IT DOESN'T HAVE TO BE EITHER/OR

Active or Passive Management In Defined Contribution Plans

By Daniel Gardner

Defined contribution plan sponsors are wondering which makes most sense for their plans—active management or passive. In the absence of certainty, many are expressing a strong preference for the lower fees associated with passive management. This article explores the following four points, which we believe are worth considering in the active/passive decision:

1. Passive may not be the safe fiduciary option. Implication: Do not automatically dismiss attractive active management opportunities.
2. Active management is worth considering. Implication: Carefully consider the alternatives to passive on a case-by-case basis.
3. Cap-weighted is not the only way to invest passively. Implication: Choosing the flavor of passive is an active decision.
4. Target date funds have no passive option. Implication: Understand your plan’s target date offering, and monitor and periodically reconfirm its appropriateness.

Passive May Not Be the Safe Fiduciary Option

Some defined contribution (DC) plan sponsors express the view that passive investing is safer than active because it lowers their fiduciary risk. Common arguments for this view invoke the typically lower fees of passive investing and never having to explain below-benchmark performance. Yet the ERISA standard of care that governs DC plans does not identify passive as the safe fiduciary option. Rather, it states that the fiduciary must act “solely in the interest of the participants and beneficiaries and for the exclusive purpose of:

A. for the exclusive purpose of:
   i. providing benefits to participants and their beneficiaries; and
   ii. defraying reasonable expenses of administering the plan;
B. with the care, skill, prudence, and diligence…that a prudent man acting in a like capacity and familiar with such matters … would use …”

The standard of care clause extends further, but this passage provides some key points. It emphasizes the need to make careful, informed decisions that are exclusively in the interests of plan participants while keeping expenses at reasonable levels.

Let’s address the perceived safety of passive management from the fiduciary’s perspective, as summarized above. To begin, we must agree on what, exactly, is in the participants’ interests. Participants have different reasons for investing in the plan, but “saving enough to retire” likely articulates a reasonable goal that most participants share. A safe investment, then, would help mitigate the risk of savings not meeting that retirement goal. Passive management, as a general criterion for selecting investment options, does not precisely address this risk. The typically low cost of passive management, taken in isolation, does support participants’ efforts to meet the goal. Yet focusing overmuch on this particular aspect of passive investing and glossing over the other aspects—especially to the point of excluding non-passive options from consideration in the plan’s fund lineup—can have unintended consequences.

Participants aren’t assured safety simply because they’re invested passively. The market exposure of many passive funds means investors take on the full systematic risk of the market. As we’ve all been reminded over the past few years, that systematic risk can be very significant. It caused many participants invested via both active and passive strategies to delay or cancel their retirements. At a minimum, passive management is no panacea for managing participants’ risks. So, plan sponsors need to dig deeper than “Is it passive?” when considering what’s best for participants.

Systematically excluding non-passive options from consideration can deprive participants of the sponsor’s best thinking. Referring back to ERISA’s language on “reasonable expenses”: In light of the directive to act in participants’ sole interests, we believe an expense that furthers those interests can be reasonable. In the context of active versus passive management, if the benefit to participants from choosing a non-passive option outweighs the opportunity costs, it makes sense to select that option. This decision often hinges on the question, “Do you believe alpha can beat active management fees?” On average, the answer will be no, as Bill Sharpe famously observed in 1991. But in a specific case, a fiduciary acting in accordance with ERISA’s prudent man standard, who is well-versed in active manager selection and has undertaken extensive due diligence, can answer “yes.” And in these specific cases, paying for active management can be reasonable. Fiduciaries need to imbibe their best thinking in their DC plans.
Dogmatically excluding an entire set of strategies from consideration inevitably deprives participants of that best thinking.

To summarize: Mandating passive management as a hard-and-fast rule is not the safe fiduciary option.

What Should a Fiduciary Do?
For fiduciaries who want to pursue the safe option, there’s a better way forward than selecting all low-cost passive options. PIMCO’s 2012 Defined Contribution Consulting Support and Trends Survey asked 35 consultants about the best ways for sponsors to mitigate litigation risk, and the top three responses were “document investment policies and processes,” “evaluate and confirm reasonable plan investment fees,” and “establish an engaged DC investment oversight committee.” In fact, “move to low-cost passive strategies” ranked near the bottom of the list, with one-third of consultants deeming it “not important.”

