The Rotten Deal: Managed Mutual Funds and Retirement Income

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Abstract

About 70 percent of mutual fund assets are in managed funds. These funds seek to earn an above average return for investors but, because of the up-front loads, fees and other costs, they generally earn less than the low cost index funds that only seek to get a return equal to that of the stock market. Investors can expect their retirement savings to be reduced by 25 percent or more by favoring managed funds over index funds. The costs imposed on investors in managed funds result in tens of billions of dollars in profit for the industry. Compromised retirement savings is of public concern if government programs are going to support elderly households in need. Two policy options are explored. One is focused on educating investors about the rotten deal offered by managed funds while the other is to impose a fiduciary responsibility on the industry that requires them to act in the best interests of its clients. There is ample evidence that the industry will vigorously combat such efforts.

Key words: retirement, income pension, public policy, economics
Introduction

Older adults have five potential sources of income to support their consumption: continue working, pension funds, personal savings, social security, and support from family members. With the rise of 401(k) and 403(b) defined contribution pension plans, the distinction between personal savings and pension benefits is blurred. Since Social Security replaces only 40 percent of the average income, it is widely recognized that most households do not save enough to sustain income after retirement.

This paper focuses on the contribution savings can make to sustaining the consumption of retirees. This contribution rests on two factors: how much individuals save during their working life and how effectively these savings are invested for future use. Rather than focus on how households can be encouraged to save more for retirement, here we concentrate on how investment strategies can improve their return on savings and, correspondingly, raise their standard of living after age 65. The evidence shows that managed mutual funds, the largest vehicles for retirement saving, systematically undermine the long-term goals of investors. By imposing excessive fees and other hidden costs, managed mutual funds offer investors a rotten deal that significantly erodes their retirement assets. In contrast are index funds that offer a low cost alternative to managed funds and offer a higher expected rate of return. This raises the question as to whether there are public policies and other avenues that can improve the investment environment for retirement planning.

A Portrait of Individual Savings

Social security effectively eliminates poverty among the elderly in the United States, largely due to the fact that the guidelines represent a low standard of living. The poverty guideline for Medicaid eligibility in 2016 was $16,020 for a family of two. This is approximately the average social security payment. Sustaining a standard of living beyond poverty is the objective purpose of saving for retirement: 91 percent of mutual fund owners report that retirement is their primary motive for saving (Investment Company Institute, 2016).

Assessing the adequacy of savings for retirement requires a target, albeit arbitrary, standard of living for the elderly. For this purpose we turn to the Consumer Expenditure Survey which reports that the average household aged 65-74 spent 46,097 in 2014 (Foster 2016).

Savings can fill the gap between this expenditure goal and Social Security payments. Assume a two-person household with each receiving the average Social Security payment of $16,000. The difference between the annual expenditures target and $32,000 in social security income, the retirement income gap, is $14,097. Net worth of the median household 65 years and over
in 2011 was $171,135 (Vornovitsky, undated). Invested in a conservative portfolio that yields a two percent real rate of return (i.e., adjusted for inflation) can support an annual withdrawal of $6,845 (four percent of the original balance) that can be sustained for more than 30 years. For the median household aged 65 and older, the income gap after accounting for the contribution of saving remains $7,252.

The distribution of wealth among elderly households over 65 is very unequal, varying from $400 at the tenth percentile, $68,783 at the 30th percentile, $344,870 at the 70th and $899,608 at the 90th percentile (Vornovitsky, undated). Income generated by a four percent draw on assets held by the 70th percentile, coupled with two average social security entitlements, yields an income of $45,795 which approximates the income target of $46,097. These rough calculations suggest that while many relatively high wealth retired households may not be satisfied with their income, they at least have a standard of living that is equal to or greater than the average of their age group.

Household retirement assets in 2015 totaled $27.5 trillion. Mutual and exchange traded funds accounted for $13.66 trillion of this total and are growing very rapidly: during the preceding decade they grew by more than $8.2 trillion, representing a 150.4 percent increase. This is indicative of a massive transformation in the finance industry: Household retirement assets overall grew only 29.1 percent during the same decade. Mutual fund ownership is widespread. In 2015 54.9 million households owned mutual funds which represents 44.1% of all households and 93.1 million individuals. The median assets held by these households is $120,000 (Investment Company Institute, 2016). The breadth of mutual fund ownership is due to the fact that many workers are covered by 401(k) and 403(b) defined contribution retirement programs that are typically invested in mutual funds.

