

Smart 401(k) Investing



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Introduction



401(k) retirement plans can make the difference between a financially secure retirement and the specter of running out of money. These plans offer tax benefits and the opportunity for your savings to compound over time. So it's important to understand every aspect of how your 401(k) plan works, whether you're just getting started or you're already retired.

FINRA's Smart 401(k) Investing takes you through the process of enrolling and managing your 401(k) account, and answers questions about everything from eligibility to rollovers, from vesting to hardship withdrawals.

<i>Retirement Savings Overview</i>	Learn how employer-sponsored retirement savings plans typically work, including history, salary deferral, tax advantages, different types of plans, eligibility, contribution limits, matching and more.
<i>Investing in Your 401(k)</i>	Learn about your investment choices, risks when investing and ways to manage that risk.
<i>Managing Your 401(k)</i>	Check up on your 401(k) on a regular basis, keep an eye on investment performance and review your asset allocation.
<i>Moving Your 401(k)</i>	Whether you're starting a new job or getting ready to retire, you may have to make decisions about what to do with your 401(k) assets.
<i>Managing Income in Retirement</i>	Once you start withdrawing assets from your 401(k) in retirement, you will need to know how to make those assets last.
<i>Special 401(k) Features</i>	Borrowing, taking hardship withdrawals or dealing with legal issues, your 401(k) has some features you might want to know about.
<i>Annual Contribution Limits</i>	Check out the maximum annual contribution limits for 401(k) plans and other retirement savings vehicles.
<i>401(k) Glossary</i>	Learn the vocabulary of 401(k) plans with this glossary of key words and concepts.

Retirement Savings Overview



THE BASICS

As you earn the income that pays for your current needs and at least some of the things that you enjoy, you may also be thinking about what you'll be able to afford when you retire—whether that's just around the corner or many years in the future. One of the ways to ensure you'll have at least some of the income you need is to participate in an employer sponsored retirement savings plan. So, instead of just dreaming about retirement, you're preparing for it.

A Brief History of Retirement

Since the Social Security Administration was created in 1935, the concept of putting aside some money now to be assured income in the future has revolutionized retirement for millions of people. Exactly how that assurance works is constantly being redefined.

Some employers offer defined benefit plans, which promise you a specific income, called a pension, after you retire, typically based on the number of years you work at the job and what you earn. Others offer cash balance plans, which calculate your pension based on a fixed return of an amount contributed each year in your name.

Still other employers offer defined contribution plans, such as profit-sharing or money purchase plans. These plans don't promise a specific pension but provide retirement income based on:

- ▶ the amount that's contributed to the account;
- ▶ the way the contribution is invested; and,
- ▶ the return the investments provide.

Most employers who offer retirement plans provide one type or another. However, some employers have switched from defined benefit to a cash balance or defined contribution plan. Both types are portable, which means you can move your assets when you leave an employer.

Salary Deferral Plans

If the defined contribution plan your employer offers is a salary deferral plan, you can put part of your earnings into a retirement savings account. Your employer may contribute to your account as well. The best-known salary deferral plans are 401(k) plans.

Salary deferral plans are generally self-directed. This means you are responsible for deciding how to invest the money that accumulates in your account. Usually you must choose among a list of investments the plan offers. The advantage of self-direction is that you can select investments that you believe will help you achieve your long-term goals. But, of course, it also means added responsibility for choosing wisely.

When you participate in a traditional 401(k) plan, the taxable salary that your employer reports to the IRS is reduced by the amount that you defer to your account. This means income taxes on that money are postponed until you withdraw from your account, usually after you retire.

If you participate in a Roth 401(k), though, the amount you defer doesn't reduce your taxable income or your current income taxes. But when you withdraw after you retire, the amounts you take out are tax-free, provided you're at least 59½ and your account has been open at least five years.

Tax Benefits

Any earnings your tax-deferred contributions produce during the time they remain in your account are also tax deferred. This means the combined amount has the opportunity to compound at a faster rate, since everything is being reinvested and no money is being taken out to pay taxes.

And no matter how many times you sell investments that have increased in value, you won't owe capital gains tax on any profit you may make. Instead, you can reinvest the entire amount, although there may be transaction fees for your trades. Of course, if you sell investments that have lost value, you can't claim your capital losses either.

The tax you eventually pay depends on your income tax rate at the time of the withdrawal. For example, if your combined taxable income including the withdrawal puts you in the 28 percent federal tax bracket, the tax you owe will be figured at that rate. Although there's no way of predicting what your income tax rate will be when you withdraw from your account, many people have less income in retirement than they did when they were working, and so pay tax at a lower rate.



DOES IT PAY TO DEFER?

Suppose you buy 200 shares of a stock for \$15 a share (for \$3,000) and sell two years later at \$30 a share (for \$6,000). In a taxable account, you would owe \$450 in capital gains tax on your \$3,000 gain, leaving you with \$5,500 to reinvest. In a tax-deferred account, on the other hand, you could reinvest the entire \$6,000 and defer paying taxes until you withdraw your money. Those taxes will be due at your regular rate.

Taxable account		Tax-deferred account
Original Cost	\$3,000	\$3,000
Earnings	+ \$3,000	+ \$3,000
Value of account	\$6,000	\$6,000
Tax on earnings	-\$450	-\$0
Amount you can invest	= \$5,500	= \$6,000

401(k) Fact

A year of employment may be determined as 365 days from your first day on the job or as 1,000 working hours within a 12-month period.

Vesting

Any money you contribute to a salary deferral plan and the earnings those contributions produce always belong to you—though you usually must change jobs or retire to withdraw or move the balance. In contrast, you don't have a right to the money your employer contributes to your account (or the earnings made from those contributions), or makes to any other retirement account for you, until you are fully vested, or have full legal rights to your account. Vesting is determined by time on the job.

Federal regulations set guidelines for vesting, but your employer determines which of the vesting schedules to use. You may be vested through one of three schedules: immediate, graded or cliff.

- ▶ **Immediate** vesting means that you automatically have legal right to all the money added to your account.
- ▶ **Cliff** vesting grants you the right to 100 percent of your account as soon as you work a certain number of years. That access must be granted within three years of your employment if your employer has made matching contributions to a 401(k) or similar plan. With plans that don't involve matching contributions, such as defined benefit plans, the cliff vesting requirement is five years.
- ▶ **Graded** vesting grants you the right to your account in increments over time. Vesting for matched contributions must occur over two to six years, with 20 percent access by the second year and 100 percent access by the sixth year. In defined benefit and similar plans that don't include matching funds, on the other hand, graded vesting must occur over three to seven years, with a required 20 percent access by the third year of employment.

	Traditional 401(k)	Roth 401(k)
Contributions	Come from pre-tax income, reducing gross income reported to IRS	Come from taxable income, not reducing gross income reported to IRS
Withdrawals	Taxed at your ordinary income tax rate	Tax-free provided account is open at least five years and you are at least 59½

Different Ways to Save

Types of Retirement Plans

The salary deferral plan that's available to you will depend on where you work. Publicly and privately held corporations typically offer 401(k) plans. Nonprofit organizations, such as schools and colleges, hospitals and museums, usually offer 403(b) plans, but may offer 401(k)s. Many state and local governments offer 457 plans, and the federal government offers a thrift savings plan.

401(k) Plans

Some provisions of your 401(k) plan are dictated by ERISA, the federal law that governs qualified retirement plans. For example, plans must cover all eligible employees and treat them equitably. Other details are specific to each individual plan. That's why, if you move from one job to another, each with a 401(k), some things will seem familiar and others different.

Each plan has a sponsor, usually your employer. The sponsor decides which factors determine your eligibility, what percentage of your salary you can contribute to your plan, whether to match your contributions and which investments will be available within your plan. The plan administrator keeps track of the company's 401(k), handling management details and making sure that the plan runs smoothly. Your sponsor also chooses your plan provider, typically a financial services company that offers investment products, plan administration and record-keeping services.

Within the guidelines set by the law, 401(k) plans are largely self-directed. You decide how much you would like to contribute to your plan, how you would like to invest—or reinvest—those contributions within the limits of your plan’s investment menu, and eventually how you would like to handle withdrawals from your account.

The federal government caps the amount you can contribute to your account each year. See the [Annual Contribution Limits table](#) for current caps, which can change from year to year. You are also responsible for the investment results you achieve, though your employer has the obligation to offer appropriate investment alternatives.

Traditional and Roth 401(k)s

An increasing number of employers are offering employees a relatively new 401(k) choice—a Roth 401(k). Both the traditional 401(k) and Roth 401(k) offer tax advantages when you defer a portion of your salary into an account in your employer’s retirement savings plan. Both feature tax-deferred compounding of contributions that are made to the account. Both have no income limits and require minimum distributions after you turn 70½ in most cases, and both can be rolled over to an IRA when you retire or leave your job for any reason.

But tax treatment between the two 401(k) options differs:

Employers may offer a Roth 401(k) only if they already offer a traditional 401(k) and may give you the option of splitting your annual contribution between a traditional and Roth 401(k)—though your total contribution can’t be more than the annual limit Congress sets for a 401(k). However, once you’ve made contributions, you may not move money between the two 401(k) accounts because of their different tax structures.

What’s more, if your modified adjusted gross income is too large to allow you to qualify for a Roth IRA, a Roth 401(k) is one way to have access to tax-free withdrawals. There are no income restrictions limiting who can participate. The only requirement is being eligible to participate in your employer’s plan.



401(K) OR ROTH 401(K): WHICH IS RIGHT FOR YOU?

There is no one-size-fits-all answer. Instead, the right answer for you will depend on your current tax situation and whether your tax rate is likely to be higher or lower in retirement.

Since you don’t pay any taxes on Roth withdrawals, the higher your tax bracket in retirement, the more advantageous a Roth is likely to be. Strong savers—including those who contribute the maximum amount allowed by the IRS each year—are good Roth candidates because they are likely to have a bigger nest egg in retirement that can benefit from Roth’s tax-free withdrawals.

On the other hand, if you’re in a low tax bracket today, you might consider a Roth now, when a lowering of your gross income will not be as significant a tax benefit as it might be later on, if you find yourself in a higher bracket.

Because it comes right out of your paycheck, a Roth contribution is likely to reduce your take home pay by more than a similar contribution to a traditional 401(k), which is made using pre-tax dollars. If you want to save—and take home as much money as possible—a traditional 401(k) is perhaps the way to go. Finally, since no one knows what tax rates will be in the future, diversifying with contributions to both a traditional 401(k) and Roth might be a way to hedge your tax bets with your retirement savings.

403(b) and 457 Plans

Depending on your employer, you might have a different retirement savings plan. These plans share the same basic structure as 401(k)s: pretax contributions and tax-deferred earnings. The contribution limits are also the same. And the money you accumulate in one type of plan may be moved into any of the others (provided the new plan permits transfers). But these plans also have features that set them apart from 401(k)s.

Nonprofit organizations, educational institutions, religious institutions and certain hospitals may offer 403(b) plans, also known as tax-sheltered annuities (TSAs) or tax-deferred annuities (TDAs). In a 403(b) your investment menu is limited to annuities—fixed or variable and in some cases equity-indexed annuities (EIAs)—or mutual funds. Your employer may choose to match your contributions, but that practice is less common than with 401(k)s. But if there is a match, you usually have immediate vesting, or the legal right to all contributions and their earnings. That differs from 401(k) plans, where it might take up to six years to fully vest.

State and local governments typically offer 457 plans, also called deferred compensation plans. Rather than belonging to you, your assets are held in trust for the duration of your employment. Not all of the same rules for early withdrawal penalties and required minimum distributions that apply to 401(k)s apply to 457s. And while you can use the same guidelines for catch-up contributions as apply to the other plans, 457s have a catch-up system of their own.

Getting Started

Before you can participate in your employer's 401(k) plan, you have to meet the plan's eligibility requirements. It's also a good idea to familiarize yourself with the contribution limits and matching benefits your employer might offer before you sign up.

With many employers, you have to sign up before you can contribute part of your earnings to your plan account. You have to choose how much to put away. And you must decide where to invest your contributions, selecting among the investment choices offered in the plan.

But a growing number of employers automatically sign up eligible employees. In that case, your employer chooses an automatic contribution rate, known as the default rate, and an automatic investment alternative, known as the default investment, for plan participants.

When you're automatically enrolled, you have the right to change the default rate and default investment to help you meet your personal retirement goals at a level of risk you're comfortable taking. You also can opt out of the 401(k) plan, either when you're initially enrolled or at a later date.

Why Participate?

Participating in a 401(k) plan gives you a head start on your long-term financial security. A 401(k) not only provides a mechanism for saving. It also allows the money in your account to compound tax-deferred. That means that the earlier you begin to participate and the more you contribute, the greater chance you'll have of amassing a substantial retirement account.

