SMALL BUSINESS REVIEW Resources for Successful Small Business Owners

Using Exchange-Traded Funds to Cut 401(k) Cost

ETFs have low expense ratios and come in more than 300 flavors

By Erin Schulte **October 27, 2006**

As CFO of Bashaw Construction Co. in Oklahoma City, Dustin Bashaw saw the financial upside to offering retirement benefits to the company's 40 employees.

"We're small, so it's hard to offer lots of benefits to employees. I wanted something to help retain employees, because we spend a lot of money and time on training," says Bashaw. But it's not just about turnover: "I really want the people who work for us-— including myself -- to be able to retire with ease," he says.

As Bashaw set out to find the right plan, his accountant warned him of the high costs. As he collected information from traditional mutual-fund 401(k) providers, he found that his accountant was right. "I was concerned about how much they were going to take for maintaining the employees' accounts, and mutual funds fees are just expensive," says Bashaw.

But, like a growing number of individual investors who are tired of paying big fees to mutual-fund money managers who can't beat their benchmark indices, Bashaw has discovered an alternative in low-cost exchange-traded funds (ETFs).

The average cost for management fees (known as the expense ratio) for ETFs stands at 0.42%, compared with 1.34% for traditional mutual funds.

Bashaw went with Sharebuilder's online, small-business 401(k) offering, which uses portfolios of ETFs. Sharebuilder is among a handful of companies now offering ETF-based 401(k)s. Stephan Roche, vice president of the small business group and business development for Sharebuilder, notes that of the 40 million employees who work for small businesses, some 26 million have no access to a company-sponsored retirement plan. For companies with fewer than 100 employees, only a third of employees have retirement plans. And the smaller the company, the less likely it is that employees will have access to or use a plan.

Because ETFs are passively managed baskets of securities, costs are significantly lower than in mutual funds, which hire highly paid managers and research staffs to pick investments and make frequent trades. But thanks to the exploding popularity of ETFs, there are now scores of variations that match mutual-fund styles, including growth, value, small cap, large cap, emerging markets, etc. There are indexes that track fixed-income investments (bonds), commodities, and market sectors and subsectors, such as homebuilders and utilities. (ETFs should not be confused with index mutual funds such as those that track the S&P 500 stock index or the Russell 2000, which are offered by many retirement plans and are based on well-known securities indices, but are more expensive in part due to record-keeping costs.)

How much cheaper are ETF-based retirement plans? For a 10-employee company with no current 401(k) plan, Sharebuilder charges a one-time $495 set-up fee, a monthly administration fee of $95, and an asset-based fee of 0.75%. According to a Sharebuilder, the average costs for a similar 401(k) plan from a mutual-fund vendor would include a $1,350 setup fee, a $270 monthly administration fee, and a 1.69% asset-based fee.

Sharebuilder says it is the only U.S. company marketing ETF-based 401(k) products directly to small businesses, though a number of other companies reach out to small business owners through financial advisors. Sharebuilder offers investors five model portfolios based on time horizons and risk tolerance; alternately, investors can pick and choose from among the 16 individual ETFs Sharebuilder offers.

Fred Barstein, CEO of 401(k) Exchange, says there are structural problems that crop up with regard to ETFs' use in 401(k)s – namely, that existing 401(k) record-keeping systems aren't set up to track intraday trades. Retirement-plan record-keeping systems are designed for mutual funds, for which net asset values are set once a day. He says he is also concerned about inexperienced investors cobbling together their own retirement funds out of ETFs.

Sharebuilder's Roche says his company bundles trades to keep costs low, which also sidesteps the record-keeping dilemma with regard to trading. "Being able to buy and sell ETFs during the day is great, but in a 401(k) that is not typically necessary: These are long-term investments," he says. In addition, portfolios are automatically rebalanced quarterly to reflect market changes

Barstein concedes that ETFs' low price tags make them an appealing investment. "With ETFs, you don't have to pay someone to actively manage the fund. And how many active managers actually beat the market? Not many." he says.

Invest n Retire, another company offering ETF-based 401(k) plans, targets slightly larger businesses that already have 401(k) plans in place; its minimum account size is $3 million. Advisors work with plan sponsors and participants to develop portfolios for clients through a calculator that each participant uses to decide how much money they want to sock away each month.

The Portland, Ore.-based company also stresses cost-effectiveness. For instance, the company cites the example of a company that switched to the Invest n Retire ETF system and saw its annual fees drop from $636,000 to $373,000 to maintain its $83 million plan. Darwin Abrahamson, CEO of the company, says fees range from 0.2% points to 0.4%, depending on the size of the plan.

Abrahamson says that the calculator his company built makes it easy for employees to create an appropriate ETF portfolio. "We have a simple calculator that all participants use – they tell us what age they want to retire, what percentage of their income they'd like to have, and from there we back into how much they need to contribute; we have had unbelievable results in increasing contribution rates," he says. Plans at Invest n Retire average a 94% participation rate, according to the company.

Increasing participation in retirement plans is an important priority both for small businesses—which can save money by getting more workers in the plan—but perhaps also for the country, say ETF vendors. "The retirement crisis is far worse than has been communicated by the government or the press," says Roche, "and small business has been totally ignored in this debate."