

Cogent Insight Series

The Future is Now:
ETFs in 401(k) Plans



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Introduction

While an increasing number of advisors and investors are becoming aware of the unique benefits of exchange-traded funds (ETFs) and even adopting them, their exclusion from the retirement plan lineup has been regarded the ETF's Achilles heel. Yet, with the growing support of ETFs in retirement platforms, the greatest barrier to widespread ETF acceptance over the long-term has finally been overcome. With the increasing downward pressure on retirement plan fees and pending government legislation on fee disclosure and transparency, there could be no better time than “now” for this change in ETF status.

Today, there are over 1,100 TPA/recordkeepers that can access ETFs (accounting for roughly 500,000 plans under administration), and the breaking of this technological barrier will surely fuel the growth of an already explosive product category.

Important ETF growth, however, can only be realized with support of the employer-sponsored retirement plan (ESRP) advisor community. For this reason, this study examines ESRP advisors' overall mindset and concerns amid today's economic environment and its impact on plan design, including the investment options they select for their plans. Specifically, this report focuses on the perceptions of retirement plan advisors that have a strong focus on the 401(k)/403(b) business. Findings reflect the opinions of experienced and successful ESRP advisors with the following credentials, on average:

- 47% of their total assets under management (AUM) dedicated to ESRPs
- 30 ESRPs under advisement
- 13 years managing or advising ESRPs

The Mindset of Today's ESRP Advisor

Despite the myriad of challenges facing them, from market losses to waning investor confidence and problems at the home office, the majority of advisors in the retirement plan business are faring well. Nearly two thirds (64%) agree that they have “been able to build their business in the current environment.” Further, over two-thirds (69%) report that their 401(k) and 403(b)-related compensation has increased or remained stable compared to two years ago.

With this guarded success, advisors still share the following significant concerns regarding the current environment [Exhibit 1]:

