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Submitted Electronically

May 5, 2010

Office of Regulations and Interpretations
Employee Benefits Security Administration
Attn: 2010 Investment Advice Proposed Rule
Room N-5655
U.S. Department of Labor
200 Constitution Avenue, NW
Washington, D.C. 20210

RE: 2010 Proposed Participant Investment Advice Rule

Dear Sir or Madam:

Vanguard appreciates the opportunity to submit these comments on the Department's February 2010 proposed rule regarding the provision of investment advice to participants and beneficiaries under sections 408(b)(14) and 408(g) of ERISA. There continues to be a well-recognized and compelling need for participant investment advice programs. We hope our comments will help the Department craft final rules that allow for flexibility in the offering of responsible, fundamentally sound, and cost-effective participant investment advice programs.

Vanguard currently manages more than \$1 trillion on behalf of millions of investors who, through their Vanguard mutual fund investments, indirectly own Vanguard. Our investors include more than 3.5 million participants in 2,500 plans for which Vanguard provides a broad range of investment and administrative services to plan sponsors and participants. This range of services includes a complete menu of investment education and advice programs ranging from simple investor education questionnaires and allocation models, to nondiscretionary advice offerings implemented at participant direction, to full-service discretionary advisory programs and third-party advice through a partnership with an independent investment advice provider.

Vanguard has a long-standing track record of being a vocal proponent of low-cost investing. We particularly believe that most investors should hold a significant portion of any long-term portfolio in low-cost, passively managed investments. At the same time, we believe that it may be reasonable for investors to assume limited exposure to active managers in their portfolios. For this reason, we offer a full suite of low-cost actively managed funds covering most asset classes in addition to a broad array of low-cost passively managed funds.

It is true that an all-passive portfolio can be an optimal strategy for many investors. In our view, however, active versus passive choices should be made by plan fiduciaries, investment advisers, and participants, and should not be mandated as a matter of public policy.

Immediately below we provide answers to portfolio management-related questions raised by the Department in the preamble to the regulation, particularly with respect to: (1) the role of past performance in the asset allocation process; (2) the importance of the ongoing availability of actively managed funds in participant portfolios; and (3) what the Department's role should be in defining practices that are considered consistent with "generally accepted investment theories."

1. Historical performance is a relevant factor—but should not be the *primary* factor—in the investment decision-making process.

In its proposed rule, the Department requested comments on how advice-giving models should use past performance data, and whether a fund's past performance relative to the benchmark for its asset class is an appropriate criterion for allocating assets.

Vanguard's view on this issue is clear: Past performance should never be the exclusive, or even the primary, basis for an investment decision or the provision of investment advice. That past performance is inadequate as a predictor of future investment performance is perhaps the most well-known maxim of all "generally accepted investment theories" (save perhaps "don't put all your eggs in one basket"). We note that whenever fund performance information is presented in advertising materials, Financial Industry Regulatory Authority ("FINRA") rules require mutual funds to include statements that past performance does not ensure future results.

Despite the unquestionable truth that past performance data can be an unreliable predictor of future performance, "unreliable" does not mean "useless."¹ Past performance data still play an essential role in most advice methodologies for the following three critical reasons:

¹ Indeed, regulatory agencies and policymakers have implicitly and explicitly acknowledged over the years that historical performance is a useful data point in the investment decision-making process. For example, the Securities and Exchange Commission requires one-, five- and ten-year return performance to be provided in the prospectus for mutual fund investors. Similarly, the Department's own ERISA

- **Modern computer-based advice services do not incorporate past performance naively, but instead use sophisticated statistical tests to interpret past performance as skill versus good or bad luck.** Many factors—including both skill and luck—can combine to determine the value a manager adds during a particular performance period. Best-in-class computer-based advice models and algorithms currently use modern statistical procedures in an attempt to distinguish a manager's skill from luck and to distinguish the value that a particular manager adds.

