

ESSENTIAL STEPS TO TAKE BEFORE RETIREMENT

BY CHRISTINE BENZ

It's a rare newbie investor who has the financial wherewithal — and foresight — to hit the ground running on a retirement-savings plan, making the maximum allowable IRA and 401(k) contributions at the same time she's getting her career off the ground.

Instead, most investors tiptoe into retirement savings. They might start with token investments in their 401(k) plans (or get opted into them, if they're not paying attention). Then, as their finances allow or if they're dissatisfied with their 401(k)s, they "graduate" into other investment vehicles for their retirement nest eggs, such as IRAs and taxable accounts.

One question investors often ask is, if they have a fixed sum of money to invest every month or every year, how should they deploy that cash for their retirement savings? As with many financial-planning questions, there are no one-size-fits-all answers: Variations in investors' company retirement plans, tax situations and time horizons mean that a retirement-savings hierarchy that makes sense for one individual may not add up for another.

That said, the following framework for retirement savings will be a good starting point for many investors.

Step 1: Invest enough in 401(k)/other company retirement plan to earn matching contributions

Why to prioritize it: To take advantage of free money.

De-prioritize if: Your 401(k) offers no matching contributions. In that case, proceed directly to Step 2.

Diversification has been called the only free lunch in investing. But there's another: 401(k) matching contributions. Even if a company's match is lackluster — say, \$0.25 on every dollar invested — it's going to be dif-

ficult to out-earn that rate of return by investing outside of the 401(k) (or 403(b) or 457 plan). And remember: Those matching contributions are in addition to any investment earnings. Thus, the first stop for individuals just starting out is to contribute at least enough to earn the full match. If the company provides a match of \$0.50 for every dollar invested, up to 6 percent of pay — which is the most common matching configuration — the employee should target a 401(k) contribution of at least 6 percent.

Step 2: Invest in an IRA

Why to prioritize it: Low costs, flexibility, the ability to contribute to a Roth.

De-prioritize if: Your company retirement plan features all the bells and whistles, including ultra-low costs and a Roth option. Alternatively, if you need the legal protections of a 401(k) or if your company offers the perfect 401(k) plan (more on that below), contribute the maximum to the 401(k) before funding an IRA.

It doesn't get much simpler than making contributions to a 401(k) plan: The money comes out of the investor's paycheck, like it or not. Moreover, IRAs enjoy no special tax advantages over 401(k)s. So, why bother with an IRA?

Costs are one of the key reasons: Many 401(k) plans feature a layer of administrative fees, whereas investors buying into an IRA can invest without that layer. And while 401(k) investors are typically wedded to a specific menu of investment choices, some of which may be high cost, IRA investors are free to invest in a broad gamut of securities, including ultra-low-cost index-tracking mutual funds or exchange-traded funds.

Finally, not all 401(k) plans offer a Roth option, whereas

all IRA investors have the option to contribute to a Roth, assuming they meet the income limits or use the "backdoor Roth IRA" maneuver.

Of course — and here's one of the big exceptions to the hierarchy — some 401(k) plans are rock-solid, featuring no layer of administrative expenses, extra-low-cost investment options and a full range of features, including the ability to make Roth contributions. If your 401(k) plan ticks all of those boxes, you can go ahead and make a full 401(k) contribution before moving to an IRA.

For married couples with a non-earning spouse, funding a spousal IRA also should come next in the hierarchy. Assuming the earning spouse has enough income to cover both her contribution and that of her spouse, the non-earning spouse can accumulate retirement savings in his name and also help build up the couple's joint retirement nest egg.

Step 3: Invest in company retirement plan up to the limit

Why to prioritize it: The ability to enjoy tax-free contributions and tax-deferred compounding (traditional) or tax-free compounding and withdrawals (Roth).

De-prioritize if: You have plenty of assets in accounts that will be taxed upon withdrawal and you're close to retirement. If that's the case, you may want to prioritize saving in a taxable (nonretirement) account instead of maxing out the company retirement plan. Ditto, if there's a chance you'll need the money prior to retirement.

