The Tyranny of Choice—Why 401(k) Plans Are Failing and the Cure to Save Them

By N. Scott Pritchard

Participant self-direction in 401(k) plans is not working. Many readers already realize that. And those that don’t simply may not be paying close enough attention.

One of life’s great truisms is a corollary known as the “Law of Unintended Consequences.” It speaks to the notion that many well-intentioned ideas often have results that could have never been anticipated and that are, as military strategists like to say, “sub-optimal.” In the Hall-of-Fame for the Law of Unintended Consequences resides the noble 401(k) plan. Although the notion of individuals managing their own retirement assets sounds sensible, it is, in fact, a fundamentally bad idea. The elephant in the room that no one seems to want to discuss is that individual investors as a whole do a poor job managing their own investments, and 401(k) participants are simply individual investors turbo-charged with an online trading platform that has no commissions and no tax consequences. It is, by and large, a recipe for disaster. And it has profound implications for the retirement security of millions of Americans.

The Plight of the Individual Investor

It has long been known that individual investors don’t typically fare well in their efforts at do-it-yourself investing. This notion has been validated by numerous studies, including one by Dalbar, Inc., which revealed the staggering margin by which the average individual investor trails the returns of the broader market.

As the study in Exhibit 1 reveals, the S&P 500 returned an annualized 11.81 percent from 1988 through 2007; yet the average...
investor’s return over that same period was a paltry 4.48 percent—even less than the most conservative of investments, the 30-day Treasury Bill.

Consider those statistics in dollar terms: A $100,000 investment in the S&P 500 at the beginning of 1988 would have grown to $932,423 by the end of 2007. Meanwhile, the average investor’s balance of $100,000 would have grown to only $240,250.

Why is the individual investor so inept at capturing the returns of the market? In a word: Emotions. Money is a very emotional thing for people and the average investor simply cannot control his or her emotions enough to stick with the consistent buy-and-hold strategy that would produce a “market” return. Emotion drives investors to buy the latest hot fund near its peak and sell the fund after riding it to the bottom on its inevitable slide downward. This “buy high, sell low” scenario is unfortunately not just an anecdote, but is very real for many individual investors.

It’s not difficult to see why. Wall Street is extraordinarily adept at selling investors on the dream of hot performance, with much of the investment industry’s advertising focused on promoting star ratings and outsized returns. Meanwhile the media bombards investors daily with salacious stories about “Seven Funds to Own for 2008” and “Hot Sectors for This Week.” While a prudent, long-term strategy would benefit the average investor immensely, “Five Index Funds to Buy & Hold” would not likely sell many magazines.

Combining the tendency of individuals to make short-term, emotional investment decisions with Wall Street’s mastery at playing on those emotions and the media’s need for sizzling investment stories, yields a poisonous brew that results in the kind of dismal investment performance noted in Exhibit 1. In the end, the only winner is Wall Street.

Enter the 401(k) Plan

Historically, employees looked to their employer for retirement savings and security. The typical defined benefit (DB) plan was managed by professionals and the individual participant had no control over the investment decisions.

Today, however, the traditional pension has largely been phased out, and the self-directed defined contribution (DC) 401(k) plan represents the future of retirement for the majority of American workers. Consider Exhibit 2 showing that assets within DB plans have grown 58 percent over the last 12 years, while assets in DC plans have grown 143 percent.

It is an unfortunate irony then, that the majority of this country’s retirement-plan assets have now been placed—squarely and intentionally—in the hands of those same investors who the Dalbar study shows dramatically underperform the market. This “tyranny of choice” [The term “tyranny of choice” was originated by Dr. Barry Schwartz, Professor of Social Theory at Swarthmore College, in his April 2004 article in Scientific American] is a burden the average 401(k) participant never wanted in the first place. And as benefits consultant Brooks Hamilton noted in a May 2006 PBS documentary, “They’re running their money into the ground.” [PBS’s Frontline documentary, “Can You Afford to Retire” May 2006]

Attempting to Educate the Uninterested

The historically poor performance of individual investors has not been lost on plan sponsors, plan providers, and lawmakers. In a good-faith effort to help participants, sponsors and providers have thrown countless hours and significant dollars into education over the years. Yet participants continue to struggle.

