Excessive Fund Choice Undermines Performance

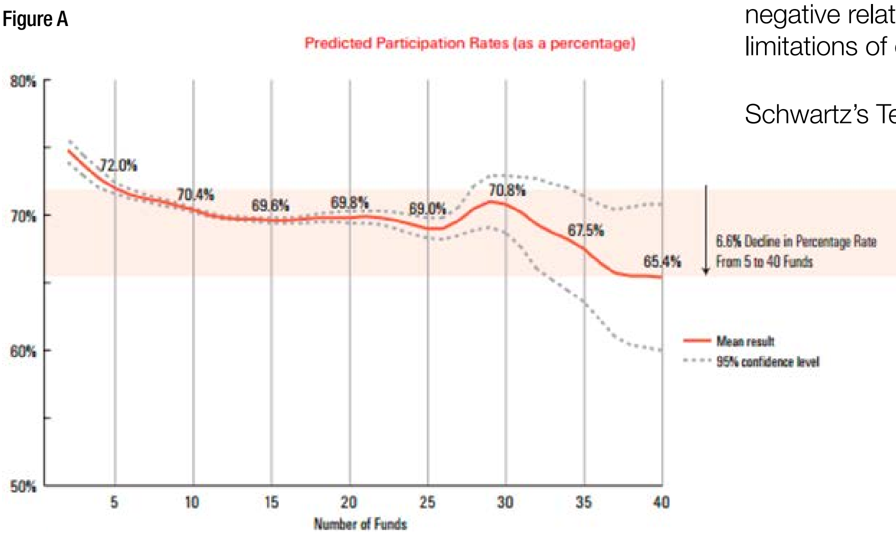
We think it makes perfect sense: give employees more funds to choose from, and they will be happier and better off. It turns out we are wrong.

The realization began in 2000 when psychologists Sheena Iyengar and Mark Lepper published a study on shopping behavior. They experimented with a display table of jam. On one day, there were 24 varieties of gourmet jam. On another day, they set out only 6 varieties of the jam. The large display attracted more interest, but people who saw the large display were one-tenth as likely to buy as people who saw the small display[1].

While this is a helpful finding for grocery stores, it is a small sample. It is not necessarily applicable to the long-term financial choices of rational people. But it is.

Using Vanguard data from nearly 800,000 employees, researchers Iyengar, Jiang and Huberman tested the hypothesis that employee 401(k) participation rates fall as the number of fund options increase. Their results confirm that participation in 401(k) plans is higher in plans offering a handful of funds, as compared to plans offering ten or more options." (Figure A.)

Figure A



Research shows participants tend to be more satisfied with their choices when faced with fewer options as well. According to the Iyengar study, test subjects were more satisfied when they chose from a limited menu of options — their satisfaction level was 6.25 for a limited set of choices, versus 5.5 for an extensive number of choices.

Iynengar's Ted Talk can be viewed here.

While a large number of funds discourages participants from choosing a portfolio that meets their goals and leaves them less interested, recent research also suggests that a large number of funds can be a flag of the sponsor's poor fund-selecting skills.

The Harvard Business Review article by Barry Schwartz[2] notes there is a negative relationship between menu size and menu quality: smaller menus tend to be better than larger menus based on fees and returns.

Previously, this relationship was thought to hold true only for those uninformed decision makers — if participants were fully informed about the different options, they would be better off with a larger menu. Schwartz's research showed this was inaccurate. His research demonstrated that the negative relationship held true regardless of the information limitations of choosers.

Schwartz's Ted Talk can be viewed here.

Works Cited:

[1] Mottola, Gary and Utkus, Stephen. "Can There Be Too Much Choice In a Retirement Savings Plan?" The Vanguard Center For Retirement Research, June 2003

[2] Schwartz, Barry. "More Isn't Always Better." Harvard Business Review, 01 June 2006. Web. 24 Feb. 2016.