HIGHTOWER
SARIAN STRATEGIC PARTNERS

The Basics of a 401(k)

Saving consistently much earlier in life allows for greater flexibility and more choices later on.

What is it?

A 401(k) is a company retirement plan that allows employees to contribute a portion of their wages to individual accounts. The salary deferrals are excluded from the employee's taxable income and the amount deferred is not taxable until it is withdrawn or distributed from the plan. Some plans, such as the Roth 401(k), are structured so as to allow an employee to make their 401(k) contributions on an after-tax basis. These amounts are not excluded from an employee's income, but they are typically tax-free when withdrawn.

401(k) plans are generally self-directed. Thus, the individual employee is responsible for deciding how to invest the money in the account. Usually, the employee must choose from a set list of investments the plan offers. Many plans have a default choice if no decisions are made upon enrollment.

What are the benefits of starting to save early?

There are three major benefits of contributing to a 401(k): the compound effect, the enhancement of this effect by tax deferred earnings, and the employer matching contribution.

Investing early gains you a significant advantage because of the effects of compounding. Compounding rolls the returns on investments back into the principal sum, and puts past returns to work earning money as well.

Compounding takes into consideration all the returns or losses of previous periods. The more compounding periods, and the greater the amount of returns or losses, the greater the impact can be. For example, one individual starts saving at 23 years old. He saves $330 a month for 40 years with an average 5% rate of return. That individual will have around $478,374.15 by age 63. Another individual starts at age 33 at $600 for 30 years a month with an average 5% return for 30 years they will have $478,364.02. The average rate of return over this period would include both the positive and negative periods. The investments will not give a set rate of return but will be subject to losses and gains, and this average will bear those out. In this example, even though the second individual is saving almost twice as much as the first individual by age 63, they will still have less than the individual that started earlier. Putting time on your side can have a significant impact on your overall savings.

One of the biggest benefits of a 401k is that the investment earnings on your contributions are also tax deferred while in your account. This means that the combined amount has the opportunity to compound more efficiently.. The entire investment is consistently being reinvested, and no money is being taken out to pay taxes, which enhances the compound effect. In addition, because you are consistently investing every paycheck, when market declines occur you will be purchasing more shares of your investment choices at lower share prices. This is known as dollar cost averaging. The premise behind this technique is that it lowers the average share price over time, giving you a better opportunity to profit in the long-term.

Another benefit to investing in a 401(k) plan is an employer matching contribution. Many employers offer 50 % on the dollar or 100% match for any contribution up to 6% of your income. A 100% match means if you were to contribute 5% of your income, your employer would match your contribution with another 5% contribution. Now you are contributing at a 10% rate. This is free money in a sense. Your employer is giving you additional money for retirement simply for participating. This additional savings further assists the compounding effect that occurs in the account.

Even if you are unable to contribute 10%-15% on your own, try at least contribute enough to qualify for the matching funds option. Not taking advantage of this option is not advisable, as this offer is an easy way to maximize your contributions and provide more easily for your retirement.

What do I need to be aware of before enrolling?

Two things you should be immediately aware of when you enroll in a new plan are eligibility and vesting. Often, details vary from employer to employer. All employees must be eligible after meeting certain restrictions. The maximum restrictions your employer can impose are as follows: (1) one full year of employment-usually at least 1,000 hours over 12 months, and (2) an individual be at least 21 years old to enroll. Most employers are not this restrictive. A good question to ask when starting or considering a new job is when you'll be eligible to contribute to a 401(k). Once an individual is eligible, they still may not be able to enroll immediately. Some plans have specific start dates for new participants, such as once a quarter or twice a year. For instance, a plan may allow its employees to be immediately eligible to participate but only allow quarterly enrollment. This could cause a 3 month waiting period.

Another thing that a new employee should be mindful of is the plan's vesting schedule. Any money an individual contributes to a salary-deferral plan, and any earnings those contributions produce, always belong to that individual entirely-even if they were to change jobs or retire. However, an individual does not always have an irrevocable right to the money that an employer contributes to the account or the earnings made from those contributions. Only when an employee has become fully vested, do they have legal rights to the total employer contributed amount. Vesting is determined by time on the job. Federal regulations set guidelines for vesting, but the employer determines which vesting schedules to use. Vesting could be immediate, which is not typical in most plans, or it could be on a graded schedule over a period of time, such as 20% after two years 40% after three years and so on. It could also be vested all at once after certain number of years, such as 100% after three years. It is important to keep vesting schedules in mind if one is looking for new employment, because substantial portions of their employer contributions may be forfeit upon departure.

What are the risks?

The risks that face anyone who has a long-term time horizon when investing for retirement are market risk, inflation risk, behavioral risk, and longevity risk.

The first one is the most obvious to investors. Market risk is the possibility that adverse market conditions will result in losses within participant portfolios. Younger participants with very long time horizons are less susceptible to market risk on a relative basis. The percentage of years US Stocks posted positive returns from 1926-2015 are encouraging. For 1 year it was 75.3%, for 5 years it was 87.3%, and for 15 years it was 99.8%. With a 20, 30 or even 40 year time horizon any dips in the market have are very likely of being easily overcome by young participants.

The next risk for investors is inflation risk. Inflation risk is the possibility that an insufficient rate of return will result in diminished buying power for the participant's savings. One simple example of inflation over the last 20 years would be the average cost of a movie ticket. In 1997, the average movie ticket cost $4.50. Now it is over $8.50. Simply saving money in cash is not sufficient, because it loses value unless it is being grown at a rate greater than or equal to the rate of inflation.. In the same way compound interest can work to your benefit, inflation can do the same to your detriment.

Behavioral risk is probably the least discussed but the most important risk to be aware of as a young investor. Behavioral risk is the possibility that participants will respond to the market in ways that undermine their retirement goals. How is behavioral risk manifested? Individuals tend to be far more negatively affected by market losses than they are positively reinforced by market gains. Typically investors tend to overreact to market downturns. Investors then make poor investment choices that hurt their investment returns. These decisions, including when to buy and sell, are often driven by emotion, and investors get the most emotional during negative periods. The best way to mitigate behavioral risk is by staying invested and holding the course. Do not run to cash at a low and buy back in at a high. Make the investment choices you feel most comfortable with and stay with them over the long term.

The final risk is longevity risk. Longevity risk is the possibility that participants will outlive their retirement savings. The best way to combat this risk is by saving as much as you can, as early as you can, and letting the power of time and compounding work for you. Protection against longevity risk starts at the beginning. A younger participant should be more aggressively positioned with a higher exposure to equities. Although stocks are more volatile, they have also proven to provide the highest return over time. The long time horizon allows the younger investor to ride the market fluctuations with less negative impact.

Closing

There are multiple benefits to saving in your company's 401(k). You receive an immediate tax benefit, any amount you contribute is excluded from federal income tax, you get into a regular savings habit, and finally, your company will typically help provide additional savings toward your retirement. Saving consistently much earlier in life allows for greater flexibility and more choices later on. Take advantage of your 401(k) as quickly as possible. The sooner you begin the better the opportunity for sustained long-term savings.

HIGHTOWER
SARIAN STRATEGIC PARTNERS

565 E Swedesford Road, Suite 210
Wayne, PA 19087
Office: (610) 850-9050
hightoweradvisors.com/sarian