Case study 1

FRAMING INVESTMENT CHOICES

Traditionally, when a fund has member investment choice as an option, trustees give members an array of fund fact sheets with basic information about fund benchmarks, asset allocations, performance histories and risk profiles. Or as Principle 10 of Pension Fund Circular 130 guides us: “Where member investment choice is offered, the details of the investment options should be described, setting out the severity of any associated risk and the performance benchmarks, as well as the underlying type of investments. Members should be able to make an informed decision from such information.”

The fund fact sheets in the example on the next page have dutifully recorded these points:

So far, so good. At least in terms of fulfilling reporting responsibilities.

The words on our fact sheets suggest that these are very different portfolios performing very different functions. We are told to expect a higher return over the long term from portfolio 1, with portfolio 2 better suited to a shorter-term strategy.

But directly below this information, the performance tables are presented. Remember, the laws of visual attraction – where do the eyes get drawn to first?

The tables will turn out to be the focal point of any visual ‘investigation’, with the written text getting a passing glance at best. How then are members likely to perceive the differences between these two portfolios based on this new information?

Is portfolio 2 now the better portfolio because the 2008 returns (the top line) are better? Very often, the top line numbers (or bottom line) become the only numbers readers remember. Note that the bottom line on the tables is the five-year return. Once again, the top performer is portfolio 2.

The point is there is no meaningful connection between the information in the table and the write-up about the fund’s differentiating characteristics. If anything, the two sets of information confuse the choice. Using cumulative performance graphs, another popular tool, would also give a poor framework for decision making.

PORTFOLIO 1 FACT SHEET

Aim of the portfolio	To grow your savings over the long term.
Best suited to…	An investor with seven years or more to save and would like the best returns.
How risky is the portfolio?	This portfolio has a low chance of capital loss over a seven-year period, although there is a big chance of capital loss over shorter periods of time.
Time frame	This portfolio will probably give you returns of around CPI (inflation) plus 5.5% over the long term and is not suited to an investor who can't stay invested for the long term (seven years or more). In the short term your savings will be exposed to volatility.

Annual investment returns:

Year	Return
2008	-9.88%
2009	18.09%
2010	14.99%
2011	8.11%
2012	19.54%

Average annual investment returns – as at 31 December 2012:

Gross return	
1 year	19.54%
3 years	14.10%
5 years	9.59%

PORTFOLIO 2 FACT SHEET

Aim of the portfolio	To give fairly consistent, stable returns over a one- to three-year period.
Best suited to…	An investor with, at most, three years to save: a short-term investment.
How risky is the portfolio?	This portfolio has a very low chance of capital loss over a short-term period. There is a chance of capital loss over the very short term, but these losses should be fairly small.
Time frame	This portfolio will probably give you returns of around CPI (inflation) plus 3.5% over the medium term and is not suited to an investor who has a long-term investment time horizon.

Annual investment returns:

Year	Return
2008	6.64%
2009	11.97%
2010	12.07%
2011	7.96%
2012	14.05%

Average annual investment returns – as at 31 December 2012:

Gross return	
1 year	14.05%
3 years	11.23%
5 years	10.44%

PORTFOLIO RESPONSES TO DIFFERENT MARKET CONDITIONS

Source: Alexander Forbes (2014)

How could we present this information? At the start, each portfolio reflects a strategy with very different objectives and time frames. So, an individual needs to know, given the time frame specified for each, whether the portfolio actually achieved its objective. But this makes it impossible to directly compare the two portfolios.

If the two portfolios are supposed to reflect a different responsiveness to market conditions, then perhaps this provides a more meaningful point of comparison. Rather than provide one-, three- and five-year comparisons, or even year-to-year comparisons, we could test how the portfolios responded to different market environments. Did the capital protection portfolio do better than the more aggressive portfolio in a collapsing market (say, 2008)? Did the more aggressive portfolio perform better in a rising market (2009, 2010, 2012, 2013)?

