

# MUTUAL FUND INVESTORS: DIVERGENT PROFILES

Alan R. Palmiter & Ahmed E. Taha\*

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*Mutual funds are owned by almost half of all U.S. households, manage nearly \$12 trillion dollars in assets, and have become a primary vehicle for retirement and investment savings in the United States. Who are mutual fund investors? The answer is critical to regulatory policy for the mutual fund industry. Fund investors, by selecting the funds in which they invest, play a central role in determining asset allocation and in controlling the fees and expenses that funds charge. Thus, the functioning of the mutual fund market turns on the knowledge and financial sophistication of fund investors.*

*This article examines the profiles of mutual fund investors presented alternatively by the mutual fund industry, by the SEC, and by an extensive empirical academic literature. The industry portrays fund investors as diligent, fairly sophisticated, and guided by professional financial advisers. The result, according to the industry, is a competitive mutual fund market in which fund investors demand low costs and solid performance. The SEC's regulatory policy paints a more cautious portrait of fund investors. While acknowledging that many investors have limitations, however, the SEC touts improved disclosure by the industry as a sufficient antidote. The academic literature, produced primarily by finance professors, finds that fund investors are generally uninformed and financially unsophisticated. Most investors are unaware of the basic characteristics of their funds, pay little attention to costs (especially ongoing costs), and chase past performance despite little evidence that high past fund returns predict future returns. Even fund investors who use financial advisers do not make better choices.*

*The SEC's belief that fund investors can fend for themselves, once armed with adequate disclosure, fails to appreciate the extent of investors' limitations. Instead, the findings of the academic literature suggest that policymakers should rethink current regulatory policy. Disclosure may not be enough.*

## I. INTRODUCTION

Mutual funds have become a primary vehicle for investment and retirement savings in the United States, managing almost \$12 *trillion* in assets and a quarter of the country's retirement savings. Almost half of all U.S. households own mutual funds, far more than own individual stocks and bonds. Unlike public and private pension plans, in which decisions about portfolio allocation and cost management are delegated to professional money managers, the mutual fund industry is subject to the decisions and discipline of millions of dispersed and diverse mutual fund investors.

Who are these mutual fund investors? Their investment knowledge and acumen, as well as their access to and use of information about mutual funds, are critical to the effective functioning of the mutual fund market. Unlike the markets for publicly-traded securities, such as stocks, the market for mutual funds lacks mechanisms—like short-selling—to ensure informational efficiency. Thus, a handful of informed, sophisticated fund investors cannot price inefficiencies (such as high-cost or mismanaged funds) out of the market.

The Investment Company Act of 1940 (the "1940 Act"), passed by Congress to regulate the disclosure and management of mutual funds, assumes that mutual fund investors cannot adequately fend for themselves. Nonetheless, despite doubts about the capabilities of fund investors, the 1940 Act also assumes (somewhat inconsistently) that fund investors can make basic asset-allocation and fund-selection decisions. The 1940 Act thus adopts a blurred policy between regulatory paternalism and market liberalism, with a significant portion of industry oversight left not to regulation but to fund investors themselves.

Today, an effective mutual fund market is more important than ever, and this importance promises only to grow. The transformation of mutual funds from the "small investor's diversified portfolio" to "every person's retirement account" makes the capabilities of fund investors critical to

the viability of our national retirement system. Do fund investors understand the risk-return characteristics of different fund assets? Do fund investors know the relationship between past fund performance and future returns? Do fund investors recognize the significance of, and respond to differences in, fund fees and expenses? In short, are fund investors capable of disciplining the mutual fund market?

This article examines the profiles of mutual fund investors presented alternatively by the mutual fund industry, by the Securities and Exchange Commission ("SEC"), and by an extensive academic literature. The fund management industry—through its trade association, the Investment Company Institute ("ICI")—portrays fund investors as diligent and fairly sophisticated. According to the ICI, before choosing a mutual fund, investors consider relevant fund characteristics, including fund fees and expenses, and consult multiple sources of information. In its public statements, the ICI regularly states that mutual funds operate in a highly competitive market driven by millions of investors clamoring for low fees and high performance. To assist investors in choosing among funds, the industry supports providing investors with simplified and standardized disclosure of information about funds.

The SEC, in its regulatory policy, paints a somewhat similar portrait of mutual fund investors. Like the fund industry, the SEC claims that investors consider much relevant information before investing in a fund. Also, like the industry, the SEC believes that investors greatly benefit from simplified and standardized disclosure. Yet the SEC has expressed concern that some investors pay too little attention to fund fees and expenses while paying too much attention to past returns. Thus, the SEC has taken some limited and cautious steps to better educate and inform investors about how to make fund choices.

The academic literature over the last decade, however, paints a much less favorable portrait of fund investors. Empirical studies of actual investor behavior—studies conducted mostly by finance professors—find that fund

investors generally are uninformed and lack financial sophistication. These studies find that most fund investors are unaware of the investment objectives, composition, and risks of their funds. Most investors are also ignorant of the level of fees and expenses charged by their funds, and these costs are often not a significant factor in their fund choices. Also, most fund investors chase past performance, despite little evidence that high past returns predict future returns. In addition, although many investors use financial advisers, little evidence exists that these advisers help investors make better fund choices.

Remarkably, the ICI and the SEC barely acknowledge the existence of this large body of academic research. Although the ICI has sometimes sought to refute some specific academic findings, it appears to have adopted the general policy that the less said the better. The SEC, while regularly citing to journalistic accounts of the behavior of fund investors, has also disregarded the academic literature. Instead, SEC rulemaking releases often cite to ICI research and comment letters, particularly with respect to the information needs of fund investors.

In short, there is overwhelming evidence of investors' limitations and of their inability to protect their own interests, lending support to a key premise of the 1940 Act regulatory regime. This evidence, however, is disregarded by the industry that purports to serve fund investors and by the regulator charged with responding to market failure. Although the industry trumpets the "fiercely competitive" market in which it operates and the SEC extols the virtues of competition, the evidence shows that fund investors lack the knowledge and financial sophistication to sufficiently discipline the mutual fund industry.

This article questions the accuracy of the portraits of mutual fund investors painted by the fund industry and the SEC, and seeks to offer a more accurate (although less attractive) portrait painted by the academic literature. It argues that policymakers should pay greater attention to fund investors' ignorance and limitations, which undermine the viability of our private retirement system. Recent efforts

by the SEC to educate investors and to improve mutual fund disclosure fail to recognize the extent of investors' limitations. Thus, these efforts are unlikely to significantly improve investors' ability to pursue their own interests and, in doing so, to provide important market discipline over mutual funds.

Part II provides background information about mutual funds, the companies that create and manage them, and the investors who buy them. Part III presents the profile of the mutual fund investor as advanced by the ICI. Part IV identifies the fund investor profile assumed by the SEC. Part V describes the academic literature on fund investor knowledge and behavior, which presents an investor profile far different from those advanced by the ICI and SEC. Finally, Part VI discusses the implications that the academic literature has for the SEC's regulatory policy toward mutual funds.

## II. THE MUTUAL FUND MARKET

A mutual fund pools multiple investors' money into a single investment portfolio created and managed by a fund management company.<sup>1</sup> Investors who purchase shares of the fund, typically organized as a separate corporation or trust, are entitled to the proportionate return from the assets held by the fund. Thus, the investors do not own the fund assets directly, but rather own pieces of the mutual fund. Investors in open-end funds (the most prevalent form) have the right to withdraw their investment at any time at a price determined by the fund's net asset value. Mutual funds vary considerably, including in the types of financial assets held, their investment objectives and strategies, and their fees and expenses—all of which are set forth in a fund's prospectus. The SEC is the primary regulator of the mutual fund

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<sup>1</sup> For a description of the basic characteristics of mutual funds, see SEC, *Invest Wisely: An Introduction to Mutual Funds*, <http://sec.gov/investor/pubs/inwsmf.htm> (last visited Dec. 3, 2008) [hereinafter SEC, *Invest Wisely*].

industry, but no government agency guarantees or insures investors' fund investments.

As of the end of 2007, U.S. mutual funds held \$12 trillion in assets<sup>2</sup> and 24% of all outstanding equity of U.S. public companies.<sup>3</sup> Investors have a great number of funds to choose from—8752 as of the end of 2007.<sup>4</sup> Although no single fund family dominates the mutual fund market, the five largest fund families control 38% of the industry's total assets.<sup>5</sup> Some fund families, such as Fidelity Investments and the Vanguard Group, offer more than a hundred funds.<sup>6</sup>

Ownership of mutual funds is widespread. Of the 116 million households in the United States, almost 51 million (or 44%) own mutual funds, far more than hold individual stocks and bonds.<sup>7</sup> Also, most households that own mutual funds have moderate income and wealth. The median household income of mutual fund investors is \$74,000.<sup>8</sup> Two-thirds of households that own mutual funds have incomes of less than \$100,000, and 26% have incomes below \$50,000.<sup>9</sup> In addition, fund-owning households have median total financial assets of only \$175,000, and a median of \$100,000 invested in mutual funds.<sup>10</sup>

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<sup>2</sup> INVESTMENT COMPANY INSTITUTE, 2008 INVESTMENT COMPANY FACT BOOK 20 (2008), *available at* [http://www.icifactbook.org/pdf/2008\\_factbook.pdf](http://www.icifactbook.org/pdf/2008_factbook.pdf) [hereinafter 2008 FACT BOOK].

<sup>3</sup> *Id.* at 11 fig.1.4.

<sup>4</sup> *Id.* at 15 & fig.1.8.

<sup>5</sup> *Id.* at 21 fig.2.2.

<sup>6</sup> Vanguard Funds Overview, <https://personal.vanguard.com/us/FundsStocksOverview?Entry=Homeoffer01> (last visited Dec. 3, 2008) (listing of current Vanguard funds); All Fidelity Funds Daily Pricing, [http://personal.fidelity.com/products/funds/framesets/daily\\_prices\\_frame.shtml?refpr=zffdfp03](http://personal.fidelity.com/products/funds/framesets/daily_prices_frame.shtml?refpr=zffdfp03) (last visited Dec. 3, 2008) (listing current Fidelity funds).

<sup>7</sup> INVESTMENT COMPANY INSTITUTE, ICI RESEARCH FUNDAMENTALS: TRENDS IN OWNERSHIP OF MUTUAL FUNDS IN THE UNITED STATES 2 fig. 1 (Nov. 2007), <http://www.ici.org/pdf/fm-v16n5.pdf>.

<sup>8</sup> INVESTMENT COMPANY INSTITUTE, PROFILE OF MUTUAL FUND SHAREHOLDERS 6 fig.1.3 (Spring 2008), [http://www.ici.org/stats/res/rpt\\_profile08.pdf](http://www.ici.org/stats/res/rpt_profile08.pdf).

<sup>9</sup> *Id.*

<sup>10</sup> 2008 FACT BOOK, *supra* note 2, at 71 fig.6.2.



Mutual fund ownership has become widespread largely because mutual funds have become a primary way that Americans save for retirement. Employers have increasingly switched from providing traditional pension plans—defined-benefit plans—to providing defined-contribution retirement plans, such as 401(k) plans. In defined-contribution plans, employers may make contributions to their employees' retirement accounts, but the employees themselves choose how to invest these contributions.<sup>11</sup> Typically, mutual funds are among the investment options available to the employees.

As of March 2008, U.S. retirement assets totaled \$17.1 trillion,<sup>12</sup> constituting 38% of all household financial assets.<sup>13</sup> About \$4.3 trillion (25%) of retirement assets were in defined-contribution plans,<sup>14</sup> and about half of the assets in these plans (\$2.2 trillion) were invested in mutual funds.<sup>15</sup> In contrast, in 1992, only \$184 billion of assets in defined-contribution plans were invested in mutual funds.<sup>16</sup> In other words, defined-contribution plans' assets invested in mutual funds have increased almost twelve-fold, growing almost 18% annually, over the past fifteen years.

Mutual fund assets in Individual Retirement Accounts ("IRAs") have experienced similar growth. As of March 2008, IRAs constituted an estimated \$4.5 trillion, or 27%, of all retirement assets.<sup>17</sup> Nearly half of IRA assets (\$2.1 trillion) were invested in mutual funds.<sup>18</sup> By comparison, in 1992, only \$233 billion of IRA assets were invested in mutual

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<sup>11</sup> Roger Lowenstein, *The End of Pensions?*, N.Y. TIMES, Oct. 30, 2005, at Sec.6., available at 2005 WLNR 17528590.

<sup>12</sup> INVESTMENT COMPANY INSTITUTE, RESEARCH FUNDAMENTALS: THE U.S. RETIREMENT MARKET, FIRST QUARTER 2008, at 2, fig.1 (Oct. 2008), [http://www.ici.org/pdf/retmrkt\\_update.pdf](http://www.ici.org/pdf/retmrkt_update.pdf) [hereinafter ICI, RETIREMENT MARKET].

<sup>13</sup> *Id.* at 3 fig.2.

<sup>14</sup> *Id.* at 11 fig.A1.

<sup>15</sup> *Id.* at 23 fig.A15.

<sup>16</sup> *Id.*

<sup>17</sup> *Id.* at 11 fig.A1.

<sup>18</sup> *Id.* at 12 fig.A2.

funds.<sup>19</sup> In other words, mutual fund assets invested in IRAs have increased nine-fold, growing almost 16% annually, over the last fifteen years.<sup>20</sup>

Primarily as a result of the rapid growth of mutual fund investments in defined-contribution plans and IRAs, mutual funds' total share of retirement assets increased from 8% at the end of 1992 to 25% in March 2008.<sup>21</sup> Mutual funds now constitute a quarter of America's retirement savings.

Although the greatest portion of mutual fund assets (44%) are held in tax-deferred retirement accounts, such as IRAs and defined-contribution plans, most mutual fund assets are held elsewhere.<sup>22</sup> Other mutual fund assets are in taxable accounts held by households (37%), taxable accounts held by non-households (12%), and tax-exempt funds (7%).<sup>23</sup> Investors, however, undoubtedly consider some of these other mutual fund assets as retirement savings too. Limits on the amount investors can contribute annually to tax-deferred accounts mean that some retirement savings are invested outside of tax-deferred accounts.<sup>24</sup>

Half of mutual fund holdings are in equity funds, with most of the rest divided between money market funds (29%)

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<sup>19</sup> *Id.*

<sup>20</sup> A significant portion of IRAs originate in employer-sponsored retirement plans that are "rolled over" into IRAs when the employee leaves an employer. For example, in 2004—the most recent year for which data is available—traditional IRAs received approximately \$214.9 billion in rollovers but only \$12.6 billion in other contributions. *Id.* at 6 fig.7.

<sup>21</sup> *Id.* at 11-13 fig.A1-A3. In addition to being in defined-contribution plans and IRAs, retirement assets are in annuities, government pension plans, and private defined benefit plans (that is, traditional private pension plans). *Id.* at 2 fig.1.

<sup>22</sup> 2008 FACT BOOK, *supra* note 2, at 23 fig.2.4.

<sup>23</sup> *Id.*

<sup>24</sup> For example, in 2007, most people were permitted to contribute no more than \$15,500 each year to defined-contribution plans and \$5,000 to an IRA. INTERNAL REVENUE SERV., PUBLICATION 525: TAXABLE AND NONTAXABLE INCOME 8 (2007), *available at* <http://www.irs.gov/pub/irs-pdf/p525.pdf>; INTERNAL REVENUE SERV., PUBLICATION 590: INDIVIDUAL RETIREMENT ACCOUNTS 11, 59 (2007), *available at* <http://www.irs.gov/pub/irs-pdf/p590.pdf>.

and bond funds (15%).<sup>25</sup> Equities tend to have higher returns in the long run, but greater risk in the short run, than bonds and money market securities.<sup>26</sup> Lifecycle funds, a relatively new segment of private retirement savings, allow investors to delegate asset allocation decisions to the fund manager. A lifecycle fund blends particular asset types (such as stocks and bonds) to match investors' risk tolerance and investment horizon, shifting the fund's asset mix over time in light of the investors' retirement target date. Although growing by 61% from the end of 2006 to \$185 billion as of March 2008, these funds still constitute only approximately 1% of retirement assets.<sup>27</sup>

In summary, our nation relies upon mutual funds. Ownership of mutual funds has become widespread, with almost half of American households owning them. These funds constitute a significant portion of our savings and are a particularly important component of our retirement system. As a result, understanding fund investors' characteristics—especially their knowledge, financial sophistication, and how they choose among mutual funds—is essential to understanding and safeguarding this system.

This article presents three profiles of the mutual fund investor: one put forward by the mutual fund industry, another assumed by the SEC, and yet another identified by the academic finance literature.

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<sup>25</sup> As of June 2008, total net assets of mutual funds were:

	\$ Billions	% of Total
Stock Funds	5,838.9	50.0
Hybrid Funds	675.0	5.8
Taxable Bond Funds	1,373.4	11.8
Municipal Bond Funds	384.2	3.3
Taxable Money Market Funds	2,909.8	24.9
Tax-Free Money Market Funds	496.8	4.3
Total	11,678.1	100%

ICI STATISTICS & RESEARCH, TRENDS IN MUTUAL FUND INVESTING (June 2008), [http://www.ici.org/stats/mf/arctrends/trends\\_06\\_08.html](http://www.ici.org/stats/mf/arctrends/trends_06_08.html).

<sup>26</sup> JEREMY J. SIEGEL, STOCKS FOR THE LONG RUN 12-18, 24-27 (4th ed. 2008).

<sup>27</sup> ICI, RETIREMENT MARKET, *supra* note 12 at 10 fig.13 & 11 fig.A1.

### III. INDUSTRY'S PORTRAIT OF FUND INVESTORS: SOPHISTICATED AND INFORMED

The first portrait of the mutual fund investor is painted by the fund industry itself. Established in 1940, the Investment Company Institute ("ICI") is the national trade association of the U.S. mutual fund industry. As of August 2007, ICI members served almost 90 million individual investors and were responsible for 8729 mutual funds that collectively held \$11.5 trillion in assets.<sup>28</sup> The ICI's stated mission includes "advancing the interests of funds, their shareholders, directors, and investment advisers . . . ."<sup>29</sup> To accomplish its mission, the ICI often provides input regarding the regulation of mutual funds to Congress, the SEC, and other regulatory organizations.<sup>30</sup>

The ICI has consistently maintained that the mutual fund industry is highly competitive, with fund choices, services, and fees determined by a robust market of sophisticated and informed mutual fund investors. Relying on the results of a 2006 ICI-sponsored survey of investors who had purchased mutual funds outside of retirement plans, the ICI has asserted that fund investors seek out and examine important fund information before investing,

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<sup>28</sup> INVESTMENT COMPANY INSTITUTE, 2007 ANNUAL REPORT TO MEMBERS ii (2007), *available at* [http://www.ici.org/statements/ppr/07\\_ici\\_annual.pdf](http://www.ici.org/statements/ppr/07_ici_annual.pdf). ICI members also were responsible for 656 closed-end funds, 546 exchange-traded funds, and 5,907 unit investment trusts. *Id.*

<sup>29</sup> INVESTMENT COMPANY INSTITUTE, ABOUT ICI, [http://www.ici.org/about\\_ici.html](http://www.ici.org/about_ici.html) (last visited Dec. 3, 2008).

<sup>30</sup> Much of this input is accessible on the ICI's website. *See generally* Investment Company Institute, Testimony, <http://www.ici.org/statements/tmny/index.html> (last visited Dec. 3, 2008) (list of occasions on which ICI staff testified before government entities); Investment Company Institute, Comment Letters, <http://www.ici.org/statements/cmltr/index.html> (last visited Dec. 3, 2008) (list of comment letters filed by ICI with government agencies and self-regulatory organizations).

including the fund's investment objectives, fees and expenses, historical performance, and risks. The ICI survey concluded that investors obtain information about mutual funds from a variety of sources, and most receive guidance from professional financial advisers. In short, the survey portrays mutual fund investors as generally knowledgeable and well-advised, leaving little need for greater regulation of the industry.