For example, suppose you contribute \$300 per month to your traditional 401(k) and earn an average annual 8 percent rate of return. If you participate for 20 years, the account could be worth \$178,184. But if you had started 10 years earlier and contributed at the same rate for 30 years, your account could be worth \$450,388.

Earning 8 percent with your 401(k) investments isn't a sure thing, of course. Your account may lose value in a down market. And if the investments you choose do not provide at least the average return in a strong market, you may accumulate less than you anticipated. But if you don't participate at all, you won't have a retirement account to draw on after you stop working.

Eligibility

You must be eligible to participate before you can enroll in a 401(k) plan. But that's not a problem. Federal law requires that when an employer sponsors a plan, all employees must have an equal opportunity to save for retirement.

Your employer can impose two restrictions: that you must work for a full year—usually at least 1,000 hours over 12 months—and be at least 21 years old before you enroll. But not all employers make you wait. One of the questions you'll want to ask when you're considering a new job is when you'll be eligible to contribute to a 401(k).

Once you're eligible, though, you might not be able to enroll immediately. Plans often have specific start dates for new participants, such as once a quarter or twice a year, or during an open enrollment season. For example, if you've been on the job for a year in August, you might have to wait until October 1 or January 1. That's something else to check—though it's not the only factor you'll consider when you're deciding between job offers.

In any year you're not eligible to contribute to your employer's account plan, you may be eligible to make a tax-deductible contribution to a traditional individual retirement account (IRA). Or, you may qualify to put retirement money into a nondeductible but tax-free Roth IRA. You probably want to check with your tax adviser to determine if you're eligible and which may be smarter for you.

Contributing to Your Plan

As part of enrolling in a 401(k), you must decide how much you are going to contribute to the plan each year. There are some limits on the upper end, and your employer may require a minimum contribution if you want to join the plan. But you may find that the critical question is what percentage of your earnings you are willing to commit to retirement savings.

How Contributions Work

When you enroll in a 401(k) plan, you authorize your employer to withhold a certain percentage of your gross pay or a specific dollar amount each pay period and put it into an account that's been set up in your name.

As a rule, your employer must deposit your contributions into your account within 15 business days after the end of the month in which the money is deducted from your pay. Those deposits should show up on your 401(k) statements. Employers have more leeway, though, in adding any matching contributions they make to your account. In fact, the match may be made as infrequently as once a year.

You can raise or lower your contribution rate as often as your employer allows. That may be just once during the year, or it may be more often. For example, if you receive a raise, you may decide that you can afford to put away more toward retirement and boost the percentage you're contributing from 6 percent of your pay to 8 percent or 10 percent.

Since your contributions to a traditional 401(k) are tax deferred, they reduce both the amount on which income taxes are withheld each pay period as well as your taxable income for the year. However, contributions to a 401(k) are included in the amount on which FICA taxes for Social Security and Medicare are figured.

Contributions to a Roth 401(k) aren't tax deferred, so don't reduce current income taxes. But withdrawals will be tax free if you're at least 59½ and your account has been open at least five years when you take the money out.

Contribution Limits

As you decide how much of your pretax income you'll contribute to your 401(k), you have to stay within two sets of limits: those set by the federal government and those set by your employer.

- ▶ The government caps your annual contributions at a dollar amount—the most recent caps can be found in the section entitled [Annual Contribution Limits](#). The annual contribution is increased periodically to reflect increases in inflation.
- ▶ Your employer may limit your contributions to a percentage of your salary. Typically, that cap is 10 percent or 15 percent of your gross income, though it may be more or less. You can't contribute more than the percentage of your pay that your employer lets you add to a 401(k) each year, even if that means you can put away less than the government's cap.
- ▶ On the other side of the scale, your employer may require a minimum contribution of 1 percent or 2 percent from any employee who wants to participate in the plan.

The Company Match

How Matching Works

Your employer may “match” some or all of your 401(k) contribution. Matching contributions are funds your employer adds to your 401(k) account over and above the amount you defer from your pay. You don't owe income tax on matching contributions at the time your company makes them, they don't count against your contribution limit, and they compound tax deferred. IRS rules require that all matched funds, including matching based on Roth-directed contributions, reside in a traditional 401(k) account. Matching isn't required, but many employers adopt it to attract employees, encourage plan participation or benefit from the tax deduction it provides.

Your employer determines how the match is calculated and whether to contribute cash or shares of company stock. One approach is to match 50 percent of what you contribute up to a percentage of your earnings—usually 5 percent or 6 percent. Another approach is to match your contributions dollar for dollar up to a percentage of your earnings—again, usually 5 percent or 6 percent.

Here's an example of how one method might work:

You qualify for matching by participating in the plan. In fact, one of the most persuasive reasons for making your own contribution is that you'll be eligible for the additional amount. And knowing that your contributions will be matched up to a certain percentage may encourage you to contribute at least enough to qualify for the maximum.

Employee's annual contribution	Employer's match (50% of up to 6%)	Total contribution
6% of \$30,000 pay, or \$1,800	50% of contribution, or \$900	\$2,700
6% of \$60,000 pay, or \$3,600	50% of contribution, or \$1,800	\$5,400
10% of \$60,000 pay, or \$6,000	50% of 6%, or \$1,800	\$7,800

Another way your employer may add money to your 401(k) account is as part of a profit-sharing plan. In these plans, your employer shares a portion of the company's profits with each employee any year that profits are made.

**SMART TIP: Active Duty and Contributions to 401(k) Plans**

If you leave your job to perform military service, and meet eligibility requirements, the Uniform Services Employment and Reemployment Rights Act (USERRA) requires your employer to continue to contribute to your 401(k) or pension plan. 401(k) plan participants have up to five years to make up missed contributions—and employers must also make up any matching contributions within five years. In addition, you may be eligible to withdraw from your account without owing a 10 percent penalty on top of the taxes you may owe, thanks to the [HEART Act of 2008](#). If you take such a withdrawal, you have two years after you leave active duty to put the money back into your account.

Making the Most of a Match

If your employer matches 50 percent of 6 percent of your pay, and you're contributing 5 percent of yours, you might want to spring for the added 1 percent. If you're earning \$75,000, that would mean \$1,125 more in your account—\$750 from you and \$375 from your employer.

You may also want to check whether your employer calculates matching based on your total annual contribution or the contribution each pay period. If it's by pay period, there may also be a cap on the amount an employer will contribute in any single period. This means you could end up with more matching if you spread out your contributions over the entire year.

Finally, if you know you'll be changing jobs before the end of the year, and will have to wait to enroll in your new plan, you may want to increase your contribution rate to put away the maximum for the year—or as much as you can afford—before you move on.

It's a good idea to check with the person or office responsible for handling your employer's 401(k) before you make a major decision. You probably won't be the first person to ask a question, and there may be some helpful answers. For more information, see FINRA's Investor Alert, [Why Leave Money on the Table—Make the Most of Your Employer's 401\(k\) Match](#).

Investing In Your 401(k)



You Have Choices

The variety of investments available in your 401(k) will depend on who your plan provider is and the choices your plan sponsor makes. Getting to know the different types of investments will help you create a portfolio that best suits your long-term needs.

Among the most important—and intimidating—decisions you must make when you participate in a 401(k) plan is how to invest the money you’re contributing to your account. The investment portfolio you choose determines the rate at which your account has the potential to grow, and the income that you’ll be able to withdraw after you retire.

Investment Options

You’ll have at least three investment choices in your 401(k) plan, and you may have 100 or more. The average plan offers between 8 and 12 alternatives, sometimes only mutual funds and sometimes a combination of mutual funds, guaranteed investment contracts (GICs) or stable value funds, company stock and variable annuities. Some plans offer brokerage accounts, which means you can select investments from the full range of stocks, bonds, mutual funds and other types of assets rather than having to choose among the plan’s alternatives.

Every 401(k) plan lets you decide how to invest the contributions you make. Some plans also let you decide how to invest your employer’s matching contributions, but others let the employer make that choice. That includes the right to provide the match in company stock.

If you have a limited number of choices—say two stock mutual funds, a bond fund, a stable value fund and a money market fund—each is likely to put your money to work quite differently from the others. But while your investment decision may be easier, you may feel the menu is too restricted.

The more choices you have, the more difficult it may be to choose the ones best suited to your investment goals and risk tolerance. It’s your responsibility to find out how the choices differ from each other and what each of them could contribute to your portfolio. But the more choices you have, the more control you have over the level of investment return you can potentially realize.

401(k) Fact

A 401(k) plan sponsor is the plan fiduciary, legally responsible for selecting the plan’s investment options and monitoring their suitability. Generally, your employer is your 401(k) plan sponsor.

When you're automatically enrolled in a 401(k), your employer chooses a default investment for your contributions. The default investment will likely be a lifecycle fund, a balanced fund or a managed account, which the federal government has approved as acceptable choices. You have the option of sticking with the default investment, or moving your money into different investments offered by the plan.

Building Portfolios

Since your 401(k) plan could offer anywhere from 3 to 100 or more investment choices. Choosing the right combination of investments is essential to setting your 401(k) portfolio on the right track. But before you begin evaluating your choices, you'll want to consider several factors:

- ▶ **Your time horizon.** Generally, the further away you are from an investing goal, the more time you have to compound earnings if the value of your investments rises and to recover from losses if the value drops. The closer you are to retirement, the more of your portfolio you may want to shift into investments that are designed to preserve your capital and provide regular income.
- ▶ **Risk tolerance.** Your risk tolerance will depend on a variety of factors that go beyond your own comfort level with taking risk or desire to achieve a particular return. You'll want to consider your goals, the time horizon for each goal, other financial assets you own, current (and projected) income from your job, the stability of your job and any other sources of income. The more willing you are to take the risk that your portfolio value will rise and fall with the markets, the more you might consider investing in equities, such as stock mutual funds. The less willing you are to take that risk, the more you might want to emphasize investments that are designed to provide regular return.
- ▶ **Other retirement assets.** If you have other assets, such as individual retirement accounts (IRAs), taxable investments, pensions or deferred annuities, you'll want to consider the bigger picture before deciding how to invest your 401(k). If the bulk of those assets are allocated to more aggressive investments, for example, you might want to invest your 401(k) more conservatively to balance your risk.

A Primer on Mutual Funds

Mutual funds are the most common 401(k) investments. They appeal to a wide range of investors for several reasons: They're diversified, they're professionally managed and they're liquid, which means you can sell shares when you wish although you may have a loss if the fund has dropped in value.

Mutual funds fall into three broad categories:

- ▶ **Stock mutual funds**, which buy shares of stock in publicly traded corporations
- ▶ **Bond mutual funds**, which buy bonds issued by public corporations, by federal, state and local governments, and by federal agencies
- ▶ **Money market funds**, which buy a variety of short-term investments from various sources

When you get the list of funds your 401(k) plan offers, you'll probably see a number of stock and bond funds. There may also be one or more balanced funds, which own both stocks and bonds, and one or more index funds. You may also be able to choose a target date fund, sometimes known as a lifecycle fund, or a managed account. Each choice has its own investment objective, management style, level of risk and fees.

Types of Stock Funds

Stock funds, sometimes known as equity funds, invest in a variety of ways. If you have a choice, it's generally better to choose two or three funds buying different types of stock than to concentrate on funds investing in the same way.

One key difference is between growth funds and value funds. In brief, growth fund managers look for stocks whose prices they expect to go up as the companies' products or services reach wider markets and their earnings increase. Value fund managers look for stocks that are seen as undervalued, or low-priced, because the company or sector is currently out of favor with investors. Value funds often outperform growth funds when the economy isn't strong. But there's still a risk with value funds because not all companies recover from setbacks or recapture investors' interest.

Another important distinction is size, or market capitalization. Large capitalization, or large-cap, companies tend to be more price stable and less vulnerable to major losses than small-cap companies. That's true in part because they have larger financial reserves. On the other hand, small- and mid-cap companies may have more growth potential.

You may find that the funds in your plan combine these designations, so you may have a choice between a small-cap growth fund and small-cap value fund, or between a large-cap growth fund and mid-cap value fund.

Your plan may also offer more narrowly focused sector funds, which invest in one segment of the economy, such as healthcare or utilities, or a contrarian fund, which invests in stocks other investors are shunning. Some plans also offer international stock funds, which invest in companies based in other countries.

Index Funds

Many 401(k) plans offer index funds as part of their investment menu, and these funds tend to be popular choices.

An index fund is designed to mirror the performance of a specific market index, such as the S&P 500 Index. If you believe that there's no way for a mutual fund manager to consistently beat the market over the long term, you may prefer index funds to trying to select among managed funds.

