Title: Let's Fix your 401(k)

Subtitle: It's time to improve your 401(k) by ditching your Target Date Fund and utilizing some other lesser known tools in your 401(k).

Everyone is familiar with 401(k) and 403(b) plan by now. They have essentially replaced defined-benefit plans in the American retirement landscape. Most people take a set-it and forget it attitude towards these accounts, picking some funds and then ignoring it for years until they either switch jobs or are getting close to retirement. This is the wrong attitude to take with such an important account. This article will show you some things you can do to repair and improve your 401(k), not only through the investment selection but also with some other features that you may not have even heard of.

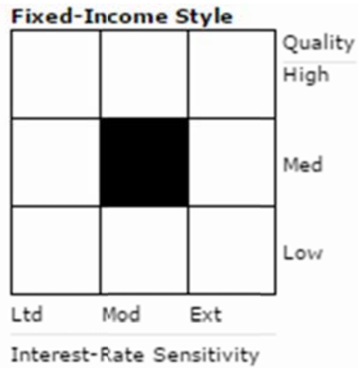
Target Date Funds – Are they any good?

Target Date Funds have been the go to investment for most 401(k) participants since the early 2000's. This is mostly because they are the default investment option for most retirement plans. Basically, you are automatically invested in them unless you say otherwise. The concept is that your portfolio will automatically adjust over time as you grow closer to retirement – shifting from stocks to bonds. They simplify investing down to one single criteria, your age. They theory being that you are more conservative as you get older therefore bonds, typically thought of as a more conservative investment, are a more appropriate asset for your portfolio. In general, this theory holds true but there are so many other variables to consider besides your age that in real life, the Target Date fund allocation is rarely the "best" allocation for you.

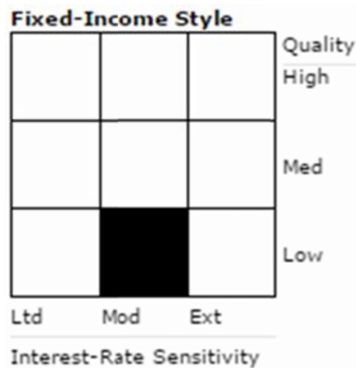
Besides your age, you should be considering your risk profile, cash flow needs, income/expenses, current net worth, and other financial goals. Tweaking any one of these could lead to a very different recommended portfolio. If the Target Date Fund gets your allocation wrong you are either taking on more risk than you should be or leaving money on the table. For example, someone who is one year out from retirement may have a portfolio that is nearly all bonds if using a Target Date Fund. In reality, this soon-to-be retiree may greatly benefit from a higher allocation to stocks, improving their overall financial position and may be very well be comfortable taking on the additional risk.

As well, the amount and type of bonds held within the target date portfolio can vary dramatically from one fund to the next even though they are "targeting" the same investment year. As an example, I'll compare two well-known fund manager's 2030 Target Date Funds. First, the Vanguard 2030 Target Retirement Fund (VTHRX). This fund has a 27% allocation to bonds at the time of this article's writing (remember the allocation changes over time). And of that allocation the bonds have a "Medium" quality

rating and a “Medium” Interest Rate Sensitivity Rating according to Morningstar and seen in the below style box. They take a moderate amount of risk.



The T. Rowe Price 2030 Retirement Fund (TRRCX) has only a 21% allocation to bonds and a low-quality bond rating and Medium Interest Rate Sensitivity. So not only is there less bonds but the bonds they hold take more risk than the Vanguard fund. Remember these two funds are targeting the exact same retirement year so in theory have the same goals. It just looks like they go about it in a different way. Which strategy and allocation is right for you?



For all their faults Target Date Funds are not all bad. Prior to the advent of Target Date Funds, many 401(k) plans had cash (or cash equivalent) as the default investment selection. This would lead many participants to dramatically underperform the markets overtime, hindering their chance at a successful retirement and requiring many more working years before quitting your job. The overall message is these funds are good but you can do better. <*See: Target Date Mutual Funds – Is it really that Easy?*>

To Roth or Not to Roth

Most 401(k)’s now have an option to contribute with after-tax dollars to what is called a Roth IRA. It combines the higher limits of a 401(k) with the after-tax deferral of a Roth IRA. The question is how do you choose between the Roth or Traditional 401(k)? There aren’t any clear cut answers but the decision comes down to your current tax situation and your expected future tax situation. If you are in a lower tax bracket now you might want to consider the Roth 401(k) as the value of the tax deduction from a Traditional 401(k) would be less. Then in the future, if you are in a higher tax bracket you can get your money out tax free. If on the other hand, you are in a high tax bracket now a Traditional 401(k) might be a better choice as you will receive a tax deduction at this higher rate. Then in retirement when your tax

rate is lower you will be able to get the money out at a favorable tax rate. It is actually a good idea to have both a Roth Assets and a Pre-Tax Assets. This will allow you to be flexible about when and which account you draw money from. During retirement your tax brackets often fluctuate so using a dynamic approach to drawing retirement funds could save you a lot in taxes. This might mean contributing to a Roth 401(k) early in your career when you income is lower and then switching to pre-tax contributions as your income pushes you into higher tax brackets.

Some companies even allow their employees to make additional “after-tax” (not specifically Roth) contributions, up to $35k, to a 401(k). This means you can contribute a maximum of $53k to your 401(k) in any given year ($59k if over age 50). This allows you to essentially make “Super-Roth” contributions since the after-tax portion can be rolled over to a Roth IRA in the Future. <*see: Tools of the Rich and Why to Avoid Them*>

Turn on Automatic Increases

If you’re not maximizing your 401(k) contributions yet there is a painless way to ensure you get there quickly. Many plans allow the option to set up an automatic increase in your salary deferral. Basically if you are currently contributing 10% of your salary you can set it up so that after one year it goes up to 12%, and then the next year 14%, until you get to the $18,000 maximum for 2017. By setting it up ahead of time the increases will go through without you even knowing it happened.

Think your Falling Behind Utilize the Catch-up Contribution

If you’ve just turned 50 and you still don’t think you have enough saved for retirement, the IRS allows for a catchup contribution to help fill that gap. In 2017, you can contribute an extra $6,000 to your 401(k) and it can be either pre-tax or after-tax dollars. If you are eligible, you can also add another $1,500 per year to your IRA or Roth IRA. This increases your total 401(k) contribution to $24,000 and $59,000 if making after-tax “Super Roth” contributions. This should help you fill in any leftover gaps in your retirement before it comes time to actually quit your job.

The big idea is to not just ignore your 401(k). With defined-benefit pensions becoming a thing of the past, it’s one of the most powerful tools you have in achieving a successful retirement. Some of the features mentioned above have not been around to that long so take a little time and review your employer plan.

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