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More Index Funds Sought for 401(k)s

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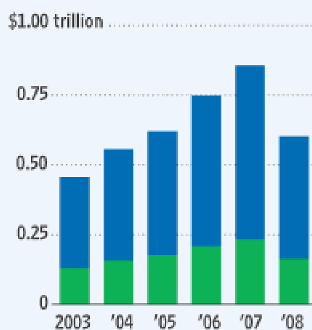
Employers are making it easier for workers in 401(k)s to own low-cost index funds and exchange-traded funds, a move that has implications for the mutual-fund industry.

As it stands, roughly 90% of the $1.5 trillion in 401(k) and other defined-contribution assets in mutual funds are in actively managed offerings. This is the case despite clear evidence from studies that index funds tend to outperform their actively managed rivals.

The stodgy 401(k) world won't change strategies overnight. Fund companies won't easily relinquish their active-management fees, which tend to be higher than those charged on index-tracking products, especially at a time when rocky markets are pinching profits. And actively managed funds tend to do more "revenue sharing," which involves fund companies making payments to plan administrators.



While total index mutual-fund assets jumped 84% over the past six years, the funds grew at a substantially slower pace inside defined-contribution plans.

Still, some big players are betting that the stars will begin realigning.

Money manager BlackRock Inc., known largely for its actively managed products, last month stressed the potential for index funds' growth in retirement plans in announcing its acquisition of indexing giant Barclays Global Investors. BGI is among several firms that recently launched 401(k) programs designed to make it easier for employers to add index-tracking ETFs to their plans.

Ascensus Inc., a large 401(k) recordkeeper, says it has received inquiries from more than 100 employers since adding ETFs to its platform in May.

In a recent survey of about 150 employers by consulting firm Hewitt Associates, 17% of them said they are likely this year to replace some or all of their plan's actively managed investment options with index funds. That is up from 8% a year earlier.

While the largest employers have long had access to the lowest-cost index funds, many small and midsize plans, which have typically been sold pricier funds, are now demanding passively managed products, too.

Service organization Rotary International, for example, last year added more index funds to its $15 million 401(k), helping to reduce plan costs, while Fremont, Calif.-based Accept Software Corp. in recent weeks dumped actively managed funds completely from its $1.5 million plan.

Some smaller plans that don't have the purchasing power to access the lowest-cost index funds on their own are banding together in multiple-employer plans that take a passive approach.

The Hawaii Prosperity Plan is one such index-based multiple-employer plan started earlier this year; it was co-founded by a former active fund manager, Cris Borden, who acknowledges that his own fund trailed its benchmark and says he is now "reformed."

All this occurs as regulators and plan participants take a hard look at 401(k) fees. Poor recent performance by active stock-pickers has forced employers to ask what value their workers are getting from these higher-priced funds.

In a spate of recent lawsuits, workers have claimed their 401(k) plans charged excessive fees and offered actively managed funds that failed to beat cheaper index-tracking alternatives. And a bill working its way through Congress would require clear disclosure of 401(k) fees and effectively mandate that plans offer at least one index fund.

But even including nonmutual-fund 401(k) investment options, such as collective investment funds, growth of indexing strategies in the plans has been relatively modest. Further, total indexed 401(k) assets declined substantially last year as workers fled to stable-value and money-market funds, retirement experts say.

A longer-term factor slowing 401(k) acceptance of index funds is "revenue sharing," experts say. In revenue-sharing arrangements, plan administrative costs are often built into the expenses of funds offered in the plan.

To avoid breaking out these administrative fees separately, which might prompt employers to more closely examine plan costs, plan advisers tend to promote the use of funds -- often actively managed -- that have plenty of revenue sharing to cover all these costs, critics say.

"Obscurity allows fees to stay higher for longer," says Ryan Alfred, the president of 401(k) data and analytics firm Brightscope.

Many retirement-plan experts are hoping the 401(k) fee disclosure bill recently approved by the House Education and Labor Committee will help remedy that. The bill would require plan fees to be broken out into separate categories for administrative, investment management, transaction and other expenses.

With such fee disclosure, employers and employees may well discover that index funds will deliver better returns at a lower cost, says the committee's chairman, Rep. George Miller, a California Democrat. As workers struggle to save, their nest eggs "should not just be the happy hunting grounds for fees and commissions," he says.

The fund industry criticizes the bill, saying the disclosure required would be confusing to participants and costly to prepare and that the government shouldn't be mandating investment options for 401(k) plans.

Ironically, the steep market slide, which spurred many employers to consider index funds for their 401(k)s, also has made some employers reluctant to jostle participants with investment-menu makeovers.

Abrix Group LP, a health-care accounting firm, wanted to shift its 401(k) to a passive approach but didn't want participants temporarily barred from making investment changes -- a typical side effect of a plan makeover -- while stocks were in free fall last year. Now that markets have stabilized somewhat, the plan is switching to a 100% index-fund-and-ETF lineup.

While plenty of obstacles remain, those who have long fought to expand 401(k) plans' use of index funds are relishing some newfound success. Invest n Retire LLC, a 401(k) service provider that started offering ETF-based plans in 2003, managed to attract only about $50 million in assets through the end of last year. But this year, assets are on pace to rise at least tenfold, says Chief Executive Darwin Abrahamson.

Matthew Hutcheson, an independent pension fiduciary, says in the past three months he has met no resistance as he converted three plans to a 100% indexing approach. That is a big change from years past, he says, when he would propose that plans switch to index funds and “people would scream bloody murder.”

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