Defined Contribution Institutional Investment Association

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WHAT'S ON THE INVESTMENT MENU?

A Recipe for A Better DC Design

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Defined Contribution (DC) plans, like restaurants, can structure their investment menus in many ways – the trick is for the menu to best reflect the purpose of the plan.

This paper seeks to provide a framework for designing DC menus to improve plan participant experiences and outcomes. First, we will review how menu design has evolved historically; then we will discuss the objectives and philosophies of various sponsors, and define menu construction frameworks for each philosophy. Finally, we present considerations for creating an effective investment menu

HOW DC INVESTMENT MENUS EVOLVED

DC investment menu designs have changed considerably over the past three decades. In the 1980s, when DC plans began to proliferate, they offered a limited number of investment options that covered the basic asset classes. Many early investment menus consisted of only three to five offerings that had no recognizable brand names and tended to be institutionally managed products. Company stock funds and stable value funds were often the two most utilized options on the menu.

In the 1990s, the rapid growth of DC plans coincided with the popularization of mutual funds. Through mutual funds, Americans were able to access a wide variety of markets and became familiar with branded retail financial products. DC plan sponsors wrestled with how to respond as their more active participants sought to diversify (and particularly to reduce exposure to company stock and stable value). DC menus began to feature more investment options, often with 30 or more retail mutual funds covering a broad range of asset classes, and asset allocation funds.

After the tech bubble burst and market downturn in 2000-2001, DC plan sponsors began to recognize that – despite an abundance of participant education efforts – participation rates were stubbornly stuck in the mid 60% range. Even with a plethora of investment options, DC participant portfolios were not well diversified, and many were disengaged from the investment process altogether. The 2006 Pension Protection Act (PPA) provided incentives for DC plan sponsors to automate enrollment and default participants into professionally managed, multi-asset class options such as target date funds. Target date assets have grown rapidly since. The auto enrollment provision has been quite successful in moving the participation dial up to the mid 70% range in only a few years. This clearly demonstrated that the behavioral patterns of participants can be leveraged to improve retirement security.

In the wake of all this change, DC providers have searched for ways to structure investment menus to facilitate better participant decision making and improve participant outcomes. The trend is to simplify menus, both by organizing them better and by consolidating the number of options. Precisely how to do this depends on what objectives the plan sponsor seeks to achieve. Target date funds have received significant attention following enactment of the PPA, which designated target date funds, balanced funds and managed accounts as qualified default investment alternatives and provided new fiduciary protection for plans electing to use them. As a result, adoption of these fund structures as default investments has become widespread. The funds have continued to attract attention following the market downturn that began in late 2008.

QUALIFIED DEFAULT INVESTMENT ALTERNATIVE (QDIA)

Background: the pension Protection Act 2006 (PPA) directed the Department of Labor to issue a regulation to assist employers in selecting default investments the best serve the retirement needs of workers who do not direct their own investments. The final regulation provides conditions that must be satisfied in order to obtain safe harbor relief from fiduciary liability for investment outcomes

According to the DOL, three types of investments define long-term QDIAs, and must include capital preservation or fixed income investments:

- Risk-based or balanced or lifestyle funds
- Age-based or target dated or lifecycle funds
- Managed accounts

DEFINING YOUR PLAN'S OBJECTIVES

While all plan sponsors are striving to provide their participants with the best opportunity to reach a dignified retirement, there is no right or standard approach to achieve this objective. Each plan sponsor needs to determine their philosophy for running the plan, and articulate a set of objectives that align with this vision. By taking the time to think through the strategic guideposts initially, plan sponsors should be better equipped to make decisions about plan design and menu construction.

Four key questions generally can help clarify the plan's objectives:

1. IS YOUR PLAN A "PRIMARY" OR "SUPPLEMENTAL" SOURCE OF RETIREMENT FUNDS FOR PARTICIPANTS?

In the event that the sponsor has a defined benefit (DB) plan as well as a DC plan, the sponsor may take a different approach when it comes to plan design and investment menu construction. Some plan sponsors with both DB and DC programs may view the DC plan as supplemental, and as such, a place where participants can afford more investment risk. Sponsors with this perspective tend to have broader investment menus, offering participants greater choice and endorsing a "self-directed" approach.

By contrast, plan sponsors that maintain a DC plan as the primary retirement program may be more likely to guide participants with a key focus on retirement outcomes and adequacy. These sponsors tend to adopt a more paternalistic philosophy in carrying out their fiduciary responsibility.

2. HOW MUCH GUIDANCE DO YOU WANT TO PROVIDE TO YOUR PARTICIPANTS?

Before 2006, most plan sponsors believed their DC plan's goal was to help participants become engaged and self-directed, therefore they focused on employee education and providing a wide range of investment options. However, over the years, plan sponsors have found that DC participants who are given too many options tend to make sub-optimal choices – or become so overwhelmed by complexity that they freeze into inaction. Participants in studies actually report greater satisfaction with their selections when their choices had been limited rather than expanded.[1,2] These considerations, and the fiduciary protections embodied in the PPA, have recently convinced many plans to guide participant behavior toward better outcomes – usually by providing better choice architecture in the investment menu and focusing on their default option (or QDIA).