In other settings, the ICI has presented a slightly more cautious portrait of mutual fund investors. In its publications, speeches by its officials, and comments to the SEC, the ICI has regularly supported simplifying and standardizing required disclosure by mutual funds. Implicit in these statements is some recognition of investors' limitations.

This part presents the profile of mutual fund investors as advanced by the ICI. It is noteworthy that, in developing this portrait, the ICI relies almost exclusively on its own studies, without reference to academic studies of fund investor knowledge and behavior.

### A. ICI Survey of (Some) Fund Investors

In 2006, the ICI "undertook a comprehensive study . . . to identify the information needs of mutual fund investors and the sources from which they obtain that information."<sup>31</sup> The study consisted of in-home interviews of 737 randomly-selected mutual fund investors who had bought—outside of a work-related retirement plan—a stock, bond, or hybrid fund that they did not own prior to 2001.<sup>32</sup> The study excluded mutual fund investors who purchased only money market funds, who had only added to an already-owned fund, or who

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<sup>31</sup> INVESTMENT COMPANY INSTITUTE, UNDERSTANDING INVESTOR PREFERENCES FOR MUTUAL FUND INFORMATION 1 (Aug. 2006), [http://ici.org/pdf/rpt\\_06\\_inv\\_prefs\\_full.pdf](http://ici.org/pdf/rpt_06_inv_prefs_full.pdf) (last visited Dec. 3, 2008) [hereinafter ICI, INVESTOR PREFERENCES].

<sup>32</sup> *Id.* at 1. The survey was conducted by GfK NOP, an independent research firm.

had purchased funds only through a 401(k) or similar work-related plan.<sup>33</sup>

## 1. Survey Findings

A “key finding” of the survey, according to the ICI, is that investors “consider a wide range of information before purchasing mutual fund shares [and] most frequently review or ask questions about a fund’s fees and expenses and its historical performance.”<sup>34</sup> Indeed, 74% of those surveyed stated that they review a fund’s fees and expenses before investing.<sup>35</sup> The second most reviewed information is the fund’s “historical performance,” which 69% of surveyed investors stated they review, and the third is the “fund risks,” which 61% said they review.<sup>36</sup>

A second “key finding” of the ICI survey was that “[s]hareholders consult a variety of sources for mutual fund information before and after purchasing shares, and one of these sources is usually a professional financial adviser. Shareholders primarily turn to advisers for assistance in understanding and interpreting fund information.”<sup>37</sup> Investors reported consulting an average of three sources before buying a fund.<sup>38</sup> Financial advisers were, by far, investors’ most consulted source of information, with 73% of those surveyed reporting that they consulted “professional financial advisers” before buying a mutual fund.<sup>39</sup> The next most consulted sources were “[f]und company or other websites” (46%) and “[f]riends, family, or business associates” (40%).<sup>40</sup>

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<sup>33</sup> *Id.* at 1 n.2.

<sup>34</sup> *Id.* at 1.

<sup>35</sup> *Id.* at 3 fig.1.

<sup>36</sup> *Id.*

<sup>37</sup> *Id.* at 1.

<sup>38</sup> *Id.* at 4 fig.2.

<sup>39</sup> *Id.*

<sup>40</sup> *Id.*

## 2. Summary and Analysis

The ICI survey paints a very favorable portrait of mutual fund investors. According to the survey, before choosing a mutual fund, investors obtain essential fund information, such as costs, returns, and risks, and they usually are assisted by professional financial advisers. If this profile is accurate, it suggests that investors have the acumen and knowledge to provide market discipline over mutual funds.

The ICI survey, however, may be of limited value. It only surveyed investors who own funds outside of employer-sponsored plans, thus missing a large and growing number of fund investors who only own funds inside such plans. Moreover, most of the surveyed investors reported using financial advisers, a resource often unavailable with employer-sponsored plans. Also, the survey relied upon investors to accurately self-report their own behavior in face-to-face interviews. Respondents predictably may have given what they saw as the right answer, not necessarily the truthful one. For example, an investor who admits to buying a fund without examining its fees and expenses (the price for investing in the fund) is admitting to buying a service without considering the price. It is well-known that survey respondents often lie to avoid embarrassing themselves.<sup>41</sup>

### B. ICI Statements Regarding Fund Investors

The ICI has also explicitly and implicitly profiled mutual fund investors in other publications and in statements by its officials. In addition, as the national trade association for the mutual fund industry, the ICI regularly sends comment

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<sup>41</sup> See, e.g., Carl Bialik, *When It Comes to Donations, Polls Don't Tell The Whole Story*, WALL ST. J. ONLINE, Feb. 11. 2005, <http://online.wsj.com/public/article/SB110806528683351584.html?mod=blogs> (discussing examples of when survey respondents have lied and quoting Jeffrey M. Jones, managing editor of the Gallup Poll, as explaining that "[t]he [survey] interview is a social experience . . . . As would be the case in a cocktail party or at a job interview, you want to give a good impression of yourself.").

letters to the SEC regarding proposed mutual fund rules.<sup>42</sup> The comment letters often state or reflect the ICI's view of mutual fund investors. As a whole, these publications, statements, and comment letters present a portrait of mutual fund investors who place great emphasis on fund fees and expenses when choosing among mutual funds, thus creating a competitive fund market that disciplines the industry. In addition, the ICI has portrayed investors as having available to them—and using—a great deal of information about funds when making their fund choices.

### 1. Investors Are Sensitive to Fund Costs

The ICI frequently asserts that investors search for funds with low fees and expenses. For example, Paul Schott Stevens, the President and CEO of the ICI, recently stated that “investors tend to seek out lower-cost funds.”<sup>43</sup>

As evidence of investors' preference for low fees and expenses, the ICI has pointed out that investors are heavily invested in lower-cost funds. In its study of competition in the mutual fund industry, the ICI concluded that “[m]ore than three-quarters of stock and bond fund assets are invested in funds charging below-average operational and management expenses . . . .”<sup>44</sup> In addition, a 2005 ICI study described a 25-year trend of declining fund fees and expenses. The ICI study found that investors paid on

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<sup>42</sup> Before the SEC adopts new regulations of mutual funds, it seeks public input. The SEC publishes the proposed regulation in the Federal Register and asks the public to comment on the proposal. The SEC typically responds in the Federal Register to these comments and sometimes even modifies or retracts the proposal in light of the comments.

<sup>43</sup> Statement by Paul Schott Stevens, President, Investment Company Institute, ICI Welcomes Efforts to Improve 401(k) Disclosure (Mar. 7, 2007), [http://www.ici.org/statements/nr/2007/07\\_news\\_401k\\_hrg.html#TopOfPage](http://www.ici.org/statements/nr/2007/07_news_401k_hrg.html#TopOfPage) (last visited Dec. 3, 2008).

<sup>44</sup> INVESTMENT COMPANY INSTITUTE, RESEARCH COMMENTARY: COMPETITION IN THE MUTUAL FUND BUSINESS 1 (2006), *available at* [http://www.ici.org/stats/res/rc\\_competition.pdf](http://www.ici.org/stats/res/rc_competition.pdf) [hereinafter ICI, COMPETITION].



average 113 basis points<sup>45</sup> to invest in stock funds, 90 basis points for bond funds, and 41 basis points for money market funds—the lowest cost levels for each class of fund in more than 25 years.<sup>46</sup>

The ICI regularly claims that cost-sensitive investors impose a strong market discipline on mutual funds. For example, in a recent publication on competition in the mutual fund industry, the ICI stated that “[t]he 90 million fund shareholders’ demand for investment performance and services at a competitive level of fees and expenses continuously impacts mutual funds.”<sup>47</sup> Similarly, the ICI noted that “[i]ncreased investor demand for low-cost funds accounted for more than half of the decline in the asset-weighted average expense ratio [in 2005].”<sup>48</sup>

ICI officials echo this view. For example, John Murphy, the General Membership Meeting Chairman of the ICI, recently stated that:

[T]he free market still reigns as the most powerful source of accountability. Market competition offers a strict, comprehensive, and daily form of discipline. The score on funds is printed in the paper and on the Internet every day. Mutual fund managers know that unhappy investors are never more than a phone

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<sup>45</sup> A basis point is 0.01% of the fund’s assets. Thus, paying 113 basis points on a \$10,000 investment costs an investor \$113 annually.

<sup>46</sup> INVESTMENT COMPANY INSTITUTE, FEES AND EXPENSES OF MUTUAL FUNDS, 2005 at 1-2 & fig.1 (2006), available at <http://www.ici.org/statements/fundamentals/fm-v15n4.pdf> [hereinafter ICI, FEES & EXPENSES].

<sup>47</sup> ICI, COMPETITION, *supra* note 44, at 1.

<sup>48</sup> ICI, FEES & EXPENSES, *supra* note 46, at 1. See also, INVESTMENT COMPANY INSTITUTE, A GUIDE TO UNDERSTANDING MUTUAL FUNDS 23 (2007), available at [http://www.ici.org/pdf/bro\\_understanding\\_mfs\\_p.pdf](http://www.ici.org/pdf/bro_understanding_mfs_p.pdf) [hereinafter ICI, UNDERSTANDING FUNDS] (“Mutual funds compete vigorously to keep costs low, since the performance figures reported by the fund, and the total value of [an investor’s] mutual fund account, are provided after all fees and expenses have been deducted.”).

call or mouse click away from switching to another provider.<sup>49</sup>

While trumpeting investor demand for lower-cost funds, however, the ICI has been careful not to encourage investors to invest in such funds. For example, an online mutual fund primer sponsored by the ICI Education Foundation and the National Urban League is silent about the effect of costs (such as loads and expenses) on fund returns.<sup>50</sup> Instead, fund investors are urged to focus on “[t]ime in the [m]arket” rather than “[t]iming the market.”<sup>51</sup> The primer points out that annual stock market returns have averaged 11% from 1926 to 2004, but does not indicate how much less mutual fund investors have received because of the drag of fund fees and expenses.<sup>52</sup>

Other ICI educational materials mention fees and expenses but do not encourage investors to seek out low-cost funds. For example, the ICI has published an educational brochure entitled “A Guide to Understanding Mutual Funds.”<sup>53</sup> Some of the information in the brochure is written in a question-and-answer format. In response to the question “Should Fund Fees Affect Your Decision?” the ICI responds only that:

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<sup>49</sup> John V. Murphy, Gen. Membership Meeting Chairman, Welcoming Remarks at the Investment Company Institute’s 2006 General Membership Meeting (May 17, 2006), *available at* [http://www.ici.org/statements/remarks/06\\_gmm\\_murphy\\_spch.html#TopOfPage](http://www.ici.org/statements/remarks/06_gmm_murphy_spch.html#TopOfPage).

<sup>50</sup> Investment Company Institute Education Foundation and National Urban League, Investing for Success, <http://www.icief.org/introduction/index.html> (last visited Dec. 3, 2008). In the 230 pages of the online primer, the terms “fees” and “expenses” do not appear except with respect to college costs, and the terms “12b-1” and “loads” are not mentioned at all.

<sup>51</sup> Investment Company Institute Education Foundation and National Urban League, Investing for Success, [http://www.icief.org/realistic/index.html?real\\_lesson3.html~text](http://www.icief.org/realistic/index.html?real_lesson3.html~text) (last visited Dec. 3, 2008).

<sup>52</sup> Investment Company Institute Education Foundation and National Urban League, Investing for Success, [http://www.icief.org/realistic/index.html?real\\_ill2.html~text](http://www.icief.org/realistic/index.html?real_ill2.html~text) (last visited Dec. 3, 2008).

<sup>53</sup> ICI, UNDERSTANDING FUNDS, *supra* note 48.

If two funds were *identical*, except for the fees and expenses they charge, the lower-cost fund would be a better option. But rarely, if ever, are funds identical. For example, stock funds typically cost more than bond and money market funds, but stock funds historically have provided a significantly higher return—even after expenses are deducted. Even different types of stock funds, U.S. or foreign, typically vary in cost. In short, there are many factors that affect the fees and expenses a fund charges. Only after weighing all of the relative benefits of different funds, including an analysis of their costs, can you decide if owning a particular fund is acceptable to you. A fund with higher costs may make more money for you, even after accounting for the costs you pay, than a fund with a lower cost. The opposite may also be true.<sup>54</sup>

## 2. Investors Access Large Amounts of Fund Information

ICI officials have also credited as a source of market discipline the great amount of information about funds available to investors.<sup>55</sup> They claim that this information

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<sup>54</sup> *Id.* at 26. Another ICI educational brochure gives a very similar answer to the same question except that it begins its answer with “Yes. Fund fees are one of many important elements that should be considered when you are making a decision about whether to purchase a particular fund.” INVESTMENT COMPANY INSTITUTE, FREQUENTLY ASKED QUESTIONS ABOUT MUTUAL FUND FEES 11 (2007), *available at* [http://www.ici.org/pdf/mf\\_fee\\_faqs.pdf](http://www.ici.org/pdf/mf_fee_faqs.pdf).

<sup>55</sup> *See, e.g.*, Paul Schott Stevens, President, Investment Company Institute, Address at the Investment Company Institute Gen. Membership Meeting (May 17, 2006), (transcript available at [http://www.ici.org/issues/tax/arc-leg/06\\_gmm\\_stevens\\_spch.html](http://www.ici.org/issues/tax/arc-leg/06_gmm_stevens_spch.html)) (“If mutual funds have succeeded, it is because they rest on strong regulatory and market disciplines—the high standard of fiduciary duty the law justly demands of fund managers, the abundant information funds must supply to their investors, the fiercely competitive environment in which funds operate, and the resulting scrutiny to which they are subject.”).

allows investors to compare funds, forcing funds to compete for investors.<sup>56</sup>

Interestingly, however, the ICI also believes that most investors are receiving too much information about funds. Thus, the ICI has supported steps taken by the SEC to reduce, summarize, and standardize the information in fund prospectuses<sup>57</sup> and to create even more basic disclosure documents, such as fund profiles.<sup>58</sup> In addition, the ICI has supported SEC initiatives to simplify the language used in disclosure documents so that investors can better understand them.<sup>59</sup>

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<sup>56</sup> Murphy, *supra* note 49 (“Mutual funds are arguably the most scrutinized, regulated, and transparent products in financial history. Our industry features a large number of firms, all competing for investors’ loyalty. Barriers to entry are low and information to compare competing products is widely available.”).

<sup>57</sup> See, e.g., Letter from Paul Schott Stevens, Senior Vice President & Gen. Counsel, Investment Company Institute, to Jonathan G. Katz, Sec’y, Sec. & Exch. Comm’n (June 9, 1997), available at [http://www.ici.org/statements/cmltr/97\\_sec\\_formn1a\\_com.html](http://www.ici.org/statements/cmltr/97_sec_formn1a_com.html) [hereinafter Stevens-Katz Letter] (supporting the SEC’s proposal to require the prospectus to contain a standardized risk/return summary because the ICI “believe[s] the summary will assist investors both in understanding the key features of a particular fund and in comparing different funds”). In addition, the ICI has supported changes to the prospectus “to minimize potential investor confusion and to avoid unnecessary clutter.” *Id.*

<sup>58</sup> *Id.*; Letter from Paul Schott Stevens, Senior Vice President & Gen. Counsel, Investment Company Institute, to Barry P. Barbash, Dir., Div. of Inv. Mgmt., Sec. & Exch. Comm’n (May 20, 1996), available at [http://www.ici.org/statements/cmltr/96\\_sec\\_profile\\_prosp\\_com2.html](http://www.ici.org/statements/cmltr/96_sec_profile_prosp_com2.html) [hereinafter Stevens-Barbash Letter] (stating that ICI and mutual fund complexes’ research found that “substantially more shareholders are likely to actually read the profile prospectus than the traditional prospectus because the profile provides the information they need more succinctly, in a way they can more readily understand, and in a format they can more easily use.”).

<sup>59</sup> For example, the ICI supported the SEC’s requiring that the risk/return summary be written in “plain English.” *Review of Current Investigations and Regulatory Actions Regarding the Mutual Fund Industry: Fund Costs and Distribution Practices: Before the S. Comm. on Banking, Housing, and Urban Affairs*, 108th Cong. 32 (Mar. 31, 2004) (statement of Paul G. Haaga, Jr., Chairman, Investment

The ICI supports such disclosure reforms because it believes that investors are more likely to read and understand simplified and standardized information.<sup>60</sup> In fact, the ICI has called for even simpler disclosure than has been adopted by the SEC so far.<sup>61</sup> Paul Schott Stevens, the ICI's President, recently suggested that investors receive "something like a quick-start guide [similar to what is provided with some electronic equipment] when they buy fund shares."<sup>62</sup> This guide would be a "clear, concise document that highlights the key information that a fund buyer wants and needs, in an easy-to-understand form."<sup>63</sup>

The ICI, however, has sometimes opposed disclosure reforms on the grounds that investors can obtain the information from other sources. For example, the ICI

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Company Institute), *available at* [http://banking.senate.gov/public/\\_file/haaga/pdf](http://banking.senate.gov/public/_file/haaga/pdf). In addition, the ICI recommended that the SEC require that, in drafting a fund profile, "mutual funds, to the extent possible, use language that a typical investor would understand and avoid the use of technical terms and the relegation of critical information to footnotes." Stevens-Barbash Letter, *supra* note 58.

<sup>60</sup> Letter from Paul Schott Stevens, Senior Vice President & Gen. Counsel, Investment Company Institute, to Jonathan G. Katz, Sec'y, Sec. & Exch. Comm'n (June 9, 1997), *available at* [http://www.ici.org/statements/cmltr/97\\_sec\\_fund\\_profile\\_com.html](http://www.ici.org/statements/cmltr/97_sec_fund_profile_com.html) ("[B]y adopting the profile, the Commission would address the clear need for a fund disclosure document that many more of today's sixty-three million fund shareholders actually will read and use in making investment decisions.").

<sup>61</sup> Paul Schott Stevens, President, Investment Company Institute, Remarks at The National Press Club: Revolution in Real Time: Using the Internet to Inform Investors Better (Feb. 14, 2006) (transcript *available at* [http://www.ici.org/statements/remarks/06\\_npc\\_stevens\\_spch.html#TopOfPage](http://www.ici.org/statements/remarks/06_npc_stevens_spch.html#TopOfPage)) ("There is widespread agreement that today's disclosure system is not optimal from the fund investor's perspective. Most investors seek information that is clear and concise. They value quality, not quantity.").

<sup>62</sup> Paul Schott Stevens, President, Investment Company Institute, ICI President's Remarks at the Mutual Funds and Investment Management Conference: When You Come to a Fork in the Road, Take It: Improving Financial Regulation in America (Mar. 26, 2007) (transcript *available at* [http://www.ici.org/statements/remarks/07\\_mfim\\_stevens\\_spch.html](http://www.ici.org/statements/remarks/07_mfim_stevens_spch.html)).

<sup>63</sup> *Id.*

supported the National Association of Securities Dealers' ("NASD") proposal to require disclosure of fund expense ratios in performance advertisements<sup>64</sup> but not disclosure of the actual dollar amount of expenses that would be incurred by a hypothetical fund investor. The ICI argued that:

Fund advertisements are not intended to be the exclusive source for investors of information about the fund, which is why all advertisements under Rule 482 are required to encourage potential investors to read the fund's prospectus carefully before investing and include information about how an investor may obtain the prospectus.<sup>65</sup>

Less has also been more when it comes to cautioning investors. For example, the ICI has assumed that investors will read cautionary disclosures placed in television advertisements. Thus, in letters to both the SEC and the Municipal Securities Rulemaking Board, the ICI pushed for disclosures required in television ads to be permitted to appear in text on the screen rather than being spoken.<sup>66</sup>

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<sup>64</sup> A performance advertisement is a mutual fund advertisement that presents a fund's historical returns.

<sup>65</sup> Letter from Dorothy M. Donohue, Assoc. Counsel, Investment Company Institute, to Barbara Z. Sweeney, Office of the Corp. Sec'y, Nat'l Assoc. Sec. Dealers (Jan. 23, 2004), [http://www.ici.org/statements/cmltr/04\\_nasd\\_ad\\_disclose\\_com.html#TopOfPage](http://www.ici.org/statements/cmltr/04_nasd_ad_disclose_com.html#TopOfPage) (footnote omitted).

