2003 Mutual Funds and Investment Management Conference: Keynote Address

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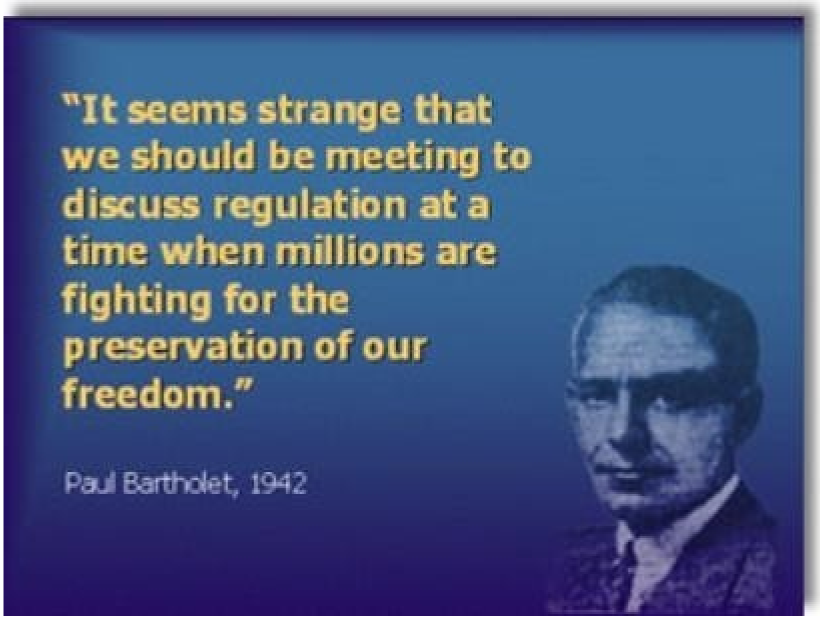
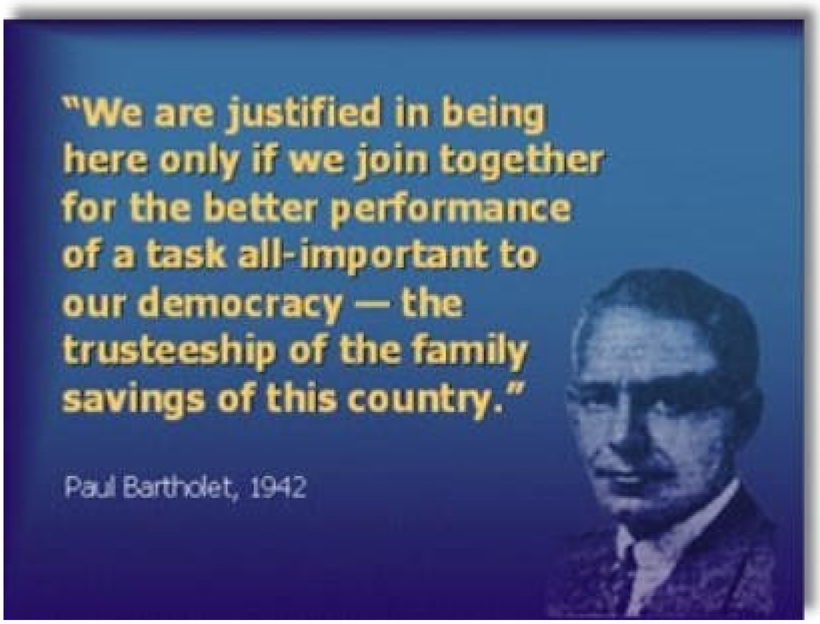
Good morning. As you all may know, Phil Kirstein will soon be retiring from Merrill Lynch Asset Managers. Fortunately, Phil intends to stay involved in our industry, which means we can continue to benefit from his wise counsel. Please join me in a round of applause to thank Phil for his many contributions to our industry and to millions of mutual fund shareholders.

I'm pleased to share the assignment of opening this conference with Paul Roye, the Director of the SEC's Division of Investment Management. Since we met last March, Paul and his staff have completed one of the busiest and most demanding years in SEC history. We look forward to working with Paul—and the SEC's new Chairman, William Donaldson, and his fellow commissioners—as their important efforts to restore confidence in our markets continue.

Paul and his SEC colleagues are not the only ones who have been busy. Those of you in the fund industry have been working intensely to keep pace. The next few days offer us a chance to step back and reflect on the state of our industry and the needs of our shareholders.

