

The background of the page is a blurred image of financial data, including stock market tickers and charts in shades of blue and green. The text is overlaid on a dark purple rectangular area.

Using Exchange- Traded Funds (ETFs) In Retirement Plans

Sheets Smith Wealth Management Marketing Commentary Disclaimer:

Sheets Smith Wealth Management, Inc. ("Sheets Smith") offers investment advisory services and is registered with the U.S. Securities and Exchange Commission ("SEC"). SEC registration does not constitute an endorsement of the advisory firm by any regulatory authority, nor does it indicate that the advisory firm has attained a particular level of skill or ability. All content available in this publication is general in nature, not directed or tailored to any particular person, and is for informational purposes only. Neither this publication nor any of its content is offered as investment advice and should not be deemed as investment advice or a recommendation to purchase or sell any specific security. The information contained herein reflects the opinions and projections of Sheets Smith as of the date hereof, which are subject to change without notice at any time. Sheets Smith does not represent that any opinion or projection will be realized. The information contained herein has been obtained from sources considered reliable, but neither Sheets Smith nor any of its managers, officers, advisers, employees, agents, or affiliates represents that any third party information presented in this publication is accurate, current, or complete, and such information is subject to change without notice. The information contained in this publication does not purport to be a complete description of the securities, markets, or developments referred to in this material. Any performance information must be considered in conjunction with applicable disclosures. Past performance is not a guarantee of future results. Neither this publication nor its contents should be construed as legal, tax, or other advice. Individuals are urged to consult with their own tax or legal advisors before entering into any advisory contract. Any investment is subject to risks, including the possible loss of principal. Individual investor's results will vary. Investing involves risk, and you may incur a profit or loss, including the entire loss of investment.



The popularity of ETFs is rising – what are some considerations for plan sponsors in including them in their retirement plan lineups?

SPRING
2026

In the recently published PSCA 68th Annual Survey, respondents detailed the type of investment structure their plan utilized. In many asset classes, plans held less than two percent in ETF assets.

See Exhibit 1.

Exhibit 1: Investment Structure by Fund Type

Fund Type	Investment Fund Structure 401(k) Plans				
	Mutual Fund	Co-Mingled	Insurance Account	ETF	Separately Managed Account
Alternative Asset Class	44.5%	28.1%	2.9%	4%	20.4%
Balanced Fund/Asset Allocation	53.1%	25.4%	1.3%	2.7%	17.5%
Bond-Actively Managed, Domestic	50.8%	26.4%	2%	2.2%	18.6%
Bond-Indexed, Domestic	58.2%	25.3%	1.6%	1.9%	13.0%
Bond, International	52.8%	25.6%	1.1%	1.9%	18.6%
TIPS	52.4%	24.4%	1.2%	2.4%	19.5%
Cash Equivalents (CD/Money Market)	59.9%	21.7%	2.6%	1.3%	14.6%
Company Stock	30.6%	32.4%	1.8%	6.3%	28.8%
Emerging Markets	58.0%	22.6%	1.3%	1.6%	16.5%
Equity-Actively Managed, Domestic	53.0%	26.7%	2.2%	1.3%	16.8%
Equity-Actively Managed, International/Global	55.2%	25.6%	1.9%	1.2%	16.1%
Equity-Indexed, Domestic	58.7%	24.1%	1.4%	1.6%	14.1%
Equity-Indexed, International/Global	55.1%	25.9%	0.9%	1.9%	16.1%
ESG Funds (Socially Responsible)	50.8%	23.8%	2.4%	3.2%	19.8%
Real Estate Fund (Including REITs)	59.5%	20.8%	1.1%	2.3%	16.3%
Sector Funds/Commodities (Other than Real Estate)	50.0%	26.1%	0.7%	2.8%	20.4%
Self-Directed Brokerage/Mutual Fund Window	39.1%	27.5%	1.9%	9.2%	22.2%
Stable Value	39.5%	35.9%	8.5%	1.4%	14.7%
Target Retirement Date	50.6%	32.3%	2.3%	2.5%	12.5%
Target Risk	43.0%	31.8%	2.6%	2.6%	19.9%
Other	33.3%	34.8%	6.1%	3.0%	22.7%

The most common investment vehicle (mutual funds, or MFs) are technically “registered investment companies” (RIC) governed by the Investment Company Act of 1940. They are “open-end funds” as the fund sponsor itself is continually issuing and redeeming shares due to underlying shareholder activity. The first U.S. MF was created in 1924. In 1980, when the first 401(k) plan was established, MFs were the only type of publicly traded commingled fund available for investment. This longevity and early “head start” help to explain in large part the dominance of MFs held by retirement plans.