Such tools tend to place much greater emphasis in their evaluation of investments on quantifiable factors that are more predictable, such as investment expenses and quantitative estimates of "beta" (i.e., the number describing the relation of an investment's return with that of the financial market as a whole). What is important is that quantitative tools or approaches that make use of past performance information in evaluating investments do so in a way that recognizes and takes into account the statistical uncertainty, or "noisiness," of past performance data.

- **Past performance is used to evaluate the asset allocation and security exposures of individual funds when the information is not otherwise available.** It is important to note that investment advisers can, with some reliability, derive beta or asset class exposure from past performance data. Also, in our view, such information need not be 100% reliable to be useful. That said, we note that it is crucial to recognize the statistical uncertainty in such information and that emphasis on past performance data should not be given an inappropriate weight.

It is also important to note that in many cases a fund's true "asset class" cannot be reliably determined without an analysis of past performance data. This is the case because many funds have holdings that may fall into certain specified asset class categories, but the fund will have performance characteristics that can deviate substantially from the average performance of that specified category (this divergence of a fund from its stated investment style or objective is called "style drift" by some in the industry and academia). Thus, past performance data is an important way to validate asset class exposures and to monitor unexpected changes in a manager's portfolio, which may be the result of style drift.

While past performance has very low predictive power with respect to the level of future performance, past performance information can be critical in evaluating other important aspects of an asset class or investment or a manager. Specifically, past performance data is more reliable when used to help reveal patterns of relationships between managers or investment options. Past performance data can be helpful in validating or invalidating claims that are otherwise unverifiable about investment strategies (given the absence of

section 404(c) regulation provides that historical performance is required to be disclosed to requesting participants in order for plan fiduciaries to be relieved of liability for investment decisions made by participants. Lastly, in the Pension Protection Act advice exemption itself, Congress requires that participants be provided with past performance and historical rates of return for a plan's investment options.

other information, such as detailed holdings or trading records). For example, recent studies have demonstrated that a thorough quantitative analysis of the past performance of Bernard Madoff's investment returns did in fact present clear warning signs that something was amiss.²

- ***While past performance cannot predict future success, it can be a useful criterion in identifying underperforming managers that should be eliminated from consideration.*** If a manager has skill, it could be expected that—at a minimum—the manager's past track record would not provide evidence suggesting that the manager has produced consistently subpar returns. A decent track record, by itself, should never be the sole basis for a portfolio recommendation, but a consistently and systematically poor record relative to peers or a benchmark over an extended period of time may be cause for removing a manager from further consideration. Consistency through time, combined with some degree of persistence in delivering excess returns, is crucial in evaluating performance records since short-term performance of even the most skilled managers can be subpar, and even the worst managers can occasionally get lucky.

2. Actively managed options should play a role in a computer model advice program.

In the preamble, the Department also raises the question of whether, in the context of developing a computer advice model, the model should be limited to “consider[ing] only the historical risks and returns of different asset classes as a whole, information about participants, and the expenses and asset allocation of each investment option under the plan.” Presumably, by limiting a computer model to the consideration of only these factors, it would be difficult to compare actively managed funds in the same asset class (thus establishing a strong preference for index versus actively managed funds in an acceptable computer model).

While we are strong index management proponents and we believe there are big expense and predictability advantages with index funds, we also believe that there is clearly a role for actively managed funds in many participant portfolios. The issue comes down to the fact that there are different kinds of risks in active versus passive investing. While there are always some managers who outperform their peers or a benchmark, in hiring an active manager, an investor is always running a risk of underperformance.

What an investment model can do is attempt to analyze an active manager's past performance return patterns and other quantitative aspects of a portfolio to provide some, albeit imperfect, indication of what the future may hold for a particular actively managed investment. Under most conditions, the existence of manager skill is a statistical uncertainty, but that does not necessarily mean that it is right to assume that manager skill does not exist. It simply means that on the basis of that performance data alone, an investor cannot make a reliable

² See Bernard, Carole and Boyle, Phelim P., *Mr. Madoff's Amazing Returns: An Analysis of the Split-Strike Conversion Strategy* (May 14, 2009). Available at SSRN: <http://ssrn.com/abstract=1371320>

determination that the manager is adding value, and models can factor in additional information to help provide effective advice.

