The Promise of Mutual Funds for Asia

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Good morning, and thank you, Mary, for that kind introduction.

It is an honor for me to open the ICI's second Mutual Funds and Investment Management in Asia Conference. But it's also somewhat humbling, especially for a speaker from the United States.

More than any other society in the world, my country has embraced mutual funds as the primary vehicle for family savings.

But today, we are meeting in the aftermath of a long overdue correction of the greatest bull market in the history of the United States.

Of course, bear markets are inevitable; they're even natural. But the current U.S. bear market has been doubly compounded—first by the bursting of our stock market bubble, together with a mild economic recession; then, after September 11th last year, by fears of terrorism and war, and the loss of confidence as waves of corporate fraud hit our securities market. That first stage of the bear market from the March 2000 peak through September 10, 2001, saw the S&P 500 fall 28 percent, from 1527 to 1093. The second bear market stage, which started on 9/11, saw the S&P 500 fall another 16 percent.

So, in America, the euphoric investment mood of the late 1990s has turned to an effort to learn from our mistakes, to restore investor confidence, to reform our securities markets, and to increase corporate governance and regulatory oversight of the securities markets.

At the beginning, I want to proudly emphasize one fundamental fact: the American mutual fund industry has not been a participant in corporate wrongdoing. But, nonetheless, our industry has been affected by the misdeeds of other related industries and individuals. And we have discovered—very painfully—how thoroughly interconnected we are, in the public's mind, with the systems that regulate corporate securities issuers, and how a material weakness in any area of securities regulation or professional oversight—such as accounting—can erode investors' confidence in our well-regulated and ethically sound industry.

The past three years have been difficult for the mutual fund industry and for our stockholders. And, today, we should ask ourselves some hard questions about the role of mutual funds. They played a valuable role in rapidly accumulating and investing money during the bull markets. But what lessons can we learn from today's bear market test?

These issues are important to the firms represented in this room. We believe in mutual funds, and, at Fidelity, we have a three-decades long commitment to actively participate in the development of Asia's mutual fund and investment management industry. Looking ahead, I expect that much of the industry's future growth will take place right here.

So today, I remain optimistic about the important role mutual funds can play in meeting some of the key financial challenges ahead for Asian investors and government policy makers.

I welcome this chance to step back with you from our day-to-day challenges and look at the future of mutual funds in Asia. I believe that Asia is now at a promising stage in the development of its extraordinary potential for mass investing and the utilization of mutual funds. And I hope I can help you draw some useful lessons from the perspective of the American mutual fund experience.

U.S. Family Investing—Four Growth Factors

Let me begin with the observation that over the past 25 years, the most powerful trend in the financial history of America—and many other countries—has been the growth and popularity of mass investing by working families.

Over the past quarter-century in America, at least half of all American households have come to rely on investments in our securities markets—not bank accounts, not insurance products, not traditional defined benefit pensions—as the mainstay for their lifetime savings.

Four major growth factors combined to create this uniquely favorable climate for long-term saving and investing by middle-class Americans.

First, preferential tax treatment for private, individual retirement accounts—called IRAs—and especially for defined contribution retirement plans sponsored by employer companies, called 401(k)s. The second factor to stimulate savings was the coming-of-investment-age of the vast, 76 million-person, post-World War II Baby Boom generation—a demographic bulge that represents one-quarter of all living Americans. Third, was a self-reinforcing bull market that consistently rewarded these new investors with positive returns when they took investment risks. And fourth, a wide array of investor education programs and market information provided by our industry—and by general media sources—that captured the imagination of these Baby Boomers.

The evolutionary result of all this—something that was not part of any pre-ordained government plan—was that mutual funds became the savings vehicle of choice in the United States. Today, mutual funds provide nearly as much capital to the American economy as all United States banks combined.

During the bullish 1990s, total assets in United States mutual funds rose from $1 trillion to $7 trillion. Since then, assets have fallen to $6.1 trillion as of September 2002, but assets have still grown over 600 percent since 1990. Worldwide during the 1990s, funds grew from $2.4 trillion to over $11 trillion by the middle of 2002.

And, even though asset levels have dropped during this bear market, between April 2000 and September 2002, nearly $200 billion of new money was invested in U.S. equity mutual funds. And, investors put nearly $375 billion of new money into all U.S. long-term funds—meaning stock, bond, and balanced funds—during this same 27-month bear market period. Similar trends prevailed outside the U.S., where investors poured almost $400 billion of new money into equity funds between January 2000 and June 2002.

And, most importantly, despite the bear market, the number of mutual fund customers generally continues to rise. It is this broadening of our customer base—not our current asset levels—that will determine our industry's future success when, inevitably, the equity markets recover. For example, during the bearish two-year period between May 2000 and May 2002, ICI data showed that the number of U.S. households that own mutual funds actually rose—by 2.5 million families—to nearly one out of every two American households.

