Target Date Funds And Do-It-Yourselfers Both Beat Brokers' Advice In 401(k)

A new study of university employees participating in a 401(k)-like plan, finds that over a decade, those who got advice from commission-earning brokers made riskier investments —and achieved significantly lower after-investment-expense returns—than those directing their own investments. Moreover, both sets of workers earned less than they would have simply by plopping their money in a Fidelity Investments target date fund, although workers who managed their own accounts took on less investment risk (and owned less stock) than did the target funds.

Count your pennies. Eighty-nine cents of commissions a year on every $100 in your 401(k) sure adds up over time. (Photo credit: Wikipedia)

The study, published by the National Bureau of Economic Research, compared the returns earned from 1999 to 2009 by workers in Oregon University System's 401(a) Optional Retirement Plan— a 401(k)-like plan for public sector workers. Participants could buy mutual funds and other investments through a financial service company that used brokers paid commissions to provide face-to-face advice or through a lower cost operator which left workers to make investment decisions on their own. Those working with brokers paid an average of 0.89% a year in brokers' fees and earned 1.54% less a year (after those fees) than the self-directed investors. The brokers' bounty came to an annual "tax" averaging $530 per plan participant, the researchers calculated.

While the brokers did help workers to diversify, they steered them into funds paying the highest commissions and those which had done well in the past—but then lagged in the future, the paper found. "It's not surprising. The higher your fees, the worst your performance. It's the one sure thing in mutual funds,'' University of Oregon finance prof John M.R. Chalmers, one of the study's authors, told *Forbes*.

The paper doesn't identity the financial service companies involved and Chalmers declined to do so. But based on information on the Oregon University System's web site, the high cost company was American International Group's Variable Annuity Life Insurance Co. subsidiary and the low cost provider was TIAA-CREF. (The plan stopped offering Valic to new participants after October 2007; newcomers can choose between TIAA-CREF and Fidelity to administer their accounts.)

Chalmers and coauthor Jonathan Reuter, of Boston College, found that those workers opting for Valic accounts were younger, less well educated, and less well paid than the self-directed investors. They were also less sophisticated financially, making it hard to predict what sort of returns they might have earned had they not paid the brokers' fees. To answer that question, Chalmers and Reuter compared all the retirement plan participants' returns with what they would have earned by putting their savings in the Fidelity Freedom target date funds. Target date funds offer an asset mix that is set and reset based on your expected years until retirement. These days, most companies use them as the "default" option for workers who don't want to pick their own investments—meaning the same workers who once felt they needed brokers' advice might now default into target dates, the profs said. (A complete run-down on target date funds, how they operate, and for whom they make sense, is here.)

In 70.4% of the investor years the researchers compared, the target date funds beat the broker advised choices; in 62.9% of the years, they beat do-it-yourselfers' returns. "The majority of the broker clients (and self-directed) investors in our sample would have earned significantly higher annual after-fee returns from being defaulted into target-date funds,'' the paper concludes.

But before you rush out to dump your 401(k) wad into a target-date, think about the warning in another new NBER paper from Reuter and coauthor Pierluigi Balduzzi of Boston College. It concludes that the differences among target date families in allocation, performance and costs is wide, and that a 401(k) saver offered only one target date choice may face—in economistspeak—"a suboptimal set of retirement savings options."

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