The inherent problem is that the majority of participants simply have no interest in the subject being taught. For example, attempting to teach Portuguese to people who never asked to learn the language will likely have very little success, because they have no interest in the subject matter. The same holds true when it comes to teaching participants how to successfully manage an investment portfolio. It is not a subject that most participants are interested in, even if they know they “should” be better informed. It is simply not a critical issue for them on a day-to-day basis.
Participants may attend the required education meeting, but the impact is minimal. Retirement is a “tomorrow” issue, not a “today” priority.

Research conducted by Dr. Shlomo Benartzi (UCLA) and Dr. Richard Thaler (University of Chicago) confirms this theory. In one example, a large employer offered financial education for its employees free of charge. The employer measured the effectiveness of the education by administering a before-and-after test of financial literacy, using a True/False format (consequently, random answers would receive, on average, a score of 50%). Before the education sessions, the average employee score was 54 percent, just slightly above chance. After the sessions, the average score “jumped” to 55 percent. [Dr. Shlomo Benartzi and Dr. Richard Thaler, “Heuristics and Biases in Retirement Savings Behavior,” Summer 2007]

In another example, an educational seminar offered by a large employer resulted in unanimous consent among attendees that they would participate in the company 401(k) plan. In reality, however, only 14 percent of attendees actually joined the plan, not significantly more than the 7 percent who joined the plan without even attending the seminar. [Dr. James J. Choi, David Laibson, Brigitte Madrian, and Andrew Metrick, “Saving for Retirement on the Path of Least Resistance,” Behavioral Public Finance: Toward a New Agenda, 2006.]

Education in some ways has even been harmful. Many education sessions are focused on teaching participants how to navigate the plan’s Web site and make changes to their holdings. However well-intentioned, these sessions have simply given participants the tools with which to practice the very behaviors that undermine their long-term success—market-timing and returns-chasing.

While education may make plan sponsors and plan providers feel good by attempting to help participants, it is simply not working and may actually be counterproductive. The reality is that more education is simply not the answer.

Lifestyle Funds: Getting Half-Way There

A growing number of plan sponsors and investment providers have realized that education is not the answer—an awareness that has driven the prodigious growth of “target-date” and “lifestyle” funds in recent years. The “do-it-for-me” aspect of these funds has been an improvement, as target-date and lifestyle funds provide access to professionally constructed portfolios which, in most cases, offer more effective diversification than what participants can achieve on their own.

Unfortunately, two main problems still persist:

1. Most of these funds are packaged by mutual fund companies, brokerage firms, banks, and insurance companies and are often filled with expensive, proprietary funds: The proprietary nature of most target-date and lifestyle funds presents a major challenge. Wall Street firms recognized early on that these packaged products could be very profitable from two perspectives: first, fund companies can hide their poor performing funds behind the “aggressive portfolio” label. Second, these funds represent a great opportunity
to build in additional layers of opaque fees, as many target-date and lifestyle funds charge a management fee in addition to the fees associated with the underlying funds. In the end, poor performance and excessive fees may prove to outweigh the benefit that target-date and lifestyle funds provide by removing the investment decision from participants.

2. **These funds are still offered largely as one choice among many in a 401(k) line-up:** Of equal concern with target-date and lifecycle funds is the lack of understanding most participants have about the fund’s purpose. Most plan sponsors have added these funds as just another option, without emphasizing to participants that such funds are intended to be single-choice, all-or-nothing options. In fact, even when extensive efforts are taken to educate participants as to how to use target-date or lifestyle funds as single-choice options, these funds continue to be misused.

For example, a study of one Southeastern law firm’s 401(k) plan revealed that roughly 50 percent of participants had a lifestyle fund in their portfolio. Unfortunately, despite repeated and intensive efforts to communicate the all-or-nothing intention of the lifestyle funds, the study found that 83 percent of the participants were using the lifestyle fund incorrectly; participants either held multiple lifestyle funds or they used a lifestyle fund as just one component along with other funds in their portfolio. [Capital Directions, LLC, October 2007]

As further confirmation, Benartzi and Thaler report that a Vanguard study from 2004 showed that participants who select a lifestyle fund allocate only 37 percent of their assets to the fund. When given a broad menu from which to choose, it appears that participants are reluctant to select only one fund, even when that fund offers the diversification of already containing several different funds. [Dr. Shlomo Benartzi and Dr. Richard Thaler, “Heuristics and Biases in Retirement Savings Behavior,” Summer 2007.]

