SPEECH

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Forces Shaping the Future of Global Asset Management: Demography, Technology, and Competition

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Thank you for the very kind introduction and to Tsinghua University for inviting me here to such a distinguished forum. It is my great honor to have the opportunity to speak in China at this premier institution of higher learning renowned for its global outlook and tradition of scholarship. I am confident that today I am addressing some of the world's top business leaders of tomorrow.

For those of you who do not know the Investment Company Institute, or ICI, we are a leading global trade association for regulated funds — that is, mutual funds; their European counterparts UCITS, or Undertakings for the Collective Investment in Transferable Securities; and similar products that are substantively regulated and offered to the public in jurisdictions worldwide. We seek to encourage adherence to high ethical standards in the fund business; to promote public understanding of funds and fund investing; and otherwise to advance the interests of funds, their shareholders, directors, and advisers.

In our international work through ICI Global, we are keenly interested in the development of the fund industry in the Asia-Pacific region, Europe, and other parts of the world. Why? Because of the benefits that funds can provide both to investors and to the economies of these regions.

Next year marks the 80th anniversary of the US Investment Company Act of 1940, which gave birth to the modern regulated fund industry, as we know it, and to ICI, organized to represent that industry first in the United States and now globally. But fund investing has a much longer past.

Following a financial crisis in the late 18th century, the Dutch broker Adriaan van Ketwich conceived of fund investing for small investors to diversify their international bond holdings and thus reduce their risk. The fund he formed 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 “good and proper management at all times”—all principles that funds today embrace.

Dutch funds helped finance the American Revolution and the young United States. A century later, fund investing spread to London–where funds channeled capital to build America’s railroads and to participate in our emerging market. The US mutual fund industry dates from 1924 with the first open-end fund—Massachusetts Investors Trust—founded in Boston.

While I may not have been a witness at the birth of that Boston fund, I was pleased to be in China in 1997 as China was considering the statute establishing its fund sector—and again, last year to celebrate the 20th anniversary of China’s fund industry.

As we observe these milestones—and as I will explain—fund investing has a very promising future, as well as a noteworthy past. In this presentation, I will outline key factors that will influence its further development.

So, where are we today? By every measure, regulated funds have achieved great success and continue to grow in reach and popularity across the world. They attained $51 trillion (in US dollars) in total net assets worldwide as of June this year, up from $29 trillion in 2010.

Yet today, regulated funds, especially in the most mature markets of the United States and Europe, face some of the stiffest competitive challenges they’ve ever encountered and are under intense pressure to provide investors more and more services at lower and lower fees. And the success and size of the fund industry are attracting growing regulatory scrutiny, adding potential new regulatory costs to the equation.

As we look ahead, though, it is clear the regulated fund industry has much more potential and much more work to accomplish. As many regions of the world continue to develop and modernize their capital markets and as the proportion of elderly around the globe grows, regulated funds will play an ever more essential role as a financial intermediary, channeling household savings to fund economic growth, while helping investors reach their financial goals.

Can funds meet these daunting challenges? I think they can. Ours is an innovative industry, continually offering investors new and better services, with greater efficiency. These challenges—changing demographics, competition, regulatory scrutiny—create new opportunities. And here, emerging technologies will play a more important role than ever. I believe that these forces together will spur our industry to build upon a longstanding commitment to serving investors and the economy, while meeting the complex demands of a new era.

Of course, China is and will be a most important part of this story. China has demonstrated a keen appreciation for the role that funds do play in the capital markets and can play in a well-structured retirement system.

Building a strong asset management industry clearly appears to be a priority for China, which, as you know, is undertaking several actions to advance that effort. They include:

- The government's focus on the third pillar of your nation's retirement system—and the potential role that funds might play as vehicles for retirement savings.
- The plan to allow 100 percent foreign ownership of domestic fund companies next year.
- The elimination of Qualified Foreign Institutional Investor (QFII) and RMB Qualified Foreign Investor (RQFII) quotas to facilitate inbound foreign investment.
- And plans to develop a wealth management center in Shenzhen that can facilitate cross-border sales of funds.

These seem to be good steps toward achieving some of the larger policy goals that the development of a strong domestic asset management industry would address.

