Fourth in Six-Part Series

Once workers have begun saving for retirement, they must make important decisions about how savings are invested. Employers can help educate them about their options.
or employers and plan sponsors that want to take a more active role in promoting the retirement security of workers and their families, there are five interrelated goals:

1. Help workers determine their retirement needs and where they stand.
2. Get workers enrolled and saving for retirement.
3. Help workers make prudent investment choices.
4. Help workers stay on track to meet their retirement objectives.
5. Support those near retirement to make the transition.

Strategies for achieving the first two goals were presented in the March issue of Benefits Magazine. This article addresses the third goal—helping workers make investment choices appropriate to their personal circumstances.

Help Workers Make Prudent Investment Decisions

Poor investment choices can be the difference between achieving one’s retirement goals and financial disaster. A Schwab study showed that 401(k) plan participants using independent professional advice are more likely to follow best practices with respect to investment such as greater diversification, periodic rebalancing and staying the course during market downturns and high volatility.1

In addition to providing access to a financial advisor, what else can plan sponsors do to help workers optimize their portfolio’s risk and return? While the advice here is primarily focused on defined contribution (DC) plans, some of this information might also be shared with employees considering or already invested in individual retirement accounts.

Limit the List of Investment Choices

DC plan sponsors must offer enough fund choices to meet the various needs of participants but not so many choices that participants become overwhelmed. People find it easier to make decisions when they have a small menu of choices. The unintended consequences of a large number of choices are participant inertia and procrastination—in other words, choice avoidance.

One study found that for every ten new investment options offered, plan enrollment dropped between 1.5% and 2%.2 The same researchers found that among workers who did enroll, increasing the number of funds offered may cause participants to shy away from equities and select simpler, easier-to-
understand bonds and bond equivalents. For every ten funds offered in a plan menu, participants reduced their exposure to equities by 3.28%. A consensus of experts recently surveyed by the TIAA-CREF Institute suggests the appropriate number of funds in a menu should be between five and ten.

**Structure Menu of Investment Options to Encourage Appropriate Choices**

How a list of investment options is structured is as important as the choices offered. When creating a menu of investment choices for participants, it might seem logical to list investments from least to most risk or alphabetically. However, when provided a menu of items, people tend to choose the first option they are given. If the list is very long, another behavior kicks in—choosing the last items because these are the ones that stick in a person's mind.

Consider the implications of these two behaviors when a list of investment choices is ordered from least to most risky. Participants may choose an option that is too conservative for their needs. At the other extreme, a very long list might result in individuals selecting inappropriately aggressive investments. As a result, at the top of the investment menu should be the funds most appropriate for the widest range of participants—very likely target-date funds (TDFs).

For plan sponsors concerned that placing “appropriate” choices at the top of the investment menu may be considered investment advice, one must recognize that no list has a neutral design. It is impossible to avoid giving implicit advice given human behavior. Ordering choices is actually guiding participants so they don’t end up with an overly conservative or aggressive portfolio. An optimal investment menu for a DC plan might have a “basket of funds” such as a balanced fund or target-date fund at the top of the list that is appropriate for a majority of workers who prefer to delegate the management of their retirement portfolio. The remaining choices could be a small group of core funds that permit those who want to have some control over their investments to create a well-diversified portfolio.

**Promote Diversification**

While stocks get the most media attention, those saving for retirement shouldn’t ignore bonds and other fixed income investments. Diversification of assets doesn’t ensure a profit or guarantee plan participants will not experience a loss, but it does reduce the volatility of their portfolios. DC plan sponsors must give careful attention to the investment options offered as part of their plan. They must also educate participants on the need to diversify and how it is accomplished.

A diverse investment menu includes several asset classes (e.g., domestic and foreign stocks, bonds and short-term investments). The financial industry offers a multitude of mutual funds that can help small investors achieve diversification—Index funds, balanced funds and TDFs are among the most popular solutions.

