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Investing

401(k)s, pension plans need diversity for workers

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On the surface, offering your employees 10 to 12 choices for investments through their 401(k) or pension plan may seem like enough. But it's important not only to consider the number of choices, but to focus on asset classes that are presented in your plan.

If eight of the investment options in the plan are in the same asset class, you could be creating a false sense of portfolio diversification for employees, in addition to exposing your company to liability risk.

There are several asset classes, or categories of investments, that are represented in effective 401(k) plans. Categories to consider include size of company, investment style, domestic and foreign funds, bonds and balanced funds.

Large and small-cap funds

The first way to categorize a fund is by the size of the companies it invests in.

Large companies with capitalization above $5 billion are referred to as large-cap holdings and are found in large-cap funds. Mutual funds that own companies with capitalization under $5 billion are dubbed mid- or small-cap funds.

It is important to have large- and small-cap holdings available because these asset classes often perform very differently over shorter periods.

Over decades, all asset classes of stock funds have produced approximately the same rate of return, but in the short run, these returns can vary dramatically.

Value and growth style funds

Mutual funds are also categorized by investment style. There are two main styles of mutual fund investing – value and growth.

Value funds try to identify companies that are worth more than their current trading price. For example, if a value fund identifies a company trading for $20 a share and thinks it is worth $30 per share, it would be interested in owning stock in that company.

Value investors hope the market will recognize the true value of the company over time and the holding will outperform other stocks because it was purchased at a discount.

Growth funds, however, invest very differently. They will put money into a company that is trading at $30 a share even if they think the shares are worth $30, but only if certain conditions are present.

For instance, growth investors may trust the management team, like the company's industry and approve of the company's R&D process. Even though the company is fairly priced, they will invest if they think these factors will help the company grow its profits faster than competitors and the holding will outperform other stocks over time for that reason.

Growth- and value-style funds have performed similarly over decades, but for shorter periods of time, the variance in their performance can be dramatic, making it important to own both styles.

Domestic, foreign and bonds

Plan options should include domestic funds and global or foreign funds.

Domestic funds invest primarily in the United States. Global funds invest in both the U.S. and other countries.

As in other categories, long-term performance is similar but short-term performance can be very different. A fixed account or money market is important for investors who want no volatility.

Bonds should also be represented. There are many types of bond funds, from conservative short-term funds to aggressive high-yield or junk bond funds.

The most appropriate bond offering for 401(k) plans is usually an intermediate-term bond fund. These tend to give investors the best combination of reasonable returns without higher volatility.

Balanced funds

Balanced funds should be made available as well. These funds invest in a mix of stocks and bonds and often will provide higher long-term returns than the fixed- and bond-type options, and less volatility than pure stock options.

As a good starting point, effective 401(k) plans should offer employees the opportunity to diversify among at least these asset classes – large-cap growth, large-cap value, small-cap growth, small-cap value, fixed or money market, bonds, balanced, domestic, foreign and global.

Other asset classes can be added, such as real estate, but the previous classes should certainly be available.

Far too often, I have evaluated company plans with 12 investment options only to find eight of them in one asset class, thus offering little if any diversification.

The last several years of investing have highlighted the need for diversification in 401(k) plans.

Most asset classes have fared better than the asset class everyone thought they needed to be in exclusively just three short years ago.

Take a close look at your company's offerings. Make sure you don't have a lot of the same thing with a different wrapper around it.

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