1:00

May 2, 1994

M E M O R A N D U M

TO: SENATOR DOLE

FROM: NINA OVIEDO

COPY TO: KERRY

SUBJECT: **REMARKS TO THE INVESTMENT COMPANY INSTITUTE**

You are scheduled to speak to the Board of Governors of the Investment Company Institute, on Wednesday, May 4 at ~~4:10 p.m.~~ Approximately 50 CEO's will be in attendance. You are their last speaker (Senators Baucus, Sarbanes, Domenici and Bryan are scheduled earlier in the day). The meeting is not open to the press.

Robert Hechler, President, Waddell Reed (United Funds), Shawnee Mission, Kansas, is expected to attend.

They would like to hear your views on the "state of Congress" -- is health care going anywhere? how's the President doing? etc. They are looking for you political insights.

INVESTMENT COMPANY INSTITUTE

April 28, 1994

The Honorable Bob Dole
United States Senate
SH-141 Hart Senate Office Building
Washington D.C. 20510

Dear Senator Dole:

RE: Confirmation to Speak on May 4

We are delighted that you can address the Investment Company Institute's Board of Governors Legislative Affairs Conference on Wednesday, May 4, in the Capitol. An agenda and list of the Governors attending the Conference are attached.

The details for your participation are as follows:

Date: Wednesday, May 4

Time: 4:10 - 4:30 p.m.

Place: S-10
The Capitol

Subject: Of your choosing
Remarks: 15 - 20 minutes with a possible 5 minute Q & A, if that is acceptable to you.

Contact: Michael Stern (202/326-5894)

For your convenience, attached is information on the Institute, issues of interest to Institute members and their shareholders, and a profile of the mutual fund industry in Kansas.

Again, thank you for agreeing to speak at our Conference. If you have any questions or wish further information, please call. We look forward to seeing you on May 4.

Sincerely,

Michael Stern

Michael Stern
Legislative Representative
for Taxation

Attachments

cc: Sheila Burke
Nina Oviedo
Yvonne Costello

Investment Company Institute
Board of Governors Legislative Briefing
United States Capitol Building
May 4, 1994

PROGRAM

U.S. House of Representatives Briefing - HC-5 Room (11:30 a.m. - 2:05 p.m.)

11:30 - 12:00	**LUNCH and Opening Remarks: Julie Domenick, Senior Vice President, Legislative Affairs**
12:00 - 12:25	**Representative Barbara Kennelly (D-CT): Prospects for Health Care Reform** Ways and Means Committee; Budget Committee; House Administration Committee; Chief Deputy Majority Whip
12:25 - 12:50	**Representative Alan Wheat (D-MO): Investing in Education** Rules Committee; District of Columbia Committee; Deputy Majority Whip
12:50 - 1:15	**Representative Charles Schumer (D-NY): The Crime Bill** Banking, Finance and Urban Affairs Committee; Foreign Affairs Committee; Judiciary Committee; Majority Whip at Large
1:15 - 1:40	**Representative W.J. (Billy) Tauzin (D-LA): U.S. Energy Policy** Energy and Commerce Committee; Chairman, Coast Guard and Navigation Subcommittee of the Merchant Marine and Fisheries Committee; Majority Whip at Large
1:40 - 2:05	**Representative Jim Leach (R-IA): Derivatives, Hedge Funds, Systemic Risk; Other Committee Priorities** Ranking Member, Banking Finance and Urban Affairs Committee; Ranking Member, Asia and the Pacific Subcommittee of the Foreign Affairs Committee
2:05 - 2:20	BREAK

U.S. Senate Briefing - SC-10 Room (2:30 p.m. - 4:30 p.m.)

2:30 - 2:55	**Senator Richard Bryan (D-NV): Counterintelligence in the Post-Cold War Period** Chairman, Select Ethics Committee; Select Intelligence Committee; Chairman, Consumer Subcommittee of the Commerce, Science and Transportation Committee; Banking, Housing and Urban Affairs Committee; Armed Services Committee

2:55 - 3:20	**Senator Max Baucus (D-MT): International Trade Developments** Chairman, International Trade Subcommittee of the Senate Finance Committee; Chairman, Environment and Public Works Committee; Agriculture, Nutrition and Forestry Committee; Select Intelligence Committee; Joint Taxation Committee
3:20 - 3:45	**Senator Pete Domenici (R-NM): Domenici/Nunn Tax Proposal: An Alternative Approach to Taxation** Ranking Member, Budget Committee; Ranking Member, Commerce, Justice, and State, the Judiciary, and Related Agencies Subcommittee of the Appropriations Committee; Banking, Housing and Urban Affairs Committee; Energy and Natural Resources Committee; Indian Affairs Committee
3:45 - 4:10	**Senator Paul Sarbanes (D-MD): Federal Reserve Board, Monetary Policy and Interest Rates** Chairman, Housing and Urban Affairs Subcommittee of the Banking, Housing and Urban Affairs Committee; Chairman, International Economic Policy Subcommittee of the Foreign Relations Committee; Budget Committee; Vice Chairman, Joint Economic Committee; Vice Chairman, Senate Democratic Policy Committee
4:10 - 4:30	**Senator Robert Dole (R-KS): Closing Remarks/Wrap-Up** The Republican Leader

Board of Governors
1994

Mr. Ronald P. Lynch
Managing Partner
Lord, Abbett & Company
New York

Mr. James Benham
Chairman
Benham Group (The)
California

Mr. George S. Bissell
Chairman
Keystone Group Inc.
Massachusetts

Mr. Edward J. Boudreau, Jr.
Chairman and CEO
John Hancock Advisers Inc.
Massachusetts

Mr. John J. Brennan
President
The Vanguard Group, Inc.
Pennsylvania

Mr. John F. Cogan, Jr.
President
Pioneering Management Corp.
Massachusetts

Mr. Harold W. Cogger
President
Colonial Management Associates Inc.
Massachusetts

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Senior Vice President
Alliance Capital Management Corporation
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PaineWebber Mutual Funds
New York

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Chairman and CEO
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Mr. Jon S. Fossel
Chairman & CEO
Oppenheimer Management Corporation
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New Jersey

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Dean Witter Group
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Eaton Vance Management
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INVESCO Funds Group Inc.
Colorado

Mr. Robert E. Holley
Director of Unit Trusts
PaineWebber Inc.
New Jersey

Mr. Stephen Hopkins
Vice President & CFO
Goldman Sachs Asset Management
New York

Mr. J. Jerry Inskeep, Jr.
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Columbia Funds Management
Company
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Executive Vice President
Franklin Distributors, Inc.
California

Mr. F. Ray Keyser, Jr.
Chairman
Keyser, Crowley, Mueb, et al
Vermont

Mr. Charles Kierscht
Chairman
Kemper Financial Services Inc.
Illinois

Mr. Lawrence J. Lasser
President and CEO
Putnam Investments
Massachusetts

Mr. David S. Lee
President
Scudder, Stevens & Clark
Massachusetts

Mr. Kenneth Leibler
President and COO
Liberty Financial Companies
Massachusetts

Mr. Daniel C. Maclean
Vice President & Gen. Counsel
The Dreyfus Corporation
New York

