Comparing the U.S. and European Mutual Fund Industries—What Is Next for Europe?

2000 European Mutual Fund 2000 Conference

Comparing the U.S. and European Mutual Fund Industries—
What Is Next for Europe?

Matthew P. Fink

President

Investment Company Institute

April 10, 2000
Seville, Spain

Good morning. I am delighted to be back in Seville, which I last visited as a student 37 years ago. This morning I will provide an overview of developments in the US mutual fund industry and highlight two factors that have contributed to the US industry's success. I also will offer some observations on how these factors may relate to developments in Europe.

The US Mutual Fund Industry, 1980-2000

The mutual fund industry in the United States has enjoyed remarkable success, particularly in the last 20 years. Total assets of mutual funds in the US stand at $6.8 trillion as of January 31, 2000, up from about $135 billion at the beginning of 1980. At the beginning of 1980, there were 564 US mutual funds. Today, there are 7,810.

Institute research finds that more than 47 million households, or about half of all US households, own mutual funds today. In 1980, the number of households owning mutual funds was just 4.6 million.

Not only has the US industry grown significantly since 1980, it has also undergone a number of important changes. I would like to highlight three of these changes.

- First, equity funds are now a much more significant portion of the industry. In 1980, most mutual fund assets consisted of money market funds and bond funds. Today, about 59 percent of total industry assets are in equity funds, about 17 percent are in bond funds, and about 24 percent are in money market funds.
- Second, the way in which mutual fund shares are distributed in the US has changed a great deal since 1980. Historically, mutual funds were sold almost exclusively through full service brokers. New distribution channels began to emerge in the 1970s and today mutual funds in the US are available from a number of different distribution channels—full-service brokers, discount brokers, insurance agents, financial planners, banks and directly from mutual fund companies.
- Third, mutual funds have become the investment of choice for individual retirement savings programs in the US. The retirement plan market has been one of the most significant engines driving US mutual fund industry growth. Retirement assets now represent 34 percent of total industry assets, up from 19 percent in 1990.

Retirement assets comprise both personal saving through individual retirement accounts (IRAs) and retirement savings through employer sponsored defined contribution pension plans.

Individual retirement accounts (IRAs) are a program under which any American worker can establish his or her own retirement account, with no employer involvement, and invest up to $2000 a year. The mutual fund industry share of the IRA market is 44 percent.

The strongest growth in industry retirement assets has involved 401(k) plans, a type of defined contribution plan that typically permits employees to select how their accounts are invested from among a menu available under the plan. Mutual funds now have 42 percent of the total 401(k) market, up from 9 percent in 1990.

Relevance of the US Experience for Europe

The European mutual fund industry also has experienced significant growth over the last 20 years. Moreover, many predict that the creation of a single European currency, the increased appetite for equity investments in Continental Europe, and the creation of new retirement savings programs will help fuel a further expansion of the European mutual fund industry.

Are there lessons Europe can learn from the US experience? I hesitate to draw any firm conclusions. Each mutual fund industry experience is different and what has worked in one country may not have any relevance elsewhere. Moreover, probably many factors contributed to the success of US mutual funds. These included a strong but flexible system of regulation, a strong economy, a system of corporate governance that provides strong protection for shareholders, and an open market. Today, however, I would like to highlight two other factors—a single continent-wide market and pension laws that permit publicly offered mutual funds to be used as funding vehicles in retirement programs.

The Importance of a Single, Large Market

First, the US industry is fortunate to have a single, continent-wide market in which to distribute mutual funds. In a single, large market, a mutual fund manager can use the same marketing strategy and program to reach a large number of prospective shareholders in a number of different jurisdictions, thereby lowering distribution costs. In a large market, it also is easier for funds to grow to a sufficient size to obtain cost-efficiencies in portfolio management, administration, and shareholder servicing.

While today the US has a single mutual fund market, for years there were impediments. Specifically, for years mutual funds in the US were subject to duplicative regulation by the SEC and securities commissions in the 50 American states. A mutual fund sponsor was required to register each fund and its shares with the SEC and to comply with all provisions of federal law. In addition, sponsors were required to register fund shares and comply with state law in each state in which the fund proposed to sell shares. State registration procedures and requirements varied widely. In addition, some states imposed requirements on mutual funds that were inconsistent with federal law or required funds to rewrite, rearrange, re-label, or supplement prospectus disclosure that had been thoroughly reviewed by the SEC staff. The result was a "crazy quilt" of duplicative, conflicting, inconsistent, and ever-changing requirements.

