Appendix: ICI Comment Letter Appendix to DOL on Participant Fee Disclosure Proposal

Appendix

Assessing the Department of Labor’s Assumption that 401(k) Plan Participants Pay Fees that are Higher than Necessary

The cost/benefit analysis in the Department of Labor’s rule proposal assumes that 401(k) plan participants “on average pay fees that are higher than necessary by 11.3 basis points per year.” We know of no evidence that would allow one to draw such a conclusion.

It is unclear how the Department reaches this 11.3 basis point figure. The Department cites a number of academic studies and industry studies in support of this estimate. [1] No such estimate appears in any of these studies and the Department provides no details on how it arrived at the 11.3 basis point estimate. Presumably, the Department calculated the 11.3 basis points from statistics presented in the studies it cites. If so, this calculation likely misinterpreted the statistics in those studies, misapplied some of those studies to 401(k) plans, and failed to recognize empirical difficulties inherent in some of those studies. In addition, the Department’s cost/benefit study failed to consider evidence showing that the mutual fund industry[2] is highly competitive.

While we agree that the rule the Department has proposed may result in some participants paying less in investment-related fees (although some may pay more if their asset allocation results in more equity exposure), there is no basis for concluding that plan participants systematically overpay for the investments and services they receive.

Misinterpretation of Statistics Presented in the Literature Cited by the Department: The Department’s cost/benefit analysis argues that dispersion in 401(k) fees implies market inefficiency. [3] As evidence, the Department points to a study by the Institute of average costs incurred by participants in 401(k) plans (not “the fees that plans pay” as the Department suggests).[4] Figure 9 in the cited Institute study shows that the bulk (77 percent) of the 401(k) plan assets invested in stock mutual funds are invested in funds with expense ratios of less than 1 percent.[5] The remainder (23 percent) is invested in stock funds with expense ratios of 1 percent or more.

These percentages, however, say little, if anything, about market efficiency or whether plan participants overpay or underpay for the services they receive. The percentages are driven largely by the broad asset allocation decisions that plan participants make, not by whether plan participants pay too much or too little for a given type of fund. For example, nearly half of the 23 percent of 401(k) plan assets that are invested in stock funds with expense ratios of 1 percent or more are invested in international equity funds. International equity funds tend to be more costly to manage and therefore have higher expense ratios than domestic equity funds (especially large-cap domestic equity funds).[6] Plan participants who choose to invest in a mix of domestic equity and international funds will incur higher fees than participants who invest only in domestic equity funds, but they also expect to earn higher returns.

Dispersion in 401(k) fees can also reflect differences in plan services or characteristics, differences in employer subsidization of plans, and differences in arrangements for how plan participants and employers defray plan administrative costs. For example, as the ICI study discusses, the costs of running a 401(k) plan generally are shared by plan sponsors and participants and these arrangements can vary widely. Many employers voluntarily cover some or all of plan-related costs that plan participants would otherwise incur. Thus, an employer’s decision to pay a portion of plan costs can have a significant effect on the 401(k) plan fees charged to plan participants. Generally, when more plan costs are subsidized by employers, plan participants incur lower fees.[7]

Literature Cited Inapplicable to 401(k) Plans: The Department states that a “review of the relevant literature suggests that plan participants on average pay fees that are higher than necessary by 11.3 basis points per year.” In support, the Department references six studies. Only two of these studies, those by the ICI and Deloitte Financial Advisory Services LLP, relate to 401(k) plans. The ICI and Deloitte studies provide evidence on the level of fees that plan participants pay, not whether they overpay or underpay for services received. To judge from these studies whether plan participants pay too much or too little, one would have to determine the “right” level of fees and services. Neither study does this, nor is it obvious how one would go about determining such a level.

The remaining four studies consider neither 401(k) fees nor the behavior of 401(k) plan investors. Two of the studies consider choices made by load fund investors.[8] A third study compares the fees charged by load and no-load S&P 500 index funds.[9] Since 401(k) plan investors do not generally incur load fees, these three studies would appear to be irrelevant. The fourth study examines brokerage fees incurred by equity mutual funds.

Empirical Difficulties with the Studies Cited by the Department: Putting aside the relevance of the studies cited by the Department, some of these studies have empirical issues that challenge the validity of their conclusions generally.

For example, the Department cites a study by Elton, Gruber, and Busse (2002) on the expenses of S&P 500 funds.[10] That study claims, on the basis of the expense ratios of S&P 500 funds available in the marketplace, that investors make irrational choices when selecting mutual funds. The ICI has previously disputed that claim,[11] showing that: (a) S&P 500 index funds are commodities in that they have essentially identical portfolios; (b) these funds nevertheless differ from one another in many respects; and (c) nearly all of the dispersion in the expense ratios of S&P 500 funds is explained by fund characteristics (such as fund size and investors' average account balances) rather than by market inefficiency or investor irrationality.

