Utilization of ETFs in 401(k) Plan Line-ups

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INTRODUCTION

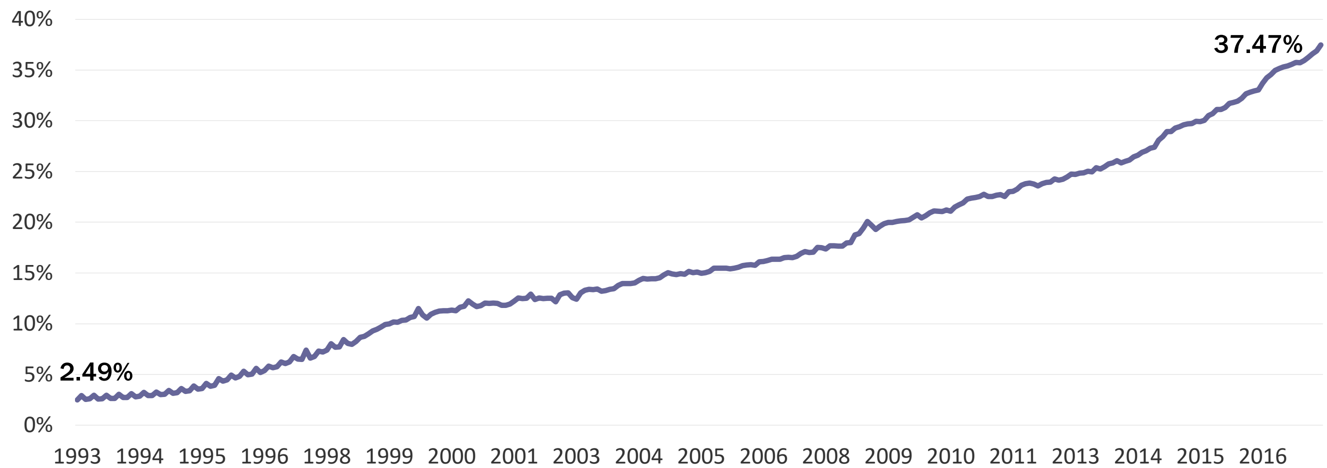
The current focus on low-cost investments in qualified retirement plans is nothing new. In 2012, after the DOL released final 408(b)(2) regulations, plan sponsors and fiduciary advisors put increased emphasis on monitoring, benchmarking and adequately disclosing plan fees and expenses. With the June 9, 2017 applicability date of the DOL's new fiduciary rule, attention on plan fees and expenses has only intensified. The March 2018 decision by the Fifth Circuit Court of Appeals to vacate the fiduciary rule introduces questions about the rule's future, but by focusing attention on conflicts of interest and unnecessary costs, the rule will have a lasting impact, regardless of its legal status.

Given the need for plan sponsors to prudently assess and monitor plan fees and be fully transparent in sharing costs with participants, it probably comes as no surprise that low cost mutual funds, collective investment trusts (CITs) and separately managed accounts are seeing increased popularity. What may come as a surprise, however, is that widely popular and low-cost exchange traded funds (ETFs) have not garnered more shelf space in qualified retirement plans menus.

In this paper, we will explore some of the reasons why ETFs are not widely utilized in defined contribution (DC) plan menus today. We will also explain why ETFs' DC representation may stand to growth indirectly going forward, through their inclusion as components of asset allocation strategies, where they can offer efficient and specific asset class exposure.

The Rise of Passive Strategies
Passive investments have been steadily gaining market share among investors since 1993 (see Figure 1 below). The popularity of passive funds has been driven by an increased awareness of the importance of low fees and the reality that actively managed funds, particularly in certain asset categories, have struggled to consistently outperform their benchmarks in recent years.

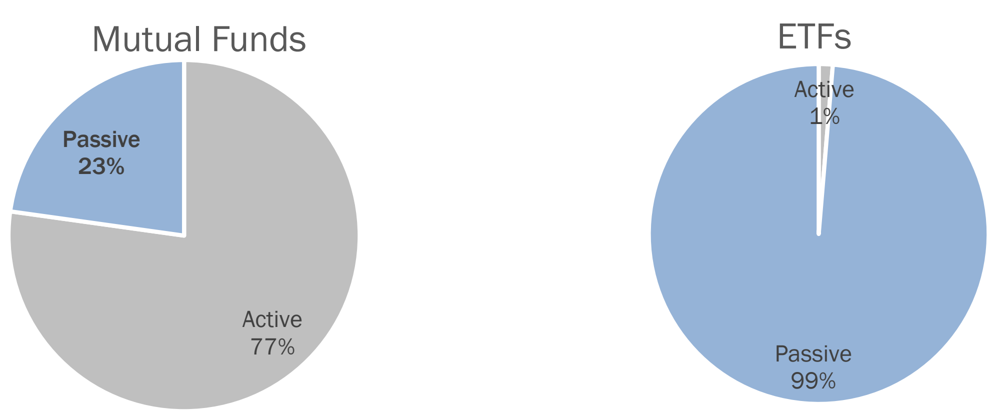
Figure 1 - Passive Proportion of US ETF & Mutual Fund Marketplace, excluding Money Market Funds, Funds of Funds, and Obsolete Funds



