ETF 401(k)s: Gaining ground?

Despite their recent growth, exchange-traded funds (ETFs) still struggle to crack the stranglehold mutual funds have on the retirement market. Best estimates currently place ETFs at less than 5% of all assets in 401(k) plans.¹

But that may be changing. Several new ETF-friendly plan providers and recordkeepers have emerged in recent years, and ETF titan iShares recently announced a new program to simplify the use of these instruments for retirement plans.

“ETFs can solve a huge problem in 401(k) plans by lowering fees,” says Darwin Abrahamson, CEO of Invest n Retire LLC, an ETF-friendly 401(k) recordkeeping service in Portland, Oregon.

Technical difficulties
The technical challenges that once prevented ETFs from being used in 401(k) plans have largely been resolved, says Abrahamson.

Historically, most 401(k) recordkeeping and accounting systems were designed to accommodate mutual funds, which trade once daily at the end of the day and can always be bought and sold in fractional shares.

ETFs, however, may only be purchased as whole shares, like a stock. And since most 401(k) investors automatically fund their accounts through payroll deduction, their contributions rarely equal the exact cost of a certain number of ETF shares. Further, placing 12 or 26 or 52 small-lot trades per year into a variety of ETF positions through a traditional brokerage mechanism would quickly eat into returns through commissions and bid/ask spreads.

“There just weren't many recordkeeping systems that could accommodate individual ETFs,” says Abrahamson.

One solution is trade aggregation systems, which is what Abrahamson's group has developed. Under Invest n Retire's program, smaller trades are aggregated under a larger group plan, keeping transaction costs low while circumventing the fractional share issue. “On the plan level, it's all whole shares,” says Abrahamson. “But the participants themselves see fractional shares.”

Bigger fish
For now, WisdomTree, which launched its own all-ETF platform two years ago, is the only ETF provider jumping into 401(k)s with both feet, targeting a niche of advisors who work with small and midsize companies. It's a good match: advisors are increasingly comfortable with ETFs, and the smaller plans are unlikely targets for direct 401(k) plan sales from the major investment management firms.

iShares, the world's largest ETF provider, has dipped a marketing toe in the water: it launched its “iShares in 401(k) Program” in April, which connects financial advisors with iShares-friendly third-party plan providers and administrators.

But despite these entrants, neither Vanguard nor Fidelity Investments—the two largest 401(k) plan providers—have announced any intention to offer ETFs in their plans, even though Vanguard is also the world’s third-largest ETF provider.

Ultimately, the main barrier for the larger players may not be technological, but financial. Mutual funds are the vehicle of choice in many 401(k) plans, in part because the higher fee structure allows plans to offset recordkeeping costs through revenue sharing under the funds’ expense ratio umbrella. In ETF-centric 401(k)s, recordkeeping expenses are more transparent and must be either picked up by the plan sponsor or charged to plan participants as a separate fee.

That level of transparency may be better for investors, but established plan providers have so far been reluctant to change. As more and more ETF recordkeeping systems gain traction, however, plan providers may be forced to adapt.

¹ “ETF giant iShares is going after 401(k) market,” May 10, 2009, Investment News.
Can an ETF be a hedge fund?

It was only a matter of time until the most exclusive of asset classes got the ETF treatment: hedge funds.

The attraction is clear: hedge funds, with more than $1.4 trillion under management at the end of 2008, deliver alternative returns that often show low correlation to other asset classes. But they come with limitations.

"Hedge funds are great diversification tools," says Adam Patti, CEO of IndexIQ, which recently launched the IQ Hedge Multi-Strategy Tracker ETF (NYSE Arca: QAI). "But they have real structural problems like low liquidity, high costs and zero transparency."

The solution, according to academic finance, is to use analytical models to replicate the pattern of returns of a given hedge fund strategy using lower-cost publicly traded securities—in a phrase, to create “alternative beta.”

The first product based on this research was a traditional mutual fund launched in 2007, the Goldman Sachs Absolute Return Tracker (ART). The ART fund follows a quantitative, algorithmic strategy that can invest in anything from swaps to structured notes.

The underlying securities in the recently launched QAI are all liquid ETFs, including leveraged, short, commodity and currency products. Each month, IndexIQ rebalances its ETF of ETFs to a new target allocation based on its regression analysis. “It’s not a black box,” insists Patti. “It’s a glass box—a fully transparent index strategy detailed in the ETF’s index rulebook. We can provide the diversification benefits without the problems.”

With an expected 80% to 100% annual turnover, these are fairly active strategies. One potential problem is taxes. With healthy creation and redemption activity, however, the tax efficiency of the ETF packaging should limit any capital gains overhang from all this trading.

