

1998 General Membership Meeting: President's Report

ICI President's Report at the 1998 General Membership Meeting

by

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Good morning. Let me join Paul Haaga and Don Powell in welcoming you to the Institute's 1998 General Membership Meeting. These annual meetings give us the chance to see old friends, to share experiences with colleagues, and to hear the views of industry leaders, regulators, and outside observers. Most importantly, we have the opportunity to put aside our day-to-day routines and to consider the longer term.

It has become a cliché? to remark on the success of the mutual fund industry. We have been transformed from a small cottage industry to a major means by which Americans save and invest for their futures. This transformation has not been sudden, but has occurred over many years at a steady pace. Industry assets have grown from less than 450 million dollars in 1940, to 2.5 billion in 1950, to 47 billion in 1970, to 134 billion in 1980, to more than one trillion dollars in 1990, to over four and one-half trillion dollars today.

Many factors have contributed to this long story of success, including strong securities markets, innovations in fund products and services, changes in retirement laws, and new distribution systems. But the key to our success is widespread public confidence in mutual fund investing.

Public confidence is the reason for our industry's steady growth. Public confidence explains why fund shareholders have not panicked in market breaks. Public confidence permits us to obtain legislative and regulatory reforms. Thus, in each of the last three years, our industry and our shareholders

achieved a major victory in Washington: realignment of federal and state regulation in 1996; repeal of the 30% test in 1997; and prospectus reform this year. These reforms were possible because legislators, regulators, and the public at large have confidence in our industry.

This widespread public confidence in mutual funds is no accident. Our industry has earned the trust of American investors and policymakers because, for over a half century, we have operated under a regulatory regime and a fiduciary culture that put investors first.

Our future, in the marketplace and in Washington, will depend upon maintaining and strengthening this public confidence.

What could cause us to lose public confidence? Forty-eight years ago, then Chairman of the Institute Dorsey Richardson, considered this very question. Richardson concluded:

"The only probable causes for loss of public confidence would be gross mismanagement, or, more likely, public expectations of miracles from investment company management."

Richardson's observations are just as valid today. The greatest threats to public confidence in mutual funds remain: unrealistic expectations on the part of investors; and the potential for one or two companies to harm the entire industry's reputation by failing to live up to our high fiduciary standards.

This morning, I would like to discuss what we must do to prevent either threat—unrealistic investor expectations and mismanagement—from becoming reality.

First, unrealistic investor expectations.

Let me begin with some important facts. Over the past five years, the S&P 500 has returned an average of 20%. At the same time, households have a record percentage of their financial assets in long-term mutual funds.

This sets the stage for a problem that Bernstein Research calls "the risk of customer disillusionment." A recent Bernstein report states:

"Surveys suggest that investors expect recent high returns to continue. They believe they are investing for the long run, but monitor performance frequently. Given the combination of high expectations and frequent monitoring, the risk of broad-based investor disappointments has rarely been higher. If it occurs, the mutual fund industry will feel the effects, including customer disenchantment."

In the interests of our shareholders, and in our own self-interest, we must do all that we can to see to it that investors have realistic expectations.

First, we must see to it that the core mutual fund disclosure document, the prospectus, provides investors with complete information, in understandable language, that will help them form realistic

expectations. The SEC, under Chairman Levitt's leadership, has just adopted the most sweeping fund [prospectus reforms](#) ever. The reforms greatly improve disclosure of risk by focusing on the fund's portfolio as a whole, by mandating a bar chart illustrating total return in each of the last 10 years, and by removing technical boilerplate. The Commission also authorized the use of fund profiles, which summarize key information about a fund in a concise, easy to read format. Now that the SEC has given us the tools to better educate investors, we must do the job.

Second, we must see to it that other [fund disclosure](#) documents, such as annual and semi-annual reports, sales literature and advertising, help investors form realistic expectations. We look forward to working with the SEC as it moves from reform of prospectuses to reform of annual and semi-annual reports.

Third, we must urge other regulators to see to it that investors are provided with full disclosure that will help them have realistic expectations. Today, more than 44 million Americans participate in defined contribution retirement plans, plans in which employees select investments from options offered by employers. These investors are no different from other investors. They need information that will help them form realistic expectations and make informed investment decisions.

But under current law, employers are not required to provide participants with essential information, such as the objectives, risks, past performance and costs of the various investment options. Many employers voluntarily provide this information to their employees, but others do not.