Source: Morningstar Direct

Because investors have overwhelmingly used ETFs as a passive investment vehicle over the years (see Figure 2 below), they have benefited from the move toward passive management to a greater degree than mutual funds, which are predominantly active in nature. Between 1998 and 2018, ETFs grew from $6 billion in total assets to $3.65 trillion, a 60,000% increase![1]

Figure 2 - Proportional Breakdown of Respective Markets between Active and Passive Strategies



Source: Morningstar Direct

[1] Morningstar Direct

The number of ETFs has also risen in line with their popularity. As of February 2018, there were 2,186 U.S. ETFs, which is up from 1,008 just 10 years ago[22]. However, there are not many plans that use ETFs as part of their core investment line-ups. Why?

What is Holding ETFs Back?
It is interesting that ETFs, although widely popular amongst retail investors, have seen little to no penetration in the qualified plan space. We note that there are a few significant headwinds that may account for the absence of ETFs in plan investment menus:

1. the legal structure of ETFs
2. current recordkeeping limitations
3. competition from increasingly low cost mutual funds and CITs

ETFs are marketable securities, similar to index mutual funds. However, unlike mutual funds, ETFs trade like shares of stock on a stock exchange. As such, ETFs experience price changes throughout the day as they are bought and sold on the secondary market. ETFs have been available in the United States since 1993 and in Europe since 1999. As previously stated, they have traditionally been (and mostly remain) passively managed, although in 2008 the U.S. Securities and Exchange Commission began to authorize the creation of actively managed ETFs[3].

ETF distributors buy or sell ETFs directly from or to Authorized Participants (APs) – large broker dealers with whom they have entered into agreements – and then only in creation units. Only APs can create or redeem creation units of an ETF. Other investors trade ETF shares in the secondary market.

Creation units are formed through a process whereby the AP assembles a portfolio of underlying assets and turns that basket of securities over to the fund in exchange for newly created ETF shares. For redemptions, the AP returns ETF shares to the fund and receives the basket consisting of the underlying securities. Each day, the fund’s underlying portfolio is disclosed to the public.

Given their structural cost benefits, why aren’t ETFs more prevalent in a DC plan environment? To answer this question, it may be helpful to review the benefits that individual investors find appealing in ETFs, and assess whether these benefits are equally appealing to DC investors.

ETFs are commonly used by professional investors or speculators to obtain exposure to specific sectors of the market. These sector-specific ETFs are occasionally used in pensions, endowments, and managed account programs but may not be considered appropriate or desirable for participant use in a DC plan.

Here are a few examples of widely traded ETFs:

- Broad equity index ETFs:
  - SPDR (pronounced “spider”) S&P 500 ETF, which trades under the ticker SPY
  - iShares Russell 2000 ETF, which trades under IWM
  - PowerShares QQQ ETF, which tracks the Nasdaq 100 and trades under QQQ
  - SPDR Dow Jones Industrial Average ETF, which trades under DIA
- Sector ETFs:
  - VanEck Vectors Oil Services ETF, which trades under OIH
  - Energy Select Sector SPDR ETF, which trades under XLE
  - Financial Select Sector SPDR ETF, which trades under XLF
  - iShares US Real Estate ETF, which trades under IYR
  - VanEck Vectors Biotech ETF, which trades under BBH
  - United States Oil, which trades under USO
  - SPDR Gold Shares, which trades under GLD
  - iShares Silver Trust, which trades under SLV
  - United States Natural Gas, which trades under UNG

ETFs are broadly popular with individual investors because they trade intraday without minimum investment thresholds and are compatible with short selling (selling a borrowed security) and margin trading (borrowing money to purchase securities). These speculative trading practices do not translate well into the qualified plan space, where the emphasis in on prudent,

[2] Retrieved from http://advisor.morningstar.com/Principia/pdf/ETFAssetAllocation.pdf
[3] http://www.sec.gov/rules/proposed/2008/33-8901fr.pdf, SEC Release Nos. 33-8901, IC-28193, 73 Fed. Reg. 14618 (March 11, 2008)

long-term investing. Minimum investment thresholds are generally less of a concern for DC plans, which frequently benefit from omnibus trading at the record keeper level. Intraday trading is also less desirable for DC plans, as plan participants typically trade less frequently than retail investors.