The mutual fund universe is comprised of actively managed portfolios, “index” funds, and Exchange Traded Funds (ETFs). Exchange-Traded Funds are mutual funds that are bought and sold in stock markets like any publicly traded company. About 98 percent of exchange-traded funds are indexed rather than actively managed. Actively managed funds are those that trade in the stock market with the intention of increasing shareholder assets by more than the percentage increase in the overall market. In contrast, index funds are passively managed in the sense that the assets are invested in a bundle of stocks that reflect the entire market. Using an index, such as the Standard and Poor’s 500, assures that the annual returns to fund holders will approximate overall trends in the stock market.

Of the over $13.66 trillion invested in mutual funds in 2015, 14.7 percent were in passively managed funds ($2.0 trillion) and 15.6 percent were in exchange traded funds with 69.6 percent in actively managed funds ($9.5 trillion). Thirty-two percent of the 54.9 million households that own a mutual fund had at least one index fund in 2015 (Investment Company Institute, 2016). Since so many retirement assets are invested in mutual funds, it is important to compare the efficacy of active and passive strategies of investing mutual fund assets.
All Mutual Funds Are Not Created Equal

Investing in an actively managed mutual fund is rooted in the belief that it is possible to get superior returns. At issue is 1) can actively managed funds consistently beat the market? 2) is their margin of success large enough to offset the fees and other costs associated with managing the fund? and 3) can investors reliably predict which funds are likely to be successful in earning superior returns that cover their costs?

The empirical evidence suggests that while some actively managed funds might be able to outperform a S&P 500 index, the median fund comes up short over the long run. Malkiel (2003) reports that the shortfall is almost two percent over a 10 year period ending in 2001. The academic literature is consistent with Malkiel’s finding in that most studies report that high-fee managed funds, on average, are outperformed by low cost index funds that track the S&P 500 (Bogle; 2014; Fisch and Wilkinson-Ryan, 2014; Haslem , 2013; and Wermers, 2000).

Investors in actively managed funds, in effect, are hiring the managers to produce superior returns. The managers, as typical of agents in any business relationship, have conflicting interests in that they want to maximize their profits while “serving” their clients. In a review of the mutual fund industry, The Economist (June 11, 2016) echoed this harsh evaluation: “The real problem is not the rise of Vanguard and the other tracker funds; it is the rotten deal that retail investors have received from the fund management industry for far too long.”

For investors to prosper in an actively managed fund, the asset managers must not only beat the market but must also exceed the market by enough to enable investors to recover the fees, charges and other costs that are imposed on them.

The basic cost of investing in a mutual fund is the expense ratio. The average mutual fund expense ratio includes administrative fees and sales or distribution (12b-1) fees and, in the case of actively managed funds, advisory fees. The distribution fees allow investors to pay indirectly for financial advice from brokers. They are also used to pay for advertising and marketing costs, i.e., they pay for the fund’s efforts to attract more customers. In 2015 the average asset weighted expense ratio for actively managed funds was more than 6 times higher than that of index funds: .8 percent versus .13 percent. According to the industry’s report, the simple average expense ratio for equity funds is 131 basis points which is 1.31 percent. Fees in funds in the 90th percentile are 205 basis points.

The power of fees and sales charges to erode returns is shown in Table 1. Using a Fund Analyzer Report that is available through the Securities Exchange Commission web site, it is possible to compare the impact of fees and sales charges on the returns. For this exercise we compare the Fidelity Advisor Equity Income Fund Class A and the Vanguard 500 Index Fund Investor Class. The latter is an example of a low cost index fund. In this comparison the hypothetical investment of $10,000 is assumed to get a seven percent rate of return over a 20 year holding period. Total fees and sales charges over the period are $4,213 for Fidelity and $666 for the Vanguard fund.
The fund value after 20 years is $29,682 for Fidelity while the lower cost Vanguard fund is valued at $37,478. For this $10,000 investment over 20 years the investor in Vanguard has an ending value that is 39 percent higher than the same investment in the Fidelity fund.

