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Recent Outperformance of Passive Investment Funds Has Provided a Rationale for Some ERISA Retirement Investors to Cry Foul. Is There a Case for Active Management?

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Under ERISA rules, various entities associated with employee retirement funds such as trustees, plan administrators, and members of a plan's investment committee have fiduciary obligations to plan participants. When selecting investment options available to employees in defined contribution plans, fiduciaries must carry out their duties with skill, prudence, and diligence.² Supreme Court rulings emphasize the need for plan sponsors to continually monitor trust investments and remove imprudent selections.³

Evidence of recent superior performance and sizeable growth in passive investment funds raises the question: are plan participants being offered an appropriate investment fund menu? Indeed, should plan participants be offered active management investments at all? Several recent ERISA cases focus on allegedly inappropriate investment choices (or options) for employees within employee sponsored plans. For example, in *Jacobs v. Verizon Communications, Inc.*, plaintiffs argued that the investment choices provided under the retirement plan involved excessive risks and excessive fees.

Many active funds benchmark their performance against an index, and implicitly seek to meet or exceed index returns. Yet passive investment funds aim to track many of these same indices, and are generally able to mimic index returns at a lower cost (and lower fees) than the “benchmarking” active funds. Why then does it make sense for fund administrators to offer actively managed funds? Do fund administrators need to offer both active and passive investment options and what disclosures should they provide to participants? In the class-certified *Leber v. Citigroup*, the plaintiffs argued that 401(k) plan participants would have earned \$40 million more in aggregate if they had been invested in the relevant passive benchmark index.⁴ Is this simply a classic hindsight biased argument or should passive funds always be deemed superior?

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² United States Department of Labor, Retirement Plan and ERISA FAQs. Available at <https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/faqs/retirement-plans-and-erisa-consumer>.

³ *Tibble v. Edison*, 2015.

⁴ *Leber v. Citigroup*, 4th Amended Class Action complaint, paragraph 59. Passive benchmark indices do not represent exactly the returns of investors, as index funds also charge fees.

Passively managed or passive funds, sometimes also known as index funds, continue to grow as a percentage of the share of funds under management at the expense of more traditional actively managed or active funds. Total passive funds under management of \$6.8 trillion continue to edge closer to actively managed funds at \$11.5 trillion.⁵ Investors have no doubt been tempted by the generally lower fees and apparently superior after fee performance of passive funds. According to Morningstar, most active funds have underperformed their passive counterparts after fees.⁶ Indeed, Warren Buffett recently stated that “both large and small investors should stick with low-cost index funds.”⁷ Given evidence that passive strategies outperform the average active fund the question arises: is it appropriate for ERISA fund managers, 401 (k) administrators or other institutions with fiduciary duties to provide plan participants with actively managed investments as part of their investment alternatives?

A passive fund manager continuously adjusts her portfolio in an effort to closely match returns on a designated market index such as the S&P 500 or the MSCI global index. By contrast, a traditional value-oriented active fund manager seeks out securities with market prices that, in the manager’s opinion, do not reflect valuation fundamentals, either in absolute terms or relative to other securities. Almost all active fund managers seek to outperform an index or achieve superior risk-adjusted returns. Risk is a critical consideration. Fund managers may achieve higher returns simply because they have pursued a higher risk strategy. For example, the manager of a target-date fund containing both equity and bond investment allocations may increase the relative size of the equity allocation in an effort to increase returns.

One widely used method to compare the performance of funds is the Sharpe ratio, a simple ratio that measures the historical return of a fund relative to its volatility (*i.e.*, risk). Alternatively, academic researchers tend to evaluate fund performance by examining “alpha” – the portion of returns that is not explained by systematic (or broader market) risk. In this context, active fund managers with superior security selection and portfolio construction skills should be able to consistently generate positive alpha. By contrast, a passive fund manager that aims to track a market index will, by definition, have zero alpha. A passive fund manager’s performance will reflect systematic returns and systematic risk, with a deduction for fees.

One frequent argument for passive fund management is that, in principle, not all active funds can outperform the market at the same time (the so-called “zero sum” argument).⁸ Indeed, some research shows that the *average* active fund has a negative alpha after fees.⁹ According to Nobel prize winning economist Eugene Fama, a leading advocate for passive funds, “if active managers win, it has to be at the expense of other active managers. And when you add them all up, the returns of active managers have to be literally zero, before costs. Then after costs, it’s a big negative sign.”¹⁰ There is also evidence that successful active fund managers do not continuously outperform the market, that is, there is no “performance persistence” amongst strongly performing funds.¹¹

⁵ Morningstar Direct Asset Flows Commentary, United States. Available at <http://www.morningstar.com/content/dam/morningstar-corporate/pdfs/fundflows/Morningstar-FundFlowCommentaryFeb2018.pdf?cid=EMQ>.

⁶ Morningstar Active/Passive Barometer, March 2018. Available at <https://www.morningstar.com/lp/active-passive-barometer#>.

⁷ Berkshire Hathaway Investor Letter. Available at <http://www.berkshirehathaway.com/letters/2016ltr.pdf>.

⁸ This market clearing argument is put forward by Fama and French (2010) and Sharpe (1991).

⁹ Fama and French (2008).

¹⁰ <https://www.cnbc.com/2014/09/19/nobel-winner-fama-active-management-never-good.html>

¹¹ For example, Busse, Goyal and Wahal (2010) find no long term persistence amongst stronger performing funds.

