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The Tiered Investment Menu: A Behavior-Based Approach to Menu Design

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Much has changed in the marketplace in the eight years since the passage of the DOL's 403(b) regulations. Prior to these regulations, multi-vendor arrangements with expansive fund menus were common. Today, plan sponsors have focused their efforts on creating efficiencies in the services provided to their participants and in the investment selection process, two areas that have been linked to participant outcomes.

In a previous FIA whitepaper titled, "Design Revolution," we explored how plan sponsors could evaluate their vendor arrangements and best practices for creating efficiency for participants in the investment selection process. As a next evolution, we are now seeing the marketplace trending towards further redesign of the investment menu. This is being done through investment menu segmentation into behavior-based levels or tiers. Many plan sponsors and financial educators are finding this new tiered menu approach easier to communicate and simpler for employees to understand how to select investment options that may be most suitable for them.

Below is an example of tier-based menu design:

Tier 1	Tier 2	Tier 3
"Do it for me"	"Do it with me"	"Do it myself"
For participants who lack the time, interest, desire or knowledge to make investment decisions and would prefer professional guidance.	For participants who prefer to select options and develop an asset allocation strategy from a core set of offerings determined by the Plan Sponsor.	For participants who wish to select from a wide variety of investment options outside the core menu. Sponsors should be aware, however, that additional administrative, compliance and fiduciary considerations may be required in order to make this option available to plan participants.
Commonly used investments may include: • Target date funds • Risk-based funds • Managed Acounts	Commonly used investments may include: • Stable Value/Money Market • Diversified Fixed Income • U.S. equity (Active/Passive) • International Equity (Active/Passive)	Commonly used investments may include: • Brokerage window[1] [1]The inclusion of a brokerage window should be discussed with your Plan's ERISA counsel, prior to implementing.

"Tier 1" looks to address the needs of potentially less sophisticated investors who require assistance in managing their investments and are looking for a "hands off" approach to retirement planning. Plan sponsors have several options to offer these employees, who may be looking to outsource the management of their portfolio, the most popular of which is target date funds. By first positioning a diversified, professionally managed investment option to employees, those who are susceptible to confusion can be pointed to an appropriately allocated portfolio. This investment tier would also be used as the plan's default investment option, i.e., Qualified Default Investment Alternative (QDIA), for participants who do not make investment elections.

"Tier 2" addresses the population of investors who wish to control their asset allocation but do not have the desire or expertise to select individual securities or weightings to specific economic sectors. To meet these needs, Tier 2 contains a reasonable number of broadly diversified investments to which participants can allocate their assets. By using a manageable number of investment options, sponsors can create economies of scale and gain access to lower cost share classes. Most sponsors choose to offer both an actively managed and passive (indexing) strategy in each major asset class to accommodate individual participant preferences.

Most plan sponsors can adequately address the needs of all participants using two tiers; however, certain employee demographics and unique circumstances might justify the evaluation of a supplemental third tier. Fiduciaries have two outlets when considering "Tier 3": (1) adding additional investments to the fund menu, or (2) offering a mutual fund window or full brokerage window to plan participants. When considering the addition of supplemental investment offerings, fiduciaries should weigh the benefit to participants against the potential for misuse of these investments. In addition, further fiduciary oversight is needed for these supplemental investments.

Some circumstances considered for adding Tier 3 include:

- Employee preference for socially responsible funds
- Employee preference and sophistication to invest in dedicated real estate, commodities, high yield bonds, emerging markets, sector funds, etc.
- Existing outsized utilization of an investment strategy that would not fall under Tier 2
- Concern of misuse of nuanced investment options among less sophisticated investors

By utilizing a tiered investment menu, plan sponsors can thoughtfully evaluate how the structure of their fund menus meets the unique needs of their participants. Not only does this process create an effective outline for constructing a fund menu, but by documenting their decision-making process, sponsors can also create a robust Fiduciary Trail®. As discussed, many sponsors will utilize this framework in communications to employees. By presenting the fund menu in terms of categories meant to address the employees' preferred investment methodology, participants can more easily distinguish between investments that may best suit their needs and which ones they may want to avoid. Sponsors should work with their advisor and/or recordkeeper to customize the materials participants will receive in order to effectively communicate the tiered strategy.

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- Liability Driven Investment ("LDI") Strategies for Pension Plans
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