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Five 401(k) Features You Should Know

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Think you can just sign up for a 401(k) and forget about it? Think again.

With only 13% of private sector employees with access to a defined benefit pension, more of the heavy lifting towards securing a sound retirement is falling on the shoulders of American employees themselves. The most widely used but perhaps least understood retirement vehicle in use today is the 401(k) plan. The ins and outs of which can vary greatly between companies. However, there are a few key aspects that you should be especially aware of.

1.) If your employer offers a match, it is important to find out what that amount is and how it is calculated and applied. If your employer has not automatically enrolled you in the 401(k) plan, make sure you set it up to have a set dollar amount or percentage of income go into your retirement account each paycheck.

2.) While maxing out your employer's match is the minimum you should do, that is often not sufficient to sustain a 20 to 30 year retirement on its own. Meet with a financial planner or use an online tool to help determine and set a goal amount for retirement. If you have a long time frame until retirement, replacing 80-100% of your current income is a good starting point. While social security may cover a portion of that, the gap will have to be made up with assets you are able to accumulate over your working career.

3.) Many 401(k) plans now offer both pre-tax and Roth portions to their plans. Deciding which option to contribute to will depend largely on your personal circumstances and tax situation. The advantage of pre-tax contributions is that the contribution amount is deducted from your income for tax purposes. While a Roth contribution offers no current tax deduction, the withdrawals in retirement are tax free, provided you are 55 or older and have owned a Roth for at least 5 years. In general, if you anticipate being in a higher tax bracket in retirement, then a Roth 401(k) would be more beneficial. Alternatively, if you anticipate a lower income in retirement, then the current tax deduction of a pre-tax contribution will be more beneficial.

4.) When setting up your 401(k) you will have to determine how you want those funds to be invested. While it is becoming more common to default to a target date fund, using your age 65 as the target year, that may not be the best fit for your particular circumstances. Depending on your age, time frame, and risk tolerance, it is better to have a retirement plan that fits your specific needs. The investment options can vary substantially between 401(k) plan providers and it is important to understand the different risk/return profiles between various asset classes. This will usually include cash, bonds, real estate, U.S. stocks, and international stocks. Typically, you will want to invest more in growth oriented investments such as U.S. stocks, international stocks, and real estate in your younger years while you have a long time frame for retirement. As you get closer to your retirement date, you would gradually shift some of your growth positions to income and lower volatility investments such as cash and bonds.

5.) Lastly, it is vital that you review your investments as well as contribution rate periodically. If you have a rise in income, consider allocating all or a portion of that increase to funding your retirement account. On the investment side, check to see if you need to alter your allocations to rebalance your portfolio. If anything has changed in your goals, time frame, or risk tolerance, you want your investment approach to reflect those changes. Depending on your comfort level and time, you have the ability to be tactical in your investment approach. Risks are not often constant and opportunities for growth can vary. Making small changes to the percentage in various asset classes can help you protect against increased risks or take advantage of perceived opportunities.

Building a strong foundation for retirement is a career long process. Following these steps will put you on the right path to achieving your retirement goals. In addition, there is a plethora of information and online tools to educate yourself on investing strategies. If you lack the time, desire, or know how to plan and invest for retirement, consider working with a fiduciary financial planner. Ideally, one that is intimately familiar with your employer's benefits and 401(k) plan options and features.