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Industry Moves to Cut Costs by Opting for Indexed Funds Over Actively Managed Equity

With cost concerns playing an increasingly significant role in the administration of 401(k) plans, some investment fund managers, recordkeepers, and advisors are reporting that passively managed indexed funds are escalating in popularity.

"The market is definitely moving toward more passive funds," says Darwin Abrahamson, founder and CEO of the Portland, Oregon-based Invest n Retire, a 401(k) service provider. "And cost is the number one factor."

Two main forces that seem to be driving almost all new developments in the defined contribution industry today are the effort to keep down the cost of services and products and the attempt to ease—or even eliminate—participant decision making.

Reducing cost and choice

A move toward indexed funds serves both of those objectives. And the new emphasis on indexed funds also ties in closely with the snowballing trend of asset allocation (or professional management) as an investment option.

Gordon Linke, principal for U.S. intermediary business with Barclays Global Investors, says one reason Barclays and StateStreet have passed Fidelity as the top money managers in terms of assets is that people have been gravitating toward indexed funds. Investors are learning, he says, that indexed funds can outperform actively managed equity in up, down, and sideways markets.

Scott Cohen, a partner and cofounder of Bellwether Consulting, which offers fiduciary and investment advice services to retirement plan sponsors, says he, too, has noticed the trend of his sponsor/clients making passive funds more available to their participants. "Active management is fairly expensive, and it may not be meeting the needs of participants," he observes.

Actively managed equity losing its gloss

One reason for any dissatisfaction with actively managed equity, Cohen suggests, is style drift, which leads to the blurring of lines between what constitutes growth, value, and balanced funds. Drift makes it difficult for 401(k) sponsors to use benchmarks for monitoring funds and confuses participants who have chosen a fund because of its investment style. With indexed funds, style drift should not present such uncertainty, at least not to the degree it does with actively managed funds.

In the early days of 401(k) plans, investment alternatives were far more circumscribed than today, with many plans offering little more in the way of options than company stock, stable value, and perhaps the S&P 500 as an indexed fund.

But the mutual-fund craze changed all that,

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with plan sponsors, at the behest of their participants, thirsting to add as many actively managed equity funds to their investment lineups as possible. That love affair with actively managed funds has reached the saturation point, with most industry analysts now believing that investment menus, which offer an average of 18 options (see Figure 1), have grown too large, confusing most participants rather than helping them make choices.

IOMA's Annual Defined Contribution Survey for 2004, *Plans in Transition*, reports, however, that more plans (64%) expect to add additional options in the future than those (36%) anticipating a reduction in the number of investment choices for their employees.

Perhaps, though, with all-encompassing options such as professionally managed accounts and life cycle funds becoming increasingly popular and indexed funds gaining currency, the tide is again shifting.

"The pendulum has started to swing back now from actively managed funds toward indexed funds," Cohen believes.

Impact of fund performance

Poor market performance has caused any loss of affection that exists for actively managed equity.

During the 1990s, plan sponsors and their participants had little to gripe about, as account balances simply expanded. But the slump that accompanied the turn of the millennium has left a bad taste in the mouths of many investors and plan fiduciaries. Actively managed mutual funds are no longer seen as the shining star they once were for enriching retirement savings.

Also the suspicion and uneasiness engendered by the mutual-fund scandal further eroded the trust that 401(k) and other investors had in actively managed equity.

Keeping control of plan costs

Yet the most pivotal reason that indexed funds seem to be gaining stature in 401(k) portfolios is that they are less expensive than actively managed funds.

An important mantra in the industry today, according to Doug McClintock, an attorney and retirement consultant with Mercer Human Resource Consulting, is, "Reduce the costs for participants." One easy way to do that, he says, is to offer less-expensive indexed funds.

Ken Fine, vice president for product management with the investment advice firm Financial Engines, says investment committees for 401(k) plans until recently were pushed by participants to select the hottest mutual funds for their investment menus. Now, however, these same committees are influenced primarily by low-cost alternatives when considering the addition of new options to their investment lineups.

"We have seen more plans recognizing the value of indexed funds," he says.

The expense ratios on indexed funds are substantially less hefty than those for actively managed funds.

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Figure 1. Average Number of Plan Options, by Year and Total Plan Assets

	1998	1999	2000	2001	2002	2003	2004
<$50 million	-	-	-	-	-	-	20.0
>$50 million	-	-	-	-	-	-	19.0
All plans	8.5	9.7	12.4	-	13.2	15.0	18.0*

*Includes plans that did not report their total assets.

