Are Actively Managed Mutual Funds *Per Se* Imprudent Choices for 401(k) Plans?

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Many corporations and financial institutions have recently faced lawsuits in which plaintiffs have alleged harm to 401(k) plan participants by the inclusion of high-fee actively managed mutual funds in plan offerings, instead of low-cost index funds. The goal of our study is to compare the performance of actively managed and passive index funds.

For this comparison, we use a large dataset of more than 11,000 mutual funds and over 120,000 fund-year observations on actively managed and passive index funds, across different asset classes, including U.S. equity and international equity, and fixed income. Our sample period covers 2000-2018, a period that spans different market environments, including the post dotcom bear market years, the severe market downturn in 2008, and the decade-long bull market since then. We find that, on average, actively managed funds do have higher fees than their index fund counterparts; this is not surprising given the costs of research required to actively manage a fund rather than passively track an index. Consistent with many prior studies, we also find that on average active U.S. equity funds do underperform index funds.

However, a key finding of our study is that a portfolio of active funds chosen based on certain key characteristics, such as low expense ratio, low turnover, high Sharpe ratio etc., have better net-of-fees returns than passive index funds in the respective asset classes. This result holds for various categories of funds including U.S. equity, international equity, fixed income, and mixed assets (i.e., funds that hold both equities and fixed income assets). The portfolio of chosen active funds not only outperforms its asset class-matched index fund counterparts in terms of average net-of-fee returns, it also provides considerably higher risk-adjusted returns. We also compared our portfolio of active funds to the asset class-matched Vanguard funds which, in “excessive fee” ERISA complaints, have been the preferred funds due to their low fees. We find that the portfolio of active funds chosen based on certain key characteristics provide superior returns than the asset class-matched Vanguard index funds.

The findings in our study imply 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 active 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.

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