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## **Preface**

The Thrift Savings Plan is an extremely valuable retirement savings program that takes advantage of its size, scale, and regulatory benefits to leverage higher gains for its participants than are available in private 401(k) plans and Individual Retirement Accounts. The higher overall gains and dramatically lower fees and expenses in the Thrift Savings Plan can account for the potential of tens of thousands of dollars more in retirement. While participation by federal employees is near 90 percent, the Thrift Savings Plan is severely underutilized by the United States Military. Less than half of the military participates in the plan and by making small program changes and improving the educational program regarding the plan, the Federal Retirement Thrift Investment Board can significantly improve military participation in the Thrift Savings Plan for the military.

## **INTRODUCTION**

One of the greatest benefits to United States military service members is being lost in a sea of benefits and programs and is marginalized or disregarded by civilian personal finance experts. To date, there are approximately 100 direct compensation benefits to active, reserve, and retired service members, including 65 special pay and incentive pay programs administered by the Department of Defense (DoD) and the United States Treasury.<sup>1</sup> This is in addition to the more than 40 health benefit programs administered by DoD, Department of Veterans Affairs (VA), and the Department of Health and Human Services and the over 200 distinct Quality of Life programs and benefits administered by eight separate federal agencies.<sup>2</sup> This is a huge amount of benefits for an individual service member to know about, keep track of, and take full advantage of during their entire military service. Compounding the problem is that service members are automatically enrolled in some programs but must request participation in others. What results is something of a benefits blizzard that blinds the service member with all of the choices in benefits and leaves them frozen and unable to make a decision. As a result, many service members miss out on some of the best programs or are simply unable to make a choice about which programs to participate in. Such is the case with the Thrift Saving Plan (TSP), an elegant solution to retirement savings for military service members that is the single greatest program in the financial market today, yet is overshadowed by the military pension system, largely dismissed by civilian financial experts, and incorrectly utilized by military account holders.

## **LITERATURE REVIEW**

When it comes to the Thrift Savings Plan, sources are limited. One source is *The Federal Thrift Savings Plan: A Model for the Private Sector?* produced by the Investment Company

Institute (ICI), a national association of U.S. investment companies. This study reveals that the unique nature and immense size of the Thrift Savings Plan offers advantages that the private sector simply cannot compete with.<sup>3</sup> For example, some of the administrative costs associated with the Thrift Savings Plan are carried by the individual employing government agency and are not charged to the account holder; this leads to extremely low fees and expenses. Additionally, due to the unique relationship between the U.S. Treasury and the Thrift Savings Plan, the Treasury performs some administrative duties free of charge. The study goes on to detail the regulatory advantage that the Thrift Savings Plan benefits from by being held to the requirements of the Federal Employee Retirement System Act (FERSA) of 1986, instead of the much more onerous Employee Retirement Income Security Act (ERISA) of 1974.<sup>4</sup> All civilian retirement savings accounts and programs are held to the requirements of ERISA. Private sector plans are subject to extensive requirements under ERISA and the Internal Revenue Code, including nondiscrimination and top-heavy testing, numerous participant disclosure obligations, procedures for correcting operational and other errors, and filing an annual report with the Department of Labor.<sup>5</sup> ERISA also requires that all account holders in a civilian retirement savings plan be provided paper copies of notices and statements generating huge expenses for printing and postage services that must be passed on to account holders to bear.<sup>6</sup> The Thrift Savings Plan electronically sends notices and statements, unless an account holder specifically requests a paper copy, saving the Thrift Savings Plan millions of dollars in printing and postage expenses alone.<sup>7</sup> The report produced by the ICI is a rare example of companies in the financial industry even addressing the Thrift Savings Plan since it is far superior to the investment products offered by those companies. There is no incentive for financial companies to complete a study or report since none of them can beat or even match the benefits or returns gained for the Thrift Savings

Plan. Any advice from a private company for a federal employee against using the Thrift Saving Plan should be treated with some caution. These companies will invariably try to spell out the virtues of investing primarily in their products first in order for to make the highest earnings from fees and commissions, and the companies often neglect to inform the investor in the hazards that can ensue from this practice.