Plan sponsors have a difficult job. On the one hand, they want to do the right things—for example, increase participation, boost contribution rates, and increase diversification of investment options. On the other, they fear getting into trouble—whether the fear is of incurring liability or inviting the disapproval of colleagues.

Yet ultimately, a plan sponsor’s loyalty must be to the plan participants. They rely on the sponsor, as the ERISA prudent expert, to provide them with a solution designed to be in their best interests. Sponsors need to diligently consider available options, whether active or passive, and select what they believe are the best alternatives for participants.

Active Management Is Worth Considering
DC plan sponsors tend to be particularly sensitive to fee considerations, due to participant concerns, government policy, and/or legal worries. Many plan sponsors who may believe in active management (as expressed, perhaps, in their defined benefit plan) feel pressure to reduce fees and active risk on the DC side. Yet, because active management pays off if benefits exceed costs, even a few extra basis points of return each year can make a meaningful difference in what participants have accrued at retirement and beyond.

Consider figure 1, which is a hypothetical analysis comparing wealth over time for a participant in a stylized plan who attains a 7-percent compounded passive return with 0.20-percent fees (blue) and another participant who attains the same passive return (gross of fees), but with alpha of 1 percent, tracking error of 3 percent, and fees of 0.70 percent. The different colors represent the 25th-percentile outcome (green), 50th-percentile outcome (red), and 75th-percentile outcome (purple).

Even modest amounts of alpha generation can add years of retirement spending potential. For example, 0.17-percent annual returns net of the passive fund return (the 25th percentile in figure 1) can add two years of retirement spending, and 0.46-percent net (the 50th percentile) can add seven years of spending. From another perspective, the performance of the passive option provides retirement income equal to the 14th-percentile outcome from active management.

Plan sponsors should not take a dogmatic either/or position on active versus passive. Fee pressures may make active management unattractive to many plan sponsors, and the easiest decision may be to go all-passive in every asset class. Yet given the potential benefits of active, it’s worth exploring whether it can benefit participants in certain cases. Such exploration is not the easiest path to travel, but it’s the right one.

What Should a Fiduciary Do?
Rather than rely on a simple binary yes/no decision on active and passive, plan sponsors should have a pragmatic framework to help them decide where and when to go active. The decision between active and passive can best benefit participants when it is not regarded as an either/or choice. Plan sponsors with fee budget or other constraints can certainly benefit their participants by mixing active and passive exposures. Russell has developed a decision-making framework for plan fiduciaries considering this issue, detailed in figure 2 (Ezra and Warren 2010). In this framework, the fiduciary starts with passive as the default assumption and considers whether another approach may make sense.

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Figure 1: Stylized Evolution of Wealth over Time for DC Plan Participants

Other assumptions include an initial age of 20, initial salary of $30,000, 3-percent annual salary growth, a 10-percent savings rate, and withdrawals beginning at age 66. The initial withdrawal is equal to 80 percent of final salary of $113,448, and subsequent withdrawals include a 3-percent annual cost-of-living adjustment. Tracking error of 3 percent is normally distributed. Annualized net of passive fund returns, including management fees, are as follows: 0.17 percent (25th percentile), 0.46 percent (50th percentile), and 0.74 percent (75th percentile).

This is a hypothetical analysis shown for illustrative purposes only.

Source: Russell Investments.
Our framework identifies five investment considerations. Typically, active management is the alternative to passive. Below, we'll provide an example for each of these considerations. Then we discuss plan-specific factors that can influence the decision.

1. No readily replicable index is available. This is certainly true of non-public asset classes, such as private real estate. Even though there are private real estate benchmarks, it would be impossible to replicate a benchmark's return, given the relative illiquidity of the market. This can also apply to more-liquid asset classes to varying degrees.

