**REFORMING THE FEE
STRUCTURE OF INVESTMENT
TRUSTS TO INCREASE DEMAND**

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Abstract

Since 1998, sales channels for investment trusts have expanded in Japan. We expected this to result in greater demand for investment trusts but these expectations have yet to be met. The underlying causes of investment trusts' slow growth may be due to negative net returns to individual investors during the economic downturn—i.e., after deducting costs from dividends.

When the Japanese economy is sluggish, asset management companies should invest in high-growth Asia, among other regions, rather than the domestic market. And when domestic financial markets are strong, the companies should invest more in Japanese markets. Investment trusts are the vehicle for seizing world economic trends. However, the performance of Japan's investment trusts has not been as good as that of the United States (US).

To further enhance demand for investment trusts, their fee structure must be changed so that asset management companies, distributors, and individual investors seek the same goals. In other words, the interest of distributors and asset management companies would need to be better aligned.

Contents

1. SIZE OF INVESTMENT TRUSTS IN JAPAN

Although their assets now exceed ¥100 trillion, investment trusts are still not popular among Japanese households. The accumulated amount of investment trusts in Japan exceeded ¥100 trillion as of May 2015, but only 5.4% of household financial assets were invested in them as of December 2015. Although that figure increased from 2.3% at the end of 1999, it is still lower than the figures for the US and the euro region (Figure 1).

Figure1: Financial Assets Held by Households
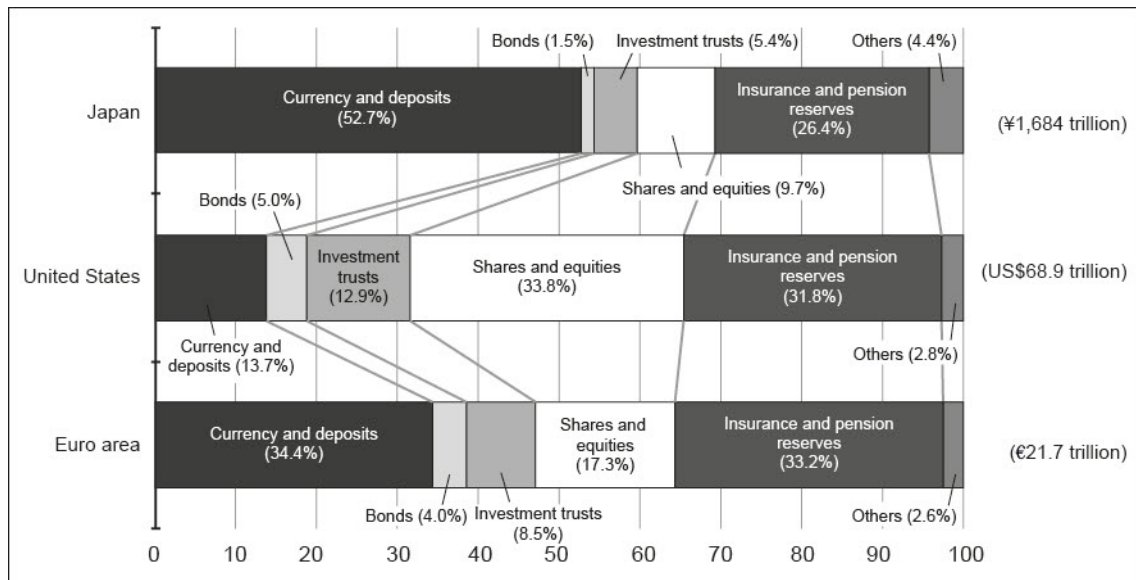
Note: Percentage ratio to the total financial assets.

"Others" is the residual after deducting currency and deposits, bonds, investment trusts, shares and equities, and insurance and pension reserves from total financial assets.

Source: Research and Statistics Department Bank of Japan. 2015. *Flow of Funds—Overview of Japan, US, and the Euro Area.* 22 December. Tokyo.

