Funding our Future: Ensuring a Strong Public and Private Retirement System

ICI President's Remarks at 2005 General Membership Meeting

Funding Our Future:

Ensuring a Strong Public and Private Retirement System

by Paul Schott Stevens

President, Investment Company Institute

May 11, 2005
Washington, D.C.

Welcome to the 2005 General Membership Meeting. This is my first GMM as President of the Institute. I've been looking forward to it. Fortunately, long before I arrived we had found the secret formula of success – recruit an excellent Chair and Organizing Committee.

We owe a big "thank- you" to Brian Zino and the entire organizing team. They've put together an exciting program and an array of excellent speakers.

The program reflects the underlying reality of the mutual fund business – the need to put the shareholder first.

"Shareholders First" is more than a feel-good slogan. It is an organizing principle for the Institute's activities. It's also a core element of any successful business model for our members.

Mutual fund companies are most successful and profitable if they attract and retain investors for the long haul. Typically, fund investors are looking for the same – not a quick hit, but a relationship with a firm to help them manage financial risks and build financial security over a lifetime.

This shared, long-term perspective points up a fact too often overlooked in all our dialogue about conflicts of interest. There are also strong, parallel interests at work across our industry. When all is said and done, the only effective way for a fund manager to achieve its goals is by helping investors achieve theirs.

Putting shareholders first demands that we address their underlying needs – starting with the reason they invest in mutual funds in the first place. Our research tells us that's to ensure a comfortable retirement. Based on a survey we did last year, 92 percent of mutual fund shareholders identify saving for retirement as one of their financial goals; 72 percent say it's their primary one.

Retirement security has become the focus of a major national debate, with Social Security at the center of it. ICI has taken several opportunities to address the Social Security issue. Today, I only want to make a brief comment on the proposed reforms.

Whatever Social Security proposal one favors, it is urgent that we ensure the system's permanent solvency and sustainability. Time can be an ally. It can give people a reasonable window of opportunity to prepare for any major change in the way they must plan for their financial future.

FDR described Social Security as a "cornerstone in a structure which is being built but is by no means complete." Today's policy makers must help more Americans complete it. Just as urgent as the issue of reforming Social Security is the need to strengthen retirement preparedness to supplement it. I want to concentrate on that this afternoon.

As our Chairman, Jim Riepe, remarked last week: "Never has it been more important for Americans to strengthen their own long-term financial capacity." Two-thirds of Americans depend on Social Security for at least half their retirement income – and that's way too high.

Social Security was meant as a safety net to provide for the basic necessities – with employer-sponsored plans and individual retirement savings seen as the keys to a better retirement lifestyle.

But many of today's workers do not yet have in place a retirement savings supplement to Social Security. And many must pay an increasing share of their health coverage. The Employee Benefit Research Institute estimates that someone retiring at age 65 in 2014 – less than ten years from now – will need almost $300,000 in savings to cover health premiums and expenses.

It comes down to this: Almost half of American workers are not offered any form of pension or retirement savings plan at work. Of those whose employers offer retirement plans, 20 percent do not participate.

If you're in an employer plan, you cannot make a deductible IRA contribution if your household income exceeds certain limits. If you're not in an employer plan, you can make a deductible IRA contribution;

but for many Americans the limits are too low to build a sufficient retirement fund. Even for the half of workers who are in an employer plan today, many will change jobs so many times there is a good chance they won't be in one tomorrow.

Leaders of both parties have expressed strong support for shoring up the private retirement system of savings, through employer-based options and individual savings.

Well before putting forward his Social Security reforms, President Bush recognized the importance of the private retirement system. As he told the 2002 National Summit on Retirement Savings: "Government must support policies that promote and protect saving. Saving is the path to independence for Americans in all phases of life, and we must encourage more Americans to take the path."

Common ground exists on this point. Senator Max Baucus, Ranking Minority Member of the Senate Finance Committee, said just weeks ago "…we should work to develop new and innovative ways to help Americans save separate and apart from Social Security."

Both parties agree on the need. We must examine new approaches to promote retirement savings and investment. There are a number of creative ideas out there to effectively encourage, empower and assist more Americans to get on a savings track, stay on it, and move ahead on it faster.

