

StrategicPoint of View[®]

FIX YOUR 401(K) WITH A LITTLE HELP

It is time to fix your 401(k), but after years of volatile markets and imperfect advice, you don't know where to turn for help anymore. Good news: August of 2006 offered a break out from the retirement plan quagmire.

For years, employers have offered tax-advantaged ways for employees to save for retirement, but only recently have they gotten the message: plan participants really need assistance when it comes to managing these plans.

During the massive bull market from 1982 to 1999, it is understandable that plan participants and sponsors ignored the details of the retirement accounts. It seemed as easy to make money as closing your eyes, picking a fund and hanging on. Some were lucky enough to be at the right place at the right time, but others learned painful lessons when the bear market of 2000 to 2002 devoured account values.

As the shock of those years mitigated, many participants asked for more information and usable advice. They were not interested in slick sales pieces, but real help. But employers and plan sponsors were reluctant to offer advice because they were uncertain about the liability of offering advice if it turned out to be faulty.

The Pension Protection Act

All that changed when the Pension Protection Act of 2006 (PPA) was signed into law on August 17, 2006. Now retirement plan providers can offer participants access to specific investment advice. The legislation clearly states that advice is permissible within retirement accounts and goes one step further by delineating the conditions under which it can be offered.

A fundamental premise of the law is that anyone offering retirement plan advice must be a fiduciary and acknowledge this fiduciary status in writing. By law, a fiduciary must put the best interests of the client first and foremost in all financial recommendations. While most plan participants might assume that the company and/or plan sponsor are plan fiduciaries, it may come as a surprise that most likely no one associated with your retirement plan carries that responsibility.

As of January 1, 2007, if you hire an advisor for your retirement plan, the Pension Protection Act requires that your advisor put your interests ahead of his/her personal gain. To make sure that this happens, the Act instructs your advisor to disclose in writing any conflicts of interest he/she might have, such as extra compensation, fees or arrangements that the advisor or company might derive from particular fund choices.

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In addition, since the best advice is unbiased advice, the PPA wants your advisor to be paid the same amount regardless of incentives or potential commissions for recommended investments.

All of this is good news for you, the plan participant. The Pension Protection Act recognizes that you are entitled to unbiased advice for a price that is arrived at fairly. The Act even allows your fees to be deducted directly from your plan and not from your pocket in order to make this advice more affordable.

Encouragement of Savings

So why is the government concerned about your getting the best advice? Because it is extremely worried that many people are not saving enough and that they are not investing wisely.

Most people start saving seriously about a decade before they want to retire. Prior to that time, children and household expenses seem to eat up most of the hard earned income. Only when wages reach a comfortable level, do people turn to their retirement plans and play catch up. By then their portfolios are subject to shorter term market forces, which may wreak havoc on the best retirement plans. Just ask those individuals who started seriously adding to their retirement plans in 1999. For many investors the bear market of 2000 to 2002 devastated existing holdings and devalued new contributions. Many employees became discouraged, hesitating to increase their savings precisely at the time they needed to the most.

By delaying savings, people assume additional risk unrelated to market performance. Health issues, job losses and divorce later in life can dramatically reduce wealth. Most people believe that they can and will work until age 65. However, the average retirement age is currently 62 (for women) and 63 (for men). Being forced to retire early for health reasons or for layoffs not only reduces future

savings, but forces individuals to start withdrawing from their portfolios much earlier than expected. In addition, early retirement reduces social security benefits, which are still the major funding source for retirement spending.

Compounding the problems of delayed savings are inadequate savings and poor investment choices. The median balance in 401(k) plans is less than \$100,000 for those approaching retirement age, which is not nearly enough to support most retirees' desired standard of living for the next 25 to 30 years. As millions of Americans became directly responsible for planning and managing their retirement savings, many have mismanaged and under-funded their retirement plans through a combination of ignorance, misunderstanding and bad advice. For example, employees often haven't contributed enough to receive the maximum employer match, allowing free money and risk-free, tax-deferred returns on their savings to pass them by. People have also borrowed from their 401(k) plan when they didn't have to or opted to cash out of their accounts after a job change, instead of rolling over the balance into a new plan or an IRA. Some employees have never even participated in their plan at all.

