What An Economic Analysis Reveals About ERISA Litigation

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The past few years have seen a proliferation of Employee Retirement Income Security Act litigation in which plaintiffs allege that 401(k) plan fiduciaries selected inferior funds for inclusion in plan offerings. Since 2015, more than 20 financial institutions and corporations have been sued under the ERISA statutes.


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The crux of the plaintiffs' allegations in these matters is that the 401(k) plan fiduciaries breached their fiduciary duties and caused harm to the plan participants 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.

For example, in bringing a class action lawsuit against Putnam Investments, the plaintiffs in Brotherston v. Putnam conclude that the plan suffered millions of dollars in damages by comparing the fees of "the portfolio of actively managed Putnam funds … to a portfolio of passively managed Vanguard funds."[1] Similarly, in Leber et al. v. CitiGroup 401(k) Plan, the plaintiffs claimed that due to the defendants' "failure to … remove and replace imprudent investments, the Plan and its participants incurred 'millions of dollars' in losses through the high fees of nine particular proprietary funds."[2] Plaintiffs have brought analogous allegations in many other ERISA matters.[3]

This article comments on the key economic premise at the heart of the plaintiffs' allegations: actively managed high-fee mutual funds are inferior to the lower-cost passively managed index funds, and thus, inclusion of the actively managed funds, when low-cost index funds were available, constitutes a breach of the plan fiduciaries duty of prudence. This article is based on our recently published full-length paper, "Actively Managed versus Passive Mutual Funds: A Horse Race of Two Portfolios," The Journal of Financial Transformation 46, Nov. 2017, 193-206.

This paper compares the performance of actively managed and passively managed funds. It finds that while 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 or imprudent choice. A higher-fee fund's gross (i.e., before-fees) performance can be high enough to more than compensate for its higher-fees, thereby delivering a higher net-of-fee performance. In that case, the plan would not be harmed, but would rather benefit from inclusion of actively managed funds.

Our Analysis and Findings

For this analysis, we collected data from Morningstar's open-end U.S. mutual fund database. Our data set is comprised of 77,687 fund-year observations across 7,469 unique funds, both active and passive. The data set 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: U.S. equity, non-U.S. equity and fixed income. Both portfolios are reconstituted annually using data from the prior year to eliminate hindsight bias. While the analysis in the study 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.

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 percent 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 to 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.

While our study 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.

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 full-length paper, we find that the largest funds' performance is indeed superior compared to smaller funds, which explains, in large part, why our results are different from the findings in the other academic studies.

Discussion

Our findings call into question the plaintiffs' claims in most ERISA matters that higher-fee actively managed funds are per se unsuitable. However, each ERISA case is fact-specific and an individualized inquiry would be required to reach any specific view in a particular matter. For example, there are a few cases where the plaintiffs have shown that the plan fiduciaries chose a higher-fee share class of a mutual fund, when lower-fee share class of the same fund was available.[4] Clearly, in these types of instances, it would be difficult to justify the inclusion of the high-fee share class in the plan offering.

But in most "excessive fee" ERISA matters, the thrust of the plaintiffs' argument is that high-fee actively managed funds are necessarily inferior to lower-fee passive index funds. As noted earlier, while on average, actively managed funds underperform their passive counterparts, it is not axiomatic that all active funds do. Furthermore, fees are one of many fund characteristics to consider. Prudent plan fiduciaries typically consider various features of funds, in addition to fees, such as past performance, assets under management, return volatility, manager reputation, years in existence etc., in making their fund selection. Indeed, in this regard the U.S. Court of Appeals for the Seventh Circuit's opinion in an ERISA matter is instructive:

The fact that it is possible that some other funds might have had even lower expense ratios is beside the point; nothing in ERISA requires every fiduciary to scour the market to find and offer the cheapest possible fund (which might, of course, be plagued by other problems).[5]

In other words, a fund can have low fees but also low returns and thus be an imprudent choice; conversely a high fee fund can yield superior net-of-fee returns. In fact, our research suggests, a choice based on fund size can lead to the selection of actively managed funds that yield superior performance relative to their passive counterparts. We believe our study will provide defendants in ERISA matters further ammunition to argue, as some have, that they did not breach their "fiduciary duty to retirement plan participants by failing to employ a passive-management strategy … because using an active-management strategy made more sense."[6]

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[1] Brotherston v. Putnam Invs., LLC, No. 17-1711 (1st Cir. Oct. 15, 2018)

[2] Leber et al. v. CitiGroup 401(k) Plan Inv. Comm. , 07-Cv-9329 (SHS) S.D.N.Y. Nov. 27, 2017, Opinion & Order.

[3] Other 'excessive fee' ERISA-related cases include:

Feinberg v. T. Rowe Price Grp., Inc. , CIVIL ACTION NO. MJG-17-0427 (D. Md. Aug. 20, 2018);
George v. Kraft Foods Global, Inc. , 270 F.R.D. 355 (N.D. Ill. 2010);
Johnson v. Delta Airlines, Case No. 2:14-cv-00696-DAK-PMW (D. Utah Sept. 19, 2016);
Martin v. Caterpillar, Inc. , Case No. 07-cv-1009. (C.D. Ill. Aug. 12, 2010);
Taylor v. United Tech. Corp. , 354 Fed. Appx. 525 (2d Cir. 2009)

[4] White v. Chevron Corp. , Case No. 16-cv-0793-PJH (N.D Cal. Aug. 29, 2016);
Andrus v. New York Life Insurance Company et. al., Case No. 1:16-cv-05698 (S.D.N.Y., July 18, 2016);
Ramsey et. al. v. Philips North America LLC, CIVIL ACTION NO. 3:18-cv-1099 (S.D.Ill., May 10, 2018)

[5] Loomis v. Exelon Corp., 658 F.3d 667 (7th Cir. 2011)

[6] Brill, Emily. "Northrop Grumman Seeks Quick Win in ERISA Fee Suit." Law360 - The Newswire for Business Lawyers, Law360, 4 Feb. 2019, www.law360.com/articles/1125398/northrop-grumman-seeks-quick-win-in-erisa-fee-suit.