

SPEECH

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Mutual Fund Investing: The Power and Promise of a Simple Idea

ICI President's Remarks Before the Investment and Financial Services Association's Connect 2006 Meeting

Mutual Fund Investing: The Power and Promise of a Simple Idea

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Broadbeach, Queensland, Australia

It is a distinct pleasure for me to be with you today. I want to thank IFSA and my friend Richard Gilbert for extending the invitation. We have had the good fortune to welcome Richard and other Australian colleagues to conferences sponsored by the Institute in the U.S. Our organizations have compared notes on many issues of common interest over the years, and it is clear that we share many goals. We value our relationship with IFSA, and we respect the important role that funds play in the financial security of your countrymen.

As Richard knows, I used to be the Institute's general counsel, and I have been an attorney for many years. A little more than two years ago, our Board selected me to be president of ICI, and I swore off lawyering. But one less lawyer in Washington doesn't make any dent in the population.

And I still get my share of lawyer jokes. You know what's wrong with lawyer jokes, don't you? Lawyers don't think they are funny, and nobody else thinks they are jokes.

I. How Mutual Funds Have Transformed Finance

Today – all joking aside – I'd like to talk about something of importance to us all – the growth of fund investing, the significance and effects of that growth, and its implications for those of us who serve fund investors.

No question -- mutual funds have become a powerful force in the world of finance, a force that has transformed markets and changed the lives of hundreds of millions of people.

Like many of the great innovations in history – from the wheel to the steam engine to the Internet – mutual funds are based on a simple but powerful insight. As one of my predecessors at ICI, Dorsey Richardson, said in the early 1960s:

“Men and women everywhere, who seek to share in the risks and rewards of ownership of American industry, do so by utilizing the professional management, the diversification and the convenience ... provided by [mutual funds].”

The concept is designed to help people of average means build their wealth – by giving them the same tools as the wealthy employ.

How well does this concept work? The proof is in the numbers. I understand that the Australian fund industry has posted a big number recently, reaching the trillion-dollar [Australian] mark in assets under management. Congratulations on this remarkable milestone!

The growth of fund investing helps account for the fact that Australia is now perhaps the world's leading shareowner nation. As recently as 1992, only 15 percent of Australia's adult population owned shares. In 2004, the Australian Stock Exchange reported that fully 55 percent of adult Australians owned stocks, directly or through mutual funds. This dramatic increase has been powered by the privatization of state-owned companies and the demutualization of other entities – changes that in some cases put shares directly in the hands of individuals. Equity ownership has also been fueled by the development and rapid growth of “super” – your superannuation retirement system.

To be sure, the U.S. is not far behind. In 1983, fewer than one in five U.S. households owned stocks. Now, about half of them do.

This transformation – the rise of an investor class and an investing culture – is a notable and positive development for our economies and societies. Consider, by way of contrast, Japan. Japan is a nation of savers, and it enjoys a historically high savings rate. But Japanese households have tended to lock up their money in low-yielding savings accounts. Instead of taking prudent risks, they have taken refuge.

The result? Last year, the McKinsey Global Institute predicted that as Japan ages, households there would be no wealthier in 2024 than they were in 1997, despite their extraordinary savings. The study concluded: “The most effective change for Japan [would be] to raise the rates of return on financial assets.” Japan's authorities have recognized this problem. Their solution? Prime Minister Koizumi has called upon his government to do everything it can to “accelerate the shift from saving to investment.” That includes developing Japan's domestic mutual fund industry.

In America, the rapid growth of mutual funds has been felt across markets, as well as in individuals' lives.

Mutual funds have poured household savings into a variety of new markets. For businesses, homebuyers, and governments, ready access to the trillions of dollars that investors have entrusted to mutual funds has meant deeper, more liquid markets. Established companies can borrow more easily and cheaply. New companies enjoy better access to equity, because venture capitalists know that there's more capital available in the public markets when they want to cash out.

And what about individuals? Mutual funds have helped overhaul the balance sheet of

American households. Consider data compiled by the U.S. Federal Reserve. In 1987 nearly one-quarter of households' financial assets were held in bank deposits, and corporate equities made up only 15 percent of financial wealth. By last year those proportions had reversed: Corporate equities, held directly or through mutual funds, accounted for more than 26 percent of household holdings, and bank accounts were less than 14 percent. In America, savers are turning into equity investors.

II. Why Mutual Funds Led the Transformation

Why did mutual funds become the force behind this great transformation? I see three factors that have made mutual funds today's investment medium of choice: innovation, competition and accountability.

Innovation

Innovation has been a hallmark of our modern fund industry. Think about the money market fund, a product that first introduced the concept of fund investing to many Americans.

In the 1970s, Americans learned that a passbook savings account with a capped interest rate couldn't shield them from the ravages of double-digit inflation. Money market funds were the answer. It's hard to remember this now, but those funds were a radical product – and their impact was enormous. They provided average Americans an alternative to banks, and offered them a rate of return on cash that, until then, only institutional investors could expect. Innovative mutual fund companies kept adding features like check writing and daily sweeps that revolutionized cash management for households and businesses alike. The numbers are truly staggering: Since 1973, money funds have handled cash flows of more than 240 trillion U.S. dollars.

