

The Role of Investment Funds in the Global Economy

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Keynote Address

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To my friends at the Investment Trust Association of Japan, many thanks for organizing this forum and for the opportunity to share some thoughts with this distinguished audience. I am very pleased to be with you, and also very pleased to be in Tokyo once again.

I first got to know this remarkable city during an extended stay in 1990 as a US-Japan Leadership Fellow. I lived in Roppongi at the International House of Japan, and worked out of the Research Institute for Peace and Security. This was around the time of the first Gulf crisis, when Japan was wrestling with the role of its armed forces in international peace cooperation. It was around the time of the enthronement of His Majesty the Emperor. And it was at the height of Japan's bubble economy, with its soaring stock and real estate prices.

In those days, I was lucky enough to travel through much of Japan—from Sapporo to Naha, and many places in between. I also had occasion to meet Japanese people from many walks of life—Sumo wrestlers, famous craftsmen, scholars, journalists, corporate leaders, government officials, senior military officers, and Diet members. I treasure the many great memories and the friends I made along the way. In the years since, business has brought me here many times. It is good to be back.

It has been said, “No man ever steps in the same river twice, for it's not the same river and he's not the same man.” The US, Japan, and the world at large are much different than they were a quarter-century ago. And we face different challenges. Notable among them are how to promote investment and economic growth, and how to provide for aging populations with long life expectancies.

It seems to me that both of these are most appropriate themes for a forum convened by the Investment Trusts Association. With combined global assets of some \$39 trillion in assets under management, regulated funds today are the largest and most efficient aggregators and allocators of capital in the world. They also are vehicles ideally suited to the kind of long-term saving and investing that individuals increasingly must do to help achieve financial security in retirement.

So my remarks today will center on two paths that more and more countries are choosing:

- The first path involves developing and strengthening capital markets in financial systems that are frequently dominated by banking.
- The second path involves integrating a defined contribution model into retirement systems dominated by defined benefit schemes.

I'll focus on why I believe both are good choices, and why regulated funds must and will have an integral role in each.

Let me begin with the first path: toward developing and strengthening capital markets.

To begin to understand why countries are working so hard toward this end, it's helpful to take a step back—to think about the goals their policymakers have in mind.

Goals like:

- allocating capital to productive uses more efficiently
- diversifying the sources of financing within the economy
- moving money out of cash and cash equivalents and into risk assets like stocks and mutual funds
- encouraging depositors to become investors who take reasonable risks for higher returns, and
- fostering a culture that encourages entrepreneurship and ownership.

A remarkably diverse array of countries is making major progress toward these goals.

Here in Japan, the government created the Panel for Vitalizing Financial and Capital Markets to help strengthen the economy—to develop “a society where individuals build wealth with risk asset allocation appropriate to [the] stage of [their] life cycle.” To that end, the Panel has made numerous recommendations designed to strengthen Japan’s asset management and investment trusts sector.

And this spring—following more than six years of negotiations—Japan joined with Australia, South Korea, and New Zealand in signing a Memorandum of Cooperation on the Asia Region Funds Passport scheme.

The passport could be available to funds as soon as next year. It promises:

- to further integrate financial markets across the Asia-Pacific region,
- to expand the opportunities of investors in the Asia-Pacific region, and
- to support the efforts by operators of regulated funds to achieve greater regional scale and efficiencies.

The European Commission likewise has been at work on fostering a Capital Markets Union. The objective there is:

- to develop and integrate the capital markets of the European Union’s 28 member states,
- to pare back Europe’s high dependence on bank funding, and
- to make Europe more attractive as a place to invest.

Then there’s the developing world. From China, India, and Brazil to smaller nations in Latin America and Southeast Asia, governments are pursuing policies to develop stock exchanges, enhance market-based debt financing, and encourage investment.

Even in sub-Saharan Africa, 16 new stock exchanges have opened in the last quarter century.

So, what’s going on here?

Why are leaders from so wide a range of countries looking to promote capital markets and the investment and ownership they imply?

I think two realizations are key. Banking alone cannot finance a thriving economy, nor can bank products alone achieve household financial goals. And strong capital markets are indispensable to realizing either of these objectives.

Economists and policymakers have identified many advantages of strong capital markets. I will concentrate on three that I believe are among the most important.

The first advantage is efficiency—capital markets make a country’s financial system more efficient.

