PREQIN INVESTOR OUTLOOK: ALTERNATIVES IN JAPAN

June 2019

CONTENTS

ABOUT THIS REPORT

The appetite for alternative investments among Japan-based institutional investors has become the subject of much conversation. After the Bank of Japan adopted negative interest rates in 2016, institutional investors in the country expanded their search for yield, demonstrating an interest in diversifying their portfolios and investing outside their traditional market. At present, two-thirds of institutional investors located in Japan invest in at least one alternative asset class.

In this report, we examine the key trends surrounding Japan-based investors' activity in alternative assets, and provide insight into their plans for future investments using the latest data from our award-winning platform, **Preqin Pro**. We have also hosted a roundtable on 'Trends in Alternative Investments among Institutional Investors in Japan,' where four local investors discuss their alternative investment activity and explore the current and future investment trends of each asset class.

We are also sincerely grateful to Mitsui & Co. Alternative Investments, Teneo Partners and Japan Post Bank for each sharing their expert insight on the changing landscape of alternative assets in Japan, and the impact on investors in the country.

We hope that you will find this report useful. If you have any questions or would like more information on how **Preqin Pro** can help you, please visit www.preqin.com or contact info@preqin.com.

IN-HOUSE CONTRIBUTORS

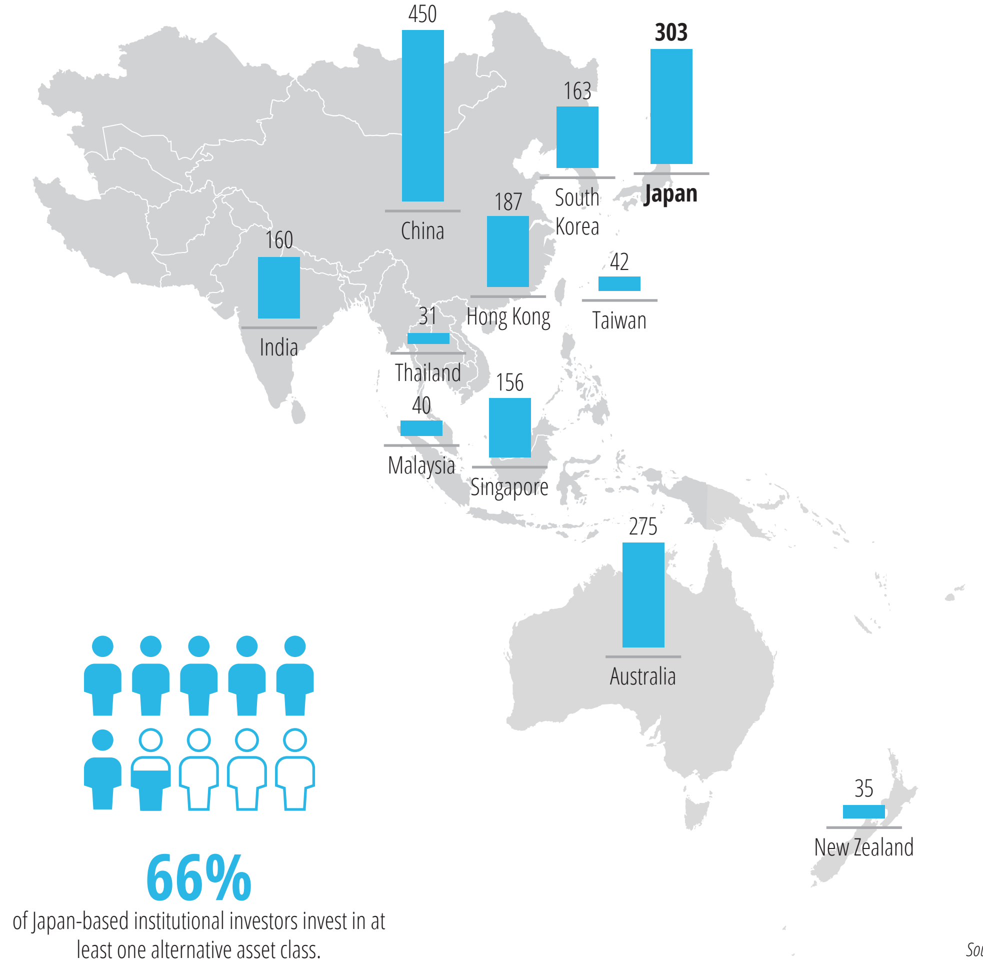
Vivian Goh
Yokaze Ito
Charlotte Mullen
Yumiko Nakazawa
Tim Short
Louise Weller
Carmen Wong
Christiana Wu
Yoko Yamada

EXTERNAL CONTRIBUTORS

Stan Howard, *Teneo Partners*
Shinichiro Ito, *Aozora Bank*
Mitsui & Co. Alternative Investments
Hideya Sadanaga, *Japan Post Bank*
Hiroaki Saito, *Asset Management One Alternative Investments*
Shuzo Takahashi, *Pension Fund Association*
Ichiro Yamamura, *Daido Life Insurance*

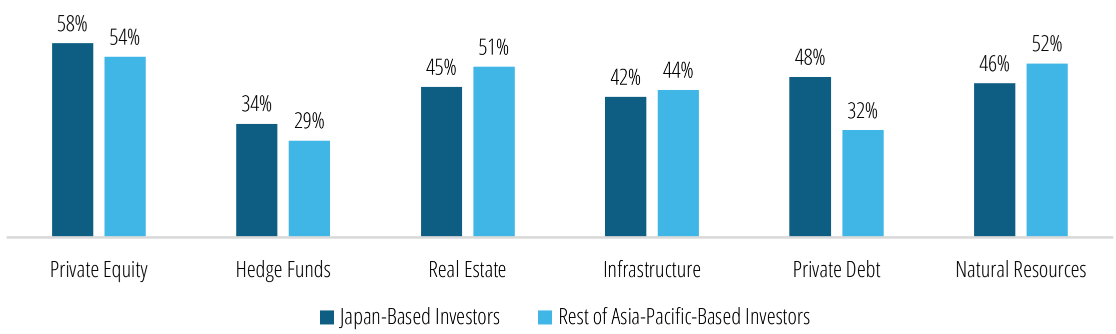
INVESTORS IN JAPAN

Number of Asia-Pacific-Based Institutional Investors by Location



Source: Preqin Pro

Proportion of Institutional Investors Allocating to Each Alternative Asset Class: Japan vs. Rest of Asia-Pacific



Source: Preqin Pro

JAPANESE INVESTORS IN THE ALTERNATIVE INVESTMENT LANDSCAPE

Challenged by the historically low interest rates that have persisted for a long time, investors in Japan are increasingly turning to various alternative assets. We attempt to show how this reorientation has been taking place for each major asset class.

