

No. 08-586

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IN THE  
**Supreme Court of the United States**

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JERRY N. JONES, MARY F. JONES,  
AND ARLINE WINERMAN,  
*Petitioners,*

v.

HARRIS ASSOCIATES L.P.,  
*Respondent.*

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**On Writ of Certiorari  
to the United States Court of Appeals  
for the Seventh Circuit**

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**BRIEF OF ROBERT LITAN, JOSEPH MASON,  
AND IAN AYRES AS *AMICI CURIAE*  
SUPPORTING PETITIONERS**

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June 17, 2009

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## INTERESTS OF *AMICI CURIAE*<sup>1</sup>

*Amici* are professors and academics who teach and write on financial economics. *Amici* wish to ensure that the Court properly assesses the limits of market forces in the mutual fund industry in deciding *Jones et al. v. Harris Associates*. *Amici* have no stake in the outcome of this case. They are filing this brief solely as individuals and not on behalf of the institutions with which they are affiliated.

Robert E. Litan is a Vice President for Research and Policy at the Kauffman Foundation in Kansas City, and a Senior Fellow in Economic Studies at the Brookings Institution. At Kauffman, Dr. Litan oversees a multi-million budget for academic research relating to entrepreneurship. At Brookings, Dr. Litan pursues a wide-ranging research agenda, which includes topics in regulation, financial institutions, telecommunications, and general economic policy. Dr. Litan has been a lecturer in banking law at the Yale Law School, consulted for numerous public and private organizations, and testified as an expert witness in a variety of legal and regulatory proceedings involving domestic (banking, antitrust) and international (primarily trade) issues. He also consulted for private sector firms and the Department of Justice on antitrust matters. Dr. Litan also has recently co-authored a book on the mutual fund

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1. No counsel for any party has authored this brief in whole or in part, and no person or entity other than *amici curiae* or their counsel has made a monetary contribution to the preparation or submission of this brief. *See* Sup. Ct. R. 37.6. Counsel for petitioners filed a letter with the Clerk granting blanket consent to the filing of *amicus* briefs, and a letter reflecting the consent of respondent to the filing of this brief has been filed with the Clerk. *See id.*

industry titled *Competitive Equity: A Better Way to Organize Mutual Funds*, which was published in 2007. Dr. Litan also has served in several capacities in the federal government. During 1995 and 1996, he was Associate Director of the Office of Management and Budget (where he was responsible for overseeing budgetary and other policies of six cabinet agencies). From 1993 to 1995, he was Deputy Assistant Attorney General, in charge of civil antitrust litigation and regulatory issues, at the Department of Justice. From 1977 to 1979, he was the regulatory and legal staff specialist at the President's Council of Economic Advisers. In the early 1990s, Dr. Litan was a Member of the Commission on the Causes of the Savings and Loan Crisis. During his career, Dr. Litan has authored or co-authored over 20 books, edited another 14, and authored or co-authored over 200 articles in journals, magazines, and newspapers on a broad range of public policy issues. Dr. Litan received his B.S. in Economics, summa cum laude, from the Wharton School of Finance at the University of Pennsylvania; his J.D. from Yale Law School; and both his M. Phil. and Ph.D. in Economics from Yale University.

Joseph R. Mason is the Moyse/LBA Chair of Banking at the Ourso School of Business at Louisiana State University, and Senior Fellow at the Wharton School. Dr. Mason's academic research focuses primarily on investigating liquidity in thinly-traded assets and illiquid market conditions. Current academic research projects analyze default risk, including both immediate and cross-default risk, and default resolution costs in the contexts of asset-backed securities, in systemic and non-systemic environments, as well as the efficacy of bailout and

resolution policies through the history of financial markets. His research and economic commentary has received hundreds of national and international press citations in publications such as the *Wall Street Journal*, *New York Times*, *Washington Times*, the *Economist*, *Financial Times*, *Barrons*, *Business Week*, *die Zeit*, *Neue Zürcher Zeitung*, *Financial Times-Germany*, *Los Echos*, *Forbes*, *Fortune*, *Portfolio Magazine*, *Bloomberg Magazine*, *American Banker*, and on press syndicates such as Associated Press, Reuters, Bloomberg, KnightRidder, and MarketWatch-Dow Jones Newswire. Dr. Mason received a B.S. in economics from Arizona State University in 1990 and a Ph.D. from the University of Illinois in 1996.

