

1999 General Membership Meeting: Chairman's Report

ICI Chairman's Report at the 1999 General Membership Meeting

by

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I'd like to begin my remarks by thanking Bob Pozen and his committee for putting together such an interesting and topical General Membership Meeting. There is an immense amount of work involved in coordinating this, and Bob, his committee, and the ICI staff should be commended for their great efforts to pull it all together.

Now, on behalf of the Board of Governors and the ICI, I'd like to welcome all of you to this week's gathering. The opportunity to listen and learn is an important tradition for the mutual fund business, and I think you will find our sessions well worthwhile.

Franklin Roosevelt had a great rule for public speaking. He said, "Be sincere; be direct; be seated." In that spirit, I'd like to spend just a few minutes recounting what has been a momentous year for the fund industry and citing some of the challenges we face moving forward.

It has been a year of great accomplishment, a year of significant challenge, and, more important, a year of opportunity. Let me address each of those subjects in order.

Accomplishments

First, quite clearly it has been a year of noteworthy accomplishment for the mutual fund industry.

Our client base continued to grow—to an estimated 44 million U.S. households, or 77 million individual investors. Mutual fund assets increased 24 percent to \$5.5 trillion in 1998, the fourth consecutive year of more than 20 percent growth, but the smallest percentage increase since 1994. About half of the growth in mutual fund assets was attributable to market appreciation; the other half to new investments by mutual fund shareholders.

Net new investments in bond and money market funds increased substantially last year, while net investments in equity and hybrid funds were strong in the first half of the year but slowed after the summer stock selloff. Overall, bond and money market funds accounted for \$310 billion, or 65 percent, of the net inflows for the year.

Households, the predominant buyers of mutual funds, continued to shift away from directly holding securities to holding them indirectly through mutual funds. The shift away from direct to indirect equity holdings through mutual funds has been an important factor in the growth of the fund industry in recent years.

Investing for retirement is a primary goal for most mutual fund shareholders and represents another trend influencing the industry's growth. Mutual fund retirement plan assets grew by \$338 billion, or 22 percent, last year. Since 1994, retirement plans, including IRAs, plans for the self-employed, 401(k) and other employer-sponsored plans, have held about 35 percent of all mutual fund industry assets. Last year, mutual funds accounted for \$1.9 trillion, or 17 percent, of the \$11 trillion U.S. retirement market. The remaining \$9.1 trillion, or 83 percent, of retirement market assets was managed by pension funds, insurance companies, banks and

brokerage firms.

So you can see that with our expanding client base, our growing assets, and our significant cash flow, 1998 was an impressive year of accomplishment.

Challenges

Now to the challenges we have faced in the past year—challenges that came both from the very volatile financial markets and from increased attention to our industry in Washington and elsewhere. While no one is eager to invite challenges in the investment markets or to their way of doing business, I believe the mutual fund industry has been well-served by facing the challenges that have arisen swiftly and head-on. Because the fact is that an industry as successful as ours is always at risk of becoming complacent.

Complacency is a dangerous enemy. It is the enemy of competition; it is the enemy of dynamism; it is the enemy of growth and innovation. Encountering challenges helps our industry to minimize the risk that we will become complacent. And, thus, I believe the challenges of the past year have been valuable to us and our clients.

Our first challenge came from the markets. Since we last met here, the markets have been favorable on balance, but extremely volatile. And that volatility put many of our industry's basic principles to the test. First, and most important, was how we would react to the first sustained period of difficulty in the markets this decade. For many of our investors, the 20 percent decline in the U.S. stock market during the third quarter of 1998 was the first experience with anything like a significant decline in their mutual fund asset values.

This volatile episode challenged our industry on many fronts. First, observers from outside the industry have often speculated on how our clients would behave in the face of a major decline in the stock market. They wondered whether mutual fund investors would redeem shares in panic, leading to a cascading "run" on our funds. The good news is that our shareholders met this volatility challenge extremely well—there was only minimal movement of money out of stock funds. And, quite appropriately, investors were well-rewarded for their discipline by the market's sharp recovery in the subsequent eight months.

A second test was whether the crucial characteristics of mutual funds that make them so attractive to investors—diversified portfolios, professional management, and liquidity—would once again demonstrate their value. Here too, the judgment is a good one. According to one expert observer, by the end of 1998's third quarter, 1,600 of the country's 7,000 or so listed stocks had lost more than 50 percent of their value. Among mutual funds however, the news was quite different. Just seven mutual funds—out of about 3,000 equity funds and more than 7,000 funds overall, had equivalent losses. At a time when substantial efforts are being made to seduce ordinary investors into becoming day traders, this is an especially powerful reminder of the value of investing through mutual funds.

Third, some observers have questioned the adequacy of our industry's efforts to educate our clients and to prepare our operations for market volatility. Again, at least during this challenging past year, our clients' behavior indicated that they were well-prepared to face significant market fluctuations. Obviously, we can never be complacent about the need to help our investors become knowledgeable about the issues and risks that they will encounter as they pursue the investing rewards that have been so bountiful in recent years. Nor, frankly, can we presume that our current operational service capabilities are good enough for the future. But the past year has shown both that our clients are far more knowledgeable than many presumed and that our operations were well-positioned to serve those clients.

