Empire of the Fund

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The Way We Save Now

WILLIAM A. BIRDTHISTLE

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For Alison.

To Elspeth, Isolde, and Alana.

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Introduction

> Nearly 80 million baby boomers will file for retirement benefits over the next 20 years—an average of 10,000 per day.
>
> —Social Security Administration,
> *Annual Performance Plan for Fiscal Year 2012*

Over the past 30 years, America has embarked on a grand experiment—perhaps the richest and riskiest in our financial history—to change the way we save money. The hypothesis of our experiment is that millions of ordinary, untrained, and busy citizens can successfully manage trillions of dollars in a financial system dominated by wealthy, skilled, and powerful investment firms—firms that on many occasions have treated investors shabbily. As ten thousand baby boomers retire from the workforce each day and look to survive for almost two decades largely on the mutual funds in their personal accounts, we will soon learn whether our massive experiment has been a success. And if not, we will also soon discover just how enormous the costs of failure will be.

Just a single generation ago, large numbers of Americans enjoyed the protection of a pension offered by their employer. The typical pension guaranteed its beneficiaries a steady stream of payments from their retirement until their death. Together with the benefits of Social Security, pensions provided secure retirements to millions of working Americans.[1] The golden age of the pension, however, is effectively over. And it may at best have been merely gilded, for not once in the past thirty-five years did more than 40 percent of American workers ever participate in such a plan.[2]

Today, the benefits of Social Security and pensions look alarmingly inadequate. The average monthly benefit for retirees from Social Security is now $1,335, or just over $16,000 per year.[3] Pensions, meanwhile, have rapidly disappeared from our economic ecosystem: public pensions are underfunded by trillions of dollars,[4] and the number of U.S. private-sector workers covered solely by pensions has fallen to an all-time low of 3 percent.[5] Americans in the future will have to support themselves far more on the success or failure of their personal investment accounts.

We as a nation have chosen to entrust our savings not to large pools overseen by professional asset managers but instead to the smaller, individual accounts of almost 90 million investing amateurs. In the argot of the investment world, Americans are losing *defined benefit plans*, such as pensions, and are being directed into *defined contribution plans*, such as 401(k)s.

The rise of these individual accounts has, in turn, funneled massive amounts of retirement savings—more than $6.9 trillion—into one of the most popular investment options in personal accounts: the mutual fund. American investments have built an empire of 8,000 funds holding more than $16 trillion.[6]

The way we save now may enable some Americans to earn comfortable returns in the years ahead, but is also likely to leave many others disappointed. Though mutual funds and 401(k) plans may feel familiar to many of us, in fact they present a number of challenges and dangers to lay investors.

The primary consequences of our new approach, for instance, are that ordinary Americans now find themselves responsible for deciding whether to enroll in an investment account, what amount of each paycheck to contribute to that account, and how to invest those savings successfully for up to forty years of a career and for decades more in retirement. As Thomas Friedman observes, "It is a 401(k) world": "Government will do less for you. Companies will do less for you."[7]

Though the rhetoric of individual choice may appeal greatly to the American psyche, this change also brings personal liability for getting any of these difficult decisions wrong. And we *are* getting them wrong: approximately one-third of U.S. households currently have no retirement savings at all.[8] Of the remaining two-thirds, those who have accumulated nest eggs have enthusiastically vouchsafed them to the mutual fund. So if there are any problems in that particular basket, American investors will find themselves extremely exposed to those vulnerabilities.

As we will see, funds do suffer from a number of problems. By illustrating the structural vulnerabilities in mutual funds, the perverse incentives of fund managers, and the litany of scandals that have bedeviled the investment industry, this book attempts to forewarn and forearm Americans. To negotiate our new investing paradigm successfully, Americans will need a greater understanding of mutual funds, more transparency from the financial firms that manage them, and stronger enforcement by prosecutors of the regulations that govern funds.

This book also proposes an alternative way for Americans to invest their savings, one that is less expensive and more scrupulously managed than the mutual funds in which individuals can participate today. By pooling the bargaining strength of millions of investors into a powerful savings plan, Americans could enjoy the benefits of both individual control and economic security.

