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Mutual Fund Performance Advertising: Inherently and Materially Misleading?

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Mutual Fund Performance Advertising: Inherently and Materially Misleading?

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Abstract

Mutual fund companies routinely advertise the past returns of their strong-performing, actively-managed equity funds. These performance advertisements imply that the advertised high past returns are likely to continue. Indeed, investors flock to these funds despite high past returns being a poor predictor of high future returns. Thus, fund performance advertising is inherently and materially misleading and violates federal securities antifraud standards. In addition, the SEC-mandated warning in these advertisements that “past performance does not guarantee future results” fails to temper investors’ focus on past returns.

The SEC should do more to prevent investors from being misled by fund performance advertisements. It should at least require a stronger warning that makes clear that high returns by actively-managed mutual funds generally do not persist. The SEC should also seriously consider reinstating its prior prohibition of performance advertisements. Such a ban would help investors focus on more important fund characteristics, such as a fund’s costs, risk, and the extent to which the fund’s investment objective matches that of the investor.

This article addresses a number of matters that the new Dodd-Frank Wall Street Reform and Consumer Protection Act requires the GAO to study. In particular, it examines the regulatory requirements for mutual fund advertisements, the industry’s marketing practices and use of past performance data, the impact of performance advertising on investors, and it makes recommendations to improve investor protections in mutual fund advertising.

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Mutual funds are a cornerstone of our national savings and retirement systems. With individual investors largely responsible for deciding how to allocate their money among different mutual funds, our national financial well-being depends upon investors making wise fund choices.

Funds’ past performance is likely the most important factor to investors choosing among equity mutual funds. Fund investors chase high past returns. Yet studies of actively-managed equity funds have found little evidence that strong past returns predict strong future returns. Performance chasing is a fool’s game.

Nonetheless, mutual fund companies routinely advertise the returns of their high-performing equity funds. These performance advertisements attract performance-chasing investors and thus increase asset-based fund management fees.

The Securities and Exchange Commission (“SEC”) has recognized the troubling tendency of fund investors to chase past returns. SEC rules, besides specifying how advertised past performance may be calculated and presented, require that performance advertisements warn that “past performance does not guarantee future results” and that investors could even lose money in the fund.

At first glance, one might expect this SEC-mandated warning to temper potential investors’ focus on past performance. But the effectiveness of performance advertisements suggests otherwise. In addition, a recent experimental study that we and Molly Mercer conducted found that the SEC’s warning is completely ineffective. Investors who receive the SEC’s warning are as likely to invest in a fund with high past returns (and have the same expectations regarding the fund’s future returns) as are investors who do not receive any warning at all.

Part of the problem is that the SEC-mandated warning is far too weak. It merely states the obvious: investing in mutual funds has no guarantees. It fails to tell investors what they really need to understand: strong past performance of actively-managed equity funds is generally a matter of luck, not investment acumen. In fact, the SEC’s warning can even be understood as suggesting that high past returns are a good predictor of high future returns, just not a guarantee of them.

In this article, we show that the current regulation of mutual fund performance advertisements is grossly inadequate. Performance advertisements, as currently regulated, are inherently and materially misleading. By implying that strong past performance will continue – the clear inference of reasonable investors – performance advertisements are used by mutual fund companies to engage in what can be described only as a form of securities deception.

Advertising of past performance is misleading because it inherently and falsely implies that high past returns are likely to persist. Past performance data also is highly material to investors; there is a substantial likelihood that
fund investors (and their advisers) view the information as important to their investment decision. In addition, the current SEC-mandated warning does not effectively “bespeak caution.”

Furthermore, if mutual fund advertisements were regulated by the Federal Trade Commission (“FTC”) rather than the SEC, the FTC likely would have deemed them misleading. The FTC, which regulates the advertising of other products and services, has recognized the dangers of testimonial advertisements, a type of performance advertisement. The FTC recently tightened restrictions on the use of testimonials describing individuals’ results with respect to products and services, such as weight-loss products and work-at-home business opportunities. Like mutual fund performance advertisements, testimonial advertisements can mislead readers by presenting atypical past results.

In addition, the FTC has recognized that advertisements that take advantage of pre-existing consumer misconceptions can be misleading. For example, it has found that advertisements for “additive-free” cigarettes misled consumers by implying that these cigarettes were healthier than other cigarettes, even though the advertisements made no health claims. Similarly, even if mutual fund advertisements do not explicitly claim that the advertised high past performance is likely to continue, they are misleading because they take advantage of investors’ erroneous beliefs regarding performance persistence.

What should be done about mutual fund performance advertisements? The SEC at least must strengthen its required warning. The current warning does not adequately convey that high past returns are a poor predictor of high future returns. In contrast, in our recent experiment, we found that investors significantly tempered their performance expectations when warned that strong past performance is generally the result of luck and shouldn’t be expected to continue in the future.

Given the inherently misleading nature of fund performance advertisements, however, stronger action might be necessary. In particular, the SEC should seriously consider prohibiting mutual fund performance advertising. This prohibition would encourage investors to instead focus on more important fund characteristics, such as the fund’s costs, the asset classes in which the fund invests, and the extent to which the fund’s investment objective and risk matches the investment objective and risk tolerance of the investor.

This article is timely. A provision of the newly-adopted Dodd-Frank Wall Street Reform and Consumer Protection Act, requires the Government Accountability Office to conduct a study on mutual fund advertising to identify (1) existing and proposed regulatory requirements for open-end investment company advertisements; (2)
current marketing practices for the sale of open-end investment company shares, including the use of past performance data, . . . (3) the impact of such advertising on consumers; and (4) recommendations to improve investor protections in mutual fund advertising and additional information necessary to ensure that investors can make informed financial decisions when purchasing shares.¹

This article addresses these issues, proceeding in five parts. Part I offers an overview of the mutual fund market and its importance to our national retirement and savings systems. Part II describes returns chasing by fund investors, an investment strategy promoted by performance advertisements despite high past returns being poor predictors of high future returns.² Part III summarizes the current regulation of performance advertisements, including the SEC-mandated warning that past performance does not “guarantee” future results. Part IV, the core of the article, demonstrates that performance advertising by actively-managed mutual funds is inherently and materially misleading under the federal securities laws – that is, mutual fund performance advertising violates securities antifraud standards. We also argue that these advertisements would be deceptive under FTC standards applicable to the advertising of other products and services. Part V concludes with proposals for change, namely, requiring a much stronger warning in fund performance advertising or even banning these advertisements.

I. OVERVIEW OF THE MUTUAL FUND MARKET

A mutual fund pools the money of multiple people and invests it in assets, such as stocks or bonds.³ Investors in the fund do not own the fund’s assets directly, but instead own a share of the fund and are entitled to their share of the returns on the fund’s assets.⁴ A fund is managed by an investment advisor, who selects the particular assets in which the fund invests.⁵

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⁴ Id.
⁵ Id.
The mutual fund industry is immense. U.S. mutual funds hold almost $12 trillion in assets, including approximately 24% of all outstanding equity of U.S. public companies. Investors have a vast choice of funds: 8,624 as of the end of 2009. Some large fund families, such as Fidelity Investments and the Vanguard Group, offer over a hundred funds, and the five largest fund families control 39% of the industry’s total assets. Mutual funds vary greatly, including in the types of assets they hold, their investment objectives and strategies, and their fees and expenses.

Ownership of mutual funds is widespread; 44% of American households own mutual funds. Also, most households that own mutual funds have only moderate income and wealth. The median household income of mutual fund investors is $80,000, and their median household financial assets are only $150,000. Furthermore, mutual funds constitute a large portion of the financial assets of most fund shareholders. Fund-holding households have a median of $80,000 invested in mutual funds.

Mutual fund ownership is so widespread largely because mutual funds are a primary way that Americans save for retirement. Almost half of defined-contribution retirement plan assets and Individual Retirement Account assets are invested in mutual funds. As a result, mutual funds hold more than one-quarter of America’s retirement savings.

Consistent with this long-term investment horizon of many fund investors, 48% of mutual fund holdings are in equity funds. The vast majority of the rest is in money market funds (24%) and bond funds (22%). Although they have greater risk in the short run, equities tend to have higher returns in the long run than do bonds and money market securities.

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8 Id. at 16 fig.1.10.
10 2010 FACT BOOK, supra note 7, at 23 fig.2.2.
11 Invest Wisely, supra note 3.
13 Id. at 81 fig.6.2. Only 36% of mutual-fund-owning households have incomes over $100,000, and nearly one-quarter have incomes below $50,000. Id. at 82.
14 Id. at 81 fig.6.2.
15 Id.
17 Id. at 15 fig.A3. Retirement assets are also in annuities, government pension plans, and private defined benefit plans (i.e., traditional private pension plans). Id. at 3 fig.1.
18 TRENDS IN FUND INVESTING, supra note 6.
The portfolios of equity funds are either indexed or actively managed. Index funds are managed to track the returns of a specified index of a market or market segment, such as the S&P 500 index. Actively-managed funds are managed to beat the market (or a specified benchmark) by superior stock picking and/or market timing. Actively-managed funds engage in more research and trading activities than do index funds, and thus generally have higher costs. In this article, we focus on performance advertisements for actively-managed equity funds.

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In summary, our nation relies on mutual funds. They are widely owned and are a key component of our nation’s savings and retirement systems. Thus, it is important that investors not be misled into making poor fund choices.

II. PERFORMANCE CHASING BY MUTUAL FUND INVESTORS

Because of mutual funds’ importance, an extensive body of research has examined how investors choose among the vast number of funds available to them. These studies paint a disturbing portrait of the typical mutual fund investor. In general, they find that fund investors are uninformed and financially unsophisticated. For example, most fund investors are unaware of the investment objectives, composition, risks, and fees and expenses of their funds. Investors, however, pay great attention to a fund’s historical returns. Indeed, studies have found that this may be the most important factor to the typical investor choosing among funds.

This returns-chasing behavior is encouraged and exploited by mutual fund companies, which frequently advertise the past returns of their high-performing funds. Unfortunately, this behavior does not benefit investors; funds that have had high returns generally do not continue their strong performance in the future.

A. Investors Chase High Past Returns

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22 Index Funds, supra note 20.
23 For a survey of these studies see Palmiter & Taha, Divergent Profiles, supra note 2, at 974-94.
Studies have uniformly found that investors choose equity funds with high past returns. For example, Capon, Fitzsimons, and Rice's survey of households that invest in mutual funds found that a fund’s “investment performance track record” is the most important factor to investors choosing among funds.\textsuperscript{24} Also, in a survey sponsored by the Investment Company Institute – the mutual fund industry’s trade association – 69\% of fund investors reported reviewing a fund’s “historical performance” before investing.\textsuperscript{25}

Wilcox’s experiment involving fund investors had similar findings. In the experiment, investors chose among hypothetical equity funds differing in up to six characteristics: (1) the fund company’s name, (2) the fund’s load, (2) the fund’s annual management fee, (4) the fund’s return during the previous year, (5) the fund’s average annual return during the previous 10 years, and (6) the fund’s beta.\textsuperscript{26} Wilcox found that a fund’s returns over the past ten years and over the past year were the two most important factors to investors.\textsuperscript{27}

Studies of the real-world behavior of investors have found that they especially buy funds with the highest past returns. Del Guercio and Tkac found that an equity fund’s past return has a strong positive effect on fund flow, the net amount invested in the fund during a particular period.\textsuperscript{28} They also found that this effect was strongest for funds with the highest past returns.\textsuperscript{29} Similarly, Sirri and Tufano found that equity funds with higher returns garnered more flow. This was especially true for the highest-performing quintile of funds, demonstrating again that investors flock to funds with the strongest past performance.\textsuperscript{30}

A recent experiment demonstrated that investors will irrationally chase high past returns even when those high returns will definitely not continue in the future. Choi, Laibson, and Madrian had participants – who included many Wharton MBA and Harvard College students – choose how to allocate an investment among four S&P 500 index funds with different costs (loads

\textsuperscript{24} Noel Capon, Gavan J. Fitzsimons, & Russ Alan Prince, An Individual Level Analysis of the Mutual Fund Investment Decision, 10 J. FIN. SERVICES RES. 59, 66 (1996).

