



2012

## Mutual Fund Performance Advertising: Inherently and Materially Misleading?

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### Recommended Citation

Palmiter, Alan R. and Taha, Ahmed E. (2012) "Mutual Fund Performance Advertising: Inherently and Materially Misleading?," *Georgia Law Review*. Vol. 46: No. 2, Article 3.

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# GEORGIA LAW REVIEW

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VOLUME 46

WINTER 2012

NUMBER 2

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## ARTICLES

### MUTUAL FUND PERFORMANCE ADVERTISING: INHERENTLY AND MATERIALLY MISLEADING?

*Alan R. Palmiter & Ahmed E. Taha\**

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\* Professors of Law, Wake Forest University School of Law. The authors thank Michael Green, Jay Kesten, William Wang, Ronald Wright, Eric Zitzewitz and participants at a faculty workshop at the University of Pennsylvania Law School for helpful comments and suggestions. The authors are also grateful to Emily Cantrell, Jonathan Ellis, and Danielle Stone for excellent research assistance.

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## I. INTRODUCTION

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.

A fund's past performance might be 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 specify how funds may calculate and present past performance in advertisements. Also, they require that performance advertisements warn that past performance does not guarantee future results and that investors could even lose money in the funds.

At first glance, one might expect this SEC-mandated warning to temper potential investors' focus on past performance. The effectiveness of performance advertisements, however, suggests otherwise. In addition, other evidence indicates that the SEC's warning is completely ineffective; investors who receive the SEC's warning are as likely to invest in a fund advertising 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.<sup>1</sup>

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<sup>1</sup> A recent experimental study conducted by us along with Professor Molly Mercer demonstrates this point and is discussed in greater detail later in this Article. See Molly Mercer, Alan R. Palmiter & Ahmed E. Taha, *Worthless Warnings? Testing the Effectiveness of Disclaimers in Mutual Fund Advertisements*, 7 J. EMPIRICAL LEGAL STUD. 429, 431–37 (2010).

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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.

This Article shows 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—mutual fund companies use performance advertisements 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) will view the information as important to their investment decisions. In addition, the current SEC-mandated warning does not effectively “bespeak caution.”<sup>2</sup>

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

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<sup>2</sup> *Luce v. Edelstein*, 802 F.2d 49, 56 (2d Cir. 1986).

misleading. For example, it has found that advertisements for additive-free cigarettes were misleading for 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 likely will 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 poorly predict high future returns. In contrast, investors likely would significantly temper their performance expectations if warned that strong past performance generally results from luck and thus should not 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 equity mutual fund performance advertising altogether. 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 proceeds in five substantive parts. Part II offers an overview of the mutual fund market and its importance to our national retirement and savings systems. Part III describes returns chasing by fund investors, an investment strategy promoted by performance advertisements despite high past returns being poor predictors of high future returns.<sup>3</sup> Part IV summarizes the current regulation of performance

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<sup>3</sup> These two background parts largely summarize parts of our previous work. Mercer, Palmiter & Taha, *supra* note 1; Alan R. Palmiter & Ahmed E. Taha, *Star Creation: The Incubation of Mutual Funds*, 62 VAND. L. REV. 1485, 1489–97 (2009); Alan R. Palmiter & Ahmed E. Taha, *Mutual Fund Investors: Divergent Profiles*, 2008 COLUM. BUS. L. REV. 934, 940–44, 974–1008 (2008) [hereinafter Palmiter & Taha, *Mutual Fund Investors*].

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advertisements, including the SEC-mandated warning that past performance does not “guarantee” future results. Part V, 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. Additionally, these advertisements would be deceptive under FTC standards applicable to the advertising of other products and services. Part VI presents proposals for change, namely, requiring a much stronger warning in fund performance advertisements or even prohibiting these advertisements.

## II. 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.<sup>4</sup> 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.<sup>5</sup> An investment advisor manages the fund, selecting the particular assets in which the fund invests.<sup>6</sup>

The mutual fund industry is immense. As of October 2011, U.S. mutual funds held more than \$11 trillion in assets,<sup>7</sup> including approximately 23% of all outstanding equity of U.S. public companies.<sup>8</sup> Investors have a vast choice of funds: 8,545 as of the end of 2010.<sup>9</sup> Some large fund families, such as Fidelity Investments and the Vanguard Group, offer more than a hundred funds,<sup>10</sup> and the five largest fund families control 40% of the

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<sup>4</sup> *Invest Wisely: An Introduction to Mutual Funds*, U.S. SEC. & EXCH. COMM’N, <http://sec.gov/investor/pubs/inwsmf.htm> (last modified July 2, 2008) [hereinafter *Invest Wisely*].

<sup>5</sup> *Id.*

<sup>6</sup> *Id.*

<sup>7</sup> *Trends in Mutual Fund Investing November 2011*, INV. CO. INST. (Dec. 29, 2011), [http://www.ici.org/research/stats/trends/trends\\_11\\_11](http://www.ici.org/research/stats/trends/trends_11_11) (last visited Jan. 30, 2012) (on file with author).

<sup>8</sup> INV. CO. INST., 2011 INVESTMENT COMPANY FACT BOOK 12 (51st ed. 2011), available at <http://www.icifactbook.org/>.

<sup>9</sup> *Id.* at 16.

<sup>10</sup> *All Vanguard Mutual Funds*, VANGUARD, <https://personal.vanguard.com/us/funds/vanguard/all?sort=name&sortorder=asc> (last visited Nov. 4, 2011) (listing current Vanguard



industry's total assets.<sup>11</sup> Mutual funds vary greatly, including in the types of assets they hold, their investment objectives and strategies, and their fees and expenses.<sup>12</sup>

Ownership of mutual funds is widespread; about 44% of American households own mutual funds.<sup>13</sup> Also, most households that own mutual funds have only moderate income and wealth. In 2011, the median household income of mutual fund investors was \$80,000,<sup>14</sup> and in 2010, their median household financial assets were only \$200,000.<sup>15</sup> Furthermore, mutual funds constitute a large portion of the financial assets of most fund shareholders. Fund-holding households had a median of \$100,000 invested in mutual funds in 2010.<sup>16</sup>

Mutual fund ownership is so widespread largely because mutual funds are a primary way Americans save for retirement. About half of Individual Retirement Account and defined-contribution retirement plan assets are invested in mutual funds.<sup>17</sup> As a result, mutual funds hold more than one-quarter of America's retirement savings.<sup>18</sup>

Consistent with this long-term investment horizon of many fund investors, 45% of mutual fund holdings were in equity funds as of November 2011.<sup>19</sup> The vast majority of the rest were in bond funds (25%) and money market funds (23%).<sup>20</sup> Although they have

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funds); *Daily Pricing for All Fidelity Funds*, FIDELITY, <http://fundresearch.fidelity.com/mutual-funds/fidelity-funds-daily-pricing-yields> (last visited Nov. 4, 2011) (listing current Fidelity funds).

<sup>11</sup> INV. CO. INST., *supra* note 8, at 23.

<sup>12</sup> See generally *Invest Wisely*, *supra* note 4 (discussing different types of mutual funds).

<sup>13</sup> Michael Bogden et al., *Characteristics of Mutual Fund Investors, 2011*, 17 RES. PERSP. 1, 1 (2011), available at <http://www.ici.org/pdf/per17-06.pdf>.

<sup>14</sup> *Id.* at 3. Only 38% of mutual-fund-owning households had incomes of at least \$100,000, and 25% had incomes below \$50,000.

<sup>15</sup> INV. CO. INST., *supra* note 8, at 81.

<sup>16</sup> *Id.*

<sup>17</sup> INV. CO. INST., *The U.S. Retirement Market, Second Quarter 2011*, at tbls.1, 6, 13 (Sept. 2011), available at [http://www.ici.org/info/ret\\_11\\_q2\\_data.xls](http://www.ici.org/info/ret_11_q2_data.xls).

<sup>18</sup> *Id.* at tbls.1, 2, 3. Retirement assets are also in annuities, government pension plans, and private defined benefit plans (i.e., traditional private pension plans). *Id.* at tbl.1.

<sup>19</sup> *Trends in Mutual Fund Investing November 2011*, *supra* note 7.

<sup>20</sup> *Id.*

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greater risk in the short run, equities tend to have higher returns in the long run than do bonds and money market securities.<sup>21</sup>

The portfolios of equity funds are either passively or actively managed. Passively managed funds typically are index funds, managed to track the returns of a specified market index, such as the S&P 500 Index.<sup>22</sup> Actively managed funds are managed to beat the market (or a specified benchmark) by superior stock picking, market timing, or both.<sup>23</sup> Actively managed funds typically engage in more research and trading activities than do index funds, and thus generally have higher costs.<sup>24</sup> In this Article, we focus on performance advertisements for actively-managed equity funds.

### III. 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.<sup>25</sup> In general, the studies have found 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.<sup>26</sup> Investors, however, pay great attention to a fund's historical returns.<sup>27</sup> Indeed, studies have found that this might be the most important factor to the typical investor choosing among funds.<sup>28</sup>

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<sup>21</sup> JEREMY J. SIEGEL, *STOCKS FOR THE LONG RUN* 24–25 (4th ed. 2008).

<sup>22</sup> *Index Funds*, U.S. SEC. & EXCH. COMM'N, <http://sec.gov/answers/indexf.htm> (last modified May 14, 2007).

<sup>23</sup> See Conrad S. Ciccotello, *The Nature of Mutual Funds*, in *MUTUAL FUNDS: PORTFOLIO STRUCTURES, ANALYSIS, MANAGEMENT, AND STEWARDSHIP* 3, 9 (John A. Haslem ed., 2010) (describing active management strategies).

<sup>24</sup> See *Index Funds*, *supra* note 22 (comparing index funds to more actively managed funds).

<sup>25</sup> See, e.g., Palmiter & Taha, *Mutual Fund Investors*, *supra* note 3, at 974–75 (summarizing academic studies as finding fund investors to be “mostly clueless”).

<sup>26</sup> See *id.* at 975.

<sup>27</sup> *Id.*

<sup>28</sup> *Id.* at 994.

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.<sup>29</sup>

#### A. INVESTORS CHASE HIGH PAST RETURNS

Studies have uniformly found that investors choose equity funds with high past returns. For example, Professor Noel Capon, Professor Gavan Fitzsimons, and Russ Alan Prince'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.<sup>30</sup> 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.<sup>31</sup> Similarly, in a survey conducted on behalf of the Consumer Federation of America, 41% of fund investors rated a fund's past performance as being "very influential" in their most recent fund purchase, and 30% rated it as being "somewhat influential."<sup>32</sup>

Professor Ronald 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's load, (2) the fund's annual management fee, (3) the fund company's name, (4) the fund's return during the previous year, (5) the fund's average annual return during the previous ten years, and (6) the fund's beta.<sup>33</sup> Wilcox found that a fund's returns over

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<sup>29</sup> *Id.* at 975.