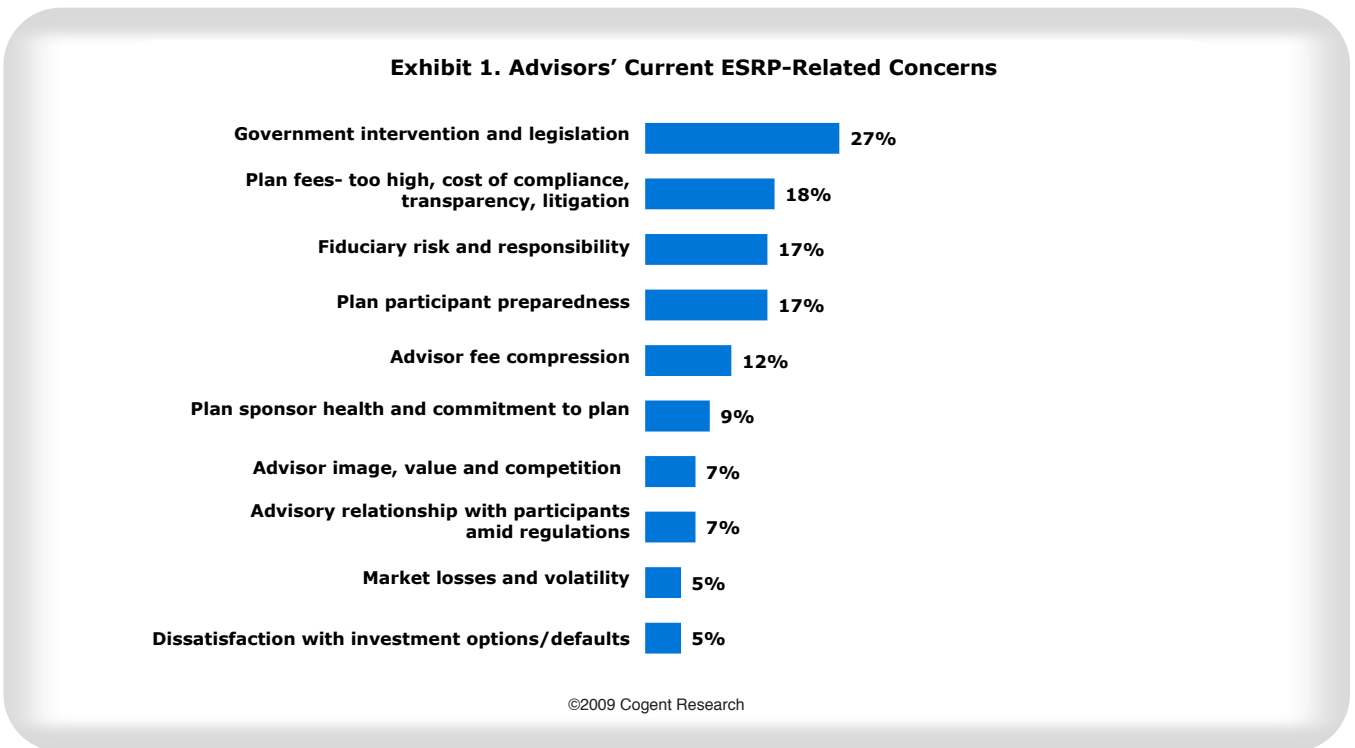


EXHIBIT 1

Government Intervention. Of leading concern to ESRP advisors is well-meaning but ultimately unhelpful legislation on ESRPs. In particular, more than one in four (27%) advisors are apprehensive that government intervention could lead to any or all of the following problems:

- Increased plan fees through a higher cost of compliance
- Downward pressure on advisor fees
- Inability to provide advice to participants without fear of liability
- The “end” of the private retirement saving system

“My greatest concern is:...”

“Overregulation could result in higher operating costs making participant fees higher...”

“Government regulators getting involved and pressuring fees down from advisors to the point where it will not be profitable for me to spend time actively prospecting for plans.”

“New structure for retirement savings outside of the 401(k), like a government-run vehicle.”

Plan Fees. Regarding plan fees, ESRP advisors have a variety of concerns, most prominently: fees being too high and their lack of transparency (both of which will attract unwanted government intervention as well as potential participant litigation).

“My greatest concern is:...”

“Vendors not being fully transparent on fees which may require a change to a new vendor.”

“Fee litigation.”

“The continued scrutiny on fees and our ability to earn appropriate profit margins.”

Fiduciary Risk. The risk of fiduciary responsibility has long been a concern of retirement plan advisors and is increasing as more and more regulations are pending and put in place. Their apprehension lies not only in their own action but in their ability to monitor sponsors’ compliance. Adding insult to injury, some ESRP advisors feel these increased fiduciary obligations are coming with less financial reward. Only advisors who have been in the business for over twenty years are unlikely to be ruffled by fiduciary worries.

“My greatest concern is:...”

“Plan trustees’ failure to recognize their liabilities and responsibilities as fiduciaries will ultimately result in damaging lawsuits... could ultimately result in government mandated/controlled solutions.”

“How our fiduciary status with plan sponsors and participants impacts our ability to assist plan participants with rollovers and assets outside the plan.”

“Downward pressure on revenue, yet increasing liability and regulations.”

Plan Participant Preparedness. Most ESRP advisors understand that their ultimate goal is to ensure that employees are set for retirement. Some advisors are concerned that lack of employee participation in plans, less money to contribute and poor education, especially in light of recent market losses, does not bode well for participants’ retirement readiness.

“My greatest concern is:...”

“Market volatility and poor participation (and the effects it will have at their retirement).”

“The overwhelming majority of people are unprepared and have not saved nearly enough for their retirement.”

“These products are becoming too complex for participants.”

ETFs Gaining Momentum

Despite their smaller piece of the pie today, the growth rate of ETFs is making waves in the investment community. Case in point: today, nearly two-thirds (64%) of ESRP advisors use ETFs in their overall advisory practice [Exhibit 2].

According to advisors overall, the number one reason for increasing their use of ETFs is their low cost. Additionally, as investors become more aware and knowledgeable about ETFs, advisors report they will increase their adoption [source: *Cogent Advisor Brandscape*™ 2009].