\textsuperscript{25} INVESTMENT COMPANY INSTITUTE, UNDERSTANDING INVESTOR PREFERENCES FOR MUTUAL FUND INFORMATION 3 Fig.1. (Aug. 2006), http://ici.org/pdf/rpt_06_inv_prefs_full.pdf (last visited Dec. 27, 2010) [hereinafter INVESTOR PREFERENCES].


\textsuperscript{27} Id. at 650.


\textsuperscript{29} Id.

The higher-cost index funds reported higher past returns, but only because they had inception dates and prospectus publishing cycles different from those of the lower-cost funds. Because all of the index funds invest in essentially identical portfolios, the lowest-cost fund would necessarily give investors the highest return in the future. Yet, despite the experiment's participants being more financially sophisticated than typical investors, few of them chose the portfolio that minimized costs and thus that would maximize future returns. Instead, they placed heavy weight on the funds' reported past returns.

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In summary, past performance is perhaps the most important factor in to investors choosing among equity mutual funds. Investors chase high past returns because they believe strong past performance predicts strong future performance.

**B. High Past Returns Are Poor Predictors Of High Future Returns**

Unfortunately for investors, chasing past performance is generally fruitless. Despite extensive study of whether there is performance persistence among high-performing funds, “within the finance literature there is [only] weak and controversial evidence that past performance has much, if any, predictive ability for future returns.” In other words, strong-performing funds generally do not continue to outperform other funds.

Furthermore, even if there is a small degree of persistence, it is likely not meaningful to many investors choosing among funds because of the transaction costs (such as loads and capital gains taxes) they would incur in chasing high performers. Indeed, in a recent survey of studies of returns

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32 Id. at 1411-14.
33 Id. at 1407.
34 Id. at 1430.
35 Wilcox, supra note 26, at 651.
36 See also, Jonathan B. Berk & Richard C. Green, Mutual Fund Flows and Performance in Rational Markets, 112 J. POL. ECON. 1269, 1270 & n.1 (2004) (“The relative performance of mutual fund managers appears to be largely unpredictable from past relative performance. . . . While some controversial evidence of persistence [of mutual fund returns] does exist. . . . it is concentrated in low-liquidity sectors or at shorter horizons.”).
persistence, Cuthbertson, Nitzsche, and O'Sullivan found some evidence of performance persistence by the highest-performing funds, but concluded that it would be “very difficult” for investors to profitably chase this performance persistence because of “potential data snooping bias, model/estimation error and possible transaction costs of rebalancing (i.e., load, advisory fees, and information costs).”

Why do high past returns generally fail to predict high future returns? A primary reason is that luck is a major factor in a fund’s returns. A fund that markedly outperforms its peers during a particular time period generally does so because of luck, not because of its manager’s stock-picking skill. This luck, however, usually does not persist.

Investors chasing past performance fail to appreciate the role of luck in funds’ returns. Because thousands of equity mutual funds exist, a very large number of funds would considerably outperform market indexes even if all fund managers were picking their portfolios randomly. Two recent studies have demonstrated luck’s ability to almost completely explain strong-performing funds’ returns.

Barras, Scaillet, and Wermers studied the lifetime performance of 2,076 actively-managed domestic equity funds that existed at any time between 1975 and 2006. To distinguish luck from managerial skill, they used a False Discovery Rate estimation approach. This technique uses the p-values of the t-statistics of the estimated alphas of funds to estimate the percentage of high-performing fund managers that were lucky rather than skilled. They found that, after costs, only 2.2% of the funds had statistically significant, long-term, abnormal positive returns relative to market benchmarks. However, when luck was accounted for – i.e., the fact that out of 2,076 funds, many would outperform solely because of luck – they estimated that only 0.6% of funds actually exhibited skill in their long-term performance. This result was not even statistically significant, meaning that there was not strong evidence that any fund managers are skillful enough to outperform their benchmarks in the long-run.

A recent study by Fama and French reached a similar conclusion. They examined the returns from 1984 to 2006 of 3,156 actively-managed mutual

accounts who sell fund shares for a gain must pay capital gains taxes. Capital gains on shares held for less than one year are taxed at higher, ordinary income tax rates. David M. Smith, Mutual Fund Fees and Expenses, in MUTUAL FUNDS: PORTFOLIO STRUCTURES, ANALYSIS, MANAGEMENT, AND STEWARDSHIP 51, 65 (John A. Haslem ed., 2010).

40 Id. at 187-89.
41 Id. at 197 tbl. II.
42 Id. at 181, 197 tbl.II.
43 Id.
44 Eugene F. Fama & Kenneth R. French, Luck versus Skill in the Cross-Section of Mutual Fund Returns, 65 J. FIN. 1915 (2010).
funds that invest primarily in U.S. equities. To distinguish luck from managerial skill, they compared the distribution of actual fund returns to simulations of the distribution of fund returns if all funds lacked skill. They found that luck could explain the performance of almost all high-returning funds, concluding that “few funds have enough skill to cover [their own] costs.”

Ironically, the tendency of investors to chase high past returns might also help explain why these returns don’t persist. As discussed above, investors flock to funds that have produced high returns. As a result, the amount invested in a high-performing fund can increase dramatically. However, this increase in fund size may make it more difficult for even a skilled fund manager to continue to produce high returns.

Managers of large, actively-managed funds may have greater difficulty producing high returns because they have fewer investment options than do managers of small funds. For example, it is more difficult to invest a large amount than a small amount in a stock with a low market capitalization. There may not be enough shares available of a small, thinly-traded stock for a large fund to purchase, or a large purchase would have to be made at a much higher price than would a small purchase.

Indeed, there is evidence that increasing fund size can harm returns. Chen, Hong, Huang, and Kubik found a significant, negative relationship between fund size and returns for funds that invest in small-capitalization stocks. Also, recall that Barras, Scaillet, and Wermers examined the lifetime performance of actively-managed domestic equity funds. Although only a statistically insignificant percentage (0.6%) exhibited any investing skill in the long run, a small, yet statistically significant, percentage (2.4%) exhibited short-run investing skill. This difference might be explained by investors flocking to funds that outperformed in the short run, forcing their fund managers to invest much more than before, rendering these managers unable to continue to outperform in the long run.

In addition, fund companies sometimes close certain mutual funds – i.e., refuse to accept new investors – when the funds reach a certain size. A closing indicates that the fund company believes that increasing the fund’s size might decrease the fund’s future performance. Fund companies have a

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45 Id. at 1923-27 & tbl. III.
46 Id. at 1941.
47 Supra Part II.A.
49 Id.
50 Barras et al., supra note 39 at 179, 181, 197 tbl. II.
51 Id. at 201 tbl.III.
52 Id. at 202-204 (noting that their findings are generally consistent with Berk and Green’s long-run equilibrium theory, which predicts that funds that exhibit short-run skill will receive so much new investment that they will not be able continue to outperform other funds in the long run).
great incentive not to close funds because management fees are directly related to fund size and there are large economies of scale in managing mutual funds. However, these companies apparently believe that at some point a fund’s size can become too large of a drag on its returns.

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In summary, investors’ performance chasing is generally fruitless. There is little evidence that strong past performance predicts strong future performance or that investors can profit from whatever small performance persistence might exist. Performance chasing as an investment strategy makes little sense.

C. Fund Companies Advertise Strong Past Performance

Mutual fund companies’ management fees are based on the amount of assets invested in their funds. Thus, because investors chase high past returns, fund companies have a great incentive to advertise their strong-performing funds.

Advertising of funds’ high past returns is common. For example, Huhmann and Bhattacharyya found that almost 42% of mutual fund advertisements in Barron’s and Money magazines over a two-year period mentioned a fund’s high or increasing returns. Also, an additional 26% of the advertisements explicitly discussed funds’ risk-adjusted returns. Similarly, Mullainathan, Schwartzstein, and Shleifer examined equity mutual fund advertisements in Money and BusinessWeek magazines over a nine-year period and ten-year period, respectively. They found that past returns were mentioned, on average, in 62% of fund advertisements appearing in Money and in 59% of fund advertisements appearing in BusinessWeek.

Performance advertisements are especially prevalent when stock market returns in general have been high. This indicates that fund companies use performance advertisements to highlight funds’ high absolute returns, not just their returns relative to those of comparable funds. For example, Mullainathan et al.’s study found a very high correlation (greater than 0.7)

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54 Chen et al., supra note 48, at 1276-77.
55 Indro et al., supra note 53, at 74.
57 Id.
59 Id at 609 fig.II.
between the percentage of equity fund advertisements that present past returns and the recent performance of the stock market in general.\textsuperscript{60}

Similarly, Swensen examined the extent of mutual fund advertising from 1997-2003 in the first quarter of the \textit{Wall Street Journal}'s Mutual Funds Quarterly Review.\textsuperscript{61} He found that the amount of fund advertising was highly positively correlated to stock prices in general. For example, during the bull market from 1998-2000, mutual fund advertisements constituted between 40-44\% of the 46-48-page Reviews. However, as the bull market ended, fund advertising was significantly reduced, falling to only 16\% of the 34-page Review in 2003.\textsuperscript{62} He also found that the prevalence of performance advertisements was very sensitive to stock prices. For example, performance advertisements plunged from being 61\% and 56\% of all mutual fund advertisements in 1999 and 2000, respectively, to being only 28\% and 26\% in 2001 and 2002, respectively.\textsuperscript{63} Total pages of performance advertisements dropped by approximately 83\%, from about 12.1 pages in 1998 to about 2.0 pages in 2003.\textsuperscript{64}

Thus, fund companies use performance advertisements much more frequently when equity fund returns in general have been high. In addition, fund companies are especially likely to advertise those equity funds that have outperformed other funds. For example, Jain and Wu examined equity mutual funds in performance advertisements in \textit{Barron’s} or \textit{Money} magazines over a two-year period.\textsuperscript{65} They found that the advertised funds had outperformed funds with the same investment objective by an average of almost 6\% over the twelve months prior to the advertisements. The advertised funds also outperformed other benchmarks, such as the S&P 500 index, although by less.\textsuperscript{66} Similarly, Koehler and Mercer examined equity mutual fund performance advertisements that appeared over a three-year

\textsuperscript{60}In particular, they found that the correlation of one-quarter-lagged S&P 500 returns with the percentage of percentage of equity fund advertisements that presented past fund returns was 0.71 for \textit{Money} and 0.74 for \textit{BusinessWeek}. \textit{Id.}

\textsuperscript{61}David F. Swensen, \textsc{Unconventional Success: A Fundamental Approach to Personal Investment} 167-69 & tbl.5.4 (2005).

