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1999 General Membership Meeting: President’s Report

ICI President's Report at the 1999 General Membership Meeting

by
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Good morning. I’m pleased to add to those who have welcomed you to the Institute’s General Membership Meeting.

Today we focus on emerging issues for the mutual fund industry beyond the year 2000. This gives us a special opportunity to put aside immediate issues and consider the long-term direction of our industry. Of course, it also creates a temptation to offer predictions as to what the new century will bring.

But prophecy is a risky business.

In 1943, the Chairman of IBM predicted a world market for five computers. In 1932, Albert Einstein predicted that nuclear energy would never be harnessed for use.

Prognosticators about the financial markets have fared no better:

- Irving Fisher, a brilliant Yale economist, predicted on October 16, 1929 that "[s]tocks have reached what looks like a permanently high plateau."
- In 1979, Business Week announced that "the U.S. economy has to regard the death of equities as a near-permanent condition." At the time, the Dow Jones Industrial Average was in the mid-800s. It is more than eleven times higher now.
- In a 1997 editorial, Money Magazine urged investors to "Sell Stock Now!" saying those who liquidated "20% of [their] stockholdings will profit handsomely." Less then two years later, the S&P 500 has moved fifty percent higher.

- We are certainly not immune from the failed prediction business. At the Institute's 1977 General Membership Meeting, we asked a highly respected Harvard Business School professor to speak, and he told us that "the mutual fund industry has seen its great growth years and now is in the mature stage of its life cycle." At the time, fund industry assets had "matured" to a total of about $48 billion.

To make sure that I'm not quoted in this fashion someday, I'll leave prophecies about the future of our markets to others. Instead, I will talk about what the mutual fund industry must do to succeed in the twenty-first century.

Since 1940, the mutual fund industry has grown from less than $450 million in assets to over $5.5 trillion today. A growing economy, strong securities markets, an expanding middle class, and government polices that promote retirement savings have all been important factors in our success. But these factors affected all financial products, not just mutual funds. Something else accounts for the extraordinary public acceptance of mutual funds.

What sets us apart? In my view, the key to our success lies in our industry's 60-year tradition of integrity.

For the mutual fund industry, success means more than just identifying the latest trends in products and services. It means more than pursuing short-term business goals. For us, it has always and must always mean supporting laws, regulations, and professional standards that put our shareholders first. This is not only the right ethical choice; it's the wisest thing that we can do to ensure the long-term success of our industry.

In the years to come, we will face many new challenges, including globalization, financial restructuring, electronic commerce, privacy concerns, and countless new developments in products, services, and markets. But, as important as these issues are, our future will largely depend on how well we address our most important issue—maintaining the integrity of the mutual fund industry.

To put things in proper perspective, we need to look back to this industry's earliest days. Investment companies first became popular in the 1920s. While many were operated prudently, many others engaged in questionable activities. By 1929, the founder of the second U.S. mutual fund, Paul Cabot, was concerned enough to write an article in the Atlantic Monthly criticizing the abuses. After the stock market crash of 1929, criticism grew louder, leading at least one industry observer to call for the abolition of investment companies.

The SEC undertook a major study of the fund industry in the 1930s, culminating in a 5,100-page report and recommendations for stringent legislation. Many predicted that the industry would oppose and defeat the legislation. Indeed, the mutual fund industry could have taken the path of many industries faced with comprehensive federal regulation, and fought the legislation.

Instead, our industry supported the SEC in helping the Investment Company Act of 1940 become law. This spirit of integrity is captured in the words of an industry leader in the 1930s, Arthur Bunker, who testified before Congress. "We recognize that abuses have existed and we believe that legislation is necessary to ... help the better elements of the industry to raise the standards of the industry to increasingly higher levels."

Working together, SEC officials and industry representatives took snapshots of the industry. The law that resulted—the Investment Company Act of 1940—made the fund industry's best practices mandatory for all, and flatly prohibited the abuses of the 1920s. As a result, we have a regulatory system whose core protections—oversight by independent directors, bans on affiliated transactions, daily marking to market of assets, limits on leveraging, and full disclosure—are unparalleled in the financial services world.

Over the years since the passage of the Investment Company Act, the mutual fund industry has supported, and even called for, new laws and regulations and stringent voluntary measures. This tradition has been critical to our success, and it continues today. We have every reason to be proud of our record.

But the Investment Company Act is nearly sixty years old. As time goes on, memories fade. Most firms that manage mutual funds today were created well after the passage of the Act. Very few of the individuals who lived through the events of the 1930s and 1940s are still with us.