While restoring investor confidence is an important national goal, it is certainly not the only important national goal we face. Our nation is at war. The stakes in that conflict are very high. Sixty-one years ago, during World War II, the first head of the Institute stated:





"It seems strange that we should be meeting to discuss regulation at a time when millions are fighting for the preservation of our freedom. We are justified in being here only if we join together for the better performance of a task all-important to our democracy—the trusteeship of the family savings of this country."

Today more than half of American households depend on us. If our job as trustees of family savings was important in 1942, it is obviously far more critical and vital today.

Fund companies and their equity fund shareholders have endured formidable difficulties over the last 37 months. Yet in the face of challenges and uncertainties fostered by a grinding bear market and egregious corporate and accounting scandals, I believe the mutual fund industry continues to serve shareholders well.

- We are serving shareholders well because mutual funds remain a remarkable and important innovation.
- We are serving shareholders well because the mutual fund industry has avoided the abusive practices that betrayed investors in other parts of the marketplace.
- We are serving shareholders well because mutual fund companies continue to develop innovative and valuable services that address investor needs.
- We are serving shareholders well because mutual funds compete vigorously and fairly with one another and with other financial services and products.
- Most importantly, we are serving shareholders well—and will continue to serve them well in bull and bear markets to come—because the interests of those who manage mutual funds are so well aligned with the interests of those who invest in mutual funds.

We all know that mutual funds democratized investing by offering diversified portfolios that are professionally managed, fully disclosed and strictly regulated at a reasonable cost. Yet just a short time ago, these qualities were dismissed: some said mutual funds were boring and obsolete, others argued that fund regulation was outmoded and a relic of the depression. These criticisms have vanished quietly, as have some of those who promoted them.

The devastating decline in some individual stocks has validated the wisdom of investing through mutual funds. Americans who were once convinced that their favorite individual investments couldn't miss surely now see the value of diversification.

Morningstar recently calculated that in 2002, 20 percent of individual stocks lost 60 percent or more. About one-tenth of one percent of equity mutual funds experienced a loss that large. In other words, at the start of 2002, an investor's chance of choosing a stock that would lose at least 60 percent of its value was one out of five. An investor's chance of choosing an equity mutual fund that would lose that much was only one out of 807.

We are thankful that during such a difficult and challenging time, mutual fund shareholders have again acted as they have during downturns in the past: steady, calm and rational. There has been no panic or mass redemptions.

One of the reasons that mutual funds have earned the confidence of millions of investors is that our industry learned long ago that protecting shareholders must be our top priority.

Making investor confidence a bedrock principle sounds commonplace today. But in good economic times, the tendency to relax regulatory standards can be a powerful temptation. Just recall the deregulation of the savings and loan industry. That industry succeeded in weakening regulatory controls, actions that contributed to a wave of spectacular collapses, costing taxpayers $200 billion or more.

During the bull market of the 90s, some suggested that our industry should leverage the popularity of mutual funds to secure the repeal or dilution of tough restrictions imposed by the Investment Company Act. But our industry steadfastly opposed weakening the Act. We successfully resisted attempts to repeal the Act's ban on affiliated transactions; we opposed calls to weaken credit quality standards for money market funds; and we argued against allowing the use of credit cards for mutual fund purchases

The mutual fund industry did more than resist the temptation to dilute investor protections during the bull market. We also supported the enactment of tough new SEC restrictions in areas such as fund names, performance advertising, and after-tax returns. Moreover, consistent with our view that the time to check the roof is when the sun is shining, we adopted voluntary standards in areas such as personal investing and fund governance.

By keeping our priorities focused on maintaining investor protections during the biggest bull market in history, we and our shareholders are better prepared for today’s challenges.

But, just like the long bull market that preceded it, a long bear market can distort how we assess the need for regulation. In the midst of an extended decline in securities prices and a series of costly scandals, it’s easy to lose sight of the fact that more regulation is not always better regulation.

Though it wasn’t clear to everyone at the time, we now recognize that we experienced a stock market bubble in the late 1990s. Today, we need to guard against the possible emergence of a regulatory bubble. Make no mistake—no one supports tough regulation more than the mutual fund industry. In just the past 12 months, we supported enactment of the Sarbanes-Oxley Act and endorsed a series of SEC regulatory reforms.

The mutual fund industry should always support regulatory change that would make a good system even better. But were a regulatory bubble to emerge, it could carry the risk of distorting decision-making and chilling innovations in ways that could be harmful to fund investors. Fortunately, the SEC has a well-deserved reputation for advancing carefully considered regulatory changes that benefit shareholders.

Reforming mutual fund disclosure requirements is a case in point.

