SPEECH

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2001 General Membership Meeting: Chairman's Report

ICI Chairman's Report at the 2001 ICI General Membership Meeting

by
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Good morning. It is a pleasure to address you today at our annual General Membership Meeting and my first as chairman of our association.

Before I begin, I'd like to thank Mitch Merin and his planning committee, as well as Matt Fink and the Investment Company Institute staff, for putting together an outstanding program. For example, later this morning, during the keynote session, you will hear about the outlook for our industry in responding to global competition, new technology, and changing investor preferences. I hope you will leave the meeting tomorrow with these and other new challenges and opportunities in mind.

Given the changes we have seen in the past year both in financial markets and in our business, the theme of this year's meeting, "Navigating the Changing Landscape," couldn't be more appropriate.

Over the course of many centuries, navigation has evolved from simply steering and setting sails into a science and a technology that encompasses detailed planning and execution.

Navigation assumes a specific objective and uses three stages to accomplish that goal. First, a course is selected. Next, the course is followed at speeds necessary to meet a scheduled arrival time. Finally, speed is increased or decreased as required by the timetable or by other conditions that require a temporary change in direction to stay on the chosen course.

A timeless saying of the sea applies to our very competitive industry: "The winds and waves are always on the side of the ablest navigators."

The parallels are many between successfully navigating a ship across the oceans and successfully guiding shareholders along the financial voyage of their lives. Both assume specific objectives and timetables. Both also require a degree of flexibility to stay on course during high seas, turbulence, or, in our case, volatile markets.

It is critically important that we, as an industry, respond to difficult market conditions and challenges and recognize changes as opportunities, as we always have in the past—especially during the last two decades where no other financial services sector has been able to seize upon change and turn it into success for our clients and growth for ourselves as has the fund industry. It is also important, in these times, that we, together with the financial intermediaries who introduce our products and services to our shareholders, help those shareholders navigate their financial journey and stay the course to realize their financial objectives.

This morning, I would first like to make some general observations and comments on the state of our industry. Then, I want to touch upon some of the basic facts about our industry and our shareholders. And finally, with your indulgence, I would like to make a personal observation.

The State of Our Industry

In terms of the state of our industry, since we last met one year ago, equity markets in the United States and abroad have witnessed substantial volatility and overall weak performance. Mutual fund shareholders, however, have responded calmly to the downturn. In fact, most mutual fund shareholders are seasoned investors. They know the importance of long-term investment horizons. Institute research, which I will discuss in detail in a few minutes, confirms that most fund shareholders are not focused on short-term market fluctuations.

Sales and redemptions of fund shares both rose on average in 2000, continuing a trend since the mid-1990s. This trend does not necessarily imply that the typical shareholder has shortened his or her holding period. Indeed, as I will discuss in a moment, a range of empirical evidence suggests that the trend more likely results from the high redemption activity of a small percentage of mutual fund investors.

Broad financial market trends, however, are mirrored in mutual fund assets and flows. For example, the rise in the Nasdaq in the early part of last year helped equity funds—especially the more aggressively invested equity funds—and they attracted strong levels of new cash from shareholders. As the year progressed and the Nasdaq declined, inflows to equity funds slowed but nonetheless remained substantial.

I believe history will reflect that 2000 was a significant year for the mutual fund industry. Despite the downturn in the equity markets, our industry ended the year with record net new cash flow into equity funds of $309 billion. The industry had $6.97 trillion in assets at the end of last year—up slightly from $6.84 trillion the year before, even with very poor equity market returns—and we continued to innovate and introduce new funds and services to meet shareholder needs.

Our industry also continues to attract investors, with notable growth in ownership occurring among younger households. Overall, ownership reached 49 percent of all U.S. households in 2000, up from just under six percent of U.S. households in 1980 and 25 percent of households in 1990—just ten years ago.

Mutual funds remain ideal investments for retirement accounts. Mutual fund retirement assets in IRAs, 401(k)s, and other employer-sponsored defined contribution plans totaled more than $2.5 trillion in 2000. Retirement assets as a share of total mutual fund assets have grown from 19 percent at the beginning of the decade to about 35 percent at its close.

The "typical" mutual fund shareholder—who is middle income, middle aged, and saving for retirement—is attracted to mutual funds for a number of time-tested reasons.

As you know, mutual funds offer a combination of diversification, professional management, liquidity, convenience and, yes, affordability. Mutual funds also are strictly regulated and the industry has been untainted by major scandal for more than 60 years—something that you can't say for any other segment of the financial services industry.

The "typical" mutual fund investor also is not particularly concerned with daily ups and downs in the markets or the latest investment fad. Most fund shareholders are focused on long-term goals. In fact, 65 percent of U.S. household owners of mutual funds in 2000 invested in funds through employer-sponsored retirement plans such as 401(k)s.

