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News Release

MUTUAL FUNDS: WHERE HAVE ALL THE PEOPLE GONE?

Remarks to

Investment Company Institute's
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Charles C. Cox
Commissioner
Securities and Exchange Commission
Washington, D. C. 20549

The views expressed herein are those of Commissioner Cox and do not necessarily represent those of the Commission, other Commissioners or the staff.

Ladies and Gentlemen, it's a pleasure to be able to speak with you this afternoon about developments in the mutual fund industry. Actually, developments is probably too modest a word to describe the changed market environment you're encountering, and I suspect this training seminar is markedly different from those of past years.

The wags and pundits will tell you that, as a result of the October crash, investors have fled the market in droves out of a fear that it is no longer a (reasonably) safe haven for their investment dollars, and unless something drastic is done, its going to be a long while before they're lured back. Well in this case, the available evidence lends some credence to the claims that investors have scurried to the marketplace sidelines, including leaving mutual funds. I'm not sure that its wholly attributable to the market crash though -- significant factors have to have been the elimination of the tax-deductible individual retirement account, which by itself, was probably worth billions of dollars in investment, and the elimination of the favorable capital gains tax rate (for equity funds). Whatever the reason though, it's not surprising that funds have adapted a rather defensive posture, stressing safety and service, with a measure of patience. After several years of unprecedented growth and high-flying euphoria, I believe the mutual fund industry has entered a period of retrenchment.

I'm not trying to be a doomsayer, though. It's just that for the near-term I believe you will be faced with a period of consolidation, intensified competition, and lagging sales. Your challenge is how to best cope with this phenomenon. The saving grace is that this changed environment does not represent an inherent investor dissatisfaction with mutual funds. Funds will continue to be, and rightly so, the investment vehicle of choice for diversified investment for retail customers. Rather, investor consternation and dissatisfaction is with the markets themselves.

You might ask what we as regulators will do, or can do, to rectify the current malaise. It's a fair question, and I believe it is incumbent on us to take into account investor confidence concerns in formulating a regulatory response to structural problems in the marketplace. What troubles investors most, I believe, is uncertainty. Unfortunately that's the state of being that exists right now -- economically, politically and in the markets. A lot of the problem is perceptual though -- not reality. I vigorously dispute the notion that we should take a course of action solely to assuage investor confidence that would ultimately have an adverse impact on the efficient functioning of the markets. It was President John F. Kennedy, not known as a man of inaction, who once said "when it is not necessary to take action, it is necessary not to take action." I'm not suggesting that the regulatory response should be to wholly maintain the status quo. The Commission has suggested, or initiated, a number of market reform measures, and I've supported most of them. However, some reform suggestions are not particularly constructive. For example, although the public has been convinced that program trading and related trading strategies are the root of all evil, I do not believe that the elimination of program trading would eliminate volatility, and indeed may exacerbate it. I also believe that mutual funds as institutional investors are uniquely able to make positive contributions to this debate about market reform; because of redeemability and the continuing need to attract retail customers, your success is directly tied to how the "average" investor feels about the market.

I would further contend that you need to ask yourselves what steps you can take to better stay aloft in the prevailing winds. I think the mutual fund industry is also uniquely positioned to lure investors back into the fold, but it may take new marketing strategies and new, innovative products, and simply the passage of time to do the job. The time for resting on one's laurels has passed.

However, before examining specific changes in the industry and regulatory environment, I believe it is appropriate to look at recent data regarding mutual funds in order to get a better picture of the problem that confronts us.

I would first reiterate that until the bloom fell off the rose this past October, the industry had experienced a period of truly amazing growth. From just 1983 total assets of funds grew from $293 billion to $815 billion. The full impact of what has transpired this past year, however, is best evidenced by comparative data in net sales of stock, bond and income funds from March 1987 to March 1988. At its peak in March of 1987, these funds' net sales totaled $16.7 billion; however by March 1988, net sales had plummeted to $400 million -- a decline of 4000 percent. Quarterly figures aren't quite as dramatic but are nonetheless eye-opening. Total sales for the first quarter of 1988 were $26 billion, compared to the year earlier figure of $72 billion. The trends in solely equity funds are even more pronounced. In four of the six months prior to April 1988, redemptions exceeded total sales. And as of yet, there isn't much indication that investors are flooding back to equity funds -- both February and March of this year were net redemption months. It appears that investors remain cautious, if not skeptical, of the equity market since the October fallout and have been switching monies into more conservative investments such as bonds, money market funds and bank certificates of deposit.

