

# DC Investment Menu Design

WHITEPAPER

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The menu of investment options for defined contribution (“DC”) plans have not always had available the multitude of offerings that they do today. With such a large number of investment options available in the market, plan sponsors are tasked with constructing a menu that balances a diverse variety of investment options while not overwhelming participants. This paper discusses how DC investment menus have evolved over time, best practices and considerations that plan sponsors should be aware of, as well as details on Meketa’s philosophy for DC investment menu design.

## Evolution of investment menus

Prior to the 1990s, the participant-directed DC plans that we know today did not exist. Advancements in technology and the Department of Labor’s release of Section 404(c) of the Employee Retirement Income Security Act of 1974, as amended (“ERISA”), in 1992 was an important catalyst that led to an explosion of participant-directed DC plans and an evolution of their investment menus over the next two decades. Mutual fund companies seeking new distribution channels capitalized on the widespread use of the internet and the technological advancements in plan administration in a way that facilitated new DC plan creation. This led to a rapid increase not only in participant-directed DC plans, but also in the number of investment options offered. In 1995, the average 401(k) plan offered six investment options. By 2005, that number had risen to 14,<sup>1</sup> and by 2019 it had grown to 28 (or 21 if counting a suite of target date funds as one).<sup>2</sup> Section 404(c) provides plan sponsors with a safe harbor, which generally allows fiduciaries to be relieved of liability for participant’s investment decisions, provided certain criteria are met. Thus, supplying another tailwind to participant-directed plans.

The Pension Protection Act of 2006 (“PPA”) marked another key milestone for participant-directed DC plans and their investment menus. The PPA coined the term Qualified Default Investment Alternative (“QDIA”) and encouraged automatic enrollment. The Department of Labor’s regulation allows for four types of QDIAs:<sup>3</sup>

1. A product with a mix of investments that takes into account the individual’s age or retirement date (e.g., a life cycle or targeted-retirement-date fund);
2. An investment service that allocates contributions among existing plan options to provide an asset mix that takes into account the individual’s age or retirement date (e.g., a professionally managed account);

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<sup>1</sup> Source: Investment Company Institute, “401(k) Plans: A 25-Year Retrospective,” November 2006.

<sup>2</sup> Source: BrightScope and Investment Company Institute, “The BrightScope/ICI Defined Contribution Plan Profile: A Close Look at 401(k) Plans: 2019,” September 2022.

<sup>3</sup> Source: US Department of Labor: Employee Benefits Security Administration, Regulation Relating to Qualified Default Investment Alternatives in Participant-Directed Individual Account Plans,” April 2008.

3. A product with a mix of investments that takes into account the characteristics of the group of employees as a whole, rather than each individual (e.g., a balanced fund); and
4. A capital preservation product, though for only the first 120 days of participation (this serves an option for plan sponsors wishing to simplify administration if workers opt-out of plan participation shortly after being enrolled).

In the years shortly following the PPA, the size and complexity of investment menus began to level off as some plan sponsors and their advisors focused on promoting the QDIA, which in most cases was a suite of target date funds. To illustrate, target date funds were offered in just 32% of 401(k) plans in 2006, and by 2019, they were offered in 86% of 401(k) plans.<sup>4</sup>

<sup>4</sup> Source: BrightScope and Investment Company Institute, "The BrightScope/ICI Defined Contribution Plan Profile: A Close Look at 401(k) Plans: 2019," September 2022.

The addition of open architecture recordkeeper platforms (i.e., the investment options are not limited to the recordkeeper's proprietary products) and separating investment fees from administrative fees (unbundling) furthered investment menu development. These advances helped enable plan sponsors to think more strategically about investment menus to better design and tailor plans to achieve goals that are most important to participants (e.g., increased savings rates, better investment outcomes, etc.).

401(k) plans being a frequent target of litigation related to excessive fees has been another important catalyst to the investment menu evolution. In recent years, the lowering of administrative fees, improving fee transparency, and an increase in the use of low-cost investment options such as index funds, have been areas of focus for many plan sponsors.

## **Requirements: ERISA section 404(c) compliance**

Meeting ERISA Section 404(c) safe harbor requirements is a central focus when designing a DC investment menu, as it protects plan sponsors from liability for losses resulting from participants' investment-directed decisions.