For higher-income investors who have significant assets to invest toward their retirement savings, taking advantage of all tax-sheltered retirement-savings options should precede investing in nonretirement accounts. And that's true even if the 401(k), 403(b), or 457 plan isn't best of

breed. Investors in traditional 401(k)s contribute pretax dollars and enjoy tax-deferred compounding; further, making pretax contributions reduces adjusted gross income, thereby increasing eligibility for valuable credits and deductions. Investors in Roth 401(k)s, meanwhile, enjoy tax-free compounding and tax-free withdrawals in retirement. Those tax benefits are the key reason that investing in a 401(k) — even one that's subpar — trumps investing in a taxable account.

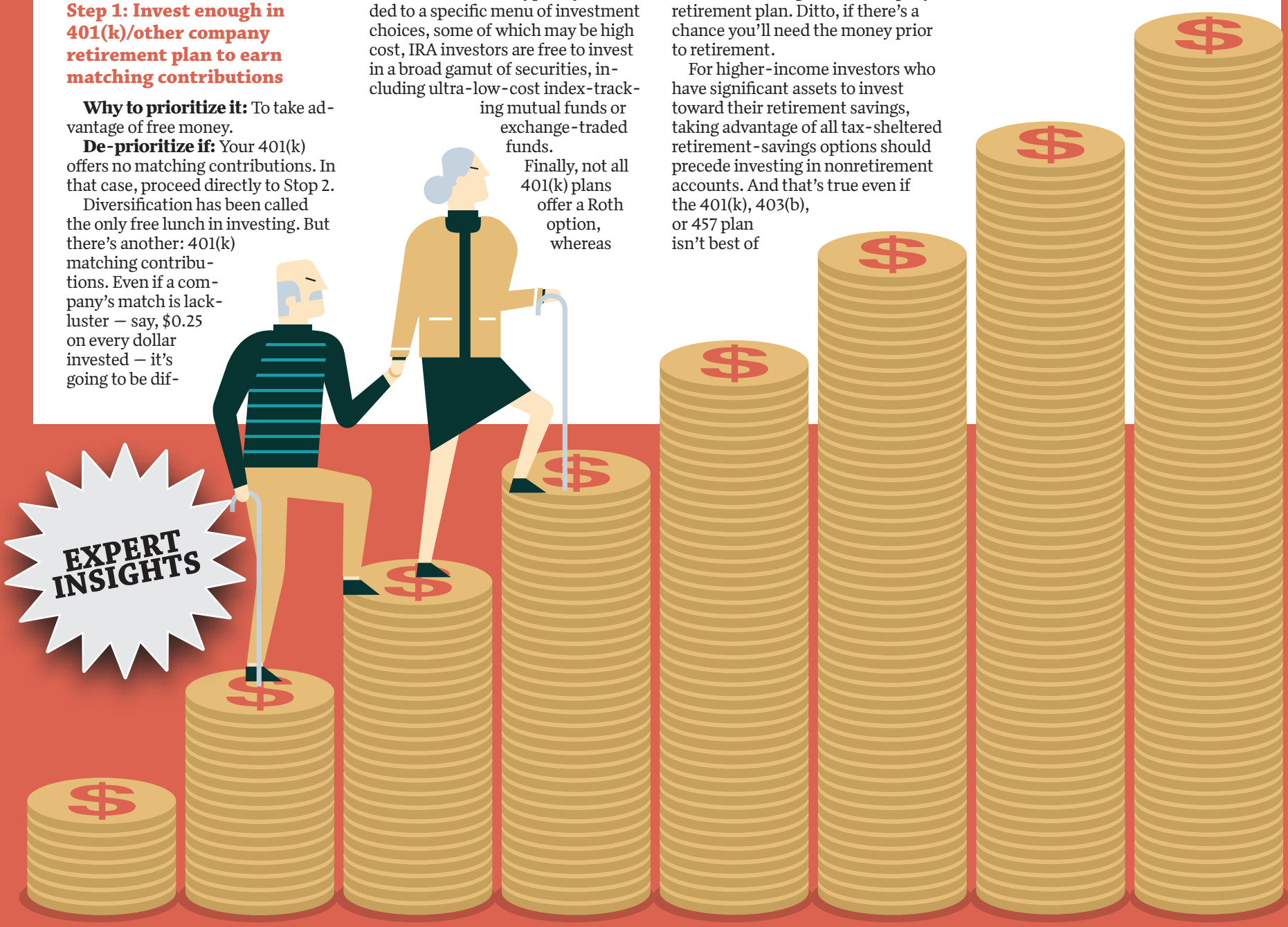
Step 4: Make aftertax 401(k) contributions to the limit

Why to prioritize it: The ability to enhance a portfolio's share of Roth assets, eventually — provided the 401(k) plan allows for the contribution of after-tax dollars.

