401(k) Plan Investment Selection

Passive Fund Management versus Active Fund Management

By Sheldon M. Geller

Retirement plan committees are increasingly selecting passively managed funds for their 401(k) plan investment menus, in many instances to replace actively managed funds. Recent excessive fee lawsuits, as well as finalized Department of Labor (DOL) regulations, have caused some plan fiduciaries to believe that retaining actively managed funds will create fiduciary liability, as a result of higher expenses and poor performance.

The selection of passively managed funds (e.g., index funds) to the exclusion of actively managed funds reflects an increasing, but mistaken, belief among plan fiduciaries that they will avoid fiduciary liability under the Employee Retirement Income Security Act (ERISA). The primary motivation for the selection of any fund, including a passively managed fund, should be participants' best interests—not protecting plan fiduciaries from lawsuits. Plan fiduciaries should not make decisions—including fund selection decisions—to protect themselves or their employer from liability. A fund selection decision may, however, be made and documented as in the participants' best interest with an ancillary benefit to the employer. In any case, the best defense to enforcement is a documented process explaining the motivation for selecting a particular investment strategy.

Investment Strategy

Investment policy statements determine the asset classes to be included in the investment menu and provide participants with the ability to build a portfolio with their desired risk/return characteristics. Passive investing selects a benchmark and then tracks the benchmark closely at minimal cost, and does not attempt to beat the market. In contrast, active investing selects a benchmark and then uses a strategy to outperform the market.

Passive and active investing characteristics. Passive investing is customarily low cost, market efficient, and tax efficient. Active investing, meanwhile, has the potential to outperform the market, has the ability to react to market conditions, is tax efficient, can be adjusted for a specific portfolio objective, and is managed by an expert. Most investors use both passive and active strategies.

Fund expenses and advisor fees. expenses and advisor fees reduce plan performance. Therefore, plan fiduciaries must contain expenses associated with fund management, as well as the fee charged by the retirement plan advisor. Selecting only index funds, however, precludes plan participants from earning above-market performance; the absence of an advisor-led investment process may result in the retention of poorly performing funds and a greater risk for plan fiduciaries. ERISA supports the retention of expert advisors, including investment advisors, for a reasonable and competitive fee. Plan fiduciaries can also effect cost containment by insisting on a fixed advisor fee over an asset-based advisor fee, as well as a disciplined and documented investment policy process.

Asset classes. Data suggests that the ability to outperform a benchmark depends upon the asset class. For example, most foreign portfolios outperform the MSCI EAFE Index benchmark, whereas few intermediate-term U.S. bond managers are able to beat the BarCap (Barclays) U.S. Aggregate Bond Index. Certainly, U.S. bond managers can beat the benchmark, but it may take a higher level of skill to overcome the actively managed fund expense. A value-style fund customarily has an inexpensive price relative to earnings and cash flow, while a growth-style fund has a higher price, reflecting the expectation of above-average growth. It is therefore beneficial to select both passively managed and actively managed funds, as well as both value and growth strategies, in order to enable participants to build diversified portfolios consistent with their objectives.

Recent Litigation, Statutory and Regulatory Construction

Lawsuits filed against plan sponsor fiduciaries allege that they acted imprudently in the selection of passively managed funds. These cases allege that less expensive share classes were available for the index funds selected [see *Bell v. Anthem Inc.*, No. 1:15-cv-2062 (S.D. Ind. filed Dec. 29, 2015); *White v. Chevron Corp.*, No. 3-16-cv-00793 (N.D. Cal. filed Feb. 17, 2016)]. Ten of the allegedly high-cost investment options were Vanguard mutual funds charging a fee of 0.04%—extremely low by industry standards; identical lower-expense mutual funds average 0.02%.

There is no statutory or regulatory mandate that employer fiduciaries offer only passively managed funds. Moreover, the DOL and ERISA express no opinion with respect to passively managed funds versus actively managed funds. Rather, the DOL has stated that employer fiduciaries wishing to avoid fiduciary liability should offer an investment menu in order to enable participants to "construct a portfolio with risk and return characteristics appropriate to their circumstances" [*Final Regulation Regarding Participant Directed Individual Account Plans*, 57 Fed. Reg. 46,906, 46,919 (Oct. 13, 1992)].

