

Win By Default — the Most Important Investment Option

Default investment options are on the rise.

By Hubert Lum

The dramatic growth in investment options offered by defined contribution plans has generated considerable and useful debate. On the one hand, the discussion encompasses participant utility via diversification, choice, and enhanced welfare and, on the other hand, participant paralysis in the face of excessive choice with limited understanding and interest in asset allocation. In this discussion on investment options, it is imperative to focus on the most important investment option, the default option — the option designated by the pension plan to receive undirected contributions from participants.

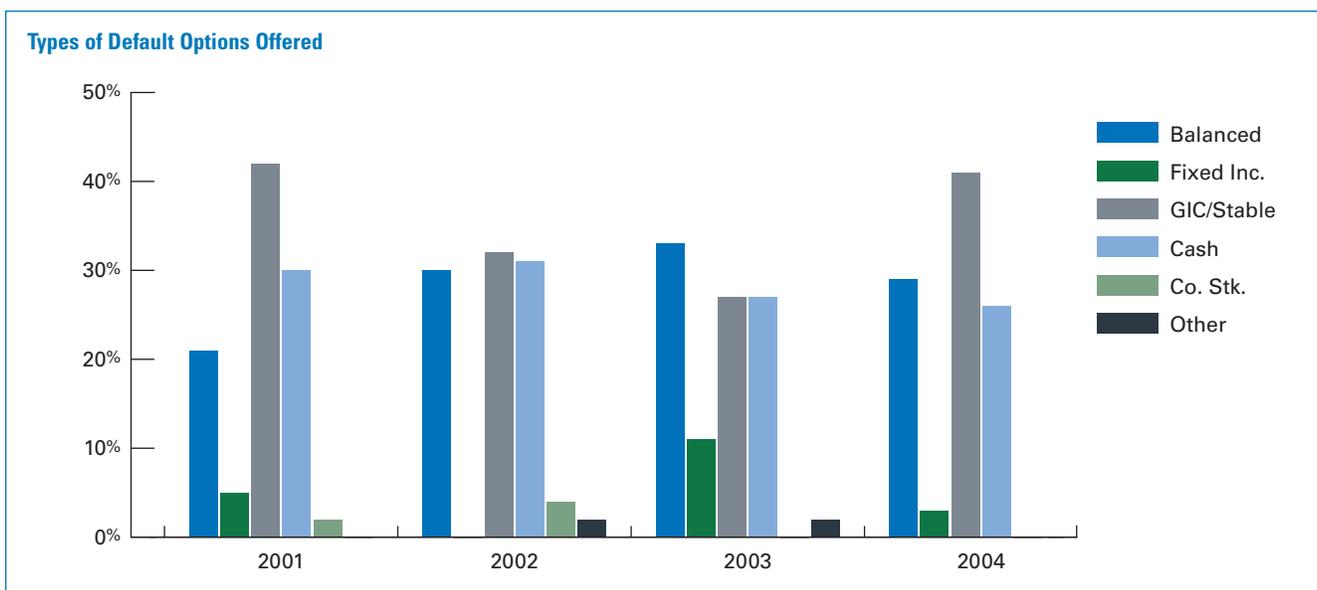
Default Option Trends

A review of the Cost Effectiveness Measurement (CEM) database* showed that the number of plans offering a default option has grown since 2001 from 54 percent to 78 percent. Further, the default option retained a high level of stability. For plans with three consecutive years of data, 90 percent of plans maintained the same default option. There were three principal default options: Balanced/Lifestyle Funds, GIC/Stable Value Funds and Cash. These three asset classes represented 93 percent of all default options offered. Use of Balanced/Lifestyle Funds recorded the greatest increase

from 21 percent to 29 percent from 2001 to 2004.

The Default Option and Automatic Enrollment

As expected, in 2004, 100 percent of plans with an automatic enrollment program also offered a default option while 70 percent of plans with no automatic enrollment program offered a default option. It was surprising, however, that almost 40 percent of plans with automatic enrollment offered a Balanced Fund default compared with 23 percent for plans without automatic enrollment. The



* From 2001 to 2004, the CEM defined contribution database comprised an annual average of 82 corporate and public plans, the median asset value of which was \$1.8 billion.

expectation of a more conservative default option profile in plans with automatic enrollment, as suggested in research literature, was unfounded.