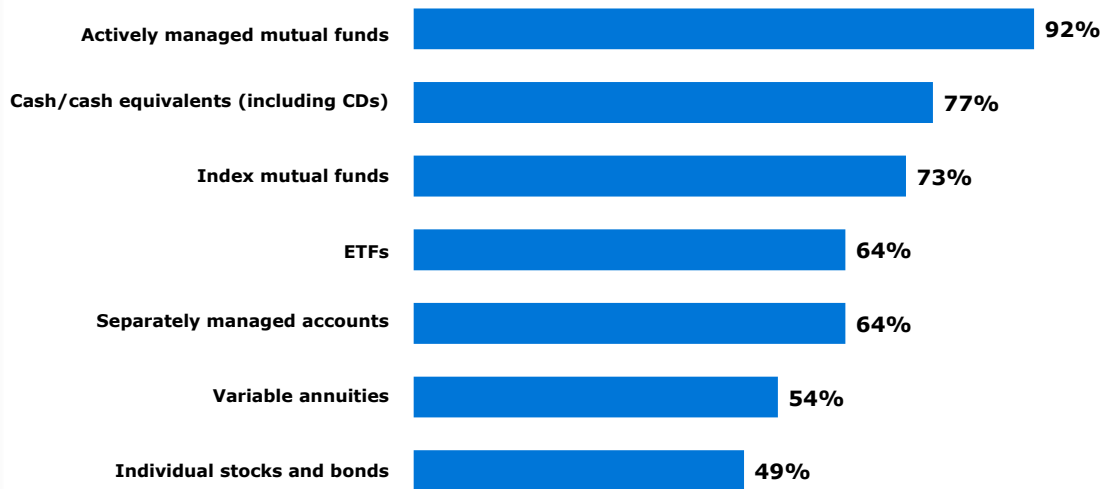
“Why do you anticipate an increase in usage of ETFs?”

“I feel this is a cost efficient way to get exposure for client portfolios and will likely continue putting more here.”

“More transparency than mutual funds and lower fees equals happy clients.”

“Client preference and lower fees for the clients as well as increased client knowledge of them.”

Exhibit 2. Products Used by ESRP Advisors in their Overall Practice



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EXHIBIT 2

Toward ETF Adoption in Retirement Plans

Due mainly to perceived recordkeeping barriers and the limited number of ETF providers, the strong ETF growth rate among self-directed investors and advised clients outside of retirement plans has not yet been mirrored in the retirement plan arena.

As a result of the removal of recordkeeping barriers, an increasing number of ETFs and providers, as well as improved awareness, the gap between ETF growth outside and inside retirement plans should be closing. In fact, today an impressive one-third of ESRP advisors use ETFs as investment options in the plans they manage or advise [Exhibit 3].

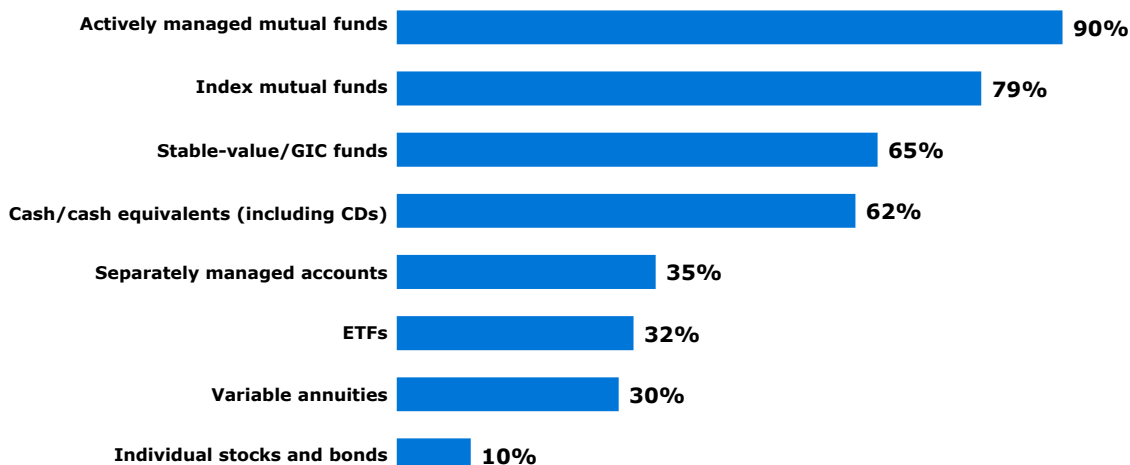
Benefits of Using ETFs in Plans. Plan sponsor and participant demand and pending legislation have prompted the scrutiny of retirement plan fee levels and the call for more transparency. But fees are not the only piece of the portfolio advisors and their clients want to understand clearly. Due to market corrections, corporate scandals and company failures, sponsors and participants