Case law also does not support the proposition that passively managed funds are more appropriate for 401(k) investment menus. Excessive fee litigation is about paying excessive fees for investment funds, as compared to identical, less expensive share class funds. This allegation can be, and has been, made with respect to both actively managed funds and passively managed funds. No case law, statute, or regulation favors passively managed funds. Rather, the only requirement is that employer fiduciaries act prudently in the selection and monitoring of investment fund choices and that fees are reasonable. The legal threshold of reasonableness does not mean the lowest fee; rather, it means an actively managed fee that fiduciaries believe is appropriate, given the expectation of better investment results. Plan fiduciaries may also support the purchase of actively managed funds that do not track an index and therefore are not entirely invested in a down market. Employer fiduciaries often offer investment menus that include actively managed funds because they believe their employees want them.

Screening and Revenue Sharing

By screening actively managed funds, a plan fiduciary can identify a group of funds that consistently beat the indices over time. Advocates will quote studies showing indexing outperforming active fund managers; however, the data in these studies includes all funds of a particular asset category, whereas plan fiduciaries apply investment policy criteria, effectively screening all funds of a particular asset category to establish a select group. There are actively managed funds that consistently outperform their index and their peer group, thereby passing guidelines and becoming part of the select group. Screening should include low expense ratios and fund manager tenure.

Revenue sharing methodology and the passive-versus-active debate are two separate, unrelated issues. Passively managed funds may include revenue sharing components that increase fund cost to a level similar to that of higher-expense classes of actively managed funds. Plan sponsors pay recordkeeping and advisor fees either from revenue sharing, by a direct charge to participant accounts, or from corporate assets. If a plan sponsor does not want to pay fees but desires low-cost funds, then it may opt for no revenue sharing and directly charge participant accounts. The plan sponsor then makes its fund selection based upon fund attributes, taking into account management fund expense (with or without revenue sharing). Accordingly, fee layering can be found in both passive and active funds, depending primarily upon the distribution channel.

Prudent Governance Processes

Case law continues to emphasize procedural prudence—plan fiduciaries must engage in a documented governance process and consistently apply investment policy guidelines. Higher-expense investment funds are not, per se, an ERISA violation, but such funds that drive unreasonable advisor compensation and recordkeeping fees may be.

There is no safe harbor when selecting index funds. Accordingly, offering actively managed funds will avoid exposing plan fiduciaries to greater risk, provided they engage in a prudent process and document the basis for their fiduciary decisions.

Fiduciary risk and liability are not increased by offering actively managed funds over passively managed funds, or in addition thereto; rather, they are a result of unreasoned fiduciary decision making, lack of a proper plan governance process, and protecting fiduciaries to the detriment of participants. The best defense to an excessive fee claim is to document the deliberations and decision-making processes of plan fiduciaries and to exercise best efforts to act for the exclusive benefit of plan participants.

The DOL and ERISA do not mandate specific investments or specific investment strategies—beyond restrictions on the investment in employer securities—as prudent or imprudent. Indeed, the DOL has rejected proposed legislation that would have required 401(k) plans to offer at least one index fund as an investment option in an investment menu (see DOL Testimony to the Committee on Ways and Means, U.S. House of Representatives, Oct. 30, 2007). Moreover, the DOL included both actively managed funds and passively managed funds in its model disclosure chart intended for distribution to plan participants under the recently issued participant disclosure regulation (29 CFR section 2550.404a-5, 2010).

Offering actively managed funds presents no additional risk under ERISA, provided that plan fiduciaries engage in a prudent governance process that takes into account the relevant facts and circumstances. Investment expense is one criterion in fund selection among many, including risk/reward attributes, relative performance, rankings, and manager tenure. ERISA requires a decision-making process and respects the reasoned decisions made by plan fiduciaries—whether they offer actively managed funds, passively managed funds, or a combination thereof. ❑

Sheldon M. Geller, JD, CPA, *is the managing member of Stone Hill Fiduciary Management, LLC, Great Neck, N.Y. He is a member of* The CPA Journal *Editorial Board.*