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Continuing a Tradition of Integrity

The Investment Company Institute held its General Membership Meeting in Washington, DC, on May 14-16, 1997. The meeting, attended by more than 2,000 mutual fund executives, government officials, news media, and others, focused on the theme of "Continuing a Tradition of Integrity." A number of distinguished speakers addressed investor needs, expectations, and education, as well as the industry's role as shareholder advocate. The Institute is pleased to publish the following remarks presented at the meeting by Barry P. Barbash, Director of Investment Management at the U.S. Securities and Exchange Commission, Institute Chairman Don Powell, and Institute President Matthew P. Fink.

Mutual Funds in the New Millennium: The Opportunity to Invent Their Future

Barry P. Barbash¹

Barry P. Barbash is Director of the Division of Investment Management at the U.S. Securities and Exchange Commission, a position he has held since 1993.

Signs of the new millennium are all around us. As we approach the year 2000, businesses throughout the world are positioning themselves for the new century:

- ▶ Twentieth Century Fox has filed an application with the U.S. Patent Office to retain the right to the name "Twenty First Century Fox," although the company has yet to decide to change its name.

- ▶ The Twentieth Century Funds and their investment adviser's holding company, Twentieth Century Companies, changed their names to "American Century." The change was costly: American Century spent \$1 million notifying its account holders of the change.
- ▶ Financial services and other companies worldwide are designing ways to respond to the impending computer glitch known as "the Year 2000 Problem," which will be much more expensive to fix than first anticipated. One report has estimated the cost to U.S. companies alone at \$30 billion. More importantly, consider the anxiety cost to all of us if the problem is not fixed by midnight on December 31, 1999—computers will fail to recognize the new millennium and will insist that our credit card bills are 99 years overdue.

Now is the time to look forward and think about big picture trends, questions, and possibilities facing the mutual fund industry in the new millennium. We all should be trying to identify the issues that will confront the industry in the 21st century.

¹ The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication or statement by any of its employees. The views expressed in this speech are those of the author, and do not necessarily reflect the views of the Commission or other members of the staff of the Commission.

Considering the new millennium inevitably raises the question of the validity of predictions. Everyone seems to have heightened respect for those in society who are adept at forecasting the future. How many articles have we seen describing the predictions of Wall Street gurus? The writings of Nostradamus, a 16th century prophet credited with having predicted many modern events, have drawn renewed interest recently. Did you know that he predicted that humans will visit Mars in the year 2000, and that aliens would be televised in the late 1990s? Gene Roddenberry, the creator of “Star Trek,” beat the prediction of televised aliens by a fair margin, and who knows, by now he may have reached Mars.

When I try to imagine the future of the fund industry, I have to pause. After all, if I were making this same speech just ten years ago, would I or anyone else have predicted some of the events of the last several years? Consider the variety and complexity of instruments available today—such as \$20 trillion in notional value of derivatives outstanding, or \$1.5 trillion traded each day in world currency markets² and the resulting challenges of adequately supervising that trading. Would anyone have predicted that the venerable Barings plc would be done in by derivatives?

Could any fund industry participant ten years ago have foreseen the popularity of fund supermarkets, and the dramatic changes they have brought to traditional distribution channels?

Would any of us here today have anticipated a decade ago the challenges facing the industry and Commission now? Would we have known that one of the most compelling questions of the waning days of this century would be whether some of the fundamental precepts of the securities laws are still valid?

Probably not. Predicting the future is a difficult—and a potentially embarrassing—business, best left to the supermarket tabloids and infomercial psychics. Having said that, and knowing full well that we may all be looking back on this moment in 20 years—or maybe even just five—with a knowing smirk and the benefit of 20/20 hindsight, I would like to discuss some of the issues that I believe will confront the industry in the 21st century.

Technological Developments

Technology has revolutionized the fund industry and will continue to do so in the new millennium. Technology will create—and allow us to

resolve—numerous challenges as we enter the Brave New World of the 21st century.

- ▶ I anticipate that a new breed of mutual fund investors will appear on the scene in the next century. These investors will have access to more financial information at the click of a mouse than their parents did in a lifetime. But will they know how to use it? Will they be able to distinguish between hard data and “hype”? I’m not sure that all investors will be up to the task. It will be the responsibility of the industry, the regulators, and investors themselves to see that people do not drown in information, while becoming starved for knowledge. In short, investor education in the age of technology will not be a luxury, but an absolute necessity.
- ▶ I foresee the potential for more market volatility, as these new investors react instantaneously to each new piece of information that comes their way. The challenge for the industry and the regulators is again to provide the knowledge to enable investors to use wisely the tools of technology. Our goal will have to be convincing investors of the need for a long-term investment vision in the face of computer advances that enable investors to buy and sell shares with just a few keystrokes.
- ▶ I believe that technology can and should be used to provide investors with information in a more readily understandable manner, a key goal of the Commission’s recent fund profile and simplified prospectus initiatives. I recently suggested that funds consider personalizing their investor statements so that shareholders can see their own performance, not just that of the fund over a particular period of time.³ I’ve been told by many in the industry that this type of data would be too costly to generate and too hard for investors to

² Bloomberg Financial Services (May 13, 1997).