REAL ESTATE

Investment in Japanese real estate

In the domestic real estate market, private REITs and private funds, after experiencing rapid growth, are maintaining their sizes in terms of AUM, but are on a plateau. Real assets have generated returns for Japanese investors, who have been investing in them for a long time. And yet, opportunities to invest in such yen-based assets are diminishing.

Shift to overseas

As opportunities to invest in real estate become more limited in Japan, investors are considering starting or resuming investments in overseas real estate. The standard approach for valuing real estate – for example, when deciding on a REIT investment – is to carry out on-site evaluations of the underlying properties. But this approach makes it more difficult to value assets structured as blind pools, because fund managers of blind pools may not disclose the specific investments that the vehicle will make. As solutions, bespoke, structured products that contain a fixed set of properties were introduced, opening the door to investment in overseas real estate – we think this development is unique to Japan.

On the other hand, we see an increasing number of Japanese investors that are capable of selecting overseas, private blind-pool funds, which are becoming more prevalent as products with attractive returns. Among overseas markets, this trend is most prominent with regards to North America-focused funds. We think that allocations to this asset class have been driven by products offered by the major asset managers, centring on open-ended core strategies.

MITSUI & CO. ALTERNATIVE INVESTMENTS

INFRASTRUCTURE

Investment in solar power projects in Japan

One of the sectors benefitting from the lower returns of Japanese government bonds and the reduced opportunities to invest in Japanese real estate may be domestic solar energy projects.

The feed-in tariff (FIT) scheme launched by the Japanese Government in 2012 encouraged widespread investment in these projects. Thanks to the scheme, which began with the attractive purchase price of JPY 40 per kilowatt hour, the total installed capacity has grown from approximately 5 GW before the scheme's inception to approximately 39 GW at the end of March 2017. Even after the reduction in the purchase price and the enforcement of the revised FIT scheme in 2017, given the paucity of options to earn attractive 'yen-based returns' elsewhere, this asset class is likely to remain popular.[1]

Investment in overseas infrastructure

To meet the need for yield-generating returns, overseas infrastructure funds have also become prevalent. Investment in infrastructure equity funds, primarily by corporate pension funds, started to spread and have been a major alternative asset class for financial institutions – many of them insurance companies – for the past five years. Infrastructure debt strategies gained acceptance among the

[1] *The Agency for Natural Resources and Energy at the Ministry of Economy, Trade and Industry. Toyo Keizai Inc.*

investor community in Japan earlier than in other countries, which is notable. For investors that used to focus on liquidity, characteristics such as the ease of currency hedging and the level and stability of returns encouraged them to start considering less liquid alternative assets for the first time. Other factors that raised interest in overseas infrastructure were as follows: as flat land is scarce in Japan, the development pace of domestic solar power projects (yen-based assets) is limited, and investors are seeking other opportunities to diversify.

DIVERSIFICATION OF RISKS THAT ARE THE SOURCES OF YIELD-GENERATING RETURNS

The prolonged historically low interest rates led to increased allocations to income-oriented assets, such as bank loans, corporate bonds and US municipal bonds. Given the heightened concerns over the duration risk of Japanese government bonds, investors also turned to income-oriented alternative strategies to replace bonds. During this period, we saw a trend in which investors were diversifying further with other sources of income returns aside from credit risk. While the credit spreads of liquid debt instruments were shrinking, less liquid direct lending strategies drew attention. Furthermore, insurance-linked products, which can offer liquidity and attractive income despite their low correlation with traditional asset markets, have become more widespread, primarily among corporate pension funds and regional banks.

HEDGE FUNDS

Hedge funds, which became prevalent in Japan earlier than other types of alternative assets, are encountering a stronger preference for high liquidity.

Hedge funds also evolved by diversifying their investment style after the Global Financial Crisis. In pursuit of transparency and liquidity, they have developed by shifting from funds of hedge funds to advisory platforms, or to single-manager hedge funds that manage multi-asset strategies.

Against such developments, different strategies have risen in prominence. For instance, investors focused increasingly on CTAs and long/short credit, which have the appeal of low correlation with stock markets, as well as on risk premia strategies and long/short equity, or on equity-market-neutral strategies with low net exposure that aim for stable returns and a volatility of less than 5% per annum. Lately, demand has picked up again for strategies that showed positive returns in 2018, the year when many strategies fought uphill battles, and for all-weather-type multi-strategy vehicles.

As an overall trend, we see that there is substantial demand particularly for strategies likely to offer stable income and for hedging against rising market volatility. This is a reflection of a growing demand for a more diversified range of hedge fund strategies.

WHAT ARE THE LATEST AREAS OF CONCERN AMONG JAPANESE INVESTORS THAT NEED ADDRESSING?

Cost drag from currency hedging

As the vast majority of overseas alternative assets are invested in US dollar-based strategies, US dollar hedging costs for yen-based investors are a major issue. Because of the widening of interest rate differentials between Japan and the US, hedging costs have increased. Many investors expect to earn returns between 3% and 5% net of hedging costs, which are currently assumed at around 3% for yen-based investors. Against this backdrop, technical proposals are being made for US dollar-denominated investments, which include, among others, hedging that capitalizes on the regime of pegging the Hong Kong dollar to the US dollar and schemes to reduce hedging costs with total return swaps. This highlights that all sorts of solutions to this problem are in demand. There have also been shifts to euro-denominated assets, where the destination countries are selected with caution, despite the uncertainty over Brexit and political risks. As the historically low interest rate environment has persisted in the eurozone as well, the interest rate differentials between the euro and the yen are smaller than ever. Accordingly, investors who have no problem buying the euro are now eyeing the European markets for some asset classes.

We are always trying to find the next assets poised to generate attractive 'returns in yen terms.'

Volatility when liquidity and marketability are two sides of the same coin
The rise in volatility experienced in the financial markets in the second half of 2018 seems to have had a major impact on investment. We saw increased demand for multi-asset strategies to curb downside risk. Furthermore, investors are more concerned about effectiveness in hedging the existing exposure to highly marketable assets, or, by approaching from the opposite direction, are more interested in private assets with low marketability.

Among private assets with low marketability, the abovementioned real assets have been broadly accepted by investors that prioritize cash yield on invested capital over high internal rate of return (IRR), while investment in private equity increased among investors that identified a need for high IRR even at the expense of liquidity.

The increase in demand was prominent for private equity due to stable asset valuations and the diversification effect on portfolios as a whole, despite the effect of the J-curve in the early stages. Demand has been also strong for private equity secondaries to mitigate the J-curve effect.

Other developments
In recent years, the concepts of environmental, social and governance (ESG) and Sustainable Development Goals (SDGs) have found broad acceptance in Japan as in other countries, and are now recognized as important issues in the due diligence process.

On the whole, there is a stronger tendency to value transparency, primarily for regulatory compliance, while the understandability of strategies is also viewed as important.

