DailyFinance
An AOL Money & Finance Site

Does Your 401(k) Have an ETF in Its Future?
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01/19/10

There's a lot of talk about exchange-traded funds being offered in 401(k) plans. While nobody was paying much attention, ETFs' share of the $1 trillion in 401(k) assets has reportedly grown to about $2 billion to $4 billion.

"For mutual funds, 401(k)s account for something like more than 30% of all assets, and more than 40% of all new money invested. This has been a great captive market for the mutual fund industry, and the ETF sponsors want in," says John McGuire, a partner in the investment management practice at the law firm Morgan, Lewis & Bockius. "Employees who have heard about ETFs are curious or interested," he adds.

Lower costs, lower costs and lower costs are the top priority for businesses offering 401(k) plans, says Stuart Robertson, general manager of ShareBuilder 401k, which has an all ETF-based offering.

Four years ago, ShareBuilder began offering 100% ETF-based 401(k) plans, and already they are supporting over 2,500 installed businesses. "It's interesting that small and mid-sized companies have been faster to move toward ETF-based 401(k) plans than those among the Fortune 500. Often, larger companies lead the way in retirement plan benefits, but the change is coming from a different direction this time around," says Robertson.

"It's kind of like the 'I want my MTV' phenomenon. Back in the early '80s, customers had to ask their cable carriers to offer MTV, and after a few years MTV became a cornerstone of cable TV. We expect it to take another five or so years, until ETFs are a common offering from most 401(k) providers," says Robertson. "We need to keep educating employers and employees about their benefits, and businesses need to keep asking their providers for ETF-based plans. As this continues to happen, more providers will support it," he adds.

The Up Side Of ETFs

There are several reasons Robertson could be right. The 401(k) market is dominated by hidden costs and an alphabet soup of mediocre mutual funds with confusing share classes; ETFs offer a transparency in a business that isn't transparent, says Ari Rosenbaum, an associate attorney with Meyer Suozzi English & Klein. Secondly, he says, more than 75% of mutual funds offered in 401(k) plans don't consistently meet their respective benchmarks, making ETFs more attractive because they typically track a certain index.

ETFs also avoid "style drift," the tendency by actively managed funds to invest in other asset classes outside their benchmark, which can reduce diversification and increase risk, points out Joni Clark, chief investment strategist for Loring Ward.

And of course, ETF's expense ratios are razor thin when compared to those of mutual funds typically offered in 401(k) plans, which also include a 12(b)1 fees and the revenue-sharing payments made to third-party administrators, costs which the average plan participant is unaware of, adds Rosenbaum.

"Lower operating expenses are critical for investors to maximize their retirement savings," says William Thomas, chief executive officer of Grail Advisors.

Simply put, says Ronald Stair, president of Creative Plan Designs, "ETFs work well for investors who find the whole process of analyzing and picking the 'right' stock confusing, boring, or too big a hassle. By owning ETFs you also improve your access to commodities and international markets."

Ultimately, the real end benefit of including ETFs is the ability to build more sophisticated and better-diversified asset-allocation models designed to deliver more consistent and stable performance over time, regardless of whether the models are managed on a strategic or tactical basis, says Jeffrey Acheson, partner and managing director of retirement plan and executive benefit services for Schneider Downs Wealth Management Advisors.

But Of Course, There's A Down Side, Too

However, don't look for ETFs to dominate 401(k) plans anytime soon. "ETFs will never dominate the 401(k) fund lineup as long as the current system, which is wedded to mutual funds, is in place," says Rosenbaum. There are a number of issues standing in the way of ETFs taking over.

Unlike a mutual fund that trades just at the close of business, ETFs trade constantly throughout the course of the day. "Unfortunately, most 401(k) record-keeping systems are not set up to handle an investment that has multiple price points," says Kendall Storch, senior vice president of retirement for Longfellow Benefits. "We have spoken to a few record-keepers that have attempted to come up with, say, an average price during the course of the trading day, and use that as the basis for valuation. But there are not many of them."

Also, ETFs don't provide any revenue to the record-keepers to offset administrative costs. As a result, the record-keepers must bill the full weight of their costs to their plans' sponsors. A typical example would be a plan which uses ETFs, and the average cost of the ETF is 25 basis points. However, since there is no revenue derived from ETF, the record-keeper must charge an additional 70 basis points to cover administrative costs. "Now the cost of the plan is more like 95 basis points, which would begin to put you back in the ballpark of mutual funds. In other words, you end up in the same place. Perhaps an index fund would be just as effective," says Storch.

Another factor is trading costs. "Every time you buy or sell an ETF, there are trading costs associated with that. Who will bear this cost? If it is the plan sponsor, then it they have an actively trading employee population, that drives up the cost of the plan. If it is the participants, most of whom are not used to seeing fees associated with switching investments -- will this be viewed negatively?" says Storch.

Understand What You're Investing In

The truth is, too, while many people have heard about ETFs, not everyone gets how they work. "The average employee has a hard enough time understanding what a mutual fund is? Will they be able to comprehend an ETF?" asks Storch.

Exotic ETFs, such as inverse ETFs, can create more harmful effects on a portfolio than positive effects, says Mike Benedict, senior wealth advisor for Weaver Wealth Management. "Plan sponsors will need to be prudent with the ETF options they provide to their plan participants," he adds. "What tools will participants have available to help them choose which ETFs are most appropriate for their personal financial goals?" Benedict asks.

If you are a plan fiduciary, don't rush to an ETF alternative just because it is low cost -- understand all the trade-offs and why the ETF option is better than other index fund options available to the plan, suggests Paul Hamburger, partner and head of the employee benefits, executive compensation and ERISA litigation practice center at the law firm of Proskauer Rose's Washington, D.C., practice. If you're an employee, education is important. "Many plans have investment education or investment advice products and information available. Use it. Don't just go into the ETF because it is 'low cost'. Make sure it fits within your overall retirement strategy," he says.

Jim Cantrell, president of Financial Strategies, thinks there is little need for ETFs in 401(k)s. He emphasizes that ETFs work well for market-timers, while 401(k)s are used for retirement investing, usually long term. Secondly, "ETFs can have additional risks, of which the general public is unaware. Most are also unaware of the strategies employed to mitigate some of these risks," he adds.

Quite frankly, asks Michael Edesess, partner and chief investment officer with Fair Advisors,"Aren't there enough mutual funds -- about 15,000 the last I checked. What do they expect to get from an ETF that they can't get from mutual funds?"