

Retirement 101, Part 3: ETFs Gaining Popularity in 401(k) Plans

Published June 21, 2013

In this installment of our Retirement 101 blog series, we'll talk about why [exchange-traded funds](#), or ETFs, may have been slow to appear in 401(k) plans. ETFs offer a number of benefits that can make them extremely attractive to investors—and well-suited for 401(k) plans in particular. One such feature is the low fees and no sales loads. While this may not seem like a big deal, [even a 1% difference in fees can have a significant impact on portfolio balance over time](#). Additionally, ETFs offer transparency, diversification and other elements. So, why was the 401(k) industry so slow in adopting them? There are a number of reasons. Consider the following:

- Some of the very features that make ETFs attractive to investors made them unattractive to record-keepers. As we discussed, many ETFs have low fees. While this can be a benefit for plan sponsors and their participants, in the past it was a drawback to record-keepers, as ETFs do not offer revenue sharing.
- When markets are doing well, people and institutions follow the “if it ain't broke, don't fix it” philosophy. Mutual funds were the 401(k) investment vehicle of choice for many years, and most people thought there was no reason to change that. But as markets unwound in 2007-2008—and as the industry started focusing increasingly on fee disclosure and other issues—record-keepers and custodians have become more interested in ETFs due to their lower fees and transparency of holdings.
- Since ETFs trade like stocks, fractional share purchases were an issue, but this has mostly been solved with executional parties. Today, ETFs are much more readily available in 401(k) plans. And it's no wonder. ETFs can offer a number of potential benefits that can make them extremely effective in helping participants reach their retirement goals:

- Diversification in one investment and broad asset class coverage
- Low fees and no sales loads ensure more of the investment goes to work for your future
- Daily transparency of holdings, so you always know what you own
- Tax efficiency¹
- Intraday liquidity

ETFs come in every style and asset class in the investment rainbow. They can help participants generate income, achieve long-term growth and gain more complete diversification. And today, more participants are gaining the chance to benefit from the many advantages ETFs offer. For more information about ETFs or 401(k) plans, please visit our [Retirement 101 blog series](#). In the next installment, we'll help you understand many of the features your 401(k) may offer. *Read our 401(k) series [here](#).*

¹The creation/mechanism of ETFs is what allows them to be very tax-efficient. Specifically, the ability of portfolio holdings to be transferred on an “in-kind” basis during redemptions allows ETFs to be tax-efficient and able to minimize their capital gains distributions. The reason: When shares are redeemed in-kind, the ETF is not liquidating or selling shares on the market—which would trigger gains inside the ETF. Rather, with in-kind redemptions, an exchange is made between qualified institutional investors and the fund company; in exchange for shares of the ETF, the qualified institutional investor receives underlying holdings of the Fund on an in-kind basis, and this swapping of holdings for ETF shares does not trigger a taxable event for the fund.

Important Risks Related to this Article

Diversification does not eliminate the risk of experiencing investment losses. Ordinary brokerage commissions apply. ETFs are subject to risk similar to those of stocks including those regarding short-selling and margin account maintenance.