Recent research has provided additional insight and alternative explanations for the apparent under-performance of active fund managers. First, the number of funds labeled as active that closely track an index has grown over time. These “closet indexers” are unlikely to significantly outperform their benchmark index after fees. Research shows that the most active fund managers, defined as those managers with the highest share of portfolio holdings that differ from the benchmark index, outperform their benchmarks both before *and* after expenses.¹² It is therefore the “closet indexers” that drag down the aggregate performance of active managers.¹³

Second, various researchers have shown that active funds outperform passive funds when the economy is doing poorly.¹⁴ This is important as investors are likely to prefer stronger fund performance when the economy is not doing well.¹⁵ Research indicates funds with highly counter-cyclical, risk-adjusted returns tend to charge higher fees and provide weaker long-term performance.¹⁶ However, some investors may wish to allocate a portion of their portfolios to more counter-cyclical funds in order to achieve better performance in weak economic periods, even at the cost of sub-par after-fee performance in other periods. Even investors that are more concerned about longer-term performance may take into consideration performance during downturns when the risk of hardship is higher.¹⁷ Owning certain actively managed funds may be viewed like owning insurance. No one likes the cost of insurance, especially when times are good, but when things get bad, insurance can mitigate significant or even catastrophic loss.

Conventional performance measurement models may not capture a preference amongst fund investors for better performance during periods of poor economic conditions (*i.e.*, the time-variation in risk-tolerance or discount rates).¹⁸ Consumers may be prepared to sacrifice some return during better economic times for better performance during downturns. In other words, during periods of poor economic conditions, fund investors may place greater emphasis on near-term performance. This time-variation in discount rates (and expected returns) is now well established in the finance literature. In his 2010 presidential address to the American Finance Association, John Cochrane focused exclusively on this topic.¹⁹ Any test of active fund performance that is not conditional on the state of the economy may understate the value proposition of active funds. Indeed, some researchers have found that a subset of active fund managers apply different skills throughout the business cycle to generate

¹² Cremers and Petajisto (2009) define “active share” as the fraction of a portfolio that is different from the benchmark index. This contrasts with the traditional way of measuring how active a manager is using tracking error, which is the volatility of the difference between a portfolio return and its benchmark index return.

¹³ Faced with an onslaught from the passive management industry, the active fund management industry has sought to differentiate itself, for example, by emphasizing quantitative skills or sectoral expertise.

¹⁴ Active funds are shown to have a higher alpha during recession periods than during expansion periods (Kosowski, 2011).

¹⁵ In such bad states of the economy, the marginal utility of consumption and wealth is relatively high (Glode, 2011; Kosowski, 2011).

¹⁶ Glode (2011).

¹⁷ In addition, investors nearing retirement are more sensitive to large swings in the market. For example, a large percentage decline in portfolio value would require an even larger percentage increase to break even. Investors nearing retirement may simply not have the time to recover in performance terms prior to retirement if such a decline in investment value were to occur.

¹⁸ Conventional performance measurement models focus on fund alpha.

¹⁹ Cochrane (2010).

returns persistently above a passive benchmark.²⁰ These active managers utilize stock picking skills during better economic conditions and market-timing skills during poorer economic conditions.

Finally, even if we were to accept the models used to assess risk-adjusted performance, the evidence on performance persistence (*e.g.*, evidence that strong returns beget stronger returns) is mixed.²¹ Some more recent studies do indeed find that managers can strategically utilize appropriate skillsets to generate higher returns. In addition, recent studies also indicate that the amount of performance persistence depends on the time period under evaluation and the modeling method used to control for risk. Active funds that employ risk management strategies may therefore underperform in studies that focus on more limited time periods with extended bull markets. Recent trends towards “closet indexing” may also influence results, as closet indexers will underperform after fees.

Conclusion

The merits of choosing active management options depends on the specific circumstances of each case. The amount of money held in active funds still greatly exceeds that in passively managed funds. Researchers have provided evidence that individual investors tend to buy in and out of passive index funds at the wrong times.²² This may weaken the applicability of the zero-sum argument made by Sharpe (1991) and Fama and French (2010), wherein not all active funds can achieve superior performance simultaneously. If investors do indeed sell at the wrong time (*e.g.*, during weaker economic conditions), active fund managers may use market-timing, fundamental analysis, and other skills to benefit from these flows.

It should not be forgotten that the performance of many investment classes over the past decade has been significantly positively skewed by massive and experimental stimulus employed by central banks around the world. It is often remarked that “a rising tide lifts all boats” and the same could be said of most long index funds. However, recent stock market performance and the inversion of interest rate yield curves may be forecasting an ebbing of “the tide” along with larger waves. When the next major downturn comes, this could result in significant gains, or alternatively the avoidance of significant losses, for those investors who have chosen effective active fund managers. It would certainly be ironic if, in the future, retirement plans that offered no or limited active fund investment options were assailed for not providing participants investment options suitable under weaker economic and market circumstances.

²⁰ Kacperczyk, Van Nieuwerburgh and Veldkamp, “Time-varying fund manager skill”, National Bureau of Economic Research Working Paper 17615, November 2011.

²¹ Earlier studies only reached a consensus that performance persistence is a feature of poorly performing funds. One explanation for the ongoing survival of persistently underperforming funds is that these funds generate counter-cyclical returns. For example, see Glode (2011).

²² Savov “Free for a Fee: The Hidden Cost of Index Fund Investing,” University of Chicago, October 19, 2019. Available at <http://faculty.chicagobooth.edu/workshops/finance/past/pdf/Savov.pdf>. Research has also shown that active fund investors might also have lower returns due to poor market timing. See Friesen and Sapp, “Mutual fund flows and investor returns: An empirical examination of fund investor timing ability,” *Journal of Banking & Finance*, September 2007. However, active managers may still use their cash holdings to execute timing strategies.