Mutual Funds vs. ETFs: The 401(k) Format War

By Ary Rosenbaum, Esq.

I have always been a big fan of business history, especially when it comes to the history as to why former corporate giants stumble, as well as the history of the format war. A format war is when there is a competition between mutually incompatible proprietary formats that compete for the same market.

The most remembered format war is VHS vs. Betamax for video tape recorder dominance. As most people don't remember, Betamax was actually the better technology. VHS won the format war because its originator, JVC licensed its technology to competitors which lowered the price for VHS video recorders (VCRs) while Sony was the only purveyor of Betamax VCRs. The other major difference was that VHS offered two hour recordings on its tape while Betamax only offered one hour recordings. Sony felt that a two hour recording made the recording inferior (which it did, remember using a VHS tape to record in SLP mode?) , but consumers wanted more tape space to record full length motion pictures (which are longer than an hour). So even though Sony had the better technology, they lost the format war because their rivals offered a product that was preferred by the masses.

Sony did get some measure of revenge when years later, their high definition optical format, Blu-Ray won the format war over HD DVD which was supported by Toshiba and other manufacturers. Blu-Ray won for two major reasons, more film studios (including Sony owned Columbia Pictures) preferred Blu-Ray and Sony produced Playstation 3 offered Blu-Ray as part of their game system which greatly increased the amount of Blu-Ray owners.

The major lesson of a format war is that many times, the inferior product will win. If superior proprietary formats would always win, I would have written this article with an Apple Macintosh instead of a Windows 7 based computer. So it should be noted that the victor in a format war could be the inferior product like VHS.

When it comes to daily participant directed 401(k) plans, we have our own format war as the investment industry leader, no transaction fee mutual funds has exchange traded funds (ETFs) to worry about. While mutual funds have been the undisputed leader as the investment choice for 401(k) plans for years (ever since it replaced the annuity based model of 401(k) plans that dominated the industry earlier), certain changes in the retirement plan industry have made ETFs make a larger penetration in the 401(k) market.

I do have to make a confession here. When it comes to my own personal investing, I used to invest completely in no-transaction mutual funds (paying a load for a mutual fund for me was like eating pork as a Jew, it was against my religion). Over time, I slowly shifted my investments to indexing. The reason was simple, if you ever invested in more than one Janus funds in the late 1990's, you know why, as well as the fact that more than 75% of mutual funds don't beat their benchmarks over time. Indexing vs. active investing is itself its own format war and I respect those who think indexing is wrong; people are entitled to their opinions. With the phase in of ETFs into the marketplace, I started to buy ETFs, especially IShares and Vanguard's Vipers because of the low management fees and easiness to trade on the stock market.

Everyone knows my experience as the former Director of ERISA of Legal Services for a producing third party administration (TPA) that was disgraced because of hidden fees. That makes me a supporter of fee transparency since I left that TPA three years before they were disgraced because of their lack of fee transparency. So many of my friends in the industry were surprised, especially some of the earlier supporters of ETFs in the 401(k) industry like Alvin Rapp of RPG Consultants and Darwin Abramson of Invest n Retire that I was quoted in the Wall Street Journal last summer that I saw ETFs still being just a niche player in the daily participant directed 401(k) market. That was the investment version of me saying that I love eating ham and cheese sandwiches.

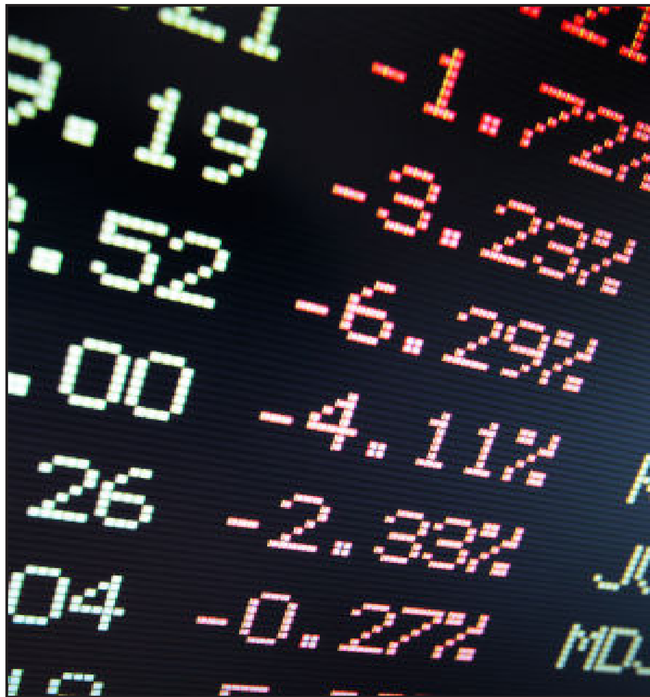
The reasons that I stated that ETFs would only be a niche player in the 401(k) world is because the 401(k) plan business is dominated by the mutual fund industry. The 401(k) daily trading platforms are tilted towards mutual funds because

the daily 401(k) trading platforms are dominated by mutual fund companies like Fidelity, Schwab, Nationwide, John Hancock, American Funds, and ING, companies who would lose out if ETFs became a more dominant form of 401(k) investment. Do you think these companies have any interest in lowering the fees for ETFs when they allow the trading of their mutual funds for free? I highly doubt it.

