ADVISOR PERSPECTIVES

The Burden of Choice

By Charlie Curnow
June 1, 2010

Sheena Iyengar

Columbia business professor Sheena Iyengar, author of The Art of Choosing, is the woman behind the famous jam study. One day in 1995, Iyengar set up a tasting booth in a grocery store. During some hours of the day, she put out a wide assortment of 24 jams for tasting. At other times, she put out just six jams. Throughout the day, she counted the number of store patrons who visited the booth, and of those people, the number who actually bought a jar of jam. The result: While 60 percent of store patrons visited the booth displaying 24 jams, just 3 percent of those shoppers ended up purchasing a jar. And while only 40 percent of store patrons visited the table when it offered six jams, a full 30 percent of those visitors ended up buying something.

The jam results show, Iyengar explains in her new book, that people can be much more decisive, and tend to report greater satisfaction with their decisions when faced with a limited assortment of choices rather than a deluge of options. While the store patrons who saw the large assortment of 24 jams often took as long as 10 minutes examining different flavors and discussing their options with others before choosing a jar to buy, the ones who saw just six choices strode confidently down the jam aisle and picked up a jar within about 30 seconds.

This preference for narrowed options stems from our limited capacity to process information. Iyengar's research was inspired by Princeton psychologist George A. Miller, who argued in a seminal 1956 paper that the number of objects the average human can keep in his working memory is seven, plus or minus two. Give the average person a list of words, letters or numbers that is between five and nine items long, and he will be able to recite it back without much trouble. Give him any more than that, however, and he will start to forget items, or jumble them.

Iyengar's marketplace extension of Miller’s findings has implications for financial planners. Despite the fact that money invested in the S&P 500 over the past 25 years would have more than a tenfold advantage over money stockpiled in a bank account, participation rates in company 401(k) retirement plans are still surprisingly low. It may be, Iyengar writes, that many workers are overwhelmed by the sheer number of investment options that are available to them.

In a 2001 study of more than 900,000 firms, Iyengar found that employee participation in 401(k) retirement plans increased as the number of investment funds offered by employers fell. Participation peaked at a high of 75 percent when employers offered just four funds, and it dropped to a low of about 60 percent when companies offered as many as 59 funds. Iyengar believes that the workers with a larger number of investment choices probably took some time to mull their options. But then as days turned to weeks and weeks into months as they put off their decisions, they eventually forgot about their 401(k)'s altogether. Meanwhile, many of the workers with just four or five options felt ready to sign up on the spot.

Sweden's retirement system could teach a few lessons to U.S. retirement planners, Iyengar writes. When Sweden privatized its social security program in 2000, it offered workers a selection of more than 450 different investment funds to choose from. Workers who did not choose their own investment funds were automatically enrolled in a default fund designed by the government to meet the needs of the average investor. The government actively encouraged Swedish citizens to choose their own investments, however, with a massive advertising campaign.

A study by economists Henrik Cronqvist of Claremont McKenna College and Richard Thaler of the University of Chicago found that the Swedish government may have been misguided in steering investors away from the default fund. On average, investors who chose their own plans underperformed the default fund by 10 percent after three years, and by 15 percent after seven. The investors who selected their own funds, they found, tended to choose investments that were familiar to them from their daily lives, rather than build a diversified portfolio that was tailored to their financial interests. They put all their money into stocks, for example, while ignoring bonds and other assets. Many invested too heavily in Swedish stocks, or in their own companies, or in stocks that were hot at the time.

Politically, findings like these lead Iyengar and other behavioral economists toward a soft paternalism. By setting sensible defaults and doing nothing to actively discourage people from choosing those defaults, they say, experts and bureaucrats can help the average person meet his needs better than he could himself, if left to his own devices.

These arguments, of course, run counter to traditional economic thought. A mainstream, neoclassical economist would argue that there should be no “default options” chosen from above. Allow every retirement fund to vie for the attention of investors on equal footing, mainstream economic theory says, and competition will drive down prices and eliminate inferior products. Default options will only lead to distortions and inefficiency. If there are specific instances in which a single expert or group of experts knows more than the rest of the market, those cases are the exceptions, not the rule. The track record of government-appointed money managers, after all, is far from perfect. Just look, for example, at how poorly state and local pension assets have performed in the U.S. over the past few years.

Furthermore, a mainstream economist would argue in response to the Sweden example, seven years of returns from a single investment fund aren't enough to prove anything. Indeed, it's ludicrous to think that experimental results or cases studies could "prove" anything at all in economics, as they do in the natural sciences. The country of Sweden has nothing even approaching the controlled, replicable conditions of a chemistry or physics lab. From politics to education to cultural norms, there are simply too many variables at play. It is therefore best to ask what a rational person would do in any given situation, and use that as a best first guess for the future, not some rule of thumb drawn from dubious experimental results.

Because of caveats like these, behavioral economics remains an interesting corollary to the neoclassical mainstream, rather than the basis for a wholesale paradigm shift. But that won't stop businesspeople from trying to put findings like Iyengar's into practice. Indeed, as the author notes, the head of Fidelity Research told her that he took her jam study as a sign that his financial services company needs to narrow down the selection of more than 4,500 mutual funds it offers to clients. One executive at McKinsey, a management consulting firm, said he used her findings to create his company's "3x3 rule," which stipulates that potential clients first choose from a selection of three choices, then another set of three choices, followed by no more than a third set of three choices during sales pitches.

If Iyengar's book strikes a chord, others will surely follow.