want to know now more than ever which companies they own. In fact, three-quarters of ESRP advisors agree “it is important to provide investment holdings transparency to clients” [Exhibit 4], and even more (88%) of the younger-tenured advisors agree, indicating transparency will be the wave of the future.

With these concerns in mind, the following benefits to ETF usage can be identified:

- Promotion of competitive fees and fee transparency to sponsors and participants. In fact, it is the concern over high fees that drives some advisors to use ETFs as investment options in the plans they manage (29% of ESRP advisors using ETFs in their plans cite plan fees as a concern vs. 12% of non-users).
- Ability to view investment holdings
- A strong solution to increased government scrutiny and legislation regarding fee disclosure and transparency

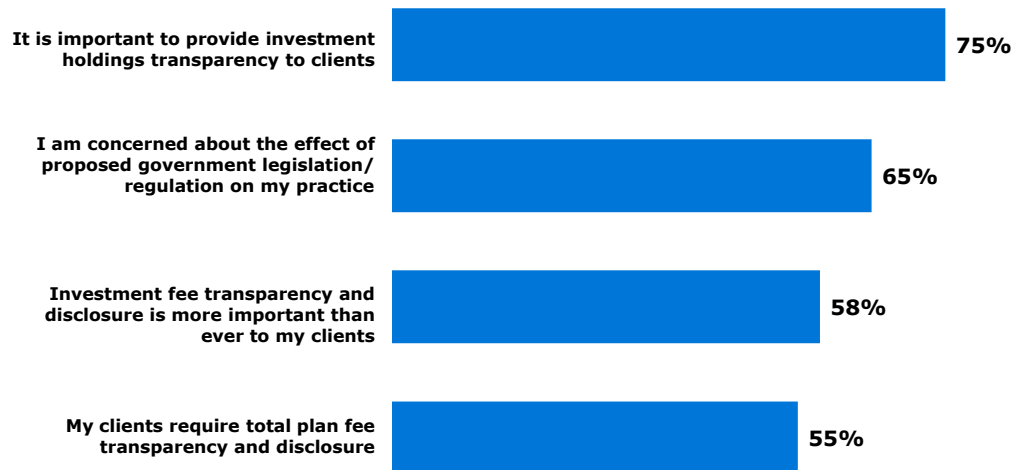
Exhibit 3. Products Advisors Use as ESRP Investment Options



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EXHIBIT 3

Exhibit 4. ETFs Address Advisors' Most Pressing Needs
(% agree)



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EXHIBIT 4

Barriers to Adoption: Perception vs. Reality.

Today, nine out of ten ESRP advisors believe that ETFs are appropriate investment options in 401(k)/403(b) plans, or have no opinion on the issue (since they are not familiar enough with ETFs) [Exhibit 5]. This supportive sentiment holds steady from two years ago.