Along these lines, ICI appreciates the very constructive relationship we have with the Asset Management Association of China, or AMAC, a key player in the development of China's fund industry. We're pleased that AMAC has produced Chinese translations of two works of ICI research: the book *How America Supports Retirement* by ICI economist Peter Brady, and ICI's *Investment Company Fact Book*, a comprehensive annual compendium of industry data and research. We hope that these translations will provide useful insights to Chinese policymakers, academics, and fund managers.

I promised to speak about challenges that will shape the future of fund investing, so let me begin with the issue of aging populations and retirement.

In China, as in Japan, Europe, the US, and elsewhere, the ratio of retirees to workers is rising. It is estimated that in China, 26 percent of the population will be aged 65 or older by 2025, compared to 10 percent in 2015. In the US, 22 percent of the population will be aged 65 or older by 2025, compared to 15 percent in 2015. Japan and Europe are aging even faster than China and the US.

Changes of this kind mean that pay-as-you-go retirement systems, where current workers fund retired ones, can no longer shoulder the needs of retirees. A thriving asset management industry can help bridge the gap. In the US, 73 percent of mutual fund investors say that retirement is their primary goal in investing. Today—as this slide shows—individual retirement accounts (IRAs) and funded defined-contribution plans, like our so-called "401(k)" accounts, hold over 60 percent of US retirement assets.

Channeling savings to the capital markets supports not only retirement incomes, but also the growth of the economy. Many countries and regions—including China, Japan, and the EU—today are focused on the need to develop broader, more liquid and efficient capital markets that will help develop nimbler, innovation-led economies.

Like many others in Asia, Europe, and elsewhere, the Chinese people have traditionally kept most of their savings in bank deposits and currency. To be sure, bank financing based on those savings helped build strong industrial bases in China, Japan, Korea, and many

European nations, just to name a few.

But capital markets have many unique advantages that are particularly helpful for all economies pursuing today’s fast-moving, innovation-led growth. These advantages include the capacity to provide highly efficient allocation of resources, economic stability, and economic flexibility.

Capital markets are more efficient than banks in matching providers of capital with enterprises or households that need funding. They provide stability through the immediate pricing feedback of every trade—making it possible to recognize risk sooner. Moreover, capital markets allow the spreading of risks broadly by engaging diverse sources of funding. And they provide the flexibility to support entrepreneurship.

Capital markets are more willing and better equipped than banks to take on the risks to fund smaller enterprises and entrepreneurs with the potential to create the innovations of the future.

Why is that? Well, investors in capital markets provide immediate, constant valuations of businesses through frequent trading. The market factors in myriad considerations by countless investors. And in that process, investors reward good ideas, strategies, and management—and punish bad ones—in real time.

Now, despite all these strengths, the further development of global capital markets is not guaranteed. Trade frictions and protectionist policies clearly pose a threat. In some places, capital markets that once have been open now threaten to put up barriers and shrink. Policymakers in those regions should reflect carefully on what could be lost. Brexit, for example, has the potential to fragment liquidity in Europe at a time when just the opposite is so imperative to meet the needs of an aging society and vibrant, innovative economies. To counter these pressures, we continue to encourage the EU to push forward its Capital Market Union project—and remind them that funds can play a key role in capital market expansion.

There’s certainly room for the fund industry’s role to expand. In China and in Japan, too, households invest less than 5 percent of their financial wealth in regulated funds, compared with European households at 8 percent and US households at 21 percent.

In China, the circumstances are ripe for the development of a thriving fund industry. Given a large domestic market with relatively limited investment options for households, the prospects are exciting. China is the market that holds the highest growth potential for the fund industry in the world.

As China’s middle class continues to grow, more households are likely to turn to regulated investment funds for the diversification, professional management, low cost, high transparency, and investor protections they offer.

By providing professional investment management and pooling of individual investors’ assets, funds give investors of even modest income levels a way to take part in the benefits of securities markets. Indeed, in the US, half of households owning mutual funds have moderate or low incomes. In time, with greater financial education, Chinese investors, like their counterparts in the US, will likely see funds as long-term holdings that can help them attain lifelong objectives, such as education and retirement financing.