<sup>66</sup> Letter from Amy B.R. Lancellotta, Senior Counsel, Investment Company Institute, to Jonathan G. Katz, Sec'y, Sec. & Exch. Comm'n (July 31, 2002), *available at* [http://www.ici.org/statements/cmltr/02\\_sec\\_fund\\_advert\\_com.html#TopOfPage](http://www.ici.org/statements/cmltr/02_sec_fund_advert_com.html#TopOfPage) ("[W]ith respect to television advertisements, we recommend that the Commission clarify that such disclosures need not be provided orally and that, instead, they may be provided in written text on the television screen."); Letter from Dorothy M. Donohue, Assoc. Counsel, Investment Company Institute, to Ernesto A. Lanza, Senior Assoc. Gen. Counsel, Mun. Sec. Rulemaking Bd., (Sept. 22, 2006), *available at* [http://www.ici.org/statements/cmltr/06\\_msrb\\_ads\\_com.html#TopOfPage](http://www.ici.org/statements/cmltr/06_msrb_ads_com.html#TopOfPage) ("We also strongly support permitting the required information to be provided in an abbreviated manner and permitting a portion of the disclosure to be provided on the screen (rather than spoken) for television advertisements.").

### 3. Summary and Analysis

Although sometimes inconsistent, the ICI's profile of fund investors should be comforting to regulators. The profile describes investors who, on their own or with the assistance of financial advisers, impose sufficient market discipline on the mutual fund industry.<sup>67</sup> According to the ICI, mutual fund investors diligently seek out and digest important information about fund expenses, performance, and risks before investing. As a result, investors create pressure on funds to lower expenses and achieve high returns. At the same time, however, the ICI warns that many investors will only read and understand disclosures that are concise and clear, and the ICI does not encourage investment in low-cost funds.

## IV. SEC'S PORTRAIT OF FUND INVESTORS: CAPABLE (WITH SOME HELP)

The Securities and Exchange Commission (the "SEC"), although less sanguine than the industry, also paints a portrait of fund investors that implies a well-functioning mutual fund market. The SEC shares the industry view that fund investors consider a variety of important information before investing. The SEC also agrees that fund investors can become confused while navigating the sea of information about mutual funds and thus can benefit from having information in a concise, readable, and standardized form. Unlike the industry, however, the SEC has specific concerns about investor sophistication, worrying that fund investors pay insufficient attention to fund fees and expenses and too much attention to past returns. The agency's solution, however, is generally more and better disclosure.

Capturing the SEC's view, then SEC Chairman Arthur Levitt testified before Congress that "[t]he Commission

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<sup>67</sup> See also INVESTMENT COMPANY INSTITUTE, UNDERSTANDING SHAREHOLDERS' USE OF INFORMATION AND ADVISERS 3 (1997), *available at* [http://www.ici.org/statements/res/arc-dis/rpt\\_undstdnd\\_share.pdf](http://www.ici.org/statements/res/arc-dis/rpt_undstdnd_share.pdf).

should not be the arbiter of the appropriate level of fund fees. Whether fund fees are too high or too low is a question that we believe must be answered by competition in the marketplace, not by government intervention.”<sup>68</sup> That is, despite the underlying premise of the Investment Act of 1940 (the “1940 Act”) that fund investors cannot fend for themselves, the agency has assumed that (properly informed) demand-side market forces are sufficient to discipline any supply-side excesses.

This part describes the profile of fund investors assumed by the SEC. This profile can be distilled from a number of sources, especially the disclosure the SEC has required in fund prospectuses, fund profiles, and advertisements. In addition, recent attempts by the SEC to directly educate fund investors also reveal some awareness of investors’ limitations. In general, it is an investor profile influenced significantly by industry comments and studies, and nearly oblivious to the findings of the academic literature on fund investor behavior.

### A. SEC Regulation of Fund Disclosure

The SEC intends the fund prospectus to be the primary source of information for investors choosing a fund.<sup>69</sup> By law, a prospective fund investor must be provided with a fund’s

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<sup>68</sup> *Transparency in the United States Debt Market and Mutual Fund Fees and Expenses: Hearings Before the H. Subcomm. on Finance and Hazardous Materials*, Comm. on Commerce, (1998) [hereinafter *Transparency Hearings*] (statement of Arthur Levitt, Chairman, SEC), available at <http://www.sec.gov/news/testimony/testarchive/1998/tsty1398.htm>. See also U.S. GEN. ACCOUNTING OFFICE, *MUTUAL FUND FEES: ADDITIONAL DISCLOSURE COULD ENCOURAGE PRICE COMPETITION* 7 (2000) [hereinafter GAO, *MUTUAL FUND FEES*] (“[R]egulators rely on competition to be a primary means of influencing the fees that mutual fund advisers charge.”).

<sup>69</sup> Registration Form Used by Open-End Management Investment Companies, 62 Fed. Reg. 10,898, 10,900 (Mar. 10, 1997) (to be codified at 17 C.F.R. pt. 230, 239, 270, 274) (“The Commission regards the prospectus as an investor’s primary source of information about a fund.”); see also, SEC, *Invest Wisely*, *supra* note 1 (“The prospectus is the fund’s selling document . . .”).



prospectus before or at the time that the investor purchases fund shares.<sup>70</sup> In addition, the SEC requires that fund advertisements explicitly direct investors to the prospectus. Advertisements must explain that the prospectus contains information about the fund, must identify where investors can obtain the prospectus, and must warn that “the prospectus should be read carefully before investing.”<sup>71</sup>

The SEC recognizes that investors vary in sophistication and thus seek different types and amounts of information before buying a mutual fund.<sup>72</sup> However, the target audience for the prospectus, in the view of the SEC, is the typical investor.<sup>73</sup> Thus, the required content and form of the disclosures in the prospectus reflect the SEC’s view of the abilities and limitations of the typical mutual fund investor.

## 1. Streamlined Disclosure

In its instructions regarding how to write a prospectus, the SEC acknowledges that most investors “may not be

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<sup>70</sup> Securities Act of 1933 § 5(b)(2), 15 U.S.C. § 77e(b)(2) (2006).

<sup>71</sup> Amendments to Investment Company Advertising Rules, 68 Fed. Reg. 57,760, 57,777 (Oct. 6, 2003) (to be codified at 17 C.F.R. pt. 230, 239, 270, 274).

<sup>72</sup> Registration Form Used by Open-End Management Investment Companies, 62 Fed. Reg. at 10,900 (“Different investors prefer different amounts of information before making an investment decision, and regulatory requirements should not foreclose options that respond to prospective investors’ information needs.”); New Disclosure Option for Open-End Management Investment Companies, 63 Fed. Reg. 13,968, 13,970 (Mar. 23, 1998) (to be codified at 17 C.F.R. pt. 230, 270) (“[D]ifferent investors desire and use different types and amounts of materials in determining whether to invest in funds.”).

<sup>73</sup> Registration Form Used by Open-End Management Investment Companies, 62 Fed. Reg. at 10,900 (“The prospectus is intended to provide information about matters of fundamental importance to most investors.”); Registration Form Used by Open-End Management Investment Companies, 63 Fed. Reg. 13,916, 13,919 (Mar. 28, 1998) (to be codified at 17 C.F.R. pt. 230, 232, 239, 240, 270, 274) (“Funds should limit disclosure in prospectuses generally to information that is necessary for an average or typical investor to make an investment decision.”).

sophisticated in legal or financial matters.”<sup>74</sup> The SEC also recognizes that most investors are less likely to read a prospectus that is difficult to understand.<sup>75</sup> Thus, the SEC has tried to “streamline prospectus disclosure requirements to focus on essential information about a particular fund and make the prospectus less technical and easier to read.”<sup>76</sup>

One way that the SEC has tried to make the prospectus more accessible to fund investors is by moving more complicated and detailed information out of the prospectus to another document. In 1983, the SEC adopted a “two-part disclosure format,” under which investors receive a “simplified prospectus designed to contain essential information” about a fund. Upon request, investors can also obtain a Statement of Additional Information that contains “more extensive information and detailed discussions of matters included in the prospectus.”<sup>77</sup> In doing so, the SEC intended the prospectus to include only fund information that would be used by “typical or average investors” and the Statement of Additional Information to contain information of interest only to “sophisticated investors.”<sup>78</sup>

Therefore, the contents of the prospectus reflect the SEC’s view of what information is useful to the “typical” mutual fund investor.<sup>79</sup> In the prospectus, the SEC requires information about:

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<sup>74</sup> SEC, Form N-1A, at General Instruction C(1)(b), *available at* <http://www.sec.gov/about/forms/formn-1a.pdf> (last visited Dec. 3, 2008).

<sup>75</sup> Registration Form Used by Open-End Management Investment Companies, 62 Fed. Reg. at 10,900 (“A prospectus . . . is not useful to investors if it is in a form that discourages investors from reading it.”).

<sup>76</sup> *Id.*

<sup>77</sup> *Id.* at 10,899.

<sup>78</sup> Registration Form Used by Open-End Management Investment Companies, 63 Fed. Reg. 13,916, 13,917.

<sup>79</sup> SEC Form N-1A, *supra* note 74, at General Instruction C(1)(b). (“The prospectus disclosure requirements . . . are intended to elicit information for an average or typical investor who may not be sophisticated in legal or financial matters.”).

- the fund's investment objectives or goals<sup>80</sup>
- the fund's principal investment strategies<sup>81</sup>
- the fund's principal risks<sup>82</sup>
- the fund's returns over each of the last ten years<sup>83</sup>
- the fund's average annual total returns over the last one, five, and ten years<sup>84</sup>
- the returns of an appropriate securities market index over the same periods<sup>85</sup>
- the fund's fees and expenses<sup>86</sup>
- the fund's managers, organization, and capital structure<sup>87</sup>
- the fund's policies regarding the pricing, purchase, and redemptions of fund shares, and regarding fund dividends and distributions (and their tax consequences)<sup>88</sup>
- the fund's distribution arrangements, including sales loads and 12b-1 fees<sup>89</sup>
- the fund's "financial highlights" for each of the last five years, including the fund's net asset value, income from investment operations, distributions, total return, net assets, expense ratio, ratio of net income to average net assets, and portfolio turnover rate.<sup>90</sup>

Except for the returns of an "appropriate" market index, the prospectus need not provide any comparative information

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<sup>80</sup> *Id.* at Items 2, 4.

<sup>81</sup> *Id.*

<sup>82</sup> *Id.*

<sup>83</sup> *Id.* at Item 2.

<sup>84</sup> *Id.*

<sup>85</sup> *Id.*

<sup>86</sup> *Id.* at Item 3. The prospectus defines "fees" as payments shareholders make directly from their investments (such as loads or exchange fees), and "expenses" as payments that are deducted from the fund's assets (such as management fees and 12b-1 fees). *Id.*

<sup>87</sup> *Id.* at Item 5.

<sup>88</sup> *Id.* at Item 6.

<sup>89</sup> *Id.* at Item 7.

<sup>90</sup> *Id.* at Item 8.

on performance, loads, fees, expenses or portfolio turnover. That is, fund investors must search elsewhere for how a particular fund compares to others. Nor does the prospectus have to suggest any sources for comparative information, such as Morningstar.<sup>91</sup> Instead, the SEC assumes fund investors, left to their own devices, can determine how a fund's performance and costs compare to those of other funds.

Likewise, the prospectus need not educate investors about diversification, long-term returns of various asset classes (such as stocks or bonds), or the relationship of risk and return. By not requiring such information in the prospectus, the SEC is at least implicitly assuming that most investors already know or do not need this information.

The SEC's rules regarding fund "profiles" offer additional insight into what the SEC perceives as the information needs of most investors. In 1998, the SEC amended its rules to allow investors to buy mutual fund shares without having received a prospectus, as long as they received a fund profile beforehand.<sup>92</sup> The fund profile must summarize key information included in the prospectus and must contain specific information about the fund, including:

- objectives/goals
- principal investment strategies
- principal risks
- average annual returns (but without any comparison to a relevant market index)
- fees and expenses
- investment adviser, sub-adviser(s), and portfolio manager(s)<sup>93</sup>

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<sup>91</sup> Morningstar, Inc. compiles detailed information about particular mutual funds and other securities. This data is accessible at <http://www.morningstar.com> (last visited Dec. 3, 2008).

<sup>92</sup> An investor who bought the fund on the basis of the profile, however, is still required to receive the prospectus with the confirmation of their purchase. New Disclosure Option for Open-End Management Investment Companies, 63 Fed. Reg. 13,968.

<sup>93</sup> It must also contain information about the experience of the portfolio manager(s). 17 C.F.R. § 230.498(c)(2)(v)(C) (2008).

- investment requirements and front-end loads
- redemption procedures and back-end loads
- policies regarding fund distributions
- tax consequences of fund distributions
- other services offered by the fund.<sup>94</sup>

When the SEC proposed the fund profile, it received several suggestions from third parties that additional information (including information on portfolio holdings, investment style, and risk measures) also be required in the profile.<sup>95</sup> While acknowledging the information might be “of interest to some fund investors,” the SEC rejected its inclusion as “not necessarily essential information for the average or typical investor.”<sup>96</sup>

In its most recent effort to improve the disclosure that fund investors receive, the SEC proposed in November 2007 to “provide investors with streamlined disclosure of key mutual fund information at the front of the statutory prospectus, in a standardized order that facilitates comparisons across funds.”<sup>97</sup> This summary would be in plain English and 3-4 pages long. The SEC has proposed that the risk/return summary (described below) currently at the front of mutual fund prospectuses be the “centerpiece” of the new summary section. The new section, however, would also include some additional information so that the summary “will function as a more comprehensive presentation” than the current risk/return summary.<sup>98</sup> The

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<sup>94</sup> 17 C.F.R. § 230.498(c) (2008).

<sup>95</sup> The suggested additional information included “a fund’s top ten portfolio holdings; an investment style box; additional measures of risk; and financial highlights.” New Disclosure Option for Open-End Management Investment Companies, 63 Fed. Reg. 13,968, 13,972.

<sup>96</sup> *Id.*

<sup>97</sup> Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, 72 Fed. Reg. 67,790, 67,793 (proposed Nov. 30, 2007) (to be codified at 17 C.F.R. pt. 230, 232, 239, 274).

<sup>98</sup> In addition, the SEC is proposing that, for prospectuses that cover multiple funds, the summary information for each fund must be presented separately. This requirement is intended to facilitate

summary section would contain the following information about the fund, in a fixed order:<sup>99</sup>

- investment objectives and goals
- costs (including a fee table and an example)
- principal investment strategies, risks, and performance (including the current risk/return bar chart and a table showing the fund's past performance and the volatility of its returns)
- top ten portfolio holdings
- investment advisers and portfolio managers
- information regarding the purchase and sale of fund shares
- information about taxes resulting from fund distributions
- financial intermediary compensation.<sup>100</sup>

Importantly, some of the modifications to the current risk/return summary are aimed at “address[ing] concerns that investors do not understand that they pay ongoing costs every year when they invest in mutual funds.”<sup>101</sup> For example, in the current risk/return summary, the heading “Annual Fund Operating Expenses” in the fee table is followed by the parenthetical “expenses that are deducted from Fund assets.” The new summary section would replace that parenthetical with the more understandable words “ongoing expenses that you pay each year as a percentage of the value of your investment.”<sup>102</sup>

In addition, the SEC's proposal would replace the fund profile with a Summary Prospectus that contains the same information (in the same order) that would be in the new

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investor understanding of the summary section in multi-fund prospectuses. *Id.*

<sup>99</sup> *Id.* at 67,794-95.

<sup>100</sup> Investors are warned that if they purchased their fund shares through an intermediary and that intermediary receives compensation for the sale of the shares, that compensation may bias the intermediary's advice to the investor. *Id.* at 67,798.

<sup>101</sup> *Id.* at 67,795.

<sup>102</sup> *Id.*

summary section of the full, statutory prospectus.<sup>103</sup> Investors would be permitted to buy a fund after having received just the Summary Prospectus, as long as the statutory prospectus is available online.<sup>104</sup>

In summary, like the ICI, the SEC believes that a variety of information is important to most mutual fund investors. Also, like the ICI, the SEC believes that if too much information is given to investors, they are unlikely to read it. Thus the SEC has adopted measures to summarize and reduce the information that investors receive in certain disclosure documents.

## 2. Standardized Disclosure

The SEC also believes that the format of information, not only its substance, is important to investors. In particular, it believes fund investors are more likely to understand clear, concise, and standardized disclosure of information in plain English or in graphical or tabular form.<sup>105</sup> For this reason, the prospectus and fund profile are required to contain much summarized information in standardized tables and graphs. For example, since 1988, the SEC has required the fund prospectus to include a fee table itemizing all fees and expenses in a uniform way because the SEC believes such a table "can be understood easily and . . . facilitates comparison among . . . funds."<sup>106</sup> This requirement arose from the SEC's concern that "investors could be confused if

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<sup>103</sup> *Id.* at 67,800.

<sup>104</sup> If requested by an investor, the fund would also have to send a copy of full, statutory prospectus by regular mail or email. *Id.* at 67,792.

<sup>105</sup> Registration Form Used by Open-End Management Investment Companies, 62 Fed. Reg. at 10,900 ("Investors have expressed a strong preference for summary information about funds in a standard format.").

<sup>106</sup> SEC, DIVISION OF INVESTMENT MANAGEMENT, REPORT ON MUTUAL FUND FEES AND EXPENSES § II(A)(2) (2000), <http://www.sec.gov/news/studies/feestudy.htm> (last visited Dec. 3, 2008) [hereinafter SEC FEE REPORT]. The table itemizes front and back-end loads, management fees, 12b-1 fees, and other fees and expenses. SEC Form N-1A, *supra* note 74, at Item 3.

the increasing variety of sales loads and other fund distribution arrangements were not uniformly presented.”<sup>107</sup> In addition, the fee table must be accompanied by a listing of the dollar amount of fees and expenses that investors would pay over one, three, five, and ten year periods if they invested \$10,000 in the fund and received a 5% annual return.<sup>108</sup>

The prospectus must also contain a standardized graph and table of the fund’s historical returns. A bar chart must show the fund’s annual returns during each of the last ten calendar years. In addition, the fund’s average annual returns over the previous one, five, and ten calendar years must be presented in the table.<sup>109</sup> The table must also show the returns of “an appropriate broad-based securities market index . . . for the same periods.”<sup>110</sup>

According to the SEC, this bar chart and table serve multiple purposes. First, they help inform investors about the fund’s past returns, both in absolute terms and relative to an appropriate index. Also, standardizing the presentation of past returns facilitates investor comparison of the returns of other mutual funds—subject to the boilerplate caution that “the Fund’s past performance (before and after taxes) is not necessarily an indication of how the Fund will perform in the future.”<sup>111</sup>

The SEC also seeks to have the prospectus convey the volatility of the fund’s returns. Thus, the prospectus must include an explanation of how the bar chart and table of the fund’s past returns illustrate:

the variability of the Fund’s returns (e.g., by stating that the information provides some indication of the risks of investing in the Fund by showing changes in the Fund’s performance from year to year and by

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<sup>107</sup> SEC FEE REPORT, *supra* note 106, at § II(A)(2).

<sup>108</sup> SEC Form N-1A, *supra* note 74, at Item 3.

<sup>109</sup> The fund’s returns before taxes, returns after taxes on distributions, and returns after taxes on distributions and sale of fund shares must each be presented in the table. *Id.* at Item 2.