If we look at it from this perspective, the graph above illustrates that both portfolios did exactly what they were supposed to do. This insight now forces the debate away from 'which portfolio did better' and back to the point of the exercise – helping members pick a portfolio that does what they need.

The point is, we have deliberately chosen an example that is almost universal in the member choice dynamic. Members get fund fact sheets that fulfil the regulator's requirements, but fund fact sheets by themselves don't really give members useful information. Given what we now understand about the way the human eye takes in the information on these fact sheets, to say nothing of the limited understanding the average member has the subtle differences in investment strategies, its little wonder that the decision-making process is full of problems.

PRESENTING TABLES FOR INVESTMENT CHOICE SELECTION

Let's carry these conventions one step further.

Many funds like to present their choices in neat tables, but as we learned in our opening discussion, when we present information in tables, it causes many unintentional biases in decision making:

- The majority of members typically choose the first option in the table. List all the more conservative choices on the left of the page, and members will go for those options. Put the aggressive portfolios first and members will choose that option.
- To try and avoid bias, trustees will often list portfolios alphabetically. Again, first come, first chosen.
- Also, in an attempt to avoid errors, trustees often leave the fund fact sheet details up to the product provider.

But note the conundrum presented to investors in the following table. Only two product providers mentioned that their funds were Regulation 28 compliant. We may know that all the funds on offer for individual choice *have* to be Regulation 28 compliant, but most members don't. So, it *appears* as though these two funds have something special that the others don't.

EXAMPLE OF AVAILABLE MEMBER CHOICES

	Trustee choices		**Your investment choices**			
	Life Stage Conservative	**Life Stage Aggressive**	**Asset X Money Market Fund**	**Asset Y Secure Growth Fund**	**Asset Y Aggressive Growth Fund**	**Asset Z Passive Fund**
Objective	CPI + 2% over a rolling 36-month period; no negative returns over a rolling 24-month period	CPI + 5% over a rolling 60-month period	No negative returns	CPI + 3.5% over a rolling 60-month period; no negative returns over a rolling 36-month period	CPI + 5.5% over a rolling 60-month period	CPI + 5% over a rolling 60-month period
Risk	Low	High	Very Low	Medium	High	High
Time frame	2-3 years	5+ years	Less than 1 year	3-5 years	5+ years	5+ years
Investment approach	Invests in stable and income funds. Equity exposure capped at 40%.	Invests in specialist funds in line with the strategic asset allocation. Equity exposure capped at 75%.	Invests in cash and cash equivalents.	Invests in all asset classes, including derivatives.	Invests in all asset classes, in line with the strategic asset allocation.	Invests in all asset classes, in line with the strategic asset allocation.
Comments	Currently invests in Asset X Money Market Fund (35%) and Asset Y Secure Growth Fund (65%).	Currently invests in Asset Y Balanced Growth Fund (60%) and Asset Z Passive Fund (40%).	This portfolio seeks to beat cash returns and preserve capital.	This portfolio offers a 100% capital guarantee over 36 months.	This portfolio can be volatile. It is compliant with Regulation 28.	This portfolio can be volatile. It is compliant with Regulation 28.

