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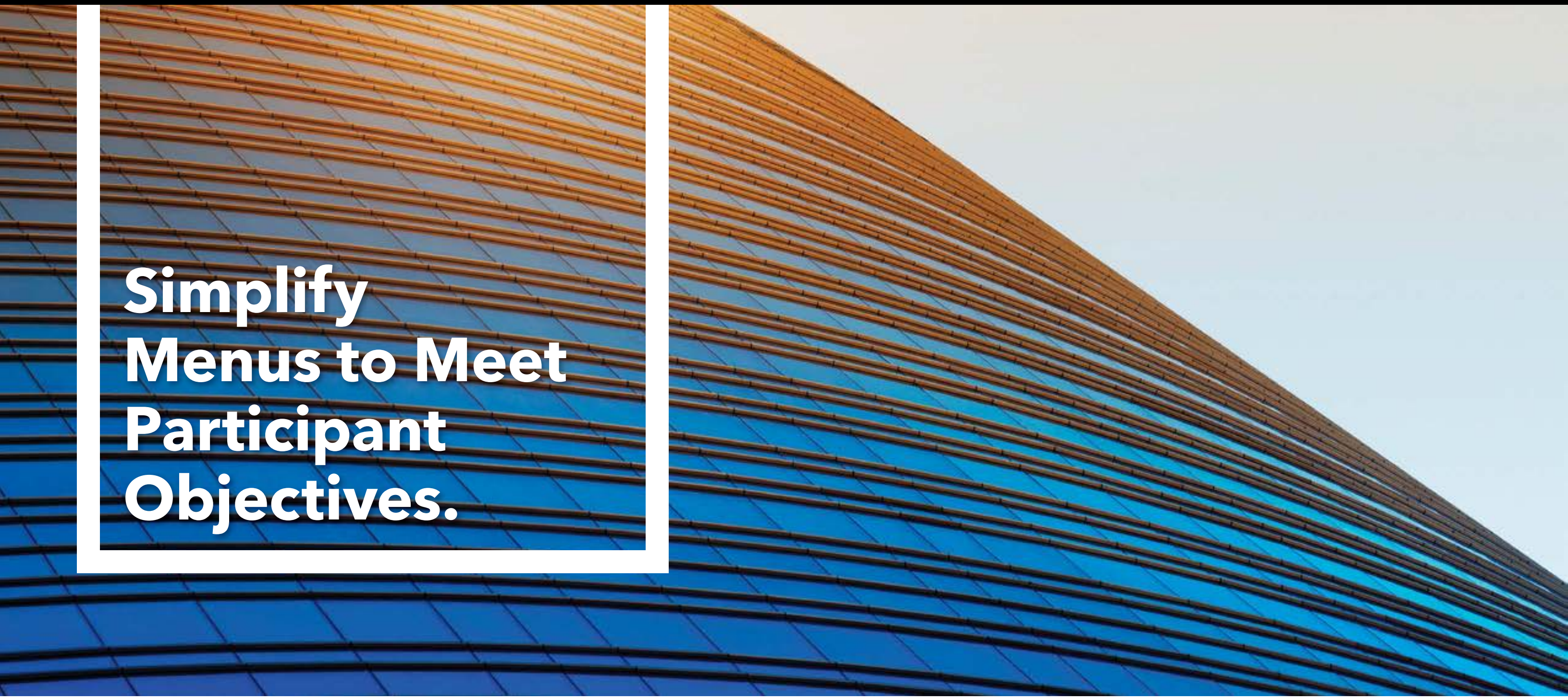
Defined Contribution Investment Perspectives

The Evolution of Investment Menu Design



Simplify Menus to Meet Participant Objectives.

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Multiple Perspectives. One Approach.®

Defined benefit (DB) plans consistently report better returns – as much as 0.9% higher per year[1] – than defined contribution (DC) plans. The Pension Protection Act gave plan sponsors tools to narrow this gap, such as investment re-enrollment and target date funds (TDFs) as default investments. These have helped improve investing behavior for many participants, but what about the 63% of DC plan participants who still make their own investment decisions?[2]

Plan sponsors can set up better decision-making from these participants by simplifying their investment options. Fewer and easier-to-understand menu choices can encourage more appropriate selections, leading to better potential outcomes. Sponsors can facilitate this with a few steps:

- **Reduce the number of menu options** to simplify decision-making.
- **Re-label menu options around easily understood life goals** to better align with participants' retirement objectives.
- **Re-organize menus using broader more flexible options** to maintain diversification with fewer choices.