3. DO YOU WANT YOUR EMPLOYEES TO REMAIN IN THE PLAN AFTER THEY LEAVE THE COMPANY?

Some DC sponsors feel there is a fiduciary risk associated with keeping terminated participants in the plan, and may encourage rollovers or implement other design features that incent departing employees to leave the plan. By contrast, plans that seek to help employees secure retirement income may want participants to stay in the plan for the rest of their lives. Another factor in this decision is that retiring participants tend to have high account balances, and can help keep plan expenses low and service levels high for everyone through aggregate asset scale.

4. DO YOU BELIEVE IT IS IMPORTANT FOR YOUR PARTICIPANTS TO ACHIEVE ADEQUATE RETIREMENT INCOME?

Another consideration for a plan sponsor when defining a plan's purpose is to decide whether the plan should help participants obtain a stream of retirement income. Particularly for organizations that have had traditional defined benefit pensions but are moving to a DC plan as their primary savings vehicle, it may be important to help employees convert savings into an income stream that can last throughout retirement. One way sponsors are doing this is by defining a target replacement income goal for the plan.[3] Once this goal is established, sponsors can focus the decision-making process for plan design, menu construction, and participant communications by simply asking; "How does this decision affect our target replacement income goal?"

Many DC plan sponsors are engaged in a lively debate on these questions. As sponsors decide what's right for them, their plan objectives become clearer.

While there is no single philosophy that suits all DC plans, two types seem to be emerging:

- DC plans that focus on helping participants make "self-directed" choices, and
- DC plans that seek to guide participants toward investment options that are designed to deliver suitable retirement outcomes

In either case, the investment menu should be consistent with the plan's objectives. For this reason, the menu design should encourage and enable the type of behavior you are hoping for from your participants.

HARNESSING YOUR PARTICIPANTS' BEHAVIOR

The famous investor Benjamin Graham once said, *"How your investments behave is less important than how you behave."* This axiom is certainly true in DC plans.

There is a considerable library of research on behavioral finance implications for retirement plans. The scope of this paper is not to expound in great detail on behavioral finance, but to highlight some of the specific behaviors to consider when designing an investment menu.

Research has identified some specific behaviors that adversely affect DC participants:

- **Chasing returns**, which can cause underperformance due to timing.[4]
- **Procrastination/Inertia**, which stalls action and can prevent enrollment, increased savings, and appropriate asset allocation.
- **Choice Overload/Paralysis**, which undermines the beneficial effect of choice. [5]
- **Loss Aversion**, which can lead participants to poor choices.[6]
- **Status Quo Bias**, which causes participants to stick with old decisions, even when circumstances have changed.[7]

DID YOU KNOW?

- While investment professionals know that portfolios should be designed based on the risk-and-return characteristics of individual investment funds, many participants simply allocate their investments evenly among the available fund options—regardless of their type, asset class, etc.
- Presented with increased choice, people are more likely to select the lower-risk alternatives available to them. For example, for every 10 funds added to a plan, there is a 5.4% increase in the allocation to money market and bond funds. In addition, there is a 1.7% increase in the probability that participants will allocate more than 50% of their contributions to money market funds, and a 3.1% to 4.6% increased probability that they will allocate nothing to equity funds.

Source: Benartzi, Shlomo, 2008, Implications of Participant Behavior for Plan Design, New York: AllianceBernstein

Ultimately, DC plan sponsors need to build an investment menu that reflects both their vision and satisfies plan participants. In an effort to create better choice architecture, many sponsors have started creating menu "tiers" for their plans. However, this practice can be enhanced across all philosophical segments by designing the "tiers" based on three broad participant behavior profiles:

- **"Do it for me"** – for participants who lack the time, interest, desire, knowledge, or skills to make investment decisions, and would like a professional to guide them.
- **"Do it with me"** – for participants who want to understand their holistic retirement plan and risk profile, and who appreciate advice in doing so.
- **"Do it myself"** – for participants who take specific interest in designing, implementing, and monitoring their own investment strategies.

If sponsors assess their employee behavioral trends, they will have the ability to design their plan's investment menu with these profiles in mind. If done effectively, participants will be able to quickly match their respective profile with the applicable menu tier, and select options from the tier intended for their profile.