Even as imitators seek to develop products to compete against mutual funds, I believe that mutual funds will continue to be preferred by many different kinds of investors for many different reasons, particularly in helping them attain their long-term financial goals. After all, our business—like our perspective—is long term. That has always meant ensuring that investors are placed first and that they are always protected.

Facts About Funds

I would like to take the opportunity now to confront some misconceptions with reality.

Oliver Wendell Holmes once said, "A wise man recognizes the convenience of a general statement, but he bows to the authority of a particular fact." With that in mind, I'd like to spend just a few minutes exploring some of the basic facts about mutual funds.

For example, mutual fund shareholders do not drive the stock market. A recent Federal Reserve report refutes the theory that the bull market of the 1990s was driven by cash flows to mutual funds. The report found "little evidence that mutual fund investors have been a destabilizing force in the U.S. equity market in recent years." Significantly, Federal Reserve researchers also found no evidence that equity fund flows cause market price change, either temporarily or permanently.

There is no established correlation between mutual fund flows and stock market activity. Consider the facts. In 2000, as I mentioned, shareholders purchased a record $309 billion in equity mutual fund shares. Yet, also in 2000, the Nasdaq Composite Index fell 39.3 percent in the worst year since it was created in 1971. The Dow Jones Industrial Average fell 6.2 percent to suffer its worst year since 1981. One year earlier, equity fund inflows totaled far less—$188 billion—even though the markets were up significantly, with the Nasdaq rising more than 86 percent and the Dow Jones Industrial Average gaining 25.2 percent.

Here's another fact: Most fund sales are made through a third party. According to Institute research, an estimated 82 percent of new sales of long-term funds were made through a third party or intermediary—such as banks, insurance companies, stockbrokers, financial planners, and retirement plans—this is up from 77 percent in 1990. During the same period, new sales of long-term funds made directly from fund companies to investors fell to only 18 percent.

It is also a fact that most mutual fund shareholders trade infrequently. Although redemptions are a normal part of the mutual fund business, a number of ICI surveys of fund owners and other empirical research have consistently found that the vast majority of owners are long-term investors and do not redeem shares during a one- or two-year period. In a recent survey of equity fund owners, 82 percent said they had not redeemed shares from any of their equity funds in a year's time and another nine percent had redeemed shares only once. A small number of fund owners, however, report that they trade frequently.

In recent years, some industry observers have used the Institute's redemption rate to calculate the average holding period for fund shareholders. But the redemption rate for mutual funds is not an appropriate indicator of redemption activity of the typical fund shareholder. Even a few high-turnover shareholders can push up a fund's redemption rate. For example, a fund whose investors all have a holding period of seven years would have an annual redemption rate of 14 percent. A fund with 98 percent of its owners holding shares for seven years and with the other two percent redeeming every month would have an annual redemption rate of 38 percent. The 38 percent redemption rate gives the misleading impression that the typical account in this fund turns over in less than three years, even though the vast majority of its shareholders are long-term investors.

The recent volatility in the financial markets has prompted some to question the mettle of mutual fund shareholders. However, it is a fact that "panic" is not a word one would associate with our investors. The Institute has conducted a number of studies, including an analysis of equity fund flows since World War II, which show that fund investors have never responded to sharp market breaks by redeeming shares en masse. And there is no evidence that this long-established pattern of behavior will change. Shareholders are not insensitive to stock price movements, but their response to market movements tends to be spread over time. For example, over the course of a typical cycle in stock prices, investors do tend to buy more when stock prices are increasing and do buy less when they are decreasing. However, stock, bond, hybrid, and money market mutual funds allow investors to choose among a variety of investment goals and styles to meet their objectives and circumstances—and their appetite for risk.

It's hard for me to imagine that in this, the world's most successful free market economy, anyone could suggest that an industry with 8,000 competing investment choices delivered through literally hundreds of thousands of points of sale, where the barrier to new market entrants is very small, that competition doesn't exist. However, as Matt Fink is fond of saying, mutual fund fees have been a topic of discussion since the first mutual fund was introduced because of the high level of disclosure mutual funds provide to shareholders. Institute research shows that the cost of investing in mutual funds has decreased significantly over the past two decades. Recent studies by the General Accounting Office and the Securities and Exchange Commission have found that, generally, mutual fund operating expense ratios decline with asset growth and that larger funds have lower expense ratios than smaller funds. This strongly suggests that most equity fund shareholders have benefited from economies of scale.

The fact is that over the past 20 years, vibrant competition has produced substantially lower mutual fund costs and an array of innovative investment products and services that make saving and investing simpler, accessible, and affordable. Institute research shows that more than three-quarters of all equity fund investor accounts in 1998 were invested in funds charging below the industry's simple average. Institute research also shows that, since 1980, the average cost of investing in equity mutual funds has decreased 40 percent; in bond funds, 29 percent; and in money market funds, 24 percent.