2. The passive index is at odds with the investor's objectives. Plan sponsors have unique beliefs and objectives. For instance, a plan sponsor who wants to offer representative, diversified exposure to real assets may not be satisfied with implementing a passive fund based on one or more of the available benchmarks. In the listed infrastructure space, active managers often produce a more "pure play" exposure to infrastructure than the available passive benchmarks do. Pure play listed infrastructure companies can be desirable, because they typically have more stable cash flows than typical public companies do. They operate in regulated industries with significant barriers to entry—industries that provide services essential to the functioning of a society (such as utilities, airports, and cell phone towers).

3. The standard passive index is inefficiently constructed. For example, passive collateralized commodities futures (CCF) indexes may face two major headwinds. First, there's no clear equivalent to the market-cap weighting often used in equity indexes, which can lead to construction of indexes that lack commodity exposure diversification. Production-weighted indexes, such as the S&P Goldman Sachs Commodity Index, will be highly concentrated in energy commodities. In addition, rules-based approaches to rolling over expiring futures contracts can lead to undesirable exposure to short-term market trends. Roll yield, or the return an investor earns in the process of rolling over an expiring futures contract, can have a significant negative or positive effect on the ultimate return from CCF investing. Active managers may be able to take account of these market dynamics to potentially benefit investors.

4. Investment environment favors active management in general. Russell's research shows that we can expect good active managers to perform better when returns of individual securities can be explained more by security-specific risks than by macroeconomic events. One way we interpret which sort of public equity return regime prevails is via cross-sectional volatility, or "cross vol." Cross vol measures the returns dispersion of a universe of securities—whether the returns are moving in lockstep (low cross vol) or diverging (high cross vol). Our research has found a strong positive relationship between cross vol and active manager dispersion—in other words, the payoff to good active management is higher when cross vol is higher (Bouchey et al. 2010). Cross vol can be persistently high in a market, or high on a merely transitory basis. Small-cap stocks have exemplified persistently high cross vol relative to large-cap, which indicates a greater payoff to good active management in the small-cap space.

5. Skilled managers can be identified. It is difficult to identify skilled active managers, but the payoff can be quite significant. As discussed earlier, generating even a small amount of active return in excess of fees can enhance the chances of a palatable retirement for participants. Selecting a good manager requires rigorous quantitative analysis of the manager's performance record and qualitative, ongoing judgment of the manager's abilities and resources. Plan sponsors who do not have the skills to evaluate managers or the resources to hire third-party manager research experts may be best served by limiting their plans' active management exposures.

Plan-specific considerations matter just as much as the investment considerations described above. Let's examine the five considerations provided in figure 2: scale, plan sponsor investment sophistication/beliefs, fee budgets, benchmark sensitivity, and core menu design.

Scale. The plan sponsor's scale significantly impacts access to certain asset classes as well as the fees charged for those options. The expense gap between active and passive fees varies depending on the asset class and the vehicle (mutual fund, collective trust, or separate account).

Plan sponsor investment sophistication/beliefs. Let’s assume a plan sponsor has decided to add an asset class exposure to the plan. Now, set to one side whether or not attractive active management opportunities exist in a given asset class. If, after performing objective due diligence, the sponsor cannot get comfortable with the notion of...
active management in a given asset class, then passive management should be chosen over the alternative of no exposure at all. One caveat to this conclusion is that it may not be possible to passively invest cheaply and efficiently in all asset classes.

Fee budgets. Even when attractive opportunities for active management exist in all asset classes under consideration, fee budgets can constrain the use of active management to only the absolute best of the opportunities. In the context of a multi-asset-class option, such as a target date fund, if a plan sponsor has fee constraints, the decision to include or exclude an asset class can impact the budget available for other asset classes and, consequently, the active versus passive decision in those asset classes. So, the focus should be on those areas with the greatest potential for net-of-fees alpha.

Benchmark sensitivity. Benchmark sensitivity could discourage a plan sponsor from taking active risk in asset classes where good active managers’ returns can deviate significantly from the benchmark. Taking multi-manager approaches, and combining active and passive investment in a single fund, can help reduce tracking error relative to returns of a single active manager.