In 1993, a new type of RIC called an Exchange-Traded Fund (ETF) was introduced by State Street Bank & Trust when they launched SPY (SPDR® S&P 500® ETF), a basket of securities tracking the performance of the S&P 500® Index.

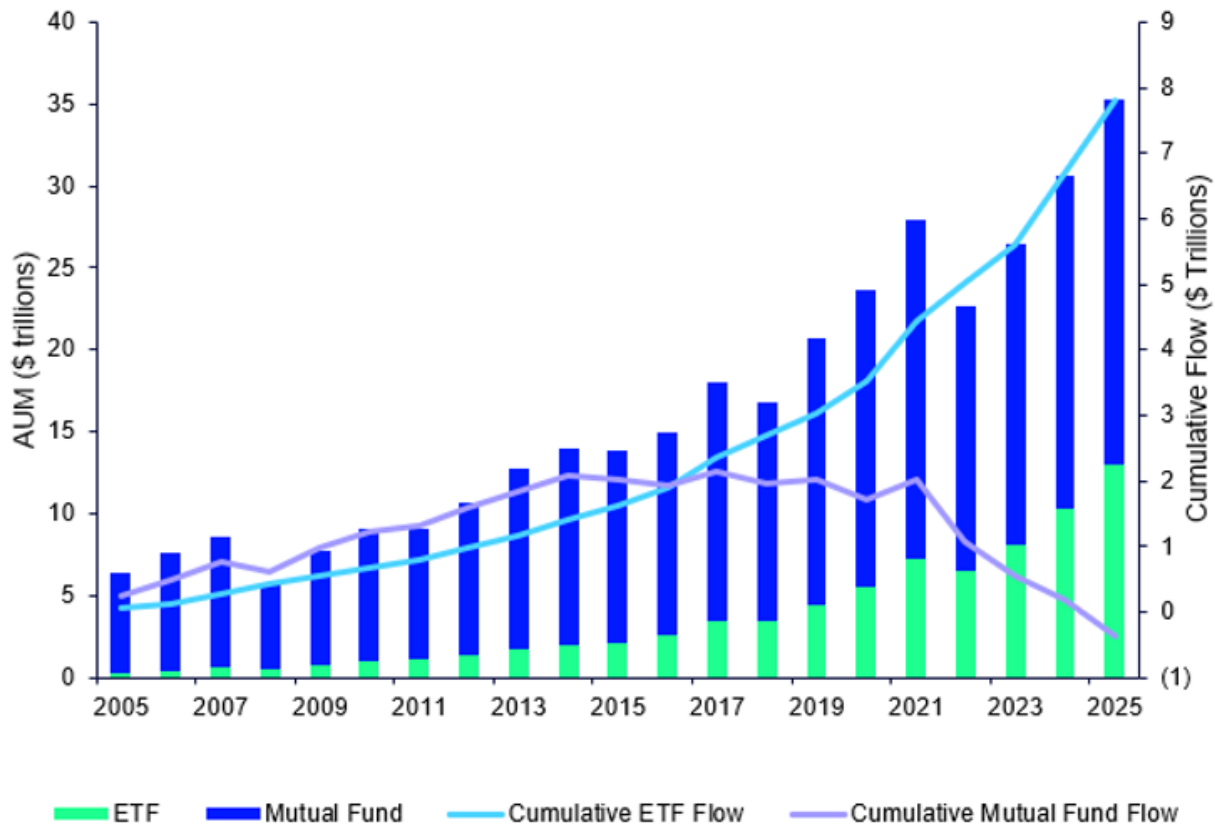
Unlike MFs, ETFs are listed and traded on a stock exchange, thus giving investors the ability to trade the fund like a stock throughout the trading day (inter-day trading). ETFs (like stocks) can also be sold short.

MF shares, by contrast, are only created or redeemed once per day by the fund company itself at the 4 pm closing price (NAV, or net asset value). A key challenge facing recordkeepers and custodians from the very start was how to trade and process ETFs on systems that had been architected on a one price per day regimen. We’ll examine that shortly.

The Growth of ETFs

The growth of assets under management (AUM) in ETFs over the past 20 years (and the concomitant decline in mutual fund flows) has been astonishing. See Exhibit 2.

