The Index Fund Revolution Comes To My 401K

I was pretty excited to see that my 401K is moving from predominantly actively-managed mutual funds to predominantly index mutual funds. The best part is that several of the funds are ones that I already hold in my Roth IRA, including the Vanguard REIT Index and the Vanguard Emerging Market Index.

Other funds being added that I could use include the Schwab International Index Fund, the Schwab Small Cap Value Index Fund, and the TIAA-CREF Large Cap Value Index Fund as they are relatively direct substitutes for funds I’m currently holding in my old 401K (the TSP) and Roth IRAs. In all, 8 actively managed funds are being removed (all but one) and 8 index funds are being added to the one that was in the 401K line-up.

Lower Expenses

According to our 401K guy, this will lower the average expense of our investment options by about 0.30%. It won’t lower mine any, since my entire 401K was invested in the Schwab Total Stock Market Index Fund, but it does give me a lot of options I could use instead of using the brokerage option the 401K provides, which is what I was planning to do in the near future.

Schwab Index Advantage

This is part of a move to the “Schwab Index Advantage” plan. Basically, they lower your expense ratios by 0.30%, then charge you 0.45% for their advice on which ones you should choose. You actually have to opt out of the advice portion or you get it whether you want it or not. But considering all the investment advice options already available to the members of our partnership, I don’t think this is necessarily a good
deal. We’re already paying 0.4% of Assets under Management (AUM) to MedAmerica (the 401K provider), and they’re willing to provide asset allocation advice as part of that fee. We also have the UMAFS available to us, either as a once a year meeting for free, or to get comprehensive investment management for ~0.6% of AUM.

I was surprised that Schwab let us have Vanguard index funds in the plan. The 401K guy explained that they wanted a variety of index options available to use, and that was why we got Schwab index funds, Vanguard index funds, and TIAA-CREF index funds. I’m not sure I care much about variety, I’d just as soon have them all be from Vanguard since Vanguard has consistently shown that they can track an index very well at rock-bottom costs, but I’m pretty happy with what we’ve got.

**Funds Versus Brokerage Option**

Now I have a tough decision. I can easily implement my desired asset allocation just using the pre-selected funds in the 401K. Or I could just use the brokerage option (PCRA in Schwab jargon). I would have to pay a fee of $200 per year, plus commissions, but I wouldn’t have to pay the 0.4% fee to MedAmerica, the 401K company. $200/0.4% = $50K. Since I now have more than that in the 401K, it would probably be cheaper for me to just buy ETFs at the brokerage window. The Schwab ones are commission-free, and I could get Vanguard ETFs for $8.95 a trade. I’ll probably still end up using the PCRA option, just for the slightly lower fees.

**The Index Revolution**

As word gets out and 401K participants become more aware of the impact of mutual fund fees on their returns, and of the failures of active management strategies, I think we’ll see this happening more and more in 401Ks across the nation. Employers have a fiduciary obligation to their employees, and
some have even suggested that they could be found liable for NOT using index funds in the company retirement plan. This example also shows that your 401K is NOT set in stone, and if enough people care about it and put a little pressure on, that you can get a 401K with low fees and attractive investing options.