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The Pros and (gasp) cons? of 401(k) plans

I know, I know, how can I say that there is something wrong with a 401(k) plan? Isn't the 401(k) the best thing to come along since sliced bread, Starbucks, and the Internet? Well, as with most things in life, there are good and bad things about 401(k) plans and I'll attempt to discuss both sides in this article.

Tax Issues to consider

One of the primary benefits of contributing to a retirement plan like an IRA or 401(k) is the contributions go into the account on a pre-tax basis. This means that instead of having to pay taxes now on the contribution, you get to add the tax to the plan and allow it to accumulate inside the account. This reduces your taxable income today and you get the benefit of having more money accumulating inside the plan. The money also grows on a tax-deferred basis so you won't be getting any 1099s for capital gains, dividends, or interest income on an annual basis.

Ordinary Income vs. Capital gain income

Contributing money into a pre-tax and tax-deferred account is a good thing. However, it also means that when you withdraw money from the account at retirement it will be taxed as ordinary income instead of capital gain income. Under current tax law this can be significant difference. You may not want all of your income subject to ordinary income taxes during the retirement years.

Current tax brackets vs. future tax brackets

The other issue, which many people may not consider, is their current tax bracket versus their tax bracket when they retire. No one knows what tax rates will do in the future, but considering the state of affairs with Social Security, the Federal deficit, and the demographics of an aging and retiring Baby Boom Generation it may mean tax rates are on their way up. Depending on your circumstances you may be in the lowest tax bracket of your life right now because of the deductions for dependents and mortgage interest.



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Solution

It doesn't make sense to me to contribute money now to save paying taxes at a low tax bracket only to take it out later on to pay taxes in a higher bracket. Since it is impossible to predict what tax rates may be in the future it may be wise to have two buckets of money at retirement, one subject to taxes, and one not.

Investment decisions and responsibilities

The 401(k) plan has had the reputation of being the saving grace for our retirement. Over the past several years we have been exposed to some of the problems with these plans and the abuses that can occur. In addition we are reading about companies stopping pension payments or filing bankruptcy to avoid making retirement plan payments to retiree's. It would appear that we have seen the demise of the classic pension, which has gone the way of the dinosaur except for a few companies and for those who work for the government. Why has this happened?

A 401(k) is a Defined Contribution Plan. This means that the amount of the benefit is determined solely by the amount of money that has accumulated in the account due to the contributions to the account and the earnings on those contributions.

A Pension is a Defined Benefit Plan. This means the amount of the benefit can be determined in advance by a formula (normally based on years of service \times a factor such as $1.5 \times$ your salary) that is used to determine the benefit. The corporation or the government is then responsible for the management of the money to fund the benefits when paid to the individual employee.

Today many companies that offer retirement plans offer a defined contribution plan rather than defined benefit plan. There is less responsibility and cost on their part and the employees have more control over their own account.

It costs money for a corporation to administer a retirement plan. It costs more money to take on the responsibility for the performance of that retirement plan and to be able to guarantee an income to a retired employee for the remainder of their lives. During the last several decades there was a large amount of political pressure put on corporations to allow employees to have control over their own investments, to allow them to direct where the



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money was invested. This has led to the popularity of the 401(k) type plans, which are based primarily on employee salary deferral.

The problem with this is that the responsibility for the investments and when and how to contribute to the retirement plan now became the responsibility of the employee, who in many cases has very little training, education, or knowledge about making these decisions. Do you feel prepared to manage the investments in your 401(k) plan? Many people manage their 401(k) like they would swing at a piñata, blindfolded and feeling helpless; or wildly, with great vigor, only at the wrong time.

Solution

Investing in some education to learn how to manage the asset allocation decisions could be the best education you ever give yourself. It has been said that 90% of the success of any investment program is due to the asset class choices rather than the individual securities. An asset allocation strategy helps you choose which asset classes to invest in and how much in each class. By understanding and implementing a sound asset allocation strategy you will be well on your way to a successful retirement.

Lack of other “Banking Capital”

What is the rate of return on liquidity?