<sup>30</sup> Noel Capon, Gavan J. Fitzsimons & Russ Alan Prince, *An Individual Level Analysis of the Mutual Fund Investment Decision*, 10 J. FIN. SERVS. RESEARCH 59, 66 (1996).

<sup>31</sup> INV. CO. INST., UNDERSTANDING INVESTOR PREFERENCES FOR MUTUAL FUND INFORMATION 3 (2006), available at [http://www.ici.org/pdf/rpt\\_06\\_inv\\_prefs\\_full.pdf](http://www.ici.org/pdf/rpt_06_inv_prefs_full.pdf).

<sup>32</sup> CONSUMER FED'N OF AM., MUTUAL FUND PURCHASE PRACTICES 10 (2006), available at [http://www.consumerfed.org/pdfs/mutual\\_fund\\_survey\\_report.pdf](http://www.consumerfed.org/pdfs/mutual_fund_survey_report.pdf).

<sup>33</sup> Ronald T. Wilcox, *Bargain Hunting or Star Gazing? Investors' Preferences for Stock Mutual Funds*, 76 J. BUS. 645, 648 (2003). Beta is a measure of a fund's risk. Lawrence A.

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the past ten years and over the past year were the two most important factors to investors.<sup>34</sup>

Studies of the real-world behavior of investors have also found that investors buy funds with the highest past returns. Professor Diane Del Guercio and Dr. Paula 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.<sup>35</sup> They also found that this effect was strongest for funds with the highest past returns.<sup>36</sup> Similarly, Professors Eric Sirri and Peter 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.<sup>37</sup>

A recent experiment demonstrated that investors will irrationally chase high past returns even when those high returns will definitely not continue in the future. Professors James Choi, David Laibson, and Brigitte Madrian had participants—including many Wharton MBA and Harvard College students—choose how to allocate an investment among four S&P 500 index funds with different costs (loads and expense ratios).<sup>38</sup> 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.<sup>39</sup> Because all of the index funds invest in essentially identical portfolios, the lowest cost fund would

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Cunningham, *From Random Walks to Chaotic Crashes: The Linear Genealogy of the Efficient Capital Market Hypothesis*, 62 GEO. WASH. L. REV. 546, 568 (1994).

<sup>34</sup> Wilcox, *supra* note 33, at 650.

<sup>35</sup> See Diane Del Guercio & Paula A. Tkac, *The Determinants of the Flow of Funds of Managed Portfolios: Mutual Funds vs. Pension Funds*, 37 J. FIN. & QUANTITATIVE ANALYSIS 523, 525 (2002) ("[T]he mutual fund flow-performance relation is highly convex, implying that mutual fund investors disproportionately flock to good performers . . .").

<sup>36</sup> *Id.* at 548.

<sup>37</sup> Erik R. Sirri & Peter Tufano, *Costly Search and Mutual Fund Flows*, 53 J. FIN. 1589, 1598 (1998). See also Travis Sapp & Ashish Tiwari, *Does Stock Return Momentum Explain the "Smart Money" Effect?*, 59 J. FIN. 2605, 2607 (2004) (explaining that fund flows into U.S. equity mutual funds "effectively demonstrate[] that fund investors appear to be chasing recent large returns").

<sup>38</sup> James J. Choi, David Laibson & Brigitte C. Madrian, *Why Does the Law of One Price Fail? An Experiment on Index Mutual Funds*, 23 REV. FIN. STUD. 1405, 1406–07 (2009).

<sup>39</sup> *Id.* at 1413–14.

necessarily give investors the highest return in the future.<sup>40</sup> Yet, despite the experiment's participants being more financially sophisticated than typical investors, few of them chose the portfolio that minimized costs and thus would maximize future returns.<sup>41</sup> Instead, they placed heavy weight on the four funds' reported past returns.<sup>42</sup>

In summary, past performance is perhaps the most important factor 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 performance persistence exists 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."<sup>43</sup> In other words, strong-performing funds generally do not continue to outperform other funds.<sup>44</sup>

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—these investors would incur in chasing high performers.<sup>45</sup>

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<sup>40</sup> *Id.* at 1407.

<sup>41</sup> *Id.*

<sup>42</sup> *Id.*

<sup>43</sup> Wilcox, *supra* note 33, at 651.

<sup>44</sup> See 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.").

<sup>45</sup> Nicolas P.B. Bollen & Jeffrey A. Busse, *Short-Term Persistence in Mutual Fund Performance*, 18 REV. FIN. STUD. 569, 587–88 (2004). Many mutual funds charge investors loads, which are fees charged when fund shares are bought or sold. David M. Smith, *Mutual Fund Fees and Expenses*, in *MUTUAL FUNDS: PORTFOLIO STRUCTURES, ANALYSIS, MANAGEMENT, AND STEWARDSHIP*, *supra* note 23, at 51, 51. Also, to discourage short-term

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Indeed, in a recent survey of studies of returns persistence, Professors Keith Cuthbertson, Dirk Nitzsche, and Niall 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)."<sup>46</sup>

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. 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 explain almost completely the returns of strong-performing funds.

Professors Laurent Barras, Oliver Scaillet, and Russ Wermers studied the lifetime performance of 2,076 actively managed domestic equity funds that existed at any time between 1975 and 2006.<sup>47</sup> To distinguish luck from managerial skill, they used a False Discovery Rate estimation approach.<sup>48</sup> They found that, after costs, only 2.2% of the funds had statistically significant, long-term, abnormal positive returns relative to market

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trading, many mutual funds impose fees on investors who sell shares soon after buying them. Michael S. Finke, David Nanigian & William Waller, *Redemption Fees: Reward for Punishment 2* (May 22, 2009) (unpublished manuscript), available at <http://ssrn.com/abstract=1118959>. In addition, investors in non-tax-advantaged 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. Smith, *supra*, at 65.

<sup>46</sup> Keith Cuthbertson, Dirk Nitzsche & Niall O'Sullivan, *Mutual Fund Performance: Measurement and Evidence*, 19 FIN. MARKETS, INSTITUTIONS & INSTRUMENTS 95, 171 (2010).

<sup>47</sup> Laurent Barras, Oliver Scaillet & Russ Wermers, *False Discoveries in Mutual Fund Performance: Measuring Luck in Estimated Alphas*, 65 J. FIN. 179, 197 (2010).

<sup>48</sup> *Id.* at 187. This approach uses the p-values of the t-statistics of the funds' estimated alphas to estimate the percentage of high-performing fund managers that were lucky rather than skilled. *Id.* at 187-89.

benchmarks.<sup>49</sup> However, when the researchers accounted for luck—the fact that out of 2,076 funds, many would outperform by chance—they estimated that only 0.6% of funds actually exhibited skill in their long-term performance.<sup>50</sup> 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.<sup>51</sup>

A recent study by Professors Eugene Fama and Kenneth French reached a similar conclusion.<sup>52</sup> They examined the returns from 1984 to 2006 of 3,156 actively-managed mutual funds that invest primarily in U.S. equities.<sup>53</sup> 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.<sup>54</sup> 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.”<sup>55</sup>

Ironically, the tendency of investors to chase high past returns might help explain why these returns do not persist. Because investors flock to funds that have produced high returns,<sup>56</sup> the amount invested in a high-performing fund can increase dramatically. However, this increase in fund size might make it harder 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 harder to invest a large amount than a small amount in a stock with a low market capitalization. There might not be enough shares available of a small, thinly-traded stock for a

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<sup>49</sup> *Id.* at 197.

<sup>50</sup> *Id.*

<sup>51</sup> *Id.* at 181.

<sup>52</sup> Eugene F. Fama & Kenneth R. French, *Luck Versus Skill in the Cross-Section of Mutual Fund Returns*, 65 J. FIN. 1915, 1915 (2010).

<sup>53</sup> *Id.* at 1915, 1938.

<sup>54</sup> *Id.* at 1923–27.

<sup>55</sup> *Id.* at 1941.

<sup>56</sup> See *supra* Part III.A.

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large fund to purchase, or a large purchase would have to be made at a much higher price than would a small purchase.<sup>57</sup>

Indeed, evidence exists that increasing fund size can harm returns. Professors Joseph Chen, Harrison Hong, Ming Huang, and Jeffrey Kubik found a significant negative relationship between fund size and returns for funds that invest in small-capitalization stocks.<sup>58</sup> 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,<sup>59</sup> a small, yet statistically significant, percentage (2.4%) exhibited short-run investing skill.<sup>60</sup> 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 and rendering these managers unable to continue to outperform in the long run.<sup>61</sup>

In addition, fund companies sometimes close certain mutual funds—i.e., refuse to accept new investors—when the funds reach a certain size.<sup>62</sup> 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 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.<sup>63</sup> However, these companies apparently believe that at some point a fund's size can become too large of a drag on its returns.<sup>64</sup>

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<sup>57</sup> Joseph Chen et al., *Does Fund Size Erode Mutual Fund Performance? The Role of Liquidity and Organization*, 94 AM. ECON. REV. 1276, 1277 (2004).

<sup>58</sup> *Id.*

<sup>59</sup> Barras, Scaillet & Wermers, *supra* note 47, at 181, 197.

<sup>60</sup> *Id.* at 201.

<sup>61</sup> *Id.* at 202–04 (noting 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 to continue to outperform other funds in the long run).

<sup>62</sup> Daniel C. Indro et al., *Mutual Fund Performance: Does Fund Size Matter?*, 55 FIN. ANALYSTS J. 74, 74 (1999).

<sup>63</sup> Chen et al., *supra* note 57, at 1276–77.

<sup>64</sup> Indro et al., *supra* note 62, at 74.



In summary, investors' performance chasing is generally fruitless. Little evidence exists 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

Because investors chase high past returns, fund companies have a great incentive to advertise their strong-performing funds. Indeed, advertising of funds' high past returns is common. For example, Professors Bruce Huhmann and Nalinaksha 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.<sup>65</sup> Also, an additional 26% of the advertisements explicitly discussed funds' risk-adjusted returns.<sup>66</sup> Similarly, Professors Sendhil Mullainathan, Joshua Schwartzstein, and Andrei Shleifer examined equity mutual fund advertisements in *Money* and *BusinessWeek* magazines over a nine-year period and ten-year period, respectively.<sup>67</sup> 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*.<sup>68</sup>

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, and not just their returns relative to those of comparable funds. For example, the Mullainathan study found a very high correlation (greater than 0.7) between the percentage of equity fund advertisements that present past

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<sup>65</sup> Bruce A. Huhmann & Nalinaksha Bhattacharyya, *Does Mutual Fund Advertising Provide Necessary Investment Information?*, 23 INT'L J. BANK MARKETING 296, 300, 303 (2005).

<sup>66</sup> *Id.*

<sup>67</sup> Sendhil Mullainathan, Joshua Schwartzstein & Andrei Shleifer, *Coarse Thinking and Persuasion*, 123 Q. J. ECON. 577, 608 (2008).

<sup>68</sup> *Id.* at 609.

