INVESTMENT DIVERSIFICATION WITH ACTIVE AND PASSIVE PLAN INVESTMENT OPTIONS

The fiduciary responsibility of plan sponsors is to periodically review policies for their retirement plans. While most plan sponsors consider a balance between large-cap and small-cap, global and domestic, and equity and bond investments in their investment policies, plan sponsors should also consider whether the balance of actively managed funds versus passively managed (index-based) funds is present in the investments. After all, actively managed funds and passively managed funds provide different levels of risk, which provides additional diversity in the retirement plan's investments.

Actively managed fund versus passively managed fund

Actively Managed Funds

As the name suggests, these funds have an active fund manager or management team that is making the decisions on how to invest the fund's money. The premise is that the fund manager or management team will use their expertise to identify investments that are undervalued or will outperform the market, to provide a greater return for the fund. However, actively managed funds generally have higher management costs.

Passively Managed Funds

Sometimes referred to as index-based funds, passively managed funds do not have a management team that is making investment decisions. Passively managed funds simply follow a market index, such as the S&P 500, for example. The goal of the fund is to benchmark returns with the market index, usually by purchasing a representative portion or all the investments of the market index it is tracking. Management costs for passively managed funds are generally lower because of not having a management team to pay.

Fund differences

In addition to the organizational structure and management cost differences between actively managed and passively managed funds, there are other differences that should be considered.

- Actively managed funds have a greater risk of the fund underperforming, and the underperformance can be hidden by the manager’s ability to dilute the portfolio with cash if the fund’s stock sector sharply declines.
- Passively managed funds generally do not perform significantly above or below the market index they are based upon, resulting in minimal additional risk above the market risk.

Comparing actively managed funds and passively managed funds

One factor to be aware of when comparing actively managed funds and passively managed funds is “survivorship bias.” Over long periods, actively managed funds that underperform tend to disappear and their results are not reflected in the data of the better-performing survivors. Another factor to be aware of is “style consistency” — actively managed funds sometimes stray from, then return to, the investment style that’s presented to investors as the fund adjusts to changes in the market or business segments.

Another variable to consider is whether reported fund category performance results have assigned greater weight to large funds' performance than smaller ones. A few extreme (good or bad) results can create a distorted picture of that fund category as a whole. It is recommended to look at asset-weighted performance data to give a more accurate picture.

The largest variable is whether the funds focus on large, mid- or small-cap stocks. In general (results can vary by time period and sector subcategories), the index funds come out ahead in the large- and mid-cap core stock categories, and actively managed funds (on average) come out ahead in the small-cap growth sector.

Deciding what's best

While data suggests that passively managed funds tend to outperform the actively managed ones in the long term, that doesn't necessarily mean a need to go "all passive" with a retirement plan fund lineup. In addition to legal considerations (see below), it's important to consider participants' preferences for investment options. Depending on a participant's stage of saving for retirement and their risk adverseness, that will drive how they want to invest their savings for retirement.

> Your retirement plan serves as an attractive element of your total compensation package. A diversified investment portfolio that consists of multiple selections of both actively managed funds and passively managed funds is more attractive than an investment portfolio that is largely actively managed or largely passively managed funds.

Also, if you've chosen a target-date fund series as your qualified default investment alternative, there's a strong probability that its underlying portfolio of funds includes some actively managed ones. And remember, target-date funds are, by nature, managed in the sense that asset managers are making decisions not only about which funds to incorporate into them but also each fund's glide path.

There is always the possibility that the actively managed funds you select will outperform the equivalent indices. But fund performance plays only a small role in participant retirement readiness, as participant contribution patterns are the primary driver of retirement readiness. There is a lot to consider as part of your fiduciary responsibility to participants of your retirement plans. Contact your investment advisor for assistance with revisiting your investment policies.

Legal considerations in the investment selection process

Litigation in recent years has focused on whether qualified retirement plans force plan participants into investing in overly expensive funds. Should this be a deciding factor in the mix of actively managed and passively managed funds in your plan's investment lineup? Probably not.

The Employee Retirement Income Security Act of 1974 (ERISA) requires plan fiduciaries to diversify plan investments to prevent concentration and minimize risk. The different risk/reward characteristics of actively managed and passively managed funds fit into that required diversity. Additionally, it is noted that at least one court has held that ERISA doesn't require fiduciaries to find and offer the cheapest possible fund.

ERISA does not necessarily focus on the outcome of a plan fiduciary's decision, but rather on the level of due care exercised in the process used to make that decision. Formally documenting that decision-making process is crucial to maintaining a plan sponsor's fiduciary responsibility.