In contrast, mutual funds in the US have increased as a result of the expansion of defined contribution plans (Figure 2). The July 2014 monitoring report of the Japan Financial Service Agency compared the scale of the transition of household assets in Japan and the US, pointing out the following:

> The background in which the expanding scale of investment trusts in Japan is low; the biggest difference between the household portfolio of Japan and the US is the percentage of stocks and investment trusts. In other words, stocks and investment trusts in Japan have not been incorporated into the household assets as much as in the US. Therefore, household assets of Japan have not increased. If people in Japan had held diversified investment portfolios of investment trusts invested in domestic and foreign assets for the long-term, they could have probably obtained a much higher rate of return that reflected the growth of the world economy.
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> (Translated by the authors from the original text issued by the monitoring report of the Japan Financial Service Agency in July 2014)

Figure 2: Percentage of US and Japanese Household Share of Investment Trusts
(%)
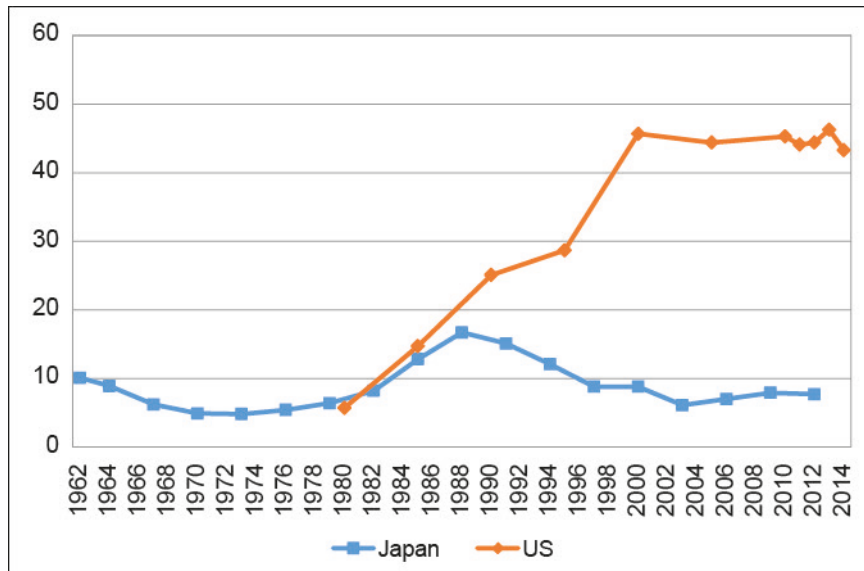
Sources: For the US: Investment Company Institute. *ICI Research Perspective*. 2014. For Japan: Japan Securities Dealers Association. *National Survey of Securities Investment,* 2012.

2. INVESTMENT TRUSTS' AVERAGE RETURN OVER THE PAST 15 YEARS

A collective investment scheme such as an investment trust is an effective means for increasing rate of return from household assets. At present, securities companies, banks, credit unions, agricultural banks, and the Japan Post Office sell investment trusts at their branch offices and through the internet. Even internet-only securities companies sell not only stocks but also investment trusts. Expanding investment trust sales channels encourages an environment that allows individual investors to diversify risk with a small amount of money. Yet, Japanese investment trusts' share of household assets is not growing, mainly because trusts perform poorly. Stock investment trusts perform better than TOPIX but not as well as Morgan Stanley Capital International (MSCI) World ex Japan Index, and the weighted average of investment trusts' returns for households during 2000 to 2014 was negative. After deducting the sales load, the net cumulative returns of investment trusts have worsened (Figure 3).

Asset management companies should invest in global financial markets, including Asia, which has much higher growth than Japan. A professional asset management business is expected to invest more in overseas markets when the Japanese economy is sluggish and less when it is upbeat.

