Volume Title: Explorations in the Economics of Aging

Volume Author/Editor: David A. Wise, editor

Volume Publisher: University of Chicago Press

Volume ISBN: 0-226-90337-0
ISBN13: 978-0-226-90337-8

Volume URL: http://www.nber.org/books/wise09-2

Conference Date: May 2009

Publication Date: March 2011

Chapter Title: Comment on "How Does Simplified Disclosure Affect Individuals' Mutual Fund Choices?"

Chapter Authors: Steven F. Venti

Chapter URL: http://www.nber.org/chapters/c11934

Chapter pages in book: (96 - 98)

References

Barber, B. M., T. Odean, and L. Zheng. 2005. Out of sight, out of mind: The effects of expenses on mutual fund flows. *Journal of Business* 78 (6): 2095–119.

Benartzi, S., and R. H. Thaler. 1999. Risk aversion or myopia? Choices in repeated gambles and retirement investments. *Management Science* 45:364–81.

———. 2001. Naïve diversification strategies in defined contribution saving plans. *American Economic Review* 90:79–98.

Choi, J. J., D. Laibson, and B. C. Madrian. 2010. Why does the law of one price fail? An experiment on index mutual funds. *Review of Financial Studies* 23: 1405–32.

Cronqvist, H. 2006. Advertising and portfolio choice. Ohio State University. Working Paper.

Elton, E., M. Gruber, and J. Busse. 2004. Are investors rational: Choices among index funds. *Journal of Finance* 59:261–88.

Investment Company Institute. 2006. *Understanding investor preferences for mutual fund information.* Washington, DC: Investment Company Institute.

Kozup, J., E. Howlett, and M. Pagano. 2008. The effects of summary information on consumer perceptions of mutual fund characteristics. *Journal of Consumer Affairs* 42:37–59.

Lusardi, A., P. A. Keller, and A. M. Keller. 2009. New ways to make people save: A social marketing approach. In *Overcoming the saving slump: How to increase the effectiveness of financial education and saving programs,* ed. A. Lusardi, 209–36. Chicago: University of Chicago Press.

Comment

Steven F. Venti

Beshears, Choi, Laibson, and Madrian have produced a series of influential and insightful studies that evaluate how often-neglected features of pension design affect saving and enrollment decisions. This chapter continues that tradition. It provides an experimental evaluation of the effectiveness of the Summary Prospectus (SP), a shortened and simplified document made available to investors. The experiment is well-designed and executed. The results show no direct effect of the SP on portfolio returns, suggesting that the summary prospectus saves time but does not lead to better investment choices. This result may not, for reasons noted later, be unexpected. Perhaps more surprising and of broader interest is what the experimental results say about the information investors consider, how investors use this information, how indecisive investors are, and how sensitive their portfolio choices are to seemingly irrelevant features of the choice environment.

Thirty years ago most workers participating in private pension plans could look forward to receiving benefits in the form of an annuity that depended

Steven F. Venti is the DeWalt Ankeny Professor of Economic Policy and professor of economics at Dartmouth College, and a research associate of the National Bureau of Economic Research.

on their earnings history and years of service. Today over 80 percent of retirement "saving" is through 401(k) and IRA plans. The payout from these plans depends on the investment choices made by the plan participant. There is much concern that participants are not making good choices. Campbell (2006) finds that the poor and less educated often make "significant" mistakes in their portfolio allocations. Mottola and Utkus (2008) find that about 30 percent of all investors make "egregious" portfolio errors that any reasonable financial planner would find objectionable. These include the failure to diversify, overinvestment in company stock, zero investment in equities, and ignoring fees, expenses, and loads when choosing funds.

One possible way to help investors make better choices is to simplify the information they use to make retirement saving decisions. The SEC has done this by adopting a new Summary Prospectus to be distributed by mutual funds. The SP is certainly much shorter than the statutory prospectus and may be simplified, but it is still not simple. It contains investment jargon, numerical examples, and graphs that some readers will surely find demanding. Moreover, some basic knowledge of financial reporting is required to understand whether, for example, the returns reported in the document are net or gross of fees, loads, and other expenses. Nonetheless, the SP is shorter that the other documents available to the investor—which should increase the likelihood that it is read—and the SP pulls together in one place the relevant information that could otherwise only be obtained by consulting multiple documents.

Should we be surprised that this simplified document does not help investors make better (higher return) decisions? I suspect that most real-world investors do not even read the SP. Most are restricted by their retirement plan to select from a single fund family so fund style (identified by fund name) may be all the information they need. If they do read the SP, it is not clear that the information contained in the document can help make better decisions. Information on fees and expenses is clearly helpful, but information on past returns, investment objectives, principal risks, the identity of the fund manager, and so forth, may be of little value. In particular, "returns since inception" is not useful to compare funds with different inception dates.

It could, however, be the case that in the real world the SP is effective but the experiment is incapable of detecting its effect. In the experiment the sample size is small and the participants are more highly educated than the general population. Moreover, investors are playing for very small stakes in the experiment. There is little motivation for investors to acquire financial knowledge when the scale of investment is so small. Also, the menu choices are very similar—all are large cap managed funds in the experiment using equities. Careful study of the SP may improve decisions when the investor has to choose between funds that are highly dissimilar along important dimensions—for example, domestic versus international, large cap versus small cap, or managed versus index.

The most surprising results have to do with investor responses to fees. If

I wanted to design an experiment just to test investor sensitivity to fees and loads, this would be it. The front-end loads vary from 1.75 percent to 5.75 percent, the back-end loads are zero or 1 percent depending on the holding period, and there is considerable variation in fees among funds. Given how little variation there is in fund style and the short time horizon, fees and loads should be the dominant consideration in investor decisions. The most striking finding in this chapter is that fees and loads do not matter. Why this is so is an open question. Are fees and loads just too complicated for investors to understand? Are investors so focused on past performance that they ignore fees and loads? When asked, investors say that past performance is the most important factor in their decision. Fees, expenses, and loads are the *sixth* most important factor—less important than the "quality of documents explaining the mutual fund." I find this behavior fascinating and worthy of further study.

More generally, the experimental results and follow-up interview suggest that even these relatively educated investors have a poor understanding of financial concepts and find financial decision making difficult. Only 20 percent know what securities are held by a money market mutual fund. Fifty percent say they are "less than confident" or "not at all confident" that they have made the right investment choices and 50 percent say they would be "very likely" to change their portfolio allocation if they consulted a financial advisor. These responses paint a picture of the investor as indecisive and loosely committed to his or her investment choices and thus easily influenced by extraneous factors (framing, document design, etc.) that in an ideal world would have little effect on investment choices.

In sum, Beshears, Choi, Laibson, and Madrian have once again provided valuable evidence on how frequently neglected features of the pension system affect the choices investors make. They show that the Summary Prospectus allows retirement plan participants to make faster decisions, but not better decisions. A more striking finding is the puzzling irrelevance of fees, loads, and expenses in investor decisions and how fragile these decisions are. Both results imply that a great deal of care should be taken in the design of materials provided to investors. For example, the findings suggest that reframing the prospectus to focus more on fees and loads and less on past returns may lead to "better" decisions. I will look forward to more experimental evidence on how the design and content of these documents can affect investment choices.

References

Campbell, J. Y. 2006. Household finance. *Journal of Finance* LXI (4): 1553–604.

Mottola, G. R., and S. P. Utkus. 2008. Red, yellow, and green: Measuring the quality of 401(k) portfolio choices. In *Overcoming the saving slump,* ed. A. Lusardi, 119–39. Chicago: University of Chicago Press.