The challenge for these hedge fund replication strategies will most likely be one of track record: will investors be willing to accept the promise of alternative returns based solely on academic research? Only time will tell.

Parsing the indicative NAV (iNAV)

Every ETF investor knows the textbook definition of net asset value: the total value of a fund’s assets (minus any liabilities) divided by the number of shares outstanding.

But this value, based on the closing market prices of all the fund’s underlying securities, can only be rigorously calculated once a day, when a fund manager has the ability to verify and confirm all the market data and carefully account for all the day’s expenses.

Yesterday’s values, however, are of little use to ETF investors interested in evaluating an ETF during market hours, since the value of an ETF’s underlying positions vary constantly during the trading day. Therefore, it’s necessary to have a real-time indicator that can reasonably approximate an ETF’s real value, to determine if trades in the ETF itself are in line with expectations.

To that end, every ETF publishes an indicative net asset value (or iNAV), usually every 15 seconds, and transmits this to market makers, exchanges and media outlets. Most quotation systems show a given iNAV by appending “.iv” onto the ticker; for example, the SPDR Gold Trust (NYSE Arca: GLD) can be tracked as GLD.IV.

While the iNAV is not the official creation/redemption price for an ETF, it’s still a valuable gauge of market behavior. Investors can compare an ETF’s iNAV to its current trading price to verify that a fund is trading in line with its true underlying value. When a fund’s trading price is either above or below its iNAV, the ETF is said to be trading at a “premium” or a “discount.”

One caveat: iNAVs are calculated using the last sale price of the underlying securities, those securities may not trade during the U.S. market day. For instance, the securities in a Hong Kong ETF do not trade at all during U.S. market hours. The iNAV, therefore, will be nearly static; it will adjust only for currency movements.

As a result, internationally-focused ETFs often trade at significant variance with their iNAVs, as the ETFs anticipate where the underlying securities will trade when their local markets reopen.

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The ETF industry matures

Stormy financial weather hasn’t slowed the growth of the exchange-traded funds industry.

In the United States, new net inflows to ETFs topped $185 billion in 2008, despite an extraordinarily challenging market environment. Compare that to mutual funds, which experienced a $55 billion net outflow.

Nor did ETF innovation slow, with more than 470 new ETFs launching worldwide last year.

Most spectacularly, ETFs came to take an increasingly central role in equity trading activity, representing more than 32% of all equity trading dollar volume in 2008 (and 38% in February 2009).

During consolidation, new categories emerge

While the industry has grown, a flood of new ETFs created substantial overlap, even in experimental and extreme-niche products. Inevitably, some of these products failed to garner assets or maintain trading volume. As a result, some 58 ETFs closed in 2008, with dozens more closing in the first quarter of 2009.

Observers call this a natural evolution for the industry. Most of the obvious categories (like large-cap domestic stocks) are already saturated with products, and first movers in these spaces have attracted such a liquidity advantage that it’s hard for new funds to compete. As a result, providers are bowing out of these competitions and branching out instead into less-traveled themes, such as qualitative-active and hedge fund replication.

Perhaps most striking has been the rise of leveraged and inverse funds. In March alone, these products drove 30% of all ETF trading volume. The funds gathered more than $15 billion in net inflows in the first quarter of 2009, and now hold more than $30 billion in assets.

International growth

While the U.S. industry evolves, the rest of the world remains in a period of midstage expansion and growth, particularly Europe.

In the past, regulatory and tax discrepancies between countries had stifled industry growth in Europe. That appears to be changing with the adoption of the latest UCITS structure, which allows ETFs to better use derivatives, thus expanding the available options for funds. As of March 2009, there were 672 ETFs in Europe, with assets totaling $135.6 billion.

The European market remains more thinly traded than its U.S. counterpart, despite a 22% increase in daily volume last year. Still, an entrepreneurial environment thrives: the relative lack of major U.S. providers in Europe—only Barclays Global Investors is a substantial presence currently—has allowed local providers like ETF Securities and db x-trackers to flourish.

Elsewhere, international investors have begun to realize the potential of ETFs. Last year, net inflows in Asia-Pacific jumped to $15.7 billion, up from $0.6 billion in 2007. In addition, although only five new funds had launched outside the United States and Europe as of February 2009, 73 more were in registration.

“We see the current environment as one of real opportunity for fund sponsors,” says Russell Warren, a managing director with J.P. Morgan. “International markets offer very strong growth potential, and in the months ahead, we expect to see further expansion overseas.”

(1) Data: courtesy of IndexUniverse.com, National Stock Exchange, Barclays Global Investors, and Citigroup Global Markets

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