From: Paul Ruedi [mailto:PRuedi@rhafinancial.com]
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To: EBSA, E-ORI - EBSA
Subject: 2010 Investment Advice Proposed Rule

I have been an investment advisor for 25 years. For most of those years (20) I have utilized index funds or passively managed funds for both 401k clients and Individual clients.

I am most encouraged by the recent views or ideas of the DOL notion that investors in 401k plans would be best served by using index funds / passive funds as it is clearly in the best interests of investors. Anecdotally, this must be true since Wall Street is so adamantly opposed to the idea.

However, the Wall Street crowd, who's only interest is their bottom line knows that once plans begin to use index funds, they will never go back to overpriced active management. They are not fighting the DOL as much as they are fighting reality and math.

For example, all the research shows that 80 to 90 percent of active managers underperform the indices. Out of the 10 to 20 percent who outperform, only 1 in 200 outperforms the indices consistently by more than 3% a year. Chances that an individual investor will find such a winning manager are less than 1% and this game is not worth playing. They know this, yet a fair deal for investors threatens their ability to fleece the public.

Consider the questions the DOL have come up with.

- "What investment theories are generally accepted … and what investment practices are consistent … with such theories?"

  The real answer is that active management consistently shows that they outperform markets no more often than you would expect from random chance.

- "On what bases can a fund's superior past performance be demonstrated to derive not from chance but from factors that are likely to persist?"

  See the answer to the first question. It takes 35 years to distinguish skill from luck. There has not been one study to show that there is

persistence in returns (alpha) or that active managers outperform markets by more than one would expect from random chance.

- "Under what if any conditions would it be consistent with generally accepted investment theories … to recommend a fund with superior past performance over an alternative fund in the same asset class with average performance but lower fees?"

  Based on all the studies, how could anyone suggest a more expensive alternative based on the notion that past performance is indicative of future performance? In fact, most investment people will talk about the Brinson study showing that most variation of returns between one portfolio and another are due to asset allocation (well over 90%). Yet, they then throw the very notion out when implementing their strategies with active management. That is, even though approximately 95% of the success of the investor will be directly related to asset allocation, they spend 100% of their time (at a very high cost to investors) trying to outperform the easily achievable benchmark return—which as all studies have shown do not increase returns, but rather DETRACT FROM RETURNS.

- "Should a model ascribe different levels of risk to passively and actively managed investment options?"

  By their very nature, actively managed funds involve more uncertainty (risk). They have to since there is always the possibility of falling short (underperformance) of the easily achieved benchmark. Active management by its very nature increases risk. Anyone who argues otherwise has an agenda. Investors never need to outperform anything to achieve their goals. However, underperformance can hurt the best laid allocation.

Finally, the definition of insanity is when you keep doing what you have always done and expect a different outcome. 401k plans today will change providers every four years. That trend has not changed. The reason is as follows. The 401k plan market is heavily dominated by active management. That increases the risk of the "heartbreak of active management" which of course is disappointing returns due to the risk of stock picking, timing and the heavy burden of cost associated with active management.

So the next 401k slick salesperson comes in and tell HR that the reason is the other firms investments are terrible and that theirs are a whole lot better (which is only after the fact). My experience is that all the major firms run around telling HR departments that the others sell cancer. The HR person is convinced (the proposals are rather convincing—fictitious and misleading—

but convincing) and makes the change. The new platform now contains all five-star funds that of course were all included recently due to the past performance that can now be determined after the fact. Those funds of course, will not likely live up to the hype (since there is no persistence in active management alpha) and further disappoint the 401k participant.

The broker or salesperson however is happy…he or she made a lot of money along the way. AND THE CYCLE OF BAD PERFORMANCE AND DISSAPPOINTMENT CONTINUES…

DOL…I say stick to your guns. What you are doing is finally going to make the difference. Combined with quality education, index based investments are the only rational investment.

I would ask the folks screaming bloody murder the following questions:

1. What percentage of active managers outperform a reasonable index fund comparison net of all costs?

2. What percentage of those can be expected to consistently do so?

3. How does that square with historical evidence?

4. How does that compare with random chance?

5. What percentage of variation or outcome between various asset allocations is explained by asset allocation between stocks and bonds and cash?

6. How much is explained by active management (timing and selection)?

7. Is there a risk of underperformance built into active management?

8. What is that risk to investors?

9. Is a financial plan using actively managed investments inherently made riskier due to the likelihood of underperformance of active management?

10. Do the prudent investor rules and restatement of trusts say that while active management is allowed, fiduciaries will have to essentially show that attempts of active management will have to be justified by higher returns?

11. Can active management be expected reliably to compensate for the higher expenses?

Sincerely,

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