

MEMORANDUM TO: Financial Intermediaries

RE: How We Can Profit From the Experience of Corporate America

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Eight months before the stock market bubble reached its bursting point in March 2000, I happened to appear on Louis Rukeyser's *Wall Street Week*. When one of the panelists asked me what advice I would give to an investor heavily committed to technology and internet stocks, the only answer I could think of was: "I'd advise him to read *Extraordinary Popular Delusions and the Madness of Crowds*."

I can only hope that investors who heard my warning quickly dashed out to their local libraries and read that classic chronicle of earlier financial booms and busts—Tulipmania in Holland, the South Sea Bubble in Great Britain, and so on. In the world of investing, the cheapest education is what we learn from the experience of others. And so today I'll discuss the failure of corporate governance that was a major contributor to that bubble, and how two financial intermediaries—mutual funds and insurance companies—can profit from that experience.

When I answered that question, it was obvious—not only to me—but to many others, from Warren Buffett on down—that we were in a bubble. We also knew that, *sooner or later, all bubbles burst*. But while we may

know *what* is going to happen, we never know *when*. And so the stock market continued its ascent for eight more months before beginning its long, painful decline, the worst bear market since 1929-1933. The NASDAQ Index is now down nearly 80% from its peak and the New York Stock Exchange Index is down 40%.

At the peak of the recent bubble, investors seemed to decide that an average price-earnings ratio of 35 times and a dividend yield of 1% were reasonable. (The historical norms are 15 times and 4%.) That there was no problem when the \$17 trillion value of the stock market was equivalent to 190% of the \$9 trillion value of our nation's gross domestic product. (The norm is about 80%.) That a corporation could somehow be worth many times the discounted value of its future cash flows. (It can't. For, however difficult to calculate, its value is precisely equal to that sum.) And so the reckoning came. It has continued to this day, and the market has reverted *toward*, if not yet quite *to*, most of those threadbare old norms—a p/e of 17 times, a dividend yield of 2%, and a valuation of 85% of GDP.

While each financial bubble is different, most have been associated with the abandonment of traditional financial standards. As Edward Chancellor, author of "Devil Take the Hindmost: A History of Speculation," reminded us, manias bring out the worst aspects of our system: "Speculative bubbles frequently occur during periods of financial innovation and deregulation . . . lax regulation is another common feature . . . *there is a tendency for businesses to be managed for the immediate gratification of speculators rather than the long-term interests of investors.*" What is more, bubbles often take on the attributes of castles built on sand, as sound business practices erode, integrity and ethics are compromised, and financial misfeasance creeps into the system.

1. Corporate America's Role in the Bubble

The first major casualty was Enron, described by *The New York Times* when it fell apart as a "catastrophic corporate implosion . . . that encompassed the company's auditors, lawyers, and directors . . . regulators, financial analysts, credit rating agencies, the media, and

Congress . . . a massive failure in the governance system." All of the traditional gatekeepers seem to have failed, and as we were to learn in the ensuing months, Enron was but the first evidence of the failure of our corporate system. Soon other dominoes were falling, including Worldcom, Adelphia, Global Crossing, and Tyco. Who among us can know which corporation will be next to fall?

Relative to the 7500 publicly-held corporations in America, the malefactors we know of so far are relatively few in number. As a result, we're told that we shouldn't let a few bad apples spoil the barrel. *While I accept the premise, I disagree with the conclusion.* Our corporate system has been permeated by distortions of sound business practices: Virtually all corporations focus on its prices of their stocks, present unrealistically high (and unachievable) projections of earnings growth, and push generally accepted accounting principles to their limit. When our rule of conduct becomes, "I can do it because everyone else is doing it," integrity and ethics go out the window and the whole idea of capitalism is soured.