\textsuperscript{62}\textit{Id.} He examined only the Reviews for the first quarter of each year. \textit{Id. at 167.}

\textsuperscript{63}\textit{Id. at 168 tbl. 5.4.}

\textsuperscript{64}In 1998, the Review had 48 total pages, 44\% of the space was mutual fund advertisements, and 44\% of these advertisements were performance advertisements, so there were approximately 12.1 performance advertisement pages (48 pages x .44 x .44 = 12.1). In 2003, the Review had 34 total pages, 16\% of the space was mutual fund advertisements, and 36\% of the advertisements were performance advertisements, so there were approximately 2.0 performance advertisement pages (34 pages x .16 x .36 = 2.0). Although Swenson did not report exactly what percentage of these pages were equity fund advertisements, he noted that equity fund advertisements constituted 92\% of asset-class-specific advertisements in 1998, but only 50\% of asset-class-specific advertisements in 2003. \textit{Id. at 168 tbl. 5.4.}


\textsuperscript{66}In particular, they outperformed the S&P 500 by almost 2\% and had a four factor alpha of over 1\%. \textit{Id. at 943-46 & tbl.II. The four-factor alpha is a risk-adjusted measure of a fund’s excess return. A fund that outperforms its benchmark index has a positive alpha; a fund that underperforms its benchmark index has a negative alpha. \textit{Id. at 944 tbl.II.}
period in *BusinessWeek* and *Fortune* magazines. They found that fund companies tend to advertise their best-performing funds. The advertised funds' median one-year, five-year, and ten-year performance was at the 80th, 100th, and 100th percentile, respectively, of all company-operated funds with the same investment objective. The advertised funds also had a median one-year, five-year, and ten-year performance at the 79th, 88th, and 88th percentile, respectively, of all company-operated equity funds, irrespective of the investment objective.

Thus, fund companies use performance advertisements only for their successful funds. This selective advertising misleads investors by obscuring the role of luck in past returns. A company operating many funds will generally have some funds outperform their peers simply because of luck. However, because investors only see the returns of the company’s high-performing funds, but not its low-performing ones, they are more likely to attribute the high returns to the fund manager’s skill rather than luck.

Koehler and Mercer’s recent experiment demonstrates that investors are misled by this selective advertising. Participants in their study were each shown one version of a performance advertisement for a hypothetical fund company’s two growth funds that had outperformed the S&P 500 by an average of several percentage points a year. After reading the advertisement, participants were asked about their perception of the quality of the funds’ management company and about their willingness to invest in a new growth fund being introduced by the fund company.

The versions of the advertisement differed in the extent that they implicitly warned about selective advertising. For example, one version contained a statement that the advertised funds were only two of thirty funds operated by the fund company. Another version stated that the advertised funds were the only two funds operated by the company. A third version did not indicate how many funds the company operated.

The study found that investors perceive selection biases in performance advertisements only if they are at least implicitly prompted to do so. Participants who were told that the fund company had thirty funds, rather than two funds, had less favorable impressions of the fund company’s quality and were less willing to invest in the company’s new fund. In fact, they responded similarly to participants who were shown a version of the advertisement that lacked any past returns at all.

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68 *Id.* at 1110.
69 *Id.*
70 *Id.* at 1111. The advertisement was modeled closely on an actual advertisement that had been used by a major fund company. *Id.*
71 *Id.*
72 *Id.*
73 *Id.* at 1112-13.
In contrast, however, participants who were shown an advertisement lacking any indication of how many funds the company operated did not discount the advertised returns. Rather, they responded similarly to participants who were told that the fund company operated only two funds. They had the same beliefs regarding the quality of the fund company and were as willing to invest in the company’s new fund. These occurred even though they assumed that the fund company had many funds.

This experiment indicates that investors ignore selection biases in real-world fund performance advertisements. Unless an advertisement mentions the company’s other funds, investors act as if the fund company operates only the advertised funds. Of course, real-world performance advertisements do not mention a fund company’s other, weaker-performing funds. Therefore, investors likely attribute the advertised high past returns to managerial skill rather than luck, and thus mistakenly believe that the returns are likely to continue.

Indeed, fund companies use performance advertisements because they are effective. Investors in Capon, Fitzsimons, and Rice’s survey reported that fund advertising was their second most important source of information in purchasing funds. Also, Jain and Wu found that equity mutual funds that were in performance advertisements in Barron’s or Money garnered approximately 20% more flow than did similar funds that were not advertised. In addition, funds that were advertised more often attracted more flow.

Although performance advertisements benefit fund companies, investors do not benefit from buying advertised funds. Fund companies advertise their highest-performing funds, yet this strong performance generally does not continue. Indeed, Jain and Wu found that equity funds in performance advertisements generally underperform the same benchmarks they outperformed prior to being advertised. For example, in the one year period after being advertised, they underperformed funds with the same investment objective by an average of almost 1%, had a four-factor alpha below -3%, and trailed the S&P 500 by almost 8.

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In summary, fund companies advertise their high-performing funds because these advertisements work. Performance advertisements are

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74 Id.
75 On average, they estimated that the fund company had fifteen funds. Id. at 1113.
76 Capon et al., supra note 24, at 66 tbl.1.
77 Jain & Wu, supra note 65, at 957.
78 Id. See also, Barber, Odean, & Zheng, Out of Sight, Out of Mind: The Effects of Expenses of Mutual Fund Flows, 78 J. Bus. 2095, 2108 (2005) (finding that funds with higher expenditures on 12b-1 fees – fees devoted to the selling and marketing of shares — garner more flow).
79 Jain & Wu, supra note 65, at 948-49 tbl.3.
effective because they exploit and encourage investors’ tendency to chase funds with high past returns. But performance advertisements do not benefit investors; advertised funds generally do not continue to outperform other funds.

III. CURRENT REGULATION OF MUTUAL FUND PERFORMANCE ADVERTISEMENTS

Mutual fund performance advertisements are extensively regulated. The general antifraud provisions of the federal securities laws apply to these advertisements. In addition, the SEC has adopted rules which impose detailed requirements specifically on fund performance advertisements. This part of this Article discusses the law governing fund performance advertisements.

A. Federal Securities Law Generally Prohibits False and Misleading Advertisements

The general antifraud provisions of the federal securities laws prohibit the use of materially false or misleading information in selling securities, including mutual funds. Section 17(a)(2) of the Securities Act of 1933 prohibits, in the offer or sale of any security by communication in interstate commerce, “obtain[ing] money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading.”

Also, Rule 10b-5 under the Securities Exchange Act of 1934 forbids, in connection with the purchase or sale of any security, by any means or instrument of interstate commerce or by the mail, “mak[ing] any untrue statement of a material fact or . . . omit[ting] to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading.”

The Investment Company Act of 1940, which applies to mutual funds, contains a similar general prohibition. Section 34(b) prohibits, in any registration statement or other documents transmitted pursuant to the Act, “any untrue statement of material fact” or the omission of “any fact necessary in order to prevent the statements made therein, in the light of the circumstances under which they were made, from being materially misleading.”

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81 17 C.F.R. § 240.10b-5(b) (2008).
Similar prohibitions have been adopted as self-regulatory rules of the Financial Industry Regulatory Association (FINRA), the successor of the National Association of Securities Dealers (NASD). These rules, approved by the SEC, govern the activities of its members. NASD Conduct Rule 2210(d)(1)(B) states that “[n]o member may make any false, exaggerated, unwarranted or misleading statement or claim in any communication with the public. No member may publish, circulate or distribute any public communication that the member knows or has reason to know contains any untrue statement of a material fact or is otherwise false or misleading.” Similarly, NASD Conduct Rule 2210(d)(1)(A) mandates that “[n]o member may omit [from a communication with the public] any material fact or qualification if the omission, in the light of the context of the material presented, would cause the communication[ ] to be misleading.”

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In summary, many general statutes, SEC regulations, and industry rules prohibit fund advertisements from containing untrue statements of material fact or omitting to state material facts necessary to make the statements made, in the light of the circumstances of their use, not misleading. That is, both lies and half-truths regarding material information are prohibited.

B. SEC Rules Specify the Calculation and Presentation of Performance Data

The SEC extensively regulates how funds’ past returns in advertisements may be calculated and presented. These regulations are intended to ensure that advertised performance data are up-to-date and accurately reflect funds’ past performance. They also facilitate investor comparison of the returns of different funds.

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Rule 482 promulgated under the Securities Act of 1933 explicitly applies to performance advertisements, standardizing how past returns in advertisements may be calculated and presented. For example, performance advertisements for an equity fund must report the fund’s average annual total returns for the last one, five, and ten years. In adopting this regulation, the SEC explained that including returns for these three time periods gives investors information regarding “the actual investment experience of a short-term, intermediate-term and long-term investor in the fund. . . . [and] permit[s] some evaluation of the level of volatility characteristic of the return on the fund’s portfolio.” Rule 482 also specifies the methodology for computing total returns, thus ensuring that total returns are calculated consistently from fund to fund.

Performance advertisements, according to the SEC rule, may also report for any time periods any other performance measure that “reflects all elements of return,” such as aggregate, average, year-by-year, or other types of total return calculations. However, these other performance measures must supplement, not replace, the required standardized average annual total returns, and they may not be presented more prominently than those returns. Also, if a performance advertisement represents that the fund is managed to limit taxes, the advertisement must also present the fund’s standardized after-tax returns.

In addition, if the fund charges a sales load or other non-recurring fee, the advertisement must state the maximum amount of that load or fee. The load or fee must also be reflected in the advertised returns or the advertisement must state that “the performance data does not reflect the deduction of the sales load or fee, and . . ., if reflected, the load or fee would reduce the performance quoted.”

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86 17 C.F.R. § 230.482 (2008). Section 10(a) of the Securities Act of 1933 states that a prospectus generally must contain the information that is in the security’s registration statement. 15 U.S.C. § 77j(a) (2008). However, Section 10(b) permits the SEC to adopt rules and regulations allowing the use of a prospectus that omits or summarizes some of the information in the registration statement. 15 U.S.C. § 77j(b) (2008). The SEC promulgated Rule 482, which defines advertisements and other sales material (which are collectively referred to as “advertisements”) respecting investment companies as being prospectuses under Section 10(b) if the advertisements comply with certain requirements. 17 C.F.R. § 230.482(a) (2008). Note, however, that advertisements that comply with Rule 482 are not automatically legal; they must still also not be misleading. 17 C.F.R. § 230.482 note to paragraph (a) (2008).

87 17 C.F.R. § 230.482(d)(3) (2008). If the fund’s registration statement has been in effect for less than one, five or ten years, then the average annual total return since the registration period has been in effect must be reported instead. Id.


94 Id.
In 2003, the SEC adopted regulations that, in part, focus on ensuring that performance data in advertisements are up-to-date. The SEC amended Rule 482 to require that either the total returns data be current to the most recent month-end or the advertisement direct investors to a website or a toll-free or collect phone number where such current data is available. The SEC explained that it was adopting this requirement so that “investors who are provided advertisements highlighting a fund’s performance [will] have ready access to performance data that is current to the most recent month-end and will not be forced to rely on performance data that may be more than three months old at the time of use by the investor.”

In adopting this requirement, the SEC also showed concern that funds could mislead investors by selectively choosing the dates for which performance data are reported. Some commentators had encouraged the SEC to exempt advertisements that include performance data that is more recent than the previous month-end from the requirement that the advertisement direct investors to a website or phone number containing the month-end performance data. After all, such advertisements contain more recent information than would be available via the website or phone number.

However, the SEC rejected this proposed exemption for two reasons. First, requiring month-end performance data allows investors to compare the performance of different funds. Second, the exemption would have allowed funds to mislead investors by “cherry picking” the date so the fund could advertise its most favorable performance. For example, if the fund had an unusually strong first two weeks of the current month, it might advertise its performance as of the end of the first two weeks of the month, rather than its performance through the end of last month. Although the SEC did not prohibit advertisements from including more recent performance data, it argued that requiring the fund to also make available the most recent month-end data would serve as a check on such cherry picking.

