Comments on Proposed Class Exemption for the Provision of Investment Advice to Participants and Beneficiaries of Self-Directed Individual Account Plans and IRAs

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Introduction

The Department of Labor ("Department") recently proposed regulations to enhance fiduciaries' ability to provide investment advice to participants in self-directed pension plans, including defined contribution plans and Individual Retirement Accounts ("IRA").[2] At the heart of this proposal is the idea that, by educating novice investors in the principles of sound investing, participants in self-directed pension plans will avoid common investment errors, thereby making better investment decisions within their plans. More broadly, disseminating investment advice has the potential to enhance the retirement income of millions of Americans, and I applaud the Department's initiative on this matter.

The Department identifies five "mistakes" that investors in self-directed pension plans make: paying higher fees and expenses than necessary; trading securities either excessively or too little; failing to adequately diversify investments; taking risks that are incompatible with an individual's risk and return preferences; and failing to minimize tax payments.[3]

Although I strongly support the Department's efforts to improve retirement plan participants' access to investment advice, I find no support for the Department's claims regarding excessive fees. Moreover, the Department needs to take care that it not impose its preferences, or its view of financial theory, on plan participants. While it may be true that some investors are making decisions based on insufficient information or understanding, the Department cannot assume that all investors who do not adhere to the currently accepted wisdom concerning asset allocation and corresponding fee levels are making mistakes. These plans are designed to be self-directed, allowing participants to use their own preferences in trading, diversification, and assumption of risks, and such decisions are not necessarily "mistakes." (For example, I'm sure some people would

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[2] Department of Labor, "Investment Advice—Participants and Beneficiaries; Proposed Class Exemption for the Provision of Investment Advice to Participants and Beneficiaries of Self-Directed Individual Account Plans and IRAs," FEDERAL REGISTER, 73(164), August 22, 2008 ("DOL Investment Proposal"), p. 49896.

[3] DOL Investment Proposal, pp. 49903-05.

consider my 100% equity portfolio a "failure to diversify," and perhaps a portfolio that results in fees that are "higher than necessary," but I picked it because it has the highest historical return and I don't mind the volatility, and I find the possibility of higher returns fair compensation for the fees I pay.)

The Department's contention regarding excessive fees continues a theme introduced in the Department's recent proposal regarding disclosures to defined contribution plan participants, that competition in the market for investment management has not provided sufficient fee disclosure to investors, resulting in "plan participants on average pay[ing] fees that are higher than necessary by 11.3 basis points."[4] In this more recent proposal, the Department repeats the same assertions, with the same support. Specifically, the Department cited six studies,[5] which I reviewed in comments that I submitted regarding the Department's disclosure proposal.[6] In those comments, I explained that none of these studies actually support the claim that plan participants pay fees that are higher than necessary by, on average, 11.3 basis points annually. Moreover, the Department's contentions in this regard are inconsistent with the evidence that the market for investment management services, generally, and the mutual fund industry, in particular, are competitive, and charge fees consistent with competition.[7] As all my earlier criticisms still apply, I attach my comments as Appendix A.

In this proposal, the Department cites three additional studies as evidence that "investors often pay higher fees than necessary."[8] These three studies have one thing in common: none of them are relevant to the Department's stated concern that participants in defined-contribution plans pay excessive fees. In addition, at least two of the studies have methodological problems sufficient to discredit their empirical findings. Finally, the

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[4] Department of Labor, "Fiduciary Requirements for Disclosure in Participant-Directed Individual Account Plans," Federal Register 73 (142), July 23, 2008 ("DOL Disclosure Proposal"), p. 43020, footnote 13.

[5] Five of these studies were cited in the DOL Disclosure Proposal, p. 43040, footnote 13. A sixth study was adding in an email from Dr. Anja Decressin, Division of Research and Economic Analysis, Office of Policy and Research, Employee Benefits Security Administration, Department of Labor, August 28, 2008.

[6] Diana Furchtgott-Roth, "Comments on Proposed Disclosure Requirements for Individual Investment Plans," September 8, 2008, attached as Appendix A to this paper.

