

Dialogue with Institutional Investors in Europe and the United States

Summary

In mid-March 2026, I had the opportunity to discuss the Japanese stock market, engagement funds, the state of quantitative investing, and challenges facing pension funds with 30 institutional investors from Europe and the United States.

The prevailing view was that the Japanese stock market has not yet lost its relative appeal from a global perspective; the market as a whole remains highly investable, and there is still significant room to generate excess returns.

Engagement funds (EFs) are showing signs of underperformance. For funds invested in global equities, many appear to be struggling to meet performance targets amid high benchmark returns and a deteriorating sustainability environment. In contrast, EFs focused on European equities are benefiting from governance characteristics distinct from those in the U.S., such as strong strategic decision-making functions within boards of directors, and constructive activism is proving effective in generating high excess returns.

Some have pointed out that alpha (α) engagement, practiced by EFs, and beta (β) engagement, practiced by passive funds, differ significantly in their activities due to their distinct investment objectives, and should therefore be discussed separately. Given that the Asset Owner Principles (AOP) have been introduced in Japan and interest in stewardship responsibilities is growing, this is a key point to keep in mind when evaluating engagement with companies.

Quantitative investing is more widely used in the U.S. than in Japan and appears to have established itself as an investment strategy capable of meeting the needs of a diverse range of investors, including high-net-worth individuals. AI, drawing on over a decade of experience processing unstructured data, is also being leveraged to improve the accuracy of existing quantitative models. We have reached a point where quantitative investing without AI is virtually unimaginable.

In Western pension funds, where pension benefit levels are often linked to the Consumer Price Index (CPI), rising inflation is driving up target nominal returns, increasing the likelihood that these targets cannot be met with the same level of risk as before. While the inclusion of alternative assets is considered effective, it is not a panacea, and many challenges remain in portfolio construction.

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1. Overview of Institutional Investors in Europe and the U.S.

From March 11 to 19, 2026, I visited London, Amsterdam, New York, and Boston, where I engaged in discussions with 30 institutional investors. As shown in Figure 1, these 30 institutional investors included a diverse range of entities such as asset owners (e.g., pension funds), asset management firms, and hedge funds, and the responsibilities of the individuals interviewed spanned a wide spectrum. However, they all shared a common interest in the Japanese market. While the topics discussed were varied, this article will focus on themes likely to be of particular interest to readers.

Figure 1. Types of Institutional Investors/Responsibilities

Types of Institutional Investors/Responsibilities	No. of Firm
Global equity fund/Portfolio manager, Asset allocator	12
Global equity fund/ESG research	1
Global equity fund/Japanese equity portfolio manager	1
Macro Hedge fund/Japanese equity portfolio manager	2
Macro Hedge fund/Asset allocator, Economist	6
Engagement fund (Activist)/CIO	4
Pension fund/CIO, Portfolio manager	2
Family office/Analyst	1
Quantitative manager/Head of investment	1

2. Discussions on the Japanese Stock Market

One of the objectives of this visit to institutional investors in Europe and the U.S. was to exchange views on the Japanese stock market. Many global equity portfolio managers (PMs) still hold Japanese stocks at a weighting below their benchmarks, and, due to the recent surge in Japanese stock prices, many are underperforming their benchmarks in relative terms. Consequently, interest in the Japanese stock market is high. I explained to them that there are still significant opportunities for excess returns in small- and mid-cap stocks, and that even among large-cap stocks, there are companies whose businesses are performing exceptionally well but whose capital policies still have significant room for improvement, presenting numerous investment opportunities. The following are the main points of discussion with institutional investors.

(1) The Relative Advantages of the Japanese Stock Market

For global equity portfolio managers, the primary focus is on trends in the Japanese stock market. While there are numerous uncertainties, such as rising geopolitical risks,

negative impacts on inflation, and the effects of the Takaichi administration's "responsible expansionary fiscal policy" on the bond market, and the outlook remains unclear, what I sensed during our discussions was that the Japanese stock market remains attractive relative to other countries. Many of the global equity portfolio managers I spoke with pointed out various relative advantages, such as the fact that no other country has public institutions as proactive as Japan's in promoting management reform among Japanese companies ⁽¹⁾, that developed nations like the U.S. are supporting industrial policies, such as those for semiconductors, while taking geopolitical risks into account (Japan's historical advantage compared to other eras), and that within Asia, with the exception of South Korea, there is no country with a higher investment appeal than Japan.