KEY CONSIDERATIONS FOR CREATING EFFECTIVE DC MENUS

To help address the needs of different profiles of participants, plan sponsors are increasingly designing investment menus around key objectives and organizing fund options into "tiers." Tiered investment structures can be designed to help participants with different behavioral profiles. And plans with a philosophy geared to be "self-directed" may opt for more choices and more tiers, whereas plans with a philosophy focused on "guiding" participants may opt for simpler menus. The table below is an example of what tier-based investment menus may include -- and note that this example is not prescriptive, but simply illustrates how plans can design investment menus that reflect their philosophy and participant preferences:

THE MENU STRUCTURES MATTER LITTLE IF PARTICIPANTS ARE NOT SAVING ENOUGH. THUS IT IS IMPERATIVE THAT SPONSORS COMBINE GOOD INVESTMENT MENU DESIGN WITH APPROPRIATE SUPPORTING FEATURES. FOR RESOURCES FROM DCIIA ON AUTOMATIC FEATURES, SEE:

- Raising the Bar; Pumping Up Retirement Savings
- Plan Sponsor Survey: Structuring DC Plan Automatic Features to Pump Up Retirement Savings
- DCIIA Senate Testimony Re Automatic features

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SAMPLE INVESTMENT MENU STRUCTURE BASED ON PLAN PHILOSOPHY

Participant Profile	Self-Directed Plans	Guided Plans
Tier 1: "Do it for me" (QDIA) *Note: Not all plan sponsors are utilizing QDIAs, but may also offer a tiered approach.*	Plans oriented to *self-direct* will have a target date fund QDIA, but some may offer risk-based funds to allow the participants to choose a particular risk objective (e.g., conservative, moderate, aggressive). *Commonly Used Investments Include:* Target Date Funds *(custom or bundled) or* Risk-based Funds *(custom or bundled)*	Plans that seek to guide participants will generally have a target date fund as their QDIA - used by 57% of sponsors.[1] Balanced Funds and Managed Accounts can also be utilized and are QDIA conforming. *Commonly Used Investments Include:* Target Date Funds *(custom or bundled) or* *Managed Accounts*
Tier 2: "Do it with me" *Note: Some plans offer Managed Accounts in this category because the participant can set risk parameters and provide other personal data.*	Plans with a *self-directed* philosophy will generally provide a selection of funds that participants can use to build their own portfolio, or to complement the QDIA. There are generally more investment options with narrower mandates, and there may be both active and passive options in a given asset class. *Commonly used investments (core menu) include:* *U.S. Large Cap - Value/Growth/Core* *US Small Cap - Value/Growth* *International Developed* *Emerging Markets* *Real / Alternative Assets* *Diversified Bond* *Stable Value/Cash*	Plans with a "guided" philosophy usually offer fewer options covering broader asset classes - and often have or build a multi-manager structure (for example, a U.S. equity option might include both active and passive components). These options generally are named something very generic like "U.S. Equity." *Commonly used investments (limited broad asset class funds) include:* *U.S. Equity* *Non-U.S. Equity* *Alternative Assets* *Diversified Bonds* *Stable Value/Cash*
Tier 3: "Do it myself"	Using a *brokerage window* is a straightforward way to offer self-directed participants the broadest possible choice, and allows the plan to describe Tier 3 specifically as an option that is appropriate only for financially educated participants who assume responsibility for their investment decisions.	

Whether you structure your plan as "self-directed" or "guided", either should adhere to the fundamental menu design principals of choice architecture, participant behavioral profiles, and institutional-quality investment options.

The implementation of an investment menu requires other important considerations such as:

- Do you offer active or passive management? Or, perhaps a combination of both?
- Should you work with a single manager or use multiple managers?
- Should the funds offered be mutual funds (and what share class?), collective trust funds, or perhaps custom funds?

Each of these considerations is a complex subject in themselves and topics that DCIIA intends to address in future research publications. The framework presented here for investment menu design is still valid regardless of these implementation decisions.

CONCLUSIONS

Plan sponsors have a significant opportunity to help employees achieve a secure retirement by carefully designing a DC menu that reflects the different levels of financial literacy and acknowledges the human behavioral biases of their employee base. Making conscious choices around the structure of the menu framework and offerings in each tier will significantly help participants to select investment options to meet their retirement needs. Just like restaurants where there is no one size fits all menu, some have long menus with many choices, whereas others offer only a few set meals, the DC menu structure is a key component of ensuring participants understand the plan objectives and order a meal designed to satisfy their needs. Done well, a DC menu – can shape expectations, direct behaviors, and help participants feel confident that their retirement plan is secure.

SOURCES:

1. *Iyengar & Lepper, "When Choice Is Demotivating: Can One Desire Too Much of a Good Thing?" (2000)*
2. *Barry Schwartz, "The Paradox of Choice: Why More Is Less" (2004)*
3. *Daniel Gardner, Josh, Cohen, CFA, "What's the right savings rate?" Russell Investments (2011)*
4. *Travis Sapp, Ashish Tiwari, "Stock Return Momentum and Investor Fund Choices." Journal of Investment Management, Vol. 4, No. 3, Third Quarter (2006)*
5. *Iyengar & Lepper, "When Choice Is Demotivating: Can One Desire Too Much of a Good Thing?" (2000)*

6,7. *Shlomo Benartzi, "Implications of Participant Behavior for Plan Design", New York: AllianceBernstein (2008)*

ABOUT DCIIA

The Defined Contribution Institutional Investment Association (DCIIA) is a nonprofit association dedicated to enhancing the retirement security of American workers. Toward this end, DCIIA fosters a dialogue among the leaders of the defined contribution community who are passionate about improving defined contribution plan design. DCIIA members include investment managers, consultants, law firms, record keepers, insurance companies, plan sponsors and others committed to the best interests of plan participants.