

Debunking the Myth that ETFs Have No Place in 401(k)s

by Darwin K Abrahamson

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The authors of the white paper, *Why ETFs And 401(k)s Will Never Match*, Gregory Kasten, President Unified Trust Co., N.A., and David Blanchett, Internal Consultant Unified Trust Co., purport to explore the benefits and costs associated with using exchange-traded funds (ETFs) in 401(k)s. The authors also give a veiled attempt at providing guidance as to whether ETFs represent a better indexing option than traditional index mutual funds.



Technology

Unfortunately, instead of basing their analysis on facts, the paper relies on the myth that the technology required to add ETFs to 401(k) plans has not been developed.

For the past decade, the entire financial industry has lamented that ETFs cannot be added to 401(k) plans due to the prohibitive cost of trading ETFs on the open market throughout the day, and the industry's inability to record-keep ETFs in 401(k) plans. If the authors had fully researched these challenges, they would have discovered that Invest n Retire, LLC, (INR), a record-keeping firm in Portland, Ore., has been trading and record-keeping ETFs in 401(k) plans, on a cost-effective basis, for over five years.

Prior to the publication of their white paper, neither David nor Gregory gave me a call to discuss our platform. In fact, INR has a patent pending on its technology for trading and record-keeping ETFs in 401(k) plans.

In their conclusion David and Gregory state: *"Given current technology, the cost savings from ETFs in 401(k) plans appear to be minimal. ..."*

Debunking the Myth

Debunking the myth that the technology necessary to trade and record-keep ETFs has not been developed requires a re-examination of Blanchett and Kasten's white paper. In their conclusion they further give the impression that even if the technology were available, the cost of trading ETFs would remain as an insurmountable obstacle to adding ETFs to 401(k) plans.

"...While the expense ratios for ETFs may be less than their respective indexed mutual fund peers, this lower cost is materially eroded by the explicit and implicit costs associated with making the ETFs 401(k)-ready. In fact, it is likely that an ETF 401(k) strategy would end up being more expensive than a mutual fund strategy after all the costs are considered."

Transaction Costs

To support their conclusion they present an argument that ETFs should be avoided due to transaction costs in the form of a bid/ask spread and commissions. *“There are two primary transaction costs associated with purchasing an ETF, the first cost is the bid/ask spread (spread) and the second cost is commissions.”*

True, ETFs do incur a cost in the form of a spread when an ETF is bought or sold on the open market. What Blanchett and Kasten fail to mention is that the stocks and bonds, which are the investment components of mutual funds, are also bought and sold on the open market.

This oversight demonstrates that their theories are flawed by their preconceived beliefs. In case you miss my point, let me be very clear. The white paper includes misleading information regarding the cost of purchasing and selling mutual funds. *“Commissions, similar to the bid/ask spread, are a cost paid each time an ETF is bought or sold, since unlike mutual funds, ETFs cannot be redeemed at NAV and must be purchased on the open market.”*

Invisible Costs

Mutual funds buy and sell thousands of shares a day on the open market. Each mutual fund transaction also includes commissions, as well as spreads. In a white paper commissioned by The Zero Alpha Group (ZAG), *Mutual Fund Brokerage Commissions*, the researchers examined the magnitude of brokerage commissions paid by mutual funds and concluded that brokerage commissions are significant, averaging 27 basis points.

In 1994 John Bogle, Founder of The Vanguard Group, coined the term, *invisible costs*, in reference to the high costs of trading shares in a mutual fund.¹ Bogle was referring to the fund's expenditures for trading the securities in the portfolio. In contrast to fund fees, which are reported as the expense ratio, trading costs within a mutual fund are invisible because they are not included in the expense ratio which makes them difficult to assess.

In the white paper, *An Analysis of Mutual Fund Trading Costs*, by John Chalmers, Roger Edelen and Gregory, the researchers directly estimated the annual trading costs for a sample of equity mutual funds and found that trading costs are large and exhibit substantial cross sectional variation. Abstract: *Trading costs average 0.78% of fund assets per year and have an inter-quartile range of 0.59%. Trading costs, like expense ratios, are negatively related to fund returns and we find no evidence that on average trading costs are recovered in higher gross fund returns. ...”*²

Using data from Morningstar Principia, the researchers of the paper, *Mutual Fund Brokerage Commissions*, illustrate that the Fidelity Growth Co fund had an estimated total cost of 1.2259% after adding the implicit trading and commission costs (explicit expense ratio 0.85 plus, the implicit trading cost which includes the trading cost for the securities within the fund based on turnover with an expense ratio of 0.2484 and commission cost of 0.1275).³

Empirically, the researchers make it clear that mutual funds pay trading costs for the securities traded within the fund and those costs are substantial.

Index Funds vs ETFs

Blanchett and Kasten also attempt to make a case that choosing a more costly index fund makes more sense than choosing a lower cost ETF since they wish their readers to conclude, from their research, that index funds are a lower cost option once you add the expense of trading the ETF.

