Walsh Advisors, LLC

Tokyo as a Global Financial Market Center for the 21st Century

An Asset Management Perspective integrated with the Abenomics Objective to achieve greater economic growth through technology and innovation

James M. Walsh
Managing Partner, Walsh Advisors, LLC

March 5, 2018

Précis

- **In 2017** Yuriko Koike, governor of Tokyo, undertook an initiative eventually to establish Tokyo as a global financial center and has convened an advisory council of industry experts to help achieve this goal.

- In the four decades since the first US$ bond issue by the ASIAN Development Bank in the ephemeral Asian dollar bond market, nominally based in Singapore, there have been repeated failed attempts to establish various cities in the Asia Pacific region as a capital market center for debt issues to replicate the market center role of London in the Eurobond market.

- However since the 1978 Asian $ bond issue by the ADB, Asia Pacific markets have developed far beyond their original single purpose for debt financing and the sale of debt and equity securities by issuers from outside the region became commonplace as separate regional equity markets developed, matured and became an integral part of the global market.

- Indeed times and markets change and for many reasons this now is an opportune time to encourage the development of Tokyo as an international financial market center on an asset management model. A Tokyo asset management center could be managed as an incubator for new FinTech companies, consistent with one of the current objectives of Abenomics, namely to develop new technologies in Japan that can increase productivity, drive innovation and measurably add to economic growth.

The role of market centers and the nature of their participants have changed over the last 15 years.

Following 15 years of asset aggregation the line between capital market and asset management functions is blurring. Capital aggregators no longer passively accept what is offered in the new issue market, but now hold the initiative in the allocation process by dealing directly with the capital users or through specialty managers.

In the past capital was accessed exclusively on the basis of price with market structures, processes and regulations

***developed to facilitate that access. But Increasingly capital now is allocated on the basis of risk*.**

This is adding a creative priority in a transition from simply selling specific products that clear markets by matching capital and investment demand, to creating outcome-oriented solutions by which issuers and investors can arbitrage their varying perceptions of risk.

The demand for an asset management center in Japan is clear, Japan has a high concentration of institutional assets with sophisticated portfolio managers at the pension funds, banks and insurance companies as well as a substantial pool of indigenous retail assets in an effective and well-regulated distribution system.

- Total pension assets in Japan represent 7.7% of global pension assets and they are undergoing a historic reallocation from their previous concentrations (some as high as 70-80% in JGBs.
- The large Japanese asset management companies have few clients outside Japan, and virtually none outside of Asia. They go to the US to obtain access to certain investment management strategies which they, in turn, deliver to their Japanese pension fund or regional bank clients.

As a matter of public policy it would be more beneficial for Japan to have those US managers set up offices in Japan.

- In view of unpredictable regulatory policy in the US and post-Brexit EU, it could be important for Japan to have a global market structure domiciled domestically.

FOCUS: Asset Management

The new model for capital allocation in a global market center is informed by the high level of asset accumulation among pension funds, sovereign wealth funds, insurance companies and other institutional investors, particularly over the last fifteen years. Asset aggregation, leveraged by advances in marketplace technology, has transformed the dynamics of the global capital markets.

Disintermediation by asset aggregators has created new roles for banks, securities firms and asset managers.

This shift of primary concern from price to risk needs to be reflected in the processes of global market centers in which capital is allocated.

The bain of financial services companies, especially asset managers, in any market, is inaccurate or ineffective backoffice operations. Innovative investment strategies can be rendered as losing businesses by faulty clearing and settlement operations.

In establishing Tokyo as an asset management center, the use of an asset management model with an operations and settlement regime based on current distributed ledger (“Blockchain) technology would establish Tokyo as a market center of the future.

Capital allocation in the global market will continue to have a high reliance on market intermediaries such as banks and securities companies to design and sell the supply of debt and equity securities that will satisfy the demand of their capital-user clients. However, the direct role of asset aggregators in finance is of increasing importance and clearly in ascendancy as a key component in the process by which global capital is deployed.

A few data points will dimension the basis of this capital market shift.

> In the period of 2006 – 2016 global **pension fund assets** increased by more than 35% to the equivalent of US$ 36.4 trillion and are projected to exceed $56 trillion by 2020. Even with the effect of the 2008-2009 financial crisis this was a compound annual growth rate of 4.0%.
>
> More importantly, over the 20 years ending in 2016, global pension fund managers reduced their allocations to bonds and equities and increased their use of alternative investments, in many cases by substantial percentages.
>
> Since 2002 **sovereign wealth funds** have seen their assets grow to US$7.4 trillion with a projected total of almost $9 trillion by 2020. But again more importantly their use of private transactions increased by more than 24 times outstripping the growth of the more traditional asset classes.
>
> Assets in **insurance companies** have had recent overall growth of more modest levels of 3 – 5% in mature markets, but growth in emerging markets particularly Emerging Asia and Latin America has approached 20%.
> Fund raising by **private equity managers** was curtailed in the aftermath of the 2008-09 crisis. But by 2016-17 they were back to their pre-crisis levels of fund raising and have significant uncommitted capita (i. e. "dry powder) As this capital is employed most likely it will be leveraged by the direct lending activity of corporate credit managers.

Retail asset growth will continue to complement the expansion of institutional assets and most projections put global high net worth individual (HNWI) assets in excess of $75 trillion by 2020. By then assets held by mass affluent retail (assets between $100,000 and $1 MM) are likely to exceed $100 trillion and the fastest growing segment of these markets is Asia.

This concentration of investible assets among HNWI and mass affluent will continue to spur the growth of passive investment products as well as alternative investment funds with good liquidity. The sum of these developments has changed the traditional role of physical markets and creates possibilities for new global market centers where there is a sufficient concentration of assets.

