"THE S. E. C. LOOKS AT MUTUAL FUNDS"

An address by

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THE S. E. C. LOOKS AT MUTUAL FUNDS

I am greatly encouraged by this conference. Your presence here is the answer to the frequent criticism that the investment industry does not change with the times.

Mutual funds are, after all, a relatively new field. Although they started in Boston during the early 'twenties, they did not "come of age" until the passage of the Investment Company Act of 1940, less than ten years ago. In just a decade the open-end investment company, as it is designated in the statute, has assumed a significant place on the financial scene, in no small measure through the efforts of the investment fraternity. I take this as an illustration of the adaptability of the investment industry to the changing financial desires of the American people.

You, who are associated with mutual funds, are probably in one of the fastest growing businesses in this country. Today, while some sections of the securities industry are hard put to make ends meet, mutual funds are continuing their unusual growth. The other day while attending the convention of the National Association of the State Securities Commissioners at Richmond, Virginia, trading small talk in the lobby of the John Marshall Hotel, I asked the underwriter of one of the well-known funds how things were going. He replied, "Oh, pretty fair. Business for the first six months was only 179% ahead of the same period last year." That certainly does not sound like the reports from most industries today.

You have spent the past three days exchanging ideas and developing your selling methods, so that this steady improvement will continue. Personally, I can see no reason why it should not. Mutual funds have something to offer in today's market, and, as you know, there are savings available for their purchase.

I want to talk to you today from the point of view of the Securities and Exchange Commission, whose responsibility is not limited to investment companies, but extends over the entire securities market - of which the mutual funds are a part. I am not going to discuss sales technique with you - you have heard the real experts on that subjects - but I do think that what I have to say has a very close connection to your day to day operations.

When reflecting on what I might say to you today, I tried to account in my own mind for the sales popularity of the mutual funds. It occurred to me that there are two rather conclusive reasons: first - the investment need which the mutual funds fill, and second - the active program you employ in selling them.

We happen to be living in a period when the search and desire for economic security has become one of man's primary motivations. At the same time, we are witnessing the emergence in this country of a new investor class, a class which considers the purchase of securities as a form of investment in which the preservation of principal is a most important consideration. This is the great middle income group - a group which has only since the depression become the reservoir for most of the savings in this country, and has thereby become the source of most investment funds.

These are the people who hold a large part of the 78 million insurance policies currently in force; they make up most of the 28 million individual

investors in government bonds; and they are the millions with savings deposits. Individually, their savings are not large; collectively, they form the great mass of reserve capital to which industry must turn for funds to replenish and expand its productive plant.

We know that so far these people have not shown great interest in the securities markets. Estimates of the number of persons owning corporate securities vary greatly. But whether one takes the low figure of 6 million or the larger figure of 14 million some people like to talk about, it is clear that the great body of savers in the middle income group have yet to be introduced to the securities markets. It seems to me that the mutual funds have a definite appeal for that purpose.

Unlike the wealthy people who formed the small investor class in years gone by, these people with their recently accumulated savings usually have had little or no experience in the buying and selling of securities. In fact, not only are they unfamiliar with the market, but they are frequently fearful of it. They have vague memories of the losses suffered by small investors in the market swings of the past. They hesitate to risk savings accumulated through long labor and self denial. To them the market is not only strange, it is technical, and best left to the full-time "experts."

To these people, as indeed to others who are more experienced investors, the mutual fund method of buying securities is particularly well adapted. It solves one of the biggest hurdles to initial investment, and that is - which particular security or securities to buy. It offers diversity of risk, professional management, and relief from the need for detailed day to day supervision.

The investment companies have approached this mass market for investment with intensive selling methods designed to merchandise their wares. Their experience has not been too dissimilar from that of the insurance companies. Insurance companies learned long ago that insurance had to be sold. It did not jump "out the window" like a hot issue. Their biggest task has been to educate the public to the need for insurance and the accessibility of insurance protection. Similarly, the investment companies have set out to convince the public it needs mutual funds, to teach them what mutual funds are, and where they fit into an individual's investment program.

