

### Three easy, sure-fire ways to help plan sponsors upgrade their investment menus

As an advisor to 401(k) and 403(b) plans, one of the most glaring errors you will encounter is the bad investment menu. The good news is this problem is easily fixable! A plan sponsor might have a bad investment for a variety of reasons. Surely, the plan's board is not committing this atrocity on purpose. As the plan advisor, you can help the success of the plan by convincing the board their well-meaning actions don't actually benefit plan participants. Bad investment menus usually stem from the following three issues: inappropriate number of investment options, inappropriate options offered, or inappropriate target date or allocation fund offerings.

The board that governs the 401(k) or 403(b) plan might think they're doing participants a favor by offering large numbers of investment options. If the plan sponsor is a small company, employees might feel comfortable requesting certain funds be added to the investment menu and board members may feel pressure to comply. Offering too many investment options can have a paralyzing effect on participants who are less sophisticated investors. When people feel overwhelmed by too many options they often do nothing. Even worse, they might revert to something called "1/n diversification," which is when a participant invests an equal portion of their contributions into each of the available investment options. This leads to inappropriate diversification. As the plan advisor, help boards by examining their plan demographics and overall plan investment allocation. If there are heavy allocations to the plan's alternative investment options, a large number of participants might be utilizing 1/n diversification.

Pare back investment menus that provide too many options by implementing a more rigorous structure for investment options. Then, present the investment options to participants in the form of a pyramid. Please note, this method only applies to "do-it-yourself" plan participants. The bottom of the pyramid is for core investment options. These options consist of both active and passive broad-based U.S. equity funds, capital preservation funds, broad-based international equity indices, and U.S. core fixed income active funds and indices. This layer should consist of about five to seven investment options. These options create the base of the do-it-yourself portfolio. The second tier of the pyramid is the supplemental layer. Participants can add these where they want to build additional exposure beyond what the core options offer. Examples of these investment options would be a TIPS fund, market-capitalization specific U.S. equity funds, and developed market international funds. Four to six options is a fair number for this supplemental tier. The third and final level is the specialty fund tier. This consists of emerging markets funds, real estate, or other investments that can be seen as alternative or particularly aggressive. Please keep in mind that a participant always retains the option to invest all of their money into one investment option. Investments in this top tier should be approached with the question, "Would we want our participants investing all of their money in this fund?" As the plan advisor, you will need to help the plan's board balance their desire for low correlation specialty funds with the added individual investment volatility and fees they can bring. Although inclusion of a low correlation alternative fund may mute the volatility of the overall portfolio in the long run, participants may lose the ability to view their portfolio as a whole entity when one investment is performing poorly. More than three options in the top tier is likely too many. Funds across the investment menu, especially in this top tier, should have adequate risk controls, a proven track record, and fees that are not excessive.

Adequate risk controls, a proven track record, and reasonable fees are three of the hallmarks of appropriate investments. An investment that does not check these boxes is asking for trouble. As the plan advisor, you'll need to help the board examine the investment menu options for these qualities. There are third party firms that provide investment manager due diligence and performance information if you do not have it available in-house. Fee studies should be performed at least annually and presented to the board to ensure investment manager fees are reasonable. Helping the board understand that it is their fiduciary duty to examine these items will help to motivate them if they are complacent.

For participants who do not wish to create their own portfolio, it is imperative to have a set of target risk or target date portfolios available. These can also serve as the QDIA for the plan. Ensuring the plan is using appropriate target date portfolios can be tricky due to glide path configuration. Not all industries are created equal. Some industries have employees that retire much younger than others, such as fire fighters and construction workers.

Participants with physical jobs may need a different glide path configuration to their target date funds. If the average age of retirement in an industry is 55, the allocation of that target date fund will initially need to be more aggressive than the average target date fund. As the plan advisor, you can assist the board with ensuring the target date and target risk portfolios used by the plan are appropriate for the plan demographics.

Even the best investment menu can create issues if plan participants aren't educated properly. Participant behaviors such as performance chasing, market timing, and 1/n diversification can severely dull participant performance over a given time period, even if the investment options themselves have performed quite well. As a plan advisor, in addition to ensuring your client has an appropriate investment menu, it's important to make sure participants are educated about market timing, performance chasing, and inappropriate diversification. A well-educated participant is a necessary companion to a great investment menu.