Business journalist Joseph Nocera has observed that the money market fund crossed “the iron-clad psychological boundaries separating ‘savings’ money and ‘investment’ money in the minds of most Americans.”

But once that boundary was breached, Americans poured across it. In the 1980s and '90s came the second great surge of mutual fund investing, the surge into the stock market. Wall Street was booming, and people wanted to be a part of it, especially as they were introduced to defined contribution retirement plans at work.

They used the vehicle that would work for them – mutual funds. In every year since 1990, U.S. households have bought equities primarily through mutual funds. By 2005, 90 percent of America's equity owners held stock mutual funds.

As mutual funds took root in household finances, investors demanded many new kinds of products – and fund companies responded. In particular, index funds were developed to give investors broad market diversification at low cost.

Today, working Americans want to simplify the challenge of building their retirement nest egg. Mutual fund companies have responded with lifestyle and lifecycle funds – products that combine stocks, bonds, and cash in different mixes for different risk profiles or time horizons. A lifecycle fund will even rebalance over time, shifting toward a more conservative mix as its investors age. This is one-stop convenience for the retirement saver – and Americans are snapping them up. Their combined assets grew by 64 percent last year alone.

And now that business is increasingly global, mutual funds literally have opened up the world to American investors. Funds that invest overseas have enjoyed explosive growth in the last 10 years. The assets of U.S. funds investing in international stocks grew at a 17 percent annual rate from 1995 to 2005. They now account for about 10 percent of our fund assets.

Competition

What drives ongoing innovation of this kind? In a word: Competition – the second key factor that has fueled the growth of mutual funds. I need not tell you that ours is a highly competitive industry, one where fund companies compete on many different levels. In the U.S., more than 500 fund organizations offer more than 8,700 mutual funds. And we're not just contending among ourselves for the investor's dollar.

Competition is rough; competition is challenging. But it's also the great engine of progress, spurring firms in all industries to offer superior service and quality. As Henry Ford said, competition also is "the keen cutting edge of business, always shaving away at costs."

Our 91 million investors are intensely focused on getting the best value for their money. In fact, 90 percent of our stock mutual fund assets are in funds whose expense ratios are below average. [The cost of mutual fund investing in America has been on a steady downward trend](#) for decades. In 2005, the average investor in a stock fund was paying total annual fees and expenses, including sales charges, of 1.13 percent of assets. That's less than half the cost incurred in 1980.

Accountability

Competition also forces funds to be accountable to shareholders. A most significant measure of accountability is the confidence that many millions of investors place in our industry. No financial product in the U.S. is more transparent to investors and the marketplace at large than the mutual fund – most competing products do not come close. Investors can easily take their money out of a mutual fund that does not perform, that costs too much, provides poor service, or fails to operate prudently and responsibly. And investors do vote with their feet: Every year in the last decade, from one-third to one-half of all American fund complexes have experienced net cash outflows.

In short, competition and market forces exact a high degree of accountability by U.S. mutual funds – to the benefit of our investors.

The invisible hand of the market works in concert with the visible hand of government. Mutual funds operate within a strong legal framework and under close scrutiny by government – in our case, under the rulemaking, inspection, and enforcement functions of the U.S. Securities and Exchange Commission.

Ultimately, however, the highest degree of accountability is the standard that we impose upon ourselves. As you probably know, when I became President of ICI in June 2004, the American mutual fund industry was in the midst of perhaps the greatest crisis in its modern history – a scandal surrounding trading practices at certain fund companies. In my [inaugural remarks at the National Press Club](#) that month, I observed, "Doing what one is relied upon to do, placing the interests of clients first, ahead of everything else – these are the lessons of the recent scandals for all who take upon themselves the trust and confidence of mutual fund investors."

Placing the interests of fund shareholders first is the only true guide for our activities at ICI as well. That's why we strongly supported the reforms projected by the SEC. Keeping faith with investors, earning their trust – this is the bedrock on which all successful fund industries stand. Maintaining that trust will be vitally important as we face the challenges of the future.

III. Challenges for Mutual Funds Around the World

What are those challenges? I see two tasks that are central for mutual funds in America. I suspect they are also crucial for funds in Australia, and in many other parts of the world.

- First, we must continue to innovate – in particular concerning the way we inform and empower fund shareholders to achieve their financial objectives.
- Second, recognizing global demographic trends, we must continue to play an active and responsible role in shaping sound national retirement policies.

As the global population of fund investors grows, we must consider how best to ensure that they have the information, understanding, and help they need to invest wisely.

Technology can be an important tool. In the U.S., SEC Chairman Christopher Cox has recognized the power of the Internet not just to communicate to investors, but to greatly enhance the quality and usefulness of the information they receive. Chairman Cox has said that the “ultimate goal is to put investors in the driver's seat when it comes to information about, and control over, their money.”

