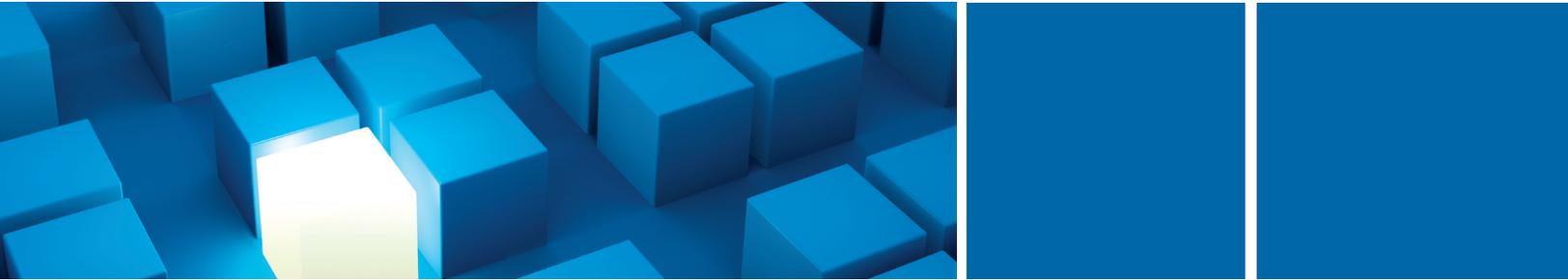


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Review of the White House Report Titled “The Effects of Conflicted Investment Advice on Retirement Savings”

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Executive Summary

The White House Report posits that US investors, in the aggregate, bear large costs because of the services provided by brokers who act in their own best interests, rather than the investors'. While the Report points to academic literature to support these aggregate cost estimates (a baseline number of \$17 billion), the estimates are not directly found in the academic literature. Instead, the aggregate costs are calculated by the authors of the Report themselves, who make generalizations and extrapolations which they often do not fully support. To calculate the aggregate estimate, the authors of the Report take the total value of load mutual funds in IRAs, plus the total value of annuities in IRAs, at year-end 2013 stood at approximately \$1.7 trillion. The Report then claims that a survey of the academic literature supports a finding that savers lose about 1% per year due to conflicted payments. By multiplying these two numbers together, they produce the claimed aggregate cost number.

This approach is flawed in multiple ways. Firstly, while it is true that the cited academic literature claims to find evidence of conflicts of interest between brokers and investors, a careful read of the academic literature suggests a more nuanced and complex set of findings than the simple claim of a 1% loss in annual returns. For example, one of the academic results on which the Report leans most heavily refers only to the year in which the fund is purchased, not to all years for which the fund is held, yet the Report uses that result as if the latter were true. This is given short shrift in the Report, and is referred to as a "detail" but is, of course, of primary quantitative importance.

Secondly, the Report provides no support for computing aggregate losses by adding in the entire market for annuities in IRAs, which represents approximately \$600 billion of the assets. Again, the Report only provides an *ipse dixit* one-line statement for the inclusion of annuities.

Thirdly, the Report does not attempt to quantify the benefits provided by brokers in the form of customer service, broader diversification, risk reduction, and other intangible benefits. For example, the Report does not consider the possibility that brokers may encourage their clients to save more than they otherwise would, as this is in the interests of both broker and client. While the Report does acknowledge that the brokers deserve fair compensation for their services, the discussion that follows is inapposite. For example, the Report does not consider the possibility that the benefits received by consumers may exceed the fees, thereby nullifying the apparent underperformance.

Additionally, much of the academic findings on which the Report focuses, such as Bergstresser et al. and Christoffersen et al., refer to the average performance of *funds* rather than of *investors* in funds. This difference is crucial, since the returns of any particular fund may or may not be reflected in the returns earned by investors who can trade in and out of funds. Individual investors may time the market correctly or incorrectly, and may or may not decide to buy the financial products their brokers suggest. It is true that the Report cites some academic studies that use account-level data, but those studies tend to be small in nature with perhaps only a few hundred observations and nearly all of them use data from outside the United States.

A substantial shortcoming of the Report is that it does not articulate a clear proposal for a future regulatory scheme that differs from the current one. As such, it is impossible to weigh the costs and benefits of whatever alternative is being proposed. This is a fundamental point. Whatever the situation is now, one needs to know the proposed alternative because cost and benefits are assessed by difference between the current situation and the proposed one.

In spite of not having yet articulated a proposal, the Report is defensive regarding the question of whether (not yet articulated) changes to the current system would harm Americans with modest savings. In particular, an entire page of the Report argues that the current system is not the only way for Americans with modest savings to obtain brokerage services. Three arguments are presented, none of which is adequately supported via analysis or academic citations. The first is a suggestion that brokers could just charge the same amount they receive now in loads directly to the clients; this implies that whatever proposal is set forth does not change the amount of work that the broker needs to do. The second is a claim that conflicted payments make it difficult for low-cost, high-quality alternatives to traditional brokers to compete. No explanation, academic citations or even examples are given by the Report about who would step in to provide these low-cost, high-quality brokerage services other than a vague reference to “new approaches to advice that exploit technological advances.” Third, the Report claims that brokers would voluntarily lose money on low-balance clients because they develop into higher-balance clients later. This claim is again offered with no support or citation to any academic work on how prevalent this effect could be. Additionally, this claim does not consider those investors whose balances can be expected to remain low.

Lastly, the Report dedicates a page to listing the experience in other countries that have recently enacted regulations to mitigate conflicts of interest. For example, the Report specifically lists the regulatory reforms in the United Kingdom, implemented under the guidance of the UK Financial Conduct Authority (FCA). However, the Report neglects to mention that the research commissioned by the FCA shows that brokers’ fees increased for at least some savers, especially those with smaller nest eggs. Moreover, the market for brokerage services is segmenting: in just three months, about 310,000 consumers stopped being serviced by their brokers because their account did not generate enough fees to cover the brokers’ costs.

