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Global Challenges and Opportunities for Mutual Funds

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Thank you for that introduction, and thanks also to the Swiss Funds Association (SFA) for inviting me to be a part of this distinguished conference.

It gives me great pleasure to come to Switzerland and to build upon the Investment Company Institute's ties to the SFA. It's not often that an American institution can look upon a European organization as a relative youngster, but this is one of those rare cases: ICI is marking its 73rd year of operation, while the SFA, founded in 1992, is just over 20 years old.

It's quite evident, however, that your association has made great strides in those two decades.

You have educated Swiss investors on the strengths of collective investment schemes; advocated for both Swiss-based and foreign funds; and promoted the strengths of Switzerland as a center for innovation, asset management, and fund distribution—all with outstanding results. Today's conference is another example of the leadership that the SFA brings to those missions.

This is my first trip to Bern, and so I was curious about the city and its history. In doing my research, however, I noted that a bear is the symbol of Bern—indeed, the city's coat of arms has been charged with “a bear passant sable” for almost 800 years, since 1224. The story goes that the founder of the city, the Duke of Za?hringen, relaxed from his labors with a hunting trip, and decided to chose as the city’s emblem the first animal he encountered—as it happened, a bear.

Of course, in the financial world, or at least in English-speaking financial centers, we commonly refer to the bear as a symbol of falling markets, pessimism, and investor losses. Since the 18th Century, the bear has been arrayed against the bull, a symbol of rising prices and exuberance.

All this set me to wondering—why do we call a falling market a “bear market,” and someone who is pessimistic about the market a “bear”?

It seems that in England in the early 1700s, dealers in bear skins often made a practice of selling skins for future delivery—in essence, going short in hopes that prices would fall before traders brought actual bear skins to market.

Around this same time, the forerunners of today’s securities markets began to spring up in London’s coffee houses, fueled in no small part by the mania surrounding the infamous South Sea Company. By the time the South Sea Bubble burst in 1721, short-sellers were clearly identified with the “bear-skin jobbers”—or “bears” for short.

A popular proverb from that time warned: “Don’t sell the skin until you’ve killed the bear.” Sound advice for investors even now.

My remarks today are titled “Global Challenges and Opportunities for Mutual Funds.” I will dwell on three specific issues. But let me say at the outset: I am a bull—and never a bear—on the future of our industry.

The greatest opportunity for our industry is the growing demand for our funds and our approach to investing, particularly as defined contribution retirement schemes become more prevalent.

Against that, I would stack two challenges. The first is external—it is the challenge of preserving the unique role of asset management for investors and markets in the face of growing, bank-centered global regulatory pressures.

The second challenge is internal, and calls upon all of us to examine carefully how we do business. We must always ensure that we serve investors’ needs ethically and effectively—with the right products, the right services, and the right innovations—even as competition and market pressures challenge our traditional ways of doing business.

Demand for Funds in Meeting Retirement Preparedness

One lesson surely to be drawn from the fiscal stresses gripping many of the advanced economies—and I certainly include my own country—is simply this: it is growing ever more difficult to sustain many of the pension schemes created in decades past, and workers and families accordingly must be encouraged toward greater self-reliance for their own long-term financial security. This reality confronts the United States as well as many other nations around the world.

ICI and its international affiliate, ICI Global, have been studying the evolution of retirement systems in many countries. One of the most striking trends is the intense level of policymaking activity. Between 2007 and 2012, virtually all member countries of the Organisation for Economic Co-operation and Development, the OECD, instituted some type of pension reform.

According to the OECD, there are two primary drivers for this activity.

First, changing demographics have made pay-as-you-go government-provided retirement schemes increasingly unsustainable. Created during a period of rapid population growth, these schemes were premised on large numbers of workers supporting smaller numbers of retirees—a premise that has been undermined by changing demographics.

Although we have seen these trends coming for decades, policymakers have found it difficult to make the changes needed to adjust. Now, the long-predicted revenue shortfalls in government-provided retirement schemes are appearing, even as the financial crisis and slower growth in the developed economies have increased the pressure on budgets generally.

The second driver of change is the funding pressure on employment-based defined benefit plans. When the 2008 financial crisis hit, those problems were exacerbated and brought to the fore.

