

Redefining the menu: Embracing behavior-driven defined contribution investment menus

What lessons can the defined contributions industry learn from the fast food industry?



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Recently an IN-N-OUT Burger® opened in my hometown of Salt Lake City, Utah. I didn't think much about the new restaurant until I noticed that every day, regardless of the time, 30 to 40 customers lined up at the drive-up window and another 30 waited at the counter. Finally, curiosity got the best of me, and I pulled into the drive-thru to see what all the craze was about. When I drove up to place my order, I expected to see every burger imaginable, but instead I stared dumbstruck at the simple menu: Hamburger, Cheeseburger, Double-Double and French Fries. That is correct. IN-N-OUT's menu offered only four food choices.

LESSONS YOU CAN LEARN FROM IN-N-OUT'S SIMPLE MENU

Think about your typical experience when you drive through an unfamiliar fast-food restaurant. You pull up to the menu board and are immediately asked for your order. If you're like me, you panic because the menu offers multiple combo meals, several sides, six desserts, and 10 drinks. You finally blurt out an answer—generally based on whatever picture is featured that month on the menu. In fact, according to a restaurant operator in the west, items with pictures on the menu account for nearly half of sales in any given month.¹

For retirement plan participants, the scenario is similar. They receive a packet with a page of 20 different choices and must choose from the "menu." Overwhelmed with too many choices, plan participants often select an investment based on a prominent brand or peer recommendation rather than the goals they're trying to reach. The proliferation of choices has done a great disservice to plan participants. According to a Burgess & Associates study, more than 80 percent of investors were better off using a lifestyle fund than building their own strategy.²

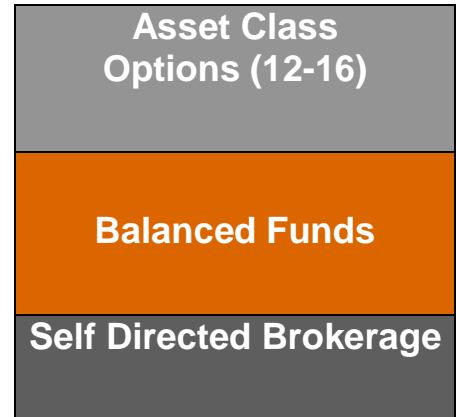
¹ Statement based on monthly sales of a Utah fast food operator with multiple locations. Based on July 2010 sales numbers.

² Burgess & Associates study for John Hancock, covering 1997-2006; information is as of September 2007. http://www.johnhancock.com/about/news_details.php?fn=oct1707-text&yr=2007

CHOICES AND MORE CHOICES

Just like some restaurants' menus try to satisfy every customer's taste by featuring a plethora of choices, many plan sponsors try to offer participants every flavor of investments. For example, we commonly see plans with an investment menu that consist of a:

- Stable value or money market fund
- Funds spanning the domestic style boxes
- Bond fund
- International/global funds
- Lifestyle or lifecycle fund suite



How did this menu design become standard for DC plans in the United States? Largely, it was due to a fundamental belief that DC plan participants should be able to invest as they want. To satisfy everyone, plan sponsors attempted to provide one of everything. This was particularly true in the 1990s, with some plans having 100+ investment options. Even today, this attitude prevails. Plan sponsors also want minimal liability for selecting investment choices on behalf of participants. For these two reasons, plan sponsors tend to shy away from more prescriptive investment menus.

A third reason for excessive choice is that many advisors, consultants, and plan committees view their primary responsibility as picking the “best” funds, rather than focusing on overall plan governance. This is similar to a restaurant spending all of its time finding the best lettuce, buns, and beef but never assembling a hamburger.

Finally, plan sponsors view the extra choices as a way to diversify away fiduciary risk. In my DC career, I can't count how many times I've been told that providing options spanning the style boxes ensures a plan meets its fiduciary duties for providing a broad range of investment options. While this could satisfy ERISA section 404C, a less complicated line-up of investment options could likely meet the guidance. 404C states: *A plan offers a broad range of investment alternatives only if the available investment alternatives are sufficient to provide the participant or beneficiary with a reasonable opportunity to.*³

- (A) *Materially affect the potential return on amounts in his individual account with respect to which he is permitted to exercise control and the degree of risk to which such amounts are subject;*
- (B) *Choose from at least three investment alternatives: (1) Each of which is diversified; (2) Each of which has materially different risk and return characteristics; (3) Which in the aggregate enable the participant or beneficiary by choosing among them to achieve a portfolio with aggregate risk and return characteristics at any point within the range normally appropriate for the participant or beneficiary; and (4) Each of which, when combined with investments in the other alternatives, tends to minimize through diversification the overall risk of a participant's or beneficiary's portfolio;*

As you can see, there is no mention of required style boxes or asset classes. It's about allowing participants to control risk/return characteristics of their choices.

³ http://www.dol.gov/dol/allcfr/title_29/part_2550/29cfr2550.404c-1.htm

THE PARTICIPANTS' VIEW

Rather than just adding extra choices, consider the needs of the participants. Who is the plan trying to serve? Every restaurant has a customer profile. Plan sponsors should adopt this same philosophy for their participants. In Russell's observations of the defined contribution industry, we've identified three typical participant profiles. They include:

“Do it for me” investors: These participants would like someone else to do the investing on their behalf. Typically, but not always, they're either unengaged or lack the interest, knowledge, or skills to make investment decisions. Generally this profile represents a majority of plan participants.

