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Abstract

We study the association between human capital and rollovers into Individual Retirement Accounts (IRAs), using administrative records from the defined contribution savings plan for U.S. government employees: the Thrift Savings Plan (TSP). Employees who separate from government employment have the option to leave balances in the TSP, where fees are currently under 4 basis points. However, we estimate that more than a third of the TSP balances end up being rolled over into IRA accounts, which are very likely to have much higher fees. We find that educational attainment has a very small positive association with the propensity to roll balances out of the TSP (the extensive margin). Hence, when deciding whether to initiate a rollover, employees with higher levels of educational attainment choose higher fee investments. However, conditional on rolling money out of the TSP, we estimate a very small negative association between educational attainment and IRA fees measured as basis points (the intensive margin). Because the extensive and intensive associations have opposite signs and are each small to begin with, educational attainment has no economically meaningful association with retirement account fees paid by TSP participants. Similar small and/or null effects are observed for another human capital variable that we study in the TSP data: AFQT scores.
Human capital includes all of the skills and capabilities that make people more productive and successful. Educational attainment is correlated with human capital for two reasons. First, education directly creates human capital. Second, people who choose to obtain more years of education tend to be those who have already had the most success in school (e.g., higher grades and greater scholastic achievement).

Economic theory posits that human capital is correlated with more sophisticated decision-making, explaining why wages are correlated with human capital. Accordingly, it is natural to hypothesize that educational attainment (a proxy for human capital) is correlated with better investment choices. We measure the strength of this protective effect in the domain of asset management fees.

Specifically, we study the association between education and rollovers from a large retirement savings plan, the federal government’s Thrift Savings Plan (TSP) to Individual Retirement Accounts (IRAs). The TSP has extremely low asset management fees: all of the funds in the TSP have management fees that are less than 4 basis points. Because employees can leave their funds in the TSP even after they leave government employment, rollovers to IRAs, which almost all have much higher management fees, are economically puzzling. We estimate that the average IRA rollover account pays annual fees (expressed as a percentage of the account’s total balance) that are substantially higher than the analogous fees paid inside the TSP. Nevertheless, we find that over a third of the TSP balances of those employees separating between ages 50 and 69 eventually rolls over to an IRA.

We study rollovers from the TSP during the 2016-2018 period. Somewhat surprisingly, we find that educational attainment has a very small positive association with the propensity to roll balances out of the TSP into an IRA. Controlling for balances, an extra year of education is associated with a 0.2 percentage point higher probability of rolling money out of the plan during this three-year period.

However, when we study only those employees who do roll money out of the plan, educational attainment has a very small negative association on the asset management fees paid at the institutions to which balances are rolled over. In our main specification (with controls), an extra year of education is associated with management fees that are one basis point lower.
Putting these two results together, we find that educational attainment does not have an economically meaningful association with fees on retirement wealth (that was initially accumulated inside the TSP). Two very small associations with opposite sign jointly amount to an extremely small positive association between educational attainment and retirement account fees. This result rules out the negative association predicted by most theories of human capital.

We are also able to study a direct measure of cognitive function: Armed Forces Qualification Test (AFQT) scores. This analysis yields empirical associations that are roughly similar to those for educational attainment; the signs and effect sizes of the AFQT associations are usually the same as those for the educational attainment associations. Higher AFQT scores are associated with a slightly higher likelihood of rolling money out of the TSP. However, among those participants rolling out, higher AFQT scores are associated with the choice of an IRA provider that charges slightly lower total asset management fees. Putting these results together, AFQT scores have an extremely small positive association with retirement account fees. Once again, this result is at odds with the negative association predicted by most theories of human capital.

In summary, we find that proxies for human capital have very little predictive power for fees, and, if anything, are on average statistically significantly positively associated with total fees. Accordingly, for DC balances originally accumulated in the TSP, we can reject the hypothesis that proxies for human capital are negatively associated with asset management fees. On the contrary, we expected to find that households with greater human capital would be better investors as judged by the normative benchmarks embraced by academic economists. Specifically, the TSP is widely viewed as an outstanding investment platform because of its extremely low asset management fees (and fiduciary protections). If the low fees on the TSP platform are a paramount consideration, then investor should leave their retirement balances inside the TSP when they are no longer employed by the federal government (e.g., see Turner et al 2016). We predicted that relatively sophisticated investors – e.g., those with the most human capital – would be the most prone to leave their retirement balances inside the TSP. Our evidence is not consistent with this prediction.

Our results may be explained by two alternative interpretations. First, “sophisticated” and “knowledgeable” investors may be the most prone to adjust their investment allocations because they perceive that they “know what they are doing.” The perception that you are a
capable investor can become a disadvantage when your retirement balance starts out in a low fee, well-diversified investment platform with strong fiduciary protections. Being sophisticated may put you at greater risk of taking an assertive stance and rejecting the menu of options on the TSP platform. Such a rejection implies that the investor would initiate an IRA rollover.

Alternatively, high human capital investors may be leaving the TSP for economically sound reasons. Maybe they are frustrated by the limited withdrawal options currently offered within the TSP. Perhaps they are optimally seeking other investment opportunities that are not available on the TSP website. They may rationally believe that the passive strategies that are available on the TSP menu are not optimal. They may rationally believe that other asset classes – e.g., hedge funds and absolute return funds, smart beta, infrastructure investment pools, etc. – are superior to the “plain vanilla” stocks and bonds on the TSP menu. Finally, they may truly benefit from the investment advice that can be obtained by holding their assets in a high-fee asset management account.

Whatever the explanation for our results and the signs of the associations that we find, it is important to emphasize that educational attainment and AFQT scores are not strongly predictive of investment decisions. All of the associations with human capital that we report are extremely small in economic magnitude, whether they have the right or the wrong sign. Participant balances are rapidly flowing out of the low-cost TSP system and the existence and destination of those flows has little relationship with general measures of human capital, like educational attainment and AFQT scores. In light of our results, we suspect that other factors, like marketing campaigns and person-to-person sales tactics (see Turner et al 2016), may play a much more important explanatory role than the personal characteristics of each TSP participant.

References