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The Report does not put forward a clear proposal and therefore it cannot perform a proper cost-benefit analysis

In this document, we review the report titled “The Effects of Conflicted Investment Advice on Retirement Savings” dated February 2015 and bearing the seal of the “Executive Office of the President of the United States” (henceforth “Report”).

It is a basic tenet of Economics that to conduct a cost-benefit analysis of an alternative public policy one needs to have a well-articulated proposal. The Report does not put forward such a proposal. The Report instead makes three arguments. First, it suggests that under the current system investors are losing large amounts as foregone returns due to conflicted payments to brokers.¹ Second, the Report argues that the current system is not the only one under which investors with “modest savings” can obtain services such as those currently provided by brokers.² Third, the Report argues that mandated disclosures are unlikely to provide a solution.^{3,4}

In terms of magnitude, the Report posits that US investors, in the aggregate, bear costs on the order of \$17 billion per year because of services provided by brokers who act in their own best interests, rather than the investors’. The aggregate cost estimates provided in the Report are not part of the academic literature that the Report cites. The aggregate costs are calculated by the authors of the Report themselves, as follows. The total value of load mutual funds in IRAs, plus the total value of annuities in IRAs, at year-end 2013 stood at approximately \$1.7 trillion. The Report then claims that a survey of the academic literature supports a finding that savers lose about 1% per year due to conflicted payments. By multiplying these two numbers together, they produce the claimed aggregate cost number.⁵

Hence, the Report claims that there is a problem—namely, that the current system is causing Americans to suffer large aggregate losses—but does not articulate a clear proposal for an alternative regulatory framework. Hence, it is not possible to weigh the costs and benefits of what is being proposed.

However, the Report does appear to suggest that other regulatory frameworks might be better, particularly in the section on p.21 titled “Is the Current System the Only Way for Americans with Modest Savings to Obtain Advice?” In this short one-page section, three arguments are presented, none of which is adequately supported via analysis or academic citations. The first is a suggestion that brokers could just charge the same amount they receive now in loads directly to the clients. This implies that whatever proposal is set forth does not change the amount of work that the broker needs to do. The second is a claim that conflicted payments make it difficult for low-cost, high-quality alternatives to traditional brokers to compete. No explanation, academic citations or even examples are given by the Report about who would step in to provide these low-cost, high-quality brokerage services other than a vague reference to “new approaches to advice that exploit technological advances.”⁶ Third, the Report claims that brokers would voluntarily lose money on low-balance clients because they develop into higher-balance clients later. This claim is again offered with no support or citation to any academic work on how prevalent this effect could be. Also, this claim does not consider those investors whose balances can be expected to remain low.

In a separate section on p.24, titled “Do Mandated Disclosures Provide a Solution?” the Report argues that disclosure is not likely to provide a solution. Indeed, the Report goes so far as to say that disclosure may “in many cases, lead to harm and weaker consumer protections.”⁷ This claim is contrary to the one made by the Government Accountability Office in its January 2011 study⁸ which seems to advocate disclosure. Note that the Report cites the GAO publication in its discussion of the costs of the current system, but it does not address this deep difference of opinion on the remedies. Additionally, the Report’s claim is contrary to standard economic theory which typically indicates that disclosure and full-information is a solution to conflict problems and that “sunshine is the best disinfectant.” The Report is probably making broad generalizations reminiscent of behavioral economics when it argues that disclosure may not work because the financial landscape is too complex, disclosures are presented at “point of sale” and hence come too late, and because “individuals can only process a limited amount of information at one time.”⁹ But the Report provides no empirical evidence that could support the claim that these behavioral effects would be stronger than the effects predicted by standard economics. The two academic citations that the Report does give for the argument that disclosure will make things worse (Cain et al. 2005, Loewenstein et al. 2011) are theoretical arguments that may or may not hold any water in practice.^{10,11}

Although never made explicit in the Report, the reader is likely to deduce from the above as well as from Table 2 on p.6 that the Report is arguing to impose fiduciary duty on all brokers. Table 2 lists the legal standards required of RIAs, versus those of Broker Dealers, and it is here implied that the suitability standard is a lower bar.

However, if the fiduciary standard were imposed, we expect the cost of brokers’ services to increase. Any additional obligation that the regulator imposes on brokers would result in higher compliance costs, part of which would be passed on to investors (as it is well known in economics, under the name of “effective incidence”). Moreover, the higher compliance costs may lead brokers to refuse low-balance accounts that they currently serve as they may not yield enough fees to cover these additional costs, contrary to claims made in the Report. The result would be that low-balance accounts would find themselves without any guidance.

Takeaway: The Report suggests that there is currently a problem with conflicted payments, but does not put forth any specific proposal. It is therefore impossible to properly make a cost-benefit analysis.

If, for example, the reforms were to be the imposition of a fiduciary standard on all brokers, the increased costs would likely be passed down to consumers and some low-balance consumers may lose access to brokers completely, contrary to the not-well-supported claims made in the Report.

While discussing the United Kingdom’s reform, the Report omits the discussion of disadvantages suffered by low-wealth consumers

The United Kingdom issued a new regulation in 2013 banning commission payments from mutual funds to brokers. In the UK, brokers are now charging consumers directly for their services. The reform also included other provisions, such as the requirement that brokers attain a given certification.