³ “Fund Disclosure: The Sequel,” remarks by Barry P. Barbash, Director, Division of Investment Management, Securities and Exchange Commission, before the Mutual Funds and Investment Management Conference, Palm Springs, CA (Mar. 17, 1997). See also M. Haltzik, “The ‘Personalized Returns’ Issue: Why Can’t Funds Do It?” *Los Angeles Times* (Apr. 15, 1997) pp. D4, D8.

understand. Technological advances may well afford the opportunity to address both of these concerns.

- ▶ Technological advances will, in my view, force the industry to come to grips with an issue that seems to generate countless press articles and letters to the Commission but very little consensus among industry participants—whether shareholders should be provided with more frequent updates about the securities held by their funds. To date, the issue has often been answered by pointing to costs many claim would be excessive. Technology is likely to render this response unconvincing. The debate, instead, will focus on questions such as whether investors want or need this information, and whether frequent reporting of the securities positions of funds compromises their investment strategies. The image that sticks in my mind as I consider these questions is a 20-30 page portfolio schedule of an index fund. Does that really help investors?
- ▶ Technological developments enabling the fund industry to provide more and more information to investors is likely to accelerate the growth in the number of financial consultants, financial planners, broker-dealer registered representatives, and the like whose business is to analyze information and advise investors. One challenge I can foresee is to ensure that these professionals meet basic levels of competence. To my mind, government regulation in this area should emphasize the fiduciary relationship between these advisers and their clients. Government is not well-suited to set competency standards for those who provide advice to clients. Establishing rules of conduct and determining the elements of competency are both best left to industry self-regulators or professional associations.

It's hard to recall a time when the pace of change in the markets has been so accelerated. Today's cutting edge is quickly made obsolete by tomorrow's

innovation. We will have to adjust to a future marketplace we can barely envision, with market participants we can barely identify.

Retirement Planning

Another question mark on the millennium's horizon is the effect of retirement savings on the fund industry, and on the market as a whole. A recent Cerulli Associates, Inc. report indicates that Americans today have more than \$2.9 trillion invested in pension plans. Perhaps more importantly for the fund industry, the percentage of 401(k) assets invested in mutual funds has more than quadrupled during the last ten years. Although Cerulli predicts that this dramatic growth is peaking, funds will account for 45 percent of the \$1.5 trillion 401(k) market by the year 2001.⁴

While these numbers are impressive, there is clearly more to be done by the industry and regulators. The Year 2000 Problem will seem very small indeed by the time we face the Year 2011 Problem. That's the year the first wave of baby boomers—those 76 million Americans born between 1946 and 1964—will reach age 65 and begin retiring en masse. What will happen when the baby boomers driving much of the stock market run-up begin to withdraw their money?

Answering this and other difficult questions about retirement savings is a significant undertaking that must be faced now if we are to enjoy the future. How do we convince younger workers struggling to pay education loans, buy a house, or simply pay the bills, to set aside money for the future? How do we teach all workers to weigh their choices carefully, in a world in which the number of choices is so rapidly increasing?

Many in the fund industry have expended much time and money in working with investors to address these issues, and are to be commended for their efforts. Employers, often working with industry participants, have made tremendous strides in educating employees. Seminars, access to financial advisers, and enhanced choices all have contributed to the encouraging news that employees are investing more, and more knowledgeably, than ever before.⁵

The actions of the private sector have been supported and supplemented by those of the regulators. Both the Commission and the Department of Labor have undertaken numerous initiatives designed to facilitate the education of plan investors. Investor education has been perhaps the most compelling retirement theme underlying actions of the fund industry and its regulators in the waning days of the 20th century. An equally

⁴ The Cerulli-Lipper Analytical Report, "The State of the Defined Contribution - 401(k) Market," pp. 13-16 (1996) (the "Cerulli Report").

⁵ E.g., K. Bergen. "401(k) Watch," *The Houston Chronicle* (Feb. 3, 1997). See generally, Cerulli Report, pp. 111-118.

important challenge for regulators in the new millennium will be reconciling regulation under the federal securities and federal pension laws.

A seemingly constant refrain among many investment management industry participants, particularly compliance officers, is frustration with overlapping, inconsistent, overly burdensome, or outdated regulations under ERISA and under the federal securities laws. Some point to inconsistent disclosure philosophies and requirements. Others complain that various types of securities transactions, such as cross trades between mutual funds under common management, are subject to different limitations under the securities and pension laws. Others point to different treatment under the federal securities laws of functionally similar pooled investment vehicles designed for retirement plan investors, and still others complain that the prohibited transaction provisions of ERISA impede the establishment of educational and investment programs that would be most beneficial to investors. The list never seems to end.

The challenge for regulators of the investment management business in the new millennium will be to assess these claims responsibly and eliminate duplicative and inconsistent requirements that are detrimental to retirement plan investors. It is hardly risky to predict that, if the regulators fail to meet the challenge, Congress will step in. Indeed, I suspect that retirement concerns will, by sheer necessity, become one of the burning issues facing Congress in the near term. The resolution of these issues has the potential to redesign dramatically the landscape that has gradually evolved since the New Deal created Social Security.

The Continued Effectiveness of the Commission

The last two decades of the 20th century have been marked by tremendous prosperity in the mutual fund business. Many industry observers agree that this prosperity has been due, in part, to a strong and active Securities and Exchange Commission anticipating and addressing matters before they become problems. Investors and legislators alike have come to expect the Commission to be, in the words of former Commission Chairman and Supreme Court Justice William O. Douglas, the investor's advocate. Will the Commission be able to continue to meet these lofty expectations in the investment management area in the new millennium?