**Figure 3: Cumulative Returns on Equity Investment Trusts and Other Assets
(End of 1999 = 100)**
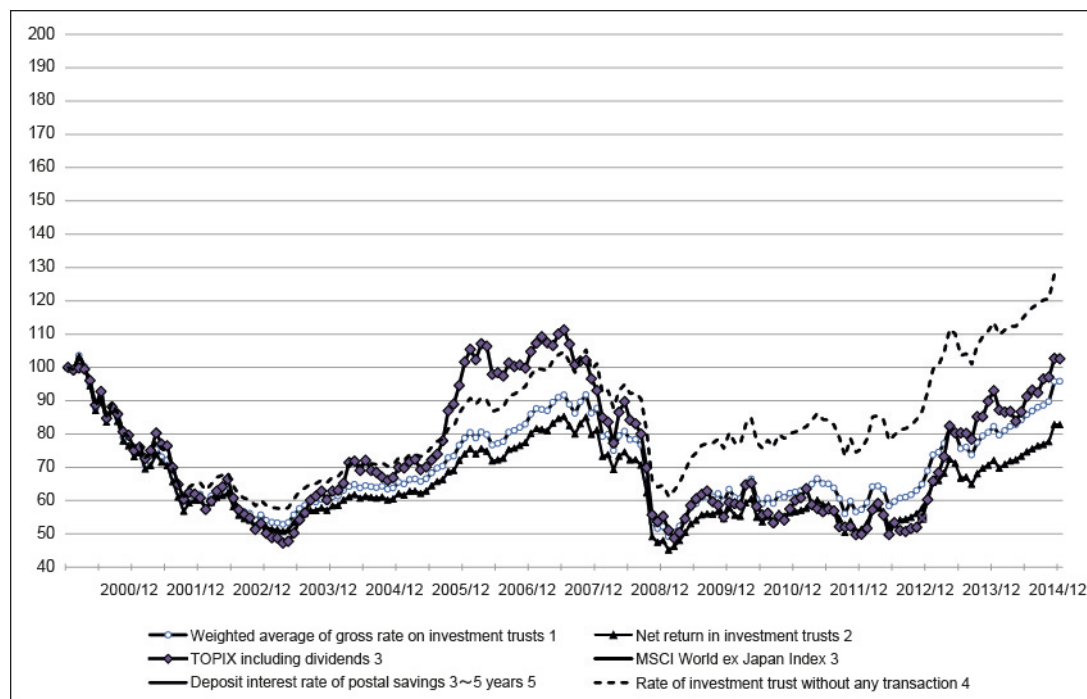
Notes:

1. Weighted average of gross rate of return = revenues of investment trusts = changes of net assets outstanding – net inflows into investment trusts = dividends + appraisal profits by investments. Monthly revenue ratio = monthly revenues/average net asset outstanding of current and preceding months.

    Source: Changes in Assets of Publicly Offered Investment Trusts (Market Value). The Investment Trusts Association, Japan.

2. Net return in investment trusts = weighted average of gross rate of return–sales charge. Sales charge = simple average of the maximum sales charges listed in prospectuses of public-offered open-ended investment trusts, excluding exchange traded funds, defined contribution plans, and separately managed accounts in December each year, divided by the past 3-year average of the estimated holding periods.

    Source: Data provided by Morningstar.

3. TOPIX and MSCI World ex Japan Index. Source: Data provided by Bloomberg.

4. Cumulative average monthly return of equity investment trusts, excluding exchange traded funds, weighted by outstanding investment trusts.

    Source: Data provided by MPI Stylus (MPI Japan).

5. The average interest rate of postal savings of each period depends on interest rates when savings holders initially deposited money. Thus, we estimated the return of postal savings by semiannually compounding the past 3-year average of the initial interest rate of postal savings held more than 3 years at the beginning of each month.

Investment trust distributors such as banks, post banks, and post offices earn sales charges (or loads), which are the pillar of their earnings. In securities companies, investment trust sales load supplement revenue from stock commissions. The sales loads of investment trusts are completely liberalized. However, sales loads on investment trust can be set at ceiling rates as prescribed in the prospective a legal disclosure document prepared by asset managers. As for banks and post banks, they are the base of off-balance service revenue. However, if incentives are not aligned between individual investors and distributors (such as banks and securities companies), individual investors might not benefit as much as they could.

We estimate whether investors in investment trusts receive a positive return or not, based on the following equations:

$$A_T = A_0 + R - \tau - \varepsilon \qquad \varepsilon = \varepsilon_1 + \varepsilon_2 + \varepsilon_3 \; (\varepsilon_1) = 47\% \; (\varepsilon_2) = 6\% \; (\varepsilon_3) = 47\% \quad (1)$$

The initial investment amount is denoted by A_0 (= the trust assets of the funds). R represents the net return on investment trusts. The fee (τ) is the sales loads received by banks, securities companies, and post offices. ε is the trust fees (called "trust remuneration" in Japan), which consists of (i) trust fee for the management fee (ε_1), (ii) trust fee for the trust fee (ε_2), and (iii) agent fee(ε_3).

By rewriting equation (1), we obtain equation (2) as follows:

$$R = (A_T - A_0) + \tau + \varepsilon \qquad\qquad\qquad\qquad (2)$$

R is the gross return from investment, which is composed of

   (i) $(A_T - A_0)$: the net return of individual investors,

   (ii) (τ): sales load,

   (iii) (ε): trust fee.