The UK regulator commissioned studies to assess the impact of the reforms. These studies are to be carried on at specific points in time as the market adjusts to the new rules. Only the first of such studies, by Europe Economics, is currently available and it is replete with caveats that “[a] definitive evaluation is not possible at this early stage,”¹² and that in some areas “the market is adjusting and more time may be required for the full effects of the [reforms] to become apparent.”¹³ While the study does mention benefits of the UK reform, the study finds that “the impact on the total cost of investment—and the value obtained by consumers—are not yet clear.”¹⁴

A sizeable number of low-balance clients lost their advisor. Europe Economics finds that just in the first three months of 2014 about 310,000 clients stopped being served by their brokers because their wealth was too small for the broker to advise profitably.¹⁵

An additional 60,000 investors were not accepted as new clients by brokers for the same reason (low-balance) over the same three months.^{16,17} Europe Economics finds that brokers are segmenting their customers. Some brokers accept only customer with at least £50,000 (about \$77,000) or £100,000 (about \$154,000) in savings.¹⁸ Others are offering different services to different groups of consumers based on wealth or specialize only in wealthy consumers.¹⁹

Moreover, Europe Economics finds that there is an *additional* group of consumers that used to receive brokers’ services before the reform but does not any longer: those clients that are not willing to pay the new fees that brokers charge for their services.²⁰ The study does not quantify the number of these investors but it does state that they (too) have low-balance accounts.²¹

Both of these groups of consumers (who no longer receive brokerage services) are left to fend for themselves in the direct-to-consumers market. While the direct-to-consumer model can have advantages for the savvy investor, consumers with smaller savings are not usually those with the highest degree of financial sophistication.

These findings go hand in hand with Europe Economics’ findings on fees. The study finds that brokers fees have gone up in at least some geographies and for at least some consumers: “The evidence available does imply that adviser charges have increased post-[reform], at least for some consumers.”²² Europe Economics also finds that the consumers whose face higher fees tend to be those with smaller savings.²³ Additionally, Europe Economics cites a KPMG study that also “finds that ongoing advice prices are higher post-[reform]”.²⁴

While the impact on the total cost of investment for the overall market—and the value obtained by consumers—are not yet clear according to the research, there is evidence of a negative impact on at least some less-wealthy savers.²⁵

More generally, to the extent to which the UK reform and any proposed US reform differ, they may have different effects on the market, on the cost of brokerage services, and on market participation by consumers. But it is a general economic principle that, to the extent to which a reform increases costs, those will be passed on to consumers at least in part through the interplay of supply and demand (called “effective incidence” in Economics). And it is a general economic principle that, to the extent to which costs are passed to consumers, some consumers (typically the poorer) will lose access to the market for brokerage services or will opt out of it (creating a “dead-weight loss”).

Takeaway: In discussing the effects of the United Kingdom reforms, the Report neglects to mention that, according to research commissioned by the U.K. regulator, brokers' fees increased for at least some savers, especially those with smaller nest eggs. Moreover, in just three months, about 310,000 consumers stopped being serviced by their brokers because their account did not generate enough fees to cover the brokers' costs.

While there is evidence of a negative impact on at least some less-wealthy savers, the impact for the overall market on the total cost of investment—and the value obtained by consumers—are “not yet clear” according to that research.

The Report gives short-shrift to the benefits that consumers receive from brokers

At times, the Report seems to imply that all fees are excessive fees. In other words, the methodology in the Report treats the reduction in investor returns-after-fees as a cost, which implies that investors are paying fees for no reason. But the academic literature does not say this. For example, Kihn (1996)²⁶ notes that mutual funds fees are at least partly explained by a desire on the part of investors for customer service. In particular, Kihn (1996) finds that loads are positively related to the broker having an 800 telephone number, as well as other indicators of customer service.²⁷ This may explain apparent willingness of investors to pay loads that reduce returns.

According to Chalmers and Reuter (2014),²⁸ customers who choose to invest through a broker are “younger, less highly educated and less highly paid” than those who are self-directed investors.²⁹ Chalmers and Reuter (2014) go on to state that savers in their sample are “more likely to seek broker recommendations when they have lower levels of financial literacy or less investment experience,” suggesting that less sophisticated investors rely upon their broker’s recommendations when deciding how to invest.³⁰

In a similar vein, another paper cited by the Report is Del Guercio and Reuter (2014),³¹ which states that “51% of mutual fund shareholders indicate that they have an ongoing relationship with a financial adviser. Of these investors, 98% indicate that they have had contact with their financial adviser in the prior 12 months, and that they have been receiving investment advice from this adviser for a median of 10 years. They reportedly use an adviser because they ‘need help with asset allocation decisions’ and ‘want a financial professional to explain various investment options’ and because doing so ‘gives them peace of mind about their investments’.”³² They further state that, “broker clients may rationally accept lower expected returns in exchange for the broker services they perceive as higher quality, such as the personal trust that comes from repeated face-to-face contact (Gennaioli, Shleifer and Vishny (2014)).”³³

In addition to the service that brokers provide, there may be as-yet-unmeasured reasons that investors choose broker-sold funds. For example, as noted in Bergstresser et al. (2009),³⁴ “brokers may help their clients save more than they would otherwise save.”³⁵ Brokers have an incentive to make their customers aware of the need to save, and this is a non-pecuniary benefit that also accrues to the client. The Report does not mention these benefits.

Another benefit to consumers that the Report does not consider is that brokers may help reduce investors' tendency to under-diversify by over-investing in local stocks. Bergstresser et al. (2009) find that "broker-sold funds are more likely to invest in foreign funds, suggesting that the broker channel may somehow combat the home-bias effect, where investors appear to overinvest in local securities."³⁶

The Report contains a very short, and rather dismissive, section on the possible benefits provided by brokers.³⁷ Specifically, the Report states that "although we acknowledge the possibility that factors other than conflicts of interest could be at play, we do not find enough compelling evidence or justification to challenge our conclusion."³⁸

The Report goes on to make two points in this regard. First, while acknowledging that brokers deserve some compensation, underperformance of mutual funds before fees (as in Bergstresser et al. 2009) makes it "unlikely that the underperformance reflects the fair price of advice."³⁹ This of course ignores such statistical issues as self-selection—that is, investors that use brokers may not be the same kinds of investors that do not, and hence the difference in performance may not have anything to do with compensation payments to brokers. In other words, the Report does not consider the possibility that the benefits received by consumers who choose to use brokerage services may exceed the total of fees *and* underperformance.