Mr. John W. McGonigle
Vice President & Gen. Counsel
Federated Investors Inc.
Pennsylvania

Mr. David Minella
President
G.T. Capital Management
California

Mr. Keith E. Mitchell
President and CEO
Delaware Distributors Inc.
Pennsylvania

Mr. William R. Molinari
President-Retail Distribution
Van Kampen Merritt Inc.
Illinois

Mr. William C. Morris
Chairman and CEO
J. & W. Seligman & Co., Inc.
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Mr. Robert A. Nesher
Executive Vice President
SEI Financial Services
Company
Pennsylvania

Mr. William J. Nutt
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Mr. Douglas G. Ober
Chairman and CEO
The Adams Express Company
Maryland

Mr. William R. Pearce
President and CEO
Investors Group of Companies
Minnesota

Mr. Michael Perini
First Vice President
Merrill Lynch Asset Management
Inc.
New Jersey

Mr. David D. Peterson
Chief Executive Officer
Baker, Fentress & Company
Illinois

Mr. Don G. Powell
Chairman, President & CEO
American Capital Management
and Research Inc.
Texas

Mr. Thomas R. Powers
Chairman of the Board & CEO
Transamerica Fund Management
Company
Texas

Mr. Robert C. Pozen
General Counsel, Managing Dir.
Fidelity Management & Research
Company
Massachusetts

Mr. Martin H. Proyect
President and CEO
Venture Advisers, Inc.
New Mexico

Mr. James S. Riepe
Managing Director
T. Rowe Price Associates, Inc.
Maryland

Mr. Michael J.C. Roth
President
USAA Investment Management
Company
Texas

Mr. Arnold D. Scott
Senior Executive VP
Massachusetts Financial
Services Company
Massachusetts

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Mr. Stephen Treadway
President
Smith Barney Harris Upham
New York

Ms. Marian A. Trimble
President
Nationwide Financial
Services Inc.
Ohio

Mrs. Palomba Weingarten
Chairman
Pilgrim Management Corporation
California

Mr. James J. Wesolowski
Vice President & Gen. Counsel
J. Nuveen & Co. Inc.
Illinois

Mr. Mark H. Williamson
Mutual Fund Group Executive
Nations Bank
North Carolina

Investment Company Institute
Legislative Affairs Conference
Wednesday, May 4, 1994
12:00 noon - 4:30 pm

About the Investment Company Institute:

The Investment Company Institute is the national association of the United States investment company industry, representing mutual funds, unit investment trusts, and closed end funds.

The Institute has over 4,500 member mutual funds with total assets under management of nearly $2 trillion, accounting for approximately 95% of industry assets, and over 38 million shareholders. **One in four American households invests in a mutual fund.**

The Institute's members consist of mutual fund companies, their investment advisers, and principal underwriters who purchase and distribute the shares to the public directly or through stockbrokers and security dealers. Unit investment trusts and publicly-traded closed end funds are also members.

The Institute represents members and their shareholders in matters of legislation, regulation, taxation, public information, marketing, statistics, and economic and market research.

Issues of Interest:

The Institute has been generally concerned with legislative matters relating to banking and securities issues, tax issues, pension and retirement issues and international competitiveness issues. Because of the broad scope of Institute members and their shareholders, our members also are concerned about national public policy relating to long-term challenges such as health care, infrastructure restoration, the budget deficit and the environment.

PROFILE OF THE MUTUAL FUND INDUSTRY IN KANSAS*

Shareholders:

Number of shareholders:	437,287
Value of shareholder assets:	$19.5 billion

Industry:

Assets managed by the mutual fund industry:	$14.34 billion
Employment, direct and indirect:	2,500

Institute members:

Ransom Managed Portfolios
Security Benefit Group
United Funds

*Source: Investment Company Institute
Data is approximate and current as of 2/28/94.

SPEAK Wednesday - May 4

SC-10

4:10 p.m. (15/20 min.)

INVESTMENT COMPANY INSTITUTE

January 25, 1994

Washington, D.C.

OK

about what?

Why

SC-10 The Capitol

The Honorable Bob Dole
United States Senate
SH-141 Hart Senate Office Building
Washington D.C. 20510

Dear Senator Dole:

RE: Request to Speak on May 4

state of Congress & whatever you want to talk about

On behalf of the Investment Company Institute, I am writing to invite you to speak at the Institute's Board of Governors annual Legislative Affairs Conference, during the afternoon on Wednesday, May 4, 1993 in the Capitol.

The Investment Company Institute is the national association of the mutual fund industry. The Institute's mutual fund members have assets under management of nearly $1.92 trillion, accounting for approximately 95 percent of industry assets, and over 38 million shareholders. One in four American households invests in a mutual fund.

In Kansas, there are approximately 440,000 mutual fund shareholders who have invested over $17.9 billion in mutual funds. Kansas also serves as the headquarters for Security Benefit, United Funds and other mutual fund companies with assets under management of over $11.9 billion. In addition, the mutual fund industry employs directly and indirectly about 2,500 people in your state.

Attending this Conference will be the Board of Governors of the Investment Company Institute, approximately 60 recognized leaders in the nearly $2 trillion mutual fund industry. (Please see the attached list.)

The purpose of this Conference is to afford Institute Board members an opportunity to hear Congressional leaders present their views on issues that require attention. The Congressional legislative agenda is of great interest to Institute Board members, as leaders in the financial services industry, as money managers and as institutional investors. A copy of last year's program is attached for your information.

1-28 Interim letter

1401 H STREET, NW ▪ WASHINGTON, DC 20005-2148 ▪ 202/326-5800

4.28 Kathleen Bovelo
Confirmed w/

If convenient, we would hope you could address our group in the afternoon on May 4. Your total time commitment would be approximately 20 - 30 minutes. We respectfully suggest that your remarks take about 15 minutes and be immediately followed by a 5 - 10 minute question and answer session. If you agree to speak to our group, we will be in contact with you and your staff regarding further details of your participation and will work very closely with your staff to accommodate your schedule.

Please call me at 202/326-5894 if you have any questions. I certainly hope you will be able to join us.

I look forward to hearing from you.

Sincerely,

Michael Stern secy Tammi Simpson

Michael Stern
Legislative Representative
for Taxation

Julie Dominic SR VP Fl Legis Affairs

Attachments

cc: Sheila Burke
Nina Oviedo
Yvonne Costello

THE POWER OF MUTUAL FUNDS

THEY'RE REINVENTING THE WAY WE SAVE—AND RESHAPING THE ECONOMY

It may be hard to believe, but less than 15 years ago, the mutual fund was an endangered species. Investors were pulling more money out of funds than they were putting in, and the number of funds was shrinking. It seemed only a matter of time before most of them closed up shop for good. But buoyant stock and bond markets, the development of a host of new investment products, and lots of savvy marketing have transformed mutual funds into one of the most dynamic and successful industries in the country.

