6 problems with 401k plans

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Over the past quarter of a century, 401(k) plans have evolved into the dominant retirement plan scheme for most U.S. workers. While many improvements have been made to the structure and features of 401(k) plans since their creation, additional problems still need to be addressed, and various enhancements still need to be made. Let's look at six problems with the current 401(k) plan structure, and then discuss how you can mitigate the negative implications of these known fallacies.

1. Structural Flaws

You have probably been told that investing your money through a process known as dollar cost averaging will allow you to prudently build your retirement nest egg over time. Unfortunately, while this concept may be true when the market is expected to trend up over time, it is not true when the market is oscillating in a relatively flat manner, nor is it true if the market is trending down. Therefore, while it may make sense for you to buy more and more shares of an asset that is increasing in value, this philosophy does not make sense if you are buying an asset that is fully valued, or one that is decreasing in value.

Sadly, you may have bought into the concept of dollar cost averaging because it was explained to you as a prudent investment methodology. Unfortunately, dollar cost averaging is simply a convenient solution to address the manner in which contributions have to be channeled from your employer to your investment funds in your 401(k) plan.

To explain, defined contribution plans, like your 401(k) plan, require periodic contributions to be made to your retirement account every time your employer processes a payroll on your behalf. Therefore, without a theory such as dollar cost averaging, the concept of funneling money on a periodic basis from your pay check to your investment options would not make sense, particularly given the fact that your investment options may be fully valued, or even worse, overvalued at the time the contributions are going being made. Fortunately, you can take control of your investment process by directing all of your retirement plan contributions into a conservative investment option that is offered in your retirement plan. Then, when the time is right, you can make a strategic investment allocation of the cash that you have accumulated to one or more of the funds offered in your 401(k) plan. Of course, you will have to be able to determine when your investment options look attractive from an investment standpoint. Nevertheless, you should expect this type of responsibility if you participate in a defined contribution plan.

2. Long Investment Time Horizons

You have also probably been told that your employer established a 401(k) plan on your behalf in order to provide you with a long-term savings plan for retirement. Given this premise, you were most likely led to believe that you should develop a long-term strategic asset allocation based on a time horizon that is likely to exceed a decade. Unfortunately, what you may not have been told is that it is highly unlikely that the portfolio managers that are currently managing your investment options will be managing them 10 or more years from now. Therefore, if you are going to develop a strategic allocation with a long-term focus in mind, you probably need to be using index funds in order to mitigate the likely mismatch between the shorter-term tenure of your fund managers and your longer-term investment holding period.

If a host of index funds are not offered in your 401(k) plan, you will have to make the assumption that your current fund managers will be managing your money for many years to come or that your future managers will be managing your money in the same manner that it is being managed today. Of course, these assumptions are highly unlikely. With that said, you do have a couple of options to address this problem. First, you can develop a tactical asset allocation contingency plan, which will allow you to be prepared to take action in the event one of your portfolio managers relinquishes responsibility. In addition, you could open a traditional IRA or Roth IRA, and contribute up to your legal limit through various types of index fund strategies that are not available in your 401(k) plan.

3. Administrative Costs

Make no doubt about it, a qualified 401(k) plan is an expensive employee benefit. 401(k) plans are expensive to offer because there are many compliance issues that have to be monitored, there are many ongoing service and administration functions that have to be provided, and there are a host of education and communication services that are required to be offered to you as a plan participant. Given these requirements, it is highly likely that you are overpaying via higher participant fees, supplemental asset based charges, itemized costs for services such as loans, hardship withdrawals and qualified domestic relations orders, and perhaps more importantly, higher fund expenses. Problems such as these are particularly acute in the small plan arena, where a lack of economies of scale fosters much higher expenses.

Fortunately, you can mitigate the negative costs of your 401(k) plan by developing a tailored retirement plan strategy. To accomplish this goal, you should always invest in your 401(k) plan up to the point where you receive 100% of your employer's matching contribution. Then, you should open a traditional IRA or Roth IRA, and contribute up to your legal limit. After you have maxed out the money that you can contribute to an IRA, you should then increase your contribution rate in your 401(k) plan in order to reach your desired level of savings.

You can open a low-cost IRA with a brokerage firm, or you can open an IRA through a local bank in your area. After reviewing your options, you will likely find that the breadth and depth of investment options available to you through an IRA will be much greater and less expensive than the investment options available to you through your employer sponsored 401(k) plan. With that in mind, it is important to understand that the savings you will experience through an IRA are a direct result of less stringent compliance responsibilities, less service and administration responsibilities, and less education and communication services that will be offered to you. Nevertheless, if you do not need any of these services, investing in an IRA is an ideal way of saving for your long-term retirement.