For many purposes, capital markets have become more efficient than banks in matching savers—the providers of capital—with borrowers—the enterprises or households that need funding.

Advances in technology have erased the information advantages that banks once relied on to underwrite loans. The result is that borrowers now can cut out or minimize the role of the banks—and cut down on costs—by raising money directly with stock investors or bond buyers.

Capital markets also help distribute risk more efficiently.

Each issuer of a stock or bond presents a unique set of risks—based on its products, its business strategy, and its financing model. And each investor gets to decide which securities to buy—and which risks it is best able to assume—based on that investor’s tolerance for risk, and whether it holds other assets with offsetting risks.

For example, younger savers have compelling reasons to invest more heavily in stocks than older savers, because young people have a longer time horizon and more working years to recover from any downturn in the market than older people do. Investors young and old voluntarily assume the risk that best fits their circumstances, and those choices help create a more efficient financial system.

The second advantage of strong capital markets is that they enhance economic stability.

Think about it—securities that trade in markets offer immediate feedback. Frequent trading provides a readily updated scorecard on the value of assets. Every trade is a reflection of the myriad economic factors that can affect the value or creditworthiness of a company or country. Unlike bank lenders, owners of stocks and bonds can’t carry their assets on their books for months or years without reflecting these changing values.

Now, on the surface, that fact might seem to make capital markets more volatile than banking—and indeed some policymakers dislike capital markets for just that reason.

In reality, however, this mark-to-market approach actually enhances economic stability. A landmark 2004 study found that capital markets make it more difficult to avoid recognizing economic or financial problems, because of the immediate feedback they offer. As the authors write, “pain is borne in real time.”

The authors contrast that real-time response to the regulatory forbearance that troubled banks all too often receive: To delay the pain, regulators sometimes look the other way and allow problems to grow. In the end, the pain becomes far worse than it ever would have been had the problems been dealt with early on.

Unfortunately, some policymakers learned this the hard way—including in the United States, with its savings and loan debacle in the 1980s and ’90s, and in Japan, with its “Lost Decade” of the 1990s.

Even without a crisis, the frequent feedback from capital markets rewards good policies and punishes bad decisions. All else being equal, when tax, spending, and regulatory policies are harmonized for economic growth, asset prices rise, investors are happier, and policymakers enjoy the results of sound growth. That’s how strong capital markets enhance economic stability.

The third advantage of strong capital markets is that they provide economic flexibility.

Put simply, capital markets encourage entrepreneurship. Risk-tolerant equity investors are better equipped than risk-averse banks to finance groundbreaking ideas. Robust capital markets can finance new companies earlier in their development, speeding their growth.

By one estimate, European companies could have tapped into an extra 90 billion euro between 2008 and 2013—funding some 4,000 more venture capital deals—if only Europe’s venture capital markets had been on the same scale as those in the United States.

Just imagine the new ideas and new industries that might have grown!

So, efficiency ... economic stability ... and economic flexibility. Those are three advantages awaiting the countries that can develop and strengthen their capital markets.

The next question is—how do they get there?

In my view, a sound, reliable investment vehicle—supported by strong, principles-based regulation—is the key ingredient. You needn’t look further than the United States to see what I mean.

Over more than 75 years, US regulated funds have thrived under a comprehensive regulatory framework.

They have become indispensable sources of financing for governments and business alike, and the primary vehicle for Americans saving for their most important financial goals—like education, homeownership, and retirement.

And they have developed new, innovative investment strategies at an extraordinary pace, providing investors with a wealth of choices in a highly competitive business environment.

Fund investing, governed by principles-based regulation, powers capital markets. It is, I believe, one of the most important avenues

that countries looking to strengthen their capital markets ought to pursue.

I'd like to turn now to the second path countries are taking: reforming their retirement systems.

As I think back, this very subject was the reason for a visit I made to Japan in late 1994, when I was general counsel of ICI. We had commissioned a report on why demographic trends in Japan made clear the need for reforms in pension regulation. The necessary reforms included rules that would foster greater competition in the management of pension funds and that would remove a bias toward allocation of retirement plan assets to fixed income, producing lower investment returns over time.

It wasn't too long ago, of course, that the concept of "retirement"—at least as we know it today—didn't even exist. For most of human history, people didn't expect an extended period of leisure after their working years.

