The Problem with Proprietary Funds

Combatting Affiliation Bias

A proprietary fund is a “house-brand” mutual fund created when a bank or brokerage firm both sells the fund and manages some or all of the fund’s underlying assets. Typically, a proprietary fund takes one of two forms. It is either a fund independent of the plan’s investment alternatives or it is a proprietary model containing funds from the plan’s investment alternatives. As described by Ken Hawkins, the founder of Ohow Investor Consultants, managing fund assets and selling funds are both very profitable business lines. He continues by noting that “the creation of proprietary mutual funds is considered a form of vertical integration - not to mention a profitable way to leverage an existing sales force.”[1]

While firms offering proprietary funds may also sell third-party funds, their motives for promoting their own brand are likely much stronger. Not only will the firm receive any sales commissions, but they may receive management fees because they are frequently managing some or all of the fund’s assets. The Financial Industry Regulatory Authority, FINRA, has prohibited the use of incentives to motivate the sale of proprietary funds in an attempt to stop brokers from putting their needs ahead of the clients. However, this has not completely stopped firms or advisors from pushing their in-house funds to boost profits. Often, the fees for proprietary funds, also coined as “wrap programs”, are grouped together as one fee encompassing the expense for servicing, trading, managing underlying investments, and financial advising. This makes it significantly more difficult for the investor to understand who is being paid, how much, and for which services.

It Pays to Set the Menu

A June 2015 study[2] concluded that, for the advisor, it pays to set the menu. The study sought to determine if mutual fund families, who act as service providers to 401(k) plans, display favoritism toward their proprietary funds. Their findings show a bias towards proprietary funds in that:

- Proprietary funds, referred to in the study as ‘affiliated funds’, are less likely than unaffiliated funds to be replaced for poor performance.
- Plan Participants are subject to affiliation bias of proprietary funds and therefore experience potential under-performance compared to other available fund alternatives.
- Tolerance of long-term under-performance of affiliated funds indicates that inclusion of these funds is not performance based.

Proprietary funds are often recommended to investors regardless of their investment needs or the performance of the underlying investments. Often, proprietary funds are used as default investment alternatives, QDIA, in the absence of a participant election.

[1] Hawkins, Ken. Mutual Funds: Brand Names Vs. House Brands. Investopedia. http://www.investopedia.com/articles/mutualfund/08/proprietary-mutual-funds.asp

[2] Pool, V. K., Clemens, S., & Stefanescu, S. It Pays to Set the Menu: Mutual Fund Investment Options in 401(k) Plans. 10 June 2015. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2112263

It is crucial that Plan Sponsors safeguard against high costs and poor performing investment alternatives that can be detrimental to participants' retirement savings. To properly construct the lineup, the Plan Sponsor must analyze the total fee for the fund with special attention to any packaging or wrap fees, the specific underlying investment alternatives in the case of a fund of funds, and overall historic performance.

The Bottom Line

While FINRA has banned incentives related to the sale of proprietary funds, they have not completely vanished. Broker-Dealers are under pressure to increase profit margins for their parent companies at a time when fees embedded in investments are under strict scrutiny. Proprietary funds may serve as a very profitable solution for advisors to the potential detriment of the investor. It is crucial for the Plan Sponsor to understand all of the Plan's investment offerings, including the components of any fund of funds, to be able to combat any potential bias.