"The End of Mutual Fund Dominance"

Keynote Speech

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Despite the title of my remarks, my purpose here today is not to predict the demise of the mutual fund industry. In fact, I've simply quoted the title of a report prepared last autumn by the respected Forrester Research organization. It predicts that by 2004—right around the corner, really—mutual fund assets will grow by 26%, while separate account assets will grow by 400%. By then, they predict the end of mutual fund dominance will be well underway:

> "By 2006, large fund firms will emphasize separate accounts at the expense of mutual funds . . . By 2010, assets in separate accounts will exceed $2.6 trillion, *at least* 30% of retail assets managed."

And that's not all. "The end of mutual fund dominance will accelerate as fund families create their own separate account products," 401(k) plans will jump on the bandwagon, and financial advisers will construct their own client portfolios with stock baskets (read "Folio*fn*").

Why will this happen? In Forrester's view, simply because "separate accounts deliver what investors want: customized money management." The alleged benefits: higher tax efficiency; ability to structure investors' portfolios around large individual holdings (e.g., company stock); real-time disclosure of portfolio holdings; and the ability to avoid investments that have "moral or sentimental importance" to them.

If we accept this reasoning, a dark era for the mutual fund industry lies close at hand. *Or does it*? One need only recall Mark Twain's famous comment, "the reports of my death are greatly exaggerated." If it merely chooses to do so, the mutual fund industry can continue its dominance on the balance sheets of individual investors for as far ahead as the mind can imagine. For America's families have spoken, and mutual funds have emerged as their investment of choice to an astonishing—and often unrecognized—degree.

Consider our nation's historical savings flow patterns. As the 1970s turned to the 1980s, our families were investing about 20% of their capital in mutual funds. By the turn to the 1990s, the rate had risen to 25%. But by 1996 it had risen to 60%. And by the turn of the millennium, it had soared to 82%. Yes, on average during 1999-2001, our families—the very backbone of the U.S. economy—saved $385 billion per year . . . and placed $320 billion of it in mutual funds.

No Longer an Equity Fund Industry

This powerful increase in market penetration says something very simple about mutual funds: They are popular with investors who use them. But it also says something else: Today's fund dominance comes because of the remarkable flexibility of the fund industry and the wide span of financial instruments that mutual funds comprehend. Lest we forget, this industry includes not only *equity* mutual funds (the apparent focus of the Forrester study), but *bond* funds and *money market* funds. When you think about it, mutual funds are the investment of choice in each asset class, and will continue to grow—no matter what the course of the financial markets, no matter what the emotional state of the American investor.

In the soaring stock prices of 1999 and the first half of 2000, for example, when fund cash flows from individual investors were $400 billion, the mix was 90% stock funds and 20% money market funds, with 10% actually *withdrawn* from bond funds. Then, when the stock market reversed course over the next year and one-half, industry cash flows remained strong at $290 billion, but the mix was 30% bond funds, 30% money market funds, and only 40% equity funds.

Clearly, mutual funds have successfully made the transition from the old equity-oriented industry that we knew from 1924 (when the first U.S. fund was formed) right up to 1975, when the money market fund was introduced. Shortly thereafter, in that seemingly ancient era of the early 1980s when yields were at double digit levels and investors wanted, of all things, *income*, from their investments, money market funds dominated the industry, with bond funds not far behind. (In a 1992 speech, I described bond funds as "the third mutual fund industry.")

Consider some of the extremes. At their peak in 1972, equity-oriented funds comprised 93% of fund industry assets. By 1974, a 50% stock market decline and net liquidations of fund shares had reduced *total* industry assets from $60 billion to $36 billion, a cool 40% decline. Then came the rise of money market funds, bailing out our shaken industry and producing a remarkable $270 billion of assets by 1982. At that point, money funds constituted an amazing 80% of industry assets, leaving equity funds with a residual share of 14%. Then, as long term interest rates moved well ahead of short-term money market rates, it was the *bond* fund segment that was the industry's fastest-growing component. At the close of 1986, Bond fund assets of $240 billion actually exceeded equity fund assets of $180 billion.

The 33% stock market crash of September-October 1987 contributed to the dimunition in equity fund share. But despite the fact that the full year 1987 saw the market *rise*, equity flows were negative in 1988, and didn't return to 1986 levels until 1991, five years in which stocks were at bargain-basement levels. But with each acceleration in the great bull market, the equity fund share of industry assets increased apace—from 30% in 1991 to 40% in 1993, to 50% in 1995. As the cash began to roll in, the equity fund share leaped to 67% in 1998, and by the time March 2000 rolled around, equity-oriented funds laid claim to 72% of the assets of this then-$7 *trillion* dollar industry.

Where Else Can An Investor Go?

