# A More Judicious Approach to Actively-Managed Funds

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**MarketWatch Blog** by Alicia H. Munnell

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*The best approach may be to focus on the level of fees rather than the nature of the fund.*

In a moment of pique, after reading a *New York Times* story on the sales practices of JPMorgan Chase, I concluded in a recent blog post that we should ban actively-managed funds from 401(k) plans and rollover IRAs. My outrage may have been justifiable. The particular story detailed how private client advisers at JPMorgan Chase were pressured to sell the bank's own – presumably high-fee – products. But, after extensive discussions with friends and foes, banning actively-managed funds may not have been my most brilliant proposal.

Fees are indeed a problem. Research conducted by economists at the Center for Retirement Research and other institutions have concluded that the high fees associated with investing in 401(k)s and IRAs seriously erode balances at retirement. Paying an additional 100 basis points reduces balances at retirement by more than 20 percent.

Actively-managed funds are expensive on average.  The evidence from the Investment Company Institute (ICI) and other organizations shows that the average fees for actively-managed funds significantly exceed those for index funds.  The numbers reported by the ICI show that, in 2012, the average expense ratio for an index equity fund was 13 basis points compared to 92 basis points for an actively-managed equity fund.  The comparable costs for bond funds were 12 basis points for index funds and 65 basis points for actively-managed funds.

At least on the equity side, active management does not produce higher returns.  The academic literature clearly shows that the majority of actively-managed funds underperform index funds and that returns are significantly lower for actively-managed funds after accounting for fees.  Moreover, even though some actively-managed funds outperform the market, the evidence suggests that they will not necessarily do so in the future.  As a result, the average investor has no basis on which to select a fund that will likely perform well.

So why not ban the suckers?  One reason is that not all actively-managed funds have high fees and not all index funds have low fees.  Moreover, index funds are good for stocks, but some bond funds need to be actively managed.  And there may even be some equity classes where active management might be helpful.

In addition to the substantive reasons, banning is not feasible in the regulatory environment in which 401(k) plans operate.  The Employee Retirement Income Security Act of 1974 (ERISA) has traditionally regulated the *process* of choosing investments rather than the investments themselves.  For example, fiduciaries currently have the obligation to find “reasonable fees” for plan services.  The Department of Labor does not have

the expertise to choose among and regulate the character of index funds. It would be necessary to create a whole new body of law around what is eligible and what is not.

Therefore, a more judicious approach may be to focus on the level of fees rather than the nature of the fund. Such an approach would include: 1) requiring all 401(k) plans have at least one low-fee index fund; 2) changing the language in ERISA that currently requires fiduciaries to find “reasonable” fees for plan services to “lowest reasonable” fees; and 3) encouraging the Department of Labor to put out warnings “If you are paying more than 15 basis points for your 401(k) investments, you may be paying too much.”

In the meantime, I commend the Department of Labor for shining a light on fees. It appears to be working. Boston College just replaced a TIAA-CREF index stock fund with a similar fund that has much lower fees. But we still have a long way to go. Make sure that you have a very good reason to buy anything other than an index fund in your 401(k) or IRA.