In the aftermath of the AIJ scandal in 2012 – when the local fund manager hid significant losses from its investors, jolting the Japanese financial industry – fiduciary duty became an important concept. At the same time, it is now commonplace to use the expertise of outside specialists and objective assessment. Such developments have been seen not only in the pension fund industry, which was directly hit by the shockwaves of the incident, but also among financial institutions and the like for other reasons (e.g. for complementing resources of investment teams, accelerating portfolio construction and actively using know-how). Investors are diversifying how they outsource the screening process as well as hiring methods, by hiring gatekeepers, combining domestic gatekeepers and overseas subadvisors, adopting the Manager Entry System and using consulting firms.

MITSUI & CO. ALTERNATIVE INVESTMENTS

Our company, Mitsui & Co. Alternative Investments Limited, was established in 2001 as a wholly owned subsidiary of Mitsui & Co., Ltd. Since then, the company has specialized in alternative assets, which are offered to the broad clientele of institutional investors in Japan. We offer services that match the needs of clients for support. For instance, our services to investor clients include due diligence before deciding on investments, monitoring of investments, and proposals for solutions. For asset manager clients, we assist in shaping various marketing strategies and in other operations. We are a securities firm registered under the Financial Instruments and Exchange Act as a financial instruments business operator of all of the four types.

www.mitsui-ai.com

This information does not constitute an offer to sell or a solicitation of an offer to buy any securities in any jurisdiction. The information contained herein has been obtained from sources believed to be reliable, but no guarantee or warranty is provided as to its accuracy and completeness.

THE PRIVATE EQUITY INVESTMENT PROGRAM OF JAPAN POST BANK

HIDEYA SADANAGA

Managing Director and Head of Private Equity, Japan Post Bank

OUR HISTORY

The program started in the spring of 2016 so we are now entering our fourth vintage.

OUR PHILOSOPHY AND AIM

We aim to create a diversified private equity program that would exhibit strong risk-adjusted returns over multiple market cycles. Given where Japanese interest rates stand, it is crucial that we augment our existing fixed income portfolio by investing in other expected high-return assets like private equity, albeit carefully, to earn meaningful investment returns for our stakeholders.

While we aim to create a diversified portfolio, as explained below, we also aim to create strong, long-term relationships with our key general partners and will work hard to gain their trust as a long-term partner.

PORTFOLIO CONSTRUCTION

We intend to create a diversified portfolio spanning many geographies and different strategies with different risk/return and cash flow characteristics, and shall seek to optimize the performance of our portfolio. We adjust our portfolio annually and shall tilt our portfolio as appropriate to take advantage of secular trends.

Our portfolio is predominantly focused on the US and Europe with a significant allocation to Asia as well. Our main investment focus is buyout, but we also invest in growth capital, venture capital, infrastructure, mezzanine, special situations and distressed strategies. We have recently decided to add long-dated strategies and investments in GPs to this menu, too. We are size agnostic: we will invest in large funds above $5bn and also in much smaller funds to capture the whole spectrum of investment opportunities.

HOW WE OPERATE

We invest mostly via professional gatekeepers in order to select the best opportunities in the market. This is especially so in the mid- to small segment of the market where we feel that we are not adequately resourced to select the best performing funds of the future.

In many cases our mandates with these gatekeepers are structured as SMAs. While the primary contact point with our underlying managers is our gatekeepers, we maintain an active dialogue with quite a few of our underlying general partners to cultivate the relationship and to keep track of our portfolio.

We are a regulated bank and have unique reporting requirements that we request of our partners, including a full look through into the portfolio.

INVESTMENTS IN JAPAN

The only exception to the operational protocol above is that we invest directly – i.e. we do not invest through gatekeepers – in Japanese buyout, special situations and mezzanine funds. Given that Japan is our home market, and since almost all of our liabilities are in yen, it is preferable for us that there exists a vibrant private equity market in Japan. The Japanese market is, however, still very small, so the vast majority of our portfolio is currently invested abroad, but it is our hope that we would be able to nurture and grow together with the Japanese private equity market.

CO-INVESTMENTS

We created a subsidiary with our sister company Japan Post Insurance in February 2018 called Japan Post Investment Corporation, which focuses on co-investments in Japan and in the rest of Asia. It is investing its inaugural co-investment fund and has already invested in a handful of investments over the past year. We hope to become a recognized and meaningful co-investor in Japan and Asia and a catalyst for growth for many Japanese and Asian private companies.

We also welcome co-investment opportunities outside of Asia and work with several managers that conduct co-investment activities on our behalf in the other geographies.

JAPAN POST BANK - HIDEYA SADANAGA

Hideya Sadanaga heads Japan Post Bank's nascent private equity investment program and is responsible for all aspects of its creation and construction. Prior to joining Japan Post Bank in January 2016, he spent most of his career at Nippon Life Insurance Company, where he was portfolio manager establishing and leading Nippon Life's private equity operations out of its US subsidiary, and was also Head of Product Development at Nissay Asset Management Co., the asset management subsidiary of Nippon Life, just prior to joining Japan Post Bank, among other various roles he held there.

Mr. Sadanaga has a Bachelor of Law degree from the University of Tokyo, LL.M. from the University of Michigan Law School, has passed the New York Bar Exam and also is a Chartered Member of the Security Analysts Association of Japan.

Please feel free to contact privateequity.ii@jp-bank.jp if you have any questions.

www.jp-bank.japanpost.jp

WHAT ARE JAPAN-BASED INVESTORS LOOKING FOR?

Fig. 1: Geographic Preferences of Japan-Based Institutional Investors in Each Alternative Asset Class

Private Equity	Hedge Funds	Real Estate	Infrastructure	Private Debt	Natural Resources
Far East	Global	Far East	Far East	Far East	Far East
North America	Asia-Pacific (Excl. Far East)	Global	Global	Global	Asia-Pacific (Excl. Far East)
Asia-Pacific (Excl. Far East)	Far East	North America	North America/ Europe	Europe	North America

Source: Preqin Pro

In Japan, regulatory factors, such as the adoption of the negative interest rate policy in 2016, and slow economic growth, are changing the country's investment landscape. More and more institutional investors are moving into alternative assets from traditional investments in search of yield.

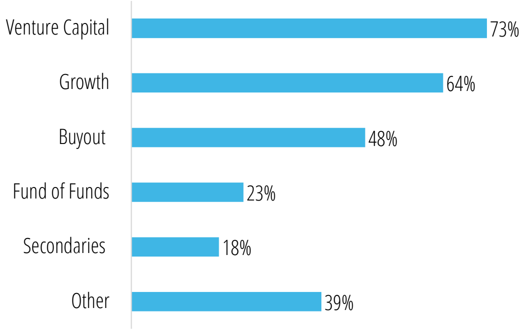
Although Japan-based institutions have demonstrated interest in outbound alternative investments in recent years to expand and diversify their portfolios, the Far East remains the preferred investment destination for private capital (Fig. 1). Among investors in hedge funds, however, the majority (79%) take a global approach when accessing the asset class.

