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HOUSE SUBCOMMITTEE HEARING EXAMINES PRICE COMPETITION IN THE MUTUAL FUND INDUSTRY

[10347] September 30, 1998 TO: BOARD OF GOVERNORS No. 65-98 DIRECTOR SERVICES COMMITTEE No. 7-98 FEDERAL LEGISLATION MEMBERS No. 25-98 PRIMARY CONTACTS - MEMBER COMPLEX No. 87-98 PUBLIC INFORMATION COMMITTEE No. 45-98 SEC RULES COMMITTEE No. 96-98 RE: HOUSE SUBCOMMITTEE HEARING EXAMINES PRICE COMPETITION IN THE MUTUAL FUND INDUSTRY

____ On September 29, the House Commerce Subcommittee on Finance and Hazardous Materials held a hearing on “Improving Price Competition in Mutual Funds and Bonds.” Attached to this memo are the available opening statements of Subcommittee Members, the Institute’s oral and written testimony, the SEC’s testimony and the written testimony of all other fund-related witnesses. Other witnesses addressed bond market transparency issues. Although those statements are not summarized below, they are available upon request. Testifying before the subcommittee on mutual fund issues were: Panel I: Arthur Levitt, Chairman, Securities and Exchange Commission Panel II: Matthew P. Fink, President, Investment Company Institute William McNabb, Managing Director, The Vanguard Group Michael Lipper, Chairman, Lipper Analytical Services Charles Trzcinka, Professor, State University of New York, Buffalo Harold Evensky, Certified Financial Planner, Evensky, Brown, Katz & Levitt David Gardner, Co-Founder, The Motley Fool Opening Statements by Subcommittee Members Commerce Committee Chairman Thomas Bliley (R-VA) began his statement by saying the hearing should try to answer the question of whether investors understand the fees they pay when investing in mutual funds, despite the pricing information that is made available to them. He asked the panel to consider “if customizing investors' quarterly statements to show exactly what was paid in fees is beneficial.” Subcommittee Chairman Michael Oxley (R-OH) asked the panelists to consider whether the average mutual fund investor knows how much of his or her money goes to fees and whether competition in the industry is sufficiently strong to protect consumers. He specifically challenged the fund industry to come up with ways to improve investor understanding of fees. Representative Edward Markey (D-MA) 2characterized the hearing as a checkup for a generally healthy patient. He emphasized the success of the industry and the absence of major scandal—a factor he contrasted at length with the current problems facing hedge funds. He added that “while there is substantial information available to investors regarding mutual fund fees and charges, more can be done to educate the public about such costs, promote comparison shopping by consumers, and facilitate competition in the industry to lower costs and fees.” Institute Testimony Institute President Matthew P. Fink delivered the Institute’s testimony. He stated that the evidence is strong and compelling that competition is working in the interests of investors. Mutual funds fiercely compete to attract and earn the loyalty of investors. Indeed, mutual funds compete on many levels, including performance, investment philosophy, experience, specialized expertise and service. The statement continued, “And let there be no doubt in anyone’s mind—mutual funds compete vigorously based on price.” The testimony emphasized the following key points: ! Competition is working. More than three-quarters of all equity fund investor accounts are in lower-cost funds—funds that charge less than the industry average. The average equity fund investor pays 36 percent less than the average fund charges. In fact, the mutual fund industry provides a near textbook example of a competitive market structure due to the number of competitors, stringent government regulation, clear disclosure, low barriers to entry and heavy scrutiny by the media. ! Disclosure is working. SEC regulations require that fees be prominently disclosed in a standardized, easy-to-use table at the front of each fund prospectus. No other financial product is subject to such comprehensive fee disclosure rules nor provides such understandable information. ! Regulation is working. The Investment Company Act of 1940 protects investors by prescribing how a mutual fund must conduct business, including limits and special procedures relating to fees. Forbes magazine once called this law “one of the world’s most perfect legal documents.” ! Economies of scale are shared with fund investors. Directors at many mutual fund companies implement policies that automatically reduce management fee rates when assets grow to a certain level. One report estimated that 75 percent of all funds have such plans in place. It is important to note, however, that although the industry has grown, this does not necessarily mean that economies of scale will be realized across the board. Economies are realized at the individual fund level. In addition, the statement stressed the importance of a quantum increase in investor education. The Institute applauded recent efforts of the SEC, particularly the national investor awareness campaign. But the statement adds, “Although we are gratified that so many investors appear to be developing the appropriate sensitivity to fees as an element of informed investing, it hardly means our job is complete. The challenge of educating investors—about fees and the other important elements of mutual fund investing—is a continuing responsibility. But