Another major trend shaping the future of the industry is the role of new technology, and here, too, I expect China to play a very important role.

The fund industry is exploring robotics, for example, which can tackle both back office functions and customer-facing functions, such as investor advice through robo-advisors. Similarly, artificial intelligence has many potential applications. Machine learning helps fund managers create more robust portfolios by sifting through terabytes of data to find investments that best meet managers' criteria. Natural language processing helps analyze not just the words spoken, but also the intonation, during a CEO's earnings call to help provide fuller context.

The interest in these technologies, of course, is worldwide. The US innovation ecosystem is well functioning and continues to create new fintech solutions. In the EU, with the threat of Brexit, regulators are redoubling efforts to promote fintech innovation hubs around the region. Likewise, the Japanese government has taken measures to promote fintech, including new laws establishing greater clarity on use of blockchain and other technologies.

In this worldwide pursuit, China enjoys unique advantages. Chinese consumers are already immersed in digital byways, living in a world of Alibaba, WeChat, and Baidu. In many ways, China is more digitally advanced than the US: while I am still carrying a wallet full of credit cards and cash, I daresay most of you have gone cashless, with the Alipay and WeChat payment systems. Indeed, as Kai-Fu Lee observed in his book *AI Super-Powers*, some beggars on the street now wear paper cards around their necks with the QR codes for Alipay and the WeChat payment systems.

In this environment of widespread digital usage, China is primed to open new fronts in the fund business. We are seeing the signs already. I had the pleasure of interviewing Alibaba co-founder and executive vice chairman Joseph Tsai a few months ago at ICI's General Membership Meeting. We talked about the remarkable rise of one of the world's largest money market funds, Yu'E Bao, which Alibaba started in 2013 just as a place for Alipay users to park spare cash in their smartphone wallets.

Given the many prospects before the fund industry in China—a promising market in its early days with new innovations to come—perhaps many of you in the audience will consider taking part in its development.

As China continues to build its domestic fund industry, it is only fair to share some of the challenges the industry is encountering, especially in its most mature markets—the US and Europe. Here, we come to the third large trend shaping the industry's future.

In the US, competitive pressures are building in the industry. Those forces have been masked somewhat by the performance of US equity markets over the last decade, but they are now becoming quite apparent.

The decoupling of growth in assets under management, or AUM, from revenue growth is an indication of a new marketplace reality.

From 2000 to 2018, the US industry's assets under management (AUM) rose 6.4 percent annually, but revenue did not keep pace—rising only 3.5 percent annually, according to ICI data.

Looking ahead, this gap is likely to widen—with US mutual fund AUM growing by 46 percent from 2018 to 2025, but revenues growing by only 10 to 15 percent, according to PricewaterhouseCoopers.

This gap is an indication that regulated funds have become a mature market after a decades-long growth spurt beginning with the Baby Boomers' entry into the investment market in the 1980s and lasting to the early 2000s. But now, a seller's market is turning into a buyer's market. Buyers have a wider array of alternative investment vehicles to choose from, and they are pickier and more price sensitive than ever.

As an investor, I can welcome these changes—providers are competing hard to offer me more services for less cost. But I recognize these developments also pose significant new challenges for the business.

Central to the new reality is a growing investor preference for lower fund management fees. Increasingly, investors are choosing index funds over actively managed ones. This reflects not only the lower fees of index products, but the trend toward greater reliance on financial advisers to manage investors' portfolios by mixing asset classes and indexes, rather than relying on fund managers' stock-picking skills. ICI projects that assets in US domestic equity index funds will surpass those of their actively managed counterparts sometime during 2020.

Meanwhile, as fees trend down, costs are trending up, for expenditures on everything from new technology and distribution expenses to growing regulatory compliance requirements.

Squeezed on both ends, industry margins are falling. A study by ICI and Accenture found that gross margins for 25 publicly-traded fund companies fell by 11 percent last year.

The inevitable result is that fund companies are facing unprecedented pressure to consolidate. PricewaterhouseCoopers projects 20 percent of the asset management industry will no longer be in existence in 2025.

In this environment, every firm in the industry is reassessing its strategy and asking: Am I large enough to go it alone based on scale? Can I survive as a small, niche player, based on a specialty? Or do I need to merge to survive?