Asset Management Market

Since the largest component of the asset management market is in the US, Japanese firms could have a greater impact on the market if they would shift their strategy from seeking international products for their domestic clients, to a strategy which develops their global presence – serving non-Japanese clients with non-¥products.

The shift from a product orientation to a solutions-based market has opened opportunities for non-US firms to achieve a competitive market position. Historically asset management products were based on in-depth domain expertise in particular industries and an ability to project earnings for the companies in those industries.

Things are different now as most institutional investors no longer allocate exclusively by asset class, so industry expertise is only one element of competitiveness for asset managers. Managing portfolios to target levels of risk provides an ability for non-US firms to offer competitive solutions to achieve constant volatility in spite of correlation changes.

Tokyo Market

Corporate pension funds are following the lead of GPIF and the other public funds in shifting their allocations to include more international strategies. By doing this they hope to achieve geographic diversification as well as to have better tools of risk management.

This significant shift in allocations has highlighted the product capability gaps in the domestic market intermediaries who provide investment strategies to the pension funds.

Since asset management products and their related risk mitigation transactions have become complex, there is strong reason to be optimistic about the development of Tokyo as a global asset management market with operations and clearing based on blockchain technology. This also could become the basis for an ancillary goal of incubating innovative fintech businesses in Japan consistent with the overall technological goals of the government of Prime Minister Abe.

Many allege that it is difficult to manage a financial services business in Japan. To support this claim they cite, among other things, a lack of English-speaking staff, confusing regulations and difficulties with regulators. From personal experience I find no merit to these arguments and see them as an example of narrow or outdated management skills within their own organizations.

For eleven years ending in 1995 I managed the Japan offices of three securities firms doing institutional sales, trading and capital markets business including underwriting of Euro bonds, Yankee bonds, private placements and swaps. Two of the three were US firms with NY-based parent companies and the third was from Zug, Switzerland. All three had Tokyo offices while two had offices in both Tokyo and Osaka. These three companies coordinated the securities and capital markets business of their respective group affiliates throughout the Asia Pacific region. Each of these businesses were profitable and none had any regulatory or operational problems.

Two were members of the Tokyo Stock Exchange and one also was a member of the Osaka Stock Exchange. In addition to cash business, two also were engaged in exchange-based futures transactions in Osaka.

Although I did not speak Japanese we were able to hire a sufficient number of talented bilingual Japanese staff to provide an excellent layer of management under me, including in operations where virtually no one spoke English, especially in Japanese equities settlements.

Each of these offices was examined and audited (at least annually) by the Ministry of Finance (this was pre-FSA), the TSE and the OSE. We found those audits to be rigorous but reasonable and the examining staff were well-trained and knowledgeable. Generally global market participants welcome such regulation as a way to ensure the smooth functioning of markets without operational problems or disruptive violations by wrongdoers.

James M. Walsh

After working for three decades in capital markets and investment management in the US, Europe and Asia Jim Walsh founded Walsh Advisors, LLC. in 2002 to provide independent advice to institutional investors and asset managers. It consults with asset management firms on cross-border merger and strategic alliance opportunities mainly between the US and Asia and operates at the intersection of financial markets, innovation technology and the secular shift noted above that has occurred in global markets as a result of more than a decade of asset accumulation.

Currently Jim also is a Senior Advisor to Freeman & Co. LLC, a New York based boutique investment bank founded in 1991 with a focus on asset management, securities firms and fintech. He has been a Senior Advisor to several financial services and technology firms in the US and Japan.

Jim has held senior positions at Zurich Financial Services (NY, Zurich), Société Générale (NY), Prudential Securities (Tokyo) and First Boston/CSFB, now Credit Suisse (NY, London and Tokyo).

At Zurich Financial Services he co-headed an initiative to rationalize their European banking and asset management business units. As COO of SG Securities Corporation Jim helped to define the Société Générale expansion in the U.S. and headed asset management, private client, floor operations and execution services at SG Cowen with its focus on US technology companies.

During eleven years based in Tokyo he built businesses in Japan, managed offices across the Asia Pacific region, initiated trading in US fixed income securities with China, expanded non-precious metals trading in China, and acquired a full service securities firm in Australia. Jim opened offices in China, established CSFB subsidiaries in Japan and Hong Kong, obtained memberships on securities and futures exchanges in the region and built sales, trading, research, compliance and operations to support those new businesses.

In Tokyo he was a frequent industry spokesperson on critical issues of market liberalization and worked closely with US and Japanese regulators on policies to support market development.

He served as chairman of CSFB Asia (Singapore) and directed its lead manager role in the early development of the Asia dollar market

Previously Jim managed the global capital markets new business effort for CSFB in London, served on the CSFB Executive Committee and had been co-head of the First Boston Capital Markets Group in New York. He began his career at The Bank of New York (now BNY Mellon).

He is a member of the Advisory Committee of North Haven Capital Partners V LP (,Morgan Stanley) a diversified domestic private equity fund. He is a former director of several alternative asset funds including a listed (NYSE) BDC. He has been an Associated Member of the NYSE and is a past member of the boards of the ACCJ in Tokyo and the Foreign Policy Association (NY).

He has an MBA from the Columbia University Graduate School of Business and BS and MS degrees in physics from Stevens Institute of Technology where his research focus had been in low temperature physics (superconductivity). He was a member of the Stevens Board of Trustees

1997 – 2013 where he chaired the Investment Committee of the Board and had been an Adjunct Instructor in Finance & Accounting in the Department of Management Science.

He is a member of the Tokyo Club, Tokyo American Club and the Tokyo Lawn Tennis Club.