In 1996, the Institute and its members worked with the US Congress, the SEC, and state securities regulators to secure passage of the National Securities Markets Improvement Act of 1996. This landmark legislation eliminated separate state requirements for mutual funds and gave the SEC exclusive authority over substantive regulation of mutual funds. At the same time, it preserved the ability of states to bring enforcement actions for sales practice abuses and to require funds to file notices of their sales and pay registration fees in the state. Today, the United States has a true single continent-wide market.

The situation in Europe is quite different. Efforts to create a single market for mutual funds began in Europe with the adoption of the UCITS Directive in 1985. As you know, the UCITS Directive was designed to provide a convenient passport to allow a single mutual fund to be sold throughout the member states of the European Union. Specifically, a mutual fund that meets the minimum standards set forth in the Directive is subject to substantive regulation only in its home country and can register to sell its shares in one or more other EU member states without complying with the substantive requirements of those other member states. It is clear that the Directive has been useful in allowing money management firms established in Europe to reach a wider European mutual fund market.

It is also clear, however, that selling the same mutual fund throughout the European Union under the UCITS Directive remains very difficult. A UCITS fund must register in each member state in which it sells its shares and member states administer these provisions differently. Some member states impose burdensome requirements for registering a UCITS fund for sale in that member state that delay the 60-day waiting period set forth in the Directive.

Moreover, because host countries have jurisdiction to set marketing requirements, funds are subject to varied and conflicting requirements relating to advertising and disclosure or are required to incur the cost and delay to file, and await approval of, detailed information about their marketing plans. The UK and Germany, for example, take different approaches to the historical period over which performance information should be presented. While some member states permit fund prospectuses to discuss the effects of inflation, other member states forbid this.

The result is a European "crazy quilt" of regulation that is far more cumbersome and burdensome than that faced by the US industry prior to 1996. These overlapping, duplicative, inconsistent and ever-changing requirements make it difficult to sell the same mutual fund throughout the European Union.

The Importance of Permitting Mutual Funds As Funding Vehicles for Retirement Savings

Second, the US industry also has been fortunate to have pension laws that permit the use of publicly-offered mutual funds as funding vehicles for employer sponsored pension plans and individual tax-advantaged savings programs.

Mutual funds are ideally suited for these programs. Mutual funds offer extensive choices and services to employees with responsibility for their investment decisions. The variety of funds offered by mutual fund sponsors provide a choice of investments with different risk and return characteristics. Mutual funds offer daily pricing and exchange features permitting investors to 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 many other investment options. Major daily newspapers carry fund prices, enabling participants to track their investments easily. Finally, mutual fund companies have extensive experience in developing educational materials, informational resources, and asset allocation services to help participants in their decisionmaking.

Many countries around the world are actively engaged in creating new retirement security systems to decrease their historic dependence on "pay as you go" social security systems. Here in Europe, for example, a report published by the European Commission in late 1999 calls for increasing the role of funded pensions, which currently represent only 13 percent of pension payouts, to 33 percent by 2030 and tripling employee participation in funded pensions.)[1] Many of the proposals under consideration involve introducing or strengthening employer sponsored defined contribution plans or tax-advantaged individual savings programs.

Some countries have implemented or are considering policies that would restrict the types of mutual funds that could be used in defined contribution plans and individual savings programs. Some of the limitations are:

- requiring the creation of entirely new mutual funds as funding vehicles for these new programs, rather than allowing existing funds to be used;
- requiring that only mutual funds with certain investment objectives or other characteristics can be used; and
- imposing fee caps or other restrictions on mutual funds that can be marketed to these programs.

- The effort to impose these types of limitations seems to derive from three concerns:
- first, that employees will not make good investment decisions,
- second, that market forces cannot be trusted to assure effective competition with respect to products, fees, and services, and
- third, that governments may be called upon to make up shortfalls if the new programs do not provide adequate retirement income for participants.

I believe that each concern is misplaced.

First, the evidence indicates that participants can be trusted to manage their accounts prudently. The Institute and the Employee Benefit Research Institute recently analyzed the behavior of 7.9 million participants in more than 30,000 401(k) plans holding nearly $372 billion in assets.)[2] The data shows that employees as a whole are making allocations that are appropriate with respect to equity, fixed income, and stable value investments and that within each age group, employees are making asset allocation decisions that are appropriate to their age. The data also shows that older employees with longer tenure with a company tend to have the largest account balances, suggesting that these employees are using their 401(k) plans appropriately to accumulate wealth for retirement.

