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Affiliated Funds Bias Affects Participants' Accounts

Researchers investigated whether mutual fund families acting as service providers in 401(k) plans display favoritism toward their own affiliated funds.

A Pension Research Council working paper suggests there is significant favoritism toward affiliated funds displayed by mutual fund companies that act as service providers to 401(k) plans.

According to the report, researchers found affiliated funds are more likely to be added and less likely to be removed from 401(k) plan fund menus. The biggest relative difference between how affiliated and unaffiliated funds are treated on the menu occurs for the worst performing funds, which have been shown to exhibit significant performance persistence.

For example, mutual funds ranked in the lowest decile based on their prior three-year performance have a deletion rate of 25.5% per year if they are unaffiliated with the plan's trustee. Similar-performing funds have a deletion rate of just 13.7% if they are affiliated with the trustee. On the other hand, funds in the top performance decile have a deletion rate of around 15% for both affiliated and unaffiliated trustees. "Protecting poorly-performing funds by keeping them on the menu helps mutual fund families to dampen the outflow of capital triggered by poor performance and, as a result, mitigates fund distress," the researchers write.

Veronika K. Pool, from Indiana University, Bloomington; Clemens Sialm, from the McCombs School of Business at University of Texas at Austin; and Irina Stefanescu, from the Board of Governors of the Federal Reserve System, drove the research by hand-collecting information about the menu of mutual fund options offered in a large sample of 401(k) plans for the period 1998 to 2009, based on annual filings of Form 11-K with the U.S. Securities and Exchange Commission (SEC). The sample includes plans that are trusteed by a mutual fund family as well as plans with non-mutual fund trustees. Most 401(k) plans in the sample adopt an open architecture whereby investment options include not only funds from the trustee's family (affiliated funds) but those from other mutual fund families as well (unaffiliated funds).

In the data set, a given fund often contemporaneously appears on several 401(k) menus that are administered by different fund families, which provided researchers with a unique identification strategy and allowed them to contrast how the very same fund is viewed across menus where the fund is affiliated with the trustee and menus where it is not.

NEXT: The role of participant choice in fund bias.

The researchers noted that if 401(k) plan participants are made aware of provider biases or are simply sensitive to poor performance, they can, at least partially, undo favoritism in their own portfolios by not allocating capital to poorly-performing affiliated funds. To test whether menu favoritism has an impact on the overall allocation of plan assets, the researchers examined the sensitivity of participant flows to the performance of affiliated and unaffiliated funds.

What they found is that, consistent with studies documenting that defined contribution plan participants are naive and inactive, the participants in the sample were generally not sensitive to poor performance and did not undo the menu's bias toward affiliated families. This in turn indicates that plan participants are affected by the affiliation bias.

The researchers conceded it is possible that fund families may also have superior information about their own proprietary funds, so participants may show a strong preference for these funds not because they are necessarily biased toward them, but rather, due to favorable information they possess about these funds. To investigate this possibility, the researchers examined future fund performance. That is, if despite lackluster past performance, the decision to keep poorly performing affiliated funds on the menu is information-driven, then these funds should perform better in the future.

The researchers found this is not the case: affiliated funds that rank poorly based on past performance but are not deleted from the menu do not generally perform well in the subsequent year. They estimate that, on average, these funds underperform by approximately 3.96% annually on a risk- and style-adjusted basis.

"These results suggest that the menu bias we document in this paper has important implications for the employees' income in retirement," the researchers wrote.

The working paper is available here. A free registration is required.

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