People are pouring money into mutual funds to the tune of $1 billion a day. The mountain of mutual-fund assets now stands at $1.6 trillion, compared with less than $50 billion in 1977—and the last $600 billion has piled up only since 1990. By some estimates, the funds could top $4 trillion by the end of the decade.

But numbers tell only a small part of the story of the funds' power. Mutual funds are altering the way Americans save and invest, offering a menu of investments unthinkable a decade ago. By channeling the savings of millions of consumers into hundreds of billions of dollars of investments, funds are reshaping the U. S. financial landscape and the economy itself. Mutual funds have lowered the cost of capital for industry and government alike. During a period when banks and other financial institutions have been pulling in their horns, mutual funds have been providing the capital for financially strapped companies and municipalities to rebuild their tattered balance sheets. And the fund companies, through their control of billions of dollars of individual investors' assets, carry enormous clout with management as stockholders and bondholders.

The idea of a mutual fund is simplicity itself. Funds pool investors' money and buy stocks, bonds, or money-market securities. Individuals get greater diversification, less risk, lower transaction costs, and far more professional management than they could achieve on their own.

But funds do a lot more than that. By pooling, they have the power to turn illiquid investments such as municipal bonds, junk bonds, or small-company stocks into highly liquid ones. To sell a couple of municipal bonds, for example, an investor might have to wait days or take a lower-than-market price from a dealer. But that same investor can sell shares in a muni-bond fund that very day, and without having to give up a nickel on price. Says investment consultant Peter L. Bernstein: "The mutual fund changes the whole nature of the underlying investment."

By liquifying the illiquid, mutual funds have affected the entire economy in ways that macroeconomists are only beginning to grasp. Take the much-watched money supply, a traditional measure of future economic activity. Because of the funds' higher yields, many investors have moved money to short-term bond funds—where the money is not counted as part of the money supply—and out of bank money-market accounts, where it is. This phenomenon, says Lawrence B. Lindsey, a member of the Federal Reserve Board, "has made understanding and interpreting the monetary aggregates more difficult." Mutual funds, in effect, are redefining "money." And the Fed—in order to get a better handle on policy—may have to rethink what it calls money, too.

HOUSEHOLD NAMES. The power of mutual funds is most obvious in their impact on the stock market. In fact, now, they are the stock market. Over the past three years, mutual funds have put more than $300 billion into equities—giving a huge lift to stock prices. The funds are making it easier for emerging companies to get new equity capital. Even mature companies can now raise equity more cheaply.

For government, especially state and local borrowers, tax-exempt funds are a mother lode—the major source

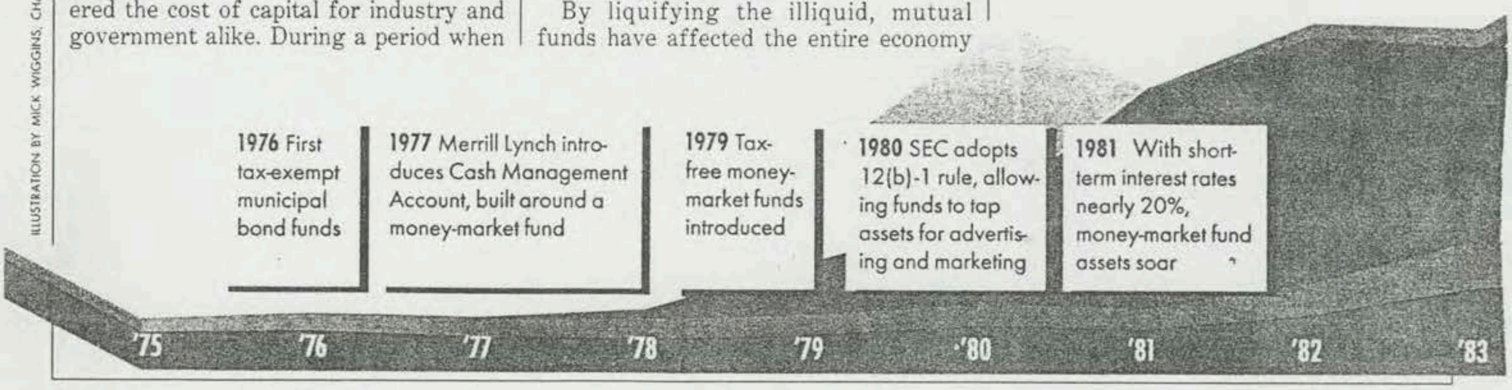


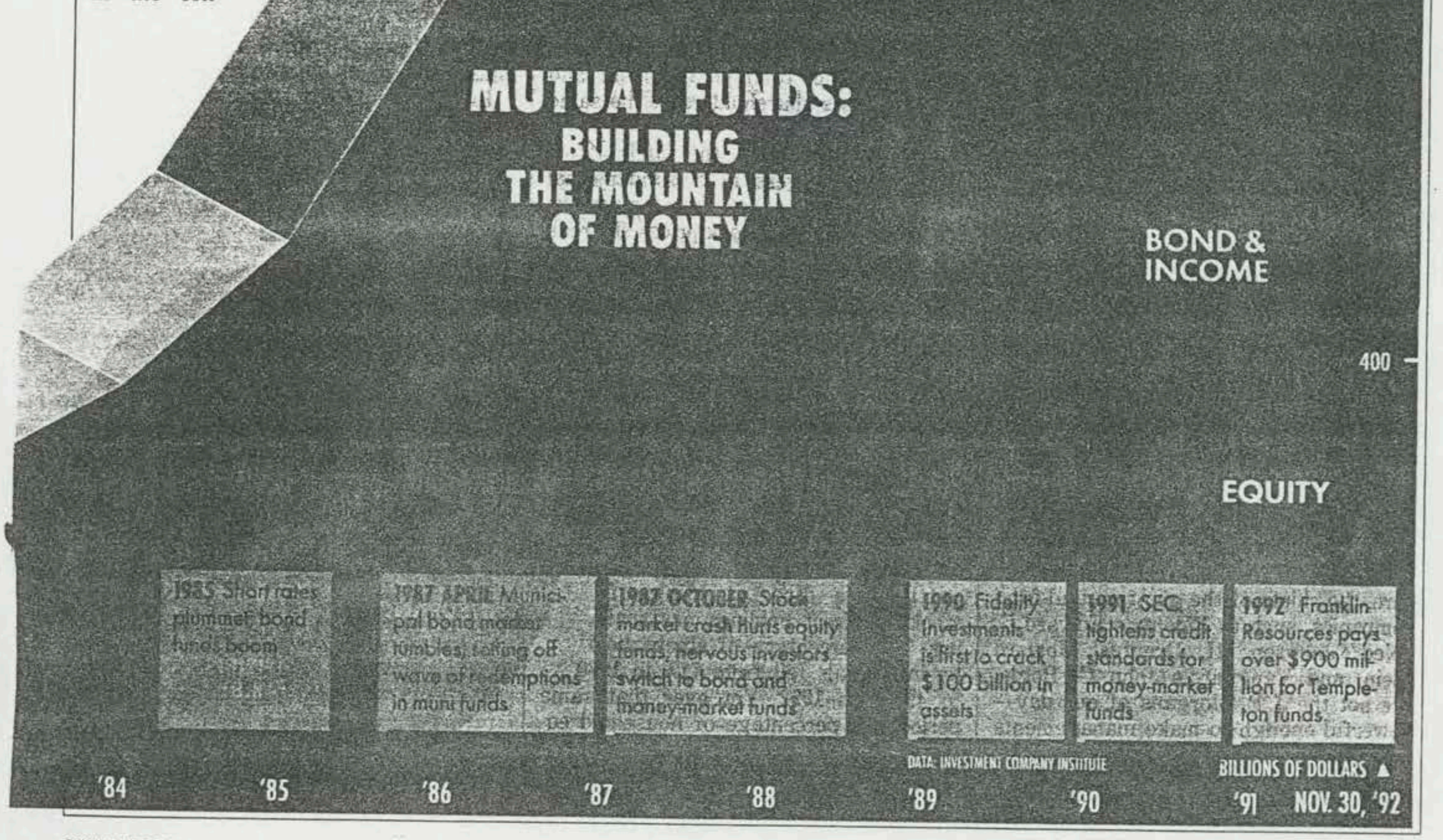
ILLUSTRATION BY MICK WIGGINS, CHART BY LISA KNOUSE BRAIMAN of capital needed to refurbish and expand the country's aging infrastructure. Hundreds of municipalities would find it far more difficult or prohibitively expensive to sell their bonds if it weren't for the marketing might of mutual funds. And by conservative estimates, the funds' power in the municipal-bond market lowered the annual interest expense by more than $200 million just on the bonds issued during 1992.