Second, the evidence indicates the market can be trusted to provide effective competition as to products, fees, and services. Based on the US experience, allowing financial services companies, including mutual fund companies, to sell their existing products to defined contribution plans enhances competition to the benefit of plans and their participants. Since the introduction of 401(k) plans in the US in 1978, the retirement market in the US has been highly competitive as banks, insurance companies, and mutual fund firms have sought a share of this market. This competition has resulted in improved services and lower costs. In addition, allowing providers to sell existing products to plans, rather than having to create new funds exclusively for these plans, allows for economies of scale that lowers costs for plans and participants.

Institute research on mutual funds, for example, demonstrates that over the last twenty years, the period in which mutual funds have been used increasingly in 401(k) plans, the total cost of investing in mutual funds has declined significantly. During this period the total cost of investing in equity funds fell 40 percent. Our research also demonstrates the importance of economies of scale to the total cost of mutual fund investing. Larger funds have significantly lower operating expenses than smaller funds.)[3]

Thus, I believe that government rules that would restrict the ability of mutual fund sponsors to market their existing funds to defined contribution plans are not only unnecessary, but could well lead to higher costs and lower levels of service for these plans.

Third, I believe that government regulations to limit the types of products that can be used in defined contribution plans are not needed or desirable to protect the government from being called upon to make up any shortfalls in their citizens' retirement income.

There is ample evidence that pension plans in countries that allow broad investment freedom, subject only to the duties of prudence and diversification, have experienced the highest long-term returns on pension assets.)[4] Moreover, government prescriptions about eligible investments cannot take into account the different needs and situations of different plans and plan participants. Thus, I believe we will produce optimum returns on pension assets if we allow plan sponsors to make decisions as to the appropriate range of investments for a particular defined contribution plan and if we allow plan participants to make the decisions as to how their accounts will be allocated.

In fact, a government that imposes paternalistic requirements on defined contribution plans may actually encourage citizens to believe that the government will make up for shortfalls.

In short, the US experience indicates that defined contribution plans work best if participants are free to choose investment options, market forces are allowed to operate with respect to products, fees, and levels of services, and citizens are encouraged to take responsibility for their retirement savings. I should also emphasize that a defined contribution system based on participant direction can only work if participants are provided with all relevant information needed to make informed investment decisions.

Conclusion

Let me conclude by saying that I believe the prospects for growth in the European mutual fund industry appear to be excellent. A single currency, a growing interest in equity investment and the need for greater retirement savings should contribute to the European mutual fund industry’s success.

However, there are existing and potential impediments to the growth of the European mutual fund industry which the industry might consider addressing:

First, while the UCITS Directive allows a single mutual fund to be sold throughout Europe, individual countries have burdensome registration requirements and different marketing standards, thereby as a practical matter making it extremely difficult to sell the same fund throughout the European Union. You may want to consider seeking reform on a country-by-country basis or by having the UCITS Directive amended to address these problems. As a starting point, it would be useful to catalog the particular problems raised by each country. The Investment Company Institute would be happy to assist our European colleagues in this effort.

Second, as European nations consider creating defined contribution pension plans, there are suggestions that ordinary mutual funds would not be suitable as investment vehicles for these plans. I disagree, and I would hope that the European mutual fund industry will be active in the debate on this issue.

In conclusion, it is wonderful to be back in Seville. Thank you.

Endnotes

[1]Rebuilding Pensions: Security, Affordability—Recommendations for a European Code of Best Practices for Second Pillar Pension Funds. European Commission, 1999.

[2]*Investment Company Institute Perspective* "401(k) Plan Asset Allocation, Account Balances and Loan Activity," January 2000.

[3]*Investment Company Institute Perspective* "Operating Expense Ratios, Assets, and Economies of Scale in Equity Mutual Funds," December 1999.

[4]See "The Impact of Market Access and Investment Restrictions on Japanese Pension Funds," *EBRI Special Report, SR-26*, October 1994. See also "Rebuilding Pensions: Security, Affordability – Recommendations for a European Code of Best Practices for Second Pillar Pension Funds." European Commission. 1999.