The Demise of the Pension

Unrest in the Midwest

February is no time to wander outside in Wisconsin. Certainly not without a compelling reason or the warmth of a grilled brat. In February 2011, the average high temperature in the state capital, Madison, was only 29.6 degrees Fahrenheit.[9] The Green Bay Packers won the Super Bowl in Texas that month,[10] but the last tailgate at Lambeau Field—prior to a satisfying home win over the Chicago Bears[11]—had been weeks before, on January 2. In any normal winter, citizens of the Badger State should have been tucked up inside, savoring their ability to play football, craft delicious dairy products,[12] and behave sensibly.

Instead, tens of thousands of them—over a hundred thousand by some estimates—were outside in the cold. Not just for a quick dash to replenish the frozen custard and cheese curds. But for hours. Then for days. Then for weeks and months. When these massive and persistent crowds of Wisconsinites did step back indoors, they did so most dramatically by forcing their way into the rotunda of the State Capitol, where they interrupted lawmakers with drumbeats and chants. Even, if reports are to be believed, with the utterance of an epithet or two.[13]

For a few tumultuous months, these un-midwestern displays by the citizens of Wisconsin captivated the front pages of newspapers across the United States. Yet they were surpassed by the enormities of the state itself. Indeed, by officials in each branch of the Wisconsin government: executive, legislative, and judicial. The newly elected governor, just a few months into his term, prompted these massive demonstrations by announcing his controversial plan to limit employee benefits.[14] Fourteen state senators who opposed the plan evaded capture by the Wisconsin State Patrol and fled to an undisclosed location in Illinois—in an attempt to prevent a quorum for a vote on the governor's bill.[15] When the bill nevertheless became law, a challenge to its legality made its way to the Wisconsin Supreme Court, where tempers amongst the justices frayed to the point that one accused another of putting her in a chokehold.[16]

Americans today are much more familiar with the Wisconsin governor who triggered this astonishing chain of events, now that he has survived a recall election, won reelection, and run for president of the United States. He is, of course, Scott Walker.[17]

But what could possibly have been in his plan that so exercised the good people of America's Dairyland? Some provisions of Governor Walker's bill enraged public employees for obvious reasons, such as requiring them to contribute far more to their pensions and curtailing their ability to bargain collectively. But the law, formally titled 2011 Wisconsin Act 10, also included another idea, one less prominent but with a greater potential impact on the citizens of Wisconsin. Section 9115 of the bill required a study of the effect of "establishing a defined contribution plan as an option for participating employees."[18]

Whatever such an academical exercise might entail, it certainly doesn't sound very important or threatening, does it? In fact, the proposal hinted at the beginning of the end of public pensions in Wisconsin and their eventual replacement by defined-contribution accounts. This substitution is one that private companies in the United States widely adopted to improve their balance sheets in the 1990s.[19] And state and municipal governments throughout our country might hope it will do the same for their budgets some day.

Illinois Isn't Burning, Yet

Perhaps the most combustible government in the union is another midwestern state, just one to the south of Wisconsin. The risks of ignition in Illinois arise from its poor credit rating, unfunded pension liability, and insoluble political paralysis. Illinois's credit rating and pension liability are the worst in the nation; its political problems might be, too, if such things could be quantified.[20]

The Standard & Poor's rating of Illinois's credit is A-, which might be cause for self-congratulation on a high-school report card, but is an abysmal score in the world of credit ratings. Six grades below the best possible rating (AAA, which fifteen states hold), Illinois's A- is lower than every other state's rating.[21]

The unfunded pension liability in Illinois is now more than $111,000,000,000 (that is, $111 billion). This caravan of zeros represents the void separating the amount that Illinois has promised to pay its retirees and the amount it has actually set aside to honor those promises. For scale, consider that Illinois collects about $40 billion in annual revenues.[22]

Though political paralysis is a difficult phenomenon to measure, the dysfunction in Illinois is evident even to a casual observer. Not only from the state's impressive lineage of incarcerated governors but, in this financial crisis, also from the inability of politicians to negotiate any sort of workable solution. A recent legislative effort to fix the gaping budgetary hole was struck down as unconstitutional by the state's supreme court, to little surprise.[23]

That people in the Land of Lincoln are not yet marching on Springfield and gatecrashing the capitol might be due only to the failure of politicians to prescribe medicine strong enough for Illinois's ailment. Still, public finances are now in such a dire condition, worsened through years of malign neglect, that when legislators do eventually get around to proposing a serious solution, large groups of Illinoisans will be upset. The most serious, if not the most popular, solution in Illinois is likely to be the same idea as set forth in Governor Walker's law: to shift new state employees out of a pension and into a defined contribution plan.[24]

Illinois and Wisconsin are far from alone in suffering these budgetary woes. The Pew Charitable Trusts reports that the majority of American states are delinquent with their pensions.[25] Indeed, the aggregate unfunded gap in state pensions is now well more than 1 trillion dollars.[26] Even by the louche standards of our nation's recent financial debacles, this number is gigantic.