Across most alternative asset classes, investors are primarily looking to gain exposure to the North American market when considering overseas investment. The majority (61%) of Japan-based private equity investors target North America-focused funds when making fund commitments, while 45% and 44% of real estate and infrastructure investors respectively hold a preference for assets in the region.

Private equity investors in Japan favour venture capital, gaining access to emerging sectors, such as new technology, through these investments (Fig. 2). More than 130 investors, including corporate investors and regional banks in Japan, committed to SBI AI & Blockchain Fund which raised JPY 60bn when it reached a final close in January 2019. Growth and buyout vehicles are also favoured by large proportions of Japan-based private equity investors.

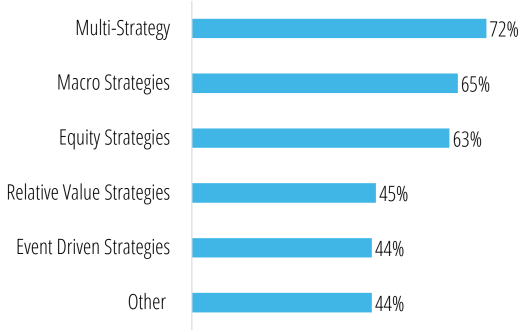
When seeking exposure to real estate, Japan-based institutions primarily target less risky equity strategies:

Fig. 2: Japan-Based Private Equity Investors by Fund Type Preference



Source: Preqin Pro

Fig. 3: Japan-Based Hedge Fund Investors by Top-Level Strategy Preference



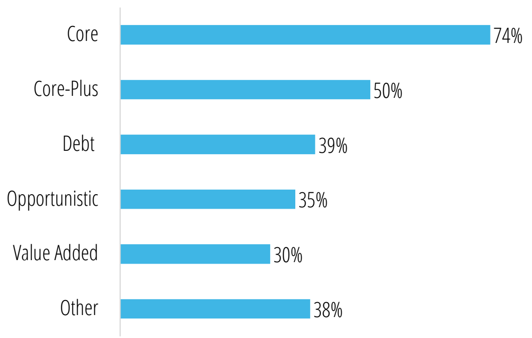
Source: Preqin Pro

74% and 50% of investors have a preference for core and core-plus assets respectively (Fig. 4). This may reflect the cautious approach towards real estate investing that investors have employed since the real estate bubble burst of the 1990s.

Typically characterized by low correlation to traditional asset classes and a stable income flow, infrastructure investments are attractive to institutions with longer investment horizons, such as pension funds and insurance companies. The majority of Japan-based investors in infrastructure prefer to access the asset class through single-manager funds, with 77% favouring primary strategy vehicles and 62% interested in debt/mezzanine funds (Fig. 5).

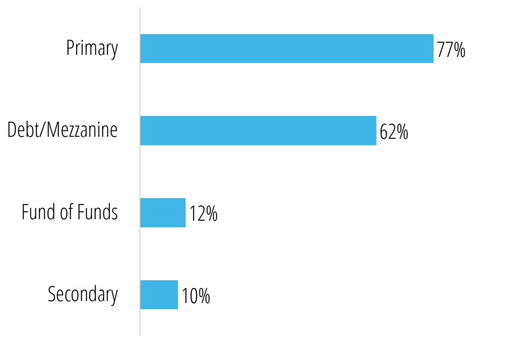
Similarly, mezzanine (62%) and distressed debt (56%) are the most targeted fund types among Japan-based investors active in the private debt market (Fig. 6). Pension Fund Association for Local Government Officials is one of the domestic institutional investors moving into private debt. The JPY 23tn public pension fund released its first request for proposal in July 2018 seeking offshore private debt fund managers.

Fig. 4: Japan-Based Real Estate Investors by Strategy Preference



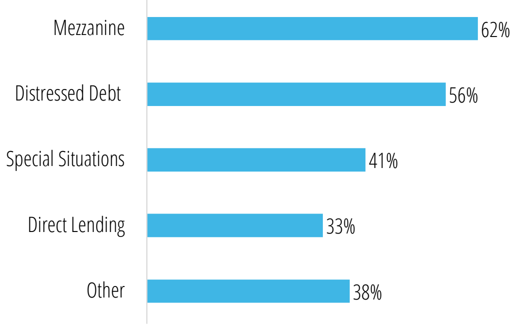
Source: Preqin Pro

Fig. 5: Japan-Based Infrastructure Investors by Strategy Preference



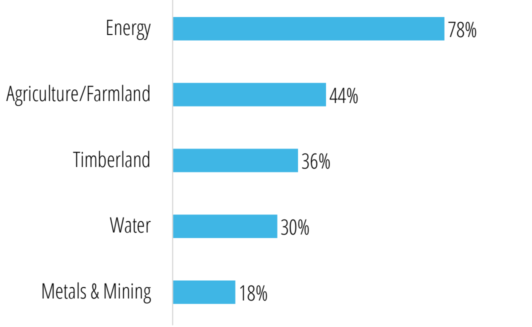
Source: Preqin Pro

Fig. 6: Japan-Based Private Debt Investors by Fund Type Preference



Source: Preqin Pro

Fig. 7: Japan-Based Natural Resources Investors by Strategy Preference



Source: Preqin Pro

FUND DISTRIBUTION IN JAPAN – IT'S ALL ABOUT FORM

Preqin: Can you provide a brief description of the investment environment in Japan?
Stan Howard: The recent equity market volatility and the prevailing minimal-to-negative interest rates have made it increasingly difficult for the Japan-based institutional investor to navigate the markets and achieve their desired returns. One point of constant concern is how they can avoid future potential drawdowns in Japanese Government Bonds (JGBs) and create stable income in their portfolios. Among the JGBs issued as of the end of 2018, JPY 109tn is scheduled to mature over the course of the coming fiscal year and investors in these bonds are seeking substitute investment strategies to what traditionally had been a roll-and-hold approach to their JGB exposure. Although they are currently finding it difficult to decide with conviction which assets to invest in, many investors view increasing their allocations to offshore assets as unavoidable. Moreover, it is clear that they are committed to expanding their exposure to alternative assets, particularly those in the areas such as credit, infrastructure and real estate that can provide a relatively stable and consistent yield. While US assets are still the dominant choice, euro-denominated assets are growing in popularity due to the relative affordability of the hedging costs between the euro and the yen.

What are the principal institutional investor segments and what are the regulatory requirements in terms of accessing them?
As we look at the investor landscape in Japan, we typically segment the institutional investor market into the following categories, each requiring unique access routes and approaches: insurance companies, large-scale commercial and specialized banks, trust banks, mid-size banks, regional banks, asset management companies and pension funds.

