CALLAN ASSOCIATES INC

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April 26, 2010

Office of Regulations and Interpretations
Employee Benefits Security Administration
Attn: 2010 Investment Advice Proposed Rule
Room N–5655
U.S. Department of Labor
200 Constitution Avenue, NW.
Washington, DC 20210

Submitted via email to e-ORI@dol.gov

Re: Investment Advice – Participants and Beneficiaries: RIN 1210-AB35

Dear Ladies and Gentlemen:

We appreciate the opportunity to provide comments on the U.S. Department of Labor's proposed regulation regarding investment advice to defined contribution participants and beneficiaries.

Callan Associates Inc. is one of the largest privately owned company engaged primarily in asset management consulting with more than 300 large fund sponsor clients who are responsible for more than $840 billion in assets. Callan clients include defined contribution plans, multi-employer plans, corporate and public pension plans, and endowments and foundations.

Callan has been conducting investment manager searches on behalf of fund sponsors for more than three decades, since the founding of our organization in 1973. On average, we conduct over 150 active and passive investment manager searches a year.

We support the Department of Labor's efforts to increase the availability of investment advice to defined contribution plan participants. At the same time, we believe that the regulation should clarify language around the need for computer-based models to refrain from "distinguishing among investment options within a single asset class on the basis of a factor [such as historical performance] that cannot confidently be expected to persist in the future."

The number of investment funds that are offered in 401(k) plans run the gamut from just a few to hundreds of funds. A plan may offer a stock, bond, and capital preservation fund. Or a plan may offer large-cap equity, small-cap equity, international-equity, emerging markets-equity, etc. among stock funds; intermediate-term fixed income, high-yield fixed income, global fixed income, etc. among fixed income funds. Some plans distinguish between growth and value funds; others offer single-sector funds (such as REIT funds). The Department seems to suggest in its guidance that while it might be appropriate to use factors such as historical performance in distinguishing between asset classes, within asset classes, such factors may not be appropriate. However, how does the Department define asset classes?

Any rules-based approach to defining asset class is likely to fall short, either by being too vague or too restrictive. Indeed, that can also be said of any rules-based approach that attempts to define which factors (e.g., historical performance versus fees) impacting investment performance can confidently be expected to persist into the future.

<u>Callan believes that the Department should remove this language from the regulation. It should be left to an eligible investment expert, as described in the regulation, to ultimately determine the efficacy of the advice model, based on the process Callan describes below.</u>

Response to the Department's Solicitation for Comments

The Department has solicited comments on a number of topics related to the use of historical performance in computer-based models. Callan would like to take the opportunity to address these topics.

1. Is a fund's past performance relative to the average for its asset class an appropriate criterion for allocating assets to the fund?

It is generally accepted investment theory that prudent fund selection is made with attention to many quantitative factors—including both past investment performance and fees—but also with attention to qualitative factors such as consistency of investment philosophy, strength of investment process, and depth of organizational structure. Such are the factors that can lead a prudent expert to conclude with a reasonable level of confidence that a strategy will continue to outperform lower-fee strategies over time, after fees.

It is not typical that historical investment performance alone is used in investment selection. Nor is it typical that fees alone should inform the investment selection decision. This is evidenced by the prevalence of active management within DC plans. If fees alone informed investment decision-making, one would expect passive investments to dominate DC investment fund line-ups.

Instead, according to Callan's DC Index™, 83% of DC assets were in active strategies (which typically have higher fees than passive strategies) as of December 31, 2009. Within strategies such as emerging markets equities, active management accounts for 100% of assets. On the other hand, according to a recent survey by Callan Associates, the vast majority (87.7%) of plan sponsors describe their fund menu as a mix of active and passive options, with 4.1% of plans offering passive-only and 8.2% offering active-only menus.

In Callan’s 2010 DC Trends Survey, plan sponsors cited portfolio construction, performance, and then fees as the top three criteria by which they selected target date funds.

Plan sponsors typically follow two approaches in determining when to use active and when to use passive investments within the plan: 1) Passive and active fund menus that mirror each other across asset classes within the plan, for example an active and passive large-cap fund; passive and active small-cap fund, etc. 2) Active funds offered in asset classes where there is evidence that active management has been able to add value over time; passive funds offered in assets classes where active management has not clearly been demonstrated to add value over time. Following is a sample of the type of analysis that plan sponsors engage in to determine the appropriateness of active versus passive investments.