Mutual-fund giants such as Fidelity, Dreyfus, Vanguard, and Franklin have earned brand-name recognition, the financial equivalent of breakfast cereals. Other countries have mutual-fund look-alikes, but none has an industry as dynamic and creative as the one in the U.S. Indeed, the mutual-fund industry may be America's secret weapon in the struggle to invigorate an investment-starved economy.

In many ways the funds have evolved into America's alternative banking system—freely moving capital around in ways that banks, still hobbled by an antiquated regulatory structure, can't. "Mutual funds are the bank deposits of the 1990s," says George M. Salem, banking analyst for Prudential Securities Inc. "A mutual-fund company is a far more sophisticated savings vehicle."

But the power of the funds has a dark side, too. By putting more money in the control of fewer hands, the funds could well make the markets more volatile if they all want to buy or sell at the same time. According to a Presidential task force, one unnamed mutual-fund group alone dumped more than $800 million on Oct. 19, 1987—contributing to the greatest one-day rout in stock market history. The municipal bond market, where the funds exert enormous power, could be thrown into a tailspin if many funds needed to raise cash in a hurry and dumped bonds.

GREAT DIVIDE. Nor is there much about mutual funds that promotes long-term stock holdings, or "patient capital." Mutual-fund managers, say many market pros, are quicker to flip stocks than pension-fund managers. Pension-fund managers report their returns quarterly; mutual-fund managers' results are in the newspapers every day. So mutual-fund



THE LARGEST FUND MANAGERS

Management company	Assets* Billions	Market share*
FIDELITY	$164.3	10.2%
MERRILL LYNCH	107.6	6.7
VANGUARD	92.6	5.8
DREYFUS	75.8	4.7
FRANKLIN**	64.6	4.0
CAPITAL RESEARCH	62.1	3.9
DEAN WITTER	52.9	3.3
KEMPER	45.4	2.8
FEDERATED	45.2	2.8
SHEARSON	45.1	2.8
PUTNAM	41.4	2.6
PRUDENTIAL	34.2	2.1
IDS	27.9	1.7
SCUDDER	26.2	1.6
NUVEEN	25.8	1.6
T. ROWE PRICE	25.3	1.6
PROVIDENT INSTITUTIONAL	24.3	1.5
MFS	23.2	1.5
GOLDMAN, SACHS	23.0	1.4
ALLIANCE CAPITAL	20.9	1.3
PAINEWEBBER	20.5	1.3
OPPENHEIMER	19.8	1.2
AIM	18.7	1.2
20TH CENTURY	17.3	1.1
AMERICAN CAPITAL	13.8	0.9

*Includes mutual funds and closed-end funds as of September, 1992

**Has since acquired Templeton funds, which would bring Franklin's total to $76.9 billion, with a 4.8% share of the market

DATA: STRATEGIC INSIGHT

managers are more short-term oriented.

By rolling over an expiring certificate of deposit into a mutual fund, consumers and their money cross a great divide. The CD is government-guaranteed, but the mutual fund isn't. However, the funds have built credibility to the point that investors are willing to give up that assurance. So far, the funds have remained relatively free from scandal, in contrast to the much-publicized wrongdoings at banks, brokerage houses, thrifts, and insurance companies. There is some concern, however, that the funds have grown far faster than regulators' ability to supervise them (page 68).

Even with the billions under their care, the chiefs of the giant mutual-fund companies, such as Fidelity's Edward C. "Ned" Johnson III, Dreyfus' Howard Stein, and Vanguard's John C. Bogle, are not the J. P. Morgans of our day—powerful enough to make managements shake with fear that they're about to pounce on a company. Sure, the fund companies may own together a big chunk of a particular stock. But each company in turn operates dozens of funds that may own that stock, each with varied investment objectives.

Still, as the funds mushroom in size, says Paul Getman, an economist at Regional Financial Associates, "the Fidelities and Dreyfuses and Vanguards will have a power over Corporate America that they never had before." Fidelity Investments, the largest fund company, encourages portfolio managers to challenge corporate managements on such issues as staggered terms for company directors, pay raises, and antitakeover measures. Nell Minnow, who counsels pension funds and other institutional investors on shareholder rights, thinks other funds will follow Fidelity's lead. She says new SEC regulations regarding proxy solicitations for all shareholders make it easier for the mutual funds to oppose management.

But legal and practical barriers prevent funds from taking part in corporate affairs in the way a Warren Buffett or a Laurence Tisch might well do—like getting a seat on the board. "The laws set up trip wires that would prevent a mutual fund from trying to control a company," says Craig Tyle, head of the legal staff at the Investment Company Institute, the fund industry's trade association. To wit: If a portfolio manager joined a corporate board, he would be privy to inside information and would be unable to make buy or sell decisions for his fund without breaking insider-trading laws. In short, the fund manager can't serve his fund shareholders and the company's shareholders at the same time.

CHEAPER CAPITAL. Still, the funds affect corporate managers in a fundamental way. In today's market, their investment decisions determine stock prices. To really see the power of mutual funds, just consider what the stock market would be without them. In the first half of 1992, mutual funds purchased stocks at an annualized rate of $192.5 billion. Other market participants bought, on balance, only $7 billion more. The bottom line: Mutual funds provided 96% of the money that went into stocks. In 1991, that figure was 80%.