So what changes are being, and will be, wrought by this period of slowed growth? First, some hard lessons have been learned. While individual mutual funds will outperform the market in a rising stock market, many tend to under perform the market or even fall faster in a bear market. The principal reasons are that funds are fully invested most of the time, many tend to invest in high beta stocks because fund managers are exceedingly performance-oriented, and because of fees and commissions. As a side note, I would add that there has been increasing criticism of the emphasis by institutional investors on short-term performance results, to the effect that money managers are compelled into "short-term" thinking and activity in order to beat the market at least on a quarterly basis. We might all ask ourselves whether the long-term view might be better as a matter of policy. At the very least, fund managers must continually reassess their portfolios in light of uncertain market conditions.

Furthermore, in view of the heightened volatility, there may be a need for equity funds to maintain a prudent liquidity cushion to handle increased redemption requests. The tradeoff, of course, is that in up markets cash positions will hurt performance. But the events of October demonstrate that exchange-traded securities are no longer <u>per se</u> liquid in any size at any given time, if indeed they ever were. Since that time we have noted the decreased ability of institutions and others to engage in large block trades. From the fund shareholder perspective, there is difficulty in knowing whether to purchase or sell shares based on the last published net asset value; because pricing by the fund occurs after receipt of the shareholder order, the price would not be known in advance. Until quite recently, the price one day was usually pretty close to that of the prior day. In today's market, however, there can be relatively wide variations. It's easy to see how investor confidence might be lacking when orders to sell are executed in the midst of precipitous market declines.

In addition, as I mentioned earlier, some consolidation in the industry is probably inevitable. In times of lowered profit margin and increased liquidity needs due to volatility, I suspect that many smaller funds will find it expedient to join forces with their larger brethren. There are already indications that this is taking place. The Franklin Resources Fund, with $33.4 billion in assets, acquired the mutual fund operations of L. F. Rothschild, which has $82 million under management. Investment Trust of Boston has indicated that its three funds, totalling $125 million will now be managed by the New England Insurance Company, while Delaware Management, with $18 billion in assets has stated that it will engage in a leveraged buyout with a private investment group.

Most importantly, however, I also believe that you will have to deal with increasing competitive pressures -- a healthy phenomenon from the retail customers' perspective I might add. It used to be the case that retail customers were easy marks when it came to putting dollars into mutual funds -- their investment decision-making process was not particularly sophisticated, and many in the industry didn't help matters by grossly overselling performance capabilities.

As you well know, the Commission has long been concerned about mutual funds' annualized yield calculations and performance advertising in general. Determining yield would seem to be a rather straightforward proposition. But when left to their own devices, some funds have been notoriously reluctant to walk the straight line. Investors have had to wade their way through mind-boggling muck and mire of figures such as interest and dividend income, short-term capital gains, premiums earned through the writing of call options, discounts and premiums on the face value of bonds, early mortgage paybacks, and bonds with call dates. It was a journey fraught with financial peril.

As a result of the industry's inability to fully address the problem, the Commission determined to take action. The result, of course, is the new package of rules pertaining to fee tables and certain advertising changes (including total return) which took effect May 1; and the standardized yield requirement which will take effect July 1. While many funds moaned and groaned and grumbled, with some suggesting that the rules placed on undue emphasis on fees rather than performance, I firmly believe that the industry as a whole will be better off. Comparison shopping by investors will be much easier and thus true competition fairer. Funds with higher than average expenses may operate at a disadvantage but those with relatively low fees and good performance can expect to attract new customers.

The recent outbreak of closed-end bond and stock fund offerings is perhaps symptomatic of the tendency to oversell. Closed-end funds have been the fastest growing sector of the investment company industry since the October market crash. It is my understanding that closed-end funds, especially bond funds, have been promoted heavily in recent months as an alternative to equity investments. The ostensible selling points are the enhanced liquidity that results from the funds being traded on an exchange -- and the so-called absence of broker commission charges in the initial offering. Yet by all accounts, the funds tend to fall to a discount to net asset value during the first several months of life. Much of this reflects the deduction of the underwriting spread, which in effect functions as a commission to the selling brokerage house. This is understandable. What's more problematic is the continuing discount from net asset value that often persists long after the initial public offering. Frankly, it doesn't sound like the best of investments to me, and from some quotes I've seen, even industry executives don't view new issue closed-end funds as particularly good investment vehicles, but additional evidence is warranted. The Commission's staff is examining the phenomenon, but at the very least, I suspect, there needs to be better disclosure as to the impact of underwriting spreads and selling arrangements with institutions.

