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Why bad funds stay in your 401(k)

It's a near certainty that your 401(k) plan's menu of investment options includes at least one stinker—a mutual fund that has lagged behind its peers and its benchmarks, year after year. But surprisingly enough, there's also a good chance that that fund has been hanging around in your plan, well, year after year. Researchers from the business schools at the University of Indiana and the University of Texas at Austin recently looked at some data to try to figure out why many 401(k) losers linger, and they identified one fairly clear explanation: A sub-par fund is much more likely to stay on the menu if it's managed by the mutual-fund company that's operating the plan.

Is this how they picked my 401(k) funds?

(The report, titled "It Pays to Set the Menu," was published earlier this month by the National Bureau of Economic Research; the curious can download a copy for $5 here.)

The report covers 401(k) plans offered by about 1,850 companies, accounting for roughly a third of the nation's 401(k) assets, over the years 1998 to 2009. Within that data set, 77% of the plans were "trusteed" by mutual fund firms, meaning the fund companies held the assets in trust and helped the employers select the investment options.

Most 401(k) plans now employ "open architecture," which means that plan members have access to funds from multiple providers besides the trustee. Indeed, the share of plan assets invested in trustee funds has been steadily declining over the past decade, from 27% in 2009 from 38% in 2002. But as the authors point out, while the trustees are required to act in the best interest of plan investors, they also "have a competing interest to maximize investments in their own proprietary funds." And as the bad grades roll in, trustees seem to be less likely to purge their own funds from their plans.

Among funds whose trailing 3-year performance was in the lowest-ranking decile, "non-trustee" funds were almost three times as likely to be removed the following year (29.6%) as trustee funds (11.9%). Did the keeper funds reward their administrators' faith by rebounding? Not in the short run: The researchers found that, on average, those trustee funds went on to underperform their benchmarks by 3.6% in the year after they survived the cut.

What keeps slacker funds from getting expunged? As MarketWatch's Ian Salisbury has reported, many trustee firms offer employers pre-packaged rosters of funds, an arrangement that can keep individual funds from getting closer scrutiny; the trustees also often cut employers a break on administrative costs if the employers let the trustees have more leeway in picking funds.

But there's another factor in play: The bad funds don't seem to bother employee-investors that much. Plan members, of course, could vote with their feet and leave these funds behind (ideally, in favor of index funds where underperformance would be less of an issue). But according to the NBER study, while 401(k) investors tend to chase good performance and pour money into hot funds, they're less likely to pull their assets out of a poor performer—unless, of course, the trustees take it out of the plan. Evidently, inertia trumps disappointment.