While the individual investor is cutting his direct holding of stocks, indirect holdings are soaring. The percentage of stocks held by individuals fell from 71% in 1980 to 49.7% in 1992. Yet over that same period, the percentage of household equity assets in mutual funds rocketed from 5% to more than 35%.

The funds have driven stock prices to historically high levels. Although that worries some investors, there's a huge, often unappreciated, beneficial impact on the economy: The cost of raising equity capital has been reduced. The higher the price-earnings ratio, the lower the cost of equity capital. Think of it this way: A stock is selling at $10 and earns $1 a share. The company wishes to raise capital. For every $10 it gets by selling a share of its stock, it gives the purchaser $1 in earnings. But now, double the share price. For giving up $1 in earnings, the company now takes in $20. In effect, its cost of equity has been halved.

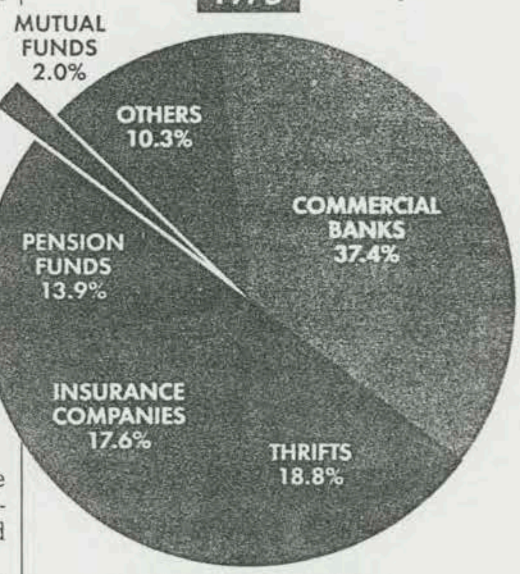
For years, sky-high stock prices in Tokyo, where price-earnings ratios were triple those in the U. S. market, brought the cost of capital down to under 2%—and were the very weapon that Japan Inc. used to eat its competitors' lunches. Even now, despite the sell-off in Japanese stocks, U. S. p-e ratios are well below those in Japan. Over the past year, companies have taken advantage of high stock prices to raise $72.4 billion in equity, according to Securities Data Co., and that's helping clean up the debt burden from the '80s and provide fresh funds to expand.

BIOTECH BALLAST. The funds are especially vital to the new-issues market, where hundreds of fledgling companies have gone public over the past two years. "When we do an [initial public offering], there are 50 to 100 accounts that matter, and most of them are mutual funds," says Vikram S. Pandit, a managing director at Morgan Stanley & Co.

Indeed, the pace of IPOs closely tracks

FUNDS GRAB A GROWING

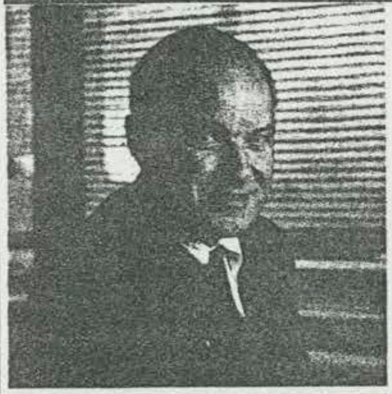
1975



DATA: FIRST BOSTON CORP., FEDERAL RESERVE BOARD

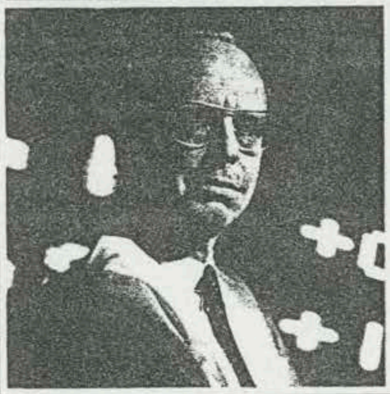
CHARTS BY LISA KNOUSE BRAIMAN

SUPERSTARS OF THE MUTUAL-FUND INDUSTRY



CHARLES JOHNSON
FRANKLIN RESOURCES
A big bond-fund manager, he is moving into equities with the purchase of Templeton funds—the industry's first megadeal

HOWARD STEIN
DREYFUS
While others emphasized stocks and bonds, he spent heavily to build his already huge money-market fund business



NED JOHNSON
FIDELITY INVESTMENTS
Clever marketing, a big investment in technology, and an army of talented portfolio managers give his firm a long lead over its rivals

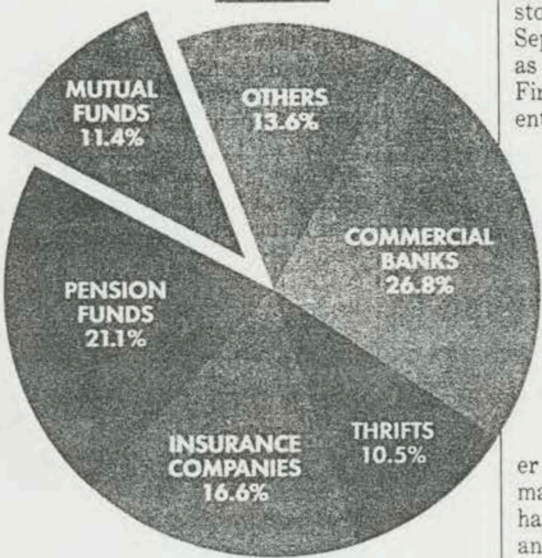
JOHN BOGLE
VANGUARD GROUP
His strategy is to drive down the cost of running mutual funds—and to pass the savings on to the investor as higher returns

CLOCKWISE FROM TOP LEFT PHOTOGRAPHS BY ROBERT HOLMGREN, JOHN S. ABBOTT, NINA BARNETT, PETER GREGOIRE

the investor purchases of equity mutual funds. Robert Natale, who follows IPOs for Standard & Poor's Corp.'s *Emerging & Special Situations*, says IPO markets always move in sync with mutual-fund inflows. "It's impossible to sell an IPO to a mutual fund when there is no new money coming in," says Natale. "But when the cash is flowing, a new issue is a quick way to put the money to work."

SLICE OF FINANCIAL ASSETS

1992*



*END OF SECOND QUARTER

Mutual funds have always had a larger influence on emerging growth companies than, say, pension funds, but in the past few years that clout has been especially strong. The biotechnology industry, for instance, is heavily dependent on mutual funds to finance its growth. Health-care funds alone control nearly $5 billion in assets, and hundreds of other funds hold billions in biotech stocks. Fidelity funds, for instance, control about $1.7 billion in biotechnology stocks—about 7% of the industry's total market capitalization, and about half of that is in one fund, the Fidelity Biotechnology fund. That makes Karen Firestone, who has run the fund only since September, a pivotal player in biotech, as was Michael Gordon, her predecessor. Firestone has no difficulty reaching scientists, clinical investigators, or executives. Says Firestone: "Biotech companies are willing to talk because sometime in the future, they're all going to sell stock again, and they're going to need the mutual funds."