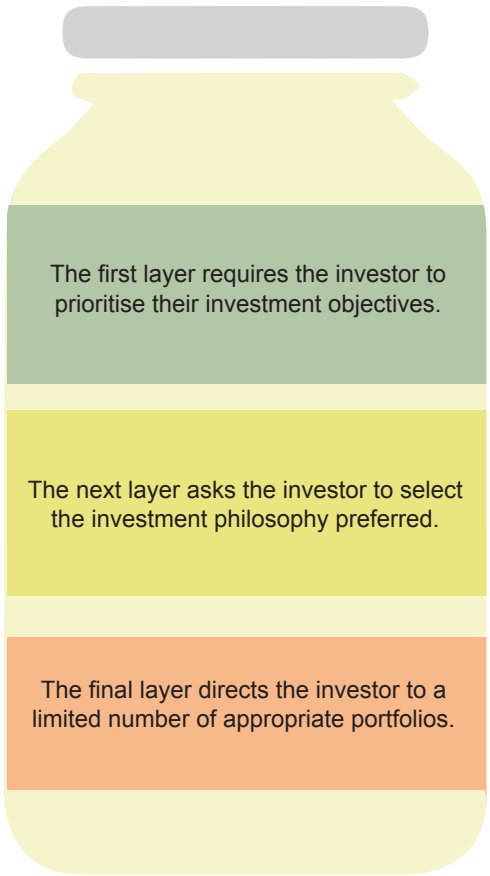
GUIDED CHOICE ARCHITECTURE: NARROWING DOWN THE CHOICES TO MAKE BETTER DECISIONS

Sheena Iyengar, in her book *The Art of Choosing*, emphasises the point that our ability to choose reduces as the number of choices on offer expands. In fact, in one of her earlier studies (Iyengar and Jiang, 2003) she found that the higher the number of investment choices, the lower the participation rates[14]. We know from much earlier work by George Miller that seven seems to be the limit on our capacity for processing information[15]. And Iyengar's own famous jam studies showed that when shoppers could choose from 24 flavours of jam, they simply abstained from buying any. But when they only had six choices to contend with, jam buying increased dramatically[16].

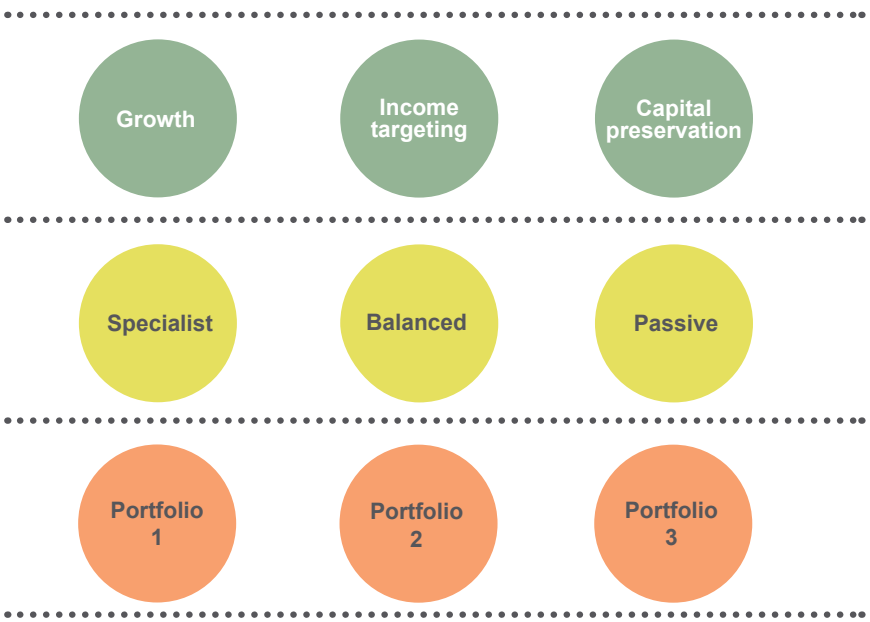
So how could we reframe the investment option choice so we can get members to where they need to get to without either freezing up or triggering a suboptimal choice?

By layering choices (maximum three layers) and then limiting the options at each level, McKinsey Consulting actually created a guided choice architecture – a way of presenting choices that helps individuals make better choices[17].

Let's show here how the McKinsey Rule could be applied in our investment choice problem in our example below:



BY LAYERING CHOICES, AN INDIVIDUAL WOULD ONLY BE CONFRONTED WITH THREE OPTIONS AT ANY TIME. HERE'S HOW IT WOULD WORK:



14 Iyengar & Huberman (2003)
15 Miller (1956)
16 Iyengar (2010)
17 Ibid