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COMMENTARY

INVESTING FOR RETIREMENT: CAN INVESTORS BE MADE WISE?*

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One thing that struck me as we have been talking about whether investor education is working to enable us to provide effectively for retirement is this: my brother likes to regale me with the way my grandmother "invested." She saved money by taking cash on hand to the bank where she kept it in a non-interest bearing bank vault. We have learned a thing or two about investing over the years, and I think it is partially because of the recent focus on making U.S. citizens literate about investing for their retirements.

I greatly enjoyed reading Professors Fanto's and Karmel's papers. I have been thinking about them for a number of days. They are thought provoking and extremely pertinent to the discussion we have been engaged in these past two days. In some ways, I find the two papers a sort of yin and yang of the pension fund discussion.

 The following discussion is presented in its original transcript format, with minor editorial changes by the Author.

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For example, Professor Fanto, at page 7 of his paper, sees existing pay-as-you-go systems as depriving foreign capital markets of the funds they need either to create, or to augment, existing, but not yet vibrant, capital markets. He specifically addresses the current state of European capital markets and looks to individual pension funds and direct investor involvement as crucial to their growth. He suggests that investor involvement may also spur the creation of capital markets in regions in which they do not yet exist.

Professor Karmel, at page 53 of her paper, on the other hand, expresses a concern that privatization may lead to new investment money overwhelming our own capital market. So, we have two opposing views as to the impact of new capital.

Again, Professor Fanto generally believes investor education can largely take care of the dangers of turning the public loose to invest for its own retirement. However, Professor Karmel stresses that regulatory systems will be forced to cope with the pressure of protecting a new class of basically uninformed and naïve investors.

I am, of course, exaggerating both of their positions. Yet, I am doing it for a pedagogical purpose because it points up a very real issue.

That issue which we have discussed today is whether the public can, in fact, make wise investment decisions. It has been, as Professor Karmel points out, something we have grappled with since at least the 1930's when the Securities Act of 1933 was enacted. At that time, the drafters wrestled between adopting a merit system in which the federal government would decide whether a security was too risky to be offered to the public versus a system which was premised on the idea that investors could reach their own conclusions as to the risk if they were simply given sufficient information. That debate was resolved in favor of the idea that investors could be made wise investors.

Times, however, have changed in terms of how investors invest. Currently, the number of mutual funds listed in the *New York Times* or *The Wall Street Journal* far outnumbers the stocks listed on the New York Stock Exchange. This means, in large measure, that U.S. investors have quit picking stocks. Rather than picking stocks, they are picking mutual funds. In doing this, they are embracing intermediaries as the means through which they invest. This means that they are making very different investment decisions from the sort of investment decisions they were making in the 1930's.

It is a decidedly easier decision to make. Rather than having to pick individual stocks, investors saving for retirement need only pick asset classes and intermediaries to undertake to invest for them in these asset classes. They need something I think Professor Fanto referred to in his paper: that is, just a few simple rules to guide them. The good news is that, in fact, only a few simple rules are necessary for individuals investing for retirement.

Investors need to know that they must begin saving earlier in their working lives to maximize their ability to have accumulated the highest possible sum for their retirement at the lowest overall risk. The longer one waits to invest, the riskier one's investments must be to achieve a particular dollar retirement goal.

Investors also need to know that they should be broadly diversified into two asset classes: debt and equity. They need to know that they should gradually, over time, as retirement nears, weight their debt/equity allocation more towards debt than is appropriate at the beginning of their careers.

Investors providing for their retirement further need to know that they should stay the course and not try to time the market. They need to know to keep just enough of their money in cash or near cash to last them, say, through six or twelve months of adversity. This short list of rules, and it *is* quite short, can be decked out with ruffles and flourishes, and it often is. But many, many, investment professionals will tell you that they will be most content if investors simply follow this short list.

As I have said, the issue of educating investors in terms of selecting mutual funds is, I think, different from the debate over educating investors in terms of picking stocks. It really is simpler. This means we must instead ask whether this short list of investment rules is being heard, absorbed and followed by the American public.

For many, the answer is "yes." Every day, *The Wall Street Journal* invokes and reinvokes this short list of rules. Magazines such as *Money Magazine*, *Forbes*, and others, invoke and reinvoke this short list. Mutual funds, either in hard print delivered to shareholders or by way of TV commercials, invoke and reinvoke this short list. The Internet also carries the message over and over. Many 401(k) plan sponsors go out of their way to invoke and reinvoke this short list of rules for investing for retirement.

So the question is: is this message being absorbed, and if it is, by whom? I think there is a real concern that, although the message is being absorbed very well by the middle class, arguably, those with less education and less money do not hear the message or hear the message but do not follow it or do not believe it is important. In this regard, the Investment Company Institute ("ICI") is trying to determine whether less educated and less well-off employees who participate in 401(k) retirement plans are hearing the retirement message.