For those Americans who still have them, such as public employees in Wisconsin and Illinois, pensions remain vitally important. But we should be careful not to overstate the historical importance of pensions. And at no time did pensions swaddle the land in a security blanket. In 1975, even before the introduction of 401(k) plans, fewer than 40 million Americans participated in pensions, and all pension plans combined held less than $200 billion. Only 21 percent of private-sector employees at the time received any money from them, and their median annual income was less than $5,000 in today's dollars. Pensions were not then a financial panacea for the United States and will not be anytime soon.

On the contrary, pensions are dwindling quickly. In America's public sector, the pension is very ill; in the private sector, it is effectively dead.

The Rise of the Fund

In place of the pension has arisen the individual savings account and, more specifically, the investment fund. Let us first examine the difference between pensions and individual investments, and then consider why we have shifted from one to the other.

Pensions versus Individual Accounts

A pension is, metaphorically, something like a bus: a functional if unglamorous conveyance driven by a professional to carry us as passengers on our trip to future financial security. Individual accounts, by metaphoric comparison, are more like cars: zippier vehicles that we drive ourselves to whatever destination we hope to reach with our savings. And for those investors who do drive their own cars, perhaps the most wildly popular road on which to travel is the mutual fund. Our experience with mutual funds, however, provides sobering evidence that these roads can be dangerous to travel.[27]

Though we have seen fierce opposition in places like Madison, employees across the United States have for the most part quietly accepted individual accounts. Recall that those protestors in Wisconsin ultimately lost their battle when Governor Walker and his legislative allies successfully enacted their new law.[28]

Indeed, the adoption of individual accounts appears to be proceeding as comprehensively as did our adoption of automobiles a century ago. We Americans, it turns out, tend to like driving our own cars. Paternalistic advice that a bus or a train might be safer isn't terribly compelling; indeed, it may seem unappealingly European. Like automobiles, our new innovation of individual accounts can, when used prudently, bring many potential benefits. And mutual funds, too, are important and useful financial pathways for guiding people to save for their future, their health care, and the education of their children. The mutual fund is now the central investment tool that Americans use to save, in both retirement and all other personal accounts.

But, one might wonder, are not financial professionals involved in both pensions and mutual funds? And, if so, are not the risks of the two modes of saving comparable? Yes, managers do indeed participate in both systems, but, no, the risks are not comparable. The timing and manner of professional involvement differ critically and lead to very different outcomes. Automotive experts help to create both buses and cars, but a professional drives the bus, while you drive the car.

In a pension plan, employees have no involvement whatsoever in how monies are invested. In an individual account, on the other hand, each employee chooses the specific mutual fund, if any, in which to invest. Managers of a pension fund act under a duty to generate streams of payments to people who are no longer working. Managers of a mutual fund pursue far narrower objectives. Investors in their funds, after all, may be senior citizens saving for retirement or hedge funds executing a short-term trading tactic. With over 8,000 U.S. mutual funds in the market, the investment approach of any given fund is often narrow, specialized, and aggressive.[29]

To use an alternative metaphor, pension managers and mutual fund advisers are both chefs of a sort. But pension managers create entire meals to provide nutrition, while fund advisers sell individual dishes to satisfy taste. If investors eat their complete pension breakfast, they are likely to benefit from a nutritious, if modest, meal. If investors pick and choose individual foods, they can easily hurt themselves by binging on obscene amounts of truffled omelets. Mutual fund investors can and regularly do lose substantial amounts through fees and poor performance; pensioners get no more, and rarely any less, than what they have been promised.

Pensions, again, are known more technically as defined benefit plans and, though hopelessly technocratic, that dollop of jargon does capture their essence: in a pension, the benefit one receives is defined in advance. That is, the payout an employee will receive at retirement is established long before that person ever becomes a pensioner.