Second, the Report argues that "households are mostly unaware of their advisers' conflicts and compensation arrangements."⁴⁰ Whether this is true is debatable, but even if it were true it seems to be a non-sequitur. Even if households were unaware, it does not mean that the compensation is unfair. The section concludes by saying that "opaque and complex pricing structures are likely to pose challenges for households."⁴¹ Again, this may or may not be true, but has no relationship to the question of whether brokers provide benefits that are valuable to consumers.

Takeaway: The Report does not give serious attention to the various ways that brokers provide benefits to consumers, even those mentioned in the academic literature, e.g. a stimulus to save more, or broader diversification.

When estimating aggregate costs, the Report does not make any adjustment for the limitations of the academic research it cites

The Report cites nine academic papers and one policy report as support for its proposition that the underperformance of funds sold through brokers is about 1%. It is true that the cited academic literature claims to find evidence of conflicts of interests between brokers and investors and many of the papers present this evidence in the form of underperformance. An in-depth review of the articles shows that, generally, they reach more limited conclusions. The Report does not make any adjustment to account for these limitations. We now focus on the primary articles cited by the Report related to US asset markets.

Reasons that cast doubt on the usability of the Christoffersen et al. (2013) result for the Report's purposes

While the Report takes the result in Christoffersen et al.'s (2013)⁴² and applies it to the whole IRA market, the Report does not account for the limitations of that research.

First, they analyze returns of *funds*, which is not the same as the performance of an individual investor because investors may trade in and out of the fund (potentially at the suggestion of their broker).⁴³ Therefore, the average performance of one fund may not be representative of the performance experienced by individual consumers. The Report does not take into consideration that investors are heterogeneous in their investment strategies and therefore some groups of consumers may gain from a brokerage services even when the performance of the fund bought/sold through brokers is lower.

Second, as mentioned above, the Christoffersen et al. (2013) paper combines data from the years 1993 to 2009 and therefore may not be representative of the current situation in the brokerage industry.⁴⁴ Christoffersen et al. (2013) also does not have an in-sample comparison with non-brokered accounts.

More technically, the R squares of the regressions in Table V are all under 4%, which means that 96% of the variation in the performance across funds is not explained by the model estimated by Christoffersen et al. (2013).⁴⁵ This strongly suggests that important drivers of the funds' performances are not accounted for by the model. If indeed factors are omitted and they correlate with brokers' fees, then the estimates in Christoffersen et al. (2013) are biased.

Perhaps most surprisingly, the Report mentions that "the authors estimate underperformance for the first year in which the funds are purchased rather than underperformance for every year that the saver holds the fund." The Report then goes on, in the next sentence, to refer to this as a "detail" which would "increase or decrease the underperformance estimate."⁴⁶ However, this is obviously of primary quantitative importance to the aggregate numerical result. Given that the cited paper by Christoffersen et al. (2013) does not provide an annual estimate, it casts doubt on its reliability and interpretability of the central claim in the Report.

Takeaway: Christoffersen et al.'s research has limitations that the Report does not account for. The returns are not those received by individual investors; they combine more than 15 years of data, and explain only a minuscule part of the variability of funds returns.

Bergstresser, et al. (2009) shows that at times the funds recommended by brokers perform better than those sold directly, while at other times they perform worse

Bergstresser, et al. (2009) compares the performance of a set of open-end mutual funds sold through brokers with a set of funds sold directly to the public.

Bergstresser et al. (2009) find that, for certain types of funds, funds sold by brokers underperform those sold directly, while for other types, they over-perform. Specifically, domestic equity funds sold by brokers underperform those sold directly; but even for this type of funds, the underperformance varies widely according to the methods used by the authors to account for risks, ranging from 23 bps to 255 bps (see their Table 3). However, for value-weighted foreign equity funds, the result goes in the other direction: broker-sold funds *over*-perform by 135 bps to 341 bps.⁴⁷ The results for money market funds are mixed and can be of either sign depending on specification. These discordant results beg a causality question; that is, if one claimed that the underperformance is due to the brokerage services, then why does the underperformance occur in some types of funds but not in others? The paper does not answer this question, undermining the contention that brokerage services causes *any* underperformance.

Takeaway: Bergstresser et al. (2009) finds that funds sold by brokers underperform those sold directly for certain types of funds, while for other types, they over-perform. So Bergstresser et al. (2009) does not support a blanket statement that brokerage services costs consumers 50 to 100 bps for the whole mutual fund market.

Other reasons that cast doubt on the usability of the Bergstresser et al.'s (2009) result for the Report's purposes

Methodologically, as the authors themselves note, characterizing mutual fund distribution channels is complicated. In their study, broker-sold are defined as those sold by an intermediary, which can include a bank, a brokerage firm (which may be captive) or a non-captive third-party broker.⁴⁸ As such, the study combines a wide variety of forms of distribution channels and does not purely study the effects of "broker involvement" as traditionally thought of.

Additionally, the study uses data which is subject to a number of limitations. Foremost, the study uses Financial Research Corporation (FRC) data to identify the primary distribution channel for each fund share class. However, this data is subject to error. For example, the authors themselves note that Lipper data differs from FRC data quite frequently when it comes to identifying distribution channels. Indeed, they disagree at a rate of 5.9% of fund classes,⁴⁹ which suggests that there is noise in the data. It is possible for such noise to affect the empirical results in this case and the paper does not explicitly address this possibility.

Second, the authors note that direct-sold funds may in fact use 12b-1 fees to pay for distribution costs.⁵⁰ Hence direct-sold funds are not to be confused with no-load funds. Similarly, funds that are considered directly distributed are sometimes used by fee-based financial advisors who are trying to assist clients.

Takeaway: Data limitations in Bergstresser et al. (2009) also cast doubt on the broad extrapolations that the Report makes of its results.

Del Guercio and Reuter (2014) does not provide a measure of performance that is germane to the use that the Report makes of it

The purpose of Del Guercio and Reuter (2014) is not to compare the performance of brokered accounts to those without brokers. Rather, it is to demonstrate that the retail mutual fund market is more accurately described as a segmented market catering to two distinct types of investors. One segment serves self-directed investors, while the other caters to investors who use brokerage services.⁵¹ Because the focus of the paper is that investors self-selected (chose) to use brokers when they could have invested directly, the paper provides one argument against the Report's claim that investors need protection from fees charged by their brokers.

