401(k) Investment Process

How much money will you have in your 401(k) plan when you retire? Add together all of your contributions and the investment return on those contributions. If you have $100,000 in your account, a 6 percent annual return brings you $4,000 less than a 10 percent return over one year. After 30 years of compounding, a 10 percent return is even more valuable. Because you want to get the best possible rate of return over your long-term time horizon, how your 401(k) money is invested is one of the most important plan design decisions.

Your employer always plays some part in your investment process, but when your 401(k) plan was first created your employer had to decide how much of a role it would play. Many plans are participant-directed, which means that you have the final say on asset allocation and investment for all the money in the plan. In some plans, you have control over the investment of your own contributions, but the company is responsible for investing the company contributions. In a few cases, the company is responsible for investing participant contributions as well.

Even if you make the final investment decision for all of your 401(k) funds, your company is still responsible for establishing a decision-making framework. This means that employers will prescreen investment choices, providing a safer and less intimidating assortment of investment fund options. Typically, funds offered include a selection of equity and bond funds, plus a stable value fund or a money market fund. Please note that in some cases you may be asked to decide how your money will be invested before you are allowed to participate in your 401(k) plan. Some plans have a default option in the event you do not provide investment direction when you join the plan. You should find out what happens if no investment election is made. Even if a default option exists, you should decide how you want to invest your money and make an election based on your decision.

Managing your 401(k) costs money. It is typical for your employer to pay part of the costs and for you through the plan to pay part as well. For example, it is typical that you will pay the management fee of the investment funds in the plan. It is your employer's responsibility to be sure that the fees you are paying are reasonable in light of the services that the plan receives from third parties.

Brokerage Window

In some 401(k) plans, if you want choices beyond those selected by your employer you may be permitted to invest directly in stocks, bonds, or mutual funds not offered by the plan. This investment alternative is often called a brokerage window. On the opposite end of the investment spectrum, 401(k) plans may also allow you to hand over your investment decisions to someone else. Companies do this by offering a professionally managed account (sometimes known as a lifestyle, lifecycle, or hybrid investment option) as an investment alternative. In a professionally managed account, your asset allocation decisions are made by investment professionals selected by your employer.

Contribution and Investment Allocation Flexibility

As a 401(k) participant, you have a great deal of control over your retirement program. You can decide when you want to contribute to your 401(k), how much to contribute, and where your money will be invested. So what role does your company play? In addition to selecting the investment options, your employer determines when and how often you can change your contribution and investment allocation. In some 401(k) plans, participants can change their asset allocation every day and the amount of their voluntary contribution every payroll period. Some plans only permit changes on a monthly or quarterly basis. Some plans let participants change as often as they like. Other plans permit only a limited number of changes. For example, a plan may permit participants to change their asset allocation whenever they want, but no more than eight times a year. In some cases if participants often change their asset allocation they will be charged a special *redemption fee*.

Matching Contributions

A 401(k) matching contribution is an employer contribution where the amount the employer contributes is based on how much you contribute to the plan. For example, in a plan with a dollar-fordollar match up to 3 percent of pay, when you contribute 3 percent of your pay to the plan your employer will contribute the same amount. But if you do not contribute to the plan, neither will your employer.

Employers are not required to provide a match on your 401(k) contributions, but about 80 percent do. When a company is designing a 401(k) plan match program, it first decides the amount that will be matched and then decides how the company matching contribution will be determined. A company can choose from several different 401(k) matching approaches, the most common being a fixed match. A fixed match is based on a set percentage of the employee contribution. The most common fixed matching approach is an employer contribution of 50 cents for every dollar that the employee contributes, up to an employee contribution of 6 percent of pay.

Some companies have a graded match. This means that the percentage contributed by the company will vary depending upon the percentage of pay contributed by the participant. The most common graded match is a company contribution equal to 100 percent of the first 3 percent of pay contributed by the employee, and 50 percent of the next 2 percent of pay that the participant contributes.

A few companies base their 401(k) matching contribution on your years of service with the company. One company with this type of matching program matches up to 8 percent of pay based on the following schedule of service:

- 25 percent for those with 1 to 5 years of service
- 50 percent for those with 6 to 10 years of service
- 75 percent for those with 11 to 15 years of service
- 100 percent for those with more than 15 years of service

Many employers tie the amount of their matching contribution to the company's financial success and profitability. As the profitability increases, the percentage contributed by the company increases as well. For example, when the company is having a really good year it contributes 100 percent of the first 6 percent that the employee contributes to the 401(k) plan, but when the company is having an average year it contributes 50 percent of the first 6 percent that

the employee contributes. In a year in which the company is not profitable it would contribute nothing.