Exhibit 2: ETF and Mutual Fund AUM and Cumulative Flows By Calendar Year, \$ trillions



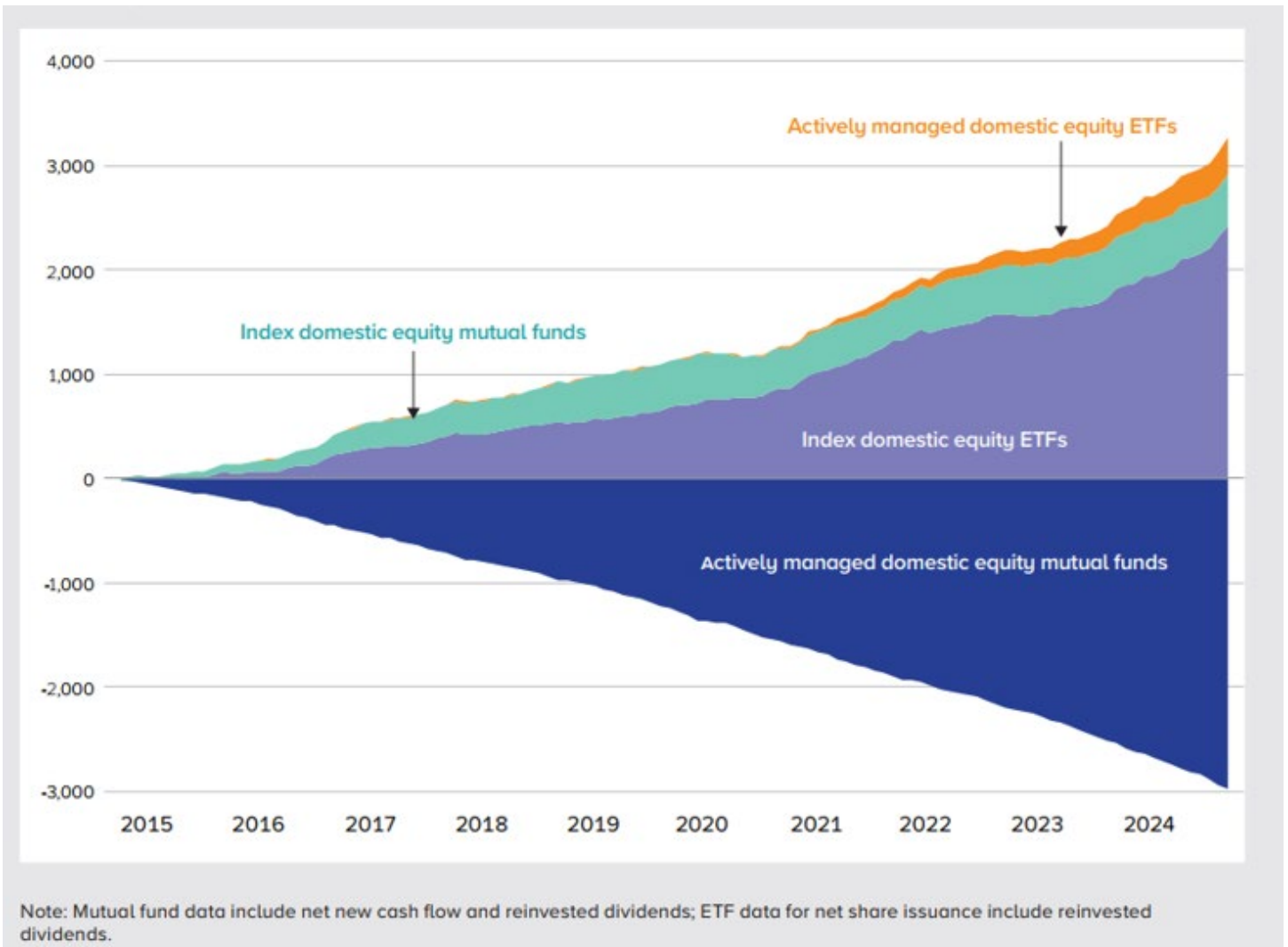
Source: State Street Investment Management as of Oct. 31, 2025

SPRING
2026

This divergence has been particularly acute in the US equity fund category, especially actively managed US equity mutual

funds. Exhibit 3 shows just how dominant passive US equity index funds have become.

Exhibit 3: Growth of Index Funds Over Time



Source: ICI Fact Book 2025

ADVANTAGES OF ETF

There are three critical reasons why ETFs have grown to be the destination of choice for new U.S. fund flows: lower costs, greater tax efficiency, and more transparency as to their holdings. In addition, the most cutting-edge and highly sophisticated strategies from leading institutional managers are now being “packaged” for retail investors almost exclusively via ETFs.

On the cost front, the median expense ratio for mutual funds is .90 percent versus .56 percent for ETFs. If we look at average operating expenses ratios (OER) for just actively managed funds, we find the same thing. See *Exhibit 4*.

