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HELPING FINANCIAL ADVISORS HELP THEIR CLIENTS

ANALYSIS

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The ETF(k) Option:

PUTTING ETFs INTO THE RETIREMENT RECIPE FOR 401(k) PLANS

One company that's successfully employed ETFs inside collective trusts is ValMark Advisers; the Akron, Ohio-based investment firm has amassed \$750 million inside ten trusts.

Detractors claim that ETFs have no business inside 401(k) plans, but are they right? Will ETFs shake up the slow-moving 401(k) market by lowering fees and offering more diversified investment choices? And which companies are at the forefront of the trend towards ETF(k) plans and how can financial advisors capitalize? Let's analyze these questions.

Trillions Up for Grabs

Defined-contribution (DC) plans such as 401(k) plans, 403(b) plans and profit-sharing plans today are dominated by mutual funds or company stock. At the end of 2008, the latest year for which the industry has figures, employer-sponsored DC plans held \$3.5 trillion in assets, with the largest share in 401(k) plans (\$2.4 trillion in assets), according to the Investment Company Institute. Of that \$3.5 trillion in DC plans, some \$1.5 trillion, or 43 percent, was invested in mutual funds.

Last year investors poured \$118 billion into ETFs, according to Strategic Insight, and total assets in both ETFs and ETNs in the U.S. are projected to reach \$1 trillion by 2012. Just how much ETF(k) plans will contribute to that asset growth is up for debate, but if ETFs are able to force their way into DC plans it could be a huge opportunity.

The actual size of the ETF(k) market is not known. Obtaining industry-wide asset inflow/outflow data is still largely impossible because it would require the participation of all third-party record keepers that offer ETFs, which is a daunting prospect. As the ETF(k) market matures, accurately measuring its asset growth is likely to become more important to key industry players.

Today's DC Market

The 2009 PlanSponsor DC survey, found that just 1 percent of DC plan sponsors — including 401(k) plans, 403(b) plans, Simple IRA plans, etc. — offered ETFs as an investment option for employees. And of those DC plans that offered ETFs, 79 percent had \$50 million in assets or less. In other words, today's ETF(k) market is focused on smaller retirement plans.

Large DC plans with \$500 million in AUM don't typically use ETFs because they're able to get less expensive institutional priced shares. And what can be said about ETFs covering important asset classes like commodities that mutual funds miss? "I think access to less-traditional asset classes and strategies is going to slowly become more important in DC plans, but we're not there yet," says Loren Fox, senior research analyst at Strategic Insight.

Meanwhile, it's the smaller DC plans that are most likely to benefit from the cost advantages of ETFs, because they're too tiny to negotiate institutional pricing on index funds. As a result, BlackRock's iShares has focused its attention on the small and micro DC plan market.

Another reason more DC plans don't offer ETFs is because of operational issues and absent financial incentives on the record-keeping side.

Most DC platforms were built long before ETFs arrived on the investment scene and are thus oriented towards mutual funds. While mutual funds can be traded on these platforms commission-free, the same cannot be said of ETFs. Likewise, next-day settlement for mutual fund trades is standard on these platforms, but three-day settlement with ETFs isn't and neither are partial share investments. Furthermore, since ETFs don't offer revenue sharing like mutual funds, there's a strong disincentive by most record-keepers to dismantle their retirement platforms to embrace ETFs.

Now, let's evaluate the retirement platforms that use ETFs.

Collective Trusts

Similar to mutual funds, collective trusts typically pool assets from multiple clients.

Because they fall under banking regulations, collective trusts are not regulated by the Securities and Exchange Commission and they have fewer reporting requirements compared to mutual funds. Banks, trust companies or money managers are the main users of the collective trust structure.

Among the benefits of collective trusts are fewer regulatory hurdles, investment flexibility and a competitive fee structure.