Our mutual fund investors are ready to get behind the steering wheel. In a [survey we did during 2005](#), ICI found that almost 90 percent of U.S. mutual fund shareholders have access to the Internet. Two-thirds of those investors go online daily, and three-quarters of those who go online use the Internet to access their financial and investment accounts.

Fund investors are logged on – our challenge is to harness the potential of the Internet to serve their interests even more effectively.

In response to Chairman Cox, ICI is pursuing that goal. Soon, we expect to complete a new framework for [electronically tagging key information about a mutual fund](#), using the computer language XBRL. This tagging will facilitate online retrieval, comparison and analysis of the data that fund investors rely on most when they make investment decisions – data on a fund's investment policies and objectives, fees, historical performance, and risks.

We view this new capability as a key building block in a new approach to regulatory disclosure – one that will serve average investors more effectively, in ways that today's lengthy, legalistic and little-used disclosure documents do not.

A second, even larger challenge is how we can encourage the development of sound national retirement policies.

The United States and Australia are both young nations, historically and demographically. Today, 12.5 percent of Americans and 13.1 percent of Australians are 65 or older. That's a shade below the average for all OECD nations. But like the rest of the developed world, the American and Australian populations are rapidly aging. Forty years from now, almost one-quarter of Australians and more than one-fifth of Americans will be 65 years old or older. This demographic challenge is already placing enormous strains on traditional defined benefit pension plans and pay-as-you-go social insurance.

True to its national character, Australia is tackling this problem in a very direct way. I read that your federal Treasurer has urged couples to have more children – as he put it, “one for Mum, one for Dad, and one for the country.” And he’s backed this up with a \$4,000 {Australian} “baby bonus” for each child born. It certainly puts a whole new meaning on the idea of doing your patriotic duty.

I’m not sure that’s likely to catch on in the United States – at least not at the level of national policy! Instead, we – like many other countries – are relying on defined contribution plans to provide for our golden years. But it’s impossible to imagine how workers could take such great responsibility for their own retirement planning without a reliable, low-cost, well-managed vehicle for investing – in other words, without mutual funds. Funds are the ideal vehicle to help individuals save little by little, year after year, to meet long-term needs. In the words of a Chinese proverb, those who wish to clear a mountain start by moving a few rocks.

I know this is an important policy issue here in Australia, where the fund industry has been instrumental in the development of the superannuation system. In the U.S., too, mutual funds have been key players in the development of Individual Retirement Accounts, 401(k)s, and other employer-provided defined contribution plans. Our industry is also the single largest holder of DC retirement plan assets. So we have a special responsibility to play an active role in developing sound retirement policy.

The [Pension Protection Act](#) now being considered in our Congress will address some of the gaps in our system. Among other things, it will make it easier for workers to participate in employer retirement plans, help savers put away a meaningful amount of money by making permanent the increased limits for tax-favored contributions, and improve workers’ investment options by clarifying employers’ ability to use default investment options with a long investing horizon.

Importantly, the legislation will also make it easier for 401(k) and IRA savers to turn to professionals for advice. No matter the quality of our disclosure or of the information available to them, for many investors, there is no substitute for sound investment advice. We want employees who participate in defined contribution retirement plans to have ready access to professional investment advice, subject to appropriate safeguards against conflicts of interest. This, too, is part of the Pension Protection Act.

Even with this legislation, we face challenges in making our defined contribution system more universal, more accessible for both employers and employees, and more effective. As we study these issues, we should engage in an international dialogue and continue to draw upon the experience of Australia and other countries.

I don’t expect the United States to adopt a mandatory retirement system like your super at any time in the foreseeable future. But we can certainly learn from your government’s ongoing efforts to reduce complexity and ease tax burdens. And I understand that co-contributions – a government match for salary-sacrifice contributions by lower-income workers – are helping improve retirement prospects for many Australians, particularly women.

As the workforce covered by defined contribution plans ages, we also must turn our attention to the challenge of helping individuals manage their money during retirement. This is a new phenomenon in the world: Large numbers of retirees seeking to manage their accumulated assets to provide the income they will need across longer life spans. These

retirees will need advice and new products specifically designed to help them address a new kind of risk –longevity risk, the risk of outliving their resources. I am confident that, once again, competition, and innovation will work to the benefit of investors.

In addressing these and other challenges, we look forward to working with, and learning from, our counterparts in the fund industry around the world. I know that IFSA is looking forward to hosting the 21st Annual Meeting of the International Investment Funds Association in 2007. You can be sure that ICI will be in attendance to participate fully in the discussions.

The modern history of the mutual fund is quite a tale – a saga of innovation, competition, and transformation. And it is still being written, in your country and mine. Indeed, it is still unfolding across the globe. I believe the most exciting chapters lie yet before us. Together, we can ensure that the power of this simple idea continues to work for the benefit of investors around the world.

Thank you.

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