This is not the end of the story, however. There are other drains on investor assets that are not disclosed in the calculator provided by the SEC. These are transaction costs, which include brokerage commissions and other trading costs. As the managed funds trade stocks in search of the superior returns the stock pickers generate commissions that are paid for by the fund’s investors. The more often a fund turns over its portfolio, the bigger the drain on investor assets. Mutual funds that are in the constant search of superior returns will obviously trade more than those that are following the market by investing in a stable index such as the S&P 500.

The non-commission costs of mutual fund trading are a second undisclosed drain on assets. A market maker in stocks offers to buy a specific stock for less than it is expects to sell it. This is how the market maker earns a profit. An individual investor can trade stocks without influencing the bid/ask spread. Not so for large mutual funds. These funds may sell hundreds of thousands or a million shares at a time and therefore can actually affect the market. Because the market maker cannot be sure what price will be received when that many shares

Table 1. A Comparison of Investments in a Managed Fund vs an Indexed Mutual Fund

<table>
<thead>
<tr>
<th>Ticker Symbol</th>
<th>FEIAX&lt;sup&gt;a&lt;/sup&gt;</th>
<th>VFINX&lt;sup&gt;b&lt;/sup&gt;</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mutual Fund Type</td>
<td>Managed</td>
<td>Indexed</td>
</tr>
<tr>
<td>Investment Amount</td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Estimated Return</td>
<td>7.00%</td>
<td>7.00%</td>
</tr>
<tr>
<td>Holding Period (years)</td>
<td>20</td>
<td>20</td>
</tr>
<tr>
<td>Fund Value After 20 Years</td>
<td>$29,682</td>
<td>$37,478</td>
</tr>
<tr>
<td>Profit/Loss</td>
<td>$19,682</td>
<td>$27,476</td>
</tr>
<tr>
<td>Total Fees</td>
<td>$3,638</td>
<td>$666</td>
</tr>
<tr>
<td>Total Sales Charges</td>
<td>$575</td>
<td>0</td>
</tr>
<tr>
<td>Total Fees and Sales Charges</td>
<td>$4,213</td>
<td>$666</td>
</tr>
</tbody>
</table>

<sup>a</sup> Fidelity Advisor Equity Income Fund Class A
<sup>b</sup> Vanguard 400 Index Fund Investor Class

Source: Financial Industry Regulatory Authority, Fund Analyzer, apps.finra.org/fundanalyzer/1/fa.aspx

are sold, the bid received by the fund selling the shares may be lower than the listed bid/ask spread. A conservative estimate of these annual transaction costs is 50 basis points (.5%). This estimate is provided by Bogle (2014) and is far below the 1.44 percent estimate provided by Edelen, Evans, and Kadlec (2013) while Baer and Gensler (2002) and Swenson (2005) provide estimates in the .6 and .7 percent range.
Actively managed mutual funds usually hold about five percent of their assets in cash. Index funds, in contrast, would normally invest these funds which would yield a market rate of return. Bogle estimates these lost returns from what he calls the “cash drag” to be 15 basis points.

Combined the transaction costs and cash drag impose another 65 basis points on managed funds that further erode their returns that are reported in Table 1. Bogle’s own estimate is that the expense ratio, transaction costs, cash drag and sales charges and fees impose a 2.27 percent annual reduction on assets invested in actively managed funds. The comparable figure for index funds is .06 percent, resulting in a 2.21 percent advantage for the latter.

Returns to investors in actively managed mutual funds are further eroded by capital gains taxes for accounts that are not in tax exempt retirement plans such as 401(k), 403(b) and IRAs. Capital gains realized from trades are distributed to these owners who then suffer the tax consequences. Short-term capital gains—those on assets held less than one year—are taxed as ordinary income. This is noteworthy because many managed funds are turning over 100 percent of their assets each year. Bogle (2014) estimates the net advantage for indexed funds is .45 percent.

The combination of these undisclosed costs to managed funds and the deleterious effect of fees and sale charges shown in Table 1 make clear that active management must beat the market by a significant margin if they are to be a better investment than low-cost index funds. A review of the literature reports that most studies find that low fee funds and passively managed index funds out-perform high fee funds (Fisch and Wilkerson-Ryan, 2014). They also cite Morningstar’s Director of Mutual Fund Research who said “If there’s anything in the whole world of mutual funds that you can take to the bank, it’s that expense ratios help you make a better decision.”