<sup>110</sup> *Id.*

<sup>111</sup> *Id.*



showing how the Fund's average annual returns for one, five, and ten years compare with those of a broad measure of market performance).<sup>112</sup>

In addition, the SEC mandates the order of the information that must be disclosed. In 1998, the SEC required the front part of prospectuses to include a risk/return summary. This risk/return summary is intended to "function[] as a standardized 'executive summary' of key information about the fund."<sup>113</sup> The summary includes the fund's investment objectives or goals, its principal investment strategies, the fee table, and the bar chart and table showing past returns.<sup>114</sup> The placement of the summary at the beginning of the prospectus reflects the SEC's belief that investors are more likely to read prominently placed information.<sup>115</sup> Similarly, the SEC requires that the information in the fund profile be presented in a specified order. The SEC believes that "requiring the profile items in a specific sequence will substantially assist investors in locating information and comparing funds."<sup>116</sup> Recognizing that comparing funds can be difficult, the SEC is also attempting to make the information in the current disclosure documents more accessible to investors. In June 2007, the SEC allowed mutual funds to file information in the risk/return summary of their prospectuses as interactive data. Using certain software, investors are able to access this information and compare it across different mutual funds much more quickly than if they had to collect the data from traditionally-filed prospectuses.<sup>117</sup>

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<sup>112</sup> *Id.*

<sup>113</sup> *Transparency Hearings*, *supra* note 68 (statement of Arthur Levitt).

<sup>114</sup> SEC Form N-1A, *supra* note 74, at Item 2.

<sup>115</sup> *Transparency Hearings*, *supra* note 68 (statement of Arthur Levitt) (requiring the fee table to be in the risk/return summary "reflects the Commission's commitment to promoting investors' access to fee information as a basis for a fund investment decision").

<sup>116</sup> New Disclosure Option for Open-End Management Investment Companies, 63 Fed. Reg. 13,968, 19,972 (Mar. 23, 1998).

<sup>117</sup> Rachel McTague, *Mutual Funds: SEC to Allow Use of Interactive Data By Mutual Funds to Submit Risk/Return Info*, 39 Sec.

### 3. Plain English Disclosure

The SEC has explicitly stated that it believes that investors are more likely to understand disclosure documents written in plain English.<sup>118</sup> Thus, in 1998, to make prospectuses (and fund profiles) easier for investors to understand, the SEC adopted a “Plain English Rule,” which requires that a prospectus’s cover page, risk/return summary, and risk factors section be written in “plain English.”<sup>119</sup> The SEC summarized the plain English rule as requiring that, in these sections of the prospectus, issuers use “short sentences; definite, concrete, everyday language; active voice; tabular presentation of complex information; no legal or business jargon; and no multiple negatives” and requiring that these sections be designed “to make them inviting to the reader.”<sup>120</sup> To help issuers comply with the new rule, the SEC also produced an 83-page “Plain English Handbook” with specific guidelines on how to write in plain English.<sup>121</sup>

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Reg. & L. Rep. 986 (June 25, 2007) (stating that information filed as interactive data “will be tagged using eXtensible Business Reporting Language, or XBRL, so that it can be manipulated through the use of software tools to cull out specified information, such as cost data, for example.”).

<sup>118</sup> Plain English Disclosure, 63 Fed. Reg. 6,370, 6,371 (Feb. 6, 1998) (to be codified at 17 C.F.R. pt. 228, 229, 230, 239, 274). (“[P]reparing documents in plain English increases investors’ understanding and helps them make informed investment decisions.”). See also, SEC, A PLAIN ENGLISH HANDBOOK: HOW TO CREATE CLEAR SEC DISCLOSURE DOCUMENTS 3 (Aug. 1998), available at <http://www.sec.gov/pdf/handbook.pdf> [hereinafter PLAIN ENGLISH HANDBOOK] (“The benefits of plain English abound. Investors will be more likely to understand what they are buying and to make informed judgments about whether they should hold or sell their investments.”).

<sup>119</sup> Although the plain English requirement applies only to certain parts of the prospectus, the entire prospectus is required to be “clear, concise, and understandable.” Plain English Disclosure, 63 Fed. Reg. 6,370, 6,371.

<sup>120</sup> *Id.* at 6,370.

<sup>121</sup> See PLAIN ENGLISH HANDBOOK, *supra* note 118.

#### 4. Summary and Analysis

The content requirements of the prospectus and fund profile reflect the SEC's views regarding which fund characteristics are relevant to most mutual fund investors. These views largely mirror those of the ICI. The SEC's requirements regarding the format of the information also reflect the SEC's belief, which is shared by the ICI, that how the information is presented affects whether investors will read and understand it.

Nonetheless, despite its awareness of investors' difficulties in processing information, the SEC has not ensured that it is really helping investors understand their fund investment choices. In the 1998 prospectus disclosure rulemaking, the SEC acknowledged that an ICI survey found that about half of fund investors do not read a fund's prospectus before investing,<sup>122</sup> but the SEC has not conducted a follow-up study on whether fund investors are reading or understanding the new streamlined prospectuses.

#### B. SEC Regulation of Fund Advertising

Mutual fund advertisements are also an important source of information for investors. In fact, investors invest more in heavily advertised funds.<sup>123</sup> The SEC's rules regarding the content and form of fund advertisements, like its rules regarding prospectus and profile disclosures, reveal the agency's view of fund investors.

##### 1. Required Warnings

One recurring theme of the advertising rules is that investors must be reminded to pay attention to certain important information when choosing a fund. To keep investors focused, the rules require that fund advertisements explicitly advise investors "to consider the investment

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<sup>122</sup> Registration Form Used by Open-End Management Investment Companies, 63 Fed. Reg. 13,916, 13,917 n.5.

<sup>123</sup> See *infra* pp. 1003-04.

objectives, risks, and charges and expenses of the investment company carefully before investing.”<sup>124</sup>

The advertising rules also acknowledge that investors often become mesmerized by past performance. The SEC closely regulates advertising of past returns, which mutual funds with strong records routinely tout despite little evidence that strong past returns predict future returns.<sup>125</sup> In 2003, the SEC amended its rules governing advertisements that contain performance data.<sup>126</sup> The SEC explained that the amendments “address[] our concern that some funds, when advertising their performance, may resort to techniques that create unrealistic investor expectations or may mislead potential investors. These concerns arose during 1999 and 2000 when many funds experienced extraordinary performance and engaged in advertising campaigns focusing on past performance.”<sup>127</sup>

The SEC mandates boilerplate warnings in performance advertisements that high past returns may not continue. In particular, the advertisements must include a legend stating that:

past performance does not guarantee future results; that the investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost; and that current performance may be lower or higher than the performance data quoted.<sup>128</sup>

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<sup>124</sup> 17 C.F.R. § 230.482(b)(1)(i) (2008).

<sup>125</sup> Funds advertise strong past returns for good reason: investors give great weight to past performance. *See infra* pp. 994-98.

<sup>126</sup> The amendments were intended to ensure that performance advertisements contain current returns data and that fund advertisements include improved narrative information and present explanatory information more prominently. *See* Amendments to Investment Company Advertising Rules, 68 Fed. Reg. 57,760, 57,763.

<sup>127</sup> *Id.* at 57,760.

<sup>128</sup> 17 C.F.R. § 230.482(b)(3)(i) (2008). Advertisements need not use this exact language; any wording that “clearly communicates” this information is sufficient. Amendments to Investment Company Advertising Rules, 68 Fed. Reg. 57,760, 57,765.

## 2. Standardized Performance Data

In addition to downplaying the importance of past performance, the SEC requires that any performance information in advertisements be largely standardized. For example, the SEC prescribes how past returns must be calculated<sup>129</sup> and the time periods for which they must be reported.<sup>130</sup> In addition, the advertisement must list “a toll-free or collect telephone number or a website where an investor may obtain performance data current to the most recent month-end, unless the advertisement includes [this information].”<sup>131</sup> These regulations are intended to ensure that advertised returns fairly reflect funds’ true historical returns, and to limit the ability of a fund to mislead investors by advertising its performance only for particular periods in which the fund performed well.<sup>132</sup> In addition, by standardizing how returns are calculated and the time periods for which they must be reported, these regulations facilitate investor comparison of different funds’ returns.<sup>133</sup>

## 3. Summary and Analysis

The SEC’s regulation of advertisements reflects misgivings about investor decision-making. The SEC encourages investors to pay attention to certain key fund characteristics, apparently worrying that investors do not do so. Also, the SEC warns investors not to overemphasize past performance, believing that investors do so. Curiously,

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<sup>129</sup> The rules regarding how to calculate past returns in advertisements are identical to those regarding how past returns must be calculated in the prospectus. See 17 C.F.R. § 230.482(d) (2008).

<sup>130</sup> The advertisements must report annual returns for one, five and ten years, current to the most recent quarter. 17 C.F.R. § 230.482(d)(3)-(4) (2008). Advertisements may also include other historical return measures, but these other measures may only supplement—not replace—the required measures. 17 C.F.R. § 230.482(d)(5) (2008).

<sup>131</sup> 17 C.F.R. § 230.482(b)(3)(i) (2008).

<sup>132</sup> Amendments to Investment Company Advertising Rules, 68 Fed. Reg. 57,760, 57,765 (Oct. 6, 2003).

<sup>133</sup> *Id.* at 57,768.

however, the SEC then requires standardized performance data, facilitating investor comparison of the performance of different funds.

Unlike its prospectus and profile regulations, the SEC's advertising regulations may not reflect the SEC's view of the "typical" or "average" investor. Unlike fund prospectuses and profiles, advertisements regularly reach audiences that have not requested information about particular mutual funds, and thus may be less financially sophisticated than most investors.

As with its prospectus regulations, the SEC's advertising regulations are largely based on the agency's unsupported perceptions of the informational and cognitive needs of fund investors. For example, although the SEC requires advertisements to warn that past returns do not guarantee future returns, there is no indication that the SEC has ever examined whether these warnings are effective.

### C. SEC Efforts to Educate Investors

Besides requiring mutual fund companies to provide investors with certain information and warnings in prospectuses, profiles, and advertisements, the SEC has also sought to directly educate fund investors. Indeed, the SEC has acknowledged it has an "important" role to play in this regard.<sup>134</sup> A 2000 study by the SEC's Division of Investment Management called on the Commission to continue its program to improve investor "financial literacy" regarding mutual funds and their costs.<sup>135</sup> In addition, the Division recommended that the Commission "develop educational materials" to help investors understand how to use any new fee disclosures.<sup>136</sup>

#### 1. Warnings About Past Performance

To educate investors, the SEC has developed some basic materials in which the agency implicitly accepts that mutual

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<sup>134</sup> SEC FEE REPORT, *supra* note 106 at § IV(A)(1).

<sup>135</sup> *Id.*

<sup>136</sup> *Id.* at § I(B)(2)(a).

fund investors are prone to certain investing mistakes. Like the advertising regulations, the materials reflect the SEC's concern that investors overweight past fund returns. A document on the SEC website, *Invest Wisely: An Introduction to Mutual Funds*, gives investors a basic introduction to mutual funds and a stern warning (in plain English) against relying on past returns:

Past performance is not a reliable indicator of future performance. So don't be dazzled by last year's high returns . . . . A fund's past performance is not as important as you might think. Advertisements, rankings, and ratings often emphasize how well a fund has performed in the past. But studies show that the future is often different. This year's "number one" fund can easily become next year's below average fund.<sup>137</sup>

Other SEC publications also make the same point, but not as strongly. For example, another document on the SEC's website, *Mutual Fund Investing: Look at More Than a Fund's Past Performance*, warns investors:

You can't open a newspaper or read a magazine without seeing ads promoting the stellar performance of "hot" mutual funds. But past performance is not as important as you may think, especially the short-term performance of relatively new or small funds. As with any investment, a fund's past performance is no guarantee of its future success. Over the long-term, the success (or failure) of your investment in a fund also will depend on [other] factors . . . . So, look at more than the fund's past performance when making your investment decisions.<sup>138</sup>

## 2. Warnings About Fees and Expenses

The SEC's educational materials also indicate concern that some investors do not pay enough attention to fund fees

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<sup>137</sup> SEC, *Invest Wisely*, *supra* note 1.

<sup>138</sup> SEC, *MUTUAL FUND INVESTING: LOOK AT MORE THAN A FUND'S PAST PERFORMANCE*, <http://sec.gov/investor/pubs/mfperform.htm> (last visited Dec. 3, 2008) [hereinafter SEC, LOOK AT MORE].

and expenses. The materials encourage investors who are choosing a mutual fund to give significant weight to costs. For example, they describe the different types of fees and expenses,<sup>139</sup> encourage investors to “review carefully”<sup>140</sup> and “scrutinize”<sup>141</sup> the fees and expenses charged by funds they are considering, and warn investors that “[e]ven small differences in fees can translate into large differences in returns over time.”<sup>142</sup>

To make the effect of costs more concrete, the SEC presents an example of the effect over twenty years of a 1% annual difference in expenses on a hypothetical \$10,000 investment.<sup>143</sup> Recall that this information is not required in fund prospectuses, profiles, or advertisements. In addition, to help investors compare the costs of different mutual funds and understand the impact of costs over time, the SEC website contains a “Mutual Fund Cost Calculator” and a link to the NASD’s “Mutual Fund Expense Analyzer.”<sup>144</sup> Again, neither of these tools is required to be mentioned in fund prospectuses, profiles, or advertisements.

Finally, the SEC’s website also encourages investors to pay attention to other basic fund characteristics. For example, it encourages investors to consider a fund’s risks and investment strategy, and how the fund fits with the investor’s own risk tolerance, long-term investment

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<sup>139</sup> SEC, *Invest Wisely*, *supra* note 1.

<sup>140</sup> *Id.*

<sup>141</sup> SEC, *LOOK AT MORE*, *supra* note 138.

<sup>142</sup> SEC, *Invest Wisely*, *supra* note 1; *see also* SEC. AND EXCH. COMM’N, *CALCULATING MUTUAL FUND FEES AND EXPENSES*, <http://sec.gov/investor/tools/mfcc/mfcc-int.htm> (last visited Dec. 3, 2008) [hereinafter SEC, *Calculating Fees*] (“Fees and expenses are an important consideration in selecting a mutual fund because these charges lower your returns.”); SEC, *Invest Wisely*, *supra* note 1 (“It is important that you understand [mutual fund fees and expenses] because they lower your returns.”).

<sup>143</sup> SEC, *Invest Wisely*, *supra* note 1 (“For example, if you invested \$10,000 in a fund that produced a 10% annual return before expenses and had annual operating expenses of 1.5%, then after 20 years you would have roughly \$49,725. But if the fund had expenses of only 0.5%, then you would end up with \$60,858 – an 18% difference.”).

<sup>144</sup> SEC, *Calculating Fees*, *supra* note 142.



strategies, and diversified investment portfolio. But, like the prospectus, it does not explain how investors should develop investment strategies or what constitutes a diversified portfolio.

### 3. Summary and Analysis

Like its advertising regulations, the SEC's educational materials indicate that the agency believes that some investors need to be reminded not to overweight a fund's past returns and not to underweight other fund characteristics such as fees and expenses, risk, and investment objectives and strategies.

But as with the advertising regulations, the intended audience of the educational material on the SEC's website is unclear. Much of the information is very basic, and titles such as "*An Introduction to Mutual Funds*" suggest that it targets new investors rather than the typical investor. Nonetheless, the SEC has indicated elsewhere that most investors may need to be reminded to make fully-informed investment decisions.<sup>145</sup> Regardless, the profile of the investor to whom the SEC's educational materials is directed is significantly less favorable than the investor profile presented by the fund industry.

## V. ACADEMIC LITERATURE'S PROFILE OF FUND INVESTORS: MOSTLY CLUELESS

Although the fund industry portrays fund investors as making informed decisions, and the SEC portrays them as

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<sup>145</sup> See, e.g., SEC FEE REPORT, *supra* note 106, § II(B)(2) (noting that the SEC "continues to be concerned . . . that the typical investor [is] not using all of the resources that are available in considering investments in mutual funds"); Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies, 69 Fed. Reg. 11,244, 11,245 (Mar. 9, 2004) (to be codified at 17 C.F.R. pt. 210, 239, 249, 270, 274) ("[T]he degree to which investors understand mutual fund fees and expenses remains a source of concern.").

needing only to be reminded to pay appropriate attention to important fund characteristics, the academic literature finds fund investors ill-prepared to choose among funds. Contradicting the industry's and regulator's favorable portraits, an extensive body of studies of investor behavior—conducted primarily by finance professors—reveals that fund investors are largely lost.

This finance literature finds that investors are mostly ignorant of the basic characteristics of the funds they own. Investors are also unaware of their funds' riskiness and pay insufficient attention to fund costs. In addition, they regularly buy funds based on strong past performance, despite there being little correlation between high past and future returns.

In short, mutual fund investors on the whole seem unable to perform the disciplining role that the industry says they do and that the SEC believes they can do with some assistance. This is not surprising: by definition, investors in mutual funds have chosen to delegate management of their investment to a professional.<sup>146</sup> But fund investors still must choose in which funds to invest. The academic literature suggests that to do this, they need much more help than they are receiving currently.

This part describes the findings of the academic literature and contrasts the investor profile that this literature reveals with the profiles advanced by the ICI and the SEC.

#### A. Investors Are Ignorant of Basic Fund Characteristics

Most fund investors do not know even the basic characteristics of the mutual funds they own. Capon, Fitzsimons and Prince's broad survey conducted in 1991 found that mutual fund investors are "in general uninformed

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<sup>146</sup> Other reasons for investing in mutual funds include the ability to diversify with even a small investment, and the liquidity of mutual fund shares. SEC, *Invest Wisely*, *supra* note 1.

regarding the nature of their investments.”<sup>147</sup> Their telephone survey of almost 3400 households that invest in mutual funds found that 72% of them did not know whether their primary fund invests in domestic or international securities, and 75% did not know whether the fund invests in equity or fixed income securities.<sup>148</sup> The 2006 ICI survey is consistent with these results. Only 57% of investors in the ICI survey said that, before investing, they review the types of securities held by the fund and only 40% said they review the fund’s investment objectives.<sup>149</sup>

In addition, investors are often ignorant of the basic costs of their mutual funds. In Capon, Fitzsimons and Prince’s survey, 39% of the respondents said they did not know whether their primary mutual fund had a load.<sup>150</sup> In addition, in a survey sponsored by the SEC and the Office of the Comptroller of the Currency of 2000 mutual fund investors, 57% admitted to not knowing the expense ratio of their primary fund even at the time they purchased it.<sup>151</sup>

Investor reaction to fund name changes also shows general investor ignorance. A mutual fund’s name often reflects its investment style, for example, by containing the word “growth” or “value.”<sup>152</sup> Sometimes, a fund’s name change suggests a change in its investment style. For

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<sup>147</sup> Noel Capon, Gavan J. Fitzsimons & Russ Alan Prince, *An Individual Level Analysis of the Mutual Fund Investment Decision*, 10 J. FIN. SERVICES RES. 59, 77 (1996).

<sup>148</sup> *Id.* at 68.

<sup>149</sup> ICI, INVESTOR PREFERENCES, *supra* note 31, at 3 fig.1. Recall, however, that the ICI surveyed only investors who own funds outside of employee-sponsored retirement accounts, and thus are likely more wealthy and sophisticated than most fund investors. *Id.* at 1 n.2.

<sup>150</sup> Capon et al., *supra* note 147, at 68.

<sup>151</sup> Gordon J. Alexander, Jonathan D. Jones & Peter J. Nigro, *Mutual fund shareholders: characteristics, investor knowledge, and sources of information*, 7 FIN. SERVICES REV. 301, 309 tbl.5 (1998).

<sup>152</sup> Michael J. Cooper, Huseyin Gulen & P. Raghavendra Rau, *Changing Names with Style: Mutual Fund Name Changes and Their Effects on Fund Flows*, 60 J. FIN. 2825, 2826 (2005).

example, the Armada Equity Fund changed its name to the Armada Equity Growth Fund.<sup>153</sup>

In a recent study, Cooper, Gulen, and Rau examined investors' reactions to 332 such style name changes in equity mutual funds.<sup>154</sup> Unsurprisingly, they found that funds that change their names to reflect a more popular investment style experience a large increase in flow (the net aggregate amount that investors put into the fund during a particular period).<sup>155</sup> However, this flow increase occurs even if the fund changes only its name, without actually changing its investment style.<sup>156</sup> This reaction to such "cosmetic" name changes demonstrates that investors are not aware of the actual holdings of their mutual funds.

