Plan Lineup Simplification

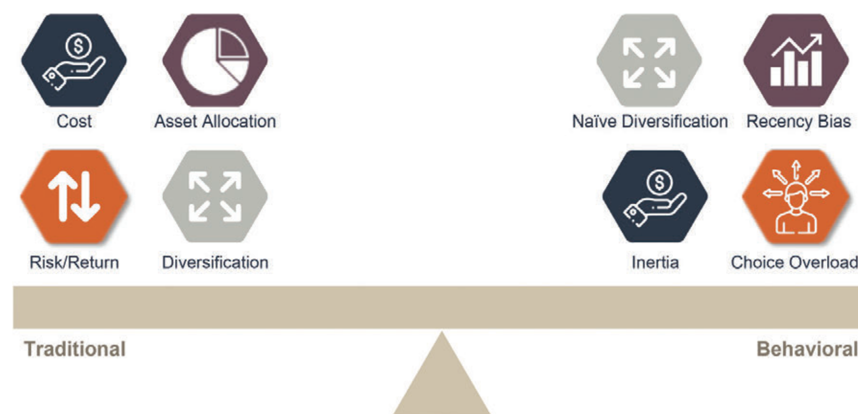
Helping participants make better decisions.

By Constantine Mulligan and Dennis Scarpa for PSCA's Investment Committee

> *"This monster is out of control. We went to 3 options, then to 6, then to 7, then to 15 — it is far beyond what most participants were able to deal with…and I am not convinced we have added value by getting more complicated."*
>
> *— Ted Benna, inventor of the 401(k)*

Sound familiar? It's a sentiment shared by many plan sponsors as they face the daunting task of constructing an investment menu for their colleagues to invest in and grow their nest eggs. A task made more complicated by the fact that in most cases your plan committee members and workforce are not professional investors. Ideally, the lineup should be diversified and improve outcomes without overwhelming employees, which often finds us asking, "How many choices should we offer, and what types of investments should be utilized?"

Exhibit 1



Balancing Traditional and Behavioral Finance

While the answers to these questions are unique for every plan, all sponsors can generally use the same framework as the foundation for their decisions. That framework combines traditional investment components such as diversification and risk and reward considerations with research about "behavioral finance" (how individuals make investment decisions). By balancing the two approaches, you can build a simple menu of diversified investment options that allows for easy decision-making and effective outcomes. See Exhibit 1.

Let's take a closer look at the framework to learn how it can be used to simplify a plan's investment lineup.

The History of Expanding Investment Menus

To start, we need to understand how we got to where we are today. Early investment menus were incredibly simple — two or three investment options (e.g., stock, bond, and money market funds) with participants typically allocating their money equally amongst them. The shift towards more choices began in the 1980s when corporations began terminating their defined benefit plans in favor of 401(k) plans. Mutual fund companies rose to prominence as funds were added to plans across the country, resulting in a rise in the number of investment options for employees. By 1996, the average number of funds offered was up to 10 and today that number is 17 (PSCA's *61st Annual Survey of Profit Sharing and 401(k) Plans*). Although, the tide appears to be shifting back. Committees have begun to understand the inherent drawbacks to offering more choice to participants but want to ensure they are balancing traditional finance approaches with newer behavioral theories.

Understanding the Traditional Part of the Equation

The phrase "there's no free lunch" is commonly used in the investment world, and for the most part that's true. Investing almost always involves a trade-off between risk and reward. However, there are a few principles of investing that have proven successful in leading to better plan outcomes and are worth considering as you construct your menu. See Exhibit 2.

Exhibit 2

Principle	Description	Investment Menu Considerations
Asset Allocation	• How an individual divides their money amongst various investment categories such as stocks and bonds to create a portfolio with a mix of return-seeking and capital preservation options. • It is viewed as the most important determinant of a portfolio's long-term performance (Brinson, Singer, & Beebower, 1995).	• Include a professionally managed asset allocation option, such as a target-risk or target-date fund, and ideally use it as the plan's qualified default investment alternative (QDIA). • Offer multiple equity, fixed income, and alternative investment options to facilitate a robust asset allocation process.
Diversification	• Building a portfolio that includes investments with non-correlated return profiles over various market cycles (meaning they don't respond to market news in the same way or to the same degree). • It also involves choosing investments that have different risk factors and market characteristics to minimize the downside while maximizing the upside potential.	• Include investment options that have distinct return profiles. • Avoid or limit options that are specific in their investment mandate such as technology funds. The exposure often overlaps with broad equity funds and can cause inadvertent overconcentration if a participant chooses both the specialized fund and the broader one.
Risk Management	• The analysis of whether or not a specific investment strategy has a risk profile that can represent extreme outcomes or large drawdowns. • These investment types can cause asymmetric (imbalanced) return profiles in a portfolio when used incorrectly such as leveraged alternative investments.	• Screen for strategies that have large downside risk profiles, or that have asymmetrically skewed return profiles. • Avoid strategies that do not offer enough diversification benefit and have significant downside probability.
Low-Cost Investing	• A strategy where you choose comparable investments that have lower expenses. • Well-regarded research has shown that when all else is equal, a lower-cost investment should outperform a higher-cost investment, so the lower cost option is superior and should be selected (Morningstar, 2016).	• Determine if active management for a particular asset class, which typically costs more, could potentially add value for participants over a passively-managed option. • Make cost a factor in the active manager screening and selection process. There is ample data and research that illustrates using cost as a criterion can lead to better investment outcomes (Morningstar's Active/Passive Barometer, 2019).