In addition, index fund fees tend to be lower, sometimes significantly lower, than managed fund fees, because buy and sell decisions are based exclusively on changes in the composition of the relevant index so there's no need for research or day-to-day investment decisions.

Of course, in a down market, an index fund will drop in value along with the index it mimics while some managed funds may achieve a stronger performance. That's one risk of using these funds. Another risk is that many indexes—and therefore the funds that track them—are not as diversified as they seem. Because an index is typically weighted, a limited number of securities may determine the direction of the index. For example, the S&P 500 index emphasizes the performance of stocks with the highest market values.

Bond Funds

Bond funds provide interest income from the underlying investments in the fund's portfolio. While you're investing in your 401(k), that income is reinvested to buy additional shares. Allocating a portion of your 401(k) contribution to these fixed income investments can play an important role in creating a diversified portfolio, reducing investment risk and helping you achieve your long-term goals.

You can differentiate bond funds from each other in two ways: by the types of bonds a fund owns and by the average term of the bonds in the fund.

Generally, 401(k) plans offer five categories of bond funds:

- ▶ **US Treasury bond funds**, which invest in bills, notes or bonds issued by the federal government
- ▶ **Agency bond funds**, which invest in bonds backed by a pool of mortgages and issued by either agencies of the federal government or government-sponsored enterprises
- ▶ **Municipal bond funds**, which invest in tax-exempt bonds issued by cities and states in order to fund public projects
- ▶ **US corporate bond funds**, which invest in bonds issued by US companies
- ▶ **International bond funds**, which invest in bonds issued by corporations based overseas or by governments other than the US

The average maturities of the bonds in a fund may be grouped as:

- ▶ **Short term**, with an average maturity of one year or less
- ▶ **Intermediate term**, with an average maturity of 2 to 10 years
- ▶ **Long term**, with an average maturity of 10 years or longer

The longer a bond fund's average maturity, the more sensitive it is to changes in interest rates. As rates go up, the net asset value (NAV) of the fund drops. And as rates drop, the NAV increases.

From an investment perspective, what matters most is a bond fund's total return. That's the interest the underlying bonds pay, which is reinvested to buy more shares, plus any increase or decrease in the value of your principal. The greater the total return, the better your investment is doing.

A long-term bond fund has greater potential than a short-term bond fund to generate high total returns when rates are falling, but its total return is more likely to decline when rates are rising. The most volatile bond funds, called high-yield funds, invest in low-rated bonds with the greatest risk of default.

Balanced Funds

Balanced funds are the most truly diversified mutual funds because they invest in stocks, preferred stocks and bonds in order to provide both potential growth and current income. By holding both asset classes, balanced funds tend to be less volatile than either pure stock or pure bond funds.

The major drawback of a balanced fund may be that it tends to under-perform pure stock funds in a bull market because only a portion of the fund's assets is invested in stock. The average stock allocation, which is typically about 60 percent of the total portfolio, is spelled out in the fund's prospectus, along with any limits the fund manager must follow.

For example, a manager may have the right to shift investments in changing economic environments but be required to keep a minimum of 25 percent in stocks or bonds at any given time.

Changes in the current interest rate may also affect a balanced fund's performance, especially if the fund is invested in long-term bonds in a period when interest rates are rising. That will tend to reduce the fund's total return.

Capital Preservation

Stable value funds and guaranteed investment contracts (GICs) are designed to preserve capital. That means they make investments that have a low risk of losing money.

Stable value funds guarantee the value of your principal, which is your initial investment, and promise a fixed rate of return. They may buy U.S. Treasury and corporate bonds as well as interest-bearing contracts from banks and insurance companies. Or all of the fund's assets may go into GICs. GICs are insurance company products that resemble individual bonds or CDs—the issuer has use of your money for the term of the contract, and pays a fixed rate of interest in return. While it is highly unlikely a stable value fund will lose money, such as scenario has occurred.

Pros and Cons of Capital Preservation

Stable value funds and GICs typically pay interest at a higher rate than money market mutual funds. That's one reason some investors who want to diversify a 401(k) account that contains more volatile investments, such as stock mutual funds, may choose these funds.

However, the interest rate on a stable value fund or GIC is generally guaranteed for only a predetermined time, sometimes as brief as three months, and varies with changing market conditions. Further, if you want to shift money out of the account, you may have to pay a penalty—sometimes a substantial one. That's not the case when you move money from a stock or bond fund into another investment.

One downside of capital preservation alternatives is that they're less likely to provide long-term protection against inflation. That can be a problem. You don't want to find yourself short of the income you need in retirement.

Beyond Mutual Funds

Variable Annuities

A variable annuity is a hybrid insurance company product, combining a number of funds that resemble mutual funds with insurance protection that guarantees, at a minimum, that your beneficiary will get your principal back if you die before beginning to collect benefits.

Your 401(k) plan may offer variable annuities as well as mutual funds as investment choices. Or, if your plan provider is an insurance company, the plan itself may be a variable annuity.

With a variable annuity, you allocate your contributions among the subaccounts that the annuity offers. Each subaccount has an investment objective and makes investments to meet that objective. Your earnings depend on the investment performance of the subaccounts you choose and the formula the company uses to credit any gains or losses to your account balance.

Variable annuities have some advocates, who point to the insurance protection as a safeguard against losing money. But critics object to the cost of this insurance protection, which makes variable annuities more expensive to own than mutual funds making similar investments. The critics also point out that many variable annuities carry higher management fees than mutual funds do, further raising the expense and reducing your return.

Brokerage Accounts

If your 401(k) plan offers a brokerage account, sometimes called a brokerage window, you can invest in stocks, bonds, mutual funds or other investments the brokerage firm handling the account offers. You give buy and sell orders just as you do with a regular, taxable account.

Advocates of this approach think that having the greatest possible choice is the way to allow experienced investors the opportunity to realize the largest possible return on their retirement savings. And because the entire account is tax-deferred, if you sell a stock or bond you've purchased through a 401(k) brokerage account for more than you paid, you owe no capital gains tax on the profit—though you will owe income tax when you withdraw from your traditional tax-deferred 401(k) account.

The Downside

Others worry that having unlimited choice may be confusing or intimidating, and that employees may not have enough information to make wise choices. However, in most cases, plans offer a menu of funds from which you can choose as well as the brokerage window.

In addition, critics argue that investing through a brokerage window might encourage participants to buy and sell frequently, trying to beat the market. This practice, known as day trading or market timing, is at odds with the long-term goals of a retirement savings plan.

The Cost of Flexibility

A 401(k) brokerage account has an annual fee—anywhere from \$25 to \$175—depending on the brokerage firm the plan uses. There may also be transaction costs and commissions on each trade you make through the account. You may also pay higher fees on mutual funds you buy through the account than on funds that are part of a plan menu.

Company Stock

Should you invest your 401(k) plan contributions in stock issued by the company you work for? That question generates intensive debate, in part because recent events demonstrate the risk of depending too heavily on any single company for your financial security. But your employer may offer incentives that are hard to refuse.

If you work for a publicly traded corporation, your 401(k) investment menu may include company stock or a fund that buys only your company's stock.

You may find that your employer encourages you to make this choice. For example, you may be able to buy the stock for less than the current market price. You may be able to contribute a higher percentage of your salary if you're buying the stock. Or your employer may match a higher percentage of your contribution if it goes into the stock.

Your employer may also choose to make any matching contributions in stock rather than in cash. In that case, your account is credited with shares of stock or shares in a company stock fund no matter how you invest your personal contributions. There are financial advantages for your employer in making matching contributions in stock, in part because the company doesn't have to lay out cash—though all of its matching contributions are tax deductible.

Offering company stock as an investment choice gives employees the incentive of partial ownership in order to strengthen their commitment to the company. It also provides a way to let employees share in the profits if the company prospers.

But if employees have the bulk of their 401(k) money in company stock, their long-term financial security is at much greater risk than if they had built a diversified portfolio.

401(k) Fact When you invest in your company's stock, you may get:

- ▶ better 401(k) matching;
- ▶ an increase in your 401(k) cap;
- ▶ low prices on stock; or
- ▶ tax advantages .

**SMART TIP: Lessons from Enron Corporation**

The fall of Enron Corporation focused attention on the potentially devastating effect of owning too much company stock. Overall, 57.73 percent of employees' 401(k) assets were invested in Enron stock as it fell 98.8 percent in value during 2001. But employees at many companies still have even larger percentages of their 401(k) assets in company stock than Enron employees did.

Pros and Cons of Company Stock

If company stock is one of your 401(k) plan choices, you'll be faced with two important decisions: Should you invest? How much of your portfolio should you commit?

There may be good reasons to choose the stock, in addition to any potential financial incentives your employer offers. If you work for a strong company in a strong market sector, you could realize a substantial gain from owning the stock. But there are potentially serious problems.

You can't ignore the fact that you already depend on your employer for your current income, so you'd be tying your financial security even more tightly to a single source. In the worst possible circumstance you could be out of a job, and that portion of your 401(k) portfolio committed to company stock could be totally worthless. Experts disagree on how much company stock in a 401(k) account is too much, but many prefer a maximum of 10 percent to 15 percent.

You may have less flexibility to change the allocation of your plan assets if some of your money is invested in company stock. But a 2006 federal law requires companies to let employees sell company stock they received as an employer match after holding it for three years. That could result in losses if the share price dropped before the time limit expired. However, some companies may permit you to sell shares received in a match immediately. For additional information, see our Investor Alert, [Putting Too Much Stock in Your Company—A 401\(k\) Problem](#).

401(k) Fact

Only 11 percent of plans offer company stock, but 59 percent of participants offered company stock invest in it (*How America Saves 2011*).

Understanding Investment Risk

Investing always means taking a risk, but not every investment carries the same level—or even the same type—of risk. As an investor, you should be familiar with the different forms of risk that can affect your portfolio, including the following.

- ▶ **Company risk.** Stock and bond values drop due to a company's internal problems or investors' changing attitudes about its products and services.
- ▶ **Market risk.** The overall value of stock or bond market drops, taking most investments down with it.
- ▶ **Interest-rate risk.** Bond and bond fund values drop due to changing interest rates.
- ▶ **Credit risk.** Bond issuers fail to make regular interest payments or fail to repay principal upon maturity.
- ▶ **Currency risk.** Exchange rates fluctuate and affect the value of overseas investments.
- ▶ **Inflation risk.** Some low-risk investments—although not Treasury Inflation Protected Securities (TIPs) or I Bonds—with lower returns fail to outpace the rate of inflation.
- ▶ **Diversification risk.** Portfolio money is concentrated in too few investments that drop in value.
- ▶ **Employer stock risk.** Retirement savings are tied too closely with primary source of income—if one goes badly so does the other.

Of course, you don't face all of these risks with the same investment at the same time. Rather, risks tend to be cyclical, with one risk posing a serious threat in some periods but very little in others. For example, rising interest rates haven't been a risk in the last several years. In contrast, company and market risk have had a strong negative impact on stock values.

Risk and Return

As we have discussed, investing always involves some degree of risk. One basic rule of investing is that there's a direct connection between risk and return, sometimes described as the "risk/reward tradeoff." In general, the higher the risk that you could lose money, the higher your potential returns. Similarly, the less you can afford to lose money on an investment, the less risk exposure you will want to assume.

Making investments of varying levels—and types—of risk can help you position your portfolio for both stability and growth. Equally important, combining investments that pose different risks might help you weather economic storms, and can help you protect your principal and take advantage of opportunities for growth.

When deciding how to invest your 401(k) assets, be sure to consider the various risks each investment choice carries as well as how much risk you are taking elsewhere in your portfolio (outside your 401(k)) and what form that risk takes. For example, if you work for a publicly traded company, your job could be on the line if the company performs poorly—and any deferred compensation in the form of company stock could be at risk. This is sometimes called "human capital" risk. Remember, your risk analysis will always be unique to you. If you have limited assets or assets that you cannot or are not willing to lose, then you will want to think twice about the risks you take—especially risks that could result in your losing your principal or seeing the value of your investment eroded by inflation.

So it's important to understand the difference between the investments in your 401(k), from the least risky to the most. Then you can create a portfolio designed to help you meet your goals with the level of risk you're prepared to tolerate.