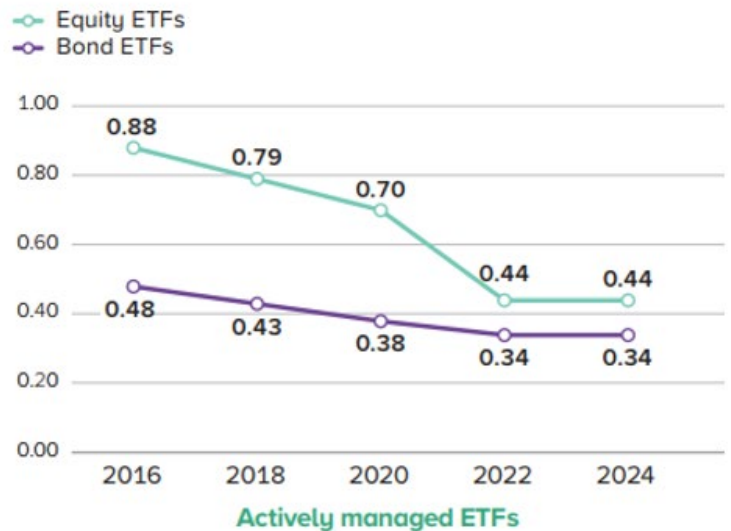
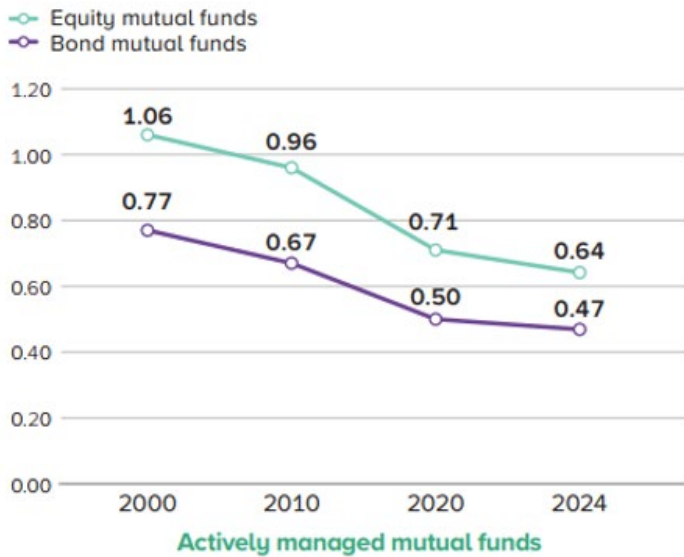
TAX EFFICIENCY

Investors in tax-deferred retirement plans do not usually consider the tax impact of a fund’s operations, but it is important to understand in the context of overall demand for a given fund (not everything is performance driven).

Mutual funds commonly distribute capital gains to all shareholders at year end regardless of the investor’s holding period. These gains are based on the aggregate trading activity for the fund’s portfolio holdings (strategic re-positioning and raising cash for redemptions by the portfolio managers are the two most common activities.) This means that a shareholder who bought and held shares (even for one day prior to the record date during the current fiscal year) will receive an entire year’s worth of capital gains generated by the portfolio even though they had no selling activity for their personally held shares.

In other words, the accumulated yearly costs of all portfolio activity (driven by other shareholders) are borne proportionately by every single fund holder (even brand-new ones) – even if they did nothing. (Some might call it “socializing” the costs of a mutual fund operation.)

Exhibit 4: Use of Actively Managed Funds Over Time



Source: ICI Factbook 2025

SPRING
2026

By contrast, ETFs rarely distribute capital gains due to a unique design feature that allows fund shares to be created or redeemed “in kind” using sophisticated tax lot management that effectively neutralizes any gains. In 2024, for instance, ETFs made up 31 percent of managed fund assets yet distributed less than one percent of all capital gains paid by all funds. *See Exhibit 5.*

Exhibit 5: Total Capital Gain Distributions

Total capital gain distributions (% of \$ paid) ¹¹

Year	ETFs	Open End Funds
2024	0.2%	99.8%
2023	0.2%	99.8%
2022	0.6%	99.4%
2021	0.4%	99.6%

Source: Blackrock – “Examining the ETF Ecosystem” April 2025

Importantly, since outstanding (issued) ETF shares trade throughout the day on an exchange, buys and sells are “netted” daily so that new share issuance or redemption is minimized. That is not true of MF shares, which must redeem specific shares or issue new shares each time a shareholder transacts (adding to fund operational costs).

