

Current Status and Challenges of Japanese Pension Fund Investments in a Positive-Interest-Rate Environment

Summary

The recent rise in interest rates in Japan has significantly affected the investment strategies of Japanese defined-benefit (DB) corporate pension funds. As short-term interest rates have risen, expected portfolio returns have increased, forcing corporate pension funds to consider various responses, such as raising their target rates of return or reducing portfolio risk.

Furthermore, rising interest rates have increased the relative attractiveness of domestic bonds, and pension funds will likely need to decide whether to reallocate assets—previously invested in foreign bonds with currency hedging—to domestic bonds.

Given recent comments by politicians regarding the GPIF's asset allocation ratios, overseas institutional investors are closely watching its investment trends. In the short term, two scenarios for changes to asset allocation are conceivable: tactical adjustments within the permitted deviation range, or changes made during the annual review of the core portfolio. It is unclear which course of action will be taken, or whether the current investment process will be maintained.

Market participants are closely watching the GPIF's rebalancing activities. In particular, rebalancing related to Japanese equities tends to have a greater impact on the market and is more likely to be amplified, partly because liquidity in this sector is relatively low compared to the other three asset classes. According to market participants, as of mid-September 2026, the GPIF's rebalancing behavior has not changed significantly.

For Japanese pension funds, the extent to which interest rates will rise in the future is the most critical factor in investment planning. While rising interest rates can benefit pension finances, depending on future interest rate levels, they could also significantly hurt the Japanese stock market. Although these are long-term investments, it is necessary to carefully assess the current and future investment environment while considering investment strategies and pension system design.

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1. Introduction

Between August and September 2026, I interviewed approximately 20 domestic defined-benefit (DB) corporate pension funds and more than 10 overseas institutional investors (in Singapore and Hong Kong) to exchange views on the current challenges facing asset management by Japanese pension funds. In Japan, the Bank of Japan's (hereinafter referred to as the "BOJ") policy interest rate, which had been at or below 0% since April 2013, has recently risen to 1.25%. Although U.S. interest rate conditions influence this, many institutional investors expect rates to continue rising. The global trend of rising interest rates is significantly affecting asset management not only in Japan but also among institutional investors worldwide.

Simply put, rising interest rates are increasing institutional investors' expected returns and, by extension, the returns they demand. This is not limited to institutional investors, as the same applies to corporations. Rising borrowing costs increase the cost of capital, meaning that higher rates of return are now required to enhance corporate value. From a global perspective, funding demand among AI companies remains robust, and interest rates are unlikely to fall anytime soon. Consequently, the most critical investment challenge over the next few years will be how to construct portfolios in a world where interest rates are expected to rise further.

In this paper, based on discussions with these experts, I share my personal views—first on defined-benefit (DB) corporate pension funds and then on the GPIF—on how Japanese pension funds should manage their assets in the current investment environment.

2. The Greatest Investment Challenge Facing Japanese Defined-Benefit (DB)

Corporate Pension Funds: Responding to Rising Expected Returns

With the Bank of Japan's policy interest rate above 1% and further increases expected, the greatest investment challenge facing Japanese corporate pension funds is how to respond to rising expected returns. While there are various methods for estimating future expected returns, many corporate pension funds adopt the "building-block method," which involves adding the historical average risk premium (the excess return over the short-term interest rate) to the current short-term interest rate. Future actual returns are uncertain. However, given that short-term interest rates are rising, it is natural to assume that the expected returns of major asset classes, such as stocks and bonds, comprising the portfolio are rising, even if

the risk premium remains unchanged.

In other words, even if the portfolio composition remains the same as in the past, the expected return on that portfolio will increase. A pension consulting firm has estimated the extent to which expected returns on pension portfolios have increased, and reports that they have risen by as much as 1.3% between the end of 2022 and the end of 2025 ⁽¹⁾. So, how might corporate pension funds respond? There are three main possible approaches.

(1) If the Target Rate of Return is Not Changed: Reduce Portfolio Risk

The first option is to reduce portfolio risk. Japanese defined-benefit (DB) corporate pension funds set a projected interest rate used to calculate pension liabilities, and many corporate pension funds determine the target rate of return for their pension assets in line with this projected interest rate. If the target rate of return does not change, the projected rate will likely remain unchanged.