There is some evidence the higher the number of lines for entering investment choices on a plan enrollment form, the higher the number of investment options selected. A sponsor may want to test whether changing the number of lines affects the investment choices made by new enrollees. The vast majority of participants choose a small number of funds (i.e., three or four) and then divide assets equally among them. At the extreme, some participants select all of the funds offered and divide their contributions equally among them. Both approaches are misguided attempts to diversify, as some investment choices may be quite similar with respect to risk and return.

While TDFs can help participants achieve diversification, many individuals are not using these funds as they are intended. An Aon Hewitt study of DC plan participants found only 38% were using these funds as a “one-stop” invest-
ment. Almost three out of four (74%) with a TDF held less than half their assets in the fund. Participants tended to misallocate the remainder of their portfolios, with 62% having an inappropriate risk level overall.8

For plan sponsors including company stock in worker DC plans, it is essential participants be informed of the risk associated with concentrating retirement savings in one stock. If the company stock takes a beating, so will their retirement savings. In a worst-case scenario, employees could lose their job and a substantial part of their retirement savings.

The Save for Tomorrow program based on the principles of behavioral economics goes a step further by encouraging employers to limit participant exposure to company stock to 10%. The program recommends the automatic and gradual divestiture of excessive company stock to this ceiling. This approach reduces concern the stock will be sold at the wrong time and the possibility the stock price will be driven down if everyone sells at once.9

**Discourage Chasing Returns**

When a particular investment is doing well, it is human nature to want to put more money into it. When something is doing poorly, investors are tempted to get out before they lose more. The problem with chasing returns is that “hot” investments don’t usually stay hot. In fact, they often crash and burn right after everyone starts buying them. As for investments that aren’t doing well, it is very possible they will make a comeback and the investors who sold them will miss out on their recovery.

Plan sponsors have a responsibility to educate participants on the importance of establishing and sticking with their investment plan with respect to asset allocation, level of risk and so forth. Sponsors must help participants understand that past returns are rarely a good indicator of future returns. Moreover, people who try to “time” when they buy and sell assets tend to (1) end up with portfolios with more risk than is appropriate and (2) lose more money than they gain.

Experience shows few individuals take these common cautions to heart. Providing participants with an example such as the painful consequences individual investors experienced in the 2008-2009 stock market crash may get plan participants’ attention. When the market crashed, many future retirees experienced devastating declines in the value of their retirement accounts. In an effort to stop the free fall, they sold the stocks in their portfolios. When the market recovered, they lost out again because they owned no stocks. Had they stuck with their original investment objectives and waited out the downturn, they would have more than recovered their initial losses.

Placing long-term monthly income projections prominently on the first page of required plan statements and moving short-term information (i.e., quarterly and annual returns and account balances) closer to the back of statements can also discourage chasing returns.

Another strategy for discouraging efforts to time the market is to restrict the number of fund transfers a participant can make within his or her portfolio during a month. Some DC plans allow participants to make transfers on a daily basis. Permitting only two transfers per month, for example, would restrict this activity. Alternatively, some plans allow daily trading but thwart excessive trading by prohibiting *round-trip transactions*—a fund purchase followed by a sell or exchange sell within 30 calendar days in the same fund and account.

**Promote Rebalancing**

While buying and selling portfolio assets to time the market is a bad idea, buying and selling stocks, bonds, etc., to rebalance a portfolio’s asset mix is a central tenet to investing for retirement. Asset values rise, fall and grow at different rates. While the relative value of one asset in a portfolio booms, the values of another asset may shrink. Over time, the result is a collection of assets out of sync with the mix initially established by the plan participant. In addition, as participants age, they should be moving into more conservative investments that have less risk than what was acceptable when they were younger.

Rebalancing is how investors make sure their portfolios...
maintain a level of risk within their comfort zone. Rebalancing annually also forces investors to take profits from investments that are doing very well and put money into other good investments that are not doing as well.

Despite the advantages of doing so, it appears few plan participants with self-directed DC plans rebalance. During the years 2009 through 2013, Vanguard found just 29% of plan participants initiated a trade and only about one in ten participants made a fund transfer in any one year.\(^1\)

Encourage participants to establish a plan for rebalancing their portfolios once or twice a year. Participants can choose an easy-to-remember date or dates when they are most likely to take any action required. Several of the investment firms that offer DC plans now offer automatic rebalancing. Look for a firm that offers this option and encourage participants to take advantage of it.