ERISA Section 404(c)'s limitation of liability is contingent upon the plan satisfying three broad categories of requirements: investment menu diversification requirements, plan design and administrative requirements, and information and disclosure requirements. In this paper, we briefly look at the investment menu requirements set forth in ERISA Section 404(c), as they are the most relevant to the discussion of designing a DC investment menu. This paper is not intended to be an all-encompassing checklist and plan sponsors should consult with experts when creating an investment menu to help ensure they are compliant with all ERISA requirements.

ERISA Section 404(c) investment menu requirements make it necessary for the plan sponsor to provide participants with the reasonable opportunity to:

- Materially affect the potential return on amounts in the participant's individual account and the degree of risk to which such amounts are subject.
- Change investments as frequently as appropriate in light of the volatility of plan investments.
- Choose from among at least three investment alternatives, each of which:
  - is diversified,
  - has materially different risk and return characteristics, and
  - enables the participant (in the aggregate) to achieve a portfolio with aggregate risk and return characteristics at any point within the range normally appropriate for said participant.

Though ERISA Section 404(c) only applies to participant-directed investments, plans can offer a QDIA for participants who do not make an investment choice and still have 404(c) protections, if they adhere to additional requirements.

## Best practices when designing an investment menu

While DC investment menus can vary by company, industry, and over time, there are a few best practices that plan sponsors should consider when designing the right investment menu for their participants. The first and, presumably, most important factors as they set the strategic design of the investment menu, are which asset classes to include and how many investment options to include. Plan sponsors must balance offering a sufficient number of investment options to give participants adequate flexibility, while being careful not to overwhelm and confuse them. The investment menu should include major asset classes to allow for a variety of participants' goals to be realized through diversification and the balancing of risk and reward.

Meketa has identified specific best practices for building a diversified and balanced investment menu, which are listed below:

- Offer Target Date Funds ("TDFs") for participants seeking professional management and time dependent risk reduction.
- Offer no more than 8 to 10 "core" (i.e., non-TDF) investment options.
- Offer a low-cost passively managed investment alternative, where available, in each major asset class.
- Consider actively managed options only when:
  - the active manager is considered skilled and likely to outperform the benchmark index net-of-fees over long time periods; and,
  - the active manager's volatility (risk) is moderate, and unlikely to result in "return chasing" by participants.
- Consider white labeling and multi-manager solutions when there is sufficient scale.

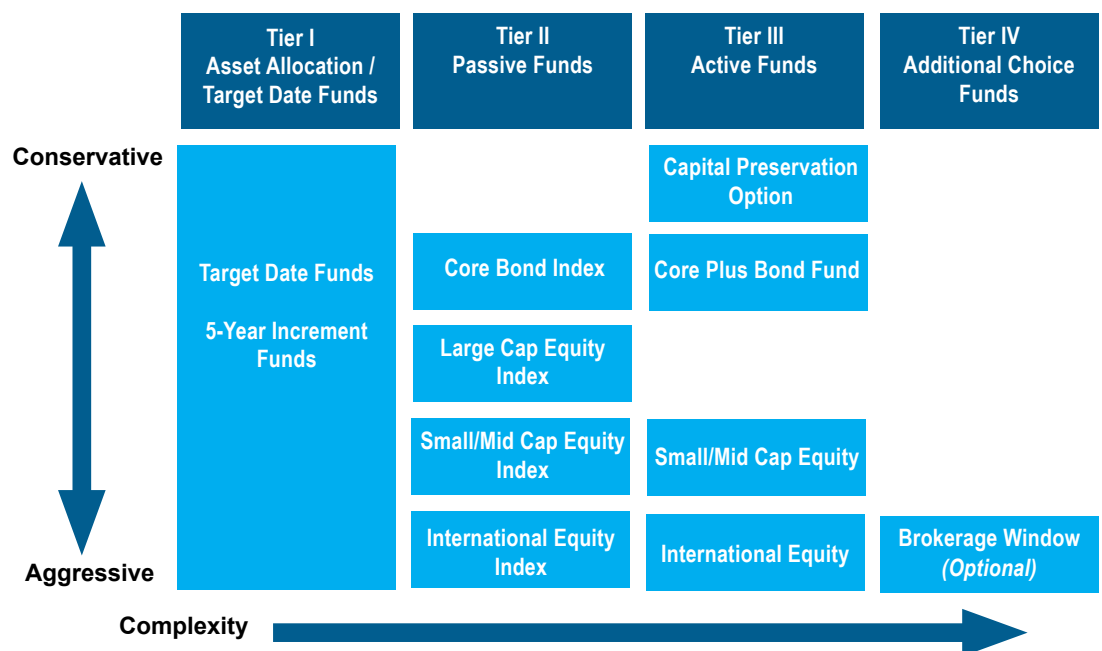
Plan sponsors should do their best to mitigate costs and fees within the investment menu. Some asset classes and strategies will have naturally higher fees. However, when designing the menu, due diligence should be conducted to ensure that the costs and fees are within industry standards and are competitive relative to similar investment options. Finally, as discussed earlier, plan sponsors are strongly encouraged to adhere to the ERISA Section 404(c).