FUND TRANSPARENCY

In addition, mutual funds offer little transparency, with holdings disclosed only quarterly in arrears per SEC guidelines. This can be highly injurious to fund shareholders, as in 2008-2009 when some U.S. money market, bond, financial sector and other value equity funds disclosed significant (and soon to be worthless) holdings in Bears Stearns, Lehman Brothers, and “value-oriented” names – after the fact of these company’s bankruptcies (and much to the surprise of fund shareholders).

By contrast, most ETFs publish their holdings daily (usually via a downloadable spreadsheet). Daily disclosure is one of the requirements of SEC Rule 6c-11 (the “ETF Rule”), passed in 2019, which reformed a cumbersome registration process for ETFs that required them to file for “exemptive relief” under the Investment Company Act of 1940 each time a new fund was proposed. This “relief” was required because ETFs allow large, identified institutions

(“authorized participants” or an AP) to transact directly with the fund. (Examples of APs are JP Morgan, Goldman Sachs, Bank of America and other large institutional broker-dealers.)

ETF CREATE / REDEEM PROCESS

Unlike MF shareholders, ETF investors don’t transact directly with the fund company when buying or selling. Instead, they buy or sell existing shares from other holders on an exchange (i.e. a “secondary market” transaction).

When demand for an ETF rises, newly issued ETF shares (“primary market” issuance) are handled by an AP via “creation units” on behalf of the fund. “Redemption units” are used to reduce the outstanding share “float” when demand decreases. This “create/redeem” process is where the tax magic happens.

Creation units are a large block of shares, say 50,000, by which an ETF effectively “issues” new shares. Cash from new shareholders is used by the AP to purchase the precise basket of securities making up the fund holdings (each security acquired having its own cost basis). (For an S&P 500® Index ETF, that means acquiring 500 new tax lots EVERY DAY there is creation activity!) The AP delivers these security “baskets” in exchange for new ETF shares issued by the fund, which are then added to the “float” on the primary exchange to satisfy that day’s demand. Any excess shares are typically held in the inventory of the market maker for any given ETF.

The process works in reverse using redemption units, with the key distinction being that the fund itself does not have to sell holdings to raise cash (i.e. incur a capital gain or loss). Instead, the fund can deliver an “in-kind” basket of shares to the AP equal to the cash required. (Note that the basket is comprised of carefully selected tax lots intended to maintain a “flat” taxable profile for the fund.)

The AP disposes of those shares through its own trading activities, and the realized cash proceeds are then sent to the fund. This avoids nearly all capital gains passing through the fund itself – it is simply swapping “securities for cash”. This is why ETFs rarely declare and distribute capital gains.

Turning back to the transparency issue, ETFs in their early form were mostly passive, index-based strategies, well suited to be “fully transparent” (i.e. daily disclosure of all fund holdings). Even today, any investor can go to the website for an index ETF and download a complete set of holdings. This provides a direct “look-through” to the underlying portfolio (and hopefully no surprises for investment analysts and others who are paid to manage and understand portfolio risk.)

Not all ETFs are fully transparent though. As an example, Vanguard’s Index ETFs are technically a separate share class of their index MFs, with holdings disclosed 15 days following each month end (a good move on Vanguard’s part as it is still more frequent than the required quarterly MF filing).

ACTIVE ETFS

Another key aspect of the 2019 ETF rule was to allow for the use of “custom baskets” during the create /redeem process. This

provision gave ETF fund managers greater flexibility to acquire portfolio holdings, particularly in less liquid markets where securities are typically more difficult to access. The implementation of this rule opened the door for active strategies to enter the ETF market.

Most active ETFs can be described as “semi-transparent” when it comes to disclosure of their portfolio holdings. This means that, to protect their “intellectual property” (stock picks for instance), and to comply with the ETF rule, their required disclosure may omit 8-10 percent of their actual holdings. This allowance gives a fund sufficient time to transact in a target security (thus preventing “front-running” by other investors).

Active ETFs usually publish their holdings either monthly or quarterly depending on the fund issuer. Some also impose a 10-15 day delay after month-end before filing their holdings list. Again, monthly is better than quarterly, another advantage of ETFs over MFs.

Another key development supporting the rise in issuance of active ETFs is the ongoing “cloning” of actively managed mutual funds with a long track record of superior performance into a new ETF. The newly cloned ETF is usually a separate Trust (distinct and separate legal entity from the MF) whose portfolio closely matches the “parent” fund (but may not exactly). The cloned ETF almost always carries a lower expense ratio, making them very attractive for all investors.

