Retirement investment fund conflicts cost Americans

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As retirement funds have shifted from defined benefit to defined contribution, Americans are required to directly manage their own retirement plans for which good investment advice is essential.

To ensure that investors receive sound investment advice, the U.S. Department of Labor recently adopted a new rule that subjects brokers and investment advisers to a higher fiduciary standard—they must recommend investment products with the "best interest" of the beneficiaries in mind.

While laudable, the new rule fails to address two big remaining problems with the current system—conflicts of interest and a lack of transparency, according to University of Michigan researchers.

Conflicts of interest arise when advisers receive fees from investment sponsors that create an incentive to recommend investments that are not necessarily in the best interest of the beneficiaries. Their research finds that when such conflicts of interest exist in defined benefit plans (because the executive of the firm is also a fiduciary), trading decisions by these plans hurt beneficiaries.

We need to learn from the experience of defined benefit plans and proactively prevent conflicts of interest in defined contribution plans, said Nejat Seyhun, professor of finance at U-M's Ross School of Business. These conflicts are costing Americans roughly 12 percent of their retirement funds, he added.

Seyhun and colleagues M.P. Narayanan and S. Burcu Avci also found a third major issue—the funds often perform poorly giving retirees even less in retirement.

The current rule also permits proprietary products in the retirement portfolio. These products can include combinations of stocks, bonds and derivatives; investments in startups and other private investment vehicles; or investments in assets such as forests, mines or works of art. The key feature of proprietary investments is that they are unique to the financial institution offering them.

Consequently, there is little or no historical performance or risk data, and the information about them is limited to what the sponsor provides. Their research demonstrates that such products often provide inferior return for the risk they entail.

"As they stand, the current investment advisory rules are deeply flawed," said Narayanan, professor of finance. "They suffer from internal conflicts since they require that investment advisers act in the best interest of the beneficiaries yet they allow them to receive income from third parties. The conflict problem is compounded by allowing proprietary products that lack transparency in retirement portfolios."

Add to that, many Americans either aren't saving anything or have less than $10,000 in their retirement accounts. And those who do contribute toward their retirement funds are then subjected to a system that doesn't require investment advice to be in their best interest.

"Clearly, the current defined contribution plans for retirement savings are not working very well for the typical American," Seyhun said.

Avci said they recommend the following changes to the policies:

- Prohibit third-party income. Investment advisers should serve only one master—the investor.
- Disallow proprietary investment vehicles. These vehicles often have complex features that are difficult for the average investor to understand and analyze. Proprietary investment products are also likely to involve higher transaction costs and underperform.
- Permit only passive index funds with broadly diversified portfolios be given the tax exempt status of retirement contributions.

"Conflicted advice promotes investment options that are profitable for the brokerage firms, and tend to be underperforming, overly costly and undiversified from the beneficiary's perspective," Avci said.

Provided by University of Michigan

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