

October 6, 2008

From: National Association of Active Investment Managers (NAAIM)  
To: Employee Benefits Security Administration (EBSA), U.S. Department of Labor  
Re: EBSA proposed rulemaking [FR Doc: E8-19272]

Submitted as an e-mail attachment to: [e-ORI@dol.gov](mailto:e-ORI@dol.gov)

The National Association of Active Investment Managers (NAAIM) appreciates the opportunity to comment on the proposed rulemaking published in the Federal Register of August 22, 2008, concerning “implementing the provisions of the statutory exemption set forth in sections 408(b)(14) and 408(g) of the Employee Retirement Income Security Act...relating to the provision of investment advice described in the Act by a fiduciary adviser to participants and beneficiaries in participant-directed individual account plans, such as 401(k) plans, and beneficiaries of individual retirement accounts (and certain similar plans).”

NAAIM was formed in 1989 as a non-profit association of registered investment advisors who provide active money management services to their clients, in order to produce favorable risk-adjusted returns as an alternative to more passive, buy and hold strategies. NAAIM has grown to include roughly 200 member firms nationwide, managing an estimated \$14 billion.

In particular, NAAIM wishes to comment on these statements made in the “Regulatory Impact Analysis” section: “Among inferior strategies, it is likely that active trading aimed at timing the market generates more adverse results than failing to rebalance. Many mutual funds investors' experience badly lags the performance of the funds they hold because they buy and sell shares too frequently and/or at the wrong times.\22\ Investors often buy and sell in response to short-term past returns, and suffer as a result.\23\ Good advice is likely to discourage market timing efforts and encourage rebalancing, thereby ameliorating adverse impacts from poor trading strategies.”

NAAIM feels that the term “market timing,” once perhaps useful, no longer defines investment strategies providing investors with enhanced risk-adjusted returns. Furthermore, even if the Department had shown that individual investors were not

proficient at actively managing their portfolios, it does not follow that professionals are not proficient. There is significant academic and practical evidence to the contrary. Finally, as a matter of general principle NAAIM does not believe the public is served by the government authorizing, formally or informally, investment strategies. NAAIM also suggests that the Department delay the proposed class exemption it published separately, to give those who would wish to comment more time to consider this controversial issue of public importance.

A) What is “market timing”?

The Department has leveled its disapproval of an investment strategy it calls “market timing.” (Poor Trading Strategies, p. 49904) Several decades ago perhaps, “market timing” might have had a widely accepted specific definition; probably referring to those who used only technical signals to move between being either 100% in stocks or 100% in cash. Today any agreement about what the term means has disappeared, judging by the variety of definitions one finds for “market timing.” The term has been used to refer to just about any active investment strategy that seeks to enhance market returns and/or reduce risk, from placing buy and sell orders, to quarterly rebalancing. The term has been applied to sector rotation and was even stretched to try to describe the after hours illegal activities brought to light in the mutual fund scandal. The term “market timing” has little meaning today.

Not only has the term “market timing” been rendered meaningless but the professional practice of active investment management has also moved well beyond what was originally encompassed by that term. First of all many active investment managers do not use a 100%-in, 100%-out strategy, but rather overweight or underweight an asset class within a maximum-to-minimum range.

For example, let’s say a manager’s neutral allocation to U.S. stocks was 50%. If his or her outlook for the stock market became very unfavorable they might pare clients’ stock positions to a minimum 25%; if that outlook markedly improved, they might increase the equity portion to a maximum 75%. Note that this type of investing can have a similar effect as rebalancing, except that the “rebalancing” is done selectively, rather than at predetermined intervals. The timing of the trade is determined by the market, not by the calendar.

Furthermore it is clear that many, probably most, active investment managers no longer only “go to cash” as their sole defensive measure (a practice that animated the complaint that investors were then uninvested). Today, especially with the advent of exchange traded funds, once an active investment manager decides to move client money out of a market/asset class he or she has many options as to what to do with the proceeds and may well immediately invest the money in another asset class, and not in cash. This type of investing, inaptly described by the term “market timing,” is more clearly understood by the term “tactical asset allocation.” As Jeremy Grantham, chairman of Boston-based Grantham Mayo Van Otterloo, which manages over \$100 billion, said in a conference call a few years ago, “We don’t do timing; we do tilting toward cheaper asset classes.”