## Meketa's general investment menu philosophy

Meketa generally believes the philosophy of "less is more" when it comes to designing an investment menu, but also recognizes that no two plans are the same. The following represents our recommendations for an investment menu, which is meant to be a starting point for a participant-directed DC plan. Factors such as participant engagement, sophistication, preferences, and demographics, for example, result in many plan sponsors deviating from this initial structure.

Most plans have three types of distinct participants when it comes to selecting investments, they are the: "do it for me," "do it with me," and "do it myself." A successful investment menu includes these three participant groups, while contemplating the common adverse investor behavioral biases that are often associated with the "do it myself" group. For example, research suggests that some participants will engage in "naïve diversification," which means equally dividing contributions among the plan's investment options. Since many plans have typically offered far more US equity options than any other asset class, this can have the unintended consequence of those investors significantly overweighting the asset class.

Meketa recommends that plan sponsors think about investment menus in terms of "tiers" that are detailed below.



**FIGURE 1**  
**Breakdown of Investment**  
**Menu "Tiers"**

Source: Meketa Investment Group,  
2023.

Tier	Approach	Description
Tier I	“Do it for me”	Intended to be the default investment option, known as the QDIA.
Tier II	“Do it with me”	Provides participants the opportunity to invest in diversified, low-cost index funds across major asset classes. This is particularly relevant because with the current litigious environment regarding fees, we believe having a tier dedicated to low-cost options may help protect plan sponsors.
Tier III	“Do it myself”	Provides access to a select number of actively managed options. This tier tends to have the most variation across plans, based on the preferences and sophistication of participants. The intent of this tier is not to cover every major asset class, but rather focus on areas where active management is recommended (i.e., passive is not optimal) or has a high likelihood of success.
Tier IV	“Make my own options”	This <i>optional</i> self-directed option enables participants to make investments in assets beyond that of the designated investment menu offered directly by the plan.

**FIGURE 2**  
**Description of Investment Menu Tiers**

Source: Meketa Investment Group, 2023.

## Types of active investment options

A DC investment menu’s active options often target specific approaches. The following sub-sections detail some of the most common approaches employed by plan sponsors within active management investment options for DC plans.

### Low tracking error

Low tracking error active management options strive to produce returns that closely track their specific benchmark. The theory behind using a low tracking error active strategy is that instead of experiencing large swings of out- (or under-) performance relative to the benchmark (i.e., a higher tracking error), this strategy aims to provide small, consistent excess returns over the long term. Within the context of DC investment menus, low tracking error strategies provide a relatively “safer” active management option than those active strategies with higher tracking error and more amplified swings. The primary reason for this approach is that it decreases the likelihood of participants exhibiting performance chasing behavior, which often negatively impacts investment outcomes.

### Capital preservation options

There are two primary options used in this space, money market funds and stable value/Guaranteed Interest Contract (“GIC”) options. Money market funds provide the most flexibility at the plan level and given the prominent use of government money market funds ( $\geq 98.5\%$  invested in government securities), they are seen as nearly riskless investment options.

There are multiple types of stable value funds available to DC plans. The traditional Guaranteed Interest Contracts (“GICs”) are stable value funds where assets are not segregated from the general account obligations, are backed solely by an insurance company’s general account, and the plan is a policy holder, giving up ownership of the assets. Separate account GICs are stable value funds where plan assets are segregated from general account obligations. However, the plan is a policy holder and does not own the assets. Many plan sponsors prefer synthetic GICs over the other two GIC structures due to a subtle distinction in the liability structure of synthetic GICs.<sup>5</sup> They are available in separate account or commingled trust vehicles. There are two components: 1) a portfolio of marketable fixed income securities that are owned by

<sup>5</sup> See Meketa’s white paper on [Stable Value](#) for more information on the underlying structure of different types of stable value vehicles.

the plan and managed by one or more investment managers, and 2) wrap contracts issued by various financial institutions such as banks and insurance companies that provide the protection layer to the underlying assets. With all stable value/GIC options, there are often termination restrictions, such as a 12-month put, restrictions on using competitive investment options, equity wash rules, and fee considerations.