I repeat the Institute's [testimony](#) last November, and urge the Department of Labor to adopt regulations requiring all employers to provide all participants in 401(k) plans with full and fair disclosure as to all investment options.

Fourth, we must see to it that Social Security reform does not create any gaps in investor protection. Many respected policymakers are urging that one element of reform consist of individually directed private accounts invested in the securities markets. If this occurs, millions of Americans will, for the first time in their lives, have the opportunity to participate in the rewards, and the risks, of the markets. We support this debate, and believe that an important component is the need for these investors to be protected by appropriate regulation under the securities laws. Equally important, there must be a major, continuous public education campaign to assist these millions of new investors in making informed investment decisions and in having realistic expectations.

Fifth, we must vigorously oppose government action that is likely to lead investors to form erroneous expectations. For this reason, our industry has objected to proposals to permit bond fund sales literature to contain overly simplistic alphabetical or numerical [risk ratings](#). [Research](#) demonstrates that such ratings would mislead many investors, who will mistakenly believe that a single number or letter can capture all elements of risk. We therefore are pleased that the NASDR's [proposed rule](#) would require ratings to be in narrative form and based on objective criteria.

I have just discussed a number of government actions that can influence investor expectations. But laws and regulations can only do so much. The key to helping investors form real-world expectations depends on voluntary actions taken by our industry.

Individual mutual funds must continue and intensify their educational efforts, through presidents' letters, shareholder reports, newsletters and websites. Fund groups must educate investors:

- with plain talk about mutual funds and investing;
- by emphasizing the need for personal planning for retirement;
- by explaining that markets go down as well as up, that trees do not grow to the sky, and that the recent string of record returns is highly unusual and unsustainable;
- by laying out the relationship between risk and reward;
- by disclosing all fees in a clear and understandable manner;
- by teaching the benefits of asset allocation and diversification;
- by stressing the need to take a patient, long-term view; and
- by doing everything we can to help investors form realistic expectations.

The Institute has intensified our own efforts to educate investors. We have developed video news releases and [investor awareness brochures](#), and have launched a public website, all of which contain information designed to help investors form realistic expectations. We have been active participants in SEC Town Meetings and in the first ever national [Saving and Investing Campaign](#). We also recognize that many investors rely on the media for investment information. We therefore commit substantial resources to working with the media, including press briefings, news releases and one-on-one meetings. These efforts supplement your own widely respected programs.

It is extraordinary that individual mutual fund organizations and their association have committed so much time and resources to educating the public about the risks, as well as the rewards, of investing. But, it is the right thing to do. It is tradition in our industry. And it is critical to maintaining investor confidence. I urge every mutual fund group to continue, and even to increase, its educational efforts.

The second threat to public confidence is the fact that missteps by even just one or two fund companies have the potential to tarnish our entire industry.

We can be proud of the fiduciary culture and high business standards that characterize our industry. Greg Jarrell, a former SEC Chief Economist, once observed:

"If you wanted to describe a clean, pro-consumer, well-operated, ethically pristine industry, and realizing of course that it will be run by imperfect human beings, probably the mutual fund business over the last 15 years would be pretty close to what you'd describe."

We must do all that we can to prevent anyone in our industry from engaging in any activity that could threaten this outstanding reputation.

We must vigorously support strict government regulation of our industry in the interests of investors.

The Investment Company Act of 1940 was passed to address abuses of the 1920s and 30s. Our industry supported the act in the hope that, in the words of one industry participant, Arthur H. Bunker, "with this legislation the confidence of the public in investment companies will be restored."

Bunker's hope has been borne out. By operating under the rigorous fiduciary standards of the 1940 Act— stringent prohibitions against self-dealing; strict limits on leveraging; required daily pricing of all assets; and a statutory system of independent directors—we have avoided problems that have beset other financial industries, and have earned an extraordinary level of public confidence.

Over the past 58 years, we have continued to support strict regulation, endorsing numerous government proposals to tighten standards, and urging others. For example, this past year: we urged the NASD to narrow use of prior performance information in advertising and sales literature; we asked the NASD to improve disclosure of cash compensation arrangements; and we called upon the Department of Labor to require full disclosure in the 401(k) market.

Our commitment to strict regulation has paid off, for our shareholders and for our industry. Sheldon Jacobs, publisher of the No-Load Fund Investor, recently noted our support for strict regulation, and concluded: "That's pretty smart. It's that regulation that has kept the mutual fund industry squeaky clean."