(2) To What Extent Do Opportunities for Excess Returns Exist?

Opinions varied as to whether there are still opportunities to generate excess returns relative to the benchmark. Management reforms at Japanese companies have progressed significantly, and more than a few voices expressed concern about how much further they can develop. One view is that "management reforms have reached the 7th or 8th stage, and there may be little room for further improvement." There are also pessimistic views suggesting that the substance of management reforms will become more difficult going forward, making it harder to achieve the high excess returns seen in the past.

It is a fact that there have been engagement funds (hereinafter referred to as EFs) that have achieved high excess returns by focusing on small- and mid-cap stocks, identifying the large amounts of cash and idle real estate on their balance sheets, and demanding so-called "straightforward management reforms that anyone can understand," such as share buybacks and dividend increases from their investee companies. When Japanese companies implemented measures in line with these demands, investor sentiment shifted, valuations rose, and stock prices increased. Some funds that have grown in size have shifted their focus to large-cap stocks and are now pressing portfolio companies to undertake more challenging management reforms,

(1) Examples include the Tokyo Stock Exchange's publication of "Action to Implement Management That Is Conscious of Cost of Capital and Stock Price" and "Disclosure and Improvement of Constructive Dialogue Between Shareholders and Management" (end of March 2023); the Ministry of Economy, Trade and Industry's announcement of the "Guidelines for Corporate Takeovers: Enhancing Corporate Value and Securing Shareholders' Interests" (end of August 2023); and the Financial Services Agency's revision of the Corporate Governance Code (scheduled for June 2026).

such as overhauling business operations or executing M&A to boost profitability. However, the likelihood of success remains uncertain.

On the other hand, some argue that significant investment opportunities still exist in the Japanese stock market. The view is that many small- and mid-cap companies still have considerable room for improvement in their capital policies, and that urging these investee companies to make improvements is likely to enhance corporate value and increase valuations.

Even among large-cap stocks, numerous companies face significant challenges in their capital policies. While this may be a somewhat unique example, several portfolio managers noted that Keyence—an exceptionally strong company with an operating profit margin exceeding 50%—holds over 3 trillion yen in excess capital on its balance sheet, suggesting substantial room for improvement in its capital policy. There were also concerns that, since the founder still effectively holds nearly 20% of the shares, shareholder voices may not be adequately reflected in capital policy decisions. It was noted that the contrast between the company’s excellent business model and its problematic capital policy is striking. Some pointed out that if changes were made to the capital policy, it could become a symbolic example of transformation for large corporations, and expectations are rising that significant improvements in capital efficiency could be achieved.

The management challenges faced by large-cap companies are remarkably diverse—encompassing business strategy, governance, capital policy, operational strategy, and more—and present difficulties distinct from simply implementing shareholder returns. However, many companies have room for improvement in management, and numerous specific companies were mentioned during our discussions. Given the current surge in interest in Japanese companies, I believe there is significant potential to accelerate management reform in Japanese firms by leveraging the influence of overseas institutional investors.

(3) High Interest in Japanese Companies and the Search for Investment Opportunities

Interest in Japanese companies remains high, and there are various perspectives on their analysis. For example, the Corporate Governance Code (hereinafter referred to as CGC) is scheduled to be revised by June 2026, and it is expected to include the following wording: “Companies should continuously verify whether they are effectively utilizing management resources, such as financial assets (cash and deposits) and

tangible assets, for growth investments and other purposes.⁽²⁾” However, there are diverse views on the impact this will have on the profitability of Japanese companies.

