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Employee Benefits Security Administration  
U.S. Department of Labor  
200 Constitution Ave., NW  
Washington, DC 20210

Subject: PTE for Advice to IRA Plans

To Whom It May Concern:

Following are my thoughts regarding the request for comments related to the existence and characteristics of computer models to provide investment advice to beneficiaries of IRAs as required in the Pension Protection Act of 2006.

As the former president of Ibbotson Associates, I am in a unique position to comment on this topic. First, Ibbotson was one of the leading providers of independent expert advice services as required in the SunAmerica Advisory opinion. I was in charge of the development of the Ibbotson models and had to understand and compare our models with those of all of Ibbotson's competitors in the advice space. Second, I am no longer employed by any advice model provider and, at this time, have nothing to gain or lose through the ultimate decision on this matter by the DOL.

I have organized my responses along the nine questions asked in the Request of Information.

1. Are there computer model investment advice programs for the current year and preceding year that are, or may be, utilized to provide investment advice to beneficiaries of IRAs?

There are a number of investment advice programs that can be utilized to provide investment advice to beneficiaries of IRAs that take into account some or all of the factors raised. Most models use some form of historical returns and generally accepted investment theories. However, I would like to note that the use of purely historical data in formulating investment advice typically yields investment allocations that were best over those past periods but not for the future. The best models use historical data to draw forecasts for the future.

Understanding whether these forecasts are prudent is critical to passing judgment of any model.

Many models do not adequately take into account the factors listed such as age, life expectancy, retirement age, risk tolerance, other assets or sources of income, and preferences as to certain types of investments. Most use some form of attitude toward risk derived from a questionnaire or simply current age of the beneficiary to set appropriate investment policy. These types of models tend to ignore the "liability" facing the beneficiary as defined by a beneficiary's income replacement goals. They also tend to ignore current wealth, savings levels, other sources of income in retirement, and life expectancy relative to that long-term goal.

All models can be adjusted or designed to eliminate self dealing by ensuring that all investment options considered are treated fairly in setting their expected return and risk characteristics and that any capital market forecasts are also set so that they do not favor any broad category of investments (stocks over bonds or bonds over real estate for example). The problem is in asking the right questions and doing the proper due diligence to uncover any potential problems in these areas.

Most models can take into account a reasonable range of investment vehicles given that universe is limited to diversified investments such as mutual funds and exchange traded funds (ETFs). No model, in my opinion, can adequately take into account all individual stocks and bonds for formulating investment advice. I would go one step further in stating that no computerized advice model should be allowed that provide advice on anything other than mutual funds or ETFs. Providing investment advice for individual stocks and bonds must take into account a vastly larger set of information, risk management and rebalancing needs that any computer model suited for use by individuals can accommodate.

Some direction and flexibility by investors in the choice of investments can be accommodated by advice models. The risk is that, in addition to the problems mentioned in the preceding paragraph, the more flexibility allowed to the investor the more complicated the model and its user interface and output become. More flexibility in options also increases the chances that investors end up in an undiversified and imprudent portfolio.

2. If currently available computer models do not satisfy all of the criteria described above, which criteria are presently not considered by such computer models? Would it be possible to develop a model that satisfies all of the specified criteria? Which criteria would pose difficulties to developers and why?

As stated above, most models do not satisfy all of the criteria in question 1. Many of the reasons are listed in the response to question 1. Models can and

have been built that provide prudent advice but for a limited pool of investment options.

The largest problems to building any model that takes into account all the criteria are related to setting expected returns, complexity of understanding risk of the overall portfolio as the number of investments gets larger, and the complexity of the presentation of the choices to the average investor. All good advice models must look ahead not back. That means that to formulate good advice any model must forecast the return of an investment. As the number of investment options grows the difficulty of developing prudent forecasts grows. This also applies to the risk management of the advice portfolio. The forecast for risk is equally important as the forecast for return. Forecasting risk has one additional complication over forecasting return. To calculate overall portfolio risk, you must forecast not only the risk of each investment option but the relation of that option to all other options. Finally, making advice using limited options easy to understand by the average investor is difficult. Opening up the investment options only makes that problem more difficult.