As countries around the globe examine and reform their pension schemes, we see that many of them are implementing defined contribution schemes. These are being used to replace or supplement occupational schemes in some cases, while other countries are using them to supplement or replace national pay-as-you-go systems. These trends are evident in countries ranging from the United Kingdom to Sweden to Chile to Australia to New Zealand.

The European fund industry has recognized the need for these powerful individual savings vehicles in a labor market that is increasingly continental. In 2010, EFAMA called for the introduction of a personal retirement plan that would comply with a set of unified standards across Europe. Last April, EFAMA organized a Pension Day to discuss Enhancing the Role for Complementary Private Retirement Schemes. EFAMA deserves credit for advancing the discussions, and I am certain that all of you would welcome the active engagement of European policymakers and stakeholders in this work.

As these schemes emerge, each is different, reflecting the demographics, culture, social contract, and economic concerns of each country.

But defined contribution plans and similar mechanisms do have common advantages. They empower individuals, by helping them build a nest egg over their working lives. They convey ownership of retirement assets to workers. The plans are transparent. They are portable, and they accrue value throughout a participant’s working life.

While these evolving defined contribution schemes are each different, our study of pension reforms reveals several common themes.

We find an increase in employee choice, whether it is a choice in investment providers or a choice in investments. We find greater use of automatic enrollment features to increase participation and to encourage retirement savings.

And—in a particularly significant trend—we see that more countries are implementing lifecycle or target date funds as default investment options. Target date funds are professionally managed funds that are designed to meet a participant’s investment objectives based on the number of years a participant plans to remain in the workforce. These funds provide participants with diversification and automatic rebalancing.

We can see the emergence of these funds in Sweden, which in 2010 changed the investment strategy of its state-managed default fund to a target date strategy. In the United Kingdom, all of the default funds in the United Kingdom’s NEST Programme are target date funds. The chairman of Hong Kong’s Mandatory Provident Fund Schemes Authority recently said that Hong Kong should make greater use of target date funds.

Target date funds were introduced in the United States in the mid-1990s, but their growth accelerated after the Pension Protection Act of 2006 gave employers confidence that they could use these funds as default investment options in auto-enrollment plans. Today, more than seven in 10 U.S. 401(k) plans offer these funds, and assets in target date mutual funds have soared from 12 billion U.S. dollars in 2001 to 503 billion dollars at the end of January 2013.

One valuable contribution from this growth is that target date funds have helped keep retirement savers in the equity market despite an understandable decline in investors’ tolerance for risk. Whatever you think about the sustainability of the U.S. stock market’s recent highs, some plan participants might well have missed out on this rise if not for the equity holdings of their target date funds.

The broad trend I have been describing—a movement in countries around the globe toward individual account, defined contribution retirement saving—creates a significant opportunity for the fund industry.

Investment funds have a vital role to play in building the future of retirement. The products that our industry has developed contain key features that serve retirement savers well.

Our investment funds are professionally managed, well regulated, transparent, diversified, and cost-effective. Fund companies have a long history of interacting with investors and can provide valuable insights into how to reach, educate, and serve retirement savers. And our industry has a global perspective that can inform policymakers as they consider needed reforms to their pension systems.

We plan to advance that perspective in June, as ICI Global hosts its first Global Retirement Savings Conference in Hong Kong. We're very excited about the program, which will feature pension regulators, academics, and fund industry experts from many jurisdictions around the world discussing all these trends in great depth. The knowledge shared there should greatly advance the discussion of the role of defined contribution retirement schemes and the role of funds within those systems.

Beyond sharing our knowledge, how can our industry help our societies meet the need for greater self-reliance in retirement security?

We must do all we can to assist individuals in their efforts to save and invest for their retirement. That means continuing to improve, and to help them use, tools to make effective investment choices and to manage their resources effectively through their retired years.

And we must embrace and defend public policies that provide structures and incentives to help investors achieve retirement security.

In the United States, as the debate over tax reform heats up, that means vigorously defending current tax treatment of retirement assets, a key element of our employer-based retirement system. Preserving these tax incentives is one of our highest public policy priorities.

Preserving the Unique Role of Asset Management

While global trends in retirement systems offer tremendous opportunities for investment funds, global trends in regulation should give us pause.

The financial crisis and its aftermath have created an urgent desire to enhance regulation of financial systems—and, most significantly, to coordinate such regulation across borders. This is a natural development and one that the fund industry welcomes, in principle.

