

Financial Illiteracy Meets Conflicted Advice: The Case of Thrift Savings Plan Rollovers

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Abstract

Bad financial decision-making can be due to a combination of lack of financial literacy and conflicted advice from advisers who know that many people are insensitive to differences in fees. The paper examines rollovers from the Thrift Savings Plan (TSP) for federal government workers. It focuses on the TSP because it has the lowest fees of any plan in the United States, charging less than 3 basis points. By analyzing issues related to TSP rollovers, this paper sheds light on the broader topic of rollovers to IRAs and the yet broader topics of the quality of financial advice that people receive and how that is affected by the fiduciary standard. The two leading models of choice—the traditional price theory model with rational decision makers and behavioral economics with its emphasis on inertia both predict that rollovers from the TSP would generally not occur. We argue that these rollovers can be explained by a model of financially illiterate consumers facing conflicted advice, which is a type of agency problem model. While the fiduciary standard is considered to be the highest standard for conduct under the law, the paper is to our knowledge the first paper to test the effect of a fiduciary standard on the quality of advice. It undertakes a small survey to find out what advice participants receive concerning TSP rollovers and to test the hypothesis that having a fiduciary duty does not affect the quality of advice provided. Because of the extremely low fees the TSP charges, the strategy of assessing advice concerning rollovers from the TSP provides a strong test of the hypothesis that the standard used by many financial advisers for quality of advice is low. Participants in a very low fee plan are being advised to roll over to high fee products. While we find a statistically significant difference between the advice provided by advisers with a suitability standard and the SEC fiduciary standard, even advisers with that fiduciary standard often appear to be insensitive to large differences in fees, focusing instead on the benefits of their advice. They provide self-interested analysis that justifies their self-interested advice. Thus, the SEC fiduciary standard does not appear to be adequate by itself, without robust enforcement, to overcome the problem arising from the advisers' conflict of interest, combined with the information asymmetry between advisers and clients.

“One of the best things you can do as an investor is to keep the costs that you can control as low as possible.” Wes Moss (2014)

Because many people lack financial literacy, they seek financial advice. Information asymmetry is inherent in that situation. The information asymmetry creates the potential for an agency problem, where the agent or adviser may not act in the best interest of the client. The financial adviser has a financial incentive to take advantage of his informational advantage because he has a conflict of interest. Because of the way the adviser is compensated, the advice that yields the adviser the most income is not the best advice for the client. This financial incentive results in clients not receiving the best advice. As a result, government has stepped in to regulate financial advice in order to protect the interests of clients. This regulation sometimes involves imposing a fiduciary standard, requiring that the advice be the best advice for the client.ⁱⁱ Because of the large amount of money at stake for financial advisers, they have attempted to influence the regulators, sometimes referred to when it is successful as regulatory capture.

This paper applies the framework just described to analyze the market for financial advice. It does so by focusing on pension rollovers to Individual Retirement Accounts (IRAs). In the market for financial advice, people with low levels of financial literacy (demand side) encounter advisers with conflicts of interest (supply side). In 2013, 38.3 percent of families reported obtaining information about investing from bankers, brokers and other sellers of financial services, and 31.3 percent of families reported obtaining information from lawyers, accounts and other financial advisers (Bricker et al. 2014).

Individual Retirement Accounts (IRAs) are the largest type of pension plan in the United States, having overtaken 401(k) plans. Rollovers are the primary source of funding for IRAs, with relatively few people contributing to IRAs (Investment Company Institute 2015b). Thus, the topic of rollovers is one of the most important topics in pension policy, involving issues that determine the fundamental structure of the way retirement savings is provided. Because of the importance of the rollover decision, many people seek financial advice. One survey finds that 61 percent of the people with rollover IRAs received advice from a financial adviser in connection to the rollover (Investment Company Institute 2015b).

In a rollover, the person receives a check from the pension plan of a former employer, then deposits the check with the IRA. In a transfer, the pension plan sends the check directly to the IRA. We follow common practice and refer to both as rollovers.

We argue that if participants are receiving bad advice where it is least likely, which is a plan with extremely low fees, it is likely that bad advice is occurring in less extreme situations. Similarly, if the financial regulators fail to take action in this situation, it is likely that they will fail to take action in less extreme situations that would still warrant action.

We focus on advice concerning rollovers from the Thrift Savings Plan because it has the lowest fees of any plan in the United States. The Thrift Savings Plan (TSP) is a 401(k)-type defined contribution plan for federal government workers, the military, and Members of Congress. The

TSP is the largest pension fund in the United States (Towers Watson 2014) and the largest defined contribution plan in the world (White 2011). It has more participants than the social security systems of more than 90 countries (World Bank 2014). It charges extremely low fees—less than three basis points for each of its funds. With fees of 3 basis points, someone investing \$100,000 would pay \$30 in fees annually. By comparison, the same person having the money managed by an adviser charging one percent per year would pay \$1,000 to the adviser, on top of the fees for the investments, and someone with a high fee adviser charging two percent per year would be paying \$2,000, and probably with the costs of the investments thus paying more than 70 times as much in fees. Yet, as documented in this paper, advisers charging as much as two percent a year are advising clients to rollover their TSP accounts so that the adviser can manage it.

