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401(k) investor plans that use index funds save time and money

ON INVESTING
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The share of 401(k) assets invested in index funds has risen from 17 percent in 2006 to 33 percent in 2016, a recent report from financial data firm Brightscope and the Investment Company Institute shows. While that is impressive growth, the share of retirement assets in index funds should be much larger, probably close to 100 percent.

Sure, index funds offer plan participants a strong likelihood of top-tier investment returns with rock-bottom fees, but that isn't the reason retirement plans should be almost entirely indexed. The real reason is that index funds can significantly reduce the fiduciary pitfalls plan sponsors face, and simplify the oversight of corporate retirement plans.

One big pitfall is Department of Labor audits. The scope and number of audits have been on the rise the past few years. In 2017, the Employee Benefits Security Administration, an agency of the DOL, conducted 1,707 compliance reviews of corporate retirement plans. This resulted in fines of $1.1 billion, a 72 percent increase over the prior year. The agency covered even more ground in 2018, with 1,329 audits that resulted in monetary recoveries of $1.6 billion. This trend is concerning for plan sponsors.

The DOL notes that participant "inquiries" or complaints are a "major source of enforcement leads." Why do participants complain? Often, they are unhappy with what they view as poor performance or unreasonably high fees. With a higher standard for fee disclosure requirements in the past few years, participants are increasingly aware of what they are paying, and to whom, in their retirement plans.

Even worse, lawsuits against corporate retirement plans have also been trending up. Some early legal wins, including at the Supreme Court, and a willingness by some companies to settle, have led plaintiffs' attorneys to flock to the corporate retirement space. Excessive fees or inappropriate investment options are cited as the primary complaint in over three quarters of the cases.

Index funds, with their ultra-low costs and solid performance track record, would address many of these problems. For example, the average expense ratio, or management fee, for a stock market mutual fund was 0.55 percent according to industry group Investment Company Institute. For bond funds, the average expense ratio was 0.48 percent. The good news is that these rates have been trending lower. However, they are still significantly higher than many index funds.

Vanguard offers a total stock market index fund with an expense ratio of 0.04 percent for its Admiral share class, which most corporate retirement plans would qualify for. An equivalent total bond market fund incurs a 0.05 percent annual fee. By using simple index funds, plan sponsors can save their participants around 90 percent in fund management costs. While these are simple "total market" funds, a full menu of index funds, including large-cap, small-cap, and international stocks, as well as bonds and money markets would still result in rock-bottom fees.

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Index funds also are generally not subject to significant underperformance, which often triggers participants' ire. A study by data firm S&P Global showed that 69 percent of actively managed mutual funds underperformed the appropriate benchmark index in 2018. Over longer periods, the results are even worse, with 84 percent underperforming over the past ten years and 89 percent underperforming over the past fifteen years. This study is conducted and released semiannually, and the recent findings are not unusual.

Even worse, the size of the underperformance by actively managed mutual funds can be significant. The S&P Global study showed that in 2018, the S&P Composite 1500 index lost 5 percent and the average domestic stock fund declined by more than 8 percent. Over 15 years, the average underperformance was almost 1.5 percent. That may not sound like much, but compounded over many years, a shortfall of that magnitude can take a serious bite out of retirement assets.

By definition, index funds track the market. They levy annual fees, which can result in underperformance versus their benchmarks just like actively managed funds, but with expense ratios of 0.05 percent, any shortfall is usually quite modest. If plan sponsors used index funds more widely, the number of participant complaints of poor performance would be very likely to decline.

Using index funds would also ease ongoing administration of retirement plans. The need for plan investment committees to constantly monitor the fund menu would significantly diminish. Generally, employees on these committees spend their time reviewing underperforming funds and conducting searches for replacement funds. Since index funds rarely underperform, there would be no reason to replace them, saving employee time and employer money. This also results in a less disruptive, more consistent experience for plan participants who, I've learned, generally do not want to spend much time thinking about retirement plan investments.

Still, even with index funds, there are pitfalls to be aware of. Not every company offering index funds is as shareholder-friendly as Vanguard. Index funds offered by insurance companies or large brokerage firms often have expense ratios and even sales loads that are way too high. Plan sponsors need to examine costs upfront and review them through time to make sure they are fair. Sticking with bellwether firms like Vanguard, State Street, Charles Schwab, or BlackRock could help avoid unnecessary fees.

The bottom line with index funds in retirement plans is that everyone wins. Plan sponsors significantly reduce the risk of adverse DOL audits and participant lawsuits. They also save time and money because of a diminished administrative burden. Participants win because they get low-cost investment options that have a history of providing industry-leading performance. This helps them achieve their retirement goals without taking on incremental risk. It is also worth noting that the Employee Retirement Income Security Act mandates that retirement plans be managed in the sole interest of plan participants and their beneficiaries. While practice can sometimes differ from that ideal, index funds help bridge the divide. They are in everyone's best interest.

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