Therefore, the net return to investors after deducting the sales load and trust fee is expressed as follows:

$$NR = (A_T - A_0) = R - \tau - \varepsilon \qquad\qquad\qquad (3)$$

If 100 is invested at the end of 1999, the average monthly return of public-offered open-ended investment trusts, excluding exchange traded funds, is $(R - \varepsilon)$ in the period from 1999 to 2014. We estimate the average holding period of investment trusts as follows:

$$\text{average holding period} = \frac{\text{average amount of investment trust } (A_T)}{\text{sum of termination} + \text{redemption amount } (\Delta A_{OUT})} \quad (4)$$

Equation (4) can be obtained by the following equations:

$$A_T = R + A_0 + \Delta A_{IN} - \Delta A_{OUT} - \tau - \varepsilon \qquad\qquad (5)$$

A_T is the terminal value of an investment trust

ΔA_{IN} denotes net inflow of funds into an investment trust in entire period

$(\Delta A_{IN} = \Delta A_{IN\,(1)} + \Delta A_{IN\,(2)} + \Delta A_{IN\,(3)} \ldots\ldots + \Delta A_{IN(t)} + \ldots\ldots + \Delta A_{IN(T-1)}$

ΔA_{OUT} denotes net outflow of funds from an investment trust (= redemption + termination) in entire period

$(\Delta A_{out} = \Delta A_{out(1)} + \Delta A_{out(2)} + \Delta A_{out(3)} \ldots\ldots + \Delta A_{out(t)} + \ldots\ldots + \Delta A_{out(T-1)}$

Equation (3) is the case where net inflow of funds ΔA_{IN} and ΔA_{out} are set to zero.

The average amount of investment trusts in Japan is ¥568.20 trillion, but the sum of redemption + the sum of termination is ¥214.40 trillion. Therefore, the average holding period is about 2.60 years. Figure 4 shows the fluctuations of average holding periods

of investment trusts: the lowest was 1.54 in 2000 and the longest 4.7 in 2008. When the gross rate of return is high, investors tend to hold investment trusts much longer. The low gross rate of return such as in 2008 saw investors holding investment trusts for short periods and shifting to other funds.

Figure 4: Estimated Average Holding Period of Public-offered Investment Trusts by Year
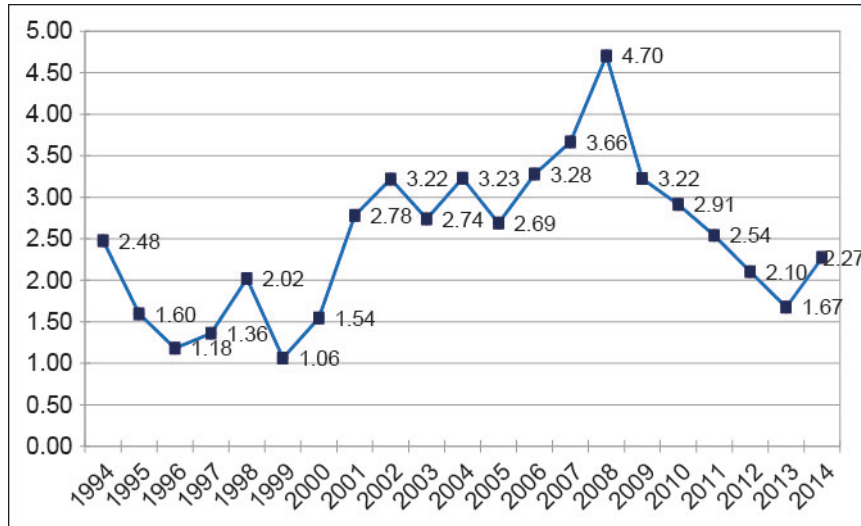
Source: Changes in Assets of Publicly Offered Investment Trusts (Market Value). The Investment Trusts Association, Japan.

According to the gross return formula (R = (A$_T$—A$_0$) + τ + ε), if investors switch funds every 2.8 years, then the net return of individual investors (NR = A$_T$—A$_0$) is 14.65, sales load (τ) are 12.13, and trust fees (ε) 16.53 for an initial investment of 100 (Figure 5).

Figure 5: Net Return of Individual Investors under Current Fee Structure

Sharp ratio: (net return of individual investors – interest rate on fixed deposit) / monthly deviation of monthly return of investment trust.

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When there was no switching between 1999 and 2014 (holding the same investment trust for the entire period), the net return of individual investors was 24.34, sales load 2.45, and trust fees 17.48 for an initial investment of 100 (Figure 5).

In the case of a 2-year turnover (used to calculate the monitoring report of the Japanese Financial Service Agency [FSA]), the net return of individual investors was 10.47, sales load 16.32, and trust fees 16.20 for an initial investment of 100 (Figure 5).

