

Seed Grant Application Cover Page FY2013

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Amount Requested:

Proposal Title:

PROPOSAL CHECKLIST:

- Abstract
- Narrative (2 single-spaced pages)
- Budget Page
- Biographical Data
- Publications/Exhibits/Performances (5 years)
- Proposals Submitted/Funded (5 years)
- Summary of Previous Seed Grant(s)
- Applicable animal/human requests for approval are attached

Has seed grant previously been awarded? Yes No

ELIGIBILITY:

- Early career faculty establishing scholarly program (5 years or less employment at UI)
- Established faculty transitioning into a new scholarly area

Project Abstract

The Role of Financial Literacy and Social Networks in Retirement Investment Decisions

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Despite the increasing significance of defined contribution (DC) plans in the U.S. private pension system, the retirement income security of the plan participants has become volatile, particularly since the financial crisis in 2008. Since the participants' retirement investment decisions rely primarily on their individual ability to manage financial investments, many scholars pay attention to participants' financial literacy as a key determinant of retirement investments, but they do not consider social contexts in the discussion of financial literacy. Social networks that provide investment advice, however, may also influence investment behaviors. Therefore, this study intends to examine the combined effects of financial literacy and investment advice from social networks on retirement investment behaviors. To achieve this goal, we will interview and conduct a survey of DC plan participants in the Northern Idaho area. Using quantified social network variables based on social network analysis, we will examine the influence of financial literacy and social networks on retirement investments. Our study will extend the existing literature in social networks and investor behavior, but also open up an interdisciplinary area of behavioral finance linked with organizational behavior/human resource management.

Project Narrative

Context and Background

Defined contribution (DC) plans (e.g., 401(k) plans) are now at the heart of the United States private pension system. Over 87 million plan participants held \$3.3 trillion at the end of 2009 (the latest available data from the Department of Labor). Despite the increasing significance of DC plans, DC plan participants' retirement security has become volatile, particularly since the financial crisis in 2008. For example, the average plan assets held by the DC plan participants *dropped* by 23.6 percent from 2007 to 2008, while the average plan assets *increased* by 17.5 percent from 2008 to 2009. This volatile retirement security significantly deteriorates retirement confidence among workers.¹

In the DC plans, investment decisions for retirement predominantly rely on one's individual ability to manage financial investments. Thus, in order to enhance retirement income security, a majority of extant research has highlighted financial literacy (the level of financial knowledge) as a primary determinant of individual ability to manage retirement investments. Assuming that individuals independently make investment decisions, this view did not take into consideration that retirement investment decision-making may be affected not only by individual financial knowledge but also by social interactions. Human beings are social creatures, so they are frequently affected by, interact with, and influence their surroundings. Therefore, this project aims to challenge and improve this dominant view of retirement investment decisions.

Given this context, we suggest that DC plan participants' social contexts as well as financial literacy play a crucial role in retirement investment decisions. Specifically, amongst various social contexts, we propose that understanding the role of social networks in providing financial advice is essential to understanding retirement-investment decision behavior. Drawing on research on social networks and financial literacy, we will focus on how financial literacy and social networks interact in the domain of individual retirement investment decisions.

Contribution to Field and to Professional Development

Interdisciplinary research efforts will be necessary to understand the influence of both financial literacy and social networks on plan participants' retirement investment decisions. The influence of financial knowledge on retirement investments has been well-documented in the finance literature.² However, social influences on retirement investment decisions have been relatively neglected and have only recently started to receive attention.³ This study is the first attempt to combine social networks (in the field of organizational behavior/human resource management)⁴ and investor behavior (in the field of finance) theories,⁵ a combination which will contribute to the strand of the literature that pertains to investor behavior in retirement plans. In order to accomplish our research goal, two scholars, one in organizational behavior/human resource management and one in finance, will collaborate. The interdisciplinary aspect of our research enables us to extend the existing literature on investor behavior in finance by identifying social networks from various sources of social influences. This study will also serve as an opportunity for scholars in organizational behavior/human resource management to expand the likelihood of applying network theories and concepts to other fields.

