ETF Focus

Retiring on ETFs

By Lawrence Carrel
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A LOW-COST RETIREMENT plan built exclusively around exchange-traded funds is offering the little guys a new and potentially lucrative way to save.

ShareBuilder launched the first Roth 401(k) based solely on ETFs on July 1. The Seattle-based online brokerage is targeting the plan at self-employed workers and employees of small businesses — niches that it says are woefully underserved by traditional retirement-plan providers.

"There are 11.9 million small businesses with less than 100 employees in the U.S.," says Stephan Roche, general manager of ShareBuilder's small-business group. "Only 15% have a retirement plan, and of those, only 3% have a 401(k) plan."

Roth 401(k)s, which have only been around since Jan. 1, are a twist on the traditional employer-sponsored retirement plan. Unlike the classic 401(k), in which a portion of pretax wages are deposited into an employee's retirement account, savings put into a Roth 401(k) are taxed immediately. While Roth 401(k) workers feel the pinch now, they can benefit at retirement because withdrawals are tax-free — even on the profits that accrue. Roth 401(k)s have the added advantage of no income limitations, unlike Roth IRAs, which aren't available to high-income earners. (For more on IRAs and 401(k)s, visit SmartMoney.com's Retirement Center.)

That's not to say a Roth 401(k) is right for everyone. Workers near retirement and those who expect to pay a lower tax rate in their golden years are usually better off with a classic 401(k). Younger workers who expect to earn more in later years, and thus pay a higher tax rate, should benefit from a Roth the most. But even people with more than 10 years to retirement and those who expect tax rates to rise might see benefits from investing in a Roth 401(k).

Last month, a survey from human resources consulting firm Hewitt Associates reported that 14% of participants in their 20s elected the Roth 401(k) when it was offered. Of employees newly enrolling in a 401(k) plan, 24.7% of them chose the Roth option.

ShareBuilder isn't the first provider of retirement-savings plans to add Roth 401(k)s to its roster, but it is the only provider to specialize in ETFs. Its plans, which went on sale July 1, are expected to go live on Oct. 1. Including the regular 401(k) plans launched last October that also focus on ETFs, industry sources estimate that ShareBuilder has sold 100 plans with $100 million in total assets. About 10% of those are Roth 401(k) plans. ShareBuilder declined to confirm those figures.

ShareBuilder decided to base its 401(k) retirement-saving plans, both Roth and traditional, around ETFs because of their low expenses. That helps keep overall costs down. ShareBuilder doesn't charge commissions on purchases and sales within the plans, but it does charge self-employed individuals $195 to set up an account. Small businesses with fewer than 50 employees pay $995 to set up a plan, regardless of the number of employees. For administration and record keeping, individuals pay $15 a month, or $180 annually. Considering an individual can only put in a maximum of $15,000 a year into a 401(k), $180 would be a 1.2% expense ratio. It seems steep. But the monthly fee doesn't change. So if an account has $45,000 after three years, then the expense ratio falls to 0.4%. Fees for administration and record keeping get progressively higher for small businesses, but top out at $200 a month for businesses with more than 50 employees.

Investors also pay the expense ratio for the 16 ETFs that ShareBuilder offers, but none is higher than 0.21%. On top of that, investors pay ShareBuilder a fee of 0.65% for portfolio selection. Together those fees should never top 0.86%. ETFs in the plan include **SPDR Trust** (SPY: **131.67**, +1.26, +1.0%), **Diamonds Trust** (DIA: **115.02**, +1.06, +0.9%), **iShares Russell 2000 Index** (IWM: **72.15**, +1.67, +2.4%) and **iShares MSCI Emerging Markets Index** (EEM: **95.55**, +1.54, +1.6%).

Fidelity Investments, the largest provider of workplace retirement plans, also offers 401(k) plans to self-employed individuals and small businesses. It doesn't offer Roth 401(k)s to the self-employed, however, and none of the plans has ETFs. However, some plans are set up with a self-directed brokerage window, in which plan participants are allowed to buy stocks and ETFs of their choosing. Fidelity doesn't charge set-up or monthly fees. However, it does charge brokerage commissions on stocks and ETFs and many of its funds have expense ratios higher than the 0.85% that ShareBuilder charges. For the entire mutual-fund industry, the average expense ratio for domestic equity funds is 1.4%, with international funds charging an average of 1.9%.

ShareBuilder's Roche says 60% of all small-business 401(k) plans are actually group variable annuities, which can add as much as an additional 4% on top of the management fees. **ING** (ING: **42.83**, +0.75, +1.8%) and **Nationwide Financial Services** (NFS: **47.91**, +0.40, +0.8%) among others offer these types of group variable annuities to small businesses. ING's average expense ratio is 1.3%.

Invest n Retire is one of the first to create 401(k) plans based on ETFs. However, the Portland, Ore., company requires a business to have $3 million in invested assets to open an account, while ShareBuilder doesn't have a minimum.

"We are working with larger plans than they work with. They are servicing a niche we don't service at all," says Darwin Abrahamson, chief executive of Invest n Retire. "ShareBuilder is a good solution for small start-up plans."