The Thrift Savings Plan is only offered to federal employees and the military, which generates a prejudice against the Thrift Savings Plan by some financial advisors. Some of this bias is reflected in the comments of personal financial experts, and financial websites simply parrot the same tired comments arguing one should avoid the Thrift Savings Plan: “there are limited investment choices... you should fund Individual Retirement Accounts (IRA) first... and there is no military match”. A match refers to contributions to a 401(k) made by the employer that “matches” the contributions made by the employee up to a predetermined limit. The website, The Military Wallet, a private firm, posted an article outlining the problems with investing in the Thrift Savings Plan that includes limited investment options and no military contribution match.<sup>8</sup> Dave Ramsey is one of the most popular personal finance experts in the country, but his advice falls short regarding the TSP. He advocates investing in an IRA before investing in the Thrift Savings Plan since there is no military match.<sup>9</sup> Another popular personal finance expert, Suze Orman, also recommends investing in an IRA instead of the Thrift Savings Plan due to the lack of a match.<sup>10</sup> These so called experts are right in that there are limited investment choices, and no agency matching contribution funds, but they too overstate the issue as the simple investment options in the Thrift Savings Plan are actually an advantage and the hidden and extremely high fees often related to IRAs negate any employer match. Additionally, these experts appear

completely unaware of the other elements of the Thrift Savings Plan that make it far superior to IRAs.

This key government program has received almost no attention from independent studies assessing its merits. This kind of review is common in the financial industry, but only for actual investments, such as mutual funds, stocks and bonds sold on the open financial market, and financial companies or entities, such as an investment broker or dealer. The Financial Industry Regulatory Authority (FINRA) is a non-governmental organization that monitors the financial marketplace, ensures financial companies comply with all federal regulations, and maintains the audited track records, transparency, and liquidity needed to provide a measure of safety to investors.<sup>11</sup> FINRA, the successor to the National Association of Security Dealers (NASD), also polices the financial industry, as is clear in the case of First Command, a financial investment company that specialized in offering systematic investment plans, which are an alternative to the Thrift Savings Plan and have the same similar structure, to the military. The SEC found that these systematic investment plans offered by First Command carried extremely high fees and that First Command misled military service members about the benefits of First Command's high priced mutual funds and even attempted to stifle service member complaints regarding the investments.<sup>12</sup> First Command was fined 12 million dollars and agreed to the sanctions while neither admitting nor denying the allegations.<sup>13</sup> Additionally, the NASD, before becoming FINRA, issued an investor alert regarding systematic investment plans and recommended that military service members utilize the Thrift Savings Plan instead of these high cost investments.<sup>14</sup> Though not an analysis of the Thrift Savings Plan, the NASD recognized its superiority over systematic investment plans offered by private financial companies.

Interviews were requested from representatives of the Thrift Savings Plan for inclusion in this MMS and were, initially, favorably received. Once the questions posed by the author were submitted to the Thrift Savings Plan Training and Liaison Specialist, they were deemed beyond the scope of the training and liaison specialist's authority to answer. The author's questions were then directed to the Office of External Affairs for the Thrift Savings Plan. The Office of External Affairs responded that all information releasable to the public was located on the FRTIB and TSP websites and no other information would be provided.<sup>15</sup> This situation highlights the difficulty of accessing information regarding the Thrift Savings Plan.

Due to the pronounced lack of independent analysis of Thrift Savings Plan, this MMS includes studies and surveys from the Federal Retirement Thrift Investment Board (Referred to as FRTIB or "the board" throughout the paper). The board is an independent government agency that administers the Thrift Savings Plan. The FRTIB produces their own plans and reports, prepares required financial statements, and conducts their own market research and analysis. The board also hires independent consulting companies to conduct surveys about participants' perspectives, attitudes, understanding, satisfaction, behaviors, and other metrics regarding the Thrift Savings Plan.<sup>16</sup> It is important to note that the information provided in the Participant Behavior and Demographics report only includes the participants under the Federal Employees Retirement System (FERS).<sup>17</sup> It does not include participants under the Civil Service Retirement System (CSRS), the retirement system in use before FERS, or the military.

CSRS participants are a small and declining segment of the Thrift Savings Plan and the information contained in the report was expanded and enhanced with data from the Office of Personnel Management (OPM), which does not maintain data on the military.<sup>18</sup> The Strategic Plan and participant surveys offers key insights into the Thrift Savings Plan, among them, the

use of automatic enrollment for FERS employees and the low rates of participation for the services of the military. Automatically enrolling all new federal employees has had a significant impact on short tenured employees, those with less than two years of service, who are also the lowest paid participants. In 2010, all new federal employees were automatically enrolled in the Thrift Savings Plan upon hire unless an active election not to participate was completed.<sup>19</sup> The contribution rate for automatic enrollment is established at three percent for new federal employees.<sup>20</sup>