“In the aggregate, since the expense ratio differences between the ETF and mutual fund strategies were so small (at most, 14 bps for Investor-share classes), it is unlikely that any material benefits are going to be obtained from unitizing an ETF, once considering all the costs (both explicit and implicit).”

Again, Blanchett and Kasten fail to mention the implicit trading and commission costs within the index mutual fund. However, the white paper, *Mutual Fund Brokerage Commissions*, debunks the myth that index funds are free of trading and commissions costs.

Using the Vanguard 500 Index as its example, the paper illustrates that the fund’s estimated total cost is .2155% (explicit expense ratio of 0.18; plus, the implicit trading cost which includes the trading cost for the securities within the fund based on turnover with an expense ratio of 0.0324 and commission cost of 0.0031).⁴

When you consider the fact that an ETF receives shares in-kind—that is, the securities within the ETF are not traded on the open market unlike traditional mutual funds—the implicit trading costs of ETFs are actually lower than traditional mutual funds. For example, Vanguard Large Cap ETF has an expense ratio of .07% and .000% in trading cost for receipt of shares in-kind within the ETF.

Revenue Sharing

Blanchett and Kasten even defend the practice of revenue sharing and attempt to illustrate that by paying a higher fee for a traditional mutual fund, a plan will actually reduce its costs if the revenue sharing fee is used to pay plan expenses.

Blanchett and Kasten rationalize, *“If the revenue share monies from mutual funds are returned to the plan to offset fees ... revenue share can actually decrease the total net cost of the mutual fund. In some cases, this can make an index mutual fund that has a higher expense ratio than an ETF actually be less expensive than the ETF.”*

In my view, that is the most preposterous justification for including investment options which pay revenue sharing. In my opinion, relying on revenue sharing fees to pay plan expenses only encourages a lack of scrutiny of the fees being charged and who’s getting paid. Case in point, how many times have you heard a plan sponsor say the plan doesn’t cost us anything – it's free?

It is interesting to note that Unified Trust discloses on its WEB site (60/40 Asset Allocation Newsletter 10/31/06) that Unified charges a fee for revenue [sharing] collection.⁵

In an article, *The Legality of Kickbacks: How 401(k) Vendors are Paid on the Eve of SEC and DOL Investigations*, another employee of Unified Trust, Pete Swisher, Vice President and Senior Institutional Consultant, stated, *“Kickbacks is ... an unfair term since it suggests that revenue sharing payments are somehow illegal or unethical when in fact they are a perfectly reasonable*

practice. ...payments typically take the form of rebates of fund expense ratios in amounts ranging from .25% to .50%, though the full range is more like 0 to 1.00%.”

Mr. Swisher does admit that revenue sharing can be used for good or evil. *“In a perfect world, revenue sharing would simply be a number subtracted from expense ratios to determine the true cost of money management. A fund costing 1% but refunding .50% is still more expensive than a fund costing .40% and refunding none. ...net cost is the number to target when evaluating fund and plan expenses.”*⁶

Conclusion

In another white paper, *Revenue Sharing Aspects of Qualified Retirement Plan Management*, Kasten states, *“The practice of revenue sharing in the retirement and investment management businesses is here to stay.”*

I guess this helps us understand why both Blanchett and Kasten believe high cost mutual funds are appropriate investment vehicles for 401(k) plan participants.

Darwin Abrahamson is the CEO of Invest n Retire LLC, Portland, Ore. He can be reached at darwin@investnretire.com Published in the **Journal of Indexes** September/October 2008

¹ An interview with John Bogle in “Volume-weighted Trading Costs and Mutual Fund Performance,” Roger M. Edelen, Echo Investment Advisors; Richard Evans, Boston College; Gregory B. Kadlec, Virginia Polytechnic Institute & State University - Pamplin College of Business, November 16, 2006.

² “An Analysis of Mutual Fund Trading Costs,” John M.R. Chalmers, University of Oregon; Roger M. Edelen, University of California, Davis – Graduate School of Management; Gregory B. Kadlec, Virginia Polytechnic Institute & State University - Pamplin College of Business, November 1999.

³ Mutual Fund Brokerage Commissions, Jason Karceski, University of Florida, Miles Livingston, University of Florida; Edward S. O’Neal, Babcock Graduate School of Management - Wake Forest University, January 2004.

⁴ Ibid.

⁵ Unified Trust passes through 100 percent of all revenue-sharing payments received to the Plan, less a trading fee cost for fund trading and revenue collection, but cannot guarantee what amounts, if any, will be collected. The trading fee is a charge levied by SunGard STN and passed through to the plan by Unified Trust to offset trading and revenue collection costs.

⁶ “The Legality of Kickbacks: How 401(k) Vendors are Paid on the Eve of SEC and DOL Investigations,” Pete Swisher, CFP, vice president and senior institutional consultant, Unified Trust Company, N.A., July 2004.