Our products depend on investor confidence and trust, and those qualities are rooted in sound regulation. Our funds, in turn, depend upon robust financial markets—and fostering such markets should be the objective of the growing ranks of transnational regulators.

Yet while we support this movement, the fund industry must pay close and critical attention to how it is carried out. As the saying goes, the devil is in the detail.

In a recent speech to the Atlantic Council in Washington, the secretary general of IOSCO—the International Organization of Securities Commissions—commented on two somewhat contradictory trends. David Wright noted that the international banking system will not be capable of supporting the growth and ambitions of emerging economies—especially as banks are constrained by rising capital requirements. This, he noted, would fuel a greater dependence on securities markets to provide critical financing.

Yet at the same time, Mr. Wright pointed out, “There is a domination of Central Banks and bank regulators in the key global policy committees…leading to the predominance of a policy culture of risk minimization, rather than risk optimization, that some feel may not be always appropriate for securities markets.”

When a rising demand for capital-market financing and innovation collides with a strong institutional bias toward bank-style regulation—that is a challenge for our funds.

We must acknowledge, preserve, and defend the unique role that asset managers play in the financial system.

I mean no disrespect to the great banking institutions for which Switzerland is rightly famous. But, as a close observer of policymaking in Washington for more than 30 years, I cannot help noting more than a little irony in the ascendancy of banking regulators. After all, the financial crisis was first and foremost a failure of the banking system—the latest in a string of perennial banking crises that have occurred despite numerous global efforts to increase the resilience of banks and reduce their risk.

Banking authorities nonetheless place an overriding priority on the need to address the risks of what they call the “shadow banking system.” Depending upon who’s using it, this loosely defined term can sweep in many activities in the capital markets, including a good portion of what funds do. The prime example that is often offered in support of this term is, of course, money market mutual funds.

This is a matter for concern—not merely for funds, but for the financial system and our economies generally.

To begin with, the term “shadow banking system” is inherently misleading. As the Federal Reserve Bank of New York conceded in a staff report, “the label ‘shadow banking system’… is an incorrect and perhaps pejorative name for such a large and important part of the financial system.”

Second, sticking this misleading label on capital market activities implies that these activities are “loosely regulated” or even unregulated. In a 2011 note on shadow banking, the Financial Stability Board implies that a bank-dominated financial system is inherently superior, with less systemic risk. This is pure ipse dixit—the note provides no substantiation for this view.

Nor does the FSB note take adequate account of the robust if different forms of regulation that characterize today’s capital markets. That regulation intently focuses on, among other things:

- protecting investors and securities markets;
- assuring an exceptionally high degree of ongoing transparency; and
- properly aligning economic interests so as to mitigate or remove conflicts.

From the earliest history of the United States, capital markets grew up in tandem with banking. Both have played critical roles in capital formation and credit intermediation. The parallel operations of these distinct sectors have added resiliency to our financial system, as they have in many other countries.

But they are different businesses and present different regulatory challenges—and those differences must be respected.

Bank-style regulation is neither necessary nor workable for U.S. mutual funds and their counterparts in other jurisdictions. It would deny our economies the benefits of diverse, competing channels for credit and capital. And it would concentrate—rather than reduce—the sort of systemic risks that we saw throughout the banking system in many, many countries in the recent crisis.

At ICI and ICI Global, we have addressed these issues broadly, by rebutting the concept of "shadow banking" at every opportunity. And we have addressed them quite specifically, by resisting the movement of national and transnational regulators to impose bank-style regulation on money market funds.

I need not tell you how that issue has consumed our attention over the past five years.

I believe that the fund industry globally must continue to defend its unique role within the financial services industry. The growth of transnational regulation was a critical motivation in ICI's decision to establish ICI Global. Now just 18 months old, ICI Global has grown rapidly. Its membership is drawn from global fund managers headquartered in Europe, Asia, and North America. We recently announced its expansion into Asia, with the impending opening of an office in Hong Kong. And it pursues an active policy agenda as the voice of global funds and long-term investing before national and transnational regulatory bodies.

Serving Investors' Needs Ethically and Effectively

The evolution of global regulatory bodies is, as I noted, an external challenge. My final topic arises from within—in fact, goes to the core of our business.

That is the challenge to ensure that we serve investors' needs ethically and effectively, in the face of competitive pressures and ever-present temptations to cut corners.