Finally, some observers have questioned whether the consolidations and mergers within our industry have been harmful to shareholders. The fact is that while there have been sizable mergers during the past year, many reflected business decisions by the firms involved to enlarge or fill out the lines of funds they offer to investors or were completed as part of a larger merger of financial service parents. And at the same time, there has been no let-up in the creation of new fund choices for investors. There are more than twice as many funds offered today as there were at the end of 1990—just ten years ago.

It is a fact that asset concentration among the largest mutual fund complexes has changed only marginally in recent years even though industry assets have grown and many fund companies have reached high asset levels. For example, the five largest fund organizations in 1990 held 37 percent of the industry's assets. In 2000, the top five had only a 34 percent share. Furthermore, the market shares for other groups among the largest 25 complexes were equally stable.

These are just some of the facts about mutual funds. In the words of Emerson, "The greatest homage we can pay truth is to use it."

Conclusion

Nathaniel Philbrick's best-selling book, In the Heart of the Sea, recounts the real-life calamity at sea that inspired Herman Melville's novel Moby Dick. After reading the book, Bloomberg columnist Chet Currier noted a correlation between the boomtown days of the Nantucket whaling industry and the investment climate of recent years. The owners of Nantucket's whaling ships commonly earned annual returns on their investments of between 28 and 44 percent, numbers not unlike the historically unsustainable gains seen by some of our own investors in the 1990s.

Because the risk in each voyage was well recognized, Nantucket whalers purchased shares in several ships rather than putting their money in a single vessel. In doing so, they spread both the risk and the reward throughout their community, not unlike today's mutual fund shareholders who pool their money with others and diversify their portfolios to withstand periods of market volatility.

Today and in the future, our challenge is to provide the products and services that will help fund shareholders successfully navigate the sometimes stormy seas. I look forward to working with all of you in serving our shareholders' needs and keeping our industry on course and moving ahead. I am confident that we can meet and exceed the high standards that our shareholders have come to expect from us.

In closing, if you would permit, I would like to make a personal observation. First, I want you to know how pleased I am to have been selected by the Board of Governors last October to serve as your chairman to represent our industry. I also appreciate your broad-based support of—and participation in— the Institute's many efforts. The Institute is the only association of investment companies, without regard to distribution method or affiliation. Today, Institute members account for 95 percent of our industry's assets. Your active participation enables our industry to continue to speak with a single, united voice before legislators, regulators, and the public.

From my vantage as chairman, I see just how important a role everyone in our industry plays:

- our sales and marketing people who, primarily through intermediaries, deliver our products and services to our clients;
- our representatives at customer service centers who speak directly with our shareholders;
- our technicians who ensure that systems are in place to provide our shareholders with the conveniences and services they expect in this Internet age;
- our researchers and analysts who scrutinize the companies in which our shareholders' assets are invested;
- our portfolio managers who invest fund assets to meet the varied investment objectives of our shareholders; and
- the directors who serve in our industry's unique system of governance and act as watchdogs on behalf of our shareholders' interests.

We are more than one industry sector or investment style. We are more than one fund or one fund complex. We, in this room, all share in common, the blessing of not only being involved in an activity that is intellectually challenging, but one where we make a significant contribution to the people that we serve. We literally are the shepherds of our shareholders' hopes and dreams. The dream of sending a child to college. The hope of a comfortable retirement for ourselves. And the ability to help take care of our parents as they grow old.

Together, we are more than 8,000 mutual funds, closed-end funds, and unit investment trusts. Together, we manage nearly $7 trillion in shareholder assets. More than 88 million Americans look to us to help them successfully navigate a course toward meeting their long-term financial goals. I am proud of the important work everyone in our industry does on a daily basis for our shareholders—and you should be as well.

I believe it is very important that every one of you recognize ours as a noble profession, built on both a moral and legal obligation to act as a fiduciary in serving our shareholders. This tradition, developed by both you and your predecessors, and the culture it has spawned, has enabled us to work with the ingenious creation of the 1940 Act, the independent directors, much more as partners than as adversaries—very much to the benefit of our industry and the shareholders we serve. This culture, embodied by the Institute, has enabled us to work with our regulators, chiefly the Securities and Exchange Commission, perhaps if not as a partner certainly as an industry of integrity that has historically done the right thing by its shareholders. This culture has earned the trust of more investors than any other financial enterprise in the history of the world, and this culture may be our greatest asset and is shared by everyone in this room.

At the risk of repeating myself, this culture is a result of both acting in a fiduciary capacity and of being responsible for helping our shareholders realize those hopes and dreams of which I spoke. While each of you competes fiercely with the folks sitting around you, ours is not a zero-sum game where for every winner there has to be a loser. All of the 88 million people who we serve can benefit from that service and when you go home at night, you should feel good about the fact that what you do for a living directly benefits your neighbors, your community, and our society, and you have good reason, and should be proud of our common enterprise—its spectacular success could not have been and was no accident.

I hope you have a wonderful two days and thank you for your attention.