MUNIS TALK. The ebb and flow of cash on high-yield bond funds has a profound impact on the junk-bond market, too. Mutual funds hold an estimated $60 billion in junk bonds and are the major player in today's high-yield market, since many of the big players of the 1980s have thrown in the towel. "Since 1991, anywhere from 50% to 80% of the daily transactions are with mutual funds," says Joe Bencivenga, a managing director and head of corporate-bond research at Salomon Brothers Inc.

But the bulk of the mutual-fund business is in neither equities nor junk bonds. Fund investors, by and large, buy conservative bond funds, both the taxable and the tax-free varieties. That makes mutual funds, with an estimated $200 billion in U.S. government securities in their portfolios, a significant force in that market, helping to finance the federal debt.

While there are other big players in the U.S. government market, such as pension funds, insurance companies, and foreign investors, mutual funds are No. 1 in the tax-exempt municipal market. A decade ago, banks and insurance companies took active roles in the market. But declining profitability and changes in the tax laws forced them to the sidelines. The muni funds are the only power left in that market.

The funds have done a bang-up job in marketing single-state municipal bond funds, one of the industry's fastest-growing products. These funds offer resident investors income that is exempt from state as well as federal taxes.

Look at the Franklin California Tax-Free Income Fund. With $13 billion in securities issued by the state and local governments, this fund accounts for about one-third of all the assets in California bond funds. That makes Franklin Resources Inc. in San Mateo the single-largest investor in California municipal

Cover Story

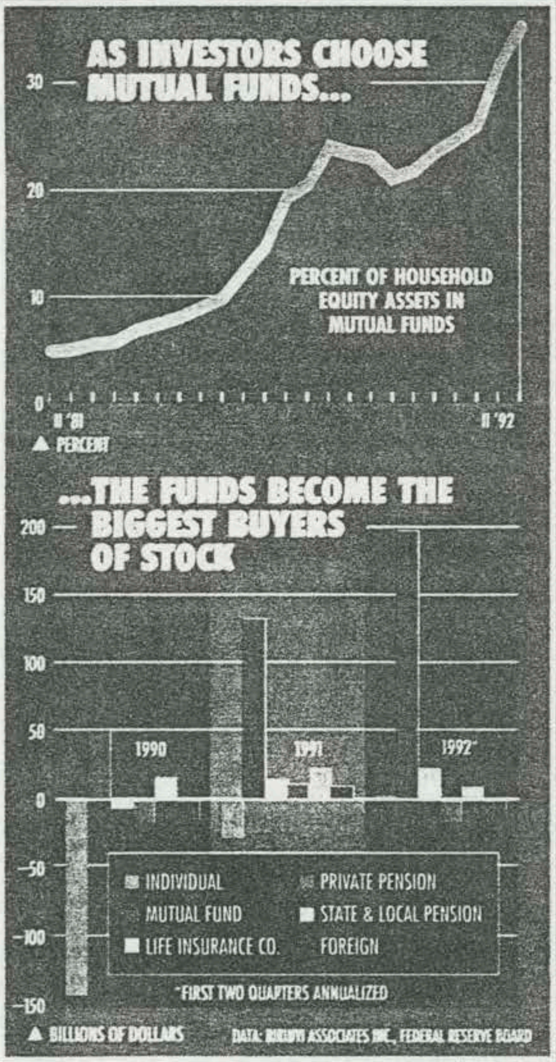


CHART BY LISA KNOUSE BRAIMAN

bonds—and the most powerful. As if to confirm Franklin's status, the California state treasurer appointed Tom Kenny, Franklin's director of municipal research, to a technical advisory committee of the California Debt Advisory Commission. He's the first representative from a mutual-fund company to hold such a post.

Few California bond deals come to market without first checking in at Franklin. "Issuers and their investment bankers are coming to see us all the time," says Kenny. "We like to be involved in the transactions early on." Kenny says issuers informally consult with his and other fund companies about upcoming bond sales, trying to shape maturities, covenants, and call features to the funds' needs.

'TWO-WAY STREET.' "Sure, we tailor [bond] provisions just for the mutual funds," says Jeffrey Holt, an investment banker in municipal finance at PaineWebber Inc. "But it's a two-way street." Holt says muni portfolio managers welcome innovative financing techniques that employ options, futures, or interest-rate swaps. "These strategies can save money for issuers, but are too complex to explain or sell to individual investors. So without the funds, they just wouldn't be done."

Muni funds also demand more and better information from issuers than do individuals. "Because of mutual funds, local governments are beginning to provide a higher level of financial reporting than they were accustomed to," says Jack Haley, who manages several California muni funds for Fidelity. While he says the expense of reports may make it more difficult for small, infrequent issuers, major bond issuers now keep bondholders informed.

Even if they are pickier, municipal-bond issuers like dealing with the funds. "It's easier to sell to a handful of funds than to thousands of individuals," says Philip Shapiro, chief financial officer for the Massachusetts Water Resources Authority. In one $836 million offering, he recalls, the Water Resources Authority met with representatives of 25 funds, and all but two bought in. In total, Shapiro estimates that funds hold about 60% of the authority's bonds.

This concentration of buying power is helping to lower the costs of selling bonds. Aaron Gurwitz, who heads municipal research at Goldman, Sachs & Co., figures lower distribution costs allow issuers to save 0.05 to 0.10 percentage points in interest expense. That may not sound like much, but it works out to as much as $230 million a year, based on the 1992 municipal-bond issuance of $230 billion.

But there is a drawback to the mutual funds' overwhelming dominance of the muni market. Should the funds be hit with a wave of redemptions, asks Ian Mackinnon, who manages the fixed-income funds for Vanguard Group, "who's going to buy the bonds?" In April, 1987, investors stampeded out of long-term municipal-bond funds, forcing fund managers to dump bonds to raise cash. Mackinnon says Vanguard alone had to sell $300 million of bonds in one week, and Drexel Burnham Lambert Inc. and Salomon Brothers bought most of them. Drexel is gone, Solly is out of the muni business—and Vanguard's muni business is nearly four times as large.

While the enormous force of mutual funds is a recent phenomenon in the equity and muni market, the funds' muscle has long been at work in the money markets. When money-market mutual funds burst on the scene in the late 1970s, they electrified the financial markets. At the time, banking regulations kept a lid on interest rates for retail, or consumer, deposits. But the money-market mutual funds enabled individual investors to participate in the wholesale, or "money," market of Treasury bills, jumbo CDs, and commercial paper—where interest rates were a lot higher.

Not only did the money funds lure banks' best depositors, they captured the best borrowers, too. Flush with cash, the money funds encouraged the expansion of the commercial paper market—short-term corporate IOUs. By issuing commercial paper, a corporation could save 1½ to 2 percentage points over what it would cost to borrow from the bank. So the banks' former depositors and former borrowers could now meet via the money-market fund, with a higher net yield to the investor and a lower interest expense to the borrower.