If neither the assumed interest rate nor the target rate of return is changed, reducing portfolio risk would be one possible response, given that the portfolio's expected return has risen by 1% or more. In fact, among U.S. corporate pension funds that count overseas institutional investors as clients, some appear to have reduced their equity allocation and increased their allocation to U.S. bonds in response to rising interest rates. Against the backdrop of the high funding ratio that I will discuss, it is also possible that the option of maintaining the high funding ratio at its current level will be considered. That would be achieved by focusing pension investments on long-duration bonds that match pension liabilities in response to rising interest rates.

Among the corporate pension funds I visited, none had decided to reduce their equity allocation. However, an increasing number are expected to reevaluate their pension portfolio's target rate of return and appropriate risk level at their next pension financial recalculation ⁽²⁾. At that time, they will likely adjust their policy asset allocation ratios. The average equity allocation ratio for Japanese corporate pension funds is already low, at around 20 percent. Equities play a crucial role in driving long-term growth for pension assets, and while some corporate pension funds are hesitant to lower this ratio, short-term interest rates are now at levels unlike those seen in the past, making the reevaluation of asset allocation ratios an unavoidable investment challenge.

(1) Based on estimates by Russell Investments.

(2) These are typically conducted once every three to five years.

(2) Raising the Target Rate of Return

Since expected returns on pension portfolios are rising, increasing the target rate of return is another option. In such a scenario, it would be a natural response to raise the assumed interest rate accordingly. In an environment of rising interest rates, inflation rates may also increase. It is easy to imagine that companies will raise their employees' pension benefits in line with inflation.

However, raising the target rate of return may also increase the volatility of pension assets. There are still many pension funds that collect special contributions and other payments from their sponsoring companies in addition to regular pension contributions. Many of these funds are cautious about increasing the investment risk of their pension assets to avoid having to ask their sponsoring companies for additional contributions again in the event of a decline in investment returns.

Some argue that other issues should be addressed before raising the target rate of return. A rise in interest rates reduces the amount of future pension liabilities by increasing the discount rate used to calculate them, which in turn improves the funding ratio, which is the ratio of pension assets to pension liabilities. Many pension funds have managed to achieve returns exceeding their target rates even during the prolonged zero-interest-rate environment, and the majority of pension funds now maintain a high funding ratio—the ratio of actual pension assets to the target amount. This funding ratio is likely to rise further as interest rates increase.

In short, an extremely high funding ratio raises the possibility of discussions that could lead to a fundamental review of the pension system design itself, such as (1) considering measures mandated by law, such as lowering or suspending contributions, (2) using surplus funds to transition from a defined benefit (DB) pension plan to an alternative plan design, such as a risk-sharing plan⁽³⁾, or (3) prioritizing improvements to benefit rates.

None of the corporate pension funds I visited planned to raise their target rates of return, which may be partly because the time has come to address design issues beyond investment. For many corporate pension funds, more pressing issues likely need to be addressed before raising their target rates of return.

(3) Make No Changes

(3) A pension plan with a basic benefit structure similar to that of a defined benefit (DB) plan, but in which not only the company but also participants and beneficiaries adjust benefits in the event of financial deterioration due to factors such as poor future investment performance.

The third option is to make no changes. Among the corporate pension funds I visited, one has lowered its target rate of return to 4.5% but had maintained a rate of 6% until the COVID-19 pandemic. This fund has achieved high actual returns of over 5% over the long term, outperforming its target rate of return. For this fund, past actual returns serve as the benchmark for determining the target rate, and there is virtually no correlation between interest rate levels and the target rate of return or the assumed interest rate.

Another corporate pension fund has reportedly kept its target rate of return at 3% for over 20 years and has never once changed the expected return level set 20 years ago. At that time, short-term interest rates were positive and not significantly different from current levels. Having successfully weathered both the Lehman Shock and the COVID-19 pandemic with the same policy asset allocation, the fund believes there is no need to change its investment policy, even amid recent interest rate hikes, given that pension assets are managed as long-term investments.