The contribution of this study is not limited to only research fields; this study may provide practical implications to corporate and government retirement policy makers. To facilitate investment decisions for retirement income security, companies usually distribute the information on new financial products and hold retirement investment seminars. Additionally,

government agencies disseminate the information on retirement investments to the public. For retirement investments, however, workers may not utilize the available information actively, but rather rely on their social networks. Therefore, an understanding of the influence of social networks on investment decisions should convince corporate and government retirement policy makers that their focus for increasing retirement income security should be on identifying and helping workers who lack financial literacy and social networks for financial advice.

This study will also help develop our scholarship. One author's research area focuses on how social networks help build knowledge and ability. The other author's major research area is personal finance and investments. Both scholars will develop their current research areas in further depth and with greater innovation by attempting to combine social networks, financial literacy, and individual investments. We expect that this interdisciplinary area will be growing as individual investment decisions become crucial for retirement income security.

Objectives and Methods

Since no previous research has investigated social networks for advice on retirement planning and investment, developing a theoretical framework on this issue is a pressing need. Hence, the first objective of this project is to identify the critical sources of social networks for retirement investment advice (e.g., spouse, friends, coworkers, etc.) and to understand how people utilize these sources for retirement investment decisions. To do this, we will first get an approval from IRB and then conduct, within a couple of months, semi-structured interviews of approximately 30 workers in local areas who currently participate in DC plans.

Our next objective is to develop a survey and to collect quantitative data. Using the network sources identified through the interviews, we will develop a set of survey questions that include social networks and financial literacy. Then we will conduct either a traditional (paper-and-pencil) or a web survey for several companies in the Northern Idaho area that offer DC plans to employees. We aim to collect the data of approximately 300 respondents within three or four months. To facilitate the data collection process, we will hire a research assistant (an undergraduate or graduate student) who will help us identify potential interviewees and collect the survey data.

Our last objective is to conduct a quantitative analysis to explore the relationships among employees' financial literacy, social networks, and retirement investments. In the data analysis we will quantify the size, quality and diversity of social networks for investment advice, using social network analysis techniques. Using the quantified social networks, we will examine interaction effects between financial literacy and social networks on retirement investment behavior.

Expected Outcomes

The short-term expected outcome of this project will be a paper and a conference presentation. We aim to submit and present this paper at the Academy of Behavioral Finance and Economics conference (conference travel expenses are requested), which is oriented to interdisciplinary scholars in finance, economics, and behavioral sciences. We also intend to publish this paper in the *Journal of Public Economics*, a leading journal in the area of retirement security. These outcomes of the paper may be extended to research for a nationwide sample. Thus, our ultimate goal is to seek external funding for this further research by applying for a grant from the Steven H. Sandell Grant Program sponsored by the U.S. Social Security Administration.

References

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- 2] Lusardi, A. and O. Mitchell (2007). "Baby Boomer Retirement Security: The Roles of Planning, Financial Literacy, and Housing Wealth." *Journal of Monetary Economics*. 54(1): 205-224; Hastings, J. and O. S. Mitchell (2011). "How Financial Literacy and Impatience Shape Retirement Wealth and Investment Behaviors." NBER Working Paper No. 16740 (available at <http://www.nber.org/papers/w167400>).
- 3] Duflo, E. and E. Saez (2002). "Participation and Investment Decision in A Retirement Plan: The Influence of Colleagues' Choices." *Journal of Public Economics* 85: 121-148; Duflo, E. and E. Saez (2003). "The Role of Information and Social Interactions in Retirement Plan Decisions: Evidence from A Randomized Experiment." *Quarterly Journal of Economics* 118: 815-842.
- 4] Adler, P. S. and Kwon, S. W. (2002). "Social Capital: Prospects for a New Concept." *Academy of Management Review*, 27: 17- 40.
- 5] Madrian, B. and D. Shea (2001). "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior." *Quarterly Journal of Economics* 116(4): 1149-1187; Choi, J., D. Laibson, B. Madrian, and A. Metrick (2004). "For Better or For Worse: Default Effects and 401(k) Savings Behavior." Chapter 2 in *Perspectives on the Economics of Aging*, ed. David A. Wise. Chicago: University of Chicago Press; Benartzi, S. and R. Thaler (2007). "Heuristics and Biases in Retirement Savings Behavior." *Journal of Economic Perspectives* 21(3): 81-104.