The silver lining in this tough scenario is that funds must work harder to continue giving investors value at lower cost. And the industry is responding.

Large fund managers are cutting fees. In other areas, managers are putting in place performance-based fees, to be paid if a fund hits or exceeds its benchmarks, or some even pay investors a penalty if a fund falls short of its investment goals.

On the product side, new offerings, such as exchanged-traded funds (ETFs), have proven attractive. US-registered ETFs grew from about $1.7 trillion in assets in 2013 to $4 trillion in assets in September 2019.

ETFs are growing in Europe, too—from €268 billion in 2013 to €751 billion in September 2019.

Another area of growth is in ESG funds—funds that satisfy increasing investor demand for socially conscious investment choices using environment, social, and governance criteria. Total net assets of US funds and UCITS using socially conscious investment strategies rose from $567 billion at the end of 2016 to nearly $1.9 trillion in July this year.

A consideration of forces shaping the industry, from competition to technology and demographics, would not be complete without finally examining trends in regulation. Here, unfortunately, the fund industry's own success is attracting greater scrutiny under the notion in certain circles that "big is bad."

In 1990, the assets of US banks were more than triple the AUM of US funds. But now, fund AUM have exceeded bank assets by more than 50 percent.

In the aftermath of the global financial crisis, regulators questioned whether the registered funds might transmit shocks to the financial system at large. They asked, what would happen in the case of large-scale redemptions of fund assets by investors during a financial crisis? After exhausting other measures, would fund managers then resort to "fire sales" of their assets to pay those investors, depressing asset prices across the market and deepening the crisis? This summer, Bank of England Governor Mark Carney expressed these concerns yet again at the US Federal Reserve's Jackson Hole Summit.

One reason for the perennial questions is that regulators around the world tend to apply the traditional lens of bank risk and regulation to the fund industry, because that lens is so familiar, stemming from financial crises of the past. But funds are not banks. And regulated funds and investors operate very differently from banks and depositors.

First, funds are not heavily leveraged. The fund business doesn't involve the risks of making long-term loans based on short-term deposits. Instead, holdings are marked to market every day with risks made transparent by up-to-date valuations, in contrast to longer-term bank loans.

In addition, individual fund investors own shares in a fund, and they are the ones to take the risk of any decline in value. Gains and losses are distributed to investors who willingly accept the risks of investing—that's very different from the situation of a bank, where losses on the loan portfolio are concentrated in the institution and depositors don't accept any risks.

Thus, unlike bank depositors, fund investors do not need government insurance against losses. And funds do not need government bailouts.

Moreover, fund shareholders have not shown any tendency to "run" on their funds in the way bank depositors in the past have run on their banks. At ICI, we have examined the behavior of equity and bond fund investors in more than 40 episodes of market stress since 1944 in the US, Europe, and Canada. In none of those episodes have those fund investors "run," or redeemed heavily. Indeed, in some cases, funds and their investors have taken advantage of falling markets by buying more shares.

Why is that? Well, certainly in the US, fund investors tend to be individuals investing to meet long-term financial goals, like retirement. They are willing to ride out the market's bumps and curves to meet their objectives.

Yet despite this record, regulators continue to call for extra safeguards against fund risk. It's up to the industry to continue underscoring that bank-like regulations don't make sense for funds and would cause unintended damage to the industry. To enable the regulated fund industry to play its crucial roles for investors and the economy, it is important that regulators recognize funds' unique attributes.

As regulated funds face their future, they're riding on a lot of positive momentum from the spirit of invention and resilience that has led to their success today. Not the least of the energy driving the industry forward is the opportunity for regulated funds to serve the needs of both emerging investors and the capital markets of so many nations and regions of the world, including China. Here, we are truly at the start point of a promising future with benefits across the board for individuals and the economy.

Thank you all for your kind attention. To the students and faculty here tonight, I hope you will look upon the Investment Company Institute as a resource. I extend the same invitation to industry participants and experts, policymakers, and regulators in China and look forward to more opportunities ahead to collaborate with all of you as you build China’s fund industry. On behalf of ICI, I thank you for the opportunity to speak with you.