This capsule history of the mutual fund industry's asset mix is, if nothing else, a confirmation of our fundamental character: *We are a market-sensitive industry*. But it also validates the fact that in all three of the pieces of the basic asset allocation pie—cash, bonds, and stocks—mutual funds are formidable competitors. Just think about it. Where else can an investor go?

- For cash, the money market fund puts bank savings accounts to shame. By leaving the traditional—and expensive—active checking accounts to the banks and focusing on large account balances with infrequent transactions, and eliminating all that costly "bricks and mortar," we provide substantially higher yields. And if you're worried about the lack of Federal deposit insurance, isn't it possible that a U.S. Treasury Money Market fund is even *safer* than a bank deposit?

- For bonds, there is no viable substitute for the bond *fund*. A choice of taxable or tax-exempt funds; a quality level to suit every taste (U.S. Treasury, investment-grade, high-yield); a maturity level to fit every risk profile; and the ability to acquire extraordinary diversification without being nickled and dimed (and dollared) to death in buying and selling small lots of individual bonds.

- And for stocks, it's hard to imagine a better concept than a broadly diversified equity fund, holding one hundred or more stocks in every imaginable industry; minimizing individual stock risk; and either retaining experienced professional managers to select and supervise the portfolio or, maybe even better, just owning the entire stock market in a single fund; and operating with remarkable efficiency. Truth told, the only other choices are to pick stocks yourself, or, if you're in the six-figure or seven-figure or eight-figure wealth category, to hire such managers to pick stocks for you.

So there are solid conceptual reasons why American families continue to pour half of their hard-earned dollars into mutual funds. And yet a moment's reflection on the industry trends that I've shown you presents a perverse riddle that, for whatever reason, has made mutual fund investing far less productive than it ought to have been. The obvious "market sensitivity" exhibited by fund investors has not helped them. *It has hurt them*.

The Perversity of Asset Exposure

Think again about the figures I mentioned earlier. The industry's peak exposure to equities came in 1972 (94%) and in March of 2000 (72%). On the first occasion, a 50% stock market decline was about to begin; on the second occasion, a 40% decline was soon to follow. Despite the nice recovery from the September 21, 2001 low, stocks today remain 30% below their 2000 high. And it is not at all clear, to me at least, that those earlier lows will not be surpassed.

So, too, when investors had the chance to lock-in bond fund yields at an attractive 9% in the late 1980s and early 1990s, investors were deserting bond funds in droves. And with yields averaging 6% in 1998 and 2001, bond fund cash inflows were higher than almost ever before in history.

In the money market fund segment, of course, current yields have no necessary relationship to past or future yields—don't forget that it is impossible to have *both* a fixed income payment *and* a fixed principal value—the capital flows (at least ever since this segment reached maturity in the mid-1980s) seem to represent a *residual* figure, with money coming *into* the funds because it is coming *out* of stock and bond funds, and vice versa.

The Tragic Flaw

But the tragic flaw of this industry is that mutual funds have failed to give our investors an adequate share of the returns actually generated in the stock market, the bond market, and the money market. During the two decades ending December 31, 1999, these returns were at the highest levels in U.S. history: 18% per year for stocks, 10% for bonds, 7% for the money markets. As a result, despite *relative* returns that significantly lagged those of the markets in which they invested, fund investors enjoyed good *absolute* returns.

In buoyant markets, that lag *may*—MAY!— have been a tolerable flaw. After all, in that 18% stock market, the average equity fund did provide a 15% return. But when the financial markets generate significantly lower returns, such a lag will become intolerable. And, in my judgment, it's precisely such an era that we have entered. The mathematics of the stock market—today's low dividend yield plus nominal earnings growth—suggests an *investment* return averaging about 6½% over the coming decade. And it seems inconceivable that the huge boost that investment returns received from the 1979 – 1999 increase in the price-earnings ratio from 7x to 30x—a speculative return of more than 7% per year!—can possibly recur. Indeed, it is reasonable to predict that p/e ratios, having *added* so much *to* previous stock returns, will now begin to *subtract from* them. That is, having seen the bright upside of *speculative* return, we are now seeing its dark downside. *Reversion to the mean* strikes again.

Current bond yields of 6% set the stage for average bond returns at a roughly similar level over the next decade. And while today's money market yields of about 2% can and will change, perhaps substantially, it would take some leap of faith to forecast a return to the earlier average. So, while I'm the first to admit that even the most reasonable expectations for future financial market returns may be wide of the mark—either way!—it seems sensible for both investment professionals and investors themselves to plan for an era of lower financial market returns. Not

18% for stocks, but perhaps 4% to 8%. Not 10% for bonds, but perhaps 5% to 7%. Not 7% for the money markets, but perhaps 3% or 4%. Maybe we'll be surprised on the upside. I hope so!