As a result, the net return of individual investors and sales load move in opposite directions. Trust fees, however, are stable compared with the fluctuating net return on individual investors.

3. THE CONFLICTS OF INTEREST IN FEE STRUCTURE

We can indicate as follows the structure of the sales load and the trust fee on the investment trust cost:

$$\text{Sales load } (\tau) = A_0 \times \rho \tag{6}$$

(ρ = ratio of sales load)

$$\text{Trust fee } (\varepsilon) = (A_0 - \tau + R) \times \theta \tag{7}$$

(θ = ratio of trust fee)

The individual investors maximize the terms $(A_T - A_0)$, the distributor (τ) and (ε_3), the asset management company (ε_1), and the trust bank (ε_2). The sales load does not depend on individual investors in the case of this fee structure.

Sales charges are only paid at the beginning of the purchase of a new investment trust. For the distributors, therefore, sales charges increase if investors switch much more frequently from one kind of investment trust to another. Japanese investors tend to hold investment trusts for short periods and switch from one to another very frequently.

Sales load in Japan are presently set to about 2.5% on average. The degree of competition in sales load since 1998 has not been clear.

The trust fee (ε) is a positive value, even if $(A_T - A_0)$ is a negative value, as long as $(A_0 - \tau + R)$ is a positive value. Even when the investor cannot get a positive return, the asset management company, the distributor, and the trust bank can regularly receive positive trust fees.

The level of the sales load has been pointed out as a deterrent for the growth of mutual funds for many years. Therefore, the number of wrap accounts is increasing. A wrap account is a type of discretionary account service that entrusts distributors to invest in financial products.

In a wrap account's fee structure, (τ) is removed from $(\varepsilon) = (A_0 - \tau + R) \times \theta$, and the account management fee is added to $(\varepsilon) = (A_0 + R) \times (\theta)$. If the wrap account's fee is set to (λ), then the total fee charged to the wrap account is $(A_0 + R) \times (\lambda)$. Therefore, the fee structure in a wrap account is similar to a trust fee.

4. ROOM FOR IMPROVEMENT ON COMPARISON OF FEES

One solution to get higher returns for investors is a more competitive environment. The prospectus discloses trust fees but only describes upper limit to sales load, leaning it to the decision by distributors.

The investment trust is a highly transparent financial product. However, transparency is meaningful only by disclosing sales load and trust fees because investors can compare one investment trust with other financial products such as deposits. Some investors in investment trusts can compare one product to another by checking sales load charged by different distributors. Ordinary investors, however, are not always conscious of comparing costs. While the investment trusts association website lists the sales charge ratio on the same fund, and some websites compare the sales load ratios of internet securities companies, ordinary investors do not always have ways compare costs in an easy way. Much more disclosure on cost will be needed to increase investors' awareness.

$$NR = (A_T - A_0) = R - \tau - \varepsilon \tag{8}$$

Desirable disclosure for individual investors will be "net rate of return on investment trust," which can be written as follows:

$$\frac{NR}{nA_0} = \frac{(A_T - A_0)}{nA_0} = \frac{R - \tau - \varepsilon}{nA_0} \tag{9}$$

The numerator of NR has been disclosed in Japan as "net return." The NR is reported to investors by distributors is called "total return." However, it is the amount of net return from an investment trust and cannot be compared with the rate of return on deposits or other financial products. It is recommended to disclose equation (9), which is the "net return ratio." Equation (9) can easily be compared with the rate of return on other financial products such as deposits.

5. REGULATION OF FEE IMPROVEMENTS IN THE UNITED STATES AND THE UNITED KINGDOM

In the United States (US), where investment trusts account for about half the world's total, investment companies ordinarily disclose all costs of the funds. However, the SEC requires a description of possible conflicts of interest in the summary prospectus if the fund or the asset management company pays a fee to the broker or the distributors. Investors are looking for higher net return. On the other hand, distributors seek higher sales charges and agent fees. There is a conflict of interest between investors and distributors, as shown in Figure 5.

In the United Kingdom (UK), payment of commissions to independent financial advisers for fund sales is prohibited by the Retail Distribution Review. Advisers may not recommend funds to investors that will result in higher fees for themselves.

6. VARIABLE FEE THAT REFLECTS INVESTORS' RETURN IN THE US AND THE UK

Conflicts of interest between investors and distributors are common not only in Japan but also in other countries such as the US and the UK. In the current cost system, distributors have no incentive to maximize investors' returns. Instead, sales load and trust fees are maximized by distributors and asset management companies.