The ICI survey also revealed basic investor ignorance even about how mutual funds work. According to the survey, 58% of respondents said they reviewed a fund's net asset value ("NAV") before investing. The NAV, however, is simply the value of the fund's holdings divided by the number of fund shares outstanding. A fund's NAV does not indicate the fund's merit and should be irrelevant to rational investors; in fact, a fund can arbitrarily change its NAV by splitting its shares.<sup>157</sup>

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<sup>153</sup> *Id.*

<sup>154</sup> *Id.* at 2829 tbl.1.

<sup>155</sup> *Id.* at 2853.

<sup>156</sup> *Id.* at 2855.

<sup>157</sup> The high percentage of investors who claim to consider the NAV also might be evidence that investors did not answer the ICI survey honestly. As discussed above, some investors might falsely claim to survey takers that they consider certain factors (such as NAV) before investing because they believe that good investors consider these factors. See ICI, INVESTOR PREFERENCES, *supra* note 31, at 10 fig.6. Even if investors are lying about considering a fund's NAV, however, their answers show that they are not financially sophisticated enough to realize that the NAV should be irrelevant to an investor.

## B. Investors Are Inattentive To Risk

Fund investors generally are not aware of fund risks and do not take them seriously.<sup>158</sup> A number of academic studies of investor behavior are at odds with the findings of the ICI survey, in which 61% of respondents reported reviewing a fund's risks before investing, making "fund risks" the third most reviewed information by investors.<sup>159</sup>

### 1. Indifference to Risk Measures

In academic studies, fund investors consistently show a lack of understanding of, and indifference to, risk. In one recent academic survey, fund investors overwhelmingly acknowledged not using standard measures of risk—such as beta<sup>160</sup> or the standard deviation of the fund's returns—in evaluating a fund.<sup>161</sup> Also, in a recent experiment by Wilcox, fund investors were asked to choose among hypothetical stock mutual funds differing in up to six characteristics: (1) the fund company's name; (2) the fund's load; (3) the fund's annual management fee; (4) the fund's return during the previous year; (5) the fund's average annual return during the previous ten years; and (6) the fund's beta.<sup>162</sup> The

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<sup>158</sup> This conclusion is also shared by professionals who work with investors. Michael A. Jones, Vance P. Lesseig, & Thomas I. Smythe, *Financial Advisors and Mutual Fund Selection*, 18 J. FIN. PLAN. 64, 68 (2005) ("[T]he consensus among most academics and practitioners is that individual investors largely ignore risk as a decision factor.").

<sup>159</sup> ICI, INVESTOR PREFERENCES, *supra* note 31, at 3 fig.1.

<sup>160</sup> Beta is a measure of the correlation of a fund's returns with the stock market's returns. WILLIAM J. CARNEY, *CORPORATE FINANCE: PRINCIPLES AND PRACTICE* 105-08 (2005).

<sup>161</sup> See, e.g., Diane Del Guercio & Paula A. Tkac, *The Determinants of the Flow of Funds of Managed Portfolios: Mutual Funds vs. Pension Funds*, 37 J. FIN. & QUANTITATIVE ANALYSIS 523, 528 (2002) (noting that a survey of investors found that only 14% "said they use standard deviation to measure risk, 10% use beta, and only 4% use an alpha or Sharpe measure").

<sup>162</sup> Ronald T. Wilcox, *Bargain Hunting or Star Gazing? Investors' Preferences for Stock Mutual Funds*, 76 J. BUS. 645, 648 (2003).

experiment found that a fund's beta was the least important characteristic to investors.<sup>163</sup>

In addition, fund investors seem indifferent to tracking error, a measure of diversifiable risk. A fund has less tracking error if its returns more closely match those of a relevant market benchmark.<sup>164</sup> Del Guercio and Tkac examined fund flows into a large sample of equity mutual funds managed by a total of 483 fund managers in 352 different fund families.<sup>165</sup> They found that fund flow is not negatively related to the fund's tracking error.<sup>166</sup> Because tracking error is a measure of diversifiable risk, its lack of negative influence on fund flows indicates that investors do not pay attention to whether a fund reduces even diversifiable risk. In contrast, pension funds, which are run by managers who generally are much more sophisticated than most mutual fund investors, put less money in mutual funds with greater tracking error.<sup>167</sup>

## 2. Only Weak Reliance on Risk Ratings

Even though investors personally do not carefully consider a fund's risk, many investors use published fund ratings or rankings—such as those from Morningstar—that often incorporate some measure of risk. The ICI survey, for example, found that 35% of investors review a fund's "rating from a mutual fund rating service" before purchasing the fund, and 19% call it "very important" to their final decision to invest.<sup>168</sup> Thus, risk might affect investors' behavior

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<sup>163</sup> *Id.* at 650 fig.1.

<sup>164</sup> Del Guercio & Tkac, *supra* note 161, at 525.

<sup>165</sup> *Id.* at 533.

<sup>166</sup> Depending on the measure of fund flow used, they found that tracking error either had a statistically insignificant effect on fund flow or a statistically significant *positive* effect on fund flow. *Id.* at 539.

<sup>167</sup> *Id.*

<sup>168</sup> ICI, INVESTOR PREFERENCES, *supra* note 31, at 10 fig.6.

indirectly by being incorporated in influential third-party advice.<sup>169</sup>

But reliance on third-party advice does not appear to markedly increase investors' sensitivity to fund risk. Although there is a positive relationship between flow and funds' risk-adjusted returns, it is not as strong as the positive relationship between flow and non-adjusted returns.<sup>170</sup> That is, fund investors focus on past returns rather than risk.

### 3. Summary and Analysis

Fund investors do not seem to understand or take into account fund risk. They ignore standard measures of fund risk and risk does not have a substantial impact on their choice of funds.

#### C. Investors Pay Insufficient Attention to Fees and Expenses

Fund investors also pay too little attention to fund fees and expenses, particularly the regular costs that funds incur, such as management fees. Overall, studies of the actual knowledge and behavior of investors show that fund fees and expenses matter little to many investors. These studies are at odds with the self-reporting by fund investors in the ICI survey, in which 74% of those surveyed claimed to review fund fees and expenses before investing, making that information the most commonly reviewed information.<sup>171</sup> These studies also suggest that the SEC's heavy reliance on fund investors ("the market") to control fees and expenses is misguided.

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<sup>169</sup> Del Guercio & Tkac, *supra* note 161, at 525 (finding evidence that the positive relationship between fund flow and Jensen's alpha—a risk-adjusted performance measure—is due to a high correlation between Jensen's alpha and "widely available summary performance measures, such as Morningstar's star rating").

<sup>170</sup> *Id.*

<sup>171</sup> ICI, INVESTOR PREFERENCES, *supra* note 31, at 3 fig.1.

## 1. Surveys of Fund Investors

Surveys of fund investors have shown that they pay little attention to fund fees and expenses. For example, in a survey sponsored by the SEC and the Office of the Comptroller of the Currency of 2000 randomly-selected mutual fund investors, only 19% of those surveyed could give even an estimate of the expenses of their largest mutual fund holding.<sup>172</sup> In addition, only 43% claimed to have known the fund's expenses at the time they first purchased it.<sup>173</sup>

Similarly, Wallison and Litan surveyed mutual fund investors and asked them to rate (on a scale of one to ten) how informed they were about their own mutual fund investments.<sup>174</sup> Only 21% of those investors rated their knowledge highly (eight or above). But fewer than 10% of even that self-described knowledgeable subgroup "knew even approximately what they were paying as an advisory fee."<sup>175</sup>

Also, Capon et al.'s survey of mutual fund investors asked them to rate the importance of nine particular factors in choosing a mutual fund.<sup>176</sup> The ratings could range from one ("not at all important") to five ("extremely important"). The respondents gave management fees an average rating of only 2.28, thus ranking it only fifth among the nine factors.<sup>177</sup>

In addition, Wilcox's study asked fund investors to choose among hypothetical stock mutual funds differing in up to six

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<sup>172</sup> Alexander et al., *supra* note 151, at 309 tbl.5.

<sup>173</sup> *Id.*

<sup>174</sup> PETER J. WALLISON & ROBERT E. LITAN, *COMPETITIVE EQUITY: A BETTER WAY TO ORGANIZE MUTUAL FUNDS* 72-73 (2007).

<sup>175</sup> *Id.* at 73. *But see* Sebastian Müller & Martin Weber, *Financial Literacy and Mutual Fund Investments: Who Buys Actively Managed Funds* 22 (Feb. 14, 2008) (unpublished manuscript, available at <http://ssrn.com/abstract=1093305>) (survey of German mutual fund investors finds that they can accurately estimate the management fees of the last mutual fund they bought).

<sup>176</sup> Capon et al., *supra* note 147, at 66.

<sup>177</sup> *Id.* The other factors were, in order of decreasing importance, the fund's investment performance track record, fund manager reputation, number of funds in the family, responsiveness to inquiries, investment management style, additional features (checking, brokerage), confidentiality, and community service/charity record. *Id.*



characteristics.<sup>178</sup> Investors chose the fund's management fee as only the fourth most important factor, ahead only of the fund's load and its beta.<sup>179</sup>

These results stand in stark contrast to those of the ICI survey. One reason may be that the ICI surveyed only investors who own mutual funds outside of employment-related retirement plans; the other surveys contained no such limitation. Thus, as a group, the investors surveyed by the ICI are likely more wealthy, and thus more financially experienced and sophisticated, than those in the other surveys.

Another possible reason for the discrepancy is the difference in the questions asked. The ICI survey asked whether the investor "reviewed" a fund's fees and expenses before investing, while the Capon et al. survey and the Wilcox study asked how "important" the fund's fees were to the investor in choosing a fund. Investors could review a fund's fees before investing, yet not give them much weight. This difference, however, would not reconcile the ICI survey's findings with the finding of the SEC/Comptroller of the Currency survey that less than half of investors knew their largest fund's expenses when they purchased the fund.

## 2. Other Studies of Investor Behavior

Although surveys generally show that most investors are unaware of their funds' expense ratios and that expenses do not greatly affect their fund choices, there is evidence that some fund investors do care about expenses. The studies, however, reach mixed conclusions regarding whether funds with lower expenses receive more flow overall.

For example, Barber, Odean, and Zheng's examination of diversified U.S. equity mutual funds from 1970 to 1999 found "at best, no relation between operating expenses and flows and, at worse, a perverse positive relation between expenses

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<sup>178</sup> Wilcox, *supra* note 162, at 649 tbl.1.

<sup>179</sup> *Id.* at 650 fig.1. Recall that the other fund characteristics were the fund company's name, the fund's return during the previous year, and the fund's return during the previous ten years.

and flows for large funds.”<sup>180</sup> In addition, they examined the mutual fund purchases and sales made by customers of a large discount broker from 1991 to 1996. From this data they identified cases in which a mutual fund purchase followed a sale within three weeks. They found that, for these cases, the operating expenses of the purchased funds were generally higher than those of the funds that were sold, indicating that investors do not switch funds to reduce the expenses they are paying.<sup>181</sup>

In a study of equity mutual funds from a slightly earlier period (1971-1990), Sirri and Tufano found that reductions in expenses have a strong positive effect on flow, yet also found that increases in expenses strangely have a marginally significant positive effect on flow as well.<sup>182</sup> Nonetheless, two other studies found that investor demand for mutual funds is elastic with respect to fund expenses—that is, overall, fund investors are sensitive to expenses.<sup>183</sup> In addition, one of these studies found that the elasticity has been increasing

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<sup>180</sup> Brad M. Barber, Terrance Odean & Lu Zheng, *Out of Sight, Out of Mind: The Effects of Expenses on Mutual Fund Flows*, 78 J. BUS. 2095, 2107 (2005).

<sup>181</sup> *Id.* at 2116.

<sup>182</sup> Erik R. Sirri & Peter Tufano, *Costly Search and Mutual Fund Flows*, 53 J. FIN. 1589, 1606-07 tbl.IV, 1612 (1998).

<sup>183</sup> John C. Coates IV & R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 J. CORP. L. 151, 183 (2007); Andrew Zhang, *Mutual Fund Expense Ratios in Market Equilibrium 2* (July 20, 2007) (unpublished manuscript, available at <http://ssrn.com/abstract=1010544>). Additionally, a recent study found a negative relationship between flows and a fund family's average expense ratio (as opposed to the expense ratios of particular funds in the family). Steven Gallaher, Ron Kaniel & Laura Starks, *Madison Avenue Meets Wall Street: Mutual Fund Families, Competition and Advertising 3* (Jan. 2006) (unpublished manuscript, available at <http://ssrn.com/abstract=879775>). Another study found that lower expenses resulted in higher market share for a fund family only if the family already had high expenses; expenses did not affect the market share if the fund family had low expenses. Ajay Khorana & Henri Servaes, *Conflicts of Interest and Competition in the Mutual Fund Industry 28* (July 2004) (unpublished manuscript, available at <http://ssrn.com/abstract=240596>).

recently, indicating that investors are becoming more sensitive to expenses.<sup>184</sup>

In a review of studies of trends in fund costs, Coates and Hubbard observe that recent studies have failed to find consistently that expense ratios have declined in recent decades, even though the industry enjoys large economies of scale and the size of funds and fund families has grown dramatically.<sup>185</sup> For example, an SEC study in 2000 found that the weighted average expense ratio for equity and bond funds rose from 0.73% in 1979 to 0.94% in 1999.<sup>186</sup> That is, despite the ease with which fund investors may move from one fund to another, investors seem not to have had a great disciplining effect on expenses.

Looking at overall fund costs (loads and expenses), the studies examined by Coates and Hubbard came to mixed results, though tending to find a decline in total investor costs. That is, when loads are added to operating expense ratios (not taking into account trading costs), the overall costs to fund investors declined from the 1970s to the 1990s. For example, Khorana and Servaes found that total costs (calculated as the weighted average expense ratio plus one-seventh of front- and back-end loads) fell from 1.40% in 1979 to 1.19% in 1998.<sup>187</sup> However, the studies do not reach uniform conclusions. For example, one study found that weighted average total costs for S&P 500 index funds rose from 0.27% in 1995 to 0.32% in 2000.<sup>188</sup> In addition, another

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<sup>184</sup> Zhang, *supra* note 183, at 21.

<sup>185</sup> Coates & Hubbard, *supra* note 183, at 175, tbl.6; GAO, *MUTUAL FUND FEES*, *supra* note 68, at 9 (“Academic studies and other research find that as mutual fund assets grow, mutual fund advisers experience operational efficiencies or economies of scale that would allow them to reduce their funds’ expense ratios.”).

<sup>186</sup> SEC FEE REPORT, *supra* note 106 at § III(c)(2).

<sup>187</sup> Khorana & Servaes, *supra* note 183, at 19.

<sup>188</sup> Ali Hortaçsu & Chad Syverson, *Product Differentiation, Search Costs, and Competition in the Mutual Fund Industry: A Case Study of S&P 500 Index Funds*, Q. J. ECON 403, 409 tbl.2 (2004).

study found that 12b-1 fees (an implicit load collected over time) rose from 0.14% in 1993 to 0.20% in 1999.<sup>189</sup>

### 3. Evidence from Index Funds

The growth of index funds over the past thirty years provides evidence that a subset of investors is sensitive to fund expenses. Index funds are funds that attempt to match, rather than beat, the returns of a particular market index, such as the S&P 500.<sup>190</sup> Index funds' management fees can be very low because, unlike actively managed funds, they need not incur stock-picking research expenses; index funds merely buy a portfolio of stocks that tracks the reference index.<sup>191</sup> In addition, index funds buy and sell securities far less often than most actively managed funds, resulting in much lower transaction costs.<sup>192</sup> As a result, the expenses of index funds are generally lower than those of actively managed funds.<sup>193</sup>

The growth of index funds is not surprising. The popular media has given increasing attention to the benefits of index funds, which generally outperform actively managed funds. Popular publications such as *Money* magazine and the "Getting Going" column in *The Wall Street Journal* have

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<sup>189</sup> Barber et al., *supra* note 180, at 2108-10. Thus, Coates and Hubbard's thesis that the mutual fund market is competitive because fund investors can and do move to lower-cost funds is not supported by much of the evidence they cite. Although investors have moved away from funds that charge loads (see *infra* pp. 990-94) they have not exercised the same discipline with respect to ongoing management expenses and 12b-1 fees. That is, there may be price competition with respect to highly-salient loads, but competition is much weaker with respect to less visible, ongoing fund costs—out of sight, out of mind.

<sup>190</sup> 4 TAMAR FRANKEL & ANN TAYLOR SCHWING, *THE REGULATION OF MONEY MANAGERS: MUTUAL FUNDS AND ADVISORS* § 31.02[J] (2008).

<sup>191</sup> BURTON G. MALKIEL, *A RANDOM WALK DOWN WALL STREET* 360 (9th ed. 2007).

<sup>192</sup> *Id.*

<sup>193</sup> *Id.* at 359.

frequently touted the wisdom of buying index funds.<sup>194</sup> This message appears to be getting through to some investors.

The popularity of index funds, however, has plateaued. Index funds first became available in 1976, and by 1999 they grew to hold 10% of equity mutual fund assets.<sup>195</sup> The market share of index funds, however, has remained stable since then.<sup>196</sup> Therefore, to the extent that the existence of index funds indicates that some investors are sensitive to fund expenses, these funds' small and flat market share indicates that cost-sensitive investors remain a weak market force, at best.

In addition, the success of high-cost index funds provides further evidence that many investors continue to disregard fund expenses. Although an investor might buy a high-cost actively-managed fund believing that the fund manager's stock-picking skills will more than compensate for the higher expenses, buying a high-cost index fund makes little sense. Index funds do not attempt to pick high-performing securities but rather just track the performance of a specific market index. Thus, by definition, an index fund manager's stock-picking skill is irrelevant. A rational index fund investor should buy the index fund that has the lowest expense ratio because all index funds hold essentially the same securities.

Strangely, however, this is not how many investors choose among index mutual funds. A study by Elton, Gruber and Busse of flows into different S&P 500 index funds from 1996 to 2001 found that investors were not moving away from high-expense index funds. Instead, it found that "a large amount of new cash flow goes to the poorest-performing

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<sup>194</sup> See, e.g., Penelope Wang & Walter Updegrave, *Funds for the Long Run*, MONEY, Feb. 1, 2008, at 69 (recommending that "index funds are the ideal foundation for your core portfolio"); Jonathan Clements, *Getting Going*, WALL ST. J., Feb. 16, 2005, at D1 (noting that index funds regularly outperform most actively managed funds).

<sup>195</sup> John C. Bogle, *Reflections on "Toward Common Sense and Common Ground?"*, 33 J. CORP. L. 31, 34 (2007).

<sup>196</sup> *Id.*

[high-cost index] funds.”<sup>197</sup> Also, new index funds that entered the market during the period covered by their study had higher expenses (0.77% average, with a maximum of 2.00%) than did the average index fund (0.44%).<sup>198</sup> In addition, during the same period, the decile of index funds with the highest expense ratios grew almost twice as quickly as the low-expense index funds.<sup>199</sup>

In response to such studies, the fund industry has attempted to explain the success of high-cost index funds. A recent ICI publication argues that differences across index funds, such as the size of fund assets and average account balances, may explain much of the variance in their expense ratios.<sup>200</sup> Because many of the funds’ costs are relatively fixed, index funds with more assets enjoy greater economies of scale.<sup>201</sup> In addition, the cost of maintaining an individual investor’s account is largely unrelated to the size of the account, so a fund with many small accounts is more costly to operate than a similarly sized fund with fewer, yet larger, accounts.<sup>202</sup> However, although this may help explain why a small index fund with low average account balances is forced to charge a relatively high expense ratio, it does not explain why so many investors would choose such a fund when identical, lower-cost alternatives exist.

In the same publication, the ICI also argues that fund investors may choose high-cost index funds because such funds offer better services.<sup>203</sup> Mutual funds can offer services

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<sup>197</sup> Edwin J. Elton, Martin J. Gruber, and Jeffrey A. Busse, *Are Investors Rational? Choices Among Index Funds*, 59 J. FIN. 261, 286 (2004).