At first this seems like a non-sense question. There is no rate of return on liquidity; it's just a definition of how easy it is to access the money, right? Well I want you to stop and think about the fact that you have no available capital, or all the available capital is inside your retirement plan. And now you need access to some money because the cost to keep repairing the old wreck in the driveway has finally gotten too steep and its time to get a new car. If it's going to take \$30,000 to buy the new car and you don't have it, where are you going to get it and how much is it going to cost you to get it from the bank? For the next 5 years the banks gets all those payments instead of you. And at the end of 5 years you're no better off than you are today, you still don't have any savings capital.

Or worse, what if the credit card balance mysteriously keeps getting larger and larger and they are charging you 21% interest for the privilege of using “plastic” to pay your bills. If you don't have access to banking capital that you can borrow from your self then the cost of the lack of liquidity becomes the interest you pay, plus the compound interest earnings you



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didn't earn because you had to pay the money to the bank instead of putting it into your own account.

If your only savings dollars get saved inside the 401(k) retirement plan it may be a very expensive solution if you remove the money to buy a new car. You will pay taxes and penalties on the entire amount you withdraw in that tax year which can mean that you will lose 30-50% of the money you put into the retirement plan.

In many cases you can take a loan from your 401(k) plan but this may not be the best choice for banking capital for the following reasons:

1. You can only borrow 50% of the account value
2. You have to pay the loan back in 5 years
3. The interest you pay goes back to your account, but you removed the money from the market and if the market does well then you lose out on those market gains
4. If you quit or get fired from your job, then you will have to pay the loan back or it will be considered a distribution and be subject to taxes and penalties

Solution

Be sure to create a source of other savings capital that you can access without taxes and penalties to allow your retirement plan to remain intact. If you save 10% of your income and place it into an account earning 5% it would take almost 8 years to accumulate a year's worth of income. This becomes a combination of emergency money and banking capital that allows you to treat your retirement plan, as you should, a long-term retirement savings vehicle, not a short-term bank account.

Several sources of banking capital might be a home equity line of credit, money market, passbook savings, or certificate of deposit accounts, or the cash value in a permanent life insurance policy. Any of these or a combination of these could be used to warehouse your banking capital so you can eliminate the financial and emotional cost of debt for the rest of your life.

How long are you going to be "On the curve"?

I'm sure you have heard of the miracle of compound interest and how important it is to start saving early. This is true but sometimes people forget this as they get closer and closer to



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retirement and don't realize how much risk they are taking with their money. The power of compounding interest is seen over a long period of time. Measure the additional earnings generated by the compounding of the interest inside the account against the risk to the principle if the market should drop.

You may realize that you aren't gaining much by the effect of the compounding on your most recent contributions. What you may be doing is subjecting those contributions to unnecessary risk and it would be better to store that money someplace safe. Or, you may find that you want to stop compounding the account and use the "cold storage" technique instead.

Much like a farmer harvests his fruit from the trees and stores it in a cold storage facility to protect it and preserve it, this is a strategy where you remove the earnings each year and store them in a safe place. If the farmer left the fruit on the trees to store it, the fruit would quickly rot and be worthless. In the last few years before you need to depend on them, harvest your earnings and store them where they won't be subject to the risk of the market taking away not only the interest earnings, but also the principle.

Summary

Retirement planning is not just about saving money in a specific type of retirement account. All of your financial decisions are part of retirement planning. Setting up your own personal banking system for eliminating and preventing debt for your entire life might be one of the best retirement planning moves you ever made. It might add \$500,000 to your available capital at retirement age because you recovered all the lost capital and opportunity costs, which would have gone to a financial institution.

Making wise choices about buying your home(s), the type of mortgage you have, purchasing the right type of insurance to prevent losses, managing your budget to be able to save 15-20% of your income, all of these will contribute to a healthy and happy retirement. Don't wait! Get started today to develop a plan to integrate and coordinate all your financial decisions to create a "laminated beam", able to hold great weight and withstand the stress of life.