If it has its intended effect, the Investment Advisers Supervision Coordination Act of 1996 should ensure that the Commission has sufficient resources to oversee the investment management business as we move into the 21st century. Under the 1996 act and its implementing rules, which were adopted in final form by the Commission earlier this week, jurisdiction over the almost 23,000 investment advisers now registered with the Commission was divided between the Commission and

the states. This sharing of oversight should reduce regulatory duplication and enable the Commission to examine registered advisers far more frequently than once every 44 years, as has been the case recently.

As I gaze into the future, I worry that the Commission's ability to inspect participants in the investment management business during the new millennium may not be matched by its ability to regulate the conduct of those participants. Over the past two decades, in an attempt to respond to legitimate concerns of business, Congress has enacted more regulations applying to the regulators. Consider, for example, the Paperwork Reduction Act and the Small Business Regulatory Enforcement Fairness Act, both of which share the laudable goals of making the regulatory process more open and less burdensome to businesses. The Paperwork Reduction Act seeks to achieve this result by setting out procedures agencies must follow before obtaining information from ten or more members of the public; the Small Business Enforcement Act provides a special review period during which Congress can disapprove various agency rules. However well-intentioned, these acts can limit the potential responsiveness of the administrative process by causing delays, restricting agencies' ability to collect important data, and increasing regulatory uncertainty. These effects would seem likely to become exaggerated as technology advances and as the pace of change accelerates as we move into the 21st century.

In commenting on the trend of regulating the regulators some 15 years ago, former SEC Commissioner Roberta Karmel questioned whether the "public interest [is] served by the imposition of elaborate and burdensome procedural requirements that further expand the federal bureaucracy and reduce the efficiency of the regulatory agencies. Just as there are many direct and indirect costs of government regulation of business, there are many costly burdens that

accompany the benefits of regulating the regulators.”⁶ I hope that Commissioner Karmel’s words do not prove as prophetic as those of Nostradamus.

Issues That Never Die

The milestone of the new millennium acts like a deadline. It encourages us to confront and resolve existing problems so that we can face new challenges with a clean slate. As we approach the 21st century, the fund industry continues to be confronted by some issues that just never seem to go away. Two such issues making headlines recently are money market fund bailouts and performance advertising

Money Market Fund Bailouts

Earlier this year, we witnessed what seems to be a recurring industry event, a bailout of a money market fund by its investment adviser. In this case, the fund found itself in jeopardy of breaking a buck as a result of holding the commercial paper of a finance company that announced, without any warning, that its published earnings were dramatically overstated. The adviser stepped up and, reportedly at some cost, purchased the commercial paper from the fund.

That money market funds from time to time may have to face breaking the buck should not be surprising. After all, neither Commission rules nor all the disclosure in the world can offer ironclad protection from an issuer’s unexpected default on an instrument appropriately held by a money fund. We have also seen enough adviser bailouts not to be surprised by the occurrence.

What I find disconcerting about bailouts is that we and fund shareholders have come to expect them. As a financial columnist noted in the wake of the most recent bailout: “You aren’t supposed to get something for nothing, but it sure seems like that’s

the way it works in the money market fund business.”⁷ After discussing the facts of the recent case, the writer concluded:

*“What [the fund manager] proved, like dozens of fund companies before it, is that investors may as well own the highest-yielding money fund they can find, because in defiance of general investment principles, there is not extra risk entailed in collecting that higher yield. So long as your fund management company’s pockets are deep enough, your money fund’s mistakes, if any, won’t cost you.”*⁸

In effect, the writer was suggesting that industry actions have caused money funds to be perceived to be guaranteed.

I ask you: Do we really want investors to have a perception of money market funds that is so inconsistent with their basic design as an investment with the potential for some risk? I submit that the answer is a resounding “no.” What then should be done? Surely, prohibiting bailouts would not be in the public interest. Disclosure also is not the answer—all money market funds currently are required to disclose prominently that they are not guaranteed.

Should the Commission require investment advisers to money market funds to meet minimum capital requirements to enable them to have the financial wherewithal to bail out a fund? Wouldn’t such a requirement only further reinforce the perception that advisers will take any actions necessary to prevent a loss? I would be loathe to follow in the footsteps of the banking regulators and move toward requiring management companies to maintain minimum amounts of risk-based capital. And I suspect that most here this morning would agree.

Should money market funds or their management companies be required to obtain some form of insurance to cover the risks of loss from portfolio investments? Many express the concern that this type of insurance may be prohibitively expensive for most cost- and yield-conscious money market funds.

To provide for more cost-effective insurance, one large fund complex is now seeking exemptive relief from the Commission to permit it to establish a mutual insurance company. We understand that at least one or two insurance companies are in the process of developing money market fund insurance. These proposals appear to be the first steps by the industry, on its own initiative, to avoid bailouts. But the proposals may not work for every mutual fund complex. We continue to think about various ways to

⁶ R. Karmel, *Regulation by Prosecution*, 1982, p. 81.

⁷ T. Petrino, “A Money Fund’s Miscues Seldom Hurt Its Investors,” *The New Hampshire Sunday Monitor* (Feb. 9, 1997), p. F4.

⁸ *Id.*

address the bailout issue and encourage you to do the same. We simply can't afford the misperception of money funds to continue.