Financial Manipulation

There are more than enough villains to go around. Too many of our corporations have vastly overstated their growth potential and then have tried to force the fulfillment of their aggressive earnings guidance by fair means or foul. Off-balance-sheet special purpose enterprises have been created, largely to conceal debt; illusory transactions have misled investors; and sham inter-company transfers have raised reported sales volumes. Assumed future returns on pension plans were raised even as the prospects for future returns tumbled. And when the loose envelope of accounting principles could be pushed no further, criminal manipulation of financial figures often followed.

And that's hardly the end of the list of sins: Enormous compensation from stock options enriched corporate executives who succeeded in hyping the *price* of their *stocks* without increasing the *value* of their *corporations*. They sold huge amounts of their own shares at bubble-driven prices, but in the aftermath millions of their employees who held company stocks in their retirement plans were impoverished. Auditors

garnered enormous fees from their consulting activities, becoming partners of management rather than independent professional evaluators of management's financial reporting. Corporate profits, it turns out, were substantially overstated, and investors came to realize that they had assumed risks that were far larger than those for which they bargained.

Capital Development and the Casino

Sadly, those problems went almost unnoticed among investment professionals. In the search for huge investment banking fees, Wall Street's conflicted sell-side analysts lost their objectivity and ignored the signs of trouble. Even the buy-side analysts of our large financial institutions engaged in their own search for glowing investment performance, put aside the lessons of their training and experience as well as their skepticism, and joined in the mania. After all, large performance gains draw in assets to manage, and large assets generate large fees. So investors themselves—especially institutional investors—share much of the responsibility for the bubble in stock prices. Aware of it or not, and whether through naivete or greed, they joined the happy conspiracy of market participants that reveled in rising stock prices. They forgot that while in the *short run*, as Benjamin Graham told us, the stock market is a *voting* machine, in the *long run* it is a *weighing* machine. *Investors engaged in short-term speculation based on the hope that the price of a stock will rise, rather than long-term investment based on the faith that value of a corporation will grow.* It was the triumph of perception over reality. But sooner or later, perception returns to reality, not the other way around.

Long before this latest bubble—in fact shortly after the 1929 bubble had burst and the Great Depression was upon us, Lord Keynes warned us of what happens when speculation achieves predominance over enterprise: "In one of the greatest investment markets in the world, namely, New York, the influence of speculation is enormous . . . it is rare for an American to 'invest for income,' and he will not readily purchase an investment except in the hope of capital appreciation. This is only another way of saying that he is attaching his hopes to a favorable change in the conventional basis of valuation, i.e., that he is a

speculator. But the position is serious when enterprise becomes a mere bubble on a whirlpool of speculation. *When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done.*" And so in the recent era, it *has* been ill-done.

A Failure of Character

At last we are beginning a wave of reform in corporate governance and are undertaking the task of turning America's capital development process away from speculation and toward enterprise. But there's even more at stake than improving governance *practices*. One must also establish a higher set of governance *principles*. This nation's founding fathers believed in high moral standards, in a just society, and in the virtuous conduct of our affairs. Those beliefs shaped the very character of our nation. If *character counts*—and I have absolutely no doubt that character *does* count—the ethical failings of today's business and financial model, the financial manipulation of corporate America, the willingness of those of us in the field of investment management to accept practices that we know are wrong, the conformity that keeps us silent, the selfishness that lets greed overwhelm reason, all erode the character we'll require in the years ahead, more than ever in the wake of this great bear market and the investor disenchantment it reflects, and especially in the post-September 11 era. The motivations of those who seek the rewards earned by engaging in commerce and finance struck the imagination of no less a man than Adam Smith as "something grand and beautiful and noble, well worth the toil and anxiety." I can't imagine that anyone in this room today would use those words to describe our corporate governance system at the outset of the 21st century.

So this is a sorry era in Corporate America. Serious ethical mistakes were made, and innocent people have been hurt, many of them irreparably. While most of these failings have not—I repeat *not*—found their way into the financial services industries such as mutual funds and life insurance, there is much that we in both of our industries can learn from them. The fundamental lesson we can learn, I think, is that when management places its own interests ahead of the interests of long-term shareholders, trouble lies ahead.