But there is an ominous trend developing that we must counteract. The second stage of the bear market—the "unnatural" stage, coupling the uncertainties of terrorism and corporate scandals—has taken its toll over the past 12 months, as mutual fund households declined by about 2 million.

Overall, these four major growth factors combined to create an environment of tremendous growth in savings and investing over 25 years. But why did so many of these investors prefer to use mutual fund products? I think it all comes down to two qualities that should keep mutual funds growing in both bull and bear markets.

Two Key Qualities of Funds

The first is the basic value proposition of mutual funds: funds combine broad diversification, asset allocation, and independent investment advice in a simple, cost-effective product.

The second factor—which I believe is the most significant—is the public trust in mutual funds that is created by strong, pro-investor, pro-consumer regulation by the government—regulation and oversight that was supported by the mutual fund industry. This trust in the fairness of our regulatory framework provides the certainty that enables our investors to take prudent risks.

But today, the 25-year-long momentum that encouraged workers to invest their money—and their dreams for a financially secure retirement—in our securities markets is facing a major test.

Millions of mutual fund investors are now experiencing the first sustained bear market of their investing lives. And it hurts.

But, we should welcome this test of adversity, because it will make us stronger. And, we should keep in mind the principle of Kaizen—the process of continuous, incremental improvement of our work, a business philosophy we learned in Japan and try to follow in all our businesses around the world. We should be confident that mutual funds will continue to improve and continue to serve as effective vehicles for allocation of investment capital and long-term savings.

Three Reasons for Continued Funds Growth

I say this for three reasons:

First, the diversified mutual fund model has never been more valid—or more validated—than by the relative performance of mutual funds in this "post-bubble" period, especially when compared to investments in individual securities. Certainly, investors in Enron—and its employees—have been reminded of the value of diversification.

And, consider this recent lesson in the value of diversification: since the Spring of the year 2000, all the thousands of stocks traded on United States exchanges have collectively lost approximately $8 trillion in market capitalization. But, nearly half of that loss—$3.9 trillion—is attributable to just 25 stocks.

And, very few mutual funds have experienced anything like the 90 percent plus declines in value that were common among many dot-com and telecom stocks.

According to ICI data, in calendar 2001, 20 percent of individual U.S. stocks lost more than 55 percent of their value. But, only 1 percent of U.S. equity mutual funds lost that much. That's the power of diversification.

The second reason to believe in mutual funds is that the market reforms—so quickly initiated in the United States and elsewhere to correct the structural causes of corporate abuse—have actually looked at how mutual funds are regulated as a good model for reform. Our Investment Company Act of 1940 is a time-tested national governance statute that has inspired trust because of requirements for truly independent and accountable boards of directors; strict rules that govern transactions among affiliated parties; and clear requirements for daily fair valuation of our securities.

For corporate America, we're now seeing an effort to raise the level of disclosure, reporting, governance, and auditing standards to the high levels that mutual funds have followed—for over 60 years. That validates the integrity and soundness of our oversight system.

And third—and most relevant to us here today—the forces that continue to make mutual funds a good way to save in America also exist in Asia. Mutual funds provide an opportunity for Asian nations to satisfy regional economic policy goals, such as encouraging long-term savings for retirement, and using those savings as an engine to drive capital market development and economic growth. But, the key to success here is for Asian governments and the regional fund industry to find a regulatory "middle way" that balances free-market competition with investor protection that is so essential to building public trust. And our industry must recognize and support the important role that sound regulation plays.

Let's now focus on this Asian opportunity, and the regulatory "middle way" that is essential for success.

Asia: Industry/Regulatory Partnership—Three Pillars

This partnership in Asia between the Asian mutual fund industry and our regulators is a platform that rests on three important pillars: the need for scale, the need for industry innovation, and the need for a strong compliance culture.

First, we need regulation that is sensitive to the scale of the fund business in Asia. There are two reciprocal parts of the scale issue. While Asia holds the promise for great future growth of the investment management business, Asia is an enormous physical area, one where a significant portion of the world's population lives. And, just looking around this room, Asia encompasses many diverse economies with different projected rates of growth for our investment services.

Mutual fund assets in Asia are projected to double over the next five years. Cerulli Associates projects a 14 percent compounded growth rate for Asian assets, outside Japan. The market in China is projected to be $37 billion by 2006. This rapid growth is primarily stimulated by the need to save for retirement.

So, we are excited by the growth of defined contribution plans in Japan, by the Mandatory Provident Fund in Hong Kong, and the liberalization of Singapore's Central Provident Fund to include foreign denominated funds. We are also encouraged by the growing distribution of mutual funds through banks, as they expand their services to long-term savers.