Taking the Toll 1: Fund Costs

But whatever the returns in those markets turn out to be, the returns of comparable mutual funds will be *significantly* lower. The reason for the lag, of course, is costs. And we know pretty much what those costs are: management fees, operating expenses, sales charges, portfolio turnover costs, out-of-pocket fees, and cash drag. (Most stock and bond funds hold a small percentage of their assets in cash.) All-in costs for the average stock fund come to something like 2½% per year; for the average bond fund, 1 1/3%; for the average money market fund, 7/10 of 1%. In the new era I foresee (I hope I'm wrong!), equity fund costs would consume between 30% and 60% of stock market returns. Bond fund costs would consume from 20% to 25% of bond market returns. And money fund costs would consume about 25% of money market returns.

Taking The Toll 2: Market Timing

Further, while the average equity *fund* provided returns of 15% during the great bull market, please don't make the mistake of thinking that the average equity fund *investor* earned 15%. No, recent data suggest that such an investor earned about 6%. *Just 6%!* Less than regularly rolling over a bank three-year certificate of deposit during the two decades. How can that possibly be? The answers are not very complicated. One reason for that remarkable shortfall is that fund investors, to an appreciable degree, were engaging in a sort of "market timing" exercise.

With the Dow Jones Industrial Average below 1300 from 1982 to 1984, for example, American savers placed just 2% of their annual savings in equity funds. Even during the early 1990s, with the Dow below 4000, the equity fund flow represented only 20% of savings. But during the twelve months ended March 31, 2000, with the Dow often over 11,000, investors invested an incredible 120% of their savings into equity funds. And, when the inevitable bear market came, investors virtually ceased their equity fund purchases. During 2001, cash flow into equity funds plummeted to just 11% of savings for the year. Sitting on the sidelines when stocks are low and plunging into the market when stocks are high, clearly, is not a formula for investment success.

Taking The Toll 3: Fund Selection

And investors are also hurt in another perverse way. They have a deep-seated tendency to buy on the basis of past performance, pouring their money into *exactly* the wrong funds at *precisely* the wrong time. For example, during the twelve months ended March 2000, when the great technology-age market bubble was inflating to its very bursting point, investors poured $240 billion dollars in technology funds and tech-oriented growth funds at their peak levels, funding some of those purchases by actually withdrawing $40 billion from the value funds that had failed to participate in the great boom. In the aftermath, the asset values of the most popular growth funds declined by an average of 63% from high to low, while the most unpopular value funds actually rose in value by 3%. Combined with the toll taken by fund costs and the toll taken by market timing, this penalty for adverse selection is the third leg of the unfortunate triumvirate of tolls that has left mutual fund investors in the backwater of the returns earned by the financial markets. If financial advisors do no more than keep your client from paying these unnecessary tolls, you've made a great start on serving them well!

Of course, stock market booms and speculative manias are merely a reflection of the public mood. Tuplipmania, the South Seas Bubble, the Crash of 1929, it is often argued "just happen." And in the recent bubble, the information age, globalization, "the long boom," and the turn of the millennium simply combined to create an era of unreasonable expectations. Investors, it is said, have no one to blame but themselves.

Please don't believe that. To do so is to ignore the role of the professional investors—and professional marketers—who helped create the aura of omnipotence that enveloped the financial community. Just like those Wall Street security analysts who gave us the "research" that inspired the internet stock craze, as well as Enron, Global Crossing, and scores of other watered stocks—all in the name of capturing more investment banking clients—along with those corporate insiders who purchased stocks through low-cost options and quickly sold them at inflated prices; so too many mutual fund managers accepted uncritically the hyped-up growth projections for technology, medical, and telecommunication stocks, and piled them into the funds they manage.

And that's not all that the mutual fund industry must answer for. We have to accept our responsibility for jumping on the new era bandwagon, forming 116 new technology funds—including 40 internet funds, and a dozen NASDAQ qube funds—and 378 new growth and aggressive growth funds during the final years of the mania, all designed to bring in public money into our coffers rather than to help investors achieve their long-term financial goals. We also have to accept our responsibility for, right at the market peak, promoting the living bejebbers out of our hottest performing funds. The 44 equity funds that advertised their performance in the March 2000 issue of MONEY magazine for example, reported an average return of 85.6% during the previous year.

The End of Fund Dominance?