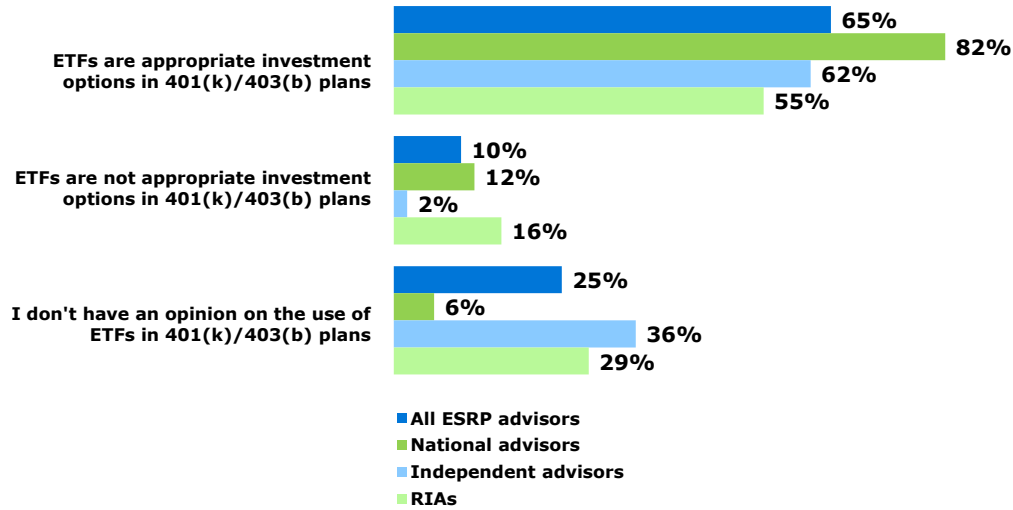
Yet, if only one out of ten ESRP advisors overall believe that ETFs are inappropriate in plans, why are only one third using them? The top two cited barriers are:

- Availability of ETFs on recordkeeping platforms
- Investor awareness of ETFs

Interestingly, recordkeeping hurdles no longer exist as ETFs are now becoming more readily available on 401(k) platforms (for example, SunGard who works with over 1,000 TPAs and recordkeepers recently announced that their recordkeeping systems can now accommodate ETFs). In addition, perceived barriers to adoption are likely to be eradicated in the near future, as:

- more advisors become aware of the increasing access to ETFs in DC plans
- aware and informed investors request ETFs in their DC plans
- advisors seek ETF based target-date funds as Qualified Default Investment Alternatives (QDIAs)

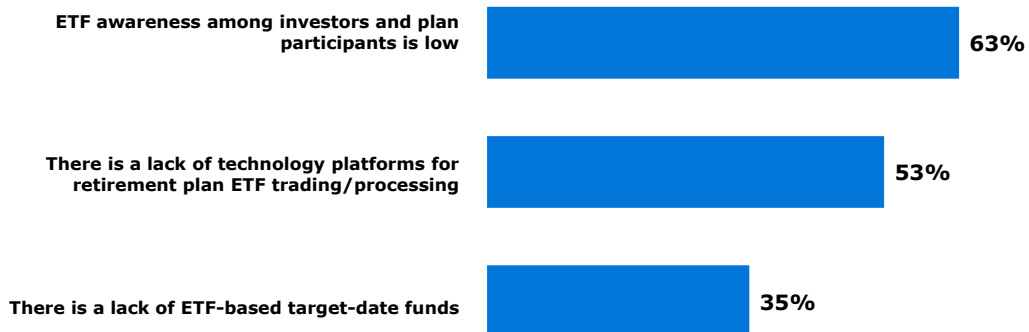
Exhibit 5. Are ETFs Appropriate ESRP Investment Options?



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EXHIBIT 5

Exhibit 6. Top Barriers to ETF Usage in Plans
(% agree)



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EXHIBIT 6

Availability. When asked why they are not currently using ETFs as investment options in the ESRPs they manage or advise, most advisors cite lack of availability- either because ETFs are not on the ESRP platform they use or the providers they use don't offer them yet. In fact, over half of ESRP advisors believe that there is a "lack of technology platforms for ETF trading/processing [Exhibit 6]."

Some comments from advisors include:

"Most of the large recordkeeping platforms are not able to operationally accommodate these investments at this time."

"Not accessible on many platforms I work with."

"Difficulty in recordkeeping. Eventually I believe that issue will be solved and the use of ETFs in plans will be widespread."