Asset managers seeking to access these investors need to be aware of the regulatory environment as it relates to solicitation activities and the placement of their funds in Japan. There are two fundamental elements to the regulations concerning the distribution and marketing of funds, each addressed within the Financial Instruments and Exchange Law (FIEA). The first relates to the form of fund registration. The second relates to the licences required for securities solicitation and placement.

STAN HOWARD

Founder and Director, Teneo Partners

Is fund registration a standard form?
Any privately placed fund that is organized as either a corporate form that issues shares to investors or as a unit trust form that issues units to investors must be registered through a notification process with the Financial Services Agency (FSA) through the local branch, which in Tokyo is the Kanto Finance Bureau (KFB). Private placements are divided into three general types.

The first is the Professional Private Placement which restricts fund solicitation to professional investors only. This is frequently referred to as the Qualified Institutional Investor (QII) registration. With a Professional Private Placement, there are no subsequent reporting requirements beyond the initial notification.

The second is the General plus Professional Private Placement which allows the solicitation of all professional investors as well as a limited number of non-professional investors. In this case a fund may only be offered to up to 49 non-professional investors on a rolling six-month basis. Moreover, because this type of private placement may include non-professional investors, the FSA requires that the asset manager file an annual fund report from the year following the initial notification.

There is a third form, the General Private Placement, but because it is restricted to the solicitation of 49 non-professional investors without reference to professional investors, it is quite ineffective and generally not utilized.

What about limited partnerships?
For funds that are organized as limited partnerships, the registration process is quite different. The general partner (GP) to the fund will need to file a Form 20 under Article 63 of the FIEA and appoint a representative in Japan. They will also need to file a management report each year within three months of the close of the asset manager's fiscal year end. It is important to note that this report relates to the asset management company, not the fund. Registration under Article 63 allows the GP to manage the assets of a Japanese entity or person and to market its fund without obtaining a fund management and a securities marketing licence in Japan. However, because the safe harbour does mandate compliance with certain reporting requirements, many GPs have opted out of the exemption in order to avoid filing the annual reports.

A GP may opt out of reporting under Article 63 and continue to manage assets for Japanese investors without a requisite fund management licence if the fund meets certain criteria: (a) it only accepts up to nine LPs from Japan, all of whom must be professional investors; (b) that no more than one-third of the fund's total assets come from investors in Japan; and (c) that it engages a registered Type-2 Financial Instruments Business Operator or "FIBO" (read Broker-Dealer) to market the fund. We should point out that the limitation on the number of LPs from Japan is on a per-fund basis, not a total across the number of funds run by the manager.

What types of licenced distributors are there and what are the differences with respect to their coverage?
The second fundamental piece of the regulation concerning fund distribution relates to the licences required for solicitation and placement. In Japan, only registered FIBOs are allowed to market securities, including fund interests; a Type-1 FIBO for the sale of fund shares or fund units and a Type-2 for the sale of partnership interests. Other than the one exemption referenced above for GPs who file under Article 63, there are no safe harbours within Japan for self-marketing by fund managers to investors. To be clear, offshore fund managers may approach and engage FIBOs for regulatory assistance in marketing but they may not directly solicit or market to investors.

But what about reverse enquiry?
Unlike some other jurisdictions in the world, there is no statutory exemption in Japan for reverse enquiry. Consequently, asset managers who decide to rely on this as a way of circumventing the Japanese FIEA regulations are taking the risk of running afoul with the regulator. We know of cases, and in fact were asked to mediate in one case, where an offshore manager was sanctioned by the FSA for accepting subscriptions from investors located in Japan without having properly registered the fund and using appropriately licenced distributors.

What is the most effective way to approach institutional investors in Japan?
The marketing approach to financial institutions is quite a straightforward, direct sales transactional process. However, it does require registering the fund if other than a limited partnership and working with a distribution agent that has a Type-1 or Type-2 FIBO licence, depending on the form of the fund being presented. The institutions themselves are becoming more sensitive to regulations surrounding the solicitation process and more frequently ask offshore asset managers about the registration of their funds and their representative in Japan. The challenge is to identify which department in the investor organization is tasked with investments in offshore funds and then to find the right people to speak with. This is further complicated by the fact that within these large financial institutions there are multiple investment groups, divided by the nature of the asset class, the asset pools or the beneficial owners.

Once identified it is a matter of getting in touch and opening a dialogue, but this is easier said than done. Working with a fund distributor that has long experience in the Japanese marketplace and can provide the capacity necessary to service the multiple investor channels and clientele is critical. The sales cycle is typically a long one. The Japanese financial institutions ask many detailed questions and take time to advance discussions internally so patience is required when working towards an allocation. Understanding their process and doing things the right way is critical to success. An allocation within six to 12 months of initial discussions is unusual; a 12- to 24-month process is more typical.

What about pension funds?

The approach to pension funds in Japan is more complex. Corporate plan sponsors cannot allocate their own assets; they are required to delegate this activity to an outside Discretionary Investment Manager (DIM). Separately, pension plan assets must be custodied at a Trust Bank. Consequently, managers will see pension plan assets flow to them initially through a DIM gatekeeper, then into a Trust Bank which then subscribes to the administrator of their fund. In many cases, an offshore asset manager may not be informed from which pension fund a specific allocation has come. Due to competition the DIM gatekeepers, more often than not, intentionally keep that information confidential. To make matters just a bit more confusing, the large Trust Banks have integrated vertically, setting up their own in-house DIM departments or subsidiaries, leading many offshore asset managers to have the false impression that only Trust Banks can manage pension fund assets. Consultants are active as well, adding another layer of complexity to the selection process.

There are approximately 300 companies in Japan that hold a DIM licence which can be used for either fund management or for contracting with pension plans to allocate their assets. However, because of the difficulty for smaller companies to successfully contract with a plan sponsor, only about 40% of DIM licence-holders are involved in the business of allocating corporate pension assets.

The challenge for an offshore asset manager is to find a way to navigate this complex maze of relationships to receive a mandate for pension fund assets. The traditional approach is to target the gatekeepers and attempt to generate sufficient interest from them to include the fund on their portfolio platform offered to their pension clients. While this may be the obvious approach, it is both an indirect and highly competitive one that can take a long time with little or no feedback from the plan sponsors. The more difficult approach, and one that only licenced FIBOs can make, is to contact the pension funds directly. This is more effective and efficient than approaching a gatekeeper, but it requires a relationship with plan sponsor that has been nurtured over time. It also requires the skill to match the pension fund with a DIM that will agree to sponsor the product through the system and execute the business. Only experienced FIBOs with extensive industry networks like Teneo Partners can successfully orchestrate this kind of coordinated effort.