Well, if the mutual fund investors haven't come within a country mile of capturing the returns of the financial markets, and if they are predestined to fall short of whatever returns the stock, bond, and money markets are generous enough to provide in the future, why *doesn't* this era of mutual fund dominance *deserve* to come to an end? Why *shouldn't* separate accounts move to center stage? Forrester Research is hardly alone in suggesting that these accounts—individually-managed, customized investment accounts that can take into consideration each investor's objectives, tax-status, and personal predilections, all the while providing real time reports of portfolio holdings—will do exactly that. Well, I, for one, doubt it. For it is not at all clear the SMAs (separately-managed accounts) have significant advantages over mutual funds:

- First of all, while fund costs may be our Achilles heel, the costs of the SMA are even *higher*: 2% to 3% per year (plus transaction costs) is the going rate. Fee-based compensation, the Forrester report asserts, could raise payouts to brokers by 50%, and it is the *client* who will bear these costs.
- Second, the tax-efficiency benefit is dubious. Who says that SMA's necessarily provide greater efficiency? And even if it exists, won't the value of such a benefit be far lower in an era of subdued equity returns. (Today, equity funds as a group may well have unrealized *losses* on their books.) Further, taxes are not a particular issue for bond and money market funds—now 40% of industry assets—and some one-half of all equity fund assets are in tax-deferred plans. Finally, regular index funds and tax-managed mutual funds offer readily available tax relief.
- Third, I don't believe that SMAs offer *investment* advantages, and they may be disadvantageous to investors. There is no arguing against the notion that the essential mission of the investor is to capture as close as possible to 100% of the returns provided by the financial markets in which they invest. While we *know* that mission can be accomplished by

owning the market through a low-cost index fund, we know next to nothing about the records of SMA Managers.

- Fourth, the challenges of operating SMAs is substantial. Few registered advisers and brokers are satisfied with today's (largely) APL technology. And while tomorrow's technology will surely be better, it's hard to imagine that it can ever be as economical as the simple pooling of accounts that has been the crux of mutual fund operational efficiency since the industry began.

A New Mutual Fund Industry

Nevertheless, if mutual funds *fail* to change, our dominance *will* come to an end. We hold no permanent monopoly on the good will of our owners; we must re-earn it every day. Fund managements can no longer bask in the warm noonday sun and continue to place their own needs ahead of the needs of their clients. During the great bull market, many firms that trod the wrong path prospered. Even where prudence, principles, and stewardship took a back seat to marketing, the money rolled in. Hundreds of new aggressive funds were formed and backed with more than a billion dollars of advertising. "We'll focus on short-term rewards, momentum, and concept stocks," was the implicit strategy, "and don't worry about higher fees, and portfolio transaction costs." In an era of exploding returns on stocks, the sky seemed to be the only limit to excess.

Those strategies won't play well in the years ahead. We must make speculation passé, and put stewardship in the driver's seat. The counterproductive leap in fund portfolio turnover—which rose six-fold (from 14% annually to an incredible 117%) from 1960 to 2001—must be reversed, as we return at long last to our original focus on middle-of-the-road funds, and on long-term investing that emphasizes, not the price of the stock, but the value of the corporation. And all of this foolishness about earnings "guidance," these forecasts of unsustainable growth rates for American corporations, and the managed earnings that haunt our capitalistic system must be replaced with realistic expectations and principled accounting standards.

And fees will have to come down. So far, there's no sign of a wave of fee reductions, but it must be obvious that investors are sending the lion's share of their cash flow to fund firms that have the highest *stewardship quotient* (SQ):

1) The lowest fees on their equity funds
2) The greatest index fund orientation (or at least the broadest kind of diversification)

3) The strongest (meaning lowest cost, highest quality) bond and money market line-up
4) The greatest reluctance to pander to the public taste in their new fund offerings
5) The lowest portfolio turnover
6) The greatest tax-efficiency
7) The longest holding periods *by their own shareholders*.

And most firms that have *one* of those high SQ characteristics, have *all* of them. (Just check the record.) But there aren't nearly enough high SQ firms, and even those that do possess high SQs have room for improvement. That improvement will come, day by day, week by week, year by year, as investors turn to high SQ firms. And as they do, other firms will be compelled to raise their own SQs, placing the mutual fund industry's dominance on a far firmer foundation.

Back to Basic Principles

To make this transition requires only that investors speak and managers listen. In order to solidify mutual fund dominance, we need to develop the *will* to go back to basics like these:

- We must honor fundamental investment principles such as asset allocation and diversification.
- We must recognize that intelligent long-term investing means a focus on the value of the corporation rather than the price of its stock.
- We must remind ourselves that the returns that investors as a group receive are, by definition, the returns earned by the financial markets, *minus the costs of the intermediaries*.
- We must give shareholders a higher share of market returns, by slashing the frictional costs of fund investing—management fees, sales charges, operating expenses, turnover costs.
- We must recognize that past financial market returns can't be interpreted as actuarial tables and realize that uncertainty is the ultimate reality of investing. In our great focus on emphasizing the probabilities of reward, we must never let our investors ignore the consequences of loss.
- And we must restore a proper balance between stewardship and salesmanship.

Summing it all up, by managing their assets in the most honest, efficient, and economical way possible, we must give our clients a fair shake. If we do only that, the age of mutual fund dominance is not only not over, it is just beginning.