The Report appears to be citing the Del Guercio and Reuter (2014) paper's finding that direct-sold funds have a higher statistical measure, known as "alpha," than broker-sold funds by about 115 bps per year.⁵² However, the Report ignores extensive discussion in Del Guercio and Reuter (2014) devoted to explaining why investors often rationally choose to use broker-sold funds even if they have higher fees. Of the mutual fund investors who say that they have an ongoing relationship with a financial advisor, 98% indicate that they have had contact with their financial adviser in the prior 12 months. They reportedly use an advisor because they "need help with asset allocation decisions" and "want a financial professional to explain various investment options" and because it "gives them peace of mind about their investment." The paper goes on to say that "broker clients may rationally accept lower expected returns in exchange for the broker services they perceive as higher quality."⁵³ The Report does not attach any value to these benefits that consumers actively look for.

Moreover, Del Guercio and Reuter (2014) finding that after-fee returns of direct-sold funds appear to outperform broker-sold funds is limited to actively-managed funds. It excludes, for example, individual securities, index funds, ETFs, annuities and a raft of other potential investment vehicles.

Additionally, as with Bergstresser et al. (2009), Del Guercio and Reuter (2014) uses Financial Research Corporation (FRC) data to identify direct-sold retail mutual funds from those that are broker-sold. Hence the data is subject to the same criticisms as in that study. The data is noisy in the sense that the identifiers do not always agree with those produced by Lipper, a competing data source. This calls into question whether, to what extent, and in what direction, the noisy data might be affecting the empirical results and conclusions in these academic studies.

Takeaway: Del Guercio and Reuter's (2014) main finding applies only to actively managed funds. Moreover, the Report ignores the focus of this paper which is consumers' self-selection into using brokers because those consumers who do select to use brokers value the services that they receive from them.

Chalmers and Reuter (2014) studies investment choice of Oregon University’s faculty. The Report has provided no basis for its extrapolation to the whole mutual fund market

Chalmers and Reuter (2014) gather data from Oregon University’s optional retirement plan (ORP), using data from 1996 to 2009. Participants in the plan can choose to invest through a firm that uses brokers to provide personal service, or they can choose from among low-service providers that do not offer such services.⁵⁴ The authors of the study use this fact to compare the ex post performance of the portfolios of the two different kinds of investors.

While the authors do find that investors who use brokers have lower returns, the authors also find that investors who choose the option with brokers are younger, less educated and have generally lower incomes.⁵⁵ This has two immediate implications. First, no evidence is provided that financially unsophisticated investors would construct portfolios that perform as well as sophisticated investors, on their own. The Report uses claims that brokers underperform, but Chalmers and Reuter (2014) does not provide any evidence that consumers that are currently using brokers would do as well as self-directed consumers if they were left to their own devices; if anything Chalmers and Reuter (2014) can be seen as suggesting the opposite.

Second, an implication of the finding that broker-clients have lower incomes and are less sophisticated is that any change to the current regulatory framework in which brokers have a reduced incentive to provide services could disproportionately hurt low-income investors.

Finally, note that this plan is available only to Oregon University faculty and administrators. The Report has provided no support to extrapolate the findings based on this sample to the whole US population.

Takeaway: Chalmers and Reuter (2014) analyzed the investment choices of some of Oregon University’s faculty and administrators. The Report has provided no basis for its extrapolation to the whole mutual fund (and annuity) market. Additionally, Chalmers and Reuter (2014) discuss the valuable services brokers provide to clients.

Other academic papers mentioned

The Report also mentions studies by Foerster et al. (2014) and Hackethal et al. (2012a, 2012b).^{56, 57, 58} The Report, however, does not address the extent to which these papers are applicable to the US market: the first paper is based on Canadian data and the latter two based on small samples of German data.

It is worth noting that Foerster et al. (2014) state that they “estimate that households gain 2.4% per year, on average, from using an advisor.”⁵⁹ While it is true that they find that this gain is offset by fees paid for brokerage services and money management, it is nevertheless the case that even in that study investors are not made worse off on net. Lastly, Foerster et al. (2014) note that their “result does not imply that clients do not benefit from using financial advisors”.⁶⁰

The Report fails to quantify the extent to which rollovers from 401(k) to IRA are driven by deliberate consumer choice

The Report posits that rollovers of funds from 401(k) to IRA are a channel by which conflicted payments manifest themselves in losses to consumers. The Report cites a GAO study for the proposition that certain advisers could earn \$6,000 to \$9,000 from rollovers. Specifically, the Reports states:

According to a recent GAO report, certain advisers could earn \$6,000 to \$9,000 if a plan participant were to purchase an IRA but only \$50 to \$100 if the same participant were to invest within the employer plan (GAO 2011).⁶¹

However, the Report does not mention that the GAO study characterizes the \$6,000 to \$9,000 figure as one example by *one* professional it interviewed.⁶²

More generally, the GAO study does not contain a cost-benefit analysis of rollovers. Rather the GAO office had explicitly been directed to focus only on costs: “GAO was asked to describe circumstances where service providers may have conflicts of interest in providing assistance related to the selection of investment options.”⁶³ The main methodology that the GAO used is interviews.

IRA accounts benefits include the access to a larger number of financial instruments (and therefore a greater opportunity to diversify), and the reduction in the burden to some consumers to keep track of small amounts of money in many separate 401(k) plans. The Report does not properly account for these benefits and fails to quantify the extent to which rollovers are driven by deliberate consumer choice.

Takeaway: The Report claims that the rollovers from 401(k) plans to IRA plans cause loss to consumers, but it overstates the strength of the evidence for the quantification of the costs it provides, and it does not properly consider the benefits.