One might argue that while the term “market timing” no longer is informative about any particular investment strategy, it still connotes a general description of strategies that claim to be able to predict the direction of the market(s). While that is a true observation it is also not a very useful observation since every active investment strategy is effectively dependent on the direction of the market, or of a security.<sup>1</sup>

Take for instance the time worn and widely accepted investment adage: “Buy low and sell high.” It too suggests the ability to predict direction. After all, it is only because you expected the direction of a stock price or market index to be lower, or at least lower relative to alternative investments, that you would sell that security/market that you deem to be “high.” Thus the claim that market timing identifies those predicting the direction of the market makes it almost all-inclusive, taking in value investors, momentum investors and perhaps everyone else except buy-and-hold investors or random dart throwers.

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<sup>1</sup> It’s interesting that if someone buys an individual stock, with the intent of buying it low and selling it high, the process is called “stock picking” or “security analysis,” emphasizing the deliberative nature of the task, whereas if someone does the same for an entire asset class/market it is called “timing” (in either case, if Warren Buffett does it, it’s called “genius”). Ironically, in many cases the signal to “select” a particular asset class is nothing more than the same signal, in aggregate, as that used to “time” the stock, e.g., moving averages and other price-based indicators, volume ratios and other sentiment indicators, or earnings-based or other fundamental indicators etc..

That the use of the term “market timing” is not a particularly helpful concept in shaping public policy is shown in the academic studies the Department has cited as supporting its contentions. (fn 22 and 23, p. 49904) Only one of those few studies covered the classic 100% stock or 100% cash decisions [in this study those trades were made within several hours of each other based on flow-of-funds (a sentiment indicator)]. Another study looked at switching between stocks, bonds and cash once a quarter based on strategists recommendations (presumably relying mostly on fundamental indicators); a third study considered moves between eight different asset classes.

All four of the studies referenced in the rulemaking focused on the activities of individuals. Even if the conclusions of those studies made a convincing case against active investment management by individuals, which they do not, it does not necessarily follow that it is also an inappropriate strategy for professionals or for the advice they give to clients.

The rulemaking’s remarks may cause readers to believe that any form of active investing is not appropriate or “good advice”. This would do plan participants a disservice as there is substantial academic and practical evidence to the contrary. An overwhelming number of academic studies have come to a conclusion different from the efficient market advocates. For example, Yin-Ching Jan and Mao-Wei Hung, in a hallmark study of the performance of over 3300 mutual funds during the 1966-2000 timeframe confirmed the tradability of short-term price persistence, as did a seminal study by James O’Shaughnessy covering thousands of common stocks (the entire S&P Compustat database) over the period 1951-1996. For an excellent summary of the research, see William G. Droms, DBA, CFA, *Journal of Financial Planning*, May, 2006. The table on the following page comes from that study:

**Table 1: Summary of Persistence Studies**

Authors(s) and Date	Type of Test	Number of Funds	Time Period	Results
Grinblatt and Titman (1992)	Alpha persistence; multiple benchmarks	279 U.S. equity funds	1974–1984	Performance persists
Hendricks, Patel, and Zeckhauser (1993)	Alpha persistence; multiple benchmarks	165 growth-oriented, no-load, U.S. equity funds	1974–1988	Short-term persists; strong “cold hands” persistence
Goetzmann and Ibbotson (1994)	Winner/loser; raw returns, alpha, style subgroups	276 U.S. and international equity funds	1976–1988	Winners and losers likely to repeat
Brown and Goetzmann (1995)	Alpha persistence	All U.S. equity [372 (1976) to 829 (1988)]	1976–1988	Persistent poor performance; Strong relative performance
Malkiel (1995)	Alpha persistence; investing in winners	All diversified U.S. equity [210 (1971) to 684 (1994)]	1971–1994	Funds lag benchmarks; Strong 1970s, weak 1980s
Elton, Gruber, and Blake (1996)	Alpha persistence; investing in winners	188 U.S. equity funds	1977–1993	Performance persists; past winners outperform
Carhart (1997)	Alpha persistence; investing in winners	All diversified U.S. equity funds (1,892)	1962–1993	Persistence due to common factors in stock returns and expenses
Blake and Morey (2000)	Morningstar ratings as predictors	Five U.S. equity style groups of open funds (635)	1992–1997	Low ratings predict poor performance
Droms and Walker (2001)	Raw returns; turnover; expense ratios	151 U.S. equity in continuous operation	1971–1990	Short-term performance persists
Droms and Walker (2001)	Alpha persistence; investing in winners	All int'l equity [11 (1977) to 473 (1996)]	1977–1996	Short-term performance persists
Carhart, Carpenter, Lynch, and Musto (2002)	Alpha persistence	All diversified U.S. equity funds [Total 2,071 funds: 465 (1972) to 1,370 (1995)]	1962–1995	Persistence exists but mainly due to expenses. Survivor bias weakens result
Jan and Hung (2004)	Alpha persistence	CRSP survivor-bias free data: total 3,316 over 40 years	1961–2000	Both short-run and long-run performance persists
Bollen and Busse (2004)	Alpha persistence	All U.S. equity “max cap gain,” “growth” and “gr and inc” funds extant in 1985 (230 funds)	1985–1995 (new funds after 1985 not added)	Short-term performance persists, but may not be economically significant