Typically, the amount of the benefit is set forth as a formula for determining an annuity—that is, a regular stream of payments the employer will pay to the employee from the moment she retires until the day she dies. A basic formula would be a certain percentage of the employee's final salary, multiplied by years worked. Pensions, of course, can differ widely and offer more or less generous benefits. A more generous pension might increase the monthly amounts through annual cost-of-living adjustments or, upon the death of the pensioner, continue to be paid to the pensioner's surviving spouse for the remainder of that person's life.[30]

Another common pension perquisite has inadvertently evolved into one of the most generous: healthcare coverage. As part of a standard pension plan, the retiring employee typically remains covered by the employer's health insurance following retirement and for the rest of the pensioner's life.[31]

An employer responsible for making monthly pension payments to its army of pensioners is confronted with a mathematical challenge. How can the employer amass enough money to pay all those indefinite obligations that will come due decades into the future? One way to tackle this problem in a pension is, in some form, to set aside regular contributions and to save those sums while the employee is an active member of the employer's workforce. As useful as that pile of money might be, it will rarely be sufficient to cover an unknown stream of pension payments years into the future. But, of course, the savings alone are not intended to support the pension payouts. Employers do not simply stash these contributions in a coffee can under the bed. Instead, they place the sums in a pension fund and hire professional money managers to invest the savings over the course of decades, in an effort to build a corpus of investment returns that will augment the original contributions. Indeed, in a successfully managed pension, those investment returns, compounded over decades, might vastly outweigh the amount of the original contributions.

If employers rely on these contributions to fund pensions and hire experts to increase those sums, why have they soured so much on these plans? The problem for employers arises when their pension plans have not saved or appreciated sufficiently to cover their obligations. And, in recent history, problems have arisen not so much with the savings and investment returns flowing in but, rather, with the amounts due to flow out. Pension obligations have ballooned well beyond what employers predicted decades ago. And the essence of a pension is that employers are contractually responsible for covering any and all shortfalls between what their pension promised and what the pension fund may actually have accumulated.

Why have obligations increased so unexpectedly? For two primary reasons. First, Americans have developed the tenacious habit of living longer. In the past quarter-century, the life expectancy of Americans has increased by almost a decade.[32] From an employer's perspective, that increase represents ten more years of obligatory pension payments. Jane Austen long ago instructed us on the health-giving powers of an annuity, when her Fanny Dashwood, in *Sense and Sensibility*, bemoaned the idea of giving one to her father-in-law's widow, Mrs. Dashwood:

> But if you observe, people always live for ever when there is an annuity to be paid them; and she is very stout and healthy, and hardly forty. An

> annuity is a very serious business; it comes over and over every year, and there is no getting rid of it.[33]

Of course, since the founding of the Republic, Americans have been increasing their life expectancy, and any decent actuarial predictions made twenty-five years ago should have foreseen many of those extra years of pension payments. They did, but their math was still off.

What the actuaries did not predict was the second reason that pension obligations have swollen so much: healthcare costs in the United States have spiked in recent years.[34] Since many pension benefits included healthcare coverage, employers have also been responsible for those unexpected increases in health insurance premiums. And not only have healthcare costs risen rapidly in general, those costs are most acute at the end of a person's life, when we devour a huge percentage of our lifetime healthcare services. That extra decade of life expectancy has come to us not, alas, in our dashing twenties but in our seventies and eighties, when we're consuming buffets of prescription medications, hip replacements, and life-prolonging treatments.

Employers surprised by—and financially responsible for—these unexpectedly expanding obligations have felt themselves shackled to a corpse and have sought to rid themselves of their pension plans.[35] For existing pensioners or employees whose pension benefits have already vested, an employer may not easily renege on pension payments. That is, an employer cannot simply announce that it has changed its mind and no longer wishes to make any more pension payments; that path would be littered with lawsuits for breach of contract. Instead, a particularly determined employer might attempt to discharge its pension obligations through bankruptcy, and many have done so. In the private sector, pensions are disappearing like a sumptuous stand of tropical rainforest. In the public sector, pensions remain prevalent, but even municipal bankruptcies are on the rise, and lawsuits are proliferating as states and municipalities attempt to obviate their pension obligations.

