Index investing

A simple, low-cost solution for retirement plans
Index investing: A simple, low-cost solution for retirement plans

Despite the challenging economic conditions of the last few years, employers are still encouraging their employees to participate in 401(k) programs, and individuals remain committed to doing so. But sponsors and participants share some common concerns: potential future losses, not saving enough for retirement and the impact that fees may have on hard-earned savings.
Many sponsors are looking for solutions that can help address their employees’ concerns. A fund lineup composed of index investments may be an effective strategy that sponsors may want to consider to support the retirement goals of plan participants.

What is index investing?¹

Index investing refers to the practice of investing in a fund that replicates the makeup of a particular market or asset class index. For example, an index fund designed to track the S&P 500 index would invest in the stocks of the companies that the index comprises, and in approximately the same proportions. If the value of the stocks in the index goes up or down in value, so does the fund. Index investing is also known as “passive” investing because the fund manager does not make active decisions about which stocks to buy and sell. This low level of management means index funds usually carry low management expenses.

What are the different types of index funds?

Index mutual funds

Mutual funds are investment companies that pool money contributed by a group of investors and use it to buy a range of investments. An index mutual fund invests in the investments represented by a specific index in order to mirror the index’s performance. The combined holdings that a mutual fund owns are known as its portfolio. Investors in a mutual fund own shares, with each share representing their proportionate ownership of the fund’s holdings.

¹ Index composition is determined by the creator of an index, in this case Standard and Poor's Financial Services LLC. The S&P 500® Index is an index of 500 widely traded stocks composed of the largest U.S. companies by market capitalization. Indexes are unmanaged, do not incur management fees, transaction fees or other related expenses, and cannot be invested in directly.
Low-cost index funds may help participants accumulate more for retirement and stay on track toward their retirement goals.

“Low-cost index funds provide sponsors with essential building blocks that give participants the flexibility to focus on making the appropriate decisions for their retirement needs. It is very difficult to predict market returns, but sponsors can select funds that can help participants control their expenses.”

— Omar Aguilar, CIO, Equities, Charles Schwab Investment Management
Exchange-traded funds

Exchange-traded funds are funds that buy many or all of the securities in a particular index, aiming to replicate its performance. An exchange-traded fund may hold stocks, bonds or other assets, depending on which index it is tracking.

Exchange-traded funds do not sell individual shares directly to investors the way mutual funds do. Instead, they issue shares in large blocks and sell them to institutions. These institutions sell the individual shares to investors on a secondary market—hence the term “exchange-traded.”

What is the difference between index mutual funds and exchange-traded funds?

At first glance, index mutual funds and exchange-traded funds seem similar, since both are collections of stocks or bonds that track an index. However, there are some major differences for investors.

Trading

The main difference is the way investors buy and sell shares in the funds:

Index mutual funds

- Shares in mutual funds are not traded on an exchange, but rather are bought directly from the fund or investment company. An order to buy or sell shares is processed only once each day, after markets close.

- To exit a mutual fund, investors sell their shares back to the fund, which in turn will use cash from other share purchases or from asset sales to pay for the shares that are sold back.

Exchange-traded funds

- An exchange-traded fund essentially trades like a stock. Investors can buy or sell shares at any time during the trading day and pay a commission just like any stock trade.\(^2\)

- Exchange-traded fund investors who want to sell their shares do so on the secondary market to another investor, as if they were selling a stock.

Why consider offering index funds in a retirement plan?

For sponsors, offering a fund lineup that helps meet participants’ investing goals is key. With this in mind, index funds can be useful tools, offering:

Simplicity

- Creating a portfolio of all index mutual funds or exchange-traded funds may help simplify the process for sponsors choosing funds, eliminating the need to differentiate among individual manager investment strategies, track records or qualifications.

- Ongoing evaluation of funds may also be simpler, allowing sponsors to judge performance of a fund by comparing it with that of the underlying index.

\(^2\) In some retirement plans, commissions may be waived for exchange-traded fund trading activity. Sponsors should consult with their plan provider to understand all fees associated with exchange-traded fund trading activity.
Diversification

- Index funds offer sponsors the opportunity to build diversified asset allocation models that may be easier to set up and run. For sponsors who want to offer access to a particular asset class, it is as easy as selecting the relevant index and the fund that tracks it.

- Index funds offer an array of choices across asset classes, allowing participants to create a diversified retirement portfolio.

- With index funds, sponsors can improve access to areas such as commodities or international markets without going through the same process required when picking an actively managed fund.

Lower operating expenses

- Index funds generally have lower expenses than actively managed funds because they don’t employ investment managers or analysts to select, monitor and actively trade underlying assets.

- Index funds, by their very nature, follow a buy-and-hold strategy, thus reducing transaction fees. Often the funds simply make minor adjustments based on investor inflows and outflows, allowing the fund to keep the management costs it charges investors low compared with actively managed funds.

Managing participant expectations

As the number of investments available in the market has grown, so has the complexity of selecting and managing an investment portfolio. Participants in retirement plans are looking for more straightforward choices when making investment decisions.