According to one portfolio manager, partly due to the Japanese government’s stance, many Japanese companies appear intent on first redirecting excess cash toward investment. While companies prioritize investment, it remains to be seen whether they can identify investment opportunities that yield returns exceeding their cost of capital. If companies lack the ability to identify investment opportunities on their own, it could actually lead to a decline in their capital efficiency. The point here is that rather than taking the simplistic view that “Japanese stocks are a buy because the CGC revision will lead to increased shareholder returns like share buybacks,” a more nuanced and strategic perspective should be adopted. Companies that can execute appropriate capital allocation on their own should be identified, as this will lead to differentiation. Many Japanese companies have large balance sheets, and some portfolio managers believe that, in line with the CGC revision, the focus will shift not only to cash but also to how companies utilize their real estate holdings. They suggest that transformation in this area still holds significant potential and room for improvement.

There is also a strong interest in investing in growth sectors. The view is that selecting growth sectors is crucial given the current highly uncertain macroeconomic environment. As one example, a portfolio manager pointed out the potential of the integrated chemicals sector. Not only is there potential for corporate restructuring, but every company in the sector has excellent products. Companies that own semiconductor materials, components, or materials used in growth products, such as those in the agricultural chemicals sector, are highly competitive, yet many are trading at undervalued levels, and it appears there are also many companies with excess assets.

Other sectors experiencing industry consolidation due to excess assets also appear to offer investment appeal, particularly for driving corporate transformation. For example, in the logistics sector, many companies have excess assets, and significant consolidation is already underway. However, the number of companies in the logistics sector remains high, leaving ample room for further consolidation. Looking at fundamentals, many companies have not made significant progress in passing on price increases, and cost reductions are also lagging in many cases. This is one of the

(2) This is not part of the main text of the CGC but is scheduled to be included in the interpretation guidelines. The interpretation guidelines are intended to provide best practices and are not considered subject to the comply or explain requirement.

industries where digital transformation (DX) has not advanced much, leaving significant room for improvement and making it highly attractive for investment. Furthermore, once regulations from the CGC and the Tokyo Stock Exchange are codified, listed companies will feel a heightened sense of responsibility to comply and follow through, making them more open to persuasion. While these are just a few examples, they demonstrate the wide variety of investment opportunities.

3. Status of Engagement Funds (EFs)

I visited only four EFs during this trip, but their investment targets varied widely, ranging from funds focused exclusively on Japanese stocks to those investing in global and European equities. As the investment targets differ, so do their respective situations.

(1) Global Equity EFs Are Struggling

Global equity EFs have recently been facing difficulties. The fund I visited is an EF focused on corporate sustainability, but I heard that this fund, as well as many ESG-focused EFs, has underperformed its benchmarks, particularly since 2023. There are several reasons for this.

First, there is the nature of the target benchmarks. While returns in the energy and defense sectors have been strong recently, ESG-focused funds typically do not invest in these sectors. The emphasis on sustainability itself has also become a factor in dragging performance down relative to benchmarks. Since 2023, returns have been particularly strong for the companies collectively known as the Magnificent Seven⁽³⁾, but investing in most of these companies is difficult from a sustainability standpoint. In recent years, the concentration of holdings within the benchmark has reached an all-time high, and the environment surrounding the benchmarks against which funds must compete has changed significantly. Rising interest rates also appear to be a factor in the decline in returns. Generally, rising interest rates make it difficult to forecast future cash flows, and there is a tendency for capital to be diverted away from high-quality companies with long-term compound growth potential ⁽⁴⁾.

(3) A collective term for Alphabet, Amazon, Apple, Microsoft, Meta, NVIDIA, and Tesla.

(4) When evaluating corporate value from a long-term perspective, cash flows are projected over an ultra-long term and discounted to present value using an interest rate-based discount rate. Consequently, rising interest rates amplify the depreciation and volatility of long-term cash flows, increasing the uncertainty of estimates and making it more difficult for customers to invest. Furthermore, while high-quality companies were not actually struggling in terms of performance, their stock prices appeared to underperform relative to the benchmark.

