Apples or Oranges in 401(k)? The Ideal 401(k) Recordkeeper Will Let You Pick Either

By Rich Brindisi

The ideal 401(k) recordkeeping platforms let advisors and clients pick their own investment, plan design, and method of payment approach, and they provide the widest range of choices to allow for the most effective execution.

Active management versus passive management? That question has been debated in asset management circles for years with no philosophy clearly beating out the other. A Google search of “active management vs. passive management” turns up 46 pages of articles with the search term in the title. Each article is thoughtful and well-written, but this is clearly not a new concept. The debate about whether active or passive management is best applies to all forms of mutual fund investments, including individual accounts, 401(k)s, annuities, life insurance policies, or IRAs.

Spotting an active or passive management proponent is a matter of examining the investment vehicles they use. Active money managers look to outperform an appropriate benchmark through decisions which could include economic sector positioning and weighting, security selection and weighting, tactical trading, and other subjective criteria. Variations in investment approaches and styles vary greatly in the financial industry. Nevertheless, the objective of all active approaches is to generate better returns for a comparable investment. You generally pay active managers higher management fees to compensate them for their resources, time, and effort involved in getting you, the investor, returns that beat the benchmark. When this type of management is used in the 401(k) market, a portion of these fees are usually passed through to service providers to cover the costs associated with the plan. This is also sometimes referred to as “revenue sharing,” which is more accurately a reimbursement for expenses for services the recordkeeper performs on behalf of the mutual fund company.

On the other hand, passive management, at the fund level, doesn’t forecast the stock market or the economy, and makes no effort to distinguish “attractive” from “unattractive” securities. Passive managers often construct their portfolios to mirror the performance of well-recognized market benchmarks such as the Standard & Poor’s 500 Composite Index (500 large U.S. companies), Russell 2000 Index (2,000 small U.S. companies), or Morgan Stanley Capital International EAFE index (large international companies). Passively managed funds typically have a lower cost than actively managed funds and, in exchange, the investor loses the ability to take any action in response to market conditions. Additionally, the investments used in a passive management approach must be allocated by asset class (stocks vs. bonds), market (domestic vs. international), and various sub-classifications. The advisor that makes these allocation decisions will charge a fee for these services that generally is a percentage of the
assets. In the context of a 401(k), since fees are separated out more distinctly, the revenue sharing that happens in an active management philosophy can be returned to the 401(k) plan itself, sometime referred to as return of mutual fund concessions. Paychex Retirement Services recently published a whitepaper written by C. Frederick Reish, a leading expert in ERISA plans and a partner at Drinker Biddle. I encourage you to take a few minutes to read Fred’s whitepaper, which you can find here: http://www.paychex.com/a/d/advisors/equitable-allocation.pdf

Financial advisors generally fall into one of these two philosophical camps, although some take a hybrid approach of the two. In the 401(k) market, financial advisors should expect a recordkeeper to be able to offer platforms that compliment either investment philosophy. The decision should be based on what best suits the needs of their client, the plan sponsor. For example, Paychex Retirement Services has three separate platforms. Two of them are completely open-architecture, an offering that supports both commission-based advisors and fee-based advisors, whether they choose to use an active or passive investment style. In addition, there is also an option to pass mutual fund revenue sharing through to the 401(k) plan participants. Special care should be taken by a plan sponsor or anyone charged with evaluating and comparing retirement plans, when a 401(k) recordkeeper, TPA, or other service provider strongly advocates for one type of investment philosophy over another. It simply isn’t their debate to wade into.

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