Interestingly, this barrier is most often cited by advisors who believe ETFs are indeed appropriate for plans but do not use them. As more

platforms continue to support ETFs, and more importantly, as advisors become aware of this availability, this barrier should weaken

Awareness. A common reason for not using ETFs as investment options is a perceived lack of general awareness, demand, or understanding of the product by plan participants and investors. In fact, nearly two-thirds of ESRP advisors agree that ETF awareness among investors and plan participants is low [Exhibit 6]. This is the barrier most commonly cited by advisors who do not use ETFs in their practice at all. However, recent investor research reveals that three-quarters of the nation's affluent investors recognize ETFs as investment options (source: *Cogent ETF Investor Brandscape, 2009*).

Finally, a smaller but still significant group of ESRP advisors (35%) incorrectly believe that there is a lack of ETF-based target-date funds [Exhibit 6]. In fact, iShares offers 8 target date ETFs in 10 year increments, and XShares offers five target date ETFs, with more providers sure to follow.

Exhibit 7. ETF Advisor Myths Revealed

Perception ¹	Reality
ETFs Are Not Supported By Most Retirement Platforms	<ul style="list-style-type: none"> •SunGard recordkeeping accommodates ETFs (1,000+ TPAs/recordkeepers, over 450,000 plans) • MATC accommodates ETFs (over 100 TPAs/recordkeepers, over 11,000 plans) • Ascensus accommodates ETFs (30,000+ plans) •PAi accommodates ETFs (13,000+ plans) •Wisdom Tree offers its own retirement platform
There Is A General Lack Of Awareness/Demand For ETFs	75% Of Investors Are Aware Of ETFs ²
There Is A Lack Of ETF-Based Target Date Funds	<p>iShares Offers 8 Target Date ETFs in 10 Year Increments</p> <p>XShares Offers 5 Target Date ETFs</p> <p>More Providers Likely To Follow</p>

Source: ¹Cogent 2009 ESRP Advisor Study; ²Cogent ETF Investor Brandscape 2009

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Action Agenda

The ESRP arena is competitive and complicated, yet allows dedicated advisors to grow their overall advisory practice. In order to proactively address current and future regulation, advisors should consider the following:

- **Demonstrate Expertise & Commitment**

In today's complex and evolving ESRP market, advisors must demonstrate that they are up to date with recently enacted and pending ESRP regulations, whether related to investment issues, fiduciary concerns, or other areas of state and federal compliance. Remind your clients and prospects that you are a key source of information and that you have their best interests at heart by conducting frequent reviews of legislation relative to the ESRP plans that you manage for plan sponsors.

- **Be As Transparent As Possible With Fees and Holdings**

In light of recent economic and financial events, it's no surprise, that "transparency" has become a key buzzword not only in the financial media, but among members of the ESRP community. While fee, compensation, and other arrangements have always been topics of discussion among plan sponsors and their trusted advisors, today's world requires more proactive disclosure, not only on fees but on investment holdings as well. Sharing information before required government disclosure will enhance your relationship and credibility with clients.

- **Augment Existing Investment Options**

The vast majority of advisors believe that ETFs are appropriate investment options in DC plans, yet, only one-third currently uses them in ESRPs. The trend in ETF adoption is growing strong both among advisors and investors, and old barriers to usage in retirement plans are quickly becoming obsolete. As low-cost, highly transparent investment vehicles, ETFs could be part of a solution for advisors and worth investigating for their benefits and appropriateness for plan sponsor and participant clients. The most proactive and relied upon advisors will become educated in this growing product and seek opportunities to introduce these products in the appropriate DC plans.

About the Study

The data examined for this report comes from Cogent Research's ESRP Advisor Study 2009, a survey of 130 financial advisors across distribution channels with a portion of their assets under management dedicated to employer-sponsored retirement plans. Results are based on a targeted sample of highly qualified retirement plan providers. Sponsored by iShares, this survey of retirement plan advisors was conducted online from August 26 to September 11, 2009. Survey respondents have, on average, 47% of their total assets under management (AUM) dedicated to ESRPs, 30 ESRPs under advisement and 13 years experience managing or advising ESRPs.

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