (approx.US$9,400) in an ISA for deposits 2/ Maximum yearly investment amounts are reviewed every year based on consumer price index)	

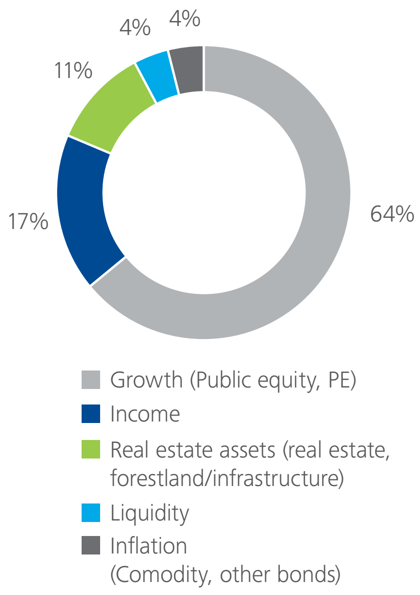
13 ibid

GPIF Signals an Increase in 'Riskier' Assets

On 6 March 2014, an advisory panel to GPIF indicated it was time to reposition its investment assets[14]. *'Pension payments are correlated with wages, so it is natural for the target to be an additional return over wage growth, in times of deflation, domestic bond-centered investment was safe and efficient, but with the planned shift to a moderate inflationary environment, there is no need to focus on local debt anymore. GPIF should become more forward-looking.'*

However, the recommended goal for a nominal rate of return, approximately 4.2%, is still quite low compared to other large retirement systems such as California Public Employees' Retirement Systems 7.5% target. CalPers targeted allocation demonstrate the differences in risk appetites.

Figure 5: CalPers targeted asset allocation[15]



A paradigm shift into local equities or alternative assets such as private equity, real estate, hedge funds and infrastructure funds cannot happen overnight. If the GPIF transitions to the global allocation norms, approximately ¥32 trillion (US$317 billion) of investment assets would become allocable to other asset types. It is not likely that allocation percentages will change that significantly, rather a somewhat gradual re-allocation will occur, which some will point out was already happening (while high compared to the global average, a 55% allocation in bonds is the lowest allocation for the GPIF in bonds for the past six years).

Additionally, on 28 February 2014, GPIF announced a new infrastructure investment programme to be executed with a co-investment agreement with the Development Bank of Japan and Ontario Municipal Employees Retirement System[16]. GPIF anticipates that the investment in infrastructure investments will provide:

- Stable income gains similar to fixed income
- Higher yields than typical fixed income securities
- Safety from public market volatility

The infrastructure investment programme will be five years in duration and the outstanding investment 'principal' may reach ¥280 billion (US$2.7 billion), or approximately 0.2% of the assets under management at GPIF[17]. While this percent of allocation is significantly below that of other pension plans, it is a very positive signal that additional risk will be accepted and risk-adjusted returns will be sought.

The current allocation of capital in Japan is not on par with global norms. It is not generating returns which create a positive cycle of reinvestment, growth and favorable sentiment

14 Kitanaka, Anna; Nohara, Yoshiaki and Nozawa, Shigeki, 'GPIF Needs Wage-Based Return Goal, Less Bond Focus: Panel', Bloomberg, 6 March 2014

15 CalPERS

16 'GPIF Launches Infrastructure Investment Programme under a Co-investment Agreement with DBJ and OMERS', GPIF

17 ibid

The final word

The sentiment and outlook has changed since Prime Minister Abe took office in 2012. While detractors believe that the pace of change or even presentation of structural reform has not been fast enough, the more effective allocation of local capital, due to the sheer size of the potential new investment capital, will be a significant reform itself and could serve as a buffer against continued or advanced policies of the Bank of Japan (BoJ) and Japanese government.

To the **point**:

- Capital allocation in Japan is not at par with global norms, with majority of assets allocated to cash and deposits
- This trend could change with the introduction of NISA, which could lead to households diversifying assets in other asset classes
- The Government of Japan is initiating several steps, including a new infrastructure investment programme to drive diversification in capital allocation
- A significant improvement in capital allocation could act as a significant policy reform in itself and provide a buffer against continued or advanced policies of BoJ and Japanese government