<sup>198</sup> *Id.*

<sup>199</sup> *Id.* See also Hortaçsu & Syverson, *supra* note 188, at 409 tbl.II (finding that the quintile of index funds with the highest expenses almost tripled their share of the S&P 500 index fund sector from 1995 to 2000).

<sup>200</sup> Sean Collins, *Are S&P 500 Index Mutual Funds Commodities?*, 11 INVESTMENT COMPANY INST. PERSP. 5 (Aug. 2005), available at <http://www.ici.org/pdf/per11-03.pdf>.

<sup>201</sup> *Id.* at 6.

<sup>202</sup> *Id.*

<sup>203</sup> *Id.* at 5-10.

such as financial advice, lower minimum account balances, and lower account maintenance fees.<sup>204</sup> But Elton, Gruber and Busse found no relationship between fund families' service quality and investors' choice of index funds.<sup>205</sup> They also found no evidence that investors' purchases were concentrated in the largest fund families, which should be better able to provide many services than can smaller families.<sup>206</sup> In addition, other studies have found that more experienced and financially sophisticated investors do not buy mutual funds with lower expenses than do other investors.<sup>207</sup> Because such investors likely have less need for some services (such as financial advice and low minimum balance requirements) than do other investors, this is additional evidence that investors generally are not buying high-cost funds to obtain more services.

A recent experiment by Choi, Laibson and Madrian casts further doubt on the hypothesis that service differences explain investor choices. Their experiment indicates that even many intelligent and financially sophisticated investors would choose high-expense index funds even if the services offered by all index funds were identical. In the experiment, participants—including many Wharton MBA and Harvard College students—were presented with the prospectuses of four S&P 500 index funds with different expense ratios and were asked to allocate an investment among these funds.<sup>208</sup> Participants would maximize their expected compensation

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<sup>204</sup> *Id.* at 5.

<sup>205</sup> Elton et al., *supra* note 197, at 281. Service quality was determined from Dalbar Inc.'s survey of over 2600 investors' and professionals' impressions of particular fund families' service. *Id.* at 278.

<sup>206</sup> *Id.* at 283, 285.

<sup>207</sup> Barber et al., *supra* note 180, at 2113; *see also* Müller & Weber, *supra* note 175, at 4 (finding that financially sophisticated German investors are not more likely to buy funds with lower management fees than are less sophisticated investors).

<sup>208</sup> James J. Choi, David Laibson & Brigitte C. Madrian, Why Does the Law of One Price Fail? An Experiment on Index Mutual Funds 7-8 (Mar. 6, 2008) (unpublished manuscript, available at <http://www.som.yale.edu/faculty/jjc83/fees.pdf>).

for participating in the experiment by choosing the fund with the highest future return, which for index funds is the fund with the lowest expense ratio.<sup>209</sup> The experiment was designed so that participants did not benefit from any fund services; all that mattered were future returns (and thus expenses).<sup>210</sup>

Nevertheless, almost none of participants picked the portfolio that would minimize their expenses.<sup>211</sup> In fact, as a whole, they chose portfolios that had expenses only slightly below the average expense ratio of the four funds.<sup>212</sup> The participants, as a group, were more financially sophisticated than the typical American investor.<sup>213</sup> Thus, this experiment indicates that many fund investors choose high-expense index funds without good reason, not because such funds provide greater services.<sup>214</sup>

#### 4. Summary and Analysis

Some investors do seek low-cost funds, and there are some indications that fund investors are becoming more savvy about mutual fund expenses. The popularity of index funds is a sign that some investors have come to notice that expenses create a drag on fund returns.

Nonetheless, many investors still do not make expenses a major factor in their fund choices. Despite the existence of large economies of scale in the industry and despite the financial press's encouragement of investors to seek low-cost funds, it is not clear that expense ratios have fallen in recent decades. Large numbers of cost-insensitive investors

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<sup>209</sup> *Id.* at 4, 21.

<sup>210</sup> *Id.*

<sup>211</sup> *Id.* at 4.

<sup>212</sup> *Id.* at 15-16.

<sup>213</sup> *Id.* at 14.

<sup>214</sup> Some investors even might be choosing higher expense funds because they believe that "you get what you pay for." The SEC/Office of the Comptroller of the Currency survey (which was not limited to index fund investors) found that 20% of fund investors expected that a fund with above average expenses would also give above average returns. Alexander et al., *supra* note 151, at 309 tbl.5.



continue to exist, and high-expense, actively-managed funds and even high-expense index funds continue to flourish.<sup>215</sup>

## D. Investors Increasingly Pay Attention to Loads

Many fund investors, although generally insensitive to fund operating expenses, increasingly pay attention to fund loads, which are becoming less common.<sup>216</sup> A load is a one-time fee paid by investors when they buy (or sometimes when they sell) fund shares.<sup>217</sup> Load proceeds are used for fund marketing, such as for commissions to brokers who direct customers to the fund.<sup>218</sup>

### 1. Studies of Loads

Do loads increase or decrease fund flows? On the one hand, investors should be averse to paying additional fees, so

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<sup>215</sup> Elton et al., *supra* note 197, at 286 (noting that because arbitrage is impossible, “all that is necessary for inferior funds to exist and grow is a set of uninformed investors and a set of distributors who have an economic incentive to sell inferior products”). See also Susan E.K. Christoffersen & David K. Musto, *Demand Curves and the Pricing of Money Management*, 15 REV. FIN. STUDIES 1499 (2002) (finding that less price-sensitive money-fund investors pay higher fees than do more price-sensitive investors).

<sup>216</sup> In 2007, flows into load funds constituted only 9.4% of all flows into long-term mutual funds (equity, bond, and hybrid funds). 2008 FACT BOOK, *supra* note 2, at 26 fig.2.7. This is a significant decline even from as recently as 2001, when they constituted 34.9% of flows into long-term mutual funds. *Id.*

<sup>217</sup> For example, if a fund charges a 2% front-end load, a person who invests \$10,000 in the fund will only have \$9800 invested in the fund.

<sup>218</sup> Investors could benefit if the greater marketing paid for by the load were to lead to an increase in the fund’s assets and the resulting economies of scale were passed along to the fund’s investors in the form of lower expense ratios. However, there is little evidence that loads actually lead to a net benefit for investors in this way. See, e.g., Barber et al., *supra* note 180, at 2103 (finding that “although low expense funds have higher front-end-load fees than high expense funds, the relation between expenses and front-end loads is far from monotonic. In addition, front-end-load funds have higher average expense ratios than funds without front-end loads.”).

one would expect a negative relationship between loads and flow. Indeed, Wilcox's experiment confirms investors' aversion to loads. Recall that his experiment required investors to choose among hypothetical stock mutual funds with different characteristics, including different expense ratio and load combinations. The investors greatly overemphasized loads compared to expense ratios, suggesting a "strong aversion to front-end loads and a commensurate disregard for annual expense ratios."<sup>219</sup>

On the other hand, load proceeds are used to market the fund, so additional marketing might offset investor aversion to loads. Indeed, studies have come to differing conclusions regarding the net effect of loads on fund flow. A study by Sirri and Tufano of equity mutual funds from 1971 to 1990 found no relationship between loads and flow; investors' aversion to loads seems to roughly offset the effect of additional marketing.<sup>220</sup> A more recent study by Barber, Odean and Zheng examining U.S. equity funds from 1970 to 1999, however, found a negative relationship between loads and flow.<sup>221</sup> Nonetheless, a study by Elton, Gruber and Busse of S&P 500 index funds from 1996 to 2001 found that the existence of a load has a positive effect on flow.<sup>222</sup> In addition, another recent study by Gallaher, Kaniel and Starks found a positive relationship between the presence of load funds in a fund family and fund flows into that family.<sup>223</sup> That study also found, however, that fund flow into the family was negatively related to the size of the load.<sup>224</sup> This may indicate that any size load encourages brokers to sell the fund—which increases flow—but also that investors' aversion towards a load increases as the load's size increases.<sup>225</sup>

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<sup>219</sup> Wilcox, *supra* note 162, at 654.

<sup>220</sup> Sirri & Tufano, *supra* note 182, at 1612.

<sup>221</sup> Barber et al., *supra* note 180, at 2107.

<sup>222</sup> Elton et al., *supra* note 197, at 280.

<sup>223</sup> Gallaher et al., *supra* note 183, at 3.

<sup>224</sup> *Id.*

<sup>225</sup> *Id.* at 14-15.

Although many fund investors are sensitive to loads, many other investors clearly do not pay attention to loads. In Capon, Fitzsimons and Prince's survey of households that invest in mutual funds, 39% of respondents stated that they did not even know if their primary fund had a load.<sup>226</sup> In addition, in Wilcox's experiment requiring investors to choose among hypothetical mutual funds, the fund's load was only the fifth most important factor (of six) to investors—ahead only of the fund's beta, and behind the fund's return over the past ten years, the fund's return over the past year, the fund company's name, and the fund's management fee.<sup>227</sup>

## 2. Studies of 12b-1 Fees

For fund investors, out of sight seems to mean out of mind—at least when it comes to marketing expenses. Fund investors seem to pay little attention to 12b-1 fees, ongoing marketing fees deducted over time from the fund's assets. Like loads, 12b-1 fees are used to pay broker commissions and other marketing costs, but unlike loads, they are not one-time fees deducted directly from investors' individual accounts.

Overall, studies indicate that investors are less averse to 12b-1 fees than to loads. Barber, Odean and Zheng examined the effect of 12b-1 fees on flows into diversified U.S. equity mutual funds from 1993 to 1999. Unlike their findings for loads, they found a positive relationship between 12b-1 fees and flows, indicating that the marketing benefits from using the proceeds of 12b-1 fees outweigh investors' aversion to paying these additional fees.<sup>228</sup> In addition, Elton, Gruber and Busse found that 12b-1 fees did not have a significant net effect on flow into S&P 500 index funds from 1996 to 2001.<sup>229</sup>

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<sup>226</sup> Capon et al., *supra* note 147, at 68.

<sup>227</sup> Wilcox, *supra* note 162, at 650.

<sup>228</sup> Barber et al., *supra* note 180, at 2108.

<sup>229</sup> Elton et al., *supra* note 197, at 280.

### 3. Summary and Analysis

There is evidence that investors are more sensitive to loads than to other fund costs, although the effect of this greater sensitivity may be offset somewhat by funds' use of load proceeds to market themselves. Why might investors be more sensitive to loads than to other costs? Investors might be listening to much of the popular financial media, which has been encouraging them to avoid funds with loads.<sup>230</sup> In fact, experienced investors are less likely to buy load funds than are other investors, providing support for this hypothesis.<sup>231</sup> However, the financial media likely does not deserve complete credit for experienced investors' aversion to loads. Much of the financial media has also been emphasizing the benefits of lower-expense funds,<sup>232</sup> yet more experienced fund investors are not more likely than other investors to buy lower-expense funds.<sup>233</sup>

A more instructive explanation may be that loads are larger and more salient than operating expenses, which are "smaller ongoing fees that are easily masked by the volatility of equity returns."<sup>234</sup> When an investor buys a fund with a front-end load, the investor sees the effect of the load quickly and vividly. The investor's initial account statement will show less money than the investor sent to the fund company. On the other hand, the investor never directly sees the effect of fund operating expenses; instead, the effect appears only

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<sup>230</sup> See, e.g., George Mannes, *The Answer Guy*, MONEY, Feb. 2007, at 56.

<sup>231</sup> Barber et al., *supra* note 180, at 2113.

<sup>232</sup> See, e.g., Asa Fitch, Amanda Gengler, Josh Hyatt & Ismat Sarah Mangla, *35 Minutes to Riches*, MONEY, Oct. 2007, at 80 (presenting a table entitled "How the Stingy Get Rich," showing that a low expense stock fund (0.2% annual expenses) will save an investor \$10,329 in expenses on a \$10,000 investment over twenty years compared to a high expense stock fund (1.5% annual expenses)).

<sup>233</sup> Barber et al., *supra* note 180, at 2113. See also Müller & Weber, *supra* note 175, at 4 (describing a recent survey of German mutual fund investors which found that more financially sophisticated investors are more likely buy funds with lower loads, but not lower management fees, than are less sophisticated investors).

<sup>234</sup> Barber et al., *supra* note 180, at 2097.

in the form of reduced returns over time. As a result, investors may underestimate the effect of operating expenses relative to loads. This type of behavior is analogous to people overemphasizing initial product costs versus later, ongoing costs. For example, many people choosing printers are influenced more by the initial cost of the printer than by the even greater cost, over time, of the type of ink the printer requires.<sup>235</sup>

This explanation also finds support in fund investors' lower aversion to 12b-1 fees than to loads. Like operating expenses, 12b-1 fees are smaller, ongoing charges deducted from fund assets rather than directly from investors' accounts. It seems that fund investors notice more when they are struck by a club than when they are slowly bled to death.

## E. Investors Chase Past Returns

Although mutual fund investors pay insufficient attention to a fund's risk and operating expenses, they pay great attention to a fund's historical returns. Surveys of investors and studies of their actual behavior find that this may be the most prominent component of the typical fund investor's profile.

### 1. Investor Surveys and Experiments

Surveys and experiments gauging investor views uniformly identify the importance of a fund's past returns. For example, Wilcox's experiment requiring investors to choose between hypothetical mutual funds found that a fund's returns over the past ten years and over the past year are the two most important factors to investors.<sup>236</sup>

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<sup>235</sup> Michael J. Chang, *Digital Copyrightability of Lexmark Toners and Cartridges Under the Digital Millennium Copyright Act*, 17 ALB. L.J. SCI & TECH. 559, 560 (2007).

<sup>236</sup> Wilcox, *supra* note 162, at 650. Recall that the other factors were the fund company's name, load, expense ratio, and beta. *Id.* at 648.

Also, Capon, Fitzsimons and Prince's survey of households that invest in mutual funds found that a fund's "investment performance track record" is the most important factor in investors' choice of funds.<sup>237</sup> In addition, in the ICI survey of fund investors, 69% of respondents stated they review a fund's "historical performance" before investing in the fund.<sup>238</sup>

## 2. Other Studies of Investor Behavior

Numerous studies of actual investor behavior find that investors flock to mutual funds with the highest past returns. For example, Del Guercio and Tkac examined flow into a large sample of equity mutual funds.<sup>239</sup> They found that a fund's past return has a strong positive effect on fund flow.<sup>240</sup> In addition, this positive relationship was strongest for funds with the highest returns, indicating that investors especially chase the highest-performing funds.<sup>241</sup> Similarly, Sirri and Tufano's study of flow into equity mutual funds found that having higher returns garnered more flow for a fund. This was especially true for the highest performing quintile of funds, showing again that investors flock to funds with the strongest past performance.<sup>242</sup>

The tendency of investors to chase returns manifests itself not only in buying specific high-performing funds, but also extends to buying the types of funds that have recently performed well. As Cooper, Gulen and Rau found, when a fund changes its name to reflect a hotter investment style, it

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<sup>237</sup> Capon et al., *supra* note 147, at 66 tbl.1.

<sup>238</sup> ICI, INVESTOR PREFERENCES, *supra* note 31, at 3 fig.1.

<sup>239</sup> Del Guercio & Tkac, *supra* note 161, at 533.

<sup>240</sup> *Id.* at 525. They used the fund's excess return (that is, the extent to which it outperforms the S&P 500) as the measure of the fund's return. *Id.* at 539.

<sup>241</sup> *Id.* at 525.

<sup>242</sup> Sirri & Tufano, *supra* note 182, at 1598. See also Travis Sapp & Ashish Tiwari, *Does Stock Return Momentum Explain the "Smart Money" Effect?*, 59 J. FIN. 2605, 2607 (2004) (examining fund flows into U.S. equity mutual funds from 1970 to 2000 "effectively demonstrates that fund investors appear to be chasing recent large returns").

receives a large increase in flow.<sup>243</sup> As discussed above, this increase occurs even if the fund does not actually change to the investment style suggested by its new name.<sup>244</sup>

Although investors flock to funds that have produced the highest returns, there is little reason for them to do so. Despite numerous studies testing the relationship between past performance and future returns, "within the finance literature there is [only] weak and controversial evidence that past performance has much, if any, predictive ability for future returns."<sup>245</sup> In other words, there is little evidence of performance persistence by top performing funds; they generally do not continue to significantly outperform other funds. Furthermore, even if some persistence exists, it may not be meaningful to investors picking among mutual funds because of the transaction costs, such as loads and capital gains taxes, that would be incurred in chasing recent high performers.<sup>246</sup> Indeed, in a survey of studies of returns persistence, Cuthbertson, Nitzsche and O'Sullivan find some evidence of small performance persistence by the highest performing funds, but conclude that "it seems likely that such costs [e.g., loads, rebalancing costs and taxes] would

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<sup>243</sup> Cooper et al., *supra* note 152, at 2853.

<sup>244</sup> *Id.* at 2855.

<sup>245</sup> Wilcox, *supra* note 162, at 651. See also Jonathan B. Berk & Richard C. Green, *Mutual Fund Flows and Performance in Rational Markets*, 112 J. POL. ECON. 1269, 1270 & n.1 (2004) ("The relative performance of mutual fund managers appears to be largely unpredictable from past relative performance . . . . While some controversial evidence of persistence [of mutual fund returns] does exist, it is concentrated in low-liquidity sectors or at shorter horizons.") (footnote and citations omitted).

<sup>246</sup> Nicolas P.B. Bollen & Jeffrey A. Busse, *Short-Term Persistence in Mutual Fund Performance*, 18 REV. FIN. STUD. 569, 587-88 (2004). Many mutual funds charge front-end or back-end (deferred) loads that investors must pay when they buy or sell fund shares, respectively. Also, to discourage short-term trading, many mutual funds impose fees on investors who sell shares soon after buying them. In addition, when an investor sells mutual fund shares for a gain, the investor must pay capital gains taxes. Investors who sell fund shares less than one year after buying them pay a higher capital gains tax rate than do investors who hold the shares for more than one year.

outweigh" the extra returns that investors could gain by chasing this performance persistence.<sup>247</sup>

Interestingly, in one survey, most mutual fund investors appeared to indicate that they realized that high past performance was not predictive of future performance. In the joint survey by the SEC and the Office of the Comptroller of the Currency of mutual fund investors, 71% of those surveyed expected that a fund with "good performance" in the previous year would have only "about average" performance the next year.<sup>248</sup> Yet, despite this knowledge, investors continue to put great weight on a fund's past returns, as noted above.<sup>249</sup>

A recent experiment also demonstrates the extent to which investors will irrationally chase high past returns. As discussed above, Choi, Laibson and Madrian asked participants to choose among S&P 500 index funds with different expense ratios and different inception dates.<sup>250</sup> The higher-expense funds had higher past annualized returns, but only because they had different inception dates than the other funds.<sup>251</sup> Participants nonetheless chose the index funds that had the higher past returns, even though these higher-expense funds would necessarily underperform the lower-expense funds in the future.<sup>252</sup>

### 3. Summary and Analysis

In choosing mutual funds, investors give too little weight to important factors such as a fund's risk and ongoing

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<sup>247</sup> Keith Cuthbertson, Dirk Nitzsche & Niall O'Sullivan, *Mutual Fund Performance* 69 (Dec. 12, 2006) (unpublished manuscript, available at <http://ssrn.com/abstract=955807>).

<sup>248</sup> Alexander et al., *supra* note 151, at 309-11 & tbl.5.

<sup>249</sup> In addition, although most of those surveyed claimed to expect only "[a]bout average" performance, more than four times as many of the surveyed investors expected that such a fund would have "above average" performance than "below average" performance (24% vs. 5%). *Id.* at 309-11 & tbl.5.

<sup>250</sup> Choi et al., *supra* note 208, at 3-4. A fund's inception date is the date it begins operations.

<sup>251</sup> *Id.* at 4.

<sup>252</sup> *Id.*



expenses. Also, they cannot seem to help themselves from overweighting past returns, a factor with little predictive value for future returns.