But note also that many active mutual funds are “closing” and converting to an ETF. This is a “forced conversion” where existing shareholders have no choice but to accept the newly minted ETF (or sell the MF shares prior to conversion). Plans need to monitor their fund shareholder correspondence closely. In the unfortunate event of a MF closure, they will need to act quickly to replace the fund or sign the required paperwork to add ETFs to their menu if they wish to retain the new ETF.

Finally, active ETFs are beginning to offer cutting-edge institutional grade (separate account) strategies that have heretofore been unavailable to retail investors. One of the most successful ETF launches in 2025, for instance, was the SPDR® Bridgewater All Weather ETF (ALLW). This ETF offers investors access to Bridgewater Associates’ flagship “global macro” strategic asset allocation approach, which has been utilized for decades by many of the world’s leading institutional investors.

ADDING ETFS TO A RETIREMENT PLAN

If a plan sponsor (in conjunction with their investment professionals) has decided to add ETFs to their plan’s fund line-up, they will first need to determine product availability on the plan’s custodial platform.

As with MFs, the custodian will scrutinize product features before approving it for use by a retirement plan. For ETFs, the primary evaluative metrics are relevance and liquidity. A newly launched ETF with \$5 million in assets and pursuing an inverse return or leveraged return to a single stock is not going to pass muster. Custodians are looking for highly liquid ETFs (trading

100,000 shares a day or more for instance) from name brand fund sponsors which pursue well-established investment objectives (large cap US equity growth funds for example).

Importantly, a real benefit when evaluating ETFs is that they do not have separate share classes as mutual funds do. As most practitioners will attest, a significant amount of analytical time for mutual funds goes towards unpacking the various share class fee structures and restrictions. This all goes away when choosing to add an ETF.

The next step is to engage the plan’s recordkeeper (RK) to ascertain the additional procedures/documents that are required to add ETFs. Importantly, not all RKs have the ability to include ETFs on their systems, so if they do not, another search must be undertaken to find a suitable RK.

RKs serve as the bridge between the plan’s participants and the plan assets, which are held by a custodian. They will typically coordinate all documentation during this process.

Plans will usually have to execute an “addendum” to their existing custodial service agreement (“contract”) which spells out in detail the additional stipulations that come with adding ETFs.

The most important of these is a small asset-based fee for trade processing and other services that is based on the “trade settlement cycle” selected, usually referred to as an “early cut-off” or “standard” pricing option.

EARLY CUT-OFF PRICING OPTION

An early cut-off means that all trades must be submitted by the RK to the custodian several hours before market close (say 1:00 pm or 2:00 pm) to receive that day’s closing prices. A typical fee would be 1 - 2 basis points (bps). This option allows ETFs to be purchased “same day” as there is ample time to prepare the ETF trade for execution prior to the close (and thus a lower cost.) However, since the mutual fund NAV is not struck until 4 pm, the offsetting leg of any fund swap occurs on the following day. This early cut-off arrangement is thus termed an “NDSE” (Non-Same Day Exchange trading cycle).

Note that ETF trading expertise is required to receive “best execution” on an exchange during normal market hours. Specific order types are used. A very common order type for an ETF is a “Market on Close” (MoC) order, where the execution agent is given in advance the ETF share quantity to be bought or sold at that day’s closing price. Every ETF has a “capital markets desk / market maker” (Jane Street and Virtu are examples) which coordinates with their designated AP to maintain ETF share and price liquidity, so this MoC information is of great assistance should large “create / redeem units” be required to satisfy an MoC order. (This is the best way to “book match” the closing prices of a mutual fund and ETF since both reflect 4 pm market values of the underlying portfolio assets.)

Alternatively, the popular “Volume Weighted Average Price” (VWAP) order type sources execution prices over a set period of time (say from 2 – 4 pm) to create a single average price based on the volume of shares associated with each trade.

SPRING
2026

Other trading methods may be used but they all satisfy the “single price” requirement used by recordkeeping systems (RKS) to record and allocate plan trading.

STANDARD PRICING OPTION

The standard option allows trade files to be submitted “after hours” (say 10 or 11 pm) on trade date to receive that day’s closing price for the ETF (remember an ETF trades on an exchange which closes at 4 pm). Pricing is higher for this option (4 to 6 bps) as the custodian’s trading partners must use sophisticated pricing and hedging techniques to “capture” a 4 pm closing ETF price (after the fact). The advantage of the standard option, however, is that the NAV of the MF sold is known with certainty. The Standard pricing option therefore enables “SDE,” or same-day exchange (for both sides of a fund swap).

Note that any “ETF program fees” (under either pricing option) can be billed to the plan sponsor and not charged directly to the participant in the form of a “commission.” (They can thus be a deductible expense for the company sponsoring the plan and, assuming no plan assets are used to pay this expense, less of a potential fiduciary liability.) Alternatively, they may be billed to the plan’s participants as an administrative fee. Understanding how these fees are billed and who exactly pays them is another important item on the due diligence checklist.