just as there is no magic pill that will produce instant good health, there is no magic regulation that will produce instant investor awareness. . . . We stand ready to consider measures that promise to improve investor awareness, including the understanding of fees.” 3SEC Testimony SEC Chairman Arthur Levitt opened the portion of his testimony that addressed fund fees by noting the importance of the U.S. mutual fund industry. He stressed that over 40 million Americans rely on mutual funds to finance the American dream. He emphasized the effect that fund fees have on an investor’s return and said that the Commission takes a three-pronged approach to protecting fund investors: 1) reduce conflicts of interest; 2) require full disclosure of mutual fund fees; and 3) let market competition, not government intervention, determine appropriate fee levels. Chairman Levitt did not take a position on whether fund fees are too high, reiterating that the market is the best arbiter of fee levels. Chairman Levitt described Commission initiatives to enhance investor protections: improvements to disclosure practices, an increased focus on investor education and a review of fund governance, including the role of independent directors in setting fees. He also announced that a study of trends in mutual fund fee levels is due early next year. The Commission’s statement stressed that ample useful information is available to investors, and that full disclosure is the cornerstone of the successful U.S. capital markets. In fact, he added, “The very existence of the debate over whether mutual fund fees are too high illustrates this; the debate is possible only because data about mutual fund fees and expenses is readily available, both to investors and to the financial press.” Nonetheless, the Chairman said that despite a wealth of available information, agency studies indicate that the average fund investor still does not understand the amount he pays in mutual fund fees. The answer, he said, lies in continued emphasis on investor education. Chairman Levitt said, “The Commission has been especially concerned with the gap between available information about fund fees and investors’ use of that information, and we intend to move forward with additional efforts to close that gap.” He called on the mutual fund industry to join in these efforts. One suggestion he asked the industry to consider is a quarterly or year-end personalized expense statement for all fund shareholders. During the hearing, Chairman Levitt acknowledged that such statements would be burdensome for the industry, would increase fund expenses and could lead to some confusion among investors. Nonetheless, he urged the industry to work with the Commission to find an effective way to help investors understand how much, in dollars, they pay for fund investments. Testimony of The Vanguard Group William McNabb, Managing Director of The Vanguard Group, testified that there is vigorous cost competition within the fund industry. He said that the industry’s average expense ratio is not a useful measure of cost competition. The best indicator is where the average shareholder assets are, and that is in lower-cost funds, rather than higher-cost funds. Mr. McNabb also discussed the importance of fund fees, not only to the final return to the shareholder, but also as a competitive advantage to a firm like Vanguard that emphasizes low costs. The Vanguard testimony suggested that the Committee should look not at whether fund fees are too high, but rather at whether investors have a choice of funds that provide competitive investment performance at reasonable cost, and whether they have access to the information needed to make informed investment choices. Mr. McNabb said the answer to both these questions is “an unequivocal yes.” 4In addition to the traditional avenues of information on the industry, such as prospectuses and shareholder reports, Mr. McNabb stressed the valuable role that the media, including the Internet, plays in providing investors with information about mutual funds. Vanguard also stated that the educational efforts of the funds industry, regulators and the media appear to be effective, “as the typical fund investor owns mutual funds whose expense ratios are far lower than the simple average expense ratio for all mutual funds.” Vanguard stated the importance of continuing efforts to educate investors about the importance of fund costs in the investment decision. Mr. McNabb concluded, “Vanguard has been actively engaged in such efforts almost since its inception, and we pledge to continue our leadership role in raising the cost-consciousness of the investing public.” Testimony of Lipper Analytical Services At the hearing, Michael Lipper of Lipper Analytical Services, released an updated edition of his company’s Third White Paper that addresses the topic “Are Mutual Fund Fees Reasonable?” The study, he said, finds that the present system is working and that “in a classical economic model, mutual fund fees and expenses are being set by the marketplace with a higher level of disclosure than any other United States investment products. Other important findings about mutual fund fees and expenses include: ! fund performance is net of expenses; ! future levels of fees will be set by future conditions; ! the press is extremely conscious of expenses and regularly covers them; ! management company profit margins are below peak levels; ! mutual funds share economies of scale