While the academic study cited in the Report indicates that investors’ attempts to time the market reduces returns, it does not show that these attempts are due to brokers

The Report argues, on p.12, that “Conflicted payments can also lead to underperformance as a result of poor timing in investment decisions.” While the Report acknowledges that market mis-timing exists for reasons other than conflicted payments, it claims that conflicted payments can exacerbate the problem. However, it does not provide solid evidence for it.

The one paper cited as evidence for this claim is Friesen and Sapp (2007).⁶⁴ This study compares two measures of mutual fund performance. One is the standard measure, which corresponds to the return that would be experienced by an investor who took a buy-and-hold strategy with respect to the fund. The second is a more complicated measure designed to reflect the fact that investors buy into and sell out of funds over an observed time period. This latter measure, referred to as the “dollar-weighted return,” is designed to account for the fact that late flows into a fund do not get early returns (and early redemptions miss late returns).⁶⁵

The central finding of the paper is that investors’ timing of cash flows into and out of mutual funds reduces performance, with the reduction averaging about 1.56% per year.⁶⁶ However, these results do not prove that the mis-timing is *due* to brokers. Indeed, since the results hold for both index funds and actively managed funds, for high load funds and low load funds, it suggests that the opposite is true. Investors engage in excessive trading on their own. This interpretation is supported by other academic evidence such as the well-known Odean and Barber (2000)⁶⁷ who showed that individual investors trade too much, and would have substantially better returns if they traded less.

As noted by the authors themselves, “a comparison of the performance of index fund investors to that of non-index fund investors shows that both groups substantially underperform due to poor timing decisions. This suggests that a significant number of investors who have decided to take a passive approach to security selection by indexing are not necessarily passive in the timing of their cash flows, perhaps preferring a pure timing strategy through this low-cost vehicle.”⁶⁸

The paper’s findings may thus be taken in the opposite spirit as that suggested by the Report—brokers and financial advisors might in fact be able to ameliorate the problem of investor mis-timing by explaining to individual investors that they should trade less frequently.

Takeaway: While Friesen and Sapp (2007) does show that market mis-timing reduced returns, it does not provide any evidence about whether brokers prompt this or customers who use brokers are less savvy and more prone to attempt to time the market.

Mutual fund fees have dropped substantially since 2000, a fact omitted by the Report

While the Report attempts to portray brokers and investment advisers in the professional IRA market as charging excessive fees to investors, it fails to mention one of the most salient developments in recent years—namely, that mutual fund fees have been declining substantially. It is notable that this has occurred independently of any explicit government driven interventions. Below we describe some of the relevant data which establishes that this development has clearly occurred.

Declining Expense Ratios

In recent years, average expense ratios paid by mutual fund investors have fallen substantially (on an asset-weighted basis). Specifically, the Investment Company Institute (ICI) compiled expense ratios for three broad types of mutual funds over the years 2000-2013. The results are reproduced in Table 1 below.⁶⁹ The data indicate, for example, that in 2000 equity mutual fund investors incurred average expense ratios of 99 basis points. By 2013, that number fell to 74 basis points, a decline of 25 percent. The same basic pattern is true for hybrid and bond funds, as can be seen from the table.

Table 1. **Expenses Incurred by Mutual Fund Investors Have Declined Substantially from 2000 to 2013**

Year (1)	Equity funds (2)	Hybrid funds (3)	Bond funds (4)
-----in Basis Point-----			
2000	99	89	76
2001	99	89	75
2002	100	89	74
2003	100	90	75
2004	95	85	72
2005	91	81	68
2006	88	78	67
2007	86	77	64
2008	83	77	61
2009	87	84	64
2010	83	82	63
2011	79	80	62
2012	77	79	61
2013	74	80	61

Notes and Sources:

Data obtained from Investment Company Institute and Lipper. Expense ratios are measured as asset-weighted averages.

Data exclude mutual funds available as investment choices in variable annuities and mutual funds that invest primarily in other mutual funds.

Interestingly, both index and actively managed funds have contributed to the decline in average expense ratios. The breakout into management types are reproduced in Table 2 below.⁷⁰ From 2000 to 2013, the average expense ratio of index equity funds fell 15 basis points, similar to the decline of 17 basis points for actively managed equity funds.

Table 2. **Expense Ratios of Actively Managed and Index Funds from 2000 to 2013**

Year (1)	Actively Managed Bond Funds (2)	Index Bond Funds (3)	Actively Managed Equity Funds (4)	Index Equity Funds (5)
-----in Basis Point-----				
2000	78	21	106	27
2001	77	21	108	25
2002	76	21	109	25
2003	77	21	110	25
2004	75	19	105	24
2005	71	18	101	21
2006	69	17	98	19
2007	67	16	95	17
2008	65	16	94	17
2009	67	16	99	17
2010	67	14	96	15
2011	66	13	92	14
2012	65	11	92	13
2013	65	11	89	12

Notes and Sources:

Data obtained from Investment Company Institute and Lipper. Expense ratios are measured as asset-weighted averages.

Data exclude mutual funds available as investment choices in variable annuities and mutual funds that invest primarily in other mutual funds.

Declining Front-end Sales Loads

In terms of front-end sales loads, it is again the case that they have declined substantially over time with no explicit government intervention. Over the period 1990-2013, they have declined by nearly 75% for equity funds and hybrid funds, and even more than that for bond funds. The data from Figure 5.9 in the 2014 Investment Company Fact Book are reproduced below in Table 3.

Table 3. **Front-End Sales Loads That Investors Pay Are Well Below the Maximum Front-End Sales Loads That Funds Charge**

Year (1)	Maximum front-end sales load ¹			Average front-end sales load that investors actually paid ²		
	Equity (2)	Hybrid (3)	Bond (4)	Equity (5)	Hybrid (6)	Bond (7)
-----in Percentage of purchase amount-----						
1990	5	5	4.6	3.9	3.8	3.5
1995	4.8	4.7	4.1	2.5	2.4	2.1
2000	5.2	5.1	4.2	1.4	1.4	1.1
2005	5.3	5.3	4	1.3	1.3	1
2010	5.4	5.2	3.9	1	1	0.8
2013	5.3	5.2	3.8	1	1	0.7

Notes and Sources:

Data obtained from Investment Company Institute, Lipper, and Strategic Insight Simfund.

