Retirement Insights

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Quality Over Quantity: Creating an Effective Retirement Plan Menu

Highlights

Offering too many investment options may cause participants to make bad decisions or not contribute.

Skilled advisors who assist with retirement plans are experienced menu setters and can help plan sponsors build diversified plan menus.

LPL Financial Research recommends creating a menu with around 10 investment options to help ensure quality.

Participant satisfaction with their employer's retirement plan is heavily influenced by the performance of their investment selection, both in absolute terms and relative to a benchmark. If they have a positive experience, they tend to be content, while a negative experience may evoke a desire for changing the status quo. This is human nature, and human nature is hard — if not impossible — to change.

How do you create an environment where the participant has a greater opportunity for a positive experience? LPL Financial Research believes a major contributor to the participants' satisfaction and a key driver of the success of an employer-sponsored retirement plan is having the "right" number of investment options on the menu available to the participants.

The Choice Not To Choose: Quality Over Quantity

People generally like having choices; however, studies have shown that the opportunity to choose among a vast number of options can be confusing and often results in either no choice being made or opting for the least risky option. The fear is that a decision among so many options may produce an outcome that is worse than not choosing at all, or lead to being worse off than the current — or default — choice.[1] For example, comparing the behavior of grocery store shoppers when faced with a display of 6 or 24 different flavors of jam, many were more attracted to the display with more choices (24), but were 27% more likely to make a purchase from the display with the limited 6 choices.[2]

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In the case of an employer sponsored retirement plan, studies have shown that for every 10 additional options on the menu, the participation rate drops by 2%.[3] There is often the urge for plan sponsors to provide a large number of investment options in anticipation that quantity will appear desirable to participants and encourage plan participation and contribution. However, this may cause more harm than good as the ability for the participant to focus on the investment options that best match up with their risk profile becomes clouded by the additional options on the menu.

Choice Affects Performance: Meeting Performance Objectives

The optimal number of investment options on the menu that will maximize participation must also provide enough breadth for participants to diversify their allocation to meet various objectives.

The main objective of a participant is to take advantage of an up market and to help protect their portfolio against a down market, with each participant having different preferences for risk and return. To do this, the participant must choose among the options on the menu to create an efficient allocation of equity, fixed income, and non-traditional asset classes (i.e., Real Estate Investment Trust (REITs) and commodities asset classes). The more efficient choices the participant makes, the better the overall experience. In contrast, the availability of an increasing number of investment options yields a less efficient allocation because the participant directs current and future resources away from perceived risky equity investment options into perceived less risky fixed income investment options.[4] Therefore, participants end up with a portfolio heavily weighted to fixed income and over-diversified among too many investment options.

Across various studies on participant behavior in 401(k) plans, a universal finding is that as the number of investment options in a menu increases, disproportionately more equity investment options are added, particularly actively managed domestic equity, over fixed income investments.[5] Counterintuitively, as the options are added, the participant's current and future allocation to equity investments actually decreases. One study found the probability of not investing in equities increases to roughly 27% for every 10 additional options added to a menu. Participants may perceive the greater number of equity options to reflect more risky, niche bets, rather than core holdings, and avoid them by investing in the perceived less risky fixed income options.[6]

For participants with longer term time horizons, the greater possibility of investing in an inefficient allocation when confronted with an increased number of investment options can have a significant impact on retirement wealth. A study of nearly one million individual portfolios across over one thousand 401(k) plans concluded that, given an expected 5% after-expense annual real rate of return, the typical participant would experience a 23% shortfall from their expected retirement wealth over a 35-year work life, due to inefficient diversification potentially driven by an insufficient investment menu.[7]

Offering an Efficient Menu: The Benefits of Diversification

The ability for the participant to properly diversify hinges on an efficient menu from which investment decisions are made. Surprisingly, a study of over one thousand 401(k) plans showed that nearly 94% of the plans offered the ability for the participant to invest in an efficient portfolio, but most do not. This leads to 76% of the inefficiency of the retirement plan, as shown by performance,* being derived from choices participants make from the plan menu.[8] This can be corrected by creating a simple and efficient plan menu.