3. If there are any currently available computer model investment advice programs meeting the criteria described in Question 1 that may be utilized for providing investment advice to IRA beneficiaries, please provide a complete description of such programs and the extent to which they are available to IRA beneficiaries.

There are models that provide more than adequate advice to investors and are available to IRA beneficiaries. I am not in a position at this time to evaluate and comment on all of those that are available.

4. With respect to any programs described in response to Question 3, do any of such programs permit the IRA beneficiary to invest IRA assets in virtually any investment? If not, what are the difficulties, if any, in creating such a model?

There are no models that in my opinion satisfy an investor's desire to invest in virtually any investment vehicle. Allowing this is not necessarily something that should be desired since it dramatically increases the chances of unprudent advice.

There are a host of problems with including this many investment vehicles. Effectively modeling an investment requires at a minimum forecasting the expected return, risk characteristics, and relationship of that investment with all other considered investments. Forecasting these characteristics is a basic tenant of modern portfolio theory. It is difficult enough to do well for investment indices like the S&P 500 or the Russell 2000 much less individual the tens of thousands of stocks, individual bonds, real estate, etc. investments.

5. If computer model investment advice programs are not currently available to IRA beneficiaries that permit the investment of IRA assets in virtually any investment, are there computer model investment advice programs currently available to IRA beneficiaries that, by design or operation, limit the investments modeled by the computer program to a subset of the investment universe? If so, who is responsible for the development of such investment limitations and how are the limitations developed? Is there any flexibility on the part of an IRA beneficiary to modify the computer model to take into account his or her preferences? Are such computer model investment advice programs available to the beneficiaries of IRAs that are not maintained by the persons offering such programs?

As stated in the response to question 3, there are programs available that limit the investment options to the investor and provide prudent advice. The flexibility of adding investment options or changing preferences varies with the model provider. These models are available, and some are developed by persons other than those offering the advice programs.

6. If you offer a computer model investment advice program based on nonproprietary investment products, do you make the program available to investment accounts maintained by you on behalf of IRA beneficiaries?

I do not currently work for any company providing these services.

7. What are the investment options considered by computer investment advice programs? What information on such options is needed? How is the information obtained and made part of the programs? Is the information publicly available or available to IRA beneficiaries?

Most prudent models today cover investments in mutual funds and ETFs. Effectively modeling any investment requires at a minimum forecasting the expected return, risk characteristics, and relationship of that investment with all other considered investments. Forecasting these characteristics is a basic tenant of modern portfolio theory. Information is obtained on historical performance from publicly available sources. How that history is used to develop forecasts is a function of each model and its developer. Some of this information can be made available to beneficiaries. It should be noted that providing too much of the details on each investment option can be confusing to investors and cause them to quite the process entirely.

8. How should the Department or a third party evaluate a computer model investment advice program to determine whether a program satisfies the criteria described in Question 1 or any other similar criteria established to evaluate such programs?

All models should be evaluated by the basics of modern portfolio theory. This includes a thorough examination of how forecasts are made or if they are made at all, how those forecasts are used, how portfolio risk level is assigned to each investor, what investment options are used to implement any recommendation and how all of these pieces interact. It is my opinion that it is not enough to establish criteria such as in question 1. It is most critical to understanding the workings of any model to dig under the hood and use the tenants of investment theory to judge the prudence of any model.

9. How do computer model investment advice programs present advice to IRA beneficiaries? How do such programs allow beneficiaries to refine, amend or override provided advice?

Presentation of the advice is one of the most difficult pieces of building an investment model. Helping investors understand how their decisions impact their potential investment outcomes is one of the key elements of the advice process. It involves making complicated issues around returns, risk management, correlations of various investments, savings rates, life expectancy, and desires for future goals all intersect. Lots of work has been done by a number of companies in this area but lots more needs to be done.

Understanding and evaluating computerized investment advice models designed for use by individual investors is a complicated undertaking. I hope you find some of thoughts useful in drawing your conclusions. Thank you for you consideration of these comments.

Sincerely,

Michael Henkel