Data exclude mutual funds available as investment choices in variable annuities and mutual funds that invest primarily in other mutual funds.

¹ The maximum front-end sales load is a simple average of the highest front-end load that funds may charge as set forth in their prospectuses.

² The average front-end sales load that investors actually paid is the total front-end sales loads collected by funds that funds collected divided by the total maximum loads that the funds could have collected based on their new sales that year. This ratio is then multiplied by each fund's maximum sales load. The resulting value is then averaged (simple average) across all funds.

It is particularly interesting to note that the ICI argues this decline, at least in part, may reflect the increasing role of mutual funds in helping investors save for retirement. That is, mutual funds now often waive load fees on purchases made through defined contribution plans, such as 401(k) plans.

Additionally, as can be seen from the data below (reproduced from Figure 5.10 of the 2014 Investment Company Fact Book), nearly all net new cash flows in recent years have accrued to no-load mutual funds. Net flows to load mutual funds have been negative for all four years of the most recent data.

Table 4. **Nearly All Net New Cash Flow Was in No-Load Institutional Share Classes**

	2004 (1)	2005 (2)	2006 (3)	2007 (4)	2008 (5)	2009 (6)	2010 (7)	2011 (8)	2012 (9)	2013 (10)
-----in billions of dollars-----										
All long-term mutual funds	\$210	\$192	\$227	\$224	-\$225	\$389	\$241	\$26	\$196	\$152
Load	42	22	30	10	-151	15	-60	-133	-83	-71
Front-end load ¹	48	41	44	18	-105	2	-57	-101	-67	-58
Back-end load ²	-40	-47	-47	-42	-39	-24	-27	-23	-16	-11
Level load ³	32	29	34	37	-9	36	22	-10	1	-8
Other load ⁴	1	0	0	0	1	0	2	0	-1	0
Unclassified	1	-1	-1	-2	0	0	0	0	0	6
No-load⁵	132	152	173	190	-48	345	293	181	307	277
Retail	103	80	89	84	-77	159	86	-30	32	58
Institutional	29	72	84	106	29	186	208	211	275	219
Variable annuities	36	18	24	25	-26	29	8	-21	-28	-53

Notes and Sources:

Data obtained from Investment Company Institute and Lipper.

Components may not add to the totals because of rounding. Data exclude mutual funds that invest primarily in other mutual funds.

¹ Front-end load > 1 percent. Primarily includes Class A shares; includes sales where front-end loads are waived.

² Front-end load = 0 percent and contingent deferred sales load (CDSL) > 2 percent. Primarily includes Class B shares.

³ Front-end load ≤ 1 percent, CDSL ≤ 2 percent, and 12b-1 fee > 0.25 percent. Primarily includes Class C shares; excludes institutional share classes.

⁴ All other load share classes not classified as front-end load, back-end load, or level load. Primarily includes retirement share classes, known as Class R shares.

⁵ Front-end load = 0 percent, CDSL = 0 percent, and 12b-1 fee ≤ 0.25 percent.

Moreover, it appears that this trend may have continued into the most recent completed year, 2014. An article published in late November of 2014 in the financial publication Investment News states that “mutual funds with sales charge and distribution fees are on pace for their fifth and possibly largest-ever year of redemptions.”⁷¹

That mutual fund fees have declined appears undeniable. There are various potential explanations for this decline. We have already seen that there is a wider availability and demand for no-load funds, as compared to load funds. That is, the downward trend may simply reflect the common-sense notion that investors tend to buy lower-cost funds as they become available. We know, for example, that in 2013, 66 percent of index equity fund assets were held in funds with expense ratios that were among the lowest 10 percent of all index equity funds (see, Investment Company Fact Book, Chapter 5).

Additionally, the ICI notes that mutual fund expenses may also have fallen because of increased competition. From 1990 to 2013, the number of households owning mutual funds more than doubled—from 23.4 million to 56.7 million. The number of shareholder accounts more than quadrupled. Perhaps competition among existing fund sponsors, new fund sponsors entering the industry, competition from products like exchange-traded funds (ETFs), and economies of scale all contribute to this trend.⁷²

Takeaway: The Report fails to mention that mutual fund fees have declined substantially in recent years. This fact appears to be robust, and discernable from publicly available data.

