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MoneyVoices: ETFs Wrong for 401(k)s

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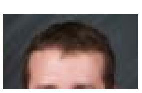
Exchange-traded funds, or ETFs, have long been known as a low-cost method of investing for retail investors. However, as ETFs expand both in number and popularity, they have begun receiving increasing media exposure as a potential solution to reduce 401(k) plan fees. I explored this issue in a recent piece for the Winter 2008 *Journal of Pension Benefits* and the July/August 2008 *Journal of Indexes* and determined that ETFs are not the best fit for 401(k) plans.

ETFs' appeal is relatively straightforward: They cost less than the average mutual fund. In fact, ETFs have been touted by at least one firm as the "low-cost solution for 401(k) s." Comparing ETFs to mutual funds is an apples-to-oranges comparison, though, because ETFs are typically a passive investing approach (i.e., indexing) while most mutual funds use active approaches. Since passive investing tends to cost less than active investing, it follows that ETFs will cost less than the average mutual funds. The real question, then, is whether or not ETFs cost less than index mutual funds. They don't.

When comparing the average index mutual fund to a respective ETF, the cost savings of ETFs virtually disappear, especially when compared against Vanguard's index funds. While some potential savings may still appear to exist versus the Vanguard investor share classes, ETFs are not "401(k) ready." In fact, there are a number of costs that must be incurred (both explicit and implicit) in order to get an ETF into the core menu of a 401(k) plan. For example, while mutual funds can be purchased in fractional shares, in order to purchase a fractional ETF, it must be in a pooled account, such as a collective investment trust (CIT). Additional costs are incurred in operating and creating CITs, such as cash drag and administrative fees.

An ETF investor also incurs the bid/ask spread, which erodes the actual return realized by the investor. Mutual funds are also able to pay revenue share to 401(k) providers to reduce the net cost of the index mutual fund to a plan. A number of mutual fund companies make their index funds available for a net cost (expense ratio minus revenue share) of 4 bps, while the cheapest ETF available has a cost of 7 bps, and this is before the additional costs associated with making an ETF 401(k) ready.

At first glance ETFs appear to be a potential solution in lowering 401(k) plan fees. However, if a plan sponsor or the plan advisor wants to reduce the cost of the plan, they're better served looking at low-cost index funds than at ETFs.



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Blanchett currently holds the following designations: Certified Financial Planner, Chartered Financial Consultant, Chartered Life Underwriter, Qualified Pension Administrator and Accredited Investment Fiduciary Analyst. He has also been awarded the Chartered Financial Analyst charter. He currently holds his Kentucky Life & Health Insurance licenses and has passed the NASD Series 6, Series 7, and Series 65 exams.

Blanchett has written a multiple papers that have been published in the *Journal of Pension Benefits*, the *Journal of Indexes*, and the *Journal of Financial Planning*. He won the *Journal of Financial Planning*'s 2007 Call for Papers (called the Financial Frontiers Awards) with a research paper titled "Dynamic Allocation Strategies for Distribution Portfolios: Determining the Optimal Distribution Glide Path." He is the past president of the Lexington Employee Benefits Council and active in the Cincinnati CFA Society and the FPA of Cincinnati..

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