2. The Mutual Fund Industry: Putting the Shareholder First?

The problems we see in Corporate America have many implications in my own field of mutual funds. While too many of our corporate stewards have failed to earn our faith, we institutional managers have, I fear, gotten the corporate governance that we deserve. We have focused on short-term speculation at the expense of long-term investing, and our voices on governance have been conspicuous solely by their silence. We have failed to recognize that ownership entails not only rights but responsibilities, and as a result have failed to act as good corporate citizens. With our 100 largest financial institutions holding almost 50% of all of corporate shares, we control corporate America, and we ought to make our voice heard.

If only we take the initiative to stand up and be counted, we will at last return to an era in which the great creative energy of American business and finance shifts from its short-term focus on the price of a stock—*speculation*—to a long-term focus on the value of the corporation—*enterprise*. When we do, we will at last get the good governance we deserve, and our corporate stewards will respond appropriately. That change, in turn, will well-serve both our investors and our nation.

This process is already beginning. Sir Isaac Newton was not only right in his third law of motion—*for every action there is an equal and opposite reaction*—he was right about our system of financial markets. The bear market is the inevitable reaction to the action of the bull market. What is more, a powerful reaction has already begun to the unacceptable actions of Wall Street, of the accounting profession, and of those we trusted to be our corporate stewards. Congress has passed the Sarbanes-Oxley bill, requiring senior corporate managers to attest to the validity of their companies' financial statements, providing for disgorgement of profits by executives who sell stocks and later restate earnings, and replacing self-regulation of accountants with a new federal Public Company Accounting Oversight Board, as well as other salutary provisions.

The New York Stock Exchange has produced a powerful set of guidelines for corporate governance, including greater director independence, new standards for audit committees and compensation committees, and even a "lead director" who is independent of corporate management. (I believe that we should go further, and require that the board chairman be an independent director, separating the powers of *governance* from the powers of *management*.) And the newly-formed Conference Board Blue-Ribbon Commission on Public Trust and Private Enterprise (on which I'm honored to serve) has already produced a strong set of best practices on executive compensation, with best practices on corporate governance and on accounting standards soon to follow.

The Silence of the Funds

In this beehive of activity, however, the mutual fund industry remains largely silent. The reasons for the silence of the funds are clear.

1. **Inertia:** "We've never done much in the way of shareholder activism. Why should we start now?"
2. **Investment Strategy:** With an average portfolio turnover at an astonishing 110% per year, the average fund holds the average stock for an average of 11 months. "We are *traders*, not *owners*, so why should we behave as owners?"
3. **Conflict of Interest:** "The corporations whose shares dominate our *portfolios* are our best *clients*, for we manage their pension and thrift plans. Why vote against management and take the risk of losing their business?"

But our failure of corporate citizenship is only one of our shortcomings. We have not adequately represented the interests of our long-term investors. Yet the law requires us to do just that. The preamble to the Investment Company Act of 1940 calls on mutual funds to be "organized, operated, and managed . . . in the interests of shareholders . . . (rather than) in interest of investment advisers and underwriters." Despite that high principle, I fear that placing our shareholders first-fiduciary duty, if you will—is more honored in the breach than in the

observance in the mutual fund industry.

The first evidence of this breach lies in the high costs of mutual fund ownership. Direct costs of equity mutual funds, as measured by the ratio of management fees and operating expenses to fund assets (the "expense ratio"), come to about 1.6% per year for the average fund, and 1.3% if weighted by fund assets. (Smaller funds typically have higher fees.) A tiny proportion of this cost—perhaps less than one-tenth—is actually spent on investment management. Much more goes to sales and marketing and operations. But the largest part of the fees paid by fund investors is represented by the substantial profits garnered by the management companies that operate the funds. (Pre-tax profit margins of 40% to 50% are not uncommon.) And the expense ratio is hardly the only cost fund shareholders incur. Indeed, when we add in sales charges, the hidden costs of that 110% turnover, and opportunity cost (funds are rarely fully invested), the total cost of equity fund ownership nearly doubles, to at least 2 ½% per year.