Timing of the match. Companies differ on when they contribute their matching dollars. Some match your money as soon as you contribute. Others put funds into your plan on a monthly, quarterly, or annual basis. Regardless of when your employer matches your 401(k) contribution, it means additional money building your account- money your employer pays you that is above and beyond your salary. An employer match is meant to encourage and reward you for participating in your company's plan, save enough to get all of it.

Vesting

Employers do not want high-quality workers like you to seek other employment, so they often design their 401(k) to reward employees who stay longer at the company. They do this by requiring employees to work several years at the company before they own the company contributions made to their 401(k) account. Even though your employer's contributions are deposited into your account, they are not yours until you have been at the company for a period of time determined by your employer and specified in the 401(k) plan. The money you contribute to the plan is always yours.

Vesting is the word used to describe how much of the company contributions, and the earnings on those company contributions, you own. If you have been at your company long enough to own part-but not all-of the employer contributions, you are said to be partially vested. When you own all of your company's contributions you are fully vested. Once you are fully vested, you are immediately vested for all future company contributions. You are always 100 percent vested in the money you contribute to a 401(k) plan.

There are three vesting approaches:

1. Immediate vesting. Some employers give you ownership of the company contri butions at the time they are deposited in your account. A plan that does this is said to have immediate vesting.

2. Graduated vesting. In graduated vesting, the percentage of the employer contributions that you own increases over time until you reach 100 percent. (Federal law limits the maximum time this can take to up to six years.) For example, in two-year graduated vesting, you own 50 percent after the first year and all of the company contributions after the second year.

3. Cliff vesting. Some 401(k) plans have what is called cliff vesting, which provides full vesting after a certain length of service with no graduated vesting along the way. Employers using this method are required to give you full ownership of employer matching contributions no later than after three years of employment.

Each year that you work 1,000 hours is equal to one year on your vesting schedule. Similarly, if you have a month worth of vacation time stored up and you take it all at once, that time still counts toward your vesting schedule. If you take the vacation time in cash, however, the time may not be counted.

Loans and Hardship Withdrawls

Your employer decides whether your 401(k) plan will permit loans and hardship withdrawals and, if so, what rules will govern these provisions (within parameters set by federal law). Some employers feel that the availability of loans and hardship distributions from a 401(k) plan will reduce the ability of participants to save enough for their retirement. They are also concerned about the tax penalties that are imposed on pre-retirement distributions from a 401(k) plan.

Other employers believe that loans and hardship withdrawals are beneficial because they allow participants to have access to their money during emergencies. However, each plan has its own restrictions on the reasons for access to 401(k) plan savings and limitations on how much may be withdrawn.

Automatic Enrollment

Automatic enrollment is the practice where your employer automatically enrolls you in your company's 401(k) plan once you become eligible, unless you specifically decide not to participate. In automatic enrollment, your employer designates how much of your pay will be contributed and how it will be invested. According to federal law, companies can automatically enroll their participants in their 401(k) plans as long as they:

- Give adequate notice of enrollment at a reasonable period before the enrollment date, including the amount of pay you will contribute and in which investments contributions will be deposited
- Provide the right to change the contribution amount or investments or opt out of the automatic enrollment

- If your plan has automatic enrollment and you do not wish to participate, your notice of enrollment form will give you the option not to join the plan. You must complete the necessary forms (usually just a box to check) and turn it in to your plan administrator as soon as possible.

Automatic enrollment moves a specific percentage of your pay into the plan every pay period, most often 3 percent. The contribution percentage may also increase periodically until a maximum percentage determined by your employer is reached. However, you may always decide to change how much you are contributing to the plan. The approach to investing automatic contributions varies from company to company. Some companies invest the money in funds such as stable value, lifecycle, or target retirement date funds, others put the money into a balanced fund or a professionally managed account. Chapter 7 and 8 provides information about these types of investments.

Automatic enrollment does not mean that you do not have a choice anymore. You can and should choose how much to contribute and where to invest your 401(k) money. If your employer provides a matching contribution, you should increase your contribution percentage and get the full match available to you. The forms required to change your contribution level and investment options should also be included in your notice of enrollment materials.

Why do employers and employees value this practice? Many employees believe that they don't know how to invest or don't make enough money to save in the plan and their employers want to get them started. When employees see their assets growing it gets their attention and teaches them the value of retirement savings. A drawback to automatic enrollment is that some employees never change their contribution rate, staying at that low, introductory 3 percent rate. This provides a benefit, but not as much as contributing at a more appropriate, higher level.

Rollovers Into the Plan

If you have a new job, you might want to put the 401(k) money you accumulated at your previous employer into your new employer's 401(k) plan. Also, you might want to put your IRA money or even your other qualified retirement plan distributions, if you have any, in your new employer's 401(k) plan. Many companies design their 401(k) plans to accept such rollovers. Those that do not accept rollovers from non-401(k) retirement programs are unable to handle the administrative complexity that accepting such rollovers requires. In this case, you may roll your distribution over into an IRA.