Core menu design. Unique to DC plans, the design of the core menu intertwines with the active or passive decision. To offer participants a variety of choices, many plans offer both an active and a passive tier of fund options. In contrast, we believe a more streamlined menu design works best for most participants. Many, if not most, participants lack the skills and level of attention required to make sound investment decisions when faced with a large number of options. At best, offering separate active and passive tiers complicates their decision making. At worst, it can lead to increased performance chasing among investment options. A strong core menu design can be the foundation of a well-designed plan. A simplified core menu could include one to three equity options, a fixed-income option, a capital preservation option, and a diversified real assets strategy. Within each of these options, the mix of active and passive approaches should reflect the sponsor’s best thinking.

Cap-Weighted Is Not the Only Way to Invest Passively
Although the definition of passive management hasn’t changed, a proliferation of innovative indexes and products has emerged in recent years. “Passive management” simply means investing in a rules-based manner. In practice, investors often add the additional criterion of “aims to replicate the returns of a specified benchmark index,” and we’ll include it for our purposes as well. The most popular application of passive management involves replicating the returns of a market portfolio via low-cost mechanical trading rules. Yet there are other ways to invest on the basis of a set of rules and an index. Today, investors can choose from a staggering array of options that fall on different points in the spectrum between traditional, capitalization-weighted passive investing and traditional active management. Let’s examine several that may be relevant to DC plans:

Passive options tracking different slices of a cap-weighted index. Examples include size, valuation, and region-specific index-based products. Although still passively managed, they can offer return patterns that significantly differ from each other. Even indexes designed to provide similar exposures can deliver different returns. Providers utilize different methodologies, which can lead to different weightings and numbers of issues in a benchmark.

Passive options tracking slices of an alternatively weighted index. Any product based on a non-cap-weighted index falls into this category. One example of this approach is a fundamentally weighted index product, where securities are weighted on the basis of company fundamental measures of size (such as cash flow) as opposed to market capitalization. Even if implemented with the transparency and liquidity of cap-weighted passive products, these products may be considered active management by proponents of the capital asset pricing model.

Enhanced indexing. “Enhanced indexing” describes a broad category of strategies that attempt to produce modest returns above an index. The funds deploying these strategies tend to exhibit much lower turnover than actively managed funds do and trade based on rules, but returns also can differ significantly from those of their index benchmarks, because the strategies attempt to add value to the benchmark. It’s difficult to classify them as either active or passive.

What Should a Fiduciary Do?
It appears, then, that selecting a passively managed product may be an active decision unto itself. So, when considering passive options for a plan, a sponsor should consider looking beyond the traditional passive option of a cap-weighted index fund. A sponsor may have very good reasons for opting for an alternative. As an example, Russell’s research has identified “the third dimension of style”—stability—which focuses on the high-quality, low-volatility (“Defensive”) stocks/low-quality, high-volatility (“Dynamic”) stocks spectrum (Hintz 2010). We see potential for the practical application of this research to give investors better management over their equity risk in a passive vehicle, which may appeal to DC plan sponsors and their participants.

Target Date Funds Have No Passive Option
The selection of a target date fund (TDF) demands an active decision on the part of the plan sponsor. A TDF’s glide path—the split between risky assets and relatively safe assets, such as fixed income, over time—will be the single most-important factor in determining the return pattern of the fund. However, unlike weights to securities within a single asset class, there is no default starting point for setting the glide path—particularly for the pace and timing of the transition to a more conservative portfolio over time. The market capitalization-based approach to passive is very popular (in, for example, public equity portfolios), but there’s no well-established corollary for TDFs. Different plan sponsors desire different asset class building blocks for inclusion in a TDF, adding to the difficulty of determining a passive benchmark.

This need for an active decision ties back to our first major point: Passive may not be
the safe fiduciary option. Participants invested in a TDF will feel the difference between a 70-percent allocation to equity and a 40-percent allocation to equity, regardless of whether the underlying strategies are managed actively or passively. For many plan sponsors, the hard lesson of the 2008 stock market drop was that the selection of a TDF matters a great deal. In 2008, even TDFs with “2010” in their names (funds designed for participants nearing or already in retirement) showed significant variations in returns (Powell 2009).