We focus on the TSP because it charges extremely low fees, making a rollover to an IRA generally a bad decision. In 2014, the fees charged to participants in the Thrift Savings Plan were 2.9 basis points (TSP 2014b), compared to 83 basis points as the participant-weighted average for a survey of 401(k) plans (Deloitte 2011), 58 basis points for an asset-weighted average of 401(k) plans and 74 basis points for the asset-weighted average of equity mutual funds held in IRAs (Investment Company Institute 2015b). IRAs have on average higher fees than do 401(k) plans, reflecting that retail fees for IRAs tend to be higher than institutional fees for 401(k) plans. While it is possible to find investments with very low fees, on average fees were roughly 25 times higher in IRAs than for the TSP, with the difference being substantially larger if the person who rolled over also started using a financial adviser, where fees are often 100 basis points or more.

This paper analyzes financial advice as a reason why rollovers are occurring. By focusing on advice, we do not claim that that is the only reason for rollovers or that it is the most important reason for all the rollovers that have occurred. Nonetheless, based on a survey of TSP participants who made a withdrawal, in 2013, an estimated 16,400 participants (about one-third of those making withdrawals) made a withdrawal of all or part of their TSP account because they were advised by their financial adviser to do so (AonHewitt 2014). In this paper, we make a preliminary attempt to assess the extent to which participants who receive advice from financial advisers are receiving bad advice.

After providing introductory material further describing the TSP, the paper discusses a few situations where it has been argued that a rollover from a TSP may be advantageous. Next, based on a survey we conducted, it assesses advice that clients receive concerning rolling over their TSP accounts to IRAs. The paper addresses the issue of whether having a fiduciary duty makes a difference in the advice received. To our knowledge, our paper is the first to empirically study whether having a fiduciary duty makes a difference in the quality of advice received.

INTRODUCTION

The market for TSP rollovers is complex, involving the activities of five parties: (1) TSP participants, (2) the TSP, (3) IRA providers, (4) advisers and (5) regulators. In this paper, we focus on the behavior of participants and advisers, commenting briefly on regulators and

describing the characteristics of the TSP and IRAs but not focusing on the activities of the TSP and of IRA providers.

Previous Literature

Relevant to this paper on the quality of advice is a small but growing literature on the quality of advice that people receive as a factor leading to poor outcomes. This literature is a subset of a larger literature on the agency problem, where agents may have a conflict of interest and not act in the best interests of their clients. Mullainathan et al. (2012) in an audit study find that people with low-fee, well-diversified portfolios are advised to invest in higher-fee, less diversified portfolios. Dvorak (2015) compares the 401(k) plan investment options in the plans of financial advisory firms with the plans of the companies they advise. He finds that the investment options that are in the advisee firms' plans but not in the adviser firms' plans tend to have high fees, with the advisers not putting the high fee funds in their own plans. Christoffersen et al. (2013) find that brokers tend to sell higher-cost funds that give them higher compensation. The Council of Economic Advisers (2015) surveys the literature on financial advice and conflicts of interest, but fail to recognize that the issues relating to pension rollovers differ from those relating to advice as to investments for an established client. Concerning the low end of the quality of advice people receive, the SEC has issued an Investor Alert concerning fraudulent advice that some participants in Self-Directed IRAs have received (SEC 2011).

Three approaches have been taken in law to deal with conflicts of interest: prohibition, disclosure and the fiduciary standard. A fourth approach in public policy is financial literacy and financial education campaigns. The law and economics literature discusses the role of a fiduciary standard as one way of dealing with the agency problem where the agent has a conflict of interest and superior knowledge, and it is difficult for the client to assess the output of the agent (Sitkoff 2011). With the fiduciary standard, the agent is supposed to act solely in the best interest of the client. Agency problems are common because in a modern economy people must rely on experts to assist them. In our paper, the monitoring problem is due to asymmetric information, with the advisers having superior knowledge to the clients. Clients have a lack of financial sophistication and are unable to evaluate the quality of the advice they receive. For this reason, they play a weak role in the enforcement of regulations protecting them. We test for whether having a fiduciary standard affects the quality of advice. Thus, our paper relates to the effect of a fiduciary standard in dealing with the agency problem.

Rollovers from the Thrift Savings Plan, and indeed from most 401(k) plans (Turner and Klein 2014), are surprising from an economics perspective. The two main choice models in economics –traditional price theory, based on rational decision-makers, and behavioral economics, with its emphasis on inertia—cannot explain rollovers from the TSP.

From the perspective of traditional price theory, most rational decision-makers presumably would not roll over from the Thrift Savings Plan to an IRA because of the large difference in fees. In addition, pension participants have fiduciary protections in the TSP, but lose those protections when they transfer their assets to an IRA. Loss of fiduciary protections can be particularly important at advanced older ages when the risk of cognitive impairment is greater (Barlyn 2010). IRAs are not protected from judgments in civil law suits (TIAA-CREF 2013), and thus are subject to greater risk than is the TSP. The weakness of this model may be due to participants not knowing how much they are paying in fees, which is due at least in part to the lack of salience of these fees. A 2013 survey of civilian TSP participants who were separated

but had not started taking benefits indicated that 18 percent expected to rollover from the TSP because of lower fees elsewhere (AonHewitt 2013), suggesting that they did not know the fees that TSP charges. That survey found that 42 percent of participants rated the TSP as about the same (37 percent) or below (5 percent) other plans. In addition, generally, people tend to think that their financial adviser is providing advice in their best interest, with roughly three out of four indicating that in a survey, while most advisers have a suitability standard for the advice they provide (Schoeff 2015).