While corporate pension funds like this one may seem like an exception, the key point when planning future investments amid major environmental changes—such as rising interest rates—is that the approach varies with each fund's specific circumstances. For corporate pension funds that have set baseline figures, such as projected interest rates or target rates of return, in the 1% range or around 2%, which may seem low compared to current interest rate levels, there is likely significant merit in adjusting pension asset management in response to major changes in interest rates. However, for corporate pension funds that, as in the previous example, have set relatively high target returns and consistently achieved them over the long term, this may imply little need to be overly swayed by changes in the current investment environment.

3. Should Japanese Corporate Pension Funds Return to Domestic Bonds?

Another key issue for Japanese defined-benefit (DB) corporate pension funds is how to determine their allocation to domestic bonds. Due to Japan's prolonged zero-interest-rate policy, many corporate pension funds have made virtually no investments in pure domestic bonds, instead investing in general accounts or foreign bonds with currency hedging as substitutes for domestic bonds. However, rising U.S. interest rates have increased currency-hedging costs, and returns on currency-hedged foreign bonds have been worse than those on domestic bonds, dragging down overall returns.

As Japan's period of rising interest rates continues, many corporate pension funds

are looking to increase their allocation to domestic bonds as an asset class capable of generating stable income in the future. In response to this environment, asset managers are proposing investment strategies based on flexible investment policies. During periods when interest rates are still expected to rise, they construct bond portfolios with short durations to protect against downside risk to a certain extent; once the upper limit of interest rate increases can be anticipated with a certain degree of probability, they shift the portfolio toward long-term bonds. They also appear to be actively marketing investment strategies to corporate pension funds that incorporate bonds offering higher yields than government bonds, such as corporate and hybrid bonds.

While it is difficult to predict exactly where domestic interest rates will peak, it is only natural that the role of domestic bonds will differ significantly from that under a zero-interest-rate environment, given that long-term interest rates are approaching the target rates of pension funds' portfolios. Rather than viewing this as a narrow issue of adjusting the allocation ratio between domestic bonds and general account/currency-hedged foreign bonds, it will be essential to reexamine the classification of stable assets and yield-seeking assets from the ground up to achieve target rates of return. Based on future interest rate conditions and changes in the stock market environment, it will be necessary to reconsider how to combine these assets and which asset class should form the core of the stable asset portfolio.

4. Discussions Regarding the GPIF's Asset Allocation Ratios

In interviews with overseas institutional investors, there was strong interest in the Government Pension Investment Fund (hereinafter referred to as "GPIF")'s review of its domestic bond allocation ratio, and I also shared my personal views with the institutional investors. Interest was likely high because officials from the Japanese government had commented on the GPIF's asset allocation, and because the GPIF's Board of Governors, which had not convened in August since 2019, held a meeting where "Discussions within the Task Force on Policy Portfolio Review, etc." was on the agenda. When considering the GPIF's asset allocation, three scenarios can be envisaged, as I will now outline. While these are not particularly novel ideas, I would like to explain them briefly.

First, within the policy asset allocation ratio's permissible deviation range, the GPIF executive office may dynamically adjust the allocation ratios across the four asset classes based on short-term outlooks. Second, there is the possibility that the policy asset allocation ratio will be revised as part of the annual review of the policy

portfolio. Third, there is the possibility that the GPIF's Board of Governors will adjust the policy portfolio at the end of March 2030 in response to the economic scenarios and target rates of return projected in the pension fiscal review to be conducted in 2029. Since the third possibility is three and a half years away, overseas institutional investors have shown little interest and are currently focusing their discussions on the first and second possibilities.

(1) Two Possible Scenarios in the Short Term

The first possibility is that the GPIF executive office will determine the asset allocation ratios based on future market outlooks, within the prescribed tolerance range. For the three asset classes excluding foreign bonds—namely, domestic bonds, domestic stocks, and foreign stocks—the executive office has the discretion to set asset allocation ratios within a range of $25\% \pm 6\%$.

