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COMMENTS ON A REVIEW OF A WHITE HOUSE REPORT ON CONFLICTED INVESTMENT ADVICE

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SUMMARY

In February 2015, the Council of Economic Advisers published a report on “The Effects of Conflicted Investment Advice on Retirement Savings” (“White House Report”). In March 2015, Jeremy Berkowitz, Renzo Comolli, and Patrick Conroy of NERA Economic Consulting posted a review of that report (“NERA Review”).[1] This document comments on the NERA Review.

Based on a review of academic studies, the White House Report concludes that conflicts of interest among financial advisers costs affected investors roughly 1 percentage point annually in foregone investment returns. The NERA Review is critical of the White House Report. It challenges the cost estimates and faults the White House Report for not articulating an alternative regime. It puts forward a few valid arguments—in particular that the White House Report undervalues benefits from adviser services—and many unconvincing ones. At no point does it present its own estimates of costs and benefits of conflicted advice. Taken together, the NERA Review fails to detract from the White House Report’s conclusion that conflicted investment advice reduces American retirement resources by billions of dollars every year, which compound over time into substantial cuts of individual nest eggs.

[1] “Review of the White House Report Titled `The Effects of Conflicted Investment Advice on Retirement Savings’.” NERA Economic Consulting, 15 March 2015. http://www.nera.com/content/dam/nera/publications/2015/PUB_WH_Report_Conflicted_Advice_Retirement_Savings_0315.pdf.

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1. INTRODUCTION

In February 2015, the Council of Economic Advisers published a report on "The Effects of Conflicted Investment Advice on Retirement Savings" ("White House Report"). In March 2015, Jeremy Berkowitz, Renzo Comolli, and Patrick Conroy of NERA Economic Consulting posted a review of that report ("NERA Review").[2] This document comments on the NERA Review.

Retirement in the United States is financed through several mechanisms, including Social Security, employer-sponsored pension plans, and Individual Retirement Accounts (IRAs). The Investment Company Institute reported that total retirement assets, excluding claims on Social Security, amounted to $24.6 trillion at the end of 2014, of which $7.4 trillion (30%) were held in IRAs (ICI 2015). Most IRA savings originated from 401(k) or other defined contribution (DC) accounts that former employees rolled over into an IRA; rollovers accounted for about 96% of IRA inflows in 2010 (Holden and Bass, 2014). Owners of IRAs may generally invest the account balance in any security offered by the institution that holds the IRA—stocks, bonds, mutual funds, cash, annuities, et cetera.

According to a 2014 survey, IRA owners often consult financial advisers in rollover decisions, asset allocation decisions, withdrawal decisions, and retirement strategy planning (Holden and Schrass, 2015). Financial advisers may be compensated in a variety of manners, including through commissions or other payments that depend on the actions taken by the advisee. These payments introduce a potential conflict of interest for the adviser and the White House Report therefore labels them "conflicted payments." Advisers who do not accept conflicted payments may charge an hourly rate, a percentage of assets, or other fees that do not directly depend on the investment decisions made by the client.

Conflicts of interest due to conflicted payments may harm investors. For example, investors may be steered into products with excessive fees or encouraged to trade excessively. They may also be steered into underperforming portfolios. The White House Report surveyed a number of studies that quantified these harms. While estimates varied, the White House Report concluded that savers receiving conflicted advice earn returns roughly 1 percentage point lower each year than savers who did not receive conflicted advice. It attempted to translate that finding into several practical terms.

- First, the White House Report estimated that roughly $1.7 trillion IRA assets were invested based on conflicted advice. An underperformance of 1 percentage point thus implies that conflicted advice costs IRA owners about $17 billion per year.
- Second, the White House Report illustrated the cumulative effects over time. For example, a 45-year-old who rolled over a 401(k) balance into an IRA and earned 5% per year would have 17% less in his IRA account at age 65 than if the rate of return had been 6%. Additional losses accrue during retirement. For example, a retiree who received conflicted advice will lose an estimated 12% of the value of his IRA savings if drawn down over 30 years.

[2] "Review of the White House Report Titled `The Effects of Conflicted Investment Advice on Retirement Savings'." NERA Economic Consulting, 15 March 2015. http://www.nera.com/content/dam/nera/publications/2015/PUB_WH_Report_Conflicted_Advice_Retirement_Savings_0315.pdf.

