THE Wealth REPORT

If your employer offers a 401(k) plan, that's the easiest way to save for retirement. But maximizing its potential may take a little more work.

6 STRATEGIES TO MAKE YOUR 401(K) PLAN WORK HARDER

Overview

You work, you save, you invest. But the key to every investment is how hard it works for you. Participating in an employer-sponsored 401(k) plan makes it easy to invest. But there is more to a 401(k) than automatically deferring income from your paycheck, choosing a few mutual funds and then letting it ride for 30 years. Using strategies suitable for your circumstances can help your retirement plan work just as hard as you do.

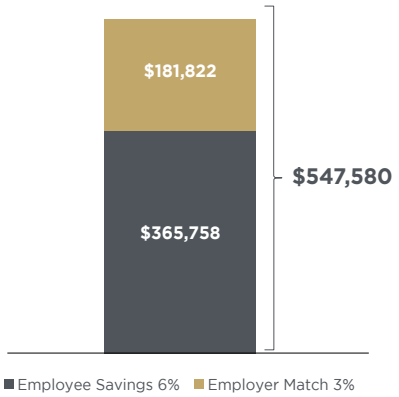
With a 401(k) retirement account, the money you contribute from each paycheck is subtracted from your current taxable income. That means you pay less in taxes each year, while your 401(k) investment has the opportunity to grow — also tax-deferred — every year until you withdraw the money. Since it's a retirement plan, presumably you'll be retired at that point and your income tax rate will likely be lower.

The following are six strategies you can deploy to help make the most of your 401(k) retirement plan.

Strategy #1: Get Free Money

If your employer offers a matching contribution to your 401(k) plan, try to defer at least the percentage of your income required to take full advantage of that match. For example, if your company pitches in 50 cents for every dollar saved, up to 6% of your pay, then try to defer 6% of your income.

401(k) Retirement Plan



This is a hypothetical example provided for illustrative purposes only; it does not represent a real-life scenario and should not be construed as advice designed to meet the particular needs of an individual's situation.

To see how this "free" money works to your advantage, take the example of someone who earns $75,000 a year. If he defers 6%, he'll contribute $4,500 a year. If his employer contributes a 3% match — for a total of 9% of his annual income — that's another $2,250 invested.[1]

Assuming he continues this investment pace and continues to earn $75,000/year (although his income would likely grow) for 30 years, at an average annual investment return of 6%, he'd accumulate $181,822 more in retirement savings because he took advantage of the company match.

Strategy #2: Make It Grow Faster

The nice thing about automatic deferrals from your paycheck is that your 401(k) balance may continue to grow regardless of market performance. One way to help it grow faster is to contribute more each paycheck.

In other words, if you're contributing only the amount that allows you to take full advantage of your employer's match, you may not be contributing as much as you're permitted. In 2022, the 401(k) employee contribution limit has increased by $1,000 — to $20,500. Employees age 50 and up may contribute an additional $6,500, for a total of $27,000. Note that employer matches do not count toward that contribution limit.

In the case of a 50-year-old earning $75,000 a year, she can contribute as much as 36% of her income to max out the $27,000 contribution limit this year.[2] While that may be significantly more than she can afford to save, couples may want to evaluate their total household income and how their contribution strategy may benefit the most from one or the other's employer 401(k) plan.

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If you are not yet maxing out your 401(k) plan contribution, here are some ideas to help you move in that direction:

- Seek to increase your deferral rate gradually, such as every time you receive a raise, promotion or bonus. This way, you can save more without reducing the amount you take home. However, ensure that any adjustment to your deferral rate won't lead to you exceeding the annual contribution limit.
- Consider increasing your deferral rate by one percentage point each year. Some companies implement an automatic escalation feature, so make sure you know your employer's policy beforehand.
- Perhaps the best time to increase your deferral rate is during your employer's annual enrollment period — when you're considering other benefits and taking a good look at your household budget.

"When you max out your 401(k) plan, you not only save more for retirement, you potentially pay less in taxes that year since your taxable income would be lowered."[3]

Strategy #3: Make It Last Longer

These days, it's not unusual for retirement to last 30 years or more. For many people, that's longer than they've accumulated enough savings to support them. One way to augment your retirement income plan may be to purchase an annuity contract. Most annuity contracts offer the option to convert your principal into a stream of income guaranteed (by the issuing company) for the rest of your life.

In recent years, some employers have begun offering an annuity option within their 401(k) plan. This is a little ironic since 401(k)s were meant to supplant the traditional, defined-benefit pension plan, but that's similar to how an annuity option works. With an annuity, however, the guarantees are backed by the insurance company, not the employer.

The SECURE Act of 2019 contains provisions designed to encourage companies to offer an insurer-issued retirement annuity option by limiting the employer's liability to provide annuity payouts. Slowly but surely, many 401(k) plan providers have begun to adopt an annuity option. So, if you don't have one now, you may in the future. One of the features of an employer-sponsored annuity option is that every year, each participant receives a customized estimate of the monthly income expected in retirement based on his current annuity account balance.[4]

Note that you may purchase an annuity either within a 401(k) plan or separately from a licensed financial professional. However, there are drawbacks you should be aware of in more complete detail, including:

- Higher fees than mutual funds and other types of investments
- Potential early surrender charges for access to funds
- A 10% early withdrawal penalty, as with early 401(k) withdrawals
- The annuity's guaranteed payout is based on several factors, such as interest rates, the balance accumulated and the participant's age when she starts drawing income

Despite the drawbacks, an annuity option is a way to make your 401(k) investment continue paying out retirement income regardless of how long you live.