Notes

- 1 See Report, p. 17-18.
- 2 See Report, p. 21.
- 3 See Report, p. 24.
- 4 From certain statements in the discussion of additional disclosures one can glean a certain disfavor of the Report for additional disclosures. On the other hand, the GAO 2011 report, which the Report repeatedly cites, makes additional disclosures the centerpiece of its proposal. See GAO (January 2011) "Improved Regulation Could Better Protect Participants from Conflicts of Interest."
- 5 See Report, p. 2.
- 6 See Report, p. 21.
- 7 See Report, p. 24.
- 8 GAO (January 2011) "Improved Regulation Could Better Protect Participants from Conflicts of Interest."
- 9 See Report, p. 24.
- 10 Cain, D. M., Loewenstein, G., & Moore, D. A. (2005). The dirt on coming clean: Perverse effects of disclosing conflicts of interest. *The Journal of Legal Studies*, 34(1), 1-25.
- 11 Loewenstein, G., Cain, D. M., & Sah, S. (2011). The limits of transparency: Pitfalls and potential of disclosing conflicts of interest. *The American Economic Review*, 101(3), 423-428.
- 12 Europe Economics, "Retail Distribution Review Post Implementation Review", December 16, 2014, p. 1. See also p. 7.
- 13 Europe Economics, p. 2.
- 14 Europe Economics, p. 5.
- 15 Europe Economics, p. 63.
- 16 Europe Economics, p. 63.
- 17 The Europe Economics study does go on to speculate that "If we assume that many of those clients with relationships terminated on the grounds of inadequate profitability sought out another adviser, the positive net increase in customers served suggests that such looking around for a replacement was largely successful. We cannot rule out the existence of a residual group of consumers denied service in this way." But that is just an assumption; Europe Economics provides no evidence that this happened in practice.
- 18 Europe Economics, p. 50. Europe Economics claims that some of this segmentation was happening even before the reform; but does not attempt to provide an estimate of the additional fragmentation caused by the reform.
- 19 Europe Economics, p. 44.
- 20 Europe Economics, p. 61.
- 21 These are consumers whose nest egg is big enough that brokers would server them, but not so large that having an advisor would result in a substantial benefit.
- 22 Europe Economics, p. 67. See also p. 64.
- 23 "The evidence currently available implies adviser charges have increased post-[reform], at least for some consumers. On the other hand, given that at least some advisory firms have been removing cross-subsidies between consumers, this does suggest higher wealth clients are likely to be paying less than pre-[reform]." Europe Economics, p. 64.
- 24 Europe Economics, p. 65.
- 25 Europe Economics, p. 60.
- 26 Kihn, J. (1996). "To load or not to load? A study of the marketing and distribution charges of mutual funds," *Financial Analysts Journal*, 52(3), 28-36.
- 27 Kihn (1996), p. 35.
- 28 Chalmers, J. and J. Reuter (2014), "What is the Impact of Financial Advisors on Retirement Portfolio Choices and Outcomes?" working paper, University of Oregon.
- 29 Chalmers and Reuter (2014), p. 23.
- 30 Chalmers and Reuter (2014), p. 2.
- 31 Del Guercio, Diane and Jonathan Reuter (2014) "Mutual Fund Performance and the Incentive to Generate Alpha", *The Journal Of Finance*, Vol. 69(4), p. 1673-1704.
- 32 Del Guercio and Reuter (2014), p. 1678.
- 33 Del Guercio and Reuter (2014), p. 1678.
- 34 Bergstresser, Daniel, John Chalmers, and Peter Tufano (2009), "Assessing the Costs and Benefits of Brokers in the Mutual Fund Industry", *The Review of Financial Studies*, 22(10), p. 4129-4156.
- 35 Bergstresser et al. (2009), p. 4131.
- 36 Bergstresser et al. (2009), p. 4149.
- 37 See Report, p. 22, "Alternative Explanations for Underperformance."
- 38 See Report, p. 22.
- 39 See Report, p. 22.
- 40 See Report, p. 22.
- 41 See Report, p. 22.
- 42 Christoffersen, Susan E. K., Richard Evans, and David K. Musto (2013) "What Do Consumers' Fund Flows Maximize? Evidence from Their Brokers' Incentives," *Journal of Finance*, Vol. 68(1), p. 201-235.
- 43 Christoffersen et al. (2013), p. 211-212.
- 44 Christoffersen et al. (2013) looks to averages over 17 years; although it uses fixed effects to account for year-specific phenomena, it spans the full 1993-2009 period.
- 45 Christoffersen et al. (2013), p. 226.
- 46 See Report, p. 15.
- 47 Bergstresser et al. (2009), p. 4138.
- 48 Bergstresser et al. (2009), p.4132.
- 49 Bergstresser et al. (2009), p.4134.
- 50 Bergstresser et al. (2009), p.4132.
- 51 Del Guercio and Reuter (2014), p. 1701.
- 52 See Report, p. 11.
- 53 Del Guercio and Reuter (2014), p. 1678.
- 54 Chalmers and Reuter (2014), p. 2.
- 55 Chalmers and Reuter (2014), p. 23.
- 56 Foerster, S. J. T. Linnainmaa, B. T. Melzer, and A. Previtero (2014), "Retail Financial Advice: Does One Size Fit All?" National Bureau of Economic Research, Working Paper, 20712.
- 57 Hackethal, A., Haliassos, M., & Jappelli, T. (2012). Financial advisors: A case of babysitters? *Journal of Banking and Banking & Finance*, 36(2), 509-524.
- 58 Hackethal, A., R. Inderst, and S. Meyer (2012b). Trading on Advice. SSRN working paper, 1701777.

- ⁵⁹ Foerster et al. (2014), p. 5.
- ⁶⁰ Foerster et al. (2014), p. 5.
- ⁶¹ See Report, p. 15.
- ⁶² "For example, according to an industry professional, a service provider could earn \$6,000 to \$9,000 in fees from a participant's purchase of an IRA, compared with \$50 to \$100 in fees if the same participant were to invest in a fund within a plan." GAO 2011, p. 36 [emphasis added].
- ⁶³ See Highlights section on the back of the cover page (unnumbered).
- ⁶⁴ Friesen, Geoffrey C., and Travis RA Sapp (2007), "Mutual Fund Flows and Investor Returns: An Empirical Examination of Fund Investor Timing Ability," *Journal of Banking and Finance*, 31(9), 2796-2816.
- ⁶⁵ Friesen and Sapp (2007), p. 2797.
- ⁶⁶ Friesen and Sapp (2007), p. 2796.
- ⁶⁷ Barber, B. M., and T. Odean (2000), "Trading is hazardous to your wealth: The common stock investment performance of individual investors," *Journal of Finance*, 55, 773-806.
- ⁶⁸ Friesen and Sapp (2007), p. 2815.
- ⁶⁹ See Figure 5.1, Chapter 5 of the 2014 Investment Company Fact Book, *Mutual Fund Expenses and Fees*, available online at http://www.icifactbook.org/fb_ch5.html
- ⁷⁰ See Figure 5.6 of the 2014 Investment Company Fact Book.html.
- ⁷¹ "Brokers' push to fee-based comp slams higher-cost funds," *InvestmentNews*, November 21, 2014. Article available online at <http://www.investmentnews.com/article/20141121/FREE/141129983/brokers-push-to-fee-based-comp-slams-higher-cost-funds>.
- ⁷² See Chapter 5 of the 2014 Investment Company Fact Book.

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Our work in this matter is ongoing. We may update our opinions as more facts become available to us and we continue our analysis.