

SPEECH

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The Success of America's Mutual Fund Marketplace: Benefiting Fund Investors

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I'm very pleased to participate in this forum. The American Enterprise Institute and the Brookings Institution aren't always identified with the same point of view. But one attitude they share is a commitment to intellectual debate and scrutiny, unhindered by ideological blinders.

Mutual funds are subject to a comprehensive framework of laws and regulations. The ICI always has sought to make sure that these work highly effectively to protect fund investors. But government regulation is not the only form in which funds are held accountable to investors.

Competition in the marketplace is a constructive and powerful form of oversight as well, and I am glad to have this opportunity to discuss the ways in which it works to the advantage of the investing public.

The impact of Adam Smith's "invisible hand" is actually quite easy to see. In any industry, competition spurs firms to cut costs and reduce prices, to innovate, and to offer superior service and quality products.

A luminary of the Austrian school of economics, Ludwig von Mises, offered one of the most lucid descriptions of how the market system works to the benefit of consumers. As he explained:

"The market process is a daily repeated plebiscite ... There is under capitalism one way to wealth: to serve the consumers better and cheaper than other people do."

Just ask someone who traveled that path, Henry Ford. As he put it: "Competition is the keen

cutting edge of business, always shaving away at costs.”

It is the competitive market that drives entrepreneurs to cut costs – and prices. It is the competitive market that spurs improved service. And, it is the competitive market that encourages, in fact demands, innovation.

In my remarks, I will seek to make the point that mutual funds throughout their modern history, at least to date, have exhibited the hallmarks of an intensely competitive market – demonstrated in fees, services and innovation – to the benefit of consumers. As I will note in my conclusion, however, these are not hallmarks that can be taken for granted.

Hallmarks of a Competitive Market

What are the hallmarks of a competitive market?

- A large number of firms, none of which can maintain a dominant market share.
- Low barriers to firm entry – and exit.
- A large number of consumers with freedom to choose among available products; in other words, with the opportunity to vote with their feet. Or, in our case, with their dollars.
- And widely available, low-cost, information for making comparisons among competing products.

The Mutual Fund Industry: The Hallmarks of a Competitive Industry

The mutual fund industry displays all these characteristics in dramatic fashion.

- To begin with, the industry has a large number of firms, none of which dominates.

Investors today can select from more than 8,000 mutual funds offered by more than 500 different firms. And none of these firms dominates the market.

In 2005, the 10 largest firms managed 48 percent of assets. The top five firms control less than 40 percent of all assets.

To put these figures in context, it is helpful to look at Herfindahl-Hirschman indexes – the standard economic measure of the degree of competition in an industry based on the size of the leading firms in relation to the industry as a whole.

Figure 1 indicates that the mutual fund industry is solidly in the spectrum of unconcentrated industries. Concentrated industries like public accounting, car manufacturing and retail banking are four to five times as concentrated as the mutual fund industry. Moderately concentrated industries like tire manufacturing and refrigerator manufacturing are still two or three times as concentrated as the mutual fund sector.

Despite vast changes over the past quarter century, no firm has been able to gain a dominant market share. Indeed, the level of market concentration has remained remarkably stable since the early 1980s, when the modern mutual fund market began to take form.

And mutual funds do not just compete with each other. They also compete with other investment services and products, including:

- direct holdings of stocks and bonds;
- insurance products;

- separate accounts;
- hedge funds; and
- bank trusts.

With so many options and alternatives, no mutual fund sponsor has a lock on any investor's money.

- In line with another distinguishing characteristic of a competitive market, the mutual fund industry is characterized by low barriers to entry and exit.

Mutual funds firms come and go. Some firms simply don't withstand von Mises' "daily repeated plebiscite." Others are bolstered by it. There have been many sizable mergers or acquisitions over the years, and some major ones are in the offing. Also, there are many fund firms now in business that did not exist in the early 1980s.

But in addition to fund firms, mutual funds themselves come and go. As Figure 2 shows, each year hundreds of new funds are created, and hundreds are merged or liquidated. A firm that launches a new type of fund will be open to competition from others firms that start similar funds, which puts downward pressure on fund fees.

To get a sense of the level of competition in the industry, take a look at the Top 10 lists of years gone by. You'll see that the largest players have shifted and changed over the years. Take the top 10 in 1985, for example – only five remained in the top 10 in 2005; of the top 25 firms in 1985, only 16 remained there by 2005.

Low barriers to entry mean that existing fund firms are always looking over their shoulders. Which fund firms are most vulnerable? Those that overcharge, offer inferior performance, give poor service, or violate the trust of their customers.

- Another characteristic of competitive markets: A vast number of people invest in mutual funds, choosing among a wide range of choices.

More than 90 million individuals in over 50 million households own mutual funds. This vast number of investors has a wide variety of funds from which to choose. Those who invest in mutual funds outside 401(k) plans can select from among the more than 8000 funds available.

Sponsors of 401(k) and other employers-sponsored plans sort through this wide range of product to provide a menu of options for their employees.

Mutual funds constitute the kind of market that von Mises would have loved. Fund investors can and do take part in a "daily plebiscite." Unlike some other investment products, such as hedge funds, mutual fund investors can redeem their shares on a daily basis.

The Internet and fund supermarkets make it even easier for investors to switch between competing fund firms.

Figure 3 illustrates the ease with which investors can move between mutual funds sponsors: In any given year, a quarter to a half of mutual fund firms experience net outflows from long-term funds.

Not only do mutual fund investors have considerable choice, they also have the tool that's vital to making an informed choice – an abundant supply of information, widely available at low cost.

- Investors can access a vast amount of information about mutual funds from a broad range of sources.