In addition, Elton, Gruber, and Busse (2002) claim that a "large amount of new cash flow goes to the poorest-performing [S&P 500 index] funds."[12] That is incorrect: over the ten year period 1998 to 2007, about 85 percent of the net new cash flowing to S&P 500 index funds went to the least costly funds, those with expense ratios of 20 basis points or less.[13] Elton, Gruber, and Busse (2002) appear to reach this inappropriate conclusion because they analyze flows scaled by assets rather than dollar flows. As a result, in their study, very small funds can have a disproportionate influence.

In addition, the paper by Barber, Odean, and Zheng (2005) is subject to alternative interpretations. Barber, Odean, and Zheng (2005) claim to have found that "[i]investors are more sensitive to salient in-your-face fees, like front-end loads and commissions, than [fund] operating expenses." One statistic that Barber, Odean, and Zheng (2005) provide in support is that repeat buyers of front-end load funds tend to pay lower loads on subsequent purchases than on initial purchases, while repeat purchasers of all funds tend to pay nearly identical expense ratios on initial and subsequent purchase. Our view is that this says little about, if anything, about whether investors are sensitive to front-end loads and fund expense ratios. Instead, it simply illustrates how front-end load funds are priced: front-end load funds typically offer discounts on load fees when the cumulative dollar value of shares purchased exceeds a given dollar amount.[14]

Another issue is that some of the studies cited by the Department rely on samples that are representative of neither 401(k) plan participants, nor mutual fund investors in general. One of the studies—Barber, Odean, and Zheng (2005)—relies on a sample of load fund investors provided by a single brokerage firm. Another study cited by the Department—the study by Choi, Laibson, and Madrian (2006)[15]—relies on a survey that asks a relatively small number of individuals how they would invest in load funds, not how they do invest. It is unclear whether the surveyed individuals are 401(k) plan participants, whether they have any mutual fund investments, or any investments at all.

The Mutual Fund Market is Highly Competitive: Finally, the Department failed to cite studies indicating that the mutual fund industry is highly competitive. The textbook definition of a competitive industry is one in which there are many firms, none of which has a dominant market share. Firms may freely enter or exit the industry, and consumers are free to vote with their feet. In a competitive industry, firms cannot overcharge and consumers do not "overpay."

The mutual fund industry is "a classic, competitively structured industry, with hundreds of competing firms offering thousands of products, low barriers to entry … and low concentration." [16] About 600 advisers manage mutual fund assets in the United States. Competition has prevented any one firm from dominating the market. For example, of the largest 25 fund complexes in 1985, only 13 remained in this top group in 2007.[17] Other measures also indicate that the fund market is competitive. In 2007, for instance, the industry had a Herfindahl index (a standard measure of industry concentration) of 440; index numbers below 1,000 indicate that an industry is unconcentrated. In addition, competition in the fund industry is fostered by low barriers to entry. Indeed, the number of mutual fund advisers nearly tripled from 1984 to 2004.[18]

Fund investors are mobile: they can take their investments elsewhere if they feel a given fund's fees are too high. To be sure, in a typical 401(k) plan, participants are limited to the menu of investments selected by plan fiduciaries. But plan fiduciaries can and do alter plan menus in order to replace poorly performing funds19 and plan participants can select from among funds in a plan's menu. There is considerable evidence that 401(k) plan participants invest in low cost funds. For example, although the fees of S&P 500 index funds exhibit considerable dispersion, nearly all (more than 90 percent) of 401(k) plan assets invested in S&P 500 funds are in the least costly of such funds (those with expense ratios of 20 basis points or less).

As we state in our letter, we agree that the Department's proposed disclosure regime will have significant benefits. But there is no basis for concluding that plan participants systematically overpay for the investments and services they receive in their 401(k) plans.