So while target-date and lifestyle funds represent an improvement over the previous mode of simply providing a menu of individual funds, significant challenges remain—the largest being that participants are still largely on their own in choosing how to utilize the tools at their disposal. Overcoming this challenge and saving 401(k) participants from themselves therefore will require a major shift in thinking among plan sponsors and plan providers.

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**The Advent of Advice**

As we have noted, do-it-yourself investors dramatically under-perform the market. Recognizing this tendency, many investors seek out the advice of an investment professional to help them navigate the investment minefield.

Fortunately, the trend of seeking professional investment counsel has also accelerated in 401(k) plans. The Pension Protection Act of 2006 (PPA) was lawmakers’ official acknowledgment that participants in self-directed 401(k) plans face the same challenges that confront the average individual investor and therefore, should have the same ability to seek professional advice.

Prior to the PPA, plan sponsors were reluctant to offer advice to participants for fear of the accompanying fiduciary liability. The only way for a plan sponsor to avoid that liability was to engage an independent, fee-only Registered Investment Advisor (RIA) that agreed to serve as a fiduciary. While some progressive plan sponsors did that, individual advice has historically been rare in the typical 401(k) plan.

With the PPA, a new safe harbor was created for plan sponsors who provide participants advice within their plans. In addition to the previous exemption for those plan sponsors who use an RIA, plan sponsors can now enter into the newly created Eligible Investment Advice Arrangement (EIAA) with any adviser when the advice provided is:

1. Generated by a recognized computer model; or
2. Level-comp (meaning that the compensation of the advisor is not affected by the advice given).

While the obvious intent is to encourage plan sponsors to offer the investment advice sorely needed by plan participants, there remain two areas of concern with the EIAA safe harbor:

1. **Even advice that is generated by a computer model or is level-comp can present a conflict of interest.** The funds offered to participants by brokerage firms, banks and insurance companies, either through a computer model or through level-comp, could still be proprietary funds with poor performance and hidden fees. While participants would receive help in constructing a portfolio, they may not be any better off than they were on their own.

2. **Participants still have to actively seek out the advice.** In a classic “You can lead a horse to
water …” scenario, a well-intentioned plan sponsor may offer advice that is never actually taken. Participant inertia will likely result in the majority of participants maintaining the status quo, despite the availability of professional assistance.

Are “Best Efforts” the Same as “Best Interests?”

Assuming that a plan sponsor adopts the EIAA and offers advice to participants, some would say that plan sponsors have done all they should do and that participants are ultimately responsible for their own actions. As one plan sponsor who was interviewed for this paper noted, “Our only responsibility as the plan sponsor is to provide our participants with the tools for diversification. It is then their responsibility to make their own decisions. Our participants are big boys and girls. They need to be responsible for themselves.”

This mindset may meet the letter of ERISA law, but it doesn’t seem to meet the spirit of the “exclusive benefit” mandate. If a plan sponsor is meeting all of its legal requirements, but participants are still struggling, is the plan sponsor truly acting “in the best interests of participants?”

Attorneys who specialize in ERISA and employee benefits encounter the challenges with 401(k) plans on a daily basis. We interviewed 47 attorneys who specialize in this area, and 46 of the 47 attorneys agreed with the premise that participant self-direction is not working. The sole hold-out was in the “let participants fend for themselves” camp. The almost unanimous consensus was that there remains a disconnect between advice being offered and advice being actively utilized.

While acknowledging that there have been advances in 401(k) plans, the vast majority of ERISA attorneys agreed that an innovative approach will be required to solve the continuing problems facing the average 401(k) participant. As one ERISA attorney commented, “I long for the days when the investment decisions were made by professionals.”

How to Save the 401(k) Plan

To find a solution to the problem of participant self-direction, it is helpful to remove all of the complicated details of 401(k) plans and consider the basic goal: to allow participants to save enough money to fund a comfortable retirement. Achieving that goal requires adequate contributions (both employee and employer) and the realization of an optimal risk-adjusted return.

