

Daily Brief

The Great Retirement Salad Bar

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Too little spinach, too many of those crispy noodles and bacon bits.

Left to our own devices, most of us are bound to make bad choices, whether at the salad bar or with our retirement plans. So concludes a new report analyzing the investment choices of nearly 1 million 401(k) plan participants.

The godfathers of modern portfolio theory would roll over in their graves — if they weren't all still alive — to learn about the mistakes workers make in selecting from plan investments.

There's the one-over-n strategy, in which diversification is taken to its illogical extreme: equal proportions of every investment option in the plan. Or the barbell — half in the most aggressive holding, and half in the most conservative.

Thirty-eight percent of the plans studied showed very inappropriate levels of risk and inefficiency, according to a study by Financial Engines, a third-party adviser to retirement plans that was founded by one of those portfolio-theory godfathers, William Sharpe.

One-third of employees allocated

too little of their salary to earn full employer matching contributions, and more than one-third of the plans allocated at least \$1 in \$5 to their own company's stock.

"Without help, advice, management, forecasting, expertise, I think it's a very, very hard task to expect someone to do on his or her own," said Sharpe, a Nobel laureate who pioneered the models for calculating risk-adjusted investment returns, and is now an emeritus professor at Stanford University.

In his early research on investment risk, Sharpe said he considered people as rational.

"I've been a student of — not an expert in — cognitive psychology (and) behavioral economics for years," he said. "But my work, the bulk of my formal work, has assumed investors are economic persons as opposed to behavioral persons."

But raw economics can't explain strategies like the one-over-n. Behavioral psychologists know that proportional selection is a common response to overwhelming choice — whether it's at the salad bar or in the retirement plan.

Unfortunately, those kinds of choices can lead to more grave consequences than a few extra pounds. In a plan with four stock funds and one bond fund, a one-over-n choice would give a 75 percent allocation to stocks — far too high for older workers.

A separate study recently published by the Vanguard Center for Retirement Research showed an 8.6 percent increase in early 401(k) plan withdrawals due to economic hardship, a choice that can greatly reduce the growth potential of a nest egg. The firm's analysis suggested the withdrawals were an early warning sign of economic troubles or a result of the subprime mortgage squeeze.

Sharpe says the solution to poor retirement planning isn't to go back to pensions, which have their own problems — largely to do with the allocation of risk between younger and older workers. His company, like other advisory firms springing up, want to give advice no differently than a family physician.

Says Sharpe: "Would you want to do your own medical diagnosis, or would you like to go to a doctor?"