One of the best ideas to come forward is a new bipartisan proposal, H.R. 2121, the GROWTH Act, introduced just last week by Republican Congressman Paul Ryan and Democratic Congressman William J. Jefferson. It would help smooth the path to long-term financial security for millions of Americans.

Right now, long-term capital gains distributed to mutual fund investors in taxable accounts are taxed every year – even if they are automatically reinvested. The GROWTH Act would defer taxation until the fund shares are sold. That keeps more retirement savings invested longer and growing longer by taxing income when it's withdrawn, not savings while they are being built up.

I'll have more to say about that specific proposal in a moment. But first, let's look at the status of private-sector retirement savings.

The mutual fund industry has become a tremendous part of what is strong about the private-sector efforts – employer-based and individual – to build retirement security. Today, mutual funds make up 43 percent of the $3.5 trillion in IRAs, and about half of the $2.1 trillion in 401(k)s.

More than 35 million American households hold mutual funds through their employer-sponsored retirement plans. There are nearly 40 million American households that are saving through mutual funds, either as supplements to their employers' plan or in place of it. Mutual funds offer the best mechanism for private saving for retirement.

When we talk about the transformation of the Middle Class into an Investing Class, mutual funds are the single biggest reason. About half of mutual fund investors have household income of less than $70,000 a year. In fact, one in seven has a household income less than $35,000.

As that snapshot suggests, we have made enormous progress. But our nation still has a long way to go to fulfilling the vision of a secure retirement in which individual retirement savings and workplace retirement provisions adequately buttress the public plan.

Just 20 years ago, it was more common for workers to bank on a traditional pension plan, a defined benefit paying out a monthly check for the rest of their lives. Today, that expectation is diminishing. The number of defined benefit plans has shrunk by more than two-thirds since 1985. Most workers who have access to an employer-based plan are in a defined contribution plan. This isn't just an American phenomenon; it's a global trend – one that appears to be here to stay.

The bottom line for retirement savers couldn't be clearer. In the future, a bigger share of the workforce will be relying exclusively on defined contribution plans and savings – requiring workers to start saving early, and keep at it through all their working years.

One of the challenges is to develop ideas to encourage people to save in their in-between years – the working decades when they need to put savings to work, when they have the power of time and compounding.

There are two external factors affecting investors' ability to build their retirement fund – fees and taxes. When it comes to fees, for every dollar fund shareholders invest, they are paying on average over 40 percent less in total fees than they were in 1980. The trend has been consistently downward.

But what about the tax code?

For millions of Americans saving for retirement, one of the most frustrating aspects of the tax law is this: For taxable accounts, they must pay taxes today on fund shares they may not sell for years. Obviously, fund shareholders, like other investors, expect to be taxed when they sell their shares. But not before. Nor should they be. Not when they are still building for retirement.

Modifying the tax treatment – so that gains are allowed to compound for taxation when shares are sold rather than being nicked year by year – would help the broad spectrum of American mutual fund investors saving for retirement.

That's why it makes sense to defer taxing fund investors on their gains every year when they're automatically reinvesting them. And that is why we were so glad to see Congressmen Ryan and Jefferson move to do exactly that -- an act of bipartisan leadership on behalf of Americans building for their future.

This proposal would help tens of millions of American savers and "should-be savers" over the course of their working lives – and make a real difference in the retirement readiness of American families.

In introducing the GROWTH Act, Congressman Ryan pointed out that investors who opt in to reinvest capital gains in the fund are pursuing policymakers' goals. "They are holding for the long term, contributing to national savings, and building up their own retirement nest egg."

Who would benefit from deferring taxation?

Millions of mutual fund investors now saving on their own for retirement without access to an employer-sponsored plan. Millions of mutual fund investors now supplementing their employers' plan because it won't be enough by itself. And millions of working Americans who have no access to an employer-sponsored plan and haven't yet begun to save on their own, either. For these people, mutual funds represent the most readily available and affordable option for retirement planning.

The change would be positive on several counts.