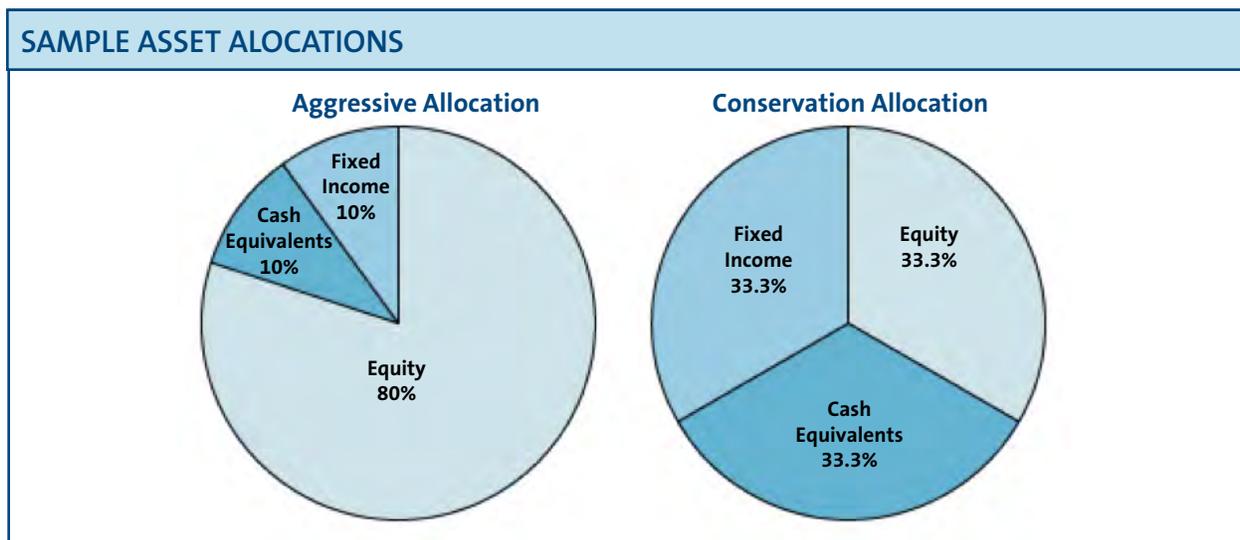
Addressing Investment Risk

Asset Allocation

You can mitigate risk in your portfolio by distributing your investments among the three major asset classes: equity, fixed income and cash or cash equivalents. Investing in all three will help to protect you against major losses, since historically, stock, bonds, and cash investments not only produce returns in different ways, but tend to provide their strongest returns at different times. In most cases, if one asset class is performing poorly, the other two are doing better.

Asset allocation means assigning a percentage of your entire portfolio to each asset class. For example, if you were investing \$10,000 and you allocated 30 percent to fixed income, you'd buy \$3,000 worth of bonds.

Your investing style will determine what percentage of your portfolio you assign to each asset class. Depending upon a number of factors, including your age, risk tolerance and other retirement assets, your style might be described as aggressive, moderate or conservative. Aggressive investors' portfolios target growth by investing heavily in stock and stock mutual funds, despite the risk of short-term losses that they carry. Moderate investors might invest 40 percent to 60 percent of their portfolios in stock or stock funds and the balance in bonds, bond funds or other fixed income investments. Conservative investors target capital preservation and weight their portfolios more heavily with cash investments.



Diversification

Once you've determined the percentage you're allocating to an asset class, you must decide how to invest the money that percentage represents.

For example, if you're assigning 60 percent of your contribution to equities, and your 401(k) offers eight equity funds, you must decide which funds to use and whether to emphasize one rather than another or put money equally into each of your choices. There are no fixed rules for what's best.

The key is to identify funds that invest in different segments of the equity market: large companies, small companies, companies that seem poised for growth and those that are ready to make a comeback. You might also consider an index fund, a balanced fund or a fund that invests internationally. That way, you're in a better position to benefit from whichever of those segments of the market is performing best. Then follow the same approach for choosing bond funds, though you are likely to discover there are fewer of them in your plan.

**SMART TIP: Look to a Fund's Name for Clues to Investment Style**

While a fund's name is often a useful clue to its investment style, don't take it at face value. Look at the fund's prospectus using the [EDGAR database](#) on the SEC website, and check to see how the fund is classified by research companies. If a fund with "Small company" in its name has substantial investments in medium- and large-sized companies, it may not have all the diversification you're seeking when you buy it.

You won't necessarily want to use all the funds your plan offers. There's little benefit to owning two funds that invest similarly, as two large-cap growth funds might, since owning the two provides no additional diversification.

Risks Change

Ideally, your investing style will provide the growth you need at a level of risk with which you're comfortable. But keep in mind that both your needs and risk tolerance may change as you come closer to reaching any of your financial goals.

Unfortunately, no single allocation model provides strong results in all economic climates, and certain circumstances might suggest that you should deviate from more common allocation models. For example, if an employer's pension promises regular income in retirement, you may be comfortable investing your 401(k) more aggressively than experts might recommend for your age.



Managing Your 401(k)

Checking Out Your Plan

You'll want to check up on your 401(k) to make sure that it's performing according to your expectations. That means keeping an eye on your investments' performances and potentially reassessing your asset allocation.

Your 401(k) takes work. Your administrator handles your portfolio's actual transactions and the recordkeeping and reporting, but you decide when and how to reallocate and rebalance your assets. If you check account expenses, regular account summaries, mutual fund quotations and other resources, you have access to information that can help you keep track of—and manage—your 401(k).

You can't overestimate the importance of a retirement plan, since your long-term financial security is likely to depend on the money you withdraw from your account after you stop working. Because so much depends on your being able to count on this source of income, it's wise to keep track of how your plan is managed.

You also should receive a copy of your summary plan description (SPD), a document that lays out the rules, schedules and procedures of your 401(k). Your employer should provide a copy of your individual benefit statement at least once every 12 months, though you may have to request it. You might want to review the document with your financial adviser or ask your plan administrator or human resources department about the details. While some account statements are relatively easy to decipher, others may be more difficult to interpret.

If you're looking for guidance on the issues you should be concerned with, or the questions to raise, you may want to check the Department of Labor's [What You Should Know About Your Retirement Plan](#).

401(k) Fact

An increase of 1 percent in your 401(k) plan fees and charges could reduce your retirement earnings by 28 percent.

Fee Overview

All 401(k) plans carry asset-based fees and expenses that have a direct impact on your investment return and your long-term financial security. An important part of managing your account effectively is knowing what those fees are, what they pay for and how they affect your return.

The difficulty is that it can be hard to calculate what fees are costing you because you don't pay them directly by writing a check. Rather, they are subtracted before your return is reported. Your account statement does document the amount of money you actually paid for various services and investments expenses, so be sure to check it out. In addition, most fees are explained in your summary plan document (SPD). You can also ask your human resources or personnel department for an explanation.

You can access more information about 401(k) fees and charges from the US Department of Labor's online publication, [A Look at 401\(k\) Plan Fees for Employees](#).

Types of Fees

Here's a look at some of the types of fees you might pay in addition to sales charges that may apply:

Administrative Fees. Your plan administrator takes care of or arranges for the recordkeeping, accounting and legal services required by your 401(k). But those services come with a price tag. The fees that you pay vary, depending on your plan's provider, the size of the plan and the services it offers participants. Generally, the larger your plan, the lower the rate at which fees are charged—either because they are being collected from more people or because your employer has more negotiating power, or both. In addition, some employers cover some or all of the administrative fees.

Investment Fees. Investment management fees, which you pay on every investment in your portfolio, generally account for the largest portion of the total. These asset-based fees may range from as low as 0.02 percent to 2.5 percent or higher. One complicating factor is that you may pay at different rates within a single 401(k) plan based on the investment choices you make. For example, fees on bond funds tend to be lower than on actively managed stock funds, and fees on index funds, if offered by your plan, are usually lower still. On the other hand, that doesn't mean you'll want to avoid all stock funds.

Some investment charges may apply only in specific circumstances. If you know what they are, such as fees for moving money out of a fixed-income investment, you are able to make more informed choices about how to invest and when to make a change. Incurring fees for moving money from one investment fund to another may also make you think twice about constant reallocation.

If your plan offers a brokerage window that permits you to trade securities within your 401(k), remember that you'll pay a broker's commission for each trade you execute.

Loan Fees. Unlike investment fees, which all participants pay, some fees are charged on specific services, such as loans. Loan fees can vary from a small percentage of the amount you borrow to a rather substantial percentage of the total value of what you'd be eligible to borrow. It pays to check what costs would apply before you commit yourself.

Your fund prospectus will include a fee table, where you can find more information on the charges you'll have to pay.

Calculating Yield and Return

Although your fees cover the administrative services needed to manage your 401(k), it's up to you to keep track of how your investments are doing. You can measure your portfolio's earnings in two ways: through yield, or through return.



WHAT IS THE DIFFERENCE?

YIELD is the amount of income you collect on an investment, expressed as a percentage of your original investment. So, if you buy a bond for \$1,000 and receive \$45 in annual interest payments, it has a 4.5% yield.

RETURN is the amount of money your investment increases in value, plus the money you earn on the investment. For example, if you sold that bond for \$1,100, your total return would be \$145, or the \$100 profit, plus \$45 in annual interest payments.

For example:

Dividends or interest	\$45
Amount you invested	+ \$1,000
Yield	= 4.5%
<hr/>	
Sale price	\$1,100
Original cost	- \$1,000
Increase in value	= \$100
Increase from interest	+ \$45
Total Return	= \$145

Variations on Return

If you've contributed different amounts to different investments, you might want to calculate your investments' percent return instead. And, if you've held an investment over a long period of time, you might want to calculate its annual percent return. For instance, a \$1,000 bond held over three years with a \$145 return has a 14.5 percent return but a 4.62 percent average annual return, which is derived by $(1+.145)(1/3)-1= 4.62\%$.¹

When you calculate your return, you might also want to account for annual inflation. Calculating your real return will give you an idea of the buying power your earnings will have in a given year. You can approximate real return by subtracting the inflation rate from your percent return. For instance, an investment with 8 percent return during a year of 3 percent inflation has a real return of only about 5 percent.

You may want to refer to the fund's prospectus, website or annual and semi-annual reports for more information on yield and total return on specific funds.

¹ The standard formula for computing annualized return is $AR=(1+return)^{1/years}-1$.

Reading Account Statements

You can find your earnings on your investments by checking your account statements. Your employer must give you an account statement at least once every quarter. Many plan providers, however, send you statements on a monthly basis. You may also be able to access account information online.

The frequency with which you receive account reports might depend on how often your account is valued, or how often recordkeepers determine the total value of your account. Valuation also directly affects the flexibility with which you can reallocate your portfolio. If you decide to reallocate your assets, but your plan is valued quarterly, you may have to wait until the close of that period before your investments can be moved.

Other Things to Look For

If you want to determine whether to stick with the investment choices you've made or move some or all of your assets into different investments offered by your plan, you'll have to consider information that mutual fund quotations and account reports don't provide.

In order to keep track of your investments' performance, you should compare your results with that of other funds within the same category, such as large-cap value or small-cap growth. Benchmarks, or averages that reflect the movement of a particular financial market or market sector, will give you an idea of how your funds are performing against the standard.

If your fund lags behind its benchmark for an extended period of time—for example, two or three years—you might want to consider replacing it. Just make sure that you're comparing your fund to the right benchmark.

Rebalancing Your Portfolio

As market performance alters the values of your asset classes, you may find that your asset allocation no longer provides the balance of growth and return that you want. In that case, you may want to consider adjusting your holdings and rebalancing your portfolio.

Assets grow at different rates—which means that your portfolio might end up out of line with the allocation you have chosen. For example, some assets might recently have grown at a much faster rate. To compensate, you might reallocate some of the value of fast-growing assets into assets with slower recent growth, which may now be poised to pick up steam while recent high-performers slow down. Otherwise, you might end up with a portfolio that carries more risk and provides a smaller long-term return than you intended.

Although there's no official timeline that determines when you should rebalance your portfolio, you may want to consider whether you need to rebalance once a year as part of an annual review of your 401(k) plan.



SMART TIP: Shifting Assets can be Costly

If you can access your account online, you may be able to shift your assets as often as you like. Keep in mind that constant shifting means potential sales charges, exchange fees, exit fees and back-end loads. The more often you trade, the more often you'll owe. And, aside from the costs this might incur, switching out of equities when the market is doing poorly means locking in your loss—and unlike a taxable account, you can't take a tax deduction on capital losses in a 401(k).

How to Rebalance

You can rebalance your portfolio in different ways to bring the way it is allocated back in line with the balance you intend it to have.

One rebalancing strategy is to redirect money to the lagging asset class until it returns to the percentage of your total portfolio that it held in your original allocation. Or, you could add new investments, and concentrate your contributions on that class.

Another strategy is to sell off a portion of your holdings within the asset class that is outperforming others. You may then reinvest the profits in the lagging asset class.