Ian Ayres is the William K. Townsend Professor at Yale Law School and a Professor at Yale's School of Management. He has been ranked as one of the most prolific and most-cited law professors of his generation. Professor Ayres is a columnist for *Forbes* magazine and writes for the *New York Times'* Freakonomics Blog. He has been a commentator on public radio's Marketplace. His research has been featured on Primetime Live, Oprah, and Good Morning America and in *Time* and *Vogue* magazines. He currently is the editor of the *Journal of Law, Economics and Organization*. Professor Ayres clerked for the Honorable James K. Logan of the Tenth Circuit Court of Appeals. He has previously taught at Illinois, Northwestern, Stanford, and Virginia law schools and has been a research fellow of the American Bar Foundation. In 2006, he was elected to the American Academy of Arts and Sciences. His book with Gregory Klass, *Insincere Promises: The Law of Misrepresented Intent*, won the 2006 Scribes book award "for the best work of legal scholarship

published during the previous year.” Professor Ayres has published 9 books and over 100 articles on a wide range of topics. In 2007, he published *Super Crunchers: Why Thinking-By-Numbers is the New Way to be Smart*. In the spring 2005, he published three books, *Straightforward: How to Mobilize Heterosexual Support for Gay Rights* (Princeton University Press 2005) (with Jennifer Gerarda Brown); *Optional Law: The Structure of Legal Entitlements* (University of Chicago Press 2005); and *Insincere Promises: The Law of Misrepresented Intent* (Yale University Press 2005) (with Gregory Klass). He also is the author of *Why Not?: How to Use Everyday Ingenuity to Solve Problems Big and Small* (2003) (with Barry Nalebuff); *Voting with Dollars: A New Paradigm for Campaign Finance* (2002) (with Bruce Ackerman); and *Pervasive Prejudice?: Non-Traditional Evidence of Race and Gender Discrimination* (2001). His two most cited articles are *Fair Driving: Gender and Race Discrimination in Retail Car Negotiations*, 104 *Harvard Law Review* 817 (1991), and *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 *Yale Law Journal* 87 (1989) (with Robert Gertner). He is the author of several empirical studies: *Does Affirmative Action Reduce the Number of Black Lawyers?*, 57 *Stanford Law Review* 1807 (2005) (with Richard Brooks); *To Insure Prejudice: Racial Disparities in Taxicab Tipping*, 114 *Yale Law Journal* 1613 (2005) (with Fred Vars and Nasser Zakariya); *A Separate Crime of Reckless Sex*, 72 *University of Chicago Law Review* 599 (2005) (with Katharine Baker); *Shooting Down the More Guns, Less Crime Hypothesis*, 55 *Stanford Law Review* 1193 (2003) (with John J. Donohue III); *Measuring the Positive Externalities from Unobservable Victim Precaution: An Empirical*

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#### SUMMARY OF ARGUMENT

For at least two reasons, market forces cannot be relied upon to constrain the fees charged by mutual funds to competitive levels. *First*, recent discoveries in the behavioral finance literature reveal that the vast majority of investors cannot accurately assess the quality of the mutual funds in which they invest—that is, they do not behave rationally as predicted by economic models. Problems such as “misperceptions of chance,” “sample-size neglect,” “loss aversion,” and “mental accounting” render the assessment of mutual fund performance extremely difficult for investors. Accordingly, the proposition that mutual fund investors will simply “fire” their advisers by “redeeming their shares and investing their assets elsewhere” ignores these natural impediments to competition.

*Second*, even if investors were purely rational, the mutual fund industry would still exhibit symptoms

of market failure due to what economists call “information costs.” As demonstrated below, there is substantial evidence that the vast majority of mutual fund investors lack essential information necessary for them to make informed decisions. And the economic literature confirms that mutual funds have been effective in hiding their costs from investors. For example, certain funds provide fees in a fragmented fashion, where returns are reported before some fees and after others. Because many funds are held pursuant to a retirement plan such as 401(k), consumers do not fastidiously monitor fund fees. Combined with the cognitive-behavioral characteristics inherent to human beings described above, these information costs prevent fees from falling to efficient levels.