Performance Advertising

Responsible marketing and sales practices are essential to the fund industry's long-term success. A fund's marketing and sales practices create the basis of the fund-shareholder relationship. We all know that investors often, perhaps too often, make investment decisions based upon sales material, especially performance information. Investors want to know about the track record of the person with whom they entrust their money. And, most would agree that a prior record of a manager can be quite useful if it reflects an investment strategy that will be mirrored by the manager in the future.

Acknowledging investors' desire for useful information, the Commission's staff confirmed through a series of letters over the past year or so that funds can include material in their prospectuses about the track record of their advisers or portfolio managers, so long as the material is not misleading or so cumbersome as to obscure other information that is required to be in the prospectuses. To date, we have been inundated by a variety of performance presentations that purport to rely on the letters. Some of them have been met by our just saying "no."

Let me give you a couple of examples. Take the proposed prospectus summary of one fund called "the fund at a glance," which included performance information of another fund managed by the same adviser. In our view, this was not a glance at the first fund, but information impeding an understanding of the fund. In another case, a newly formed fund sought to include in its prospectus a track record of its portfolio manager. The record reflected the performance of a fund for which the portfolio manager served as one of three managers, although it was argued that the manager played the primary role in advising the fund. To our minds, the track record was not that of the portfolio manager and could not be included in the prospectus.

These examples suggest that the industry is reading our letters more broadly than we intended or anticipated. Last December, when speaking at the ICI's Procedures Conference, I cautioned against overstating, overselling, and overdoing past performance. I characterized our position in our letters not as a green light, but as a yellow light of caution. The industry has an obligation to keep performance presentations balanced and clear so that prospective investors can evaluate them fairly. Showing the adviser's track record is one thing. Trying to substitute some other performance for that of a fund is something else.

Industry participants would be ill-advised to operate under the impression that "anything goes" when it comes to presenting prior performance. We will be looking closely at prospectus disclosure and asking questions about presentations that seem to be unclear or misleading.

Our examiners will be asking questions about how the information was derived, whether backup data exists to support performance claims, and whether important, but less favorable, information was omitted from presentations. Most importantly, we will be working with the industry and the NASD to consider the limits of performance presentations that can be used in fund prospectuses. This effort may well result in some performance presentations that are being used today disappearing from the scene tomorrow.

Our recent experience with fund prospectuses showing performance makes me reflect on the conclusion reached by two authors in a recently published article entitled "Performance Games":

"It would be good [the authors said] if we would be granted a moratorium from performance games [played by fund managers] until we perfect a stopwatch by which to judge the winners. But a moratorium will never be granted; the race is too tempting, and the desire to declare a winner too strong.

So individual investors will continue to jump from mutual fund to mutual fund in search of winners, and plan sponsors will continue to hire and fire money managers. All players will be exhausted, but the games will go on."⁹

The statement could have been made at any time over the past 57 years—it echoes some of the concerns of the drafters of the Investment Company Act of 1940, it captures the issues

⁹John J. Bowen, Jr. and Meir Statman, "Performance Games," *The Journal of Portfolio Management*, Vol. 23 (Winter 1997), p. 15.

facing the Commission's staff today as it reviews fund prospectuses, and I'm afraid, it will have validity in the future. Nevertheless, I am not yet willing to abandon my high expectations of the fund industry. The industry should understand better than anyone the limits of performance information and act responsibly. Failing to do so risks damaging the excellent relationship that the industry has built in the 20th century with its shareholders. Acting responsibly will help ensure that the industry continues to prosper well into the 21st century.

Conclusion

Some believe that "futurism is not so much predicting tomorrow . . . as it is inventing it." The future presents us with many challenges, but with those challenges comes opportunity—the opportunity to make our industry more efficient, more responsive to its shareholders, and with more educated investors than ever before. This is a particularly exciting time to be involved in the financial markets, whether as a participant or as a regulator. None of us should shrink from the challenge. Thank you.

Investment Company Institute Chairman's Report

Don Powell

Don Powell is Chairman of the Board of Governors and Executive Committee for the Investment Company Institute. He is also Chairman and CEO of Van Kampen American Capital, Inc.

Thank you for that warm and generous introduction.

I too want to welcome our members and guests to the 1997 General Membership Meeting, and there are certainly a lot of you to welcome.

In a couple of hours, Matt Fink will deliver his annual address to you. Let me just say that we can be proud that this past year the Institute has once again been ahead of the curve. We participated in the most important mutual fund legislation passed in 57 years.

First, let me set the stage with a brief overview of the state of the industry. Let me put some statistics in perspective. In spite of the recent ups and downs of the market, 1996 was a good year, but not an exceptional year, for our industry and our shareholders.

The industry continued to grow and the growth was remarkably balanced. Total assets owned by the nation's 63 million mutual fund shareholders grew by about 26 percent or about \$720 billion in 1996.

The 26 percent growth in total mutual fund assets during 1996 compares with total asset growth of 31 percent in 1995. So far in the 1990s, total asset growth has been running about 22 percent a year. Last year was, therefore, somewhat above average, but it was not one for the record books.

Stock fund assets grew about 38 percent last year, which translates to a \$483 billion gain. The 1996 growth rate was about equal to the average yearly gain we have seen so far in the 1990s—roughly 39 percent. Last year was well below 1995's 46 percent rate and did not even come close to the high-water mark of 67 percent set in 1991.

Dispelling Misconceptions

Despite what you have read, new cash was not the source of this growth. In 1996, market performance and new cash flow shared roughly equal roles in asset growth.