[7] See, for example, Coates, IV, J. C. and Hubbard, R.G., (2007) "Competition in the Mutual Fund Industry: Evidence and Implications for Policy," THE JOURNAL OF CORPORATION LAW, 33(1), pp. 151-222; and Baumol, W. J., et al., 1990, THE ECONOMICS OF MUTUAL FUND MARKETS: COMPETITION VERSUS REGULATION, Boston: Kluwer Academic Publishers.

[8] DOL Investment Proposal, p. 49903, footnote 16. The three articles are: Todd Houge and Jay W. Wellman, "The Use and Abuse of Mutual Fund Expenses," Unpublished working paper, Social Science Research Network Abstract 880463, January 31, 2006 ("Houge and Wellman"); Paul G. Mahoney, "Manager-Investor Conflicts in Mutual Funds," JOURNAL OF ECONOMIC PERSPECTIVES, 18 (2) (Spring 2004), pp. 161-182 (Mahoney); and Javier Gil-Bazo and Pablo Ruiz-Verdu, "Yet Another Puzzle? The Relationship Between Price and Performance in the Mutual Fund Industry," Unpublished working paper, Social Science Research Network Abstract 947448, March 2, 2007 ("Gil-Bazo and Ruiz-Verdu"). In the same footnote, the Department does acknowledge that other research has found the opposite result, that mutual fund fees are consistent with competitive markets, though their references to that literature are somewhat abbreviated.

studies' interpretation of their findings does not hold up under closer examination. Thus, these three studies do not suffice as proof that participants in defined contribution plans pay excessive fees on their investments.

Analysis of Literature Cited by the Department

In what follows, I review each of these studies, summarizing its findings, discussing the study's applicability to defined-contribution plan mutual fund investing, analyzing the economic logic of the authors' interpretation of their results, and, where appropriate, discussing methodological issues and the credibility of the findings.

Houge and Wellman: The Houge and Wellman study first examines differences in expense ratios, including 12b-1 fees, between no-load and load mutual funds from 1970 to 2004, grouping funds into equity, bond, new equity, new bond, and equity index funds. The authors find that up to 1989, expense ratios were lower on average in load funds than in no-load equity and bond funds. However, from 1990 to 2004, they find the reverse held: the expense ratios of funds with loads rose, while the expense ratio of no-load funds fell. Houge and Wellman interpret their finding of higher expense ratios in load funds relative to no-load funds as evidence that mutual fund investment advisers segment share holders into unsophisticated, novice investors buying load fund shares and sophisticated investors buying no-load fund shares.[9] In the authors' interpretation, load fund advisers – because they are serving unsophisticated investors – need not and do not compete on the basis of fees, while no-load fund advisers – because they serve sophisticated investors – are forced to compete by lowering their fees.

This study fails to support the Department's claim of excessive fees to defined-contribution plan participants on many different levels. Most importantly, the results and the authors' interpretation of those results are simply irrelevant in the case of defined-contribution plans. First, 75 percent of mutual fund investments in defined contribution plans are in no-load funds; another 19 percent are in front-load funds that waive their loads for DC participants.[10] Because the authors believe that the level of sophistication

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[9] The authors assume there are two classes of mutual fund investors: inexperienced, unknowledgeable investors who purchase through a broker, paying a load or commission for investment advice, and experienced, knowledgeable fund investors who do not seek counsel from a broker and invest in no-load funds. The distinction drawn between novice investors selecting load funds and experienced investors selecting no-load funds, however, is far too crude. Eighty percent of households in 2007 owning funds outside of defined contribution plans purchased them through a professional financial adviser. (Investment Company Institute, "Ownership of Mutual Funds through Professional Financial Advisers, 2007," ICI RESEARCH FUNDAMENTALS, 17 (4), September 2008.) Industry data, however, show that the overwhelming majority of new investment flows are directed to no-load funds; for example, in 2007, flows to no-load funds were 8.4 times the level of flows into funds charging loads ($177 billion compared to $21billion). (Investment Company Institute, ICI MUTUAL FUND FACTBOOK 2008, p. 26) It is highly unlikely that the 80 percent of household who invest through brokers are responsible only for the $21 billion invested in load funds in 2007, while the remaining 20 percent of households directed $177 billion to no-load funds. Thus, it seems highly likely that at least some households who invest in no-load funds do so with the assistance of professional advice.

