INVESTMENT COMPANY INSTITUTE®

PERSPECTIVE

Vol. 6 / No. 3

July 2000

Perspective *is a series of occasional papers published by the Investment Company Institute, the national association of the American investment company industry.*

John Rea, *executive editor;* Craig Tyle, *executive editor;* Sue Duncan, *managing editor.*

1401 H Street, NW
Suite 1200
Washington, DC 20005

www.ici.org

The 1990s: A Decade of Expansion and Change in the U.S. Mutual Fund Industry

by Brian Reid[1]

INTRODUCTION

Mutual funds grew to be a more important part of the U.S. financial system during the 1990s than they had been the decade before. Assets held in mutual funds rose from slightly less than $1 trillion at the beginning of the decade to just under $7 trillion by the end of the decade.

A near-perfect set of economic conditions set the stage for the expansion of the mutual fund industry. Strong economic and corporate profit growth, low inflation, technological innovation, exceptional stock returns, and relatively low interest rates all favored financial investments, a substantial share of which households and businesses chose to make through mutual funds. In addition, the strong growth of defined contribution retirement plans, with their emphasis on individual investments, provided mutual funds with the opportunity to expand their presence in the private pension system. At the same time, growing concern about retirement security added to the role mutual funds played in accumulating assets for retirement.

Nonetheless, the decade was not without its uncertainties and challenges. Stock and bond markets were highly volatile at times, and foreign emerging markets were rocked periodically by economic and financial crises that created uncertainty about the outlook for the U.S. economy and financial markets. Such developments tested the mettle of all investors, including fund shareholders.

This issue of *Perspective* examines major developments in the U.S. mutual fund industry during the 1990s. The article focuses on those factors behind the growth in mutual fund assets. With households owning the majority of mutual funds, the examination of the growth in fund assets

TABLE OF CONTENTS

Summary of Major Developments 2
Growth in Mutual Fund Assets 3
Mutual Funds in the Retirement Market 9
Changes in the Distribution of Long-term Mutual Funds 11
Expansion of the Number and Types of Mutual Funds 13
Asset Concentration 15
Changes in the Cost of Purchasing Mutual Funds . . 17
Shareholder Response to Stock Market Volatility . . . 19
Conclusion 20

[1] Brian Reid is Assistant Vice President and Director of Industry and Financial Analysis at the Investment Company Institute. Amanda Kimball, Travis Lee, Kimberlee Millar, and Janet Thompson-Conley provided research support.

INVESTMENT COMPANY INSTITUTE®

necessarily concentrates on household demand for mutual funds. The article also considers the response of mutual fund companies to the strong demand for mutual funds, including changes in the distribution system and industry structure and the expansion of the types of funds offered. These and other competitive pressures contributed to the decline in the cost of purchasing mutual funds. Finally, the article examines the reaction of fund shareholders to market volatility and economic uncertainty, in light of the concerns expressed by some that fund shareholders might withdraw a large volume of assets during market setbacks.

SUMMARY OF MAJOR DEVELOPMENTS

Asset Growth and the Demand for Mutual Funds

- Mutual fund assets grew at a 21.4 percent annual rate during the 1990s. More than half the growth came from fund performance, and 40 percent from net new investments with the remaining growth attributable to new funds. Net new investments in the 1990s were more than 5 times those in the 1980s, attesting to the strength of the demand for mutual funds.
- The increased demand for mutual funds was part of a broader pickup in household demand for financial assets in the 1990s, buoyed by rising stock prices, relatively low and stable interest rates, and subdued inflation. In this environment, households chose to invest a greater share of their financial assets indirectly through mutual funds rather than through direct holdings.
- Other factors contributing to the growth in mutual fund assets included the expansion of 401(k) plans and other retirement accounts, asset diversification into foreign securities, a declining purchase cost of mutual funds, and yield advantages of money funds over other short-term instruments.

Changes in the Structure of the Mutual Fund Industry

- The retirement market increased in importance as a source of assets in the mutual fund industry during the 1990s. Assets from defined contribution plans and individual retirement accounts (IRAs) rose from less than one-fifth of all fund assets in 1990 to more than a third in 1999. The increased share reflected the growth and expansion of defined contribution retirement plans and the advantages and services mutual funds offered in these plans. Mutual funds also benefited from defined contribution plan

FIGURE 1

Net New Cash Flow and Assets of Mutual Funds,* 1990–1999
(billions of dollars)

	Equity Funds		Bond Funds		Hybrid Funds		Money Market Funds		Total Funds	
	Net Flow	Assets	Net Flow	Assets	Net Flow	Assets	Net Flow	Assets	Net Flow	Assets
1990	13	239	7	291	1	36	23	498	44	1,065
1991	40	405	59	394	7	52	5	542	112	1,393
1992	79	514	71	504	22	78	-16	546	155	1,643
1993	127	741	71	619	44	145	-14	565	228	2,070
1994	115	853	-62	527	23	164	9	611	84	2,155
1995	124	1,249	-6	599	4	211	89	753	212	2,811
1996	217	1,726	3	645	12	253	89	902	321	3,526
1997	227	2,368	28	724	16	317	102	1,059	374	4,468
1998	157	2,978	75	831	10	365	235	1,352	477	5,525
1999	188	4,042	-6	808	-12	383	194	1,613	363	6,846
Total	1,287		239		128		717		2,371	

**Net new cash flow is for calendar year. Assets are for yearend.*

Note: Components may not sum to totals due to rounding.

Source: Investment Company Institute

rollovers into IRAs and a shift in investor preference toward holding mutual funds in their IRAs.

- In conjunction with the increased demand for mutual funds, fund companies and fund distributors developed and expanded sales channels in the 1990s beyond traditional direct sales to investors and sales through brokers. Nontraditional sales channels included mutual fund supermarkets, fee-based financial advisors, mutual fund wrap programs, 401(k) plans, banks, and variable annuities. As the decade ended, fund complexes' use of multiple distribution channels resulted in a blurring of the distinction between direct and sales-force funds that had characterized funds at the beginning of the decade.
- Mutual fund companies increased the number and variety of mutual fund offerings to accommodate the increase in demand for mutual funds in the 1990s. The number of funds increased 168 percent over the decade. New offerings included specialty, sector, and international funds as well as funds of funds. In addition, index funds achieved prominence in the second half of the decade. Finally, many funds introduced or added share classes that, in many instances, offered investors alternative means of compensating sales professionals for advice and assistance.
- The share of total industry assets held by the largest fund complexes was relatively unchanged during the 1990s, despite a large number of mergers and acquisitions and extraordinary increases in assets of some complexes. The stability of asset concentration ratios is attributable to several factors. Mergers and acquisitions rarely combined two large complexes. In addition, a significant number of new complexes entered the industry during the decade, collectively garnering an appreciable level of assets. Finally, the makeup of the largest complexes changed over the decade, with the greatest gains in asset share being in complexes with disproportionate concentrations of domestic equity funds.
- The cost of purchasing mutual funds declined significantly during the 1990s, in spite of the strong demand for mutual fund services. The fall in cost reflected reductions in sales loads, relative shifts by investors to lower-cost funds, and economies of scale.

Stock Market Volatility and Shareholder Behavior

- The reaction of mutual fund shareholders to volatility in stock prices during the 1990s was marked by restraint. Shareholders exhibited no tendency toward mass redemptions.
- U.S. stock markets experienced several sharp sell-offs, starting with the market downturn in 1990 during the decade's only recession and including other severe drops in 1994, 1997, and 1998. During these periods, domestic equity funds experienced net outflows or net redemptions that were very small relative to assets and of short duration. Net inflows typically resumed with recoveries in stock prices.
- Financial and economic crises in emerging market economies in 1994, 1997, and 1998 likewise elicited a muted response from owners of international and emerging market mutual funds.
- This pattern of net flows is similar to the reaction of mutual fund owners during stock market sell-offs and breaks of earlier decades, pointing to a consistency in shareholder behavior that was not altered by the institutional changes and the expansion of fund ownership during the 1990s.

GROWTH IN MUTUAL FUND ASSETS

Assets of mutual funds grew at an annual rate of 21.4 percent over the 1990s. This growth brought fund assets to $6.8 trillion at the end of the decade (Figure 1), making mutual funds the largest type of financial institution when measured by assets under management. Commercial banks were the second largest, with $6.0 trillion in assets on their balance sheets at the end of 1999.[2]

Both fund performance and new investments contributed to the growth in assets. Fund performance, representing unrealized asset appreciation, reinvested capital gain distributions, and reinvested dividends, accounted for more than half of the growth in fund assets.[3] Net new cash flow,

[2] *Flow of Funds Accounts of the United States*, June 9, 2000, Board of Governors of the Federal Reserve System, Washington, DC.

[3] The broad advance of U.S. and international stock markets during the 1990s boosted equity fund performance, which alone accounted for three-fourths of the performance-related growth of fund assets. The remaining performance-related increase came primarily from reinvested dividend distributions in bond, hybrid, and money funds.

consisting of new sales of shares less redemptions plus net exchanges,[4] accounted for slightly more than 40 percent of the asset growth.[5] Over the entire decade, net new cash cumulated to $2.4 trillion, a figure that was almost 2½ times the level of fund assets at the beginning of the decade and five times the net flow in the 1980s. This large influx of new investments by fund investors is a clear indication of the strength of investor demand for mutual funds during the 1990s.[6]

This section examines factors that contributed to the strong demand for mutual funds in the 1990s. Because households own approximately 90 percent of all mutual fund assets, the discussion necessarily focuses upon this sector. The decade began with a substantial base of households investing in mutual funds,[7] and this base expanded further during the 1990s, rising from roughly one-quarter of all U.S. households in 1989 to nearly one-half in 1999. At the end of the decade, 48 million households, representing 83 million individual investors, owned mutual funds. In addition to the household sector, business demand for mutual funds rose, with many businesses using money market funds as a liquid asset.

The Economic Environment and Household Demand for Financial Assets

A strong U.S. economy provided the underpinning for the growth in household demand for financial assets generally and for mutual funds specifically. A record-long economic expansion that stretched from 1991 through the end of the decade produced more than 20 million new jobs[8] and pushed the unemployment rate down to near 30-year lows. Robust growth in the economy did not spur inflation, which fell to its lowest level since the 1960s.[9] The moderate inflation rate helped to keep interest rates in check and, along with a doubling of corporate profits, contributed to the rise in equity prices. By the end of the decade, household net worth had more than doubled to $42 trillion,[10] boosted in large part by the long-running bull market in equities.

Attracted by the relatively high returns on corporate equity and other financial assets, households' asset allocation shifted away from real estate and other tangible assets to financial assets.[11] At the beginning of the decade, nearly 40 percent of household assets were invested in real estate and other tangible assets, but by the decade's end that share had fallen to less than 30 percent. In contrast, discretionary financial assets[12] rose to 44 percent of household assets, up from 34 percent in 1989.

