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TOPIC #14: **Evaluating Funds in a 401k**

PROMPT: **Mutual fund offerings in 401k plans are hitting their 10 and 15 year milestones; what is the quality and vetting process for mutual funds available? How are underperformers removed?**

Davis, Payne and McMahan (2007) get straight to the point, determining how mutual fund managers' illegal actions vary by mutual fund management fees and by the reward and control structures in place inside/outside the mutual funds which may have had occurrence of wrongdoing or illegal activity. The article's findings "support the hypothesized relationship that higher levels of management fees decrease the likelihood of illegal behavior" (p. 319).

The article divulges arguments from previous research which address corporate misbehavior such as market-timing, rapid trading, late-trading, mispricing, and insider trading (p. 320). Mutual fund assets have grown from $47B in 1980's, to $8.6T in 2005, where $1.6 trillion are part of a 401k or similar retirement plan (in 2013 that figure was closer to $2.4T). Additionally, "most of the brand-name, marketing-based mutual fund companies solicit large organizations who seek comprehensive [401k] plans to offer their employees. Thus, many mutual fund investors are investing based on brand recognition, low management fees (price-shopping), and/or have been provided limited investment options" (p. 323).

The authors go on to reveal previous studies like Elton et al. (2003) that found mutual funds with performance based fee incentive structures take on more risk in the beginning, and more risk after periods of poor performances, which may adversely affect proper stewardship. The authors also recognize how the industry is mostly based on an asset-based fee structure highly influenced by strong marketing (among other indicators, like short-term performance). The study empirically supports a famous 2004 statement from Don Phillips, a Managing Director at Morningstar, Inc., who testified to US Senate Committee on Banking that mutual fund companies have altogether had too many violations given their record level heights in role and importance of the American people (p. 331).

The findings of this research will improve plan sponsors and fiduciaries to identify characteristics in mutual fund companies that may promote misbehaviors, like low fees or high marketing. Its findings directly impact the stability of retirement planning. For research purposes, the sample group could be cross-referenced for any fund family with share class counterparts offered in 401k plans.

Reference:

- **Davis, J. L., Payne, G. T., & McMahan, G. C. (2007). A few bad apples? scandalous behavior of mutual fund managers. *Journal of Business Ethics, 76*(3), 319-334.**

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