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In summary, the SEC has largely standardized the calculation and presentation of performance data in fund advertisements. This is intended to ensure that the advertised returns are up-to-date and accurately reflect the fund’s past performance. It is also intended to limit fund companies’ ability to cherry pick particular time periods’ performances to advertise, and to

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96 Id.
97 Id. at 57,765.
98 Id.
99 Id.
100 Id. Of course, it would only serve as a check on such cherry picking if fund companies believe that investors actually would go to the website or call the phone number to obtain month-end performance data that is less current than that provided in the advertisement.
facilitate investor comparison of different funds’ returns. Without such requirements, performance advertisements could calculate and present past returns in ways that mislead potential investors regarding a fund’s true past performance. However, performance advertisements also can mislead investors in another way: they can suggest that a fund’s high past returns are predictive of high future returns. The SEC has taken only limited steps to address this problem.

C. SEC and Other Rules Limit Implication that Past Returns Predict Future Returns

A number of SEC and other rules attempt to prevent performance advertisements from encouraging investors to rely heavily on past returns. These rules give content to the general prohibition against the use of materially false or misleading fund advertising. Rule 156 promulgated by the SEC under the Securities Act of 1933 provides guidance on what types of investment company sales literature might be materially misleading. Rule 156 makes clear that whether particular sales literature – including a mutual fund advertisement – is materially misleading must be decided on a case-by-case basis because this determination “depends on an evaluation of the context in which [the allegedly misleading statement] is made.”

Rule 156 provides guidance on its reach by listing some types of statements that could be misleading. Included in this guidance are two specific situations in which the use of past performance could be materially misleading: first, if the sales literature contains “[r]epresentations implying that future gain or income may be inferred from or predicted based on past investment performance,” and second, if it contains “[p]ortrayals of past performance, made in a manner which would imply that gains or income realized in the past would be repeated in the future.”

Similarly, NASD Conduct Rule 2210(d)(1)(D) provides that “[c]ommunications with the public may not predict or project performance, imply that past performance will recur or make any exaggerated or unwarranted claim, opinion or forecast.”

Rule 482 under the Securities Act of 1933 imposes the most specific requirements on mutual fund performance advertisements. In 1988, the SEC amended Rule 482 to require performance advertisements to include a legend “disclosing that the performance data quoted represents past performance and that the investment return and principal value of an investment will fluctuate so that an investor’s shares, when redeemed, may be worth more or

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102 17 C.F.R. § 230.156(b) (2008).
103 Id.
106 Nat’l Ass’n of Sec. Dealers R. 2210(d)(1)(D). This rule has not yet been consolidated as a FINRA rule, so it is still referred to as a “NASD rule.” Supra note 83.
less than their original cost.”

This disclosure was intended to address two concerns. First, the SEC was worried that some potential investors did not understand that the performance data in advertisements was historical information only (unlike a current yield, for example). The SEC observed that disclosures that performance data are “historic and not necessarily indicative of future performance are often relegated to footnotes and very small print or presented in an incomplete or confusing manner,” if such disclosures are included in advertisements at all. Second, the SEC was concerned that advertisements were insufficiently explaining the risks of investing in mutual funds, including the risk that investors could lose some of their principal.

In 2003, the SEC again amended Rule 482 to strengthen the required disclosure. The SEC acted out of “concern that some funds, when advertising their performance, may resort to techniques that create unrealistic investor expectations or may mislead potential investors.” This concern arose because many funds engaged in advertising campaigns focused on their short-term performance after experiencing extraordinarily high returns in 1999, 2000, and 2003.

Thus, “to help investors understand the limitations of past performance data,” the SEC amended Rule 482 to require performance advertisements to contain a warning that

- past performance does not guarantee future results;
- that the investment return and principal value of an investment will fluctuate so that an investor’s shares, when redeemed, may be worth more or less than their original cost; and
- that current performance may be lower or higher than the performance data quoted.

The warning, however, need not use this exact language; any wording that “clearly communicates” this information is sufficient. Also, to

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109 Id.
110 Id. at 34,390-91.
112 Id. at 57,760-61.
encourage investors to read it, the warning is required to be somewhat prominent in the advertisement. In particular, its font size must be at least as large as that of the major portion of the advertisement. Also, it must be in a font style different from – but at least as prominent as – the font style used in the major portion of the advertisement.\textsuperscript{116} In addition, it must be placed in “close proximity” to the performance data and, in print advertisements, must be in the body of the advertisement rather than in a footnote.\textsuperscript{117}

Finally, all Rule 482 advertisements, whether or not they contain performance data, must at least implicitly discourage investors from focusing exclusively on a fund’s past returns. Specifically, they must contain a statement “that advises an investor to consider the investment objectives, risks, and charges and expenses of the investment company carefully before investing” and that directs potential investors to the fund prospectus to obtain this and other information about the fund.\textsuperscript{118}

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In summary, besides regulating how past returns in fund performance advertisements are calculated and presented, the SEC requires these advertisements to warn investors against relying too heavily on past returns. In particular, the SEC mandates that performance advertisements contain a disclaimer that includes a warning that “past performance does not guarantee future results.” Nonetheless, performance advertisements still mislead investors into chasing high past returns.

\section*{IV. Mutual Fund Performance Advertisements as Inherently and Materially Misleading Statements}

Under the general prohibitions against using materially false or misleading information in selling securities, fund advertisements cannot contain untrue statements of material fact or omit to state material facts necessary to make the statements made, in the light of the circumstances of their use, not misleading.\textsuperscript{119} In this Part of the Article, we first explain why fund performance advertisements violate these prohibitions. Performance advertisements present high past returns and falsely imply that these returns are good predictors of high future returns. These advertisements omit to state a necessary material fact: high past returns are poor predictors of high future returns. Indeed, when the SEC first permitted the use of performance advertising by mutual funds, the agency cautioned that such

\begin{itemize}
\item \textsuperscript{116} 17 C.F.R. § 230.482(b)(5) (2008). Prominence requirements also exist for this warning in electronically delivered advertisements and television and radio advertisements. \textit{Id.}
\item \textsuperscript{117} \textit{Id.}
\item \textsuperscript{118} 17 C.F.R. § 230.482(b)(1)(i) (2008).
\item \textsuperscript{119} \textit{Supra} Part III.A.
\end{itemize}
advertising might be misleading if it implies (or is subject to an inference) that investors should expect the strong performance to persist, if the mutual fund company knows or should know of contrary data. Given the evidence showing a general lack of performance persistence, failing to correct the advertisements’ false implication regarding the importance of past performance is misleading.

Next, we discuss why the SEC-mandated warning that “past performance does not guarantee future results” fails to cleanse performance advertisements of their misleading nature. The warning only cautions investors that high past returns do not guarantee high future returns, not that high past returns are poor predictors of high future returns. In fact, our study of investor reactions to the SEC-mandated warning found that the warning does not reduce fund investors’ chasing of past performance.

We conclude this Part by contrasting the SEC’s limited approach toward performance advertisements with the regulatory approach of another agency. First, we examine the Federal Trade Commission’s regulation of testimonial advertisements – a type of performance advertisement – for non-investment products and services. The FTC has concluded that even a stronger warning that “results are not typical” is generally insufficient to inform consumers that advertised atypical past performance is not a good predictor of future results. Second, we analyze the FTC’s actions against advertisers of additive-free tobacco products for implying that additive-free tobacco is healthier than other tobacco. Even when the advertisements contain no health claims about additive-free tobacco products, the FTC has found these advertisements misleading, apparently because they take advantage of consumer misperceptions regarding the safety of the products.

Finally, we discuss two recent regulatory initiatives that question the use of fund performance data. The first is the Dodd-Frank Wall Street Reform and Consumer Protection Act, which requires the Government Accountability Office to conduct a study of mutual fund marketing, including performance advertisements. The second is the Department of Labor’s recent proposal under the Employee Retirement Income and Securities Act (ERISA) to restrict or even prohibit the use of a fund’s past performance as a basis for investment advice given by pension plan fiduciaries.

A. Performance Advertisements Are Material to Investors and Are Inherently Misleading for Implying Performance Persistence

Mutual fund advertising, like other sales material subject to the federal securities laws, cannot contain material statements that are false or, although facially truthful, misleading. Performance advertising is material to fund investors, and it is misleading for implying (or creating the inference) that strong past performance predicts strong future performance.

\[120\] Id.
Under the securities laws, information is material if there is a substantial likelihood that reasonable investors would consider it important in their investment decisions. That is, the information is material if it would be viewed by the reasonable investor as having significantly altered the “total mix” of information made available.\(^{121}\) For mutual fund disclosures, unlike disclosures made to investors in informationally-efficient markets, the reasonable investor is the average or typical fund investor to whom the disclosure is targeted.\(^{122}\) For this reason, the SEC requires that mutual fund prospectuses contain “information that is necessary for an average or typical investor to make an investment decision.”\(^{123}\)

Past returns are material to typical fund investors, who believe (erroneously) that high past returns predict high future returns. As discussed above, studies uniformly find that a fund’s past returns are important to investors. Investors report that a fund’s past performance is a very important factor to them in choosing a fund,\(^ {124}\) and fund flow is strongly influenced by a fund’s past returns.\(^ {125}\)

In addition, the SEC’s rules on how past returns in fund advertisements are computed and presented reflect the agency’s recognition of the data’s materiality to investors. In fact, the SEC has specifically acknowledged the materiality of performance data:

The prominence of performance information in many fund advertisements and the apparent interest of investors in performance information indicates that it is an important factor affecting an investor’s investment decision.\(^ {126}\)

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\(^{122}\) Mutual funds are not traded in organized markets in which publicly-available information, absorbed and acted on by sophisticated analysts and traders, is impounded in prices. See William Birdthistle, Investment Indiscipline: A Behavioral Approach to Mutual Fund Jurisprudence, 2010 Ill. L. Rev. 61, 71 (2010) (identifying mechanisms that create price efficiency in public trading markets, such as price arbitrage and other signaling by financial analysts, sophisticated investors, and ratings agencies); Donald C. Langevoort, Private Litigation to Enforce Fiduciary Duties in Mutual Funds: Derivative Suits, Disinterested Directors and the Ideology of Investor Sovereignty, 83 Wash. U. L.Q. 1017, 1030–32 (2005) (pointing out that the mutual fund market lacks price-efficiency mechanisms found in stock markets). Thus, for example, if information becomes available that a mutual fund is being mismanaged, there is no arbitrage or other trading mechanism by which this information would be impounded in the fund’s price. Even if some investors figure out that the fund is mispriced – and redeem their shares at net asset value – this does not result in a price signal to other investors.\(^ {123}\) Registration Form Used by Open-End Management Investment Companies, Securities Act Release No. 7512, Exchange Act Release No 39,748, Investment Company Act Release No. 23,064, 63 Fed. Reg. 13,916, 13,918-19 (Mar. 23, 1998). \(^{124}\) See also, Operating Local 649 Trust Fund v. Smith Barney Fund Management LLC, 595 F.3d 86, 92 (2d Cir. 2010) (holding that fee tables must be understood by the typical mutual fund investor). \(^{125}\) See supra pp. 8-9.  

Indeed, the pervasiveness of performance advertisements is further persuasive evidence that investors give past returns great weight. Fund companies commonly use performance advertisements, strongly suggesting that companies believe that past returns are an important factor in investors’ decisions. In fact, as discussed above, often more than half of equity mutual fund advertisements are performance advertisements. Advertising is expensive, so fund companies would not buy performance advertisements if they were not effective. Indeed, funds in performance advertisements garner significantly more flow than similar funds that are not advertised.

The past returns in performance advertisements, though factually accurate, are misleading because they falsely imply that these high past returns are good predictors of high future returns. In many performance advertisements, this implication is not subtle. In addition to reporting past returns, performance advertisements often contain text that implies that the performance is likely to continue. For example, performance advertisements with headlines touting the advertised fund’s “proven” or “strong” performance can only be understood as saying that such past performance predicts likely future performance.