Last year's figures also put to rest another common misconception—that the mutual fund industry is just stocks. Equity funds may garner the most media attention, but they are by no means the whole story.

The mutual fund industry is diversified and balanced. At the close of 1996, the nation's 6,270 mutual funds had combined assets of \$3.5 trillion. Stock funds totaled \$1.8 trillion, or 50 percent of industry assets. Bond funds posted assets of \$886 billion, or 25 percent. And money market funds had just under \$902 billion, or 25 percent of total industry assets.

Last year, the ICI conducted a major survey of fund shareholders and found that over 60 percent of America's mutual fund-owning households own shares in at least two or three basic types of funds.

For example, investors in *equity* funds typically own three different funds. Fifty-four percent also own bond funds, and 50 percent own money market funds.

The typical *bond* fund shareholder owns shares in four mutual funds. Eighty percent also own shares of equity funds and 56 percent own money market funds. In addition, 61 percent of equity fund and 59 percent of bond fund shareholders also own individual stocks.

It may come as a surprise to many, but stock mutual funds hold a relatively minor share of the total stock market. According to the Federal Reserve, stock mutual fund assets represent only 14 percent of the nation's \$9.4 trillion in corporate equities.

There is another interesting point about the latest mutual fund calculus. The industry has an ever-expanding core of long-term investors. Mutual funds are coming of age as a retirement savings tool as America's Baby Boomers start to age.

A substantial portion of the money flowing into mutual funds—47 percent in 1995—came through retirement plans of all types. ICI found that even 84 percent of shareholders *outside* of

employer-sponsored retirement plans identified retirement as their fund investment objective.

While I'm in the process of dispelling myths, let me expose another. ICI research, which covers 50 years of stockholder behavior, shows that during market downturns, shareholders don't run for the exits. Quite the contrary, they behave rationally and conservatively. And I have a keen awareness of shareholder behavior during market breaks. I don't take it personally, but my birthday falls on October 19th, which coincides with a somewhat unfortunate day on Wall Street in 1987.

The ICI study found no evidence of large redemptions in spite of 14 major stock market contractions and several sharp sell-offs. Even on that October day ten years ago, redemptions were only 2 percent of stock fund assets. There is no evidence to support predictions of panicky redemptions by our shareholders.

Shareholder behavior helps explain why the 1994 market disruptions did not produce large redemptions of mutual fund shares. Let me give you two examples. First, the tightening of monetary policy and the run-up in interest rates that began in February 1994 led to redemptions in domestic bond funds, *but* they were spread over a longer time period. Second, the devaluation of the Mexican peso in December 1994 sparked only small redemptions from Latin American and emerging market funds, despite sizable declines in these funds' share prices.

What this tells me is that our shareholders don't have hair triggers. They are sensitive to movements in security prices, but their response to falling security prices is spread over time. The rate of redemptions has generally remained unchanged or declined slightly during bear markets. It does not rise until the bear market has ended and prices begin to recover. In other words, our shareholders show a lot of composure and common sense.

So much for 1996. Now, let us take a look into the future for our industry.

Setting Goals for the Future

Barry Barbash of the SEC has said that the mutual fund industry "has gone from a cottage industry to an indispensable part of the American financial landscape."

Mr. Barbash gave us quite a compliment but rightly observed that it comes with enormous responsibilities and challenges. I agree. Just think about it. Almost one in four Americans owns mutual fund shares.

So what has accounted for our amazing success as an industry? Benjamin Disraeli said, "The secret of success is constancy to purpose." I believe our success as an industry is also due to constancy of purpose. Our purpose has been and will continue to be giving the American people a great product. We've given them a great product in which they have confidence.

Sixty-three million Americans have invested more than their hard-earned dollars in mutual funds. Our shareholders have invested their futures; they have invested their confidence. They have invested it in you . . . and you . . . and you, and in every man and woman who serves shareholders, from the customer rep to the Chairman of the Board. Shareholder confidence is the true currency of our industry and it must never be devalued. It must be our purpose to continue to give our shareholders great products that deserve their confidence.

In his speech, Mr. Barbash warned us about complacency. He's right. Our excellent track record should not be a lullaby that rocks us to sleep. It should be a reveille that wakes us up to the challenges that lie ahead and the innovations that must be made to meet shareholder needs and desires.

Our industry is a marriage of hard-nosed practicality and a devotion to the ideal of integrity. That is what our past deeds have proven. That is what we honor today. That is what we must ensure tomorrow.

We pride ourselves on being leaders—leaders in a strong regulatory system—leaders in shareholder communications and education—leaders in competition and shareholder services—leaders in promoting savings opportunities—and leaders in a commitment to excellence. We have taken our cue from Winston Churchill, who said, "It is no use saying, 'We are doing our best.' You have to succeed in doing what is necessary."

And that's what we as an industry have been doing and will continue to do—doing what's necessary to serve our shareholders and doing it where it counts. We have in the past and we will in the future.

Mutual funds have succeeded, in part, because of the partnership between us and the ICI on behalf of our shareholders. Together, we have committed to the highest ethical standards and quality services for our shareholders. We can and must continue this tradition of quality shareholder service. Henry Ford said, "Obstacles are those frightful things you see when you take your eyes off your goal."

I believe our goals going forward should include the following:

1. Plain talk to our shareholders about our funds and investing.
2. Explaining the need for personal planning for retirement.
3. Teaching our shareholders to have realistic expectations about fund performance.
4. Teaching them the relationship between risk and reward.
5. Disclosing fees in a clear and understandable manner.
6. Teaching the benefits of diversification.
7. Doing everything we can to encourage long-term investment objectives.
8. Avoiding unrealistic shareholder expectations that will result in disappointment.

