Passive management and the false premise of fiduciary relief

Going passive is an active decision

Russell Investments Research / Viewpoint

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There has been an increase in interest among defined contribution (DC) plan sponsors for passive investment options that seems to be, in part, based on the false premise that fiduciary oversight requirements are nearly eliminated. Plan sponsor fiduciary responsibility may not be reduced to the extent plan sponsors believe when selecting passive funds to include in their DC lineup.

While there are differences in evaluating passive and active funds, this paper details certain items plan sponsors are obligated to look at, when selecting passive investment options (including both single asset class and target date funds), by ERISA requirements of selection and monitoring of plan investments. The obligations detailed throughout this paper consider the sponsor's duty to review the:

- Index provider's organization and methodology
- Investment manager's implementation capabilities
- Investment manager's fee structure
- Lack of exposure for participants to asset classes that are expensive to implement passively
- The structure of the target date fund glide path and underlying asset allocation

Introduction

Defined contribution (DC) retirement plan fiduciaries have become increasingly interested in greater utilization of passive management, for both target date funds and single asset class options, in plan lineups for participants. This trend has undoubtedly been spurred by the increased focus on fees following recent class-action lawsuits, regulatory scrutiny and media attention.

While this focus on fees is laudable and important, the decision to move to a purely passive approach seems to be based on two dubious premises – namely, that 1) it is safer for fiduciaries to offer funds that have the lowest absolute cost and little risk of underperforming a stated benchmark,[i] and 2) fiduciary oversight obligations are nearly eliminated. This paper particularly examines the second premise.

If you decide to implement passively managed investments in your DC plan, your job as a fiduciary is not over. Every decision you and your hired managers make is an active decision that has implications and requires prudent review, even if implemented through passive investment vehicles. Some monitoring requirements are unique to passive management, while many others are similar to those associated with the review of a fund implemented through active management. While in passive management there are certainly some areas that will require less monitoring relative to an active fund, the fiduciary burden and due diligence requirements related to passive investments may not be reduced to the extent some sponsors believe they will be.

Below we provide a series of plan sponsor obligations when selecting and monitoring a passively managed vehicle, followed by the specific case of passively implemented target date funds.

Exhibit 1: General obligations

•	Review the index provider's organization
•	Review the index provider's methodology
•	Review the passive fund manager's implementation capability
•	Review the manager's ability to replicate the index and the costs to do so
•	Review the fees charged by the passive fund provider
•	Determine whether active management opportunities may be more prudent
•	Review the glide path*
•	Review the asset allocation*

*Additional considerations for Target Date funds

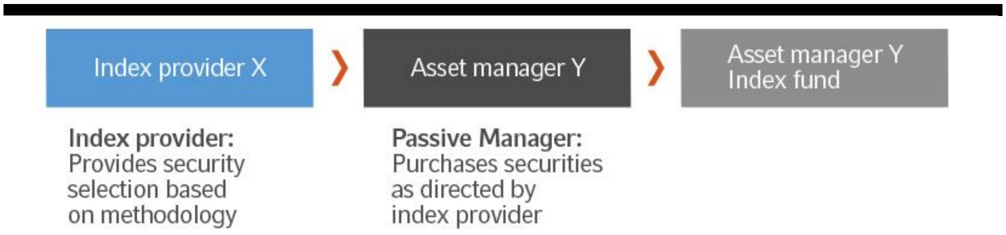
General obligations

1. Review the index provider's organization

Several index providers – including FTSE Russell, S&P, Dow Jones, MSCI, CRSP and others – provide data to managers of passive investment vehicles. You cannot actually invest directly with these index providers. Rather, the index provider provides a money manager with the index holdings and weights. The money manager then typically constructs and manages a fund that closely replicates the index (see Exhibit 2) – for example, FTSE Russell provides and licenses index data to BlackRock so that the latter can create its iShares Russell 2000® ETF.

It's important to know who is providing index data for the fund you are purchasing. Make sure the provider comes from a strong organization that has experience and expertise in creating indexes. Creating an index is more than just coming up with a list of securities. It takes extensive research to construct robust portfolios and the infrastructure to handle all the data required to understand the investable universe. Also, make sure the index provider has a strong focus on and commitment to index creation.

