The Issue is Net Returns, Not the Nature of the Fund

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MarketWatch Blog by Alicia H. Munnell

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Not all actively managed funds have high fees, and not all index funds have low fees.

Every time I talk about investment fees, I lapse into arguing for index funds rather than actively managed funds. And every time I do so, both friend and foe point out 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.

Nevertheless, fees are a problem. Research conducted by economists at the Center for Retirement Research at Boston College 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 these balances by more than 20 percent.

And fees are generally high for active management compared to index funds. The numbers reported by the Investment Company Institute show that, in 2014, the average expense ratio for an index equity fund was 11 basis points compared to 86 basis points for an actively managed equity fund. The comparable costs for bond funds were 11 basis points for index funds and 63 basis points for actively managed funds.

And, at least on the equity side, active management does not *generally* 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.

But that generalization does not preclude some actively managed funds from producing good returns for low fees. And it does not make any sense to throw out the baby with the bath water. A more judicious approach may be to focus on the level of fees rather than the nature of the fund.

If I had my way – which I rarely do – I would like some changes to ensure that participants have good options and are getting good value. These include: 1) require all 401(k) plans have at least one low-fee index fund; 2) change the language in the Employee Retirement Income Security Act (ERISA) that currently requires fiduciaries to find “reasonable” fees for plan services to “lowest reasonable” fees; 3) encourage the Department of Labor to put out warnings such as “If you are paying more than 15 basis points for your 401(k) investments, you may be paying too much;” and 4) require companies providing Individual Retirement Accounts to publish expense ratios, just as sponsors of 401(k) plans are currently required to do.

In the meantime, if you select any actively managed fund, monitor it carefully to make sure that the gross return more than compensates for the higher fees.