Sustainability funds investing in clean technology companies face an even tougher situation. While some asset managers have sought to invest in energy companies that fall outside their original investment criteria to support the energy transition, the environment over the past few years has been extremely challenging. For example, companies like ExxonMobil and Shell, which until a few years ago were viewed as partners or targets for engagement and were expected to become more environmentally conscious, used to listen intently to the funds. However, these companies are no longer listening to our proposals, particularly with crude oil prices returning to the \$100-per-barrel range, the growing importance of the investment environment and energy security, and the ongoing review of infrastructure and electricity policies. Instead, they are moving to further strengthen their investments in fossil fuels, and their attitude toward engagement has changed significantly in recent years. Clean technology companies are clearly facing a difficult period in the U.S. While they received significant support under the Biden administration, it is now evident that many of them are facing strong headwinds. The situation has become far more challenging than before, and the results of engagement efforts over the past few years appear to be less than favorable.

It remains unclear how these aforementioned factors will affect future returns, but since these are outside their control, the fund I visited stated that it will not change its investment style of focusing on high-quality companies. As this is a fund I have personally supported for many years, I hope to see a recovery in returns.

(2) Case Study of the Activities of a European Equity EF

Some engagement funds, however, continue to perform well. One such firm is engaged in asset management, investing exclusively in European equities and operating one of the world's top five engagement funds, with assets under management of \$18 billion as of year-end 2025. While the fact that excluding U.S. equities likely contributes to its benchmark's lower absolute return level ⁽⁵⁾, it has achieved an annualized excess return of approximately 5% over the past 20 years and has maintained a similar level of excess return over the last five years.

This asset manager targets European-listed stocks with attractive fundamentals. It invests in companies whose stock prices are undervalued and have the potential to create significant value. It has developed an investment strategy that improves the fundamentals of portfolio companies through hands-on constructive activism. This refers to the practice of serving on the boards of most portfolio companies and

(5) The benchmark's return over the 19-year period through 2025 was approximately 7% per annum.

implementing corporate reforms as insiders. The effectiveness of this approach appears to stem from differences in corporate governance characteristics across countries. Specifically, compared to the U.S., many countries have boards of directors that are more deeply committed to formulating management strategies. As a result, this fund, as a major shareholder, can lead management reforms.

Through these activities, the fund claims it can create companies with competitive advantages and strong profitability, and thus higher corporate value. By investing in companies with clear structural advantages and high barriers to entry, it has achieved high returns, in contrast to many so-called constructive activism funds in Japan that are struggling with their investment performance ⁽⁶⁾.

There are other reasons for this fund's strong returns. Thanks to 20 years of engagement experience and the high quality of its proposals, the fund has built trusting relationships with its portfolio companies, and engagement activities proceed smoothly. However, it is particularly noteworthy that the fund excels at risk management to avoid permanent capital losses. The focus of risk management is not on minimizing short-term stock price fluctuations, but on protecting against downside risk to avoid permanent capital loss. For example, to identify business risks that could undermine a company's long-term intrinsic value, the fund conducts thorough fundamental research and due diligence (DD). This process is achieved by maintaining at least two investment professionals per company. To avoid permanent capital loss, measures are implemented such as: (1) avoiding companies and industries whose value is mainly driven by uncontrollable external factors (e.g., direct commodity producers, biotechnology); (2) seeking attractive entry points (investing in companies that are undervalued on a "current-state basis"); (3) engaging in activist activities (the ability to urge underperforming companies to accelerate the execution of value creation plans); and (4) maintaining a stable capital base as an investment manager (allowing for the selection of optimal timing for divesting portfolio companies and avoiding forced sales during market turmoil). By implementing these measures, this investment strategy maintains an extremely high success rate and achieves positive realized returns in nearly all investment cases. The sophistication of its portfolio construction and management methods, including

(6) It is reported that over 90% of this fund's client contracts include a lock-up period of three years or more. The fact that the fund possesses the characteristics of long-term capital is thought to compensate for the operational drawback of the fund, whereby directors serving as insiders are unable to trade shares of portfolio companies for an extended period.

risk management, is particularly striking.