TENEO PARTNERS

Teneo Partners is a fully licenced, independently owned boutique securities company in Japan with an exclusive focus on marketing offshore funds. We have been in business for over 15 years and provide a unique set of customized distribution and placement offerings for both public and private market strategies to asset managers seeking support in accessing Japanese investors.

info@teneopartners.co.jp
www.teneopartners.com

LP ROUNDTABLE: THE PRESENT AND FUTURE OF ALTERNATIVE INVESTMENT IN JAPAN

PARTICIPANTS

- Hiroaki Saito (Moderator), Head of Private Investments, *Asset Management One Alternative Investments*
- Shinichiro Ito, General Manager of Private Equity Division, *Aozora Bank*
- Shuzo Takahashi, Head of Private Equity, *Pension Fund Association*
- Ichiro Yamamura, Market & Alternative Investment Department General Manager, *Daido Life Insurance*

Preqin's Yoko Yamada held a roundtable discussion with four institutional investor participants in Japan. The theme was 'Trends in Alternative Investments among Institutional Investors in Japan.' We had a lively discussion about topics including the alternative investment activity of each institution, the current and future investment trends of each alternative asset class, and what they are each looking for from overseas fund managers or general partners (GPs).

1. ALTERNATIVE INVESTMENT ACTIVITY OF EACH INSTITUTION

Saito: Let us start by introducing our alternative investment activity. Our company was established in 2010 as a subsidiary of Mizuho Bank, and it operated as Mizuho Global Alternative Investments (MGAI). In 2018, we became a subsidiary of Asset Management One, which is a joint venture between Mizuho Financial Group and Dai-ichi Life Insurance. As a gatekeeper specializing in alternative investments, we mainly handle hedge funds and private assets. By taking advantage of the group's channels, we primarily manage assets of corporate pension funds in Japan and offer global alternative investment opportunities.

Ito: Among alternative assets funds on the equity side, Aozora Bank is involved in private equity (PE) funds as well as real estate and turnaround funds. We used to invest in hedge funds, but not anymore. We started getting involved in buyout and venture capital funds from around 2001; although we temporarily stopped investing after the Global Financial Crisis (GFC), we resumed in 2011, and currently invest in more than 60 funds in Japan and abroad. Our team for PE funds essentially consists of six members, who monitor the investments overall. In tandem with tie-ups with financial institutions in Southeast Asia, we also started investing in funds in this region about three years ago.

Yamamura: Eighty percent or more of Daido Life's assets under management (AUM) is allocated to income-generating assets, such as domestic or overseas bonds (ALM assets, etc.). Our mission for alternative-type assets (our internal jargon) is to earn returns in excess of ALM assets by taking price fluctuation risk, liquidity risk, credit risk and other risks. About 5% of our total AUM is managed by three teams.

First, we have the PE fund investment team. Second, we have the structured debt team, which invests in credit assets, such as project financing and LBO loans. Any other alternative investments (e.g. bank loans, hedge funds, infrastructure funds) are covered by our alternative investment team. Our investment in PE started in 1999, and its market value accounts for about 2% of our total assets. At present, we have relationships with about 70 GPs and invest in about 150 funds. Although there are four staff members who are dedicated to PE investment, we outsource due diligence and monitoring to Alternative Investment Capital Limited, which is a gatekeeper established in 2002 as a joint venture between our company and Mitsubishi Corporation; 15 or more employees have been seconded from our company to this firm. The majority of our PE portfolio is in buyout strategies. By region, about 70% of our PE investment is in North America and Europe, and the rest in Asia (including Japan).

Takahashi: The Pension Fund Association is currently involved in alternative assets – including PE, hedge funds, real estate and infrastructure – and is engaged in alternative investment strategies, such as certain credit strategies, that are focused on the generation of income. In our policy asset mix, investments in PE are positioned as an alternative to stocks, and investments in infrastructure and real estate etc. as an alternative to bonds, which are managed in the corresponding asset classes. Among them, PE was the first we dealt with; a commitment was made to the first PE fund in 2002. Back then, alternative investments were in their early days in Japan, and a predominantly large number of pension funds started with hedge funds. However, we started with PE, for which construction of portfolios takes time. At present, the AUM of PE totals JPY 450bn, and the investment program is worth JPY 700bn or more if dry powder is included. The portfolio breakdown by strategy is as follows: 70-80% for buyout, 10-15% for venture capital and growth, and the rest for special situations and others. The breakdown by region is as follows: 60% in North America, 20% in Europe, 10% in Japan and 10% in other Asian regions.

2. WHAT FACTORS ARE DRIVING JAPANESE INSTITUTIONAL INVESTORS TO THE ALTERNATIVE INVESTMENT MARKET?

Saito: The need for alternative investment among pension funds in Japan is limited, albeit with some variation, because their assumed target returns are generally lower than that of their overseas counterparts. However, it is now difficult even to achieve such target returns given the global low interest rate environment. Against this background, there is more interest in alternative investments, such as private debt and infrastructure, from which income gains can be expected. How have changes in the environment over recent years affected your institution in terms of alternative investments?

Ito: As I have said, we temporarily suspended investments in PE funds after the GFC. In hindsight, this was the period that offered the most attractive investment opportunities. Now that the underlying companies of funds are quite different, we are seeking to restructure our portfolios with possible reallocation.

We occasionally meet with regional financial institutions which, more often than before, ask us questions on our management methods and stance on investment in PE funds. Furthermore, I get the impression that there are now significantly more regional financial institutions that have become limited partners (LPs) of various funds, and there are more and more cases where large regional banks make direct investments without gatekeepers if the funds are based in Japan. On the other hand, some regional banks are more active than us in overseas investment through gatekeepers. While negative interest rates make it difficult for banks to increase profit by expanding loans, investment in equity funds seems to be getting popular, and the same is true with multiple layers of debt, or subordinated loans and debt-focused funds for alternative investments.

Yamamura: After the GFC, our company was compelled to suspend investments in PE funds for about two years; we stopped making distributions from our PE portfolio, and our PE portfolio's market value plummeted for a while, leading many within the company to voice their opinions. However, our investment has since resumed. Consequently, owing to a favourable market environment with brisk M&A activity in recent years, among other factors, PE is significantly contributing to the investment income of our company with higher-than-expected distributions. On the other hand, we are in fact heavily dependent on PE among alternative assets, and are looking to invest in assets that will be the second and third pillars of income after PE among alternative-type assets.

Let me explain our recent activity. On the equity side, we started investing in infrastructure funds five years ago, which can produce not only capital gains but also stable income gains. However, we are carefully and selectively accumulating such assets given the slightly overheated market now.

