WORKING PAPER
Executive Summary
MARCH 2006, WP # 2006-9

CENTER FOR RETIREMENT RESEARCH AT BOSTON COLLEGE

PERSONALIZED RETIREMENT ADVICE AND MANAGED ACCOUNTS: WHO USES THEM AND HOW DOES ADVICE AFFECT BEHAVIOR IN 401(k) PLANS?

BY JULIE AGNEW

Many 401(k) plan sponsors are concerned by the frequency of suboptimal asset allocation decisions made by participants in their 401(k) plans. An excellent example of a popular allocation that is suboptimal is the tendency for investors to over-invest in company stock. The concern about asset allocations is growing as plans featuring auto-enrollment increase and many auto-enrolled individuals anchor to the default investment choice.[1] Default investment choices tend to be very conservative resulting in participant portfolios that are undiversified and unlikely to generate returns sufficient for a secure retirement. Setting more diversified defaults is one option for plan sponsors to improve allocations. However, many companies are concerned about liability issues related to defaulting participants into more risky investments. Another option for plan sponsors is to offer investment education classes that encourage savings and diversified investments. Previous research shows some success with these programs. However, other research shows a tendency for seminar participants to procrastinate and not follow through with the advice they are given. This paper studies two additional methods for improving asset allocations: personalized asset allocation advice from a third party computer system, "online advice," and managed account services that allow the participant to hand over the management of their 401(k) portfolio to an outside party.[2]

The goal of this research paper is to investigate what type of individual takes advantage of online advice and/or managed accounts. While the demand for financial assistance by participants is clear from recent surveys, many individuals surprisingly still do not take advantage of the services when they are offered. For example, in a recent John Hancock Financial Services Survey, over three-quarters of those surveyed stated that they would like expert investment advice. Close to the same proportion wanted an expert to "support and affirm their investment decision."[3] However, the survey also found that less than half of individuals who are offered financial planning or investment advisory services by their employer actually use them. This becomes an issue if those opting out are those who have been identified in the literature as the most likely to make the least efficient decisions.

In order to study who is using these services, a unique individual-level dataset was constructed for this paper from two separate data sources: Hewitt Associates, the 401(k) plan's administrator, and Financial Engines, a company specializing in portfolio allocation advice and managed account services. The data relate to one company's 401(k) plan. The company is a large retail firm that employs many part-time and seasonal workers. The cross-sectional data provided from Hewitt Associates include the participants' sex, age, salary, years employed, full-time/part-time status and 401(k) balances. In addition, the Hewitt data include daily transfer and contribution data for each individual over the period March 1, 2004 through March 1, 2005.

The Financial Engines data set includes a rich set of variables that can be matched to the Hewitt data, including if and when the individual enrolled in the online system and if and when they enrolled in the managed account service. Observations on every *participant initiated* session on the online system are also included. Recommendation information is also available in the Financial Engines data. If a recommendation is generated from a session, then the date of the recommendation and the recommended 401(k) fund asset allocations for each participant's 401(k) plan are available.

The preliminary findings of our paper suggest that the online advice system and managed accounts service appeal to different populations. Managed accounts tend to be attractive to individuals across most demographic groups, including sex, employment tenure and full-time/part-time status. While salary is related to the probability of being a managed accounts user, the effect of salary is less compared to its influence on the probability of being an online user. The average salary for managed account users was approximately $28,000 compared to $41,000 for online users. These figures contrast with the $19,583 average salary for non-users. In addition to appealing more to higher salaried employees, the online advice system also appeals more to full-time workers and slightly more to males. It also appears that individuals who show a predisposition to seek advice or help, proxied for by investment in lifestyle funds, are more likely to use both offerings. Finally, although a causal relationship cannot be determined, trading activity is higher for those using the online advice system compared to those who do nothing.

These preliminary findings have some implications for plan sponsors and raise interesting questions for future research. First, the finding that a predisposition to seek advice proxied for by investment in lifestyle funds is interesting because it suggests that plan sponsors may be able to identify "interested" and "reluctant" investors by studying their current asset allocations. In addition, the results suggest that further examination of the lowest salaried participants who tend to be non-users is still needed. This is especially true given that previous research suggests that low salaried individuals are more likely to make inefficient financial decisions in their 401(k) plans.[4] An outstanding question is the extent to which the relationship with salary is driven by a correlation between salary and financial literacy or by attitudes towards savings and finance that are specific to lower salaried individuals.

This paper is a first step towards understanding what types of individuals use online advice and managed account resources. These services are additional methods for plan sponsors to improve their participants' asset allocations. This paper lays the foundation for future research that will study how these services affect subsequent trading and investment behavior and whether certain populations groups behave differently. Plans for future research are included in the paper.

[1] This tendency is referred to as the "default bias."

[2] The *2005 Hewitt Trends and Experiences in 401(k) Plans Survey* reports that 8 percent of plans surveyed offer or plan to offer in 2006 a managed account option.

[3] John Hancock Financial Services, 8th Defined Contribution Plan Survey, p. 16.

[4] Agnew, Julie. "Do Behavioral Biases Vary Across Individuals?: Evidence from Individual Level 401(k) Data." Forthcoming in the *Journal of Financial and Quantitative Analysis.*

 The research reported herein was performed, in part, pursuant to a grant from the U.S. Social Security Administration (SSA) funded as part of the Retirement Research Consortium. The findings and conclusions expressed are solely those of the authors and do not represent the views of SSA, any agency of the Federal government, the College of William and Mary or the Center for Retirement Research at Boston College.

CENTER FOR RETIREMENT RESEARCH AT BOSTON COLLEGE

Fulton Hall 550, 140 Commonwealth Avenue, Chestnut Hill, MA 02467-3808
phone 617.552.1762 fax 617.552.0191 crr@bc.edu www.bc.edu/crr