Exhibit 2: Creation of an index fund



Sometimes passive fund managers elect to change index providers. For example, in 2013, Vanguard changed the provider from MSCI to CRSP for index provision for several of its equity funds. Such changes can easily go unnoticed by shareholders and DC plan sponsors, but it is very important to be aware of them. In many cases, a fund name will be generic (such as "Passive Manager X Large Cap U.S. Equity Index Fund"), and the passive manager could swap one index provider for another with no change to the fund name, which means the change in index provision could easily go unnoticed. As a plan sponsor, you should be asking critical questions of your manager when such changes are made. Some of these questions are: Was the motivation for the change related only to the fees the passive manager is paying? What is the investment rationale? How are these changes likely to impact the construction of the fund exposures and the expected return stream?

2. Review the index provider's methodology

When selecting an active manager, plan sponsors typically want to review and understand the investment methodology and how decisions are made. For a passive option, the investment experience is driven, almost completely, by the index provider's methodology and thus it is equally important to understand the underlying methodology.

You will want to verify that the index exposures you are getting as a result of the methodology reflect your desired exposures. There are several different methodologies across index providers, which can lead to different types of exposures.

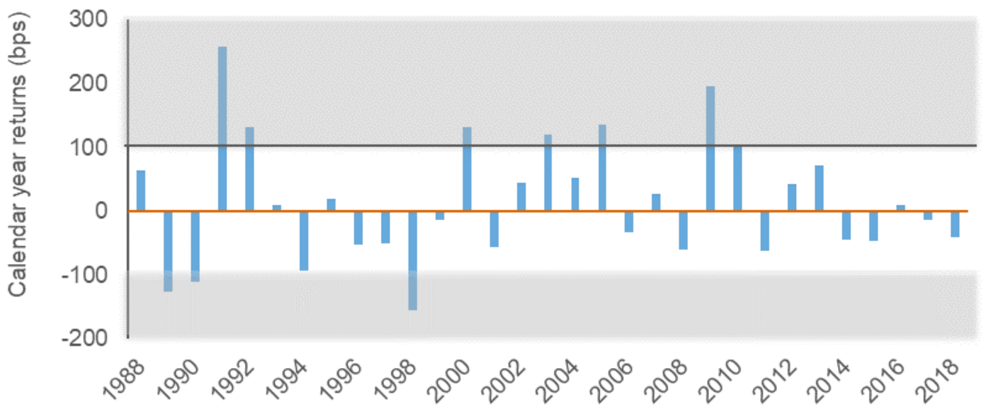
One example is the Russell 1000 and S&P 500, competing indexes for U.S. large cap equity securities. The Russell 1000 Index is very rules based and includes the top 1000 largest companies by market capitalization while the S&P 500 selects around 500 securities among more than 950 of the largest cap securities, leading to a very similar capitalization range of securities, by committee vote. As you can see in Exhibit 3, this has led to different results over time.

On the fixed income side, the Bloomberg Barclays U.S. Aggregate Bond Index, the most well-known bond index, has a methodology that includes total outstanding debt in the U.S. fixed income universe, which today leads to a significant allocation to lower yielding, duration sensitive government and government related securities. If interest rates increase, these exposures can leave participants unguarded.

Finally, there are active decisions that index providers need to make that can lead to large differences in exposures and performance. In one example, FTSE Russell decided to include China A shares in their global, international and emerging market indexes, while MSCI did not. China A shares returned 112% in the year leading up to June 30, 2015 and subsequently dropped -31% in the following quarter.

While we are not advocating in this paper the merits of one index or group of indexes over another, these examples show how active decisions can lead to significant differences in passive portfolios and the return experience of the participant.

Exhibit 3: Performance of the Russell 1000® Index[ii] vs. the S&P 500® Index – despite both being considered good proxies for U.S. Large Cap Equity, active decisions can lead to differing results.



Source: Bloomberg data as of December 31, 2018. Indexes are unmanaged and cannot be invested in directly. Past performance is not indicative of future results.