Even performance advertisements that lack such text are misleading. By their very nature, performance advertisements inherently imply that high returns are likely to persist. The only purpose of performance advertisements is to convince investors that a particular fund that has performed well in the past is likely to continue to do so in the future. Indeed, we are unaware of any advertisement that touts a fund’s low past returns. It is for this reason that calculation and presentation of fund performance is closely regulated by the SEC.

In addition, as discussed above, fund companies use performance advertisements much more often when the stock market in general has performed well, and fund companies especially advertise their highest performing funds. This again demonstrates that fund companies use performance advertisements when there are strong returns to highlight, hoping that investors will infer that the advertised funds’ high returns are likely to persist.

Concerns that performance advertising might mislead by implying returns persistence was on the mind of the SEC when, in 1977, it first proposed a rule change to permit performance advertisements:

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127 Supra Part II.A.
128 Id.
130 Supra Part II.C.
[I]nformation concerning investment company performance may be misleading if it implies, or is subject to an inference, that prospective investors may expect performance or quality of investment advice similar to that suggested by the performance data provided, if there are additional data, with respect to the competence of the investment adviser or otherwise, which are known to, or in the exercise of reasonable care, should be known to, the provider of the information and which are inconsistent with any such implication or inference.\textsuperscript{131}

Thus, the SEC believed that a performance advertisement would be misleading if it implies performance persistence when fund managers have reason to doubt the truth of this implication. As discussed above, performance advertisements inherently imply performance persistence.\textsuperscript{132} Therefore, the finance studies showing a general lack of performance persistence\textsuperscript{133} – studies which should be known to fund managers – would make performance advertising misleading.

Nor does the existence of the current SEC-mandated warning preclude claims of deceptive advertising. Neither in its rule requiring the warning, nor in its release accompanying the rule, does the SEC state that the warning acts as a "safe harbor" to preclude any claims that performance advertising is misleading. Absent a clear statement of preclusion, the validity of which would in any event be questionable, the SEC-mandated warning cannot exculpate a fund company from liability for presenting materially misleading information.\textsuperscript{134}

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In summary, investors view past performance as important in their choice of mutual funds – and thus as "material" information. Even though SEC rules specify how past returns must be calculated and presented in performance advertisements, the accuracy and consistent presentation of the returns do not prevent the advertisements from being misleading. This is the essence of the half-truth doctrine in securities regulation: even if what is

\textsuperscript{132} Supra pp. 25-26.
\textsuperscript{133} Supra Part II.B.
\textsuperscript{134} A similar analysis applies to the preclusion of state claims by federal warning labels. In 2009, the Supreme Court held that an FDA-approved drug label did not preempt a state-law claim that the label did not contain an adequate warning. \textit{Wyeth v. Levine}, 129 S.Ct. 1187, 1202 (2009). Absent an express statement of federal preemption or an implied conflict (because of the impossibility of complying with both state and federal law or because state law prevents the accomplishment of the federal law's objectives), federal labeling requirements do not preclude state-based claims that the labels were inadequate. By like reasoning, an SEC-mandated warning does not preclude federal claims that the warning was inadequate and the information presented was materially misleading.
said is true, it is misleading if it omits necessary material information. Performance advertisements are inherently misleading because they fail to disclose the falseness of their very premise: strong past performance is a good predictor of strong future performance.

B. Current SEC Regulation Of Performance Advertisements Is Ineffective In Cautioning Investors

Performance advertisements are misleading because they omit a necessary material fact: high past returns are a poor predictor of high future returns. As discussed above, however, performance advertisements must contain an SEC-mandated warning that seeks to reduce investors’ enthusiasm for strong past performance:

[P]ast performance does not guarantee future results; . . . the investment return and principal value of an investment will fluctuate so that an investor’s shares, when redeemed, may be worth more or less than their original cost; and . . . current performance may be lower or higher than the performance data quoted.¹³⁵

This warning seems to “bespeak caution.”¹³⁶ Perhaps, one could argue, this warning sufficiently discourages investors from focusing on advertised past returns, so that the advertisements are not materially misleading.

However, this SEC-mandated warning is far too weak. It merely cautions investors that the advertised high past returns do not guarantee high future returns, that returns vary, and that investors in the fund might even lose money. It is unlikely that many investors do not know that an equity fund’s returns are not guaranteed, can vary over time, and can even be negative. The fall in stock prices after the dot-com bubble and during the recent financial crisis have made clear to investors that the stock market is volatile and subject to dramatic declines.¹³⁷

The SEC-mandated warning fails to tell investors what they really need to know: high past returns are usually a matter of luck and thus are poor predictors of high future returns. Ironically, the SEC-mandated warnings can even be understood as encouraging investors to rely on past returns. Warning that “past performance does not guarantee future results” arguably implies that there is a positive relationship between high past and high future returns, just not a guaranteed one.¹³⁸

¹³⁶ Luce v. Edelstein, 802 F.2d 49, 56 (2d. Cir. 1986).
¹³⁸ Other SEC regulations also might implicitly encourage fund investors to chase high past returns. For example, as noted before, performance advertisements must include a “toll-free or collect telephone number or a
To test the effectiveness of the SEC-mandated warning, we – along with Molly Mercer – recently conducted an experiment. Participants in the experiment were presented a version of a performance advertisement for a fictional mutual fund that had outperformed its peers in the past. The advertisement was based closely on an equity advertisement that recently appeared in *Money* magazine. Participants then were asked about their propensity to invest in the fund and about their expectations regarding the fund’s future returns. Versions of the advertisement differed in the strength and prominence of its warning against relying on past returns.

We found that the current SEC-mandated warning is completely ineffective. Participants viewing the version of the advertisement containing that warning were as likely to invest in the fund, and had the same expectations regarding the fund’s future returns, as did participants viewing a version of the advertisement that had no warning whatsoever.

The SEC-mandated warning likely fails, at least in part, because it is so weak. In our experiment, we found that participants who were less likely to believe that the advertised fund’s past performance is a good predictor of its future performance were also less willing to invest in the advertised fund. The SEC-mandated warning fails to convey this information. Instead, it merely informs investors that past performance does not “guarantee” future results.

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In summary, despite the SEC-mandated warning, performance advertisements remain materially misleading. The warning does not adequately caution investors against relying on past performance in evaluating a fund’s future prospects. Indeed, investors appear to respond to performance advertisements as if the advertisements contained no warning at all.

C. Mutual Fund Performance Advertisements Also Fail to Satisfy FTC Advertising Standards

Fund performance advertisements not only fail to satisfy the general antifraud provisions of the federal securities laws, they also fail to satisfy general standards governing false and misleading advertising for other products and services. Section 5 of the Federal Trade Commission Act website where an investor may obtain performance data current to the most recent month-end.” 7 C.F.R. § 230.482(b)(3)(i) (2008). Although this requirement ensures that investors have access to the fund’s recent returns and reduces fund companies’ ability to cherry pick which periods’ returns to advertise, it also might convey to investors that a fund’s very recent returns should be an important factor in choosing a fund.

139 Mercer et al., *Worthless Warnings*, supra note 2.

140 Id. at 447-53.

141 Id. at 453-55.
prohibits “unfair methods of competition in or affecting commerce, and unfair or deceptive acts or practices in or affecting commerce.” If mutual fund performance advertisements were regulated by the Federal Trade Commission (FTC), rather than the SEC, they likely would be deemed to be deceptive advertisements. Indeed, the FTC and courts have found advertisements for other products and services that are similar to mutual performance advertisements to be deceptive under the Section 5 of Federal Trade Commission Act.

1. Fund performance advertisements fail to satisfy FTC standards for testimonial advertisements

Testimonial advertisements include a statement by a person who claims to have had a positive experience using the advertised product or service. For example, advertisements for weight loss products frequently contain a testimonial from someone who lost a large amount of weight using the product. Similarly, advertisements for business opportunities often contain a testimonial from someone who made a large amount of money through the opportunity.

Mutual fund performance advertisements are similar to testimonial advertisements. Testimonials for a product present a consumer’s past experience with the advertised product, and, from this testimonial, viewers of the advertisement may infer what their own results are likely to be if they were to use the product. Similarly, mutual fund performance advertisements present the past returns achieved by the mutual fund, allowing potential investors to infer what returns they likely would earn if they were to invest in the fund.

To provide guidance to advertisers and endorsers regarding how Section 5 of the Federal Trade Commission Act applies to testimonials, the FTC has issued its Guides Concerning the Use of Endorsements and Testimonials in Advertising (“Guides”). When first adopted in 1980, the Guides permitted advertisements with testimonials of atypical results provided that the advertisements also contained disclaimers warning that the advertised results were not typical of the results most people would achieve.

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144 There is at least one difference between product/service testimonials and fund performance advertisements. All investors in a mutual fund over the specified period actually earned the returns highlighted in the performance advertisement. In contrast, usually most people who bought the advertised weight loss product (or business opportunity) did not lose as much weight (or make as much money) as did the person giving the testimonial. But both kinds of advertisements can use atypically strong past results to mislead readers regarding their own likely future results. Testimonial advertisements can falsely imply that the reader is likely to lose as much weight as did the person in the advertisement; mutual fund performance advertisements can falsely imply that the fund is likely to continue its strong past performance.
145 According to the original Guides, any testimonial relating to a consumer’s experience regarding a key attribute of a product or service
For example, imagine a weight loss product advertisement containing a testimonial from someone who had lost 100 pounds using the product. The Guides stated that the FTC would deem this testimonial to imply that users of the product generally lose about 100 pounds. Unless the advertiser could substantiate this implication, the advertisement would have had to also either state what amount of weight users of the product generally lose or warn that product users do not typically lose 100 pounds. Thus, the Guides created a safe harbor for advertisements containing testimonials presenting even extreme positive results, as long as the advertisements also contained a disclaimer warning that the advertised “results are not typical.”

Recognizing that disclaimers accompanying potentially misleading advertisements may not be enough, the FTC amended the Guides in October 2009. The amended Guides now state that a testimonial relating to a consumer’s experience regarding a key attribute of a product or service will likely be interpreted [by the FTC] as representing that the endorser’s experience is representative of what consumers will generally achieve with the advertised product in actual, albeit variable, conditions of use. Therefore, an advertiser should possess and rely upon adequate substantiation for this representation. If the advertiser does not have substantiation that the endorser’s experience is representative of what consumers will generally achieve, the advertisement should clearly and conspicuously disclose the generally expected performance, and the advertiser must possess and rely on adequate substantiation for that representation.

Two changes in these amended Guides are noteworthy. First, the amended Guides state that the FTC is only “likely” to interpret testimonial advertising as representing typical results. This change, however, still reflects the FTC’s belief that testimonial advertisements generally are understood by consumers as implying that the endorser’s experience is

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146 Id.