2. SYNOPSIS OF THE NERA REVIEW

The NERA Review is critical of the White House Report. In its Executive Summary, the authors emphasize two issues. First, they present arguments to cast doubt on the accuracy of the White House Report's estimate of $17 billion annual losses due to conflicted advice. Second, they argue that the White House Report does not permit a cost-benefit analysis of alternative regulation because the Report does not articulate a clear proposal for a future regulatory scheme.

The body of the NERA Review makes six main arguments in six sections, summarized here in part with quotes from the NERA Review:

I. "The Report does not put forward a clear proposal and therefore it cannot perform a proper cost-benefit analysis" (p. 1);

II. "The Report gives short-shrift to the benefits that consumers receive from brokers" (p. 4);

III. "When estimating aggregate costs, the Report does not make any adjustment for the limitations of the academic research it cites" (p. 5);

IV. "The Report claims that the rollovers from 401(k) plans to IRA plans cause loss to consumers, but it overstates the strength of the evidence for the quantification of the costs it provides, and it does not properly consider the benefits" (p. 10);

V. "While the academic study cited in the Report indicates that investors' attempts to time the market reduces returns, it does not show that these attempts are due to brokers" (p. 10); and

VI. The academic studies surveyed by the White House Report were based on historical data that, in some cases, range back to the mid-1990s. However, "[m]utual fund fees have dropped substantially since 2000" (p. 11), suggesting that historical studies may overstate harm caused by current conflicted advice.

3. DISCUSSION

The NERA Review makes several good points, chief among them that the White House Report "gives short-shrift" to the benefits that consumers receive from brokers. Indeed, while the White House Report acknowledges such potential benefits, it does not quantify them and does not account for benefits in its headline results. That said, the NERA Review struggles to undermine the White House Report's central message, namely that conflicted advice causes billions of dollars in losses to IRA investors annually and that those losses compound over time into substantial cuts in retirement nest eggs. The NERA Review presents dozens of arguments that do not convince, instead focusing on peripheral issues, faulting the White House Report for an out-of-scope issue, misleadingly quoting academic studies out of context, and omitting to present its own estimates of costs and benefits.

The discussion below addresses each of the NERA Review's six sections in turn.

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

The NERA Report repeatedly criticizes the White House Report for not proposing an alternative regulatory regime and not performing a cost-benefit analysis of that alternative regime. Indeed, while the White House Report floats some thoughts about alternatives—in text boxes, not in the main text—it does not formulate any alternative proposal or set out to do so. Instead, the White House Report makes it clear that it is concerned with current circumstances:

> "The Effects of Conflicted Investment Advice on Retirement Savings" (Title)
>
> "This report focuses on quantifying the impact of conflicting incentives in the particular case of financial advisers providing conflicted advice to IRA account holders." (p. 10)
>
> "This report examines the evidence on the cost of conflicted investment advice and its effects on Americans' retirement savings, with a focus on IRAs." (p. 26)

Since an alternative proposal was not within the White House Report's scope, the NERA Review's criticism appears misplaced.

The White House Report contains text boxes in which it ponders whether the current system is the only way for Americans with modest savings to obtain advice (p. 21) and whether mandated disclosures provide a solution (p. 24). The NERA Review characterizes those passages as more prescriptive than they appear to be intended. It attacks the White House Report's arguments and makes at least one good observation,[3] but none of it is germane to the White House Report's central message.

The White House Report contains another text box in which it briefly mentions how some foreign countries have attempted to mitigate conflicted advice (p. 25). The NERA Review uses a preliminary evaluation by Europe Economics (2014) of the reforms in the United Kingdom to suggest two potentially unpalatable consequences. First, the NERA Review argues that many low-wealth investors appear to have lost broker advice after the reform: 310,000 clients stopped being served by their brokers because their wealth was too small for the broker to advise profitably, and another 60,000 investors were not accepted as new clients by brokers for the same reason. These numbers are misleading and hide a net increase in clients. In the words of Europe Economics (2014):

[3] The White House Report argues that advisers can provide the same quality of advice while receiving non-conflict-based payments as they can when receiving a payment of equal amount based in conflict, because their costs do not depend on their compensation structure. The NERA Review points out that this assumes that the amount of work that the brokers need to do would remain constant (p. 1). Relatedly, it expects the cost of brokers' services to increase if the fiduciary standard were imposed on brokers (p. 2). This is a valid point; additional obligations will likely translate into higher compliance costs.