From the perspective of behavioral economics, rollovers are surprising because some studies have documented the tendency for pension participants to exhibit inertia (Madrian and Shea 2001, Choi et al. 2002; see, however, Muller and Turner 2013). Inertia would cause TSP participants to not roll over because that is the “path of least resistance.” Rollovers would seem to be even more unlikely when considering that many participants presumably would be overwhelmed by the large number of options as to IRA providers and then as to investment choices. However, the force of inertia may be less for workers at the point of job change or retirement, when the worker’s attention is focused on choices related to the change in employment, than for workers who are continuing in the same job.

We propose the decision-making model of financial illiteracy with conflicted advice, which is an aspect of agency theory. This model dominates the traditional economics model and the behavioral economics model in the problem we analyze in that it predicts that TSP rollovers will occur, while the other two models predict the opposite for most participants. The effects of inertia and differences in fees are offset by conflicted advice. The client is not able to judge the quality of the advice and trusts the expertise and motivations of the adviser. We thus argue that the explanation for rollovers from the TSP, at least to some extent, is bad financial advice, both generalized advice provided through widespread advertising to rollover your “old” 401(k) plan, and advice provided to individuals.

Why do price theory and behavioral economics fail to explain TSP rollovers? We present evidence in this paper suggesting that in financial markets people often do not know what the prices are. We also suggest that the force of inertia may be less at job change than while working at a job and that inertia has been overcome at that point by advice.

THE MARKET FOR RETIREMENT SAVINGS VEHICLES AND THE DERIVED DEMAND FOR FINANCIAL ADVICE

Participants in the TSP face the choice of whether to continue in the TSP at job change or to transfer their TSP account to an IRA. Thus, they presumably consider the relative merits of the two forms of retirement savings. In addition, because they tend to lack financial literacy, they may seek the assistance of a financial adviser.

The TSP

The TSP is administered by the Federal Retirement Thrift Investment Board--an independent board whose members are nominated by the President and confirmed by the Senate. The TSP provides the same type of savings and tax benefits that are offered by 401(k) plans. Participants can make either Roth or traditional contributions. Its 4.6 million participants make it the largest defined contribution plan in the United States. The Thrift Savings Plan as of May 2014 had assets of \$412 billion (Long 2014b) and in early 2015 was up to \$440 billion (Money Management Intelligence 2015). The participation rate of 88.6 percent for employees in the Federal Employees Retirement System (FERS) (Thrift Savings Plan 2013) is higher than is typical for 401(k) plans, which tends to be less than 70 percent (U.S. Department of Labor 2014).

Participants in the TSP pay extremely low fees. The fees for all the TSP funds were 2.9 basis points or less in 2013 and 2014 (Thrift Savings Plan 2014b). The fees in 2013 were less than one-twentieth the average cost of a stock index fund (Zweig 2013), and one-thirtieth the average cost of target date funds (Vanguard 2014). Its fees are low primarily because of its large size and in part because some administrative costs are borne directly by the Federal government (Boccia 2014). The advantage of these low fees can be passed on to a surviving spouse, who can maintain an account in the TSP.

While 401(k) participants tend not to know how much they are paying in fees (Turner and Korczyk 2004), TSP participants may particularly be uninformed about their plan fees because all the funds charge essentially the same fee, making the level of fees irrelevant in the choice of funds.

Inertia Has Been Overcome

Inertia, which plays a key role in pension policy based on behavioral economics and choice architecture, has been overcome in the case of TSP rollovers. The default is to remain in the TSP. A survey in 2008 indicated that relatively few TSP participants (14.0 percent) planned to rollover their TSP to an IRA when they left government service (Watson Wyatt 2009). The intention to roll over was more prevalent among participants with small account balances at the time of the survey, with 15.7 percent of those with account balances of between \$5,000 and \$25,000 indicating that they planned to rollover to an IRA, versus 12.7 percent for those with account balances of \$100,000 or more. One-fifth (22.5 percent) of participants planned to not take withdrawals until required to at age 70 ½. That percentage rises with age, and among those already retired, 40.7 percent planned to not take a withdrawal until age 70 ½.