There are Two Types of Menu Setters: Inexperienced and Experienced

For the inexperienced, there is a negative correlation between menu size and menu quality. This correlation is even more pronounced for plans

* Performance is measured against a benchmark composed of following eight indexes; Russell 1000 Growth, Russell 1000 Value, Russell 2000 Growth, Russell 2000 Value, Barclays Capital Aggregate Bond, Credit Suisse High Yield, MSCI EAFE, and the JP Morgan Global Government Bond non-US$.

with fewer assets.[9] When the cost of adding options to a menu is low, the inexperienced will add additional, less valuable options beyond the top choices, lowering the average quality of the menu.[10] In this situation, it becomes more difficult for the participant to properly identify the most appropriate option, and further, may be more likely to construct an inefficient portfolio. The confused participant may unintentionally make the decision to allocate across several highly correlating investments and not allocate into low correlating niche investment options (as previously discussed), lowering the benefit of diversification. Or perhaps, the abundance of choice may cause the employee not to choose at all, and not invest in the plan.

On the other hand, the experienced menu setter will generally construct a smaller menu exhibiting low correlation among the investment options, and thus a higher probability for better diversification. Larger menus created by an experienced menu setter generally include investment options that continue to provide additional utility to the participants, yet still maintain low correlations with other investment options in the menu. In this situation, the participant is constrained to the experienced menu setter's top ideas.[11] With fewer items on the menu, the participant is more likely to invest in the otherwise overlooked niche products that aid in maximizing diversification and potentially better performance. Skilled advisors who assist retirement plans are experienced menu setters and can help plan sponsors build diversified plan menus.

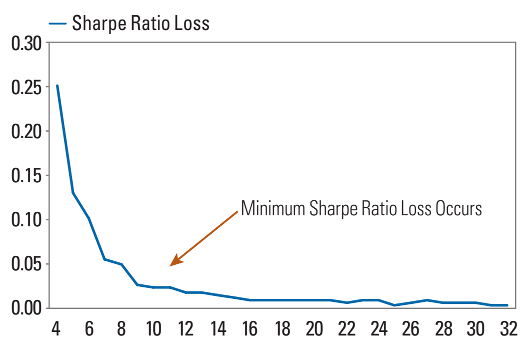
Optimizing the Menu: LPL Financial Research Recommendations

LPL Financial Research believes that an efficient and well-diversified portfolio, along with optimal participation, can be achieved by using an allocation of around 10 investment options. For example, many of the portfolios managed by LPL Financial Research contain a diversified allocation that range from 5 to 17 low-correlating investment choices. As these portfolios are created by experienced menu setters, some models with a higher amount of investment options include tactical positions designed to help take advantage of short-term opportunities and non-traditional asset classes that contribute to the overall diversification of the portfolio, but may not be suitable for a retirement plan menu.

The optimal 10-option plan is corroborated by recent studies that have utilized Sharpe ratio as a means of measuring how the number of options affects menu quality.^ By analyzing the five years of historical data of 112 plans, one study determined that the threshold for maximizing menu quality — measured by Sharpe ratio — occurred at 10 investment options. Plans with more than 10 options exhibited a 1.7% decline in menu quality for each additional option added.[12] A second study also concluded, after reviewing the historical data of nearly 1,000 plans, that much of the efficiency gains are achieved by using a menu of 10 options,† the point at which the minimum Sharpe ratio loss occurred.[13] [Chart 1]

When faced with the opportunity to invest in their employer-sponsored retirement plan and presented with too many investment options, employees may either choose not to participate or may unknowingly invest

1 Performance Measures by Number of Investment Options Offered



Source: Tang, Mitchell, Mattola, Utkus 2009

Data compiled from 993 401(k) Plans

^ Sharpe ratio is calculated by subtracting the risk-free rate from the rate of return for a portfolio and dividing the result by the standard deviation of the portfolio returns. Sharpe ratio is most commonly used to measure risk-adjusted return.

† Suite of Target Date Allocation Investments is counted as one investment option.

in an inefficient allocation. Plan sponsors can create menus that allow the participant to invest in a well-diversified portfolio on their own, given that participants are properly educated and are able to make wise choices among the several investment options offered on a menu.[14] However, we believe in order for a plan sponsor to offer a menu with increased efficiency and a greater probability of participant satisfaction, it is imperative to utilize an experienced menu setter to construct a menu with an appropriate number of carefully chosen options.

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12 Goldreich, & Halaburda, "Smaller Menus."

13 Tang, Mitchell, Mattola, & Utkus, "Efficiency of Sponsor."

14 Tang, Mitchell, Mattola, & Utkus, "Efficiency of Sponsor."