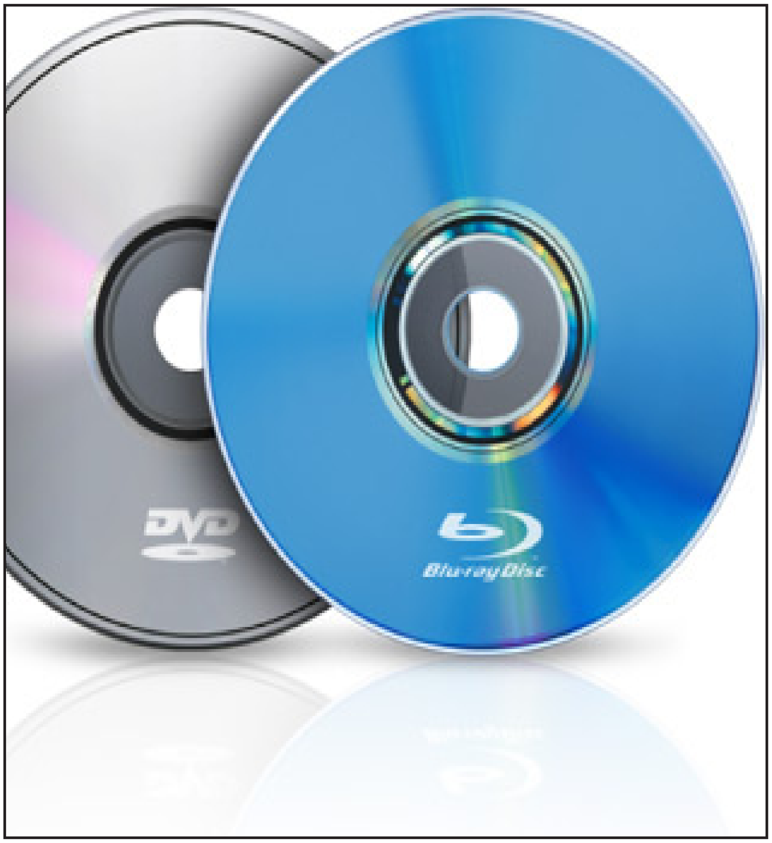
"Introducing" Index Mutual Funds to 401(k) Plans

By Ary Rosenbaum, Esq.

The Internet was created in 1969. The first broadcast in high definition television was in 1996. The DVD was first released in 1998 and the Blu-Ray player made its debut in 2006. 401(k) plans made their debut in 1981. The index mutual fund made its debut in 1975. Sometimes it takes awhile for a new product or service to get greater acceptance in the marketplace. While index mutual funds could have always been an option for 401(k) plans since the mutual fund industry started to dominate the 401(k) asset business in the late 1980s, only recent changes in the market and the retirement plan industry have made them more attractive for plan sponsors and participants.



401(k) plan participants may be shocked to learn that in 2009, 90% of the $1.5 trillion of assets in 401(k) and defined contribution assets that were in mutual funds were in funds that were actively managed. Even more shocking is that 80% of all actively managed mutual funds fail to beat their benchmark index in any given year. Of course, actively fund managers and their proponents will state that using index funds will merely net mediocre returns. While the passive vs. active debate of investment style will continue into the end of the time, the reason that index funds are only starting to become more prevalent in 401(k) plans is because of changes in the marketplace and the 401(k) industry.

