INVESTMENT COMPANY INSTITUTE

SPEECH

May 17, 2006

2006 General Membership Meeting: Address by President and CEO

2006 General Membership Meeting

Address by
Paul Schott Stevens
President, Investment Company Institute

May 17, 2006
Washington, DC

Good afternoon, ladies and gentlemen. I am truly delighted to be here this afternoon, to help kick off the Institute's 48th General Membership Meeting. Thank you, John, for your thought-provoking comments, and for your kind remarks. And thanks to you and the organizing committee for an excellent job in putting together this meeting.

The theme of this year's GMM is Creating Shareholder Value. As John points out, mutual funds have certainly done just that.

If America's mutual funds have thrived, it is because they have been agents of change – changing the way Americans save and invest.

If mutual funds have prospered, it is because they have innovated – identifying and embracing new opportunities to serve investors.

If mutual funds have succeeded, it is because they rest on strong regulatory and market disciplines – the high standard of fiduciary duty the law justly demands of fund managers, the abundant information funds must supply to their investors, the fiercely competitive environment in which funds operate, and the resulting scrutiny to which they are subject. As I said at this meeting in 2004, mutual funds should not only expect close scrutiny, but also understand that -- with $9.4 trillion in total assets today -- our size and importance demand it.

But that very size and importance demand still more of us. They demand that we take an active and responsible role in the debate over public policies that impact saving and investing. That's why we strongly supported the two-year extension of lower tax rates on capital gains and dividends, which President Bush today signed into law. The President and Congress are to be commended for their leadership on behalf of investors.

Our active and responsible policy role is particularly vital when the issue is retirement, the top financial priority in the minds of the overwhelming majority of fund shareholders. In public policy, as in our business, we must continue to innovate to meet the current and future needs of investors.

A History of Innovation

Like so much else, we take mutual fund investing for granted today. But the very idea of fund investing itself was a remarkable innovation. Following a financial crisis in the late 18th century, a Dutch broker conceived of fund investing as a way to permit small investors to diversify their international bond holdings and thus reduce their risk. This first fund was named “Unity Creates Strength.” In 1774, the fund’s prospectus promised investors a diversified portfolio, an annual accounting, careful custody of securities, and full disclosure to assure (quote) “good and proper management at all times.”

Dutch funds helped finance the American Revolution and our young Republic. A century later, fund investing spread to London – where funds channeled capital to build America’s railroads and to participate in our emerging market.

It has been said that you never know how many apples there are in a seed. When it comes to mutual funds, we are still finding out.

The modern U.S. mutual fund industry dates from just 1924, with the founding of Massachusetts Investors Trust. Consider the array of options and new services that the intervening years produced for investors.

- For savers seeking a current market return on their cash -- money market funds.
- For investors wanting the most diversification at the least cost – index funds.
- For those trying to manage tax liabilities – municipal bond funds.
- For workers wanting to simplify the management of their retirement assets -- lifecycle and lifestyle funds.
- For investors searching for investments that satisfy goals beyond the purely financial – socially conscious funds.
- For those seeking access to foreign securities -- international and emerging markets funds.
- For investors wishing to trade fund positions throughout the day – exchange-traded funds.
- For those pursuing a specific investment style or asset class -- a world of value, growth, small-cap, mid-cap, hybrid, sector, and other fund choices.
- And for shareholders wanting more information about funds, fund investing or their accounts – a wealth of service innovations, including consolidated statements, call centers, automated phone services, fund supermarkets, fund websites, 24/7 access, and more.

That’s quite a saga – but surely there is still more to come.

The only thing certain about the future is that it will be different – and it is incumbent upon us to embrace and shape that difference in a way that serves fund shareholders. That is why ICI supports SEC Chairman Christopher Cox in his drive to harness the power of the Internet to better inform fund investors, to provide them information in ways that they want and they will use.

Now, continuing innovation is a challenge. It involves uncertainty and risk. There will always be expert doubters, who insist that everything worth trying has been tried, and that change is unnecessary. In 1921, Tris Speaker, one of baseball's most successful player-managers, opined that Babe Ruth had made a big mistake when he gave up pitching to make his mark as a slugger. Ruth went on to bat the Yankees to seven American League pennants and four World Series titles!

Where serving the interests of mutual fund investors is concerned, we – like The Babe – must never stop swinging for the fences.

"Inventing" The 401(k)

When it comes to how Americans seek to achieve their long-term financial goals and secure a decent retirement -- change is a constant in this arena as well. Let there be no mistake: Our nation confronts significant challenges in meeting the needs of current and future retirees. While much has been done to improve retirement preparedness, there is still plenty to do to strengthen both the public and private retirement systems.

But we know that we can rise to these challenges – because we have done it before, with creativity and innovation. With others, mutual funds played a pivotal role in one of the most important innovations powering the growth of U.S. retirement savings – the 401(k).

