Index Funds: Above & Beyond Cost

By: Patrick Fischbach, Principal

Due to their ease of use, transparency, and exceptionally low costs, index funds have increasingly become popular with many investors, including those in retirement plans. However, as is the case with any investment, it is becoming important to have a sound process in place for selecting and monitoring these types of strategies outside of cost alone.

Cerity Partners has been a long-time advocate of including these strategies in retirement plans, within the appropriate circumstance. Some key questions that we often get from our plan sponsors are:

- What are index funds, why has their popularity increased, and are they right for my plan?
- How do I select an index fund manager?
- What are the best practices for governance and ongoing monitoring an index fund?

WHAT IS AN INDEX FUND?

Index funds are "passively managed" and typically operate by replicating the performance and risk characteristics of a specific marketplace (e.g., US equities or global bonds). This is in contrast to "active management" whereby asset managers selectively pick and choose individual securities within a marketplace, with the goal of outperforming indexes over the long term.

They have become increasingly popular due to their straightforward approach, ease of implementation, diversification, investment performance and extremely low cost characteristics. To illustrate this, consider recent data from the Investment Company Institute. Over the 10-year period ending December 2021, assets in indexed mutual funds grew from $1.1 trillion to $5.7 trillion, accounting for over 400% growth. This does not even count the asset flows in other investment vehicle types such as collective investment trusts (a widely used investment vehicle in DC plans), which has also skyrocketed.

ARE THEY RIGHT FOR MY PLAN?

More and more research suggests that active managers have consistently been unable to outperform indexes over the longer-term across a variety of different asset classes traditionally offered in retirement plans. For example, consider the US Large Cap Blend equity asset class, as represented by Morningstar's peer group. As of December 31, 2021, Morningstar reports that only 9.5% of active managers were able to outperform the S&P 500 over the trailing 10-year period. Stretch that out to 15- and 20-year periods, and similar success rates can be seen.

Additionally, consider the cost element as it relates to investor returns. An investment's expense ratio, typically published in basis points, is taken directly out of a fund's returns. The higher the fee, the more that is taken out of the end return received by the investor.

HOW DO I SELECT AN INDEX FUND?

Despite their ease-of-use and transparency, index funds should still be scrutinized in their selection and monitoring process. Investment managers such as BlackRock and Vanguard, have used their size and scale to provide extremely efficient index solutions to retirement plans of all sizes. While mutual funds had long been the vehicle of choice, collective investment trusts continue to become more prevalent in retirement plans, as they typically will provide the same product at a lower cost given the economies of scale achieved from higher asset volumes that often come with retirement plans.

Fees should certainly be evaluated relative to other index fund peers, but what comes with that fee? Is the investment manager replicating the index via a full-replication methodology (i.e., attempting to track each underlying security of the index at its exact weight), or is it perhaps a representative sampling methodology (i.e., attempting to replicate the risk and performance characteristics, but not necessarily holding all underlying securities by exact weight)? Both types can be useful depending on the asset class covered.

On the flip side, it should also be noted that index funds may not be the optimal solution for all asset classes, especially some of the more esoteric asset classes where a stronger case for the use of active management has existed on a historical basis. Index fund usage should be regularly evaluated based on the asset classes offered in the plan.

A topic often neglected when reviewing index funds is securities lending. In short, this means the fund is allowed to lend out its underlying holdings for a certain period of time and receive additional compensation for doing so. This can become attractive when done in moderation, as it can add to returns received by investors and make up the difference in performance relative to the index that comes with the fund's fee. But it becomes crucial to understanding the mechanisms of the manager's securities lending program, as it adds another nuance when evaluating the fund.

WHAT ARE KEY GOVERNANCE AND MONITORING CONSIDERATIONS?

Many retirement plan lawsuits in the last decade often have a direct or indirect focus on investment fees charged to participants. Whether an active or passive investment is used, a thorough review of fees in relation to similar peers should be conducted. Index funds, with their low costs, have provided plan sponsors with an effective method in lowering overall investment costs of plans, broadly speaking.

Performance monitoring should be regularly incorporated into any plan sponsor's process, ensuring any index fund is appropriately tracking its prospectus index. Typically, tracking error can be used to measure how closely the fund has followed its index from a performance perspective. The difference in performance between fund and index should typically be close to the overall expense ratio of the fund, with any wide variation often warranting further analysis.

IN CLOSING

There are many tools that plan sponsors have at their disposal that provides retirement plan participants the ability to achieve stronger financial outcomes in retirement. Index funds increasingly play a more significant role in this journey. But incorporating them requires the same thoughtfulness and rigor in overall plan menu design associated with all other investment types.

LET US HELP.

RetirementServices@ceritypartners.com

Cerity Partners LLC ("Cerity Partners") is an SEC-registered investment adviser with office locations throughout the United States. Registration of an Investment Advisor does not imply any level of skill or training. The foregoing is limited to general information about Cerity Partners' financial market outlook. You should not construe the information contained herein as personalized investment, tax, or legal advice. There is no guarantee that the views and opinions expressed in this commentary will come to pass. The information presented is subject to change without notice and should not be considered as an offer to sell or a solicitation of an offer to buy any security. Material economic conditions and/or events may affect future results. All information is deemed reliable as of the date of this commentary but is not guaranteed. Before making any decision or taking any action that may affect your finances or your company's finances, you should consult a qualified professional adviser. For information pertaining to the registration status of Cerity Partners, please contact us or refer to the Investment Adviser Public Disclosure website (www.adviserinfo.sec.gov). For additional information about Cerity Partners, including fees, conflicts of interest, and services, send for our disclosure statement as set forth on Form CRS and ADV Part 2 using the contact information herein. Please read the disclosure statement carefully before you invest or send money.

©2022 Cerity Partners LLC, an SEC-registered investment adviser. All Rights Reserved. (06/22)