(Source: IOMA)

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tion Survey for 2004 found, for instance, that the average expense ratio for actively managed small-cap domestic equity is 1.23%, compared with 0.47% for passively managed small-cap U.S. equity (see Figure 2).

When it comes to large-cap equity, the average expense ratio on actively managed funds, according to the IOMA survey, is 87 basis points, but only 43 basis points for passively managed funds. Passively managed mid-cap equity funds are only nine basis points less costly than actively managed mid-caps, 94 basis points to 103.

And according to Morningstar, the average expense ratio of all actively managed domestic equity funds is 1.50%, which, again, is significantly higher than most domestic indexed funds available to 401(k) plans.

"It's hard to beat indexed funds," says Abrahamson. He points out that company executives of plans offering 401(k) plans, as well as plan fiduciaries, frequently invest their personal assets in indexed funds, because they recognize not only the cost factor, but also the relative value of their risk and return. That makes it straightforward for them to see the benefits of adding indexed funds to their companies' defined contribution plans. "Cost matters," Abrahamson says.

Figure 2. Fund Option Expense Ratios Versus Total Plan Assets

	<$50 Mill.	>$50 Mil.	All Plans	Difference, Small-Large	Percentage Difference
Long-term active	0.97%	0.22%	0.47%	0.75%	77.0%
Small-cap passive	0.69	0.25	0.47	0.44	64.00
Mid-cap passive	1.17	0.50	0.94	0.67	57.00
Large-cap passive	0.59	0.33	0.43	0.26	44.00
Sector	1.99	1.23	1.53	0.76	38.00
Balanced	0.97	0.64	0.78	0.33	34.00
GIC	0.56	0.37	0.42	0.19	34.00
Intermediate active	0.84	0.56	0.68	0.28	33.00
Money market	0.50	0.35	0.45	0.15	30.00
Lifestyle	0.87	0.63	0.74	0.24	28.00
Emerging eq	1.53	1.13	1.26	0.41	26.00
Mid-cap active	1.17	0.90	1.03	0.27	23.00
Large-cap active	0.96	0.78	0.87	0.18	19.00
Global	1.15	0.94	1.00	0.21	18.00
Small-cap active	1.37	1.15	1.23	0.23	16.00
Int'l small cap	1.45	1.28	1.38	0.17	12.00
Non-U.S. equity	1.20	1.07	1.14	0.13	11.00
High yield	0.68	0.65	0.67	0.03	4.00
REIT	0.92	0.90	0.91	0.01	2.00
Cash	-	-	-	-	-
Self-directed brokerage	-	-	-	-	-
Company dtock	-	0.25	0.25	-	-
Intermediate passive	-	0.15	0.15	-	-
Long-term passive	-	-	-	-	-
Convert	-	0.90	0.90	-	-
Int'l bond	-	-	-	-	-
Emerging bond	-	0.99	0.99	-	-
Alternative	1.05	-	1.05	-	-
Private	-	-	-	-	-
Other	0.60	-	0.60	-	-

(Source: IOMA)

According to the Profit Sharing/401(k) Council of America (PSCA)'s annual survey of sponsors, 73.7% of all plans make actively managed domestic equity funds available to their participants, while 62.5% include at least one indexed domestic equity fund in their investment lineup.

The PSCA also finds that 18.0% of all plan assets are invested in actively managed domestic equity funds, compared with 10.0% in domestic indexed funds.

Trend to indexed funds isn't universal

Not every provider and sponsor has noticed the trend toward passively managed investment options. Deanna Miller, vice president for strategy and

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planning at Prudential Retirement, says she has detected no such movement among her company's clients.

And Carrie N. Pierce, defined contribution program specialist for the California Savings Plus Program (the defined contribution plan for California state workers), also says that she has seen no such movement toward indexed funds. Nonetheless, Pierce says it is important to give participants access to an indexed fund.

"We feel it's important to offer both passively and actively managed funds," she says. Currently, the California Savings Plus Program has an investment lineup that includes 30 choices. Pierce says that is too many, and next year the number will be honed down to about 20.

Jeff Cimini, senior vice president for investment consulting services with Fidelity Investments, concurs. "In a defined contribution plan, your obligation is to provide choices to your employees, so it should be a mix of passive and active," he says. ❑

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