In light of these two impediments to efficient outcomes, the relevant question for an economist is how best to regulate fees in the mutual fund industry. We are reluctant to embrace price controls established through regulatory agencies. Regulators have been shown to be particularly bad at setting prices or avoiding capture by interested parties, especially in the absence of a natural monopoly. A better approach is to expose the few bad actors in the profession to legal liability.

We understand that the legal question raised in this matter is whether, when searching for a competitive “benchmark” rate, evidence of fees paid by comparable mutual funds should be given significant weight. For reasons we describe below, we do not believe such fees serve as a reliable benchmark; they will tend to be affected by the same forces that inflate defendant’s fees. We advocate instead the use of fees set in the market for advisory

services to unaffiliated institutional clients, such as those paid to pension fund managers.

## **ARGUMENT**

### **I. MARKET FORCES CANNOT BE RELIED UPON TO CONSTRAIN MUTUAL FUND FEES TO COMPETITIVE LEVELS**

An essential foundation of the general economic conclusion that competition will discipline prices is that consumers in the market are well informed and make decisions that advance their self-interested, economic goals. The faster consumers detect low-quality products, the faster the market delivers high-quality products, ensuring efficient pricing. Although economic theory predicts that consumers will react to supra-competitive pricing by substituting their consumption to more reasonably priced alternatives, in the absence of reliable quality information, such substitution will not occur. Consequently, the normally effective market mechanism will not reliably bring prices in line with costs.

In the majority of markets, product quality information will be readily observable. Even in cases where product quality is not immediately apparent to consumers, the detection of poor quality products will be sufficiently likely that rational firms will price efficiently to avoid backlash and prevent the deterioration of their brand. However, when the observation of product quality is highly complex and detection of poor quality is difficult, real-world markets will fail to protect consumers from supra-competitive prices. As we discuss below, the structure and performance of the market for the financial services supplied by mutual funds indicate that the

normally reliable competitive mechanism has not engendered efficient pricing.

**A. The Behavior of Investors Creates an Environment Where Competition May Not Protect Investors from Excessive Fees**

The vast majority of investors cannot accurately assess the quality of the mutual funds in which they invest. That task is rendered extremely difficult by certain cognitive processes inherent to human beings. Beginning in the 1970s, economists and psychologists began to explore how psychological factors affected economic behavior. These initial researchers found that certain cognitive structures in the human mind caused people's behavior in the financial markets to deviate from what economists suspected rational actors would do. In the ensuing decades, the field now known as "behavioral economics" has come to be an enormously important field of economic research.<sup>2</sup> Its findings are highly relevant here as there are a number of extremely well-documented cognitive anomalies intrinsic in human behavior, which prevent individual investors from creating the competitive conditions necessary to induce mutual fund advisers to price commensurately with their performance. These cognitive anomalies combined with the inherently volatile nature of financial investments render it nearly impossible for the vast majority of investors to assess the price-adjusted quality of mutual funds.

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2. The application of behavioral economics to the study of finance is called behavioral finance. See Justin Fox, *The Myth of the Rational Market: A History of Risk, Reward, and Delusion on Wall Street* (Harper Business 2009).

One of the key problems facing mutual fund investors is the difficulty of making predictions about the fee-adjusted performance of a fund they are considering. Research in behavioral economics has demonstrated that people have an inherently poor grasp of probability. Early studies in the field demonstrated that, even in situations where the probabilities of an event could be easily calculated, people showed very little understanding of what those probabilities actually meant. As Daniel Kahneman, who won the Nobel Prize for Economics in 2002, and his frequent co-author Amos Tversky observed in an early paper, the vast majority of people are under the impression that, if a roulette wheel has repeatedly hit black, then red is somehow due. They explained these “misperceptions of chance” as follows: “Chance is commonly viewed as a self-correcting process in which a deviation in one direction induces a deviation in the opposite direction to restore the equilibrium.” Amos Tversky & Daniel Kahneman, *Judgment under Uncertainty: Heuristics and Biases*, 185 *Science* 1124, 1125 (1974). This phenomenon is highly relevant to the evaluation of fund management performance because, even if some fund managers exhibit skill in their stock selection, their year-to-year returns will be highly influenced by probabilistic events—that is, the random fluctuations inherent to the stock market. Investors face an incredibly difficult task in discerning whether their money is being managed well. Such an assessment requires investors to distinguish whether the returns they observe are due to the skill of their advisers or to random chance. This challenge is complicated by the fact that the concept of probability is so hard to grasp in and of itself.