> Some advisers have sought to terminate unprofitable client relationships. Data from NMG Consulting, for example, imply that in the year to Q1 2014 about 310,000 clients stopped being served for this reason. On the other hand 820,000 clients were gained in the same period. The same survey indicates that advisers refused to serve about 60,000 (potential new) clients in the same period. If we assume that many of those clients with relationships terminated on the grounds of inadequate profitability sought out another adviser, the positive net increase in customers served suggests that such looking around for a replacement was largely successful. We cannot rule out the existence of a residual group of consumers denied service in this way. However these data do not speak to a significant issue here.

In other words, Europe Economics (2014) found the opposite of what the NERA Review attempted to make the reader believe. Second, broker fees appear to have gone up in at least some geographies and for at least some consumers. Europe Economics (2014) notes that the underlying data are sparse and that consumer price pressure may push down fees as clarity around firms' disclosure of adviser charging continues to increase over time. Separately, fees may have increased because the U.K. reforms imposed higher education and credentialing standards on advisers.

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

The NERA Review argues that brokers, compensated with conflicted payments, generate benefits to advisees and that the White House Report understates the importance of these benefits.

Conceptually, the NERA Review's observation has merit: brokers' advice may benefit investors by nudging them to think about their needs in retirement; helping select a portfolio; bringing awareness of investment strategies; raising issues related to taxes, college savings, and estate planning; et cetera.

The White House Report explores whether portfolio underperformance is fair compensation for the benefits that broker advice brings. Pointing out that brokers are already compensated through front-end load fees and citing an experiment that found that investors are unlikely to buy high-fee funds once fees are made transparent,[4] it concludes that the benefits do not outweigh the costs. However, the possibility remains that the benefits may partially justify some underperformance. Unfortunately, the academic literature offers little or no quantitative estimates of the benefits of broker advice.

The NERA Review points at several articles that mention potential benefits, but none of those articles quantifies the benefits. For example, Kihn (1996) shows that funds' sales loads are positively related to the broker having a toll-free telephone number and other indicators of customer service, but do not measure the value of those benefits. Bergstresser et al. (2009) raise the theoretical possibilities that "[b]rokers 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

[4] James J. Choi, David Laibson, and Brigitte C. Madrian. 2010. "Why does the law of one price fail? An experiment on index mutual funds." *Review of Financial Studies* 23 (4): 1405-1432.

investors' risk tolerances, and they may increase overall investor comfort with their investment decisions,", but acknowledge that they cannot measure those benefits. They also suggest that brokers help diversify clients' portfolios, noting that "broker-sold funds are more likely to invest in foreign funds, suggesting that the broker channel may somehow combat the home-bias effect, where investors appear to overinvest in local securities." Similarly, Foerster et al. (2014) raise the theoretical possibilities that benefits include advice on saving for college and retirement, tax planning and estate planning.

We echo the conclusion by Foerster et al. (2014) that "[e]xploring the importance of these benefits is an important topic for future work."

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

In this section, the NERA Review lists numerous issues that aim to cast doubt on the robustness or generalizability of findings in the academic literature. Most issues are raised as theoretical objections without empirical basis, were addressed in the White House Report, or amount to misleading quotes from external sources. We discuss an illustrative subset here.

The NERA Review criticizes Christoffersen et al. (2013) for analyzing "returns of funds, which is not the same as the performance of an individual investor because investors may trade in and out of the fund (potentially at the suggestion of their broker)" (p.6). The criticism might fit if there were evidence that individual investors are worse at timing the market than brokers. However, Bergstresser et al. (2009) find no superior market-timing advice by brokers, and Foerster et al. (2014) find "little evidence of superior stock-picking or market-timing abilities even in the right tail of the distribution."