The Investment Committee makes key decisions on behalf of the executive office. Decision-making authority rests with three members: the President, the CIO (Committee Chair), and the Director in charge of General Affairs and Planning. The regulations stipulate that “decisions of the Investment Committee may be made by a majority vote of the Chair and members present.” Even under current law, the executive office can use the allowable deviation range to adjust actual asset allocation ratios to values different from the policy portfolio.

However, it is not easy to outperform the composite benchmark return by utilizing the deviation tolerance. Over the five-year period from April 2015 to March 2020, the investment strategy utilizing this deviation tolerance was unsuccessful, resulting in a drag on performance of -0.28% per annum.

The second possibility is to conduct actual verification of the GPIF's policy portfolio each fiscal year in a timely and appropriate manner, examining, for example, whether the investment environment assumed at the time of formulation has changed significantly. If the Board of Governors deems it necessary, it may consider a review even during the medium-term target period and make prompt adjustments as needed.

At the 119th Board of Governors meeting on March 9, 2026, the GPIF announced that “regarding the review of the basic portfolio for fiscal year 2025, the Task Force on Policy Portfolio Review, etc., reported that no review was necessary, and no objections were raised by the members.” However, the fact that the review of the policy portfolio was raised again as an agenda item in August, less than half a year later, is believed to be a factor contributing to the growing interest among market participants regarding this possibility.

It is true that changes to the GPIF's target return level are made only once every five years. As in the example of corporate pension funds discussed in Section 1 of Chapter 2, there is a certain logic to the idea that, if the target rate of return is not changed, the option of reducing portfolio risk—that is, lowering the equity allocation and increasing the allocation to domestic bonds—might be considered. However, the GPIF employs a decision-making process that differs from that used by corporate pension funds to determine asset allocation ratios. While reducing risk may be one option for corporate pension funds, the GPIF must consider various factors, making its decision-making process far more complex.

First, the GPIF uses one-year interest rates from the past 30 years to determine the expected short-term interest rate for a given economic scenario. Even if the most recent interest rate levels were incorporated and the calculations redone, the impact of interest rate changes on the expected short-term interest rate is considered relatively minor. Furthermore, the GPIF's actual validation process involves recalculating various variables, such as the equilibrium rate of return ⁽⁴⁾, in addition to interest rate levels, so it does not follow a simple process like that of corporate pension funds. For example, while expected returns are said to be calculated by combining returns derived from the equilibrium rate of return and the building-block method, the specific weighting ratios are not disclosed, so it is unclear to what extent changes in interest rates affect expected returns. Furthermore, since the basic portfolio consists of asset allocation ratios rounded to the nearest 5% from the optimal portfolio determined through a prescribed procedure, the exact magnitude of the difference between the optimal portfolio and the basic portfolio is unclear.

Because the GPIF's verification process involves various factors, the situation is not as straightforward as in cases where rising short-term interest rates have raised the expected return levels of corporate pension funds. It is also unclear whether the impact on asset allocation ratios will necessarily lead to an increase in bond allocation.

(2) Monitoring of GPIF's Rebalancing Activities by Institutional Investors

At this stage, we can only speculate about the first and second possibilities, and it remains unclear whether the asset allocation ratios will actually change. Meanwhile,

(4) Unlike standard portfolio optimization, which derives an optimal portfolio from a set expected return, the equilibrium rate of return is calculated by working backward to determine what expected return is implied when the market portfolio (the ratio of the market capitalizations of the four asset classes) is assumed to be the optimal portfolio.

institutional investors are closely monitoring GPIF's rebalancing activities, aimed at returning its asset allocation ratios to the levels of its policy portfolio. In particular, institutional investors appear to be closely analyzing the details of GPIF's rebalancing activities involving Japanese equities. I spoke with several portfolio managers (PMs) who have been managing long-short strategies for Japanese stocks for over 20 years, and they made the following comments:

"I presume they are conducting trades using futures contracts, but market participants keep a close eye on cross-trading between spot and futures markets. When transaction amounts are temporarily large, or activity continues for a full week, market participants can detect it. Also, after the market opens, some days a direction emerges, and some days it does not, even after a period of initial buying and selling. However, when an entity like the GPIF rebalances, it immediately sets the direction. What matters more than the amount is that the direction is set. Once the direction is set, a large volume of trades follows that trend. Even if the initial trade size is small, the volume of trades riding that trend grows, and the reaction is often greater than expected, so this becomes apparent right from the first trades. It is not a matter of scale or trading skill; rather, directional trades are increasingly amplified by the large number of participants capitalizing on them."