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returns and the recent performance of the stock market in general.<sup>69</sup>

Likewise, Professor David Swensen examined the extent of mutual fund advertising from 1997 to 2003 in the *Wall Street Journal's Mutual Funds Quarterly Review*.<sup>70</sup> 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 to 2000, mutual fund advertisements constituted between 40% and 44% of the *Reviews*, which were each between forty-six and forty-eight pages long.<sup>71</sup> However, as the bull market ended, fund advertising was significantly reduced, falling to only 16% of the thirty-four page *Review* in 2003.<sup>72</sup> 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.<sup>73</sup> The total number of pages of performance advertisements dropped by approximately 78%, from about 9.3 pages in 1998 to about 2.0 pages in 2003.<sup>74</sup>

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<sup>69</sup> *Id.* In particular, they found that the correlation of one-quarter-lagged S&P 500 returns with the percentage of equity fund advertisements that presented past fund returns was 0.71 for *Money* and 0.74 for *BusinessWeek*. *Id.* See also U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-11-697, *MUTUAL FUND ADVERTISING: IMPROVING HOW REGULATORS COMMUNICATE NEW RULE INTERPRETATIONS TO INDUSTRY WOULD FURTHER PROTECT INVESTORS* 15 (2011), available at <http://www.gao.gov/new.items/d11697.pdf> ("[A]gency officials and representatives of mutual fund companies with whom we spoke, as well as some researchers, said that more advertisements showing superior past returns for mutual funds appear after the market has performed well.").

<sup>70</sup> DAVID F. SWENSEN, *UNCONVENTIONAL SUCCESS: A FUNDAMENTAL APPROACH TO PERSONAL INVESTMENT* 166-67 (2005). Swensen examined only the *Reviews* for the first quarter of each year. *Id.* at 167.

<sup>71</sup> *Id.* at 168.

<sup>72</sup> *Id.*

<sup>73</sup> *Id.*

<sup>74</sup> 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 9.3 performance advertisement pages ( $48 \text{ pages} \times 0.44 \times 0.44 = 9.3$ ). In 2003, the *Review* had 34 total pages: 16% of the space was mutual fund advertisements and 36% of these advertisements were performance advertisements, so there were approximately 2.0 performance advertisement pages ( $34 \text{ pages} \times 0.16 \times 0.36 = 2.0$ ). *Id.* Although Swenson did not report exactly what percentage of these pages were equity fund advertisements, he noted that equity fund advertisements constituted 92% of

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, Professors Prem Jain and Joanna Shuang Wu examined equity mutual funds in performance advertisements in *Barron's* and *Money* magazines over a two-year period.<sup>75</sup> They found that the advertised funds outperformed funds with the same investment objective by an average of almost 6% over the twelve months prior to the advertisements.<sup>76</sup> The advertised funds also outperformed other benchmarks, such as the S&P 500 index, although by less.<sup>77</sup> Similarly, Professors Jonathan Koehler and Molly Mercer examined equity mutual fund performance advertisements that appeared over a three-year period in *BusinessWeek* and *Fortune* magazines.<sup>78</sup> They found that fund companies tend to advertise their best-performing funds.<sup>79</sup> The advertised funds' median one-year, five-year, and ten-year performance was at the 80th, 100th, and 100th percentiles, respectively, of all company-operated funds with the same investment objective.<sup>80</sup> The advertised funds also had a median one-year, five-year, and ten-year performance at the 79th, 88th, and 88th percentiles, respectively, of all company-operated equity funds irrespective of the investment objective.<sup>81</sup>

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asset-class-specific advertisements in 1998, but only 50% of asset-class-specific advertisements in 2003. *Id.*

<sup>75</sup> Prem C. Jain & Joanna Shuang Wu, *Truth in Mutual Fund Advertising: Evidence on Future Performance and Fund Flows*, 55 J. FIN. 937, 940 (2000).

<sup>76</sup> *Id.* at 943.

<sup>77</sup> In particular, they outperformed the S&P 500 by almost 2% and had a four factor alpha of over 1%. *Id.* at 943–45. 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. *Id.* at 944.

<sup>78</sup> Jonathan J. Koehler & Molly Mercer, *Selection Neglect in Mutual Fund Advertisements*, 55 MGMT. SCI. 1107, 1109 (2009).

<sup>79</sup> *Id.* at 1107.

<sup>80</sup> *Id.* at 1110.

<sup>81</sup> *Id.* See also U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 69, at 11 ("Representatives of some mutual fund firms with whom we spoke confirmed that they choose which funds to advertise based on the fund's performance level or rankings by

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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.<sup>82</sup> However, because investors only see the returns of the company's high-performing funds rather than its low-performing funds, they are more likely to attribute the high returns to the fund manager's skill rather than luck.

Koehler and Mercer's experiment demonstrates that investors are misled by this selective advertising. Participants in their study were each shown one of four versions 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 per year.<sup>83</sup> After reading the advertisement, participants were asked about their perception of the quality of the fund company and about their willingness to invest in a new growth fund being introduced by the company.<sup>84</sup>

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 but two of thirty funds operated by the fund company.<sup>85</sup> Another version stated that the advertised funds were the only two funds operated by the company.<sup>86</sup> A third version did not indicate how many funds the company operated.<sup>87</sup>

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

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industry research organizations such as Lipper and Morningstar, Inc., which periodically issue comparative ratings and rankings of funds' performance over different time periods.").

<sup>82</sup> Koehler & Mercer, *supra* note 78, at 1109.

<sup>83</sup> *Id.* at 1111. The advertisement was modeled closely on an actual advertisement that had been used by a major fund company. *Id.*

<sup>84</sup> *Id.*

<sup>85</sup> *Id.*

<sup>86</sup> *Id.*

<sup>87</sup> *Id.* There was also a control group who reviewed an advertisement containing no past performance data. *Id.* at 1113.

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.<sup>88</sup> In fact, they responded similarly to participants who were shown a version of the advertisement that lacked any past returns at all.<sup>89</sup>

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.<sup>90</sup> This occurred even though they assumed that the fund company had many funds.<sup>91</sup>

This experiment indicates that 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.<sup>92</sup> 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.<sup>93</sup> Also, Jain and Wu found that equity mutual funds featured in performance advertisements in *Barron's* and *Money* garnered approximately

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<sup>88</sup> *Id.* at 1112.

<sup>89</sup> *Id.* at 1113.

<sup>90</sup> *Id.* at 1112–13.

<sup>91</sup> On average, participants estimated that the fund company had fifteen funds. *Id.* at 1113.

<sup>92</sup> *Id.* at 1114.

<sup>93</sup> Capon, Fitzsimons & Prince, *supra* note 30, at 66. *But see* CONSUMER FED'N OF AM., *supra* note 32, at 12–13 (reporting that only 6% of surveyed fund investors reported that fund advertisements were either "very influential" or "somewhat influential" in their most recent mutual fund purchase).

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20% more flow than did similar, unadvertised funds.<sup>94</sup> In addition, funds that were advertised more often attracted more flow.<sup>95</sup>

Although performance advertisements benefit fund companies, investors do not benefit from buying advertised funds. 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, those funds 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%.<sup>96</sup>

In summary, fund companies advertise their high-performing funds because these advertisements exploit and encourage investors' tendency to chase funds with high past returns. Performance advertisements, however, do not benefit investors; advertised funds generally do not continue to outperform other funds.

#### IV. 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 the Article discusses the law governing fund performance advertisements.

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<sup>94</sup> Jain & Wu, *supra* note 75, at 957.

<sup>95</sup> *Id.* See also Brad M. Barber et al., *Out of Sight, Out of Mind: The Effects of Expenses on Mutual Fund Flows*, 78 J. BUS. 2095, 2108 (2005) (finding that funds with higher expenditures on 12b-1 fees, which are devoted to the selling and marketing of shares, garner more flow).

<sup>96</sup> Jain & Wu, *supra* note 75, at 948–49 tbl.3.

#### 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 in order to make the statements made, in light of the circumstances under which they were made, not misleading.”<sup>97</sup>

Also, Rule 10b-5 promulgated 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 mail, “mak[ing] any untrue statement of a material fact or . . . omit[ting] to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading . . . .”<sup>98</sup>

The Investment Company Act of 1940, which applies to mutual funds, contains a similar general prohibition. Section 33(b) prohibits, in any registration statement or other documents transmitted pursuant to the Act, “any untrue statement of a 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.”<sup>99</sup>

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).<sup>100</sup> These rules, approved by the SEC, govern the

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<sup>97</sup> 15 U.S.C. § 77q(a)(2) (2006).

<sup>98</sup> Employment of Manipulative and Deceptive Devices, 17 C.F.R. § 240.10b-5(b) (2011).

<sup>99</sup> 15 U.S.C. § 80a-33(b) (2006).

<sup>100</sup> Bradley J. Bondi, *Securities Arbitrations Involving Mortgage-Backed Securities and Collateralized Mortgage Obligations: Suitable for Unsuitability Claims?*, 14 FORDHAM J. CORP. & FIN. L. 251, 259 n.55 (2009). FINRA was created in July 2007, combining the NASD and the regulation, enforcement, and arbitration functions of the New York Stock

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activities of FINRA's members.<sup>101</sup> NASD Conduct Rule 2210(d)(1)(B) states:

No 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.<sup>102</sup>

Similarly, NASD Conduct Rule 2210(d)(1)(A) mandates that no member 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."<sup>103</sup>

In summary, the NASD rules prohibit the same misrepresentations and omissions banned by general statutes and SEC regulation, all forbidding both lies and half truths.

**B. SEC RULES SPECIFY HOW PERFORMANCE DATA IN ADVERTISEMENTS IS CALCULATED AND PRESENTED**

The SEC extensively regulates how mutual fund companies calculate and present funds' past returns in advertisements. These regulations are intended to ensure that advertised

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Exchange (NYSE). *Id.* The current, transitional FINRA rulebook contains two sets of rules: the NASD rules and the rules incorporated from the NYSE, although FINRA is gradually reviewing and consolidating these rules as "FINRA Rules," which the SEC must approve. FINRA, INFORMATION NOTICE: RULEBOOK CONSOLIDATION PROCESS 2-3 (2008) [hereinafter FINRA, INFORMATION NOTICE], available at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p038121.pdf>. The NASD Rules discussed in this article have not yet been consolidated as FINRA Rules, so they are still referred to as "NASD Rules." See FINRA MANUAL: NASD RULES, [http://finra.complinet.com/en/display/display\\_viewatl.html?rbid=2403&element\\_id=605&record+id=607](http://finra.complinet.com/en/display/display_viewatl.html?rbid=2403&element_id=605&record+id=607) (last visited Nov. 14, 2011) (listing current FINRA and NASD Rules).

<sup>101</sup> FINRA, INFORMATION NOTICE, *supra* note 100, at 2-3.

<sup>102</sup> Nat'l Ass'n of Sec. Dealers Rule 2210(d)(1)(B) (2009), available at [http://finra.complinet.com/en/display/display\\_main.html?rbid=2403&element\\_id=3677](http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=3677) (last visited Nov. 11, 2011).