OPERATIONAL CHALLENGES FOR ETFs

For any plan, there are essentially two types of trades: daily participant directed trades (salary deferrals/contributions, redemptions, and rebalancing) and plan level fund changes (swaps) where an existing fund is replaced by another, with the proceeds being “mapped” to the replacement fund. (It is common practice, however, to limit the number of fund changes to once or twice per year without an additional fee being added.)

In both cases, the RK will prepare each day an “omnibus trade file” for submission to their various custodians. An “omnibus” file (also called an “exchange file”) is a summary of all trades for all funds for all plans on the RKS. These files include all product types, including not only mutual funds and ETFs, but also CITs and stable value funds, and other unique assets (company stock for example). All RK file submissions must meet the guidelines and, most importantly, the timelines established by the plan’s custodian.

Upon receipt by the custodian, these trades are prepared and executed according to their established procedures. MF to MF trades present no problems as the assets are swapped on the same trade date.

However, as we have seen, under the NDSE trading cycle, the next day execution of the fund swap exposes plan assets to overnight price movements. This presents a significant fiduciary risk.

Any savvy trader knows that a true “swap” is the only way to minimize risk via “price slippage”: the proceeds (dollars) from a sale of an asset are immediately re-invested into the purchased asset

(same time stamp if possible). No time should elapse in a true swap, as assets are sold and bought nearly instantaneously (or, in the case of a mutual fund or ETF, both sides are executed the same day at the daily NAV closing price at 4 pm.)

This “fund swap” price risk under the “early cut off” option should be unacceptable to any plan fiduciary. The standard option, which allows for late / after- hours exchange file submission (i.e. same day trading), should be preferred for any plan which includes ETFs (despite its slightly higher program cost). This difference is not well known among the plan sponsor community or even by many service providers, but it is critical to understand the impact of the ETF trading choice made.

AUDIT ISSUES

An emerging area of concern among plan auditors is potential pricing discrepancies due to the inter-day trading of ETFs. When “sampling” a mutual fund price for verification, it is rare to find divergences from the 4 pm close. But which ETF price is used to report plan fund balances? What if different prices are reported for the same day depending on participant level fund(s) activity?

MANAGED MODELS

Finally, another development worth noting is the ability of recordkeepers and custodians to offer third party managed “models” on their platforms. These customized strategies are managed by investment advisors, who increasingly use ETFs as a primary component. Each “model portfolio” is “unitized” on the RKS so that the model is treated just like a mutual fund. All trading activity is “marked” using the 4 pm closing price of ALL the model holdings (including MFs). This solution embeds “same day settlement” into its foundational architecture and is a good example of how technology can evolve to meet challenges presented by changes in the collective fund marketplace.

ETFs IN SELF-DIRECTED BROKERAGE ACCOUNTS (SDBA)

Given the trading cycle challenges described above, ETFs at present are probably better suited for use by retirement plan investors via a Self-Directed Brokerage Account (SDBA). (See my Spring 2025 INSIGHTS article “Self-Directed Brokerage Accounts in Defined Contribution Plans” for more information.) SDBAs are common in large plans and are not difficult to add, provided there is good integration with the plan’s RKS.

PROS & CONS OF ETFs IN SDBAS

ETFs offer a robust investment opportunity set that is equal to that of MFs. ETFs also have no share class distinctions (i.e. different fee structures), and they generally have lower operating expenses (OER, or operating expense ratios). And, since most brokerage platforms are “commission free,” there are effectively no trading costs for ETFs other than being mindful of a fund’s bid-ask spread (buying between the spread if possible).

However, using mutual funds in a SDBA presents some challenges. Lower priced “retirement share classes” (R6 etc.) are not available in brokerage accounts, which are architected off retail custodial platforms. Also, lower-priced “advisor share classes” have limited availability unless the participant engages an investment advisor to manage their portfolio.

MFs that are available in a brokerage account are offered under negotiated agreements between the MF company (sponsor) and the brokerage firm. Larger firms like Charles Schwab & Co. offer their “OneSource” MF marketplace, where investors can access many MF “institutional class” shares without a transaction fee. Otherwise, transaction fees can apply to these lowest cost institutional share classes. Plan sponsors are well advised to examine these transaction fees closely before adding a SDBA to their plan.

