

## HOW DOES SIMPLIFIED DISCLOSURE AFFECT INDIVIDUALS' MUTUAL FUND CHOICES?

Many Americans invest in mutual funds, but they may not understand what they are investing in. The Securities and Exchange Commission (SEC) requires that mutual fund companies give investors a statutory prospectus in order to educate people about their mutual funds. The prospectuses sometimes run hundreds of pages in length and contain complex financial terms and legal language. Due in part to these factors, two-thirds of investors do not read the prospectus before purchasing mutual fund shares.



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Motivated by these concerns, the SEC recently proposed and adopted a new simplified summary of the prospectus. Mutual funds can now send investors a two to four page document, or the "Summary Prospectus," instead of the lengthy statutory prospectus. Like the statutory prospectus, the Summary Prospectus contains key information about the mutual fund's investment objectives, strategies, risks, costs, and performance. The SEC is hoping the "proposal will improve investors' ability to make informed investment decisions and, therefore, lead to increased efficiency and competitiveness of the U.S. capital markets." However, to our knowledge there has been no direct study of how the Summary Prospectus would change investors' choices. Our research attempts to fill that gap.

## THE RESEARCH TEAM

This summarized study was conducted by a team of researchers from Harvard and Yale with expertise in behavioral economics, experimental economics, finance, and retirement savings. The team has recently delved into the field of behavioral health economics.

### **John Beshears**

Post-doctoral Fellow in Aging Research  
National Bureau of Economic Research  
<http://kuznets.fas.harvard.edu/~beshears/>



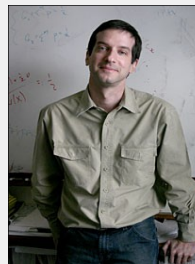
### **James J. Choi**

Assistant Professor of Finance  
Yale School of Management  
<http://mba.yale.edu/faculty/profiles/choi.shtml>



### **David Laibson**

Robert I. Goldman Professor of Economics  
Harvard University  
<http://www.economics.harvard.edu/faculty/laibson>



### **Brigitte Madrian**

Aetna Professor of Public Policy and Corporate Management  
Harvard Kennedy School  
<http://www.hks.harvard.edu/about/faculty-staff-directory/brigitte-madrian>



# THE EXPERIMENT

- We recruited 186 non-faculty Harvard employees from the ranks of the administrative, professional, clerical and technical staff.
- Each participant was randomly assigned to one of three information conditions:
  1. Participants received only the funds' statutory prospectuses.
  2. Participants received only the funds' Summary Prospectuses, which we constructed using the specifications in the SEC's original Summary Prospectus proposal.
  3. Participants received the Summary Prospectuses but could additionally request the statutory prospectuses (a request that only a few of the subjects in this condition actually made).
- Each participant in all of the information conditions had to make investment choices for two hypothetical \$100,000 portfolios. One portfolio could only be invested among stock mutual funds; the other could only be invested among bond mutual funds.
- Participants were randomly assigned to receive one of ten mutual fund menus, each consisting of four stock funds and four bond funds. Each menu had two stock funds and two bond funds with a front-end load, and two stock funds and two bond funds with no front-end load.
- Participants were instructed to allocate their investment across as many or as few funds as they desired with two constraints:
  1. They had to allocate exactly \$100,000 in total.
  2. They had to satisfy the minimum opening balance requirement for any fund to which they made an allocation, just as they would when making a real investment in these funds.
- Each participant was randomly assigned into one of two investment horizons: one month, or one year. At the end of the investment period, the portfolio would be liquidated, incurring any fees that would apply from this liquidation. For each participant, we randomly chose one of the two portfolios and paid him or her 0.1% of the portfolio's final liquidation value.
- Participants also completed a questionnaire that included demographic and financial literacy questions.

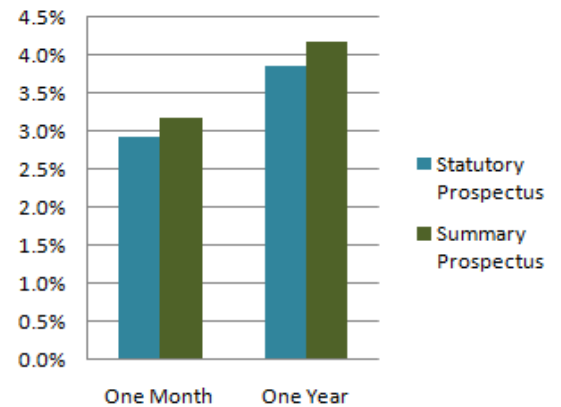
## THE PROBLEM WITH LOADS FOR ONE MONTH INVESTORS

One way to test whether the participants were making wise mutual fund choices is to examine how they responded to front-end loads in the one month investment horizon condition. Half the funds on each subject's investment menu had front-end loads, ranging from 1.75% to 5.75%. The shorter the investment horizon, the more a fund needs to outperform on an annualized basis in order to earn back its load. For a one month investment horizon, it is always in the participants' interest to choose the funds with no front-end loads. To justify investing for one month in a fund with a 2% load, one must expect it to outperform a no-load fund by an implausibly large 24 percentage points on an annualized basis.