Do costs matter? You bet they do! And they matter most in financial institutions. Why? Because while much of the value of most consumer goods is measured by immeasurable factors such as taste and tone and prestige and image, the value of financial products is measured almost *entirely* by that most measurable of all assets, *dollars*. And costs matter most in those financial instruments for which costs are (1) easily calculable, (2) *directly* related to returns, and (3) compounded over time. It should go without saying that the mutual fund is the paradigm of that definition.

How *Much* Do Costs Matter?

How *much* do costs matter? Let's consider what costs mean to a long-term investor, and see what toll a 2 ½% annual cost would take on a 10% stock market return over, say, thirty years. When compounded over thirty years, \$1,000 earning the 10% stock market return would grow to \$17,500. Pretty nice! That same \$1,000 invested in the typical fund, earning 7 ½% *after* costs, would grow to \$8,750. Not too bad! But only half as much as the market—a dead-weight loss of \$8,750 engendered *solely* by reason of the costs of financial intermediation. Put

another way, the intermediaries put up 0% of the capital, took 0% of the risk, and garnered 50% of the return, the investor put up 100% of the capital, took 100% of the risk, and received 50% of the return. Put me squarely in the camp of those who don't think that's good enough.

That simple example reflects both the *miracle* of compounding returns and the *tyranny* of compounding costs. But the story gets worse. Intermediation costs are paid in *current* dollars, while the investor's final capital must be measured in *constant* dollars. Let's assume a future inflation rate of 2 ½%. Result: *Real* annual return for the market, 7.5%; *real* return for the fund investor, 5%. The final purchasing power of each initial \$1,000 falls to \$8,750 in real terms in the market, and to only \$4,300 in the fund. We're surely a long way from that \$17,500 that appears on a table showing the magic of compounding 10% returns.

If the fund industry doesn't wish to recognize the need for these changes and reduce its costs, it is only a matter of time until investors will recognize it—and they will vote with their feet. But my industry's problems transcend these economics. Investors' faith in their fund trustees has been shaken even more emphatically by the fact that fund managers have moved away from being prudent guardians of their shareholders' resources and toward being imprudent promoters of their own wares. We pander to the public taste by bringing out new funds to capitalize on each new market fad, and we magnify the problem by heavily advertising the boxcar returns earned by our hottest funds.

The result of this powerful marketing is that mutual fund investors have fared far worse than mutual funds themselves. They invested infinitely more in equity funds during the period immediately preceding the peak of the stock market bubble than when values were at far more reasonable levels, and then invested the overwhelming portion of their dollars in technology funds and technology-oriented growth funds (including internet funds!) and took their money out of value funds which, bless them, both lagged as the bubble inflated and held steady as it burst.

An Industry Without Scandal?

Early in 2001, an independent study showed that while the annual return of the stock market itself averaged 16% per year during the 1984-2000 period, the return of the average *mutual fund* averaged 13%, about the differential one would expect, given that fund costs amounted to about 2 ½% to 3% per year. But, because of the market timing and adverse selection issues I've just described, the annual return of the average mutual fund *investor* averaged just 5%. Today, the bear market has reduced that cumulative market return to about 11%, and the return of the average *mutual fund* to about 8%. That relationship suggests that the return of the average fund investor, during this excellent (from point to point!) period for stocks, was 0%(!). Nothing. It is not a record of which we should be proud.

As our industry leaders accurately say, "the mutual fund industry has never had a major scandal," and certainly nothing like those we've seen among the corporate malefactors whom I've earlier described. But it's surely arguable that the astonishing shortfall in return that we've provided to our fund shareholders is itself scandalous. So we'd best learn from this recent sorry era in corporate America and put our own house in order.

