Japan's Increasing Attraction to Alternative Investments

Traditionally risk-averse Japanese institutions are massively rebalancing their portfolios and moving into alternative investments at record rates.

Some of the country's largest investors have publicly announced their intentions. The Global Pension Investment Fund, the world's largest pension fund with a ¥158.58 trillion (US$1.42 trillion) portfolio, has stated its intention to increase its allocation to alternatives from 0.07% at the end of 2016 to a target of 5%. Japan Post Bank, with an even larger US$1.8 trillion portfolio, has similarly announced plans to increase its alternatives allocation to 3%.

Other Japanese institutional investors are beginning to follow suit. J.P. Morgan Asset Management's annual survey of the country's pension funds recently found that their average allocation to alternative investments reached a record 17.1% in March 2018, up from 11.4% over the past five years. Just less than 60% of corporate pension funds surveyed said they intend to raise their exposure to alternatives over the coming year.[1]

What is behind this rebalancing of portfolios into alternative investments?

Yield or, more precisely, the search for yield. Japanese banks, pension funds and life insurance companies all require steady returns on their portfolios in order to service current liabilities. However, the Bank of Japan has been holding 10-year Japanese government bond yields around 0% as part of the government's Abenomics policies, leaving local investors with minimal levels of return on local bonds.

Additionally, dividend yields of Japanese equities have averaged just 1.8% in recent years. Investors are therefore being forced to rebalance their portfolios at record rates into higher yielding alternative investments.

What type of alternative investments are proving popular?

For a while Japanese investors were interested in highly structured products, known as 'double-decker' and 'triple decker' funds. These funds used currency strategies and / or call option strategies to target an additional source of income over and above the returns offered by traditional equities portfolios. In recent years however, these funds have largely fallen out of favour and have been replaced by more traditional alternative investment classes.

Overseas equities and fixed income, private equity, private debt, infrastructure and other alternative investments are among the most popular options with Japanese investors today. Of these, the most prevalent have been exposures to international equities and bonds. The value of Japan's holdings of foreign equities has tripled since 2012.[2]

One key trend to arise in recent years is an increasing interest in private equity. The asset class was not previously on the radar of most Japanese institutional investors, but many now view it as an essential component of yield starved portfolios. In recent years several institutions have established multi-year alternative investment programmes with a particular focus on private equity.

What type of fund structures are being used to make alternative investments?

The preferred investment vehicle for most Japanese investors wishing to access alternative investments is the Cayman Islands fund. In 2016, 94.3% of the foreign domiciled

[1] J.P. Morgan Asset Management's annual survey of Japanese pension funds

[2] "Made in Japan", The Economist 4 August 2018

funds that were publicly offered in Japan were established as Cayman Islands funds.[3]

The reasons why Japanese investors prefer the Cayman Islands over other fund domiciles is not dissimilar to investors in other jurisdictions. Vehicles established in the jurisdiction typically offer increased flexibility, speed to market, cost considerations and a familiarity with both the fund structure and the jurisdiction, among other reasons.

The newfound interest in private equity in Japan has also seen the development of a new type of Cayman Islands investment vehicle: the "private equity type" unit trust. This hybrid vehicle is basically a Cayman Islands unit trust (the preferred investment vehicle for many Japanese investors) that incorporates some characteristics of a private equity fund, including a capital call feature and defaulting investor provisions. Aside from a general familiarity with the unit trust structure, many Japanese investors find a PE type unit trust offers tax benefits when compared to the limited partnership structure typically used by international investors when making private equity investments.

What is the future outlook for alternatives in the Japanese market?

Japanese institutional investors have already shifted a lot of assets away from domestic bonds and equities into alternatives but the current signs are that this will continue and may increase.

Faced with a negative benchmark interest rate (-0.1%), many ordinary savers may similarly seek increasing exposure to foreign bonds, equities and alternative investments. A shift into alternative investments by ordinary savers, were it to occur, could be significant. Total household currency and deposits currently consist of around 52.5% of financial assets in Japan (compared to only 13.1% in the United States).[4]

Another contributing factor could hasten the shift into alternative assets - Japan's rapidly ageing population. The country has the fastest ageing population globally; 28% of its population are 65 years or older, and this will rise to over 33% by 2040 and 40% by 2065.[5] This fast changing demography will greatly increase the annual liabilities further for many Japanese institutions, thereby driving even more interest in higher yielding alternative investments in the coming years.

It is not coincidental that many global asset managers are now showing a keen interest in the world's third largest economy.

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[3] Statistics provided by Moore Management (Bermuda) Limited, compiled from publicly available sources

[4] Research and Statistics Department Bank of Japan 14 August 2018

[5] "Silver Linings", The Economist 4 August 2018