(3) Exercise of Voting Rights by Fund

Although this is an example of a general long-only asset manager rather than an EF, one such firm recently switched from a company-wide unified approach to voting to a system where voting is conducted on a fund-by-fund basis ⁽⁷⁾. Under this system, a department specializing in corporate governance provides advice to portfolio managers (PMs) on the exercise of voting rights, but the actual voting is carried out by each fund's PM. This shift occurred a few years ago, and prior to that, the firm had exercised its voting rights uniformly under a single set of standards. However, the firm decided to make the change because it believed that tailoring voting criteria to each fund's specific investment objectives would better serve client interests. While the practical processes involved in having numerous funds exercise voting rights independently are not clear to me, the fact that investment decisions serving client interests are also required in Japan makes this a useful case study.

In Europe and the U.S., where many listed companies adopt a monitoring board (a board of directors with a clear separation of oversight and execution), some major asset management firms choose not to adopt strict voting criteria opposing the appointment of directors. Instead, they oppose only those directors (primarily outside directors who also serve on nomination or compensation committees) who appoint top management, such as CEOs, that fail to make appropriate management decisions, thereby damaging corporate value. In Japan, many listed companies still have an independent director ratio below 50% ⁽⁸⁾, and the managing board (a board of directors where oversight and execution are not clearly separated) remains mainstream. It is believed that the trend is toward tightening voting criteria and opposing the appointment of representative directors who do not meet them. If monitoring boards become mainstream in Japan as well, allowing for a clear separation of supervisory and executive functions, wouldn't this asset manager's approach to voting, which focuses on independent directors responsible for appointing and evaluating top management, be an interesting one?

(4) α -Engagement and β -Engagement

Given the current mix of engagement activities, some have suggested that clearly distinguishing them by objective is important for helping asset owners and other

(7) We have not verified whether this is a general trend among asset management firms in Europe and the U.S.

(8) As of July 2025, approximately 26% of companies listed on the Tokyo Stock Exchange Prime Market had boards where more than half of their members were independent outside directors.

clients understand a fund's engagement activities. I categorize these as α -Engagement and β -Engagement. α -Engagement refers to activities directly aligned with the corporate values of investee companies. It is characterized by assessing which strategies, such as M&A, business, or capital allocation policies, enhance corporate value given each company's specific circumstances, and then discussing them with management. This activity is typically undertaken by equity funds (EFs) that concentrate their investments on approximately 10 stocks.

On the other hand, β -Engagement refers to activities that, while not necessarily directly linked to corporate value, aim to improve overall market management quality by mitigating risk factors through ESG improvements, such as enhancing internal controls, including increasing the proportion of independent directors. This type of engagement is applicable to all companies and is typically carried out by passive managers.

These two activities are not mutually exclusive. Since the investment objectives of the funds driving each activity differ, it is only natural that activities should be conducted in accordance with those objectives. It is believed that α -Engagement and β -Engagement are two sides of the same coin, thereby enhancing management discipline among investee companies. The existence of engagement activities tailored to specific investment objectives strengthens the ability to scrutinize corporate management from multiple angles.

One EF distinguishes its activities from β -Engagement by calling them "value activism." This implies that the proposals are clearly explained as financially sound and linked to enhancing corporate value. The view is that a key differentiator for an EF is its ability to clearly demonstrate the connection between its proposals and corporate valuation, cash flow, and engagement themes, and to explain to management why these are beneficial.

In Japan, the Asset Owner Principles (AOP) have been established, requiring the fulfillment of stewardship responsibilities. This necessitates more rigorous monitoring than ever before of the engagement activities that asset managers conduct with investee companies acting on behalf of asset owners. It is essential to properly evaluate asset managers' engagement activities while keeping the distinctions outlined here in mind.

4. The Current State of Quantitative Investing

I also conducted interviews with executives at one of the world's leading quantitative investment firms and confirmed that significant business opportunities

exist there that differ from those in Japan. The firm I visited is one of the largest players in quantitative investing, and I spoke with the head of the department specializing in equity investment. We discussed the vast potential of quantitative investing itself and the cutting-edge applications of artificial intelligence (AI).