At this relatively early, and promising, stage of growth, good regulation should encourage our industry to develop economies of scale—to keep our costs low—as we rapidly develop products and distribution relationships across this vast region.

For example, good regulation should not require that companies that offer investment advice and companies that manage mutual funds obtain separate licenses and maintain separate staffs. Similarly, requirements to locate a minimum number of employees within a country, or to make portfolio decisions from within the borders of a country, defeat the ability of firms to bring cost-effective solutions to Asian investors.

The foremost responsibilities of regulators are to protect their citizens and savers, and inspire trust. But we can satisfy these responsibilities and still enable investment firms to leverage their expertise and resources, and share the resulting economies of scale with Asian customers.

Now, if our industry successfully satisfies the growing appetite for investment management services here, we will also grow in size and complexity. And that brings up the other challenge of scale. The industry cannot afford to outgrow our regulators. Regulators must keep up with the industry's growth and change, with additional resources and new approaches to regulation. For example, as our industry grows, it will become less important for regulators to review every fund document, but more important to add auditors and inspectors to periodically check the internal controls and operations of funds with on-site examinations. This risk-based approach to oversight should encourage the formulation of industry "best practices," and the development of analytical tools that prioritize those parts of our operations that merit special attention.

And, because the larger we grow, the more our industry and our customers rely on information technology—to manage scale, to make investment decisions, to keep good records of transactions, to distribute our funds, and to minimize risk. Our regulators will be called upon to master new information technologies to keep pace. So, effective regulation will require adequate budgets to enable substantial investments in systems and technology by government agencies, and the employment of regulatory professionals with technical systems backgrounds. For example, at Fidelity, over 20 percent of our employees worldwide work in systems and telecommunications functions.

The second pillar of our partnership is a regulatory platform that is flexible enough to allow for industry innovation. Our industry is strong and we attract smart people. But that doesn't necessarily lead to success.

The great British naturalist Charles Darwin—a man who was born and died before mutual funds were ever invented—observed about the survival of the species that the race goes not to the strongest or the smartest, "but the ones most adaptable to change."

Our industry has succeeded by adapting to the changing needs of customers in different markets with valuable innovations such as check writing to increase the convenience of U.S. money market funds when interest rates were high in the 1970s. By making it easier for investors to take their money out of money market funds, they became more comfortable leaving their money in. Later innovations included sector funds that specialized in securities of particular industries or countries; then index funds and exchange traded funds around the world; and, the recent innovation of "principal protected funds," especially in the Asian and European markets.

Sound regulation should both protect investors and permit new types of fund products to meet their emerging needs. Fund companies and our customers thrive in environments where healthy competition among firms creates new varieties of products that customers want, with new investment objectives, so long as we follow the highest fiduciary standards and fully and fairly disclose the risks to our investors. Overly proscriptive rules about how fund assets can be invested, and unreasonable delays in the approval of new products, will only frustrate innovation.

Good regulation will place a premium on investor protection. But we hope governments will not exercise their power to regulate mutual funds in a way that favors particular markets, local currencies, or other policies designed to limit competition. Charles Darwin would not approve.

The third pillar is the need for the mutual fund industry to develop a strong compliance culture. The participants in our industry must clearly know what rules we are expected to follow. We need transparency of regulation to succeed.

And, our firms must go beyond the technical rules to develop voluntary standards of ethics and compliance that go further than current law to protect the industry's reputation and avoid any appearance of conflicts of interest.

The industry must also establish and maintain good working relationships with our regulators. Both formal processes—such as the ability to comment on proposed rules and help shape them to meet investors' needs—and informal opportunities must work together to achieve our common goals of protecting investors, educating investors, and helping investors reach their financial objectives. For example, we should work together to make sure that Asians who invest in “principal protected funds” understand the nature of the protection and its impact on overall performance. We also should take care, particularly in today’s volatile markets, to assure accurate valuation and appropriate liquidity of our fund portfolios. If our investors understand what they are investing in, and have reasonable expectations about market performance, they will become long-term savers. And that’s good news, because educated investors add stability to our securities markets and they are less likely to panic during volatile times.

Conclusion

In conclusion, this conference offers us the opportunity for industry players to talk about exciting new markets and products, and to hear from our regulators across Asia about their perspectives. Over the next two days, we have the potential to build solid relationships that will help shape the success of the Asian investment management marketplace.

We meet here in a populous and diverse part of the world that is filled with opportunity for the future of our industry. But, we also meet during a tough market cycle, during a time when we have to work together to maintain the high standards of integrity that put investors first. I am confident that we can realize this promise to ensure that, no matter what the markets do, Asian investors will come to trust mutual funds as savings vehicles they can rely upon to fulfill their long-term dreams. Building this bridge of trust with Asian investors is the most important responsibility we can fulfill.

Thank you.

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