eActionAlert

Top Ten Mistakes Participants Make on their 401(k) Plans

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For many employees, the money they save in their 401(k) Plan will be the primary source of retirement income. For this reason, it is critical that they have a complete understanding of how their Plan works. ***This is primarily the responsibility of the employer.***

All too often employees fail to realize the full potential of their 401(k) Plan. This may be because the employer did not provide the proper training or because the employee did not take the time to learn about their Plan. This can result in costly mistakes including missed Plan participation, poor investment choices or over-utilizing Plan loan provisions. It is vital that employees understand the implications of their participation, investment and withdrawal decisions.

The following list of "don'ts" will help you help participants avoid these common mistakes.

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Don't miss the match.

Would you throw away free money? Surprisingly, a third of 401(k) participants recently surveyed by Palo Alto, Calif., advisory firm Financial Engines are doing essentially that, by failing to contribute enough to receive their employer's match. A common match is 50 cents on the dollar, up to 6 percent. For a worker who earns $50,000 and sets aside 6 percent a year ($3,000), the company chips in $1,500.

Don't cash out your 401(k).

An analysis of nearly 170,000 defined contribution plan distributions shows that 68 percent of 401(k) plan participants opt for lump sum cash payments when changing jobs. Less than one-third (26 percent) roll their balances into IRAs and only 6 percent move their money to their new employers' plans.

No matter how small the balance is, it is important to keep the money tax-deferred. Not only will employees cashing out lose out due to tax implications, but they will not reap the benefits of potential savings over time.

Don't forget to rebalance your portfolio.

Further evidence that 401(k) plan participants tend to buy and hold is a study of nearly 500,000 401(k) participants, which found that 28 percent of participants made a trade. Older participants with higher salaries and longer service histories were more likely to make a trade than younger participants. Over time, it's possible that because funds grow at different rates, a moderate portfolio could become more aggressive, leading to unexpected vulnerability when the market gets rough.

Don't load up on bonds.

When you have decades of compounding growth ahead of you, a heavy allocation to bonds can act as a drag on your portfolio. Young investors should take advantage of the current market volatility by contributing mostly to stock funds. It's important during the growth stage to let the market work for you.

Don't bet it all on a few good stocks.

One big advantage of mutual funds is that they can diversify by investing in a basket of stocks. But take a close look at the basket, because it might hold 100 stocks, or it might hold just 20 or 30 (what's known as a concentrated portfolio). Look at how much of a fund's assets it has in its top 10 stocks. If it has 50 percent of its money in 10 stocks, that's a risk factor. That doesn't mean you shouldn't invest in concentrated funds at all – just make sure you're diversified elsewhere.

Don't blindly pick funds.

Don't lull yourself into a false sense of diversification. Many times, participants own a lot of funds that seem different, but when you look closely, they own very similar stocks. The bottom line: You can't rely on the name of a fund to tell you what it contains. A quick way to get a sense of a fund's style and holdings is to look it up on Morningstar. (After typing in the fund's name, select the "portfolio" tab on the left side of the page.)

Don't get hung up on past performance.

It's important to maintain a diversified mix of investments, even if the historical performance of an asset class has been less than desirable. Owning things that go up and down at different times can add multiple percentage points to your return over time, even if some of the underlying funds don't perform well. So even if large-cap value funds are down this year, they'll help cushion the impact when your large cap growth funds run out of steam. It pays to be a contrarian, and add to funds that haven't been performing well.

Don't ignore asset allocation.

Believe it or not, the most important decision you'll make as an investor isn't which funds you buy. A bigger key to your portfolio's long-term success is how you divvy up the money among different types of stocks and bonds. If you get the allocation wrong, there's nothing you can do as far as finding funds or managers to fix that problem. Need some guidance? An asset allocation calculator can help you determine your best mix.

Don't borrow from the plan for consumer purchases.

One of the selling points of the 401(k) is that you can borrow money from your plan, which means that you are actually borrowing from yourself. As you pay off the loan, you are paying yourself back, and when you pay interest on the loan, the interest goes back into your account.

However, the loan provisions of the 401(k) were never intended to encourage consumer spending, and, from an investment standpoint, assets should work for you toward your retirement, not toward current purchases. It's important to remember that interest on a 401(k) plan loan is rarely tax deductible. You'd be better off preserving your retirement account and taking a tax deductible home equity loan.

Don't go gung-ho with company stock.

Most advisers recommend investing no more than 10 percent of your 401(k) in a single company's stock – including your employer's. In case you don't remember what happened at Bear Stearns or Enron, loading up can be a dangerous proposition should the stock tank.

According to Financial Engines, more than a third of participants have at least 20 percent of their portfolios invested in company stock. Even more alarming, a quarter of participants over age 60 have 50 percent or more of their 401(k) money riding on company stock.

What this means to you and M&A's Recommendations

Employers can encourage better Plan utilization through increased employee education, targeted communications and even providing third-party investment advice. M&A's 401(k) consulting services can help Plan sponsors offer platforms that minimize these common mistakes.

M&A is an employee benefit consulting and management firm and, as such, we do not practice law. If you have any questions regarding the information in this eAlert, please contact your Senior Consultant at (877) 564-4300.