This end run around the banks has helped save corporations more than $100 billion in interest expense over the past 15 years. But it has been devastating for the banks. "By taking away the biggest and most creditworthy borrowers, the funds made it harder for banks to extend credit to small and medium-size borrowers," says Neal Soss, an economist at First Boston Corp.

MORE FLAVORS. Banks are still groping for ways to challenge mutual funds for the investor's dollar. With loan demand weak, banks are unable and unwilling to pay competitive rates for deposits. Nor can banks, which must maintain an expensive branch system, hope to compete with the funds' lower cost structure. For example, Vanguard Group Inc., the No. 3 fund manager and the leader in low-cost funds, recently introduced a series of U.S. government-securities funds with a maximum expense ratio—the cost of operating the fund—of 0.15, or 15¢ per $100. In contrast, banks now must pay 23¢ per $100 just for federal deposit insurance.

Prudential's George Sa-

Money funds have raised billions for business while luring away banks' best depositors lem, among many others, thinks funds have a special appeal to aging baby boomers who are just starting to hit their prime savings-and-investment years. By 2000, the 45- to 64-year-old age group will increase by 30%. The boomers, who make up a good part of that group, "are not going to be satisfied with the three flavors of investments that banks offer," says Salem. "They'll want 50 or 100 flavors from a mutual-fund company."

The weakness of the banks and the strong demographics lead J. William Bowen of First Manhattan Consulting Group to forecast that the public's holdings of mutual funds will grow by 15% a year for the remainder of the decade. Over the same period, Bowen thinks that consumers' bank deposits will grow only 4% per year. If he's right, by the year 2000, mutual funds will have $4.3 trillion, vs. $4 trillion for the banks.

A good chunk of the new money is coming from savers fleeing low-yielding bank deposits or from stock investors latching on to the bull market. What happens if interest rates start moving up or the stock market swoons? Some nervous investors may dump their initial fund, but experience shows that they are more likely to switch funds than go out of funds completely. After the 1987 stock market debacle, less than 1% of the money left the fund companies. The dollars remain because the funds have

HOW DO YOU INVEST $117 BILLION? ART ZEIKEL KNOWS

Charles E. Merrill, the patriarch of Merrill Lynch & Co., brought "Wall Street to Main Street" by selling stocks and bonds. What he refused to sell, unlike his rivals, was mutual funds. Merrill, the firm's history notes, considered them "unnecessary intermediaries whose early record and practices he found, at best, unimpressive."

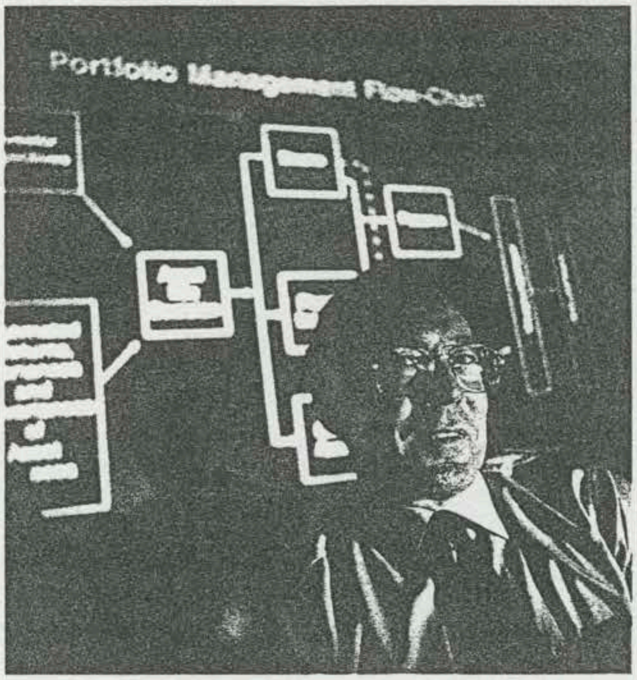
Too bad Merrill, who died in 1956, didn't live to meet Arthur Zeikel, president of Merrill Lynch Asset Management Inc. Zeikel, 60, who joined MLAM in 1976 and became president a year later, turned a small two-fund firm into the nation's second-largest mutual-fund operation, with $116.6 billion under management in 158 funds. More important, mutual funds are one of Merrill Lynch's most steadfast moneymakers. Merrill-watcher Perrin Long of First of Michigan Corp. estimates that selling and managing funds will account for about 20% of Merrill Lynch's estimated $940 million in 1992 profits and perhaps as much as 25% in 1993.

It shouldn't come as a surprise that the nation's largest brokerage firm, with 12,000 brokers, or "financial consultants," is also one of the largest fund companies. Remember, too, that there's about $43 billion in money-market funds tied to the firm's cash management accounts (CMAs), which Merrill pioneered in the 1970s.

'MAJOR BOOST.' Zeikel can't claim credit for inventing the CMA, but under his guidance, Merrill won the go-ahead from the Securities & Exchange Commission for "dual pricing" in 1988. That enabled it to offer two versions of each stock-and-bond fund: one sold with an up-front load, or sales charge, and the other with a back-end load and annual distribution fee. "It was a major boost to the business," says Zeikel, since many investors balked at the up-front charges. Dual pricing has since been widely copied by Merrill's competitors.

Zeikel's unit does have a lock on all Merrill money-fund business, but the brokers also sell other fund managers' wares. "The FCs [financial consultants] don't get paid extra to sell our funds," he says. "We have to earn their confidence." Zeikel says the FCs are, in effect, his customers, since they determine how clients' funds are invested.

Although his background is in investment management, Zeikel, who worked previously at Dreyfus, Standard & Poor's, and Oppenheimer, has never managed any Merrill funds. "I've been tempted," he says, "but fortunately, I backed down." Instead, he gives his managers a free hand. Nonetheless, fund maven A. Michael Lipper of Lipper Analytical Services Inc. notes Zeikel's imprint on the portfolios: "Art's a value investor with a fundamental orientation, and he's risk-averse. And that's what you see in the funds."



ZEIKEL: FEW RESTRICTIONS ON MERRILL'S FUND MANAGERS

Like any good salesman, Zeikel takes every opportunity to press the flesh with Merrill brokers and clients, from golf outings in Jacksonville, Fla., to speeches on global economics in Taipei. Several times a month, he lectures to visiting Merrill Lynchers at the conference center and office campus in Plainsboro, N. J., where MLAM is housed. Those talks are not about mutual funds, nor are they sales pitches.

STANDOUTS. Instead, Zeikel speaks about asset allocation and portfolio management, subjects on which he, well, wrote the book: Zeikel, along with Edward D. Zinbarg, an executive vice-president of Prudential Insurance Co., and the late Jerome B. Cohen, Zeikel's and Zinbarg's one-time professor at City College of New York, are authors of *Investment Analysis & Portfolio Management*, a textbook that is used at more than 300 colleges. A sixth edition is now under way. He's also a member of the editorial board of, and occasional contributor to, *Financial Analysts Journal*.