The relative shift toward discretionary financial assets primarily occurred in corporate equities. Some of the increased stock holdings came from an increase in allocation among existing equity owners. In addition, new investors were attracted

[4] New sales exclude reinvested capital gain distributions and reinvested dividends. Net exchanges are sales of shares coming from exchanges from other funds within the same fund family less redemptions of shares through exchanges to other funds in the same fund family. Although individual funds can have positive or negative net exchanges, net exchanges sum to zero for fund complexes as well as for the industry as a whole.

[5] The remaining increase, amounting to roughly 6 percent of the total growth, represented assets of newly reporting funds to the Investment Company Institute. These assets include those from new funds and from existing funds that began reporting to the Investment Company Institute.

[6] The increased demand was also reflected in the higher levels of mutual fund assets. Higher asset levels, regardless of whether they are attributable to net new flows or appreciation, reflect investors' increased willingness to hold mutual fund assets.

[7] Indeed, household demand for mutual funds rose more rapidly during the 1980s than during the 1990s. The number of households owning mutual funds rose more than fourfold from 5 million in 1980 to 23 million in 1989. (See *Profiles of Mutual Fund Shareholders*, Fall 1992, Investment Company Institute, Washington, DC for the number of households owning mutual funds by year during the 1980s.) Furthermore, net flows to mutual funds rose from $20 billion during the 1970s to $470 billion in the 1980s.

[8] Measured as the change in total employees on nonagricultural payrolls. *Economic Report of the President,* February 2000, p. 358.

[9] Measured as the core rate of inflation. *Economic Report of the President*, February 2000, p. 277.

[10] *Flow of Funds Accounts of the United States,* June 9, 2000.

[11] The average annual return on stocks of large corporations, as measured by the S&P 500 total return index, was 18 percent during the 1990s, while the median sales price of existing single-family housing rose at a 4 percent annual rate. Equity returns were largely attributable to rising stock prices. Among the factors contributing to the rise was the strength in after-tax corporate profits, which rose at a 9.6 percent annual rate. Furthermore, U.S. corporations reduced the supply of equity through share repurchases, mergers, and acquisitions, on balance retiring $629 billion of equity during the 1990s. A third factor contributing to the rise in equity prices was the increased demand for equity, in part boosted by lower interest rates in the 1990s than in the 1980s.

[12] Discretionary financial assets are those assets over which households have direct control. These assets are composed of assets in defined contribution pension plans, personal bank trusts, and direct holdings of deposits, credit market instruments, corporate equities, and mutual fund shares.

to equity investments. Nearly one-half of all U.S. households owned stock either directly or indirectly in 1999, up from just under one-third 10 years earlier.[13]

Households' Shift to Mutual Funds

As households shifted into financial assets, they increased their preference for indirect ownership through mutual funds over direct ownership of stocks and bonds. By the end of 1999, mutual funds accounted for 28 percent of household discretionary financial assets, up from 12 percent at the end of 1989.[14]

The rising share of household financial assets held through mutual funds was evident for a variety of assets. The share of household equity assets held in mutual funds reached 30 percent in 1999, a threefold increase in 10 years (Figure 2). Moreover, 85 percent of the equity-owning households held a portion of their stocks through mutual funds in 1999, up from about 50 percent in 1992.[15]

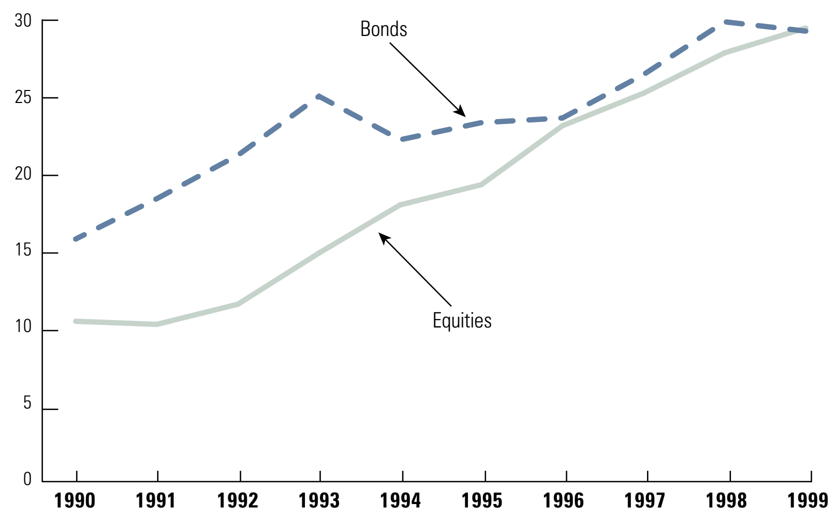
Households also held a greater share of their bonds through mutual funds by the end of the decade. Most of the share increase occurred during the first part of the decade when bond and hybrid funds experienced strong inflows as falling interest rates lifted returns on bond and hybrid funds. During the second half of the decade, net flows to bond and hybrid funds were notably weaker and the shift toward indirect ownership of bonds slowed. Finally, households increasingly relied on money market funds for holding short-term assets after 1994, as yields on money market funds, which closely track short-term interest rates, rose relative to those on bank deposits.

FIGURE 2

Share of Household and Business Assets Held Through Mutual Funds, 1990–1999

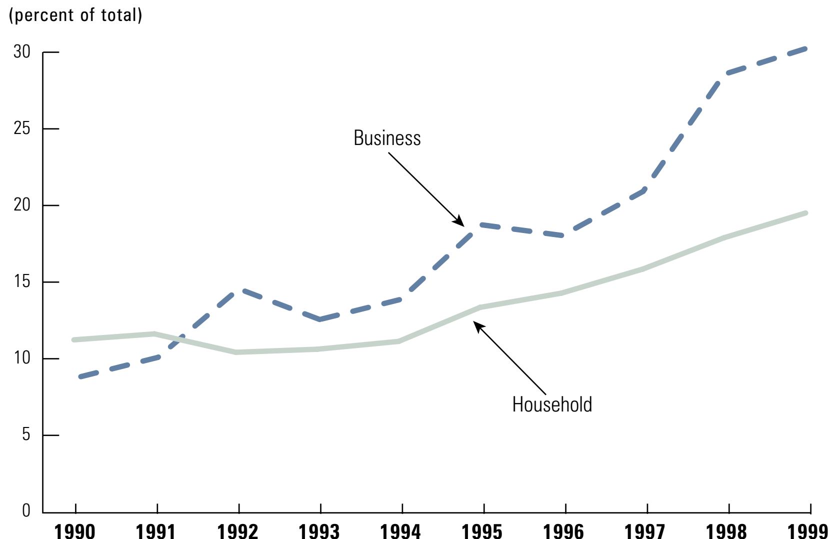
Household Bond and Equity Assets Held Through Long-term Mutual Funds

(percent of total)



Household and Business Short-term Assets* Held Through Money Market Mutual Funds

(percent of total)



**Household short-term assets consist of foreign deposits, checkable deposits, currency, time and savings deposits and money market funds. Business short-term assets consist of the same financial instruments as well as repurchase agreements and commercial paper.*

Sources: Federal Reserve Board and Investment Company Institute

---

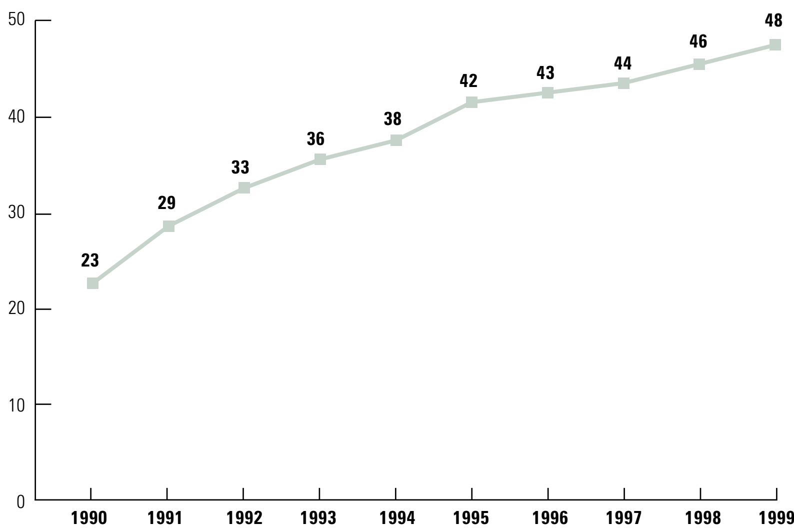
[13] Equity ownership in 1989 is from Arthur B. Kennickell, Martha Starr-McCluer, and Brian J. Surette, "Recent Changes in U.S. Family Finances: Results from the 1998 Survey of Consumer Finances," *Federal Reserve Bulletin,* vol. 86 (January 2000), p. 15. Equity ownership in 1999 is from *Equity Ownership in America,* Investment Company Institute and the Securities Industry Association, Fall 1999, p. 5, available through ICI's website at www.ici.org/pdf/rpt_equity_owners.pdf. Kennickell et. al. found that 49 percent of U.S. households owned equity in 1998.

[14] Household holdings of mutual funds consist of holdings through non-retirement retail accounts, employer-sponsored pension plans, individual retirement accounts, trusts, and variable annuities.

[15] The 1999 ownership rate is from *Equity Ownership in America,* Fall 1999, p. 5. The 1992 ownership rate is the ratio of the 19 percent of the population that owned equity mutual funds outside of employer-sponsored defined contribution plans (*Profiles of Mutual Fund Shareholders,* Fall 1992) to 37 percent of the households owning equity in 1992 (Kennickell et. al., January 2000).

FIGURE 3

Share of Household Mutual Fund Assets in Tax-deferred Accounts, 1990–1999
(percent)



Source: Investment Company Institute

Factors Contributing to Increased Household Demand for Mutual Funds

Mutual funds offer investors several advantages over direct investments in securities, such as asset diversification, professional money management, asset liquidity, investment information and advice, and account reporting.[16] Moreover, the cost of these services is generally less than that which would be incurred by most investors through direct investments.[17] These advantages undoubtedly contributed to the relative shift by households to mutual funds as they expanded their holdings of financial assets generally. In addition, other factors and developments contributed importantly to the increased share of mutual funds in household financial assets.

One of the most important factors was the growth of tax-deferred investing for retirement through defined contribution pension plans,[18] IRAs, and variable annuities held outside of employer-sponsored retirement plans. Although these tax-deferred vehicles were available before the 1990s, they became increasingly popular during the decade as more employers offered defined contribution plans and baby boomers began to prepare for retirement. By the end of the decade, households held 20 percent of their discretionary financial assets in tax-deferred products, up from 14 percent at yearend 1989. Moreover, tax-deferred accounts became the primary means of owning mutual funds for many households. In 1999, nearly $3 trillion or 48 percent of household mutual fund assets (Figure 3) were held in these accounts, up from $234 billion in 1990.