<sup>103</sup> *Id.* at Rule 2210(d)(1)(A).



performance data are up-to-date and accurately reflect past performance. They also facilitate investor comparison of the returns of different funds.

Rule 482 promulgated under the Securities Act of 1933 explicitly applies to performance advertisements and standardizes how past returns in advertisements may be calculated and presented.<sup>104</sup> 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.<sup>105</sup> 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."<sup>106</sup> Rule 482 also specifies the methodology for computing total returns, thus ensuring that total returns are calculated consistently from fund to fund.<sup>107</sup>

Performance advertisements, according to the SEC rule, may also report for any time periods any other performance measure that "[r]eflects all elements of return," such as aggregate, average, year-by-year, or other types of total return calculations.<sup>108</sup> However, these other performance measures must supplement, not

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<sup>104</sup> Advertising by an Investment Company as Satisfying Requirements of Section 10, 17 C.F.R. § 230.482 (2011). 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. Securities Act of 1933, Pub. L. No. 22, 48 Stat. 74, 81 (codified as amended at 15 U.S.C. § 77j(a)(1) (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). The SEC promulgated Rule 482, which defines advertisements and other sales material (collectively referred to as "advertisements") respecting investment companies as prospectuses under section 10(b) if the advertisements comply with certain requirements. 17 C.F.R. § 230.482(a) (2011). Note, however, that advertisements that comply with Rule 482 are not automatically legal; they must also not be misleading. *Id.* § 230.482, note to paragraph (a).

<sup>105</sup> 17 C.F.R. § 230.482(d)(3) (2011). If the fund's registration statement has been in effect for less than one, five, or ten years, then the company must report the average annual total return since the registration period has been in effect instead. *Id.*

<sup>106</sup> Advertising by Investment Companies, 53 Fed. Reg. 3868, 3875 & n.28 (Feb. 10, 1988) (to be codified at 17 C.F.R. pt. 230, 270, and 274).

<sup>107</sup> 17 C.F.R. § 230.482(d)(3)(i) (2011).

<sup>108</sup> *Id.* § 230.482(d)(5)(i).

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replace, the required standardized average annual total returns, and they may not be presented more prominently than those returns.<sup>109</sup> Also, if a performance advertisement represents that the fund is managed to limit taxes, the advertisement must present the fund's standardized after-tax returns.<sup>110</sup>

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.<sup>111</sup> The advertised returns must also reflect the load or fee or the advertisement must state "that the performance data does not reflect the deduction of the sales load or fee, and that, if reflected, the load or fee would reduce the performance quoted."<sup>112</sup>

In 2003, the SEC adopted regulations that, in part, focus on ensuring that performance data in advertisements are up-to-date.<sup>113</sup> 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.<sup>114</sup> The SEC explained that it was adopting this requirement so that

[i]nvestors 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.<sup>115</sup>

In adopting this requirement, the SEC also showed concern that funds could mislead investors by selectively choosing the

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<sup>109</sup> *Id.* § 230.482(d)(5). The advertisement must also identify the time period covered by the alternative measure "with no less prominence than the measurement." *Id.* § 230.482(d)(5)(v).

<sup>110</sup> *Id.* § 230.482(d)(4)(f).

<sup>111</sup> *Id.* § 230.482(b)(3)(ii).

<sup>112</sup> *Id.*

<sup>113</sup> Amendments to Investment Company Advertising Rules, 68 Fed. Reg. 57,760 (Oct. 6, 2003) (to be codified at 17 C.F.R. pts. 230, 239, 270, and 274).

<sup>114</sup> *Id.* at 57,763.

<sup>115</sup> *Id.*

dates for which performance data are reported.<sup>116</sup> 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.<sup>117</sup> 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 for the same periods.<sup>118</sup> Second, the exemption would have allowed funds to mislead investors by “cherry picking” the date so the fund could advertise its most favorable performance.<sup>119</sup> 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 current month, rather than its performance through the end of the previous 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.<sup>120</sup>

In summary, the SEC has largely standardized the calculation and presentation of performance data in fund advertisements in an effort to ensure that the advertised returns are up-to-date and accurately reflect the fund’s past performance. The SEC also intended to facilitate investor comparison of different funds’ returns and to limit fund companies’ ability to cherry pick particular time periods of performances to advertise. Without such requirements, performance advertisements could calculate and present past returns in ways that mislead potential investors

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<sup>116</sup> *Id.* at 57,765.

<sup>117</sup> *Id.*

<sup>118</sup> *Id.*

<sup>119</sup> *Id.*

<sup>120</sup> *Id.* Of course, it would only serve as a check on 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.

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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 INDUSTRY RULES LIMIT IMPLICATION THAT PAST RETURNS PREDICT FUTURE RETURNS

A number of SEC and industry 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.<sup>121</sup> 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.”<sup>122</sup>

Rule 156 provides guidance on its reach by listing some types of statements that could be misleading.<sup>123</sup> Included in this guidance are two specific situations in which the use of past performance could be materially misleading: if the sales literature contains “[r]epresentations implying that future gain or income may be inferred from or predicted based on past investment performance,”<sup>124</sup> or 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.”<sup>125</sup> Similarly, NASD Rule 2210(d)(1)(D) provides that “[c]ommunications with the public may not predict or project performance, imply that past

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<sup>121</sup> Investment Company Sales Literature, 17 C.F.R. § 230.156 (2011).

<sup>122</sup> *Id.* § 230.156(b).

<sup>123</sup> *Id.*

<sup>124</sup> *Id.* § 230.156(b)(2)(ii)(B).

<sup>125</sup> *Id.* § 230.156(b)(2)(ii)(C).

performance will recur or make any exaggerated or unwarranted claim, opinion or forecast.”<sup>126</sup>

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 less than their original cost.”<sup>127</sup> 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).<sup>128</sup> The SEC observed that companies often relegated to footnotes and very small print disclosures that performance data are “historic and not necessarily indicative of future performance” or presented the information “in an incomplete or confusing manner,” if they included such disclosures in advertisements at all.<sup>129</sup> Second, the SEC was concerned that advertisements insufficiently explained the risks of investing in mutual funds, including the risk that investors could lose some of their principal.<sup>130</sup>

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.”<sup>131</sup> This concern arose because many funds engaged in advertising campaigns focused on their short-

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<sup>126</sup> Nat’l Ass’n of Sec. Dealers Rule 2210(d)(1)(D). *See supra* note 100 (explaining the distinction between FINRA and NASD rules).

<sup>127</sup> Advertising by Investment Companies, 53 Fed. Reg. 3868, 3879 (Feb. 10, 1988) (to be codified at 17 C.F.R. pts. 230, 239, 270, and 274).

<sup>128</sup> Advertising by Investment Companies; Proposed Rules and Amendments to Rules, Forms, and Guidelines, 51 Fed. Reg. 34,384, 34,390 (Sept. 26, 1986) (to be codified at 17 C.F.R. pts. 230, 270, and 274).

<sup>129</sup> *Id.*

<sup>130</sup> *Id.* at 34,390–91.

<sup>131</sup> Amendments to Investment Company Advertising Rules, 68 Fed. Reg. 57,760, 57,760 (Oct. 6, 2003) (to be codified at 17 C.F.R. pts. 230, 239, 270, and 274).

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term performance after experiencing extraordinarily high returns in 1999, 2000, and 2003.<sup>132</sup>

Thus, “to help investors understand the limitations of past performance data,”<sup>133</sup> the SEC amended Rule 482 to require performance advertisements to contain a warning that:

[P]ast 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.<sup>134</sup>

The warning, however, need not use this exact language; any wording that “clearly communicates” this information is sufficient.<sup>135</sup> Also, to encourage investors to read the warning, it must be somewhat prominent in the advertisement. In particular, the warning’s type size must be at least as large as that of “the major portion of the advertisement.”<sup>136</sup> Moreover, 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.<sup>137</sup> In addition, it must be placed in “close proximity to the performance data, and, in a print advertisement, must be presented in the body of the advertisement and not in a footnote.”<sup>138</sup>

Finally, all Rule 482 advertisements, regardless of whether they contain performance data, must at least implicitly discourage

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<sup>132</sup> *Id.* at 57,760–61.

<sup>133</sup> Proposed Amendments to Investment Company Advertising Rules, 67 Fed. Reg. 36,712, 36,719 (May 24, 2002) (to be codified at 17 C.F.R. 230, 239, 270, and 274).

<sup>134</sup> Advertising by an Investment Company as Satisfying Requirements of Section 10, 17 C.F.R. § 230.482(b)(3)(i) (2011).

<sup>135</sup> Amendments to Investment Company Advertising Rules, 68 Fed. Reg. at 57,765.

<sup>136</sup> 17 C.F.R. § 230.482(b)(5). Prominence requirements also exist for this warning in electronically delivered advertisements and television and radio advertisements. *Id.*

<sup>137</sup> *Id.*

<sup>138</sup> *Id.* Also, Rule 346-1 under the Investment Company Act states that any sales literature that companies must file with the SEC shall be deemed materially misleading unless it, among other things, contains the warning required by Rule 482. Sales Literature Deemed to be Misleading, 17 C.F.R. § 270.346-1(b)(1)(i) (2011).

investors from focusing exclusively on a fund's past returns. Specifically, they must contain a statement that "[a]dvises 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's prospectus to obtain this and other information about the fund.<sup>139</sup>

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 including a warning that "past performance does not guarantee future results." Nonetheless, as shown below, performance advertisements still mislead investors into chasing high past returns.

#### V. 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 material facts necessary to make the statements made, in light of the circumstances of their use, not misleading.<sup>140</sup> In this Part of the Article, we first explain why fund performance advertisements violate these prohibitions.<sup>141</sup> Performance advertisements present high past returns and falsely imply that these returns are good predictors of high future returns. These advertisements omit 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 advertising might be misleading if it implies (or is subject to an inference) that investors should expect the strong performance to persist and the mutual fund company knows or should know of contrary data. Given the evidence showing a

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<sup>139</sup> *Id.* § 230.482(b)(1)(i).

<sup>140</sup> *See supra* Part IV.A.

<sup>141</sup> *See infra* Part V.A.

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general lack of performance persistence, failing to correct the advertisements' false implication regarding the importance of past performance is misleading.

The SEC-mandated warning that "past performance does not guarantee future results" fails to cleanse performance advertisements of their misleading nature.<sup>142</sup> 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. Indeed, a study of investor reactions to the SEC-mandated warning found that the warning does not reduce investors' chasing of past performance.<sup>143</sup>

This Part concludes by contrasting the SEC's limited approach toward performance advertisements with other regulatory approaches.<sup>144</sup> First, examination of the Federal Trade Commission's (FTC) regulation of testimonial advertisements—a type of performance advertisement—for non-investment products and services reveals the shortcomings of the SEC approach. The FTC has concluded that an even 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, the FTC's actions against advertisers of additive-free tobacco products who implied that additive-free tobacco was healthier than other tobacco demonstrate deficiencies in the SEC's approach. Even when the advertisements contained no health claims about additive-free tobacco products, the FTC found these advertisements misleading, apparently because they took advantage of consumer misperceptions regarding the safety of the products. Similarly, mutual fund performance advertisements take advantage of investors' misperceptions regarding the importance of strong past performance.