This was the subject of my first speech as head of ICI in June 2004, when our industry was still addressing the late trading and market timing scandal. It is a theme to which I return frequently—because it is altogether fundamental.

Our industry is built upon trust. We always must bear that in mind, and a survey of U.S. financial advisors published earlier this month by the Financial Times drives the point home once again.

The survey found that 96 percent of respondents ranked the "trustworthiness" of an asset manager as the key to a strong reputation among intermediaries. They associated this quality with many factors. The most important were:

- the clarity and consistency of a manager's investment process;
- the consistency of portfolio returns;
- increased transparency;
- reasonable fees; and
- a commitment to customer service.

No surprises there.

But the survey did contain one troubling surprise: 58 percent of the financial advisors surveyed thought that trust issues had become "more of a concern" in the past 12 months.

It is important to consider why this may be.

As representatives of the world's fund industry, each of us may take some pride in the fact that from the very beginning, fund sponsors have been innovators. That is in fact part of our mission—to bring the best ideas in portfolio design to a wide range of investors. We can point to a long series of product innovations, including money market funds, index funds, and exchange-traded funds, among many others.

But innovation is not an unalloyed blessing. Growing complexity and new strategies must be accompanied by a vigorous effort to properly frame investors' expectations of our funds.

All the products that we make available to investors, whether they pursue the simplest or most complex investment strategies, involve risks. And, as we learned once again in the financial crisis, those risks can come from unexpected quarters and have significant consequences.

I believe our investors generally understand that investing brings risks—and that the prospect of enhanced returns brings with it a need to assume greater risks and volatility.

But that does not relieve us of our responsibility to help investors balance their perceptions about our products with market realities. To this end, as ever, we must help investors understand our funds, with clear and concise information about the funds they choose.

Let me cite three examples.

I've mentioned the growing use of target date funds as a great benefit for American retirement savers. But the financial crisis exposed fundamental misunderstandings about those funds. While all of these funds rebalance away from equity investments over time, they do so at different rates. Even funds with the same target date may have different allocations to equity at any point in time.

After the market downturn, there were concerns that not all investors understood their exposure to equities through these funds, particularly for investors holding funds with a target date of 2010.

In response to the concerns this raised, ICI has worked closely with U.S. securities and pension regulators to improve disclosures surrounding target date funds. Again, the goal is to help frame investors' expectations properly.

My second example arises from the technology bubble of the late 1990s. At that time, some fund sponsors aggressively promoted technology funds to an investing public eager to catch the Internet wave. While these funds' risk disclosures met the technical standards, some fund sponsors suffered significant reputational damage when the tech bubble burst so dramatically. Managers who had resisted the tech craze were, by contrast, rewarded in the market.

My third example reflects the turmoil in the German fund industry occasioned by recent problems surrounding open-end real estate funds. As I understand the matter, it seems many investors regarded these funds as more liquid than they were, when in fact they held long-term investments and were subject to limits on redemptions. Many of these funds were forced to liquidate after suspending redemptions—an episode that led to parliamentary debates over banning or restricting open-end real estate funds.

Those measures were ultimately rejected, but the damage was done. At a meeting of the International Investment Funds Association last fall, a colleague from the German fund association shared survey data on consumers' attitudes about a range of service providers, from power utilities to auto repair shops. Of 28 different types of firms, fund companies received the very lowest rating for consumer satisfaction.

Our German colleague observed that concerted effort would be required to regain retail investor confidence. Truly, confidence is a plant of slow growth.

Conclusion

These three cautionary tales should give all of us pause. They remind us that we must always be unflinchingly loyal to the interests of the investors whom we serve, and deeply conscious of the obligations we assume as fiduciaries on their behalf.

Nonetheless, as I said earlier, I am a bull—an optimist—on the future of the fund industry worldwide, even in the face of all the challenges that I've addressed today!

Why am I bullish?

I am confident because our industry provides funds that serve investors' needs well. They offer a wide range of investment strategies, with professional management, clear disclosure, and numerous investor protections.

I am upbeat because our industry is intensely competitive and highly innovative.

And I am optimistic about the future because we have a history of constructive engagement with regulators that will stand us in good stead as we face the challenges ahead.

As we draw upon our past and examine our present strengths, I am certain that our industry faces a bright—bullish—tomorrow.

Thank you again for your time and attention.