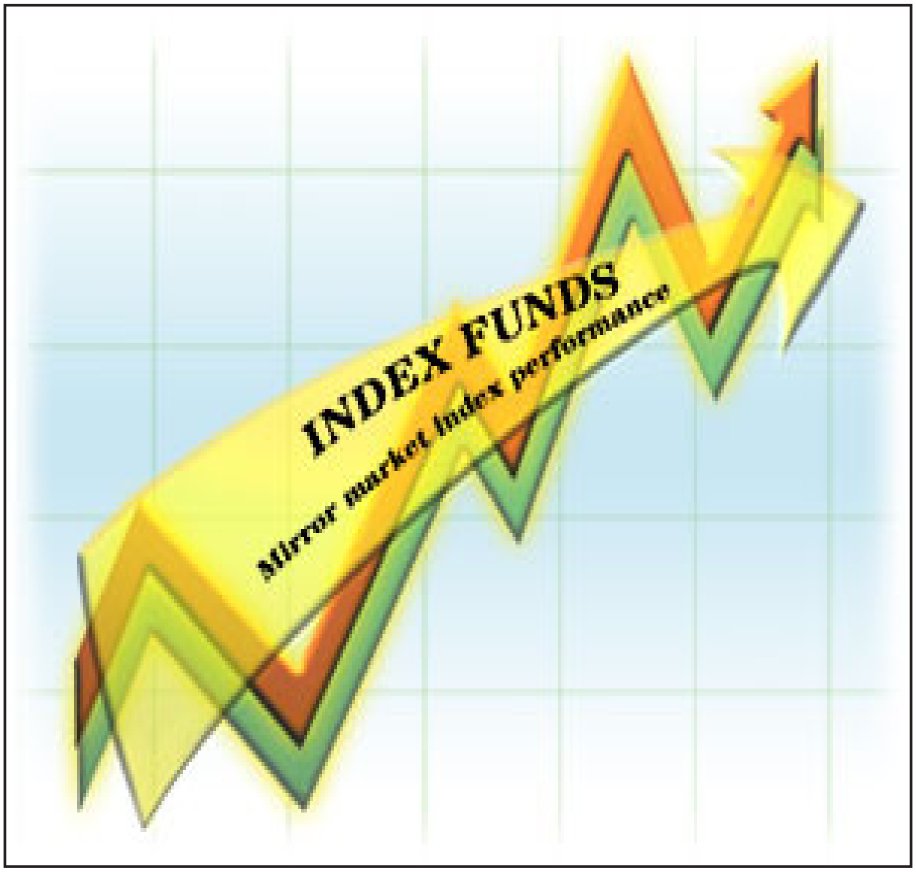
The 401(k) industry is dominated by the mutual funds companies. Their push for participant directed, daily valued 401(k) plans was prefaced on the fact that participant directed plans under Section 404(c) of ERISA would limit a plan sponsor's fiduciary liability in the participant's gains or losses with their own directed account. The reason that the mutual fund industry really pushed for these daily valued plans was because it helped make mutual funds the dominant form of 401(k) investment because they had created daily valued platforms where trades were made without transaction fees. With such platforms, mutual funds became the dominant form of investment for 401(k) plans. Of course, mutual funds companies (except for the folks at Dimensional and Vanguard) tend to favor participants to invest in actively managed funds because actively managed funds have higher expense ratios (management fees) and mutual funds companies make more money with funds that have higher expense ratios. While many of the large fund companies did add index funds to their lineups, it was only because of the demand from investors for such type of investments.

Index funds have low expense ratios and are transparent; they represent the underlying benchmark minus some tracking error and its minimal expense ratio. Their transparency was their Achilles heel in a 401(k) industry that was not transparent, which was full of hidden fees and hidden payments. The fees in the 401(k) industry were so well hidden that plan sponsors were either unaware of the fees they were paying for plan administration or they thought that they were getting the administration for free. One of the expenses that plan sponsor and participants were unaware of or never considered was the expense ratios of the funds in their plan. I believe that they still don't factor in fund expenses as a cost of plan administration, which they should because higher expenses cut into investment returns and make it harder for plan participants to meet the benchmarks that the mutual funds compare their rate of return against. Higher expense ratios also allow mutual fund companies to offer the greatest enticement to choose their funds for 401(k) investment lineups, a shady practice called revenue sharing.