While past academic studies have tended to conclude that there is little evidence that active managers can reliably add value above their fees on a risk-adjusted basis versus their index benchmarks, the statistical properties of the distribution of manager returns are not consistent with the notion that value added is random, and there is still a vigorous debate of the issue among academics and professionals.³ Thus, in our view, the Department should avoid mandating criteria as a matter of public policy that would make it unnecessarily difficult to offer computer model advice on actively managed funds.

3. The Department should avoid attempting to define and mandate the criteria that will be considered consistent with generally accepted investment theories.

In the proposed rule's preamble, the Department asked about the level of specificity that should be in the regulation with respect to what models, methods, or procedures are consistent with "generally accepted investment theories." For example, the Department asked if the regulation should dictate the bases for model parameters such as the probability distribution of future returns to asset classes or particular investments.

In this regard, Vanguard's view is that it is *not* the role of regulators to dictate criteria or specific mechanisms for the provision of investment advice. There is, and has been for decades, great debate around the merits of various investment theories. The specific question raised in the preamble with respect to whether the Department should dictate a certain probability distribution of future returns to asset classes or particular investments is particularly revealing because there are huge differences of opinion in the investment community with respect to this question—not just around what "distribution" should be used in modeling, but how that distribution might change over time.

Rather than specifying the parameters or specific techniques that must be used to make recommendations, we favor rules that encourage transparency with respect to the methodology that is being used. Ultimately, the most important question is not what exact technique was applied to generate advised allocations or return predictions, but rather whether those calculations and predictions are performed in a way that is consistent only with the best interests of the advised client in mind. Specifying techniques is highly unlikely to ensure that this most important, overriding objective is met.

³ Recent entries with differing points of view in this debate include: [i] Fama, Eugene F. and French, Kenneth R., *Luck Versus Skill in the Cross Section of Mutual Fund Returns* (December 14, 2009). Tuck School of Business Working Paper No. 2009-56; Chicago Booth School of Business Research Paper; *Journal of Finance*, forthcoming. Available at SSRN: <http://ssrn.com/abstract=1356021>; and [ii] Kosowski, Robert, Timmerman, Allan G., Wermers, Russ R., and White, Jr., Halbert L., 2006, *Can Mutual Fund "Stars" Really pick Stocks? New Evidence from a Bootstrap Analysis*, *Journal of Finance*, Forthcoming 61, 2551-2595. Available at SSRN: <http://ssrn.com/abstract855425> or doi:10.2139/ssrn.414441

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The remainder of our comment letter will address certain legal and practical aspects of the Department's proposed rule.

4. The Department's affirmation of prior advice guidance will encourage the continued development and adoption of advice programs.

Plan participants need assistance in managing their investments, perhaps now more than ever before. Having come through the sharp declines and extreme volatility experienced by all investors in the economic downturn of 2008–2009, participants now seek to rebalance portfolios, rebuild accounts, and recover confidence that consistent, long-term savings and investment through employer-sponsored retirement plans will provide them with an avenue to retirement security.

Many participants now realize that they need to make better allocation decisions and exercise greater control over the investment of their accounts, yet they lack the knowledge and, all too often, the tools needed to match their investment allocations to their long-term goals. Professional investment advice can fill a critical gap for many investors and, through the proposed rule, the Department has taken a strong step toward ensuring that quality, expert advice is available to the greatest number of participants.

Importantly, the Department affirmed its view that nothing in the statutory prohibited transaction exemption or in the proposed rule invalidates or otherwise undermines programs established under prior Department guidance. Thus, plan sponsors and participants confidently may continue to utilize these well-established programs that already provide high-quality, cost-effective advice from qualified advisers.

5. The Department properly excluded compensation received by an affiliate of the fiduciary adviser from the fee-leveling requirement.

The proposed rule once again affirms the Department's conclusion that the fee-leveling requirement applies only to compensation received by the fiduciary adviser, as well as the fiduciary adviser's employees, agents, and registered representatives. As first noted by the Department in Field Assistance Bulletin 2007-01, the fee-leveling requirement does not reach to the compensation received by an affiliate of the fiduciary adviser.