Many mutual fund investors no doubt have a hankering for above average returns in their mutual funds and succumb to promises that they will be forthcoming. They have, however, no way to reliably predict which funds will out-perform the market. History is no guide for investors; the SEC cautions all investors that past performance is not an indicator of future success.

Economic theory suggests that competition for the investor dollar should lower sales charges and fees and, correspondingly, yield a higher return for fund owners. We now turn to this proposition.

**The Corrective Power of Rational Investors in a Competitive Environment**

Market trends suggest that there is some truth to the proposition that rational investors can move the mutual fund market. If this is the situation we would expect that passively managed funds would increase their market share at the expense of actively managed funds and that fees charged by the latter would fall. This is what has happened.
During the 2005-2015 period the market share of index funds and ETFs rose from 15.5 percent to 30.4 percent. Assets in these funds grew 388.9 percent compared to growth of 106 percent for the actively managed sector. The total expense ratio fell for both types of funds. The asset weighted expense ratio fell from .27 percent to .13 in the passive sector and from .95 to .8 for actively managed funds. Can we infer from the 2005-2015 trends that rational investors are in a competitive environment that will over time reduce the sales charges and fees that undermine the retirement security of older adults?

There is an extensive literature on financial literacy which indicates that “Although a significant majority of respondents indicated that they were knowledgeable about finance and highly competent in handling day-to-day financial matters, they performed poorly on basic financial literacy questions....” (Library of Congress, 2011). A survey by the Transamerica Center for Retirement Studies reported that “Workers’ lack of knowledge is perhaps best illustrated by a general lack of understanding about asset allocation principles... Forty-four percent have ‘some’ understanding about asset allocation principals, yet only eight percent have a ‘great deal’ .... An alarming 30 percent have no knowledge” (Collinson, 2015).

The concept of diversification is elusive as well. Only 52 percent of respondents understood that mutual funds offer a safer return than a single company stock. Benartzi and Thaler (2001) show that investors have a decided lack of sophistication in the decision to diversify within plans because participants tend to divide their contributions evenly across funds in the plan.

While lower fees are a good predictor of fund performance, only 16 percent of one survey’s respondents believed that higher expenses led to lower than average returns. Another study reported that 84 percent of investors believe that higher operating expenses mean better performance. This bias may well be rooted in a belief that “you get what you pay for” (Brown, 2016).

The apparent absence of well informed investors does not necessarily undermine the notion that competition in the mutual fund industry can lower fees and sales charges in the long run. Economic theory shows that all buyers in a competitive market do not need to be sensitive to price; if there is a sufficient number of these buyers, competitive firms must lower prices to an equilibrium level in order to retain the price sensitive consumers. Cremers, Ferreira, Matos and Starks (2015) examine competition in the mutual fund industry world-wide and find that actively managed funds charge lower fees when they face more competition from low cost indexed funds.

The fact that the market shares of indexed funds rose from 15.5 percent to 30.4 percent between 2005 and 2015 shows that some investors are deciding to maximize their expected returns. If most retail investors were well informed and made decisions that maximize their expected rate of return, the mutual fund industry would surely be transformed. Exploring why the market share of indexed funds has not increased faster is our next task.
Can we explain the “irrational” investor?

It is easy to make too much of the modest financial literacy of investors. One does not need to understand very much finance theory to absorb the information that 1) it is hard to beat the market and 2) investing in a low cost index fund offers the highest expected rate of return on your retirement assets. In principle, this should be an easy message to communicate to people planning for their retirement.

It is instructive to consider that the most cost effective investment vehicle in existence is, ironically, a creature of the federal government and is available only to federal employees. The Thrift Savings Plan (TSP) has five indexed funds with an average expense ratio of .03 percent: $3 for a $10,000 portfolio. Despite the low fees 45 percent of participants who retired from federal service in 2012 withdrew all of their savings from the TSP –almost $10 billion (Hicken, 2014). Viewed objectively, this behavior might be characterized as an aggressively ignorant investment strategy that almost guarantees a smaller nest egg for retirement.