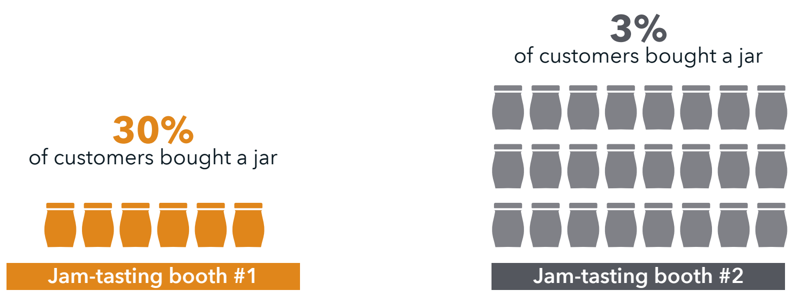
Too Many Choices Can Overwhelm Participants

Participants may not be selecting the most appropriate investments. Out of the 19 investment options offered on average by plans of all sizes,[3] participants choose on average only 3.6 investments.[2]

Sponsors naturally want to give participants sufficient investment options. Freedom of choice, after all, gives the feeling of control over outcomes. But too much choice can be debilitating, because it emphasizes the responsibility for making the right decision. Professor Sheena Iyengar calls this "the paradox of choice."

To illustrate, she set up a tasting booth in a gourmet market that offered either 24 or 6 fruit jams. 60% of visitors were drawn to the larger assortment, but only 3% bought a jar. Meanwhile, the 6-jar booth attracted 20% fewer people, but 30% of visitors to that booth bought a jar.

The Jam Study: Fewer Choices Create More Decisions



Iyengar found comparable results with 401(k) plans. When the number of options increased from 2 to 11, participation rates dropped 5%.[4] Fewer choices made decision-making easier. Many choices overwhelmed participants, to the point some declined to even participate in the plan at all!

It's not uncommon to see this paralysis in decision-making take the form of counterproductive investing behaviors like 25-year-olds investing 100% into money market funds and 65-year-olds not adjusting their 100% equity positions. Or participants will "naively diversify" by dividing their contributions equally among the plan menu options.[5]

The Evolution of Plan Menus

Under the 404(c) safe harbor provisions, 401(k) plans are required to have at least three distinct and materially different investment options. Back in the 1980s, that's exactly what most plans offered: a stock, bond and cash option. Over time, investment menus proliferated to include options dedicated to sub-asset classes, specific styles such as growth or value, and later, multiple funds in each distinct category.

We believe sponsors should support a "natural selection" back to more manageable menu sizes. The questions to consider are:

- What organizing principle promises the most engagement from participants?
- What menu size provides adequate diversification and choice?

"Unless participants and beneficiaries are financially sophisticated, many of them will need guidance when choosing their own investments from among a large number of alternatives."

– Department of Labor Field Assistance Bulletin No. 2012-02, May 7, 2012

Over 70% of 1,000-5,000 participant plans offer 16 or more investment options, as do nearly 50% of over 5,000 participant plans.

– PSCA's 58th Annual Survey of Profit Sharing and 401(k) Plans, 2015

[1] Source: Munnell, Aubry and Crawford, "Investment Returns: Defined Benefit vs. Defined Contribution Plans," *Center for Retirement Research*, December 2015. The quoted figure represents an asset-weighted calculation for all plans over the period 1990-2012 that measures the change in assets as reported on the 5500 form, netting out for cash flows.

[2] Aon Hewitt, "2015 Universe Benchmarks: Measuring Employee Savings and Investing Behavior in Defined Contribution Plans," July 2015

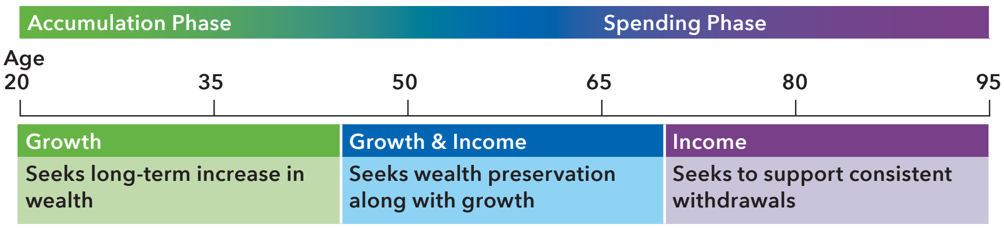
[3] PSCA's 58th Annual Survey of Profit Sharing and 401(k) Plans, 2015

Re-Label Menu Choices to Match Participant Objectives

TDFs deliver a one-stop investment solution that aligns with participants' time-based objectives. A similar framework can streamline the rest of the investment menu.

Simply divide the menu into investment objectives that reflect the participants' years to retirement. Then organize a smaller selection of investment options around these life stages.

Such a re-labeling might look something like this:



In this grouping, more volatile equities gradually shift to higher yielding assets like dividend stocks and bonds as participants age, then to capital preservation and income that addresses market risk.