Before automatic enrollment, Thrift Savings Plan participation rates for the newest employees were the lowest for any tenured band at 81.5 percent; yet, two years after automatic enrollment began, shortest tenured employees now participated at the highest rate, 98.3 percent.<sup>21</sup> For a comparison, the overall FERS employee participation rate is 89.6 percent.<sup>22</sup> The board's Strategic Plan identifies the military as a potential source of growth for the Thrift Savings Plan due to the 1.2 million service members who are eligible to participate in the plan but currently do not.<sup>23</sup> With a total participation rate of 42 percent, less than half of the total participation rate of federal employees, the 1.2 million service members not currently participating in the Thrift Savings Plan represent an underserved segment of eligible participants that should be educated in the benefits of the best retirement savings program. The success of the automatic enrollment for new FERS employees, and the low rate of participation in the military, presents an excellent opportunity for growth in Thrift Savings Plan participation by automatically enrolling newly enlisted and commissioned members of the military. Military members should still be able to opt out of the Thrift Savings Plan before the automatic enrollment occurs, but the choice not to use the best retirement savings plan offered today would be a conscious and deliberate one.

## **THE THRIFT SAVINGS PLAN**

The Thrift Savings Plan is a retirement savings and investment plan that was created for federal employees and members of the military. It was enacted into law under the Federal Employees Retirement System Act (FERSA) of 1986 and extended to the military in 2002. The Thrift Savings Plan offers the same savings and tax benefits as civilian 401(k) plans offered in the private sector.<sup>24</sup> The Thrift Savings Plan is considered a defined contribution plan, which means that income received in retirement from the Thrift Savings Plan will depend entirely on how much money is contributed to the account and the earnings gained on those contributions. The Federal Retirement Thrift Investment Board administers the Thrift Savings Plan and is required by law to prudently manage the Plan solely in the interest of the participants and their beneficiaries. This represents a fiduciary duty, which is the highest standard of responsibility. The board is comprised of five presidentially appointed board members and an Executive Director. Additionally, the board is advised by the Employee Thrift Advisory Council (ETAC), which is a statutorily created Advisor Committee comprised of representatives of employee organizations, unions, and the military.<sup>25</sup> The Thrift Savings Plan is a simple and efficiently managed retirement savings plan, but the beauty of the Thrift Savings Plan is its ability to leverage its products and services into the best retirement savings plan in the financial market today.

Though very similar to a corporate 401(k) account, the Thrift Savings Plan has several distinct advantages over these private sector plans. First, the Thrift Savings Plan receives higher interest rates on government securities than are possible in the private sector. Second, the Thrift Savings Plan tracks the contributions service members make from tax-exempt income, often while deployed in a combat tax exclusion zone. Third, the Thrift Savings Plan offers five distinct

investment options that are simple, broadly diversified, and do not overlap across asset classes. Finally, the biggest advantage of the Thrift Savings Plan is the extremely low investment fund expense ratios that allow for more earning from service member contributions. These advantages result in higher overall account returns, lower taxes on contributions or withdrawals, and lower levels of risk.

How does the Thrift Savings Plan gain higher overall account returns? The Thrift Savings Plan maintains a special relationship with the United States Treasury that allows the Thrift Savings Plan to receive long-term gains on short-term treasury securities. By law, the Thrift Savings Plan G Fund must be invested in non-marketable U.S. Treasury securities specially issued to the Thrift Savings Plan.<sup>26</sup> The securities are held electronically with the Treasury so there are no transaction fees associated with the purchase or sale of the securities and these investments earn a statutory interest rate equal to the average market yield on marketable Treasury securities with four or more years to maturity.<sup>27</sup> This advantage means that the Thrift Savings Plan G Fund currently earns interest at the rate for securities with a maturity of 11 years on extremely short-term (daily) securities. This outperforms even 90-day U.S. Treasury securities offered to the general public on the open market by nearly two percent without any risk of principal loss.<sup>28</sup> Even during the worst economic recession in decades that saw the C Fund lose over one third of its total value in 2008, the G Fund not only prevented capital loss, it gained 3.75 percent during the same year, 2008.<sup>29</sup> Additionally, the G Fund has been able to outpace inflation since the fund was established in 1987, protecting purchasing power and providing growth. For example, an investment of \$100 in the G Fund at inception, April 1, 1987, would be worth \$424 at the end of 2013 while inflation only grew to \$208.<sup>30</sup>