Five years later, in 2013, 47,836 TSP participants requested transfers. Of those who separated from service in 2012, by the end of 2013, 45 percent had withdrawn all their funds (Long 2014b). The total amount rolled over to IRAs or other plans in 2013 was roughly \$7.2 billion. Thus, the average rollover was about \$150,000, which is slightly lower than the median account balance for someone with more than 20 years of tenure, which in 2011 was \$155,119 and somewhat lower than the average account balance for that group, which was \$185,741 (Thrift Savings Plan 2012). These figures compare to a median account balance for families with retirement accounts in 2013 of \$59,000 (Bricker et al. 2014). In the age group where the family head was 55 to 64, the median value of assets in retirement accounts for households with a retirement account was \$105,000 (Bricker et al. 2012). Thus, the rollovers are considerably larger than typical 401(k) account balances for those near retirement, which may make them a desirable target for financial advisers. In 2012, transfers of the full account balance to an IRA or another plan accounted for 65 percent of the money withdrawn from the TSP (Long 2014c).ⁱⁱⁱ

A beneficial aspect of maintaining a TSP account rather than rolling it over is that participants can roll in money from plans from previous or subsequent employers or IRAs. The ability to roll in from subsequent employers is rarely if ever found in 401(k) plans. In 2014, \$1 billion was rolled into the TSP (Steyer 2015). The roll ins suggest that the traditional, rational economic analysis still applies for some participants, who are financially astute and realize that the low fees in the TSP make it a desirable place to hold retirement savings.

Among those responding to a survey conducted by the Federal Retirement Thrift Investment Board, the primary reason for withdrawing money (rollovers and withdrawals) was a life event or major expenditure (36 percent), wanting greater withdrawal flexibility in benefits options (27 percent), wanting other investment options (23 percent), and wanting a managed account, wanting investment advice, receiving advice from a financial adviser, or other factors such as account consolidation or required minimum distributions (20 percent) (Long 2014b). Workers age 59 ½ and older can take a one-time partial or full withdrawal from the TSP while still working for the Federal government. A survey found that 23 percent of persons taking an in-service withdrawal were doing so because a financial adviser recommended that they do so (Long 2014b). Reacting to the situation that participants are being advised to roll over from the TSP the TSP has undertaken a policy of active retention, meaning that it is attempting to encourage participants to remain in the plan.

Are IRAs a Good Alternative?

In terms of fees, two types of rollovers to IRAs can be identified. In one type, the participant is advised by an adviser to rollover and the adviser manages the account for a fee, which is added to the fees charged by the underlying investments. In the second type, the participant is not charged an ongoing advisory fee, but only pays the investment fees. Advisory fees generally are at least one percent of assets, but in one rollover we encountered involving a major financial adviser in the Washington, DC area fees are two percent.

As indicated earlier, in 2013, \$7.2 billion was rolled over from the TSP to other pension plans and IRAs (Long 2014b). If the other pension plans had the average fee of 74 basis points, which is the asset-weighted average of fees for equity mutual funds held in IRAS (Investment Company Institute 2015b), the participants would lose in aggregate about \$50 million due to higher fees in the first year, with annual losses continuing for the life of the account. That would be a loss of more than \$1,000 per participant per year. Because that amount would compound over time due to the loss of investment income due to the smaller asset base, it can be used as the basis of a present value calculation, yielding a rough estimated present value loss of \$20,000 for a person making the average rollover. That estimate is an understatement because it does not include fees for financial advice. However, it is also a rough approximation, depending on the age at which the person retires, how long the person lives, when the person starts drawing down their assets and how rapidly, and the rate of return on their assets.

When Would a Rollover Make Sense?

While generally, advice to rollover from the TSP is bad advice because of the substantially higher fees the individual will pay in IRAs and to advisers, in a few circumstances, the higher fees may be outweighed by the benefits of a rollover. We discuss the primary reasons given by financial advisers for rolling over the TSP.

First, for people preferring investment options not in the TSP, or a high tolerance for risk, a rollover may be desirable. These options would include high-risk investments, actively managed mutual funds, real estate, and international bonds. However, individuals having the financial sophistication and risk tolerance to want these investments probably have sufficient assets outside of the TSP to use to make those investments. They could make these investments through

their IRA, assuming they had one, and would not need to rollover to do so. Many TSP participants have exposure to the real estate market through owning their home.

Second, as indicated by the Federal Retirement Thrift Investment Board survey, some people find the TSP withdrawal options too inflexible. The TSP works well for people who want to receive regular monthly payments, but it does not work well for people who want to make an occasional withdrawal. Because most TSP members also receive a defined benefit plan monthly benefit, some may prefer to use the TSP for irregular withdrawals for special needs, but it cannot be used that way. Retirees can only take one partial withdrawal. People wanting to have extra money for special purposes could do a partial rollover to an IRA. After that, they must withdraw the full amount remaining, either as an annuity, a lump sum payment, or a series of payments, which can be tied to life expectancy. They can use a combination of those options that are available for full withdrawal. For the partial withdrawal, workers cannot choose which fund the withdrawal comes from, with the withdrawal being made on a pro rata basis from all funds in which they are invested. Allowing more than one partial withdrawal, and allowing workers to specify the fund from which it is taken, would be a step toward greater flexibility. The inflexibility in withdrawal options appears to be one reason why workers rollover their TSP accounts. However, because of its low fees, participants should first spend down their non-pension savings and their higher fee pension savings before making withdrawals from the TSP.

Third, people with small TSP account balances may roll over to an IRA rather than to maintain a separate small account. However, a superior strategy would be to maintain a small TSP account and later roll over higher-fee pension assets into that account. This type of rollover can be done by former and current federal employees who maintain a TSP account.

