LESS IS MORE WHEN DESIGNING A 401(K) PLAN TO IMPROVE PARTICIPANT OUTCOMES

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Behavioral finance has taught us a lot in recent years about how people make decisions. Just as importantly, it has taught us how plan sponsors can help participants make better decisions while still providing them with choices. However, providing people with too many choices can overwhelm them and lead to decision paralysis.

I am reminded of a lesson I learned working part-time in a men's clothing store as a teenager. On my first day, the owner showed me around the store. When we got to the tie counter, he looked me in the eye and told me to never show more than three ties to a customer. I was a bit confused and asked for clarification. Patiently, he explained I could show as many ties as needed to make the sale, but never have more than three on the counter at a time. More than that and the customer would likely have trouble making a decision. So from that time on, I dutifully put only three ties on the counter. When the customer decided he did not like one, I would put it back in the case and, if needed, pull another one out but always being careful to limit the customer's choice to three. In recent years, this type of test has been tried under controlled conditions by academics. While three may or may not be optimal, limiting choices in decision making has been proven effective.

So how can this be applied to the 401(k) plan?

Simplify the investment decision

No one believes that target date funds are the optimal investment. After all, they are based on only one factor – a participant's age. They do not take into account other holdings, risk tolerance, life expectancy, etc., yet target date funds have become one of the most popular investments in history. Why? It is because they are a simple way to get a professionally managed portfolio. All you need to decide is approximately when you expect to retire. Simple.

Participants who want to choose their own asset allocation can also benefit from simplification. After all, they are not investment professionals. So plan sponsors can help them by simplifying their decision-making. Instead of offering large-cap, mid-cap, small-cap, value and growth, plan sponsors could consider offering one large-cap manager that covers both value and growth or consider offering a multi-cap fund that covers all of the above. Participants will have the benefit of diversification without having to know the difference between value and growth, large-cap and small-cap.

Make joining the plan easier

Today, nearly half of all 401(k) plans have immediate eligibility. Plan sponsors can join this trend by eliminating complicated eligibility and entry dates. Instead of: "you are eligible for the plan after three months of service and will enter the plan on the next quarterly entry date after becoming eligible", how about: "you will be enrolled in the plan beginning with your first paycheck?" Companies worried about high employee turnover or increased cost of the match can address this by delaying match eligibility for a year, while still getting employees engaged in the plan immediately and simply.

Make the plan easier to understand

Many participants struggle with understanding the employer's matching contribution. Companies could address this by keeping the formula simple. For example: "we match $0.50 for each $1 you put into the plan up to "x" amount." Complicated match formulas, even those designed to favor the lower-paid employees can confuse people and result in lower participation.

People do not know how much they need to save in order to retire with adequate income replacement. Plan sponsors can help them. If participants are auto-enrolled, be sure to include an auto-increase feature. Otherwise participant savings rates will be clustered at the auto-enrolled rate due to employees incorrectly assuming that they were enrolled at a rate that would put them on track for retirement.

Just as importantly, plan sponsors could provide participants with context for what is adequate savings. Consider this simple message: “Many experts believe that you need to save between 10-15% of your income in order to have enough money for retirement.” This provides participants with concrete information on what will work rather than having them guess. Or consider delivering this message: “’X‘ of your peers save X% in the plan.” The idiom of keeping up with the Joneses can be a powerful motivator for positive change.

Make keeping money in the plan easier

Most employers now understand that it is good for all participants if terminated participants leave their money in the plan. Larger plan assets can provide bargaining power to the employer resulting in lower fees for all participants, both terminated and active. Terminated participants can also continue to benefit from professional oversight of the plan. However, terminated participants will not keep money in the plan if it is hard to withdraw when they need it.

A review of the distribution options may be necessary. Does the plan only allow for lump-sum distributions? This all-or-nothing option encourages, in fact requires, terminated participants to take all of their money out of the plan when they only need some of it. Installment payments could be added, enabling participants to receive monthly or quarterly distributions, while keeping the rest of their money in the plan.

A review of the investment options may be necessary. While target date may be appropriate for many terminated participants, what options are provided for those looking for an alternative? Many retirees want a reliable way to generate income. Does the plan provide them with an attractive option?

Summing it up

The suggestions above are just a few of the ways to simplify a plan and make it more attractive to employees. None of these ideas create more risk or fiduciary liability for the plan sponsor. They engage participants more effectively, with a goal to improve potential outcomes. That is a win for everyone.

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