The great success of the mutual fund industry can be traced in part to our ability to respond to shareholders' needs. While our competition was complacent with old unresponsive products and services, we listened to our shareholders and took the lead in creating new financial products to meet their needs.

Over the years, we have developed Keoghs, IRAs, and 401(k)s. Who would have thought that our shareholders would have 24-hour phone access, 800-numbers, computerized account information, personal computer link-ups, and a variety of funds from emerging global market funds to money market funds to meet every investment need?

We are a very competitive industry. We compete with each other and with other parts of the financial services industry. Competition is good for mutual fund shareholders.

I am confident our edge is never dulled by complacency. The people in this room will not let that happen.

The spirit of innovation that began 73 years with the introduction of the first mutual fund is alive today. We harness new technologies. We provide new services. We forge the way to new investment opportunities.

Serving our shareholders, and doing it with integrity, is perhaps the most powerful and enduring legacy of our industry. But as our industry adapts and changes to meet new shareholder needs, certain things remain constant. Integrity and commitment to our shareholders are two of them. Before this meeting, I took the time to reread the Institute's by-laws. They memorialize what we as an industry will always seek to be. One of ICI's main purposes is:

"To encourage adherence to high ethical standards by all elements of the investment company and investment advisory business to the end that the interests of the public will be served by the efforts and activities of all members of the corporation."

Those words were written half a century ago, but we honor them still. We honor them by our commitment to integrity. We honor them by our commitment to shareholder service. We honor them by saying, like Churchill, that doing our best is not enough. Instead we ask, "How can we be better?" "How can we have even higher standards and even more effective laws and regulations?" "How can we better serve our customers?"

I believe we can do it through clear disclosure of risk. We can do it through strong internal compliance standards. We can do it through simple communications in everyday English, like the profile prospectus. We can do it through shareholder education. We can do it through new technology and shareholder services. We can do it both as individual firms and by uniting under ICI's banner.

It is remarkable how ICI continues to unite our industry and allows us to speak to legislators and regulators with a single united voice. I appeal to you today to stay involved in the Institute. Don't let this meeting be the end of your participation in industry efforts. Let it be the beginning. Stay engaged. Stay active. Stay committed. And most of all, *take* what you have learned from this meeting and *share* it with your colleagues.

Teddy Roosevelt believed that the future of our nation depends upon its citizens translating good intentions into good deeds. He wrote: “We in America can attain our great destiny only by service . . . and . . . Our service must be the service of deeds.” Our service to mutual fund shareholders must too be the service of deeds. It has been for 57 years and with your help, and the leadership of the Institute, it will be for all the years to come. Thank you.

Investment Company Institute President's Report

Matthew P. Fink

Matthew P. Fink has been President of the Investment Company Institute since 1991.

Good morning.

The theme of this year's annual meeting, "Continuing a Tradition of Integrity," calls to mind the unique culture of the mutual fund industry—a commitment to investor education; advocacy of savings incentives for middle America; support for strong government regulation under a single national regulator; and adherence to high voluntary standards.

These traditions are fundamental. They are based on the absolute necessity of maintaining the confidence of our shareholders.

I am convinced that these traditions have been critical to our past success. I am equally convinced that our future will depend upon our ability to continue and strengthen these traditions in the face of new circumstances.

The mutual fund industry is now at the forefront of U.S. financial services. In 1980, about 4.6 million households owned mutual funds, and industry assets totaled \$134.8 billion. Today, 36.8 million households, or about 63 million individuals, own mutual funds, and assets are nearly \$3.7 trillion, second only to commercial banks. About one-fifth of United States retirement assets are entrusted to mutual funds.

Never before has our industry been subject to more scrutiny—appropriate scrutiny—from Congress, the SEC, the media, and the public at large.

The steadfastness of our investors in years to come will depend, in large measure, on their understanding of markets and investing, and their confidence in the integrity of the mutual fund industry. Today, I would like to share my thoughts on what we must do to maintain the confidence of our shareholders.

Investor Education

A commitment to educating consumers is perhaps our industry's most long-standing tradition. In 1929, Paul Cabot, one of the founding fathers of our industry, declared that "the remedies for possible abuses are publicity and education." We have followed Cabot's advice for the past 57 years,

and the rewards, for our shareholders and our industry, have been tremendous.

A number of self-proclaimed experts have been predicting that, at the first significant downturn in the markets, there will be massive redemptions by fund shareholders, redemptions that will in turn produce even greater market declines.

As Don Powell mentioned, last spring the Institute completed a comprehensive study of shareholder behavior over the last 50 years. Our study found no evidence of shareholder runs during 14 market setbacks. Our study did not find that shareholders are insensitive to market declines, but that their response is measured and gradual.

Recent events support these conclusions. From its March 11 high, the stock market lost nearly 10 percent of its value by April 14 before rallying. While not a major correction, this drop was somewhat of a test. Again, there was no shareholder panic. There were no mass redemptions. Investors reacted calmly and rationally.

A major reason for this steadfastness is investor education. Educated investors take a long-term view of investing, understand potential risks and rewards, and do not panic. I have no doubt that, in the future, there will be difficult markets and adverse events. Therefore, we must do all that we can now to educate our shareholders as to the risks, as well as the rewards, of investing.