All three approaches work well, but some people are more comfortable with the first two alternatives than the third. They find it hard to sell off investments that are doing well in order to put money into those that aren't. Remember, though, that if you invest in the lagging classes, you'll be positioned to benefit if they turn around and begin to prosper again.

Three Approaches to Rebalancing:

- ▶ redirecting money to lagging asset class;
- ▶ increasing investment to lagging asset class; or
- ▶ selling off stronger asset class.

Automatic Rebalancing with Lifecycle Funds

The asset allocation you choose to help you meet your goals when you begin to invest in a 401(k) may no longer be the ideal allocation after you've been participating in the plan for 15 or 20 years or are nearing retirement.

Will you take the initiative to examine your portfolio and realign it if it seems advisable—for example, to shift its concentration in certain types of investments and perhaps reduce its risk potential? Or, like many 401(k) participants, you may not take the time to modify your allocation, or you may not be certain what to do—and so you do nothing.

That's where lifecycle funds come in. These funds are increasingly being offered as investment alternatives in 401(k) plans. Each lifecycle fund is designed to have its allocation modified gradually over a period of years, shifting its focus from seeking growth to providing income and preserving principal.

Usually, this is accomplished by reducing your exposure to stocks and increasing the percentage your lifecycle fund allocates to bonds. To make matters simpler, a fund's timeframe is often part of its name. So if you're thinking of retiring in about 20 years, you might put money into Fund 2030. And if your target date is 30 years away, you might choose Fund 2040. Before transferring your balances to a lifecycle fund, you'll want to investigate the fund as you would any potential investment, looking at its objective, fees, manager, historical performance and risk levels, among other details. If it passes those tests, it may be an alternative to consider.

Also keep in mind that lifecycle fund managers may be making allocation decisions assuming that this is your sole investment. Take the time to evaluate lifecycle funds relative to your overall investment portfolio.

One of the benefits of a lifecycle fund, also known as a target date fund, is that it may help provide a more financially secure retirement. But remember, while these funds take some of the weight off your shoulders, they don't guarantee that you'll meet your goals.

Where to Look for Advice

You're not alone when it comes to managing your 401(k). You'll want to anticipate future returns as accurately as possible—and you may need the help of outside resources to do so. Luckily, there are a few places where you can look for advice.

Your Employer

Your employer or 401(k) plan administrator may offer resources to help you with your financial planning. Many provide educational material and seminars about retirement planning and saving. They also may provide access to investment advice for retirement online or through a financial professional. Most of these services are available at little or no cost to you.

Online Resources

There are many websites that specialize in 401(k) advice. Most likely, these sites will ask you to provide information about yourself, such as the investments you own, your contribution rate, your financial goals, the age you would like to retire and the level of risk you're comfortable taking.

Some sites may run your information through simulations to determine the most probable outcomes for your current allocation. Based on those outcomes, the programs also may recommend that you adjust your investing strategies or goals. However, there's usually a charge for this analysis.

Online resources can offer a quick overview of your 401(k) portfolio. Just keep in mind that some of these resources will charge you for more personalized recommendations. And some sites sell their own investments, so you should weigh their recommendations against the profit they stand to make from your investment decisions.

Investment Professionals

You also may want to consult an investment professional for advice. You can obtain investment advice from most financial institutions that sell investments, including brokerages, banks, mutual funds and insurance companies. You can also hire an investment adviser, an accountant, a financial planner or other professional to help you make investment decisions.

Ask any potential adviser about his or her background and how they earned their credentials. Also ask for an explanation of their fees. Most importantly, check their backgrounds. [FINRA BrokerCheck](#) tracks the credentials of licensed brokers and investment adviser representatives.

The SEC's [Investment Adviser Public Disclosure website](#) also allows you to search for information about investment adviser firms registered with the SEC or state regulators. You also can view an adviser's Form ADV on the SEC's website or by contacting your [state securities regulator](#).

For more information, including an explanation of different types of investment professionals, see FINRA's [Selecting Investment Professionals](#).

Moving Your 401(k)



Rollovers

Whether you're starting a new job or getting ready to retire, you'll have to make a decision about your 401(k). You might want to consider moving your money to your new employer's plan if the plan accepts transfers. You always have the right to move your assets to an individual retirement account (IRA) or withdraw the money as a lump sum. Or you may be able to leave the account where it is. Just make sure you know the benefits and penalties involved with each choice.

401(k) Portability

Chances are, you'll change jobs several times over the course of your career. In fact, the average US employee switches jobs 11 times before retiring. That means employees may participate in 11 different 401(k)s or other retirement savings plans during a career.

Fortunately, 401(k) plans are portable. If you switch jobs before retirement, you usually can choose among several things to do with your 401(k):

- ▶ leave the money in your former employer's plan;
- ▶ roll over the money to your new employer's plan, if the plan accepts transfers;
- ▶ roll over the money into an IRA; or
- ▶ take the cash value of your account.

With the first three alternatives, you won't lose the contributions you've made, your employer's contributions if you're vested, or earnings you've accumulated in your old 401(k). And, your money will maintain its tax-deferred status until you withdraw it. Remember, though, that if you move your money into a new employer's plan, you'll have to wait until you switch jobs before you can move it again.

Although you have the option of taking your money out of your 401(k) when you change jobs, taking an early withdrawal may incur a 10 percent penalty on top of the taxes you owe, while keeping your money in a 401(k) or IRA will allow it to compound tax deferred.

You do have some time to consider your options and complete transactions. By law, you must have at least 30 days to decide what to do with your 401(k) when you switch jobs.



SMART TIP: Think Twice Before Cashing Out

The repercussions of taking money out now could be enormous: If you took \$10,000 out of your 401(k) instead of rolling it over into an account earning 8 percent tax-deferred earnings, your retirement fund could end up more than \$100,000 short after 30 years.

When You Don't Roll Over

Cashing out your account is a simple but costly option. You can ask your plan administrator for a check—but your employer will withhold 20 percent of your account balance to prepay the tax you'll owe. Plus, the IRS will consider your payout an early distribution, meaning you could owe the 10 percent early withdrawal penalty on top of combined federal, state and local taxes. That could total more than 50 percent of your account value.

If your former employer's plan has provided strong returns with reasonable fees, you might consider leaving your account behind. You don't give up the right to move your account to your new 401(k) or an IRA at any time. While your money remains in your former employer's 401(k) plan, you won't be able to make additional contributions to the account, and you may not be able to take a loan from the plan. In addition, some employers might charge higher fees if you're not an active employee.

Further, you might not qualify to stay in your old 401(k) account: Your employer has the option of cashing out your account if the balance is less than \$1,000 (minus 20 percent withholding) and, in some cases, automatically rolling your assets out of the plan and into an IRA if your plan balance is between \$1,000 and \$5,000.

New Job, New Plan

Putting all your retirement savings into one 401(k) plan has its advantages. For example, it will make it easier for you to track your assets' performance.

But you should evaluate your new employer's plan before deciding to roll your assets over. Make sure the new plan has plenty of investment choices and includes the investment options you prefer. Also check to make sure that accompanying fees aren't too high. If you're unhappy with the options provided by your new employer's 401(k), you can always consider your other options, including a rollover into an IRA.

Remember, too, that even if your new employer accepts rollovers, you may have to wait until the next enrollment period, or sometimes until you've been on the job a full year, to move your assets.

Making Your Move

If you've decided to roll over your former employer's 401(k) directly into your new employer's plan, you'll have to:

1. Arrange the rollover with your new 401(k) plan administrator. You may have to select the investments you'd like to make before you complete the rollover. Otherwise, you can transfer the lump sum and allocate it gradually to investments of your choosing.
2. Complete the forms required to move your money from your former employer's plan.
3. Ask your former administrator to send a check or electronically transmit your account value directly to the administrator of your new plan.

401(k) Fact

Remember, before you move your old 401(k) plan to a new plan, consider the following:

- ▶ Are the fees higher than your old plan?
- ▶ Are there enough investment options?
- ▶ Can you make the switch right away?

Indirect Rollovers

You can handle a rollover yourself by withdrawing money from your account and depositing it in your new employer's plan or an individual retirement account (IRA). You may opt for an indirect rollover to take advantage of a short-term loan if you're temporarily between jobs or you're waiting to close on your old home to make the down payment on a new one.

However, opting for an indirect rollover as a short-term loan should be a financial last resort, since you'll face early withdrawal penalties unless you repay the loan within 60 days.

When you indirectly roll over a 401(k), your employer gives you a check for the value of your account, minus 20 percent withholding. The IRS requires your employer to take out that 20 percent in case you decide to keep the money rather than roll it into another account. If you complete the full rollover within the time limit, the withholding will be returned to you when you file your tax return for the year. However, if you do decide to keep the money, the withholding will go towards the taxes you'll owe on the early distribution.

Once your employer hands you your check, you have 60 days to complete the rollover. Hold the money any longer, and you'll have taken a full lump-sum distribution whether you meant to or not.

The trick is that when you deposit your money into a new account, you must roll over the full balance of your original 401(k). So, you'll have to replace the 20 percent that is withheld, from savings or another source, to cover the full amount that you are rolling over. Otherwise the 20 percent withholding will be treated like an early distribution, and you'll have to pay the taxes, a possible penalty, and, worse yet, the money will no longer be tax deferred. These factors make an indirect rollover unappealing on many levels.

IRAs

When you retire or leave your job for any reason, you have the right to roll over your 401(k) assets to an individual retirement account (IRA). You have a number of direct rollover options:

Rolling your traditional 401(k) to a traditional IRA. You can roll your traditional 401(k) assets into a new or existing traditional IRA. To initiate the rollover, you complete the forms required by both the IRA provider you choose and your 401(k) plan administrator. The money is moved directly, either electronically or by check. No taxes are due on the assets you move, and any new earnings accumulate tax deferred.

Rolling your Roth 401(k) to a Roth IRA. You can roll your Roth 401(k) assets into a new or existing Roth IRA with a custodian of your choice. You complete the forms required by the IRA provider and your 401(k) plan administrator, and the money is moved directly either electronically or by check. No taxes are due when the money is moved and any new earnings accumulate tax deferred. Earnings are eligible for tax-free withdrawal once the IRA has been open at least five years and you are at least 59½.

Rolling your traditional 401(k) to a Roth IRA. If your traditional 401(k) plan permits direct rollovers to a Roth IRA, you can roll over assets in your traditional 401(k) to a new or existing Roth IRA. Keep in mind you'll have to pay taxes on the rollover amount you convert.

401(k) Fact

Watch out for the tax bite. If you indirectly roll over a 401(k), your employer will deduct 20 percent withholding from the value of your account. You have 60 days to complete the rollover.

It's a good idea to check with your plan administrator and a tax advisor to determine whether a move from a traditional 401(k) to a Roth IRA is allowed and right for you. To authorize the rollover, you complete the forms required by your Roth IRA provider and your 401(k) plan administrator. Earnings that accumulate after the rollover will be eligible for tax-free withdrawal when the IRA into which your assets are moved has been open at least five years and you are at least 59½.

Indirect Rollovers. You can roll over assets from your 401(k) to an IRA yourself by requesting a lump-sum distribution from your plan administrator and depositing the check in an IRA. However, you must complete the transaction within 60 days. Any pretax contributions and all earnings that you don't deposit on time are considered withdrawals and are taxable. You may also be vulnerable to an additional 10% tax penalty if you are younger than 59½.

In addition, your employer is required by law to withhold 20 percent of the potentially taxable amount you are moving. Even though that amount isn't included in the check you receive, you must provide it from another source if you want the full amount of your rollover to remain tax deferred.

Investing Your Contributions

Once your money is in your IRA, you can invest it in any of the alternatives available through the custodian you have chosen. If you continue to earn income, you may continue to make contributions to your IRA, up to the annual limit set by Congress. You can see the annual caps in the [Annual Contribution Limits](#) section. However, you can't contribute more than you earn in a year, and you can't contribute to a traditional IRA once you turn 70½ even if you continue to earn income.

You must take required minimum withdrawals from your traditional IRA by April 1 of the year following the year you turn 70½ (see [Required Withdrawals](#)). Taxes on those withdrawals are due at the same rate you are paying on your other income. In contrast, Roth IRAs are not subject to minimum withdrawal requirements, since taxes have already been paid on contributions and any gains may be withdrawn tax-free.

Managing Income In Retirement



Retirement Income Basics

The two big decisions you have to make are the timetable for taking money from your tax-deferred retirement account and the amount you should take at each withdrawal. The questions are:

1. Should you begin when you retire or should you postpone withdrawals until they're required?
2. Will your money last your lifetime?