The Thrift Savings Plan is designed around the federal pay system, easily administered through the Defense Finance and Accounting Service website MyPay, and is a benefit that no other civilian 401(k) or IRA can match. This benefit is particularly powerful during any military deployment to an income tax exclusion zone. The Thrift Savings Plan will track the contributions made while receiving tax-free income and will ensure that those contributions remain tax-free when they are withdrawn. Additionally, while a service member receives tax-free income, that service member is able to contribute significantly more pay to their account as they are no longer subject to the Internal Revenue Service (IRS) Elective Deferral Limit and instead are allowed the much higher Annual Addition Limit.<sup>31</sup> For example, the 2014 Elective Deferral Limit was only \$17,500; however, the Annual Addition Limit was much higher at \$52,000.<sup>32</sup> With the potential for multiple deployments over a career or even a single enlistment, tax-free contributions could make up a significant amount of total contributions. These tax-free contributions would be converted to taxable income if the service member utilized an IRA instead of the Thrift Savings Plan for retirement savings.

The five individual funds of the Thrift Savings Plan are broadly diversified across all asset classes and provide very little overlap. This ensures that participants know which securities they are invested in and exposes them to the widest range of assets to protect against volatile market swings. The G Fund, as previously stated, is invested in specially issued U.S. Treasury securities that are guaranteed to never lose value. The remaining funds of the Thrift Savings Plan are index funds that are designed to mirror a market index. An index is a measure of the value of a section of a financial market. The Thrift Savings Plan uses indexing for the remaining funds. The F Fund mirrors the Barclays Capital U.S. Aggregate Bond Index and is invested in U.S. Treasury and Agency bonds, asset-backed securities, and corporate bonds.<sup>33</sup> The C Fund consists

entirely of the stocks of the largest 500 companies in the U.S. stock market and mirrors the Standard and Poors 500 Index (S&P 500).<sup>34</sup> The S&P 500 accounts for about 70 percent of the total U.S. stock market. The S Fund is made up of the stocks of the companies in the remaining 30 percent of the U.S. stock market and mirrors the Dow Jones U.S. Completion Total Stock Market Index.<sup>35</sup> Together, the C and the S Funds make up nearly the entire U.S. stock market. The final fund, the I Fund, mirrors the Morgan Stanley Capital International Europe, Australasia, and Far East Index and is invested in the stocks of companies in the developed countries outside of the United States. Each of the individual funds is invested in securities, assets, or stocks that are not included in the other funds; therefore, each investment is mutually exclusive of the other funds. This prevents a participant's account from becoming over-weighted in one asset sector without realizing it. In other words, investing in the different Thrift Savings Plan funds provides the greatest potential for diversification. Each of the funds of the Thrift Savings Plan provides service members a powerful and simple investment option that has fees and expenses far below other funds offered to the civilian sector.

Indexing is one of the ways the Thrift Savings Plan is able to keep fees and expenses so low. Indexing is a simple and powerful investing plan that uses a stock market index to select the investments in a mutual fund. A stock market index is an aggregate value produced by combining several stocks or other investment vehicles together and expressing their total values against a base value from a specific date and are intended to represent an entire stock market and thus track the market's changes over time.<sup>36</sup> Since the index is a mathematical construct, it may not be invested in directly but can be used as a construct to create a mutual fund that is referred to as an index fund. By mirroring a stock market index, there is no need for an index fund to pay for investment research or an active fund manager and since fund investments only change when

the index does transaction costs and administration expenses are kept very low. Index funds buy and hold the stocks in all or one segment of the financial market and are used to limit fees and maximize returns.<sup>37</sup> Indexing eliminates the anxiety and expense of trying to predict which individual stocks or mutual funds will beat the market and has outperformed all but a handful of the thousands of equity and bond funds that are sold to the public.<sup>38</sup> Indexing avoids the “crowd” phenomena of trying to beat the market by investing in popular stocks with prices that are rising and already near yearly or historical highs and then selling those stocks when they fall out of favor and the prices are falling. Individuals that do not typically trade equities often and do not have the financial education and knowledge to withstand the volatilities of the market, such as most military service members, follow this crowd behavior. Investing in the Thrift Savings Plan protects against the crowd phenomenon since the Thrift Savings Plan uses index funds as the foundation of four of the five individual funds.

