IDC Independent Directors Council
Promoting Excellence in Fund Governance

2000 General Membership Meeting: Chairman’s Report

ICI Chairman’s Report at the 2000 General Membership Meeting

by

John J. Brennan

Chairman, Board of Governors,

Investment Company Institute

May 18, 2000

I’d like to begin my remarks by thanking Bill Lyons and his committee for putting together such a stimulating and forward-thinking General Membership Meeting. It takes an incredible amount of effort and energy to coordinate this meeting, so please join me in commending Bill, the GMM committee, and the ICI staff for their great work in creating this event.

On behalf of the Board of Governors and the ICI, I welcome you all to this week’s gathering. The opportunity to gather annually with colleagues from across the country is an important tradition for the mutual fund industry. Yogi Berra once said, "You can observe a lot just by watching." I hope you’ll observe a lot during the next few days not just by watching, but also by listening and actively participating in discussion groups and other "interactive" opportunities that are part of this program.

Now, I’d like to spend just a few minutes recounting what has been a significant year for the fund industry, and then cite some of the challenges we face as we move ahead. For if we are to remain vibrant, growing, and relevant to our shareholders for another 60 years, we must make a continuing commitment to embrace new challenges.

David Brinkley has said that the one function that TV news performs very well is that when there is no news, TV gives it to you with the same emphasis as if there is news. Well, last year there was lots of news for the mutual fund industry, and I'll try to give it the emphasis it deserves—while leaving myself enough time to make some quick comments on the challenges of the future.

Accomplishments

Since we met one year ago, the mutual fund industry has continued to grow and diversify. On balance, the past year has been full of good news, thanks to a wide range of accomplishments. Our shareholder base expanded further—to an estimated 48 million U.S. households, or 83 million individual investors. Households, the predominant buyers of mutual funds, continued the trend of shifting away from directly holding securities to holding them indirectly through mutual funds. This shift has been an important factor in the growth of our industry.

Mutual fund assets increased 24 percent last year to $6.8 trillion, the fifth consecutive year of more than 20 percent growth, and the third best year of cash flow. About one-quarter of the growth in mutual fund assets last year was attributable to new investments. Most of the remainder came from investment performance, largely from rising stock prices. The growth trend appears to be holding strong through the first quarter of this year, as assets now exceed $7.2 trillion.

Investing for retirement, both inside and outside of retirement plans, continues to be a primary goal for most mutual fund shareholders. Last year, mutual funds accounted for $2.5 trillion, or 20 percent, of the $12.7 trillion U.S. retirement market. The remaining $10.2 trillion, or 80 percent, of retirement market assets was managed by pension funds, insurance companies, banks, and brokerage firms. Mutual fund retirement plan assets grew by $553 billion, or 29 percent, last year. Since 1994, retirement plans, including IRAs, plans for the self-employed, and 401(k) and other defined contribution plans, have held about one-third of all mutual fund industry assets.

Among our other accomplishments in 1999, progress on mutual fund governance stands out. Last year, an advisory group identified 15 best practices, including a requirement that there be a supermajority of independent directors on every fund's board of directors. Because the recommendations extend well beyond current law and practices, and because we are awaiting adoption of new SEC rules, implementation could take a while, but we believe these measures will make a strong system of governance even stronger. Independent directors are the watchdogs who ensure that a fund is operated in the best interests of its shareholders. For 60 years, we have been well served by the independence of investment company boards of directors; their independence is essential to the continued success and integrity of our industry.

Challenges and Opportunities

Last year also brought challenges. When we met this time a year ago, the specter of Y2K hung over the world. Although the mutual fund industry had devoted enormous time and resources to addressing Y2K issues over several years, a number of unknowns remained. Amid public uncertainty about the readiness of all government and business, you'll recall that some extremists were suggesting that individuals should liquidate all their investments in preparation for a global meltdown on January 1,

2000. What a gratifying experience it was to see that the dire predictions proved wrong. We can say with pride that the nation's 83 million mutual fund shareholders were very well-served by our diligence in preparing for Y2K—and of course, by their own sensible restraint.

If only all business challenges could be so smoothly resolved and neatly consigned to "Old Business" with the end of one year and the beginning of another. The fact is that several other issues that loomed large in 1999 continue to bedevil us now.

Reasonable Expectations. We must continue to emphasize to investors the importance of reasonable expectations. Polls still find that individuals are incredibly confident about the future, expecting average annual returns of 20 percent or thereabouts in the stock market over the next 10 years—far more than the long-term average of 11.3 percent for stocks would suggest. In fact, many investors apparently see no need to save more for the future, given the gains they've seen in their existing portfolios in recent years. But these investors are overlooking the risks of the stock market.

Not long ago, in a speech at Boston College, SEC Chairman Arthur Levitt cautioned that unless investors truly understand both the opportunities and the risks of today's market, too many may fall victim "to their own wishful thinking." Chairman Levitt remarked that he is "concerned that some of the basic but important fundamentals of investing are being lost on investors. Or, even worse, simply ignored."