Retirement Income Considerations

If you need to withdraw from your 401(k) to live comfortably when you retire, there's no reason to wait. But if you have other sources of income, or if you expect to be earning money from another job or a post-retirement career, you may want to wait as long as the law allows. Since there's the potential your account value will increase, it may make sense to allow your tax-deferred accounts to continue to accumulate untouched as long as possible.

You can anticipate your post-retirement living expenses by analyzing what you're spending in the year or two before you retire. You may feel comfortable estimating that you'll need 15 percent to 20 percent less after you retire. But be sure to consider the possibility of increasing medical expenses, insurance costs, local taxes and other regular bills.

Then add up what you expect to receive from Social Security, any defined benefit pension you qualify for, your spouse's income if you're married and any income you'll be earning. You might also add dividends and interest from your taxable investment accounts, or the possibility of taking capital gains. If that total is less than you'll need, that may be a signal to begin withdrawals.



WHEN IS THE RIGHT TIME TO ROLLOVER TO AN IRA?

Remember, in some cases, your employer may require you to begin drawing on your assets at retirement. If immediate income fits in with your plans, there's no issue. But if you prefer to wait, that may be a reason to roll over the assets into an IRA.

Systematic Withdrawals

One way to receive income from a 401(k) plan or individual retirement account (IRA) is to arrange for a systematic withdrawal, sometimes called a periodic withdrawal. You do have to be certain, though, that this is an option your plan or IRA offers.

You can generally choose to receive:

- ▶ A regular, fixed dollar amount on a specific schedule
- ▶ A specific percentage of your account value on a specific schedule
- ▶ The total value of your account in equal distributions over a set period of time

You select a monthly, quarterly, semi-annual or annual schedule. But systematic withdrawal arrangements are usually flexible, which means you can adjust the withdrawal arrangement by notifying the plan administrator or your IRA custodian. You can generally stop the payments, readjust the amount you receive or choose another withdrawal method.

Systematic withdrawals can make it easier to budget, since your money arrives on schedule. And you don't have to make the decisions about what to liquidate or when to sell. A professional handles those details. That includes ensuring that your withdrawal meets the required minimum distribution after you turn 70½. The one potential drawback of systematic withdrawals is that you could use up your assets during your lifetime. If your money is paid out at a faster rate than your account is growing, you'll be receiving principal as well as interest and dividends, reducing the amount available to accumulate additional earnings. Eventually your account value could be zero.

Immediate Annuities

In relatively rare instances, you may be offered the option of liquidating the assets in your 401(k) plan and purchasing a lifetime annuity. The annuity pays you income for your lifetime or for the joint lifetimes of two people—you and the person you name.

This alternative, sometimes known as annuitization, closely resembles the way that a defined benefit pension plan pays its retired workers. The chief advantage is that you can't outlive your assets, something that many people fear. The drawbacks are those of other annuities: potentially high management and insurance costs and lack of flexibility. In most cases, once you have annuitized you can't change your mind or you can do so only after paying a substantial fee.

If you annuitize, you may be able to choose between a fixed annuity and a variable annuity. With a variable annuity, your income depends on the investment performance of the funds you select from among those offered by the annuity company. A fixed annuity provides the security of regular income but exposes you to inflation risk. A variable annuity offers the possibility of larger payments in the future, but carries the risk that your payments could shrink.



SMART TIP: Look Carefully at Individual Retirement Annuities

You can rollover your 401(k) and buy an individual retirement annuity. For people who want to make sure they have income for life this may seem like a good option. However, before investing, you may want to consider their potentially steep fees, lack of flexibility for making unscheduled withdrawals and the financial condition of the insurance companies that stand behind them.

Strategic Planning

Your employer may provide lots of advanced notice about the details of arranging retirement income, but it's your responsibility to meet the deadlines. It's often a good idea to plan ahead and to get professional advice.

You don't want to be forced to make decisions in a hurry, since once you've done certain things—such as a lump sum withdrawal—you can't change your mind.

- ▶ Three Ways to Withdraw
- ▶ Lump Sum
- ▶ As You Need It
- ▶ Regular Schedule

Start by finding out from your plan administrator what your distribution choices will be, since not all plans offer all the possible alternatives. Figure out the date you'll want to start receiving retirement income and find out how much advance notice the administrator needs to meet that deadline.

Your account has to be valued to determine how much it is worth. Every plan values each employee's account on a regular schedule. But no plan does a separate valuation for account holders who want to move their money or begin distributions. You have to wait until the next regular valuation. In addition, 401(k) plans may hold your money for up to 60 days after valuing your assets. A plan doesn't have to wait the maximum amount of time, but it can and sometimes does.

Expert Guidance

Working with an experienced retirement planner can help you avoid some of the pitfalls of making inappropriate withdrawal decisions. It can also make you more confident about making the whole series of choices that are part of retiring and withdrawing from your 401(k) plan.

Through your employer, you may have access to someone who knows the ins and outs of your plan, and how other employees with similar situations have handled the issues you are facing. And, if you already have a good working relationship with one or more investment professionals, ask them if they are qualified to guide you on retirement decisions or if they could recommend a colleague with that experience. Using an investment professional with whom you are comfortable working can make your life simpler.

One area in which you may need help is in looking at the big picture. Rather than assuming you will—or should—withdraw all of your 401(k) assets before you die, an adviser should consider your retirement savings in the context of your estate plan. The larger your account balance and the more other assets you have, the more important a comprehensive plan becomes.

You'll have to provide your adviser with a copy of your 401(k) plan document. Its terms have a direct impact on the decisions you can make, and on what will happen to your assets at your death.

When you're choosing an adviser, be sure to ask how he or she is paid, and how much you should expect to pay each year. Some advisers charge a flat fee determined by the assets in your account. Others may charge a commission for each transaction. Be sure you read and understand the adviser's fee structure before you hire him or her.

Also, ask about the adviser's background. If an adviser has a [credential](#), ask what it means and what's required to earn it. If advisers are brokers or investment advisers, you should [check their background](#).

Required Withdrawals

Once you turn 70½, you must begin withdrawals from your 401(k) unless you're still working. These required withdrawals are designed to ensure that you use the money in your account for the purpose it was intended: to provide retirement income. You may not be required to put money into a 401(k) plan. In fact, only a few employers have mandatory plans. But if you do contribute, you must eventually take required minimum distributions (RMDs) from your plan if you haven't made arrangements for moving the accumulated assets out of your account. Check your minimum required distribution using [our calculator](#).

The reason the government requires withdrawals is that these tax-deferred savings plans were established to provide you with retirement income, not as a way for you to accumulate an estate to leave to your heirs—though if you die before you have withdrawn your assets you can pass them on to a beneficiary or beneficiaries you name.

Of course, you're free to begin withdrawing sooner than the law requires—which is when you reach 70½—if you retire or leave your job. You can also take more than the required minimum each year if your plan offers a flexible withdrawal arrangement. But if you take less for any reason, or if the required annual withdrawal isn't made before the end of the year, you face a 50 percent federal penalty on the amount you should have taken but didn't.

Age Limits

The age limits most commonly associated with 401(k) plans are 59½ and 70½. The first is usually the age at which you may begin to take money from your tax-deferred savings without owing a 10 percent early withdrawal penalty, provided that you've left your job. The second is the age by which you must begin taking mandatory withdrawals—though in fact you actually have until April 1 of the year following the year you turn 70½ to take the first withdrawal.

In most cases, you can begin withdrawing from your 401(k) account when you retire from your job, provided you've reached your employer's retirement age. In fact, some employers require you to start withdrawing when you retire if your money is in the plan. Instead, you could take a lump-sum withdrawal or transfer the balance into an individual retirement account (IRA).

AGE	RETIREMENT EVENT
59 1/2	Penalty Free Withdrawals
62	Social Security (Early)
65 1/2	Medicare
70	Social Security (Late)
70 1/2	Required Withdrawals
75	Last Call for 403(b)s

If you're still working at 70½, you can postpone withdrawals from your 401(k) until April 1 of the year following the year you retire. The only exception occurs if you own at least 5 percent of the company. Then you can't postpone taking income and must begin withdrawals on the regular schedule.



SMART TIP: Social Security's Retirement Estimator

Determining the best age to start receiving retirement benefits depends on a number of individual and family factors, including the amount of your future Social Security benefit. Get a personalized online estimate of your potential Social Security benefit, and see how that benefit varies across different retirement scenarios, using the [Retirement Estimator](#).

Paying the Tax

Tax-deferred investing has some strings attached, but it doesn't have to tie you in knots. The one tangle you can't avoid is owing federal income tax—plus state and local tax if they apply—at your regular tax rate on your retirement income. If the income is paid from your 401(k) plan, a percentage of each payment will probably be withheld to cover what you owe.

One argument for taking as little as permitted from your 401(k)—though not so little that you withdraw less than the required minimum—is that it reduces your annual income tax bill. But remember that anything that remains in your account at your death becomes part of your estate, potentially vulnerable to estate taxes.

If you take an early withdrawal, which usually means taking money out of your account before you turn 59½, you may owe an additional 10 percent penalty on the amount you take. However, if you retire, change jobs, or stop working at 55 or later and begin withdrawals, that penalty won't apply.

There's another alternative if you want to begin withdrawing early. You can set up what's known as a series of substantially equal withdrawals over a period of at least five years or until you turn 59½, whichever is longer. The tax applies, but not the penalty. The drawback, though, is that you will probably have used up a substantial portion of your savings before you're ready to retire. That could leave you short of cash when you need it.

Special 401(k) Features



Borrowing From Your 401(k)

You may be able to tap into your 401(k) plan assets during a financial emergency. But while taking a loan or a hardship withdrawal may help solve an immediate need, there can be consequences that may reduce your long-term security.

401(k) Loans

If you need cash, you may be tempted to borrow from your 401(k) rather than applying to a bank or other lender. While not all plans permit loans, many do. And with most plans, you repay your loan through payroll deductions so you're unlikely to fall behind as long as you remain employed.

When you borrow from your 401(k), you sign a loan agreement that spells out the principal, the term of the loan, the interest rate, any fees and other terms that may apply. You may also have to wait for the loan to be approved, though in most cases you'll qualify. After all, you're borrowing your own money.

Federal law caps the amount you can borrow at the lesser of \$50,000 or half the amount you have vested in the plan. Sometimes there's a loan floor, or minimum amount you must borrow. The law also requires that you pay market interest rates. That means the rate must be comparable to what a conventional lender would charge on a similar-sized personal loan.

Normally, the term of a 401(k) loan is five years. That's the longest repayment period the government allows—though if you prefer a shorter term, you may be able to arrange it. The only exception occurs if you're using the money to buy a primary residence—the home where you'll be living full time. In that case, some plans allow you to borrow for 25 years.



SMART TIP: Spousal Stamp of Approval

If you're married, your plan may require your spouse to agree in writing to a loan. This is because a spouse may have the right to a portion of your retirement assets if you divorce. If you borrow, change jobs and don't repay, that money may be gone, and your spouse's share may be affected.

Coming Out... Going In

When you borrow from your 401(k), the money usually comes out of your account balance. In many plans, the money is taken in equal portions from each of the different investments. So, for example, if you have money in four mutual funds, 25 percent of the loan total comes from each of the funds. In other plans, you may be able to designate which investments you'd prefer to tap to put together the total amount.

The advantage of being able to choose is that you can leave the investments providing the strongest performance untouched, provided that you have enough money in other plan investments to equal the amount you want to borrow. Of course, since there is no way to predict market performance, you might choose to take money from poorly performing stock funds only to find that those funds were about to regain their strength. Then, having suffered losses, you would also miss out on gains.

Weighing Pros and Cons

There are several advantages and some potential drawbacks in borrowing from your 401(k) account.

On the plus side:

- ▶ You usually don't have to explain why you need the money or how you intend to spend it.
- ▶ You may qualify for a lower interest rate than you would at a bank or other lender, especially if you have a low credit score.
- ▶ The interest you repay is paid back into your account.
- ▶ Since you're borrowing rather than withdrawing money, no income tax or potential early withdrawal penalty is due.

On the negative side:

- ▶ The money you withdraw will not grow if it isn't invested.
- ▶ Repayments are made with after-tax dollars that will be taxed again when you eventually withdraw them from your account.
- ▶ The fees you pay to arrange the loan may be higher than on a conventional loan, depending on the way they are calculated.
- ▶ The interest is never deductible even if you use the money to buy or renovate your home.

Perhaps the biggest risk you run is leaving your job while you have an outstanding loan balance. If that's the case, you'll probably have to repay the entire balance within 90 days of your departure.

If you don't repay, you're in default, and the remaining loan balance is considered a withdrawal. Income taxes are due on the full amount. And if you're younger than 59½, you may owe the 10 percent early withdrawal penalty as well. If this should happen, you could find your retirement savings substantially drained.