America's Embrace of Individual Savings Accounts

The public employees of Wisconsin, Illinois, and many other states may be fighting to keep their pension plans, but they appear to be losing the struggle. Employers both private and public are prevailing in their efforts to shunt their employees into individual accounts, primarily as a means of shifting the costs and risks of future payouts from employers to employees.

These days, in the private—and perhaps soon the public—sector, employers rarely promise newly hired employees a pension. Instead, they offer a different savings plan: a defined contribution plan. That technical term includes 401(k) plans, 403(b) plans, 529 plans, and individual retirement accounts. What is defined in this new species of plan is no longer the *benefit*, as it was in a classic pension plan. Rather, these plans define only the *contribution*, which is the amount paid in. That is, the employer disavows any responsibility for what the plan is capable of—or answerable for—paying out in the future.[36]

In practice, a certain percentage of each employee's paycheck is set aside, before taxes are deducted, and contributed to the defined contribution plan. Sometimes, but not always, the employer chooses to contribute an additional amount into the employee's plan with each paycheck. An employer's decision to contribute any matching sums will turn on the same array of factors as influence all employers' offers to their employees: in the market for labor, how much do they need to sweeten their package of salary and benefits to attract talent?

Once an employee elects to enroll in one of these accounts, the employee—not a firm of investment professionals—determines how much of each paycheck to set aside (up to certain federal maximums) and in what particular investments to allocate those sums. As in pension plans, the overarching goal is that the corpus of contributions, augmented with decades of investment returns, will eventually amount to a valuable nest egg that can support the employee when she is no longer actively employed and earning. To accomplish that goal, most investors with individual accounts direct their savings into mutual funds.

Funds May Not Be as Familiar as They Seem

Though mutual funds may seem ubiquitous and familiar to many Americans, they can carry hidden dangers. Let us return to our automotive analogy for a vivid warning.

Karl Benz, widely acknowledged as the inventor of the modern automobile, designed his first engine in 1878.[37] Section 401(k) of the Internal Revenue Code, widely acknowledged as the source of the individual tax-advantaged retirement account, first appeared in the Revenue Act of 1978.[38] We are now almost forty years into our experience with the 401(k). At about this stage of our embrace of the automobile, in 1915, approximately 6,800 people died in motor vehicle accidents.[39] As Americans tightened their embrace of automobiles in the subsequent decades, annual deaths swelled to the tens of thousands before reaching a grisly peak of more than 54,000 in 1972.[40]

Now consider the financial crisis of 2008. During that unpleasantness, we saw the value of mutual funds plummet, slashing as much as 40 percent from the savings of investors on the very cusp of their retirement.[41] Our national zeal for individual accounts might very well inflict significant costs on Americans in the years to come. As individuals, obviously, but also as a nation.

What Don't We Know About Mutual Funds?

Mutual funds are widely considered to be simple tools used by school teachers and plumbers as a safe means to preserve their life savings. When scandals afflicted other aspects of our financial industry, these funds appeared to be the rare investment resistant to fiscal intemperance. Indeed, observers hailed their portfolio managers and boards of trustees as models for corporate America.[42] Mutual funds, alas, do have plenty of their own secrets.

Many of these skeletons tumbled out in a dramatic press conference in September 2003.[43] The attorney general of New York State surprised watchers that day by naming four large mutual fund firms as perpetrators of "a fundamental violation of the rights of shareholders."[44] Bank of America, Janus, Strong Financial, and Bank One had collaborated with a hedge fund named Canary Capital Partners, alleged the attorney general in his complaint, to swindle fund investors using a pair of schemes known as late trading and market timing.[45]

The head of Canary was a fellow by the name of Edward Stern, most famous prior to this unpleasantness as the son of Leonard Stern, the billionaire magnate whose name graces the business school of New York University. Stern the younger did not follow his father's path by making a fortune selling dog food and copies of the *Village Voice*; instead, he went panning for gold in the quiet waters of mutual funds.[46]