Other oversights employees have made include being too conservative or too aggressive. Some may hold too much of their employer's stock while others keep their plans in the money market investment election, which reduces risk exposure but may only bring low returns. Employees might also neglect to rebalance their plans regularly, exposing portfolios to unnecessary risk. Witness the plan participants who sat frozen from 2000 to 2002, watching their retirement savings dwindle because they simply didn't know what to do.

Recognizing that future retirees are in trouble, Congress added provisions to the Pension Protection

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Act to shore up retirement plans by providing incentives to save. The PPA sanctions companies' ability to automatically enroll employees in retirement plans. Before now, employees had to sign up for retirement plans — allowing many to forego saving. Going forward, employees who don't want to participate, will need to opt out of plans. This will result in more people adding money to retirement accounts. In addition, employers can automatically increase the amount of an employee's deferral, as wages increase. These plan provisions are optional on the part of the employer, but are likely to become increasingly popular, as more and more employees turn to their employers for support.

Even with all of the good measures enacted by Congress recently, you cannot rely on the government to salvage your retirement. Ultimately, your retirement is your responsibility. So what to do? *Take control!*

Here are six steps that will help you more effectively manage your 401(k):

STEP 1:
Evaluate where you are, where you want to be and what you need to do to get there.

Most retirement plans are tied directly to not having a financial plan. You can't measure your progress or decide to change your strategy if you don't have a strategy to begin with. Take a page from the book of the pension consultants: when a pension consultant advises a corporation regarding the funding of a retirement plan, the first thing they do is examine the expected benefits to be paid. You should do the same by asking, "How much will I need to retire?" Next, they look at what is currently available to fund those benefits. In your case, "How much do I have?" Lastly, they come up with the amount that must be invested in regular intervals to make up for any shortfall. If there is no shortfall, then congratulations! You're in great shape. However, if you're like most people, you've got some work to do.

Clearly there's some math in here. You can go to any number of websites for calculators that will do the heavy lifting for you or take a financial check-up at a firm like StrategicPoint. Here is the catch: when the diminishing assets calculator asks for an input for rate of return on your assets, you should use a number no higher than 8%. If you are nearing retirement, use 7% before retirement and 6% after retirement. In addition, you want to make sure that the calculator is set to a life expectancy of at least 95.

As part of your strategy, it is important to review your plan regularly and to adjust accordingly. If the markets have underperformed, you may need to change your assumptions regarding your age of retirement. If you have been able to save more than planned, you may be able to increase your maximum spending rate or retire earlier. Planning is an ongoing process that requires periodic attention and revisions to ensure that you can meet your goals.

STEP 2:
Know thyself.

Understanding risk and how you tolerate it can help you avoid the second biggest failing of most retirement strategies: buying high and selling low.

See if this sounds familiar: "I don't mind taking risk, as long as I make money." We know you have said it, or at least thought it. There are so many things wrong with that statement that it's hard to know where to begin. Risk is not knowing what will occur — risk is the chance that something other than what you hope will happen — happens. Ask yourself, "How great is the risk that I will lose money instead of making it, or how likely am I to achieve my goals?"

Consider the following: if a portfolio invested in 70% stocks and 30% bonds has a 70% chance of making money, then there is a 30% chance that it will lose money. Accordingly, there is a 30% chance that you

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will not achieve your goals (assuming your goal is to make money). This is an over-simplification of risk but it illustrates the point. Is a 30% chance of a negative outcome acceptable? Most people would say “yes” in relation to their investments, but what about the security of their families?

We frequently assume more risk with our investments than we would take elsewhere in our lives because investments are not real to us. We see them as an illusion. When you reach the golden age of retirement, it's no longer an illusion. Here is a tool to measure your risk tolerance, which will help you evaluate your feelings about risk and your financial reality. How much of your salary are you willing to risk annually for the opportunity to double your salary for that year? It is a simple question, but it gets you thinking about risk in a more concrete way.