Finally, two recent regulatory initiatives that question the use of fund performance data are also relevant here. The first is the Dodd–Frank Wall Street Reform and Consumer Protection Act, which required the Government Accountability Office (GAO) to

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<sup>142</sup> See *infra* Part V.B.

<sup>143</sup> See *infra* notes 166–72 and accompanying text.

<sup>144</sup> See *infra* Part V.C.–D.



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) questioning the usefulness of a fund's past performance as a basis for pension plan fiduciaries to give investment advice.

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 true, misleading.<sup>145</sup> 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.

Under the securities laws, information is material if there is a substantial likelihood that reasonable investors would consider it important in their investment decisions.<sup>146</sup> 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."<sup>147</sup> For mutual fund disclosures, unlike disclosures made to investors in informationally efficient markets, the reasonable investor is the average or typical fund investor at whom the disclosure is targeted.<sup>148</sup> For this reason, the

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<sup>145</sup> See *supra* Part IV.A.

<sup>146</sup> *Basic, Inc. v. Levinson*, 485 U.S. 224, 231 (1988).

<sup>147</sup> *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976). This standard has been applied in cases alleging false or misleading disclosures by mutual funds. *E.g.*, *Rodney v. KPMG Peat Marwick*, 143 F.3d 1140, 1144 (8th Cir. 1998) (applying the "reasonable shareholder" and "total mix" standards to mutual fund disclosures claimed to be false or misleading under the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Company Act of 1940).

<sup>148</sup> Mutual funds are not traded in organized markets in which publicly available information is absorbed, acted on by sophisticated analysts and traders, and reflected in prices. See William A. Birdthistle, *Investment Indiscipline: A Behavioral Approach to Mutual Fund Jurisprudence*, 2010 U. ILL. L. REV. 61, 71–72 (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.

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SEC requires that mutual fund prospectuses contain “information that is necessary for an average or typical investor to make an investment decision.”<sup>149</sup>

Past returns are material to typical fund investors, who (erroneously) believe 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<sup>150</sup> and a fund’s past returns strongly influence fund flow.<sup>151</sup>

In addition, the SEC’s rules on computing and presenting past returns in fund advertisements 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.”<sup>152</sup>

Indeed, performance advertisements’ pervasiveness is further persuasive evidence that investors give past returns great weight. Fund companies commonly use performance advertisements, which strongly suggests that companies believe past returns are

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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, 1031–32 (2005) (pointing out that the mutual fund market lacks price-efficiency mechanisms found in stock markets). Thus, for example, if information becomes available suggesting mismanagement of a mutual fund, there is no arbitrage or other trading mechanism that might help the fund’s price reflect this information. Even if some investors figure out that the fund is mispriced and redeem their shares at net asset value, this does not send a price signal to other investors. *Id.* at 1032.

<sup>149</sup> Registration Form Used by Open-End Management Investment Companies, 63 Fed. Reg. 13,916, 13,919 (Mar. 23, 1998) (to be codified at 17 C.F.R. pts. 230, 232, 239, 240, 270, and 274). See also *Operating Local 649 Trust Fund v. Smith Barney Fund Mgmt. LLC*, 595 F.3d 86, 94 (2d Cir. 2010) (holding that fee tables must be understood by the typical mutual fund investor).

<sup>150</sup> See *supra* notes 31–32 and accompanying text (describing surveys that show investors choose funds based on past performance).

<sup>151</sup> See *supra* notes 35–37 and accompanying text (showing relationship between fund flow and past performance).

<sup>152</sup> Advertising by Investment Companies, 53 Fed. Reg. 3868, 3875 (Feb. 10, 1988) (to be codified at 17 C.F.R. pts. 230, 270, and 274).

an important factor in investors' decisions. In fact, as discussed above, sometimes more than half of equity mutual fund advertisements include performance information.<sup>153</sup> Advertising is expensive, so fund companies would not buy performance advertisements unless they believed such advertisements were not effective. Indeed, funds in performance advertisements garner significantly more flow than do similar, unadvertised funds.<sup>154</sup>

The past returns in performance advertisements, though factually accurate, mislead investors 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 implying 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.<sup>155</sup>

Even performance advertisements that lack such text are misleading. By their very nature, performance advertisements *inherently* imply that high returns will likely persist. The only conceivable 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, an advertisement that touts a fund's low past returns seems unimaginable.

In addition, 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.<sup>156</sup> This again demonstrates that fund

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<sup>153</sup> See *supra* Part III.A.

<sup>154</sup> See *supra* Part III.A.

<sup>155</sup> See, e.g., Fidelity, Advertisement, *Knowledge is Power*, FORBES, Jan. 28, 2008, at 2–3 (advertisement for five Fidelity funds with table of past returns titled "Proven Performance at Home and Abroad"); MONEY, Mar. 2008, at 3–4 (headline of performance advertisement for Fidelity Balanced Fund stating "Strong performance or reduced risk? Most investors say, 'Yes'"); Franklin Templeton Investments, Advertisement, *All-Weather Investing*, MONEY, Mar. 2008, at 47 (heading of table presenting past returns in performance advertisement for Franklin Templeton Investments' Mutual Discovery Fund stating "Strong Performance & Lower Volatility").

<sup>156</sup> See *supra* Part III.C.

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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:

[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.<sup>157</sup>

Thus, the SEC believed that a performance advertisement would be misleading if it implied performance persistence when fund managers had reason to doubt the truth of this implication. Performance advertisements inherently imply performance persistence. Therefore, the finance studies showing a general lack of performance persistence<sup>158</sup>—studies which should be known to fund managers—would make performance advertising misleading.

The existence of the current SEC-mandated warning does not 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.<sup>159</sup>

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<sup>157</sup> Advertising by Investment Companies, Securities Act Release No. 5833, Investment Company Act Release No. 9811, 1977 WL 173459, at \*5 (June 8, 1977).

<sup>158</sup> See *supra* Part III.B.

<sup>159</sup> See *supra* note 134 and accompanying text (discussing content of SEC-mandated warning).

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.<sup>160</sup>

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 accurate and consistent presentation of the returns does not prevent the advertisements from being misleading. This is the essence of the half-truth doctrine in securities regulation. Even if what is 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. However, performance advertisements contain an SEC-mandated warning that seeks to reduce investors’ enthusiasm for strong past performance. Advertisements including performance data require a legend disclosing

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

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<sup>160</sup> 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. *Wyeth v. Levine*, 555 U.S. 555, 581 (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 did not preclude additional state-based claims that the labels were inadequate. *Id.* By like reasoning, an SEC-mandated warning in performance advertisements does not preclude additional federal claims that the warning is inadequate and the advertisement is materially misleading.

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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.<sup>161</sup>

At first glance, this warning seems to “bespeak caution.”<sup>162</sup> Perhaps one could argue that 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 actually 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 may be negative. The fall in stock prices after the dot-com bubble burst and during the recent financial crisis have made clear to investors that the stock market is volatile and subject to dramatic declines.<sup>163</sup>

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”<sup>164</sup> arguably implies that there is a positive relationship between high past and high future returns, just not a guaranteed one.<sup>165</sup>

To test the effectiveness of the SEC-mandated warning, we—along with Molly Mercer—recently conducted an experiment.<sup>166</sup> Participants in the experiment viewed a version of a performance advertisement for a fictional mutual fund that had outperformed

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<sup>161</sup> Advertising by an Investment Company as Satisfying Requirements of Section 10, 17 C.F.R. § 230.482(b)(3)(i) (2011).

<sup>162</sup> *Luce v. Edelstein*, 802 F.2d 49, 56 (2d Cir. 1986) (“We are not inclined to impose liability on the basis of statements that clearly ‘bespeak caution.’”).

<sup>163</sup> See Robert Frank, *Young, Affluent Investors Feel Burned*, WEALTH REP., WALL ST. J. (July 28, 2010, 10:42 AM), <http://blogs.wsj.com/wealth/2010/07/28/young-affluent-investors-feel-burned/> (stating that the dot-com bust and the “Great Recession” have increased the risk aversion of young investors).

its peers in the past.<sup>167</sup> The advertisement closely resembled an equity advertisement that recently appeared in *Money* magazine.<sup>168</sup> Participants then responded to questions about their propensity to invest in the fund and about their expectations regarding the fund's future returns.<sup>169</sup> Versions of the advertisement differed in the strength and prominence of their warning against relying on past returns.<sup>170</sup>

The experiment showed that the current SEC-mandated warning is completely ineffective. Participants viewing the version of the advertisement containing the mandated warning were not less likely to invest in the fund, nor had lower expectations regarding the fund's future returns, than were participants viewing a version of the advertisement that had no warning whatsoever.<sup>171</sup>

The SEC-mandated warning likely fails, at least in part, because it is so weak. In our experiment, participants who were less likely to believe that the advertised fund's past performance was a good predictor of its future performance were also less willing to invest in the advertised fund.<sup>172</sup> The SEC-mandated warning, however, fails to convey that strong past performance is a poor predictor of strong future performance. Instead, it merely informs investors that past performance does not "guarantee" future results.

In summary, despite the SEC-mandated warning, performance advertisements remain materially misleading. The warning does not adequately caution investors against relying on past

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<sup>164</sup> 17 C.F.R. § 230.482(b)(3)(i) (emphasis added).

<sup>165</sup> 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 Web site where an investor may obtain performance data current to the most recent month-end." *Id.* Although this requirement ensures that investors have access to information about 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.

<sup>166</sup> Mercer, Palmiter & Taha, *supra* note 1, at 445.

<sup>167</sup> *Id.*

<sup>168</sup> *Id.*

<sup>169</sup> *Id.* at 446–47.

<sup>170</sup> *Id.* at 445.

<sup>171</sup> *Id.* at 449, 451–53.

<sup>172</sup> *Id.* at 453–55.

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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 violate 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 prohibits “[u]nfair methods of competition in or affecting commerce, and unfair or deceptive acts or practices in or affecting commerce.”<sup>173</sup> If the Federal Trade Commission (FTC), rather than the SEC, regulated mutual fund performance advertisements, the FTC would likely deem the advertisements deceptive. Indeed, the FTC and courts have found advertisements for other products and services similar to mutual fund performance advertisements deceptive under section 5 of the 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.<sup>174</sup> Similarly, advertisements for business opportunities often contain a testimonial from someone who made a large amount of money through the opportunity.<sup>175</sup>

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<sup>173</sup> Federal Trade Commission Act, Pub. L. No. 203, 38 Stat. 717, 719 (codified as amended at 15 U.S.C. § 45(a)(1) (2006)).