Another related problem that renders the assessment of mutual fund performance difficult for investors is what has been termed “sample-size neglect.” This cognitive process results in people concluding that “[s]ix tosses of a coin resulting in three heads and three tails are as representative of a fair coin as 500 heads and 500 tails are in a total of 1000 tosses.” Nicholas Barberis & Richard Thaler, *A Survey of Behavioral Finance*, NBER Working Paper No. 9222, at 13 (Sept. 2002). Sample-size neglect means that investors will be far too likely to consider a few years of above-average mutual fund performance evidence of managerial skill when in reality it has been driven by the random fluctuations inherent to the stock market. In fact, the link between sample-size neglect and misinterpretation of the performance of financial analysts has been directly recognized in the economic literature.<sup>3</sup>

In addition to cognitive biases that make the assessment of mutual fund quality a difficult if not intractable problem, the literature has identified a series of human behavioral characteristics that create substantial consumer inertia. One cognitive process that creates consumer inertia is known as “loss aversion.” Loss aversion refers to the finding by behavioral economists that people find a proportionate loss more painful than they find a proportionate gain satisfying. *See* Daniel Kahneman,

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3. *See* Barberis & Thaler, *supra*, at 11 (“Sample size neglect means that in case where people do not initially know the data-generating process, they will tend to infer it too quickly on the basis of a few data points. For instance, they will come to believe that a financial analyst with four good stock picks is talented because four successes are not representative of a bad or mediocre analyst.”).

Jack L. Knetsch & Richard H. Thaler, *The Endowment Effect, Loss Aversion, and Status Quo Bias*, 5 J. Econ. Persp. 193, 194 (1991). Loss aversion is highly relevant because it means that mutual fund investors may be unwilling to react to poor performance, even if they identify it. Thus, the proposition that mutual fund investors will simply “fire” their advisers by “redeeming their shares and investing their assets elsewhere,” as two defenders of the mutual fund industry recently asserted, ignores these natural impediments to competition. See John C. Coates IV & R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 J. Corp. L. 151, 160 (2007).<sup>4</sup> Due to the inherent difficulty investors face in evaluating the decisions of their money managers, it is simply not true that mutual investors will generally be able to identify a better investment option. Without well-informed consumers switching funds as punishment for poor performance, the market mechanism will not effectively push mutual fund advisory prices towards cost.

Furthermore, the inertia created by loss aversion is exacerbated by other related behavioral phenomena. A cognitive process that is particularly relevant to

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4. Coates and Hubbard purport to demonstrate this “elasticity” or responsiveness to high prices by estimating a negative relationship between a fund’s fees and a fund’s market share. But the authors themselves noted that there is no variation in individual fund fees, which implies that they could not analyze the effect of fees on the *change* in a fund’s market share. Accordingly, their results merely show that, in a time of overall market expansion (1998 to 2004), lower-cost funds outperformed higher-cost funds. Even taking their results at face value, they provide no evidence that fees have been disciplined by competitive forces.

the lack of price competition in the mutual fund industry is known as “mental accounting” and was introduced to the economic lexicon in a seminal paper in 1985 by the prominent University of Chicago economist, Richard Thaler. Mental accounting refers to the propensity of people to treat individual bank accounts or investments separately from other sources of wealth. See Barberis & Thaler, *supra*, at 19. The result of this behavioral characteristic is that investors will not consider their financial investments in terms of an aggregate portfolio of investments as traditional financial economics assumes; instead, investors show a propensity for segregating their portfolios based on the principle of limiting their disutility from losses, exacerbating the effects of misperceptions of chance, sample-size neglect, and loss-aversion. Studies have confirmed that investors have a propensity to “sell winners too early and hold losers too long.” Hersh Shefrin & Meir Statman, *The Disposition to Sell Winners Too Early and Ride Losers Too Long: Theory and Evidence*, 40 J. Fin. 777, 788 (1985); see Terrance Odean, *Are Investors Reluctant to Realize Their Losses?*, 53 J. Fin. 1775, 1795-97 (1998).

