9.4: 401(k) PLANS

A 401(k) plan is a retirement savings plan offered through an employer that allows employees to put away a portion of their paycheck each period on a pre-tax basis into an investment plan. Typically, the employer will have a selection of different accounts into which employees can allocate their investment. The accounts will usually have a mix of low risk to higher risk alternatives such as a money market fund, a couple different types of bond funds, and a couple of different types of stock funds so that you can match the risk/return profile you are searching for. Some employers will match (or partially match) an employee's contribution. The money in the 401(k) plan compounds tax-free during the employee's working life and withdraws are taxed as ordinary income. The tax structure is similar to the traditional IRA. Roth 401(k) plans were introduced in 2006 and are offered by some employers. A Roth 401(k) will have a tax structure similar to the Roth IRA (no tax deduction on contributions, withdraws are tax-free). The maximum contribution to a 401(k) plan for an employee in 2020 is $19,500 ($26,000 for 50+ years of age) per year.

If you leave the company prior to retirement, you can have several options.

Leave your money with the company

Most firms will allow you to leave the money in the plan and then access it when you retire. The downside of this is that you have less control and if you change jobs frequently you will have several accounts to keep track of.

Move your money to your new employer's 401(k) plan

Most employers will allow you to transfer your money to your new company's plan. The downside of this is that you are limited to the options available in your new plan.

Use a Rollover IRA

You can set up a special account called a "rollover IRA" (discussed above), which allows you control over your investment decisions. If you put your money in a rollover IRA it is important that your old employer transfer the money directly to the IRA account to avoid a 20% withholding penalty.

Cash Out

This will result in significant tax penalties and should only be done as a last resort if you desperately need the cash.

Vesting

Vesting refers to the concept that your retirement benefits belong to you even if you leave the firm before retirement. Every company has different vesting requirements, but there are minimum vesting standards that require you to be fully vested in 3-6 years. If you are 60% vested, then 60% of your retirement benefits belong to you if you leave the firm early. Note that your contributions and the return on those contributions always belong to you. It is only the matching contributions and the return on those contributions that need to be vested.

401(k) Tips

Consider employer's retirement plan when choosing a job

Look at your employer's retirement plan as a key benefit when considering a job. The quality of plans varies dramatically from employer to employer with regard to matching, investment options, and vesting. Take a look at this web page for some general information on common 401(k) benefits.

Diversify

Don't use the stock of the company you work for as your primary investment choice! If the company matches in company stock, transfer it out as soon as possible. Don't get "Enroned." Don't let company stock represent more than 20% of your retirement assets (and 20% is way on the high side – less than 10% is even better)

Be careful about being too safe

If you choose the safest investment option you likely won't ever lose money, but you won't make much either. If you have a low return, it will be hard to accumulate much wealth. The person that puts away $300 per month (note that with a 50% match from your employer, this is only $200 out of your pocket and $100 from your employer) for thirty-five years and earns 10% will have $1,138,991 whereas the person that puts away $300 per month for thirty-five years and earns 5% will only have $340,828 (or would need to put away about $1000 per month to get the same amount as the person who saved $300 per month at 10%). As you get closer to retirement, you should start to reduce your risk exposure. Don't worry too much about stock market crashes during your first 10-20 years of savings. They mainly create opportunities for your monthly contributions to buy more.

Participate

The biggest mistake many people make is they say "I'll start participating next year" and next year never comes. The person that saves $250 per month for thirty-five years at 9% will have $735,446 whereas the person that saves $250 per month for twenty years at 9% will only have $166,972.
