Why Investment Brokers Provide Poor Advice

Sitting face-to-face across from a professional investment broker is widely extolled as the preferred way for individual investors to get the best advice. Yet a study of retirement-plan investors who took advantage of this option found that their investment results were markedly worse than participants in the same plan who made their own investment decisions. And both groups, it turns out, did worse than plan participants who used the plan's default investment option for target-date mutual funds.

[See top-rated funds by category ranked by *U.S. News* Mutual Fund Score.]

Researchers John Chalmers (University of Oregon) and Jonathan Reuter (Boston College) conducted a detailed study of participants in the defined-contribution plan of the Oregon University System (OUS). It offers employees the option of working directly with investment brokers or of making their own choices from the plan's investment options. The study looked at the choices and investment results made by participants as well as their level of investment expertise.

Younger OUS employees with the least investment experience were the most apt to sit down with brokers and follow their advice. The investment results of this group were then compared with OUS employees making their own investment choices. These two groups, in turn, were compared with the plan's default investment choice—a series of target-date funds. Such funds invest in portfolios of stocks and bonds designed to automatically shift their investment goals to protect assets as employees near retirement age.

Over the 11-year period from 1999 through 2009, OUS investors who based their decisions on broker advice earned an average annual return of 1.81 percent, a figure that also reflects the 0.9 percent in average annual investment fees paid to the brokers providing them advice. Investors who managed their own accounts earned an average of 3.35 percent and, of course, paid no direct broker fees.

The difference between the results of the two groups—more than 1.5 percentage points a year—can mean large differences in plan assets over time. However, returns for the plan's target-date funds averaged 5 percent, further widening the cumulative difference in asset accumulation among the three approaches. Reuter stressed in an interview that there is no way to project these findings into the future, especially given the unusual market conditions during the 1999-2009 period.

[See Beware Playing 401(k) Catch-Up Close to Retirement.]

It turns out that brokers also placed clients in riskier investments than did self-directed investors making their own choices. The brokerage group did better than the self-directed group in years with strong stock-market results, but did worse in years when the stock market declined.

In analyzing the investment picks recommended by brokers, the research discovered strong evidence that brokers steered OUS clients into investments that paid brokers the highest fees. "We also find robust evidence," their paper said, that brokers guided investors to "invest less in funds that have high fees that are not retained by the broker. This suggests that brokers steer investors away from high fee funds when those fees do not benefit the brokers."

Reuter noted that OUS employees are probably more highly educated than employees in a typical retirement plan. "So, if you thought [from their study] that brokers were taking advantage of people," he said, "you might think that the ability of brokers to take advantage of people would be limited in this setting" due to participants being well-educated.

[See Do Not Make This Investing Mistake.]

With higher levels of financial literacy, self-directed investors built investment portfolios superior to those recommended by investment professionals. "In this sense, financial literacy dominates financial advice," the researchers said in their paper. "It seems likely that those investors most likely to invest through a financial advisor are the same investors who are the most likely to accept the default investment options in the absence of access to a financial advisor."

"Our paper provides provocative evidence that brokers are a poor substitute for not only financial literacy, but also the use of target date funds as default investments options," Chalmers and Reuter concluded.

The downside of using target-date funds and taking a hands-off approach to investing, Reuter said, is that people would be less likely to acquire more financial literacy and become comfortable making these important financial decisions. "If people make enough choices for you," he said, "you lose the incentive to learn how to make these choices yourself."