The SEC recently proposed a comprehensive overhaul to improve shareholder reports. The SEC’s proposal will help shareholders by requiring summaries and analytical information about portfolio holdings and a discussion by managers about performance. Portfolios will be disclosed each quarter rather than semi-annually, with a 60-day reporting lag. We initially expressed concern that requiring every fund to provide more frequent portfolio disclosure would help opportunists and professional traders "front run" stocks a fund is buying or selling and "free ride" on the fund’s proprietary strategies. However, we believe that, with modest modifications, the SEC’s proposal would guard against these risks to shareholders.

The SEC’s proposal also establishes a new disclosure requirement concerning fund fees. For the first time, shareholder reports would disclose information about the actual rate at which fund fees were determined over the previous six months. This information would be based on a standard $10,000 investment, similar to the hypothetical included with the fee table in the fund prospectus. While we’ve suggested that the SEC keep the presentation of this information as straightforward as possible to maximize its usefulness, our key point is clear: we support the SEC proposal as an excellent way to reinforce awareness of mutual fund costs as one of several important elements in evaluating funds.

The SEC's proposal has arisen at a time when mutual fund fees have become the subject of renewed attention. For example, a General Accounting Office report was released at a congressional hearing held earlier this month. The GAO report's bottom line confirms the existence of positive fee trends that, over the long-term, have produced substantially lower costs for fund shareholders. The GAO also found that while the fee levels of many large equity funds were lower in 2001 than they were in 1990, they actually increased somewhat recently, as assets under management declined. Paradoxically, the finding about the recent rise in some expense ratios reinforces earlier findings by both the GAO and the SEC—that when assets grow, most mutual funds realize economies of scale and thus reduce their fee level for investors. In fact, fee schedules at most mutual funds provide for multiple, automatic fee reductions when assets grow beyond certain levels. By definition, however, the reverse is also true: the benefits of some automatic fee reductions can be lost, hopefully temporarily, when equity fund assets fall.

Analyzing recent data about investors' actual behavior suggests that the message about the importance of fees is being heard. The ICI looked at all equity fund sales over a five year period ending in 2001, a period that included significant parts of both the bull and bear markets. We found that 83 percent of all equity funds bought by investors had total expense ratios below the 1.62 percent charged by the average equity fund. In fact, the average investor holds equity funds with a total operating expense ratio of 0.99 percent—about 39 percent lower than the fee level charged by the average fund. We also found that the apparent preference for lower cost mutual funds extends to bond and money market funds.

The fund industry is acutely aware that most investors in equity mutual funds have seen their accounts lose value in recent years. We believe that fund shareholders continue to recognize that equity funds are long-term investments, and that the fees they pay are being used to try to achieve the funds' investment objectives. The current system of mutual fund fee disclosure—reinforced by extensive media commentary—has been carefully designed to work in the interests of investors. We also believe that an effective disclosure system can made even better, which is why we endorsed the SEC's proposal to add fee information to shareholder reports.

Last week, several members of the House Financial Services Subcommittee that sponsored the hearing on mutual funds submitted follow-up questions to the SEC. Many of the issues underlying these questions have been studied by the SEC, GAO and others over the last decade. Overall, these studies have found the mutual fund industry—and the regulatory structure that governs it—to be fundamentally sound. Ironically, a mutual fund's transparency—a quality we often take for granted but which is unusual compared to other financial products—is part of the reason we are studied so frequently. As a former SEC chairman once testified, analyzing industry trends and practices is only possible because data about mutual fund fees and expenses is readily available to investors, academics and the financial press.

As the SEC prepares to respond to these questions, our industry stands ready to provide whatever information or assistance the SEC may need. As in the past, we remain open to regulatory changes that offer real hope of informing, rather than confusing, fund investors.

One area where well-intended regulatory interest could harm shareholders is the SEC's initiative to reexamine the desirability of creating a mutual fund self-regulatory organization. We are deeply skeptical that developing an organization requiring mutual funds to assume significant responsibility for regulating themselves is either wise or necessary. Strong day-to-day regulation by the SEC has protected the nation's 95 million mutual fund shareholders and kept the industry free of systemic scandal for more than 60 years.

Adequate financial resources for the SEC are absolutely essential to effective regulatory oversight, and are a more reassuring alternative for fund shareholders than self-regulation. We applaud the Bush Administration for proposing to nearly double the SEC's 2004 budget to $842 million from its level in 2002. Similarly, we commend Chairmen Mike Oxley and Richard Baker and their colleagues on the House Financial Services Committee for supporting a bill to bolster the SEC's ability to attract and retain the economists, accountants, and compliance examiners it so badly needs. The Institute has endorsed this legislation and we are hopeful it will be enacted swiftly.