We need to continue to support not only strict regulation, but also a strong government agency to vigorously administer that regulation. We all know that sports teams tend to play at the level set by their opponents. I am convinced that, in much the same way, regulated industries play at the level set by their regulators. It is widely known that the Securities and Exchange Commission is a very tough regulator. Study after study has concluded that the SEC is, as stated in President Reagan's transition report, "a model government agency," that sets high standards of performance, both for its own staff and for those it regulates. The Institute will continue to support adequate funding and a strong staff for the SEC.

SEC regulation has as its primary goal the protection of investors. We therefore must oppose proposals that would displace SEC regulation and thereby weaken investor protection.

An example of legislation that would displace SEC investor protection is the idea of imposing bank community reinvestment requirements on non-banks, including mutual funds. There are many reasons why CRA requirements are inappropriate for mutual funds. Funds do not make loans; are not chartered to serve local communities; and do not receive government benefits, such as deposit insurance and the federal safety net. But, most importantly, unlike banks, mutual funds are required to be managed solely in the interests of their shareholders.

Imposing CRA requirements on mutual funds would, in the words of former Acting SEC Chairman Mary Schapiro, be "fundamentally incompatible with the requirements of the Investment Company Act." In fact, it would amount to a totally unjustified tax on the assets of 66 million fund shareholders. The fund

industry will do all that we can to ensure that our shareholders' assets are invested solely for their benefit.

In sum, our industry benefits from strict government regulation administered by a single strong government agency committed to one goal—investor protection.

But, we also need to do all that we can to see to it that every firm, and every person, in the mutual fund industry, follows the letter, and the spirit, of the law.

The Institute's charter states that one of our principal purposes is:

"To encourage adherence to high ethical standards by all elements of the investment company business to the end that the interests of the public will be served."

A major portion of the Institute's efforts is devoted to fulfilling this mandate. We provide our members with analysis, on a daily basis, of legislative and regulatory developments. We publish compliance and best practices guides, in areas such as personal investing, derivatives, liquidity and valuation, and brokerage allocation. Our numerous committees focus on legislation, regulation and compliance. We sponsor a number of national conferences each year designed to help members meet their legal and ethical responsibilities. We also run a series of regional seminars and workshops, in areas such as money market fund regulation, SEC filings, tax compliance and advertising rules. We provide a variety of self-paced training and compliance programs, particularly designed for new fund personnel.

Our educational program for mutual fund directors, the "watchdogs" of our industry, includes an annual conference, regional meetings and papers in areas of special concern to directors.

I urge every Institute member to take advantage of all of these services.

Government can lay down laws and regulations, and the Institute can keep the industry abreast of developments and best practices. But in the end, it is up to each mutual fund organization, and to each fund officer, director, and employee, to see to it that every participant in our industry understands all of the rules, and plays by them.

The growth of our industry has put us in the spotlight. Legislators, regulators, the media, competitors, and the public at large follow every development in our industry. The failure of a single organization or individual to live up to high standards could tarnish the reputation of our entire industry, and erode hard-earned public confidence. All of us have a duty to see to it that this does not occur.

In this connection, I urge all industry participants to continue their efforts to be ready for the Year 2000. The securities industry has a number of initiatives and task forces to prepare computer systems for the new millennium. The Institute is actively involved in these efforts, and is distributing information to our members. Every Institute member, and every industry service provider, must meet this challenge.

The noted British philosopher and historian of ideas, Sir Isaiah Berlin, once observed that "there are great impersonal factors" that affect the future. A number of impersonal factors will affect our industry's future—the state of the economy, changes in interest rates, stock market movements, technological innovations, and demographic trends.

But Sir Isaiah also went on to observe that "at crucial moments, at turning points, when factors appear more or less equally balanced, individuals and their decisions and acts can determine the course of history." The history of our industry, from the creation of the first mutual fund in 1924, through the passage of the Investment Company Act in 1940, and continuing today, bears this out. Our industry's success is attributable to the responsible decisions and acts of thousands of individuals, including many of you here this morning.

History teaches that our industry is dependent on investor confidence. The two great threats to that confidence remain those identified by Dorsey Richardson half a century ago: unrealistic expectations on the part of investors, and poor practices within our industry.

Thus, the future level of public confidence in mutual funds will depend on how well all of you in the mutual fund industry help investors establish realistic expectations, and on how well you adhere to the highest standards in managing investors' assets. The Institute is committed to assisting you in any way possible.

By working together, we can assure continued public confidence in mutual fund investing, and hence, the continued success of our industry.

Thank you.

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