Stern persuaded this quartet of mutual fund firms and other intermediaries to grant him permission to do the legally impermissible. With Bank of America, for instance, Stern bargained for the ability to place late trades in mutual funds until 6:30 P.M. New York time. Entering a mutual fund trade any time after 4:00 P.M. Eastern Time and receiving that day's price, however, is a violation of federal securities law. As the New York State attorney general characterized the practice, "late trading can be analogized to betting today on yesterday's horse races."[47] The winnings from Canary's dead certs came out of gains that would otherwise have accrued to ordinary, law-abiding investors in the mutual funds. Bank of America, naturally, received compensation from Canary for extending this privilege.[48]

In Stern's other schemes, involving market timing, he won the complicity of investment firms to trade millions of dollars in and out of their funds on short notice. This style of rapid trading, which capitalizes on arbitrage opportunities, was expressly banned by the funds' legal documents. Funds publicly prohibit market timing because it diverts profits out of the accounts of the funds' long-term investors and into the hands of market timers. Indeed, fund firms like Bank of America even employed "timing police" to protect their funds from this sort of behavior. As with their late-trading arrangement, however, Canary simply paid Bank of America to keep those constables off the beat.[49]

Stern may have lacked his father's acumen and integrity, but he certainly shared his ambition. Stern *fils* and Bank of America were not content with the occasional order faxed over after market-moving news, nor a few hundred thousand dollars quickly bounced in and out of a fund. Instead, the bank gave Stern a "state-of-the-art electronic late-trading platform"[50] that allowed Canary to place late trades from its own computers directly into Bank of America's system without needing anyone's authorization. The bank also provided Canary with a credit line of approximately $300 million to finance this late trading and market timing. Only when Canary's practice of churning $9 million in and out of funds each day had sufficiently exasperated employees at Bank of America did they deploy their own timing police.[51]

The New York State attorney general with this gift for a narrative—and telegenic Repp ties, tailored suits, and scandals of his own to come—was of course Eliot Spitzer. His revelation on September 3, 2003, triggered a wave of investigations into all aspects of mutual funds. Lawyers and accountants scoured this multi-trillion-dollar industry to which 91 million individuals had entrusted their savings.[52]

Regulators, plaintiffs, and trustees soon alleged that many of the most trusted firms in the business had engaged in illicit practices beyond the original sins of market timing and late trading; for instance, failing to remit promised discounts;[53] selectively disclosing the holdings of fund portfolios to preferred clients;[54] failing to "fair value" the worth of assets under their management;[55] and, not surprisingly, destroying evidence of these abuses.[56]

Twenty of the country's oldest and most renowned fund complexes paid out unprecedented settlements to government regulators: Bank of America paid $375 million; Invesco Funds Group Inc. paid $325 million; and Bear, Stearns paid $250 million. Many more, including Alliance Capital Management, MFS, Citigroup, and AIG, also paid nine-digit settlements, for a total of almost $4 billion in penalties.[57]

But news coverage of these abuses in mutual funds soon gave way to the subprime mortgage scandals of our subsequent financial crisis.[58] And the public's appetite for mutual funds soured only for a short while. After a brief period of withdrawals, the number of fund investors rose to 96 million, and by 2006 their assets climbed above $10 trillion.[59]

So why should we continue to worry about the failings of one sleepy financial instrument amid the regular implosions of so many? As we shall see, problems with mutual funds are problems for millions of ordinary Americans.

How Does Our Experiment Appear to Be Proceeding So Far?

The Center for Retirement Research at Boston College reports that for those on the cusp of retirement—workers between the ages of fifty-five and sixty-four—the median balance in household 401(k) or IRA accounts is $111,000.[60] Perhaps such a six-figure sum appears opulent, but when we consider that it must support a retirement that could continue for decades, it is inadequate.

Today, the average American retires at sixty-one and dies at seventy-nine.[61] At our current rates of interest, inflation, and life expectancy, $111,000 would provide only about $7,300 in each year of a two-decade retirement. People with a balance that meager are about to confront an extremely lean retirement. Note also that more than one-fifth of the workers in this survey hold balances of less than $13,000. Amounts that small would not even provide the pittance of $1,000 each year.

The state of our experiment is alarming. In the cohort of 76 million retiring baby boomers,[62] many of whom are going to rely heavily on individual accounts, we can be sure that millions will fall short. When they do, large swaths of Americans will soon require substantial financial assistance from other sources.

We won't really discover the broader results of our experiment until these baby boomers have retired en masse and have attempted to support themselves on the balances of their accounts without additional income from regular salaries. The statistics on savings we have amassed so far suggest that we are likely to hear a great deal more about the inadequacy of individual savings accounts in the years to come.

