

SPEECH

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After the Financial Crisis: The Outlook for Investors and Investing

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Thank you, Karl [Ege, senior counsel, Perkins Coie LLP], and thank you to the Rotary Club of Seattle for inviting me to speak. This is a podium that has hosted many notable speakers—Jamie Dimon of JP Morgan, Dr. Anthony Fauci, General Barry McCaffery, and Microsoft’s Steve Ballmer, among others. I’m very honored to be here, and in such company.

I was asked to talk to you about the financial crisis that we all endured three years ago and its lingering aftereffects on investors. I’m willing to bet that individually, none of you needs the head of the mutual fund trade association, coming all the way from that other Washington, to tell you how painful the crisis, the ensuing bear market, and the ongoing economic and financial turmoil have been.

You have been there. You have lived it.

No investor has been immune to the turmoil, volatility, and severe declines that struck stocks and other assets in the wake of the worst financial crisis since the Great Depression. All investors are still watching with some anxiety as the crisis in the Euro zone continues, the U.S. struggles with its fiscal policies, and the global economy sputters.

What’s interesting, however, is what we find when we look at the reactions of mutual fund investors, particularly those saving for Americans’ No. 1 financial goal—retirement security.

At ICI, we have been studying mutual fund investors since the 1950s. We’ve conducted an

annual survey on their behavior and sentiments since 1987. Since the 1990s, we have been the primary source of data on Individual Retirement Accounts and have conducted extensive studies of 401(k) and IRA savers.

Late in 2008, in the depths of the bear market, we decided to step up our research on retirement savers' actions and attitudes.

Now, we look at the records for more than 22 million 401(k) accounts at the end of every quarter to see whether those investors are still contributing, taking withdrawals, or reallocating their assets. And we have added an annual survey of public attitudes toward 401(k)s and other parts of the private-sector defined contribution retirement system.

It's true that the two bear markets of the last decade have made investors less comfortable with financial risk.

In 1998, one-third of households that held defined contribution plans or individual retirement accounts expressed willingness to take above-average or substantial risk in return for commensurate financial gains. Since 2009, only one-quarter of these households have said they accept that level of risk.

And it's true that investors are behaving more conservatively with their finances.

In the Institute's survey at the end of 2010, we found that almost three out of every five households with financial assets had increased their regular savings rate, reduced their allocation to stocks, or postponed their planned retirement age. Many households made two or all three of these changes.

But while investors have become more conservative, they haven't panicked. Nor have they given up on investing.

Instead, in each of the three years since the crisis, we've found that:

Fewer than one in 25 participants in defined contribution retirement plans quit contributing to their 401(k) or similar plan.

The number that took any withdrawal at all from their plan was on the same order—fewer than one in 25.

And fewer than one in 50 took a hardship withdrawal.

Finally, we know that retirement savers have been rewarded for their commitment.

Consistent savers who remained invested in 2008 were poised to benefit both from continued contributions and from the market upswing of 2009. As result, the 28 percent drop in 401(k) account balances they suffered in 2008 was largely offset by a 32 percent gain in 2009.

You'll recall that in 2008, about the time we stepped up this research, the press was full of stories about workers fleeing from their 401(k) plans in panic.

Obviously, that's not what we have found. As Ed Bernard of T. Rowe Price, the chairman of our board for the past two years, likes to say: "The people who invest have been a lot calmer than the people who just write about it." The people who actually invest have

stayed the course.

So I've been up here about six minutes, and I've given you my punch line. Where do I go from here?

Well, I'd like to try to explain why we have seen this calm reaction in the face of the greatest financial and market crisis in generations.

And to do that, I want to step back in time—way back. About 300 years, to be precise.

Financial history is littered with speculative bubbles, from Holland's tulip mania to our own Roaring Twenties. But of all these episodes, I find the story of John Law and the Mississippi Company to be especially interesting. In part, that's because of the connection between John Law's escapades and my home town, New Orleans. But the Mississippi bubble is also fascinating for its scale and for its consequences—and those are what I want to emphasize.

In 1715, after decades of extravagance and ruinous wars, France was close to bankruptcy. When Louis the Fourteenth needed to borrow 8 million livre in gold from one of the leading financiers of Paris, the legendary "Sun King" had to pledge four times that amount in notes. Taxes were ubiquitous—so much so that couples would marry or baptize their children without the services of a priest to avoid extra levies.

Into this wreckage came John Law—one of the true fathers of modern finance.