147 16 C.F.R. § 255.2(b) (2010).
typical. Although, in some situations, consumers may understand that testimonials of favorable results are not necessarily typical – such as testimonials by slot machine winners at casinos\textsuperscript{148} – the FTC made clear that such instances were only exceptions to the general tendency of consumers to believe that testimonials reflect typical results. In fact, when proposing the amendments to the Guides, the FTC cited two new empirical studies of consumers’ interpretations of advertisements – as well as the FTC’s findings in a number of litigated cases – as “support[ing] the Guides’ position that consumers interpret advertisements containing endorsements as representing the results achieved by the endorsers are generally representative of what new users can expect.”\textsuperscript{149}

A second change in the amended Guides is more important. The FTC eliminated the safe harbor for testimonial advertisements that contain disclaimers that the advertised “results are not typical,” a warning that is even stronger than the SEC-mandated “past performance does not guarantee future results” warning in mutual fund performance advertisements. In proposing this amendment, the FTC cited the same two empirical studies as evidence that the disclaimer was ineffective. One of these studies found that “despite the presence of strongly worded, highly prominent disclaimers of typicality,” between 44.1% and 70.5% of the readers of testimonials regarding the benefits of a dietary supplement believed that the supplement would provide the benefits to “at least half of the people who try it.”\textsuperscript{150}

Similarly, in the second study, participants were shown testimonial advertisements for a weight loss program, dietary supplement, or a business opportunity. Even when they viewed versions of the advertisements containing disclaimers that the advertised “[r]esults [are] not typical” or that “[t]hese testimonials are based on the experiences of a few people. You are not likely to have similar results,” between 22.6% and 50.8% of participants believed that “at least half of new users would achieve results similar to those experienced by the endorsers featured in the advertisements.”\textsuperscript{151}

Based on these studies and its own experience, the FTC eliminated the safe harbor for “results not typical” disclaimers. However, the FTC did not prohibit these disclaimers because it could not “rule out the possibility that a clear, conspicuous, and informative disclaimer” could prevent consumers from being misled regarding the typicality of a testimonial.\textsuperscript{152} Nevertheless, the agency warned that it is “skeptical that most disclaimers of typicality will be effective in preventing deception.”\textsuperscript{153}

\textsuperscript{148} Guides Concerning the Use of Endorsements and Testimonials in Advertising, 73 Fed. Reg. 72,374, 72,378 (proposed Nov. 28, 2008).
\textsuperscript{149} Id.
\textsuperscript{150} Id. at 72,379.
\textsuperscript{151} Id.
\textsuperscript{153} Id.
Mutual fund performance advertisements fail to satisfy the standards in the Guides. As discussed above, advertised past fund returns generally are not typical of the returns that investors in the fund can expect in the future for two reasons. First, there is not performance persistence. Fund companies advertise those funds that have outperformed their peers in the past, but this relative outperformance generally doesn’t continue. Second, performance advertisements are much more prevalent when equity fund returns have been high overall. Bull markets, however, always eventually end. Thus, performance advertisements highlight past returns that are atypically high both in relative and in absolute terms.

Despite this, the SEC requires only that performance advertisements warn that high past returns are not “guaranteed” to continue, that returns may vary, and that an investor might lose money in the fund. This is far weaker than warning that high past returns are not “typical” of future returns. Yet even such a stronger typicality disclaimer would generally no longer satisfy the FTC. Under the current Guides, advertisements of atypical results usually also require a disclosure of what results are typical.

Furthermore, courts and the FTC have concluded that a “results may vary” disclaimer – which is similar to that required by the SEC in fund performance advertisements – does not prevent an advertisement of atypical results from being misleading. For example, a federal court granted the FTC a summary judgment in an action under Section 5 of Federal Trade Commission Act against the sellers of a work-at-home business opportunity for their advertisements regarding an electronic claims processing package sold to consumers. Although the company’s advertisements claimed that the package offered earnings potential of $20,000 to $45,000 per year, the vast majority of consumers who bought the package actually earned much less.

The sellers argued in their defense that the advertisements contained a disclaimer warning that “results may vary.” Despite the disclaimer, the court found the work-at-home advertisements to be deceptive and misleading. The court reasoned that even with such a disclaimer, “consumers could reasonably believe that the statements of earnings potential represent typical or average earnings.”

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154 Supra pp. 13-14.
155 Supra pp. 9-12, 15.
157 Federal Trade Commission v. Medicor, LLC, 217 F.Supp.2d 1048 (C.D. Cal 2002). The package allowed consumers to conduct a business from their homes, submitting medical bills on behalf of doctors to benefits programs such as Medicaid and Medicare. Id. at 1050.
158 Id. at 1054.
159 Id. at 1054.
In summary, the FTC and courts have recognized that consumer advertisements that present past results generally imply that those results are typical. When this implication is untrue, disclaimers that “results are not typical” or that “results may vary” are insufficient to prevent consumers from being misled. Instead, the FTC has taken the position that consumers generally must be informed of the actual results they should expect.

Mutual fund performance advertisements fail to meet this standard. Like testimonials, fund performance advertisements suggest generalized results. They imply that current shareholders are likely to earn high returns, just as past shareholders did. Given the lack of performance persistence in actively-managed equity mutual funds, and the fact that performance advertisements are much more prevalent during bull markets, performance advertisements advertise atypically high relative and absolute fund returns and thus are misleading. The SEC-mandated warning, which is even weaker than the warning once permitted by the FTC in testimonial advertisements, is inadequate to protect investors.

2. Fund performance advertisements fail to meet FTC standards for advertisements of additive-free tobacco products

In the 1990s, a number of tobacco companies advertised cigarettes that lacked chemical additives.\(^\text{160}\) The FTC filed suit against three companies for these advertisements. In its complaints, the FTC claimed that the advertisements “represented, expressly or by implication, that smoking [the] cigarettes, because they contain no additives, is less hazardous to a smoker’s health than smoking otherwise comparable cigarettes that contain additives.”\(^\text{161}\)

The FTC’s complaints against two of the companies, R.J. Reynolds Tobacco Company and Santa Fe Natural Tobacco Company, are particularly noteworthy. None of the advertisements cited in those complaints claimed

\(^{160}\) Patricia A. McDaniel & Ruth E. Malone, “I Always Thought They Were All Pure Tobacco”: American Smokers’ Perceptions Of “Natural” Cigarettes and Tobacco Industry Advertising Strategies, 16(7) TOBACCO CONTROL 5-6 (2007).

\(^{161}\) Complaint at para. 5, In the Matter of R.J. Reynolds Tobacco Company, 128 F.T.C. 262 (Aug. 16, 1999). The FTC sued R.J. Reynolds Tobacco Company, Santa Fe Natural Tobacco Company (“Santa Fe”), and Alternative Cigarettes, Inc. Because Santa Fe’s advertisements referred to their products as “chemical-additive-free” rather than just additive-free, the FTC’s complaint against Santa Fe claimed that the company “represented, expressly or by implication, that smoking . . . [the] cigarettes, because they contain no additives or chemicals, is less hazardous to a smoker’s health than smoking otherwise comparable cigarettes that contain additives or chemicals.” Complaint at para. 5, In the Matter of Santa Fe Natural Tobacco Company, Inc., 2000 WL 559854 (Apr. 27, 2000). Similarly, the advertisements of Alternative Cigarettes, Inc. specified that that its cigarettes contained “no added chemicals, flavorings, [or] preservatives,” so the FTC’s complaint against Alternative Cigarettes claimed that the company “represented, expressly or by implication, that smoking . . . [the] cigarettes, because they contain no additives, chemicals, flavorings or preservatives, is less hazardous to a smoker’s health than smoking otherwise comparable cigarettes that contain additives, chemicals, flavorings, or preservatives.” Complaint at para. 6, In the Matter of Alternative Cigarettes, Inc., 2000 WL 559811 (Apr. 27, 2000).
that additive-free cigarettes were safer than cigarettes with additives. In fact, they contained no health claims at all, and they displayed the Surgeon General’s standard health warnings against smoking that all cigarette advertisements were required to have.162

Rather than make health claims, the cited advertisements indicated only that additive-free cigarettes taste better or last longer than other cigarettes. Six of the seven R.J. Reynolds’ advertisements contained text stating that “No additives are in our tobacco, for true taste” or “No additives in our tobacco means true taste, straight up”, and/or had taglines stating “100% Tobacco True Taste” or “New Winston[.] No Additives[.] True Taste[.].”163 Similarly, one of Santa Fe’s three advertisements stated that the advertised cigarettes “are made from 100% chemical-additive-free natural tobacco . . . and nothing else. The result is great tobacco flavor, with no chemical after-taste. Discover the slower-burning, longer-lasting, all-natural smoking experience . . . .”164 The other R.J. Reynolds advertisement and the other two Santa Fe advertisements did not indicate any reason that additive-free cigarettes are superior to other cigarettes.165

Nevertheless, numerous studies indicated that many smokers erroneously assumed that additive-free cigarettes were healthier.166 The FTC claimed the advertisements were misleading, and entered into consent decrees with the tobacco companies in which they agreed to include disclosures in the advertisements that additive-free cigarettes are not safer than other cigarettes.167

Mutual fund performance advertisements and additive-free cigarette advertisements are misleading for very similar reasons. Advertisements for additive-free cigarettes – even those advertisements that make no explicit health claims – mislead consumers regarding the safety of the advertised

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166 McDaniel & Malone, supra note 160, at 4, 6 (citing the results of studies conducted for tobacco companies of consumer reactions to additive-free cigarettes).
cigarettes by exploiting consumers’ erroneous belief that additive-free cigarettes are healthier than other cigarettes. Similarly, fund advertisements that present strong past performance – even if they make no explicit claims regarding likely future performance – mislead investors regarding the advertised funds likely future returns by exploiting investors’ erroneous belief that strong past performance is a good predictor of strong future performance.

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In summary, the FTC’s actions against advertisers of additive-free cigarettes, even when the advertisements did not make any explicit health claims, buttress the conclusion that advertisements that merely exploit consumers’ misconceptions – as fund performance advertisements do – can be misleading. Protecting mutual fund investors from misleading performance advertising is no less important than protecting consumers from misleading advertising of products and services.

D. Other Regulatory Initiatives Raise Questions about Performance Advertising

The misleading nature of mutual fund performance advertising has also caught the attention of Congress and the Department of Labor.

1. The Dodd-Frank Act calls on the Government Accountability Office to study fund performance advertising

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 takes notice of the broad implications of performance chasing by mutual fund investors and mandates the Comptroller General, the head of the Government Accountability Office (GAO), to study mutual fund advertising.\(^{168}\) That study is required to address many of the issues discussed in this Article.

The GAO study, which is to be conducted by January 2012, must identify (1) existing and proposed regulatory requirements regarding mutual fund advertising, (2) current marketing practices for the sale of mutual funds, including the use of past performance data, (3) the impact of such advertising on consumers, and (4) recommendations to improve investor protections in mutual fund advertising and additional information necessary to ensure that investors make informed decisions when buying mutual funds.\(^{169}\)

\(^{168}\) It is unclear why the legislation calls on the GAO, not the SEC, to conduct the study. It is reasonable to speculate that there might be concern that the SEC would not be objective in assessing its own performance in regulating mutual fund marketing.

In addition, the Dodd-Frank Act requires the SEC to study the effectiveness of existing legal and regulatory standards of care of brokers, dealers and investment advisers, and specifically authorizes the SEC to issue point-of-sale disclosure rules for retail investors. This study could examine how such retail intermediaries present mutual fund performance data to investors. Any effort to prevent performance chasing by mutual fund investors would be incomplete if it did not also address the fund investment advice given them by broker-dealers and investment advisers. That is, any SEC action on mutual fund advertising of past returns must also set consistent standards for those who advise mutual fund investors.

