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WEALTH ADVISORY SERVICES

Personal 401(k) Management

Managed effectively, your 401(k) plan account is likely to provide a powerful boost to your retirement savings. But a widely discussed new survey has raised some significant doubts about how well participants are managing their investments and the extent to which they are taking full advantage of their plans.

The Financial Engines National 401(k) Evaluation: Who Benefits from Today's 401(k)? examined nearly one million 401(k) portfolios from 82 plan sponsors, using data collected in 2007. The survey focused on three elements: risk and diversification of account investments, ownership of company stock and participant contributions.

Financial Engines, Inc., applied their forecasting methodology to calculate what they call the ***expected growth rate*** of participant account balances (net of inflation) so as to quantify the impact of participants' decisions on their estimated 401(k) wealth at retirement. The expected growth rate formula adjusts a portfolio's expected return, to allow for the risk-reward tradeoff inherent in investments. This adjustment for risk decreases the long-term return growth rate of a portfolio, explaining why, in their findings, a portfolio with high-risk investments yields a lower "expected" return.*

Risk and diversification

Findings:

Overall, 69% of those surveyed are making investment mistakes. "Mistakes" are defined as having portfolios with inappropriate risk levels or that are insufficiently diversified. For example, these portfolios: are overly concentrated in either a single asset class or company stock; have overly conservative allocations; or have improper allocations (balances that are invested equally in the most conservative and aggressive fund options, or spread evenly across all investment options). Thirty-three percent of the participants earning more than $100,000 a year had portfolios that the survey defined as highly inappropriate in both risk and diversification.

Impact:

A portfolio with appropriate risk and diversification, using the survey's standards, has an average expected growth rate of 4.64% a year, compared with 3.34% for the most risky and inefficient portfolios. That growth rate may not, at first glance, look particularly substantial. But over 20 years, a participant could accumulate 28% more for retirement with the 1.3% difference in the two growth rates. The study found, also, that for participants with the most risky and inefficient portfolios, those with the highest salaries ($100,000+) did significantly better than those with the lowest (under $25,000): 2.46% versus 4.13%. The gap was smaller for the lowest account balances (under $5,000) and highest ($500,000+ account balances)—2.57% versus 3.88%. Interestingly, comparing the best-managed portfolios to the poorest, participants with the lowest salaries and smallest balances outperformed participants with the highest salaries and largest balances.

Ownership of company stock

Findings:

The majority (53%) of participants who have the option to own company stock hold less than 10% in their portfolios. But the holdings of certain demographic groups show surprisingly high concentrations of company stock. For instance, 43% of participants over age 60 have portfolios with more than 20% in company stock, and 25% of them have a concentration of more than one-half of their portfolios. Twenty-seven percent of those earning at least $100,000 have holdings of 20% or more, as well.

continued

Impact:

Using the Financial Engines, Inc., "expected return" formula, the study concludes that a high concentration of company stock is a major reason why a portfolio may be inappropriate or improperly diversified. Financial Engines, Inc., estimates that by keeping ownership of company stock to less than 10%, after 20 years a participant could accumulate over 22% more in his or her account—given the same starting balance and assuming no future contributions. How much company stock ***should*** a participant own? There are no-hard-and-fast rules, but many experts suggest no more than 10% to 15%. (Federal law limits the amount of company stock that a pension plan can hold to 10%.)

Participant contributions

Findings:

Not unexpectedly, maximizing employer matching and contribution opportunities is a function of age and salary. Across the board, 33% of active plan participants did not save enough to take advantage of the full employer match (typically, between 50% to 100% of the first 6% of pay). Most of the rest met the match but failed to make the maximum tax-deductible contribution allowed by law—only 7% came within $500 of meeting that goal. But 72% of those age 60 or older did meet the match and contributed the highest percentage of their pay (9.1%) to the plan. Eighty-eight percent of those earning $100,000 or more met the full match and saved 9.2% of their pay, the highest percentage by salary.

Impact:

The study found that, on average, a participant who fails to make a full match saves only 1.9% of his or her salary and has a median account balance of $5,872. If he or she maintains that same rate and receives the partial match, he or she could expect to have $46,779 after 20 years. Based upon Financial Engines' methodology, taking full advantage of the plan's match makes a big difference in an account's expected growth, $120,905 over 20 years (a difference of 158%).

A personal strategy matters

Of course, not everyone's boundaries and choices should be the same.

For example, an investor's aggressive or conservative posture may not be a mistake, but a carefully calculated, informed decision.

Owning more than the "typical" percentage of company stock may be warranted in the case of a company that is doing extremely well, and when there's good reason to believe that it is likely to continue to do so.

Tax-deductible contributions to a 401(k) plan become taxable at ordinary income rates when withdrawn. For some, tax consequences may be a factor in deciding to make less than the full annual contribution allowed (although contributing enough for the full employer match should be a given).

In other words, as is the case with your personal portfolio, management of your 401(k) plan requires that you make your decisions based upon your own unique circumstances and needs.

*This methodology projects the likelihood of various investment outcomes that are hypothetical in nature. They do not reflect actual results or adjustments over time, and are not guaranties of future results. The full survey is available at ***www.financialengines.com***.

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