

Investment INSIGHTS

The Forgotten Participant – What’s Missing from the DC Investment Menu?



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Defined contribution plan decision-makers have made significant progress in helping participants address the challenges of reaching a financially secure retirement through auto enrollment, auto escalation and auto default into target-date funds. The trend has been successful in that 401(k) participation and savings balances have increased, and allocations overall have vastly improved. However, there is a significant segment of participants not wanting to put their entire balance in a target-date fund. This group is actively making investment decisions, often ineffectively, across the DC investment menu in an effort to diversify and fine-tune their risk profile.

New research from Invesco suggests there is room to evolve the DC investment menu to address the needs of these “Forgotten Participants” – those who want to feel in control of their investment decisions but would benefit from an investment menu with more avenues to professionally managed options. *Pensions & Investments* spoke to Greg Jenkins, managing director and head of institutional defined contribution at Invesco, about the study and how risk-based strategies can potentially enhance 401(k) investment lineups and increase participant engagement.

Pensions & Investments: What prompted you to embark upon this body of research?

GREG JENKINS: Many of us in the industry thought that target-date funds would more fully address the asset allocation challenge by now, and I think we believed that by 2020 there would be more assets and a higher percentage of participants invested in target-date funds. When we look at our ReDefined Contribution Plans research from 2018, we see that only about 50% of plan participants seemed to be interested in putting all of their money in a target-date fund. We wanted to find out why participants feel this way, so we embarked on an in-depth study of large-plan participants, which included 10 focus groups and a survey of 2,001 participants nationwide.

P&I: What did you find?

JENKINS: There’s a significant segment, the Forgotten Participants, that want more investment control than they get in a target-date fund, which is why they’re unlikely to

ever put all their money in one. We also found that many participants are overconfident and lack the investment knowledge to competently build their own portfolio, monitor it appropriately and systematically rebalance it. We recognize that there are managed accounts and other services to help them, but on average, they’re still not capturing a large percentage of this group. That’s reflected in the data – 65% of defined contribution assets are in the core menu (*Source: Callan DC Index, quarter-end, Sept. 30, 2019*).

P&I: You’ve titled this report *The Forgotten Participant*. What’s behind that name?

JENKINS: There’s been so much focus on target-date funds over the years, and it seems like now there’s a shift occurring with more focus and energy being paid to retirement income and the decumulation side. That’s really important, but all along the way, there’s a group of participants – investors who prefer not to invest 100% in a single target-date fund or aren’t using them correctly – that have been overlooked. The goal should be to direct those participants into professionally managed options.

P&I: What’s keeping those investors from allocating 100% to a target-date fund?

JENKINS: The main factor we found was desire for control. We saw this in the focus groups, and it was reflected in the online survey data. This group wants more control over their investment decisions, specifically around risk and diversification, than a target-date fund offers. It would seem that with more education, more people would move to target-date funds, but this group of participants just isn’t wired that way. Behaviorally, they are very unlikely to put all their money into one fund and set it and forget it.

These are engaged investors. They check their retirement plan statement a few times a year to see how their balance has changed, they might review and change their contribution rate periodically or check the performance of individual funds. But they may be making these decisions with overconfidence and limited investment knowledge.

P&I: What’s the risk for plan sponsors if their partici-



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participants are misunderstanding their options in the core menu or misusing target-date funds?

JENKINS: There’s an ethical risk and a fiduciary risk. The ethical risk is that this segment of participants is not preparing themselves correctly for retirement or not understanding the exposure in their portfolio. If you have a participant, for example, who has a target-date fund and then they mix in an equity fund, you end up with a pretty large balance in the equity markets. If you fail to rebalance over time – which most people do – an imbalance can get worse. The current market environment underlines this problem.

There’s a chance you then have participants retiring at the wrong time when the market goes down, and they end up losing a significant part of their retirement income right before they retire. That’s a potential fiduciary risk.

P&I: So what is the solution?