But the problems which the mutual fund companies pose for the economy as a whole are broader than the exercise of salesmanship or of competent day-to-day management of the portfolio.

Much like banks and insurance companies, the investment companies are a form of institutionalized saving. In other words, the savings of many individuals are pooled, and investment is channeled through professional managers who determine investment policy. This basic fact has significant consequences.

Those of us, in government and out, who like to view the functioning of our capital markets with some perspective, see the continuous development of institutionalized savings as transforming the investment market as we know it. Ours has been traditionally a market place based on the individual judgments of many thousands of investors. The sum total of their separate responses constitutes the market at a given time. As investment becomes institutionalized and individuals delegate their investment decisions to institutions, more and more of our savings become translated into investment on the basis of rules and formulas of a few professional managers.

Your salesmen stress the merits of professional management. You try to sell the investor on letting "experts" pick securities for him. You urge him to abdicate his position in the market, and discourage him from exercising his own judgment. With what result? If this sales approach is carried too far, the end result may be quite deleterious to our economy. Let me try to explain why.

Unless you take care, this sales approach may eliminate from the market thousands of potential purchasers of corporate securities. The mutual fund, as I have said, can do much to introduce the unfamiliar to the so-called secrets of the securities markets. But, the purchase of mutual shares should be only the first step in that process. It would seem to me that mutual funds should be sold with the approach that they represent a part of the investment program of the average individual and not the complete program in itself. The way to buying other types of securities should also be left open. As the new fund-holder gathers experience, he will also gain courage. He will learn some of the terminology of the stock market. He will learn to read the financial page. And one day, unless you have completely discouraged him from taking the initiative, he will be prepared to exercise his own personal selection, and become a direct investor in corporate securities and, perchance, in equity stock. His individuality then becomes a factor in the market, as it should be.

What must be avoided as far as possible is the type of selling of investment shares which completely discourages the investor from ever buying individual securities. Our economy demands all types of people in the market. It requires amateurs as well as professionals, speculation as well as restraint, blue chips and new promotions. That is what makes the wheels go 'round.

Few of you present are exclusively dealers in mutual funds. Either you yourselves, or your firms, also do a general brokerage business. For the economy as a whole, and for the sake of maintaining a balance in your own business, you should not ignore the fact that many of your mutual fund customers are potentially direct investors.

You and I know that the mutual funds, like other institutional portfolios, are growing -- in part -- at the expense of young and unseasoned securities. The mutual funds are large purchasers of equity securities, but generally these are limited to outstanding issues of well-known businesses. With some few exceptions, mutual funds do not invest the large sums at their command in new enterprises. Rarely do they buy new issues. Yet the lifeblood of this nation is the creation and growth of new business enterprise. Only by encouraging new enterprise can we avoid stagnation and deterioration.

I am not suggesting that mutual funds go into the business of underwriting new business. I am suggesting that the maintenance of a vital economy requires the maintenance of private, individual investment. As more and more individual investors succumb to your sales approach, there are fewer and fewer around to invest in the new, struggling outfit just getting on its feet. In due time, the widely recognized problem of risk capital will be put up to the investment companies as it is increasingly being put up to the insurance companies. This is a responsibility fund managers should take cognizance of.

The growth of the investment companies poses another economic problem. As they grow, they are acquiring sizeable positions in the voting stock of many corporations. What responsibility do they have for the management of those companies? While the charters of most mutual funds prohibit them from

owning stock control of portfolio companies, they frequently are among the largest stockholders of those companies. I know there are at least two schools of thought on how fund managers should exercise their responsibility to their own shareholders in this situation. Some feel that if they are dissatisfied with the management, their duty is to dispose of the stock: others believe their duty is to take steps to improve the management. I express no opinion as to either course. I want only to point this up as another problem to which the mutual funds must give increasing attention.