Effective SEC regulation and oversight will always be front and center for our industry and our shareholders. But that can't be our only focus. We also must ensure that other systems of regulation advance the interests of our shareholders.

Our national policy on personal savings and retirement is a prime example. One of the most serious long-term issues facing the United States are the difficulties many Americans face when trying to save for their future needs.

Millions of employees save for retirement in several different types of defined contribution plans. Each plan's purpose is to encourage retirement savings. But different sets of rules for different types of plans needlessly complicate and confuse employers and employees.

Feelings of confusion and frustration are also far too common among Individual Retirement Account investors. In 1982, the IRS publication explaining IRAs was 12 pages long. By 1998, the publication had grown to 82 pages.

The mutual fund industry welcomes the Bush Administration's vision to sweep away the confusion by creating simpler systems that will benefit all working Americans. The President's proposal would create a single Employer Retirement Savings Account in place of today's multiple defined contribution plans; a single Universal Retirement Savings Account in place of most types of current IRAs; and a new Lifetime Savings Accounts which could be used for shorter term needs.

We believe that the Bush Administration's dramatic redesign of long-term savings plans makes common sense for middle income Americans trying to save for their futures. This far-reaching program is unlikely to be enacted in its entirety in the near future. But it remains an excellent blueprint for long-term reform. In the near-term, we expect that congressional leaders in the area of retirement security—like Representatives Rob Portman and Ben Cardin—will continue to move forward on longstanding efforts to promote retirement savings.

As we work to ensure that our shareholders have better and simpler savings and investment opportunities, we must also do all that we can to make sure that they receive the advice they need in making their investment decisions.

The vast majority of 401(k) participants do not have an investment advisory service available to them through their plans. This situation contrasts sharply with the use of advisers by mutual fund investors outside of retirement plans, where a substantial majority depends on professional advisers.

Chairman John Boehner of the House Education and the Workforce Committee recognizes the significance of the “advice gap” that exists in the 401(k) market, and has worked tirelessly to make advisory services for 401(k) participants more widely available. We must continue to work for enactment of Chairman Boehner’s legislation. It will increase the flow of meaningful advice to participants, while subjecting that advice to strict fiduciary regulation and full and fair disclosure.

Tax policy is another example. The mutual fund industry supports legislation that would assist Americans who are investing to meet their long-term goals by deferring taxes on reinvested capital gains until mutual fund shares are sold.

Under current law, capital gains distributions are taxed even when automatically reinvested. This frustrates many fund shareholders and unnecessarily inhibits their ability to save. Deferral of tax until the shareholder redeems fund shares means that a shareholder's own actions will determine when taxes are paid. By reducing current tax bills and allowing earnings to grow tax-deferred, such legislation would boost long-term savings.

The mutual fund industry also supports the President’s proposal to eliminate the double taxation of dividends, another measure that will encourage long-term savings and investment. In addition, we’ve emphasized that tax legislation should repeal the sunset that will cause critical incentives for Section 529 college savings plans to expire; speed up approved increases in contribution limits for IRAs and 401ks; and simplify and liberalize minimum distribution requirements from qualified retirement plans.

Finally, our industry must continue to do all that it can to support Congress, the SEC and other regulators as they grapple with issues that affect our shareholders.

The SEC and NASD recently announced initiatives to modernize sales practices and back office systems that resulted in some fund shareholders not being credited with discounts for mutual fund investments made through intermediaries. Our industry is working with the SEC, NASD and SIA to ensure that investors receive the breakpoints provided by mutual funds.