All funds in the financial market have fees and expenses related to managing the fund and the Thrift Savings Plan is no different. The Thrift Savings Plan’s size and scale however sets it apart from civilian plans. The Thrift Savings Plan currently has over 4.7 million account holders and manages over 400 billion dollars in investments that mirror top rated indices to keep transaction costs and management fees to a minimum. The enormous scale allows the board to spread the small amount of fees, expenses and administrative costs of the Thrift Savings Plan across all of the account holders which results in costs dramatically lower than civilian plans. The net expense ratio for each Thrift Savings Plan account is 2.9 basis points or .029 percent.<sup>39</sup> This means that expenses charged to each Thrift Savings Plan account were approximately 29 cents for every 1000 dollars invested. With the average cost of civilian 401(k) accounts at 75 to 150 basis points, this represents costs 30 to 50 times more expensive than the Thrift Savings Plan

and could account for an additional \$75,000 to \$120,000 in earnings at retirement over civilian accounts.<sup>40</sup>

Many critics of the Thrift Savings Plan often cite the small number of investment choices in the program as a detractor.<sup>41</sup> Choice is viewed by many economists, and some policy makers, as always beneficial.<sup>42</sup> The recent explosion of investment options in defined contribution plans offered to civilians by their employer and financial companies that offer an IRA is an example of that thinking. There are costs associated with expanded choice though and those costs come in three kinds; time, error, and psychic costs.<sup>43</sup> It takes a great deal of time to thoroughly research and investigate investments to determine if they are suitable for your portfolio. The more investment choices presented the greater the amount of time required to properly allocate your retirement savings. This reduces the amount of time for other activities. As the demands on time increase, people become increasingly anxious about whether they are making the best use of scarce hours and minutes, regretful about tasks left undone, and guilty about relationships that are neglected.<sup>44</sup> The error cost associated with more choice is people's tendency to choose badly who people lack expertise.<sup>45</sup> For example, when faced with choices where the outcome is uncertain, people tend to be highly risk averse.<sup>46</sup> Being risk adverse with your retirement savings can result in lower returns on investments and smaller account balances in retirement. Psychic costs are when people tend to avoid decisions with a high potential for regret, some such decisions are unavoidable, and feelings of regret about decisions that turned out badly remain an important source of personal misery and thus an added potential cost of expanding choice.<sup>47</sup>

A large number of investment options are seen as offering more freedom, choice, and control to individual investors. There is research to the contrary, though. In his book, *The Paradox of Choice*, Dr. Barry Schwartz describes how the increasing number of options may

bring powerful and positive feelings of autonomy, control, and liberation, but as the number of choices continues to increase, negative aspects begin to appear and as choices continue to rise, it becomes overwhelming and debilitating.<sup>48</sup> The fact that some choice is good does not necessarily mean that more choice is better.<sup>49</sup> The hundreds or even thousands of investment options offered in IRAs or civilian 401(k) plans often creates paralysis for participants instead of financial freedom.<sup>50</sup> With so many options to choose from, people often do not chose at all. This is due to the difficulty in evaluating numerous investment options and determining which option is actually the best for the participant. In fact, a 2003 study by the Vanguard Center for Retirement Research determined that the probability of a worker participating in a savings plan declines as the number of investment options offered increases.<sup>51</sup> The small number of investment options in the Thrift Savings Plan is actually an advantage over civilian retirement savings plans currently in the financial market today for the average user. The Thrift Savings Plan only offers five simple and easily understood individual funds that make up ten total investment options that are available to all participants.

The remaining investment choices in the Thrift Savings Plan, besides individual funds, are Lifecycle funds, or L Funds. A lifecycle fund is a mutual fund in which the relational allocation of an asset class in a fund's portfolio is automatically adjusted during the course of the fund's time horizon. The lifecycle fund's portfolio begins with a higher risk position that typically weighted towards equities and automatically changes to one of lower risk that typically weights towards bonds and treasuries mirroring the professionally recommended asset allocation based on the investor's time horizon. In other words, as an investor ages, the fund moves from riskier investments toward safer investments. The L Funds in the Thrift Savings Plan use professionally determined investment mixes that are tailored to meet investment objectives based

on various time horizons to strike an optimal balance between risk and return.<sup>52</sup> The L Funds are made up of the five individual investment options in the Thrift Savings Plan and have the same extremely low fee ratios. The L Funds offered in the Thrift Savings Plan are L Income, L 2020, L 2030, L 2040, and L 2050.<sup>53</sup> Each number represents the year closest to the investor's retirement date and L Income represents the most conservative lifecycle fund and is intended for investors that will make withdrawals from their account in the near future.