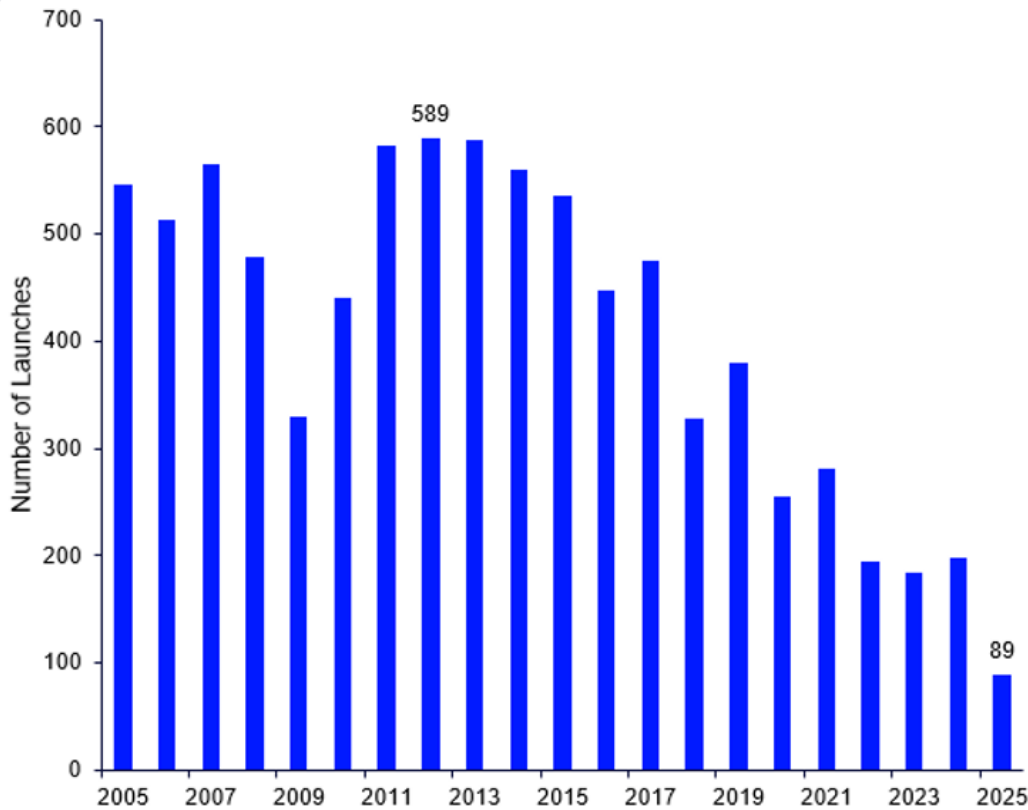
Finally, with regards to ETF trading, it is common in the investment practitioner community to execute a true fund swap by buying/selling a MF and using the proceeds to buy or sell an ETF (or vice versa) using a “market on close” (MoC) order type for the ETF. This effectively “book matches” all fund prices (eliminates price “slippage”). Any participant using a SBDA can trade the same way, but most are not aware of how to do this (ask the SDBA brokerage account trading desk).

CONCLUSIONS

The launch of new “mainstream” US mutual funds has ground to a virtual halt due to the preference of many investors for tax-friendly vehicles (ETFs). See Exhibit 6.

Exhibit 6: Mutual Fund Launches by Calendar Year

**Mutual Fund Launches
by Calendar Year**



Source: State Street Investment Management as of Oct. 31, 2025

Plan sponsors will continue to have a wide selection of existing MFs to choose from, but these funds might best be viewed as “legacy” products.

That said, MF sponsors are continuing to innovate. For retirement plans, one of the more useful recent developments is the inclusion of “lifetime income” features in a target date fund (TDF). Another emerging and useful feature is the inclusion of private investments (credit, equity, real estate, infrastructure etc.), again within a TDF or CIT product. These are niche funds focused on qualified retirement plans, however, and may not be available to a retail investor.

ETFs are the future of investing, but operational hurdles can present additional challenges when trying to incorporate their use in company-sponsored retirement plans. The good news is that participants can gain unlimited access to all publicly traded ETFs through a Self-Directed Brokerage Account (SDBA), allowing them to construct their own unique portfolio best suited to their investment objectives and risk tolerances.

Robert E. “Emery” Pike, CFA, AIF, is a Senior Advisor at Sheets Smith Wealth Management Inc. and a member of PSCA’s Investment Committee.

Footnotes

The author wishes to thank the following organizations and their talented professionals for their assistance in researching this article:
 American Trust Custody
 Blackrock
 Charles Schwab & Co.
 PCS Retirement
 Sentinel Group
 State Street Investment Management
 T. Rowe Price & Associates
 Vanguard