Investment Guide

The New 401(k): A User's Guide

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Six changes that could be coming to your retirement savings account. Get ready.

Even if you've had the same 401(k) plan for years and are content with your current investment choices, pay attention: You may well have new decisions to make about how you pilot your tax-deferred, employer-sponsored retirement account. In response to Congress' rewrite of federal pension law last summer and other new federal edicts, employers are revamping their plans, adding new choices and eliminating others.

And while you're reviewing your plan, scrutinize the fees you're being charged. Complain if they seem out of line. With both politicians and class action lawyers attacking high (and hidden) 401(k) fees, you're more likely to get results than in the past.

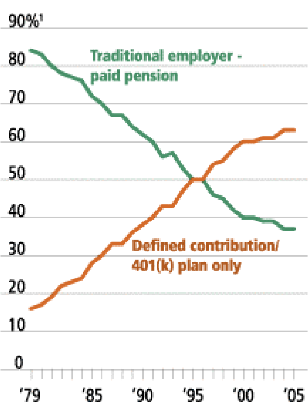
The Roth Option

After Congress made permanent the Roth 401(k)--first allowed in January 2006 on a temporary basis--employers started getting on board. A Profit Sharing/401(k) Council of America survey early this year found 22% of companies (up from 7% in early 2006) offering a Roth K and another 48% planning to or considering it.

A Roth K works much like a Roth individual retirement account: You put already taxed money in and (after five years) all withdrawals in retirement are tax free. By contrast, in a traditional deductible 401(k) or IRA, pretax money goes in and all withdrawals are taxed as ordinary income. Whether the money is going into a traditional 401(k) or a nondeductible Roth or a blend, the most you can put in this year is \$15,500 (\$20,500 if you were born before 1958).

No Parachute

Most workers no longer have a traditional pension to save them if their 401(k)s crash.



[1]Percentage of all workers participating in retirement plans. *Source: Employee Benefit Research Institute.*

Two types of employees are likely to benefit from using the nondeductible option: young workers who expect their income tax rates to rise and high-income workers who have so much loose cash that they can shrug off the loss of the tax deduction. If you can afford one, a Roth beats a deductible account.

Suppose you are now and always will be in a 40% tax bracket (state and federal). And suppose you can double your money between now and when it's time to spend it. Put \$20,000 into a Roth now and it becomes \$40,000 of spending money at retirement. Alternatively, you could put the \$20,000 into a deductible account and generate \$8,000 in tax savings for investment outside the account. Come retirement, this strategy gets you \$24,000 of aftertax money from the 401(k) and something less than \$16,000 from the side account. Less, because this side account is not protected from taxes along the way. So the deductible strategy leaves you with something less than \$40,000 of spending money during retirement.

Another Roth K advantage for the well heeled: When you leave your job, you can roll the money into a Roth IRA, which isn't subject to the same minimum withdrawal requirements, beginning at age $70\frac{1}{2}$, as a regular IRA. That allows you and your heirs to stretch out tax-free growth, potentially for decades.

If your tax rate is likely to fall in retirement (say, because your income will drop or you're moving from highly taxed New York City to Florida, which has no state income tax), stick with a deductible 401(k). Unsure of the future? Hedge your bets by splitting your contributions between a Roth K and a traditional account. (Note: your employer's contributions can't go in the Roth anyway.)

Autopilot 1: The Escalator

To promote savings, the new pension law encourages firms to automatically enroll new employees in 401(k) plans, forcing them to make the effort to opt out if they don't want to contribute. A Hewitt Associates survey found 58% of large companies plan to use automatic enrollment by the end of 2007, up from 24% at the end of 2005. At some, there will be escalators that jack up contributions over time unless you voice objections. Unless you're really strapped, put up with all this paternalism. Saving money is good for you.

Autopilot 2: Life-Cycle Funds

The government is involving itself not just in workers' spending decisions but in their asset allocation, too. Under proposed Department of Labor rules, employers will be encouraged to make something other than money-market accounts the default investment option for savers who are too lazy to specify a choice. The favored alternatives: balanced funds (more or less fixed-percentage blends of stocks and bonds), life-cycle funds (which shift from stocks into bonds as the saver ages) and managed accounts (custom blends created by computers).

Yes, there's a lot of inertia in investment allocations. A recent Wharton School Pension Research Council study of 1.2 million participants in 1,500 plans found that over two years 80% made no trades and another 11% just a single trade. So even if they started with a well-thought-out asset allocation, they allowed the market to skew it. The result: Account holders who "passively" rebalanced their accounts by investing in either balanced or life-cycle funds earned 0.84 percentage points more a year on their investments (on a risk-adjusted basis) than their inert brethren.

If you want to stay 60% in stocks and 40% in fixed-income investments, the right balanced fund can keep you there. If you want to shift into more bonds as you age, consider a life-cycle fund. The latter is getting very popular, but watch out for the fees, says Joseph Nagengast of Turnstone Advisory Group.