Another reason that household demand for mutual funds rose in the 1990s is that some individuals increasingly sought to diversify their financial assets by looking to overseas investments. Net purchases of foreign equities by U.S. residents averaged $52 billion per year during the decade, up from $3 billion per year in the 1980s.[19] Mutual funds are one of the primary vehicles through which many investors purchase foreign stocks largely because of the difficulty and expense of making direct purchases of stocks not listed on U.S. exchanges. Annual net flows into world equity funds[20] averaged $22 billion during the 1990s, representing about one-sixth of net flow to all equity funds.

[16] Roger Edelen, “Investor Flows and the Assessed Performance of Open-end Mutual Funds,” *Journal of Financial Economics,* Vol. 53 (1999), pp. 429-466 finds that the indirect cost of providing liquidity to investors is significant. As the total cost to the shareholder declines, so does the cost of liquidity, encouraging investors to shift out of direct equity and bond holdings to mutual funds to gain this liquidity.

[17] See Erik R. Sirri and Peter Tufano, “Competition and Change in the Mutual Fund Industry,” in Samuel Hayes III, ed. *Financial Services: Perspectives and Challenges* (HBS Press, Boston, Mass.), 1993 for a summary of the services provided by mutual funds and a comparison of costs of alternative investment vehicles for individuals with modest amounts of wealth.

[18] Employer-sponsored defined contribution plans include 401(k), 403(b), and 457 plans; Keoghs; and profit-sharing, stock bonus, and money purchase plans without 401(k) features.

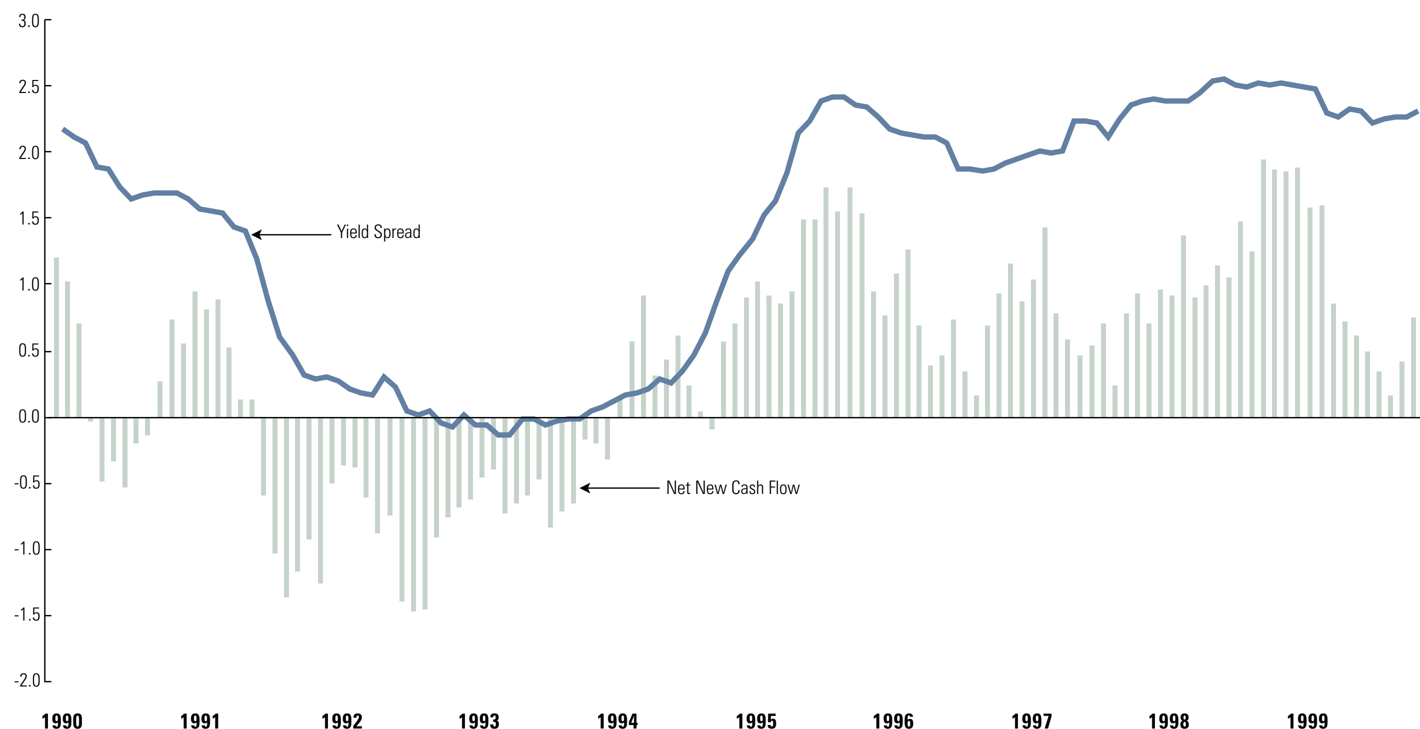
[19] Net purchases of foreign equities by households is not available. Instead, the increase in net purchases by U.S. residents, which also includes purchases by businesses and other U.S.-based entities including mutual funds, is used as a proxy for the change in household demand. Data on purchases of foreign equity by U.S. residents is obtained from the *Flow of Funds Accounts of the United States,* June 9, 2000.

[20] World equity funds consist of international, global, regional, and emerging market funds. Global equity funds may invest in domestic as well as foreign securities.

FIGURE 4

Yield Spread Between Retail Money Market Funds and Bank Deposits; Net New Cash Flow to Retail Money Market Funds, Monthly 1990–1999

(percent)



Note: Net new cash flow is a percentage of taxable retail money market fund assets and is shown as a six-month moving average. The interest rate spread is the difference between the taxable money market fund yield and the average interest rate on savings deposits; the series is plotted with a six-month lag.

Sources: iMoneyNet, Inc., Federal Reserve Board, and Investment Company Institute

The general upward trend in the share of financial assets held by households through mutual funds also was aided by the declining purchase cost of mutual fund shares.[21] As total cost to the shareholder declines, so does the cost of purchasing liquidity, asset diversification, and other services provided by mutual funds. For example, purchase costs declined 25 percent for equity funds between 1990 and 1998, the latest year for which data are available. Consequently, compared with 1990, investors purchasing equity funds in 1998 paid, on average, $46.00 less for mutual fund services per $10,000 invested.[22]

Finally, the greater reliance on mutual funds by households reflected the persistently wide yield gap between money market funds and savings deposits during the last half of the 1990s (Figure 4). After 1994, retail money market fund investors, on average, earned about 230 basis points more than on the savings deposits. This wide yield spread encouraged retail investors to shift a larger portion of their short-term assets into money funds. By the end of the decade, 19 percent of households' short-term assets[23] were held in money funds, up from 11 percent in 1990.

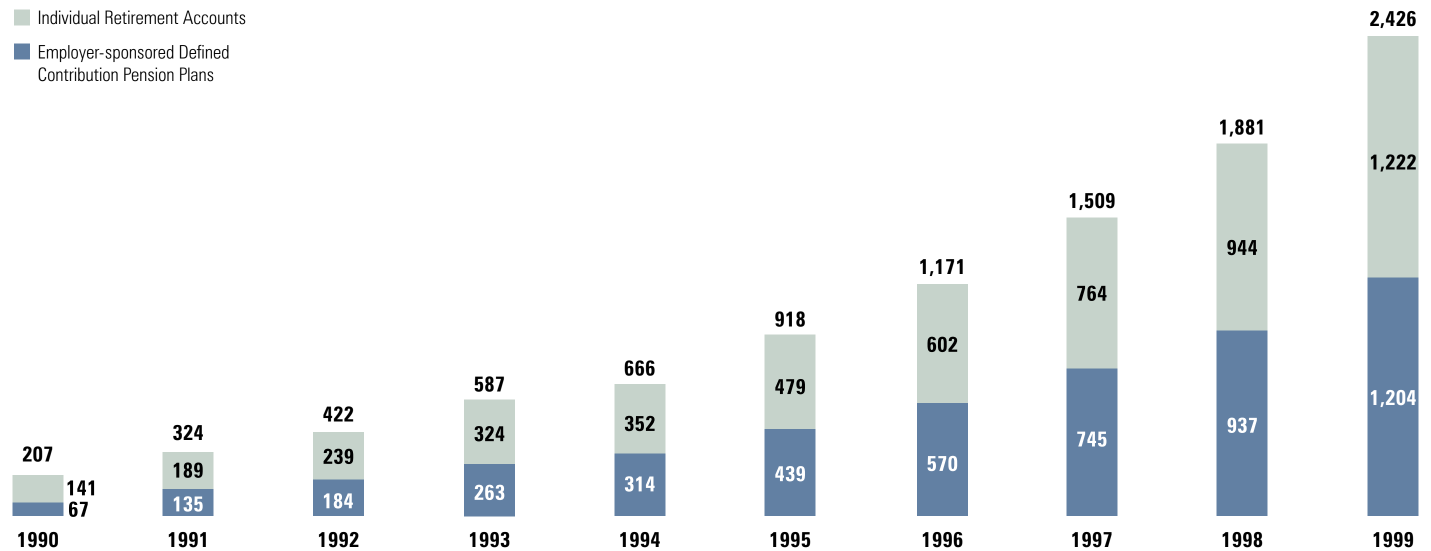
[21] The trends in total shareholder costs are discussed in more detail below.

[22] Several studies have discussed investors' substitution of long-term funds for deposits and other short-term assets. See Sean Collins and Cheryl Edwards, "Redefining M2 to Include Bond and Equity Mutual Funds," Federal Reserve Bank of St. Louis *Review* (November/December 1994); John V. Duca, "Should Bond Funds be Included in M2?" *Journal of Banking and Finance* 19 (April 1995), 131-52 (a); Peter Ireland, "Endogenous Financial Innovation and the Demand for Money," *Journal of Money, Credit, and Banking* 27 (February 1995), 107-23. John V. Duca, "Financial Technology Shocks and the Case of the Missing M2," *Journal of Money, Credit, and Banking,* forthcoming, provides evidence that some of the substitution into bond funds is attributable to the declining costs of purchasing and owning these funds.

