Selecting Your Plan's Investments: How Many Options Is Enough?

Open-architecture environments and advances in recordkeeping technology have made it possible for sponsors to offer participants an ever-increasing array of investment choices. Providing as many choices as possible may sound like a good idea, but research indicates that having too many investment options may actually hinder participation. Sponsors may be more likely to enhance participation by limiting investment selections to a number that participants can understand and educating them about the potential benefits and risks associated with each fund.

More Funds, Less Participation?
According to the Profit Sharing/401(k) Council of America, plan sponsors provided an average of 19 investment selections in 2010.[1] But even when participants say they want more investment choices, research has documented that they often do not select new options when they are available.

After controlling for variables such as employer match and participant demographics, a survey by professors at Columbia University and the University of Chicago indicated a significant number of investment choices is likely to reduce the probability of participation.[2] The probability that a participant in a defined contribution plan with five funds would enroll was 72%. The rate dropped to 67.5% for a participant in a plan with 35 investment choices. On average, for every additional 10 funds available, the predicted individual participation probability declined by about 2%.

Keep in mind that the larger your investment menu, the more time you and plan participants may need to spend on investment education. Many participants may be unlikely to spend significantly more time on their plan even when new investment choices become available. The investment knowledge of plan participants varies widely, and many may lack the experience necessary to compare a large number of options. Also, providing too many choices may increase the likelihood that you'll eventually terminate a fund due to poor performance or lack of participation. Closing a fund may create administrative headaches and disappoint participants.

In addition, remember that an investment smorgasbord may increase your costs. As a plan fiduciary, you are responsible for minimizing discretionary expenses levied against the assets within your organization's retirement plan. If an investment roster that numbers close to the industry average meets your needs, offering a larger menu may result in unnecessary expenses that could ultimately dampen participants' returns and their likelihood of participating.

Implications for Plan Sponsors
When developing your menu of investment selections, you may want to focus on a limited number of core funds -- such as domestic equity, diversified bond, asset allocation, and money market funds -- that participants are likely to understand. You may want to supplement your core group with target-date or lifestyle funds that offer simplified diversification.[3]

There is no magic number for plan sponsors to focus on, but too many investment choices may detract from your ultimate goal of enhancing participation. Keeping things simple may streamline your administrative responsibilities while making it less complicated for participants to save for their later years.

[1]Source: Profit Sharing/401(k) Council of America, *53rd Annual Survey of Profit Sharing and 401(k) Plans,* October 2010.
[2]Source: *Choice Overload and Simplicity Seeking*, Sheena S. Iyengar, Columbia University, Graduate School of Business; and Emir Kamenica, University of Chicago, Graduate School of Business; February 2007.

[3] **Diversification does not ensure a profit or protect against a loss in declining markets. Investing in mutual funds are subject to the risk of their underlying investment holdings including possible loss of principle. Investments in specialized industry sectors have additional risks, which are outlined in the prospectus.**