The NERA Review also criticizes Christoffersen et al. (2013) for the poor overall explanatory power of its regression models. "[T]he R squares of the regressions in Table V are all under 4%, which means that 96% of the variation in the performance across funds is not explained by the model estimated by Christoffersen et al. (2013)." Rates of return are indeed notoriously difficult to explain or predict so that it is noteworthy when a certain factor exerts a statistically significant effect. In this case, the effect of "excess load paid to broker" is robust to four alternative specifications and statistically significant in all four specifications at significance levels of less than 1%. The NERA Review further notes "This strongly suggests that important drivers of the funds' performances are not accounted for by the model. If indeed factors are omitted and they correlate with brokers' fees, then the estimates in Christoffersen et al. (2013) are biased." This statement exemplifies issues raised by the NERA Review that are theoretical possibilities but lack empirical support.

The NERA Review notes that the findings of Bergstresser et al. (2009) are mixed: "for certain types of funds, funds sold by brokers underperform those sold directly, while for other types, they over-perform." In particular, it stresses "value-weighted foreign equity funds," where broker-sold funds outperformed direct-sold funds (on a pre-distribution fee basis). The White House Report addresses this issue; it is attributable to a small number of large funds sold through a single fund family. Indeed Bergstresser et al. (2009) show that most foreign equity funds sold through brokers underperform, except for a small number of very large international funds sold through one specific broker-channel fund family. Weighted by assets, those exceptions dominate the results. At best, this example illustrates that not all broker-sold funds universally underperform direct-sold funds.

The NERA Review also criticizes Bergstresser et al. (2009) and Del Guercio and Reuter (2014) for using Financial Research Corporation (FRC) data to identify the primary distribution channel for each fund share class. The data are reportedly noisy in the sense that the distribution channel may not always be accurate. "This calls into question whether, to what extent, and in what direction, the noisy data might be affecting the empirical results and conclusions in these academic studies." (p. 8). Fortunately, the bias is not ambiguous: measurement error will shrink parameters toward zero (e.g., Greene 2000). In other words, the true underperformance of broker-sold funds studied by Bergstresser et al. (2009) and Del Guercio and Reuter (2014) is at least as high as reported by those authors.

The NERA Review faults the White House Report for ignoring "extensive discussion in Del Guercio and Reuter (2014) devoted to explaining why investors often rationally choose to use broker-sold funds even if they have higher fees." It goes on to present quotes from Del Guercio and Reuter (2014) as if they are conclusions reached by that article. However, the quoted passages are in turn quotes from other publications, used by Del Guercio and Reuter (2014) to motivate their starting point, namely that funds sold by brokers underperform those sold directly.

The NERA Review quotes Foerster et al. (2014) out of context, thereby presenting it as supportive of their viewpoint where it is in fact the opposite. "It is worth noting that Foerster et al. (2014) state that they `estimate that households gain 2.4% per year, on average, from using an advisor.'" (p. 9). A closer reading of Foerster et al. (2014) reveals that they find that advisers induce their clients to raise their allocation to risky assets by 40 percentage points. The estimated "gain" of 2.4% is solely due to that increased exposure to risk. In the words of Foerster et al. (2014):

> "Including all management fees and loads paid to advisors and mutual funds, we find that the average client pays at least 2.5% per year. Since advisors do not add value through superior investment recommendations (there is no evidence of skill in the distribution of gross alphas) investors' net underperformance equals the fees they pay. Accounting for an equity premium of, say, 6% per year and our earlier finding that advisors raise their clients' allocation to risky assets by 40 percentage points, we estimate that households gain 2.4% per year, on average, from using an advisor."

On a risk-adjusted basis, Foerster et al. (2014) find that there is no gain and that advisers cost their clients at least 2.5% per year.

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

The title of this section seems disconnected from its contents. Here the NERA Review discusses rollovers of funds from 401(k) plans to IRAs. Its first criticism concerns the way in which the White House Report presents cost estimates from a study by the Government Accountability Office (GAO). The White House Report wrote:

> "According to a recent GAO report, certain advisers could earn $6,000 to $9,000 if a plan participant were to purchase an IRA." (p. 15)

The NERA Review points out that these earnings figures are based on an interview with a single industry professional. We agree; the figures are more likely to represent an outlier than the average. That said, the issue does not weaken the White House Report's observation that conflicted payments are particularly relevant when individuals roll over their 401(k) balance into an IRA.