Section 401(k) of the Internal Revenue Code was intended for modest purposes. It was designed to resolve a narrow dispute about whether executives could defer taxes on their profit-sharing bonuses. But the potential of the statute – reflected in the regulations that brought 401(k) to life 25 years ago -- was much, much greater. The law opened the door to a new way to save and invest for retirement – and provided an incredible tool of wealth creation for average Americans who wield the tool effectively.

How did that happen? Even the best idea doesn't just take off by itself. The growth of 401(k)s was the result of a partnership, an innovative partnership – involving employers, the government, and mutual funds and other financial services providers.

Some years ago, I had the privilege of working for David Packard, the late chairman and co-founder of the Hewlett-Packard Company and a true giant of American business. Dave used to urge H-P employees: "Make a contribution. Innovate, don't emulate." That's what mutual funds and others did with 401(k).

On the spare legal foundation that Congress gave us, we built a vast structure of creative investment options, recordkeeping systems, marketing programs for employers, education programs for workers, and information systems to help employers cope with complicated IRS and Labor Department rules. Today, any company can go to the market and find a turnkey 401(k) plan – or assemble a customized plan suited to its needs.

How many apples are there in this seed? Again, we're still finding out. As of today, 47 million Americans participate in 401(k) plans, more than four times as many as two decades ago. At the end of 2005, 401(k) plans held assets worth more than $2.4 trillion, 17 times the total of two decades ago.

The Growth of the DC System

401(k) is one part of a larger trend – the dramatic growth of "defined contribution" retirement savings plans.

Today, 53 percent of workers are offered DC plans – compared to just 22 percent of workers have access to defined benefit plans. Those DC plans -- which include 403(b) and 457 plans, in addition to 401(k) – together hold $3.7 trillion for millions of Americans.

These are remarkable figures. And with the pressures on Social Security and the traditional pension system, think about where America would be now without this quarter-century of innovation in the DC system.

Many nations face similar economic and demographic problems – and many are following a similar path.

- In Canada, the number of workers covered by DC-type plans has almost doubled since 1993.
- In the United Kingdom, a 2002 survey found that almost one-third of occupational retirement plans were defined contribution – more than twice the proportion in a study five years earlier.
- In Denmark, the majority of employer-sponsored retirement programs follow the DC model. DC plans are also common in Switzerland, and are growing rapidly in Spain, Belgium, and Austria.
- In 2001, Japan’s Diet passed a DC plan, open to firms and the self-employed. It is based on the 401(k) concept -- indeed, in Tokyo it is informally known as “the Japanese 401(k).” The one major difference: employee contributions are not permitted. Even so, these plans already have more than 1.6 million participants.

Why are we seeing this rise in DC investing -- in the U.S. and elsewhere in the developed world?

Because DC plans reflect reality -- the reality of a fluid economy and a mobile workforce, the hard fact that lifetime employment is increasingly rare. After all, even among workers aged 55 to 64, only about one-quarter have been with their current employers for 20 years or longer.

In this new economy, we will need every means at our disposal to help Americans achieve retirement security. We must strengthen the Social Security system to ensure its vitality for today’s workers and tomorrow’s. We must try to ensure that the traditional defined benefit pension system fulfills its promise to the millions of retirees and workers who are counting on it for a part of their retirement income.

And we must make sure that the defined contribution system lives up to its enormous potential to help many more millions of Americans to a secure retirement.

Of course, some observers look at the DC system and see only the grimmest of futures for retirees, now and for years to come. The full picture is more complex -- and the true outlook, brighter.

We are in a transitional period. The bulk of today’s 65-year-olds have not participated in DC plans throughout their entire careers. They have not enjoyed a long run of accumulating savings and compounding growth, and it is unlikely that their 401(k)s will be the mainstay of their retirement.

But looking forward, the DC system holds enormous promise to provide a solid retirement for today’s workers.

ICI has conducted research on the 401(k) system’s potential, in collaboration with the

Employee Benefit Research Institute. Our joint analysis, based on actual worker behavior, makes it clear: Under a wide range of projected scenarios, workers can save enough through 401(k) plans over a full career to replace a significant portion of their pre-retirement income when they retire.

Consider today's 30-something 401(k) participants, who will turn 65 between 2030 and 2039. For more than 60 percent of this cohort, their DC accumulations are projected to replace more than half their salary.

The key to this success: DC plans will do an ever-better job of providing for retirees as workers spend more of their career -- or even their entire career -- in jobs that offer such plans. The DC system already offers great potential -- and we can make it even better, with needed reforms.

The DC System: Addressing Urgent Needs

The trend toward DC plans is clear and irreversible. The challenge now is to empower people with the tools they need to succeed in the defined contribution savings system.

How can we encourage workers to start saving early, and to keep saving through their working years? How can we best protect and help low- and moderate-income workers? How can we help them maximize their savings -- and make their nest eggs last through retirement?

Continue to apply our minds to these tasks, and I am confident that we can succeed.

Even as we speak, Congress is working on several pieces of legislation that are vital to the continued health of the DC system. They address several urgent needs.

