

INSIDE BUSINESS

by Bradley R. Newman

401(k) accounts have unknowns

Self reliance

Employers have been steadily pushing the responsibility of preparing for retirement on to the shoulders of the employee during the past 20 years. With the exception of government employees, relatively few employees have the benefit of the traditional employer provided pension that previous generations knew. Today the most prevalent means of retirement savings is the 401(k), a plan that allows the employee to defer current income until retirement. Many employers will match employee contributions to some extent, but the burden of saving the dollars and the investment risk is borne by the employee.

Despite the fact that these plans are the cornerstone to the retirement of most Americans, neither employees nor employers are as familiar with their plans as they should be or spend the time to educate themselves on what their options/responsibilities are.

Employee issues

The majority of 401(k) questions arise at the time of a job change. People are forced to make a critical decision – “what do I do with my 401(k) dollars?” When an employee terminates employment there are four options for the 401(k) funds:

- Leave the dollars with the existing plan, if the plan allows and the balance is above the minimum (typically \$5,000).

- Roll the dollars into the new employer’s 401(k), if the plan allows.
- Roll the dollars into a self-directed IRA.
- Take the dollars as a cash distribution.

Sadly, some studies have reported that almost 70 percent of participants withdraw and spend the dollars when they change jobs. The main disappointment regarding the withdrawal of the dollars occurs when the employee realizes that they may only get 50% of the value in their account after they subtract the 10% penalty if they are not age 59 ½.

The other issue, which the employee may never realize, is the loss of future value to their retirement account – a withdrawal of \$10,000 today will result in a \$100,000 smaller account balance in 30 years assuming the account earned 8 percent.

The percentage of 401(k) participants making cash withdrawals would likely be much smaller if the long-term impact of a withdrawal was communicated, and carefully considered, before the final paperwork.

Assuming the employee does not elect to take the cash, a direct ‘trustee-to-trustee’ transfer is the preferred method to move a 401(k).

Some situations, such as a rollover to an IRA, allow for either a direct transfer to the IRA or for the funds to be paid to the employee who then has 60 days to deposit the funds into the IRA. The direct transfer to an IRA will avoid a 20% mandatory withholding that would apply to a distribution to the employee.

Once the dollars have been rolled into an IRA, there are substantially more investment options than the handful of mutual funds typically provided by a 401(k). The IRA may continue to invest in mutual funds, but also has access to the high quality, no-load funds that 401(k) plans typically do not offer.

As the IRA grows, the use of individual stocks and individual bonds may be an appropriate option. The IRA will provide enough investment flexibility that will allow a professional investment advisor to provide significant benefits.

Employer issues

While the trend from full pension to 401(k) plans has transferred the burden of retirement planning on the employee, it has not removed all responsibility from the employer.

The main areas of fiduciary responsibility relate to areas that directly affect the employee's plan balances:

- **Vendor selection:** Suffice it to say that all plans are not created equal. There are vast differences between fees, expenses, investment options and plan features such as automatic rebalancing.
- **Investment monitoring:** Employers must regularly ensure that investment options are suitable. The recent mutual fund scandals have made this an onerous task. Relying on the vendor for this analysis creates a conflict of interest that puts everyone at risk; this should be outsourced to an independent and unbiased third party to create a system of checks and balances for the employer.
- **Monitoring fees and expenses:** The bottom line is that plans with higher fees and investments with higher expenses will produce lower balances for employees at retirement.

Three converging factors point towards high levels of potential litigation in the future: the baby boomers are rapidly approaching retirement; they have less money than expected based on the effects of the last bear market; and most employers have done a poor job of communicating plan features, investment options and investment results to employees.

Seek help

Regardless of whether you are an employee facing a rollover or an employer concerned that your company has not met its fiduciary responsibilities, seeking an independent advisor to guide you through the 401(k) maze will be imperative. Interview potential advisors and inquire about their area of specialty, how they are compensated and be certain that you feel comfortable with them before you proceed.

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