We believe this interpretation is entirely consistent with the intent of Congress in adding these participant advice rules to ERISA. Indeed, as the Department noted in the Field Assistance Bulletin, "if the fees and compensation received by an affiliate of a fiduciary that provides investment advice do not vary or are offset against those received by the fiduciary for the provision of investment advice, no prohibited transaction would result solely by reason of providing investment advice and thus there would be no need for a prohibited transaction exemption."

This interpretation, combined with other safeguards under the proposed rule such as; (i) the adviser's acceptance of ERISA fiduciary responsibility for the advice provided; (ii) the performance of an annual audit by an independent auditor; and (iii) the provision of detailed participant disclosures with respect to material affiliations of and fees received by the adviser, will help to ensure that responsible and cost-effective advice programs will be available to participants through the advice provider selected and approved by their employer.

6. Description of available target-date or life-cycle funds is best provided with the initial advice disclosures and contemporaneous with the advice generated by a computer model.

Under the proposed rule, the Department requires that "contemporaneous with the provision of investment advice generated by a computer model," a participant must be furnished with a general description of any available target-date or life-cycle funds that are excluded from the advice recommendations. We wholeheartedly agree with the Department that participants should be made aware of these often lower-cost and simpler alternatives to an advice program.

However, we believe that it will be most effective if the disclosure describing target-date and life-cycle funds is provided **before** the participant and the fiduciary adviser have gone through all the steps necessary for the provision of advice (including solicitation and consideration of the participant's information relating to age, time horizons, risk tolerance, current investments, other assets, or sources of income and investment preferences). This will allow the participant sufficient time to consider the target-date or life-cycle fund alternative to an advice program.

As such, we suggest that the Department require, both as part of the initial disclosures required to be furnished when an investment adviser is engaged (as outlined in paragraph (b)(7) of section 2550.408g-1 of the proposed rule) and then contemporaneous with the provision of the computer model investment advice, the participant be furnished with a general description of available target-date or life-cycle funds and how they operate.

7. Advice for IRA investors should not be required to model the entire universe of investment options.

The Department notes in the preamble to the proposed rule that its explanation of provisions in the preambles to the prior proposed and withdrawn final rule should be read as applicable to the new proposed rule. We encourage the Department when it issues the final rule to affirmatively restate comments made in the January 2009 preamble to the withdrawn final rule regarding advice for IRA beneficiaries.

In the January 2009 preamble, the Department noted that it is not reasonable to expect that all computer models will be capable of modeling the universe of investment options. Such models may focus on investments available through the IRA, while accommodating "hold"

and "sell" recommendations for investments not available through the IRA, provided that the IRA beneficiary is fully informed of the model's limitations in advance of the recommendations, thereby enabling the recipient of the advice to assess the usefulness of the recommendations.

Many of our IRA clients come to Vanguard because they approve of our fundamental investment and business principles and thus they expect that we will be advising them within the available universe of Vanguard investment options. Vanguard strongly believes that the Department should permit IRA holders to preselect the funds to which the advice arrangement will apply in the same way that a plan fiduciary selects the menu of investment options within a plan.

8. The Department should create a self-correction program for nonsubstantial operational failures.

As we have in our prior comments to the Department on the advice exemption, Vanguard encourages the Department to consider a self-correction approach for instances of noncompliance if the fiduciary adviser has made a good faith effort to comply with the requirements for eligible investment advice arrangements and any failure to do so is not substantial. The Department has retained the requirement that audit reports disclosing failures must be submitted to the Department, and we remain hopeful that the Department will utilize the information received in these reports as a basis for creating a self-correction program.

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Vanguard appreciates the opportunity to submit these comments and we would welcome the opportunity to continue working with the Department if we can be of additional assistance. If there are any aspects of our comments that you would like to explore in greater detail, please do not hesitate to contact Ann Combs at 610-503-6305 or Dennis Simmons at 610-669-4065.

Sincerely,



R. Gregory Barton



George U. Sauter