Taking Hardship Withdrawals

You may be able to withdraw from your 401(k) account to meet the needs of a real financial emergency. The IRS cites a number of circumstances that may qualify as a hardship withdrawal, including:

- ▶ out-of-pocket medical expenses;
- ▶ down payment or repairs on a primary home;
- ▶ college tuition and related educational expenses;
- ▶ threat of mortgage foreclosure or eviction; and
- ▶ burial and funeral expenses.

While the IRS sets certain guidelines, it leaves it to your employer to determine the specific criteria of a hardship withdrawal. For instance, one plan may consider a medical expense to be a hardship, but not payment of college tuition. Even if your plan allows for a hardship withdrawal, you should probably think of it as a last resort. Companies often prohibit contributions for at least six months after taking the withdrawal, and hardship distributions permanently reduce your account balance. In addition, you will have to pay taxes on the amount you withdraw, plus a 10 percent penalty if you are under age 59½.

If you do apply, your plan will probably require you:

- ▶ to prove that your situation qualifies as a hardship, usually by providing itemized bills or other supporting documents; and
- ▶ to show you can't get the money you need any other way.

You may be expected to withdraw any after-tax dollars you've contributed to your 401(k) account, borrow the maximum permitted from the plan, and apply for commercial loans as part of the qualification process.

Finally, your plan administrator may follow up after the withdrawal to verify that you used the money as you indicated you would in your application. And you'll usually have to wait six months before you can again contribute to your plan.

What Hardship Costs

A hardship withdrawal costs you any future earnings you might accumulate on the amounts you take out of your plan account. In most cases, you will also owe income tax and possibly a 10 percent tax penalty on early distributions on your withdrawal.

You can take hardship withdrawals from either a traditional or Roth 401(k) account, if your employer plan allows them. If you take your withdrawal before age 59½, you must pay an additional 10 percent penalty. The IRS grants several exceptions to the age rule, including:

- ▶ disability;
- ▶ medical bills exceeding 7.5 percent of your adjusted gross income;
- ▶ court order to pay funds to a spouse, child or dependent; and
- ▶ permanent lay off, termination, quitting or taking early retirement in the same year you turn 55.

401(k) Tip

Not all plans permit distributions from 401(k) accounts because of hardship. Ask your employer if hardship withdrawals are allowed in your plan.

Legal Issues

Dealing with Creditors

If you're in debt, or if you get divorced, your creditors or your former spouse may want a share of your 401(k) plan assets. Their rights, and yours, are spelled out in the law. If you're in debt, your creditors—businesses, family or governments—may try to collect what you owe. But whether or not they will be able to force you to liquidate your 401(k) assets to meet your obligations depends on who they are, and the legal routes they take.

It's generally true that your 401(k) is safe from commercial and professional claims—such as car repair bills or legal fees—whether you're sued in either federal or state court. That's because the federal ERISA law, which governs all 401(k) plans and supersedes state laws governing retirement plans, protects your money from these creditors. You won't be ordered to withdraw from your plan to pay now, nor can your account be frozen until you pay the debts.

For the most part, you cannot be forced to use your 401(k) money to pay state and local income, property or other taxes. However, if you owe child support, alimony or federal income taxes, a court may order you to withdraw money from your 401(k) to pay those debts. Because state and federal laws differ, you may want to seek legal advice to be sure which will apply.

If you change jobs or retire and want to be sure that protection continues, you may want to consider leaving your assets in your former employer's plan or rolling them into an individual retirement account (IRA). Cash you withdraw is no longer safe from claims against you, though IRA assets are.

Dividing Your Assets

If you divorce, your former spouse may be entitled to some of the assets in your 401(k) account or to a portion of the actual account. That depends on where you live, as the laws governing marital property differ from state to state.

In community property states, you and your former spouse generally divide the value of your accounts equally. In the other states, assets are typically divided equitably rather than equally. That means that the division of your assets might not necessarily be a 50/50 split. In some cases, the partner who has the larger income will receive a larger share.

For your former spouse to get a share of your 401(k), his or her attorney will ask the court to issue a Qualified Domestic Relations Order (QDRO). It instructs your plan administrator to create two subaccounts, one that you control and the other that your former spouse controls. In effect, that makes you both participants in the plan. Though your spouse can't make additional contributions, he or she may be able to change the way the assets are allocated.

Your plan administrator has 18 months to rule on the validity of the QDRO, and your spouse's attorney may ask that you not be allowed to borrow from your plan, withdraw the assets or roll them into an IRA before that ruling is final. Once the division is final, your former spouse may choose to take the money in cash, roll it into an IRA or leave the assets in the plan.

If there's a cash settlement, income taxes will be due on the amount that's taken out of the account. If your spouse gets the money, he or she is responsible for paying that bill. But if as part of the settlement, the money goes to your children or other dependents, you owe the tax.

401(k) Warning Signs

The vast majority of 401(k) plans operate fairly, efficiently and in a manner that satisfies everyone involved. But problems can arise. The Department of Labor lists signs that might alert you to potential problems with your plan:

- ▶ consistently late or irregular account statements;
- ▶ late or irregular investment of your contributions;
- ▶ inaccurate account balance;
- ▶ losses that can't be explained by market performance;
- ▶ investments you didn't authorize;
- ▶ late or irregular payment of benefits to former employees;
- ▶ contributions that do not appear on your account statement;
- ▶ unusual transactions that appear on your account statement;
- ▶ frequent and unexplained changes in plan providers; or
- ▶ recent financial difficulty for your employer.



WHAT TO DO WHEN PROBLEMS ARISE?

If you believe there is a problem with your 401(k) plan, contact your plan administrator or employer first. They may immediately agree that you have a valid complaint or they may be able to clear up any misunderstanding. If you're not satisfied with their response, there are a number of places to turn for help. Several are listed on the next page.

Where to Look for Help

Employee Benefits Security Administration

The Labor Department's Employee Benefits Security Administration (EBSA) is the agency charged with enforcing the rules governing the conduct of plan managers, investment of plan money, reporting and disclosure of plan information, enforcement of the fiduciary provisions of the law and workers' benefit rights. You can call EBSA toll-free at 1-866-444-3272, or contact the regional EBSA office nearest you for help.

When you call EBSA to file a complaint, make sure you have the necessary documents, such as your summary plan description and recent plan statements, with you. The regional office will ask you a series of questions to help determine the nature of your complaint. If it's warranted, EBSA will then contact your employer and launch an investigation into the administration of your plan. EBSA will not disclose your identity to your employer. However, if your employer discovers that you have filed a complaint, your job will not be affected. Anti-retaliation provisions protect you from mistreatment or discrimination and ensure that you can't be fired.

FINRA

If a problem involves a brokerage firm serving as the 401(k) fund administrator, or brokers who provided advice or handled transactions, you have the option of filing a complaint with FINRA.

- ▶ You can check online whether a brokerage firm or its representatives are FINRA members through [FINRA BrokerCheck](#).
- ▶ You can file an online complaint at FINRA's [Investor Complaint Center](#).

Annual Contribution Limits

The annual contribution limits are increased periodically due to inflation, but they are not increased every year. Keep in mind that in some 457 plans and the TSP plan, there are a few circumstances when you can contribute above the annual limits. In addition, the maximum contribution to a Roth IRA and the maximum deductible contribution to a traditional IRA may be reduced depending upon your income.

PRODUCT	MAXIMUM ANNUAL CONTRIBUTION LIMIT
Traditional IRA & Roth IRA	\$5,500, plus \$1,000 catch-up if 50 or older
Traditional 401(k) & 403(b)	\$17,500, plus \$5,500 catch-up if 50 or older
Roth 401(k) & 403(b)	\$17,500, plus \$5,500 catch-up if 50 or older
457	\$17,500, plus \$5,500 catch-up if 50 or older, plus additional catch-up when approaching retirement
Thrift Savings Plan	\$17,500, plus \$5,500 catch-up if 50 or older

401(k) Glossary

401(k)

A 401(k) plan is an employer sponsored retirement savings plan. 401(k)s are largely self-directed: You decide how much you would like to contribute, and which investments from among those offered by the plan you would like to invest in. Traditional 401(k)s are funded with money deducted from your pre-tax salary. Your earnings are tax deferred until you withdraw your money from your account. Roth 401(k)s are funded with after-tax income, but withdrawals are tax free if you follow the rules.

403(b)

A 403(b) plan, sometimes known as a tax-sheltered annuity (TSA) or a tax-deferred annuity (TDA), is an employer sponsored retirement savings plan for employees of not-for-profit organizations, such as colleges, hospitals, foundations and cultural institutions. Some employers offer 403(b) plans as a supplement to— rather than a replacement for— defined benefit pensions.

457

These tax-deferred retirement savings plans are available to state and municipal employees. Like traditional 401(k) and 403(b) plans, the money you contribute and any earnings that accumulate in your name are not taxed until you withdraw.

Annual report

Your plan administrator must file an annual report with the IRS using Form 5500. The report, which you may request from your plan administrator, includes information on plan participation, funding and administration.

Asset allocation

Asset allocation means dividing your assets on a percentage basis among different broad categories of investments, including stocks, bonds and cash. Asset allocation is a strategy for reducing the risk associated with investing. Since your portfolio is spread among different asset classes, it's less likely that they will all perform badly at the same time. Finding the right mix of assets depends on your age, your assets, your financial objectives and your risk tolerance.

Asset class

Different categories of investments that provide returns in different ways are sometimes described as asset classes. Stocks, bonds, cash and cash equivalents, real estate, collectibles and precious metals are among the primary asset classes.

Balanced fund

Balanced funds are mutual funds that invest in a combination of common stock, preferred stock and bonds or other fixed-income investments to meet their dual investment goal of seeking a strong return while minimizing risk.

Benchmark

A stock market benchmark is an index or average whose movement is considered a general indicator of the direction of the overall market and against which investors and financial professionals may measure the performance of individual stocks or market sectors. There are also benchmarks for other types of investments, such as bonds, mutual funds and commodities.

BrokerCheck

See FINRA BrokerCheck

Brokerage window

Some 401(k) plans allow participants to invest in stocks and funds offered by a brokerage firm selected by your plan administrator. This is often referred to as a brokerage window, or a self-directed account.

Capital gains tax (CGT)

A capital gains tax is due on profits you realize on the sale of a capital asset, such as stock, bonds or real estate. Long-term gains, on assets you own more than a year, are taxed at a lower rate than ordinary income while short-term gains are taxed at your regular rate. Assets held for over five years may be taxed at an even lower capital gains rate.

Cash balance plan

A cash balance retirement plan is a defined benefit plan that has some characteristics of a defined contribution plan, such as portability. The pension benefit accrues over time from contributions, based on a percentage of your current pay, which are credited to a hypothetical account in your name.

Commission

The fee paid to a broker for executing a securities trade. If your 401(k) plan has a brokerage window, you should be aware of how high the commissions will be when you trade and what impact those costs may have on your return.

Contrarian

A contrarian is an investor who buys things other investors are shunning. If most investors are buying stocks, a contrarian is concentrating on building a bond portfolio or putting more money into cash investments. Contrarians may also invest in unpopular market sectors and/or styles. Contrarian mutual funds use this approach as their investment strategy, concentrating on building a portfolio of out-of-favor (and therefore often undervalued) investments.

Creditor

A person or company who provides credit to another person or company functions as a creditor. For example, if you take out a mortgage or car loan at your bank, then the bank is your creditor. But if you buy a bond issued by a corporation or other institution, you are the creditor because the money you pay to buy the bond is actually a loan to the issuer.

Deferred annuity

A deferred annuity contract allows you to accumulate tax-deferred earnings during the term of the contract and sometimes add assets to your contract over time. Your deferred annuity earnings may be either fixed or variable, depending on the way your money is invested. Deferred annuities are subject to withdrawal rules so you may owe a 10 percent penalty if you withdraw earnings before you reach age 59½. Surrender charges also may apply.

Defined benefit plan

A defined benefit plan provides a specific income for retired employees, either as a lump sum or as a pension, or lifetime annuity. The pension amount usually depends on the employee's age at retirement, final salary and the number of years on the job.

Defined contribution plan

A defined contribution plan is an employer sponsored retirement plan. The income the plan provides is not predetermined or guaranteed, as it is with a defined benefit pension. Rather, it varies according to how much is contributed to the plan, how the contributions are invested and what the return on that investment is. 401(k), 403(b), 457 and profit-sharing plans are examples of defined contribution plans.

Diversification

Diversification is an investment strategy for spreading your principal among different markets, sectors, industries and securities. The goal is to protect the value of your overall portfolio in case a single security or market sector takes a serious downturn and drops in price.