<sup>174</sup> See Edward Correia, *The Federal Trade Commission's Regulation of Weight-Loss Advertising Claims*, 59 FOOD & DRUG L.J. 585, 587 (2004) (noting that “[a]dvertisers frequently promote weight-loss products through . . . statements by individuals who have tried the product”).

<sup>175</sup> See, e.g., Luke Froeb, *Fraudsters and Testimonial Ads*, MANAGERIAL ECON: ECON. ANALYSIS OF BUS. PRAC. (Sept. 18, 2007, 4:03 AM), [http://managerialecon.blogspot.com/2007/09/fraudsters-and-testimonial-ads\\_9096.html](http://managerialecon.blogspot.com/2007/09/fraudsters-and-testimonial-ads_9096.html) (noting that work-at-home scams often include testimonials).



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, viewers of the advertisement may infer what their own results likely would 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.<sup>176</sup>

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).<sup>177</sup> 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.<sup>178</sup>

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<sup>176</sup> There is at least one difference between product or service testimonials and fund performance advertisements. All investors in a mutual fund actually earned the returns highlighted in the performance advertisement over the specified period. In contrast, 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. However, 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 the person in the advertisement; mutual fund performance advertisements can falsely imply that the fund will likely continue its strong past performance.

<sup>177</sup> Guides Concerning the Use of Endorsements and Testimonials in Advertising, 74 Fed. Reg. 53,124, 53,126 (Oct. 15, 2009) (to be codified at 16 C.F.R. pt. 255) ("The Guides merely elucidate the Commission's interpretation of Section 5 . . .").

<sup>178</sup> *Id.* at 53,129. According to the original Guides, any testimonial relating to a consumer's experience regarding a key attribute of a product or service

will 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, unless the advertiser possesses and relies upon adequate substantiation for this representation, the advertisement should either clearly and conspicuously disclose what the generally expected performance would be in the depicted circumstances or clearly and conspicuously disclose the limited applicability of the endorser's experience to what consumers may generally expect to achieve.

*Id.*

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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.<sup>179</sup> Unless the advertiser could substantiate this implication, the advertisement would have 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.<sup>180</sup> 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.”<sup>181</sup>

Recognizing that disclaimers accompanying potentially misleading advertisements might not be enough, the FTC amended the Guides in October 2009.<sup>182</sup> 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 or service 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 in the depicted circumstances, and the

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<sup>179</sup> See *id.* (stating that testimonial advertisements are susceptible to the interpretation “that the endorser’s experience is representative of what consumers will generally achieve”).

<sup>180</sup> *Id.*

<sup>181</sup> Guides Concerning The Use of Endorsements and Testimonials in Advertising, 74 Fed. Reg. at 53,129.

<sup>182</sup> *Id.*

advertiser must possess and rely on adequate substantiation for that representation.<sup>183</sup>

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 consumers generally understand testimonial advertisements as implying that the endorser’s experience is 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—the FTC made clear that such instances were only exceptions to the general tendency of consumers to believe that testimonials reflect typical results.<sup>184</sup> 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 that the results achieved by the endorsers are generally representative of what new users can expect.”<sup>185</sup>

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,”<sup>186</sup> a warning even stronger than the SEC-mandated “past performance does not guarantee future results”<sup>187</sup> warning in mutual fund performance advertisements. In proposing this amendment, the FTC cited the same two empirical studies it cited to support the FTC’s “likely” interpretation, this time as evidence that the safe harbor disclaimer was ineffective. One of these studies found that

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<sup>183</sup> Consumer Endorsements, 16 C.F.R. § 255.2(b) (2011).

<sup>184</sup> Guides Concerning the Use of Endorsements and Testimonials in Advertising, 73 Fed. Reg. 72,374, 72,378 (Nov. 28, 2008) (to be codified at 16 C.F.R. pt. 255).

<sup>185</sup> *Id.*

<sup>186</sup> *Id.* at 72,379.

<sup>187</sup> Advertising by an Investment Company as Satisfying Requirements of Section 10, 17 C.F.R. § 230.482(b)(3)(i).

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“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 benefit “at least half of the people who try it.”<sup>188</sup>

Similarly, in the second study, participants were shown testimonial advertisements for a weight-loss program, dietary supplement, or business opportunity.<sup>189</sup> 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 [and] [y]ou 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.”<sup>190</sup>

Based on these studies and its own experience, the FTC eliminated the safe harbor for “results not typical” disclaimers.<sup>191</sup> However, the FTC did not prohibit these disclaimers because it “[did] not rule out the possibility that a clear, conspicuous, and informative disclaimer could” prevent consumers from being misled regarding the typicality of a testimonial.<sup>192</sup> Nevertheless, the agency warned that it is “skeptical that most disclaimers of typicality will be effective in preventing deception.”<sup>193</sup>

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, relative superior performance generally does not persist. Fund companies advertise those funds that have outperformed their peers in the past,<sup>194</sup> but this relative outperformance generally does not

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<sup>188</sup> 73 Fed. Reg. at 72,379.

<sup>189</sup> *Id.* at 72,378.

<sup>190</sup> *Id.* at 72,379.

<sup>191</sup> *Id.* at 72,381.

<sup>192</sup> Guides Concerning the Use of Endorsements and Testimonials in Advertising, 74 Fed. Reg. 53,124, 53,131 (Oct. 15, 2009).

<sup>193</sup> *Id.*

<sup>194</sup> See *supra* Part III.C.

continue.<sup>195</sup> Second, performance advertisements are much more prevalent when equity fund returns have been high overall.<sup>196</sup> Bull markets, however, always end eventually. 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.<sup>197</sup> This is far weaker than warning that high past returns are likely not “typical” of future returns. However, even such a typicality disclaimer would generally no longer satisfy the FTC. Under the current FTC Guides, advertisements of atypical results usually also require a disclosure of what results are typical.<sup>198</sup>

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 summary judgment to the FTC in an action under section 5 of the 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.<sup>199</sup> 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.<sup>200</sup>

The sellers argued that the advertisements contained a disclaimer warning that “results may vary.”<sup>201</sup> Despite the

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<sup>195</sup> See *supra* Part III.B.

<sup>196</sup> See *supra* notes 69–74 and accompanying text.

<sup>197</sup> Advertising by an Investment Company as Satisfying Requirements of Section 10, 17 C.F.R. § 230.482(b)(3)(i) (2011).

<sup>198</sup> Consumer Endorsements, 16 C.F.R. § 255.2(b) (2011).

<sup>199</sup> *Fed. Trade Comm’n v. Medicor, LLC*, 217 F. Supp. 2d 1048, 1050 (C.D. Cal. 2002). The package allowed consumers to conduct a business from their homes by submitting medical bills on behalf of doctors to benefits programs such as Medicaid and Medicare. *Id.*

<sup>200</sup> *Id.* at 1054.

<sup>201</sup> *Id.* at 1053.

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disclaimer, the court found the work-at-home advertisements deceptive. The court reasoned that even with such a disclaimer, “consumers could reasonably believe that the statements of earnings potential represent typical or average earnings.”<sup>202</sup> In short, 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 the advertisements generally must inform consumers 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.* Historically, a number of tobacco companies have advertised cigarettes that lack chemical additives.<sup>203</sup> The FTC filed suit against three companies for such advertisements. In its complaints, the FTC claimed that the companies’ advertisements “represented, expressly or by implication, that smoking [the] cigarettes, because they contain no additives, is less hazardous to

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<sup>202</sup> *Id.* at 1054.

<sup>203</sup> 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 TOBACCO CONTROL e1, e5-6 (2007), <http://tobaccocontrol.bmj.com/content/16/6/e7.bull>.

a smoker's health than smoking otherwise comparable cigarettes that contain additives."<sup>204</sup>

The FTC's complaints against two of the companies, R.J. Reynolds and Santa Fe, are particularly noteworthy. None of the advertisements cited in those complaints claimed 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.<sup>205</sup>

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 "[n]o additives are in our tobacco, for true taste" or "[n]o additives in our tobacco means true taste, straight up," or had taglines stating: "100% [t]obacco [t]rue taste" or "[n]ew Winston . . . [n]o [a]dditives . . . [t]rue

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<sup>204</sup> Complaint ¶ 5, *In re R.J. Reynolds Tobacco Co.*, 128 F.T.C. 262 (Aug. 16, 1999) (No. C-3892). The FTC sued R.J. Reynolds Tobacco Company (R.J. Reynolds), Santa Fe Natural Tobacco Company (Santa Fe), and Alternative Cigarettes, Inc. (Alternative Cigarettes). 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 ¶ 5, *In re Santa Fe Natural Tobacco Co.*, No. 992-3026, 2000 WL 559854, at \*1 (F.T.C. Apr. 27, 2000) (emphasis added). Similarly, the advertisements of Alternative Cigarettes specified 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 ¶¶ 5-6, *In re Alt. Cigarettes, Inc.*, No. 992-3022, 2000 WL 559811, at \*3-4 (F.T.C. Apr. 27, 2000) (emphasis added).

<sup>205</sup> Complaint at exs. A-C, *Santa Fe Natural Tobacco Co.*, No. 992-3026, 2000 WL 559854, at \*2; Complaint at exs. A-F, *R.J. Reynolds*, 128 F.T.C. at 266-70 (No. C-3892). In contrast to the R.J. Reynolds and Santa Fe advertisements, one of the advertisements cited in the FTC's complaint against Alternative Cigarettes did claim that additive-free cigarettes might be healthier than other cigarettes: "Native Americans smoked all natural tobacco without the ills that are associated with smoking today. Could it be that the chemicals and additives cause more health problems than the natural tobacco itself? Much research needs to be done on this subject." Complaint at ex. A, *Alt. Cigarettes, Inc.*, No. 992-3022, 2000 WL 559811, at \*5.

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[t]aste.”<sup>206</sup> Similarly, one of Santa Fe’s three advertisements stated that the advertised cigarettes were “made from 100% chemical-additive-free, natural tobacco . . . and nothing else,” which results in a “great tobacco flavor, with no chemical aftertaste.” The advertisement also encouraged readers to “[d]iscover the slower-burning, longer-lasting, all-natural smoking experience . . . .”<sup>207</sup> The other R.J. Reynolds advertisement and the other two Santa Fe advertisements did not indicate any reason why additive-free cigarettes were superior to other cigarettes.<sup>208</sup>

Nevertheless, numerous studies indicated that many smokers erroneously assumed additive-free cigarettes were healthier.<sup>209</sup> The FTC claimed the advertisements were misleading, and entered into consent decrees with the tobacco companies in which the companies agreed to include disclaimers in the advertisements stating that additive-free cigarettes are not safer than other cigarettes.<sup>210</sup>

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 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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<sup>206</sup> Complaint at exs. A, C-F, *R.J. Reynolds Tobacco Co.*, 128 F.T.C. at 265, 267–72 (No. C-3892).

