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Promoting Excellence in Fund Governance

Sustaining Asset Management's Global Momentum

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ALFI Global Distribution Conference

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Thank you, and thanks to ALFI for giving me the opportunity to appear before you all today. It's a great honor to participate in the 20th edition of this important conference.

Every year since 1992, the Luxembourg Funds Association has brought together the world's major sponsors and distributors of investment funds to confront important issues that we all must deal with—whether we're in Luxembourg, London, Mumbai, Hong Kong, or the United States. The participation of NICSA and the Hong Kong Investment Funds Association brings added perspective and insights to these discussions. This is a valuable chance to share, to learn—and to see many long-time friends and colleagues. It's truly good to be here.

The 20 years since the first Global Distribution Conference have seen many changes in the world. In 1992, apartheid was still the official policy governing South Africa. Eastern Europe was emerging from decades behind the Iron Curtain. And the Treaty of Maastricht, formally creating the European Union and setting Europe on its current economic course, was signed in 1992.

Aspects of our lives that we now take for granted were, 20 years ago, still in their infancy. Take the Internet. The term “surfing the Net” was coined in 1992, and the number of hosted Internet sites hit 1 million for the first time. Today, there are 800 million such sites.

I would argue that the past two decades have witnessed another historic change: the rise of asset managers as financial intermediaries, all around the world—in North and South America, in Europe, and in Asia.

One clear sign of this rise is the explosive growth of defined contribution retirement systems around the world, with many variations—as exemplified by Australia’s superannuation scheme, Chile’s private investment plan, Sweden’s “premium pension,” the United Kingdom’s new NEST plan, and, of course, the United States’ 401(k) system, among others.

But we also see funds and other forms of asset management brought to bear to serve families and institutions across a broad spectrum of financial needs.

People young and old, working and retired, of modest and ample means, turn to us for help as they try to manage some of life’s more important and complex challenges.

Through us, they harness the power of today’s financial markets to build and manage wealth, provide for retirement, provide for their children, and achieve other major goals.

Through us, they access markets and investments, and manage risks, in ways that otherwise would not be possible for most.

And the sheer scale of the investment capital they entrust to us has, in turn, helped shape our world, driving progress and innovation, creating jobs and opportunities, building communities—indeed, developing nations and transforming whole economies.

We see this trend vividly in the growth of the fund industry. Since 1992, worldwide mutual fund assets have risen from roughly $3 trillion to about $25 trillion, an eight-fold increase.

And mutual funds are only part of the story. Boston Consulting Group estimates that the global value of professionally managed assets was $56.4 trillion in 2010, having fully recovered from the market downturn in the financial crisis.

This remarkable rise was not preordained. It came, as the American statesman Dean Acheson observed, the way the future always does: “one day at a time.”

You might also say one investor at a time. Today, this far-reaching fiduciary enterprise boasts a multitude of highly competitive and innovative participants upon which literally hundreds of millions of investors rely.

We have a record of which to be proud, no doubt—and a very sobering set of responsibilities. If the next 20 years are to be as successful, we must continue to keep faith with our investors—one investor at a time, one day at a time.

As might be expected, the global rise of asset management brings rising challenges, both for us and our regulators—and many of these challenges came to the fore during the most recent financial crisis.

The crisis reminded us—if we needed reminding—that managing assets is not the same thing as managing results. Like all other participants in the financial markets, our funds are affected by events in the real economy, by events in financial markets, and by government policies. Funds and their investors were hit hard by the crisis.

I do not mean to suggest that asset managers were at the center of the financial crisis. Funds, in particular, did not cause the crisis. Instead, the strong systems of regulation that govern registered investment companies in the United States and comparable funds in other jurisdictions withstood that storm and served investors well.

We are still cleaning up from that storm. We are wrestling with dozens or scores of discrete regulatory initiatives and measures. From that, there are four issues that I'd like to highlight for you today:

- First, the need to properly frame our investors' expectations of us;
- Second, our drive to continue to innovate in serving investors' interests;
- Third, the need for regulators to recognize and preserve the unique role of asset management within the larger financial services sector;
- And finally, the challenge of fulfilling our special role in promoting and managing retirement savings.

First, framing expectations. All the products 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 recent 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 some policymakers and commentators don't understand that tradeoff—or don't think investors are capable of comprehending it on their own. We see this in calls for regulation that would limit investor choices or impose particular investing models.

While we work to protect our investors' choices, we also must ensure that we help investors balance their perceptions about our products with market realities. To this end, as ever, investors need better understanding of our funds. They need clear and concise information about the funds they choose.