Why did they do it? For starters, there are thousands of financial advisors selling mutual funds that offer investors a “chance” to get superior returns while the advisors surely increase their income. John Turner, director of the Pension Policy Center tested the objectivity of mutual fund advisors. He “called up major IRA providers and asked for advice, explaining he was a former government employee with savings in the thrift plan. Only one firm acknowledged he could do better by staying with the plan’s super low fees, while the rest all encouraged an IRA rollover” (Hicken, 2014).

The sellers of managed mutual funds have reasons to be optimistic that they can convince individuals to ditch their excellent investment in the TSP in favor of a demonstrably inferior product. Pitching the idea that it is possible to earn superior returns may fall on the receptive ears of those who are subject to the “illusion of control” (Langer, 1975). Psychological experiments show that people often have an expectation of success that is higher than the objective probability would predict. This tendency for excessive optimism would lead mutual fund investors to be attracted to managed mutual funds as opposed to index funds.

Individuals who have a preference for risk may be more receptive to a sales pitch that promises higher returns by investing in actively managed mutual funds. The Investment Company Institute (2016) reports that mutual fund owners have a higher tolerance for risk than the general population. For example, thirty-one percent of mutual fund owners are willing to take substantial risk for substantial gain or above average risk for above average gain. The corresponding proportion for all households is 21 percent.

Industry representatives have every incentive to claim they may get superior returns and many individual investors may like the idea of being actively engaged in enhancing their retirement nest egg. There may be one more factor that will undermine the desirability of investing in a low cost index fund: time preference. All people prefer rewards sooner than later. The discount rate reflects how much a person discounts future benefits and is used to determine
the present value of future rewards. In short, a dollar in the future is not valued as much as much as a dollar today. The costs of being in a managed mutual fund are diminished retirement funds some years in the future; an immediate gain may be the satisfaction of pursuing superior returns.

Almost 70 percent of mutual fund assets are invested in actively managed funds that on average will yield an inferior return compared to indexed funds. Given society’s interest in having the elderly as self-sufficient as possible, we now explore what avenues can lead to greater investment in low cost index funds relative to actively managed mutual funds.

**Public Policy Options**

**Introduction**

Fisch and Wilkinson-Ryan (2014) note that “Congress, the SEC, the Department of Labor, and the courts have struggled with the possibility that market forces are insufficient to protect retail investors from making poor investments.” It is understandable that efforts to protect small investors have had limited success. Financial illiteracy is foremost among the barriers to improving their investment decisions. Any direct regulations in support of people saving in indexed mutual funds will be fought vigorously by the industry. The industry’s managed funds impose front end loads, fees, and other costs that erode the equity of individuals by thousands of dollars but, in aggregate, generate billions of dollars for the industry each year. The industry has extraordinary incentives to interfere with any efforts at reform that favor individual investors.

Swenson (2005) chronicles that the Securities and Exchange Commission is not effective in combating industry interests and in the process undermines its mission to “protect investors.” Given the alignment of industry interests against reform that would help individuals get a higher return on their retirement savings, we cannot be sanguine about the efficacy of public policy reforms that try to “do good.”

Nevertheless, our goal now is to explore ways what public efforts and non-government actors might stimulate the recent market trend toward investment in indexed mutual funds. We explore two possible avenues of action. Informing investors about low cost index funds is an obvious way for them to change their portfolios to increase returns. The old saying that “you can lead a horse to water but you can’t make him drink” is apropos here. While more and better information is important, we have also seen that many individuals are attracted to the siren call of elusive superior future returns at the cost of asset draining fees and hidden costs.

The second avenue is to impose fiduciary responsibility on investment advisors and on the design of 401(k) and 403(b) plans. This means the investments must be in the best interests of the investor, a stronger requirement than just being suitable for them.
The Efficacy of Better Information

Many individuals seek advice about their investment options because financial instruments are complicated and they fully understand that they don’t understand. So they seek the advice of experts. As we have seen, the financial planners they hire are agents with conflicting incentives: they try to serve the client but their primary goal is to make a profit.