[10] Investment Company Institute, "The Economics of Providing 401(k) Plans: Services, Fees and Expenses, 2006," ICI RESEARCH FUNDAMENTALS,16(4), September 2007, pp. 8-9.

among no-load fund investors is sufficient to lead that segment of the market to a competitive equilibrium, Houge and Wellman's work – by their own reasoning – cannot support the contention that investors in defined contribution plans are paying fees that are "higher than necessary." Second, mutual funds must compete with one another – on the basis of price, past performance, services offered, and so forth – to be selected for inclusion in such plans. And when there are two or more mutual funds in the same investment objective category within a plan, the funds must compete on fees and performance to attract and retain shareholders. There is, therefore, a fundamental disconnection between the claim of Houge and Wellman that relatively higher fees in load funds are the result of segmenting the market into sophisticated and unsophisticated investors, and the reality that funds must be competitive to be selected for and remain competitive within a defined contribution plan's investment menu.

The economic logic behind Houge and Wellman's interpretation of their results also is implausible. The story they provide is inconsistent with profit incentives associated with load funds. Their story implies that load funds will experience high investor turnover relative to no-load funds because, as novice investors gain investment experience, they will move their assets to no-load funds. High investor turnover is costly to mutual funds.[11] Moreover, if a load fund charges high fees that are not commensurate with services provided, it will lose business: brokers have little incentive to recommend such funds when competitively-priced vehicles are available, since the broker must anticipate that as clients develop experience, such recommendations would put an account at risk. So, contrary to Houge and Wellman's inferences, a load fund's charging high fees that are not commensurate with services is not a road to long-term financial success.

The Houge and Wellman study also has serious methodological flaws. A growing disparity between load and no-load expense ratios, starting in the 1990s, is known to be at least partly explained by the increasing use of 12b-1 fees by load funds to compensate for reductions in average sales loads.[12] Houge and Wellman attempt to take this into account in a second reporting of their results, subtracting 12b-1 fees from expense ratios, but still conclude that expense ratios (net of 12b-1 fees) in load funds are higher than in no-load funds in each of the periods they studied, 1990-1994, 1995-1999, and 2000-2004.[13] Importantly, however, the authors make no attempt to control for other variables that may explain differences between the expense ratios of load and no-load funds. For

[11] This is apparent in the restriction that mutual funds impose on short-term investors. To reduce these costs, the SEC introduced a new rule in 2005, allowing mutual funds to impose redemption fees on shares held fewer than seven days. (Securities and Exchange Commission, "Mutual Fund Redemption Fees: Final Rule," FEDERAL REGISTER, March 18, 2005)

[12] Investment Company Institute, "The Cost of Buying and Owning Mutual Funds," ICI RESEARCH FUNDAMENTALS,13(1), February 2004.

[13] Houge and Wellman make arithmetic errors in the expense ratio minus 12b-l in the 1990-1994 period in their Table II. When corrected, no-load equity funds have a higher average expense ratio than load funds in the 1990-1994 period and the difference in expense ratios for bond funds in that time period falls from the study's reported statistically significant 0.13 percent to 0.03 percent, which is likely not statistically significant. Their finding of higher expense ratios in load funds, after adjusting for 12b-1 charges, only applies to 1995-2004 in the case of equity and bond funds.

example, expense ratios and assets under management are well known to be inversely related, with large funds having lower expense ratios:[14] if the average size of no-load funds is greater than load funds in the sample tested by Houge and Wellman, this would explain at least part of the fee differences they observe. Similarly, the authors do not consider differences in services provided to investors: if load funds provide greater value, on average, than no-load funds, load funds can therefore command higher expense ratios. Without adjusting for other determinants of expense ratios, Houge and Wellman's results are not credible.

