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FEES AND TRADING COSTS OF EQUITY MUTUAL FUNDS IN 401(k) PLANS AND POTENTIAL SAVINGS FROM ETFs AND COMMINGLED TRUSTS

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As the role of 401(k) and similar defined-contribution plans continues to expand in our retirement system, participants in these plans are paying more of the cost of financing their retirement income. This study examines the fees and trading costs for domestic equity mutual funds held in defined-contribution pension plans during the five years from 2004 through 2008. It finds that mutual funds have provided valuable investment options for 401(k)-type plans. On average, the domestic equity funds examined in this study paid, net of all fees and transaction costs, returns that were competitive with market returns given the funds' exposure to market risks. Nevertheless, the design and pricing of these funds cost the average participant 0.70 of a percentage point or more in annual returns. Much of this toll can be attributed to trading costs, which can be reduced by shifting the investment options from mutual funds to ETFs or commingled trusts that hold ETFs.

401(k)-type plans provide a range of financial services that allow their participants to accumulate wealth in diversified pools of funds that are invested in stocks, bonds, and other capital market securities. The cost of providing these services is covered by fees paid by participants in 401(k) plans and, to a lesser extent, by employers who sponsor these plans. The most common explicit fees within plans are assessments per dollar of assets – expense ratios – and per capita assessments. In addition, plans also incur less explicit transaction costs that result from their asset managers' trading activity.

The expense ratio covers much of the cost of administering plans and the cost of managing plans' pools of investments, except for the expenses arising from trading assets. This bundled fee is not closely aligned with the structure of the costs of providing services for participants in a 401(k) plan or even the costs for an entire plan. Much of the cost of administration and management is relatively constant for all participants, yet the participants pay fees in proportion to their balances. Also, as the assets under management in plans grow, their fees tend to grow proportionately, even when their costs do not grow so rapidly. The alignment of fees with costs treats a plan's participants more equitably as their balances grow and can allow the entire plan to monitor and control its expenses as its aggregate balances expand. The bundled approach does not encourage plan sponsors to investigate potential economies from purchasing administration and management services from specialized providers.

ETFs and commingled trusts allow 401(k) plans to separate their administration costs from the cost of managing their plans' investments. This unbundling allows for greater economies of scale in the provision of services to small and medium sized 401(k) plans. Providers that specialize in administering plans for per capita fees can enroll many smaller plans in a common record-keeping system and offer a common set of ETFs and commingled trusts as investment options to achieve the economies of a very large plan. These savings can range from 0.20 to 0.35 percent of assets for the average size 401(k) plan.

Participants in 401(k) plans also pay the trading cost incurred by mutual funds. This study estimates that the trading costs for the predominantly actively managed mutual funds in its sample are, on average, are significant, about three-quarters the magnitude of the funds' expense ratios. ETFs avoid this cost by accepting or making payments in kind from authorized participants, typically large institutional investors, instead of making trades in the market. In effect, ETFs are supplying their authorized participants a degree of liquidity, instead of paying the cost of obtaining liquidity.

This study estimates that the trading costs for the predominantly actively managed mutual funds in its sample are, on average, about 0.66 percent of assets. ETFs, by design, incur fewer trading costs. As a result, ETFs that reflect the style of actively managed funds could allow 401(k) plans to boost net returns an additional 0.50 of a percentage point or more. Participants holding actively managed mutual funds also could realize much of this saving by shifting to low-cost index mutual funds or to index commingled trusts.

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