Even with their huge sales force, Merrill funds would not be so large if they didn't perform. John Rekenthaler, editor of *Morningstar Mutual Funds*, says their returns are better than other big brokers' funds but are only middle-of-the-pack compared with the top 30 fund companies. Still, Merrill has some standouts: Merrill Lynch High Income, with a 10-year average annual return of 13.4%, is a leader among junk-bond funds, and Merrill Lynch Pacific, 20.6%, is one of the first and best Asian funds. Those are records even Charles Merrill would tip his hat to.

By Jeffrey M. Laderman in Plainsboro, N. J.

JOHN S. ABBOTT

created investments for all seasons.

In fact, it seems the only way banks can compete with mutual funds for the consumer's dollar is to get into the fund business. Avi Nachmany of Strategic Insight Inc., a New York mutual-fund research and consulting service, estimates that banks now manage about 10% of fund assets and account for 12% of mutual-fund sales—a number that will likely increase in coming years.

It's not only the banks that are turning to funds. Most major brokerage firms have long since climbed on the mutual-fund bandwagon, using them as core holdings for their clients. Merrill Lynch & Co., the nation's largest brokerage firm, is the second-largest mutual-fund manager, and 3 of the 10 largest fund managers are brokerage affiliates or subsidiaries. Revenues from selling mutual funds to investors have grown tenfold over the past decade, according to the Securities Industry Assn.—and fees for managing funds, more than eightfold. Says A. Michael Lipper of Lipper Analytical Securities Corp.: "Mutual funds are some of the most profitable products that brokerage firms can sell."

EXPANDING OPTIONS. With banks and brokerages also feeding money into them, mutual funds are gaining ground on the pension funds, which now control nearly twice as many financial assets as the mutual funds. But employers are increasingly turning away from defined-benefit retirement plans—the bulk of today's pension assets—toward defined-contribution pension plans, such as the 401(k), that play into the hands of the mutual-fund companies. Mutual funds have about 18% of that $300 billion market now, but their market share is expected to grow to 27% within five years, according to Access Research Corp. The reason is simple. These pension plans put the investment decision in the employee's hands by offering investment options. And since mutual-fund companies already do that for investors, they're well-positioned to capture that booming business.

Skeptics may question the mutual funds' ability to maintain their double-digit growth rate and hold on to their newfound power. The naysayers may also dismiss America's enthusiasm for the funds as a passing fancy, much like the mania for hard assets in the 1970s and the leveraged-buyout binge of the 1980s. But the funds offer a multitude of investment choices at a low cost to a public that's hungry to increase the returns on its financial assets. That's just the mix of ingredients that could keep the funds on top for years to come.

By Jeffrey M. Laderman in New York, with Geoffrey Smith in Boston

THE SEC MAY NOT HAVE ENOUGH GUNS

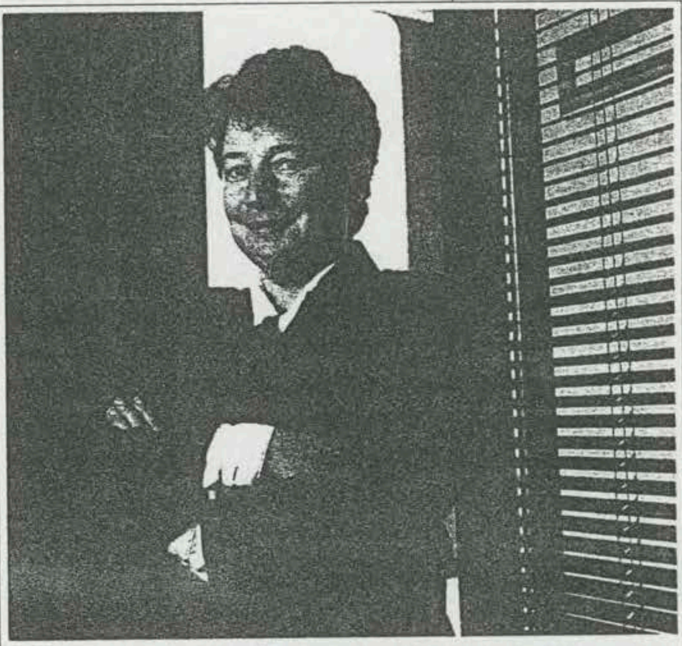
In the 1980s, the deregulators missed the mutual funds. The web of rules that govern funds, such as those designed to prevent self-dealing, maintain the integrity of fund assets, and keep investors apprised of fund activities, went unchanged. But the funds boomed nonetheless, and perhaps because of the rules, the funds have avoided the sort of scandals that rocked other financial institutions and cost investors money.

Yet the industry's explosive growth in recent years has given pause to regulators. The Securities & Exchange Commission is nervous that its staff assigned to monitor funds may be stretched too thin. Only 126 federal examiners keep tabs on nearly 3,800 mutual-fund portfolios with assets of $1.6 trillion. If the lack of examinations leads to a scandal, "investor confidence will be at risk," worries Douglas J. Scheidt, the enforcement chief for the SEC's Investment Management Div.

The fund industry itself is the biggest booster for stronger enforcement. The Investment Company Institute, which represents 95% of the funds, has lobbied to bolster the monitoring effort. "The industry is very cognizant that any guy screwing up is going to have horrendous consequences across the board," says Thomas R. Smith Jr., a New York securities lawyer.

The SEC decided in 1991 that it could maximize its resources by concentrating on the 100 largest fund managers. By reviewing such giants as Fidelity Investments and Vanguard each year, examiners keep watch on companies that account for 87% of fund assets.

'BIG STICK.' But smaller firms are more troublesome. Scheidt says that their record-keeping is often lax, yet they don't receive SEC scrutiny unless someone has filed a complaint. In March, for instance, the SEC censured Prime Financial Funds Inc. in Scottsdale, Ariz., for records and disclosure violations. Prime agreed to return $50,000 plus accrued interest to shareholders.



A "BIG STICK" STRATEGY: MUTUAL-FUND REGULATOR SMYTHE

The SEC has targeted other areas of potential abuse: fund directors who neglect their watchdog role, illegal use of inside information, and failure to perform credit analyses before buying securities. The message to violators: SEC Investment Management Div. Director Marianne K. Smythe intends to use enforcement actions as a "big stick," says Scheidt. Smythe's unit is negotiating settlements with two yet-unnamed funds. Both cases involve the mispricing of securities in fund portfolios.

In May, the SEC issued a 560-page review of the Investment Company Act of 1940, the main law that rules the funds. The report proposed only modest technical changes. "The act is very tough, and it's something that works," says Matthew P. Fink, president of the Investment Company Institute. Indeed, there's probably nothing wrong with fund regulation that a beefed-up enforcement effort wouldn't fix.

By Michael Schroeder, with Dean Foust in Washington

KATHERINE LAMBERT