So what happens if an individual employee mismanages this project and the monies in his retirement account turn out to be insufficient to cover the necessities of his retirement?

Recall that with a pension, the employer promises to draw upon the corporate or public revenues to cover any such shortfalls in the plan. Corporate employers make this promise via contracts, so they are legally enforceable for as long as the employer remains solvent. Public employers make their promises via contracts, state statutes, or even provisions in state constitutions, which can render them extremely difficult to break. Staring into their budget chasm, Illinois lawmakers have tried but failed to wriggle out of the state's constitutional provision mandating that pension benefits "shall not be diminished or impaired."[63]

Even in bankruptcy, pension payments may be continued to some extent by the Pension Benefit Guaranty Corporation (PBGC), a governmental agency charged with insuring pensions in much the way the Federal Deposit Insurance Corporation protects deposits in banks that go bust.[64] But with so many demands on its insurance of late, the PBGC is not a well institution. Like so many of its beneficiaries, the PBGC runs a worrisome deficit of its own: in 2015, its obligations exceeded its assets by more than $76 billion.[65]

Unlike a pensioner, the employee in a defined contribution plan is alone left with the consequences. If money in the employee's account runs short, the employee runs out. So the implicit promise of a defined contribution plan differs fundamentally from that of a defined benefit plan.

Perhaps, though, this difference is capitalist and meritocratic, and so is quintessentially American: more risk, certainly, but also greater possible reward.

Whether trillions of dollars of American life savings ought to be directed into investments with higher risks and rewards depends, in great part, on the personal and societal consequences of those risks' being realized.

Failure and Success

The Consequences of Failure in Our Experiment with Mutual Funds

If, indeed, mutual funds and individual accounts are vulnerable, heaping so much of our money upon them could be an extremely dangerous adventure in public policy.

One might argue that the risk of people losing their own money in individual accounts is offset by their greater possible rewards and, in any event, ought to be no concern of the rest of society. This libertarian strain of argument insists that government should have no interest in the success or failure of an individual's efforts to save for her own future. As with the perils of smoking—the argument might go—what business is it of ours if someone wishes to harm herself, whether it be with cigarettes or inept investing?

The answer might turn, as it did with smoking, on the second-hand and societal consequences of disastrous investing. As a country, we began to care far more about cigarettes when we learned of the harms that smoking inflicts on the lungs of others, as well as on the public health budgets of our commonwealth. The value of individual accounts will implicate similar policy considerations if maladroit investing on a vast scale damages our nation's fiscal health.

If Americans turn out to be largely inexpert at saving and our experiment does not succeed, great swaths of our fellow citizens could become destitute in their most vulnerable years. How likely is that eventuality? John C. Bogle, one of America's leading authorities on mutual fund investments, warns that our retirement system is "headed for a train wreck."[66] If he and many like-minded experts are correct, then as a nation we will face the choice of either ignoring the plight of those whose 401(k)s are bare or of providing very expensive support to the impoverished.[67] At a time of historic financial inequality, the state of our union surely will not benefit from more sources of economic dysfunction.

One cannot know, of course, how our future politicians and policymakers might solve such a problem, but the elderly have long been a very powerful voting constituency in our democracy. Little imagination is needed to suspect that if defined contribution plans turn out to be a widespread disaster, those suffering the most will vote for financial assistance. If millions of elderly Americans lose in the 401(k) sweepstakes and face crushing poverty in their later years, they are likely to push for all American taxpayers to share in the costs of our grand misadventure. And, like our other post hoc financial bailouts, the consequences are likely to be expensive, divisive, and broadly unsatisfying.

Success with Better Investors and Better Investments

Just like racing down the open road in our own cars, taking control of our finances can be a compelling notion with intuitive American appeal. But with investing as with driving, we can be injured through any combination of engineering flaws in the cars or roads we use, of our own shortcomings as drivers, and of the peril of others on the road. This book proposes a suite of tools—transparency, financial literacy, and enforcement—to help investors avoid these dangers.

