Conflicted Financial Advice Hurts IRA Investors

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MarketWatch Blog by Alicia H. Munnell

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Critique of Council of Economic Advisers report is off base.

A **recent report** by the President's Council of Economic Advisers (CEA) highlighted the costs of conflicted investment advice. It estimated that of the $7 trillion invested in IRAs, $1.7 trillion is invested in products that involve conflicts of interest between the investor and the advisor. For example, two index tracker funds may provide identical pre-expense returns, yet one may provide a kickback to the advisor, lowering the return to the investor. As long as the higher cost fund passes the suitability test, the advisor can put the household in the high-cost fund and pocket the kickback. The CEA report estimates that such arrangements reduce returns by one percent a year, a total of $17 billion. One percent a year may not sound like a lot, but it cumulates over time, reducing retirement income by an estimated 25 percent.

Eliminating these conflicts of interest would obviously reduce securities industry profits. But this concern would not carry much weight with lawmakers. To forestall reform, the industry needs to show that: 1) the calculations ignore the value of the advice provided by brokers to investors;

2) reform would result in investors losing access to this advice; and 3) in any case, the report has got its numbers wrong.

The securities industry asked NERA Economic Consulting to analyze the report. The **NERA analysis** repeats the industry claim that brokers provide valuable advice. This claim may or may not be true – the NERA analysis offers no real evidence. And even if true, it only matters if one believes that reform is going to decrease the availability of that advice. The NERA analysis provides no real evidence on this latter point, beyond drawing parallels with radical U.K. reforms and making the unsubstantiated claim that reform will raise costs and thus make it unprofitable for advisors to service low-wealth households. I think that, if anything, plausible reforms will increase the availability of advice. Many low-wealth households are wary of dealing with financial advisors, often with good reason. Any reform that increases the perceived trustworthiness of advisors will reduce the time involved in establishing trust, which is a significant cost of doing business.

The NERA analysis critiques the substantial academic literature cited in the CEA study. NERA emphasizes that some broker-sold funds outperform their direct-sold equivalents and that models explain only a small part of the variation in fund performance. Both of these points are true but irrelevant. Some broker-sold funds outperform both market indices and their direct-sold peers. But it is next to impossible to identify those funds in advance. Consistent with the efficient market hypothesis, the higher fees associated with broker-sold funds lead to lower, not higher returns, net of fees.

The NERA analysis reproduces Investment Company Institute data showing that mutual fund fees have declined in recent years. This point is also true but irrelevant. The concern highlighted by the CEA report is with the impact on fees of conflicted investment advice, not the level of fees in general. The

NERA analysis provides no evidence of a decline in the additional fees resulting from conflicted advice, or that market forces will reduce the size of the problem.

The NERA analysis argues that one needs to carefully weigh the costs and benefits of any reform. I agree. But only when there *are* both costs and benefits. I see only benefits. The discussion should focus not on whether reform is desirable, but on how to maximize the benefits. The financial security of American households depends on it.