We must not only reduce the costs our investors incur, but increase the horizons of our investment strategies. We must not only focus far less on salesmanship, but far more on stewardship. And we must commit ourselves to improving corporate governance and corporate value. If we simply put our clients first, just imagine how well the mutual fund industry can serve investors in the coming years.

3. The Life Insurance Industry

My candor about my own industry, I hope, gives me license to address with equal candor some lessons that the life insurance industry might learn from the failings of the Corporate America. As Robert Burns wrote, "Oh that God would give us the very smallest of gifts to be able to see ourselves as others see us." And I hope the views of this outsider to your business will be both constructive and helpful.

While your industry's recent record has been largely free of corporate and financial scandal, you have had to face up to some serious charges of improper market conduct and overly-aggressive sales practices, and have settled them at huge expense. But the greatest scandal that plagued your industry actually took place almost a century ago. Then, the Armstrong Investigation in the New York State Senate called the life insurance companies on the carpet for "their excessive salaries, nepotism, unethical and unsound business practices, and fraudulent management . . . It became clear that mutuals had not dedicated themselves to the altruistic pursuit of policyholder profits."¹ The investigation uncovered "excessive commissions to field agents, inadequate accounting procedures . . . and company funds used to support prices of Wall Street securities in which officers were intimately interested."²

If those phrases could easily have been written about Corporate America in our newspapers this very morning, so could the event that precipitated the Armstrong Investigation. It was a lavish Louis the Fourteenth costume ball, a spectacular party that unveiled the splendor of Versailles, said to have cost \$100,000 (in today's dollars, \$2.1 million) given in 1905 by a dashing young playboy named James Hazen Hyde, a vice president and leading stockholder of the giant Equitable Life. This "social event of the century," as it was described in the press of that day, ignited a highly-publicized power struggle within the company, and enough dirty laundry popped into view to alarm the State's senate, which then unveiled a whole panoply of corrupt industry practices that directly impaired the interests of policyholders. The attendant publicity infuriated the public and set the insurance industry back for years before the beneficial effects of the consequent reform took hold.

"Nothing Succeeds Like Excess"

If that brief anecdote sounds to you like one you read about just a few weeks ago, you are very observant. As it happens, it quite resembles the extravagant 40th birthday party thrown in Sardinia by Tyco International's then-chief-executive L. Dennis Kozlowski for his wife. No, not Versailles. But a Roman Empire theme, complete with waiters

dressed in togas and wreaths on their heads, and a large ice sculpture of Michaelangelo's David, surrounded by shellfish and caviar and, well, *exuding* Stolichvinsky vodka into the guests' crystal glasses. The cost—one-half of which was paid by the Tyco public shareholders—was \$2.1 million, precisely the real cost of the Equitable costume ball of nearly a century earlier. I'm not sure whether to say, "nothing succeeds like excess," or "the more things change the more they remain the same."

I'm sure that Corporate America's excesses will be ultimately mitigated, not only by the egregious example of the Tyco party but by the response we are already seeing from Congress and regulatory agencies, and by the public outcry for reform, just as the insurance industry's excesses of a century ago were finally subdued. But it took time, and I like to think that change was fostered not only by New York State Senator Frank Armstrong, who led the investigation, but by Philander Banister Armstrong, an insurance industry pioneer who culminated his career by writing, in 1917, a book entitled *A License to Steal: Life Insurance, the Swindle of Swindles*. An industry insider, he catalogued the accounting peccadillos and political graft that had scandalized some of the industry's largest companies.

While those old problems of life insurance need not concern us today, I mention the latter Mr. Armstrong for two reasons. One, he just happens to be my great-grandfather. Two, like his great-grandson, he was also a believer in giving policyholders the best possible financial terms. In an 1875 speech, he said: "Gentlemen, you must recognize that companies having the smallest expense will have the ultimate advantage (and) that companies having this advantage are the most desirous of correcting present abuses. To save our business from ruin, we must at once undertake a vigorous reform. The first step must be to *reduce expenses*." He was a missionary for your industry, and he had his own way of reforming it: "Life insurance," he wrote, "has become one of the necessities of modern civilization, and it should be furnished at cost." I guess you could say that the apple's apple's apple didn't fall very far from the tree!

