Abstract: This paper examines how the menu of investment options made available to workers influences portfolio choice. Using a unique panel data set of 401(k) plans, we examine four aspects of investment behavior. First, we show that the share of investment options in a particular asset class (i.e., company stock, equities, fixed income, and balanced funds) has a significant effect on participant portfolio allocations across these asset classes. For example, our estimates suggest that by increasing the share of equity funds from 1/3 to 1/2 (such as by adding an additional equity fund option to a plan that already offers company stock, one equity fund, and one fixed income fund), overall participant allocations to equity funds increase by nearly 6 percentage points. Second, we show that investment restrictions – such as requiring a match in company stock, or placing a ceiling on the fraction of assets that can be held in a particular asset – can change the overall risk/return profile of the portfolio much more than would be expected in a standard portfolio model. This finding is consistent with a view that participants view such restrictions as a form of implicit investment advice. Third, we find that investors respond to past asset returns, such as by allocating a higher fraction of contributions to equities when past 5-year returns on equities have been high. Finally, we provide strong evidence of inertia in investment behavior, as it takes several years for participant contributions to fully adjust to the addition of a new fund. Each of these findings has important implications for the design of any individual account based investment program, including one that were part of Social Security.

Acknowledgements: This research was supported by the U.S. Social Security Administration through grant #10-P-98363-1 to the National Bureau of Economic Research as part of the SSA Retirement Research Consortium. The opinions and conclusions expressed are solely those of the author(s) and do not represent the opinions or policy of SSA, any agency of the Federal Government, or the NBER. We are grateful to the Social Security Administration for this financial support. We thank Vivek Choudhary, Soonho Lee, and Yoon Sok Lee for excellent research assistance.