<sup>207</sup> Complaint at ex. B, *Santa Fe Natural Tobacco Co.*, No. 992-3026, 2000 WL 559854, at \*1.

<sup>208</sup> Complaint at ex. B, *R.J. Reynolds Tobacco Co.*, 128 F.T.C. at 266 (No. C-3892); Complaint at exs. A, C, *Santa Fe Natural Tobacco Co.*, No. 992-3026, 2000 WL 559854, at \*2.

<sup>209</sup> See McDaniel & Malone, *supra* note 203, at 4, 6 (citing the results of studies conducted for tobacco companies regarding consumer reactions to additive-free cigarettes).

<sup>210</sup> The consent decrees with all three companies required them to include in their advertisements the disclaimer that “[n]o additives in our tobacco does NOT mean a safer cigarette.” Consent Order, *Alt. Cigarettes, Inc.*, No. 992-3022, 2000 WL 559811, at \*11; Consent Order, *Santa Fe Natural Tobacco Co.*, No. 992-3026, 2000 WL 559854, at \*6; Consent Order, *R.J. Reynolds Tobacco Co.*, 128 F.T.C. at 275 (No. C-3952).



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 other products and services.

#### D. OTHER REGULATORY INITIATIVES RAISE QUESTIONS ABOUT PERFORMANCE ADVERTISING

The potential misuse of mutual funds' past returns has also caught the attention of Congress and the Department of Labor.

1. *The Dodd–Frank Act Called on the GAO to Study Fund Performance Advertising.* The Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010<sup>211</sup> took notice of the broad implications of performance chasing by mutual fund investors and mandated the Comptroller General, the head of the GAO, to study mutual fund advertising.<sup>212</sup> That study was required to address many of the issues discussed in this Article.

The GAO study, completed in July 2011, was required to 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 can make informed financial decisions when” buying mutual funds.<sup>213</sup>

The GAO summarized its findings in part as follows:

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<sup>211</sup> Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended at 12 U.S.C. §§ 5201–5641).

<sup>212</sup> Why the legislation calls on the GAO, not the SEC, to conduct the study is unclear. 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.

<sup>213</sup> § 918, 124 Stat. at 1837.

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While some academic studies and others have suggested that advertisements that emphasize a fund's past performance can influence investors to make inappropriate investments, the evidence that investors are harmed by these advertisements is mixed. Some academics believe that because research has shown that past performance generally does not persist and is not predictive of future performance, performance advertisements are inherently misleading. However, some studies illustrate that investors who are influenced by performance advertising may still achieve returns that exceed market indexes or other funds. In addition, the extent to which investors rely on performance advertisements is unclear. Industry surveys show that investors are increasingly relying on information from financial advisors and other sources and use a variety of information—beyond performance information—when making investment decisions.<sup>214</sup>

The GAO thus downplayed the risk that performance advertising misleads investors, even though this was inconsistent with information in its report. For example, the GAO's report acknowledged our experimental study finding that the current SEC-mandated disclaimer in performance advertisements is completely ineffective in dissuading investors from focusing on past returns.<sup>215</sup> However, the GAO's report made no recommendation regarding improving this disclaimer, instead it merely mentioned that FINRA is considering conducting its own study to "determine if disclosures can be used to encourage investors not to overly rely on past performance information."<sup>216</sup>

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<sup>214</sup> U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-11-697, GAO HIGHLIGHTS: MUTUAL FUND ADVERTISING 1 (2011), available at <http://www.gao.gov/new.items/d11697.pdf>.

<sup>215</sup> U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 69, at 24–25. For a discussion of our study, see *supra* notes 166–72 and accompanying text.

<sup>216</sup> U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 69, at 25.

Similarly, the GAO report observed that the timing of performance advertisements might harm investors by encouraging them to buy funds after they have already risen significantly in value.<sup>217</sup> The GAO's report, however, failed to make recommendations to address this problem.

Overall, the mutual fund industry's view that performance advertising is already sufficiently regulated carried the day. The GAO made only one recommendation: the SEC should ensure that FINRA "develops sufficient mechanisms to notify all fund companies of new [FINRA] interpretations of existing rules" regarding fund advertising.<sup>218</sup> Thus, the report at least implicitly viewed the current regulatory framework—with only very minor adjustment—to be adequate.

2. *The Labor Department Regulates the Use of Performance Data by ERISA Plan Fiduciaries.* The Department of Labor—the agency charged with setting standards for private pension plans under the Employee Retirement Income and Securities Act (ERISA) has also expressed concern about the use of mutual funds' past returns.<sup>219</sup> 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,<sup>220</sup> the Labor Department made clear that such models should "avoid investment recommendations that inappropriately distinguish

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<sup>217</sup> *Id.* at 14.

<sup>218</sup> *Id.* at 36.

<sup>219</sup> Employee Retirement Security Act of 1974, Pub. L. 93-406, 88 Stat. 829 (codified as amended at 29 U.S.C. §§ 1001–1461 (2006)).

<sup>220</sup> Investment Advice—Participants and Beneficiaries, 75 Fed. Reg. 9360, 9361 (Mar. 2, 2010) (to be codified at 29 C.F.R. at 2550). The rulemaking sought 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 fiduciaries with respect to the plan or parties in interest to the plan. *Id.* Among the section 408 exemptions is one for investment advice provided to plan participants and beneficiaries 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)(i) (2008). The proposed rulemaking sought to exempt investment advice provided pursuant to a computer model "designed and operated to . . . [a]pply 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. at 9366.

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among investment options within a single asset class on the basis of a factor that cannot confidently be expected to persist in the future.”<sup>221</sup> The Labor Department justified this restriction saying:

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 differences in their historical risk and return characteristics.<sup>222</sup>

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 fact, in its rulemaking proposal, the Labor Department questioned the usefulness of funds’ past returns. It 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? 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? On what if any bases can a fund’s superior past performance be demonstrated to derive not from

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<sup>221</sup> 75 Fed. Reg. at 9361.

<sup>222</sup> *Id.* at 9361–62 (emphasis added).

chance but from factors that are likely to persist and continue to affect performance in the future? Should the use of a fund's superior past performance as a criterion for allocating assets to the fund be conditioned on such demonstration?<sup>223</sup>

In its final rule, the Department of Labor required the computer models to "[a]pply generally accepted investment theories that take into account the historic risks and returns of different asset classes over defined periods of time"<sup>224</sup> and to "[t]ake into account investment management and other fees and expenses attendant to the recommended investments."<sup>225</sup> The models also may consider the past performance of the particular investment options so long as this performance is given only "appropriate[ ] weight."<sup>226</sup>

Although Congress and the Department of Labor have recently expressed concern over the use of funds' past performance data, the SEC appears unlikely to focus on the issue. At a meeting of the Mutual Fund Directors' Forum in April 2010, Andrew Donohue, the director of the SEC's Division of Investment Management, stated that even if the Department of Labor adopted its proposed rule, the SEC would be unlikely to alter its own rules permitting the use of past performance to promote funds.<sup>227</sup>

## VI. REFORMING THE REGULATION OF MUTUAL FUND PERFORMANCE ADVERTISEMENTS

Having shown that performance advertisements mislead consumers into chasing funds with high past returns, this section of the Article details how this performance chasing harms investors, and thus our national savings and retirement systems.

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<sup>223</sup> *Id.* at 9362.

<sup>224</sup> Investment Advice—Participants and Beneficiaries, 76 Fed. Reg. 66,136, 66,163 (Oct. 25, 2011) (to be codified at 29 C.F.R. at 2550).

<sup>225</sup> *Id.*

<sup>226</sup> *Id.*

<sup>227</sup> Malini Manickavasagam, *DOL Decision on Past Performance Unlikely to Impact SEC*, Donohue Says, Sec. Reg. & L. Rep. Online (BNA) No. 42, at 730 (Apr. 19, 2010).

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Two possible regulatory approaches exist to address this harm. One is for the SEC to require performance advertisements to contain a stronger warning discouraging investors from chasing high past returns. A bolder approach, however, might 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 than they otherwise could. Funds that have earned high returns in the past generally do not continue to do so.<sup>228</sup> In addition, Jain and Wu's study found that funds in performance advertisements even tend to underperform their benchmarks after being advertised.<sup>229</sup>

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 “advis[ing] an investor to consider the investment objectives, risks, and charges and expenses of the investment company carefully before investing” and directing potential investors to the fund prospectus to obtain this and other information about the fund.<sup>230</sup> 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, Fitzsimmons, and Prince's survey of fund-owning households found that 72% of them did not know whether their funds focused on domestic or

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<sup>228</sup> See *supra* Part III.B (discussing studies examining relationship between past returns and future performance).

<sup>229</sup> Jain & Wu, *supra* note 75, at 948–49.

<sup>230</sup> Advertising by an Investment Company as Satisfying the Requirements of Section 10, 17 C.F.R. § 230.482(b)(1) (2011).

international securities, and 75% of them did not know whether their funds invested in equities or fixed-income securities.<sup>231</sup> Also, in an Investment Company Institute sponsored survey of fund investors, only 57% claimed to review, before investing, the type of securities held by a fund and only 40% claimed to review the fund's investment objectives.<sup>232</sup> In addition, other studies have found that investors pay little attention to a fund's risk when choosing among funds.<sup>233</sup>

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 better matched to 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 Professors Beth Pontari, Andrea Stanaland, and Tom Smythe found that people choosing among funds gave much more weight to the funds' advertised past returns than to the funds' expense ratios, even when the expense ratios were made highly salient in the advertisements.<sup>234</sup>

As discussed in Part III.B, high past returns are generally a matter of luck, and because luck usually 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

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<sup>231</sup> Capon, Fitzsimons & Prince, *supra* note 30, at 68.

<sup>232</sup> INV. CO. INST., *supra* note 31, at 3.

<sup>233</sup> For a discussion of these studies demonstrating investors' indifference to risk, see Palmiter & Taha, *Mutual Fund Investors*, *supra* note 3, at 978–80.

<sup>234</sup> Beth A. Pontari et al., *Regulating Information Disclosure in Mutual Fund Advertising in the United States: Will Consumers Utilize Cost Information?*, 32 J. CONSUMER POLY 333, 346, 348 (2009). See also CONSUMER FED'N OF AM., *supra* note 32, at 10 (reporting that 71% of surveyed fund investors stated that a fund's past performance was very or somewhat influential in their most recent purchase while only 54% stated that a fund's expenses were very or somewhat influential).

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these funds, albeit not as dramatic as the returns highlighted in performance advertisements.<sup>235</sup> Ironically, therefore, by encouraging investors to buy funds with high past returns, performance 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. Performance advertisements are much more common when the stock market in general has recently had high returns.<sup>236</sup> 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, but 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. Performance advertisements prompt investors to buy equity funds only when the recent returns on equity funds have been high. This is the opposite of what investors should do.

Consider a simple example. Imagine an investor who, based on his age, financial situation, and risk tolerance, decides at the beginning of the year to hold 50% of his investment portfolio in equity funds. If his 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. If his other investments outperform the equity

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<sup>235</sup> Mark Carhart, *On Persistence in Mutual Fund Performance*, 52 J. FIN. 57, 80 (1997).