Life Insurance as an Investment

So let's talk about the cost of life insurance. Just as in mutual funds, the costs incurred in operating, investing, and selling the product come directly, dollar for dollar, out of the returns earned on the policyholders' assets. In the case of insurance, however, the linkage is much less obvious, and in your field you enjoy the pricing flexibility to make any given product more attractive, albeit only by making another less so. The product you are selling, you may argue, provides most of its value in the form of the face-amount payment that come to survivors when the insured comes to the end of his or her days.

Nonetheless, most insurance is an investment, and increasingly so. Today, annuity reserves, *not* insurance reserves, have come to dominate your industry's book of business. While your clients don't (and perhaps can't) calculate an expense ratio in the manner that a mutual fund investor can, I've perused your *Life Insurers Fact Book* and estimated your annual operating expenses. Including taxes, these costs came to about \$72 billion in 2000, resulting in an expense ratio equal to about 2.3% of your \$3.2 trillion asset total—consuming fully *one-third* of the 7.0% rate of return on your investment assets, leaving two-thirds to be added to the resources of your policyholders. While I claim no expertise on the accounting practices of your business, I would observe that, valuable as it may be as a medium for meeting the needs of families for income maintenance and death protection, life insurance is an *expensive* way to invest—indeed consuming significantly *more* of your policyholders' investment returns than is the case in the mutual fund industry.

The Tension Between Client Return and Marketing Power

For both financial service providers—mutual funds and insurance companies—a strong tension exists between the need to serve policyholders by minimizing costs without jeopardizing your ability to provide incentives to the field force. It is not easy to reconcile enhancing the investment return of the policyholder with providing powerful incentives to sell more policies. Since life insurance costs are heavily weighted by sales costs (40% of costs are commissions to agents, the remaining 60% represents home-and field-office expenses), the major means of reducing costs would appear to be an increasing

emphasis on direct, commission-free, sales. Unless I miss my guess, a great opportunity awaits any company that figures out how to reconcile that dilemma.

On the other hand, I'm sure most of you would argue that "life insurance is sold and not bought," and, for better or worse, that aphorism seems to remain true today. But as the knowledge of consumers inevitably grows, as their education levels rise, and as the Information Age facilitates comparison-shopping, it's hard to argue that the dynamics will not gradually—although perhaps glacially—shift from a seller-driven to a buyer-driven system. Wise insurers cannot afford to ignore such a potentiality, for increasing policyholder returns could well serve to enhance public confidence both in your product and in your industry.

You don't need to tell me it's not easy. In February 1977, shortly after I started Vanguard, we eliminated all commissions and abandoned—overnight!—the broker-dealer network that had distributed shares of our funds for nearly 50 years, immediately beginning to distribute our funds to investors directly, without sales loads. As you might guess, new business plummeted. So even with normal share liquidations we experienced a steady cash outflow. But the situation reversed within two years, and we've enjoyed positive cash flow every year since. Indeed, over the past ten years our nearly \$350 billion of cash flow represented the largest total in our entire industry.

But it is not only our experience as a no-load distributor that might interest you. We also have a characteristic that makes us unique in the fund industry: Our mutual structure. Our operating company is actually owned by our fund shareholders, and we operate on an "at cost" basis. (Shades of Grandpa Armstrong!) The net result is that our expense ratio is presently running at about 0.27% of the combined assets of our stock, bond and money market funds. Our major rivals, on the other hand, operate at an expense ratio of about 1.07%. Result: An expense advantage of 0.80% (80 basis points) which, when applied to our current \$520 billion asset base, will result in annual savings of more than \$4 billion for our investors in 2002 alone. Put another way, assuming a 5% combined gross return in the stock, bond, and money

markets, we could deliver almost 95% of that return to investors, while our peers would deliver less than 80%. The fact is that our mutual structure is the force that shapes not only our investment strategy and our marketing strategy, but our corporate strategy as well. "Strategy follows structure."