Another problem: Life-cycle funds treat everyone of the same age the same. But a 55-year-old midlevel worker five years from retirement should probably invest more conservatively than a 55-year-old executive planning on working 15 more years. If you're 55 and plan to toil until 70, pick a fund designed for 45-year-olds. (Make sure your plan doesn't automatically move you into the "proper" retirement age fund.)

Autopilot 3: Managed Accounts

While many more companies are making life-cycle funds their default, managed accounts are also a fast-growing--and intriguing--option. As of the end of April Financial Engines, the leading provider of this service, had signed up 174 employers with $170 billion in assets. Your company could be one of them; only half of those signed up had rolled the service out yet.

Cofounded by modern portfolio theory guru William Sharpe, Financial Engines charges 0.15% to 0.6% of assets a year, on top of normal mutual fund expenses, which vary, depending on what's offered in your plan. For its cut, Financial Engines picks your funds and rebalances your holdings quarterly, if needed.

While the allocation is heavily influenced by your age, there's more customization than in a life-cycle fund. The service will diversify your portfolio away from the industry you work in, particularly if you hold company stock, and will take into account how much you save, your holdings outside the plan and even your spouse's holdings. "Not all 50-year-olds should be treated the same," says Chief Investment Officer Christopher Jones.

Some other managed accounts services reallocate your portfolio more aggressively, based on changing market conditions. You'll be charged more for this market-timing approach--upward of 1.5% of assets--on top of fund fees. A bad idea.

Shrinking Choices

As of June General Motors is reducing from 73 to 39 the number of funds offered in its salaried workers' 401(k)--a move that should cut both company and participants' costs. Watson Wyatt pension consultant Robyn Credico reports that six of her largest corporate clients are reducing their offerings. GM and other sponsors are reacting to research showing that more fund choice doesn't lead to better asset allocation by average participants and may even paralyze them. Bounty is wasted on the ignorant.

What about those who know what they're doing or use professional advisers? Then a smaller smorgasbord is not a good development, argues financial planner David Kudla of Mainstay Capital in Grand Blanc, Mich., who has GM clients.

It you don't like your 401(k)'s new, pared-down menu, lobby for a brokerage window. For a fee of $80 or so a year (plus transaction costs), this service will allow you to buy any stock or fund you like. Some mutual funds even waive their loads if you invest through a window. Currently only about 8% of plans offer this escape hatch, says Hewitt Director of Retirement Research Pamela Hess. The companies say they don't see a demand; just 1% of workers offered a window use it.

Find Those Fees

Most employees (and some employers, particularly smaller ones) have no idea how much fees, both obvious and hidden, are eating into their retirement savings. Expenses are, on average, lower at big companies.

According to a study by HR Investment Consultants, fees consume an average of 1.59% of assets per year in plans with 25 participants and 1.07% of assets in plans with 5,000 participants. But costs vary widely. When HR examined plans with 100 participants and $5 million in assets, it found annual investment fees for fixed-income funds ranged from 0.2% of assets to 2.24%, for large-cap U.S. equity from 0.37% to 2.48%, for international equity from 0.48% to 2.95%. Overall costs can run even higher, if extra administrative fees are imposed.

Here's how to evaluate your plan. First look at the administrative charges, which should be modest. Are you charged for an annual account maintenance fee? For purchases? For fund sales? Many employers absorb all administrative costs--or think they do. One trick is for a plan administrator to woo sponsors with lower administrative fees, then charge slightly higher expenses for the funds, says David Campbell of financial planning firm Bingham, Osborn & Scarborough. "There's a migration away from companies picking up as much as they can toward putting it on the participants."

Then, assuming your plan offers individual mutual funds, examine the expense ratio found in the funds' prospectuses. Even if some offerings are pricey, you should have at least a few low-cost index fund choices--say, an S&P 500 or other broad stock market index fund costing around 0.2% of assets and a bond index fund at 0.4%.

Interested in more exotic or managed funds? Compare the fees charged by comparable publicly sold funds. Large 401(k) plans often use institutional funds that should, if anything, cost less than a retail fund. If a mutual fund fee is higher than the comparable retail product, that could be a tip-off that administrative and other costs are being shifted to you and hidden in the fund fee.

Also, check the fund's turnover, or how often the manager buys and sells stocks, in the fund's prospectus. Rule of thumb: A 100% turnover can nick your annual return by as much as 0.75% in commission costs and spreads, says Campbell.

Should expenses look high, talk to your company. Class actions against companies and plan administrators, as well as new federal rules in the works, are making employers more sensitive to their legal duty to try to get a good deal for workers.

If you can't make headway, consider cutting your 401(k) contributions to the minimum level needed (usually anywhere from 3% to 6% of salary) to snag your employer's full match. Then put your money in an IRA if you're poor enough to be eligible or a taxable account if you're not. Saving taxes isn't worth it when your savings get eaten up by fees.