The regulators who oversee DC plans responded by holding a hearing on TDFs9 and issuing guidance on them.10 Some of the key points from the guidance are that investors need to do the following:

• monitor a TDF’s investments over time;
• look at the fund’s prospectus to see where the fund will invest their money; and
• understand how the investments will change over time.

Unfortunately, it is not clear that sponsors have embraced the recommendation to understand their plans’ glide paths. A recent survey indicated that about half of plan sponsors did not know what their funds’ glide path is—and yet 70 percent believed that their participants understood the structure and purpose of target date funds.11 Although plan sponsors have safe harbor protections for use of TDFs as default investment vehicles, they still have a fiduciary duty to understand how the fund works and whether it is best for plan participants. Simply selecting any TDF series does not fulfill fiduciary obligations.

Confounding plan sponsors’ efforts to understand and evaluate their target date offerings is the fact that the fund families themselves can change over time. Recent research from Ibbotson/Morningstar illuminates how the historical allocations of several TDF series have shifted over time (Idzorek et al. 2011). In general, potential reasons for these shifts include methodological changes, a tactical asset allocation overlay, loose rebalancing bands, and more. Figure 3 shows an example of these shifts in one TDF series, where the glide path seems to change significantly over time—especially near the target date of age 65, where equity exposure fluctuates between about 25 percent and 50 percent. We note the allocations shown in figure 3 are adjusted for the annual “roll-down” of the glide path, and so if there are no changes to the glide path the chart would show the same allocations for each year.

Even if the reasons for shifts are valid, a target date series that shows a wide variety of allocations over time is difficult to judge.

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Figure 3: Observed Glide Paths of Fidelity Freedom Funds, 1996–2010

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Source: Ibbotson Associates and Morningstar Direct
Worse yet, the fund provider’s glide path can, per the Morningstar paper, “change dramatically over time, often with no explanation.” These findings underscore the importance of performing ongoing due diligence of target date funds.

What Should a Fiduciary Do?
For plan sponsors with TDFs in their line-ups, the best course of action begins with becoming familiar with the funds. Important characteristics of a target date fund include the following:

• the shape of the overall glide path over the life of the fund, particularly around the retirement date;
• the potential for change in the glide path;
• which asset classes are included, and how the mix changes over time;
• whether the fund is managed passively, actively, or with a combination of both approaches;
• the skill levels of any active managers in the fund; and
• fees.

Then, a sponsor must decide whether a given fund remains best for the plan’s participants, and should consider alternatives if it doesn’t. Of course, sponsors should always document their decision rationale.

Conclusion
To properly address the simple question of active or passive requires complex thinking—the kind ERISA’s standard of care asks of plan fiduciaries. It’s hoped that we’ve made clear there’s no blanket answer to the question. It’s tempting to go with the decision that feels safe, but this is not the same thing as making a safe fiduciary decision. So, what should plan sponsors consider as they decide between active or passive in their DC plans? To reiterate the points we’ve been discussing throughout:

Passive may not be the safe fiduciary option. Do not automatically dismiss attractive active management opportunities.

Active management is worth considering. Carefully consider the alternatives to passive on a case-by-case basis.
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Please remember that all investments carry some level of risk, including the potential loss of principal invested. They do not typically grow at an even rate of return and may experience negative growth. As with any type of portfolio structuring, attempting to reduce risk and increase return could, at certain times, unintentionally reduce returns.

Diversification does not assure a profit and does not protect against loss in declining markets.

Target date fund investing involves risk, principal loss is possible. The principal value of the fund is not guaranteed at any time, including the target date. The target date is the approximate date when investors plan to retire and would likely stop making new investments in the fund. Investments that are allocated across multiple types of securities may be exposed to a variety of risks based on the asset classes, investment styles, market sectors and size of companies preferred by the advisors. Investors should consider how the combined risks impact their total investment portfolio and understand that different risks can lead to varying financial consequences, including loss of principal.

Target date funds are not intended to be a complete solution to investors retirement income needs. Investors must weigh many factors when considering to invest in these funds, including how much an investor will need, how long will the investor need it for, what other sources the investor will have and, if the investor is purchasing shares in an IRA account, whether the fund’s target distributions will meet IRS minimum distribution requirements once age 70-1/2 is reached.

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