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Asset allocation and asset location: household evidence from the survey of consumer finances

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Abstract

The rapid growth of assets in self-directed tax-deferred retirement accounts has generated a new set of financial decisions for many households. In addition to deciding which assets to hold, the traditional choice among bonds, stocks, and other investment classes, households with substantial assets in both taxable and tax-deferred accounts (TDA) must now decide where to hold them. This paper uses data from the Survey of Consumer Finances to assess how many households have enough assets in both taxable and tax-deferred accounts to face significant asset location choices. It also investigates the asset location decisions these households make. In 2001, 49% of households had at least some assets in a tax-deferred account, and more than 11 million households had at least US\$25,000 in both a taxable and a tax-deferred account. Asset allocation inside and outside tax-deferred accounts is quite similar, with about 70% of assets in each location invested in equity securities. Roughly two thirds of households with financial assets in both taxable and tax-deferred accounts hold portfolios that are tax efficient. Most of the other third could reduce their taxes by relocating heavily taxed fixed income assets to their tax-deferred account. For more than half of the households that hold apparently tax-inefficient portfolios, however, a shift of less than US\$10,000 in financial assets would eliminate tax inefficiency.

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Households have always faced the asset allocation problem, having to decide which assets to purchase and how much to invest in each of them. The recent growth of self-

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directed retirement plan assets has created a new problem for many households: asset location. This is the question of how much of a given asset to hold in a taxable account, and how much of it to hold in a tax-deferred account (TDA). In the United States, assets in participant-directed tax-deferred accounts totaled nearly 5 trillion dollars at the end of 2001, with US\$2.4 trillion in Individual Retirement Accounts (IRA) and US\$2.3 trillion in 401(k)-type retirement plans. At the end of 1990, by comparison, IRAs totaled US\$637 billion, and there were US\$735 billion in all defined contribution plans.

Asset location has attracted attention from researchers in public finance and financial economics, and is a frequent topic of discussion among financial planners, such as [Novack \(2003\)](#). [Shoven \(1999\)](#) outlined the structure of the asset location problem, and observed that tax minimization would usually dictate holding heavily taxed taxable bonds in the tax-deferred account, with less heavily taxed equities in the taxable account. Recent works by [Amromin \(2002\)](#), [Dammon et al. \(forthcoming\)](#), [Huang \(2001\)](#), [Poterba et al. \(2004\)](#), and [Shoven and Sialm \(2004\)](#) offer further insight on the optimal asset mix for households facing various tax and financial circumstances. The earliest studies of asset location derived very strong rules about optimal asset location in stylized environments. More recent work has emphasized that various institutional realities, such as limitations on the set of investment options available to the household or the structure of lending markets for large expenditure needs, may significantly affect optimal asset location decisions and may lead to deviations from predictions in a stylized setting. Taxes are only one of the factors affecting asset location decisions in such environments. Transaction costs or liquidity needs may make it optimal to hold some heavily taxed assets outside the tax-deferred account.

Most of the recent research on asset location has focused on the derivation of tax-minimizing portfolio strategies, rather than on the analysis of household portfolio choices. Several studies, however, have presented empirical evidence on asset location. Two studies have been based on surveys of TIAA-CREF participants. One by [Bodie and Crane \(1997\)](#) finds that investors choose similar asset allocations in their taxable and tax-deferred accounts. A related study by [Ameriks and Zeldes \(2001\)](#) investigates age and cohort effects in portfolio choices of TIAA-CREF participants, and shows that most participants make very few, if any, allocation changes with respect to their contribution flows. The extent to which the behavior of TIAA-CREF participants can be generalized to the population at large is an open issue.

A third study ([Barber and Odean, 2004](#)) is based on data drawn from client records at a discount brokerage firm. It shows that households hold equity mutual funds and taxable bonds in their tax-deferred accounts, while they hold individual equities in their taxable account. Because individual equity holdings tend to be less heavily taxed than bonds or equity mutual funds, this asset location pattern is broadly consistent with tax-minimizing behavior. However, households are also more likely to trade stocks in their taxable than in their tax-deferred account, even though trading in the tax-deferred account does not generate capital gains tax liability. A key concern with this study is whether data on assets held through a single brokerage firm adequately capture a household's broader balance sheet.

A fourth study ([Amromin, 2002](#)) uses data from the Survey of Consumer Finances to summarize tax-deferred account holdings and to investigate whether precautionary

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