Fixing the 401(k) Plan

> “We’ll begin with the obvious: about 80% of all mutual funds could shut their doors today and not be missed.” – David Snowball

According to Walter Bettinger, CEO of Charles Schwab, 84% of the $3.7 trillion invested in defined-contributions assets -- 401(k)s, 403(b)s, etc. -- are in actively managed funds.

I’m not surprised by many retirement statistics anymore, but this one was shocking to me. Everyone assumes that passive indexing is taking over the fund management business, but obviously someone is still buying actively managed funds. But it’s not that actively managed funds are inherently bad. They’re not. It’s that most of the active funds out there, especially those in workplace retirement plans, are high cost closet index funds. These are the funds that need to completely disappear from the industry.

The Reuters mutual fund screener has over 23,000 mutual funds to choose from. I broke out all of these funds by cost:

Expense Ratio	No. of Funds
Less Than 0.5%	3,994
0.5-1.0%	6,466
1.0-1.5%	6,671
1.5-2.0%	3,866
Greater Than 2.0%	2,013

Less than 20% of these funds offer expense ratios of less than 0.5%, but more than half charge 1% or more in expenses. More than a quarter of these funds still charge more than 1.5% and almost one in ten charges more than 2%. There's no way that this many funds deserve to be charging this much for their services, especially when you look at the dreadful performance against simple index funds over time.

Here’s David Snowball in the latest Mutual Fund Observer with more:

We’ll begin with the obvious: about 80% of all mutual funds could shut their doors today and not be missed. If I had to describe them, I’d use words like

- *Large*
- *Unimaginative*
- *Undistinguished*
- *Asset sponges*

They thrive by never being bad enough to dump and so, year after year, their numbers swell. By one estimate, 30% of all mutual fund money is invested in closet index funds – nominally active funds whose strategy and portfolio is barely distinguishable from an index.

Passive investments now make up roughly 30% of all fund assets. So there is just as much money invested in overpriced closet index funds as there is in actual index products. It doesn't have to be this way.

There are now plenty of active or quant-based ETFs that can be bought at a fraction of the cost of the active funds you will find in most 401(k) plans. It doesn't have to be active funds versus index funds anymore. That whole debate should be going away as ETFs continue to build market share. It needs to be high cost versus low cost.

But as easy as it is to buy an ETF in an IRA or through a brokerage account, for most retirement savers, their defined contribution plan at work is the simplest way to save and invest. Money can be deducted straight from your paycheck. Many companies offer a matching program. You get a tax break up front. It's just easier.

I can't tell you the last time I heard something good about a 401(k) plan. I constantly hear horror stories from people about high-cost funds, terrible fund choices, a lack of basic education and overwhelmed and under-qualified people administering them on the company's behalf.

The simple solution for the majority of defined contribution retirement plans is to offer robo-advisor portfolios as the default option. Robo-advisors aren't perfect (what is?), but putting the average investor in an automated, low-cost portfolio is by far the best solution for the majority of retirement savers. Add in a feature that automatically increases the amount people save each year and have the robo-advisors help educate people on the benefits of an automated, disciplined retirement plan and now we're talking.

The entire space is ripe for disruption. I really hope something like this happens.

Sources:
Inside Schwab (Barron's)
Mutual Fund Observer

Further Reading:
Why Don't Scary Retirement Stats Work?

99 Retirement Problems

Subscribe to receive email updates and my monthly newsletter by clicking here.

Follow me on Twitter: @awealthofcs