Other important challenges during the past year came from regulators and legislators in this great city. Their key concerns focused on three questions:

- Are we providing value to our clients commensurate with our charges? Or, put more simply, are our fees too high?
- Is the industry competitive?
- Does our governance process work as effectively as possible or are major revisions required to better serve our clients?

With respect to the value of the products we offer to our clients and the level of competition within the industry, the issues are quite simple. First, do our investors have a broad range of investment options, shareholder services, distribution methods, and prices to choose from? Second, are the costs of investing disclosed clearly enough so that our clients can make appropriate choices? I believe the answer to these questions is an unequivocal YES.

To be sure, there will always be debates about whether fees are too high and about whether fees are rising or declining. And, frankly, our industry will always be subject to greater scrutiny than most because we disclose so much more about costs than most. But debate about the value of mutual funds and challenges to our mode of operation can only benefit our clients and can only enhance the competitiveness of our industry. And make no mistake, this industry is competitive. While there will certainly be some

pain associated with responding to those challenges, our dynamic businesses must respond and recognize that clients' needs and desires change, and that our business practices must change with them.

With respect to our governance structure and practices, the past 12 months saw the most scrutiny in years on the role of boards of directors in the mutual fund industry. SEC Chairman Levitt appropriately raised the question of whether our independent directors are meeting the needs of their constituency—the mutual fund investor. A two-day SEC roundtable in Washington addressed many facets of this subject.

At the roundtable, Chairman Levitt raised three primary questions. (I quote from [Chairman Levitt's speech](#) at the Mutual Funds and Investment Management Conference in March.) "First, are independent directors really effective? Second, can they act as an effective check on management? And third, are they serving investors' interests above all others?"

Again, the challenge laid out by Chairman Levitt is a complacency check for us. Our unique system of governance—codified in the Investment Company Act of 1940—has served our shareholders well for nearly 60 years. Sixty essentially scandal-free years is a record of prudence unmatched by any other financial services business in this country and the corporate governance system has played an important role in that fine record. So, we could look at this governance system and say, "It ain't broke, so why tinker with it?"

I assert that such a response would be a major mistake. Why? Again, it would be a victory for our foe, complacency. In fact, the success of our existing system of governance presents us with a heavier burden—a larger challenge—to constantly review and improve the stewardship of our shareholders' assets. Does a system that worked for an industry of a few hundred billion dollars 17 years ago work for a 5½-trillion-dollar industry today? Without pre-judging the answer, it is evident that we should be asking the question.

Opportunity

The past year has not all been about challenges confronting the industry. There have been many great opportunities presented to us as well. Perhaps the most promising opportunity, as we will hear later in this conference, is being presented by the increasing importance that Americans are placing on the issue of retirement savings. This vital issue will only grow in importance as we move forward. When we met here a year ago we were experiencing the phenomenon known as the Roth IRA and marveling at its rapid acceptance by our investors. But the opportunities don't stop there. We are entering a new era in Washington where the political presence of the Baby Boom generation and the change in fiscal dynamics from large deficits to nominal—and even real—budget surpluses present the opportunity—I would even say the obligation—for our industry to lead the way in developing new, enhanced savings and investment opportunities for our clients.

During 1998, we saw the lowest savings rate in the United States since data have been accumulated. That clearly is bad news. The expression "I'm letting the market do my saving for me" has become prevalent. I believe such complacency can and will be damaging to our clients, and to us as an industry, if we don't take an even more active role in educating our investors about the need for savings and about realistic return expectations. At the same time, we must help to shape the legislative and regulatory future for savings and retirement. There are many opportunities on the legislative front, including expansion of limits on 401(k) contributions, reinstatement of universal tax benefits for IRAs, increased contribution limits on education IRAs, and opportunities for those who have been out of the workforce to "catch-up" on retirement contributions and savings. Any one of these measures would be beneficial to our clients, and each can do much to improve the savings and investment climate in the U.S. The opportunity to help our clients to earn a better future is at our fingertips. We must work together to ensure that our elected officials make it happen.

Conclusion

Let me conclude. The past 12 months have been filled with great accomplishment, great challenge, and great opportunity. We should take pride—but only briefly—in the accomplishments. Vigorously and thoughtfully responding to existing challenges and anticipating new ones are requirements for our continued success. And using our energy and resources to capitalize on opportunities as we move into the new millennium is absolutely essential if we are to maintain a vibrant, growing, and, most important of all, trustworthy industry for ourselves and, especially, for our shareholders.

The very foundation upon which our businesses have been built over the past 75 years can be described with just one word. That word is trust—whether our clients can trust that they are getting a fair shake and trust that their investment companies are managed solely with their best interests in mind under the supervision of independent Boards of Directors. This element of trust is an absolute fundamental for this industry. And, if we are to have 75 more years of success, we must ensure that we respond effectively to questions about our trusteeship.

Winston Churchill put it best when he said, "The price of greatness is responsibility." He could have been speaking about our industry as we enter the new millennium. We have a great past and a challenging future full of tremendous possibilities and responsibilities. I

have no doubt that if we focus our attention on our two primary assets—our reputation for integrity and our loyal clients—we will truly remain great for another 75 years.

Thank you.

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