2. The Labor Department has proposed restricting the use of performance data by ERISA plan fiduciaries

The misleading nature of mutual funds’ past returns has also been noticed by the Department of Labor, the agency charged with setting standards for private pension plans under the Employee Retirement Income and Securities Act (ERISA). In a March 2010 proposal to permit plan fiduciaries to give investment advice to employees based on computer models of past returns of different asset classes, the Labor Department made clear that such models should “[a]void investment recommendations that . . . inappropriately distinguish among investment options within a single asset class on the basis of a factor that cannot confidently be expected to persist in the future. . . .” The Labor Department justified this restriction on the grounds that

while some differences between investment options within a single asset class, such as differences in fees and expenses or management style, are likely to persist in the future and therefore to constitute appropriate criteria for asset allocation, other differences, such as differences in historical performance, are less likely to persist and therefore less likely to constitute appropriate criteria for asset allocation. Asset classes, in contrast, can more often be distinguished from one another on the basis of

\[170\] Id. at § 913(b).
\[171\] Id. at § 913(g).
\[172\] The rulemaking seeks to implement provisions of Section 408 of ERISA, which provides exemptions to prohibitions found in Section 406 aimed at certain transactions between an ERISA plan and plan fiduciaries of parties with interests in the plan. Among the Section 408 exemptions is one for investment advice provided by a fiduciary adviser “pursuant to a computer model that . . . applies generally accepted investment theories that take into account the historic returns of different asset classes over defined periods of time.” 29 U.S.C. § 1108(g)(3)(B). The proposed rulemaking would exempt investment advice provided pursuant to a computer model “designed and operated to . . . apply generally accepted investment theories that take into account the historic risks and returns of different asset classes over defined periods of time. . . .” Investment Advice – Participants and Beneficiaries, 75 Fed. Reg. 9360, 9366 (proposed Mar. 2, 2010).
\[173\] Id. at 9361.
differences in their historical risk and return characteristics.\footnote{Id. at 9361-62.}

Thus, the Labor Department has recognized that past returns are less predictive of future returns than are other fund characteristics, such as fund costs and asset classes. In its rulemaking proposal, the Department explicitly solicited public responses to questions including:

- “Is a fund’s past performance relative to the average for its asset class an appropriate criterion for allocating assets to the fund?”\footnote{Id. at 9362.}

- “Under what if any conditions would it be consistent with generally accepted investment theories and with consideration of fees ... to recommend a fund with superior past performance over an alternative fund in the same asset class with average performance but lower fees? Should the regulation specify such conditions?”\footnote{Id.}

- “On what if any bases can a fund’s superior past performance be demonstrated to derive not from chance but from factors that are likely to persist and continue to affect performance in the future?”\footnote{Id.}

- “Should the use of a fund’s superior past performance as a criterion for allocating assets to the fund be conditioned on such demonstration?”\footnote{Id.}

With respect to mutual funds, many of these questions are already answered in the academic financial literature. Superior past performance by actively-managed equity funds is rarely, and perhaps never, an appropriate criterion for investing in such funds. As discussed above, strong past performance by specific actively-managed equity funds is generally a matter of luck and does not persist.\footnote{Mark Carhart, On Persistence in Mutual Fund Performance, 52 J. Fin. 57, 80 (1997).} The level of a fund’s fees, expense ratios, and other costs are more predictive of its future returns.\footnote{Recall that in its release accompanying its 1977 proposal to allow fund performance advertisements, the SEC placed on fund companies the burden to exercise “reasonable care” in finding data that contradicts any implication in the advertisements that investors can expect future performance similar to the advertised past performance. Supra p. 26.} And the burden to show that performance data is not misleading would, according to the SEC, seem to be on fund companies.\footnote{Supra Part II.B.}
In summary, the Labor Department recognizes the unreliability of past performance as a predictor of future performance. Although the final form of the regulation is not yet determined, it is telling that the Department is considering restricting, or even prohibiting, the use of fund past performance data by pension fund advisers as a basis for their investment advice.

Whether the SEC will read the tea leaves from the GAO and the Labor Department has yet to be seen. At a meeting of the Mutual Fund Directors’ Forum in April 2010, however, Andrew Donohue, the director of the SEC’s Division of Investment Management, stated that even if the Labor Department adopts the proposed rule, the SEC would be unlikely to alter its own rules permitting the use of past performance to promote funds.182

V. REFORMING THE REGULATION OF MUTUAL FUND PERFORMANCE ADVERTISEMENTS

We have shown that performance advertisements mislead consumers into chasing funds with high past returns. In this section of the Article, we detail how this performance chasing harms investors, and thus our national savings and retirement systems. We then discuss two possible regulatory approaches to address this harm. One approach is for the SEC to require performance advertisements to contain a stronger warning discouraging investors from chasing high past returns. A bolder approach, however, may be necessary: a return to the regulatory prohibition of fund performance advertisements.

A. Performance Advertisements Harm Investors

By enticing investors to chase high past returns, fund performance advertising harms investors in multiple ways. First, it causes them to earn lower returns than they expect and perhaps that they could otherwise. As detailed above, funds that have earned high returns in the past generally do not continue to do so.183 In addition, Jain and Wu’s study found that funds in performance advertisements even tend to underperform their benchmarks after being advertised.184

The greater problem with performance advertisements, however, is that they encourage poor investing behavior. Recall that all Rule 482 advertisements – whether or not they are performance advertisements – must contain a statement “advising an investor to consider the investment objectives, risks, and charges and expenses of the investment company

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183 Supra Part II.B.
184 Jain & Wu, supra note 65, at 948-49 tbl.3.
carefully before investing” and directing potential investors to the fund prospectus to obtain this and other information about the fund. Performance advertisements greatly undermine this important advice. To the extent that investors choosing among funds give weight to past returns, they necessarily give less weight to these other, more important fund characteristics.

Indeed, studies confirm that investors pay insufficient attention to those other characteristics. For example, Capon et al.’s survey of fund-owning households found that 72% of them did not know whether their funds focus on domestic or international securities, and 75% of them did not know whether their funds invest in equities or fixed-income securities. Also, in an Investment Company Institute sponsored survey of fund investors, only 57% claimed to, before investing, review the type of securities held by a fund and only 40% claimed to review the fund’s investment objectives. In addition, other studies have found that investors pay little attention to funds’ risk when choosing among funds.

Performance advertisements indirectly encourage investors to choose funds that are not good matches for them. If an investor erroneously believes that an advertised fund is likely to continue to achieve high returns, the investor might choose the fund over lesser-performing funds that are better matches for the investor’s investment objective and risk tolerance.

Furthermore, when focusing on past returns, investors pay less attention to a fund’s costs. For example, imagine that a particular fund advertises that it has earned 3% a year more than its peers. Investors who believe that such performance is likely to continue will prefer the fund even if it has a 1% higher expense ratio than its peers. Indeed, a recent experiment by Pontari, Stanaland, and Smythe found that people choosing among funds gave much more weight to the funds’ advertised past returns than to the funds’ expense ratio, even when the expense ratios were made highly salient in the advertisements.

As discussed above, high past returns are generally a matter of luck, and because luck generally does not continue, neither do the high returns. In contrast, low-cost funds generally continue to have low costs, and thus investors earn higher returns from these funds, albeit not as dramatic as the returns highlighted in performance advertisements. Ironically, therefore, by encouraging investors to buy funds with high past returns, performance

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186 Capon et al., supra note 24, at 68 (1996).
187 INVESTOR PREFERENCES, supra note 25, at 3 fig.1.
188 For a discussion of these studies see Palmier & Taha, Mutual Fund Investors, supra note 2, at 978-80.
190 Carhart, supra, note 180, at 80.
advertisements cause investors to pay less attention to what will actually give them higher returns: low costs.

Investors are also harmed by the strong correlation between the prevalence of performance advertisements and the performance of the stock market. As discussed above, performance advertisements are much more common when the stock market in general has recently had high returns.\(^\text{191}\) Even when the stock market declines sharply, some equity funds will outperform their peers by declining less. One might expect these funds to advertise their relative success (e.g., “growth funds declined by an average of 30% last year, our growth fund only declined by 20%”). However, one does not see such performance advertisements. Instead, funds with poor absolute past returns – even if they have very good returns relative to comparable funds – do not advertise those returns.

This phenomenon is very important. It means that performance advertisements entice investors not only to chase hot funds, but also to chase hot asset classes. Thus, the timing of performance advertisements encourages investors to make a major investing mistake: poor asset allocation decisions. Performance advertisements prompt investors to buy equity funds only when the recent returns on equity funds have been high. This is opposite of what investors should do.

Consider a simple example. Imagine an investor who (based on his age, financial situation, and risk tolerance) decides to hold 50% of his investment portfolio in equity funds. In a year when equity funds outperform other investments in his portfolio, he generally should rebalance his portfolio at the end of the year – that is sell some of the equity funds and buy other investments. In a year when his other investments outperform the equity funds, he should rebalance in the other direction.\(^\text{192}\) This rebalancing strategy means selling some of his equity fund shares when they have performed well and buying more after they have performed poorly. Performance advertising of equity funds, however, which is prevalent after periods of strong equity fund performance and rare after periods of poor performance, encourages precisely the opposite behavior. Thus, fund performance advertising encourages poor asset allocation decisions.

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In summary, performance advertising misleads investors into believing that funds with high past returns are likely to have high future returns. This harms investors by causing them to focus on the wrong fund characteristic – past returns – when choosing among funds. It causes them to put less emphasis on more important factors, such as the fund’s costs and

\(^{191}\) Supra pp. 12-13.

\(^{192}\) J. Alex Tarquinio, Oops, It May Be Time to Rebalance That Portfolio, N.Y. TIMES, May 6, 2007, § 3, at 34.
how well the fund’s risk and objective match the investor’s risk tolerance and investment objective. Furthermore, the timing of performance advertisements causes investors to make poor asset allocation decisions. Performance advertisements encourage investors to buy equity funds when investors’ equity fund holdings have already risen in value. To protect investors from being misled by performance advertisements, the SEC must take stronger action.

B. The SEC Should At Least Require a Much Stronger Warning in Performance Advertisements

So what should be done about performance advertisements? The current warning is ineffective. As discussed above, our experiment found that people who viewed a performance advertisement with the current SEC-mandated warning were as likely to invest in the advertised fund, and had the same expectations regarding its future returns, as did people who viewed the same advertisement without any warning whatsoever.193

The current warning’s ineffectiveness reflects the weakness of its wording: it merely warns investors that past performance doesn’t guarantee future results, that returns fluctuate, and that investors might even might lose money in the fund. Very likely, however, few potential investors are unaware of this. The warning fails to tell them what they really need to know: high past returns are generally a matter of luck, and thus a poor predictor of high future returns.

Therefore, one possible reform is for the SEC to strengthen its mandated warning. In our experiment, we also tested a more strongly-worded warning that clearly communicates the weak relationship between high past returns and high future returns. In particular, some participants were shown a version of the advertisement that instead contained the warning:

Do not expect the fund’s quoted past performance to continue in the future. Studies show that mutual funds that have outperformed their peers in the past generally do not outperform them in the future. Strong past performance is often a matter of chance.194

We found that this stronger warning reduced participants’ expectations regarding the fund’s future returns and their willingness to invest in the fund by 12 - 23%, depending on the measure used.195 In fact, by some measures, participants who viewed this stronger warning responded to the performance advertisement virtually the same way as did participants who viewed a

193 Supra p. 28.
194 Mercer et al., Worthless Warnings, supra note 2, at 445.
195 Id. at 457.
version of the advertisement containing no performance data at all.\textsuperscript{196} This provides some evidence that this strong warning might even be fully effective; it might cause potential investors to completely disregard advertised high past returns.

Interestingly, there is evidence that the SEC realizes that its current warning is too weak. Part of the SEC’s website is dedicated to teaching investors about how to invest wisely. One such webpage is entitled “An Introduction to Mutual Funds.” Included there is a warning to investors against chasing high past returns:

\begin{quote}
Past performance is not a reliable indicator of future performance. So don’t be dazzled by last year’s high returns. . . . A fund’s past performance is not as important as you think. Advertisements, rankings, and ratings often emphasize how well a fund has performed in the past. But studies show that the future is often different. This year’s ‘number one’ fund can easily become next year’s below average fund.\textsuperscript{197}
\end{quote}

Although not quite as strong as the warning in our experiment, this warning is much stronger and more informative than the current SEC-mandated warning that “past performance does not guarantee future results.”