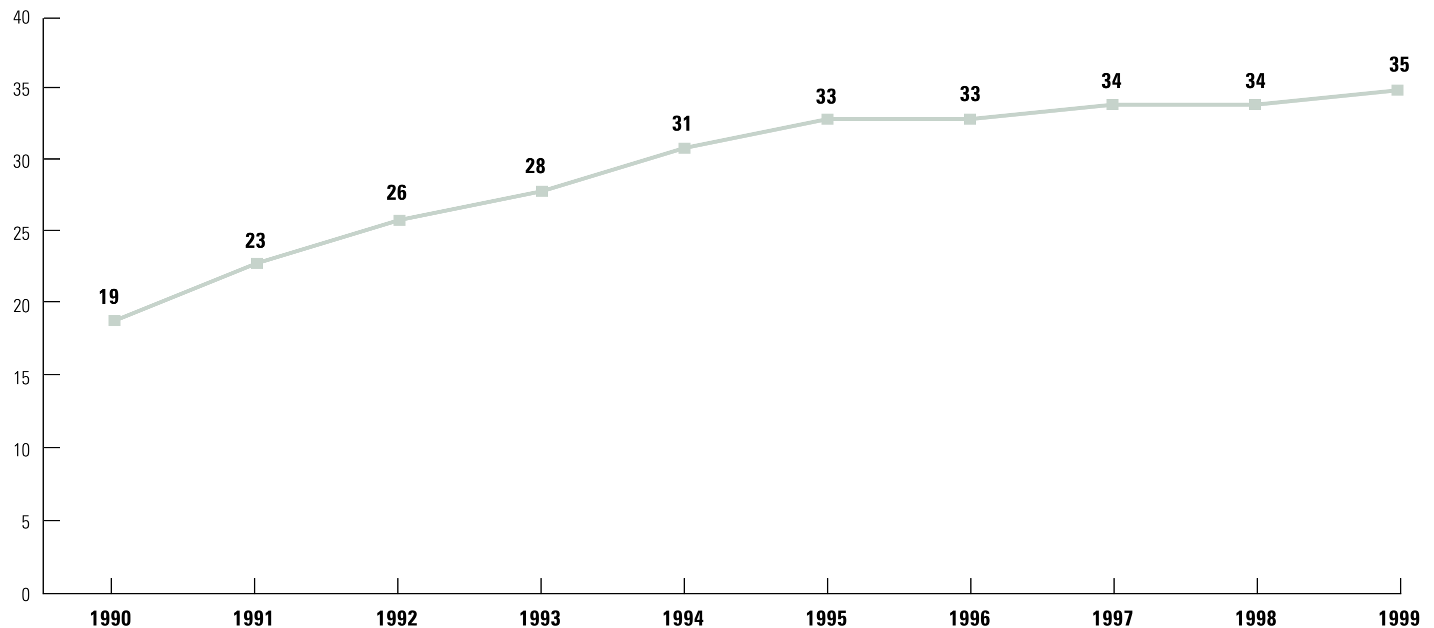
[23] Short-term household assets are foreign deposits, checkable deposits, currency, time and savings deposits, and money market funds.

FIGURE 5

Mutual Fund Assets in Employer-sponsored Defined Contribution Pension Plans and Individual Retirement Accounts,[1,2] 1990–1999
(billions of dollars)



Mutual Fund Retirement Assets[3] as a Share of Total Mutual Fund Assets, 1990–1999
(percent)



[1]Components may not sum to totals due to rounding.

[2]Assets are for yearend.

[3]Mutual fund retirement assets consist of individual retirement accounts and employer-sponsored defined contribution pension plans. Mutual fund retirement assets exclude defined benefit plans' mutual fund holdings which amount to about one-half of one percent of mutual fund assets.

Sources: Investment Company Institute, Federal Reserve Board, American Council of Life Insurance, and Internal Revenue Service

Some of this shift occurred because more households owned money market mutual funds. Between 1994 and 1999, the percentage of U.S. households owning money funds (including holdings through retirement accounts) rose from 10 percent of U.S. households to 21 percent.[24]

Business Demand for Money Market Mutual Funds

During the 1990s, businesses increasingly turned to money market funds for cash management. Money fund assets held by nonfinancial businesses[25] grew at a 28 percent annual rate from $16 billion at the beginning of 1990 to almost $200 billion in 1999.[26] As a result of this growth, money funds' share of short-term business assets rose from 9 percent in 1990 to 30 percent in 1999.[27] Much of the increase in business money market fund holdings occurred during the second half of the decade, when the sum of net new cash flows and reinvested dividends averaged $18 billion annually.

The growth in business holdings of mutual funds is partly attributable to corporations outsourcing a larger portion of their cash management to mutual funds rather than holding liquid securities directly. By using money funds, these corporations benefit from the scale economies provided by the mutual funds that they would be unable to achieve through internal management of their liquid assets. The shift also reflected the increased use of money funds in corporate bank sweep accounts. Through these accounts, corporations are able to move excess cash balances into other liquid assets overnight.[28] Assets in sweep accounts rose sharply during the last half of the decade, from about $50 billion in 1994 to more than $200 billion in 1999.[29] About one-third of these assets were invested in mutual funds in 1999.[30]

MUTUAL FUNDS IN THE RETIREMENT MARKET

Employer-sponsored pension plans and IRAs became more significant sources of assets for mutual funds in the 1990s, coinciding with the overall growth of U.S. retirement assets. In 1990, mutual fund assets held in these accounts were about $200 billion, amounting to 19 percent of all fund assets (Figure 5). At the end of the decade, retirement assets in mutual funds stood at $2.4 trillion, roughly a twelve-fold increase. As a result, over one of every three dollars in mutual funds were held in retirement plans and accounts in 1999. During this same period, total U.S. retirement assets rose from $4 trillion to nearly $13 trillion, and mutual funds' share of this market increased from 5 percent to 19 percent.[31]

At the beginning of the decade, most of the retirement assets in mutual funds were held in IRAs, which had accumulated during the first half of the 1980s following the passage of the Economic Recovery Tax Act of 1981. That legislation extended the availability of IRAs to all workers. Restrictions on the deductibility of contributions in the Tax Reform Act of 1986 sharply curtailed new contributions to IRAs, including those investing in mutual funds. Even so, IRA balances were significant in 1990, accounting for about 13 percent of all mutual fund assets. In contrast, balances in employer-sponsored plans were relatively insignificant, representing only 6 percent of mutual fund assets.

During the 1990s, however, employer-sponsored defined contribution plans became an important source of net new flow to mutual funds, either directly from contributions from employer-sponsored pension plans or

[24] See "Mutual Fund Ownership Among U.S. Households," *Fundamentals,* Investment Company Institute, September 1994 and "U.S. Household Ownership of Mutual Funds in 1999," *Fundamentals*, Investment Company Institute, September 1999, for more information on household ownership of mutual funds in 1994 and 1999, respectively. This and other issues of *Fundamentals* are available at www.ici.org/ici_info/publications.html.

[25] Nonfinancial businesses are defined as nonfarm, nonfinancial, corporate businesses.

[26] *Flow of Funds Accounts of the United States,* June 9, 2000.

[27] Short-term business assets are defined as foreign deposits, checkable deposits, currency, time and savings deposits, money market fund shares, repurchase agreements, and commercial paper.

[28] For a more detailed discussion of the use of mutual funds in sweep accounts, see "Money Market Funds," *Strategic Insight Overview,* December 1999, New York, NY.

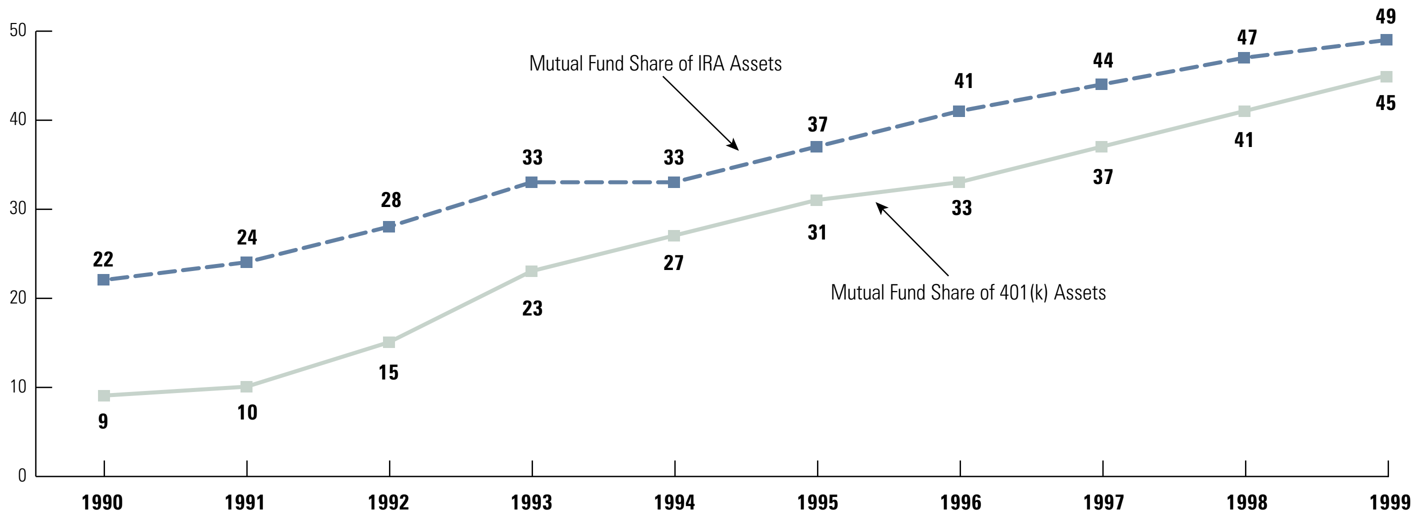
[29] *2000 Commercial Banking Sweep Account Survey: Executive Summary,* Treasury Strategies, Inc., Chicago, IL, p. 2.

[30] *2000 Commercial Banking Sweep Account Survey: Executive Summary,* p. 3.

[31] See "Mutual Funds and the Retirement Market," *Fundamentals,* Vol. 9, No. 2, May 2000, Investment Company Institute, for a detailed discussion of retirement account holdings of mutual funds.

FIGURE 6

Mutual Fund Share of 401(k) and IRA Assets, 1990–1999
(percent of total market)



Sources: Investment Company Institute, Federal Reserve Board, and Department of Labor

indirectly from rollovers to IRAs. The increased availability of and participation in defined contribution plans during the 1980s and 1990s created a large potential base of mutual fund investors.[32] Because these plans place the responsibility for managing retirement savings with the individual investor, plan sponsors typically offer pooled investment products issued by financial intermediaries such as mutual funds, life insurance companies, and banks to assist employees. Plan sponsors increasingly turned to mutual funds because they provided services such as daily pricing, exchange features, and telephonic access to account information that were not typically offered through other pooled investment products. In addition, because mutual funds are diversified under securities and tax law, they satisfied regulatory criteria established for participant-directed plans.[33] Finally, mutual funds had the advantage of carrying widely recognized brand names, which appealed to participants in these plans.

The increased availability of mutual funds in defined contribution plans along with the rise in stock prices caused mutual fund assets in employer-sponsored defined contribution pension plans to rise rapidly during the 1990s. By 1999, more than $1.2 trillion of mutual fund assets were held through employer-sponsored defined contribution pension plans, up from $67 billion in 1990.[34] Two-thirds, or $777 billion, of all mutual fund defined contribution pension plan assets were held in 401(k) plans at the end of 1999. Mutual funds' share of the entire 401(k) market reached 45 percent in 1999, up from 9 percent in 1990 (Figure 6). Mutual fund assets held outside 401(k) plans at the end of the decade included $281 billion in 403(b) plans and $30 billion in 457 plans.