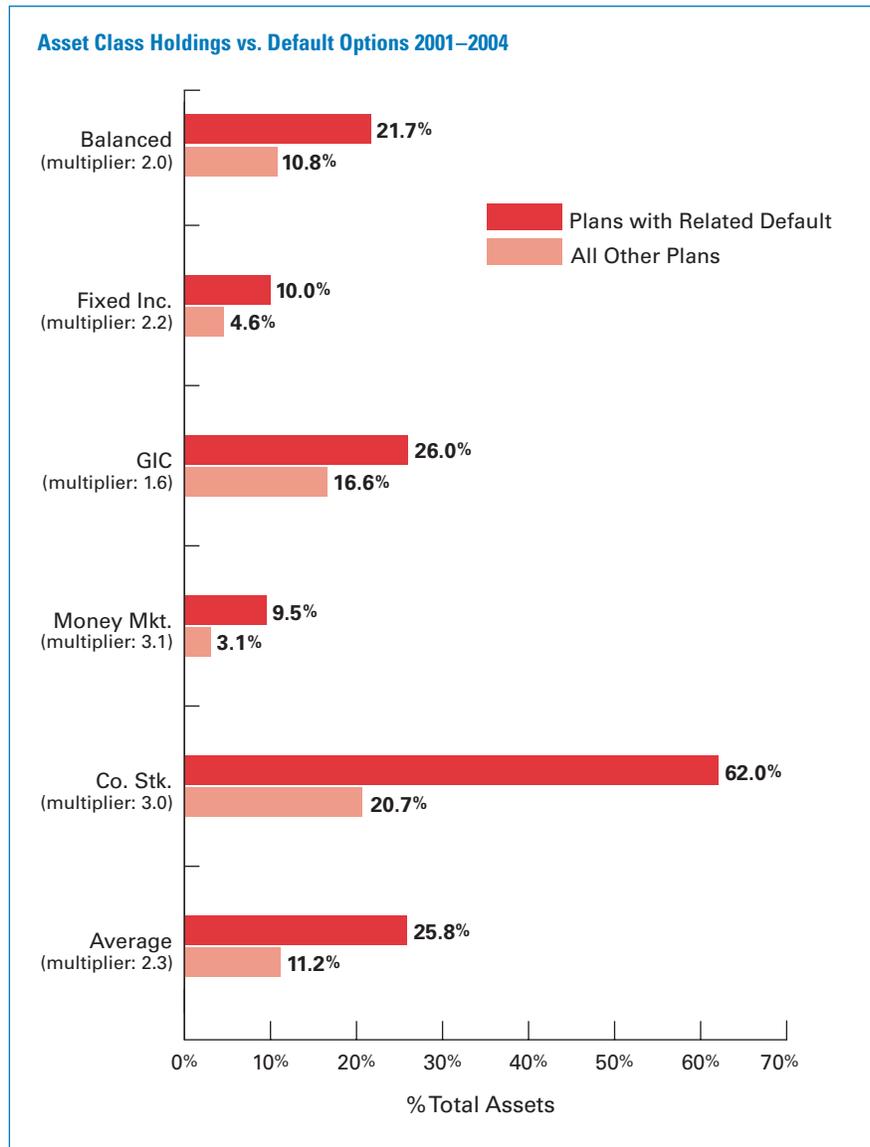
The Default Option and Access to Investment Advice

The default option was not a substitute for access to investment advice. On the contrary, access to advice grew at an increasing rate. In 2001, the proportion of plans which offered a default option and also offered access to advice was one-quarter. By 2004, this proportion exceeded one-half. The proportion of plans in the universe which offered neither a default option nor access to investment advice was 10 percent.

The Most Important Investment Option

Nobel Laureate, Daniel Kahneman, argues that the default option is essential to the pension plan design. It serves all the participants who lack the confidence or interest to establish their own asset allocation: "If we are going to make people fly their own planes, we should expect them to rely on the autopilot, and it must be designed accordingly."¹

The CEM database highlights the importance of the default option. For the period from 2001 to 2004, default options increased the percentage holdings for a given asset class by a significant level. For example, as shown in the graph, plans whose default option was Balanced Funds had 22 percent of total assets invested in Balanced Funds. By comparison, plans whose default option was not Balanced Funds had only 11 percent. The multiplier effect was 2.0x. On average, across different types of default options, the multiplier effect was 2.3x.



The strong propensity to invest in the default option is supported by research literature. In a U.S. study, Choi found that almost one-half of study participants invested solely in the default option after three years.² Also, Kahneman reports that three years after the establishment of private pension accounts in Sweden, the number of participants selecting the default option rose from 33 percent to 93 percent.³ Given the powerful impact of the

default option on asset allocation, the success of a pension plan's ability to provide suitable diversification and long-run wealth accumulation will reflect the careful consideration given to the selection of the default option.

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¹ Kahneman, D., Odean, T., and Barber B. "Private Pensions: An Irrational Choice." *Global Agenda*, a publication of the World Economic Forum, 2005.

² Choi, J., Laibson, D., Madrian, B., and Metrick, A. "For Better or For Worse: Default Effects and 401(k) Savings Behaviour." *Perspectives in the Economics of Aging*. Ed. David Wise. Chicago: University of Chicago Press, 2004. 81–121.

³ Kahneman.