## FINDINGS

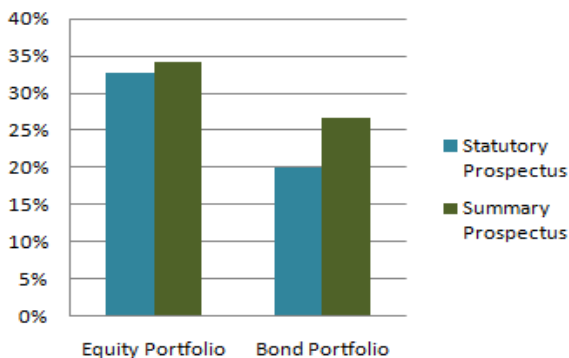
- Our experimental participants have higher levels of educational attainment and financial literacy than the overall U.S. population.
- Despite being more financially literate than the average American, most of our participants do not have much confidence in their investment abilities. About half describe themselves as an investor who is "less than knowledgeable" or "not at all knowledgeable." This fact is consistent with other surveys on financial literacy.
- Receiving the Summary Prospectus instead of the statutory prospectus did not induce any statistically significant differences in the average front-end load, back-end load, expense ratio, total fees, past one-year return, or past long-horizon return of the portfolios chosen.
- Participants generally did not avoid loads in the one month investment period, even though with a one month horizon, minimizing loads is the only sensible strategy.

### Total Fees as a % of Equity Investments



Graph 1 shows the Summary Prospectus did not significantly help participants avoid total fees in the one month or the one year investment horizon in the Equity Portfolio. The Bond Portfolio's results were similar.

### % of People Reporting Being Very or Relatively Confident in their Investment Choices



Graph 2 shows the Summary Prospectus did not make a statistically significant difference in how confident participants felt about their investment decisions.

- There is no evidence that the Summary Prospectus causes participants to respond to mutual fund fees more optimally. The Summary Prospectus did not cause participants to avoid loads more aggressively in the one month investment horizon.
- The Summary Prospectus did not lead participants to change the extent to which they deviate from the naïve diversification strategy of equal allocations to four funds.
- The Summary Prospectus did not make participants report feeling better about their investment decisions.
- The Summary Prospectus did decrease the average time spent on making portfolio allocation decisions, from 31.2 minutes for participants who received the statutory prospectus to 22.5 minutes for participants who received the Summary Prospectus.

## CONCLUSION & REAL WORLD IMPLICATIONS

One of the most important findings of this study is the scope of investor confusion regarding loads. Even when our participants had a one month investment horizon—where minimizing loads was the only sensible strategy—they did not avoid loads. We conclude that participants either don't understand how loads work or don't take them into account. Our study finds that the Summary Prospectus did not help investors think about loads, and therefore did not help investors "make informed investment decisions."

### FOR REGULATORS:

This research demonstrates that the Summary Prospectus does not change, let alone improve, portfolio choices. The shorter format of the Summary Prospectus does save paper and investors' time. Regulators should keep this in mind, but realize that more change is necessary to help investors understand loads.

Regulators should also be aware that experiments to evaluate policy proposals can be produced extremely rapidly. We learned of the Summary Prospectus proposal in mid-January 2008, and we were able to finish collecting data and tabulate preliminary results by the end of February 2008, which we sent to the SEC. We believe that in the future, laboratory experiments should become a common part of the policy proposal vetting process.

## FOR FURTHER READING

- Barber, Brad M., Terrance Odean, and Lu Zheng, 2005. "Out of Sight, Out of Mind: The Effects of Expenses on Mutual Fund Flows." *Journal of Business* 78(6), pp. 2095-2119.
- Choi, James, David Laibson, and Brigitte Madrian, "Why Does the Law of One Price Fail? An Experiment on Index Mutual Funds." *Review of Financial Studies*, forthcoming.
- Elton, Edwin, Martin Gruber, and Jeffrey Busse, 2004. "Are Investors Rational: Choices Among Index Funds," *Journal of Finance* 59, pp. 261-288.
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