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ASSET ALLOCATION AND INFORMATION OVERLOAD: THE INFLUENCE OF INFORMATION DISPLAY, ASSET CHOICE, AND INVESTOR EXPERIENCE

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For many individuals, their financial security during retirement depends on the financial decisions they make in their defined contribution (DC) plans today. Yet despite the importance of these investment decisions, growing research shows that individuals tend to make choices based on the “path of least resistance” (Choi, Laibson, Madrian and Metrick, 2002). The downside of this behavior is that it often results in individuals investing according to their plans’ default options. One issue is that these default options are generally not tailored to the individual. In addition, these options are typically conservative which can lead to inadequate savings. Thus, understanding what is driving this behavior and how plan design can or cannot alleviate this problem is an issue of critical importance.

Literature suggests that procrastination, the status quo bias, and anticipated regret are all reasons for individuals’ tendency to follow the path of least resistance (Choi, Laibson, Madrian and Metrick 2003). In this paper, we offer an additional explanation for individuals’ reluctance to make investment decisions in their DC plans. We hypothesize that these participants are experiencing information overload. As a result, these participants are becoming overwhelmed when making their decision and therefore look for an easy way out, the default.

Motivated by previous research showing the strong influence of plan design on investment behavior, this paper investigates three common differences among DC plans that may lead to varying degrees of information overload. In two experiments, we manipulate the display of the investment information and the number and similarity of the choices offered. We also measure each participant’s financial knowledge. We test how these factors influence the participant’s feelings of information overload, decision satisfaction, and choice of the default. The main contribution of this analysis is that it explores the interaction between the individual’s tested financial knowledge and the manipulated plan features.

Our findings show that changes to plan design can help some individuals. We find individuals with above average financial knowledge report significantly less overload when given fewer investment choices. This confirms previous research that plan design is important.

Our results also show that financial knowledge plays a large role in who opts for the default. We find that low knowledge individuals opt for the default allocation more often than high knowledge individuals. In experiment one (two), twenty (twenty five) percent of the low knowledge participants chose the default compared to two (four) percent of the high knowledge individuals. We also find that these low knowledge individuals are the same types of individuals the Employee Benefit Research

Institute finds are not saving enough for retirement (EBRI 2003). These results highlight the importance of carefully designed plan defaults and supports the move by some plan sponsors away from offering “one size fits all” defaults.

Finally, our findings suggest individuals with below average knowledge are overwhelmed by the investment decision in general. Altering the plan by offering investment information in a more easily comparable format or by reducing the choices offered does not attenuate the low knowledge individuals’ feelings of overload. Thus in addition to improving plan design, plan sponsors should also consider improving financial education, especially for participants with below average financial knowledge. However, whether improving an individual’s financial knowledge can reduce his subsequent feelings of overload when making financial decisions remains to be tested.

In closing, the lack of financial knowledge in our sample raises concerns about the public’s ability to effectively manage their retirement accounts. As a result, more research into ways to design plans to promote sound decision making, methods for improving the presentation of investment information and making it more easy to use and techniques for effectively educating individuals in finance is needed.

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