NEWSLETTER

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IN THE NEWS:

The Journal of Financial Transformation recently published an analysis of mutual funds, titled "Actively Managed Versus Passive Mutual Funds: A Race of Two Portfolios". In this paper, authors Atanu Saha and Alex Rinaudo undertake an in-depth analysis of the differences between these two types of mutual funds and find the average investor would be better off investing in a portfolio of actively managed funds rather than passively managed funds. This paper raises questions about the current "wisdom" of investing exclusively in low fee passively managed funds.

ERISA LITIGATION:
IS THE INCLUSION OF HIGH-FEE FUNDS A BREACH OF DUTY?

The past few years have seen a proliferation of ERISA litigation in which plaintiffs allege that 401(k) plan fiduciaries selected inferior funds for inclusion in plan offerings. Since 2015, more than twenty financial institutions have been sued under the ERISA statutes. The crux of the plaintiffs' allegations in these matters is that the 401(k) plan fiduciaries breached their fiduciary duties by including proprietary or affiliated mutual funds as investment options in the plans and failed to consider lower-fee options, typically passively-managed index funds.

This newsletter comments on the key economic premise at the heart of the plaintiffs' allegations: actively managed high-fee mutual funds are necessarily inferior to the lower-cost passively managed index funds. Despite the common theme among recent ERISA cases, each matter is unique, with a distinct set of allegations requiring fact-specific inquiries and expert analyses which are beyond the scope of this newsletter.

Our recently published article, "Actively Managed versus Passive Mutual Funds: A Race of Two Portfolios," compares the performance of actively managed and passively managed funds. While we find that actively managed funds do have higher fees than their index fund counterparts—not surprising given the costs of research required to actively manage a fund rather than passively mimic an index—**the net-of-fee performance of the active fund portfolio is superior to the corresponding portfolio of passive funds**. This finding implies that inclusion of a higher-fee active fund in a 401(k) plan does not necessarily imply an inferior choice. A higher-fee fund's gross (i.e., before-fees) performance can be superior enough to more than compensate for its higher-fees, thereby delivering a higher net-of-fee performance.

Plaintiffs in these ERISA cases have nonetheless focused on the higher fees of active funds as a central part of their claim. One complaint, for example, supports this argument quoting a 2009 study by the Government Accountability Office which found: "even a seemingly small fee can have a large negative effect on savings in the long run . . . an additional 1 percent annual charge for fees would significantly reduce an account balance at retirement." Plaintiffs use this argument to imply that a higher fee fund will not outperform a lower fee alternative. Our published paper specifically examines this claim.

For this paper, we collected data from Morningstar's open-end U.S. mutual fund database. Our dataset is comprised of 77,687 fund-year observations across 7,469 unique funds, both active and passive. The dataset is free from survivorship bias because it encompasses all funds, dead or alive, during the entire period 1996 to 2015.

Using this data, we constructed two portfolios. Both portfolios contain the five largest funds in the prior year across each of the three major asset categories: US Equity, Non-US Equity and Fixed Income. Both portfolios are reconstituted annually using data from the prior year to eliminate hindsight bias. While the analysis in the paper is limited to retail funds available to the average investor, by selecting the largest funds, we analyze funds similar to those used in ERISA plans. [1]

The following table shows some of the key performance statistics for the two portfolios.

Performance of the Two Portfolios: 1996-2015

	Active	**Passive**
Average Annual Returns	5.9%	5.5%
Standard Deviation	14.8%	15.7%
Sharpe Ratio	0.24	0.20
Sortino Ratio	0.13	0.12

The above results show that, despite higher fees, the actively managed fund portfolio outperforms the passively managed one. The active portfolio's average return is better than that of the passive portfolio by 0.4% per year, while exhibiting less volatility of returns (measured by the standard deviation). Consequently, the Sharpe ratio (a commonly-used metric which compares the amount of return per unit of risk) is higher for the active funds compared with the passive funds. Examining the performances of the two portfolios across the individual years, 1996-2015, we find that this outperformance is explained by the comparatively better returns of active funds during market downturns. This suggests that active funds likely provide higher downside risk protection than their passive index counterparts.

Many prior academic studies have compared the performance of active funds to market indices and have typically found that, *on average*, active funds generally underperform indices. By contrast, in our study, we have compared the performances of the *largest* funds available in their respective asset category. As discussed in further detail in our paper, we find that the largest funds' performance is indeed superior to that of relatively smaller funds, which explains, in large part, why our results are different from the findings in the other academic studies.

[1] While our paper does not specifically analyze the institutional share classes commonly used by ERISA plans, the funds used (the largest in their respective category) generally offer institutional share classes. Since institutional share classes typically have lower fees than retail share classes, the incorporation of these share classes is likely to only increase the outperformance of the actively managed portfolio.

Our findings call into question the plaintiffs' claims that the selection of higher fee funds was necessarily against plan participants' interests. However, as noted earlier, each ERISA case is fact specific and an individualized inquiry would be required to reach any specific view in a particular matter.

The full-length paper can be found here.

Additional Related Research:

In the article "Calculating damages in ERISA litigation", Atanu Saha and his co-author discuss four different methodologies for calculaing ERISA damages using data from actual ERISA litigations.

The full-length paper can be found here.

DSP experts have worked on and provided expert testimony in various ERISA matters. For more information on our experience and expertise, please visit our website at www.datasp.com.

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