At low or no cost, investors can compare fund alternatives and make informed decisions, through several information vehicles, including:

- fund websites and toll-free telephone numbers;
- fund supermarkets;
- Yahoo, newspapers, and magazines;
- 401(k) plan sponsors; and
- fund advertising.

Funds are closely scrutinized by independent mutual fund analysts, such as Morningstar and Lipper – providing yet another independent check on the industry, available to investors at the click of a mouse.

So investors aren't just voting with their feet and their pocketbooks – they are voting with the benefit of a lot of valuable information from an abundance of sources.

There is widespread evidence that many investors – as well as the financial advisers and 401(k) plan sponsors on whom they rely to help guide their choices – incorporate this information in their decisions.

How can we tell? Because investors heavily favor funds with above-average, long-term performance (Figure 4). As can be seen, over three-fourths of stock and bond fund assets are held in funds with above-average 10-year performance.

We can also tell because investors' assets are highly concentrated in lower-cost funds. As Figure 5 indicates, nearly 90 percent of the assets of stock and bond funds are invested in low-cost funds. This is true for both actively managed funds and index funds.

Investors look for – and stick with – funds that deliver strong performance at a competitive price. By the same token, they penalize funds that do not deliver good performance by moving their dollars elsewhere.

Market pressure has been a driving force in reducing the cost of owning mutual funds over time. ICI research, summarized in Figure 6, shows that the amount that shareholders pay in fees and expenses for equity funds has fallen nearly 50 percent since 1980.

The cost of obtaining fund information likewise has fallen dramatically, largely by virtue of the Internet. ICI research has found that fund investors are big users of the Internet. A study of mutual fund shareholders that we conducted last year found they are very much "logged-on." Nearly 90 percent of mutual fund investors have access to the Internet at work, or home, or both. Of those, about two-thirds go online at least once a day. Almost

another quarter goes online at least once a week.

And three-quarters of mutual fund investors who go online use the Internet to access their financial and investment accounts.

Moreover, use of the Internet has grown dramatically among all segments of mutual fund investors, regardless of age, education, or household income.

- Competition = Innovation

One of the most important effects of competition – in any industry – is that it drives innovation. A firm has no choice but to innovate if it wants to push its head above the crowd. In fact, a firm has no choice but to innovate if it wants to survive.

Impelled by the market, mutual funds have innovated greatly in service (Figure 7). Investor demand for services has pushed fund firms to constantly undertake new and substantial investments, for example, in telephone call centers, automated voice-response telephone systems, Internet web sites, and consolidated account reporting. Fund firms know they must continually upgrade and improve such systems to attract and retain customers.

Innovation also has led to an ever-broadening array of types of mutual funds (Figure 8). Over the years, mutual fund sponsors have worked assiduously to develop an ever-broadening array of fund types designed to help investors meet their financial goals, from international equity funds, which were first introduced in the 1950s, to the ongoing development of new kinds of lifestyle funds and exchange-traded funds.

Mutual fund firms have also been innovators in the retirement market. Consider IRAs, 401(k) plans, and 529 plans. It was of course Congress that passed the enabling legislation for these retirement vehicles. But mutual fund firms made them workable, convenient, and attractive – that is, a real proposition for retirement investors.

The ease and convenience of investing in these kinds of plans through mutual funds is reflected in the share of retirement assets held in mutual funds (Figure 9). As of 2004, mutual funds managed 43 percent of IRA assets, up from 22 percent in 1990. In 2004, mutual funds managed 51 percent of 401(K) assets – up from 9 percent in 1990.

Conclusion

It may be heresy in Washington to assert, but government is not the only regulator. Competition drives markets toward goals regulators sometimes seek. Competition encourages firms to cut costs, reduce prices, provide varied and high-quality service, and innovate, all of which advance the interests of consumers. I trust that that lesson will never be lost at either end of Pennsylvania Avenue or here in the think tanks that do so much to shape ideas about public policy.

The mutual fund industry is a competitive industry. Robust competition, through von Mises' daily plebiscite, rewards fund sponsors that deliver value to investors and penalizes sponsors that don't. However, the competitive nature of the mutual fund industry is not

invulnerable to change. Indeed, it could be undermined by new or proposed regulations, whose unintended consequences reduce competition and thereby hurt investors.

For example, escalating compliance costs likely affect smaller fund sponsors disproportionately because these overhead costs are spread over a smaller asset base. In Washington, we often focus on those at the top of the food chain. As shown in Figure 10, however, only 5% of fund complexes in the United States assets in excess of \$100 billion. A far larger percent has less than \$1 billion. So, when we think about cost, when we think about competition, when we think about the health of the industry, we are by no means thinking solely about the largest 5% of all fund complexes. Instead, we must consider the spectrum of competitors and participants in the business and the health of the smaller complexes ought to of significant concern to us going forward.

While data are not yet available to measure these effects precisely, some of our smaller members tell us that compliance costs have reached 10 percent of gross revenues. With these added regulatory costs becoming so onerous, small firms are withdrawing from the mutual fund business and other firms likely will be deterred from entering. As a result, the industry could well become more concentrated and therefore less competitive over time.

Increased regulation of mutual funds could result in another unintended consequence: a shift by intermediaries toward less heavily regulated products, such as collective investment trusts, hedge funds, and separate accounts. Wealthy investors would adapt by shifting to these alternative products, leaving smaller investors to bear the brunt of increasing mutual fund compliance costs.

These cautionary notes have also been sounded by numerous industry analysts and participants in the media and elsewhere.

The dynamism of America's mutual fund marketplace has permitted millions of investors to access a wide array of securities markets, obtain professional investment management services, effectively manage their financial assets, and to do so with low cost and outstanding service. Because the tool of mutual fund investing is today more important than ever, maintaining the dynamism of this marketplace is a matter of importance to investors, regulators and our industry alike.

Thank you.

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