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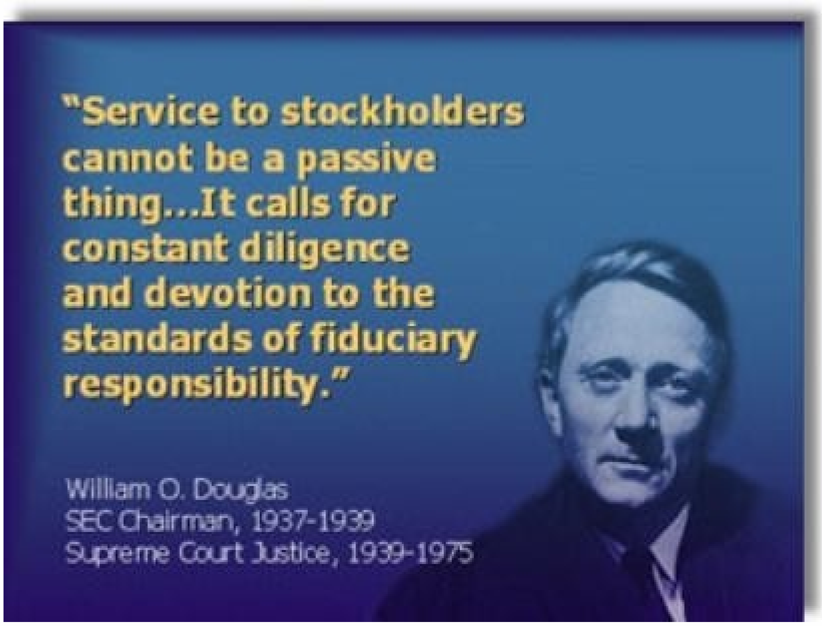
William O. Douglas, the late Supreme Court Justice and SEC Chairman, once observed that:

Service to stockholders cannot be a passive thing . . . It calls for constant diligence and devotion to the standards of fiduciary responsibility.

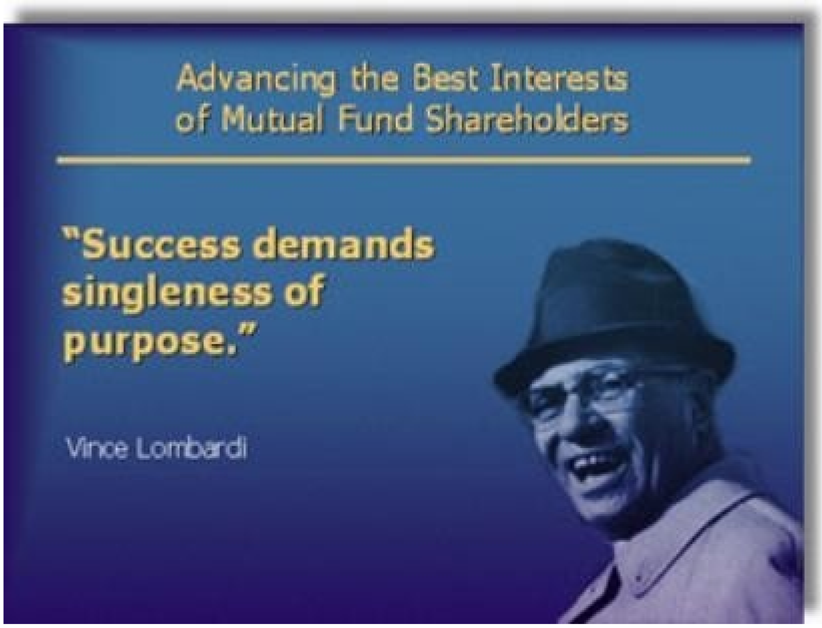


The key factor in the success of mutual funds is that we always have taken Justice Douglas' words to heart. We have embraced comprehensive pro-investor regulation and have been a strong supporter of the SEC's mission to protect investors. We must keep up the good work. We must continue to seek regulatory change that benefits our shareholders and oppose change that harms their interests.

Our success carries great responsibility—to our shareholders and to the unique fiduciary culture that we have inherited. In the years to come, more beneficial change can be achieved. Not by looking to short-term interests. Not by urging that the law accommodate the latest fad. Not by getting caught up in either the euphoria of a bull market or the pain of a bear market. But by working with Congress and regulators to identify and solve specific problems for investors responsibly, analytically and thoughtfully.

Our industry has every reason to be proud of its record. Time and again, we have worked for new laws and regulations that meet investors' changing needs. And, we've subjected ourselves to higher standards than the law requires. When the adequacy of rules governing personal trading was questioned, our industry quickly developed voluntary standards widely hailed as tough restrictions. Long before Enron and other scandals, our industry developed best practices for fund directors that have been hailed as "a blueprint for the guidelines publicly-traded companies are only now being urged to follow. "We've also helped advance reforms in retirement savings law and tax policy to benefit our shareholders.

Vince Lombardi once observed that: "success demands singleness of purpose." Our industry's singleness of purpose—advancing the best interests of our shareholders—has been the key to our success for sixty-three years. It's up to each of us here today to keep up the good work. By putting our shareholders first—in both good and difficult times—I have no doubt that our shareholders and our industry will prosper in years to come.


Advancing the Best Interests
of Mutual Fund Shareholders
"Success demands singleness of purpose."
Vince Lombardi

Thank you.