Confused about your 401k?

If you are one of the lucky employees who have a 401k, it probably is the most important element to your retirement financial security. Unfortunately, these critical accounts are often confusing and overwhelming, especially if you don't have the time or knowledge to study all the details.

In this article we list and briefly discuss some of the pitfalls and mistakes many participants make in managing their employee sponsored retirement plans (which include 403(b), 457, SIMPLE and SEP plans as well as 401k's). Also, please remember that your advisor is here to help you with any questions or guidance you need relating to your plan. Together, we will try to help you avoid some of the common mistakes.

Not participating: The biggest mistake you can make is to not participate in your 401(k). Some employers automatically start employees at a 3% savings rate unless they opt out or elect a higher rate—don't opt out! Ideally, you contribute the maximum (Currently $17,500 for a 401k, your max may be different) although it is understandable that the max may be burdensome for some people. You are leaving "free money" on the table by not participating because the IRS is, in effect, giving you money in terms of a tax break for contributing. Other than the tax break, you could put your future financial security in jeopardy by not participating.

The matching mistake: Many employers "match" a portion of the employees' contributions. Be sure to contribute at least up to your employer's match level or you are losing free money in addition to losing the tax break mentioned above. On average, employer matches are 50% of the employees' first 6% of salary; so the employee who contributes 6%, just gave themselves a 3% raise, in that example. Know your company's matching policies and be sure to take full advantage of them.

Not making an asset allocation decision. Most 401(k) plans now offer target date funds, a popular option to investing because of the "set it and forget it" mind-set. Another allocation option is a balanced fund (typically around 50% equities/50% bonds). The best decision is choosing an allocation that fits your risk tolerance and includes a mix of investments to give you more protection during market downturns. The allocation and fund selection decision is where real financial proficiency is required. Plans usually offer some basic help, but if you aren't sure you have the appropriate selections, consider getting professional advice.

Holding too much company stock: You may feel confident about your company's future prospects, but look no further than the now-defunct Enron, Lehman, and even Kodak for proof that bad things can happen. Some experts suggest a maximum of 15% invested in company stock, others dial that back to 10%. If your company match is in the form of company stock consider periodically selling some and moving the proceeds into other positions.

Being young and too conservative. It is well understood that the crises of recent years have driven many investors away from financial markets. A recent study showed younger investors (those under 50) were even less comfortable investing in the stock market than older investors. A big mistake many younger investors make in their 401k's is being far too conservative. One rule of thumb to determine your equity exposure is to subtract your age from 110 with the result being an appropriate percentage for equities as opposed to safer, more conservative assets. This crude rule is better than no evaluation of your risk parameters but, here too, professional advice may be a better approach.

Withdrawing funds too soon. Cashing out your retirement fund is **never** a good idea. The money will be taxed at your highest current income tax bracket, plus you'll get hit with a 10% penalty. And, most importantly, you lose the growth you could have earned on the amount of your withdrawal.

Not paying attention to fees. A new law requires retirement plans to clearly state how much 401(k) accountholders pay in fees and expenses. But recent studies indicate that only half of plan participants know how much they're paying, and about a quarter (mistakenly) think they don't pay any fees at all. The fees you pay come straight out of your returns and eat away at your gains.

Taking a loan. When you borrow money from your 401(k), you are taking out a loan. Just like an auto loan or home loan, you promise to pay back what you borrow with interest. Your retirement plan contributions are made on a pre-tax basis, so when you take a loan from your plan, you may be subjecting yourself to additional taxes and reducing the amount of money that can compound. By the way, if you leave the company, voluntary or not, you typically are still required to repay the loan.

Job-hopping mistakes. Before making a major career move, be sure to take a close look at 401k vesting schedules and waiting periods. Once you change jobs, you have several options including leaving your assets in the current plan, rolling it over into an IRA or rolling it into your new employer's 401k plan. This may be an excellent time to talk to your financial advisor because without careful attention, a variety of taxes and fees could significantly reduce your retirement savings.

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Questions or comments?
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