As part of our exposure to private debt, we also participate in direct lending. Direct lending is less liquid than bank loans, and so the credit cycle and economic slowdowns should be taken into consideration. Accordingly, it is difficult for us to accumulate such assets drastically. Faced with this situation, we are actively involved in project financing, whether in Japan or abroad, where the probability of repayment is less influenced by economic trends (few institutional investors may position it as alternative investments, however). Although its total returns are not as high as those of other alternative-type assets, this asset class has attractive risk/return features and can generate long-term, stable cash flows, making it suitable for investments by life insurance companies. Like PE, hedge funds are an asset class we have dealt with for many years; despite its sluggish performance, the asset class can be expected to earn absolute returns while suppressing market beta. We continue to invest in hedge funds, although we have significantly cut back the amount of holding from the peak period.

Takahashi: Lately, when discussing alternative assets, people seem less prone to lump together various kinds of alternative investments into one category. In my view, they are classified nowadays into the broad investment categories of equity type and fixed-income type, and then further into the methods of achieving alpha and diversification; only then is the discussion based on characteristics, such as liability structures, on the investor side. We can consider various aspects, such as long term vs. short term and capital gain vs. income gain. Recently, it seems that people are particularly focusing on the private vs. public aspect, and private assets are attracting more attention.

We invest in PE as part of stock investments, that is, as part of investments in companies and businesses in a broad sense, whether public or private. Our purpose is to obtain alpha from listed stocks in the long term. To achieve that goal, we run investment programs with the understanding that consistent investment is extremely important. As you know, no-one can time the market well, even with maximum effort. After all, consistent investment is a shortcut to the creation of good programs, which is the lesson learned from experience by many institutional investors around the world.

On the other hand, the income-generating type of private assets is increasingly more important as an alternative to bonds, given the continued low interest rates. Previously, this asset type was covered by our PE team, but is now covered by a separate, independent team in our reinforced system.

3. THE CURRENT STATUS AND FUTURE INVESTMENT TRENDS BY ASSET CLASS

Saito: Figures from Preqin's survey of investors in November 2018[1] revealed the global trends in alternative investments. Are they consistent with your company's investment activities? Or are they different for certain asset classes, and if so, how? I myself do not perceive any gaps. We have operated our business as a gatekeeper, focused on infrastructure and private debt. The survey results seem to reflect the asset owners' intentions.

Ito: Regional financial institutions we talked with expressed strong interest in infrastructure and private debt funds, confirming this view. Aozora Bank's stance may be a little different in that, although we will constantly invest in PE funds, we do not invest in hedge funds, where information is not easy to obtain. We invest in real estate through domestic and overseas listed/unlisted REITs, equity funds and other vehicles. Our exposure to infrastructure funds is more often in the form of loans rather than funds, due to their long timeframes. In consideration of the bank's core business, we will not significantly increase our private debt fund exposure.

Yamamura: Mr. Takahashi referred to the definition of alternative investments. I think we should also regard PE as one asset class given our many years of investing in it, and should continue to invest in this class by maintaining a weighting at around the current level, if not increasing it. In recent years, the scope of investable instruments is expanding with new products derived from the traditional PE funds, such as GP-stake deals/long-duration types.

Infrastructure funds are suited to the liability features of insurers, and can also produce stable income gains. Accordingly, we are seeking to invest in infrastructure funds, primarily in open-ended types, of which the underlying assets can be known upfront at the time of making an investment. In the past couple of years,

[1] *Refer to page 6 of Preqin Investor Update: Alternative Assets, H2 2018.*

however, strong demand from investors made it difficult for us to accumulate such assets as much as we had planned. We were not keen on overseas real estate due to tax issues (FIRPTA), and spent a long time looking in to it. However, since the market is large, we started investing in core real estate funds last year, which do not rely excessively on capital gains. We think it necessary to exercise caution in the current market environment, as this asset class tends to move in tandem with the economy more so than infrastructure.

Takahashi: As cash yield is an important factor for pension funds, I think the strong demand for income-oriented investment strategies will continue. On the other hand, although new investment strategies always draw attention in general, it should be noted that some have track records of only 10 years after the GFC, in the period when the market was steadily rising. This contrasts with those asset classes that have withstood the test of time, to a certain degree, having gone through many economic cycles and difficult phases. For private assets overall, I think it is important to tackle two challenges: focusing on quality instead of market timing, and diversifying well.

What I can say about PE is that, compared to 10 years ago, there are significantly more LPs in Japan that are investors of various levels. However, as before, the total number is smaller than in North America and Europe, and investment appetite fluctuates a lot with changes in the market environment. The market may experience healthy growth if there is an increase in the number of investors that approach the market by running investment programs that make commitments in a stable and continuous manner.

4. INCORPORATION OF ESG FACTORS IN ALTERNATIVE INVESTMENT

Yamada (Preqin): While the major investors across the world are paying attention to environmental, social and governance (ESG) investing, it is our understanding that investors in Japan are taking a lead in ESG investing within Asia. To what extent are you interested in this area, and what are you undertaking to incorporate ESG factors in alternative investments?

Saito: I believe we are taking actions, such as formulating guidelines and creating internal checking processes, that are expected from gatekeepers like us. During fund due diligence, we extract some checkpoints from the ESG viewpoint and conduct a negative check separately.

Yamamura: Our company checks all new investment deals to see whether they have any problems in terms of ESG. As alternative investments are primarily made by funds, which are often blind pools, our due diligence process includes the checking of underlying assets in the past, and the ESG principles and guidelines of fund managers.

Our group has become a signatory to the UN PRI. I also think that ESG-conscious investments are important and should contribute to improved returns in both the medium and long term. On the other hand, while it is quite straightforward with some types of investment like PE – for which the source of returns is improved corporate value through enhanced governance (G) – I think it is extremely difficult to determine which factor among E, S and G was effective when evaluating performance after the investment.

Takahashi: Establishing a sustainable society, which includes solving environmental problems, is an important issue for the beneficiaries of pension funds including ourselves. Accordingly, we take active steps to incorporate ESG factors as part of our fiduciary duty to beneficiaries and stewardship responsibility in a broader sense. But the basic premise, of course, is that returns should not be sacrificed. When it comes to alternative investments, I think ESG factors are actually built into PE investment strategies by their nature. In particular, enhanced corporate value by improved governance is indeed an important source of value addition in PE investments – the governance, G, means effective governance. Furthermore, investments in education, medical care and other fields to solve social problems and create a better world by using information technology and other methods are socially meaningful.

In a due diligence process, too, one cannot ignore E and S – not thinking about them would incur some sort of reputation risk for individual investee companies. Meanwhile, just a box-ticking exercise may easily turn into form over substance. I personally think that effective operations require flexible and practical responses without sticking to formalities.

Ito: In terms of ESG investment, our banking industry may actually be the slowest. Only a handful of banks are signatories of the UN PRI. I think this is partly because banks need time for consideration in their development of rules that determine which processes should incorporate and use ESG assessment in their loan, investment and other operations; however, recently major banks are close to completing the development of rules. Furthermore, banks including our bank are itemizing their ESG activities and disclosing various kinds of information about them on their websites.