That all changed in the 19th Century, when both private and public pension systems emerged to help support older people who could no longer keep up with the pace of work in factories or offices. Nearly all of these plans offered what we refer to today as "defined benefits."

Governments introduced "pay as you go" retirement systems, where the current workforce pays taxes to support current retirees. And workplaces introduced their own plans, where the employer and the plan bore the risk of delivering on the promise of a regular pension payment for life.

Both of these defined benefit models have had their share of success. But recently, they've come under immense pressure.

Changing demographics—people living longer and women bearing fewer children—have made the "pay as you go" systems increasingly unsustainable.

It's not hard to see why.

When governments introduced these systems, populations were growing rapidly, and countries had a large number of workers to support a smaller number of retirees. But now, as populations are growing more slowly—or in some countries, like Japan, are even declining—the pool of retirees is growing faster than the pool of workers supporting them, burdening each new generation of workers with a heavier load.

Employer-sponsored defined benefit plans, meanwhile, have faced funding pressures of their own. They've proven more expensive—and their costs more volatile—than many employers ever anticipated.

These problems have been mounting for several decades. But recent bear markets—the great financial crisis, especially—have made them worse, as has a protracted period of low and even negative interest rates.

It is not surprising therefore that more and more countries are considering alternatives to supplement or replace struggling defined benefit schemes, and in particular considering a defined contribution model. As you know, in this model, a worker's ultimate retirement benefits are determined by the amount of contributions credited to the worker—whether from the employer, the worker, or the state—and the investment returns earned on those savings.

What makes defined contribution-type schemes so attractive? I believe there are three distinct advantages.

One important advantage is portability.

Workers today are far more mobile than in the past. It is not unusual for them to move from job to job, career to career, or country to country. Assets in a defined contribution plan can grow with a worker throughout his or her lifetime—wherever he or she chooses to live or work. The European Commission is now considering a Pan-European Personal Pension product that would both recognize and facilitate labor mobility.

A second advantage is ownership.

Participants in defined contribution plans actually own assets—not just a promise of future benefits. Over time, the design of defined contribution plans has evolved to expand—and improve—the array of available investment choices. And these plans have demonstrated that steady participation over one's career, paycheck by paycheck, can translate into the accumulation of substantial resources for retirement.

Another advantage is innovation.

Defined contribution plans can be tailored in many ways. In the US, insights of behavioral economics have prompted the introduction

of features like automatic enrollment and target date funds to help put workers on a path towards success as savers and investors.

To be sure, many different factors influence the overall design of a given nation's retirement system, and one country's approach is not necessarily a blueprint for any others. But it seems clear that different forms of defined contribution arrangements will grow in importance.

So, too, I believe will be the role of regulated funds as retirement savings vehicles.

They, too, offer many advantages—including diversification, professional management, low cost, high transparency, and a strong framework of regulations for the protection of investors. These and other factors help explain why in the US regulated funds play such a prominent role in the retirement system, accounting for roughly half of the assets held in the US in DC plans and individual retirement accounts—some \$7.3 trillion. I am confident that the role of regulated funds in retirement systems outside the US will continue to grow as well in the years ahead.

That is why all participants in the global fund industry must engage with policymakers as well as investors on issues of retirement security. That means remaining informed about global developments in this area. It means participating in the policy dialogue as changes to retirement systems are considered, something that so very many countries are engaged in today. It also means doing our very best to help shareholders use funds to the best possible effect as they seek to achieve their most important, long-term financial goals.

As many of you know, at the direction of our Board, ICI greatly expanded its international activities beginning in 2011, with the establishment of ICI Global and a presence in London and Hong Kong as well as Washington. From the outset, two of ICI Global's most important missions were these:

- promoting policies that ensure global capital markets remain competitive and efficient to serve the needs of investors; and
- promoting a global dialogue about the valuable role that regulated funds and defined contribution plans can play in retirement systems.

As my remarks suggest, I believe these missions have become only more important in the five years since. Today, the health of our economies depends critically on the robustness of our financial system, and that means strong capital markets. And the welfare of our societies depends critically upon how we provide for a growing elderly population with longer life expectancies.

Both are fit challenges for our global industry to address in forums like this. Both are deserving of our continued close attention, and also our close collaboration with public policymakers. Our shareholders deserve no less.

Thank you for your time and attention. I look forward to participating in what promises to be a valuable, thought-provoking seminar.