An L Fund in the Thrift Savings Plan is a great resting place for money in the long term for retirement if the person does not want to spend a lot of time researching and analyzing investment options. This fact presents an excellent opportunity to improve the earnings of a large number of Thrift Savings Plan account holders by defaulting the contributions to the Thrift Savings Plan to an appropriate L Fund. Currently, individual contributions to the Thrift Savings Plan are defaulted to the G Fund until the account holder changes the investment allocation. This results in the G Fund managing the most contributions of any Thrift Savings Plan fund and indicates that a large percentage of participants are receiving a very small return on their investment. To change contributions allocations, login details and information must be received through regular mail after the participant opens a Thrift Savings Plan account through the employing agency. This additional step requiring users to allocate contributions past the G Fund default results in service members leaving their entire contribution allocation in a fund that, while very safe and guaranteed to never lose money, underperforms when compared to the L Funds. A much better default fund would be an appropriate L Fund based on the participants age.

The current military pension system is a comprehensive and complex system of pays and benefits that has been in place for decades and is paid to a military service member who has reached at least 20 years of active duty service. The vast majority of the information and advice

on military retirement is dedicated to the military pension system completely overshadowing the Thrift Savings Plan. It is easy to understand why this happens. The military pension is extremely valuable, very complex, and it is often difficult to determine which program to use to maximize your retired pay. Much of the study and research regarding the military pension system is devoted to the differences in the pension programs and largely ignores the tremendous benefit of the Thrift Savings Plan. Additionally, the military pension program accounts for a large portion of the annual DoD budget that is already the subject of much debate and conjecture and precludes any matching of Thrift Savings Plan contributions for military service members.

In an effort to reduce the costs associated with a defined benefit pension plan; employers in the early 1980s began moving away from the traditional pension and toward a defined contribution retirement plan, the 401(k). Defined contribution plans have become so popular that now the majority of corporate retirement plans are defined contribution. The employer's portion of the defined contribution program is in the form of matching funds. Matching funds are contributions made by an employer on behalf of the employee to the employee's retirement savings account equal to a predetermined percentage. All military service members are covered by the military retirement pension plan and the DoD does not currently match any Thrift Savings Plan contributions.

Since the DoD does not match military service members' Thrift Savings Plan contributions, financial advisors and personal finance experts, like Dave Ramsey and Suze Orman, mostly ignore or discount the Thrift Savings Plan in favor of an IRA. Investing retirement savings in an IRA often results in higher fees, lower account balances, and lower returns on investments compared with 401(k) accounts due to many financial advisors offering "conflicted advice". Conflicted advice is advice given by financial advisers that steer savers into

products or investment strategies that provide larger payments to the adviser but are not necessarily the best choice for the saver.<sup>54</sup> Due to the conflicted payments to financial advisers, the mutual funds that investors are steered towards often have significantly higher expense ratios than the Thrift Savings Plan. The Council of Economic Advisors released a report February 2015, detailing how this “advice” impacts IRA owners. IRA investors are particularly vulnerable due to the unique nature of the IRA market.<sup>55</sup> Most investors do not contribute directly to an IRA and instead, the majority of money flowing into the IRA market comes from funds rolled over from employers’ plans such as a 401(k).<sup>56</sup> A roll over is a method to transfer tax advantaged retirement savings from one account to another without incurring withdrawal and tax penalties. A large amount of savings could have been accumulated in the employer’s plan and the investor is now potentially making decisions without the full knowledge about their options or a complete understanding of the regulatory differences between the accounts.<sup>57</sup> Most notably, the advice to roll money out of a 401(k) and into an IRA is subject to a much lower standard of care than received in the employer plan.<sup>58</sup> The fees inside an IRA are also typically higher than a private sector 401(k) making a roll over into an IRA a poor decision that could potentially account for a reduction of 12 percent at retirement.<sup>59</sup> These fees include front-end sales load, back-end sales load, and revenue sharing arrangements between the mutual fund and the financial advisor that recommends them.<sup>60</sup> It is important to note that the 12 percent reduction at retirement is calculated with average 401(k) expense ratios and the Thrift Savings Plan expense ratios are significantly lower meaning that for Thrift Savings Plan account holders the reduction at retirement would be much higher than 12 percent and IRA roll overs should not be considered at all.<sup>61</sup>

Not only does the conflicted advice increase the expenses of the recommended fund but overall fund performance is also impacted by conflicted advice. Research into the performance of investments recommended through conflicted advice reveals that even when returns are examined without the extra cost associated with IRA investments, they still underperform most of the investments offered through a 401(k) plan.<sup>62</sup> The vast majority of investments that offer the most or highest payments to financial advisors are actively managed funds sold through intermediaries, and these funds underperform lower fee, passively managed funds also sold through intermediaries.<sup>63</sup> This means that not only are IRA investors saddled with higher fees and expenses that erode their return on investment, that return is less than what they would otherwise receive from a 401(k).