Although 401(k) data bases will not provide information about the educational levels of its participants because that simply is not a fact that is relevant to these programs, plan data can be mined to reveal salary information. To the extent that salary levels can serve as a proxy for educational levels, the ICI is trying to tease out of the data some understanding as to who, in fact, follows the short list of investment rules. Does anybody follow it? Is it related to educational or salary levels?

I think the ICI's efforts provide a line of inquiry worthy of investigation. I have suggested to the Institute that they might want to layer their broad 401(k) data base analysis with a narrower special survey that could directly relate such matters as education level and salary to wise investment to see if the two data bases "line up."

In talking about the phenomenon of investor education, one of the things that strikes me is how much of the educational message is being delivered by the private sector and, in particular, by the mutual fund industry. In fact, delivery of the message is vital to the industry. The industry has come to understand that the very reason people will invest through them is that people feel comfortable with the idea of giving a fund their retirement money and having it put in appropriate asset classes. It does not do the fund industry any good to achieve a reputation of putting investors into highly risky investments that fail.

In talking about investor retirement education outside the U.S., once again the huge global mutual fund companies very much want to first develop European interest in retirement investing and then expand this interest into Asian markets. They know that the current Continental view is that personal investment, if done at all, should be done through a banker, and then investment should be only in debt.

Global fund complexes recognize that in order to thrive they must overcome the Continental view. They are developing massive programs designed to change the viewpoint of European investors. A great deal of private money and energy is going into this educational process. Julius Baer, a Swiss banking firm, which in the past hardly thought of itself as a public purveyor of funds, is now targeting, among other things, the Italian public. To do that, they, like other companies with a significant commercial interest, are testing the waters to see how they can get across the premise of investing for retirement to a European public. So, there is a large private force that is seeking to educate the European public on how to invest wisely for retirement.

Finally, I did want to say something about the regulation in this country of investment advisers and investment funds because it has been suggested over the course of the last two days that the industry may be under-regulated.

The Securities and Exchange Commission ("SEC") has recognized that the mutual fund industry has grown tremendously and plays a critical role in terms of the ability of Americans to retire safely. The industry now has some $5.5 trillion under management. It is very clear to the staff of the SEC and to the SEC's commissioners that they must make sure that the industry they regulate continues to enjoy the trust of the public which it has enjoyed over the years.

Without much fanfare, a significant amount of money has been redirected toward increasing the size of the SEC staff that goes out on the road to inspect the operations of investment advisers and mutual funds. The SEC's inspection staff may stay at an adviser's office for two, three or four weeks, and they are now doing this on an annual basis in many cases.

The SEC uses its right to look at the books and records of funds and advisers to probe deeply and acquire insight into how a fund is being run. The SEC's examinations uncover both sloppy operations as well as operations that are "light," in following the wealth of regulations applicable to mutual funds and advisers. Knowing the SEC's staff will return next year, keeps funds alert.

The SEC also utilizes a form which registered advisers are required to file with the Commission to force accurate disclosures of adviser practices. Do advisers engage in soft dollar trades? How do they get best execution of trades for their clients? Do the portfolio managers trade for themselves? Do they trade with their clients? Do they bunch client orders? If so, how do they bunch orders?

It is important to understand that the staff of the SEC is very aware of their responsibility to help investors prepare for their retirement. The staff is very much concerned with its reputation and with its ability to be seen as a good regulator. Finally, the SEC brings numerous enforcement actions that serve to police the industry. In the main, the industry is clean as a whistle. It is really only at the edges and the margins that you see problems.

The last thing I wanted to add came to me in thinking about this symposium, and the things that have been said, and in reading *The Wall Street Journal*. It strikes me that possibly there is another thesis to advance: that U.S. and U.K. asset management companies of huge reputational size have, in fact, so internalized what their regulators have told them to do that it has become central to their culture. I certainly see this when I work with U.S. asset managers and with U.K. asset managers. I also see both of these groups intensely interested in attracting investors in other parts of the world in order to become global managers. It seems to me that this private force may well be exporting both good business practices and good regulatory standards as they cover the globe.

For example, the U.S. preoccupation with financial transparency is being exported. *The Wall Street Journal*, two days ago, reported that investors in Europe facing losses now want more information before they invest again. Galvanized by the prospect of write-offs and losses tied to the turmoil in emerging markets, European investors are belatedly, but finally, clamoring for improved financial disclosure. The *Journal* article quotes a major U.K. asset manager as saying that until a certain Swiss bank gives it more information about its financial condition, it will refuse to invest on behalf of its investors in that bank. It is this kind of phenomenon that strikes me as something we should watch because it suggests that the rules and regulations promulgated in the U.S. and the U.K. are being directly exported into other market places by private market participants.