Mutual fund assets in IRAs continued to grow rapidly during the 1990s, totaling $1.2 trillion by

[32] The number of participants in employer-sponsored defined contribution plans rose from 20 million in 1980 to 51 million in 1996, the latest year that data are available. The number of participants rose primarily because many medium- and large-sized employers began to offer such plans during the 1980s and early 1990s. Between 1980 and 1996 the number of plans with 100 or more participants rose from 13,350 to 47,150.

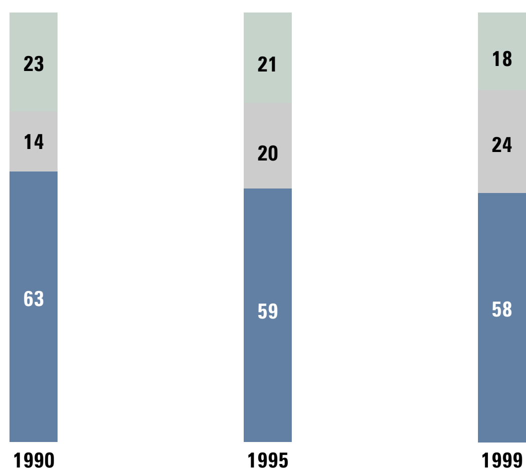
In comparison, the number of participants in employer-sponsored defined benefit plans rose from 38 million in 1980 to 41 million in 1996, and the number of such plans with 100 or more participants fell from 24,505 to 16,553. Source: *Private Pension Plan Bulletin, Abstract of 1996, Form 5500, Annual Reports,* Number 9, Winter 1999-2000, U.S. Department of Labor, Pension and Welfare Benefits Administration, Washington, DC.

[33] The diversification standards for investment options provided in private defined contribution plans were promulgated by the Department of Labor in 1992. See 29 C.F.R. Sec. 2550.404c-1.

[34] About three-fifths of the growth resulted from asset appreciation.

FIGURE 7

Share of New Sales of Long-term Funds by Distribution Channel, Selected Years
(percent)



Source: Investment Company Institute

yearend 1999, up from $141 billion in 1990. About three-fifths of the growth was attributable to asset appreciation. In addition, mutual funds received an estimated $413 billion of net new cash from IRAs.[35] Some of these flows came on the coattails of employer-sponsored pension plans, as mutual funds captured some of the assets that employees rolled from these plans into IRAs when changing jobs.[36]

In addition, inflows from employer-sponsored IRAs became a source of growth. Most of the asset growth was in Simplified Employee Pension (SEP) and salary reduction (SAR) SEP-IRAs, which rose from $8 billion in 1992 to $70 billion at yearend 1999. Mutual fund assets in savings incentive match plans for employees (SIMPLE) IRAs, which were first available in 1997, held more than $6 billion in mutual fund assets by decade-end.[37]

As with 401(k) plans, mutual funds became a core asset in many IRAs, rising from 25 percent of IRA assets in 1990 to 50 percent in 1999. The rising share was partly attributable to the rising stock market, which caused IRA assets invested in stocks, including through equity mutual funds, to appreciate more rapidly than assets invested in fixed-rate products such as deposits.

CHANGES IN THE DISTRIBUTION OF LONG-TERM MUTUAL FUNDS

In the environment of rising demand for mutual funds in the 1990s, fund companies and distribution companies developed new outlets for selling mutual funds and expanded traditional sales channels. The changes that occurred are evident in the rising share of sales through third parties and intermediaries. In particular, the estimated share of new sales[38] of equity, bond, and hybrid funds made directly to investors was 18 percent in 1999, down from 23 percent in 1990 (Figure 7). Over the same period, new sales of long-term funds made through a third party or intermediary rose from 77 percent to 82 percent.

In addition to the rising share of third-party sales, significant changes occurred beneath the surface. In particular, many funds that primarily marketed directly to investors turned increasingly to third parties and intermediaries for distribution. For example, in 1990, an estimated 62 percent of new sales of direct-market funds came through traditional direct sales; by 1999, this share had fallen to 43 percent (Figure 8). The nontraditional, third-party distribution channels used by direct-market funds included employer-sponsored pension plans, mutual fund supermarkets, fee-based advisors, mutual fund wrap account programs, and bank trust departments.[39]

[35] Roth IRAs, which were created by the Taxpayer Relief Act of 1997, provided a new vehicle for tax-deferred investing. By yearend 1999, $51 billion were invested in mutual funds through Roth accounts. An ad hoc survey of ICI members indicated that the bulk of these assets came from conversions of traditional IRA accounts.

[36] There are no estimates of the share of rollovers and contributions invested in mutual funds. However, *net* inflows to mutual funds from IRAs accounted for 63 percent of total *gross* rollovers and contributions in 1993 and 40 percent in 1996 and 1997. Rollover and contribution data are provided by the Statistics of Income Division of the Internal Revenue Service.

[37] The Institute surveyed certain of its members representing 65 percent of SIMPLE IRA assets invested in mutual funds at yearend 1999. The ad hoc survey indicated that about 810,800 workers were participating in SIMPLE IRA plans at yearend 1999. Eighty-seven percent of the plans had 10 or fewer participants, indicating the popularity of these plans among small employers.

[38] New sales exclude sales from reinvested distributions and exchanges from other funds within a mutual fund complex. New sales of variable annuities are excluded.

[39] Nontraditional new sales for direct market funds were estimated as follows. All new sales to institutional funds or share classes at traditionally direct-market complexes were treated as nontraditional. For all other funds and share classes, the share of assets in employer-sponsored retirement accounts and broker street-name and omnibus accounts were assumed to be the share of new sales to these nontraditional accounts.

Like direct-market funds, funds that were traditionally sold through a sales force of stock brokers moved increasingly to nontraditional sources of sales such as employer-sponsored pension plans, banks, and life insurance companies in the 1990s. Only 41 percent of new sales of sales-force funds came through such nontraditional sources in 1990, whereas 59 percent originated with the traditional sources of stock brokers and other sales professionals. By 1999, the nontraditional share had risen to 65 percent.[40]

Pension Plans

Employer-sponsored defined contribution pension plans became a core channel of distribution for many mutual fund complexes during the 1990s. In 1999, more than three-fifths of all fund owners held fund shares in defined contribution plans, and half of all fund owners considered their employers to be their principal source of funds.[41] The share of net flows to long-term funds coming from defined contribution plans rose over the decade from 10 percent in 1990–91 to 26 percent in 1998–99.

Other Nontraditional Channels

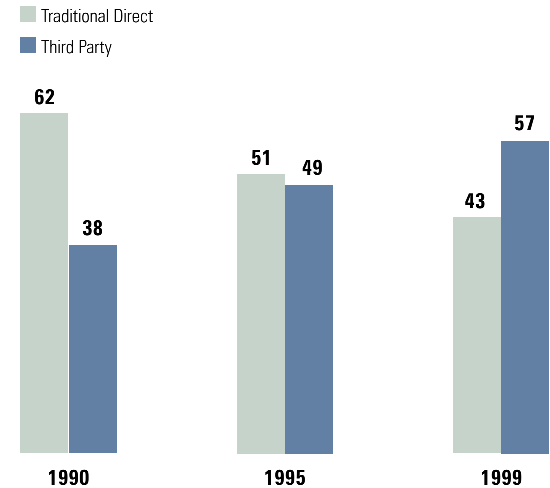
The introduction of the first mutual fund supermarket by a discount broker in 1992 marked the beginning of a significant change in the distribution of direct-market funds. Other discount brokers and some fund companies themselves have since organized fund supermarkets.[42] Under these programs, the organizer of the supermarket offers no-load funds from a number of different mutual fund complexes. These supermarkets allow investors to purchase funds from participating complexes without investors having to contact each fund complex. The organizer of the supermarket provides the investor with consolidated recordkeeping and a single account statement. Assets in mutual fund supermarkets reached an estimated $500 billion in 1999.[43]

Mutual fund wrap programs—another distribution channel—also gained in popularity. These programs provide investors with advice and assistance for an asset-based fee rather than the traditional front-end load. Traditional direct market funds as well as sales force funds are marketed through this channel. Mutual fund assets in wrap programs totaled an estimated $94 billion in late 1999.[44]

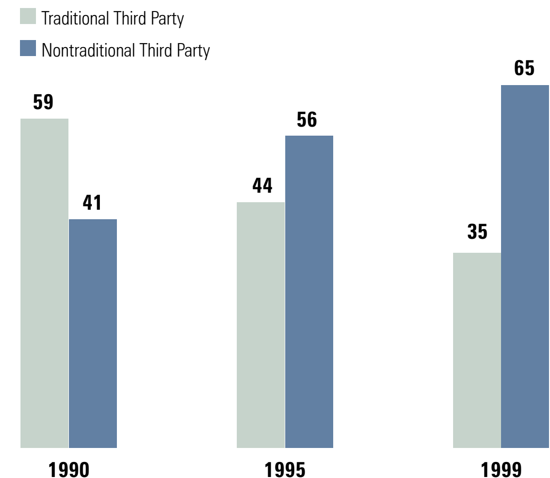
FIGURE 8

Share of New Sales of Long-term Funds within Distribution Channel, Selected Years

Direct Market
(percent)



Sales Force
(percent)



Source: Investment Company Institute

[40] Nontraditional new sales for sales force funds were estimated by treating new sales of institutional funds and share classes as nontraditional. In addition, nontraditional new sales from other funds and share classes were assumed to be equal to the share of assets in these funds held in employer-sponsored retirement accounts.

[41] *1998 Profile of Mutual Fund Shareholders,* Investment Company Institute, Summer 1999, p. 5, www.ici.org/pdf/rpt_profile99.pdf.

[42] See *The Cerulli Edge,* December 1998, Cerulli Associates, Inc., Boston, MA for a detailed discussion of distribution trends for mutual funds.

[43] New River Investor Communications, Inc., Wrentham, MA.

[44] *The Cerulli Edge,* December 1999, Cerulli Associates, Inc., Boston, MA, p. 17.

Fee-based financial advisors also became a significant channel of distribution. These independent registered financial planners charge investors an annual fee as a percentage of the assets under management. In return, they provide investment advice to their clients by selecting portfolios of mutual funds and other securities. Mutual fund assets in these accounts reached $150 billion by the end of the decade.[45]

Finally, variable annuities represent yet another alternative distribution channel. They are sold through insurance agents as well as directly through some fund complexes. Assets in variable annuities exceeded $800 billion in 1999. About one-quarter of these assets were held through 403(b) and other employer-sponsored retirement plans.