#### **USING THE PLAN TO FULL ADVANTAGE**

The problem of conflicted advice greatly affects military service members once they separate or retire from the military. The questions about what to do with your Thrift Savings Plan account post-service have always been a difficult question. Once you leave active duty, you can no longer contribute regular monthly installments into your account and even at military retirement, the service member is years away from being able to withdraw funds without penalty. Financial advisors will use this information to persuade service members to roll the Thrift Savings Plan funds into a managed account at a large investment firm, although most TSP holders do not understand the dangers of this conflicted advice. This financial advice offered to military service members is typically a thinly veiled sales pitch in order to earn commissions for the advisor. With 4.7 million accounts and nearly 400 billion dollars in total value, the Thrift Savings Plan is a significant source of potential fees and commissions for financial advisors. At a modest one to two percent fee, the Thrift Savings Plan represents four to eight billion dollars a

year in potential income for financial investment companies. All of these financial companies recommend that military service members open an account with their company to roll over the funds in the Thrift Savings Plan. This recommendation is not only flawed, it can potentially cost the service member tens of thousands of dollars in fees, severely undercut account performance, and reduce retirement savings.

This is not, however, the only way service members mismanage their Thrift Savings Plan account. Service members also place their retirement savings in jeopardy by taking out a loan from their Thrift Savings Plan account. While essentially paying themselves interest from the loan, many service members fail to realize the devastating effects of a loan from your Thrift Savings Plan account. When funds are withdrawn from the account for the loan, those funds are no longer available in the account to earn interest or grow in value. The interest earned on the loan is often far less than the potential earning inside the fund, hampering the ability of the account to grow earnings.<sup>64</sup> The damage is made permanent if a service member separates from active duty while having a loan out from their account. If there is an outstanding loan when you leave Federal service, you must pay it back within 90 days or the outstanding balance will be treated as taxable income.<sup>65</sup> The benefits of the Thrift Savings Plan are only received when money is put into the plan, one should never take money out of the Thrift Savings Plan until retirement.

While experts in the financial industry have called the military pension system unfair, unaffordable and inflexible, this is not a uniform critique. Many aspects of that military system are quite viable and profitable, notably the Thrift Savings Plan. The Thrift Savings Plan is available to every service member regardless of rank or service length, the plan has extremely low fees, and is very flexible, yet too few service members take advantage of the program. Only

about 40 percent of the uniformed services participate in the Thrift Savings Plan, but this number includes the National Oceanic and Atmospheric Administration (NOAA) and the Public Health Administration (PHA) as they are considered uniformed services.<sup>66</sup> Although both organizations have high rates of participation, they account for less than 5000 Thrift Savings Plan participants due to their small size.<sup>67</sup> Currently, the United States Navy is the only military service with more than half of its members using the Thrift Savings Plan at 59 percent and the other services are significantly lower.<sup>68</sup> The Marines and the Army have about a third of their service members using the Thrift Savings Plan at 33 and 32 percent respectively and the Air Force is slightly higher at 38 percent.<sup>69</sup> Each service member is 100 percent vested in their Thrift Savings Plan account immediately upon enrollment, and is able to take that money with them when they separate or retire from the military. The advantages of the Thrift Savings Plan over typical civilian 401(k) accounts or IRAs are so clear that each military service member should not only open a Thrift Savings Plan account but also keep that account well into retirement.

## **CONCLUSION**

That a more complete enrollment does not unfold is a topic requiring further study. One could point to a distinct distrust of the government and the belief that government programs are often inferior to private ones. That contradiction is confounding, surprising, and of course harms the service member. To get the Thrift Savings Plan into the sights of service members to allow them to take advantage of that plan, the following simple steps are suggested. First, automatically enroll new service members upon commissioning and enlistment into the Thrift Savings Plan. Automatic enrollment significantly increased the level of participation of the newest federal employees, and that demographic now has the highest participation rate at 98.3 percent. That program should be extended to military service members.<sup>70</sup> Second, encourage

