



401(k) Investment Options: What is the Right Number?

Over the last few weeks, I have had the opportunity to review two different 401(k) retirement plans; each one having over seventy different investment options. Participants had to choose from dozens of different investment options, many of which were in the same investment category or asset class. This large number of choices had the potential to become an overwhelming task that could create a situation where a participant was likely to become less diversified, rather than more.

For example, if a plan has several different large stock growth mutual funds available, how does the average participant determine which large growth fund makes the most sense for them? The average participant actually has no way of knowing which of the multiple large growth funds available makes the most sense for them to choose, and he or she is very likely less diversified by choosing more than one fund in a given asset class.

One interesting study that examines how investment decision-makers, such as qualified retirement plan participants, are impacted by more choices is, "The Psychological Costs of Ever Increasing Choice: A Fallback to the Sure Bet," written by Sheena S. Iyengar and Wei Jiang of Columbia University in 2005. This study drew upon information attained by examining nearly 650 retirement plans with approximately 800,000 participants.

The study has a number of very interesting observations and conclusions. One of the most fascinating conclusions was that having a large number of choices from an investment standpoint induced retirement plan participants to refrain from making any choices even when it was costly to do so.

Further, a significant number of investment choices motivated retirement plan participants to choose less risky investment options. The attitude of the typical participant seems to be, "This is not what I do. There are too many choices here. I think I'll just play it safe." The selection of less risky investment options, such as money market accounts and stable value funds, may be appropriate for some participants. However, this could be a costly allocation decision for participants with a long time horizon.

One of the most dramatic conclusions of this study was that having too many investment choices actually created a situation where participants were more likely to completely opt out of a pension plan. This tendency was even proven to be true when there were clear monetary advantages to participate, such as an employer matching contributions. As options increase, the probability of participation declines. I found this to be an incredible observation.

Clearly, participants must have a fund menu that enables them to develop an appropriate allocation based on their personal goals, time horizon, and risk tolerance. However, excessive choices actually decrease the likelihood that participants will develop a prudent investment mix.

Another practical administrative challenge for plan sponsors who have a large number of investment choices on their menu is the ongoing need to monitor those investments based on a prudent fiduciary process. It is reasonable to expect that if you have a significant number of investment choices and have a reasonably high standard for

performance of those investment options, that you will need to make rather frequent changes to your investment lineup. Changing investments on a frequent basis can be costly in a variety of ways including administrative fees associated with changing a fund, the necessity to place the plan into an administrative blackout, and the possible need to communicate the change to retirement plan participants.

In conclusion, having too many choices has proven to actually decrease participation in defined contribution plans such as 401(k)s, even when participants are incented to participate through a matching contribution. Further, participants that make investment allocation decisions when there are a significant number of choices available are more likely to weight their allocations toward fixed income and cash equivalent investment options. This bias toward less risky investment options when there are a large number of choices occurs even when the end result may not be the most reasonable long-term investment decision for the participants.

A 'best practice' for retirement plan sponsors building an investment menu is to first determine which investment categories make the most sense to include in their fund lineup and then select well-managed mutual funds that fit into those asset classes. These mutual funds can then be monitored carefully, based on a prudent fiduciary standard of care and replaced when necessary.



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