Maloney: The primary focus of the second study cited by the Department, by Maloney, is whether promulgating regulations that encouraged monitoring by institutional investors would be a better response to the mutual fund late-trading scandals than relying on more traditional regulation. Maloney speculates that the market can be divided into sophisticated investors, who purchase less expensive no-load funds, and unsophisticated investors, who buy more expensive load funds. He specifically investigates whether one can explain differences in expense ratios among S&P 500 index funds using size of fund and whether the fund is a load or no-load fund. Restricting the sample to S&P 500 index funds ensures that performance varies little across the funds. Maloney finds that, among S&P 500 index funds, expense ratios decline as fund asset size increases, and that load S&P 500 index funds have higher expense ratios than their no-load counterparts. He concludes that these data are consistent with his speculation that the market is segmented into sophisticated and unsophisticated investors. Maloney draws no conclusions on the presence or absence of price competition in load funds.

Maloney's statistical analysis leaves unexplained over 70 percent of the variation in expense ratios within his sample. If variables he omits are correlated with load funds, such as greater services to investors, those omitted variables could explain the higher expense ratios in load funds and have nothing to do with unsubstantiated claims of no price competition between load funds. Again, the Department's use of Maloney's results does not support a claim of plan participants paying fees above the level of the value they receive.

As with the Houge and Wellman study, the Maloney article provides no direct evidence that fees paid by participants in defined-contribution plans are unnecessarily high. Moreover, Maloney's findings do not contravene the evidence that mutual funds compete to gain access to a defined contribution plan, remain in the plan, and to attract investors.[15]

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[14] See, for example, John C. Coates IV and R. Glenn Hubbard, 2007, "Competition in the Mutual Fund Industry: Evidence and Implications for Policy," THE JOURNAL OF CORPORATION LAW, 33(1), pp. 151-222.

[15] See, for example, Coates and Hubbard (2007) regarding competition among mutual funds for investors, generally. Note that tax-deferred accounts are an important market segment for mutual funds, accounting for 44 percent of all mutual fund assets as of the end of 2007. (Investment Company Institute, 2008 ICI MUTUAL FUND FACTBOOK, p. 23) Competition among funds offered by defined contribution plans is apparent in the 2008 edition of the Deloitte & Touche 401(k) benchmarking survey, which reported that 70 percent of plan sponsors replace under-performing funds in their line-ups, and 64 percent report having taken such action in the past two years. (Deloitte & Touche, 401(K) BENCHMARKING SURVEY: 2008 EDITION, p. 22) Elsewhere, Deloitte has discussed the effect that this competition has on asset managers, stating that "for a provider of a DC plan's investment option, there is an ongoing competition for existing

Gil-Bazo and Ruiz-Verdu: The last additional study on purportedly higher "than necessary" fund fees cited by the Department, by Gil-Bazo and Ruiz-Verdu, hypothesizes that if mutual fund managers competed in a perfectly competitive market (with no transaction costs, no barriers to entry and expansion, and instantaneous changes in fees), fees would adjust so that in equilibrium each firm would earn zero economic profits. In studying a sample of actively-managed diversified U.S. equity mutual funds, the authors found that the funds with the poorest before-fee performance charged the highest fees. They explained this result by hypothesizing that investors differ in their sensitivity to fund performance and fees. In the authors' view, poorly performing funds lose performance-sensitive investors to well performing funds, leaving behind performance-insensitive, fee-insensitive investors, who they characterized as unsophisticated investors. They posit that funds with insensitive investors succeed by charging high fees even though they perform poorly. The authors do not explain how poorly performing, high fee funds can survive over the long-term when fund managers are competing for customers based on superior performance.

The results of this study are also irrelevant to the Department's concern over plan participants paying fees above the competitive level. Employer-sponsors with a fiduciary duty to employees have little interest in selecting funds with poor performance and high fees over well performing funds with lower fees. The inverse relationship found by the study's authors has no applicability to defined-contribution plans.

Conclusion

Given that under the Department's own analysis, the so-called errors from allegedly excessive fees amount to considerably less than ten percent of the asserted quantification of "investment mistakes" identified in the proposal, and the absence of support for the underlying contention of excessive fees, I suggest that the Department remove excessive fees from its list of investment mistakes.

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assets within the plan, as well as for new contributions." (Deloitte & Touche, GLOBAL ASSET MANAGEMENT INDUSTRY OUTLOOK, April 2007, p. 5