In addition, the 401(k) daily trading platforms strips many of the benefits of ETFs, namely because it won't let participants buy ETFs throughout the day (unless they have a self directed brokerage account). In addition, the ETFs main strength, their low fees and fee transparency had been its greatest Achilles heel in gaining ground in the 401(k) market. Isn't that absurd? It is absurd and it's true because since participants pay the bulk of 401(k) administration fees, it will add substantial fees to what is a financially transparent product. So while ETFs' main strength is its low management fees and fee transparency, these are drawbacks in an industry where fees are still hidden and mutual fund companies pay revenue sharing fees to TPAs that remind me of payola and kickbacks. Financial advisors and plan sponsors think that revenue sharing is essentially free money that a mutual fund company simply hands off to the TPA to lower the cost of administering 401(k) plans (unless TPAs like my old firm simply put the revenue sharing in their pocket or invent fees like bloated custody charges to hide the fact that they are putting it in their pocket). Financial advisors and plan sponsors forget that there is a cost to revenue sharing because revenue sharing is accounted by mutual fund companies in increased management fees.

Index mutual funds and ETFs can't afford to pay revenue sharing because of its low management fees. Some mutual funds can pay 15 to 25 basis points in revenue sharing (.15 to .25%). ETFs can't afford to pay those amounts when the IShares S&P 500 Index ETF (IVV) has an expense ratio of 9 basis points (0.09%). So since ETFs pay no revenue sharing, advisors and plan sponsors were under this crazy notion that ETF 401(k) plans costs more to administer because the industry did not play on a leveled playing field when it came to the disclosure of all fees in 401(k) plan administration.

As we all know, 401(k) fee disclosure is around the corner and plan sponsors will finally know the truth and perhaps like Tom Cruise's character in A Few Good Men, they may or may not handle the

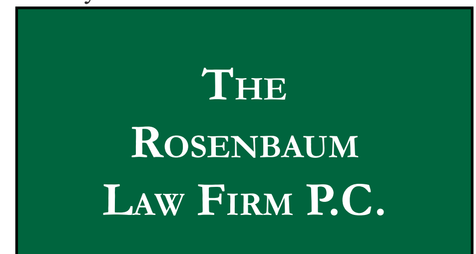


truth. The truth will reveal what service providers charge when it comes to 401(k) plan administration and what kind of compensation they indirectly receive. So TPAs will be forced to admit what they charge 401(k) plan sponsors and what kind of money they are receiving from the mutual funds in the plan. This is going to be the opening that ETFs need because it will re-open the conversation as to whether mutual funds or ETFs are cheaper to administer in a 401(k) plan. Based on the plan size, plan sponsors may be in for a shock and or/treat, that ETFs are not only competitive, but can be more cost effective that no-transaction fee mutual funds.

In addition, the further penetration of ETFs into the 401(k) market will be a positive development for all 401(k) plan participants regardless of whether their plans offer ETFs or not. If mutual funds lose ground to ETFs, they will be under a strain to cut their management fees as they try to compete with ETFs on lower expenses. This will also force mutual funds to slash revenue sharing payments they make to TPAs which may have a domino effect as plan sponsors and TPAs shy away from these revenue sharing funds (since they no longer pay them or will pay at a much lower amount) and consider lower expense options like index funds and ETFs. Plan sponsors will complain that the end of revenue sharing will raise plan administration costs. I say hogwash because plan sponsors were already paying for revenue sharing fees that they were receiving, they were just hidden in the mutual funds' management fees.

One thing that is different about this format war is that plan sponsors don't have to pick mutual funds or ETFs. A plan sponsor can simply sprinkle a few ETFs among its mutual fund lineup in order to spice up the offering to plan participants. So plan participant could get a lineup of actively managed mutual funds sprinkled with a few index ETFs. ETFs don't have to dominate the conversation; they can just be a part of the conversation. Sort of like a VHS owner being able to play Betamax tapes.

Regardless of your view concerning ETFs, I think ground gained by ETFs within the 401(k) market is a positive development because choice is a good thing and a good competition always has the positive effect of reducing management fees. While mutual funds have a long way before losing the format war, they will be losing ground, inch by inch.



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