The sales load is collected at the initial sale of the investment trust, and it does not depend on investment performance. Although the trust fees depend on investment performance, it is also collected at the initial investment and investment performance. Investment performance is borne only by investors rather than distributors and asset managers.

For example, the fee structure of Fidelity Magellan Fund's management fee is adjusted up and down 20 basis points every month based on fund performance and the S&P 500 index. Management fees often change. The March 2015 prospectus said that it was 0.52%, and most recently it was 0.68% in May 2016.

Japan has two types of funds: (i) high-watermark funds; and (ii) Japanese stock funds, where performance fees are added to or subtracted from trust fees for the asset management companies, depending on the percentage in price of NIKKEI225 or TOPIX. However, a cost system should be considered where investors' net return and earnings of distributors serve the same objective: to make the investment trust as popular as households' self-help efforts and to cultivate an investment mind-set among individuals.

7. THE FEE STRUCTURE ON INVESTMENT TRUSTS BASED ON CUSTOMERS' NEEDS

If a fee structure materializes combining a fixed fee that reflects the costs of each fund—such as for systems, infrastructure, and labor—and a variable fee that depends on investors' net return, investment trusts may produce and sell products that give priority to investors' returns.

Household financial assets of Japan are about ¥1,700 trillion. Providing a high return only when the Japanese stock market is performing well is not truly professional management. Developed countries are faced with an aging population and it is quite important to obtain higher rates of return to household assets. Retired people rely on the return from their accumulated financial assets without receiving wages and salaries. In the periods of 1999 to 2014, the revenue from investment trusts was lower than the interest earnings from deposits in Japan. What people seek in investment trusts is a higher rate of return. Both asset management companies and distributors have to manage their assets in order to achieve high net return for investors.

We showed in this paper that distributors may behave to maximize sales load and trust fees. Asset management business is expected to earn a higher rate of return than the deposit interest rate. We showed in this paper that sales load and trust fees are as follows.

$$(A_0) \times \rho = \tau$$

$$(A_0 - \tau + R) \times \theta = \varepsilon$$

The fee structure on investment trusts based on customers' needs can be summarized as follows:

<Case1, Hold the investment trust until maturity>

$C + (R \times \rho)$ sales load

$C + (R \times \theta)$ trust fees

C is an initial fixed fee (= the necessary fee to produce each investment trust such as wages, computer costs etc.). R is the return on the entire period. ρ is the rate of sales charge and θ is the rate on trust fees.

It is necessary for people to be able to compare the net return of other financial products and investment trusts, and to reform the structure of investment trusts so that asset management companies and distributors maximize investors' net return.

<Case 2, Sell the investment trust before maturity>

Case 2 denotes where sales load are replaced by advisory fees to the distributors and trust fees are received by sales companies and asset management companies in each period based on the rate of return on investment trusts where negative rate of return could be possible. When the rate of return on investment trusts becomes negative, the losses are shared by advisories, asset management companies, and investors. Of course the positive rate of return (Rt) is also shared by all the members.

$C + (R_1 \times \rho) + (R_2 \times \rho) + (R_3 \times \rho) + (R_N \times \rho)$ advisory fees

$C + (R_1 \times \theta) + (R_2 \times \theta) + (R_3 \times \theta) + (R_N \times \theta)$ trust fees

8. CONCLUSION

Japan's investment trusts did not grow much compared with the United States' due to lack of clarity of the true rate of return, from which fees and commissions are deducted. Distributors of investment trusts in Japan may be perceived as seeking to maximize their sales load rather than provide higher rates of return to investors. Very high share of deposits delayed the recovery of the Japanese economy since bank loans could not supply capital to startups and riskier SMEs due to stringent Basel capital requirements. Banks tend to continue lending to existing companies for as long as possible until the borrowers are clearly in bad shape in the hope of recovery of the sector. Zombie firms tend to exist longer in economies dominated by capital market. Development of investment trusts would have created a supply of finance for startups and riskier small businesses. Japan's investment trust did not grow so much compared to the US also because the net rate of return on investment trusts was low. Incentives for distributors to maximize the rate of return needed to be restructured. Instead, they were focused on maximizing their fees and commissions. Disclosure of net rates of return is crucial so that investors can compare with the rates of return on deposits and other financial products. Additional incentives for distributors may need to be introduced so that investors' rate of return can be maximized. Aligning interest between distributors and investors will serve as a strong incentive for distributors to work towards increasing rates of return for investors.

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