(1) Strong Investment Performance

While quantitative investing does not appear to be a mainstream investment strategy in Japan, the situation is quite different in the U.S.. This asset management firm has consistently delivered strong performance. Although it manages more than 10 investment strategies, including global equities and international equities (excluding the U.S.), every single strategy has consistently delivered strong results. Regardless of the time period, many of these strategies have outperformed their benchmarks, and more than half rank in the top quartile compared to competitors.

The best-performing strategy targets U.S. investors, using the MSCI EAFE Index (excluding the U.S.) as its benchmark, and has generated an annualized excess return of over 3% over the past five years. While the excess return is positive when the benchmark is the MSCI ACWI Index (including the U.S.), it is reportedly lower than that of the EAFE Index. This illustrates the difficulty of generating alpha in U.S. stocks.

A distinctive feature of this asset management firm is that it does not apply any tilt ⁽⁹⁾ to commonly known factors, such as value or growth, but instead applies a tilt exclusively to proprietary factors developed in-house. On the stock market, various factors can serve as sources of excess returns and can also become sources of risk. For example, in the U.S. market, the "meme stock phenomenon" frequently occurs. This is where stocks that become the topic of discussion on social media or online forums experience sharp price surges. While these phenomena may seem irrelevant to institutional investors, ignoring them as risk factors in the stock market poses risks to portfolio management. Specifically, portfolios are constructed to maintain a neutral position toward such factors that cannot be confidently predicted. This is just one example, but the stock market is subject to multiple sudden risk factors. Therefore, it was noted that asset management firms possessing risk management capabilities—using the latest technology to respond to unforeseen risks—will have an increasingly greater opportunity to demonstrate their strengths.

(9) Tilt is a term used in quantitative investing that refers to constructing a portfolio with a weighting toward a specific factor. When the return on that factor is high, it is possible to achieve excess returns relative to the benchmark.

(2) Flexibility in Customization

The previously-mentioned high level of risk management capability also enables the customization of various factors to create factor tilts tailored to client needs. For example, ESG factors can significantly impact portfolio returns, for better or worse. While ESG considerations are generally unpopular in the U.S., they remain extremely attractive among institutional investors in Europe and the Middle East, as well as among some Japanese institutional investors. Consequently, the firm can meet customization needs, such as constructing portfolios that emphasize ESG factors to align with institutional investors' preferences. Such customization needs are well established and appear to be a key factor in this asset management firm's significant growth in assets under management.

This type of customization to meet investor needs is also known as "direct indexing." Tax-exempt indices are in particularly high demand in the U.S. and are extremely popular among high-net-worth individuals. Strategies aimed at maximizing after-tax returns to achieve tax savings have long been a major category and a core strength of quantitative investing, and they appear to be regaining popularity of late. This is likely because tax savings have a far greater impact on after-tax returns than outperforming a benchmark by a few percentage points.

(3) Utilization of AI

The use of AI is essential to quantitative investing. This asset management firm has been utilizing alternative data ⁽¹⁰⁾ for over a decade, and with the addition of AI, its investment strategies appear to have become even more sophisticated. There are primarily two ways AI is utilized. The first is to improve existing investment strategies. The second is to dramatically improve operational efficiency through program coding.

The first application is an extension of what should inherently be done in quantitative investing. One example of its application is in securities analyst reports. Securities analysts write reports after careful consideration, providing ratings (such as sell, buy, or neutral) and earnings forecasts. In other words, they must arrive at a conclusion, but computer analysis is being used to evaluate these reports, capturing even subtle and underlying nuances. Initially, the process began at a basic level, such

(10) In contrast to traditionally-used data such as financial information and economic statistics (traditional data), data that has not been widely utilized until now is referred to as alternative data. Various types of data exist, including POS data, credit card data, location data, and satellite imagery data; how effectively these are incorporated into investment strategies reflects each asset manager's expertise.

as determining the ratio of positive to negative words. However, it has now advanced to a stage where large language models (LLMs) specifically fine-tuned to analyze analyst reports are used to read each report, interpret its conclusions, and assess how favorable the report's investment recommendation is for the company being analyzed. Furthermore, the validity of such usage can be objectively assessed. By comparing the accuracy of old and new technology models, it becomes possible to quantify improvements. Even if the improvement is only 10%, it appears to translate into a significant difference in actual operations.