<sup>236</sup> See *supra* notes 70–74 and accompanying text (discussing the correlation between performance advertising and stock prices).



funds, he should rebalance in the other direction.<sup>237</sup> This rebalancing strategy means selling some of his equity fund shares when they have performed well and buying more after they have performed poorly.<sup>238</sup> Equity fund performance advertising encourages precisely the opposite behavior, however, because the advertising is prevalent after periods of strong equity fund performance and rare after periods of poor performance. Thus, fund performance advertising encourages poor asset allocation decisions.

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. Investors' focus on past returns comes at the expense of more important factors, such as the fund's costs and how well the fund's risk and objective match the relevant 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 STRONGER WARNING IN PERFORMANCE ADVERTISEMENTS

So what should be done about performance advertisements? The current SEC-mandated warning is ineffective. Our experiment found that people who viewed a performance advertisement with the current warning were neither less likely to invest in the advertised fund, nor had lower expectations regarding its future returns, than were people who viewed the same advertisement without any warning whatsoever.<sup>239</sup>

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<sup>237</sup> J. Alex Tarquinio, *Oops, It May Be Time to Rebalance That Portfolio*, N.Y. TIMES, May 6, 2007, at C4.

<sup>238</sup> *Id.*

<sup>239</sup> See Mercer, Palmiter & Taha, *supra* note 1, at 449, 451–53.

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The current warning's ineffectiveness reflects the weakness of its wording: it merely warns investors that past performance does not *guarantee* future results, that returns fluctuate, and that investors might even 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 are a poor predictor of high future returns.

Therefore, one possible reform is for the SEC to strengthen its mandated warning. Our experiment tested a more strongly worded warning that clearly communicates the weak relationship between high past returns and high future returns. In particular, some participants viewed 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.<sup>240</sup>

This stronger warning reduced participants' expectations regarding the fund's future returns and their willingness to invest in the fund by 12% to 23%, depending on the measure used.<sup>241</sup> 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 version of the advertisement containing no performance data at all.<sup>242</sup> 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, evidence exists that the SEC realizes 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

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<sup>240</sup> *Id.* at 445.

<sup>241</sup> *Id.* at 457.

<sup>242</sup> *Id.* at 449, 453.

is titled “An Introduction to Mutual Funds.” Included there is a warning to investors against chasing high past returns:

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 might 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.<sup>243</sup>

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.”

Also, FINRA might be preliminarily considering requiring a stronger warning. According to the GAO's recent study of fund advertising, FINRA's Office of Investor Education “has been considering conducting research to determine if disclosures can be used to encourage investors not to overly rely on past performance,” research which “could help inform regulatory changes.”<sup>244</sup>

Nevertheless, there is reason to doubt 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 forecast the fund's future returns and state their propensity to invest in the fund.<sup>245</sup> 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.

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<sup>243</sup> *Invest Wisely*, *supra* note 4.

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As a result, a strong warning likely would have a smaller effect in the real world than it did in our experiment.<sup>246</sup>

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, poorly predict high future returns. There is evidence that this warning could reduce investors' propensity to chase advertised high 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

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 very 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 implying that this superior performance will continue. Such a warning would not address the misleading timing of performance advertisements, whereby fund companies use performance advertisements for equity funds much more frequently when stock market returns in general have been high

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<sup>244</sup> U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 69, at 25.

<sup>245</sup> Mercer, Palmiter & Taha, *supra* note 1.

<sup>246</sup> Note also, however, that this experimental design issue makes even more remarkable the finding that the SEC-mandated warning has no effect. Because the current warning had no impact even on experiment participants, who focused on the advertisement, it almost certainly has no impact on people who view the advertisement in the real world and possibly skim or even entirely skip the warning.

rather than low.<sup>247</sup> A prohibition of performance advertisements, however, would alleviate this timing problem.

In addition, if a truly effective warning that addressed all of performance advertisements' problems were somehow adopted, performance advertisements would probably disappear anyway. Advertising is costly, so if fund companies still used performance advertisements after the SEC mandated a new warning, it would indicate that the new warning did not effectively dissuade 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' 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 pay 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, suggesting that performance advertising is important.<sup>248</sup>

A prohibition on performance advertisements could raise another objection. The SEC requires a fund's prospectus—the fund's primary selling document, according to the SEC—to report

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<sup>247</sup> See *supra* notes 236–38 and accompanying text.

<sup>248</sup> Jain & Wu, *supra* note 75, at 957.

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past returns.<sup>249</sup> At first glance, it would seem strange to prohibit advertising of information that companies must disclose in a prospectus.

This inconsistency, however, would not be 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.<sup>250</sup> 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 a prospectus's audience. People who make investment decisions only after reviewing a fund's prospectus are likely more sophisticated than investors who would purchase a fund after reading little more than 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 might see them only in performance advertisements.

Before banning performance advertisements, the SEC would also need to determine the exact parameters of the prohibition. Ideally, the prohibition would only forbid advertising fund characteristics that investors erroneously believe are good predictors of future performance. Thus, although funds could not advertise high past returns, the prohibition would permit funds to advertise factors that actually are good predictors of future performance. Although actively managed equity funds that outperform their peers for a certain period generally do not 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

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<sup>249</sup> *Invest Wisely*, *supra* note 4.

<sup>250</sup> See SEC Form N-1A, 10-27, available at <http://www.sec.gov/about/forms/formn-1a.pdf> (listing information required in a fund prospectus).

in the long run. For example, small-capitalization stocks tend to have higher returns than do large-capitalization stocks.<sup>251</sup> This fact could be relevant to a reasonable investor choosing among funds. Thus, any change to the current approach probably should permit a fund that invests in small stocks rather than large stocks to advertise the higher historical returns of this asset class. This differs dramatically, however, from advertising the past returns of the fund itself. The past returns of the asset classes in which a fund invests are somewhat predictive of the fund's future returns. The extent to which a fund outperformed other funds that invest in the *same* asset class, however, is generally not predictive.

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, reflecting many investors' focus on the short-term. The SEC, however, might discourage the advertising of hot asset classes by allowing advertising of only long-term asset class returns.<sup>252</sup>

Another factor that is 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.<sup>253</sup> Thus, the SEC should permit advertisements to encourage investors to buy low-cost funds. A flat prohibition on performance advertisements, however, would prevent low-cost funds from advertising that they have out-performed comparable funds.

Yet, a prohibition on performance advertisements need not prevent low-cost funds from advertising their lower costs and those costs' impact on returns. Indeed, such advertisements exist

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<sup>251</sup> SIEGEL, *supra* note 21, at 142–44.

<sup>252</sup> Recall that performance advertisements currently must present the fund's average annual total returns for the past one, five, and ten years. Advertising by an Investment Company as Satisfying Requirements of Section 10, 17 C.F.R. § 230.482(d)(3) (2011).

<sup>253</sup> Carhart, *supra* note 235, at 80.

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now. For example, rather than use performance advertisements, the Vanguard Group—the most prominent low-cost fund company—often uses advertisements that promote its funds' low costs and explain how costs affect fund returns.<sup>254</sup>

In fact, low-cost funds likely would benefit from a prohibition of performance advertisements. Low-cost funds provide investors a relatively small short-term advantage. For example, an investor in a fund with 1% lower annual costs than a comparable fund should earn, on average, 1% more each year. This cost savings is very important over the long run. The difference in returns between funds that have been lucky in their stock picking and those that have not, however, dwarfs this 1% savings in the short run. 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.<sup>255</sup>

Another objection to prohibiting performance advertisements might be that not all funds that outperform their peers are just lucky. Studies show funds that outperform their peers *generally* do not continue to do so, but, as discussed earlier, some evidence exists of performance persistence among a small percentage of funds. For example, Fama and French found some evidence that, in the top 3% of actively managed funds, some fund managers have more than enough skill to cover their costs.<sup>256</sup> Thus, prohibiting performance advertisements might deprive investors of

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<sup>254</sup> For example, a recent Vanguard advertisement had the headline: "Simple Truth: It's important to keep an eye on costs." The advertisement stated 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!

MONEY, Oct. 2009, at 113 (presenting advertisement for Vanguard Group) (footnotes omitted).

<sup>255</sup> See Pontari et al., *supra* note 234, at 346 (finding that investors are much more influenced by past performance data than expense data in mutual fund advertisements even if both types of data are very prominent).

<sup>256</sup> Fama & French, *supra* note 52, at 1932–33.



information that could help them identify these few superior fund managers.<sup>257</sup>

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 were unlikely to garner noticeably higher returns for investors than would large, low-cost index funds.<sup>258</sup> Also, because they generally trade more than index funds, actively managed funds result in higher capital gains taxes for investors.<sup>259</sup> Furthermore, buying and selling funds to chase high past performance may result in investors incurring substantial transaction costs, such as loads, short-term trading fees, and capital gains taxes.<sup>260</sup>

More importantly, as discussed 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 investor's objectives and risk tolerance.<sup>261</sup> Thus, even if performance advertisements lead some investors to slightly higher future returns, these advertisements very likely cause more harm than good.

Finally, recall that a prohibition on performance advertisements would not prevent access to past returns data.

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<sup>257</sup> For the same reason, prohibiting performance advertisements might also raise a First Amendment issue. Because past returns might not have *zero* predictive ability for future returns, a court might deem performance advertisements merely potentially misleading, rather than inherently misleading. Thus, courts might only permit the SEC to mandate that performance advertisements contain a warning regarding the importance of past returns (such as the one proposed above), rather than allow prohibition of such advertisements. See *Int'l Dairy Foods Ass'n 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 contain a disclaimer would be sufficient). As discussed above, whether such a stronger warning would be effective is questionable. See *supra* notes 245–46 and accompanying text.

<sup>258</sup> Fama & French, *supra* note 52, at 1933.

<sup>259</sup> *Index Funds*, *supra* note 22.

<sup>260</sup> See *supra* note 45 and accompanying text.

<sup>261</sup> See *supra* Part VI.A.

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This information would still be available in fund prospectuses, personal finance magazines, and other sources. Thus, investors determined to chase past returns could still do so. A prohibition would simply prevent fund companies from enticing other investors to join this generally unwise chase.

In summary, performance advertisements by their nature encourage investors to buy funds with high past returns and to overlook 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. An SEC ban and the resulting press coverage could attract significant public attention to the folly of chasing past returns.

## VII. CONCLUSION

This Article throws down the gauntlet. Much of the mutual fund industry bases its business model on exploiting investor beliefs that “past is prologue.” But high past 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 current 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 fund’s costs, investment objective, and risk. 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,”<sup>262</sup> the SEC owes us all nothing less.

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<sup>262</sup> *The Investor’s Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, U.S. SEC. & EXCH. COMM’N, <http://sec.gov/about/whatwedo.shtml> (last modified Oct. 24, 2011).