#### **B. Limited Information About Fees Precludes Investors from Making Informed Decisions**

Many of the cognitive processes discussed above suggest that the market failures in the mutual funds industry are caused by deviation from what is generally considered rational behavior in economics. Even if investors were purely rational, however, the mutual fund industry would still exhibit symptoms of market failure due to what economists call “information costs”—that is, the cost incurred by investors to overcome deficiencies in the information

provided by mutual funds. For example, some funds report fees in a fractured and segmented manner, which exacerbates the cognitive-behavioral issues described above.

There is substantial evidence that the vast majority of mutual fund investors lack essential information necessary for them to make informed decisions. For instance, the Securities and Exchange Commission (“SEC”) recognized this information gap as an ongoing problem in a 2004 rule-making announcement.<sup>5</sup> The General Accounting Office (“GAO”) also concluded that mutual fund investors would benefit from additional information about their advisers’ fees. GAO, *Mutual Fund Fees: Additional Disclosure Could Encourage Price Competition* 7 (June 2000). Similarly, a survey conducted by International Communications Research for a recent

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5. See SEC, Final Rule, Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies, 69 Fed. Reg. 11244, 11245 (Mar. 9, 2004) (“Despite these ongoing efforts, the degree to which investors understand mutual fund fees and expenses remains a source of concern. Mutual fund fees are of two types, transactional (*e.g.*, sales loads, redemption fees) and ongoing (*e.g.*, asset-based charges such as management fees and 12b-1 fees). While transactional fees are relatively transparent, ongoing fees are less evident because they are deducted from fund assets and are reflected in reduced account balances rather than being separately stated. Significant concerns have been raised regarding the degree to which investors understand the nature and effect of these ongoing fees. These ongoing fees can have a dramatic effect on an investor’s return. A 1% annual fee, for example, will reduce an ending account balance by 18% on an investment held for 20 years. In December 2002, we proposed amendments intended to address these concerns, that would require a registered open-end management investment company to include in its shareholder reports disclosure of fund expenses borne by shareholders during the reporting period.”) (footnotes omitted).

book on the mutual fund industry found investors to be poorly informed about fees. As financial experts Peter Wallison and Robert Litan explained in their recent comprehensive analysis of mutual fund fee arrangements, “the survey confirmed that investors are not well informed and do not believe themselves to be well informed about their mutual funds.” Peter J. Wallison & Robert E. Litan, *Competitive Equity* 72 (AEI Press 2007). Indeed, the survey indicated that, even among participants who considered themselves the most informed about mutual fund advisory fees, only a small minority even knew they paid percentage advisory fees, and only a fraction of that group responded with a percentage in the vicinity of what mutual fund advisers generally charge. *Id.* at 73. Thus, investors not only have difficulty identifying the absolute amount of the advisory fees they pay, but are oblivious to what they pay relative to other investors.

The economic literature confirms that many mutual funds have been effective in hiding their costs from investors through fragmented reporting of fees. The results of a recent study by a group of economists indicate that, while first-time buyers are the most likely to pay obvious fees like loads and commissions, even experienced investors are likely to be insensitive to operating expenses. See Brad M. Barber, Terrance Odean & Lu Zheng, *Out of Sight, Out of Mind: The Effects of Expenses on Mutual Fund Flows* 19 (July 2002). The authors conclude: “Investors would benefit from a greater understanding and awareness of mutual fund expense. While educating investors is a complex and multifaceted task, our results support the [GAO’s] recommendation that one step in that process would be for mutual funds to disclose to

investors the actual dollar amount of fees paid. Expenses that remain out of sight are likely to remain out of mind.” *Id.* at 20. This conclusion was echoed in another recent paper, where the authors found that mutual funds have been able to reap stable profits from high-fee funds that take advantage of the most ill-informed investors.<sup>6</sup>

Between the cognitive processes that make it difficult for investors to recognize and reward high-quality, low-cost mutual funds and the lack of information consumers have on the fees they pay, the mutual fund industry is rife with the potential for market failure. In the next section, we examine the empirical evidence that confirms that the performance of the mutual fund market is not consistent with efficient pricing.

