Ban Actively Managed Funds in 401(k)s/IRAs

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A recent front page *New York Times* story "Selling the home Brand: A Look Inside an Elite JPMorgan Unit" reinforced the view that broker-dealers are in the business of making money for their firm – not necessarily doing the best for their clients. The particular story detailed how private client advisers at JPMorgan Chase were pressured to sell the bank's own – presumably high fee — products. The firm responded that their advisers were permitted to sell third-party products, but some brokers said that they faced repercussions for deviating from the script. Fees have a significant effect on how much an individual will have at retirement: an additional 100 basis points over a 40-year period reduces final assets by about one fifth. Not to worry, you might think, those served by Chase Private Client program are wealthy. Well, they are better off than most – $250,000 in deposits or $500,000 in investments – but not super rich.

The tendency to push high fee products goes way beyond JPMorgan Chase. This type of concern motivated the Department of Labor's 2010 proposals to eliminate 12b-1 fees – incentive payments that encourage the selling of more expensive mutual funds – for anyone who gives advice to holders of Individual Retirement Accounts (IRAs) (banks, insurance companies, Registered Investment Advisers, and broker-dealers). Broker-dealers account for the bulk of IRA investments. We undertook a detailed analysis of the DOL proposal and concluded that it would have a very modest beneficial effect.

A more direct approach is warranted: actively-managed high-fee funds should be banned, from any type of account that receives favorable treatment under the Internal Revenue Code to encourage retirement saving. Many studies have also shown that actively-managed funds underperform index funds, even before accounting for the higher fees charged by the former (For example, see Malkiel,1995 and 2005). But broker-sold mutual funds perform worst of all. One estimate is that broker-sold funds underperform average actively-managed stock funds by 23 to 255 basis points a year (see Bergstresser, Chalmers, and Tufano, 2009). Investments in tax-favored accounts should be limited to indexed funds.

The government foregoes considerable revenue in order to encourage retirement saving in 401(k)-type plans and IRAs, it has a responsibility to ensure that these accounts are managed in the best interest of the best interests of participants. Participants have nothing to gain on average from investing in actively managed funds but end up in these investments either through ignorance in 401(k) plans or through pressured sales in IRAs. The high fees associated with actively managed mutually funds are not associated with higher returns. They simply frustrate the policy objective of increased retirement saving.

Banning actively managed funds from tax-favored plans would also send a message to those investing outside these plans that they have little to gain from active management. A wary consumer would give advisers in the Chase Private Client program a run for their money.