Revenue sharing is a payment offered by mutual funds companies as an enticement for plan sponsors and their financial advisors to choose their funds for 401(k) fund lineups. The revenue sharing payments go from the mutual funds company to the TPA and it is supposed to be used to offset the administration expenses that the TPA is charging. Revenue sharing is paid by some mutual fund companies for some of their mutual funds, so revenue sharing is an enticement for plan sponsors to choose that funds because they will believe that they will help defray their plan expenses. Mutual funds that pay revenue sharing pay varying amounts up to about 25basis points (.25%). So obviously if index funds have expense ratios about 25 basis points or less, they certainly can't afford to pay revenue sharing and since they represent their underlying benchmark index, there is no reason for them to pay revenue sharing. While plan sponsors think that picking revenue sharing paying funds cuts down plan expenses, I believe they actually increase plan expenses.

Revenue sharing reminds me of the bottle deposit. When I was 10, New York implemented the bottle deposit law and I was so ecstatic that I was going to get a nickel for every soda can that I would return to the supermarket. Of course as a 10 year old I failed to understand that the bottle deposit would be a wash since I had to pay a nickel as a deposit for each can. The same thing goes for revenue sharing. Plan sponsors and their financial advisors think that revenue sharing payments are some sort of gift from the gods and the mutual fund companies, but plan sponsors are paying for these revenue sharing payments by choosing these funds that have higher expense ratios than funds that don't, especially index funds. The average actively managed fund's expense ratio is 1.25%, the average expense ratio for an index fund is .25%. So even if an active mutual fund pays .25% as revenue sharing to the TPA, an average actively managed fund is still .75% more expensive than an index fund (if you count the .25% as a return like a soda can for a bottle deposit). So while plan sponsors and their advisors don't count mutual fund expense ratios as plan expenses, they still are plan expenses. So picking revenue sharing funds don't decrease plan expenses, they actually increase it because revenue sharing paying funds are more expensive than index funds that don't. Revenue sharing is the 401(k) version of robbing Peter (plan sponsors and participants) to pay Paul (the TPA).

With fee disclosure being required by retirement plan providers to plan sponsors and then eventual disclosure from plan sponsors to plan participants, many plan sponsors and participants will suffer from sticker shock. They will have the opportunity to understand their true cost of administration and understand the bottom line. With fee transparency in the retirement plan industry, index funds will certainly get a bigger foothold in the marketplace because plan sponsors will finally understand that actively managed funds are more expensive to administer than index funds. Add this to the fact that actively managed funds fail to meet their benchmarks 80% of the time; it will be a 1-2 punch for the marketing of index funds and the financial advisors that promote them.



It should be noted that not all index funds are created equal. Fund companies like Dimensional Fund Advisors and Vanguard have made low fees part of their index fund repertoire. There are index funds being marketed with expense ratios as high as .95%. Some even charge as much as 2% as a front load charge. Index funds with high expense ratios are worse than any actively managed fund because they are guaranteed to always fail to meet the benchmark while actively managed funds have a chance to beat them. Plan sponsors and financial advisors that decide index funds for their 401(k) plans should choose low expense index funds such as the offerings from Dimensional and Vanguard.

The purpose of this article is not supposed to be a firing shot in the active vs. passive debate on investing. That argument will go on as long as the chicken vs. the egg debate. Adding index funds to a 401(k) plan doesn't have to be part of the debate because it doesn't have to be all or nothing. Plan sponsors don't have to only use index funds or only use active funds; they can simply ad d a few index funds to a fund lineup dominated by actively managed funds. Choice is a good thing and allowing plan participants to have at least one or two low costs index funds at a minimum is a good idea.

Index funds will certainly get bigger traction in 401(k) plans because fee transparency will eliminate the illusion that actively managed funds help cut down plan expenses through revenue sharing. Plan sponsors have the fiduciary duty of prudence and that duty requires plan sponsors to pay only reasonable plan expenses. One part of paying only reasonable expense could be the addition by plan sponsors of low fee index funds to their 401(k) fund lineup.

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