Given that most fund investors are investing for retirement—and given the market's continuing volatility and performance—the Institute recently ran a Message to Investors in national publications to emphasize the importance of taking a long-term view. The message, which is part of the Institute's Investor Awareness Campaign, encourages investors to keep short-term market movements in perspective and maintain realistic expectations about the performance of the financial markets. Reactions from the public, regulators, and legislators have been very positive.

There's no doubt in my mind that a decade from now, the most successful investors will be those who began the new century with a fundamental understanding of risk and a great sense of discipline about their investment programs. It's critical that we as an industry take a more active role in educating investors about the risks and rewards of investing—because open communication has been a vital element in the confidence that the mutual fund industry has earned with investors throughout its history.

The Enduring Benefits of Mutual Funds. Some segments of the news media and some investors have asserted recently that mutual funds are boring or obsolete. According to this line of thinking, investors who want something exciting should trade individual stocks instead of investing in mutual funds. Some of the "exciting" days we witnessed last month in the Nasdaq should have reminded anyone who was paying attention of the advantages of diversification.

Throughout this industry's history, observers have declared our product to be under siege and about to become obsolete. For example, many of you can recall how money market deposit accounts at banks were predicted to become the ruin of money market funds in the early 1980s. More recently, the focus has been on investors' appetites for risk and trading—and the inability of mutual funds to satisfy those desires. But on both occasions, reports of our demise have been greatly exaggerated. Mutual funds remain the best investment vehicle ever invented for long-term investors, even in an intensely competitive post-Glass-Steagall environment. That said, it's critical that we in this industry do a better job of defining our fundamental and enduring value proposition: sound investment products and exceptionally good service at a fair price.

Broadening the Base of Investors. At the outset of these remarks, I reported that our shareholder base continues to grow—to an estimated 48 million U.S. households, or 83 million individual investors, at the end of 1999. Eighty-three million is an astounding figure—that's almost as many people who voted in the last presidential election. But there is more we can do to reach out to different segments of the population. Tonight, the Institute will announce an exciting new initiative, Investing for Success, aimed at educating African Americans about the value of investing as a way to reach long-term financial goals. This is a great initiative for the country and our industry.

Asset Velocity. My final point relates to asset velocity. Just a few years ago, annual redemption rates for stock funds averaged about 10%—equivalent to an average holding period of 10 years. At year-end 1999, the combined exchange-out and redemption rates were approaching 40% per year—equating to only a 2½-year holding period.

Constant trading activity is perilous for the investor who engages in it, as well as for everyone else. For the trader of funds, rapid-fire trading is a loser's game—not only because of the costs and taxes incurred in trading, but also in terms of performance. Many investors jump into a "hot fund" just in time to see it cool off. But hyperactivity also can harm the long-term fund investors who, in many cases, bear the transaction costs and tax burden of market-timers and speculators. Constant trading activity is bad for our business.

Some of our greatest challenges and opportunities in the coming years will relate to technology, a double-edged sword. As an industry, we'll continue to use technology to develop innovative products and services that benefit our shareholders. Because it offers education, service, and advice and guidance, the Internet is an incredibly powerful tool for investors. But this same technology poses great hazards. By allowing—even encouraging—investors to transact at lightning speed, technology tempts some investors to alter their investment behavior in perilous ways. While technology also gives us a new channel for communicating with our shareholders, at the same time, it makes it more difficult for our voices to be heard. Investors are exposed to an endless stream of information and advice from the financial press, the all-day television news programs, and the self-appointed experts who reign over Internet chat rooms. We must find a way to cut through the noise and convey the basic rules of investing in a manner that is clear, consistent, and convincing. Finally, technology gives us a way to know our clients even better, but it also presents us with an enormous responsibility to protect the confidentiality and security of our clients' personal information.

And now, in closing, I'd like to make a couple of personal comments. As many of you know, this will be my final general meeting as Chairman, although my final one-year term won't end until October. It has been my honor and privilege to serve as your Chairman for the past two years. Getting to work closely with our industry's leaders and the outstanding staff of the Institute has been one of the highlights of my career. I'd like to take this occasion to thank Matt and the rest of the ICI staff, and my fellow Board members for their professionalism and their support.

Finally, I have a hope to share with you—a hope based on the fact that I'm 45 years old and have had the privilege of serving as Chairman of this great industry association at a relatively young age. What I hope is that I'll be coming back to this meeting for years—even decades—and feeling good about our "single voice" in national affairs . . . about our willingness and ability to put parochial views aside for the best interests of our shareholders . . . about our unwavering focus on our only significant asset—our reputation as a trustworthy industry. For this is a business where it is decades, not years, that matter; where the interests of the client take precedence over any single fund provider's self-interest; and where embracing change means finding new ways to better serve our clients with integrity, fair dealing, and a commitment to their well-being.

I look forward to continuing the journey with you.

Thank you.