The following charts provide rolling three-year analyses showing the frequency of periods that active managers outperform/underperform their benchmarks, considering various fee level assumptions, and assumed “manager-picking” skill (percentile of peer group). It covers 20 3-year periods, thereby showing return consistency over a very long time frame relevant to a DC participant investing for retirement. The average annual excess return shows the significance of the average annual outperformance.

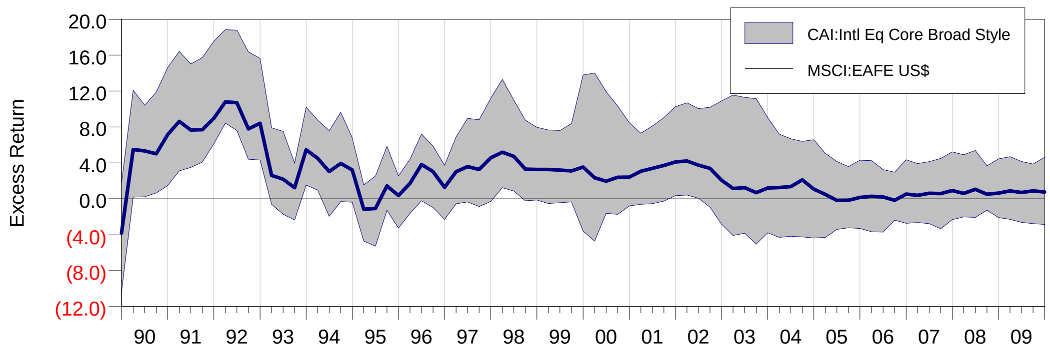
International Equity – 20 Years Ended December 31, 2009

Percent of Three-Year Periods where Manager Beat Benchmark by More than Hurdle - by Percentile

Hurdle	0.45%	0.50%	0.55%	0.60%	0.65%	0.70%	0.75%	0.80%	0.85%	0.90%
Median	88%	88%	85%	84%	79%	79%	78%	76%	75%	74%
45th Percentile	95%	93%	93%	93%	91%	89%	88%	88%	86%	85%
40th Percentile	98%	98%	98%	98%	96%	96%	95%	95%	94%	91%
35th Percentile	98%	98%	98%	98%	98%	98%	98%	96%	96%	96%
30th Percentile	98%	98%	98%	98%	98%	98%	98%	98%	98%	98%
25th Percentile	100%	99%	98%	98%	98%	98%	98%	98%	98%	98%

Average Annualized Excess Return - Median Manager: 2.91%

Rolling 12 Quarter Excess Return Relative To MSCI:EAFE US$
for 20 Years Ended December 31, 2009



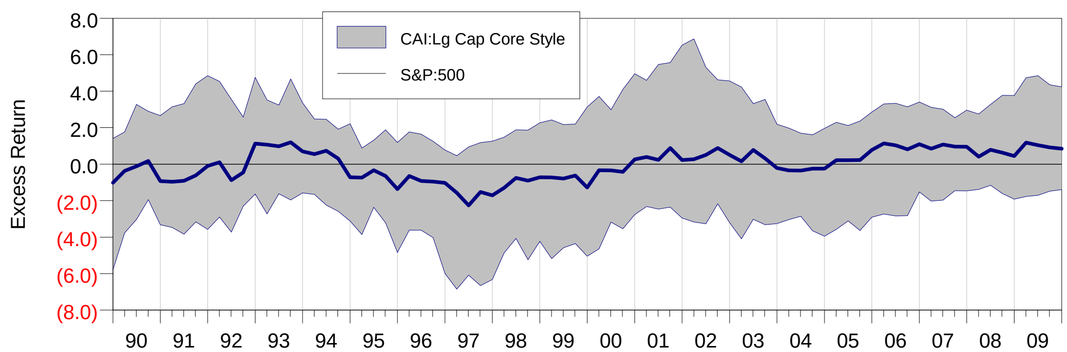
Large Cap Core – 20 Years Ended December 31, 2009

Percent of Three-Year Periods where Manager Beat Benchmark by More than Hurdle - by Percentile