First, consider the structural vulnerabilities of mutual funds. Many investors are unaware of the operations or economics of these funds. The financial houses that run mutual funds, for instance, owe conflicting allegiances to two very different groups of people: their own shareholders and the fund investors whose money they manage. To satisfy their own shareholders, fund managers must maximize fees, yet every increase in fees drains money directly from the savings of fund investors. Each year, the industry with this conflict of interest pockets nearly $100 billion of our savings.[68]

With greater transparency, investors would learn that fund firms make more money by increasing the size of a fund, even if they do so only by bringing in new investments without generating any positive returns for existing investors. In this system, therefore, marketing can triumph over prudent investment. Indeed, federal law permits fund advisers to use the money of current investors—via infamous 12b-1 fees[69]—to advertise the fund to prospective investors. Ultimately, every fund investor should be taken aback to learn that this industry is one of the rare economic markets in which price and performance are inversely related.[70] That is, the more one pays for a mutual fund, the more likely that fund is to produce lower investment returns. Imagine a world in which the most expensive cars were the worst jalopies. Financial drag from high fees causes this quirk of mutual funds and can profoundly erode our savings, particularly when compounded over decades. But greater transparency in the ways of the mutual fund can help investors to protect themselves from these structural impediments.

Second—and though we all hate to do it—let us reflect upon our own possible shortcomings. We would all like to believe that, with a little motivation and some self-help, we could win friends like Dale Carnegie and invest like Warren Buffett. But empirical studies repeatedly demonstrate that laypersons lack the institutional resources and the financial expertise we need to succeed at this project of investing large amounts by ourselves for years to come.[71]

The discomfiting reality is that the average individual does not abound in the key requirements of successful investing: discipline, deferred gratification, and math.[72] As humans, we tend not to be very sapient at forecasting our economic requirements decades into the future, at setting aside income today that we will need for the years ahead, and at calculating the investment options that will provide the best mix of risk and reward to increase our savings to sustain our future lives. As Richard Thaler notes, we simply don't enjoy many opportunities to get better at this project: "when it comes to saving for retirement, barring reincarnation we do that exactly once."[73] Indeed, those challenges are difficult even for the most powerful, wealthy, and experienced investors in our nation's economy.[74] Improving financial literacy, however, can help prepare investors to face these challenges.

Third, consider the risks from our counterparts' behaving badly. The history of Wall Street is blotted with tales of financial insiders who have deceived ordinary investors. Though the structure of funds allows firms to obtain large amounts of our savings legally, some professionals have proved creative at squeezing ever more pennies out of our accounts illegally. Investment banks like Bear, Stearns and Bank of America, hedge funds like Canary Capital, and fund advisers like Putnam, MFS, and Allianz among many others have paid many billions of dollars to settle claims of wrongdoing in an alarming array of unlawful schemes like late trading, market timing, unfair valuation, and more. Several of the chapters in this book will illustrate the diverse array of schemes by which experts in the fund industry have absconded with the savings of ordinary investors. Through greater enforcement of mutual fund investments, financial regulators could reduce the most problematic excesses in the industry.

To forestall those ominous outcomes, American investors need alternative—and better—solutions.

This book is an effort to teach investors how to use our new investing technology safely. How many lives might have been saved if our society had more quickly recognized the perils of speeding and drinking? Or the benefits of seatbelts, safety glass, and airbags? If investors today can—with a little driver's education—learn the structural vulnerabilities of investing on their own and the dangers to avoid in mutual funds, we stand a much greater chance of preserving our individual financial health and the nation's fiscal and democratic vitality in the years to come.

Of course, even the most sophisticated investors need better tools. No individual 401(k) investor, no matter how brilliant or wealthy, has the bargaining power to demand the best prices and most scrupulous behavior from a trillion-dollar investment industry. To ensure that Americans can make the most of our new world of individual accounts, we must create an inexpensive and well-run account for all Americans. As it happens, just such an option already exists in the Thrift Savings Plan for federal employees: a plan managed by one of America's leading investment firms for astonishingly low fees. Why does BlackRock run these investments so well and so inexpensively? Because the 4.5 million investors constitute a powerful buying club with more than $400 billion in assets. By opening this plan more broadly or creating similar pools, more Americans could prosper in our new investing paradigm.

This book provides an introductory lesson in how to navigate investment funds, and makes an argument for how individuals can work together to demand better investment tools. The sooner we improve the way we save now, the more surely we can safeguard our own financial destinies and our nation's fiscal strength.