3. Review the passive fund manager's implementation capability

The first two items in this paper looked at the index provider. Now let's consider the fund manager who is implementing these passive portfolios. More goes into managing a passive fund than one might think. Poor implementation can lead to unwanted tracking error. There are rebalancing rules, pricing rules and rules on market-timing differences. Important considerations for implementation are the index replication method, sophistication of the quantitative tools used, trading practices, the amount and timing of cross trading, and the stability of the processes used to correctly track the benchmark. Make sure that you understand the manager's capabilities and are comfortable with them.

4. Review the manager's ability to replicate the index and the costs to do so

A typical motivator in a plan sponsors' selection of a passive manager is to minimize costs. Some indexes can be replicated easily. Those are typically in asset classes that are highly liquid and publicly traded. For example, there is plenty of liquidity in listed U.S. large cap equities, but what about less-liquid markets, such as high-yield fixed income or certain real assets? Often, substantial costs go into managing some of the less-traditional asset classes; there may be significant implementation costs coupled with high tracking error. Some privately held securities, like private real estate, can't be replicated in an index. So, in addition to its being costly, you may not have any exposure to a certain asset class if you limit yourself to passive management, due to the lack of quality index funds representing that asset class.

5. Review the fees charged by the passive fund provider

Several passive fund managers provide very similar or competing products. In fact, there are several different fund providers who look to replicate the same index, yet they have different fee structures. For example, many different providers have funds that seek to passively replicate the S&P 500 Index. Are you paying the least you can pay, given your asset size? Are you in the cheapest share class you can get? Have you looked at collective trust funds? If you are paying more than you would for other options in the market offering the exact same exposure, is there a justifiable reason? In a U.S. Supreme Court ruling in 2017 – Tibble v. Edison International – the court decided against Edison (the plan sponsor) for including the higher-fee retail share class in the plan's fund menu when the exact same option was available in a lower-cost share class.

6. Determine whether allowing for active management opportunities may be more prudent

Going passive is an active decision. While passive management is a good starting point, a prudent plan sponsor should consider active management as well, to ensure that the most appropriate management technique is selected. In cases involving asset classes that are considered "less efficient" or difficult to passively manage in a cost-effective manner, it may make more sense to choose an actively managed fund. For example, asset classes that are covered by fewer analysts, such as U.S. Small Cap Equity, have typically led to a higher probability that active management would outperform. Even though it may seem "safer" to pick a particular index option, if you are deciding on a passive option in an asset class where active management tends to provide strong outperformance opportunities, and if you can access such active management cost-effectively, you have a fiduciary obligation to consider that for your participants. While every basis point matters in terms of cost, positive net-of-fee excess performance can also have meaningful impact to participants' retirement readiness over the long-term. Certain asset classes offer a higher probability of generating excess performance.

Target date funds

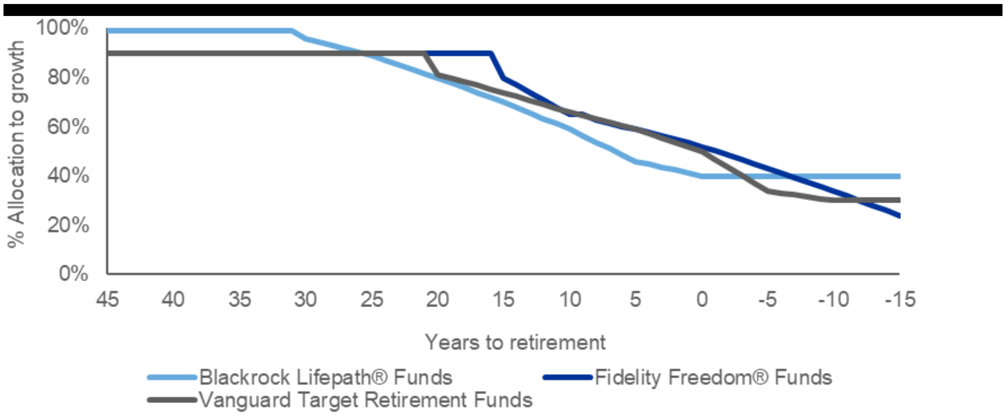
Target date funds (TDFs) are a special case for review. Some sponsors have chosen TDFs in which all of the underlying investments are implemented passively, often for reasons similar to those expressed earlier. While these are often referred to as "passive target date funds," there really isn't such a thing.[iii] For those considering a passive TDF, the following are additional due diligence requirements, beyond those discussed in the sections above.