The tendency to chase past returns also may help explain fund investors' choice of asset classes. Investors tend to be optimistic about future stock prices during bull markets and pessimistic about them during bear markets.<sup>253</sup> Thus, it is unsurprising that aggregate fund flows into equity mutual funds increase following stock market gains.<sup>254</sup> Unfortunately, this behavior is unwise. Future returns do not tend to be higher following market rises than market declines.<sup>255</sup>

## F. Financial Advisers Provide Little Help

Many investors consult a professional financial adviser before buying a mutual fund, and investors pay a high price for doing so. Little evidence exists, however, that these advisers provide tangible benefits. On balance, therefore, fund investors in general may not be better off using professional advisers.

### 1. Widespread Use of Financial Advisers

Many mutual fund investors use financial advisers. The ICI survey found that a professional financial adviser is the most common source of information consulted by mutual fund investors, with 73% of those surveyed responding that they consulted a professional financial adviser before buying a fund.<sup>256</sup> Other researchers have made similar findings. For example, Capon, Fitzsimons and Prince's survey of households that invest in mutual funds found that—out of nine sources of information—investors identified commission-based financial advisers as their third most

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<sup>253</sup> Werner P.M. De Bondt, *Betting on Trends: Intuitive Forecasts of Financial Risk and Return*, 9 INT'L. J. FORECASTING 355 (1993).

<sup>254</sup> Jason Karceski, *Returns-Chasing Behavior, Mutual Funds, and Beta's Death*, 37 J. FIN. & QUANTITATIVE ANALYSIS 559, 577-79 (2002).

<sup>255</sup> *Id.* at 584.

<sup>256</sup> ICI, INVESTOR PREFERENCES, *supra* note 31, at 4 Fig.2.

important information source and fee-based financial advisers as their seventh most important.<sup>257</sup>

At first glance, the widespread use of financial advisers by mutual fund investors is encouraging. Although most investors are not financially sophisticated, many are receiving professional advice that could help them overcome their limitations. Thus, professional advisers may help investors provide market discipline over mutual funds. Before reaching such a conclusion, however, advisers' behavior must be understood.

## 2. Survey of Financial Advisers

A recent survey by Jones, Lesseig, and Smythe of 530 professional financial advisers asked them about the importance that fourteen fund characteristics played in their recommendations of mutual funds to their clients.<sup>258</sup> First, the good news. Financial advisers ranked the fund's objective as the second most important factor in their recommendations.<sup>259</sup> This is a much greater emphasis than investors give to a fund's objective. For example, the ICI survey found that only 40% of investors review a fund's objective before investing,<sup>260</sup> and Capon, Fitzsimons, and Prince's survey found that most investors were not even aware of the types of securities their funds hold.<sup>261</sup>

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<sup>257</sup> Capon et al., *supra* note 147, at 66 tbl.1. Differences between the questions asked in this survey and the ICI survey make exact comparisons of the results impossible. For example, the ICI survey did not distinguish between commission-based and fee-based financial advisers. Also, the ICI asked investors whether they consulted a particular information source. ICI, INVESTOR PREFERENCES, *supra* note 31, at 4 fig.2. Capon et al., on the other hand, asked investors to rate the importance of a particular information source. Capon et al., *supra* note 147, at 65.

<sup>258</sup> Jones et al., *supra* note 158, at 65.

<sup>259</sup> *Id.* at 68 tbl.3.

<sup>260</sup> ICI, INVESTOR PREFERENCES, *supra* note 31, at 3 fig.1.

<sup>261</sup> Recall that 72% of the surveyed investors did not know if their primary fund invests in domestic or international securities, and 75% did not know whether the fund invests in equity or fixed income securities. Capon et al., *supra* note 147, at 68 tbl.2.

In addition, financial advisers ranked a fund's risk as the third most important factor.<sup>262</sup> This contrasts with the actions of investors, who, as discussed above, generally pay little attention to a fund's risk. Thus, to the extent that investors heed the advice of their financial advisers, investors may buy funds that are better suited to their financial objectives and risk tolerances.

Unfortunately, other results of the survey of financial advisers are less encouraging. Advisers admit to putting less emphasis on a fund's cost to their clients than on other factors. For example, advisers ranked a fund's expenses (excluding commissions) as only the eighth most important factor among the fourteen examined.<sup>263</sup> In addition, a fund's load and 12b-1 fee were the least important factor to advisers.<sup>264</sup> This last finding should not be surprising; mutual funds often use loads and 12b-1 fees to compensate financial advisers for directing their clients to the funds. Thus, the survey indicates that financial advisers may make investors even less sensitive to fees and expenses than investors would be on their own.

In addition, like investors, financial advisers place great emphasis on a fund's past returns. Advisers in the survey ranked a fund's "Performance Relative to Other Funds with Similar Style" as the most important factor and ranked the "Absolute Fund Performance" sixth.<sup>265</sup> Thus, financial advisers give high priority to funds that have performed well in the past. As discussed above, such a fund-picking strategy is unwise; past performance is at best a weak predictor of future performance.

### 3. Advisers' Effects on Investor Behavior

Studies have also looked at the actual effects of financial advisers on investors. An extensive study by Bergstresser,

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<sup>262</sup> Jones et al., *supra* note 158, at 68 tbl.3.

<sup>263</sup> *Id.* Also, a fund's tax efficiency—which can also affect investors' returns—was only the ninth ranked factor. *Id.*

<sup>264</sup> *Id.*

<sup>265</sup> *Id.*

Chalmers and Tufano compared fund choices from 1996 to 2004 of investors who bought funds through direct channels with those of investors who bought through brokers.<sup>266</sup> They found that brokers direct investors toward funds with higher front-end loads and 12b-1 fees.<sup>267</sup> Also, they found that the larger a fund's load and 12b-1 fee, the more flow it receives from investors using brokers.<sup>268</sup> Because mutual funds often use loads and 12b-1 fees to compensate brokers, these findings indicate that brokers direct investors to funds that offer the brokers more compensation.

As a result, investors pay a steep price for using brokers. It has been estimated that, in 2002, investors paid up to a total of \$3.6 billion in front-end loads, \$2.8 billion in back-end loads, and \$8.8 billion in 12b-1 fees.<sup>269</sup> Unfortunately, there is little evidence that fund investors receive commensurate benefits from brokers. Bergstresser, Chalmers and Tufano found that funds purchased through brokers tend to underperform funds that investors buy directly, even before taking into account the higher distribution-related expenses (such as loads) of broker-channel funds.<sup>270</sup> This underperformance exists in both absolute returns and in risk-adjusted returns.<sup>271</sup> They estimate that this underperformance cost investors approximately another \$4.6 billion in 2004 alone.<sup>272</sup>

Also, they found no evidence that "brokers provide superior asset allocation advice that helps their investors

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<sup>266</sup> For 2004, their sample covered 4253 mutual funds with assets of \$5.1 trillion. Daniel Bergstresser, John Chalmers & Peter Tufano, *Assessing the Costs and Benefits of Brokers in the Mutual Fund Industry* 7 (Harvard Business School Finance Working Paper No. 616981, Sept. 26, 2007), available at <http://ssrn.com/abstract=616981>. Note that many, but not all, brokers provide advice regarding which funds investors should purchase. In addition, some financial advisers do not provide broker services to their clients.

<sup>267</sup> *Id.* at 17.

<sup>268</sup> *Id.* at 17-18.

<sup>269</sup> *Id.* at 2.

<sup>270</sup> *Id.* at 9-10.

<sup>271</sup> *Id.* at 8-9.

<sup>272</sup> *Id.* at 9-10.

time the market.”<sup>273</sup> The asset allocation choices made through broker-channel funds did not earn higher absolute or risk-adjusted returns than did funds bought through direct channels.<sup>274</sup>

In theory, investors who buy funds through brokers, thus paying higher distribution expenses in the form of loads and 12b-1 fees, might still benefit if broker-channel funds have lower non-distribution expenses (such as management fees) than do other funds. Unfortunately, Bergstresser, Chalmers and Tufano found that funds bought through brokers do not have lower non-distribution expenses, so investors do not benefit in this way either.<sup>275</sup>

There is some evidence, however, that brokers help investors at least partially overcome their “home-bias,” a well-known tendency of investors to disproportionately buy assets located geographically close to them and to underweight foreign and distant domestic assets.<sup>276</sup> Bergstresser, Chalmers, and Tufano found that investors using brokers buy funds that hold a greater percentage of foreign assets than do other investors.<sup>277</sup>

Similarly, brokers appear to direct investors to smaller funds and younger funds than investors would find on their own.<sup>278</sup> But, as discussed above, this does not appear to give their clients better returns or lower expenses. In addition, brokers do not reduce investors’ chasing of past performance; investors who buy funds through brokers are as likely to chase “hot” funds as are investors who buy through direct channels.<sup>279</sup>

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<sup>273</sup> *Id.* at 12.

<sup>274</sup> *Id.* at 11-12.

<sup>275</sup> *Id.* at 13-14.

<sup>276</sup> *Id.* at 15.

<sup>277</sup> *Id.*

<sup>278</sup> *Id.* at 13. Another indication that brokers direct investors to less well-known mutual funds is that funds bought through brokers are less likely to be covered by Morningstar than are funds investors buy directly. *Id.*

<sup>279</sup> *Id.* at 15-16.

#### 4. Summary and Analysis

Many investors seek the advice of financial advisers when picking a mutual fund. But this should not give comfort to regulators. There is little evidence that financial advisers provide tangible benefits to fund investors or help them provide market discipline over mutual funds.

Nonetheless, financial advisers might benefit investors in other ways that have not been studied. For example, they “may help their clients save more than they would otherwise save, they may help clients more efficiently use their scarce time, they may help customize portfolios to investors’ risk tolerances, and they may increase overall investor comfort with their investment decisions.”<sup>280</sup> Still, even if such benefits exist, they do not help provide the market discipline over mutual funds upon which the SEC’s disclosure-based regime relies.

#### G. Advertising Does Not Benefit Investors

In addition to listening to financial advisers, investors pay attention to mutual fund advertisements. Unfortunately, these advertisements do not help investors make better fund choices. Instead, advertisements tend to exploit the tendency of investors to chase past returns.

##### 1. Importance of Advertising to Investors

In Capon, Fitzsimons and Prince’s survey, fund investors stated that advertising was their second most important source of information.<sup>281</sup> Advertising’s importance to investors is confirmed by studies finding that mutual fund advertising works. For example, Jain and Wu examined fund flows into 294 equity mutual funds that advertised in *Barron’s* or *Money* magazine. They found that these advertised funds experienced approximately 20% greater

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<sup>280</sup> *Id.* at 2-3.

<sup>281</sup> Capon et al., *supra* note 147, at 66 tbl.1.

flow than did similar funds that did not advertise.<sup>282</sup> In addition, they found that funds that are advertised more often received even more flow.<sup>283</sup>

Similarly, Gallaher, Kaniel and Starks examined the effect of advertising on flows into approximately 100 fund families. They found that the effect of advertising on flows into fund families is convex: "High relative levels of advertising are significantly related to high fund flows at the family level, while variations of relative levels of advertising within the low advertising group do not have a significant impact on flows to the family."<sup>284</sup> In other words, fund investors respond to advertising inundation.

## 2. Benefits and Harms of Advertising

Advertising clearly benefits mutual fund management companies. Management fees are based on the amount of assets in the fund, so advertising can increase management fees by increasing flow.

Because investors chase past returns, it is unsurprising that mutual fund companies often advertise high past returns. Huhmann and Bhattacharyya found that almost 42% of mutual fund advertisements in *Barron's* and *Money* magazine over a two-year period mentioned a fund's high or increasing returns, and an additional 26% of the advertisements explicitly discussed risk-adjusted returns.<sup>285</sup>

Similarly, Mullainathan and Shleifer examined mutual fund advertisements that appeared in *Money* and *BusinessWeek* over a nine-year period and ten-year period,

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<sup>282</sup> Prem C. Jain & Joanna Shuang Wu, *Truth in Mutual Fund Advertising: Evidence on Future Performance and Fund Flows*, 55 J. FIN. 937, 957 (2000).

<sup>283</sup> *Id.*

<sup>284</sup> Gallaher et al., *supra* note 183, at 31.

<sup>285</sup> Bruce A. Huhmann & Nalinaksha Bhattacharyya, *Does Mutual Fund Advertising Provide Necessary Investment Information?*, 23 INT'L. J. BANK MKTG. 296, 303 tbl.I (2005).

respectively.<sup>286</sup> They found that funds' past returns were mentioned, on average, in 62% of equity mutual fund advertisements appearing in *Money*, and in 59% of equity mutual fund advertisements appearing in *BusinessWeek*.<sup>287</sup> Moreover, they found a high correlation (greater than 0.7) between the percentage of equity fund advertisements that mention past returns and the recent performance of the stock market in general.<sup>288</sup>

In addition, Swensen examined the extent of mutual fund advertising from 1997 to 2003 in the first quarter of the *Wall Street Journal's Mutual Funds Quarterly Review*, a quarterly mutual-fund supplement in the *Wall Street Journal*.<sup>289</sup> He found that the space in the *Review* that was taken up by mutual fund advertisements was highly positively correlated to stock prices. For example, during the bull market from 1998 to 2000, mutual fund advertisements constituted between 40-44% of the nearly fifty page *Reviews*. Then, as the bull market ended, advertising was significantly reduced, reaching only 16% of the thirty-four page *Review* in 2003. In addition, performance advertisements plunged from being 61% and 56% of all mutual advertisements in the *Reviews* in 1999 and 2000, to being only 28% and 26% in 2001 and

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<sup>286</sup> Sendhil Mullainathan & Andrei Shleifer, Persuasion in Finance 9-10 (Dec. 2005) (unpublished manuscript, available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=870601](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=870601)).

<sup>287</sup> *Id.* at fig. 5. These averages were calculated by counting the percentage of equity fund advertisements each quarter that mentioned the fund's returns, and then averaging these quarterly measures.

<sup>288</sup> In particular they found that the correlation of one quarter lagged S&P 500 returns with the percentage of equity fund advertisements was 0.71 for *Money* and 0.74 for *BusinessWeek*. *Id.* See also Henrik Cronqvist, Advertising and Portfolio Choice 22-23 (July 2006) (unpublished manuscript, available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=920693](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=920693)) (finding, in Sweden, that performance advertisements are approximately twice as effective as other advertisements in generating investment into the funds, and finding that performance advertisements for funds with high past returns are particularly effective).

<sup>289</sup> DAVID F. SWENSEN, UNCONVENTIONAL SUCCESS: A FUNDAMENTAL APPROACH TO PERSONAL INVESTMENT 167-69 & tbl.5.4 (2005).



2002.<sup>290</sup> Thus, total pages of performance advertisements dropped by approximately 83% from about 12.1 pages in 1999 to about 2.0 pages in 2003.<sup>291</sup>

Mutual fund companies are particularly likely to advertise funds that have performed well. Jain and Wu found that advertised funds outperformed non-advertised funds with the same investment objective by an average of approximately 6% over the twelve months prior to the advertisements.<sup>292</sup> The advertised funds also outperformed other benchmarks, such as the S&P 500 index, although by less.<sup>293</sup> Similarly, Koehler and Mercer examined equity mutual fund performance advertisements that appeared in *BusinessWeek* and *Fortune* magazines over a four-year period.<sup>294</sup> They found that mutual fund companies tend to advertise their funds that have performed the best.<sup>295</sup>

Although advertising benefits fund companies, there is little evidence that advertising benefits investors as well. Indeed, Jain and Wu found that funds do not continue to

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<sup>290</sup> *Id.* at 168 tbl. 5.4.

<sup>291</sup> *Id.* In 1998, the *Review* had 48 total pages, 44% of the space was mutual fund ads, and 44% of the ads were performance ads, so there were a total of 12.1 performance ad pages (48 pages x .44 x .44 = 12.1). In 2003, the *Review* had 34 total pages, 16% of the space was mutual fund ads, and 36% of the ads were performance ads, so there were a total of 2.0 performance ad pages (34 pages x .16 x .36 = 2.0).

<sup>292</sup> Jain & Wu, *supra* note 282, at 943. See also Cronqvist, *supra* note 288, at 22 (finding that Swedish mutual funds with “higher recent performance advertise significantly more”). But see Gallaher et al., *supra* note 183, at 29, 44 tbl.8 (finding a relationship between the past returns of fund families and the amount of advertising only for small, low-performing fund families).

<sup>293</sup> Jain & Wu, *supra* note 282, at 943-46 & tbl.II.

<sup>294</sup> Jonathan J. Koehler & Molly Mercer, Selection Neglect in Mutual Fund Advertisements (May 29, 2008) (unpublished manuscript, on file with the *Columbia Business Law Review*).

<sup>295</sup> In particular, the advertised funds’ median one-year, five-year, and ten-year performance was at the 80<sup>th</sup>, 100<sup>th</sup>, and 100<sup>th</sup> percentile, respectively, of all company-operated equity funds that share a common investment objective. They are also had a median one-year, five-year, and ten-year performance at the 79<sup>th</sup>, 88<sup>th</sup>, and 88<sup>th</sup> percentile, respectively, of all company-operated equity funds, irrespective of the investment objective. *Id.* at 9.

perform well after being advertised, and actually tend to underperform the same benchmarks that they beat prior to being advertised.<sup>296</sup>

Advertising may also have a disturbing effect on other sources of mutual fund information. Mutual fund families often advertise in personal finance magazines, and there is evidence that these advertising expenditures bias the mutual fund recommendations of these magazines. In particular, Reuter and Zitzewitz found that a fund family's advertising expenditures increased the probability that the family's funds are recommended in each of three popular personal finance magazines: *Money*, *Kiplinger's Personal Finance* and *SmartMoney*.<sup>297</sup> Thus, advertising can bias what investors may perceive as unbiased advice. Interestingly, however, this bias likely causes little, if any, harm to investors because the future returns of these biased fund recommendations are similar to the returns of those funds that would have been recommended in the absence of bias.<sup>298</sup> Even unbiased fund recommendations overweight factors (such as a fund's past return) that have little predictive power regarding future returns, and underweight factors that have significant predictive power (such as a fund's expense ratio).<sup>299</sup> As a result, even unbiased mutual fund recommendations in personal finance magazines fail to give investors better returns.

### 3. Summary and Analysis

Advertising works: investors buy funds that are advertised, especially heavily advertised funds. But advertising does not benefit investors; advertised funds do not outperform unadvertised funds going forward. Advertising likely works, at least in part, because it exploits and encourages a flaw in investors' decisionmaking—the

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<sup>296</sup> Jain & Wu, *supra* note 282 at 956.

<sup>297</sup> Jonathan Reuter & Eric Zitzewitz, *Do Ads Influence Editors? Advertising and Bias in the Financial Media*, 121 Q. J. ECON. 197, 198 (2006).

<sup>298</sup> *Id.* at 199.

<sup>299</sup> *Id.* at 221-22.

belief that high past returns predict future returns. Advertisements exacerbate the seemingly irresistible tendency of investors to chase past returns. No doubt because of this tendency, mutual fund companies especially advertise funds that have performed well in the past.

## VI. FIXING A DYSFUNCTIONAL MARKET

The academic literature paints a disturbing picture of how mutual fund investors actually behave. They erroneously focus on funds' past returns, while paying little attention to funds' risks and ongoing costs. What should be done in response to this behavior? The disclosure currently mandated by the SEC, the required warnings in mutual fund advertisements, and the advice of financial advisers are not sufficiently helping investors overcome their limitations. This part considers whether there are additional steps the SEC should take to help the mutual fund market function well.

### A. Facilitating Investor Access to Important Fund Information

The SEC ensures that important information about funds is available to investors, and encourages them to access the information. It requires mutual fund advertisements to advise investors "to consider the investment objectives, risks, and charges and expenses of the investment company carefully before investing."<sup>300</sup> This and other information is in the fund prospectus, which the SEC urges investors to read before investing.<sup>301</sup> In addition, the SEC requires that

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<sup>300</sup> 17 C.F.R. § 230.482(b)(1) (2008).