They are also evaluating text that is not directly related to investing. For example, there is a service called Expert Call which is a one-on-one interview service that connects experts in specific industries or specialized fields with customers seeking to solve business challenges, whose Q&A database they are considering using. Meeting minutes come in various formats, and the content discussed is varied, making cross-comparison difficult. However, they are exploring whether AI can be used to convert this into signals useful for investment strategies. This first application uses LLMs in various ways to improve the accuracy of quantitative models.

The second application involves programming (coding), which is said to enable dramatic efficiency gains. Quantitative management involves significant programming; for example, when migrating from an old system to a new one, having AI translate legacy code into the new language enables the foundational code to be created quickly, resulting in vastly improved conversion efficiency.

However, there are many caveats to using AI. This is because, in quantitative investing, simply increasing the number of factors or tests is not a viable solution. Inexperienced quantitative investors tend to test many factors with low confidence levels and end up selecting only those that yield good results. Caution is needed regarding this overuse of AI, which can lead to data mining. On the other hand, a major advantage of using AI is that it reduces the time spent on trial-and-error. While AI has various pitfalls and can sometimes be misleading, using it appropriately can significantly improve the scope and quality of quantitative management.

5. The Difficulty of Maintaining Real Returns

Although I visited only two pension funds (defined benefit) this time, I heard that maintaining target returns is becoming increasingly difficult due to the recent rise in inflation. I would like to briefly address that.

One of the pension funds I visited is for employees of an international organization. For over 30 years, the fund has maintained a target return of 3.5% in real terms (CPI + 3.5%). Recently, inflation has been rising, and as a result, the nominal target return is also increasing. Consequently, they say it is becoming difficult to maintain the target return with their current asset allocation. The current policy asset allocation is 60% equities (global) and 40% bonds (global). Over the period 2011-2025, the fund achieved a real return of 4.7%, exceeding the target by 1.2%.

However, with the next ALM analysis approaching in 2027, it remains unclear whether this target can be maintained. In fact, when conducting ALM analyses, the pension fund calculates the probability of achieving the target return over the next 10 years. As of 2019, this probability stood at 60%, and by 2023—the time of the previous ALM analysis—it had fallen to 49%. Although the Investment Committee approved the plan, the approval was based on a very slim probability. The current CPI level exceeds 3%, and the next nominal target return is expected to significantly exceed 6%, possibly reaching 7%. To increase the probability of achieving the target, the equity allocation would need to be raised. However, doing so would also increase the fund's downside risk, making such a change far from straightforward.

When we inquired with asset managers and pension consultants about the projected future returns of major asset classes, it became clear that the risk-return ratio of so-called real assets ⁽¹¹⁾ which carry liquidity risk is quite favorable, and it is obvious that the conclusion will be that the allocation to real assets should be increased. Anticipating this, our fund established a department specializing in real asset investments several years ago and has been working on talent development and actual investments. However, managing real assets presents challenges distinct from those of traditional assets, making it difficult to increase their allocation. For example, the methods for calculating returns and decomposing factors differ for real assets, and even the CIO reportedly cannot accurately determine whether the team's explanations are correct when issues arise with the investments.

Furthermore, looking at investment performance over the past five years, returns on listed equities have outperformed those of real assets, casting doubt on whether taking on liquidity risk actually offers any advantage for long-term investors.

This pension fund currently has assets exceeding 108 billion US dollars, and while its investment team is considered relatively well-staffed compared to standard

(11) A collective term for so-called illiquid assets, such as infrastructure, real estate, private equity, and private debt.

Japanese pension funds, it still faces the same challenges as its Japanese equivalents.

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