members to change the default investment fund from the G Fund to an L Fund that corresponds to the service member's age. Each L Fund invests in a mix of the five individual funds that is chosen by experts based on each fund's time horizon.<sup>71</sup> Since the investment allocations change over time to a more conservative mix, L Funds provide the highest expected rate of return for the amount of risk expected over a service member's time horizon and is a much more appropriate default than the government securities fund to provide, not only protection against inflation, but also growth. Third, expand the financial education program for the Thrift Savings Plan. There are currently 1.2 million service members who are eligible to participate in the Thrift Saving Plan but do not. The Federal Retirement Thrift Investment Board needs to implement an education and communication program for potential participants, not just participants. The current strategic plan for the board only addresses the needs of current plan participants and does not include an outreach program to increase plan participation for those eligible. Of course, the DoD and each service bear some of this responsibility as the employing agency, but educational efforts could be performed in concert. Additionally, the board needs to better explain the advantages that the TSP enjoys over other 401(k) programs and IRAs during and after the service career. Too many service members have been sold inferior financial products and funds through conflicted advice, and this misdirection is undermining their potential retirement income often without the proper knowledge of their options specifying the regulatory differences between the plans. An expanded education program that discloses the powerful benefits and advantages of the Thrift Savings Plan and greater transparency regarding the dramatically reduced fee structure of the plan compared to IRAs will work to change the mindset of dismissing the government as somehow nefarious when it comes to money, and will demonstrate

that the Thrift Savings Plan truly is the greatest retirement savings plan in the financial market today.

## ENDNOTES

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<sup>3</sup> Investment Company Institute, *The Federal Thrift Savings Plan: A Model for the Private Sector?* (Washington, DC: Investment Company Institute, 2008), 1.

<sup>4</sup> *Ibid.*, 2.

<sup>5</sup> *Ibid.*, 3.

<sup>6</sup> *Ibid.*, 3.

<sup>7</sup> *Ibid.*, 3.

<sup>8</sup> “Disadvantages to Investing in the Thrift Savings Plan,” Ryan Guina, *The Military Wallet*, last modified May 23, 2012, 1. <http://themilitarywallet.com/disadvantages-investing-thrift-savings-plan-tsp/>

<sup>9</sup> “Dave’s Investment Philosophy,” Dave Ramsey, *daveramsey.com*, last modified July 14, 2009, [http://www.daveramsey.com/articles/article/articleID/daves-investing-philosophy/category/lifeandmoney\\_investing/](http://www.daveramsey.com/articles/article/articleID/daves-investing-philosophy/category/lifeandmoney_investing/)

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<sup>11</sup> Securities and Exchange Commission *Self-Regulatory Organizations Release: No. 34-56145; File No. SR-NASD-2007-023* (Washington, DC: Securities and Exchange Commission July 26, 2007) <https://www.sec.gov/rules/sro/nasd/2007/34-56145.pdf>

<sup>12</sup> National Association of Securities Dealers, “NASD Orders First Command to Pay \$12 Million for Misleading Statements in Sales of Systematic Investment Plans to Military Personnel” news release, Dec 15, 2004, <http://www.finra.org/newsroom/2004/nasd-orders-first-command-pay-12-million-misleading-statements-sales-systematic>

<sup>13</sup> *Ibid.*

<sup>14</sup> Financial Investor Regulatory Authority, “Systematic Investment Plans—Educate Yourself Before You Enlist” investor alert, October 13 2008. <http://www.finra.org/investors/alerts/systematic-investment-plans—educate-yourself-you-enlist>

<sup>15</sup> Email with Training and Liaison Specialist, Thrift Savings Plan, February 9, 2015.

<sup>16</sup> Thrift Savings Plan, *2013 Thrift Savings Plan Survey Results* (Washington, DC: Thrift Savings Plan, 2013), 2.

<sup>17</sup> Thrift Savings Plan, *Analysis of Participant Behavior and Demographics for 2009–2013* (Washington, DC: Thrift Savings Plan, 2013), 2.

<sup>18</sup> *Ibid.*, 2.

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- <sup>19</sup> Ibid, 3.
- <sup>20</sup> Ibid, 6.
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- <sup>22</sup> Ibid, 2.
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- <sup>24</sup> “Who Administers the TSP?” Federal Retirement Thrift Investment Board, *TSP.gov* accessed March 7 2015, <https://www.tsp.gov/planparticipation/about/purposeAndHistory.shtml>
- <sup>25</sup> Ibid.
- <sup>26</sup> Thrift Savings Plan, “G Fund: Government Securities Investment Fund” (hand out, Thrift Savings Plan, Washington, DC, 2014), 1.
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- <sup>47</sup> Ibid, 6.
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- <sup>57</sup> Ibid, 8.
- <sup>58</sup> Ibid, 8.
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- <sup>62</sup> Ibid, 11.
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