Over the years, our industry has worked with the SEC to improve fund prospectuses, advertisements, and sales literature. As a result, we offer the best disclosure in financial services, and we support the SEC's efforts to make it even better.

But we have realized that laws and regulations aren't enough. Therefore, individual fund organizations have stepped up their voluntary educational efforts, through presidents' letters, shareholder reports, and newsletters. An enormous amount of useful information is communicated to fund shareholders in this manner.

The Institute has intensified its own efforts. We've published consumer brochures on matters as

diverse as how to read a fund prospectus, the benefits of dollar cost averaging, and IRAs. We've produced video news releases on the importance of long-term investing, the impact of interest rate changes on bond funds, and money market funds' lack of FDIC and SIPC insurance.

Today, we are launching the ICI Mutual Fund Connection, our public-access website. We're also releasing a new series of brochures to help investors better understand all types of investment companies. More is planned.

We're working on an educational video on the basics of mutual fund investing, as well as a series of video news releases emphasizing investor education. We're also expanding our TV and radio tours, featuring industry leaders who will focus on improving shareholders' understanding of key investment issues.

It is extraordinary that an industry has committed so much of its resources to educating the public about the risks, as well as the rewards, of its services. But it is the right thing to do. And I am convinced that our industry's tradition of investor education has been critical in producing widespread public confidence in our industry.

Advocacy of National Policies

Hand in hand with investor education is a second tradition—our advocacy of national policies that enable ordinary Americans to realize their investment goals.

For most Americans, financial security, whether it means paying for a child's college education or building a nest egg for retirement, will only be realized through effective personal savings and investing. That's why the mutual fund industry has always supported legislative changes that provide incentives to ordinary Americans to invest for their futures.

In 1962, our industry supported Keogh plans. We were at the forefront in the battles for IRAs in 1974, and for universal IRAs in 1981. Last year, we worked for legislation that expanded the spousal IRA, and established SIMPLE plans for small businesses, and 401(k) plans for tax-exempt organizations.

Today, the mutual fund industry continues to lead the fight for expanded availability of IRAs. We support measures to improve pension portability, to expand retirement plan coverage, and to make employer plans easier to administer and to understand.

Many of these initiatives are part of a trend away from defined benefit pension plans—where the employer selects investments—to defined contribution plans—where each worker directs his or her own investments.

Some assert that workers generally are better off under defined benefit plans, which, in theory, guarantee a specific level of benefits with little risk. However, research conducted by Dartmouth Professors Samwick and Skinner demonstrates that defined contribution plans generally are better, and less risky, for most workers. The study notes that retirement income from a defined benefit plan typically is heavily dependent on earnings in the last three to five years before retirement. Therefore, job changes can cause workers to forgo some or most of their benefits. Earnings fluctuations raise other risks. The study finds, in contrast, that steady annual contributions to defined contribution plans reduce risk by smoothing out fluctuations in earnings and investment returns. The professors conclude that:

“defined contribution plans with reasonable rates of return and modest contribution rates yield both a higher median income, and considerably less risk, than a typical defined benefit plan.”

This research demonstrates that defined contribution plans deserve a prominent role in our retirement system. We must continue to do all that we can to support improvements in these and other retirement savings vehicles.

Support for Strong Regulation

While other financial service providers opposed the reform measures of the 1930s, the mutual fund industry actively worked for enactment of the Investment Company Act. We have supported tough regulation ever since.

By operating under the strict standards of the Investment Company Act—daily pricing, prohibitions against affiliated transactions, limits on leveraging, and a system of independent directors—our industry has avoided the types of scandals that have repeatedly plagued other types of pooled investment funds. Moreover, over the years, while other industries have resisted regulation, we have consistently supported, and even called for, new regulation of our industry to meet new conditions. I submit that the record demonstrates the wisdom of our approach. A recent *New York Times* story stated that the mutual fund industry's effectiveness “comes from its willingness to accept federal oversight.”

This past year was no exception. We supported the 1996 legislation, which ensured adequate SEC funding, eliminated duplicative and confusing state regulation, and expanded the SEC's authority over mutual fund

books and records. We fought for tough standards to ensure that new qualified purchaser pools are not marketed to unsophisticated 401(k) participants. We encouraged the SEC's efforts to improve fund risk disclosure, and developed specific proposals for the Commission's consideration. But we stood hard against mandatory quantitative risk measures in fund prospectuses, because they would confuse, rather than enlighten, investors. We strongly supported the SEC's examination of soft dollar practices.

Our system of regulation has been extraordinarily successful. But we can't afford to sit on our lead. There is a clear need to reform the core disclosure document, the fund prospectus.

Complex prospectuses always have been a problem for mutual funds. In 1941, Walter Morgan, the founder of the Wellington Fund, wrote to the Institute: "Even a C.P.A. can't understand some of the prospectii that are issued now."

The need for a more readable prospectus has become even more evident in recent years, with the growth of direct marketing and the increasing use of mutual funds in defined contribution plans. On top of this is the general problem of information overload. SEC Chairman Levitt recently stated:

"We are the most wired, signaled, cabled, beeped, paged, plugged-in, on-line, and communicated-to society the world has ever seen. Years ago, the problem was a lack of information; today it is a glut of information."