Index funds may provide plan sponsors with a way to offer straightforward investment options to their plan participants:

- Index funds generally deliver exactly what they say they will: performance in line with a specific index.

- It’s easy for participants to monitor, since fund performance should mirror its underlying index, less management expenses.

- In an uncertain world, index funds can provide investors with a clear way to understand what they are buying.

Consistency

Because index funds purchase assets in order to replicate the composition of an index, the potential that the fund will drift from a previously stated investment strategy and invest in new sectors or asset classes is lessened, helping mitigate the risk of reduced diversification.

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3 Because index funds deliver returns that mirror an index, participants do give up any potential for outperformance.
Reduced deviation from benchmark

Index funds generally deviate from their established benchmark less frequently than actively managed funds, since they generally buy and sell investments only to replicate an index. In addition, index investing may reduce other investment risks, including:

- The potential volatility associated with concentrated portfolios consisting of a limited number of investments
- The risk of potentially inconsistent returns over time compared with an established investment benchmark

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<th>Percentage of U.S. Equity Funds outperformed by benchmarks</th>
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<tr>
<td><strong>Fund Category</strong></td>
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<td>All Domestic Equity Funds</td>
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<td>All Emerging Market Funds</td>
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<td>All Global Funds</td>
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Source: Standard & Poor’s Index vs. Active (SPIVA®) Scorecard, U.S. Year-End 2013. Outperformance is based upon equal weight fund counts. Charts are provided for illustrative purposes only. S&P, STANDARD & POOR’S, S&P 500, S&P COMPOSITE 1500, S&P MIDCAP 400, and S&P SMALLCAP 600 are registered trademarks of Standard & Poor’s Financial Services LLC. *Past performance is no guarantee of future results.*

Transparency

The holdings of an index fund are generally more transparent since each fund is designed to track the underlying investments in an index. Changes to the investments held by an index fund usually occur when a change is made to the composition of the underlying index.
“Index funds offer sponsors a way to manage the expectations of participants. Rather than promising the potential for outperformance, what these funds can actually deliver is simple—matching the performance of an index.”

— Michael Iachini, Managing Director of ETF Research, Charles Schwab Investment Advisory, Inc.
What considerations should sponsors keep in mind when selecting plan investments?

As sponsors decide whether index funds are right for their retirement plan fund lineup, they may want to take the following factors into account:

**Suitability of investment**

As with all investment selection decisions, sponsors should undertake a concerted review of all available investment options so they are confident that index investments are appropriate for their participants.  

**Awareness among participants**

While many people have heard of exchange-traded funds, not everyone knows exactly how they work. The same could be said for index funds. Plan sponsors will need to ensure that participants clearly understand the options that are presented to them.

**A long-term approach**

Participants should also be made aware that the values of exchange-traded funds fluctuate during the day in the course of trading. Retirement saving is often best served by keeping a long-term saving and investment plan in mind.

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*Plan sponsors should seek professional legal and/or investment advice when selecting a fund lineup.*
With low costs and returns that are linked to index performance, index funds can offer participants an easy way to help them drive toward meeting their retirement goals.

**Index investing: An approach worth considering**

A survey of 401(k) plan participants showed that a majority are not confident about their retirement, feeling that they won’t have saved or invested enough to live the kind of life they want. Index funds offer a simple, low-cost way to potentially help address this problem.

A particularly compelling feature of index investing is the transparency it offers. There is no mystery surrounding the returns that index funds achieve—they should rise or fall along with the index they are tracking, less management expenses.

While no one can predict future market returns, index funds give sponsors an element of control over an area that may influence outcomes: cost. As a low-cost alternative, index investing can help employees potentially accumulate more for retirement and help them drive toward meeting their retirement goals.

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We welcome the opportunity to discuss the range of retirement plan alternatives that you might want to consider to help your participants become financially fit. To continue this conversation, please contact Schwab Retirement Plan Services at 877-223-7036 or visit schwab.com/workplace.
Diversification strategies do not ensure a profit and do not protect against losses in declining markets.

Remember that cost is only one consideration when making an investment decision. Some specialized exchange-traded funds can be subject to additional market risks. Investment returns and principal value of exchange-traded funds and index mutual funds will fluctuate and are subject to market volatility, so that an investor’s shares, when redeemed or sold, may be worth more or less than their original cost. Unlike mutual funds, shares of exchange-traded funds are not individually redeemable directly with the exchange-traded funds. Shares are bought and sold at market price, which may be higher or lower than the net asset value (NAV). Index funds are not without risk and an investor may give up the opportunity to outperform the market by not being in an actively managed fund. All exchange-traded funds and index mutual funds are subject to management fees and expenses.

Since a commodity fund is typically not diversified and focuses its investments in a single commodity or basket of commodities, the fund may involve a greater degree of risk than an investment in other mutual funds with greater diversification.

International investments are subject to additional risks, such as currency fluctuation, political instability and the potential for illiquid markets.

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