EXPANSION OF THE NUMBER AND TYPES OF MUTUAL FUNDS

The increased demand for mutual funds in the 1990s led to the creation of a large number of new mutual funds. The number of funds rose from around 2,900 at the beginning of the decade to about 8,000, including funds of funds, at the end (Figure 9).[46]

Equity funds accounted for more than half of the increase in the number of funds. Because of the rapid growth in the number of equity funds, the typical fund remained quite small. Half of the funds in early 1990 had less than $50 million in assets. By 1999, median fund assets had risen to only about $130 million. Reflecting the rapid growth of a small number of larger equity funds, the average fund size rose from $217 million to about $1 billion. Nonetheless, only 16 percent of the funds in 1999 had assets greater than the average fund.

The variety of equity funds also expanded, with fund complexes offering specialized funds appealing to diverse investor tastes. The wider range of funds was most evident among those funds investing primarily in foreign stocks, with the number of both emerging market and foreign regional funds experiencing the most growth. Domestic funds increasingly differentiated themselves not only by investment style—growth, value, or a blend of the two—but also by market capitalization of the underlying companies—small-, mid-, and large-capitalization stocks. Specialty or sector funds, which concentrate investments within a particular sector of the market, further expanded the diversity of funds available. Technology funds, including those investing in companies associated with the Internet, grew in popularity during the second half of the decade, rising from 21 funds at the end of 1995 to 97 funds in 1999.

Bond and hybrid funds accounted for about one-third of the new funds, increasing from 1,186 in early 1990 to 2,794 in 1999. Most of the growth occurred during the first half of the decade when falling interest rates boosted the demand for these funds. As demand flattened out during the second half of the decade, mutual fund complexes liquidated or merged some of their bond funds.[47] The consolidation was most apparent for municipal bond funds. The number of municipal bond funds reached a peak of 1,027 in 1995 and declined to 888 by the end of the decade. High-yield funds, which invest primarily in higher risk corporate bonds, were an exception to the slowdown in the net new bond fund creation. These funds became a more common component of investors' portfolios, with assets rising from $45 billion in 1994 to $117 billion in 1999 and the number of funds increasing from 95 to 208.

Money market funds accounted for only 8 percent of the increase in funds. By regulation, money funds must limit their investments to high-grade, short-term instruments.[48] As a result, the types of money funds offered are significantly less varied than longer-term funds.

---

[45] New River Investor Communications, Inc., Wrentham, MA.

[46] The total number of mutual funds cited in other Institute publications excludes funds of funds. There are 7,791 funds at yearend 1999 when funds of funds are excluded.

[47] Fund mergers, acquisitions, and other reorganization transactions involve a number of legal, compliance, and operational issues. In a fund acquisition, for example, a new advisory contract must be approved by a majority of the independent directors of the target fund's board and its shareholders. In fulfilling this obligation and their broader responsibility to safeguard the rights and interests of the fund's shareholders, the independent directors must determine, among other things, that the transaction is in the best interest of the shareholders. See Michael L. Sapir and James A. Bernstein, "Reorganization of Investment Companies," *The Business Lawyer,* Vol. 50, May 1995, for a detailed discussion of the legal requirements of investment company reorganizations.

[48] Rule 2a-7 imposes maturity, quality, and diversification restrictions on money fund portfolios. In general, a money market fund must limit its portfolio to U.S. dollar-denominated instruments that the fund's board determines present minimal credit risk and are at the time of the acquisition "eligible securities," as defined in the rule.

FIGURE 9

Number and Assets of Mutual Funds by Investment Objective, 1990 and 1999

	Funds		Share Classes		Assets[1]	
Investment Objective	**January 1990**	**December 1999**	**January 1990**	**December 1999**	**January 1990**	**December 1999**
Domestic Equity						
Growth	311	1,054	312	2,047	59	1,287
Aggressive Growth	169	810	172	1,510	32	624
Growth and Income	249	672	254	1,329	81	1,202
Sector	131	344	131	674	15	205
Income	62	122	62	256	17	139
World Equity						
International	52	439	52	842	8	276
Regional	23	203	25	455	3	51
Global	54	199	58	461	14	236
Emerging Markets	0	109	0	211	0	22
Hybrid	180	533	182	1,030	34	383
Taxable Bond						
Government	265	375	268	761	106	139
Corporate	106	329	107	662	22	143
Strategic Income	58	284	58	501	6	114
High Yield	103	208	105	452	27	117
World	36	177	37	342	4	24
Tax-exempt Bond						
State	257	605	259	1,380	41	128
National	181	283	184	619	64	144
Money Market						
Taxable	461	702	470	1,226	375	1,409
Tax-exempt	203	343	205	504	74	204
Total for All Investment Objectives	2,901	7,791	2,941	15,262	983	6,846
Funds of Funds	16	213	16	395	*	48
Index Funds	15	193	15	316	3	383

[1]In billions of dollars
**Less than $500 million*
Source: Investment Company Institute

Other Offerings

Index funds came of age in the 1990s. These funds target specific market indexes with the general objective of meeting the performance of that index. The number of index funds rose from 15 in 1990 to 193 in 1999 with $383 billion in total assets. In addition to their overall growth, the variety of index funds expanded, offering investors the ability to invest in mutual funds seeking to match the performance of domestic and international equity market indexes, as well as bond and hybrid fund indexes.

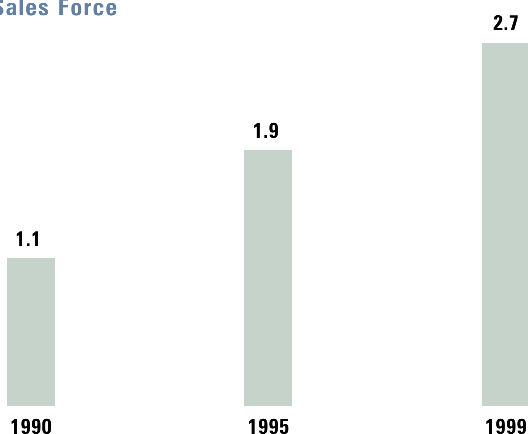
Some funds offered products that were designed to be hedges against a particular index, falling when the index rose and rising when the index fell. Still other funds were designed to augment index movements by rising or falling by some multiple of the market. Equity funds were the most common type of index funds, accounting for 88 percent of these funds and $357 billion in assets.[49]

[49] Equity index funds accounted for 9 percent of all equity fund assets.

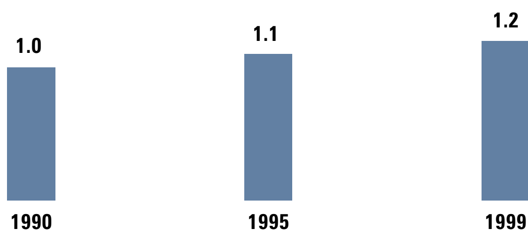
FIGURE 10

Average Number of Share Classes per Long-term Fund, by Distribution Channel, Selected Years

Sales Force



Direct Market



Source: Investment Company Institute

Mutual funds that invest in other mutual funds, known as funds of funds, also grew in popularity during the 1990s. In 1990, there were 16 funds of funds with a total of $1.4 billion in assets. By 1999, the number of funds had grown to 213 with total assets of $48 billion.[50] About 70 percent of the funds of funds were created after the passage of the National Securities Markets Improvement Act of 1996 (NSMIA). Prior to the passage of the Act, mutual funds were required to receive exemptive relief from the Securities and Exchange Commission (SEC) to create mutual funds that invested in affiliated funds. NSMIA eased the creation of affiliated funds of funds by allowing mutual fund complexes to create affiliated funds of funds without first receiving exemptive relief from the SEC as long as certain conditions were met. Unaffiliated funds of funds continue to need to apply to the SEC for exemptive relief.[51]

Multiple Share Classes

The number of share classes expanded even more rapidly than did the number of funds, rising from 2,941 in January 1990 to 15,262 in December 1999. Share classes were first offered in 1989 following the SEC's approval of multiple share classes. The first share classes were used primarily by sales-force funds to offer alternatives to the front-end load as a means of compensating brokers. Later, some of these funds used additional share classes as a means of offering the same fund or portfolio in alternative distribution channels in which some fund expenses varied by channel. For example, some funds created institutional share classes to be distributed through employer-sponsored retirement plans. Offering new share classes was more efficient and less costly than setting up two separate funds. By the end of the decade, the average long-term sales-force fund offered nearly three share classes (Figure 10). Although most direct-market funds did not offer multiple share classes, more of these funds began to adopt the strategy of offering share classes in alternative distribution channels later in the decade.

ASSET CONCENTRATION

Even though industry assets grew during the 1990s and many fund companies reached high asset levels, asset concentration among the largest mutual fund complexes underwent only marginal change during the decade.[52] The five largest fund organizations in 1990 held 37 percent of the industry's assets, whereas in 1999 the top five had a 35 percent share (Figure 11).[53] The market shares for other groupings among the largest

[50] These funds, along with their assets, are excluded from the industry data published by the Investment Company Institute to avoid double counting of assets.

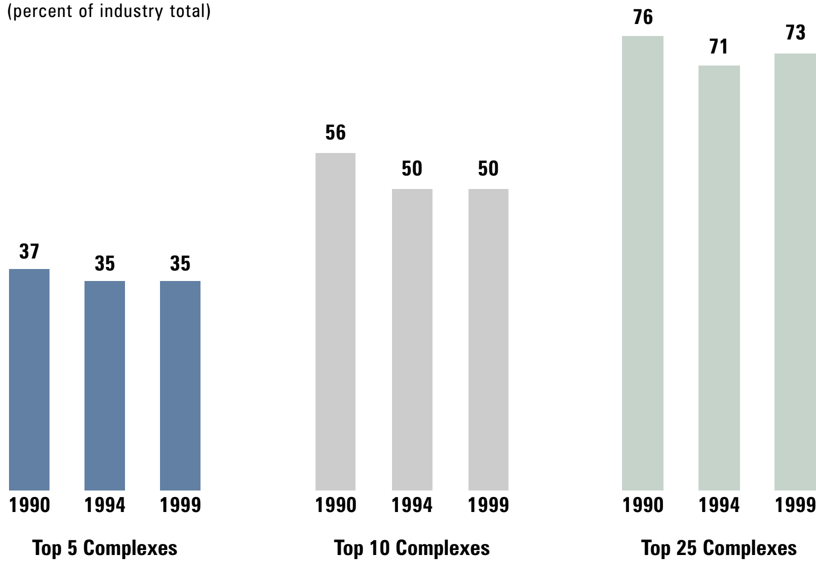
[51] See Paul S. Stevens and Craig S. Tyle, "Mutual Funds, Investment Advisers, and the National Securities Markets Improvement Act," *The Business Lawyer,* Vol. 52, No. 2 (February 1997), pp. 419-78 and Martin E. Lybecker, "Fund of Funds: The 1996 Act and Related Industry Developments," *The Investment Lawyer,* Vol. 4, No. 1 (January 1997), pp. 3-7 for more detailed discussions of the provisions in NSMIA regarding funds of funds.