<sup>301</sup> See, e.g., SEC, LOOK AT MORE, *supra* note 138 ("[L]ook at more than the fund's past performance when making your investment decisions. Read the fund's prospectus and shareholder reports . . . ."); SEC, Invest Wisely, *supra* note 1 ("Before you invest, be sure to read a fund's prospectus and shareholder reports . . . ."); *Id.* ("[Y]ou can—and should—request and read a fund's prospectus before you invest . . . . While they may seem daunting at first, mutual fund prospectuses contain a treasure trove of valuable information.").

critical information in the prospectus be presented in plain English and in standardized formats.<sup>302</sup> The SEC's website also explains how to read the prospectus, including the fee table and the risk/return bar charts.<sup>303</sup>

Despite the SEC's efforts, however, few investors refer to the prospectus. As a result, the SEC requirements largely create only the illusion of effective fund disclosure. For example, only 34% of the participants in the ICI survey said that they consulted a fund prospectus before investing.<sup>304</sup> This number may even understate the degree to which the prospectus is ignored by investors. Recall that the ICI survey was conducted through face-to-face interviews. Out of embarrassment, respondents may have over-reported their use of the prospectus. In addition, because the ICI only surveyed investors who own funds outside of a work-related retirement plan, those surveyed are likely more experienced and financially sophisticated than the average fund investor, and thus may be more likely to understand the importance of reading the prospectus.

However, even relatively sophisticated investors may be unable to understand the prospectus. As noted above, an experiment by Choi, Laibson, and Madrian asked participants, who as a group were more financially sophisticated than the typical investor, to allocate an investment among four S&P 500 index funds.<sup>305</sup> To guide them, the participants were given the funds' prospectuses, which included information on fund expenses.<sup>306</sup> Despite this, almost none of the participants picked the best portfolio, which would have minimized expenses and thus maximized their return.<sup>307</sup>

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<sup>302</sup> These requirements are discussed *supra* pp. 964-68.

<sup>303</sup> SEC, Mutual Fund Prospectus: Tips for Reading One, <http://sec.gov/answers/mfprospectustips.htm> (last visited Dec. 3, 2008).

<sup>304</sup> ICI, INVESTOR PREFERENCES, *supra* note 31, at 4 fig.2.

<sup>305</sup> Choi et al., *supra* note 208, at 3-4.

<sup>306</sup> *Id.* at 3.

<sup>307</sup> *Id.* at 4.

The SEC also tries to educate fund investors through its website.<sup>308</sup> But this effort may be a futile gesture. At one time, the SEC reported 8500 “hits” per month (about 100,000 hits per year) on its Mutual Fund Cost Calculator, “making it one of the most frequented portions of the SEC website.”<sup>309</sup> But the significance of that number must be viewed in context. A single investor can be responsible for multiple hits on a website. In addition, even if each hit came from a different investor, it would still constitute a tiny percentage of the fifty-five million U.S. households that own mutual funds.

Further evidence of the SEC’s lack of influence in educating fund investors is that no investor survey has even mentioned the SEC as a source of information for investors. Indeed, even the SEC has acknowledged that its ability to educate investors is limited, and that investors must primarily learn about mutual funds from information provided by fund companies themselves.

#### B. Inducing Investors to Pay Greater Attention to Fund Expenses

The SEC encourages investors to pay attention to fund expenses and requires that the prospectuses and shareholder reports highlight expenses, putting them in a standardized tabular form for investors. This is salutary—investors are more likely to use clear, simplified information. For example, Choi, Laibson and Madrian’s experiment found that investors given a one-page expense summary sheet with the prospectuses are more likely to pay attention to expenses and choose lower-expense funds than investors given only the prospectus.<sup>310</sup> Despite the SEC’s efforts, however, many investors still give little weight to fund expenses.

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<sup>308</sup> See *supra* pp. 971-75 for a discussion of these efforts.

<sup>309</sup> Letter from Paul F. Royce, Division of Inv. Management, SEC, to Thomas J. McCool, Director, Financial Institutions & Market Issues, General Government Division., U.S. Gen. Accounting Office (May 10, 2000), available at <http://www.gao.gov/archive/2000/gg00126.pdf> at 104.

<sup>310</sup> Choi et al., *supra* note 208, at 17.

How can the SEC get investors to pay more attention to fund costs? Cost information is already readily available. For example, as noted above, the SEC's website offers a Mutual Fund Cost Calculator that allows investors to compare the impact of different funds' loads and expense ratios.<sup>311</sup> The problem is getting investors to access and act upon such information.

One possibility for getting investor attention is further disclosure reform. For example, as discussed above, the SEC's new proposal for a summary at the beginning of fund prospectuses in part attempts to "address[] concerns that investors do not understand that they pay ongoing costs every year when they invest in mutual funds."<sup>312</sup> It does this by improving the explanation of ongoing costs.<sup>313</sup> In addition, the proposal tries to increase the prominence of fund cost disclosure by moving the fee table to near the front of the prospectus summary.<sup>314</sup>

Cox and Payne have argued for a different type of disclosure. They have called for requiring each mutual fund to report how its expense ratio compares to that of comparable funds.<sup>315</sup> They argue that this data is necessary to help investors overcome an evaluability problem. That is, knowing a fund's expense ratio is only helpful if the investor can readily compare it to that of other funds.<sup>316</sup>

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<sup>311</sup> SEC, The SEC Mutual Fund Cost Calculator: A Tool for Comparing Mutual Funds, <http://www.sec.gov/investor/tools/mfcc/mfcc-intsec.htm> (last visited Dec. 3, 2008).

<sup>312</sup> Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, *supra* note 97 at 67,795 (proposed Nov. 30, 2007).

<sup>313</sup> Recall that it changes an explanatory parenthetical that follows the heading "Annual Fund Operating Expenses" from "expenses that are deducted from Fund assets" to "ongoing expenses that you pay each year as a percentage of the value of your investment." *Id.*

<sup>314</sup> *Id.* at 67,794.

<sup>315</sup> James D. Cox & John W. Payne, *Mutual Fund Expense Disclosures: A Behavioral Perspective*, 83 WASH. U. L.Q. 907, 936-37 (2005).

<sup>316</sup> *Id.* at 933-36.

The mutual fund industry has criticized efforts to require comparable data on expense ratios. In particular, the industry has argued that it is difficult to determine which funds are comparable to others.<sup>317</sup> But the argument is a red herring. Investors choosing among mutual funds already must compare funds. The SEC or mutual funds themselves are unquestionably better able than most investors to determine which funds are comparable. In addition, mutual funds already must make comparability determinations: the prospectus must compare a fund's historical returns to that of a relevant market index, necessarily requiring a comparability determination.<sup>318</sup>

Nonetheless, leading a horse to water is no assurance it will drink. Even if expense information were presented on a comparative basis and displayed more prominently, fund investors likely would still not give it sufficient weight given their obsession (and that of an obliging industry) with past performance. If investors believe that a strong-performing fund will continue to outperform other funds, expenses become much less important. For example, if investors believe that a particular fund, given its past performance, will outperform comparable funds even by only 2% annually, investors would buy that fund even if it has a 1% higher expense ratio than its peers. Thus, dissuading fund investors of the persistence of returns may be a key to getting them to pay more attention to fund expenses.<sup>319</sup>

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<sup>317</sup> GAO, *MUTUAL FUND FEES*, *supra* note 68, at 81 (noting that most industry participants interviewed by the General Accounting Office raised such concerns).

<sup>318</sup> SEC Form N-1A, *supra* note 74, at 10-11.

<sup>319</sup> GAO, *MUTUAL FUND FEES*, *supra* note 68, at 7 ("[C]ompetition in the mutual fund industry may not be strongly influencing fee levels because fund advisers generally compete on the basis of performance (measured by returns net of fees) or services provided rather than on the basis of the fees they charge.").

### C. Encouraging Investors to Pay Less Attention to Past Performance

The SEC already warns investors to discount the predictive value of past returns. For example, performance advertisements must include a statement conveying that “past performance does not guarantee future results [and] current performance may be lower or higher than the performance data quoted.”<sup>320</sup> Also, the SEC’s website warns investors that “past performance does not necessarily predict future returns” and “past performance is not as important as you may think.”<sup>321</sup>

Yet the SEC’s warnings greatly understate the dangers of relying on past returns. Simply, there is little evidence that high past returns predict high future returns.<sup>322</sup> Thus, warnings such as “past performance does not guarantee future results” are actually misleading. Investors need to understand not that a fund’s past returns do not *guarantee* future results, but that past returns are not a very useful fund selection criterion at all. The SEC does not come close to conveying this.

In addition, the other SEC requirements undermine even its understated warnings about relying on past returns. For example, performance advertisements must also include a “toll-free or collect telephone number or a website where an investor may obtain performance data current to the most recent month-end.”<sup>323</sup> Although this requirement seeks to ensure that investors do not buy a fund based on stale performance data,<sup>324</sup> it also sends the implicit message that

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<sup>320</sup> 17 C.F.R. § 230.482(b)(3)(i) (2008).

<sup>321</sup> SEC, LOOK AT MORE, *supra* note 138.

<sup>322</sup> See *supra* pp. 996-97.

<sup>323</sup> 17 C.F.R. § 230.482(b)(3)(i) (2008).

<sup>324</sup> The SEC explained that it was adopting this requirement so that “investors who are provided advertisements highlighting a fund’s performance [will] have ready access to performance data that is current to the most recent month-end and will not be forced to rely on performance data that may be more than three months old at the time of use by the investor.” Amendments to Investment Company Advertising Rules, 68 Fed. Reg. 57,760, 57,763 (Oct. 6, 2003).



the fund's most recent performance is important in choosing a fund. Thus, the SEC is throwing fuel on the returns-chasing fire.

The problem of investors chasing past returns is further exacerbated by the way mutual funds, fund advisers, and financial publications pander to this tendency. Fund advisers and fund performance rankings encourage investors to focus on a fund's past performance. Indeed, fund investors in Capon, Fitzsimons and Prince's survey said that published performance rankings are their most important information source<sup>325</sup> and that a fund's "Investment Performance Track Record" is their most important selection criterion.<sup>326</sup>

#### D. Having the SEC Pay Attention to the Academic Literature

The SEC's current disclosure-based regime is unlikely to result in fund investors imposing a strong market discipline on fund management companies. The agency's implicit and explicit assumptions about fund investors are unrealistic, given the realities of fund investor behavior documented by an extensive academic literature. To date, the SEC essentially ignores this literature in formulating its regulation of the industry.

The extent to which the SEC disregards this academic research is evident from the SEC's rulemaking releases, which contain the agency's explanations of, and rationales for, its rule proposals. In these releases, the SEC often cites to outside sources. We identified five times that the SEC has recently amended rules regarding information that mutual funds must disclose to current or potential investors. Table 1 identifies the sources cited by the SEC as possible evidence of investor behavior or information needs in its releases accompanying these amendments, and the number of times the SEC cited to each source.

As shown in Table 1, the SEC's efforts to reform fund disclosure have not relied on independent empirical data

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<sup>325</sup> Capon et al., *supra* note 147, at 66 tbl.1.

<sup>326</sup> *Id.*

indicating whether investors can understand, and will use, the information that the SEC requires mutual funds to present to them. For example, in 1998 the SEC amended the prospectus disclosure requirements.<sup>327</sup> The amendments were “intended to improve fund prospectus disclosure and to promote more effective communication of information about funds to investors.”<sup>328</sup> In its rulemaking, however, the SEC cited no academic studies of how investors actually make their fund choices.

Instead of turning to the academic literature, the SEC has relied on the fund industry to formulate its understanding of investors’ informational needs. For example, in its 1998 prospectus disclosure rulemaking, the SEC cited to ICI research seven times, and to ICI comment letters five times, to support SEC conclusions about the information needs of fund investors.<sup>329</sup> The SEC noted, for example, that an ICI survey found that investors responded “very positively” to profile summaries of fund information.<sup>330</sup> The only non-ICI studies cited by the SEC were a survey by the American Association of Retired Persons, the Consumer Federation of America, and the North American Securities Administrators, Inc., that found that “the vast majority of American bank customers who hold shares of mutual funds are unaware of the risks and fees involved in the sale of mutual funds”,<sup>331</sup> a survey by the Investor Protection Trust finding that two-thirds of investors “believed that no-load mutual funds involve no sales charges or fees”,<sup>332</sup> and a survey by the Federal Deposit Insurance Corporation indicating that about one-third of bank customers did not know that mutual funds sold through banks were not

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<sup>327</sup> Registration Form Used by Open-End Management Investment Companies, *supra* note 72.

<sup>328</sup> *Id.*

<sup>329</sup> *Id.*

<sup>330</sup> *Id.* at 13,918. See also New Disclosure Option for Open-End Management Investment Companies, *supra* note 72, at 13,970 n.23.

<sup>331</sup> Registration Form Used by Open-End Management Investment Companies, *supra* note 72, at 13,925 n.82.

<sup>332</sup> *Id.*

insured.<sup>333</sup> As noted in Table 1, there were no references to academic research on investor behavior in any of the five SEC releases.

In fact, it appears that the SEC, until very recently, had referred to the academic literature only once in connection with the informational needs of fund investors. As noted above, in an educational document on its website, "Invest Wisely: An Introduction to Mutual Funds," the SEC states:

Past performance is not a reliable indicator of future performance. So don't be dazzled by last year's high returns . . . . A fund's past performance is not as important as you might think. Advertisements, rankings, and ratings often emphasize how well a fund has performed in the past. *But studies show that the future is often different.* This year's "number one" fund can easily become next year's below average fund.<sup>334</sup>

In its November 2007 proposal regarding the summary section of the full prospectus and the creation of the Summary Prospectus, the SEC again cited academic literature. In that rulemaking proposal, the SEC cited to one academic study as support for the general proposition that there are "continuing concerns about investor understanding of mutual fund costs."<sup>335</sup>

Although SEC references to the academic literature are rare, Table 1 shows that the SEC has sometimes cited to the popular media for anecdotal evidence of the difficulties fund investors have in understanding fund disclosure. In its rulemaking on prospectus disclosure,<sup>336</sup> its adoption of the fund profile,<sup>337</sup> its changes to the rules on advertising

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<sup>333</sup> *Id.* at 13,922 n.48.

<sup>334</sup> SEC, *Invest Wisely*, *supra* note 1 (emphasis added).

<sup>335</sup> Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, *supra* note 97 at 67,794 & n.45.

<sup>336</sup> Registration Form Used by Open-End Management Investment Companies, *supra* note 72.

<sup>337</sup> New Disclosure Option for Open-End Management Investment Companies, *supra* note 72, at 13,969.

content,<sup>338</sup> and its changes to rules on the content of shareholder reports<sup>339</sup> the SEC liberally cites to news articles suggesting fund investors' limitations. In the SEC's adopting release on fund prospectus disclosure, for example, there are thirteen cites to news articles, including journalistic critiques of the opacity of fund disclosure.<sup>340</sup>

In short, in developing its understanding of the mutual fund investor, the SEC has essentially ignored the academic literature, instead relying heavily on the fund industry itself. Interestingly, the need to pay attention to academic research is not lost on everyone in the agency. In a recent speech, Brian Cartwright, the General Counsel of the SEC, pointed out that:

Given the practical applications of theoretical finance, it's not surprising that today's hedge fund managers regularly turn up at academic conferences and eagerly scour the academic literature for the next big thing. Regulators should too. If the investment choice most important for retail investors these days is not which stock or bond to buy, but which fund (or other intermediary) to choose, we need to find ways to apply the insights recent finance theory has given us in the service of retail investors.<sup>341</sup>

This would be a step in the right direction.

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<sup>338</sup> Amendments to Investment Company Advertising Rules, *supra* note 71.

<sup>339</sup> Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies, *supra* note 145.

<sup>340</sup> See, e.g., Registration Form Used by Open-End Management Investment Companies, 63 Fed. Reg. 13,916 n.4, 13,933 n.150.

<sup>341</sup> Brian G. Cartwright, General Counsel, SEC, Remarks at the University of Pennsylvania Law School Institute for Law and Economics: The Future of Securities Regulation (Oct. 24, 2007), <http://www.sec.gov/news/speech/2007/spch102407bgc.htm>.

## VII. CONCLUSION

Saving for one's retirement is a relatively recent phenomenon. Seven decades ago our national retirement program was entrusted to a federal bureaucracy. Two decades later, our private retirement savings moved to company and government pension plans, administered by professional money managers. Today as Social Security becomes less certain and defined-benefit pension plans give way to defined-contribution plans, our retirement savings have moved to mutual funds. In the process, fund investors have found themselves responsible for making the essential investment choices regarding their own retirement savings.

Are mutual fund investors up to this heady new role? The mutual fund industry takes the position that fund investors are mostly knowledgeable and capable, although they could always use even more simplified disclosure. The SEC, the regulator on behalf of fund investors, has expressed some concern about investors' capabilities but has sought to address these concerns through required warnings and simplified disclosure, with a casual nod to more investor education. Unfortunately, however, an extensive academic literature finds that mutual fund investors remain largely ignorant of even the basics of their mutual funds and chase past returns while neglecting fund risks and costs.

The fund industry, while painting a favorable portrait of fund investors, benefits from investor ignorance. The industry earns fees based on assets under management, and investors who pay little attention to fund costs create little pressure to lower these costs. In addition, investors' tendency to chase past returns makes promoting past winners an effective marketing method. So long as investors pay insufficient attention to fund costs, the industry has an unassailable and highly profitable business model.

Furthermore, the industry's favorable portrait of fund investors undercuts the need for regulatory protection. By advancing the notion of a functioning, investor-driven

market, the ICI discourages intrusive regulation of the industry. The ICI has masterfully played the role of supporting disclosure-simplification reforms in the name of investor empowerment, while resisting providing clear, comparative information regarding fund costs on the grounds that investors can glean such information on their own.

The SEC has undertaken only marginal reforms, primarily focused on streamlined disclosure and formulaic warnings. Relying significantly on the industry for information about investor needs, the SEC has largely accepted the story of a well-functioning market. While the SEC's reforms play around the edges of addressing investors' inability to fend for themselves, the agency seems in denial about the extent of this problem. The SEC's almost complete disregard of academic studies of fund investor behavior ensures that investors' limitations will continue to be greatly underestimated, and that any further reforms will miss their mark.

As mutual fund investors, our financial future has been placed in our hands. And, as Pogo observed and the SEC has yet to fully recognize, "we have met the enemy and he is us."

**Table 1: SEC Cites to Outside Sources**

TOPIC	Comment Letters	News Stories	ICI Comments	Industry Members	SEC Research	ICI Research	Academic Research	Other Research	Other Sources
Prospectus disclosure (1998) <sup>342</sup>	106	13	5	6	3	7	0	3	6
Fund profile disclosure (1998) <sup>343</sup>	63	4	0	0	7	4	0	1	2
Advertising rules (2003) <sup>344</sup>	22	6	0	2	0	0	0	0	0
Shareholder reports disclosure (2004) <sup>345</sup>	35	5	1	2	0	1	0	2	6
Portfolio manager disclosure (2004) <sup>346</sup>	27	0	0	0	0	0	0	0	0
<b>TOTAL</b>	<b>253</b>	<b>28</b>	<b>6</b>	<b>10</b>	<b>10</b>	<b>12</b>	<b>0</b>	<b>6</b>	<b>14</b>

<sup>342</sup> Registration Form Used by Open-End Management Investment Companies, 63 Fed. Reg. 13,916 (Mar. 23, 1998) (to be codified at 17 C.F.R. pt. 230, 274).

<sup>343</sup> New Disclosure Option for Open-End Management Investment Companies, 63 Fed. Reg. 13,968 (Mar. 23, 1998) (to be codified at 17 C.F.R. pt. 230).

<sup>344</sup> Amendments to Investment Company Advertising Rules, 68 Fed. Reg. 57,760 (Oct. 6, 2003) (to be codified at 17 C.F.R. pt. 230, 239, 274).

<sup>345</sup> Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies, 69 Fed. Reg. 11,244 (Mar. 9, 2004) (to be codified at 17 C.F.R. pt. 210, 239, 240, 270, 274).

<sup>346</sup> Disclosure Regarding Portfolio Managers of Registered Management Investment Companies, 69 Fed. Reg. 52,788 (Aug. 27, 2004) (to be codified at 17 C.F.R. pt. 239, 249, 270, 274).