Capital Ideas℠

RETIREMENT

How Can Plan Sponsors Help Participants Make Better Investment Decisions?

Key Takeaways

- Complexity and choice make investment decisions challenging for retirement plan participants.
- Simplifying menus can follow the successful model of the one-stop target date fund.
- Plan sponsors can simplify by merging funds into broader, easier-to-understand categories.

Despite the popularity of one-stop target date funds, about 63% of retirement plan participants still choose their own investments. Strapped for time and often lacking financial expertise, how do they feel about making investment selections for their retirement future?

- Are they afraid of making costly mistakes?
- Do they believe they have the knowledge to make informed choices?
- Do they view investing as intimidating, overwhelming, even scary?

Fear is the Dominant Motivator in Investment Decisions

Behavioral finance pioneers Daniel Kahneman and Amos Tversky discovered that investors are nearly twice as motivated by a fear of losing money as by an anticipation of gains. The stress response of the amygdala in the human brain takes over, they showed, when investment decisions are important, confusing and uncertain.

Consider that 2:1 ratio when thinking about [too much choice](#) in plan investment lineups, confusing investment terminology, and the widespread media narrative that people are not saving enough to retire.

The Average Investor Does Worse Than the Market Average

When the fear response is triggered, the results are predictable: counterproductive investor behaviors, such as selling after a large market decline or keeping all one's retirement account in a money market fund.

In fact, the average investor earned significantly less than the stock or bond market averages. According to a 2016 Dalbar research study, the average equity investor received a 4.23% average annual return over the past 10 years ending December 31, 2015. That compares to a 7.31% average annual return over the same time period for the S&P 500, an index that is seen by many as reflective of the overall stock market.

It's even worse over 30 years, with an average investment return gap of 6.69% per year.

And it's not limited to the more volatile stock market. Over the same 10 years, the average fixed income investor received 0.39% per year vs 4.51% for the comparable Bloomberg Barclay's Aggregate Bond Index.

Simplify Menus to Support Better Participant Decision-Making

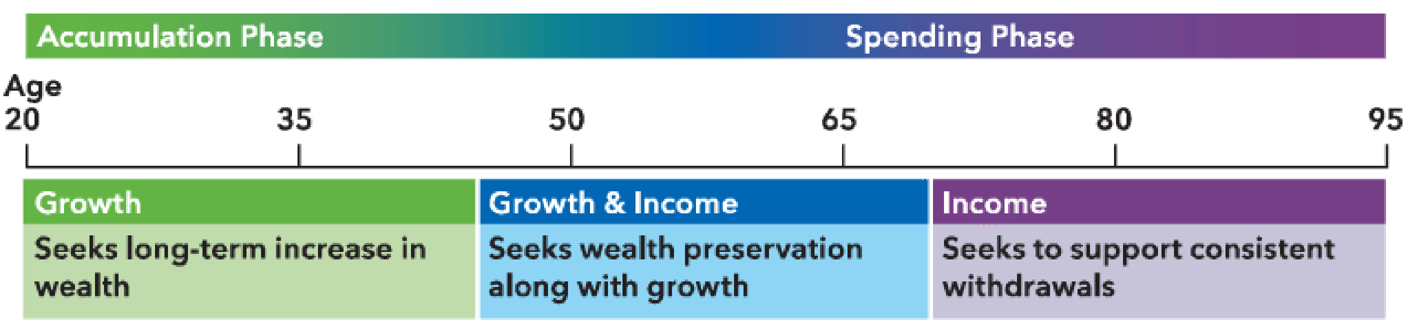
How can plan sponsors promote better outcomes? By simplifying the choices and making them relevant to participants.

Some people look at the success of target date funds as a model. In less than 10 years, target date funds have become the dominant investment in 401(k) and other defined contribution plans. A key reason is simplicity: all a participant has to know is their age to make an investment decision. Everything else is done for them.

Similarly, plan sponsors can simplify the choices in plan menus using participant's age as a foundation:

- Reduce participant anxiety about too much choice by selecting fewer funds in broader investment categories.
- Make the investment choices relevant to participants by organizing them based on the two stages of retirement planning: saving/growth and spending/income.
- Create incentive for participants to save by re-labelling the menu options around their real-life, time-based goals.