Such an approach makes it easier for participants to see how their investments relate to their life stage. As such, they may be more likely to make decisions that support investment success.

The Core Menu, Simplified

Sponsors can reduce the number of investment choices by merging them: Combining U.S. large growth and value styles into a single U.S. large-cap option, for example, or blending small- and mid-cap exposures. This reorganizes the building blocks into broader and more flexible choices that cover the same spectrum of underlying securities.

Sponsors should use the model below to reduce menu options, per their plan size and asset mix. Participants may better resonate with their choices if the new menu options are re-labelled using the objective-based framework of "growth" and "income" rather than "equity" and "fixed income."

Core Building Blocks	Simplified Core Building Blocks	Next Generation (Objective-Based)
U.S. Small/Mid Cap Non-U.S. Equity U.S. Large Cap	Global Equity	Growth
U.S. Core Bond	Global Fixed Income	Income
Stable Value or Money Market	Capital Preservation	Capital Preservation

"Investing based on participants' real-life retirement goals is a great way to rationalize menu options. The single objective is to retire with enough money at retirement on an evolving asset allocation plan appropriate for your age."

– Craig Duglin, SVP, DC Product Management

"Simpler labels to better involve participants can still express the full range of investment strategies, including ones that are often missing from plan lineups."

– Toni Brown, CFA, SVP, Defined Contribution

[4] Source: Iyengar, Jiang and Huberman, "How Much Choice is Too Much?: Contributions to 401(k) Retirement Plans," *Pension Design and Structure: New Lessons from Behavioral Finance*, 2003

[5] Benartzi and Thaler, "Heuristics and Biases in Retirement Savings Behavior," *Journal of Economic Perspectives*, 2007

Can Broader Mandates Deliver?

How can core menus achieve adequate risk/return exposures with fewer funds? A lot depends on the investment managers.

Some managers take a strict style- or benchmark-driven approach that seeks to avoid style drift.

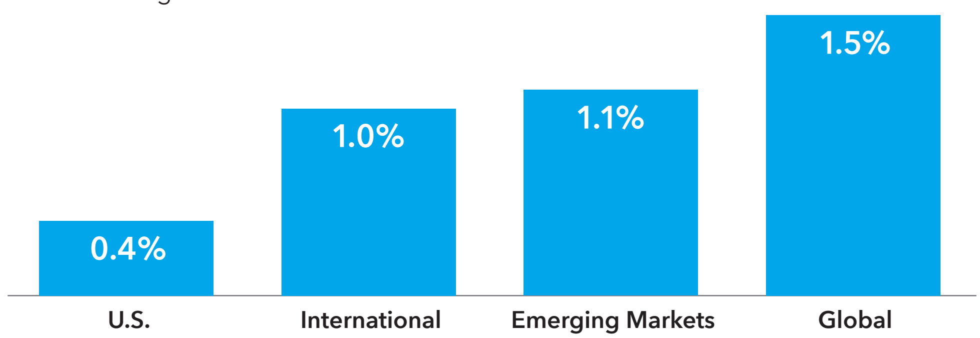
Other managers use a wider opportunity set – and longer-term view of investor outcomes – to pursue capital appreciation and income goals. This gives them the latitude to pursue their best ideas, as well as take action to protect participants when a narrow style or sector comes under duress.

Breaking Menu Boundaries To Generate Better Returns

Most menus separate U.S. and non-U.S. investments. The world is undergoing a rebalancing to a global economy, where companies compete globally regardless of country of domicile.

As the chart below shows, a broad, worldwide strategy can replace multiple equity managers while potentially generating additional excess return over time.

Global Equity Offers More Opportunities Than U.S. Equity Alone
Median Manager Excess Return 2006-2015



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

Conclusion

Complex menus lead to participant confusion, disengagement and poor investment decisions. So the traditional DC investment menu spread across asset classes and styles is evolving toward a smaller set of choices.

The success of target-date options offers plan sponsors a road map for how to simplify menus, improve participant engagement and deliver better investment outcomes.

Simplifying the plan menu with fewer, broader menu choices, and re-labelling those choices to correspond with the way participants understand their retirement objectives, can help plans:

- Organize menus around basic, easily understood categories.
- Create incentive for participants to align their investments with their retirement time frames.
- Offer more flexible options to better pursue investment returns and volatility management.

"Managers, sponsors and participants often feel boxed in by constraints designed to create diversification. We need to get back to a world where managers pick securities, and participants save with discipline."

– John Doyle,
SVP, Defined Contribution

"Most DC professionals recognize the need to simplify menus. The art is to make the change relevant enough to participants that it feels seamless."

– Sue Walton,
SVP, Defined Contribution

For additional ways to simplify fund menus, call your American Funds representative, or visit americanfunds.com

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