## **II. THE PERFORMANCE OF THE MUTUAL FUND INDUSTRY CONFIRMS THAT COMPETITION AMONG MUTUAL FUND ADVISERS DOES NOT EFFECTIVELY CONSTRAIN FEES**

A growing body of empirical evidence shows that mutual funds have not consistently provided their investors with superior risk-adjusted returns. Yet despite their questionable track record, mutual fund advisers have achieved long-term growth in profits

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6. See Todd Hogue & Jay Wellman, *The Use and Abuse of Mutual Fund Expenses*, 70 *J. Bus. Ethics* 23, 31 (2007) (“Mutual funds aggressively advertise historical performance but rarely compete on expenses. Even though these fees represent a deadweight cost on long-term returns, few investors can actually estimate the annual expenses of their fund holdings. We contend the fund industry has become very adept at segmenting customers by level of investment sophistication. The industry uses this ability to market high expense funds to less-knowledgeable customers.”).

that is inconsistent with a competitive market. Combined, such evidence strongly suggests that market forces are not functioning properly.

#### **A. Mutual Fund Advisers Have Not Consistently Provided Fund Investors with Superior Risk-Adjusted Returns**

There is a substantial empirical literature demonstrating that high-fee, actively managed mutual funds have not provided investors with returns any greater than those they would have earned buying low-fee funds that track a stock index like the S&P 500. For instance, the renowned financial economist Burton Malkiel found in a study of mutual fund performance over the period 1971 to 1991 that, “[i]n aggregate, funds have underperformed benchmark portfolios both after management expenses and even gross of expenses.” Burton G. Malkiel, *Returns from Investing in Equity Mutual Funds 1971 to 1991*, 50 J. Fin. 549, 549 (1995). Additional articles released more recently have also found scant evidence of superior performance from actively managed mutual funds. See Mark M. Carhart, *On Persistence in Mutual Fund Performance*, 52 J. Fin. 57 (1997); Laurie Prather, William J. Bertin & Thomas Henker, *Mutual Fund Characteristics, Managerial Attributes, and Fund Performance*, 13 Rev. Fin. Econ. 305 (2004).

To be sure, some active managers have achieved superior returns than those realized by the broader indices. But the empirical literature demonstrates that the vast majority of funds do not provide their investors with superior returns. As a group of prominent financial economists wrote in a Brookings research paper: “While our results suggest quite

clearly that the average or the median fund manager does not add value during our sample period, some funds in some years show superior performance.” Josef Lakonishok, Andrei Shleifer & Robert W. Vishny, *The Structure and Performance of the Money Management Industry*, Brookings Papers: Microeconomics 356 (1992). Furthermore, other research has suggested that the persistence of superior returns by certain funds is explained by factors other than managerial skill. As economist Mark Carhart explained in a paper considering this evidence: “Persistence in mutual fund performance does not reflect superior stock-picking skill. Rather, common factors in stock returns and persistent differences in mutual fund expenses and transaction costs explain almost all of the predictability in mutual fund returns. Only the strong, persistent underperformance by the worst-return mutual funds remains anomalous.” Carhart, *supra*, at 58.

A particularly salient finding for the issues raised here is that high fees can be directly attributed to poor performance. The direct relationship between low fees and superior performance was first explored in a 1966 paper by Nobel Prize winning economist William Sharpe, who found that the mutual fund performance and mutual fund fees are *negatively* related—that is, the lower the fees the better the returns for investors. This counter-intuitive result also has been demonstrated in more recent research. *See* Malkiel, *supra*, at 568; Carhart, *supra*, at 58. For instance, Dr. Carhart finds that expenses, active trading by fund managers, and load fees are all correlated with negative mutual fund performance. *See* Carhart, *supra*, at 58.

A common response to the argument that behavioral quirks of mutual fund investors have prevented the mutual fund industry from operating efficiently is that the presence of a few rational investors will protect the rest. Indeed, this is the line of argument the Seventh Circuit articulated in the decision below.<sup>7</sup> However, in any science, theory must be borne out by the facts. As discussed above, there is clear *empirical evidence* that, contrary to the “few-sophisticated-investors hypothesis,” high advisory fees are actually associated with poor performance. Moreover, even the economists who have found superior performance at a few standout funds acknowledge that, for the vast majority of funds, fees are not set in accordance with performance.