Nevertheless, we have doubts that even a warning as strong as that in our experiment would be very effective. In our experiment, participants were asked to read a performance advertisement and then to forecast the fund’s future returns and to state their propensity to invest in the fund. Normally, however, when people see a performance advertisement in a magazine or newspaper, no one asks them to focus on the advertisement. Thus, experiment participants were probably more likely to have read the warning than would the typical viewer of an advertisement. As a result, a strong warning likely would have a smaller effect in the real world than it did in our experiment.\textsuperscript{198}

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In summary, the SEC should at least require that performance advertisements for actively-managed equity funds contain a stronger warning informing readers that high past returns are generally a matter of chance, and thus a poor predictor of high future returns. There is evidence that this warning could reduce investors’ propensity to chase advertised high

\textsuperscript{196} Id. at 449-53.
\textsuperscript{197} Invest Wisely, supra note 3.
\textsuperscript{198} Note also, however, that this experimental design issue makes even more remarkable our finding that the SEC-mandated warning has no effect. Because the current warning had no impact even on experiment participants, who are focusing on the advertisement, then it almost certainly has no impact on people who view the advertisement in the real world, possibly skimming or even entirely skipping the warning.
returns. However, because it is questionable whether investors would read this warning, the SEC should consider stronger action: a prohibition on performance advertisements.

C. The SEC Should Consider Reinstating Its Prohibition of Performance Advertisements

Given the harm that performance advertisements cause, the SEC must prevent them from misleading investors into chasing high returns. Although our experiment found some evidence that a stronger disclaimer might be sufficient, a prohibition on performance advertisements may be necessary. That is, the SEC should consider reinstating its prior ban on performance advertising.

Relying on a warning to prevent performance advertisements from misleading investors is risky. The SEC would need to develop a warning that potential investors would actually read and that would offset the message conveyed by the rest of the advertisement – namely, that high past returns are important. Prohibiting performance advertisements is a much more direct approach that has a greater chance of success.

Also, even an effective warning about the lack of performance persistence addresses only the problem that performance advertisements tout funds with higher returns than their peers, inherently and misleadingly implying that this superior performance will continue. It would not address the harmful timing of performance advertisements. As noted above, fund companies use performance advertisements for equity funds much more frequently when stock market returns in general have been high rather than low. This timing encourages poor asset allocation decisions by investors.

A prohibition of performance advertisements, however, would alleviate this timing problem. In addition, if a truly effective warning that addresses all of the performance advertisements’ problems were somehow adopted, performance advertisements would probably disappear anyway. Advertising is costly, so if funds companies still used performance advertisements after a completely effective warning were mandated, it would indicate that the new warning was not effective in dissuading investors from chasing the high advertised returns. In other words, if a warning really were effective then fund companies would likely stop using performance advertisements anyway. A prohibition on performance advertisements would achieve this result more directly.

Before prohibiting performance advertisements, however, the SEC would need to address several concerns. First, even without performance advertisements, investors would still have access to past performance data. For example, popular financial periodicals such as Barron’s and Money and companies such as Morningstar will continue to report and rank funds’

199 Supra p. 40.
returns. Thus, banning performance advertisements would not prevent investor access to past returns data.

The continued availability of returns data from other sources, however, does not mean that a prohibition on performance advertisements would be unimportant. These other data sources exist today, yet fund companies still engage in a great amount of performance advertising. Fund companies would not be paying for performance advertisements if they were not effective. This suggests that, without performance advertisements, some investors would no longer be aware of a fund’s high performance. Indeed, recall that equity funds in performance advertisements receive more flow than do similar funds that are not advertised.\footnote{Jain & Wu, supra note 65 at 957.}

A prohibition on performance advertisements could raise another objection. The SEC requires – not just permits – past returns to be disclosed in the prospectus, which the SEC considers a fund’s primary selling document.\footnote{Invest Wisely, supra note 3.} At first glance, it would seem strange to prohibit advertising of information that is required to be disclosed in a prospectus.

However, we believe that this inconsistency would not problematic. The prospectus is a much more comprehensive document than is a performance advertisement. The fund’s past returns constitute only a small portion of a prospectus, which contains detailed information about all aspects of the fund.\footnote{See Form N-1A, General Instructions, Part A, available at http://www.sec.gov/about/forms/formn-1a.pdf (listing information required in a fund prospectus).} In contrast, past returns are the focus of performance advertisements. Indeed, unlike a prospectus, a performance advertisement has the very purpose of encouraging investors to invest in a fund because of its high past returns. Thus, a performance advertisement is more likely than a prospectus to entice investors to chase past returns.

In addition, a performance advertisement’s audience likely is less financially sophisticated than is a prospectus’s audience. People who make investment decisions only after reviewing a fund’s prospectus are likely more sophisticated than are investors who would purchase a fund after merely seeing an advertisement of its past returns. Thus the SEC might reasonably conclude that the investors who see past returns in prospectuses need less protection than do investors who see them only in performance advertisements.

Before banning performance advertisements, the SEC would also need to determine the exact parameters of the prohibition. Ideally, it only would forbid advertising fund characteristics that investors erroneously believe predict future performance. Thus, although funds would not be permitted to advertise high past returns, they would be permitted to advertise factors that actually predict future performance. Although actively-managed equity funds
that outperform their peers for a certain period generally don’t continue to do so, past performance is not irrelevant.

Past performance data is relevant in choosing among asset classes. Some asset classes tend to outperform other asset classes in the long run. For example, small-capitalization stocks tend to have higher returns than large-capitalization stocks. This fact could be relevant to a reasonable investor choosing among funds. Thus, a fund that invests in small stocks (rather than large stocks) probably should be permitted to advertise the higher historical returns of this asset class. This is very different, however, than advertising the past returns of the fund itself. The past returns of the asset class(es) in which a fund invests are somewhat predictive of the fund’s future returns.

Unfortunately, however, advertising of past returns of asset classes could encourage investors to chase “hot” asset classes, much as they chase hot funds now. For example, if growth stocks recently performed very well, growth stock funds might advertise this high performance. Indeed, as discussed above, equity funds use performance advertisements much more often when stocks have had high recent absolute returns, which reflects many investors’ focus on the short-term. The SEC, however, might discourage the advertising of hot asset classes by allowing only long-term asset class returns to be advertised, not short-term returns.

Another factor that is actually predictive of future returns is a fund’s costs, such as its load, expense ratio, and portfolio turnover costs. Funds that have low costs tend to give investors higher returns than do comparable funds because costs reduce a fund’s returns. Thus, investors should be encouraged to buy low-cost funds. A flat prohibition on performance advertisements, however, would prevent low-cost funds from advertising that their returns have been higher than comparable funds.

Yet a prohibition on performance advertisements need not prevent low-cost funds from advertising their lower costs and their impact on returns. Indeed, such advertisements exist now. For example, rather than use performance advertisements, the Vanguard Group – the most prominent low-cost fund company – regularly uses advertisements that promote its funds’ low costs and explain how costs affect fund returns.

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203 SIEGEL, supra note 19, at 142-144.
204 Recall that performance advertisements currently are required to present the fund’s average annual total returns for the past one, five, and ten years. 17 C.F.R. § 230.482(d)(3) (2008).
205 Carhart, supra note 180, at 80.
206 For example, a recent Vanguard advertisement has the headline “Simple Truth: It’s important to keep an eye on costs.” The advertisement states that “Many investment firms call themselves low-cost. But the truth is many of them charge about six times as much as Vanguard. This can cost you thousands of dollars. For instance, over 20 years, if you invest $10,000 a year with an average annual return of 8% before expenses, you would keep about $58,000 more with the lower-cost fund!” (footnotes omitted). MONEY, Oct. 2009, at 113 (advertisement for Vanguard Group).
In fact, low-cost funds likely would benefit from a prohibition of performance advertisements. The short-term advantage that low-cost funds provide investors is relatively small. For example, an investor in a fund with 1% lower annual costs than a comparable fund should earn, on average, 1% more each year. Although this cost savings is very important over the long run, it is dwarfed in the short run by the difference in returns between funds that have been lucky in their stock picking and those that have not been. A prohibition on performance advertisements would give low-cost funds a competitive advantage because it would prevent fund companies from highlighting the returns of higher-cost funds that have been lucky.

Another possible objection to prohibiting performance advertisements is that not all funds that outperform their peers are just lucky. Studies show that funds that outperform their peers generally don't continue to do so, but, as discussed earlier, there is some evidence of performance persistence among a small number of funds. For example, Fama and French found some evidence that in the top 3% of actively-managed funds there are some fund managers with more than enough skill to cover their costs.207 Thus, prohibiting performance advertisements might be depriving investors of information that could help them identify these few superior fund managers.208

Although high past returns might contain some limited information regarding future returns, the harms of performance advertisements likely outweigh this benefit. First, even to the extent that there is some performance persistence, it still may not be useful to investors to chase high performers because the level of persistence is very likely quite small. For example, Fama and French found that the top 3% of actively-managed funds was unlikely to garner investors noticeably higher returns than they would earn in large, low-cost index funds.209 Also, because they generally trade more than index funds, actively-managed funds cause investors to have higher capital gains taxes.210 Furthermore, chasing high performers may result in investors incurring transaction costs, such as loads, short-term trading fees, and capital gains taxes, from buying and selling funds.211

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207 Fama & French, supra note 44, at 1932-33.
208 For the same reason, prohibiting performance advertisements might also raise a First Amendment issue. Because past returns may not have zero predictive ability for future returns, a court might deem performance advertisements merely potentially misleading, rather than inherently misleading. Thus, the court might only permit the SEC to mandate that performance advertisements contain a warning regarding the importance of past returns (such as one we propose above), rather than allow the advertisements’ prohibition. International Dairy Foods Assoc. v. Boggs, 622 F.3d 628, 639-40 (6th Cir. 2010) (striking down prohibition of a potentially misleading claim on milk labels because requiring the labels to also contain a disclaimer would be sufficient to make the claim not misleading).
209 Fama & French, supra note 44, at 1933.
211 Supra pp. 9-10 & note 37.
More importantly, as detailed above, performance advertisements cause investors to focus on past returns at the expense of other important considerations, such as a fund's costs and whether the fund is a good match for the investors' objectives and risk tolerances. Thus, even if performance advertisements lead some investors to slightly higher future returns, this benefit is likely much more than offset by the damage these advertisements cause overall.

Finally, recall that a prohibition on performance advertisements would not prevent access to past returns data. This information would still be available in fund prospectuses, personal finance magazines, and other sources. Thus, investors who were determined to chase past returns could still do so. A prohibition would just prevent fund companies from enticing other investors to join this generally unwise chase.

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In summary, performance advertisements by their nature encourage investors to buy funds with high past returns at the expense of overlooking other, more important factors. Prohibiting these advertisements would eliminate at least some of the voices calling on investors to chase past returns. In addition, the announcement of a prohibition could be a teaching moment. A SEC ban and the resulting press coverage could attract significant public attention to the folly of chasing past returns.

VI. CONCLUSION

We throw down the gauntlet. Much of the mutual fund industry bases its business model on exploiting investor beliefs that “past is prologue.” But the evidence is clear: high past fund returns are poor predictors of high future returns. By using past fund performance to attract investors, mutual fund companies engage in deception. Performance advertising is inherently and materially misleading, and the SEC-mandated warning does not temper investor enthusiasm for chasing past returns.

Allowing performance advertising to continue under the current regulatory regime disserves fund investors, and thus our national retirement and savings systems. It encourages investors to focus on past returns rather than on more important factors such as a funds’ costs and the extent to which the funds are consistent with the investors’ investment objectives and risk tolerances. The SEC must rethink its regulatory policy. To avoid complicity in the industry deception, the agency must at least strengthen its currently-mandated warning, and it should seriously consider reinstating its
prohibition of fund performance advertising. As “the investor’s advocate,” the SEC owes us all nothing less.