

RETIREMENT PLANNING



fees in a number of ways. The employer can pay administrative costs itself, or it can pass them on to plan participants. If the latter, the administrative costs may be deducted directly from plan assets, or they might be embedded in the individual-fund fees. Those varying fee setups mean that there’s no single location for the information. But a starting point is your plan’s annual report (Form 5500). In it, you may see your plan’s administrative expenses expressed as a dollar amount. You’ll then need to divide that dollar amount by the total assets in the plan to arrive at a percentage.

BrightScope.com also provides some comparative information on 401(k) plan expenses. There aren’t hard-and-fast cutoffs about what constitutes a high-cost plan, and administrative-expense percentages will tend to vary based on employer size. In general, however, if your plan’s administrative costs edge above 0.5 percent — and certainly if they’re more than 1 percent — that’s a red flag that you have a high-cost plan. After all, those expenses come on top of whatever the underlying investments charge.

Investment lineup breadth

Does your plan offer the basic portfolio building blocks for workers at various life stages, including well-diversified U.S. stock, foreign-stock and core bond funds? Does it include target-date funds for investors who don’t want to handle asset allocation? Many 401(k) plans fall short on the bond side, offering just a single government-bond fund, for example. It’s not cause for concern if your lineup doesn’t offer exposure to each and every small asset class — in fact,

that may be by design — but it’s fair to ask to be able to build a plain-vanilla stock/bond portfolio within the confines of the 401(k).

Quality of investment lineup

In addition to checking up on the breadth of your 401(k) lineup, you should also assess the quality of the offerings. Morningstar.com offers an abundance of information on this front, including fee comparisons for individual funds relative to appropriate peer groups; but be sure that you’re matching the share class in your plan to the appropriate share class on the site. (For a given fund, click the “Expense” tab on its main page to see more details about its expenses.) Also, pay attention to what share classes you can buy: Does your plan hold higher-cost share classes when cheaper ones are available? (The cheaper share classes may not be available to your particular plan, but it’s worth asking.)

Not every fund option must have ultra-low expenses and earn a Morningstar Analyst Rating of Gold (or any medalist rating at all), but document funds that have low ratings and/or above-average expenses.

Additional features

While the quality of the investment lineup is key to making an assessment of it, also take stock of additional features. Does it include additional useful features, such as automatic rebalancing and automatic escalation? Does it include a Roth 401(k) option or the ability to make after-tax contributions? A lack of such features shouldn’t be a deal breaker, but if you value any of them, be sure to tell the individual(s) overseeing your 401(k) plan.

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RETIREMENT ACCOUNTS

see the big picture,” Streithorst says. Fewer accounts mean fewer monthly or quarterly statements and possibly lower costs.

Consolidating also makes it easier to calculate and take required minimum distributions after age 70 1/2, Kaisth says. For each 401(k) you own, you must take a separate RMD. But if you consolidate old 401(k)s into one rollover IRA, you can take a single distribution.

But there are some drawbacks, and many of them affect early retirees, who might lose options to access money penalty-free if accounts are consolidated. For instance, if you leave your job at age 55 and your 401(k) allows partial withdrawals, you’d want to keep that account separate, says Tiffany Beard, a CFP in Jacksonville, Fla. This would allow you to take out money before age 59½ without paying the 10 percent penalty for early withdrawals that you would usually face if you

rolled the 401(k) into an IRA.

You can still take penalty-free withdrawals from an IRA if you’re younger than 59½, although it may take a few financial steps. This involves using the 72(t) strategy, in which you withdraw the money in substantially equal periodic payments, Beard says. Say you have \$1 million in your IRA but you don’t want to take distributions based on that large balance. You could split off \$500,000 into a separate IRA and take withdrawals penalty-free using the 72(t) rules on the new, smaller IRA. Once you finish the distributions from that IRA, you’d still have the other IRA to use later in life.

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401(K) INVESTMENT MISTAKES TO AVOID

A company retirement plan — whether a 401(k), 403(b) or 457 plan — is the starter savings vehicle for many investors, so it’s probably not surprising that the plans usually have more guardrails than other investment vehicles.

Company-retirement plan menus typically feature plain vanilla stock and bond funds to keep plan participants from gorging on exotic investment choices and participants are often opted into age-appropriate target-date fund vehicles. And because 401(k) participants are often hands-off, many plans offer features such as automatic escalation to increase contributions as participants’ salaries grow.

Yet, not all plans include such safety features, and 401(k) menus aren’t universally high quality.

In short, 401(k) plans invite the potential for plenty of goofs. Here are common ones, as well as tips on avoiding those mistakes.

1. Not considering asset allocation before making investment choices

When making investment selections, 401(k) participants are typically confronted with a menu of individual fund choices. The importance of setting an age- and situation-appropriate stock/bond mix never even comes up, even though that will be the biggest determinant of how the portfolio behaves. Setting an appropriate asset allocation is more art than science; refer to “Finding the Right Stock/Bond Mix” on Page 7 for tips on setting your own.