One company that's successfully employed ETFs inside collective trusts is ValMark Advisers. The Akron, Ohio-based investment firm has amassed \$750 million inside ten trusts. TD Ameritrade serves as the trust provider and ValMark manages the assets. Six of the trusts are risk-based whereas the other four use a target date strategy. Each of the trusts only uses ETFs, with the exception of small cash positions. In addition, ValMark makes its trusts available on eight different custodial platforms. They're listed on NSCC with CUSIPs.

Using ETFs has allowed ValMark to offer its 401(k) clients greater diversification too, by reaching important asset classes like commodities, foreign bonds and international real estate.

"We feel that ETFs allow us to get into important asset classes that other funds don't dare enter. For example, our models include exposure to timber and international real estate," says Michael McClary, ValMark's chief investment officer. He also says that Sherwin Williams became the first Fortune 500 firm to offer ETFs inside their 401(k) plan when they recently added six of ValMark's collective trusts to their menu.

According to McClary, the total all in costs for ValMark's trusts range from 0.47 percent to 0.51 percent. The fees are all-inclusive and they cover the trading costs of the ETFs, the ETF expense ratios, the trustee fee and ValMark's subadvisory fee. Further information about the company's trusts is

at available at TopsPortfolios.com.

Drawbacks with collective trusts are that participants can't roll over collective trust assets into an IRA. They must first convert the account to cash and then roll the proceeds over. Also, participants cannot follow the performance of their assets in the newspaper or on public Web sites as they can with mutual fund investments.

Independent Platforms

Trading ETFs inside 401(k) plans has stretched legacy record-keeping platforms built exclusively for mutual funds to the limit. So instead of trying to fix the problems associated with these one-trick ponies, some companies are by-passing them altogether in favor of more robust solutions.

To that end, Invest n Retire in Portland, Ore., has handcrafted its own proprietary record-keeping system. The company uses ETFs from BlackRock, State Street Global Advisors and Vanguard to build its asset allocation models. It also has patent pending on its system, which allows employees to own whole and fractional shares of ETFs along with self-aligning portfolios.

Invest n Retire is also high on training and education. The company has a training program for financial professionals that helps them to qualify as ERISA 3(38) investment fiduciaries. The 3(38) investment fiduciary has sole legal responsibility for making the investment decisions for the 401(k) plan. According to the company, this alleviates the work of investment management and legal liabilities for 401(k) plan sponsors.

Invest n Retire recently entered into a marketing agreement with Ceredian, a large employee benefits administration specialist to expand its ETF(k) platform.

Hybrid Platforms

While many new breed retirement platforms just offer ETFs, hybrid platforms accommodate mutual funds, collective trusts and other financial products.

"Our platform is built on an open architecture platform that allows for institutional grade asset classes to be made available to the average investor, says Greg Moerchen, CEO of ETF Advisor k. "We are obviously biased towards ETFs since we believe they deliver greater consistency, provide transparency and generally have a lower operating cost when compared to a lot securities offered in retirement plans."

The ETF Advisor k Program was specifically designed as a fee based program to be used by RIAs with full transparency of fees as its utmost concern. RIA fees are negotiated directly with the plan sponsor, independent from the ETF Advisor k Program.

The Advisor k Program accepts start-up 401(k) plans and it uses ETFs from BlackRock, InvescoPowerShares, State Street Global Advisors and Vanguard. The company provides marketing support to advisors with various tutorials available at [ETFAdvisor K.com](http://ETFAdvisorK.com).

Brokerage Accounts

Generally speaking, ETF(k) plans with a brokerage window tend to be used by small businesses with less than ten employees. Unfortunately, the transaction costs of buying and selling ETFs in these types of plans puts them at a strong disadvantage.

But an ongoing battle between brokerage firms could make ETF(k) plans with brokerage accounts a more cost effective solution. Charles Schwab recently made trading in Schwab ETFs commission-free for its brokerage clients. This would open up the door for dollar cost averaging into ETFs without burdensome trading costs. Similarly, Fidelity Investments eliminated commissions for on-line trades on 25 iShares ETFs from BlackRock. Such commission-free trading could accelerate the usage of self-directed brokerage accounts. ●