It's up to us to make sure that the tradition continues—we must never take our commitment for granted. The worst mistake that we could make would be to rest on our laurels, to sit on our lead. Missteps by just one fund organization could tarnish an industry-wide reputation sixty years in the making. Nothing that we do in the next millennium—no new product or service—will help us to succeed if we fail in this regard.

There are at least six things that we must continue to do:

Continue Support for Fiduciary Requirements

Number one, we must remain unwavering in our support for the core fiduciary provisions of the Investment Company Act, and resist siren calls for their dilution or elimination. You do not need to go back to the 1920s to see what can and will happen when pooled investments are managed without limits on leveraging, without independent oversight, without bans on self-dealing, or without full disclosure. Just consider the events of recent years with real estate investment trusts, limited partnerships, highly leveraged hedge funds, and municipal investment pools.

In my role as president of the Institute, I spend a good deal of time talking with and listening to people in the industry. Although it is rare, I occasionally encounter disturbing signs of a loss of historical perspective on the importance of our core protections. Once, a new entrant to the industry remarked that independent director requirements were a mutual fund oddity that ought to be eliminated. Another member once criticized our industry's tough voluntary standards on personal investing, because other industries don't have such tough requirements. Comments like these reflect a profoundly flawed understanding of what makes mutual funds successful and exceptional. They miss the point—yes, our requirements are different and tougher, and that's what is responsible for our success.

Supporting the core protections of our system also requires that we re-examine them from time to time. That's why I'm pleased to report that in March, the Institute formed an Advisory Group to consider best practices for fund directors. Mutual funds have the strongest governance system in the private sector, and independent directors in particular play a critical role in investor protection. It makes sense to examine current best practices to see if they can be made even better, and we are pleased to be part of Chairman Levitt's initiative for a careful and thorough review of this central element of our regulatory system.

Propose New Laws to Address New Issues

Second, we must keep a finger on the pulse of change and propose new laws, regulations, and voluntary measures to address new issues head-on. Justice William O. Douglas—who also served as Chairman of the Securities and Exchange Commission—once said, "security can only be achieved through constant change" in the law. This past year, the Institute took an active role in urging the SEC not to allow credit card payments for fund shares. We urged the NASD to adopt a rule governing the sharing of customer information. We supported long overdue reform of the laws governing the structure of the financial services industry. And we submitted a series of recommendations to the SEC that would modernize the Commission's rules governing affiliated transactions without diluting the effectiveness of the Act's bans on self-dealing. We must be always vigilant to the constant changes, large and small, that may be needed to ensure that our system of regulation keeps pace with changes in our industry and in the markets.

Insist on Functional Regulation

Third, we must continue to support strong regulation of our industry by a single regulator enforcing one body of law committed to one goal—the protection of investors. For over six decades, the SEC has admirably filled this crucial responsibility. The Congress continues to recognize the important role of SEC regulation as Congress considers legislation that would permit the affiliation of mutual fund companies, securities firms, banks, thrifts, and insurance companies. The legislation calls for "functional regulation," under which mutual funds and securities firms would continue to be regulated exclusively by the SEC. Wisely, the Congress continues to resist the entreaties of the Office of Thrift Supervision and the Comptroller of the Currency, which insist that they must have full authority to regulate non-banks, including mutual funds and securities firms, that are affiliated with banks and thrifts. The position of OTS and the Comptroller would lead to duplicative and conflicting regulation. More importantly, their position risks erosion of the uniform investor protections of the federal securities laws, which serve a very different purpose than the safety and soundness concerns of banking regulation. We must continue to support those legislative leaders who insist on legislation that provides for true functional regulation.

Challenge Misinformation

Fourth, we must guard against recurring myths and unfounded suggestions of problems that do not, in fact, exist. Misinformation is to no one's benefit. One myth is that when markets break, fund shareholders will panic and engage in massive redemptions, forcing funds to sell securities and causing the market to spiral further downward. This question has been studied exhaustively. Every study has found that through numerous market breaks over the past sixty years, fund shareholders have never panicked. Shareholders are not insensitive to market declines, but their response has been measured and gradual.

Another concern that is voiced from time to time is that mutual fund flows drive stock prices. Again, this is a theory in search of facts. Lazlo Birinyi has written: "[It is a] myth that the stock market runs on mutual fund fuel." He cited the fact that in 1994, despite monthly net inflows that were very strong all year, stock market performance was flat and actually ended the year off by 3.4%. The following year, equity fund inflows remained at their 1994 levels, but this time the market was up 18.7%.

