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Schwab introduces all-ETF 401(k) plan

By Kerry Pechter *Wed, Feb 5, 2014*

"The real question is whether there is a significant price difference between index funds and ETFs, and will it matter in the small and mid-size market?" commented Fred Barstein of TRAU on the new Schwab offering.

If index funds are good for 401(k) plan participants, would ETFs be even better? Charles Schwab seems to think so.

Schwab Retirement Plan Services, Inc., which serves 1.3 million 401(k) plan participants, this week announced a new full-service 401(k) program in which exchange-traded funds will serve as core investments. Participants will be able to own the ETFs in a Guided Choice or Morningstar Associates managed account, or in a self-directed brokerage account, if the plan offers one.

Fred Barstein, founder of The Retirement Advisor University (TRAU), told *RIJ* that Schwab's move is "Potentially important—though the real question is whether there is a significant price difference between index funds and ETFs, and will it matter in the small and mid-size market? Will the perception that ETFs are cleaner (no trading costs) than index funds be appealing? Will the greater variety be appealing?

"For most people, ETFs are excellent building blocks to capture beta within managed investments like TDFs, custom asset allocation funds and even retirement income—which is the strategy BlackRock seems to be pursuing for the DC market," he added.

In a release, Schwab claimed to be the first major full-service provider to offer such a plan. Steve Anderson, head of Schwab's institutional retirement business, described it as "an additional version of Schwab Index Advantage," a program that Schwab started in 2012 to help participants "use low-cost index mutual funds and personalized advice."

The new version has a goal of "further driving down investment costs by using low-cost exchange-traded funds," the release said.

Schwab estimated that a 401(k) plan using index exchange-traded funds could cost 90% less than a 401(k) plan using actively managed mutual funds and 30% less than a 401(k) plan using index mutual funds.

"Several employers have already expressed strong interest in becoming first adopters of the exchange-traded fund version of Schwab Index Advantage. Given the typical 6-12 month sales and implementation cycle in the 401(k) industry, the firm anticipates clients will be offering this new version of Schwab Index Advantage to their employees later this year," the Schwab release said.

According to the release:

> "Using a patent-pending process, Schwab Index Advantage is the first 401(k) program that fully integrates exchange-traded funds as core investments within the plan, including commission-free

> intraday investing along with the ability to process partial share interests," Anderson said.
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> "Many solutions on the market today unitize shares, batch trades, trade only once a day at a single price, or require individuals to open a self-directed brokerage account to access exchange-traded funds. "We believe a truly effective offering requires the ability to invest in and receive allocations of both full and partial shares of exchange-traded funds when the market is open, and that's what we've built. Other 401(k) offerings that we've seen take a less comprehensive approach to including exchange-traded funds and also tend to serve smaller plans," he added.

Assets in exchange-traded funds have grown from $66 billion in 2000 to more than $1.6 trillion at the end of 2013 according to the Investment Company Institute. "The notion by some industry commentators that these benefits should not be available to 401(k) participants reminds me of the proponents of gas lighting who, 100 years ago, argued that electricity was dangerous and unnecessary," Anderson said in the release. He added:

> "Despite the obvious benefits of exchange-traded funds, mutual fund companies that dominate the 401(k) industry have largely ignored them – simply because these companies lack either the capabilities or the will to effectively accommodate exchange-traded funds in the retirement plans they offer. Others in the industry suggest that offering exchange-traded funds to 401(k) participants will lead to over-active trading, an argument not supported by the facts.[2] We heard the same false argument 25 years ago when the industry began updating participant 401(k) balances on a daily basis, instead of quarterly," Anderson noted.

Employers and their retirement plan consultants who use the new Schwab program will be able to build investment lineups from a list of 80 low-cost index exchange-traded funds in more than 25 asset categories. Providers include Charles Schwab Investment Management, ETF Securities, First Trust, Guggenheim Investments, Invesco PowerShares, iShares ETFs, PIMCO, State Street Global Advisors, Van Eck Global, Vanguard and United States Commodity Funds.

Participants will be able to use managed account programs fromGuidedChoice Asset Management, Inc. or Morningstar Associates, LLC.

The index mutual fund version of Schwab Index Advantage was launched in 2012 and includes an automatic enrollment feature and a managed account advisory service. Before the introduction of Schwab Index Advantage, only about four percent of Schwab participants elected to opt for a managed account; today, 85% do.

Schwab said it can deliver the managed account service for 45 basis points or less ($45 per $10,000 invested). With the ETF management fees, participants would pay about 60 basis points per year in fund investment costs and managed account fees. The typical expense ratio for managed account program based on actively managed mutual funds would be 90 to 140 basis points, Schwab said.