**B. Despite Their Questionable Track Record, Mutual Fund Advisers Have Achieved Long-Term Growth in Profits That Is Inconsistent with a Competitive Market**

Despite the questionable performance of mutual funds (relative to broad indices), mutual fund advisers are earning persistent profits far above their costs. First, some background on the industry is essential. Mutual funds have grown by enormous proportions over the previous decades. In 1940, the total assets held by the mutual fund industry totaled \$450 million; by 2006, this figure exceeded \$10 trillion, representing an approximately 2,000-fold increase in nominal terms. *See* Wallison & Litan, *supra*, at 41. A recent law review article documented that residual payments to fund managers and their

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7. *Jones v. Harris*, 527 F.3d 627, 634 (7th Cir. 2008) (“It won’t do to reply that most investors are unsophisticated and don’t compare prices. The sophisticated investors who do shop create a competitive pressure that protects the rest.”).

affiliates and service providers net of all relevant costs have risen from \$1.5 billion to \$90 billion per year over the period from 1980 to 2006. Adjusted for inflation, this growth represents approximately a 23-fold increase in real compensation.<sup>8</sup> See John P. Freeman, Stewart L. Brown & Steve Pomerantz, *Mutual Fund Advisory Fees: New Evidence and a Fair Fiduciary Duty Test*, 61 Okla. L. Rev. 83, 91 (2008). Thus, mutual fund advisers have had enormous success over the previous decades. As we discuss below, the empirical economic literature has demonstrated that much of this success represents persistent economic profits detrimental to consumers and overall economic efficiency.

Two recent academic papers provide direct evidence that the fees charged by mutual fund advisers in aggregate have resulted in fee structures that would not persist in a fully competitive environment. The first concludes that low-quality funds actually charge investors higher fees than high-quality funds, all other things being equal. The authors explain: “[P]ut together, the empirical evidence implies that superior management is not priced through higher expense ratios. On the

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8. The inflation calculation is based on a comparison of the CPI-U in January 1980 to the CPI-U in January 2006 available at <ftp://ftp.bls.gov/pub/special.requests/cpi/cpiiai.txt>. The Bureau of Labor Statistics reports that in January 1980 the CPI-U index had a value of 77.8, while in January 2006 it had a value of 198.3. Dividing 198.3 by 77.8 yields a figure of approximately 2.55. Multiplying mutual fund advisers total compensation of \$1.5 billion in 1980 by 2.55 yields a value of \$3.83 billion—the value of adviser compensation in 1980, in 2006 dollars. Dividing \$90 billion by \$3.83 billion yields a value of 23.49, representing the factor by which advisers real compensation has increased over the period from 1980 to 2006.

contrary, it appears that the effect of expenses on after-expense performance (even after controlling for funds' observable characteristics) is more than one-to-one, which would imply that low-quality funds charge higher fees." Javier Gil-Bazo & Pablo Ruiz-Verdu, *When Cheaper is Better: Fee Determination in the Market for Equity Mutual Funds*, 67 J. Econ. Behav. & Org. 871, 883 (2008). Of course, in an effectively competitive market, this *negative* relationship between fees and quality simply would not exist. A second article concludes that the fees charged by mutual fund advisers represent persistent economic profits that would not persist under more competitive circumstances, leading to the conclusion that, in the aggregate, "the majority of the [mutual fund] fee is explained by mark-ups that funds add to the marginal cost owing to the market power possessed by the funds." Guo Ying Luo, *Mutual Fund Fee-Setting, Market Structure and Mark-ups*, 69 *Economica* 245, 245 (2002). Thus, the overwhelming evidence is that competition in the mutual fund industry has not produced competitive outcomes.

### **III. EXCESSIVE-FEE LITIGATION IS AN IMPORTANT TOOL FOR CORRECTING THE MARKET FAILURES INHERENT TO THE MUTUAL FUND INDUSTRY**

Excessive-fee litigation represents a non-regulatory option for restraining abuses in the mutual fund industry. Importantly, it preserves the underlying market mechanism that rewards innovation. Because all mutual funds suffer from the same "costly state verification" problems, comparisons to fees paid by other mutual funds are not the appropriate benchmark for assessing fees charged by an investment adviser. And the arguments advanced by investment advisers against using pension fund

fees as the proper benchmark in the context of excessive-fee litigation are not grounded in solid theory or evidence.

**A. Excessive-Fee Litigation Provides a Check on Investment Advisers Without Undermining the Underlying Market Mechanism**

It is important that the empirical findings described above be understood in their proper context. The fact that certain characteristics of the fund industry have prevented it from serving consumers as efficiently as possible does not mean that a tighter regulatory apparatus is desirable or even that competition has been completely ineffective. Under the current regulatory environment, the Vanguard mutual fund complex has grown impressively by offering consumers low-fee investment options. *See* Wallison & Litan, *supra*, at 84. Full-scale regulation is likely to retard the emergence of innovators like John Bogle of Vanguard, who recognized a niche that sophisticated investors have embraced.