Finally, another hardy perennial—and one that has received much attention lately—is that mutual fund fees are rising. The reality is that in the past two decades, the total cost to shareholders of owning mutual fund shares has fallen across the board: in equity funds by more than one-third; in bond funds by 25%; and in money market funds by 15%. Nor are shareholders in the dark about the impact of mutual fund fees on their returns. A significant majority of equity fund investors—over three-quarters—own shares in funds whose fees are below industry averages.

Red herrings such as these divert our attention from real issues and concerns. We must never be hesitant to challenge myths and misinformation.

Ensure Rules that Help Inform Investors

Fifth, we must ensure that our regulatory requirements help investors make informed investment decisions. In the past few years, Chairman Levitt and the SEC, with the enthusiastic support of the fund industry, revised the mutual fund prospectus to make it a more readable document, and adopted plain English requirements. We are pleased that the SEC now is turning its reform efforts to other disclosure documents, such as shareholder reports. We believe that an important element of this initiative should be to improve after-tax performance reporting, as has been urged by Congressman Gillmor.

But these reforms, as critical as they are, are only part of a larger picture. We must bear in mind that about eighty percent of investors rely to some extent on the advice of third parties in purchasing fund shares, including brokers, banks, financial planners, insurance agents and employers. Our efforts must ensure that these distribution systems work in the interests of our shareholders.

A prime example is the defined contribution market. Over forty million Americans are covered by defined contribution plans, under which they select their own investments from a menu of options offered by their employers. These options include mutual funds, bank and insurance products, and the employer's own stock. Simple fairness tells us that these employees deserve complete information about these options, including clear information about fees and expenses. Some employers provide the information; others do not.

This is an accident waiting to happen. Pensions and Investments magazine has warned that "when participants are kept in the dark about fees, [there is] a risk of erosion of support for 401(k) plans." We must continue to urge the Department of Labor to require every sponsor of every 401(k) plan to provide every employee with full disclosure about every investment option. The mutual fund prospectus and the new fund profile offer two models for regulators to consider.

Remain Committed to Education

Finally, we must remain committed to education.

We must continue to educate investors about the risks, as well as the rewards, of mutual fund investing, and about the benefits of asset allocation, diversification, and long-term investing. We must continue to teach them about the impact of fees and taxes, the role of fund directors, the need for retirement planning, and the importance of a long-term investment horizon. We must continue to appreciate the media's role in educating investors, and keep up our press briefings, news releases, and one-on-one meetings. And we must always do all that we can to help legislators and regulators understand the actual day-to-day workings of our industry.

Most importantly, we must educate all of the men and women who work in our industry. More than anything else, the actions of the individuals working in our industry each day have the greatest impact of all on our integrity. We must help them understand that it is essential to comply with the spirit, not just the letter, of the law. We must pass on to them the fiduciary culture that we inherited.

So far, I have described how our support for stringent laws, regulations, and voluntary measures are critical to the integrity of our industry in coming years. Industry-wide support can only be achieved if we continue to put aside our differences to work together for the common good, and continue to speak with one voice. For almost sixty years, we have done so, to the great advantage of our shareholders and our industry.

The mutual fund industry is one of the great American success stories of the twentieth century. We have brought the benefits of professional management and diversification, at reasonable cost, to millions of American families. And, in our entire seventy-five year history, we have not cost the U.S. taxpayer one cent.

I suppose it is possible that, in the coming century, someone could devise a new and better investment medium, and mutual funds could become obsolete. I do not believe that this will be the case.

Instead, if we are true to our tradition of integrity, I believe that the mutual fund industry has a most enviable future. Our fate is in our own hands. We must remember the lessons of the past, and always put the integrity of the industry above all else.

When I began, I made light of some predictions that were proved wrong by history. In closing, I'd like to share with you a prediction that proved to be right. In 1940, SEC Commissioner Robert Healey offered the following prediction. Remarking on the willingness of the mutual fund industry to work with the SEC to develop stringent legislation, he observed:

"[I]t leads me to express the belief I have that under this regulation and under this kind of sensible and honest management, I believe that [mutual funds] will have a very fine future, a very promising future, one rendering useful service to the small investor. I believe they can make a definite and very useful contribution to our economy and to our national welfare."

The mutual fund industry's greatest accomplishment is that we have proven worthy of this prediction. The years to come will present many challenges and many trials. But so long as we devote ourselves above all to maintaining the integrity of our industry, I have no doubt that our future will be bright as that foreseen sixty years ago.

Thank you.