While skepticism of financial counselors is merited, most mutual fund investors have a favorable impression of the industry: 16 percent reported they had a very favorable impression of the industry while 51 percent reported a somewhat favorable view. Only nine percent had a somewhat unfavorable view, two percent very unfavorable view of the industry and 22 percent had no opinion (Investment Company Institute, 2016). Good long term relationships with a company or agent may undermine the efficacy of any new information that suggests moving assets from managed to indexed funds.

The “Fund Analyzer Report” used to generate Table 1 provides ready access to fee and cost data for every mutual fund. Hidden costs related to transactions and the cash drag are, of course, not included. But as we showed in Table 1, these data can effectively reveal the dramatically better performance of low fee indexed funds compared to managed funds.

It would be useful to add a base-line investment to all comparative cost comparisons. For example, a generic index fund could be created for this purpose. An algorithm could be created that would calculate the “deadweight loss” for managed funds: i.e., given the load and fees, how much must the managed fund beat the market in order to have the same level of assets earned by the baseline index fund at the end of the period. This proposal could easily be integrated into the fee and cost calculator that the SEC already offers through its website. In addition to providing important information for investors willing to search for it, the stark comparison may also give an added incentive for managed funds to lower their fees and costs in order to reduce their deadweight loss.

Since compound interest is the very best friend of future retirees, it is important to educate young investors as to the wisdom of investing retirement assets in indexed funds. Most effective would be regulations that require a strong information campaign for individuals who are investing in 401(k) and 403(b) plans. These serve all age groups and people with modest incomes, so such an effort could improve the retirement security for a significant portion of the population.

Given the power of the industry to effect decision-making in the SEC and the Congress, prudence would have private and non-profit institutions, particularly advocacy groups for older adults engaged in the education process. The Association for the Advancement of Retired Persons (AARP) could be engaged in this process, for example. Its magazine is produced six times a year with a claimed circulation of over 23.4 million (an estimated 47 million readers) who are 50 years of age or older. It also publishes the AARP Bulletin 11 times a year. While it is
preferred to move funds out of managed funds at an earlier age, younger AARP members can nevertheless significantly improve their retirement nest-egg.

Consumer advocacy groups could also engage in this education process. The Consumer Federation of America has an America Save$ initiative that would be a logical partner in efforts to get long term investors of all ages to be aware of the higher returns that are offered by low-cost index funds relative to managed funds. The American Association of Individual Investors is an independent non-profit corporation that claims to be dedicated to helping individuals becoming more effective managers of their assets. These and other interest groups could play a role in making people aware of the advantages of investing in low fee indexed mutual funds.

With 70 percent of mutual fund assets invested in actively managed accounts, it would seem that educating investors about the higher net returns that are expected in index accounts is a worthwhile effort. According to Thaler and Sunstein (2008) however, the evidence does not suggest that education “is, in and of itself, an inadequate solution.”

**Imposing Fiduciary Responsibility**

Requiring financial advisors to be in a fiduciary role means that they are obligated to recommend investments that are not just “suitable” but “in the best interest” of customers. It seems clear that the principal-agent problem that we have outlined above—that investment advisors’ profit incentives conflict with maximizing the returns of their customers—is very real in the mutual fund industry. Guiding investor dollars into managed funds instead of low cost index funds undermines financial preparation for retirement. Encouraging federal government retirees to withdraw funds from the Thrift Savings Plan serves as a blatant example of financial advisors increasing profits while reducing the assets available to support life in retirement. This hurts their clients and is not in the public interest.

Regulation is too cumbersome to fix excesses of the financial industry according to Davis, Lukomnick and Pitt-Watson (2016). They claim that regulators identify specific problems and after they surface impose rules to correct the situation. Davis et. al. call it a policy of “whack-a-mole” and argue that a more systematic approach would be to focus on imposing fiduciary responsibility on those advising financial clients.

