ETFs becoming popular in 401(k) plans

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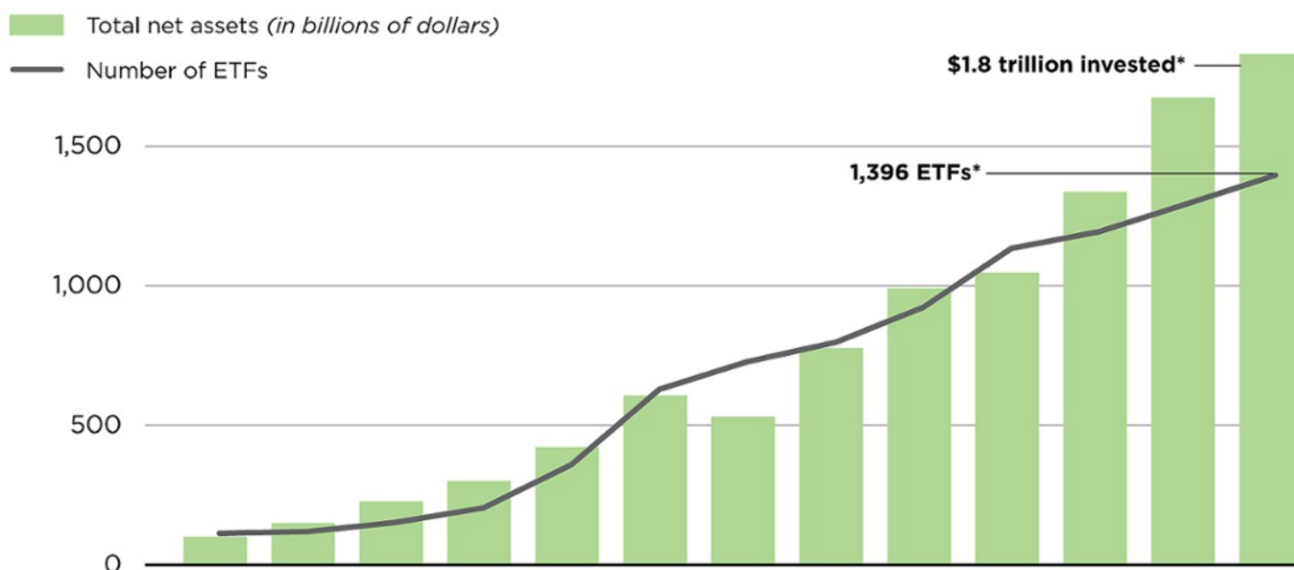

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Exchange-traded funds have taken the investment world by storm, and now they're entering the realm of company retirement savings plans.

Earlier this year, Charles Schwab Corp. became the first major firm to launch a 401(k) program that allows participants to invest all of their plan in ETFs. It joined a handful of other firms offering ETFs in retirement plans, including TD Ameritrade and ShareBuilder.

"It allows the employer that's sponsoring the retirement plan to offer exchange-traded funds as part of the core fund lineup within the plan," said Dave Gray, vice president of 401(k) client experience at Schwab. "We're seeing clients being very supportive of this approach because they like the low cost that exchange-traded funds bring."

Other large players, like Fidelity, say they have no plans to offer ETFs as part of their 401(k)s. "Fidelity believes index mutual funds are more suitable than index ETFs for workplace savings plan participants seeking passive exposure to the capital markets," it said in a statement.

Still, many expect the trend to continue.

"ETFs are still a very, very small portion of the 401(k) market, but it's certainly growing, and I expect the growth rate to increase," said Jeremy Stempien, director of investments and retirement solutions at Morningstar Investment Management.

But know this: While ETFs may give you a fresh investment option in your retirement plan, it's not money you want to play with.

And be sure you know the pros and cons before jumping in.

What is an ETF?

ETFs and mutual funds are like kissing cousins in many aspects. Both ETFs and mutual funds bundle together investments, such as stocks, commodities or bonds, to offer investors diversified portfolios.

But ETFs and mutual funds are different in other aspects.

ETFs are bought and sold like stocks and trade throughout the day on exchanges at prices set by the market. Mutual funds don't trade during the day, and their prices are set at the end of each trading day.

Most ETFs track a particular index. As a result, they typically have lower operating expenses than actively managed mutual funds. Their lower cost is a key part of their appeal to investors.

Know your costs

There are three costs to consider in ETFs:

Operating expense ratio — This is the ongoing cost that the ETF manager charges for overseeing the portfolio. It's expressed as a percentage of the fund's average daily net assets.

If you plan to hold an ETF for a long time — which you should if it's in a retirement plan — you want to focus on that expense ratio because that hits you every single year, rather than the trading cost, which is paid only when you trade.

Bid/ask spread — This is essentially the difference between the highest price that a buyer is willing to pay for an asset (the bid) and the lowest price for which a seller is willing to sell it (the ask).

In the case of an ETF, bid/ask spreads represent the difference between the price at which an ETF can be bought and the price at which it is being sold.

For example, say the bid price on an ETF is $25.10 a share, while the ask price is $25.14 a share. That would be a 4-cent spread between the bid and the ask.

In general, the lower the spread, the better. Higher bid/ask spreads mean you're paying a premium for the ETF, which adds to your transaction costs.

Commissions — Because ETFs trade like stocks, brokerage firms will usually charge a commission for each trade. Depending on how often you trade an ETF, your trading fees can quickly add up and reduce your investment's performance.

A discount brokerage may charge less than a full-service broker, and commission-free ETFs are a growing trend.

"We don't charge any commissions," said Gray of Schwab.

The track record

Check a performance chart that compares how well the ETF performed compared with the index it's tracking. You want to look at how closely the ETF's performance has matched its benchmark. "It should be tracking to the benchmark," Gray said. "That's essentially what you're paying for."

Your holdings

"What one should be going after is ultra-broad diversification, the right stock/bond mix, and then forget it," said Rob Brown, chief investment strategist at United Capital Financial Advisers.

"Do they have the stock/bond mix right? Is it something they can live with over the long run and not mess with it because they get scared or greedy?"

And don't go for the exotic stuff.

"When people talk about ETFs, often they say you can have access to some of these very niche things like individual precious metals or maybe like leveraged gold funds," Stempien said. "Just because they have access to all of these new and exciting vehicles doesn't mean that they necessarily should be investing in them."

Day trading

Similarly, just because you can trade ETFs during the day doesn't mean you should.

"We advise everybody that this is long-term money and they shouldn't trade more than a couple of times a year max," said Michael R. Beck, executive vice president of Gerald L. Ray & Associates LTD in Dallas, an investment advisory firm that offers businesses 401(k)s that use only ETFs. "It can't be every month."

Besides, there are limits to how much you can trade ETFs during the day in a retirement plan, he said.

"The option is there to trade intraday, but it's a limited option," Beck said. "Most plans bunch the trades, meaning that if I rebalance a portfolio, they'll do a trade like at 1 o'clock and at the end of the day, so they have two trading windows. That's the average 401(k)."

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