Employer sponsored retirement plan

Employers may offer their employees either defined benefit or defined contribution retirement plans, or they may make both types of plans available. Any employer may offer a defined benefit plan, but certain types of defined contribution plans are available only through specific categories of employers. However, employers are not required to offer plans.

Equity fund

Equity mutual funds invest primarily in stocks. The particular stocks a fund buys depends on the fund's investment objectives and management style.

ERISA

The Employee Retirement Income Security Act of 1974 (ERISA) sets certain standards for 401(k) plan administrators and requires uniform rights for plan participants.

Expense ratio

An expense ratio is the amount you pay annually to a mutual fund for operating expenses and management fees, expressed as a percentage of the net asset value of your investment in the fund.

FINRA BrokerCheck

FINRA BrokerCheck is a resource for learning about the professional background, registration/license status and conduct of brokerage firms, individual brokers, investment advisers and firms. If your 401(k) plan has a brokerage window, or if you roll your 401(k) into an IRA at a brokerage firm, you'll want to use [FINRA BrokerCheck](#) to check out the firm and its brokers.

Government-sponsored enterprises

Federally chartered government-sponsored enterprises (GSEs) are shareholder-owned corporations, not federal agencies. Although GSEs, such as Fannie Mae and Freddie Mac, were created to fulfill a public purpose, the mortgage-backed bonds they issue are not insured by the government or backed by its full faith and credit.

Growth and income fund

These mutual funds invest in securities that provide a combination of growth and income. They generally funnel most of their assets into common stocks of well-established companies that pay regular dividends. They may also invest in high-rated bonds.

Growth fund

Growth fund managers invest in stocks of companies that have recently exhibited faster than average earnings gains. Such stocks generally have higher price/earning ratios and often do not pay dividends. Growth stock funds are often characterized by high levels of price volatility.

Guaranteed investment contract (GIC)

A GIC (pronounced gick) is an insurance company product designed to preserve your principal and to provide a fixed rate of return. You may invest in a GIC through an employer sponsored salary reduction plan, such as a 401(k) or 403(b), if it is one of the investment options offered.

Hardship withdrawal

A hardship withdrawal occurs when you take money out of your 401(k) or other qualified retirement savings plan to cover a pressing financial need. You must qualify to withdraw by meeting the conditions your plan imposes in keeping with Internal Revenue Service (IRS) guidelines. If you're younger than 59½, you may have to pay a 10 percent penalty, plus income tax, on the amount you withdraw, and you may not be permitted to contribute to the plan again for a period of time.

Highly compensated employees

Highly compensated employees are people who earned more from their employer, or own a larger stake in the company, than the floor the government has established for this category of worker. The drawback of being highly compensated is that you may be restricted on what you can contribute to a 401(k).

Index fund

An index mutual fund is designed to mirror the performance of a stock or bond index, such as Standard & Poor's 500 Index (S&P 500) or the Russell 2000 Index. To do that, the fund purchases all of the securities included in the index, or a representative sample of them, and adds or sells investments only when the securities in the index are changed.

Individual retirement account (IRA)

Individual retirement accounts (IRAs) are self-directed investment accounts that provide the incentive of tax-deferred (in the case of traditional IRAs) or tax-free (in the case of Roth IRAs) earnings on assets in the account. If you earn income, or are married to someone who does, you are limited in how much money you can contribute to your IRA. You can see the current limits in the [Annual Contribution Limits table](#).

Lifecycle fund

A lifecycle fund is a package of individual mutual funds that a fund company puts together to help investors meet their investment objectives without having to select portfolios of funds on their own. The allocation of funds within the fund is altered as the investor moves closer to retirement to help reduce potential volatility and preserve capital.

Liquid investment

A liquid investment is one that can be bought or sold quickly in large volume without dramatically affecting its market price. However, the term is sometimes used more generally to describe investments you can buy or sell easily, including mutual funds and most publicly traded stocks and bonds. It may also be used to describe those investments you can sell or cash in easily without loss of principal, such as a money market fund.

Lump-sum distribution

A lump-sum distribution is a one-time payout of assets in an account, typically a retirement savings account. When you retire or change jobs, you can take a lump-sum distribution as cash, or you can roll over the distribution into an individual retirement account (IRA). If you take the cash, you owe income tax on the full amount of the distribution, and you may owe an additional 10 percent penalty if you're younger than 59½. If you roll over the lump sum into an IRA, the full amount continues to be tax deferred, and you can postpone paying income tax until you withdraw from the account.

Managed account

A managed account is a portfolio of stocks or bonds owned by an individual investor. The account has a professional investment manager who makes buy and sell decisions, sometimes in response to the account owner's instructions. Each managed account has an investment objective, and each manager oversees multiple individual accounts invested to meet the same objective.

Managed Funds

Unlike index funds that are designed to track a market index, managed funds rely on the expertise of the mutual fund manager to research and select the stocks or bonds that make up the fund's portfolio.

Market capitalization

Market capitalization is a measure of the value of a company, calculated by multiplying the number of existing shares, or shares the company has issued, by the current price per share. For example, a company with 100 million shares of stock with a current market value of \$25 a share would have a market capitalization of \$2.5 billion. Market capitalization is sometimes used interchangeably with market value. Mutual funds often will note if their focus is on large-, mid- or small-cap stocks.

Market index

A market index measures changes in the value of a specific group of stocks, bonds or other investments that it tracks from a specific starting point, which may be as recent as the previous day or some date in the past. An index may be broad, encompassing a large number of stocks or bonds, or quite narrow, including only a limited number.

Monte Carlo simulation

A Monte Carlo simulation generates thousands of probable performance outcomes, called scenarios, which might occur in the future. An investment simulation incorporates economic data such as a range of potential interest rates, inflation rates, tax rates, and so on, combined in random order. As a result, it's designed to account for the uncertainty and performance variation that's always present in financial markets.

Net asset value (NAV)

The NAV is the dollar value of one share of a mutual fund at the close of the trading day. It is calculated by totaling the value of all the fund's holdings and dividing by the number of outstanding shares. That means the NAV changes regularly, though day-to-day changes are usually small.

Plan administrator

Your 401(k) plan administrator is the person or more typically the company your employer chooses to manage the organization's retirement savings plan. The administrator works with the plan provider to ensure that the plan meets government regulations and that you and other employees have the information you need to enroll, select and change investments in the plan, apply for a loan if the plan allows loans and request distributions.

Plan provider

A 401(k) plan provider is the mutual fund company, insurance company, brokerage firm or other financial services company that creates and sells the plan your employer selects.

Plan sponsor

A 401(k) plan sponsor is an employer who offers the plan to employees. The sponsor is responsible for choosing the plan, the plan provider and the plan administrator, and for deciding which investments will be offered through the plan.

Portable

A portable retirement plan is one where you can take your contributions plus any earnings with you when you change jobs. 401(k) plans are portable and you can usually leave the money with your former employer, roll over the money into your new employer's plan, roll over the money into an IRA or take the cash value of your contributions and any earnings.

Principal

Principal can refer to an amount of money you invest, the face amount of a bond or the balance you owe on a debt, aside from the interest.

Profit sharing

A profit-sharing plan is a type of defined contribution retirement plan that employers may establish for their workers. The employer may add up to the annual limit set by Congress to each employee's profit-sharing account in any year the company has a profit to share, though there is no obligation to make a contribution in any year.

Real rate of return

The real rate of return on an investment is the rate of return minus the rate of inflation. For example, if you are earning 6 percent interest on a bond in a period when inflation is running at 2 percent, your real rate of return is 4 percent. But if inflation were at 4 percent, your real rate of return would be only 2 percent.

Required minimum distribution (RMD)

A required minimum distribution is the smallest amount you can take each year from your 401(k), 403(b), traditional IRA or other retirement savings plan once you've reached the mandatory age for making withdrawals, usually 70½. If you take less than the required minimum, you owe a 50 percent penalty on the amount you should have taken. You calculate your RMD by dividing your account balance at the end of your plan's fiscal year—usually, but not always, December 31—using a divisor determined by your age.

Rollover

If you move your assets from one tax-deferred or tax-free investment to another, it's called a rollover. For example, if you move money from one individual retirement account (IRA) to another IRA, or from a qualified retirement plan into an IRA, the transaction is a rollover.

Roth IRA

A Roth IRA is an individual retirement account from which you can withdraw your earnings completely tax free any time after you reach age 59½, provided your account has been open at least five years. To qualify to contribute to a Roth IRA, your income must be less than the level set by Congress. However, even if you are not eligible to contribute to a Roth IRA, you may convert a traditional IRA to a Roth IRA and pay the tax that's due on contributions and accumulated earnings.

Salary reduction plan

A salary reduction plan, such as a traditional 401(k) or 403(b), is a type of employer sponsored retirement savings plan that allows you to contribute pretax income to a retirement account in your name and to accumulate tax-deferred earnings. In contrast, with a Roth 401(k) and 403(b) you contribute after-tax income to a retirement account in your name and may make tax-free withdrawals after you retire if you're at least 59½ and your account has been open at least five years. All of these plans, which may be described as salary deferral plans because part of your current salary goes into your retirement account rather than being included in your take-home pay, have the same annual contribution cap, which is set by Congress, and allow annual catch-up contributions for participants 50 and older.

Sector fund

Sector mutual funds, also called specialty or specialized funds, concentrate their investments in a single segment of an industry, such as biotechnology, natural resources, utilities or regional banks, for example. Sector funds tend to be more volatile than more broadly diversified funds, and often dominate both the top and bottom of annual mutual fund performance charts.

Self-directed retirement plan

A self-directed retirement plan is one in which you select the investments. When the plan is employer sponsored, you usually select from a menu of choices your plan offers. When it's an individual retirement account (IRA), you typically may choose from the full range of investments other than collectibles and non-US coins. In contrast, if you're part of a defined benefit pension plan, your employer is responsible for making the investment decisions.

Summary plan description (SPD)

A summary plan description is a document describing the features of an employer sponsored plan. The Employee Retirement Income Security Act (ERISA) requires that SPDs address several different aspects of the plan, such as participant rights.

Tax deferral

Tax deferral means that income taxes that would otherwise be due on employment or investment earnings are postponed until some point the future, often when you retire. Then tax is due on the amounts you withdraw, at the same rate you pay on your regular income. For example, if you contribute pretax income to a retirement savings plan, such as a 401(k) or 403(b), you owe no tax on the contributions or any earnings in the plan until you withdraw those funds. In other plans, such as individual retirement accounts (IRA), the contribution may be taxable but the earnings are tax deferred.

Total return

Total return is your annual gain or loss on an equity or debt investment. It includes reinvested dividends or interest, plus any change in the market value of the investment. When total return is expressed as a percentage, it's figured by dividing the increase in value, plus dividends or interest, by the original purchase price. On bonds you hold to maturity, however, your total return is the same as your yield to maturity (YTM).

Value fund

When a mutual fund manager buys primarily undervalued stocks for the fund's portfolio with the expectation that these stocks will increase in value, that fund is described as a value fund. A value fund may be limited to stocks of a certain size, such as those included in a small-cap value fund, or it may include undervalued stocks with different levels of capitalization.

Variable annuity

A variable annuity is a contract offered by an insurance company that can be used to accumulate savings tax deferred. You allocate your premium among a number of subaccounts or investment portfolios offered through the contract. Your contract value, which fluctuates over time, reflects the performance of the underlying investments held by the funds you have selected, minus the contract expenses. Withdrawals are taxed as ordinary income, rather than at the lower capital gains rate. If you make withdrawals before you reach age 59½, you may also be subject to a 10 percent early withdrawal penalty. Unlike fixed annuities, variable annuities are securities registered with the Securities and Exchange Commission (SEC).

Vesting

If you are part of an employer pension plan or participate in an employer sponsored retirement plan, such as a 401(k), you become fully vested—or entitled to the contributions your employer has made to the plan, including matching and discretionary contributions—after a certain period of service with the employer. Qualified plans must determine the period using standards set by the federal government. If you leave your job before becoming fully vested, you forfeit all or part of those benefits.

Weighted stock index

In a market value or price weighted index, changes in some stocks have a greater impact than changes in others in computing the direction of the overall index. By contrast, in an equally weighted index, changes in all the stocks have an equal impact.

In a price weighted index, such as the Dow Jones Industrial Average (DJIA), changes in the prices of its higher-priced securities have more impact on the index than changes in the prices of lower-priced securities. Similarly, a market capitalization weighted index, such as the NASDAQ Composite Index, gives more weight to price changes in its securities with the highest market values, calculated by multiplying the current price per share by the number of existing shares.



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