Despite Vanguard's success in low-cost funds, its model has not been imitated. Indeed, even Vanguard has been attracted to the higher fees offered by actively managed funds in recent years. When the bulk of investors are not able to gauge accurately the quality of their mutual funds, even firms that gained success on the basis of low-margin offerings can be attracted to the greater earnings obtained by making fees more opaque. This economic fact means that competition among funds will not be sufficient in and of itself to discipline the prices charged by investment advisers. While regulated fee limits will result in funds charging the maximum fees allowed (regardless

of quality), excessive-fee litigation maintains incentives for advisers to charge fees according to their actual costs and the value they add, consistent with a truly competitive market.

**B. Facile Comparisons to Other Mutual Funds Are Not the Appropriate Benchmark for Assessing the Fees Charged by an Investment Adviser in an Excessive-Fee Case**

What evidence should courts consider in excessive-fee litigation, given the fact that rates paid by other mutual funds may very well be inflated above their competitive levels? Economic research suggests that competition works more effectively in the market for pension fund money management: “In contrast to mutual fund investors, pension clients punish poorly performing managers by withdrawing assets under management and do not flock disproportionately to recent winners.” Diane Del Guerico & Paula A. Tkac, *The Determinants of the Flow of Funds of Managed Portfolios: Mutual Funds vs. Pension Funds*, 37 J. Fin. & Quantitative Analysis 523, 523 (2002).

The view that fees paid to the advisers of pension funds can be used to assess the competitiveness of mutual fund fees was recently criticized by Coates and Hubbard. In particular, the authors argue that the cost of providing both services differs, which justifies fee differences. *See* Coates & Hubbard, *supra*, at 185. Coates and Hubbard claim that the expense categories reported by mutual funds make it impossible to separate the cost of portfolio management from other costs, like administrative or marketing costs, incurred by mutual funds. As a result, they claim that it is impossible to identify a measure of the cost of managing a mutual fund

portfolio that is truly comparable to the cost of managing a pension fund. *Id.* at 186. Furthermore, they argue that, even if this comparison could be made, it would remain inapposite because mutual funds must have greater liquidity than pension funds to ensure that shares are redeemable upon request. *Id.*

But these arguments rely on specious economic logic. From the perspective of setting fees, economics teaches us that the only costs that matter are *marginal* costs—that is, the additional cost of serving the last customer. The cost concerns voiced by Coates and Hubbard are not relevant, because the administrative and marketing fees incurred by mutual funds (both *fixed* costs) will play a negligible role in the cost of serving the marginal mutual fund customer.

Additionally, a recent article in the Oklahoma Law Review belies the argument advanced by Coates and Hubbard that pension fund management fees cannot be used to evaluate the competitiveness of the associated fees for mutual funds. The authors show that, when sufficient cost data have been made available through legal or regulatory inquiries, the fees associated with the pure cost of portfolio management for mutual fund investors greatly exceed those charged to pension fund clients. See Freeman, Brown & Pomerantz, *supra*, at 110-12. The authors also show that the liquidity argument is a red-herring because portfolio management fees are not substantially different between mutual funds and closed-end funds that do not issue redeemable shares. *Id.* at 114. In summary, the arguments against comparing mutual fund fees to pension fund

management fees are theoretically untenable and empirically inaccurate.

### CONCLUSION

For these reasons and those more fully developed in petitioners' briefing, the Court should overturn the finding by the Seventh Circuit that competition between mutual funds has forced mutual fund advisers to price efficiently. The cognitive-behavioral characteristics inherent to people and the costs of obtaining full information on advisory fees have led to a market failure in the supply of mutual fund advisory services. Those who insist that the mutual fund advisory market is operating efficiently have simply ignored the fee-adjusted performance record of advisers, which simply cannot be consistent with a well-functioning, competitive market. Allowing courts to use a reasonable competitive benchmark like the fees advisers charge to pension fund clients in evaluating excessive fee cases will encourage the mutual fund industry to price more efficiently and increase consumer welfare.

Respectfully submitted,

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