Public Stockholders vs. Mutuality

With the staggering advantages the mutual structure has accorded us in *our* field, I find myself vaguely puzzled about why mutuality—the traditional hallmark of the largest companies in the life insurance field—has almost vanished. In 1980, four of the five giant life companies were mutuals; today none are. Now, if de-mutualization enables you to serve your policyholders more efficiently and cost-effectively, I can easily relate to that. And if moving to a traditional corporate structure with public shareholders in fact enhances your capital base and facilitates your ability to make acquisitions by giving you the "currency" to do so, I'll be interested to see who you acquire and how successful the combinations prove to be. (So far, it looks as though mutuals that have converted have been less likely to *acquire* than to be *acquired*. And in my industry, I believe that the acquisition of fund firms by large financial conglomerates have been more likely to *burden* mutual fund shareholders than to *serve* them.)

What is more, publicly-owned insurers face those very same pressures that have caused such problems in Corporate America: Pressures to set earnings targets, followed by pressure to meet them. Public ownership also offers executives and staff the opportunity for rich stock options, though in the recent bubble, only the sharpest executives—those with the intelligence, or the luck, or the cupidity to sell before the bubble burst—realized box-car gains. But I seriously wonder whether the potential advantages of the shift involved in moving from mutual form to stock form might not be vastly outweighed by the disadvantages, particularly the extraordinary change in corporate culture and the potential negative change in public attitudes about life insurance.

Suffice it to say that, whether you are mutual or stock in form, you enjoy at least one *staggering* advantage over your mutual fund rivals

(most of which, of course, are *not* mutual in structure): The investment income you earn for those you insure builds up on a tax-free basis, while no such advantage accrues to our industry. And that's fair enough. But when this inside build-up goes beyond the ordinary course of your regular business and is sold to corporations as a tax-arbitrage play, I wonder whether your industry might not risk jeopardizing one of its largest competitive advantages. It's worth thinking about.

Today's Challenge: Variable Annuities

This brings me to an area where our industries join forces. No longer can it be said that, "life insurance is life insurance and mutual funds are mutual funds, and never the twain shall meet." For we meet in the field of variable annuities. And annuities have become the driving force in your business. A half-century ago, premiums on annuities were one-seventh those on life insurance. Fifteen years ago they were equal. By 2000, annuity considerations of \$300 billion were more than double life premiums of \$130 billion. And it is variable annuities that now dominate your annuity business. Only \$5 billion of your annuity premiums (4% of the total) as the 1990s began, variable annuity premiums of \$137 billion in 1999 actually *exceeded* fixed premiums, only to fall back sharply during 2001-2002 as the stock market bubble burst.

The variable product field is dominated by insurance firms using mutual funds operated by traditional fund firms rather than the insurance companies themselves. Indeed, after TIAA-CREF—the 800-lb. gorilla of the field with \$130 billion of variable annuity assets—the 11 largest providers are major fund complexes. In all, insurance companies manage but 13% of the total. This combination of mutual fund shares with annuity protections makes consummate economic sense *for the providers*. But, alas, the same cannot be said *for the investors*. Average fund expenses come to 0.9%, and average insurance wrap costs come to 1.3%, for a total charge of 2.2%. Given that portfolio turnover and other costs doubtless parallel the 1.2% that I estimated earlier for regular funds, that would bring the total annual expense drag to 3.4%. And surrender charges imposed on policyholders who, for whatever reason, fail to stay the course, can only add to this total drag. Thus, while the enormous tax-deferred inside build-up advantage of variable

annuities is a powerful benefit to investors, many independent observers believe it to be totally overwhelmed by the huge hurdle rate imposed by costs.