## White label funds

White label funds are a unitized investment structure that consists of a single manager or multiple managers (e.g., multiple underlying funds) with a generic name based on the fund objective or asset class exposure being provided. For example, a plan sponsor might create an international equity white label fund that includes an international equity index fund, along with actively managed international funds, both in developed and emerging markets. Generally, white label funds are a way for plan sponsors to simplify investment decisions for participants, improve investment option descriptions, and potentially enhance diversification.

White label funds are most appropriate for a more inactive (e.g., “set it and forget it”) type of participant base. Plans that have participants who are more actively engaged and like to trade their account more frequently may not be good candidates for a white label structure. Second, the plan sponsor needs to determine if the participants, recordkeeper, Trustees, and the investment consultant, all have the capability and willingness to assume some level of increased fiduciary or administrative responsibility to help facilitate a white label structure. If these criteria are met, then the plan sponsor can work with their consultant to discuss which white label funds or strategies would be most impactful for participants.

## Considerations that influence design

Knowing the participant base and their level of engagement in the plan is a key factor that plan sponsors need to take into consideration in creating an investment menu. If the majority of plan participants lack financial literacy, an investment menu that is simplified, easily understood, and focuses on more pre-designed investment options may be a better fit. On the other hand, if the participant base is generally well versed in investments, then a more complex investment menu with a wider variety of options and higher customization may be a better fit. While plan sponsors should offer some form of both simple/pre-designed and complex/customizable investment options, the concentration of such offerings may be influenced by the participation base. Similarly, plan sponsors should be familiar with their participation base’s level of engagement and desire for engagement. While investment menu offerings should be designed to accommodate both high and low engagement, the participation base should strongly influence the investment menu design.

Another key consideration when designing a DC investment menu is that participants may have tendencies towards certain biases. This is a factor across all participant bases as it is inherent to the nature of personal investments. The first bias is performance chasing, whereby participants tend to “jump on” the latest investment trends or assets

that have performed well recently, though they often do so too late to capture future outperformance. Other biases include investing in name brands and emotional investing. In these instances, participants invest based primarily on their feelings or the fact that they recognize the company/index name, instead of making decisions based on financial metrics. Finally, participants have a tendency toward loss aversion, whereby they hold onto losing assets too long. Even when an investment is doing poorly, participants may be inclined to hold onto it with the rationale that “it will eventually have to go up” or they even have emotional attachments/sentiments towards that particular investment. Many participants do not even realize they are falling into these common biases, and so plan sponsors should do their best to try and mitigate them through construction of the investment menu. Below are three ways that plan sponsors can structure their investment menu to reduce the likelihood of participants falling into these common biases:

- Avoid style biased funds, sector funds, and niche funds.
- If using active management offerings, employ those with low tracking error.
- Aim to have investment options be diversified.

Finally, plan sponsors should be aware of and continuously monitor the legal landscape as it develops. 2020 had the highest number of ERISA class action lawsuits in the statute’s 45-year history.<sup>6</sup> While 2021 was lower than the 2020 peak, the number of class action lawsuits was still higher than it was in 2018 and 2019.<sup>6</sup> Furthermore, many of these lawsuits have been based on fees and performance. Thus, it is critical for plan sponsors and their advisors to monitor the rulings, dismissals, and regulatory changes that may arise as a result of these lawsuits. Not only should plan sponsors monitor the legal environment, but they should also continuously ensure that their investment menu complies and keeps up to date with all legal provisions.

<sup>6</sup> Source: Groom Law Group, “How the ERISA Landscape May Shift This Year,” January 2022.

## Conclusion

Designing a menu of investment offerings for DC plans has become even more important and complicated. Plan sponsors must not only balance offering a sufficient number and variety of investment options, but they must do so while keeping in mind their participant base’s investment knowledge and level of engagement. Other considerations that plan sponsors should keep in mind are mitigating costs and fees and creating a schedule and parameters to evaluate and add/remove investment options, when needed. Finally, all ERISA Section 404(c) considerations should be contemplated in order to limit plan sponsors from liability for losses resulting from participant-directed investment decisions.

Meketa Investment Group recommends that plan sponsors think about defined contribution investment menus in terms of various “tiers.” These tiers traditionally fall into the investment menu cohorts of “do it for me,” “do it with me,” and “do it myself.” Meketa’s starting-point investment menu is broadly structured as four tiers that range from least hands-on (QDIAs), to passive management, to active management, and finally to additional choices that are not as common or highly utilized.

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