Adding in Behavioral Finance

Behavioral finance sometimes carries a voodoo-like connotation, especially in the more traditional investment circles. At times it can seem like these two concepts (traditional and behavioral finance) cannot live together. However, in the context of a defined contribution plan, that's not true. Recognizing commonly observed behavioral tendencies, and implementing strategies to mitigate their adverse effects can lead to better outcomes for plan participants. See Exhibit 3 for some of the more common behavioral biases that can impact retirement readiness.

Implementing a Simple Lineup

Using the traditional-behavioral framework gives your committee a good sense of the types of investments they may want to include in the plan's lineup. The next step is to put the theory into practice, applying these concepts to create a diversified, manageable list of investments. Here are a few factors to consider to help achieve this goal:

- **Style box collapse.** The age-old approach was to offer investments across all nine style boxes, allowing participants to select from small-cap value to large-cap growth and everything in between. Due to the high correlations between asset classes, many committees are beginning to reduce the number of options down to four to six.
- **Participant demographics.** Consider the size and sophistication of your participants when reviewing your investment menu. For example, the investment offering for a small financial services company comprised primarily of investment professionals would be different from one for a large fortune 500 company with a diverse workforce.
- **Core asset classes.** To slim down the menu, many committees are using core asset classes that allow the investment manager the flexibility to diversify its approach as it sees fit. For example, you might choose an international equity fund whose manager can invest in both emerging and developed markets depending on market conditions. This approach enables you to collapse two options into one.
- **White labeling.** This approach takes core asset classes one step further. In this instance, the committee creates a fund that invests in a variety of underlying investment managers. For example, a U.S. equity fund might include a large, mid- and small-cap manager. Even though there are multiple underlying funds, it's considered one option, so white labeling can be an effective way to increase diversification without having to expand your investment menu. Although, it's important to note this approach is most commonly used by larger plans because of the cost to implement.

Exhibit 3

Bias	Description	Investment Menu Considerations
Inertia/Status Quo	• The tendency to keep the current state of affairs as-is, or to not take action to change the status quo. • It's revealed through the lack of participant engagement and the failure to select investments or revisit investment allocations over time.	• Select a QDIA such as a target-date fund that attempts to invest a participant's contributions based on time and risk profile. • Combine the selection of a QDIA with auto-enrollment to get the most participants enrolled and invested in the plan.
Choice Overload	• The tendency to opt-out of the decision-making process or to make naïve/suboptimal choices when presented with too many options. • For example, a study found that when buyers had a choice between 6 jars of jam versus 24, 30 percent bought a jar in the first instance compared to only 3 percent in the second (Lyengar & Lepper, 2000).	• Limit the plan's investment lineup to 10 to 15 options. • Strive to make the options distinct and non-correlated so that the decision to allocate is easier for participants and less prone to redundancy.
Naïve Diversification	• The tendency to allocate assets in an overly simplistic manner such as splitting assets equally amongst all options, or weighting more heavily towards equity when there are more equity options than fixed income. • It can also present itself in instances of using more active or passive options depending on the representation in the menu (Brown & Weisbenner, 2005).	• Strive for parity — try to offer a similar number of equity and fixed-income options. • Offer a range of asset classes including perhaps multi-real asset or alternatives to enhance a participant's diversification, even when the weighting they choose is suboptimal.
Recency Bias	• The tendency to use the most recently available information to make decisions. • This bias is apparent when participants choose investments solely on recent performance (return chasers), which can result in "buy high, sell low" behavior.	• Offer broadly diversified funds to mitigate the risks of this bias. • Avoid or limit investment options that represent a specific style or sector of the market such as value/growth funds, tech or healthcare funds, gold, etc. (DALBAR, 2018). These investments can have more extreme performance fluctuations.

Exhibit 4

Tier 1 "Do it for me"	Tier 2 "Do it with me"	Tier 3 "Do it myself"
For participants who don't have the time, desire, or knowledge to select their investments and would prefer professional guidance	For participants who prefer to select options and develop an asset allocation strategy from a core set of offerings determined by the plan sponsor	For participants who wish to select from a wide variety of investment options outside the core menu *Note: Offering this option may involve additional administrative, fiduciary, and compliance considerations.*
Commonly used investments may include: • Target-date funds • Risk-based funds • Managed accounts	Commonly used investments may include: • Stable value/money market • Diversified fixed income • U.S. equity (active/passive) • International equity (active/passive)	Commonly used investments may include: • Brokerage window

Communicating Your Lineup

Once you've constructed your menu, the final step is to communicate it to your participants. A tiered structure that organizes the options into logical groupings (as in Exhibit 4) is an effective way to share this information. It provides participants with an easy starting point for their investment and asset allocation decisions.

Key Takeaways

- ✓ Building an investment menu that improves outcomes by promoting good decisions can be a challenge. Traditional finance methods can only do so much. Participant behavior must be accounted for as well.
- ✓ Asset allocation and diversification are key drivers of portfolio performance.
- ✓ People tend to behave sub-optimally when it comes to investing. Simple mechanisms such as menu design and auto features can steer participants in the right direction.
- ✓ Providing too much choice not only lowers engagement but decreases participants ability to build successful retirement portfolios due to high costs and poor diversification.
- ✓ Simple menus are better for participants — makes it easier for them to build a well-rounded portfolio that will help them achieve their retirement goals.

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