Our conclusion is that rarely is a complete rollover from the TSP good advice. Generally, the cost of a rollover in terms of higher fees outweighs the advantages of a rollover in the circumstances where there are advantages.

SUPPLY OF ADVICE

This section discusses issues relating to advice concerning rollovers.

Conflicts of Interest, Advice and the Compensation Model

Conflicts of interest arise from the ways advisers are compensated. Conflicted advice arises whenever the adviser earns higher fees from advising a strategy that is not in the best interest of the client. Generally, advisers earn higher fees by doing what is in the best interest of their companies or themselves. However, the analysis of conflicts of interest relating to investment advice, as has been done by the Council of Economic Advisers (2015), does not directly apply to conflicts of interest in the case of pension rollovers. In the case of investment advice, advisers charging by the hour or based on assets under management do not have an incentive to provide bad advice. In the case of rollovers, however, advisers charging by the hour or based on assets under management will generally make more money if their clients decide to roll over their assets. When an adviser has a client who is considering a rollover, the adviser generally will receive higher fees over time from that client by advising a rollover because that advice will lead to the need for continuing advice on managing the person's investments.

An Assessment of Advice Concerning Rollovers from the TSP

Since the TSP does not provide individualized advice, participants may turn to the financial services industry for advice. Advice can be categorized in two dimensions—it can be self-interested versus neutral advice, and it can be generalized versus individualized advice. With self-interested advice, the adviser has a conflict of interest in that his compensation may be higher if he provides advice that is not in the best interest of the client. With neutral advice, the adviser's compensation does not depend on what he advises. With generalized advice, the advice is provided through advertising and through information on websites. With individualized advice, the advice is provided by a financial services professional to an individual. Different regulatory standards apply to generalized versus individualized advice, and arguably different regulatory reforms are needed concerning the current standards.

A Survey Concerning Individualized Advice. In 2013, the Government Accountability Office (2013) conducted a survey of thirty call-in centers to assess what advice people were receiving concerning rollovers from 401(k) plans to IRAs. It found that frequently people were being encouraged to roll over to an IRA by financial advisers who had obtained little information concerning the situation of the person, including information on the fees being charged by the plan they were in. Because of its extremely low fees, advice concerning rollovers from the TSP provides a stronger test of the quality of advice people are receiving than does the GAO survey.

Empirical Analysis

Studying advice received by TSP participants provides at least two advantages over studying advice to pension participants in 401(k) plans. First, we know the TSP participants are paying less than 3 basis points for their investments. Second, we know that any investment they are advised to roll over to will have higher fees, with the fees generally being substantially higher.

To obtain information on the advice that TSP participants receive from different types of financial advisers, we selected thirty advisers through a telephone survey and an email survey. With these surveys, we test two hypotheses. First, we test the hypothesis that participants in an extremely low fee plan are being advised to rollover to higher fee arrangements. Second, we test the hypothesis that having a fiduciary duty makes no difference in the quality of advice that advisers provide. To our knowledge, this is the first study to test that hypothesis, a weakness of previous studies according to the Investment Company Institute (2015a).

For most people, the best advice concerning rollovers would be to roll over IRAs and other pension accounts into the TSP. However, many advisers may not be aware that that is an option. The next best advice would be to leave the money with the TSP. The worst advice would be to roll over from the TSP to an IRA.

Telephone Survey. In the telephone survey, we contacted firms providing IRAs to see what advice one of the authors would receive concerning his own TSP account as a former federal government employee. We obtained contact information in two ways. We obtained telephone numbers from websites encouraging rollovers to IRAs. We also obtained telephone numbers for financial services firms from the Washington, DC telephone book. This survey is a convenience

sample survey, and is not meant to be statistically representative of any universe of advisers. In most cases, we believe that the person providing advice was a person subject to a “suitability” standard, rather than a registered investment advisor subject to a fiduciary standard requiring that services be in the best interests of the customer.

We contacted seven mutual fund companies, seven banks and one insurance company seeking advice (a total of fifteen service providers) (Table 1).^{iv} It was clear that many of the advisers were aware that the TSP charges extremely low fees, but it was also clear that some of the advisers did not know that. The advice generally ignored fees as an issue. The advice we received generally focused on TSP participants having a small number of investment options, while IRA participants had a large number of options. Ten companies indicated that the client should rollover the TSP to an IRA. We can state unequivocally that this was bad advice because we know the details of the person receiving it.

Four declined to provide advice, but instead to differing degrees tried to sell the idea that a rollover would be desirable. One adviser asked about the risk tolerance of the client and then advised that a client with moderate to high risk tolerance should roll over to obtain a greater range of funds, while a client with low risk tolerance should stay in the G Fund. One adviser said that we would receive \$600 as an incentive to rollover plus 300 free stock exchange trades through their brokerage service. None of them advised rolling into the TSP.

From some of the advisers, we received false information that made a rollover seem to be desirable. One adviser said that we could reduce fees by rolling over. The insurance company indicated that we could obtain lower priced annuities outside of the Thrift Savings Plan. One company said we had no control of our investments in the Thrift Savings Plan. Two advisers praised actively managed funds, which are not an option with the Thrift Savings Plan.