Endnotes

[1]The Department's cost/benefit analysis cites six papers in support of its view that plan participants pay fees that are on average too high by 11.3 basis points: Brad M. Barber, Terrance Odean and Lu Zheng, "Out of Sight, Out of Mind, The Effects of Expenses on Mutual Fund Flows," Journal of Business, 79(6), 2095-2119, 2005; James J. Choi, David I. Laibson, and Bridgette Madrian, "Why Does the Law of One Price Fail? An Experiment on Index Mutual Funds," NBER working paper W12261, May 2006; Deloitte Financial Advisory Services LLP, Fees and Revenue Sharing in Defined Contribution Plans, December 6, 2007; Edwin J. Elton, Martin J. Gruber, and Jeffrey A. Busse, "Are Investors Rational? Choices Among Index Funds," NYU working paper, June 2002; Sarah Holden and Michael Hadley, "The Economics of Providing 401(k) Plans: Services, Fees, and Expenses 2006, Fundamentals, 16(4), September 2007; and Jason Karceski, Miles Livingston, and Edward O'Neal, "Portfolio Transactions Costs at U.S. Equity Mutual Funds," University of Florida working paper, 2004.

[2]The Department's analysis and cited references appear to relate almost exclusively to mutual fund fees, and as a result (and because of the Institute's expertise), our comments also relate to mutual fund issues. The Department's analysis is incomplete because mutual funds represent only about half of the assets in participant-directed plans. We believe one benefit of the proposal is that participants

will now be able to compare fees and expenses of all pooled investments.

[3]There is a “wide dispersion of fees paid in 401(k) plans. As supported by a report of the Investment Company Institute, the fees that plans pay vary over a wide range. According to their study, 23% of 401(k) stock mutual fund assets are in funds with expense ratios of less than 50 basis points, while an equal amount are in funds with an expense ratio of over 100 basis points. Some of this variation could be explained by varying amounts of assets in plans and their accompanying economies of scale. In addition, some plans might offer more, or more expensive, plan features. The Department believes, however, that a significant portion of the variation in plan fees is due to market inefficiencies.” 73 Fed. Reg. at 43020.

[4]See Sarah Holden and Michael Hadley, “The Economics of Providing 401(k) Plans: Services, Fees, and Expenses, 2006,” Fundamentals, Vol. 16, No. 4, September 2007 (hereinafter Holden and Hadley), available at http:/www.ici.org/pdf/fm-v15n7.pdf.

[5]See Holden and Hadley, Figure 9, page 13.

[6]As evidence, see Figure 8 in Holden and Hadley, which shows that in 2006 the average expense ratio incurred by 401(k) plan participants for investing in foreign stock funds was 97 basis points, compared to 70 basis points incurred for investing in domestic stock funds.

[7]See, for example, Figure 4 in Holden and Hadley, which shows that about 40 percent of plan sponsors pay some or all 401(k) recordkeeping and administrative costs.

[8]Brad M. Barber, Terrance Odean and Lu Zheng, “Out of Sight, Out of Mind, The Effects of Expenses on Mutual Fund Flows,” Journal of Business, 79(6), 2095-2119, 2005; James J. Choi, David I. Laibson, and Bridgette Madrian, “Why Does the Law of One Price Fail? An Experiment on Index Mutual Funds,” NBER working paper W12261, May 2006.

[9]Edwin J. Elton, Martin J. Gruber, and Jeffrey A. Busse, “Are Investors Rational? Choices Among Index Funds,” NYU working paper, June 2002.

[10]Id.

[11]See Sean Collins, Investment Company Institute, “Are S&P 500 Index Mutual Funds Commodities,” Perspective, Vol. 11, No. 3, August 2005.

[12]Edwin J. Elton, Martin J. Gruber, and Jeffrey A. Busse, “Are Investors Rational? Choices Among Index Funds,” NYU working paper, June 2002, page 25.

[13]Investment Company Institute, 2008 Investment Company Factbook, 48th edition, page 65.

[14]Thus, for example, an investor who initially invests $25,000 and pays a front-load of 5.25 percent might expect to pay a front-load of just 3.00 percent on a subsequent purchase of $25,000 in the same front-end load fund.

[15]James J. Choi, David I. Laibson, and Bridgette Madrian, “Why Does the Law of One Price Fail? An Experiment on Index Mutual Funds,” NBER working paper W12261, May 2006.

[16]John C. Coates IV and R. Glenn Hubbard, “Competition and Shareholder Fees in the Mutual Fund Industry: Evidence and Implications for Policy,” American Enterprise Institute, working paper #127, June 2006, page i.

[17]See Investment Company Institute, 2008 Investment Company Factbook, 48th edition, page 21.

[18]See table 1 in John C. Coates IV and R. Glenn Hubbard, “Competition and Shareholder Fees in the Mutual Fund Industry: Evidence and Implications for Policy,” American Enterprise Institute, working paper #127, June 2006.

[19]See Deloitte Consulting, 401(k) Benchmarking Survey, 2008 Edition, page 22. The report finds that 95% of responding plan sponsors evaluate and benchmark their plan’s investments at least annually, and that 64% have replaced a fund due to poor performance in the past two years.