In order to address these problems, the SEC, under Chairman Levitt's leadership, has proposed the most sweeping reform ever of the mutual fund prospectus. It is based on the idea that a prospectus should be a document that investors actually use. Under the SEC's proposal, there would be a major shift from generic disclosure of technical matters common to all funds, to disclosure of essential information about the particular fund. Moreover, the SEC proposal would permit the use of a shorter profile prospectus, with each investor given the option of either purchasing fund shares from the profile or ordering the full prospectus.

No regulatory change is more needed than prospectus reform. The SEC's proposals reflect years of careful work. The Commission should adopt new rules in this area as soon as practicable.

A related tradition is our industry's *support for a single strong national regulator*. For over 60 years, the mutual fund industry has been subject to one set of federal standards administered by one agency—the Securities and Exchange Commission—and designed to accomplish one goal—the protection of investors. Over the years, we have consistently urged adequate funding to permit the SEC to oversee our industry, and we have vigorously opposed fragmentation of regulatory responsibility among a number of different regulators.

But this hugely successful system of regulation is under attack. Some policymakers are urging Glass-Steagall reform that could subject the new financial services holding companies, including the mutual fund components, to banking regulation. This would be a huge mistake.

Banking regulation has as its guiding principle the safety and soundness of *banks*. In contrast, the federal securities laws value not the soundness of any institution, but the protection of *investors*. Moreover, imposing bank safety and soundness regulation on securities firms would stifle the vibrancy and creativity of the securities industry. As SEC Chairman Levitt testified:

"Securities firms must be able to continue to engage in entrepreneurial, risk-taking activities crucial to the capital formation process without the constraints of bank-like regulation."

The Institute supports legislation under which each entity in a holding company would be subject to functional regulation—the SEC would regulate mutual funds, and bank regulators would regulate banks. There is no reason, however, why the mutual fund and other securities subsidiaries of financial services holding companies should be subject to regulation by the Federal Reserve Board.

It clearly is time for Congress to restructure the financial services industry. But restructuring will do far more harm than good if it extends bank regulation throughout our financial system.

Adherence to High Voluntary Standards

Justice Brandeis once observed: "The law has everywhere a tendency to lag behind the facts of life." Our industry has long recognized that the lags between the facts of life and the law must be filled by voluntary standards that exceed legal requirements.

This past year, the Institute continued its efforts to improve industry standards and compliance. We published a best practices paper on liquidity and pricing. We've begun work on a similar paper on fund brokerage issues, and on two new guides for fund directors. We have developed a new loose-leaf

service to assist funds in offering their shares abroad in compliance with foreign laws. We provided guidance to our members on reevaluating their operations capacity. We also expanded our training programs for fund personnel, and now sponsor about 13 major conferences and 30 seminars and workshops each year, as well as producing a series of self-paced training programs.

This Institute will continue to do all that it can to promote the highest voluntary industry standards. Please keep doing your part. The confidence that shareholders, legislators, and regulators place in our industry will be influenced most heavily by the integrity that each of you display in the individual decisions that you make every day.

This morning, I have discussed traditions that have guided our industry since our inception—a commitment to investor education, advocacy of savings incentives, support for strong regulation under a single national regulator, and high voluntary standards—and how we must adapt these traditions to meet new challenges.

Willingness to Work Together

There is another tradition that is vital—the willingness of participants in our highly competitive industry to work together on issues of mutual concern, and to speak with one voice to legislators, regulators, and the public.

Other industries are fragmented into subgroups and rival associations, who spend an inordinate amount of time sparring with one another, rather than cooperating on common industry goals. In contrast, the investment company industry, with all of its variations—open-end, closed-end, unit trust, load, no-load, spread-load, independent, broker-affiliated, insurance-related, bank-affiliated, retail, and institutional—is represented by one association. This remarkable unity has enabled us to achieve a series of notable successes on behalf of our industry and our shareholders, beginning with the Investment Company Act in 1940, through last year's enactment of the National Securities Markets Improvement Act.

A former Chairman of the Institute, Ben Korschot, noted in his recent autobiography that:

“[o]ne of the great achievements of the ICI has been the ability to work, in an unbelievably effective manner, in leading the industry to decisions, where the ICI could speak as one voice for the industry.”

Industry-wide cooperation requires leadership and vision from the Institute's governing bodies and staff. But even more, it requires a commitment by each and every member of the industry to put the common good above parochial interests, and to be willing to “give a little” in order to achieve consensus.

We can be proud of our industry's record. Mutual funds provide middle America with professional management and diversification at reasonable cost. We operate within a culture and regulatory system that puts investors first. And, in over 70 years of operation, mutual funds have not cost the American taxpayer one cent.

In order to succeed in the future, we must remain true to our traditions—educating investors, supporting strong proconsumer regulation, and adhering to high voluntary standards. But, above all, we must continue to work together in the interest of our shareholders.

Institute viewpoints on a variety of issues may be obtained by ordering back issues of *Perspective*. Contact the Institute's Public Information Department at 202/326-5881. All *Perspectives* are also available on the Institute's website at <http://www.ici.org>.

- Vol 1, No. 1, July 1995: *"Mutual Fund Shareholder Response to Market Disruptions"*
- Vol 1, No. 2, November 1995: *"Improving Mutual Fund Risk Disclosure"*
- Vol. 2, No. 1, January 1996: *"Mutual Fund Regulation: Forging a New Federal and State Partnership"*
- Vol. 2, No. 2, March 1996: *"Mutual Fund Shareholder Activity During U.S. Stock Market Cycles, 1944-95"*
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