Betterment Wants to Build a Better 401(k)

By Kerry Pechter *Thu, Jan 28, 2016*

Betterment, the largest independent retail robo-advisor, said Wednesday that it has entered the small company segment of the 401(k) market. But will its model confine it to the shallow end of the pool?

Grandly declaring that the “the era of expensive, impersonal, unguided retirement saving is over,” Jon Stein, the CEO of Betterment, announced yesterday that his New York-based, venture-cap-backed robo-advice company has officially entered the 401(k) business as a full-service small plan provider.

In recent years, several Internet start-ups like **Ubiquity** and **blooom** have tried to build low-cost turnkey 401(k) plans for the tens of thousands of small companies in the U.S. that either have high-cost broker-sold retirement plans or no savings plans at all. Success has been elusive.

As a result, the percentage of full-time U.S. workers without a savings plan at work has remained stuck at about 50%. California and other states have taken steps to fill the vacuum with public defined contribution options, and the Obama administration has urged small employers to offer its “MyRA” workplace IRA. But none of those initiatives has momentum yet.

Now Betterment has stepped into the batter’s box. It puts new participants in managed accounts made up of exchange-traded funds (ETFs), assigning them asset allocations based on their Social Security full retirement ages. The all-in costs are similar to the costs that large plans enjoy: as little as 10 basis points for plans with the most assets under management and up to 60 basis points for plans with the least. (A 30-basis point expense ratio, for instance, generates revenue of $30,000 per $10 million in AUM.)

The 401(k) business is the newest of Betterment’s three business lines. The others are its retail robo-advice business, with 130,000 online customers and $3.2 billion in ETF assets under management, and Betterment Institutional, a version of the Betterment retail platform that advisors can license and brand as their own customer-facing digital advisory channel.

Betterment says it already has about 50 401(k) customers. One of the first was **Boxed**, a privately-held 80-employee firm whose HR director, Elena Krieger, describes it as a “mobile-first e-commerce” company. Founded in 2013, it takes phone-mediated orders for Costco-sized amounts of food and household items and delivers them from its own warehouses to individuals and businesses throughout the lower 48 states. The two companies share a common investor and a fondness for digital disruption.

“There was a cultural fit between us and Betterment. That was what was interesting to Boxed from the get go,” said David Taft, vice president of communications at Boxed. Elena Krieger, the firm’s HR director, said, “Betterment had a similar philosophy. We’re both mobile-first e-commerce.” Boxed had no existing retirement plan, she said. She disagreed with the conventional wisdom that small business owners tend not to bother sponsoring retirement plans unless a highly incentivized broker shows them how much they can reduce their own taxes by doing so.

“I would say its more common than not in companies at our stage of growth to offer a 401(k) plan now,” Krieger told *RIJ*. “The 401(k) is not seen only as a management enrichment tool. The people we hire are asking us, ‘Where’s the 401(k)?”

Homegrown recordkeeping

One of the most difficult aspects of offering a 401(k) plan is the recordkeeping function. The recordkeeper accepts transaction requests, processes and allocates contributions and updates participant records when transactions are settled. It’s a complex, low-margin business that has seen rapid consolidation in recent years, with firms like JP Morgan and New York Life selling their recordkeeping businesses to Great-West and Manulife, respectively.

Recordkeeping grows in complexity when a plan uses revenue-sharing, which bundles the all of the costs of a plan into the expense ratios of the funds. In such cases, the recordkeeper must keep track of “how much money [the plan] keeps and how much money [the fund managers] keep,” said Tom Clark, an ERISA attorney at the Wagner Law Firm who serves on Betterment’s advisory board.

Recordkeepers often find themselves doing that for a multitude of plans sponsors using funds from different asset managers, whose funds may have multiple share classes, each of which might entail different payment terms. “You can imagine how complicated it can get,” Clark (right) added.

Betterment leapfrogs those complexities by not using revenue-sharing in the first place and by offering only ETFs, rather than the mutual funds whose share classes facilitate revenue-sharing. Since revenue-sharing tends to be non-transparent and introduces conflicts of interest among the various parties, no revenue-sharing means a lower likelihood of fiduciary breaches and lawsuits.

Cynthia Loh, who runs Betterment’s 401(k) business, said that the company’s decision to use ETFs without revenue sharing made it necessary to build its own recordkeeping system. “We’d been speaking to different recordkeepers, and we found that 401(k) recordkeepers don’t support ETFs. The whole 401(k) system has been set up for mutual funds. They do it that way so companies can use revenue sharing. And there’s no incentive for them to get out of mutual funds,” she told *RIJ*.

“With mutual funds, you can add different share classes, and then share revenue in different ways. It’s not transparent, and you can’t do that with ETFs. The 401(k) ecosystem was built on the idea that brokers get paid, administrators get paid, and the participant suffers. You couldn’t have that scenario with ETFs. That’s not how ETFs work at all. You couldn’t have that scenario,” she added.

Other 401(k) companies do offer ETFs, but almost all of them turn their ETFs into mutual funds to accommodate revenue sharing, she said. “Except for Schwab, what we’ve seen from the other recordkeepers is that they repackage the ETFs as mutual funds. They’re technologically not capable of using [pure] ETFs. So we had to build our own.” Since Betterment’s retail business already used ETFs, “we didn’t have that much more to build on top of our existing system,” Loh (at left) told *RIJ*.

Betterment uses about 30 of the 1,600 or so ETFs on the market. It generally selects either a Vanguard or iShares ETF as the primary investment choice for each asset class in its managed accounts. “Whatever ETF we’ve chosen for each asset class is the default purchase if a customer needs to purchase that asset class. We have secondary and tertiary tickers for tax-loss harvesting purposes (to avoid wash sales),” a Betterment spokesman said.

Plain vanilla for small plans

But by simplifying its offering, Betterment may be limiting itself to the small plan market. Small sponsors are often willing to accept a one-size-fits-all solution, but large sponsors want customized solutions, said Rob Foregger, the former Fidelity Investments executive who co-founded **NextCapital Group**, a digital advice provider.

NextCapital’s customers are large enough to have their own research departments that produce their own investment methodologies and their own capital market assumptions, which NextCapital converts into scalable web-based participant advice. “Betterment can afford to take a more plain-vanilla approach because they’re going after the micro market. Having said that, I have a lot of respect for Betterment and Jon Stein and I wouldn’t underestimate their long-term capabilities.”

Moving into the 401(k) space “is a logical extension of Betterment’s business model,” Foregger added. “Winning in the retail space, in the long run, requires winning in the defined contribution space. The retirement market is just too big to ignore. And the DC market is perfect for scalable advice,” he told *RIJ*. “The Department of Labor is also going to make digital advice the de facto solution in the coming decade. But people who think you can just take a retail robo platform and put it in the DC market are sadly mistaken.”

Veterans of the 401(k) business agree that the small plan segment is tougher than it looks. “The movement of the money itself is getting easier,” said one executive who spent many years at a major retirement plan provider. “But then you have all the legal and regulatory requirements for changing ownership of a piece of property. The problem is that you have 300,000 small plans and they all have their peculiarities. Once you go into all the permutations, and the individual circumstances and the beneficiary designations, it gets complicated. I can show you easy cases. I can show you horror stories. But no doubt Betterment does have ‘leapfrog’ advantages.”