Regulatory improvements like the Key Investor Information Document in the European Union and the summary prospectus in the United States can certainly help. In Canada, the Ontario Securities

Commission has adopted a “Fund Facts” document that gives all fund investors a standard, plain-language disclosure at the point of sale.

There is more that can be done. For example, in the United States, we can greatly improve the usefulness of our annual and semi-annual reports to fund shareholders. Regulators should let us exploit the most powerful tool ever invented for investor disclosure and education—the Internet.

But meeting the challenge of framing investor expectations properly involves far more than perfecting fund disclosure documents. It involves assuring the integrity and transparency of distribution practices, while preserving a level playing field among competing financial products.

In the United States, ICI has argued that brokers who provide individualized investment advice to retail investors should be brought under a fiduciary standard at least as strong as that applied to investment advisers.

In Europe, ALFI, EFAMA, and others are working vigorously to ensure that bank and insurance products meet the same standards of disclosure as funds under the European Commission’s pending Packaged Retail Investment Products initiative. This is a crucial condition for competitive markets that will serve investors well, and we applaud your efforts.

More broadly, we face a societal challenge in all of our countries to educate our citizens as investors. That means, first of all, educating citizens on the need to invest—making sure they understand the risks of failing to participate in our financial markets, just as they understand the risks those markets pose.

Financial education is a task for governments, schools, and families. But asset managers can contribute by providing more and better educational resources, and finding new ways to help investors make well-informed decisions.

We cannot afford to be complacent about any of these needs and concerns. Our own firms must consistently pursue these educational initiatives. And we must help to ensure that the regulatory standards and business practices of the markets in which we are active meet the same standards.

Our second challenge is to maintain a strong culture of innovation.

To a very large extent, finding new ways to serve the needs of investors has been at the heart of our success. Money market funds, index funds, exchange-traded funds, lifecycle or target date funds, sector and hybrid funds—these are all examples of innovations that have answered investors’ needs and fueled the global growth of investment management.

Unfortunately, the financial crisis has given financial innovation a bad name in some quarters. Some policymakers and academics have concluded that financial innovation is useless or dangerous. Former Federal Reserve Chairman Paul Volcker has said on several recent occasions that “the most important

financial innovation that I have seen the past 20 years is the automatic teller machine."

Yes—he's serious when he says that.

No question, regulation must keep pace with market developments, precisely because of the crucial role it plays in protecting investors. As regulators craft rules, however, they must take great care not to stifle financial innovation that brings real benefits to investors.

Just now, the risk of such setbacks seems to be on the rise. Whether discussing securitization and asset-backed securities, exchange-traded funds, or target date funds, many critics seem ready to halt development, without ever examining why those innovations arose or how they serve the interests of investors.

The current attention focused on derivatives is a case in point.

Some financial market participants use derivatives primarily for speculative purposes. Many mutual fund managers, however, routinely use futures, options, and swaps to hedge risks or to pursue their investment mandates more effectively. These are uses that benefit investors and reduce investment risk.

At ICI, we have supported improvements in the regulation of the derivatives markets. We favor robust disclosure to investors about the ways funds use these tools. But in tightening the rules around derivatives, policymakers must strike the right balance between costs and benefits.

Now, it is probably no accident that innovation in the capital markets is under attack at this time. One result of the financial crisis is the ascendancy of banking regulators and the notion that prudential supervision is the only valid model for financial regulation.

That notion raises the third of the four challenges I want to discuss: the need to acknowledge and preserve the unique role that asset managers play in the financial system.

There is, of course, more than a little irony in the ascendancy of banking regulators, given that 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 bank capital and reduce risk.

Indeed, three years after the worst of the financial crisis, policymakers trying to deal with sovereign debt issues on Europe's periphery are still constrained by fears about the banking system's stability. As one analyst recently observed, problems in the banking sector truly have been at the very center of all the recent turmoil.

And yet many authorities place an overriding priority on the need to address the risks of the "shadow banking system." Depending upon who's using it, this loosely defined term can sweep in many of the

activities in the capital markets, including a good portion of what funds do.

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" is inherently misleading. As the Federal Reserve Bank of New York said 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. The Financial Stability Board's recent note on shadow banking, for example, implies that a bank-dominated financial system is inherently superior, with less systemic risk. The note provides no substantiated basis 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;
- providing an exceptionally high degree of transparency;
- and properly aligning economic interests so as to mitigate conflicts of interests.