5. IMPORTANT CRITERIA FOR SELECTING FUND MANAGERS

Saito: Overseas fund managers are demonstrating interest in institutional investors in Japan. Given the theme of this roundtable discussion, the key criteria for selecting fund managers depends on what investors in Japan seek from overseas GPs, and whether there are some points unique to Japanese investors besides performance.

Yamamura: As our company does not have any overseas offices, it is helpful in practical terms if a fund manager has an office in Tokyo. However, this does not affect our investment decisions. Besides track records, we place importance on whether it has a good system in place that enables us to periodically communicate with key fund managers about investment activities, etc. Although we have learned that communication should be initiated from our end as well, we value GPs that frequently create opportunities to communicate with us by having conference calls and such, instead of limiting themselves to just face-to-face meetings. Another important point is disclosure of information about capital call notifications and quarterly reports, as that is essential to our monitoring.

Takahashi: Yes, indeed. It is important that they appropriately communicate with us at times other than the time of fundraising. As PE is a long-term business, we need to grasp situations through constant communication and to solidify relationships. In a similar vein, we had a case where we finally made the first commitment after communicating for nearly 10 years since the initial meeting. Lately, however, fundraising cycles are obviously getting shorter in general, which gives us a different kind of headache in terms of portfolio construction.

When thinking about the points of selecting funds, as you know, PE is a people business – people are the most important element. I think there will be more cases where the so-called succession issues for GPs will surface as the PE industry matures. We also place importance on the alignment of interests surrounding terms and conditions. In addition, we want GPs to be more concerned about net returns.

Ito: As we are an investor that cannot invest significantly large sums of money, we experience hardships during negotiations, like many small-sized investors. For information disclosure, we inform beforehand what items we will need to know, so that we can periodically receive them; to put it differently, unless a fund manager agrees to this, we find it hard to invest. We also have the internal rule that we will contact in some way the person responsible for investing, regardless of whether in Japan or abroad, when investing in a new fund.

Saito: Thank you. The world is aware that, with increasing appetite among investors in Japan, large investors in particular are actively involved in PE and other areas, such as private debt and hedge funds. That is probably why GPs are making more marketing trips. I hope they continue to visit Japan and communicate with various investors as much as possible, regardless of fund flows. Although it may take time to build relationships with investors in Japan, once relationships are established, I think they will remain strong.

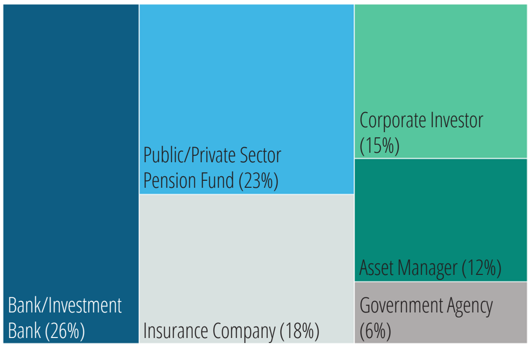
Yamamura: We constantly remind ourselves that, although we select fund managers/GPs based on various criteria, we are also selected by GPs. To be selected as an LP, we try to fully understand the relevant asset classes and maintain our organization so that we can properly communicate our policy of making commitments seriously, among other matters, instead of acting like a novice investor. Several years ago, we introduced a new HR policy: 'investment professional system' catered for the front team of the Investment Department. This is done to retain talents with specialty knowledge as it is common practice for companies in Japan to rotate personnel to different positions every few years.

Saito: That is true. On the other hand, working as someone who introduces fund managers and gives advice to investors, I look to resist becoming comfortable with the thought that a company with an office in Tokyo can be relied on to do all the work after closing the contract. Instead, I believe it is important to search relentlessly for better fund managers to introduce to investors. Thank you for participating today.

WHAT'S NEXT FOR ALTERNATIVES IN JAPAN?

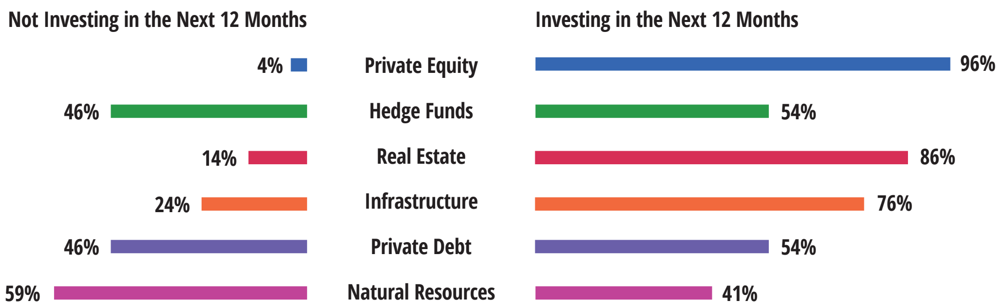
In March 2019, we conducted a survey of institutional investors in Japan to understand their views on alternative assets. Investors across all alternative asset classes are planning to make new investments in the coming year, and the 96% of private equity investors that are looking to make fresh investments in the next 12 months constitute the largest proportion of any asset class (Fig. 9). Furthermore, half of these investors looking to invest in private equity funds expect to allocate more capital than they did in the past 12 months. More Japan-based investors are looking at gaining exposure to international investments; one investor we spoke to told us they intend to increase their private equity allocation overseas, focusing on North America and Europe.

Fig. 8: Survey Respondents by Investor Type



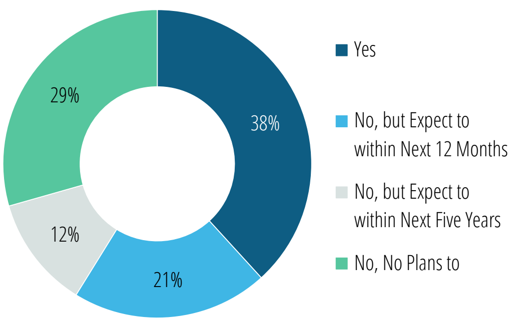
Source: Preqin Investor Interviews, March 2019

Fig. 9: Japan-Based Institutional Investors' Plans for the Coming Year by Asset Class



Source: Preqin Investor Interviews, March 2019

Fig. 10: Japan-Based Institutional Investors with an ESG Policy in Place for Their Alternative Assets Portfolio



Source: Preqin Investor Interviews, March 2019

Among the respondents seeking new opportunities in infrastructure over the next year, 45% are looking to commit more capital than they did in 2018.

Over the past year, environmental, social and governance (ESG) factors have become increasingly important to investors in Japan. Under pressure to adhere to the UN-supported Principles of Responsible Investment, coupled with the aim of supporting the growth of companies that generate social or environmental benefits, 71% of survey respondents have either already established ESG policies or are planning to include ESG investment criteria in their mandates within the next five years (Fig. 10).

THE HOME OF ALTERNATIVES

info@preqin.com
www.preqin.com