7. Review the glide path

In March 2013, the Department of Labor (DOL) published "Tips" for fiduciaries conducting target date fund selection.[iv] The first two items were related to establishing a process for comparing and selecting, and then periodically reviewing, TDFs. Whether the TDF provider you select provides its underlying investments through passively managed funds or active (or both), the design of the overall glide path (the shift in asset allocation over time) is an active decision. As a plan sponsor, you are required to evaluate, understand and periodically review your TDF series glide path.

All target date funds are certainly not created equal and the same holds true for TDF managers' strategies. Passively managed target date funds' allocations to growth assets can range from around 30% to around 65% at retirement. At some point, a TDF provider made that decision, which can significantly impact your plan participants' retirement outcomes. Make sure you are comfortable with the exposures and risks throughout the glide path, including when and at what risk level it reaches its most conservative allocation. As you can see from the subset of passive glide paths in Exhibit 4, allocations can vary significantly across providers.

Exhibit 4: A few examples of glide paths run by passive providers



Source: Fund prospectuses as of 12/31/2018. Actual prospectus dates will vary. Largest passive TDF providers selected.

As you periodically review the glide path, also be sure to keep abreast of any changes the TDF provider makes to the glide path. There have been several providers who have changed or modified their glide paths. You are responsible for assuring that you are comfortable with the glide path at all times, and for documenting the reason for your selection. In Tibble v. Edison International, the court ruled that the sponsor was responsible not only for the original selection, but also for the ongoing monitoring of that selection.

8. Review the asset allocation

The third piece of advice from the DOL's "Tips" is to understand the underlying asset class investments and how they change over time. As discussed previously, there are certain asset classes that either cannot be managed passively or are too expensive to be so managed. For example, investments in certain real assets are difficult to implement passively and can incur high tracking error or expensive trading fees. If a passive target date fund manager leaves these diversifying asset classes out, that exclusion is an active decision that you, as a plan sponsor, need to be comfortable with.

Plan sponsors also need to consider how the TDF manager is allocating across the asset classes that are included. For example, how much of the equity allocation is to U.S. securities (in what is often called "home country bias")? In many cases, TDF providers have 70%-plus in U.S. equity. A concentrated allocation to any particular asset class or region could lead to higher portfolio volatility, while a more globally focused allocation could potentially lead to a smoother ride, which is important to many participants saving for retirement.

Conclusion

As a plan sponsor, you have a big responsibility. When something doesn't go the way participants want it to, they may blame you. While there are several ways to protect yourself, selecting a passive management provider without conducting proper due diligence and documentation is not one of them. Nor is picking that provider because you think it's safest for you as a sponsor. Responsibility for the selection and monitoring of passive managers can be just as extensive as for selecting any active or active/passive provider. Don't fall into the trap of thinking all-passive management is the "safe fiduciary option."

[i] Whether this leads to a safer fiduciary position remains to be seen. The court ruling in Tatum v. RJR (2013, 2014, 2017) found that making a decision to avoid fiduciary responsibility is, in fact, a breach of fiduciary responsibility. Tatum v. RJR is a reverse stock drop suit. When RJR was spun off from Nabisco, participants' shares of Nabisco were sold off in January 2000 at all-time lows. A year later, Nabisco soared back to hit all-time highs. After a U.S. District Court ruled in favor of RJR, the 4th Circuit overturned that decision, ruling that a fiduciary can be held liable for losses from an investment decision, even if that decision was "objectively prudent." Essentially, it was ruled that RJR's attempt to relieve itself of fiduciary duty was a breach of fiduciary duty.

[ii] Source: Source: Bloomberg data as of December 31, 2018.

[iii] See D. Gardner (2012), "Active or passive management in defined contribution plans? It doesn't have to be either/or" and R. Collie (2007), "The risks and benefits of active management in target date funds: It doesn't have to be either/or.

[iv] Department of Labor "Target Retirement Funds – Tips for ERISA Plan Fiduciaries (Feb 2013), https://www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/fact-sheets/target-date-retirement-funds.pdf

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Important information

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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 the investor will need it for, what other income 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.

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.

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