In the United States and many other countries, over many years, capital markets have grown up in tandem with banking systems. Both have played critical roles in capital formation and credit intermediation. The parallel operations of these distinct sectors have added resiliency to the financial system.

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, we have addressed these issues in a comprehensive response to the FSB's note. I urge that the fund industry globally continue to defend its unique role within the financial services industry.

The final challenge I'd like to discuss is this: how can asset managers fulfill our special role in facilitating and promoting retirement savings?

One lesson surely to be drawn from the fiscal crisis gripping many of the advanced economies, including my own country, is simply this: workers and families must assume greater self-reliance for their own long-term financial security. This reality confronts the United States and the EU—but it also challenges countries around the globe.

We are seeing some countries, like the United Kingdom, moving toward a greater reliance on private, account-based retirement plans to supplement or replace public pay-as-you-go systems. These defined contribution plans and similar mechanisms empower individuals, by helping them build a nest egg over their working lives. They also relieve succeeding generations of the future fiscal and economic burden of underfunded retirement promises.

The European fund industry has recognized the need for these powerful individual savings vehicles in a labor market that is increasingly continental. EFAMA's comprehensive report advocating the creation of the Officially Certified European Retirement Plan, or OCERP, has helped fuel a welcome debate on how to foster long-term savings under consistent, consumer-friendly standards. This debate is long overdue, and EFAMA deserves great credit for advancing it.

Let me highlight some features of defined contribution plan savings that are especially encouraging in today's environment, based on the findings of ICI Research. These findings are from the United States, but I think they have useful implications for other parts of the world.

Not surprisingly, our surveys of U.S. households have found investors of nearly all ages have become less willing to take financial risk. In 1998, one-third of households that held defined contribution plans or individual retirement accounts expressed willingness to take above-average or substantial risk in return for commensurate financial gains. By 2009 and 2010, after two bear markets, that had fallen to one-quarter.

This decline in risk appetite has been particularly pronounced among younger investors—those born in the 1970s. This is the group who came of age as investors in the past decade—a time of two major bear markets and sideways performance in major equity indexes. Not surprisingly, we also find that households in this age cohort are less likely to own stocks in 2010, when compared to the portfolios that their older counterparts held at the same age.

These developments have sparked talk of a "lost generation" of investors.

However, we don't see that happening—thanks in part to the features of defined contribution retirement plans.

First, we have found that retirement plan participants have stayed with their plans, even through the market losses of the financial crisis. In a series of studies we launched in 2008—in the depths of the financial crisis—we consistently have found that few working plan participants have quit contributing or taken withdrawals from their plan assets. We're talking about 2 to 4 percent of participants suspending their contributions in any given year and fewer than 2 percent taking hardship withdrawals—hardly the massive flight that many commentators have presupposed.

Second, we've found that this consistent participation has paid off. Retirement savers who remained invested in 2008 were poised to benefit both from continued contributions and from the market upswing

of 2009. As result, the 28 percent drop in account balances they suffered in 2008 was largely offset by a 32 percent gain in 2009.

Finally, we see evidence that features of these defined contribution plans—including features that U.S. 401(k)s share with many other plans around the world—can help the younger investors that some are quick to call the “lost generation.”

I spoke earlier of the grave risk of not investing—of failing to take advantage of compound growth and market returns that can overcome inflation. Well, one of the most powerful tools in the American context for turning savers into investors is the 401(k) plan—particularly with increasing use of automatic enrollment, and with more employers putting young savers into target date funds. These age-appropriate portfolios, with balanced allocations to equities and fixed-income, appear to be helping to counter extremes in investor behavior that might have resulted from the hard times we’ve been through. I find that most encouraging.

How can our industry help our societies meet the need for greater self-reliance in retirement security?

We must assist individuals in their efforts to save and invest for their retirement. We must develop, and help them use, new tools to manage their resources effectively through their retired years. We must embrace and defend public policies that provide structures and incentives to help investors achieve retirement security.

None of this is easy. The four issues I’ve outlined today all pose enormous challenges to asset managers globally.

But our industry brings enormous advantages to its efforts. Now more than ever, investors need our professional expertise to help them navigate increasingly complex and volatile financial markets. Now more than ever, investors need our global reach to help them pursue investment opportunities wherever they may lead—whether that’s San Francisco or St. Petersburg or Sao Paulo or Singapore.

And now more than ever, our financial systems need to return to our kind of investing—focused on the long term, on fundamental values, and, above all else, on the best interests of investors.

If we maintain that focus, if we strive every day to work for our investors, then the growth in our business in the next two decades will match or even outshine that of the past 20 years.

Thank you for your time and attention.

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