John Law was a Scotsman best known for his prowess at the gaming tables of London, Venice, and Genoa. He arrived in Paris as an exile from Britain, where he had fled from prison and the hangman's noose—under a sentence of death imposed after he killed his neighbor in a duel.

For much of the following 20 years, he had lived in Amsterdam—at the time, the world capital of finance—where he had studied the success of the Dutch East India Company and the rapid growth of the Amsterdam Beurs, the world's first stock exchange.

Law spent those years thinking about how to combine commerce and credit into a powerful system for trade and economic growth. What he needed to make his system work was a country desperate enough to allow him free rein. He got his opportunity upon the death of the Sun King, when Law's friend the Duc d'Orleans became Regent to the five-year-old Louis the Fifteenth.

With Orleans' help, Law founded a new bank, the Banque Generale. The bank began issuing legal tender—an early form of paper money—when the Regent decreed that the bank's notes could be used to pay taxes.

Over the next few years, Law took over tax collections, wiped out hundreds of excises, and replaced them with one of the world's first income taxes. He gained control over the mints where coins were made.

And he launched his greatest creation—the Mississippi Company. To the Regent, Law pledged to refinance the royal debt, accepting lower interest rates on the government notes he took in as payment for Mississippi shares. In return, the Company was granted monopoly control over trade with France's colonies, including the Louisiana Territory and French Canada.

Shares in the Mississippi Company were sold to the public, and investors were promised riches on the scale that Spain and England were extracting from their colonies. Louisiana was hailed in song as a “new wonderland,” endowed with gold and silver mines and pearl fisheries.

To sweeten the deal, Law made the terms for buying shares remarkably easy—20 percent down in gold or notes, with the rest financed by Law’s bank, which by now was the Banque Royale.

What resulted was one of the greatest speculative booms in history. Everyone in France—from royal princes to servants—wanted to own Mississippi stock. Shares issued for 500 livres skyrocketed in price to 10,000. The Paris street where the company was headquartered became an open-air market, and rents there shot up 10- and 15-fold. An English clerk observed that dukes and duchesses “sell estates and pawn jewels to purchase Mississippi.” The term “millionaire” was coined to describe the newly wealthy.

You can anticipate what came next.

Louisiana had no gold—unless you count the black gold discovered almost two centuries later. The governor of Nouvelle Orleans reported that there were four houses completed—not the 800 that Law touted—as half of the émigrés sent there had either died or turned back.

The cycle of easy credit and skyrocketing share prices fueled inflation, and the Banque Royale had scant reserves of gold and silver to back the paper money supply it created. Savvy investors began to sell shares and send their cash abroad.

One after another, Law’s desperate measures to prop up Mississippi stock and halt capital flight failed—and the crash came. Deadly riots broke out as mobs fought to get gold or silver for their notes. Suspicion and disorder reigned, as the government launched a campaign to root out speculators and profiteers. By 1720, Law’s system was undone.

Perversely, the royal treasury registered an immediate gain from the breakdown: inflation reduced the real value of the royal debt by two-thirds.

But France’s financial institutions were ruined. As historian Niall Ferguson wrote, “Law’s bubble and bust...[put] Frenchmen off paper money and stock markets for generations”—and set the royal family on a course of fiscal mismanagement that helped trigger the French Revolution some 70 years later.

I single out John Law because of his connections to my birthplace, because his story is so colorful, and because of the historic impact of his scheme. But the Mississippi bubble is hardly the only example of financial engineering gone wrong.

Indeed, one of the surprise bestsellers of 2009 was a thick book, chock full of dense charts, titled *This Time Is Different: Eight Centuries of Financial Folly*. In it, two economists examine data from 66 countries and hundreds of banking, sovereign debt, currency, and inflation crises to tease out the common factors that lead to what historian Charles MacKay called “Extraordinary Popular Delusions and the Madness of Crowds.”

The key point of their book, the authors say, is simply this: “We have been here before.” Every crisis is different—but there are remarkable similarities repeated over and over throughout history.

So how does our latest financial crisis resemble the Mississippi bubble, and what lessons does John Law offer?

First is the role of government policy in triggering and fostering boom-and-bust cycles. Law was able to rise so quickly because he worked for an absolute ruler who could override councils of state.

Yet even in a democracy, public policy can go awry and fuel speculative bubbles. Most analysts agree that policy errors in no small part fueled the latest financial crisis.

A decade-long push by government to promote home ownership led many lenders to ease the terms of mortgage lending. As a result, by some estimates, in 2007, 27 million mortgages—half of all mortgages in the United States—were subprime or non-traditional.