2. Not investing differently if your situation is an outlier

Target-date funds often are the default options in 401(k) plans, and they’re valuable in that they can help investors set their asset allocations and monitor them on an ongoing basis. Even investors who don’t intend to invest in a target-date fund can use them to help determine an age-appropriate investment mix. That said, the allocations embedded in target-date funds won’t be right for everyone, especially for people with substantial assets outside their 401(k) plans. For example, individuals who will be able to rely on pensions to cover most of their in-retirement expenses will likely want a more aggressive asset allocation than would be the case for generic target-date funds. (For this reason, some employers use custom target-date funds, tailored to the situations of their plan participants.)

3. Not factoring in other assets when making investment selections

For investors who have been working and investing for a while — or those with spouses who hold their own investment accounts — their 401(k) plans may be but a small piece of their overall assets. In that case, it’s wise to factor in all of the retirement assets when determining how to allocate the 401(k). Morningstar.com’s X-Ray function (morningstar.com) can help investors see the composition of their total portfolios across accounts. They can then use their 401(k) plan assets to help steer the total portfolio toward their desired asset-allocation mix.

4. Focusing too much on past returns when making investment choices

In addition to not getting much coaching on their asset allocations, many 401(k) participants are given a limited amount of information about the investment choices on their plans’ menus. They may see a fund’s asset class or category, as well as its returns over a certain time period, such as the past five years. Is it any wonder so many novice investors simply reach for the funds with the highest numbers? Of course, that’s not a recipe for great investment results, as those high performers often fall back to Earth. Rather than chasing the hottest performers, investors are better off focusing on fundamental information about funds’ strategies, management, and expenses to help populate their asset-allocation mixes. Morningstar’s qualitative Analyst Ratings, available on Morningstar.com, attempt to pull all of these considerations together into a single forward-looking measure.

5. Venturing into the brokerage window without paying attention to transaction costs

If investors do their homework on the fund options on their 401(k) menu and find them wanting, the ability to invest via a brokerage window might appear to be a godsend. Such windows typically give participants many more choices than they have on the preset menu, including the ability to invest in individual

stocks and exchange-traded funds. The big downside, however, is that participants will typically incur transaction costs to buy and sell securities within the brokerage window. Those trading costs can drag on returns, especially for investors who are making frequent small purchases.

6. Avoiding no-name funds

Company-retirement-plan menus are often populated with funds from the big shops — Vanguard, Fidelity, T. Rowe Price, and American Funds. But plans also may include less-familiar names, often collective investment trusts that are explicitly managed for retirement plans. Although information may be less widely available on some of these options than is the case for conventional mutual funds, their expenses may be low and their quality may be good.

7. Overdosing on company stock

In 2014, the average 401(k) plan participant has more than 7 percent of his or her portfolio in stock of the employer, according to information from the Investment Company Institute. That’s not a scary number in and of itself, but many participants obviously have much higher stakes and some have none. Even if an employer doesn’t run into Enron-style problems, employees with a lot of company stock have too much of their economic wherewithal riding on their employer’s performance: their own jobs, plus their portfolio’s performance as well. As Morningstar research has indicated, most investors are better off limiting their positions in company stock, though there may be a few mitigating situations in which to hang on to it.

8. Not taking full advantage of the tax-advantaged wrapper

One of the big advantages of a 401(k) plan is tax-deferred compounding: Even if an investment is kicking off heavy income or capital gains distributions, the 401(k) investor won’t owe any taxes until he or she begins pulling money from the plan. For that reason, it’s wise to stash those investments with heavy year-to-year tax costs inside a 401(k) or IRA. That includes funds that invest in high-yield bonds and Treasury Inflation-Protected Securities, REITs, and high-turnover equity funds. That said, investors needn’t go out of their way to add high-tax-cost investments if they don’t make sense for them from an investment standpoint. Most young investors have little need for bonds within their 401(k) plans, for example.

9. Trading too frequently

The tax-deferred nature of a 401(k) — combined with the fact that 401(k) investors don’t typically incur sales charges to buy and sell shares of funds on the plan’s preset menu — can be an invitation to trade frequently or to employ tactical, market-timing strategies. But Morningstar Investor Returns data casts doubt on whether investors can add value with frequent trading; investors in target-date funds, a type of allocation fund, because they often buy and then sit tight, often garner better outcomes than investors venturing into and out of individual categories.

10. Sticking with default contribution rate

In the interest of encouraging more employees to participate, many employers now are automatically enrolling their employees in the 401(k). The early results of these efforts show that many employees who are automatically enrolled do, in fact, stick with the plan — a positive outcome. However, employees who stick with the default contribution rate after they’ve been automatically enrolled — the average is 3.4 percent — may not earn their full employer matching contribution, if it’s a generous one. Moreover, a 3.4 percent savings rate — assuming the employee isn’t also saving outside the 401(k) plan and/or doesn’t have a very high salary — is far below any reasonable retirement-savings target.

11. Not taking advantage of other automatic features

In recognition of the fact that initial default contribution rates may be insufficient, some plans also opt their employees into auto-escalation, nudging up their contributions as the years go by. For other plans, automatic escalation is voluntary. Taking advantage of this option can be a painless way for employees to save more of their salaries, particularly if their contributions increase at the same time they receive raises. Automatic rebalancing also can help hands-off investors by regularly restoring their portfolios back to their target-allocation mixes.

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