Hurdle	0.25%	0.30%	0.35%	0.40%	0.45%	0.50%	0.55%	0.60%	0.65%	0.70%
Median	46%	43%	40%	36%	33%	33%	31%	30%	29%	29%
45th Percentile	51%	51%	51%	50%	50%	48%	45%	43%	38%	35%
40th Percentile	60%	59%	56%	56%	55%	55%	54%	53%	51%	51%
35th Percentile	78%	78%	73%	68%	68%	66%	64%	63%	58%	56%
30th Percentile	84%	83%	83%	79%	79%	79%	78%	78%	74%	71%
25th Percentile	91%	89%	86%	85%	85%	85%	81%	81%	80%	80%

Average Annualized Excess Return - Median Manager: 0.00%

Rolling 12 Quarter Excess Return Relative To S&P:500
for 20 Years Ended December 31, 2009



The first set of charts above show that the average annualized excess return of the median international equity manager over the past twenty years has been 2.91%, and that the median international equity manager has outperformed the benchmark 88% of three-year periods during that time, with assumed expenses of 45 basis points, and median fund selection skill (random).

In contrast, the second set of charts show that large cap core managers provided no excess return relative to the S&P 500 Index over the period cited, and that the median manager was only able to beat the benchmark 46% of three-year periods during that time with median fund selection skill (random), even with a lower assumed expense level of 0.25%.

From this analysis, a plan sponsor might determine that an actively-managed international equity option may be appropriate within the plan, while a passively-managed large-cap core fund may be appropriate.

According to Callan's DC Index, 42% of plans offer passive large-cap funds, while 90% of plans offer active international equity funds. This implies that many plan sponsors understand these dynamics and are already choosing active management more often where appropriate.

As mentioned above, once the plan sponsor opts for an active investment approach within an asset class, the next step is to select an active manager that is likely to outperform its benchmark over time, after fees. This is done first by using multiple periods in evaluating historical performance to eliminate time period bias and to measure the consistency of outperforming benchmarks and peers over time. Other critical factors to be evaluated are the appropriateness of the levels and types of risk taken in the pursuit of return, as well as the reasonableness of the fees involved. As mentioned, qualitative screening is then used to assess the likelihood that performance strength will persist into the future. Qualitative factors include: manager type, organizational history, depth and experience of investment personnel, investment process and style, and resource allocation.

2. 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?

Generally accepted investment theories would dictate that the superior-performing fund with reasonable risk levels would be recommended over a fund within the same asset class, with average performance and lower fees when one is able to conclude with a reasonable level of confidence, that the philosophy, people, process, and organizational structure of the investment manager with the superior performance will lead to continued outperformance net of fees.

3. Should the regulation specify such conditions?

The regulation should allow for the plan sponsor to exercise his or her own judgment in fund selection as described above.

4. On what if any bases can a fund's superior past performance be demonstrated to derive not from chance but from factors that are likely to persist and continue to affect performance in the future?

From a quantitative perspective, consistency of performance over time is a key variable in determining the likelihood of persistent outperformance. Conversely, concentrated or uneven performance may weaken the case for continue outperformance. For example, persistent outperformance would be more likely from a fund that performed in the top 50%-25% of peers on a consistent basis, versus one whose historical outperformance hinged on just a few years of top decile performance, paired with many years of bottom half performance.

From a qualitative perspective, evidence of an investment management firm’s organizational strength, experience, and stability are key factors in the persistence of superior performance. Conversely, personnel turnover, changes in investment philosophy, and major organizational disruptions would reduce confidence in the investment firm's ability to continue to outperform.

5. Should the use of a fund's superior past performance as a criterion for allocating assets to the fund be conditioned on such demonstration?

A model based solely on unfiltered historical performance should be expected to do no better than a random process at identifying superior performing funds on a forward looking basis. It is necessary to have a documented rationale and methodology for choosing investment options, but methods should be flexible/customizable to effectively address the sponsor/participant's particular needs and goals.

6. How, if at all, should a model take into account investment management style? For example, all else equal, should a model ascribe different levels of risk to passively and actively managed investment options?

The risk of a strategy relative to the overall risk of the market is more stable than relative performance. Many active strategies by design are consistently less risky than the market (and by extension passive strategies). Others are more risky by design on a relative basis. Quantitative models based on past performance can be very useful in categorizing strategies in terms of their expected risk relative to the market.

Sincerely,

Lori Lucas

Lori Lucas, CFA
Defined Contribution Practice Leader
Callan Associates