This may be true, but given the complexity of the financial industry and the variety of motives affecting investor decisions, implementing a fiduciary scheme may be difficult. Any attempt to impose such standards on financial advisors will be met with serious industry opposition as indicated by its response to the U.S. Department of Labor (2016) issuance of the Final Fiduciary and Conflict of Interest Rule. Labor Secretary Thomas Perez said that “People saving for retirement have a legal right and a compelling economic need to receive retirement investment advice that is in their best interest. Today a handful of industry groups and lobbyists are suing for the right to put their financial self-interests ahead of the best interests of their customers.”
The first lawsuits against this rule were brought by the Chamber of Commerce of the U.S. and the National Association for Fixed Annuities. They argue that the Department of Labor exceeded its regulatory authority and violated the Administrative Procedures Act. Leaving no stone unturned, “the lawsuits allege that DOL usurped the role of the Securities and Exchange Commission and contravened the Dodd-Frank Act by imposing a fiduciary standard on broker-dealers and wire houses. Finally, there are arguments that the Fiduciary Rule violates the First and Fourth Amendments” (Groom Law Group, 2016).

Generating an effective fiduciary standard is not straightforward. The Rule allows advisors and financial institutions to receive commissions provided that they are in the investors best interest and do not involve “unreasonable compensation.” When financial institutions or their advisors breach their obligations and cause losses to investors the latter may seek restitution through the courts. As the hypothetical in Table 1 shows, investors in the managed fund realized a $19,682 gain, which was 72 percent of the gain realized by the low fee index account. Rotten deals like this make investors worse off but, because they receive a positive return, advisors will almost surely be waived of any liability when all is said and done because lower returns will not be construed to be losses.

Imposing a fiduciary responsibility on sponsors of 401(k) and 403(b) plans may be an important vehicle to improve investor outcomes. Fund sponsors often give many options to invest in managed funds and few, if any, index fund options. Since many investors simply divide their investment equally among the options available, limiting the number of managed funds available and requiring that all funds have a low-cost indexed option would result in relatively more investment in index funds.

Research shows that sponsors of 401(k) and 403(b) plans can improve their programs in ways that help prepare workers for retirement. First, workers should be faced with an opt-in default which requires them to make an active decision to not invest in the plan. Evidence suggests that this would almost surely increase the number of younger and relatively low income workers who participate in retirement programs (Thaler and Sunstein, 2008). Secondly, the opt-in choice should be the fund with the highest expected return: a low cost index fund.

Entities with a fiduciary responsibility for a retirement plan can be subject to law suits if they fail to comply with this legal obligation. Suits have been brought against private firms whose 401(k) plans charge excessive fees (e.g., Boeing Co, Kraft Foods Inc., United Technologies Corp, and Fidelity Investments) as have non-profit institutions with 403(b) plans (e.g., New York University, Yale, Duke, and Vanderbilt). Settlements in such cases can provide compensation to plan participants but, more importantly, can provide affirmative relieve that results in reduced administrative and management fees going forward. The threat of legal action may well cause fund sponsors to be more diligent in negotiating better retirement plans for their employees.
Conclusion

The burgeoning older adult population that is projected between now and 2050 will pose significant problems for retirees, their families and public programs charged with providing medical care and income support. This paper reports that individuals can improve their savings for retirement by investing in indexed mutual funds as opposed to managed funds. Ample evidence reveals that changing retirement investment in IRAs, 401(k), 403(b) and private accounts from managed mutual funds to index funds can substantially increase savings at retirement.

Managed mutual funds charge up-front loads and fees to investors who hope they will earn higher returns than those delivered by the overall stock market. Evidence shows that most funds do not accomplish this well enough to offset these costs. The net result is that the industry rakes in tens of billions of dollars each year while each investor loses thousands of dollars compared to an alternative investment in a low cost index fund.

Greater savings improves the quality of life for the elderly and, correspondingly, have the potential to reduce the burden on public programs that support unmet needs among retirees. Almost 70 percent of mutual fund assets are in managed funds. Investors need to understand how their investments in these funds produce great profits for the industry and reduce their retirement assets. Educating investors about improving their investment strategy can be undertaken by both the public sector and private advocates for older adults. A policy requiring that fund sponsors have a fiduciary responsibility for investors might force them to provide options that is are their best interest rather than the weaker requirement that investments are suitable. Requiring sponsors of 401(k) and 403(b) retirement plans to place new employees in a low cost index fund unless they explicitly opt out would increase both the level of savings and the rate of return on investments in these retirement plans.

Given the billions of dollars at stake, any effort to impose a fiduciary standard is likely to face extraordinary opposition from the industry. A countervailing power is offered by class action law suits that seek relief from excessive fees in 401(k) and 403(b) plans.

Bibliography