What is more, the investment merits of variable annuities, just like those of their regular mutual fund cousins, were heavily exaggerated by the high returns of the stock market before the recent bubble burst. Some 85% of the \$780 billion of variable annuity assets at the end of 2000 was represented by equity funds, often the most aggressive in their class. With the asset value of the average fund now off 50% from their level at the bubble's peak, and the aggressive funds that were the recipient of most of the cash flows down 65%, total assets are down to \$520 billion. Now, variable annuities are contending with the depleting affect of *both* tumbling stock prices *and* heavy costs. (While, say, 3 1/3% per year may not sound all that bad, it consumes nearly 40% of an investment over 15 years.) In addition, death benefits that guarantee the payment of the face of policies are sure to impose an additional burden on the resources of insurance companies, unless and until the market recoups the lost ground.

Like mutual fund managers, variable annuity issuers can only watch and wait and hope that investment returns will improve. But, again like the fund industry, the insurance industry must work to improve the financial terms on which variable annuities are offered to clients. It doesn't appear to be impossible: The two programs with the lowest costs carry all-in *expense* charges averaging 50 basis points, less than one-quarter of the 2.2% average, and neither carry sales loads. Any insurance firm that can challenge them has quite an opportunity before it. What is more, it's hard to imagine that high-cost annuities that garner distribution by aggressive sales promotion techniques such as high surrender charges and purported "bonuses" in which the annuitants are simply given their own money back, however good for marketing, won't come back to haunt this product. Please don't forget that in an increasingly informed investor community, your industry's credibility is a priceless asset.

But it is more than competitive realities that should motivate financial service firms. Enlightened self-interest suggests that our services

increasingly demand public trust. And in these difficult financial markets that trust, like our trust in the stewards of America's corporations, is not only being tested, it is being found wanting. *For both your industry and mine, forewarned is forearmed.*

Back to the Future

Assets of the insurance industry, like those of the mutual fund industry, have been deeply depleted by the failures of corporate America that I have discussed today. And it is not only equity assets that have tumbled in the bear market, but fixed-income assets that have suffered major credit downgrades and even some well-publicized bankruptcies. It is too late for those who have ignored investment quality in either arena (or both) to recoup, but it is incumbent on both of our industries to take a more aggressive approach to enhancing corporate value by practicing sound corporate governance and demanding high credit quality.

I apologize for being the purveyor of a tough message. But it is a realistic one, especially as we look to the future. Looking back, we can revel in the bounty of two decades in which returns on stocks have averaged 11% per year and returns on bonds have averaged 9% per year. Generous financial market returns are especially important to our industries for, holding costs constant, the higher the return, the lower the proportion consumed by our operating, investment, trading, and marketing expenses. So controlling investor and policyholder costs must remain a high priority.

Given the present vastly depleted level of stock prices, together with metrics that suggest we are now in a fair value range, I believe that reasonable expectations suggest future annual stock returns in the 7% to 10% range. If we are lucky enough to hold the annual inflation rate to 2%, future real returns would be in the 5% to 8% range, or roughly "normal," in that the long-term real return on stocks has averaged 6 ½%. For bonds, the current 5% yield would suggest a future return of 3%, in real terms, about equal to the historical norm.

So in a sense it is "back to the future" in the financial markets. *The old*

order hath changeth. If and if we are to maintain the confidence of our clients, we must get our respective houses in order and ready ourselves for the *new order*. It is impossible for me to imagine that each passing day does not come with an increasingly aware public, and we'd best not only give those who have entrusted their financial future futures to us a not only a fair shake, but an honest stake and, an integrity-laden shake. It is only by doing so that we will affirm to our clients that we have learned from the painful experience of our cousins in corporate America that I've described today—experience that has directly affected the \$9 trillion asset base of our combined industries—and readied ourselves for a bright future. The concepts underlying insurance and annuities, and mutual funds too, remain as sound as they have always been. It is up to us to implement them in a manner that puts our clients first.

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