Another feature of ETFs that appeals to individual investors is the potential for tax efficiency, since capital gains from sales inside the fund are not passed through to shareholders. Of course, this advantage does not benefit assets held in tax-deferred retirement plans.

It should also be noted that not all ETF attributes are favorable. The fact that they are traded on the secondary market means that their trading price can vary from the underlying net asset value (NAV) and benchmark index. ETFs have been subject to two different "Flash Crashes" (the first in 2010 and the second in 2015) in which ETF prices rapidly declined and trading volumes spiked. ETFs are also subject to potential regulatory risk from the Financial Stability Board (FSB) and International Monetary Fund (IMF).

Recordkeeping Limitations

Another significant headwind to the utilization of ETFs in DC plans pertains to record keeping platform limitations that have yet to be broadly solved. The vast majority of the $6 trillion in DC plan assets in the U.S are administered on recordkeeping systems that are 30 or more years old and which are incapable of accounting for investments that may be traded more than once per day.[4] Conversely, the legacy systems are designed to track fractional shares of underlying funds at both the plan and participant level, while ETFs trade only in whole shares. Without special workarounds, ETF options require recordkeeping systems to truncate trades to the nearest whole ETF share, and track the residual as uninvested cash. Constraints inherent in these legacy recordkeeping systems effectively restricts many platforms to offering only NAV-based investments that can trade in fractional share increments, such as mutual funds or CITs.

While the aforementioned restrictions are the norm in the industry, there are some notable exceptions. ETFs are offered as standalone funds in the Vanguard Retirement Plan Access Program, which caters to small plans with assets of less than $20 million. Charles Schwab can offer an all-ETF 401(k) plan lineup, as can TD Ameritrade. Providers such as John Hancock, Principal Financial Group, Wells Fargo, and Milliman, among others, offer various ETF solutions in the 401(k) space with specific conditions. ETFs are available through some participant-directed brokerage accounts as well. Generally, offering ETFs as a designated investment option requires some form of workaround, such as embedding the ETF within a pooled investment structure such as a CIT, or unitizing the ETF at the platform level to minimize fractional share issues. Consequently, most retirement plan ETF options have slight performance variances relative to their directly invested counterparts.

The Competition

The single biggest advantage that ETFs have historically offered to individual investors is their low cost structure. However, in recent years, mutual fund expense ratios have come down dramatically, so much so that ETFs have lost their cost advantage in many cases. While CITs and SMAs are ineligible for use across all plan types (e.g. 403(b) plans), they too can offer pricing that is frequently as low as or less than that of ETFs. Given that many of the alternatives to ETFs are equally inexpensive and may suffer fewer recordkeeping platform incompatibilities, it comes as no surprise that ETFs have found few opportunities inside a core DC plan fund menu.

Conclusion

In conclusion, many of the features that make ETFs attractive to individual investors – intraday trading, short selling, buying on margin, tax efficiency – are neither appealing nor applicable to long-term, tax-deferred savings plans. Furthermore, the cost advantages that have historically been associated with ETFs have dissipated in recent years as investment costs for institutional products like mutual funds and CITs have come down. Finally, legacy record keeping platforms are predominantly optimized toward end-of-day NAV mutual fund or CIT investment options, which limits the platform opportunity set through which to offer ETFs as standalone investment options.

Nevertheless, ETFs are inexpensive and can offer targeted asset class, commodity, sector, and even industry exposure, which may be appealing for endowments, foundations, and defined benefit plans. In a DC plan context, ETFs have thus far gained traction indirectly as building blocks for professionally managed portfolio solutions, such as off-the-shelf target date funds and managed accounts. To the extent these types of solutions are utilized by plans, sponsors may consider whether or not it would be beneficial to incorporate ETFs into the portfolio or menu. Lastly, as it relates to ETFs use as standalone options in core fund menus, it should be noted that while structural and record keeping system limitations have hindered ETFs market share growth in defined contribution retirement plans, technological development and innovations are beginning to address many of these constraints. Decisions reached today may no longer apply in the near future.

[4] https://www.ici.org/pdf/ppr 14 rec survey q1.pdf

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