Strategy #4: Beat Inflation

During the past 25 years, overall inflation has increased by nearly 75%. To put that into real-life perspective, consider that between 1995 and 2020, the cost of:[5]

- a gallon of milk rose 30%
- a loaf of bread rose 57%
- a dozen eggs rose 117%
- a pound of ground beef rose 172%

Now, imagine how much those household staples will increase over another 25 years. The key may be to invest a robust allocation to stocks in order to keep up with inflation. Since 1900, both U.S. stocks and long-term bonds have managed to outpace inflation. However, stocks tend to offer higher returns because they invest in companies that stand to increase revenues as inflation rises — whereas bonds may lose money because they have fixed payouts.[6]

The 401(k) is generally a good vehicle for a higher stock allocation because it is inherently a long-term investment plan. The longer you stay invested, the less likely your returns are affected by periodic market declines.

Strategy #5: Temper Volatility

While a substantial allocation to stocks offers greater potential for growth, it also increases the risk of loss. The investment markets are always subject to dramatic swings, so the best way to temper that volatility is by appropriately diversifying your assets based on your financial goals, investment timeline and tolerance for market risk.

Fortunately, most 401(k) plans offer a wide array of stock and bond mutual funds and exchange-traded funds (ETF), as well as cash instruments. Spreading your contributions across a strategic allocation of these options can help protect your account from periodic market declines.

As a general rule, young adults are advised to invest a higher allocation to stocks, and that allocation may grow more conservative over time as they get closer to retirement age. The closer you get to retiring, the more you want to protect your investment from a market downturn — as there is less time to recover large losses.[7]

Remember to Rebalance

Once you select your 401(k) investment allocation (e.g., 50% stock fund, 40% bond fund, 10% money market fund), it's important to rebalance that mix periodically to help keep your investments on track with your goals and comfort with market risk. For example, should your stock fund outperform and represent 65% of your overall 401(k) portfolio, you may want to sell off some of those gains and reinvest the proceeds in your bond and cash funds. Note that since you are buying and selling within the tax umbrella of a 401(k) plan, you won't incur taxes on capital gains because rebalancing isn't the same as withdrawing money.

Strategy #6: Minimize Taxes

However, the day will come when you need to begin withdrawing your 401(k) plan assets for retirement income. At that time, all of the money distributed will be taxed at your then-income-tax rate. That tax rate will

be determined by all of your retirement income sources, including Social Security, pension benefits and any taxable investment income.

But not all retirement investments generate income taxes. For example, Roth IRA contributions are made on a post-tax basis. Not only are contributions not taxed again, but investment gains grow tax free. While the 401(k) offers the opportunity to save taxes on current income throughout your career, the Roth IRA can save money on income taxes when you're in retirement.

It may be a good idea to diversify your income tax liability so that not everything you receive in retirement is taxable. One way to do this is to transition portions of your 401(k) assets into a Roth as you approach your retirement date. You will have to pay income taxes as the money is converted, but it's likely best to pay those taxes while you're still working. Then once you retire, you won't owe any taxes on Roth distributions.

If you decide to convert 401(k) assets to a Roth IRA, consider doing so incrementally so that you don't tip your income into a higher bracket in any one tax year. Also think about converting during market declines. That way, you'll pay less in taxes but have the opportunity to recoup losses on a tax-free basis in the Roth. Some employer 401(k) plans allow in-service withdrawals or an in-plan Roth conversion. It's important to check with your plan's rules and work with an experienced financial professional if you're considering a Roth conversion.[8]

One more key benefit to remember: The Roth IRA does not compel required minimum distributions (RMDs), but RMDs are required for a Roth 401(k) in an employer-sponsored retirement program.[9]

Final Thoughts

The employer-sponsored 401(k) plan is an excellent accumulation vehicle for retirement income, as well as a tax-savings benefit for employees. If you do nothing but set your deferral rate to your employer's match, pick a target-date fund and ignore it until you retire, you've already made good decisions.

However, with a little effort and strategic planning, you can get your plan to work harder to help achieve your retirement goals. It's important to discuss your 401(k) plan as part of your overall investment portfolio with your financial professional — even if he or she does not actively manage those assets. This holistic approach ensures that your investments do not overlap and are appropriately allocated and diversified. It's also helpful in developing a distribution plan for your retirement income that minimizes your tax bill and addresses your needs for growth, risk management and a long, fulfilling retirement.

[1] Morgan Stanley. Dec. 1, 2021. "You Work Hard, Make Your 401(k) Plan Work Harder." https://www.morganstanley.com/articles/401k-strategies. Accessed Jan. 3, 2022.
[2] Ibid.
[3] Ibid.
[4] William H. Byrnes and Robert Bloink. ThinkAdvisor. Jan. 14, 2020. "Secure Act's 401(k) Annuity Options: The Pros and Cons." https://www.thinkadvisor.com/2020/01/14/secure-acts-401k-annuity-options-what-to-know/. Accessed Jan. 3, 2022.
[5] John Hancock. June 4, 2021. "How inflation can affect your 401(k)." https://retirement.johnhancock.com/us/en/viewpoints/retirement-readiness/how-inflation-can-affect-your-401-k-. Accessed Jan. 3, 2022.
[6] Ibid.
[7] Patrick Villanova. SmartAsset. Oct. 6, 2021. "How to Protect Your 401(k) From a Stock Market Crash." https://smartasset.com/retirement/how-to-protect-your-401k-from-stock-market-crash. Accessed Jan. 3, 2022.
[8] Fidelity. Aug. 25, 2021. "Do you earn too much for a Roth IRA?" https://www.fidelity.com/viewpoints/retirement/earn-too-much-contribute-Roth-IRA-conversion. Accessed Jan. 3, 2022.
[9] Fidelity. June 14, 2021. "Why consider a Roth conversion now?" https://www.fidelity.com/learning-center/personal-finance/retirement/answers-to-roth-conversion-questions. Accessed Jan. 3, 2022.

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