One, middle-income taxpayers would be encouraged to build their retirement portfolios – not penalized for it. Most mutual fund investors have less ability than high-income taxpayers to rearrange their finances to minimize capital gains. When examining this issue, the Wall Street Journal has reported on taxpayers who have found themselves with little practical choice but to sell shares to pay their taxes.

Two, deferral would recognize shareholders' expectations. People who plan in advance to automatically reinvest dividends should not find themselves taxed on what they didn't receive, didn't sell, didn't spend -- didn't even touch.

Three, permitting tax deferral would recognize the unique nature of mutual fund investing. The investors who are automatically reinvesting are in for the long haul. With a balanced diversified portfolio, they aren't making a buy-or-sell decision about each holding and they aren't making year-to-year decisions about keeping their money invested. What should be taxed is the growth of the overall fund from the day a taxpayer first invests in it to the day they dispose of it. Long-term investors need a long-term tax policy.

Obviously, the potential cost will concern some. As our industry knows, costs matter. But it is important to keep in mind the finding of a Joint Economic Committee study that deferring taxes on a mutual fund's capital gain will ultimately increase federal revenue, by producing larger account balances and higher tax revenues when sold.

When you add it up, it's clear that the current treatment of reinvested gains is counter-productive – it slows down savings and discourages savers. At the same time, we need to examine other promising ideas to help people begin to accumulate retirement savings that will last through their retirement years.

That includes proposals to encourage employers to set up plans that automatically enroll employees unless they opt out, and institute automatic contribution increases each year.

There are ideas to encourage low and moderate-income workers to save for retirement. That includes promoting payroll deduction mechanisms to encourage individual retirement savings. Employers can facilitate individual retirement savings without becoming retirement plan sponsors under federal pension law.

Some, for example, favor extending and improving the SAVER's Credit for moderate-income workers, enabling them to get some cash back at tax time and start them on a retirement investing path.

For those who are already investing, there are ideas to encourage workers to keep at it. Congress can make permanent the savings enhancement provisions enacted in 2001. They are just beginning to show results. It makes sense to build on that momentum, rather than cut it short.

There are ideas to help retirees spread their income throughout their retirement years. That includes initiatives to encourage careful distribution of retirement assets, perhaps through annuities or periodic payment plans – and to modernize tax rules that require IRA distribution to begin when an investor reaches 70 and a half, recognizing that people are living longer in retirement.

Of course, for these initiatives to have maximum impact in encouraging investing and saving for retirement, more Americans must be familiar with the tools of investment, the fundamentals of finance -- and even the essentials of budgeting to save.

In other words, we must encourage financial literacy and education as a national priority. It's a big undertaking, one that must involve the federal and state governments, public sector and private, and our education system at every level.

After all, in defined benefit programs, employers make funding decisions, participation decisions, investment decisions. But in defined contribution programs, decision-making shifts. Today, it's the individual worker who has to decide whether to participate, how much to save, how to invest savings given the options provided, when to rebalance, when to withdraw, and how to withdraw.

Our industry knows it has a role to play. We have begun working with the Consumer Federation of America, with the America Saves campaign and its partners, with AARP, with Treasury, Labor and other federal partners in retirement savings education. Tomorrow's panel session on investor education and industry responsibility will deal with some of the issues, and underscore just how urgent the need is for educational research.

Whether it's expanding investor education, increasing the incentives to save or removing the obstacles to long-term investing, the ideas I've offered today are just some of the ways to build retirement security – to build an even stronger investment ethic in America, to help both individual investors and the overall economy.

- Let’s widen the circle of savers.
- Let’s end the mixed signals: If we say we want people to save more – let’s not tax them when they do.
- Let’s reduce the complexity of investing for retirement, and do all we can to empower people to succeed.

There is a clear need to ensure retirement security for Americans. There are options out there. We have the opportunity to seize them.

We have the opportunity to encourage more people to save and invest – and make use of their remaining working years to build up their retirement portfolio.

We have the opportunity to ensure that public and private mechanisms are fully engaged to help Americans reach a secure retirement. It is crucial to America’s future. And it is crucial to putting shareholders first.