**Offer Target-Date Plans**

For the large majority of participants who don’t want to think about asset diversification, rebalancing and so forth, the investment industry’s solution to helping plan participants make prudent investment decisions is TDFs, also referred to as *age-based funds* and *lifecycle funds*.

TDFs are hybrid mutual funds that invest in a mix of assets (e.g., stocks, bonds and cash) that put retirement savings on autopilot. Participants choose the fund with the date nearest when they plan to retire. The target year is identified in the name of the fund; for instance, a person who plans to retire in or near 2050 would pick a fund with 2050 in its name. The mix of assets in the fund is automatically rebalanced as the fund date approaches and typically becomes less risky so investors have more stable values and returns as they near the time when they will begin withdrawals.

Plan sponsors choosing a TDF should be aware that great diversity exists in products on the market. It is essential to understand what the specific TDF’s *glidepath* (asset allocation over time) is designed to accomplish. Some products feature a glidepath that matures at the participant’s projected retirement date, while others carry the investor well into retirement. TDFs also vary in risk, ranging from conservative to aggressive. Some funds are actively managed while others use index funds with a passive management approach.

**Provide Model Portfolios**

For investors who want a little more control over their retirement portfolio than that provided by a TDF, some plan sponsors, vendors and online calculators are providing model investment portfolios that suggest a mix of assets based on where an individual is in the life cycle. A few calculators go a step further and consider the risk tolerance of the user. In general, assets in model portfolios have less and less risk as persons age.

The figure provides a sample of model portfolios designed specifically for those in the California State Teachers’ Retirement System (CalSTRS). In this set of model portfolios, risk declines as individuals move from early in their career to midcareer, near retirement and, eventually, retirement.
Pay Attention to Investment Expenses and Other Costs

Administrative, investment and other expenses associated with a retirement account can have a sizable impact on retirement savings. A U.S. Government Accountability Office report showed how a 1% expense could result in a 17% reduction in asset value over 20 years in a hypothetical investment account.11 Plan sponsors should negotiate with service providers to reduce the negative effect of fees on worker retirement savings.

No law requires plan sponsors to select investment options with the lowest fees available, but sponsors do have a responsibility to make sure the fees charged are reasonable in terms of the quantity and quality of services provided. Fees should be benchmarked with those charged to plans that are similar in size, number of participants, industry, employer match and asset allocation. Once investment choices have been made, fees should be monitored regularly to ensure they remain competitive.

A good place to start an examination of fees is investment expenses. Low-cost index funds might be an appropriate replacement for more costly actively managed funds. Index funds are mutual funds composed of securities selected to mirror a designated market index (e.g., S&P 500, Barclays U.S. Long-Term Bond Index). Historically, passively managed index funds have outperformed the majority of actively managed mutual funds.

Beware of the wide range of payments for different asset managers and investment vehicles; there are situations where a minority of workers is paying the majority of plan costs. Even participants with the same account balances may be paying significantly different amounts for plan administration. Plan expenses should be distributed equitably across the plan population.

Conducting a detailed analysis of plan fees helps a sponsor determine whether certain workers are shouldering a larger percentage of fees than others. Ideally, sponsors can select a set of funds with no reimbursement for administration included and, instead, deduct the fees needed to cover administrative expenses equitably across all asset classes.

Sponsors that have or are considering annuities as lifetime income generators should not overlook the special fees associated with these accounts. Participants pay fees to compensate the insurance company for various risks it assumes under the annuity contract such as the life expectancy of the annuitant. While immediate fixed annuities providing a retirement income are available for a relatively low cost, fees for deferred variable annuities used to accumulate assets before retirement can be much more costly than those of comparable mutual funds.

Any fees that add little value in terms of investment return or service might be lowered or eliminated. A sponsor should investigate whether a plan is paying for features or services that participants are not using.

Endnotes

9. Supra note 5, Benartzi, pp. 185, 189.