Table 1. Telephone survey results for advisers with a suitability standard

Outcome	Number of Firms
Advised not to roll over	1
Declined to advise but suggested a rollover would be a good idea	4
Recommended a rollover	10
Total	15

Source: Author’s calculations

Advisers who worked for companies that took a more aggressive stance on their websites concerning IRA rollovers also tended to take a more aggressive stance in advising those rollovers in our phone conversations. We do not know how the people we contacted on the telephone were compensated, but it was clear that they viewed it as their job to encourage us to rollover from the TSP. While most of the companies we contacted advised rollovers, some companies that had more balanced presentations on their websites declined to provide advice, but instead focused on what they considered to be the advantages of rolling over. One adviser indicated that for rollovers, the company would make available mutual funds it managed that were currently closed to new investors as an incentive to rollover. One adviser suggested investing in a small cap fund

when he learned that our portfolio did not include that. The lowest fee small cap fund that mutual fund company offers has an expense ratio of 91 basis points, compared to 2.9 basis points for the TSP small cap fund (the S Fund). Thus, fees would be more than 30 times higher. One adviser stated that we would have thousands of investment options if we rolled over.^v

Information received in the mail from one mutual fund company we contacted indicated that an advantage of their IRA was that their investment advisers are noncommissioned, implying presumably that their advice would not be affected by a conflict of interest. An adviser from that company subsequently advised rolling over the TSP account to an IRA at their company.

All the fifteen advisers we contacted worked for companies that sold financial products. In total, two-thirds of the companies advised rollovers, one advised against rollovers for participants who were highly risk averse, and four companies declined to provide advice but indicated that their companies offered a good alternative. They generally ignored the issue of fees and made little effort to find out information about their client.

Email Survey. To test the hypothesis that having a fiduciary standard makes no difference in the quality of advice clients receive, we obtained a list of such advisers from the website for the National Association of Personal Financial Advisors (NAPFA 2015). That website provides email addresses, and we contacted the advisers in this survey by email.^{vi} All members of NAPFA have a NAPFA fiduciary duty concerning the advice they provide their clients, but we believe that all of the ones we contacted were also subject to the SEC fiduciary standard. In addition, members of NAPFA can only receive compensation as fees from their clients. They cannot receive compensation from investment management companies whose products they purchase for their clients. The fees can be on an hourly basis, as a percentage of assets under management (AUM) or as a combination of those two approaches. Thus, this survey allows us to test for the effect of having a fiduciary duty concerning the advice provided. Our null hypothesis is that having a fiduciary standard has no effect on advice.

In the email survey, because we were dealing with financial advisers in one-person or small firms, for ethical reasons we wanted to make it clear that we were not actual clients but that we were doing a survey. The email survey may have two biases. First, by providing their answers in writing, the advisers may have felt more cautious about providing “bad” advice, or even any definite advice. Second, because we indicated it was a survey, they may have been less aggressive in seeking rollovers because they knew they were not dealing with actual potential clients, so that no money was at stake. Both effects may bias the results away from recommending rollovers.

Because we did not specify a fixed set of response options, the responses we received were varied, as indicated in Table 2. Among these advisers, the issue of fees was more commonly discussed. Four advisers recognized the extremely low fees charged by the TSP and recommended against rolling over. One of these advisers recommended rolling other pension accounts into the TSP. The majority of advisers argued that in some circumstances a rollover might be advisable. Because it is our conclusion that in most circumstances it would not be advisable, the effect of having a fiduciary standard is weaker than we expected. It appears that having a conflict of interest still affects the quality of advice. For those advisers, we do not know whether they would recommend a rollover to most of their clients, but that is a possibility, given

the responses. Nonetheless, when comparing these responses with those in the earlier survey, the null hypothesis is rejected—the two sets of responses are statistically different at the 2.5 percent level according to a chi square test.

One reason why some advisers may recommend a rollover from the TSP is that they have misperceptions concerning the TSP. For example, one adviser told us that the TSP does not have investments in corporate bonds, which it does, and that a comparable Vanguard fund had lower fees, which it does not.

Table 2. Email survey results of fee-only advisers with a fiduciary standard

Outcome	Number of Firms
Advised not to roll over because of low fees	4
Advised not to roll over during accumulation phase, but would recommend rollover during the distribution phase	2
Would recommend partial rollover in some circumstances for greater diversification	3
Would recommend rollover in some circumstances, depending on the individual situation	4
Recommended a rollover for greater diversification	2
Total	15

Source: authors' calculations

This survey suggests that having a fiduciary duty does affect the advice advisers provide. However, the survey suggests that advisers with a fiduciary duty often use the argument that a rollover would provide the opportunity for greater diversification, which is true, without the adviser considering the extra cost in fees that a rollover would entail. This finding suggests that in addition to a fiduciary standard, education of advisers may be needed as to what a fiduciary standard implies, particularly with respect to the cost of alternative investment approaches. Greater enforcement may also be needed.