4. Lackluster Recordkeeping

It is safe to say that you probably do not understand the complexities associated with recordkeeping the assets that you have accumulated in your 401(k) plan. Ironically, even in today's age of technology, recordkeeping is still a labor intensive endeavor, particularly if your records have to be generated for many years. To make matter worse, even if your record keeper does a perfect job for you, you will probably only give the record keeper an average grade for the services that are provided, because you will undoubtedly expect your records and statements to be produced in a timely manner, and free of any errors and omissions. Given these very high standards and expectations, virtually none of the retirement plan providers will provide investor-friendly statements. Instead, they tend to generate only what the law requires. Unfortunately, what is required by the law is not necessarily what you need in order to make a financial assessment of your investment strategy.

In order to successfully plan for your retirement, you need to know on a monthly basis what your beginning account balance is, how much you and your employer contributed to your retirement plan account, the amount of any transfers or withdrawals that you made during the period, the amount of any gains or losses that you experienced, and your endings balance. Unfortunately, your record keeper probably does not provide this information to you in a user-friendly way. Therefore, you will most likely have to take the information from your monthly or quarterly statements, and build a spreadsheet that you can use to track your information. Once you have properly compiled the information, you will then need to manually calculate your annualized rate of return in order to conduct a thorough analysis and review. As you can probably tell, this type of work can become very time consuming, and may require more financial skills than you currently possess. Nevertheless, if you do not compile this type of information, it will be virtually impossible for you to determine if you are on track in terms of meeting your long-term financial goals. Therefore, to address this problem, it is recommended that you review the Global Investment Performance Standards in order to learn how to complete this important endeavor.

5. Sub-Par Investment Plan Designs and Marginal Quality Investment Options

In terms of retirement plan design, the conventional wisdom in the 401(k) plan investment industry is that "less is more". What is meant by this concept is that a comprehensive retirement plan design can be developed by offering a host of investment options that cover roughly five asset class categories. These categories in terms of theoretical risk order are money market funds or stable value funds, core bond funds, large capitalization funds, small capitalization funds, and international funds. The concept behind less is more is an attempt by the investment community to streamline your investment decision making responsibilities in order to minimize the complexity of your investment choices. Unfortunately, while you can develop a diversified portfolio by investing in funds that fall in these five asset class categories, it is highly likely that you will also need access to TIPS funds, high yield funds, REIT funds, mid-capitalization equity funds, emerging markets funds and commodity funds in order to build a comprehensive portfolio that is capable of meeting your long-term financial needs.

In addition to the potential issues with your 401(k) retirement plan design, the quality of the investment options offered in your plan may be well below average, particularly if you are a participant in a small retirement plan. Therefore, you should asses how comprehensive your 401(k) retirement plan design is, and conduct a thorough due diligence analysis on the funds that are offered in your plan, before making any type of investment. Once this assessment has been completed, your best course of action will be to notify your human resources department of any enhancements that need to be made. In addition, you should offset any of your 401(k) plan deficiencies by investing in a host of index funds through an individual IRA.

6. Complex Tax Implications

Arguably the most highly touted 401(k) plan attribute is the pre-tax treatment of invested cash flows. This feature is important, because if you have more money to invest up front, you should have a greater opportunity to enhance your returns down the road. However, before blindly accepting the premise that pre-tax investing is a big investment advantage for you, keep in mind that when you withdrawal your money from your 401(k) plan, the entire amount that is withdrawn will be taxed at your personal income tax level. In retrospect, this may be a material disadvantage to you, because it is highly likely that your long-term investment strategy would have achieved substantial long-term gains that should have been taxed at the much lower capital gains tax rate level. Since these gains will be taxed as income under a 401(k) plan structure, your perceived pre-tax advantage on the front end will be offset to a certain degree by the tax disadvantage on the back end.

Assessing tax implications is a very difficult endeavor, because your tax status may change over time, and the tax laws may change over time as well. In addition, new retirement plan schemes will continually be developed in the future. Therefore, what looks like a good deal today, may very well be a bad deal tomorrow. Given all of the uncertainties associated with taxes, you probably should not base your decision to contribute to your 401(K) plan by taking into account any type of perceived tax benefits.

Conclusion

While 401(k) plans are an important part of your employee benefits package, the issues associated with some of their provisions are very problematic. Nevertheless, if you pay close attention to the issues previously discussed, and take an active role in preparing for your financial future, you should be able to mitigate the negative features of your 401(k) plan, and navigate your way in a manner that will allow you to meet your retirement plan goals.