I had heard similar comments in the past from transition managers ⁽⁵⁾, but now that the environment has shifted to one where algorithmic trading has increased significantly, I have come to understand the difficulty of executing rebalancing activities involving massive amounts of capital. Not only are such intentional rebalancing moves easily detected, but they also tend to be amplified.

It has been more than four years since I left the GPIF, and I am not aware of the specific rebalancing activities currently being carried out. However, according to several portfolio managers of Japanese long-short equity strategies, it is inferred that the GPIF still conducts rebalancing activities frequently.

5. The Future Direction of Pension Fund Investments

Thus far, I have explained the impact of rising interest rates on Japanese pension fund investments, drawing on corporate pension fund perspectives and the views of overseas institutional investors. While rising interest rates may offer many benefits

(5) This refers to securities firms or asset management companies that assist pension funds in executing asset transfers, while minimizing transaction costs and risks, when the funds change their asset allocation or investment managers.

for defined-benefit (DB) corporate pension funds, such as higher expected returns on pension portfolios and improved funding ratios through reduced pension liabilities, they also have significant side effects.

Howard Marks, a renowned bond investor, has stated, “Higher long-term interest rates tend to (a) depress economic growth, (b) reduce the affordability of things that are usually paid for through loans (like cars and houses), (c) increase the cost of servicing the federal debt (which has recently reached an astounding \$40 trillion), and (d) suggest a loss of confidence among market participants.” Overseas institutional investors are paying particular attention to how high the Bank of Japan’s policy interest rate will rise in the future. Remarks by Japanese politicians about the GPIF’s asset allocation ratios also suggest the risk that funds intended to be managed for future pension benefits could be used to suppress rising government bond yields. This has become a source of concern about Japan’s fiscal health.

In other words, against the backdrop of fiscal concerns, views are beginning to emerge among overseas institutional investors that if the 10-year government bond yield reaches a level well above 3 percent, and if the Bank of Japan’s policy rate rises not just to 1.5 percent but to 2 percent, it could have a significant impact.

Furthermore, because more than 80 percent of individual mortgage loans are variable-rate loans, further interest rate hikes could significantly affect household consumption. If the policy interest rate exceeds 2%, it could also deal a significant blow to the earnings of small and medium-sized enterprises (SMEs), which find it difficult to pass on price increases. While large corporations may not face major problems, overseas institutional investors have expressed concerns that further interest rate hikes will squeeze SME profits and are likely to negatively affect the Japanese stock market ⁽⁶⁾. Some economists familiar with the bond market argue that the current market has already priced in a 2% policy rate and are calling for the BOJ to follow suit with policy rate hikes in Europe and the U.S. Therefore, the stock market is likely to remain sensitive to Japan’s interest rate environment going forward.

Japanese pension funds now face interest-rate conditions unlike anything they have experienced in the past 20 years. Under a pension system designed to provide a portion of the funds needed for retirement, we have entered a phase that requires prudent portfolio management and system design, based on a clear understanding of

(6) It is important to note that rising interest rates are also influenced by factors such as inflation concerns and are not determined solely by the factors mentioned here.

both the current and future investment environments. Japanese pension funds must conduct daily investment activities while keeping in mind that, although they invest long term, they have entered a phase that requires managing portfolios while closely monitoring changes in the current environment.

In writing this article, I referenced and quoted statements and opinions from investment managers at Japanese corporate pension funds and overseas institutional investors whom I interviewed between August and September 2026. Please note that the opinions and observations expressed in this paper are solely those of the author and do not represent the official stance of the Japan Securities Research Institute. Furthermore, any remaining errors or omissions are entirely my own.

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