Another area where you are going to find increasing competitive pressure is in the international arena. The October crash rather drastically demonstrated the extent to which markets have become internationalized. Investment companies have played a key role in the tremendous growth in global securities markets, and will continue to do so as investors look to diversify their portfolios and tap into foreign markets.

Currently there are over 100 U.S. funds, both open and closed-end, with more than $22 billion in assets (up from $3.5 billion in 1983), that invest principally in foreign securities. These funds have made foreign investing practical and popular with individual investors. In fact, in some instances, investing through a fund is the only way in which to access a foreign market. This past week I participated in a conference in Korea, and officials there lauded the performance of the closed-end Korea Fund. The Korea Fund is the only vehicle for foreigners to invest in the Korean market and is unique in that it trades at a premium to net asset value.

So far, only five foreign investment companies are registered for sale to investors in the U.S., principally due to substantial regulatory barriers. In fact, the general lack of uniformity among regulatory schemes makes it difficult for any single investment company, whether U.S. or foreign, to be marketed on an international basis.

However, the Commission's staff is presently engaged in discussions with foreign regulatory authorities and multilateral organizations to permit cross-border marketing of investment company shares, primarily through reciprocal agreements. This could result in the transfer of business to those jurisdictions with the most favorable rules. So be prepared.

While I earlier characterized the industry's focus on service as part of a defensive posture, I believe that it is an appropriate posture, and can be used aggressively to retain old, and attract new, customers. Funds should enhance communication with their shareholders, in order to better be able to ascertain their investment goals and how the funds can best meet these objectives. Funds also need to do a better job of educating their customers as to realistic performance expectations, not promises of rose gardens. As part of the servicing process, funds should continue to emphasize timely handling of new investment, exchange privileges, and redemption requests. With respect to exchange privileges, I believe that it is particularly important that funds clearly state at the outset whether such privileges exist, and if so, whether any charges attach. The successful funds will be well-positioned with a broadened base of investment options, a reasonable fee base in relation to performance, an efficient servicing operation, and positive relations with its customers.

From the regulatory perspective, the Commission has engaged, and will continue to engage, in industry-specific rulemaking when appropriate such as on advertising, 12b-1 fees, and yield calculation measures. As Kathryn McGrath, Director of the Commission's Division of Investment Management, recently indicated, we'll be looking at industry issues from "soup to nuts."

With respect to more broad-based market reform, however, the issue is somewhat more problematic. Not only has there been a cacophony of differing views as to what should be done about the market crash, there also has been fundamental disagreement as to what actually transpired and why. As I indicated at the outset, everyone's favorite scapegoat has been program trading. Even apart from the merits of these allegations about program trading, that kind of focus represents a simplistic view of the incredibly complex interplay between the markets.

As to specific measures, the Presidential Working Group reached agreement on coordinated "circuit breakers" across all markets, given a 250-300 point equivalent drop in the Dow Jones index, and initiatives to improve the credit, clearing and settlement systems. The Working Group also agreed that current margin requirements are adequate for prudential protection of our nation's financial system. The Commission agreed with these recommendations but felt that some additional measures would be appropriate to increase investor confidence and the stability and resiliency of our securities markets and has recently approved certain legislative proposals to be made to Congress. These proposals included authority for the Commission to stop trading or take other measures as appropriate in emergency situations; authorization to develop, in conjunction with the CFTC, an integrated clearance and settlement system, jurisdiction by the Commission over stock derivative products, and certain information reporting requirements. Self-regulatory organizations like the exchanges have also initiated a number of measures in response to the market crash in order to improve their ability to respond to extraordinary volume and volatility, such as enhancing their order processing capability and imposing (by the NYSE) limits on DOT usage for program trades when the market moves by 50 points.

While some decry these steps as wholly inadequate, these measures, taken together, will ultimately, I think, go a long way toward instilling the necessary confidence in investors that the markets are functioning properly. To borrow from Defense Department lingo, regulators have engaged in "measured responses" to market problems, rather than adopting a shotgun approach which could result in injury to "innocent" market participants. I take some comfort that this approach is the correct one from the recent price and volume surge on the NYSE.

So, I don't believe that investors have really abandoned the marketplace. They've just called a timeout to take a breather and re-evaluate their investment options. The regulator's task is only to ensure that the investment game is played and played fairly. It's your task to convince investors that it's in their interest to play. By focusing upon competitive hallmarks such as service, safety, and realistic assessments of performance, I trust you'll be able to do just that in fairly short order.