JENKINS: One potential solution is adding risk-based funds as a separate tier of options within the investment menu, and a corresponding tool to help participants understand how to select the right strategy for them based on their risk profile. This is an old idea that is new again and something that many plan sponsors haven’t thought about previously. We received positive responses to this

concept from plan sponsors and participants. According to our survey, 64% of plan sponsors were interested in adding risk-based strategies to their investment menu, and 65% of participants felt they could be a good fit for them personally.

From a plan sponsor perspective, implementation would be arguably less difficult than other investment menu changes. You're not eliminating existing options. Instead, you're simply adding professionally managed solutions that can be helpful to participants and potentially drive better engagement. Risk-based strategies can act as a 'middle option' between target-date funds and the core menu.

I want to emphasize that target-date funds are the right default option for most plans. This is adding a tier of risk-based funds to the menu and a set of tools to help understand them. More than 70% of participants in our national survey said that they'd consider a risk-based strategy with the right, 'easy-to-understand' resources available.

P&I: There are a lot of tools and calculators out there already. How do you make sure that participants use them?

JENKINS: It needs to address not only the logical part — years to retirement or your age — but also the emotional part — how you feel about your savings or whether you have additional family financial issues to worry about. All of these things factor into risk tolerance. But it also has to be straightforward and easy to use. One thing we heard from many participants is they don't have the patience to go through a complex process — especially answering lengthy questionnaires.

Most important, it also needs to have a check-in feature. People's risk tolerances change over time. That's one of the challenges with target-date funds. If your risk tolerance changes, participants don't know how to make adjustments. In general, the industry hasn't addressed this.

P&I: What's the best way to deliver these types of tools?

JENKINS: We heard consistently from participants is that there is an appetite for mobile app-based tools. Mobile apps are being leveraged in retail and other areas that affect us every day. This technology helps us make better decisions and predicts our choices. It feels like

defined contribution has been behind the curve and we haven't taken advantage of technology that could help participants.

This doesn't need to be an all-encompassing tool that links to record-keeping systems and tries to do too many things. One of the problems in the past in the defined contribution industry has been that we tend to wait for perfect solutions that never quite materialize. One of our takeaways from the research is that participants have wide-ranging needs and we should have the right tools to help them. We believe an easy-to-use risk tolerance tool would benefit this segment of the population.

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P&I: Is there a specific type of plan participant who would be most amenable to risk-based funds?

JENKINS: A variety of participants are interested, but there are three groups in particular that stand out. First, older participants who are closer to retirement. Many of them feel like they have a more complicated financial situation than a single target-date fund will address. They typically have several household retirement accounts, and for their current DC plan, simply want a fund that maintains a constant risk level.

The second group is a segment of younger participants, and that was a bit of a surprise to us at first. For them, this idea of picking a date now when you're going to retire seems silly. They also don't think about retirement like their parents did. They think more in terms of a staged retirement or a changed lifestyle. We also heard

some of them say that they didn't understand the risk level they were getting from target-date funds, and they wanted to take more control of that.

Finally, higher-income participants were also interested. Our research found that among participants making more than \$100,000, about 80% were more likely to invest in risk-based strategies. They want more control over their investments than they get from a target-date fund, but they don't want the hassle of choosing and managing individual investments on their own.

P&I: ESG investing is another area that some plan sponsors have been hoping to introduce to their menu. Is this one way to accomplish that goal?

JENKINS: Yes. The challenge with early ESG adoption in defined contribution was that plan sponsors often introduced ESG into their menu as an actively managed equity fund, and they were sometimes expensive and often misunderstood. Participants who really cared about ESG issues tended to put all of their money into that one option. This of course means they were 100% in equities, which is not desirable.

Risk-based funds are an interesting way to incorporate ESG that we think makes more sense. Participants get a balanced option that's professionally managed, but also gives them the ESG portfolio that they want. For plan sponsors considering adding ESG to the investment menu, this may seem like a more viable route. ●

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