At this stage in the development of mutual funds, one of your main selling tasks is to build public acceptance of mutual shares as a mode of investment. It is a mode of investment which has its own characteristics, and which should and can be sold for what it is. Some salesmen seem to find it expedient to emphasize the "security" aspect by likening investment shares to insurance policies, to government bonds, or to savings accounts. Such comparisons, of course, are most improper. A mutual fund share is not an annuity. It is not like an annuity. There is missing that basic ingredient of an annuity contract, a commitment to pay a sum certain on a fixed date. No matter how mutual funds are dressed up, they are not annuities.

It is similarly misleading to suggest that an investment in mutual shares is as safe as government bonds or a savings account.

This type of selling is not only wrong, it is also most unsound from a sheer selling point of view. The ultimate success of investment companies as investment media will depend as much on continued public confidence as on performance. Over-selling is self-defeating. If you lead the purchaser to think he is getting something he is not buying, you will be the loser when he discovers his mistake. Further sales under such circumstances are next to impossible.

Current sales technique also raises another difficulty. In looking over the figures regularly published by the S. E. C. on the growth and size of investment companies, I was surprised and distressed to learn that for some time redemptions have run at just about 50% of sales. I am told that for the first quarter of 1949 the rate has dropped to one-third. This is still something you in mutual funds must consider seriously. Redemptions most frequently occur during the first two years, before the customer has absorbed the sales expense. Here are the figures for 1948 if you would like to have them: Total sales, just over 35 million shares; redemptions, about 17½ million shares; net growth, the balance of about 17½ million shares.

May I point out to you - and I speak as one who was for many years engaged in the investment banking business - that to sell shares, and then have the customer turn them back within a short time establishes quite definitely that the investor was not properly sold in the first instance. The high redemption rate is a reflection on the quality and adequacy of existing selling technique. Normal turnover, formula-plan operations, and those who by nature cannot stay put in a situation, produce an expected amount of turnover. But I suspect that a large amount comes from misdirected salesmanship and from deliberate "switching."

I could discuss at length the evils of "switching" from one fund to another in order to earn sales commissions, for this invidious practice strikes at the very heart and integrity of the mutual funds. However, I know that fund managers are aware of the problem and are making efforts to meet it.

Perhaps the insurance companies can furnish still another lesson in this connection. As you are aware, lapsed policies create a problem for them just as switching does for you, for it is detrimental to the public and adds to the overall cost of insurance. One company has a directive to company personnel and clients which, in part, says: -

> "Do not lapse your policy in any old line company to take one with us. Do not lapse your policy with us to take one in any other old line company. You lose in either case."

I suggest that with appropriate changes in language, this might become a watchword with you, too. Perhaps it may also prove one way to reduce distribution expense.

The Investment Company Act of 1940 is a unique piece of legislation. It is perhaps one of the rare instances where an entire industry was able to agree on a comprehensive code of regulation. Many of you will recall that the statute was drafted jointly by representatives of the industry and the S. E. C. It was presented to the Congress with the "distinction of having the virtually unanimous support of the persons for whose regulation it provides, as well as of the regulatory agency by which it is to be administered" (quoting from Representative Cole of Maryland who introduced the bill into the House). It was unanimously approved in Committee by both houses, and passed without a dissenting vote.

The industry has prospered under the legislation. Public acceptance of investment company shares was never so high. Last year, mutual funds added over $145,000,000 to their assets through additional sales. They have tripled in size since the Act was passed. Indications are that there will be continued growth. During this period there have been no major casualties to mar the record.

The S. E. C. and the industry do have frictions. Some in the industry would like more freedom than we believe the Act can permit. From time to time we have found it necessary to restrain certain practices which were developing along unsatisfactory lines. We shall undoubtedly have friction in the future. But these are only incidental to the larger harmony which this joint effort in regulation presents.

In closing, I want to assure you that we at the S. E. C. recognize the importance of well-managed investment companies in the overall investment picture. They have become a permanent part of our national economy. We are sympathetic to your problems. While we may not always agree on their solution, we want to be told about them and work them out with you.

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