Powell: Don't let inertia sink 401(k) plans

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Mutual fund firms that also act as service providers to 401(k) plans don't always act in the plan participant's best interests. Instead, they seemingly act in the firms' best interests, often displaying favoritism toward their own funds, according to new research.

Consider: Poorly performing funds are less likely to be removed and more likely to be added to a 401(k) menu if they are affiliated with the plan trustee, wrote the authors of the paper, It Pays to Set the Menu: Mutual Fund Investment Options in 401(k) plans (http://ssrn.com/abstract=2112263).

What's more, plan participants don't undo what's called "affiliation bias" through their investment choices, the researchers wrote.

And if all that wasn't bad enough, the study's authors noted the "subsequent performance of poorly performing affiliated funds indicates that these trustee decisions are not information driven."

To be fair, these findings don't come as a surprise to everyone. "The conflicts in the 401(k) business have been inherent since the beginning of the industry," says Mike Alfred, the co-founder and CEO of BrightScope, a San Diego-based provider of 401(k) plan research. "Recordkeeping as a standalone is at best a very low-margin business. Most recordkeepers only get profitable by selling proprietary funds, collecting high-revenue sharing payments from non-proprietary funds, or capturing rollovers."

So given this research, what should 401(k) plan participants do?

Problem mostly for small 401(k) plans. First off, consider that the affiliation bias problem might not affect you. If you participate in a medium or large 401(k) plan — there are about 62,000 such plans with 100 or more participants — then you likely don't have to worry as much about affiliation bias.

If, however you're a plan participant in a small 401(k) plan — one of some 450,000 or so firms that have fewer than 100 plan participants — you might have reason to worry.

"All of these conflicts are most prevalent in the smallest plans where the company owner, CFO, and the like has neither the time, knowledge or leverage to push for non-proprietary funds," says Alfred. "For participants in the smallest plans, they should assume that the funds placed in their plans are not optimal."

Avoid investing in affiliated funds. One way to avoid affiliation bias is to avoid investing in affiliated funds. "Plan participants should be wary of using funds on a fund lineup that is dominated by proprietary funds of the plan provider," says Ary Rosenbaum, an attorney with the Rosenbaum Law Firm in Garden City, N.Y.

And they should especially avoid affiliated target-date funds (TDFs). "All participants should be particularly wary of placing all of their assets in a TDF since it's likely that there was no due diligence done by the plan sponsor in selecting the TDF family," says Alfred.

FYI: You might have ask your employee benefits department or plan administrator to identify the affiliated funds in your 401(k) menu.

Others, however, disagree. "My recommendation is not to avoid all funds that are offered by service providers," says Clemens Sialm, an associate professor at the University of Texas at Austin and one of the co-authors of the study. "Often these are funds with lower expense ratios and superior diversification levels. "

Do due diligence. Consider, too, that your poorly performing funds might have less to do with affiliation bias and more to do with its investment objective being out of favor. Your job, or course, will be to determine if it's the former or the latter. If your fund is out of favor, there may be no need to jettison the affiliated fund from your portfolio. If, however, it's the former, you might want to consider replacing it with a similar investment objective from a non-affiliated fund firm.

"The bottom line is to review (your funds) frequently," says Michael Adamson, the owner of Evergreen Benefit Services, a retirement plan consulting firm in Medford, N.J. "Too many participants forget to view the holdings in their account."

Others also urge participants to search for and avoid or sell high expense 401(k) investments. "Plan participants should monitor their investment options regularly and avoid funds with high expense ratios, funds with inferior prior performance and funds that are poorly diversified," says Sialm. "Funds with high expense ratios and funds with a poor track record on average underperform other funds."

And Aaron Skloff, the CEO of Skloff Financial Group in Naples, Fla., offered this advice: "Like a registered investment adviser that must be unbiased in making investment selections, participants should be unbiased in building and managing their 401(k) portfolio. They should evaluate all their choices, not just those recommended or highlighted by the service provider. This includes index funds, where the service provider's proprietary index funds may be more or less expensive than the non-proprietary funds for the same index."

Hire help. Also consider that you might need help with your 401(k) investments. "The true challenge participants face is inertia," said Adam Sokolic, a senior vice president at LPL Financial Retirement Partners in San Diego. "The vast majority take a 'set-it-and-forget-it approach' to investing in their 401 (k). This is where working with an adviser in some capacity can be beneficial. While participants may not have the expertise, knowledge or time to be an expert at investing, an adviser does. So working with an adviser can pay huge dividends, regardless if it's in a TDF, a managed account solution or detailed strategic/tactical asset allocation."

If you choose to go it alone, however; to be a do-it-yourself investor, Sokolic says reviewing a fund's performance is paramount, along with the expense of a fund. "A participant cannot make an informed decision about what do to without that information," he says. "In some cases, a proprietary fund may be a good option, but it is something that has to be reviewed and looked at on a case-by-case basis. Just saying 'no' to all proprietary funds is not the right answer as many do perform well and could be a good fit for that participant."

Ask for an open-architecture platform. If the only investment choices you have are affiliated funds consider asking your plan administrator to add non-affiliated funds. In some cases, plan sponsors have the ability to offer an "open architecture" 401(k) plan, where participants have the ability to choose investment options from many different mutual fund firms.

"There are 401(k) investment platforms that offer multiple fund families to choose from," says Evergreen Benefit Services' Adamson. "Plan participants can place this request to the plan sponsor."

To be fair though, open architecture 401(k) plans are not without shortcomings. According to BrightScope's Alfred, large plan sponsors are increasingly adding non-proprietary collective trusts, ETFs and custom TDFs to the 401(k) menu. The problem? They "typically have to pay a penalty fee for the right to do this," says Alfred. "I would argue that it's not true open architecture if you have to pay the penalty to the record-keeper to not use their products."

Don't worry about it. At least one expert says plan participants shouldn't lose sight of the forest for the trees when it comes to affiliation bias. "While it is important to choose mutual funds that have reasonable or 'benchmarked' expense ratios, the main purpose of the 401(k) is to allow plan participants to save for retirement on a tax-deferred basis," says Adamson.

So instead of fussing about affiliation bias, "make meaningful contributions," he says.

Remember the maximum allowable deferral contribution is not the amount needed to receive the employer matching contribution, Adamson says. For 2015, the maximum allowable deferral contribution is $18,000 and $24,000 for those 50 and older. FYI: The maximum deferral amount is specified in your 401(k) plan document and in the Summary Plan Description, which you can get from your employee benefits department.

Robert Powell is editor of Retirement Weekly, contributes regularly to USA WEEKEND, USA TODAY, The Wall Street Journal and MarketWatch and teaches at Boston University.