Banking regulators failed to prevent the deterioration in underwriting standards—a crucial policy error.

The second key factor that links Mississippi in 1720 to America today is the central role of monetary policy.

John Law has been recognized by many notable economists—from Adam Smith to John Kenneth Galbraith—as a master of monetary theory.

He just didn't know when to stop.

Could we say the same of the central banks of the U.S. and Europe, and the long credit and asset boom that so much of the world enjoyed during the past decade? Or, for that matter, of the leaders of financial institutions who rode the bubble without looking ahead to its inevitable collapse?

For some reason, economic booms invite party metaphors. Central bankers are supposed to know when to “take away the punchbowl.” CEOs of financial firms are said to be playing musical chairs: they are obliged to stay on their feet so long as the music is playing. But taxpayers and shareholders count on government and business leaders to know exactly when to end all the fun. Trouble is, neither group exhibits such perfect timing.

A third parallel was that many voices offered warnings of a breakdown in Law's system—but too many people were too caught up in the euphoria to pay heed.

In 1719, the ever-skeptical Voltaire wrote to a friend: “Have you all gone crazy in Paris?” The English author Daniel Defoe said the French economy was “run up [on] a piece of refined air.”

Today, the bookshelves groan with volumes of “I told you so.” But at the time when it mattered—when bankers could have turned away subprime loans, when regulators could have raised capital standards, when credit rating agencies could have quit slapping Triple-A ratings on suspect paper—the warning signs were largely ignored. Confidence fed confidence until the bubble burst.

There are many other parallels, and yet one important contrast remains.

Remember, Niall Ferguson said that the Mississippi bubble “[put] Frenchmen off...stock markets for generations.”

Yet the research we have done at the Investment Company Institute finds that mutual fund investors, particularly retirement savers, for the most part are holding steady.

Even over the past few months—with the unprecedented downgrade of the U.S. government's credit rating, the remarkable volatility in stock markets, and the ongoing crisis for sovereign debt in Europe—our recent data on flows into and out of mutual funds show that fund investors are not fleeing equity funds. In fact, despite a rapid increase in stock market volatility in August, the vast majority of mutual fund investors stayed the course with their investments.

What accounts for this response?

To me, the two key differences are in the investors and in the investing vehicle.

Clearly, greed and euphoria haven't been bred out of the human race over the past three centuries. Today's Americans can chase a tech boom, or leverage themselves into a house they can't truly afford, based on the conviction that "this time is different."

But as average Americans have in the past generation assumed greater control over and responsibility for their retirement savings, views about investing have evolved. Our retirement savers are well aware that they are in this for the long term. They are investing for the rest of their lives—not going for a killing.

With that attitude, investors realize that they have to make plans and stick with them. Indeed, our mutual fund members tell us that investors are saying: "The market is volatile—I have to save more." They recognize that saving is the foundation.

That long-term approach is reinforced by the plethora of educational materials that investors today have at their fingertips, offered by the government, regulatory authorities, non-profit organizations, our member firms, and many other financial institutions.

Just as the attitude of fund investors is different, so too is their chosen vehicle. Mutual funds offer a diversified, professionally managed portfolio that is closely regulated. Investors receive thorough disclosure of their funds' investments, strategies, risks, and returns. While fund investors are not immune to the market's shocks, they are protected from the falsified returns of a Madoff scheme or the high leverage of many hedge funds.

Fund protections weren't always so strong. In the Roaring Twenties, investment funds were, in the words of John Kenneth Galbraith, "the most notable piece of speculative architecture."

Their assets soared from \$1 billion in 1926 to \$8 billion three years later—just before the stock-market crash ushered in the Great Depression.

That crisis led to the greatest reform of finance in U.S. history—and mutual funds were not exempt. After a decade of study and deliberation, Congress in 1940 passed the Investment Company Act and Investment Adviser Act, laying the foundations for our industry. In addition to the framework of strict regulations, these statutes gave fund advisers a simple charge: put your investors' interests above your own.

This fiduciary duty has helped build the trust that Americans have today in the mutual funds that manage their investments.

We see that trust in their ongoing dedication to saving and investing for their future—despite all the challenges that today’s markets pose.

Preserving that trust is imperative. It is something that we, America’s mutual funds, never take for granted. We know we must earn investors’ confidence every day.

That is our commitment—and that is our mission.

Thank you.

What a great pleasure it has been to address you. And now I’d be happy to take your questions.

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