“Do it with me” investors: These participants are more engaged, such as employees who show up to the voluntary retirement plan education meeting. They want to understand their risk profile and may talk to an advisor. They may also have other assets they would like to include in their planning process. As much as they're interested in securing a good retirement, they don't want to select investment managers or be responsible for implementation and rebalancing. Generally, this profile represents a smaller but significant percent of participants.

“Do it myself” investors: These individuals take special interest in designing, implementing, and monitoring their own investment strategies. They typically ask for more funds. No matter how large your investment menu grows, it likely won't satisfy a “do it myself” investor. This profile represents a very small minority of participants.

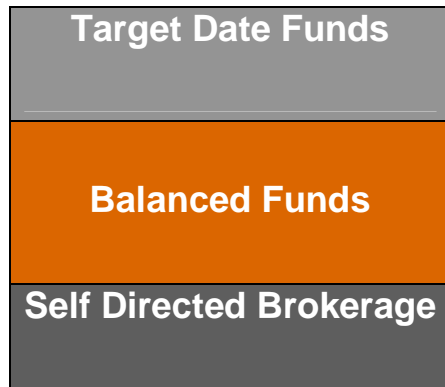
As you can see, you could design your plan to satisfy the vast majority of your participants by simply focusing your attention on the first two profiles—“the do-it-for-me” and “do-it-with-me” participants. Knowing your audience allows you to create an appealing menu that provides relatively simple choices, such as those at a focused fast-food restaurant.

For example, the combo meal revolutionized the fast food industry in the early 1990s and led to increased sales of combo meals today accounting for over 55% of sales.⁴ Why? Predesigned meal selections make picking and pricing a meal for hungry customers a pleasant experience. This can also work for the large majority of plan participants. The primary solution for your largest customer base—the do-it-for-me investors—could be a suite of target date funds. Even with the recent scrutiny levied against these funds, they still likely provide a better alternative than what participants may have created on their own. Other default options lack the benefit of target date funds' dynamic asset allocation over time. This allows inertia to work against participants, potentially over or under exposing them to equities in critical times, including early or late in their savings cycle.

Like the fast-food restaurant, your other large customer base is investors who want to spend a little more time thinking about their selection. The “do-it-with-me” investors like the idea of a combo meal but want to tweak the selection to fit their specific risk appetites. They're willing to think about how hungry they are (risk appetite) and when their next meal is (retirement). For these participants, a possible solution is a suite of risk-based funds or managed accounts, such as conservative, balanced, and aggressive, that can satisfy this group's various appetites.

Such a plan design may leave the do-it-myself investors unsatisfied. While these investors are usually a very small minority, they can be the most vocal. At restaurants, such guests must simply order off the menu or go somewhere else. Plan sponsors can accommodate them without allowing them dictate the investment choices. Generally,

⁴ Statement based on monthly sales of a Utah fast food operator with multiple locations. Based on July 2010 sales numbers.



these participants are best served with a brokerage window. They can sign a fiduciary waiver and choose from the universe of stocks, bonds, mutual funds, and ETFs. Some smaller plans might deem that the cost or liability of this option isn't viable for one or two participants. Plan sponsors should then take their cue from restaurant owners and politely tell those participants to order from the provided menu.

THE BENEFITS OF A BEHAVIOR-DRIVEN MENU

The benefits of using behavior profiles to build simple menus that serve the participant population are substantial. If you'll bear with my restaurant analogy a little longer, you'll see how everybody can benefit.

Happy customers: Participants can easily choose from the short menu. The choices and overall experience may enhance participants' satisfaction and could increase the likelihood of long-term participation. Participation is the first step to a more secure retirement.

Increased efficiency: Happy participants create less drain on plan sponsors' human resources departments. With fewer choices to communicate, it's easier to manage the process and provide time for meaningful conversations with participants about how much to save and how to plan for retirement.

Inventory control: Because choices are limited, plan sponsors can use the higher concentration of assets to get lower-priced share classes, reduced costs of administration, and reduced costs of plan services. Think of the IN-N-OUT Burger chain. It only sells burgers, so the volume of beef it buys allows the chain to negotiate better prices.

Food Poisoning: The risk of customers getting food poisoning can be devastating for restaurants. For plan sponsors, the risk is fiduciary liability. A behavioral-driven plan design can help manage that liability. Some of the most important fiduciary responsibilities can be solved through process, procedures, and governance. Many of these responsibilities are neglected when the focus shifts to evaluating too many investment options. Fewer investment options provide more time to manage the important aspects of fiduciary liability.

Supply chain: Plan advisors are an integral part of a retirement plan. They help establish policies, procedures, investment policy statements, investment monitoring, education, and sometimes, direct advice to participants. This can be time consuming and particularly tricky for an advisor who works with multiple plans. By implementing a behavioral-driven plan design, plan advisors can reduce the time spent evaluating the multitude of investment options. This frees time to work on more valuable matters for the plan sponsor and participants, such as managing fiduciary issues, reducing the burden of providing a retirement plan, and creating better participant outcomes.

Quality: Three menu solutions enable advisors and plan sponsors to work even more diligently to provide the highest quality and most durable solutions possible for participants. Russell believes all participants deserve access to multi-asset, multi-style, non-proprietary multi-manager solutions. These choices should be easy-to-use

solutions that feature the most sophisticated and innovative investment thinking available.

Plan sponsors should ask these three questions at their next plan review:

- Are the participants best served by the current menu?
- Do the investment options help participants make better investment decisions?
- What types of investor profiles exist in the plan?

Just as the food industry has designed menus to improve quality and efficiency, implementing a behavioral-driven investment menu can help improve efficiency for plan sponsors and retirement security for participants.

For more information:

Call Russell at **800-787-7354** or

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