Further Reasons Why an Adviser May Advise a Rollover

We have already identified two general categories of reasons why an adviser might advise a rollover from the TSP. First, under limited circumstances, a rollover may be good advice. Second, the adviser may be acting based on a conflict of interest. In addition to those sets of reasons, based on our surveys, we now add two other categories.

First, we encountered advisers who are not familiar with the TSP or have incorrect information about it which makes it seem to be less favorable than it is.

Second, advisers may have valid reasons for recommending a rollover, but they fail to balance those reasons against the cost of the rollover in terms of higher fees. Thus, their analysis is flawed by not taking into account costs. In effect, they are telling a half-truth because they are not divulging all the relevant information, and in particular they are ignoring fees. They are not alone in this last respect. NASDAQ (2010) lists five common errors in making rollovers to IRAs,

but it does not include considering differences in fees. Similarly, the SEC (2015) provides information on the availability of rollovers, but it does not mention that the person should consider the level of fees in the new plan versus the old plan. FINRA (2013) provides the following advice: “An IRA often enables an investor to select from a broader range of investment options than a plan. The importance of this factor will depend in part on how satisfied the investor is with the options available in the plan under consideration. For example, an investor who is satisfied by the low-cost institutional funds available in some plans may not regard an IRA’s broader array of investments as an important factor.” This advice does not indicate that the extra diversification should be weighed against the extra cost.

Counter Arguments

This section responds to two counter arguments—first, that the TSP offers too few options and second, that higher fees can be paying for other services, such as peace of mind and having a person to interact with.

Does the TSP Offer Too Few Options? One of the main criticisms of the TSP by advisers advocating rollovers from it is that it offers too few funds. A survey of TSP active participants found that 36 percent would roll over once they left federal employment to access more or better investment options (Long 2014). Thus, addressing this issue is key in evaluating the advice that TSP participants receive. Hewitt (2013) addresses the question of whether a non-U.S. bond fund and other categories of investments not currently included in the TSP funds should be added. For some categories, such as value and growth stocks, and real estate, it concludes that the TSP funds already provide access to investments in those areas. For the non-U.S. bond fund, it concludes that a small improvement in the efficient frontier (risk-return tradeoff) would be obtained for participants, particularly those with low-risk portfolios.

The TSP stock funds do not cover emerging markets, Canada, and international small capitalization stocks, and its other investment options do not international bonds. Copeland (2013) finds that in aggregate, IRA participants invest 13.8 percent of their assets in the category “other,” which refers to investments not in stocks, bonds, or target date funds. This finding suggests that IRA participants do hold a wider range of investments, since the TSP does not have any investments in that category. The TSP does not offer actively managed funds.

Adding new funds would improve the opportunity for diversification, but because the TSP already offers wide diversification in international and domestic stocks and domestic bonds, the benefits of increased diversification are likely to be relatively small. Investment advisers encouraging rollovers for this reason apparently do not weigh the relatively small benefits against the costs in increased fees. Advisers with a conflict of interest need a justification for advising a rollover, but it appears that when they find one, they do not fully explore its merits. They provide self-interested analysis that justifies their self-interested advice.

In addition to traditional arguments relating to the advantage of having more choice versus the added costs, behavioral economics also provides analysis. The paradox of choice refers to the negative effects of having too many choices. For some pension participants, having too many options may make investment decisions more difficult, which would cause the limited options in

the TSP to be an advantage. Several studies have documented problems people have generally in making decisions when facing a large number of options (Iyengar and Lepper 2000, Carosa 2011). Despite the concept from traditional economics that more options are always better, recent research has documented that for psychological reasons of mental overload, above a minimum level, fewer choices are better for many people when the remaining choices allow a sufficient range of choice. A further study found that too many investment options in 401(k) plans lowered participation rates (Iyengar, Huberman and Jiang 2004). The idea that having unlimited choice is a good feature is thus not supported by behavioral research.

Another aspect of too much choice, in the context of IRAs, is that there may be a tradeoff between quantity of choice and quality of choice, with a larger number of choices including more options that are of poor quality, having high fees, poor rates of return and being poorly diversified because of their limited scope (Goldreich and Halaburda 2011).

In the TSP, where the choices have been preselected by financial experts, the average quality of choice is better than for IRA participants who face a much larger range of choice, with limited or no elimination of poorly performing investment options. Because the TSP has a preselected choice of investments, it may be easier for participants to make good investment choices in that setting than with an IRA, particularly for participants who are not financially sophisticated.

Are Higher Fees Justified by Other Services? The response to this argument is basically the same as for the preceding argument. The fees may be paying for other services besides asset management. The question is, does the marginal value of the other services justify the substantially higher cost incurred by rolling over?

CONCLUSIONS

We argue that a logical place to look for bad advice concerning pension rollovers is participants in a really low-fee plan. The same words spoken to participants in a high-fee plan advocating a rollover may be good advice, while they would be bad advice to someone in a really low-fee plan. While a lower-cost investment option is not always the best choice, when the cost difference is large, the cost of not taking that option needs to be considered.