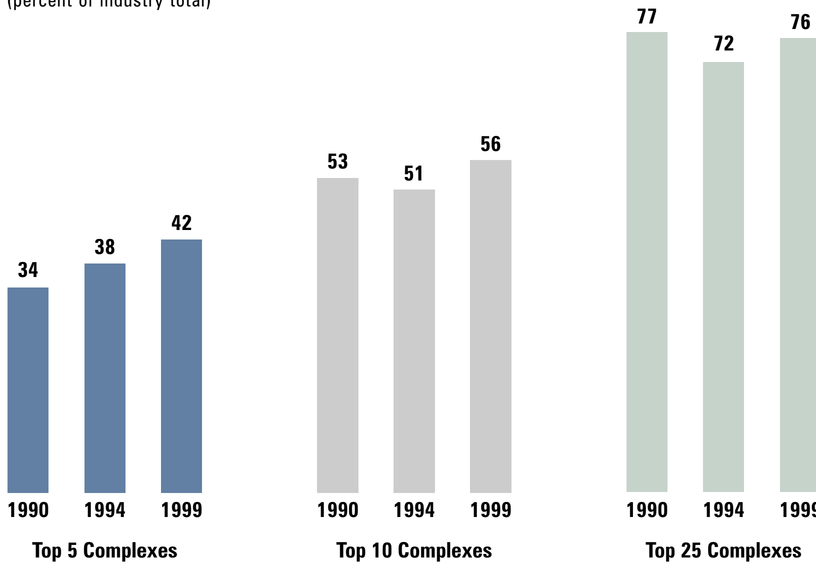
[52] Concentration ratios and complex assets are based on those complexes that provide data to the Investment Company Institute. These complexes account for about 95 percent of the industry's assets. Nonetheless, using the ICI database undercounts small mutual fund complexes and overstates the share of assets at the largest mutual fund complexes.

[53] Variable annuities were excluded from the calculation of concentration ratios to improve consistency across years. Including variable annuities does not materially affect the findings.

FIGURE 11

Share of Assets at Largest Mutual Fund Complexes, Selected Years





Source: Investment Company Institute

25 complexes were equally stable.[54] Focusing on long-term fund assets, concentration ratios edged higher for the five largest complexes but were little changed among the top 10 and top 25.

The stability of the concentration ratios occurred despite a high volume of mergers and acquisitions. During the second half of the decade alone, there were more than 100 transactions involving mutual fund families.[55] For several reasons, merger and acquisition activity did not affect concentration. Most important, virtually all the transactions were either between two small fund complexes or between one large and one small complex. In only four instances did the transactions involve fund companies from the top 25 complexes on both sides of the deal. And, in these instances, any gains in asset share from the merger or acquisition were transitory for the surviving complex. In fact, the surviving fund organizations had lower shares at the end of the decade than the larger of the predecessor companies at the beginning of the decade.

New entrants also contributed to the stability in asset concentration. There were 464 mutual fund complexes at the beginning of the decade and 629 by the close.[56] Among the 464 complexes at the beginning of the decade, 313 remained in 1999 with the others having left either through mergers or liquidations. The exiting complexes were more than replaced by new entrants that began and maintained operations in the 1990s. Although none were among the 25 largest complexes at the end of the decade, they contributed to the industry's asset growth and to the stability of the concentration ratios. Assets in these new fund complexes totaled $1.1 trillion by the end of the

[54] The Herfindahl index, another measure of market concentration, stood at 361 in 1999, down slightly from 376 in 1990. This index takes into account the asset shares of all companies in the industry, not just the largest companies. The maximum level of the index, 10,000, occurs when the industry consists of a single firm.

[55] The number of mergers is based on data published in various issues of *Annual Strategy Report,* Investment Counseling, Inc., West Conshohocken, PA.

[56] The number of funds include all mutual fund complexes that are members of the Institute as well as organizations that are not members but provide the Institute with data. The number of mutual fund complexes reported here is larger than that reported in the *Mutual Fund Fact Book,* 40th Edition, Investment Company Institute, Washington, DC, which reports the number of Institute member firms.

decade, and accounted for 16 percent of the total industry assets.

Finally, a substantial amount of rotation in rank among the 25 largest complexes helped to keep the concentration ratios stable. Many of the changes were the result of the compositional differences of funds within the complexes at the beginning of the decade. In 1990, 75 percent of the industry's assets were held in bond and money market funds and 20 percent in domestic equity funds. In contrast, by the end of the decade, domestic equity funds had 50 percent. As a result, those fund organizations that grew the most rapidly were positioned for the rising domestic stock market during the decade by having a higher than average share of their assets under management in domestic equity funds and a lower than average share in bond and money market funds.[57]

CHANGES IN THE COST OF PURCHASING MUTUAL FUNDS

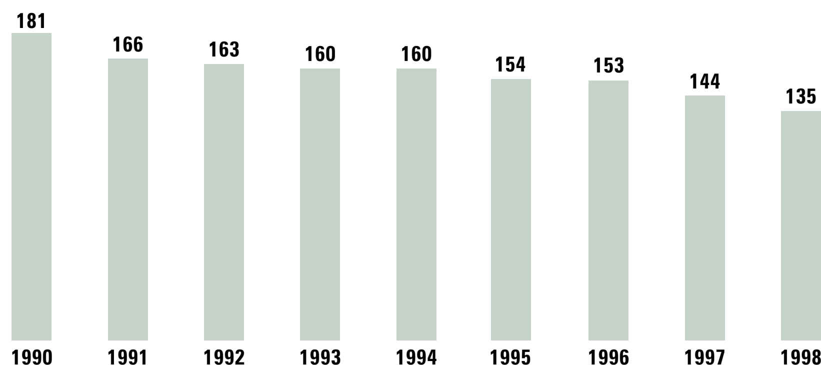
Despite the strength and growth in demand for mutual funds and their services in the 1990s, the purchase cost or price of these services declined substantially. Purchase cost is measured by total shareholder cost, which is the average cost of share purchases incurred by buyers of funds in a given year. Total shareholder cost includes costs from annual fund expenses and from sales loads.[58]

The decline in total shareholder cost occurred across all major types of funds.[59] For equity funds, total shareholder cost stood at 181 basis points in 1990, meaning that every $100 of equity fund purchases in that year incurred an average cost of

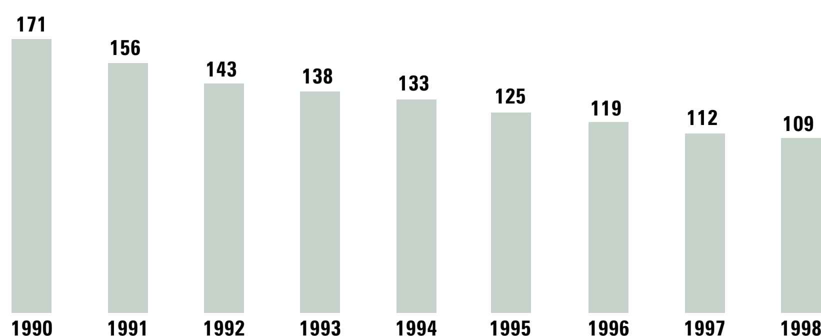
FIGURE 12

Total Shareholder Cost for Mutual Funds,[1] 1990–1998
(basis points)

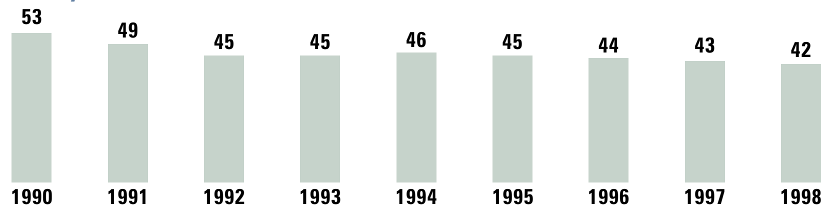
Equity Funds[2]



Bond Funds



Money Market Funds



[1]Sales-weighted average of total shareholder costs for individual funds.

[2]Includes hybrid funds.

Sources: Investment Company Institute; Morningstar, Inc.; Lipper Analytical Services, Inc.; Value Line Publishing, Inc.; CDA/Wiesenberger Investment Companies Service; Wiesenberger Investment Companies Service; © CRSP University of Chicago, used with permission, all rights reserved (773.702.7467/www.crsp.com); Primary datasource & © Standard & Poor's Micropal, Inc. 1998 (617.451.1585/www.micropal.com); and Strategic Insight Mutual Fund Research and Consulting, LLC

[57] Of the 25 largest complexes in 1990, 21 of them existed as unaffiliated entities in 1999. Of these, 11 increased or were unchanged in rank, while 10 fell in rank. Those that increased or were unchanged in rank on average had 63 percent of their assets under management in bond and money market funds and 30 percent in domestic equity funds in 1990. For those that decreased in rank, 87 percent of the assets managed were in bond or money market funds and 9 percent were in domestic equity funds.

[58] A complete explanation of total shareholder cost is in John D. Rea and Brian K. Reid, "Trends in the Ownership Cost of Equity Mutual Funds," *Perspective,* Investment Company Institute, Vol. 4, No. 3 (November 1998), pp. 3-9. From an investor's point of view, total shareholder cost is the annual cost that the investor would expect to incur over the period of time in which the investor plans to hold the fund. For measurement purposes, total shareholder cost is estimated for an individual fund as a weighted average of cost for different holding periods. For a group of funds, an aggregate measure is computed as a sales-weighted average of each fund's total shareholder cost.

[59] For a detailed discussion of trends in shareholder cost, see John D. Rea, Brian K. Reid, and Travis Lee, "Mutual Fund Costs, 1980-1998," *Perspective,* Investment Company Institute, Vol. 5, No. 4 (September 1999).

$1.81. By 1998, the latest year for which data are available, total shareholder cost was 135 basis points, a decrease of 25 percent since 1990 (Figure 12). Over the same period, total shareholder cost dropped 36 percent for bond funds and 21 percent for money funds.

The increased demand for mutual funds in the 1990s, by itself, would be expected to place upward pressure on total shareholder cost. The absence of an increase in total shareholder cost likely reflected several factors, one of which was the entry of a large number of fund companies into the industry in the 1990s. New entrants serve to expand the supply and availability of mutual funds, thereby offsetting upward pressure on total shareholder cost coming from the higher demand.

In general, load funds responded to the competitive gains made by no-load funds by lowering distribution costs. Distribution cost itself is a component of total shareholder cost that largely reflects the cost of advice and assistance provided by brokers and sales professionals to buyers of mutual funds. As measured, distribution cost is the sum of annuitized sales load and 12b-1 fee.

Load funds lowered distribution costs, in part, by reducing front-end sales loads.[60] In addition, load funds introduced alternatives to front-end loads that, depending upon an individual investor's circumstances, could be less costly than front-end loads as a means of compensating sales professionals. One common distribution cost structure combined a 12b-1 fee with a contingent deferred sales load that would be paid by the investor when shares were redeemed. The contingent deferred load declined as the length of time the shares were held, eventually reaching zero.