While increasing participation and salary deferrals is a key component, the goal of this article is to address the self-directed investment aspects of 401(k) plans. Significant work on maximizing participation and deferral rates has been done by a host of noted academics, including the aforementioned Benartzi of UCLA and Thaler of the University of Chicago, as well as Dr. James Choi of Yale and Dr. Sheena Iyengar of Columbia.

To address the goal of achieving an optimal risk-adjusted return, we have to consider the asset allocation achieved by each individual participant. As the seminal study by Brinson, Singer, and Beebower concluded, over 91 percent of the long-term performance of a participant’s portfolio is dependent on the asset allocation, not on security selection or market-timing. [“Determinants of Portfolio Performance,” by Brinson, Singer and Beebower, 1986 and 1991]

Unfortunately, very few 401(k) participants actually understand proper asset allocation. The average participant is provided with an extensive menu of mutual funds, attends the requisite enrollment meeting, and is told “Turn your forms in to HR by Friday.” Without a proper understanding of asset allocation and diversification, the participant pursues a variety of options including seeking advice from a coworker or friend, simply choosing the funds with the best historical performance, or, worst of all, choosing not to participate because of “analysis paralysis.” For most, proper asset allocation remains an elusive goal.

The introduction of target-date/lifestyle funds and the provision of investment advice have been intended to provide participants with proper asset allocation. While these options are a better alternative than leaving participants to fend for themselves, a more advanced solution is needed to achieve proper asset allocation for the majority of 401(k) participants. Instead of forcing participants to make their own investment decisions, we have to provide a simplified means for participants to achieve truly effective diversification.

The traditional DB pension plan achieved proper asset allocation by utilizing the expertise of professional investment advisors and following the established tenets of Modern Portfolio Theory (MPT). To bring those same benefits to the average 401(k) participant, a move toward “advisor-managed portfolios” must take place. Such portfolios free participants from the asset allocation burden while still allowing for the flexibility of self-direction.
These portfolios achieve the "DB-ization of DC plans" by providing a small menu of well-diversified, risk-based portfolios designed by the fiduciary advisor and making each portfolio a single-choice, all-or-nothing option. Participants then only need to determine their individual comfort with risk (e.g., aggressive, moderate, or conservative). An example of the resulting diversification achieved through an advisor-managed portfolio is reflected in the 80 percent equity/20 percent fixed-income portfolio in Exhibit 3.

Ideally, these advisor-managed portfolios would be designed in keeping with Modern Portfolio Theory using only low-cost, institutional mutual funds that are passively managed and do not utilize revenue-sharing. The fiduciary advisers constructing the portfolios would provide one-on-one advice and would periodically rebalance to keep participants on target.

This innovative approach can be implemented by engaging an independent, fee-only RIA, or through the use of an EIAA as outlined in the PPA. A plan sponsor utilizing advisor-managed portfolios would then be insulated from the fiduciary liability of investment selection and monitoring, as well as the fiduciary liability associated with the provision of investment advice.

The shift from participant-managed portfolios to advisor-managed portfolios is quickly gaining advocates in the benefits community. As prominent ERISA attorney Fred Reish noted at a May 2008 fiduciary conference in Charlotte, N.C., "The more you get participants into portfolio investing, the better off the participants and the plan will be."

**Conclusion**

For better or worse, 401(k) plans represent the future of retirement in this country. Yet the design of these plans leaves the critical investment decisions to emotion-driven, novice investors who are typically uneducated and uninterested when it comes to properly managing an investment portfolio. As a result, this “freedom of choice” becomes the “tyranny of choice,” and a vast number of American workers face an uncertain future in retirement.

The move to advisor-managed portfolios will provide participants with a better chance of achieving long-term investment success and the peace of mind of a “do-it-for-me” solution, while also reducing the fiduciary liability of plan sponsors. That is a win-win scenario that can make a difference in the future of retirement in this country.

But this cure will not administer itself. Plan sponsors must realize that their participants need a different solution. Employers will have to overcome the inertia of accepting “good enough” in favor of taking action to fully meet the ERISA mandate.
of “acting solely in the best interests of plan participants.”

As one ERISA attorney admitted, “I think this approach (advisor-managed portfolios) is better, but we won’t make a change with our plan. We just have too much going on.”

If we as a society are to solve the challenges of saving and investing for a secure retirement, this satisfaction with the status-quo must change.

The reality is that participants don’t need more choice or more education.

They need more help.