with investors; ! reports that fund fees are increasing are methodologically flawed; and ! American mutual funds cost much less than overseas funds. Testimony of Harold Evensky Harold Evensky, a certified financial planner from Evensky, Brown, Katz & Levitt, testified that the mutual fund industry in aggregate is extremely professional and ethically well-managed, but that it has drifted from its traditional focus on the management of assets for the benefit of shareholders. He asserted that the securities laws have not been effective in ensuring that independent trustees adequately protect investors’ interest. He also criticized the fund fee table as too complex and incomplete. Mr. Evensky testified that competition has not been effective, demonstrated by his finding that fund expenses have increased as assets have increased. These facts have been masked by the strength of the bull market. “The combination of these factors results in poorly informed investors making bad decisions about investing in funds that often do not deliver the benefits reasonably expected of competition and economies of scale.” Mr. Evensky advocated several solutions to these problems. Overall, he said that the industry should keep before it the admonition of the ’40 Act that “the national public interest and the interest of investors are adversely affected when investment companies . . . are managed in the interest of investment advisors . . . rather than in the interest of (their) shareholders.” First, Evensky suggested that the SEC should reinforce the trusteeship responsibilities of fund companies and modify inappropriate regulatory constraints. He encouraged regulators and the industry to increase the accountability of independent trustees. He also recommended that the industry simplify the explanation of fund costs by unbundling expenses, providing more detailed expense reporting and by providing a 5regular accounting of the actual costs paid by the investor to the fund company, perhaps through quarterly reports. Testimony of Charles Trzcinka Charles Trzcinka, Professor of Finance at the School of Management at SUNY, Buffalo, advocated deregulation of sales fees and standardization of risk and return measures. He said the theme of his work is simple—investors have a hard time determining how much they are paying for their investments and an even more difficult time determining what they are getting in real returns. He said his research indicates, “It is clear from the evidence that the current mixture of fees have little relationship with the quality of the fund when ‘quality’ is defined as a better return for the risk taken.” From this he concludes that competition is not working. Professor Trzcinka found these arguments to support his conclusion: ! total expenses paid by investors have not fallen over the past decade and probably have risen; ! there is no relationship between level of expense ratios and risk-adjusted performance except that large expense ratios substantially reduce performance; ! there is little evidence of persistence of good performance, there is stronger evidence of persistence of poor performance; ! good performance is rewarded by investors, poor performance is ignored except when extreme; and ! information available to investors on mutual fund portfolio management is poor. Trzcinka concluded, “from an investor’s point of view, mutual fund expense ratios are stable, soft dollars are hidden and distribution expenses are complicated. The investor has little incentive to carefully examine the fees and compare funds. From an economist’s view, fees that are hidden and complicated are not likely to fall—especially when there is a restricted market for advice.” Testimony of David Gardner David Gardner, co-founder of The Motley Fool, testified in favor of improving Americans’ education regarding personal finance so that investors can understand what they are paying and make sound decisions regarding their futures. Mr. Gardner stressed the impact of fees on fund returns, as well as the fact that some studies indicate investors do not understand fees or consider them when making investment decisions. This poor understanding, he claimed, makes price competition among firms unlikely. He said funds need to provide investors with a clear, accessible statement of fees. The answer to all of these problems, said Mr. Gardner, is improved financial literacy. “The shockingly low level of financial literacy in this country complicates people’s confusion. We enjoy tremendous economic freedoms, and we are each responsible for our own financial decisions. At the same time, our schools offer virtually no training in money management or investing . . .. The mutual fund companies may benefit from such ignorance, but one of the tasks of The Motley Fool is to combat it. That is also a task that this Committee, along with the SEC and state and local governments, should strive to accomplish.” * * * * * 6We will keep you informed of further developments. Matthew P. Fink President Attachment Note: Not all recipients of this memo will receive an attachment. If you wish to obtain a copy of the attachment referred to in this memo, please call the Institute's Library Services Division at (202)326- 8304, and ask for this memo's attachment number: 10347. If you would like the bond market transparency testimony referred to in this memo but not attached, please call the Institute’s Library Services Division and ask for the bond market testimony.