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The Role of the Mutual Fund Industry in the U.S. Economy

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Good afternoon. I am delighted to be here today. I want to thank my friend Alain Leclair for providing me with the opportunity to talk to you about the role played by the mutual fund industry in the United States.

The largest mutual fund industries today are those in the U.S. and France. Indeed, I often tell Alain and my other French friends that the greatest fear of the U.S. mutual fund industry is not a bad economy or stock market crash, but the danger that the U.S. industry soon will be surpassed by the French industry.

This afternoon I am going to provide an overview of the U.S. mutual fund industry and the role it is playing in helping Americans save for the future.

Total assets of U.S. mutual funds now stand at about $5 trillion. At the end of 1980, assets were only $135 billion. As recently as 1971, 94 percent of industry assets were in equity funds. During the 1980s and 1990s, the U.S. industry became much more diversified. Today, 51 percent of the assets invested in U.S. mutual funds are in stock funds, 16 percent are in bond funds, and 26 percent are in money market funds. The remaining 7 percent is invested in hybrid funds—funds that invest in a mix of equity and debt securities.

Sources of Industry Growth

Since the mid 1980s, mutual funds have experienced the highest growth rate of all major financial intermediaries in the U.S. The assets of U.S. mutual funds are second to commercial banks among major U.S. financial institutions. Private pension funds, life insurance companies, state and local government pension plans, and savings institutions have smaller shares.

There are many reasons that the mutual fund industry has experienced success in the U.S. One of the most important factors has been a strong regulatory system which is designed to achieve only one goal: investor protection.

Mutual funds are regulated under all four of the U.S. securities laws. The Investment Company Act of 1940, the principal U.S. securities law regulating mutual funds, is a model of effective regulation in that it imposes very strict controls on mutual funds. For example, the act: prohibits a fund sponsor from selling securities to the fund; it requires the fund's assets to be held by an independent custodian; it imposes strict limits on leveraging; and it requires mutual funds to have directors that are totally independent of the fund sponsor. Moreover, the securities laws are administered by a regulatory body, the United States Securities Commission, which has the reputation of being an independent and tough regulator. A strong regulatory system, a strong regulator, and strong industry commitment to investor protection are indispensable to fostering public confidence.

The absence of barriers to entry into the U.S. mutual fund industry has encouraged innovation and has helped the U.S. industry grow. The types of firms that sponsor mutual funds in the U.S. include firms of all types and sizes—investment advisory firms, brokerage firms, insurance companies, banks, industrial companies, and foreign firms. An open market encourages competition to develop the

kinds of products and services that meet investor needs and to offer them at reasonable cost.

Another important factor in U.S. industry growth has been the presence of multiple distribution channels that make mutual funds easily accessible to investors. Today, mutual funds in the U.S. are available from many types of intermediaries, directly from mutual fund companies, and through employer-sponsored retirement plans such as 401(k) plans.

Intermediaries include full-service brokers, discount brokers, insurance agents, financial planners, and banks. These investment professionals analyze a client's financial needs and objectives and recommend appropriate funds. Generally, they are compensated for these services through sales commissions paid by investors or service fees deducted from the fund's assets under an SEC rule, Rule 12b-1, that allows funds to pay certain distribution expenses.

Direct-marketed funds are sold through the mail, by telephone, or at office locations. They typically offer their shares to the public with a low sales charge or none at all.

The third important distribution channel involves employer-sponsored retirement plans. Mutual funds often are offered as investment options under 401(k) plans and other types of defined contribution retirement plans. Under these plans, both employees and employers make contributions to individual accounts for employees. Typically, employees make their own investment decisions by choosing from a menu of investment options offered by their employer.

The 401(k) plan is the most popular type of defined contribution plan in the U.S. Total assets of 401(k) plans have grown from $385 billion in 1990 to over $1.068 trillion at the end of 1997. The mutual fund industry's share of the 401(k) market rose to about 42 percent at the end of 1997, continuing an upward trend that has been in place throughout the 1990s. Inflows to mutual funds from 401(k) plans totaled $45 billion in 1997.

