Law Professor Goes Postal

By Editor Test *Fri, Jul 26, 2013*

Yale law professor Ian Ayres sent a provocative letter to thousands of plan sponsors. But his research is more temperate than his mail.

While *Retirement Income Journal* was publishing its story on 401(k) fee litigation ("Measuring You for an ERISA Suit," June 26), a Yale Law School professor apparently went postal and mailed letters to thousands of plan sponsors warning them that their investment fees were too high and hinting at dire consequences.

Dozens of plan sponsors subsequently picked up their smartphones and called their plan advisor or their ERISA attorneys, setting off an ever-widening ripple of anguish that culminated in indignant responses from the leaders of associations that represent the retirement industry. BrightScope, whose 401(k) fee data the professor used in his analyses of plan fees, denied complicity with him.

Samples of the signed letters sent by Ian Ayres, the law professor, are available here. Yale Law School reportedly confirmed their existence to media outlets. Ayres' voicemail box was full when I called his number. He hasn't answered an email I sent.

On the Internet, however, I obtained a draft of relevant research by Ayres and Quinn Curtis, a professor at the University of Virginia Law School. Its tone wasn't nearly as provocative as the letters supposedly were. Its conclusions, while interesting, shouldn't surprise anyone familiar with the ongoing debate about whether some 401(k) participants are paying too much plan services, through hidden investment fees, and that the fees substantially reduce their retirement accumulations over the course of their careers.

The undated monograph, "Measuring Fiduciary and Investor Losses in 401(k) Plans," still in draft form, claims to be the "first study to measure, within a unified framework, the relative costs investors of limited investment menus, fund- and plan-level expenses, and investor allocation mistakes."

In short, Ayres and Curtis tried to identify and weigh the causes of poor participant returns: faulty plan design and excess fees ("fiduciary losses"), or participant errors in portfolio choice or trading ("investor error").

To me, this would seem almost as difficult a task as determining, after scooping a bucket of water from the Mississippi River at New Orleans, whether that water originated from the Missouri, Ohio, Arkansas or Red Rivers, or perhaps even from Lake Itasca in northern Minnesota. But that's what regression analysis is supposedly all about.

After sifting through the paper, I extracted these salient quotes:

- "Fiduciary losses are smaller than investor losses on average, comprising 7.7% (68 basis points) of optimal excess returns compared to 13.3% (116 bps) for investor losses."
- "We also decompose [fiduciary] losses into the relative proportion of losses which come from

excessive fees and from insufficient diversified allocations, and find that excess fees represent more than 60%."

- "Taken together, these losses consume about 20% of the optimal risk premium."
- "While adding index fund options would benefit most plans, eliminating poor choices would also be a powerful palliative, and our regressions suggesting elimination of poor funds might be a more effective strategy than adding good ones."
- "If fiduciaries adapt their menus to accommodate well-understood investor behavioral biases, investor outcomes may be improved."
- "Large plans have lower fiduciary losses than small plans, but there is substantial variation in plan quality independent of plan size."
- "The results of this study suggest that improving fiduciary decision-making may prove a more tractable problem than educating millions of investors, particularly in light of fiduciaries' duty of prudence."
- We find evidence that a substantial majority of funds could reduce total losses by (i) offering additional lower-fee index funds, (ii) not offering funds with high fees."

Shocking would be the wrong word to describe these results and recommendations, if I'm interpreting the paper accurately. It comes to the common-sense conclusions that more plans should include more index funds and that it will be a lot easier to try to change the behavior of a relatively limited number of plan sponsors than to try to educate millions of participants. Not much controversy there.

The authors of the paper briefly visit the highly charged issue of revenue-sharing. They compare plans where sponsors pay directly for plan services with those where the cost of services is built into the fund fees.

They found that "the amount of direct compensation is associated with an increase in the fraction of index funds offered. Fee loss is also lower as direct compensation to investment advisors increases. The number of funds in the plan is also decreasing in direct compensation, an interesting result in light of the finding… that plans with more funds are associated with higher investor losses."

Again, no surprise. You would expect an inverse relationship between revenue-sharing and index funds. Overall, the Ayres-Curtis paper seemed to have something reasonably useful to say. It would be a shame if its substance is lost in the furor over Ayres' evidently unreasonable letter.

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