The reduction in distribution cost during the 1990s resulting from these developments was substantial. For equity load funds, distribution cost declined 30 percent between 1990 and 1998, while the distribution cost for bond load funds dropped 24 percent (Figure 13). For both types of funds, the lowering of front-end sales loads, along with the growth of alternatives to front-end loads, resulted in 12b-1 fees becoming a larger portion of distribution cost, reaching almost 40 percent in 1998.

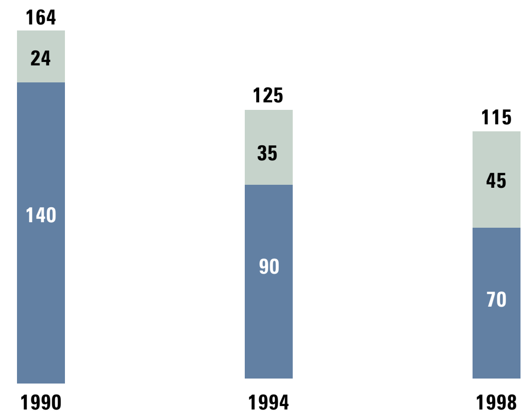
The measured decline in total shareholder cost for equity and bond funds also reflected actions of fund investors themselves, who shifted

FIGURE 13

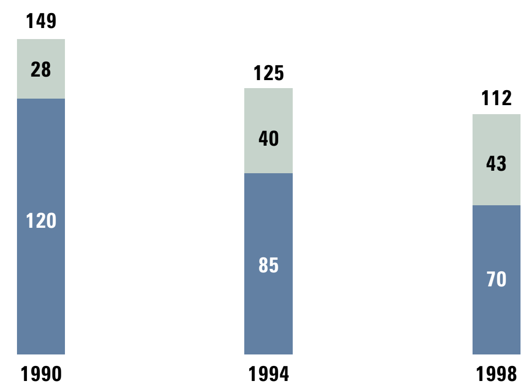
Distribution Costs for Bond and Equity Load Funds,* Selected Years

(basis points)

Equity Funds



Bond Funds



**Sales-weighted average of distribution costs for individual funds.*

Note: Components may not sum to totals due to rounding.

Sources: Investment Company Institute; Morningstar, Inc.; Lipper Analytical Services, Inc.; Value Line Publishing, Inc.; CDA/Wiesenberger Investment Companies Service; Wiesenberger Investment Companies Service; © CRSP University of Chicago, used with permission, all rights reserved (773.702.7467/www.crsp.com); Primary datasource & ©Standard & Poor's Micropal, Inc. 1998 (617.451.1585/www.micropal.com); and Strategic Insight Mutual Fund Research and Consulting, LLC

[60] Distribution costs also declined as funds reduced or waived loads on a larger share of their sales. For instance, loads on large-sized sales in 401(k) plans and wrap programs are often waived. Consequently, the actual average load paid is considerably less than the average maximum load. In 1989, the average actual front load paid was 80 percent of the average maximum front load. In 1998, the average actual front load was less than 40 percent of the maximum.

long-term share purchases to lower-cost funds. For example, in 1990, equity funds with a shareholder cost below the average fund cost accounted for 63 percent of new sales. By 1998, the share going to lower-cost funds had risen to 80 percent. Bond funds experienced an even greater shift, with new sales of lower-cost funds rising from 47 percent in 1990 to 76 percent in 1998. In many cases, the lower-cost funds making gains in new sales were no-load funds.

A final element in the decline of total shareholder cost was the achievement of economies of scale by many individual funds.[61] The growth in assets experienced by many funds resulted in greater operating efficiencies associated with the larger scale or size of the fund. Consequently, many funds were able to provide fund services at a lower cost per dollar of assets.[62]

SHAREHOLDER RESPONSE TO STOCK MARKET VOLATILITY

The broad, upward movement in U.S. equity prices in the 1990s was interrupted on several occasions by sharp but relatively brief market sell-offs. In addition, foreign stock markets suffered several periods of turmoil that sharply depressed returns on foreign-related stock funds. These periods of market volatility, however, did not lead to heavy outflows from stock funds. Indeed, to the extent that outflows occurred, they were small relative to assets and lasted only a short period of time.[63]

U.S. Market Breaks

The longest period of falling U.S. stock prices occurred in 1990 between mid-July and mid-October during the midst of the decade's only recession. The Dow Jones Industrial Average (DJIA) dropped 21 percent, while the S&P 500 index sustained nearly a 20 percent decline. Although domestic equity funds experienced net redemptions from July to September, the cumulative net outflow was $4.2 billion—only 1.8 percent of assets held by these funds at the end of June 1990.[64]

Another market break occurred in late March and early April 1994 following monetary tightening by the Federal Reserve.[65] In this environment, major stock price indexes moved sharply lower in volatile trading, with the DJIA posting a 7.1 percent loss between March 23 and April 4. Domestic equity funds experienced a small net outflow of $2.2 billion amounting to only 0.4 percent of assets. Net inflows, averaging about $1.7 billion per week before the sell-off, snapped back to roughly that level by mid-April and into May.

A third and more dramatic sell-off occurred in late October 1997, triggered by extreme weakness in East Asian stock markets.[66] From October 23 to October 27, the DJIA declined 10.9 percent, culminating with a record decline of 554 points on October 27. Net new cash flow to domestic equity funds slackened but led to only a small outflow of about 0.1 percent of assets on October 27.

The final significant sell-off in U.S. stock markets lasted from July to August of 1998. During the first five weeks of the downturn, major U.S. stock price indexes drifted lower by as much as 11 percent. Over the final four trading days in August, major indexes shed another 12 to 17

[61] For a discussion of economies of scale in equity funds, see John D. Rea, Brian K. Reid, and Kimberlee W. Millar, "Operating Expense Ratios, Assets, and Economies of Scale in Equity Mutual Funds," *Perspective,* Investment Company Institute, Vol. 5, No. 5 (December 1999).

[62] The increased demand for mutual funds likely put upward pressure on labor costs necessary to attract additional labor to the industry. Some of the upward pressure on labor costs was offset by mutual funds relying on increased automation of some labor-intensive activities such as distribution and shareholder servicing functions. As a result, between 1992 and 1999, the number of mutual fund employees providing distribution and shareholder services about doubled, while the number of shareholder accounts rose nearly threefold and the assets under management rose fourfold.

[63] The restraint shown by stock fund owners in the 1990s during market disruptions and sell-offs is consistent with their reaction to setbacks dating back to the 1940s. No market break or short-term sell-off has produced massive net redemptions concentrated within a short timespan. The absence of large-scale redemptions in these circumstances occurred despite substantial changes in fund ownership demographics and the industry's structural changes. For an analysis of equity fund flows in market breaks and cycles, see John Rea and Richard Marcis, "Mutual Fund Shareholder Activity During U.S. Stock Market Cycles, 1944-95," *Perspective,* Investment Company Institute, Vol. 2, No. 2 (March 1996).

[64] John Rea and Richard Marcis, pp. 5-7.

[65] Richard Marcis, Sandra West, and Victoria Leonard-Chambers, "Mutual Fund Shareholder Response to Market Disruptions," *Perspective,* Investment Company Institute, Vol. 1, No. 1 (July 1995), pp. 6-8.

[66] Brian Reid, Samuel Ankrah, and Kimberlee Millar, "Mutual Fund Developments in 1997," *Perspective,* Investment Company Institute, Vol. 4, No. 1 (March 1998), pp. 5-6.

percent, sparked principally by the Russian bond default. Altogether, the DJIA fell 19 percent, the largest decline since 1990, and the Nasdaq index suffered a 26 percent loss. Although domestic equity funds experienced their first monthly outflow since 1990, net redemptions were only $6.4 billion in August and represented a relatively small 0.3 percent of assets.

Market Breaks Overseas

The stock market volatility during the summer of 1998 was not confined to U.S. stock markets but also was experienced in overseas markets. Reflecting the turmoil abroad, U.S.-based world equity funds recorded a net outflow in August 1998 of $5.2 billion or 1.2 percent of these funds' assets. Net outflows from these funds continued through July 1999. Although the net redemptions for this 12-month period were $19 billion or about 5 percent of world equity fund assets, the net outflows were not large on a monthly basis. Average net outflow per month was $1.6 billion or only 0.4 percent of assets. Similar muted reactions to overseas volatility occurred during the 1994 Mexican peso crisis and the 1997 Asian financial crisis.[67]

The 1990s did not produce a bear market; that is, an extended period of falling equity prices. The record of net flow in previous decades during bear markets is mixed, with some bear markets showing continued net inflows to stock funds and with others showing net outflows. In those bear markets with net outflows, net redemptions have tended to be spaced over the course of the decline in prices and to be of a small monthly magnitude. This pattern is very similar to that in net outflows seen in emerging market funds in the aftermath of the Asian financial crisis in 1997 and to world equity funds after the Russian bond default in August 1998.

CONCLUSION

This paper examined major developments in the mutual fund industry during the past decade. The strong growth of the industry was attributable to a combination of beneficial economic, demographic, and regulatory events that dramatically increased investor demand for mutual funds. In response to the strong demand, a large number of new mutual funds were offered to investors, including funds from new entrants to the industry. In addition, changes in the distribution system, rising investor demand for no-load, index, and other lower-cost funds placed competitive pressures on the industry that led to a steady decline in the average cost of purchasing mutual funds during the decade. Finally, despite the changes in the structure of the industry and large numbers of new shareholders, mutual fund investors reacted to sharp market contractions in similar fashion to contractions in earlier periods. During periods of market volatility, net flows to mutual funds slowed or turned negative, but fund shareholders on balance did not withdraw a large volume of assets.

[67] See Marcis, West, and Leonard-Chambers, July 1995; John Rea, "U.S. Emerging Market Funds: Hot Money or a Stable Source of Investment Capital," *Perspective,* Investment Company Institute, Vol. 2, No. 6 (December 1996); and Mitchell A. Post and Kimberlee Millar, "U.S. Emerging Market Equity Funds and the 1997 Crisis in Asian Financial Markets," *Perspective,* Investment Company Institute, Vol. 4, No. 2 (June 1998) for further discussions of these events.

Back issues of *Perspective,* written by Institute staff, leading scholars, and other contributors, address public policy issues of importance to mutual funds and their shareholders. Contact the Institute's Public Information Department at 202/326-5945 for more information. All issues of *Perspective* are also available on the Institute's website; for an index of issues, see http://www.ici.org/economy/perspective.html.

Although information or data provided by independent sources is believed to be reliable, the Investment Company Institute is not responsible for its accuracy, completeness, or timeliness. Opinions expressed by independent sources are not necessarily those of the Institute. If you have questions or comments about this material, please contact the source directly.

Copyright © 2000 by the Investment Company Institute