Because of the low fees the Thrift Savings Plan charges and the quality of the investment options it provides, the advice provided by financial advisers concerning rollovers from the TSP permits a particularly strong test of the hypothesis that the standard used by many financial advisers concerning the advice they provide is low. The Thrift Savings Plan provides participants uniquely low fees, many times lower than fees generally available in IRAs.

Because of its very low fees, for most people it would be bad advice to rollover from the TSP. For this reason, the advice does not even meet the suitability standard, much less the standard that it is in the best interest of the client. On average, workers taking this advice appear to be paying more than \$20,000 extra in present value of fees compared to if they had stayed in the TSP. In some cases, the fees are more than 70 times larger. We thus provide evidence of insensitivity by some pension participants to large differences in fees. We argue that this is the outcome of financial illiteracy meeting conflicted advice.

Advisers with a conflict of interest need a justification for advising a rollover, which for the TSP often is the possibility of greater diversification. However, it appears that when conflicted advisers find a justification, they do not weigh the added costs against the benefits. Our surveys suggest that a fiduciary standard does have some effect on advice, but it does not guarantee good advice. It appears that advisers with a conflict of interest concerning rollovers may engage in a partial analysis that justifies their position, focusing on the benefits of a rollover, while not fully considering the costs.

In sum, we provide evidence on the following points. First, traditional economics (rationality) and behavioral economics (inertia) cannot explain TSP rollovers. We argue that a new decision-making model is needed. The model we present is financial illiteracy with conflicted advice, which is in the class of models relating to agency problems. Second, pension participant inertia has been overcome by advice, and for other reasons. Pension participant inertia appears to depend on the context, being less at the point of job change than while working for the employer. This concept relates to research on “fresh starts,” indicating that people are more likely to make changes following the New Year or a birthday (Benartzi et al. 2015).

Third, because of the financial illiteracy of many people and the conflicts of interest of advisers, the market for financial advice may result in bad outcomes for clients. Fourth, some people are insensitive to large differences in fees. While not everyone rolling over from the TSP does so because of financial advice, those rolling over for other reasons appear often to not be taking into account the cost of doing so in terms of higher fees. The insensitivity to fees may be due in part to lack of knowledge of the fees the person is paying and lack of knowledge relating to the effect of apparently small differences in fees. Fifth, some people are not aware when they are receiving bad advice. Bad advice has been followed by pension participants, presumably due to financial illiteracy. Sixth, bad advice can be very costly, with a present value cost of roughly \$20,000 for a person making the average TSP rollover.

Seventh, the analysis of conflicts of interest for pension rollovers differs from the standard analysis of conflicts of interest concerning investment advice. When advising concerning rollovers, advisers generally have a conflict of interest, even if they charge by the hour or by assets under management, because the rollover will lead to the need for further advice in the future. Eighth, in our survey of advice, we find that among advisers with a suitability standard, fees were rarely mentioned. Ninth, advisers with a conflict of interest need a justification for advising a rollover, but it appears that when they find one, they do not fully explore its merits. It appears that even advisers with a fiduciary duty often do not weigh the costs of higher fees against the benefits of a rollover, that being, for example, the benefits of marginally greater diversification. They are telling a half-truth because they do not fully divulge the relevant information.

Tenth, existing regulatory standards, as they currently are enforced, are not adequate to protect pension participants from seriously bad advice. Eleventh, a fiduciary standard, in particular the SEC standard, for advisers does make a difference, but it does not completely solve the problem that arises from the financial incentives inherent in their conflicts of interest. Just making an adviser a fiduciary is not sufficient to overcome self-interest and assure good advice for clients.

They may use self-interested analysis to support self-interested advice, with the end result being harm to pension participants.

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ⁱ We have received valuable comments from Brigitte Madrian, David Laibson and other participants in a session at the 2015 American Economic Association meetings; from Natalya Shnitser and Peter Weidenbeck and other participants at the Fourth Annual ERISA Scholars Conference, from Ike Brannon and other participants at the Savings & Retirement Forum, from Anna Maria I Lusardi and other participants in the Global Financial Literacy Excellence Center Seminar on Financial Literacy, and from Stewart Kaplan, Daniel Kasprzyk, Anna Rappaport and Steve Vernon.

ⁱⁱ Unless otherwise indicated, we are referring to the SEC fiduciary standard. Different organizations have different fiduciary standards, as discussed later in the paper. The SEC standards are not as stringent as standards found in ERISA and the IRC. In particular, the SEC generally permits self-dealing transactions that would largely be prohibited under ERISA and the IRC, as long as the Registered Investment Adviser (RIA) fully discloses the conflict to the client.

ⁱⁱⁱ Some of the transfers may have been for the purpose of making a withdrawal, while avoiding the 20 percent withholding tax. We have no information on the importance of that strategy.

^{iv} We presented the following scenario. "I am a retired Federal employee. I am trying to decide whether I should keep my Thrift Savings Plan account or I should roll it over to an IRA. What would you advise?"

^v One adviser told us that he had recently advised his mother-in-law to roll over her TSP account to an IRA.

^{vi} We sent the following email text: "I am an economist investigating advice that fee only financial advisers provide concerning TSP rollovers to IRAs. Would you generally advise a retired federal government employee to roll over their TSP account to an IRA? Thanks for your help."