Mutual funds are ideal products for defined contribution plans. The variety of funds offered by an individual mutual fund firm provides employees a choice of investments with wide-ranging risk and return characteristics. Mutual funds offer daily pricing, and exchange features whereby investors can move investments from one fund to another. Mutual funds are mandated to provide disclosure documents such as prospectuses and annual reports not typically available with respect to many other investment options. Major daily newspapers publish fund prices daily, enabling employees to track their retirement investments easily. Finally, fund companies have developed extensive educational materials to assist employees in their investment decision-making. For all these reasons, I believe the retirement market will continue to be a key source of growth for the U.S. industry in the years ahead.

More than 37.4 million households in the United States, over 37 percent of all households, own mutual funds today, up from 5.7 percent in 1980. As of yearend 1997, these households held $3.52 trillion, or 78 percent of mutual fund assets. Fiduciaries—banks and individuals serving as trustees, guardians, or administrators—and other institutional investors held the remaining 22 percent.

Mutual Fund Shareholders

What are the characteristics of the households investing in U.S. mutual funds?

U.S. households own many financial assets, including mutual funds, stocks, bonds, and bank deposits. In 1997, U.S. households made $549 billion of net purchases of financial assets. According to the Federal Reserve Board, U.S. households invested $358 billion, or 65.3 percent, of their total net purchases of financial assets in mutual funds. Other financial assets, such as stocks, bonds, and bank deposits captured the remaining 34.7 percent.

The large inflows to U.S. equity mutual funds that occurred throughout the 1990s have occurred at the same time that U.S. households have been net sellers of stock. From 1990 to 1997, U.S. households, on net, sold $1.2 trillion of equity holdings from sources other than mutual funds, while purchasing $870 billion through mutual funds. In 1990, net equity purchases through mutual funds were $13 billion; by 1997, that figure had reached $190 billion.

Investors in U.S. mutual funds tend to take a long-term view of investing. Eighty-four percent of fund investors say they are saving for retirement. Investment Company Institute research finds that the average mutual fund investor in the U.S. is middle class, 44 years old, likely to be married and employed, and possesses financial assets (excluding a residence) of $80,000 and an annual income of $57,000. In fact, most investors come from moderate-income households. Sixty percent of households owning mutual funds had income between $25,000 and $5,000.

Stock Market Concerns

The increased popularity of stock mutual funds in the U.S. today has led to two concerns that I would like to address.

First, some have expressed concern about the magnitude of equity investment in the U.S. held by mutual funds and whether this places too much economic control in the hands of a few mutual fund companies. This concern is misplaced. Stock mutual fund

assets account for only 19 percent of the total value of publicly traded U.S. stocks. The remaining 81 percent are held by households, private pension funds, state and local government retirement funds, insurance companies, private trusts, residents of foreign countries, and others.

The second concern is whether, in the event of a sharp stock market downturn, fund shareholders will engage in panicked redemptions, forcing funds to sell securities in a falling market, thus driving prices even lower. But as I have pointed out this afternoon, survey data indicate that fund shareholders typically are experienced investors with a long-term orientation. Moreover, research demonstrates that, historically, fund shareholders have not responded to equity market breaks and sharp declines by selling their shares in large numbers. The largest outflow in the past 50 years occurred the two weeks during and immediately after the 1987 stock market break, yet amounted to only 4.5% of total assets of stock funds. Nevertheless, during prolonged market downturns, equity funds have experienced moderate yet steady outflows. For instance, stock funds generally experienced outflows throughout the 1971- 1983 period when equity returns were relatively low. However, this was a slow process, rather than a sudden panic reaction. Thus, the likelihood that precipitous redemptions by mutual fund owners would occur during a sharp market downturn is not borne out by the historical evidence.

In conclusion, the experience of the U.S. demonstrates the important role that mutual funds can play in providing a way for millions of small investors to participate in the securities markets and to save for their futures. Moreover, because they offer the benefits of diversification and professional management, mutual funds can be more attractive to investors than investment in individual stocks. Our research suggests that mutual fund investment in the equity markets provides a stable source of capital.

In the end, however, I believe by far the most important factor in whether a mutual fund industry can attract and maintain long-term investor assets is investor confidence in the industry. There must be a strong regulatory law that protects investors. There must be a strong regulatory body that vigorously administers that law. But above all, to succeed, the industry itself must be committed to strong regulation and to the best interests of investors.

Thank you.

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