De-prioritize if: The 401(k) is especially poor or especially costly.

Investors who make the maximum 401(k) contribution of \$19,000 (\$25,000 if over age 50) in 2019 can contribute at an even higher level — up to \$56,000 in total contributions in 2019 for those under age 50 and up to \$62,000 in total contributions for those 50-plus — provided their plans allow for contributions of aftertax 401(k) dollars. Those aftertax 401(k) contributions can be converted to Roth IRA assets once the investor has retired, left the company, or is taking in-service distributions from their plans.

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RETHINK REBALANCING

BY CHRISTINE BENZ

Investment gurus Harold Evenksy and Bill Bernstein are fans. Vanguard founder Jack Bogle? Not all that much.

I'm talking about rebalancing — the practice of bringing a portfolio's allocations back into line with its targets by selling appreciated securities and adding them to underperforming parts of the portfolio.

Bogle isn't totally sold on rebalancing for a diversified portfolio of stocks and bonds for the simple reason that it will tend to detract from returns. If stocks outperform bonds, as they typically do over long periods of time, an investor will earn a better return by letting the portfolio's stock allocation ride than trimming it on an ongoing basis. Moreover, rebalancing can entail costs — both trading costs and tax costs — another reason that Bogle isn't a huge believer, except at big market inflection points.

Proponents of rebalancing generally concede those points. Rebalancing between stocks and bonds will tend to reduce a portfolio's return over most long-

term market environments. Instead, the main benefit of rebalancing among stocks and bonds is in the realm of risk reduction.

Thus, it stands to reason that the virtues of traditional rebalancing — among asset classes — are greatest for investors who value that risk reduction the most. On the short list are those investors who, unnerved by market volatility, have tended to reduce their portfolios' risk levels after the market has fallen a great deal. Such investors would be particularly well served by rebalancing, or perhaps better yet, employing funds that do that rebalancing for them, such as target-date or allocation funds.

Meanwhile, younger investors, say, those under 50 who aren't overly flummoxed by volatility in their stock-heavy portfolios, can probably get by with infrequent rebalancing, or none at all. (They may benefit more from intra-asset rebalancing, however; for example, periodically scaling back their large-cap weightings after such stocks have outperformed and adding the money to small- and mid-caps.)

For pre-retirees and retirees, however, rebalancing is essential, regardless of risk tolerance. Not only can it help them sidestep all sorts of ill effects from overly heavy equity weightings in the years leading up to retirement, but it can aid them in extracting their desired in-retirement cash flows, too.

Risk tolerance versus risk capacity: What difference does it make?

The reason rebalancing matters more for pre-retirees and retirees than it does for younger investors gets back to the distinction between risk tolerance and risk capacity. Risk tolerance describes an investor's ability to psychologically cope with periodic losses in his or her portfolio. Risk capacity relates to whether those losses will be so significant that the investor will need to change his plan.

It's not uncommon for people in their 50s, 60s, and beyond to have high risk tolerances: They've been stress-tested by two major bear markets in the space of 20 years, the market has recovered, and so have their portfolios. What many investors fitting this description may not realize, however, is that their risk

The portfolio strategy is vital for many

capacities have declined even as their risk tolerances have remained the same or even grown. And when a too-high equity allocation is combined with higher equity valuations and a shortened time horizon before spending, the results can be disastrous.

Rebalancing can help with cash flows, too

Protecting against market downdrafts isn't the only reason retirees should consider rebalancing. A subtype of rebalancing, in which the proceeds from appreciated assets are spent rather than reinvested, can also prove advantageous as a means of unlocking cash flow from a portfolio during retirement. Such a strategy also serves to reduce risk. That's a neat trick when you consider that today's low yields make it difficult to subsist on yield alone and have forced income-centric retirees to venture into risky securities.

By incorporating rebalancing at both the asset-class and intra-asset-class levels, a retiree can extract cash flow even when the income gods are not delivering it.

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