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Do 401(k) Providers Favor Their Own Funds?

Study suggests yes, and that underperforming funds are kept on menu too long

'It is similar to when you have kids,' and favor your own, says Prof. Clemens Sialm of the University of Texas at Austin.
PHOTO: STEVE CASTILLO

By **ANDREW BLACKMAN**
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For many 401(k) retirement-plan participants, choosing the right fund can be hard enough. It gets even harder when they don't have the best funds to choose from in the first place.

New academic research shows that mutual-fund companies tend to favor their own funds when setting the menus for the 401(k) plans they administer. And, more important, they tend to keep those funds on the menu even when the funds are underperforming. This apparent conflict of interest, the researchers found, can result in significant losses for investors.

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We spoke with Clemens Sialm, professor of finance at the University of Texas at Austin and a co-author of the study, with Indiana University's Veronika Pool and Federal Reserve economist Irina Stefanescu, in the Journal of Finance. Excerpts from that interview:

Conflicts studied

WSJ: *Your research examined conflicts of interest for 401(k) plan providers. What kinds of conflicts were you looking at?*

PROF. SIALM: In the U.S., most 401(k) plans follow an open architecture, which means that some of the options on the menu are affiliated with the service provider of the plan, and other options are unaffiliated, offered by different fund companies.

We wanted to see whether there is favoritism toward the affiliated funds. It is similar to when you have kids, and you might favor your own kids compared with your neighbor's kids. We wanted to see whether the options being offered to retirement savers are appropriate.

WSJ: *What was your methodology, and what did you find?*

PROF. SIALM: We hand-collected data covering 2,500 distinct plans from 1998 to 2009. What we looked at were the decisions to add and delete options on the menu. We wanted to see whether those additions and deletions depend on the affiliation of the fund with the service provider.

What we find is that, first of all, providers are significantly less likely to delete affiliated funds than unaffiliated funds. And, more interestingly, the effect is much stronger for poorly performing funds. Providers are much less likely to delete poorly performing funds if the funds are their own.

So, we conclude that there is favoritism toward the providers' own affiliated options.

Effect on investors

WSJ: *How does this affect people who invest in 401(k) plans?*

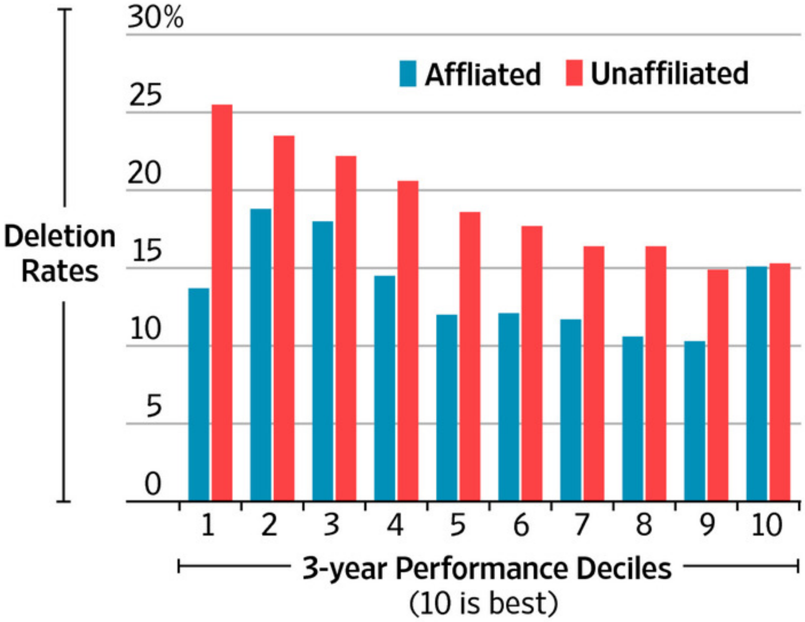
PROF. SIALM: The fact that those poorly performing funds aren't deleted can often be costly for retirement savers. What we find is that for the worst decile of funds—those that performed among the worst 10% over the prior years—they will continue to underperform by about 4 percentage points for the next year if they are kept on the menu.

WSJ: *Did your study look at how individual investors treat those underperforming funds?*

PROF. SIALM: Yes, and what we find is that they typically don't react much to performance. That is consistent with prior literature that has shown that individual participants in 401(k) plans are quite inert, they don't monitor their options, they often don't pay close attention to fees.

More Patience With Their Own

Which funds get deleted from the menu? The rejects, especially among poorly performing funds, tend to be those funds that aren't affiliated with 401(k) providers.



Source: 'It Pays to Set the Menu: Mutual Fund Investment Options in 401(k) Plans,' by Pool, Sialm and Stefanescu

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WSJ: *Investors are often told not to chase performance. Isn't inertia sometimes a good thing?*

PROF. SIALM: The mutual-fund literature has devoted a lot of attention to this question of whether performance is persistent. The general conclusion is that for the top performers, there is not a lot of persistence. But on the other hand, there is more performance persistence for poor performers. For the underperforming funds we looked at in our study, we also found that they continued to underperform in the subsequent year.

So it is important to see how your funds are performing. If they're performing poorly, you might want to investigate why, and it is reasonable to consider selling them. But I agree that you shouldn't just blindly chase performance, especially when it comes to timing the markets of different asset classes.

WSJ: *What can individual investors do to overcome the favoritism you've identified?*

PROF. SIALM: A lot of individual 401(k) investors might not be experts in making financial decisions, but what they should do is try to inform themselves and to analyze the options being offered. And if they see that their company doesn't offer a good plan, then they should lobby their company to improve it.

The strength of 401(k) plans is that they enable the whole population to participate in the stock and bond markets. But for people to be able to do that effectively, it is important that they acquire the necessary information to make good decisions.

Use independents?

WSJ: *To avoid conflicts of interest, should 401(k) plans be administered by independent* *firms instead of fund companies?*

PROF. SIALM: Some service providers already are independent, although the proportion of plans run by mutual-fund companies has increased from about 60% in 1998 to 75% in 2009.

But we don't find that plans run by mutual-fund companies are necessarily worse than independent plans. They do have some advantages. For example, we found that the fees charged by affiliated funds are lower on average. There are potentially some synergies. And, if you bring in another provider, you potentially have another layer of costs and fees.

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WSJ: *What are the broader implications of your research?*

PROF. SIALM: The implications of our findings are that 401(k) participants and sponsors should pay closer attention to the options being offered. It is important for companies to look after their employees and offer good investment options. It is important also for employees to monitor their investment options and form well-diversified portfolios that enable them to efficiently save for retirement.

Mr. Blackman is a writer in Crete. He can be reached at reports@wsj.com.

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