Such a framework might look something like this:



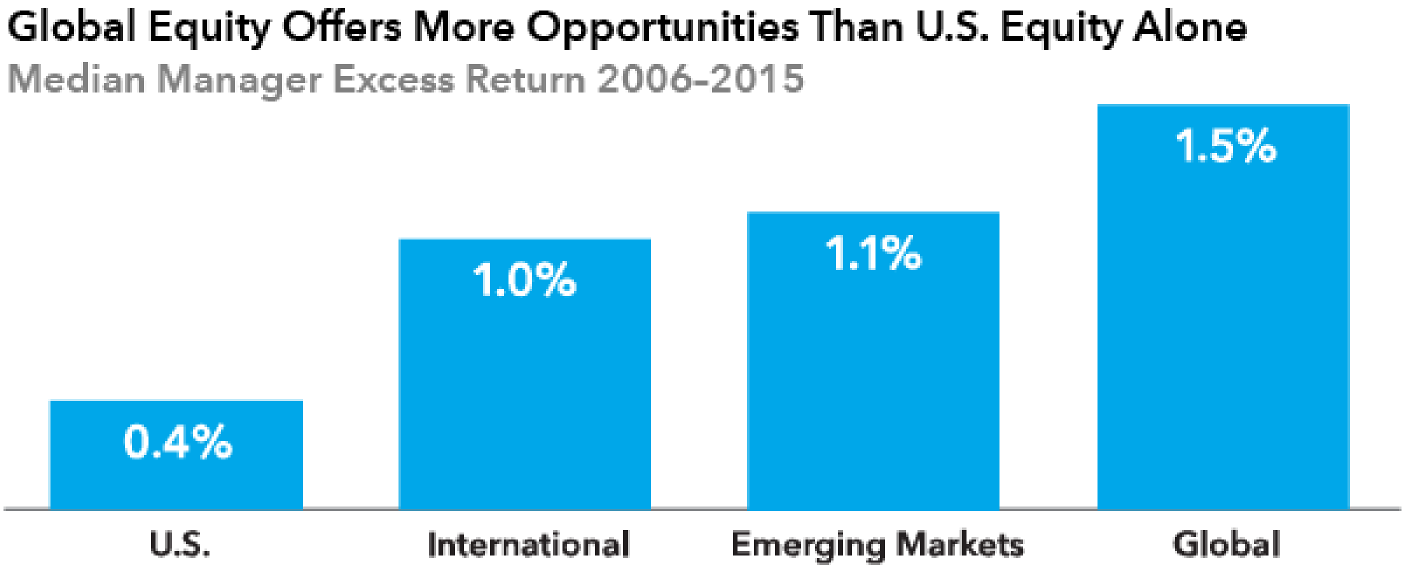
"Investing based on participants' real-life retirement goals is a great way to rationalize menu options," says Craig Duglin, senior vice president of Defined Contribution Product Management at Capital Group.

Fewer Choices Can Deliver Better Results

Breaking from the traditional philosophy of style-based investing and, instead, hiring a manager with broader, less-constrained mandates has proven to deliver more successful results.

According to a 2012 academic study by Russ Wermers, unconstrained managers outpaced style-pure managers by as much as 1.8% per year over a period of 30 years (1976-2006).

Geographic flexibility has also delivered more excess return relative to the benchmark:



Source: eVestment, based on the median returns of institutional equity managers grouped by region. Results before fees.

Three Tips on Simplifying Menus

Here on some tips on putting this simple organizing principle into practice:

1. Merge existing menu offerings into ones with wider coverage – combine growth and value styles, for example, or offer a mix of market capitalizations.
2. Convert U.S. and international choices into unified global ones that reflect the changing character of world markets.
3. Seek flexible managers with a long-term focus – those that can pursue the optimal investment returns and volatility management without having to conform to style or size requirements.

"Most DC professionals recognize the need to simplify menus. The art is to make the change relevant enough to participants that it feels seamless," says Sue Walton, senior vice president of Defined Contribution at Capital Group.

Streamline Investment Menus

Fewer and easier-to-understand investment menu choices can encourage more appropriate participant selections – and potentially generate better returns.

For more practical tips on how to rationalize and re-label plan menu options, see our Simplify Menus to Meet Participant Objectives.

Investing outside the United States involves risks, such as currency fluctuations, periods of illiquidity and price volatility, as more fully described in the prospectus. These risks may be heightened in connection with investments in developing countries.

Disclosure