B) The Department does not serve the public interest by judging investment strategies

The rulemaking had it right when it said “there are competing and evolving theories” of optimal investment “which have much in common ...but also important differences.” (Footnote 59; p. 49909) Yet the rulemaking also unfortunately seeks to be the judge of these competing strategies by talking about “inferior strategies” and telling us what “good advice is likely” to do.

NAAIM believes that the government is not an appropriate evaluator of investment strategies, especially when there is any excellent system for such discernment already at

hand. That superior system is composed of two parts: the rules governing Registered Investment Advisors [RIA] and the markets themselves.

The Supreme Court declared in 1963 that advisors registered under the Investment Advisors Act have a fiduciary duty to their clients. *S.E.C. v. Capital Gains Research Bureau*, 375 U.S. 180 (1963). As part of that it is generally recognized that RIA's have to put their clients' interests first. That fiduciary duty, along with the fee-based compensation system used by many advisors, produces an alignment of interests that makes it in an advisors' interest to find strategies and advice that provide good risk-adjusted performance for their clients. Many advisors invest substantial amounts of their own retirement money in exactly the same way as they invest for their clients.

As for the markets, they provide immediate feedback on which investment strategies work and which don't work. Markets not only measure existing investment strategies, market-based developments often suggest new strategies in a much quicker way than a government entity ever could. <sup>2</sup>

On the one hand, you have an efficient system for generating and measuring investment strategies; on the other hand you have a profession that is motivated to provide good risk-adjusted returns. It is a beautifully simple system that works exceedingly well.

For many years the government, through statute, mandated how another fiduciary, the trustee, could invest. In many states trustees were restricted to certain types of investments, each of which had to meet low-risk standards in isolation, apart from the

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<sup>2</sup> One mistaken assumption the Department seems to have is that it is good for advisors to adopt "commonly accepted" investment strategies. Ten years ago "hedge funds" and alternative investments were not commonly accepted; surveys found there were hardly any financial advisors who would recommend either to their clients. Today everyone from pension funds to university endowments have substantial investments in both. Interestingly the alpha generated by many hedge fund strategies is worse now than it was when hedge fund investing was relatively uncommon. Part of that is due to the fact that crowded investment strategies tend to be less profitable. This is all the more reason not to force investors into so-called "commonly accepted" theories or strategies.

risk of the portfolio as a whole. Trustees were also forbidden from delegating any investment responsibility. Fortunately governments slowly came around to the realization that the realities of investing were better left to the judgment and discretion of the fiduciary trustee. We hope the Department does not reverse course and go back to telling registered investment advisors how to invest or how to advise their clients.

NAAIM realizes that the Department's comments made in the "Regulatory Impact Analysis" section may not have resulted from a thorough examination of investment strategies. If the Department conducts such an examination at some point, we look forward to helping the Department understand the benefits that active investment management provides to growing and preserving retirement plan assets. In the meantime, it is NAAIM's hope that the Department will omit favoring or disparaging any form of investment advice.

Thank you for the opportunity to express our views on this important topic.

Sincerely,

William Hepburn  
NAAIM President