After you have a sense of your risk tolerance, you can match the portfolio choices to what is comfortable for you. You're going to have to do some work here. You can't ask your co-worker because her risk tolerance may be different from yours. You're going to have to actually read about your plan options. Making informed decisions should help you avoid chasing the latest high flyers—buying when they're high and selling when they're low—something many participants have done.

STEP 3:
Control what you can control.

The financial markets are out of your control. Stop worrying about them. What you can control is your contribution level. Make sure that you are maximizing your 401(k) benefit. Every dollar you contribute saves you money in taxes. This is money that belongs to you and is not at risk. Even if your account returns 0% you're ahead of the game because of the tax savings.

If you're over the age of 50, take advantage of the catch-up provisions that allow you to increase your contributions. For 2008, the maximum retirement plan contribution is \$15,500 for someone under age 50, and \$20,500 for someone over age 50. These numbers are periodically indexed for inflation and will rise in the future.

Avoid taking out any loans unless you absolutely have to. When you make retirement contributions, you use pre-tax dollars. When you pay back loans, you apply after-tax dollars to repay them.

Most importantly, if you change jobs, consider rolling your account over to a new plan or to a traditional IRA. Millions of dollars in retirement benefits are lost each year when people change jobs, cash out their accounts and spend the money instead of moving it into another retirement account. Not only do they pay taxes on this money but the government tacks on an additional 10% penalty to boot (if the participant is under the age of 59½). When deciding what to do with an old 401(k), compare the investment options of your new plan to those available through an IRA and select the alternative that provides you with the greatest flexibility and control.

STEP 4:
Make additional contributions and/or set up additional savings vehicles.

If you need to save more money to achieve your goals, consider establishing a Roth IRA. While the limited deductibility of the traditional IRA for 401(k) plan participants makes it impractical for many employees, the Roth IRA has greater qualification limits and allows tax-free withdrawals later in retirement, making it a useful vehicle for supplementing your 401(k).

Alternatively, your retirement plan may allow after-tax contributions. Although these accounts are usually not tax-deductible, they do grow tax-deferred,

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which is an effective way to increase your retirement assets. And beginning in 2008, non-deductible retirement plan contributions can be rolled directly into a Roth IRA when you leave your job or retire.

Finally, once you have exhausted all tax-deferred opportunities, establish a taxable long term investment account. Although the earnings from this account will be taxable every year, the additional savings can provide flexibility for your retirement spending needs.

STEP 6:

Ask your employer to change your plan.

The Pension Protection Act can only go so far. Your employer has to add the new features to the retirement plan before you can take advantage of them. In addition, it is your employer who chooses the fund options by selecting an investment company to work with and negotiate your fees and fund choices. To take advantage of all federal laws and IRS rulings, as well as to ensure your plan has desirable investment options at a reasonable price, talk to your employer. Your company plan is your retirement; let your employer know how you feel and what you want included in your 401(k).

STEP 6:

Hire an advisor.

Now you have a choice. Where before, there was no one to turn to for advice on your retirement plan, you are now able to choose among a variety of financial advisors. The challenge will not be, "Should I?" but "Which one?" Caveat Emptor: Even with the requirement that retirement plan advisors act in your best interest, not all advisors are created equal. Some have more knowledge and experience than others. Some will rely more on future market opportunities and less on past performance.

You should seek a Registered Investment Advisor, like StrategicPoint, who is bound by a fiduciary duty to

you. StrategicPoint's investment strategy is based on proactive investment management of your retirement assets, which means daily review of economic data, markets and specific assets to help create a diversified, risk-sensitive portfolio for you. As part of this process, StrategicPoint takes the time to understand your goals and help you maximize this critical component of your financial life.

Saving for retirement is more challenging than ever. But the rules are clear — you don't have to go it alone.

Questions about this article:

Please send an email to info@strategicpoint.com.

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