First, we need to broaden the saving population.

Many who are offered a plan at work do not take advantage of the opportunity. Of those workers who are offered defined contribution retirement plans, more than 20 percent do not participate.

One of the best ways to get more Americans onto the savings track is automatic enrollment. Employers should be able to easily sign up all new employees in the company 401(k) plan at a designated contribution rate. The EBRI/ICI study found that automatic enrollment increases participation significantly, particularly among lower-income workers.

Second, we need to maintain savings incentives.

In 2001, Congress increased contribution limits in both DC plans and IRAs, and made a number of other important changes to the rules governing retirement savings plans. These changes must be made permanent to strengthen Americans' ability to save for retirement. Otherwise, IRA and DC contribution limits will fall back and older workers will lose the opportunity to make the catch-up contributions they need.

These provisions were passed to encourage workers to save more. That objective is still as important as ever.

Third, we need to facilitate good investment decisions.

Employers need help designing default investments that meet the actual savings needs of their employees. Today, many employers fear they'll be held liable for any bad outcome in the default investment where they put their workers' 401(k) contributions. So they select the option that has the least immediate risk -- a money market fund, for example. What that means, however, is a far greater long-term risk for workers -- the risk of low returns and a diminished nest egg. Employers need clarification of the legal protections available when they select a balanced portfolio that meets workers' long-term needs.

Employees need help making good investment decisions. Many workers want and need access to professional advice. Regulations governing professional advice to retirement plan participants are based on laws that are more than 30 years old -- written when DC plans were smaller and offered workers far fewer choices. With appropriate safeguards, we must expand the circle of those who can provide advice to plan participants.

For ICI, these measures -- automatic enrollment, permanent savings incentives, and reforms to improve investment decisions -- remain top legislative priorities. Right now, the House and the Senate are negotiating legislation that will encourage millions of working Americans to participate in retirement plans, and help all participants get more out of their plans. We will work vigorously with Congress, with employers, and with other groups that share our sense of urgency on retirement issues until this legislation becomes law.

Building the DC System of the Future

Yet even as Congress completes these improvements, we still face serious challenges in delivering the retirement security that Americans need. We must continue to innovate and explore ways to improve the defined contribution system.

We have to expand savings opportunities for workers who are not covered now.

Forty percent of American workers are not offered any form of pension or retirement savings plan at work. Many work for firms that are too new, too small, or too financially uncertain to consider a retirement plan as an affordable or valuable option. And those who now participate in a plan have no guarantee that they'll be covered if they change jobs.

We have to help those who are covered increase their savings. And we must help all retirees make their savings last longer, especially as life spans grow.

These are tough problems -- but we are up to the challenge. Legislators, advocacy groups, academics, employers, and the financial services industry have advanced many proposals to strengthen further our nation's system of retirement savings. Let me suggest that experience be our guide, and commend some principles to lead us forward.

First, let's keep it simple – the simpler the better.

Universal tax deductions for IRA contributions in the 1980s generated a great influx of savings dedicated to retirement. Financial firms devoted enormous resources to making taxpayers aware of the immediate and long-term benefits of retirement savings. The result was a culture of saving. But since 1986, the rules for IRAs have grown ever more complex -- and that culture unfortunately has dissipated. IRAs today function largely as a repository for rollover accounts -- not as a strong engine for additional savings.

Employers too are discouraged by complex tax rules governing participation, non-discrimination, and vesting. We need to think about changes that will simplify these requirements so that the pension and investing worlds function seamlessly to help

American families save for their future.

Second, take a broad-based approach.

That means Americans also must save outside their tax-favored retirement and education accounts to meet long-term financial needs. One very practical measure to advance that goal is the GROWTH Act. This bill would defer taxing fund investors on their capital gains so long as those gains are automatically reinvested. Gains would compound, untaxed, until the fund shares are sold -- rather than being nicked year after year. Investors could avoid selling shares just to pay taxes. The GROWTH Act embodies a basic principle: Long-term investors need a long-term tax policy.

Third, leave room for the market, for competitive forces, and for innovation to do their part to solve our retirement problems.

Another major challenge will be to help Americans make their savings last through a longer life span. But this is an area where the market is creating solutions, through tools like the Lifetime Payment Account, or LPA. LPA’s are mutual fund accounts that help retirees stay invested, yet provide for sound, systematic withdrawals. Where these and other innovations can lead the way, policymakers should let the market function.

Earlier, I told you that even the best ideas don’t just take off by themselves. Our defined contribution retirement system will not realize its full potential without the concerted effort of many groups, public and private. We are prepared to invest in that effort. America’s mutual funds, and the Investment Company Institute on their behalf, are committed to being a constructive -- better still, an innovative -- partner in finding solutions.

Voltaire once said: “The present is pregnant with the future.” We know what kind of future we must build. It must be one that provides a new era in retirement security. We have the opportunity -- and we have the obligation -- to ensure that all Americans can share in that future.

Thank you.