Separately, the NERA Review argues that the White House Report does not properly account for benefits of rolling 401(k) balances over into an IRA, such as access to a larger number of financial instruments (and therefore a greater opportunity to diversify), and the reduction in the burden to some consumers to keep track of small amounts of money in many separate 401(k) plans. Those benefits may indeed exist, but not because of the involvement of an adviser.

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

The White House Report argued in one paragraph that conflicted payments can exacerbate underperformance due to poor timing in investment decisions. Among others, it cited Friesen and Sapp (2007) who showed that equity fund investor timing decisions reduce fund investor average returns by 1.56% annually. The NERA Review argued that there is no evidence that poor market timing is caused by brokers. However, this is beside the point. The point is that losses were found to be larger among load funds which, in the words of Friesen and Sapp (2007) "are typically purchased with the help of a broker or investment advisor, and our evidence suggests that those investors who are most likely relying on advice from a broker perform especially poorly from a timing standpoint."

The NERA Review further presents a misleading argument: "[…] these results do not prove that the mis-timing is *due* to brokers. Indeed, since the results hold for both index funds and actively managed funds, for high load funds and low load funds, it suggests that the opposite is true." (p.11). The NERA Review omits to mention that mis-timing losses were lowest for no-load funds and increased with fund load.

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

The academic studies surveyed by the White House Report were based on historical data that, in some cases, range back to the mid-1990s. The final and lengthiest section of the NERA Review documents that mutual fund fees have dropped substantially since 2000, presumably to suggest that excessive fees probably dropped as well. It asserts repeatedly that the decline in fees was overlooked by the White House Report. For example, "The Report fails to mention that mutual fund fees have declined substantially in recent years." (p. 16). This is false. The White House Report explicitly addressed this trend:

> "Christoffersen et al. (2013) conclude that the magnitude of losses from conflict corresponding to the fund with the average load-sharing payment is

> 113 basis points, which is in line with our estimate. However, whether this estimate is a good indicator of conflict-driven underperformance today depends on the relative magnitudes of at least three adjustments that may either push the estimate higher or lower. *First, average loads may be somewhat lower today than the average during the period studied in the paper (1993 to 2009), which would lead us to adjust the underperformance estimate down*. Second, this estimate does not factor in the direct impact of the additional load payment the investor incurs as a result of the recommendation to invest in funds with higher loads, which would lead to an upward adjustment. Third, the authors estimate underperformance for the first year in which the funds are purchased rather than underperformance for every year that the saver holds the fund. [...] Taking all three of these adjustments into consideration leads us to conclude that 100 basis points is a plausible estimate around which to center the magnitude of underperformance." (pp. 15-16; emphasis added.)

In sum, the White House Report's headline estimate of 1 percentage point underperformance includes a downward adjustment for lower fund fees.

The White House Report and the NERA Review differ in their characterization of lower fees. The former employs weaker language ("average loads may be somewhat lower today") than the latter ("mutual fund fees have declined substantially in recent years"). The difference may be grounded in emphases on funds favored by brokers (White House Report) and all funds (NERA Review). For example, Table 2 of the NERA Review shows that the average expense ratio of actively managed equity funds declined from 106 basis points in 2000 to 89 basis points in 2013, compared with a decline from 27 to 12 basis points for index equity funds over the same period. The NERA Review highlights that the (absolute) declines were similar for the two groups, but the relative decline for actively managed equity funds (16%) was much more muted than for index equity funds (56%).

4. CONCLUSION

The White House Report reviews academic literature on underperformance of investments due to the involvement of financial advisers with conflicts of interest. The NERA Review criticizes that Report with dozens of arguments, but most fail to convince because they lack relevance, are unfounded, are misleading, or are already addressed in the White House Report. Indeed there is little controversy in the academic literature that conflicts of interest cause harm to investors. The NERA Review may cast doubt in some minds over the precise magnitude of the harm, but it struggles to detract from the White House Report's central message.

The White House Report places some emphasis on its estimate that investor losses amount to roughly $17 billion per year. That is a large sum, but so are aggregate retirement savings in the United States. As illustrated by the White House Report, 1 percentage point lower returns translate into about 17% lower balances after 20 years of accumulation, and another 12% lower balances after 30 years of decumulation. That translation from an annual flow into stock losses after many years of compounding perhaps places the effects from conflicts of interest in perspective.

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