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The 401(k) Rethink

David K. Randall, 09.07.09, 12:00 AM ET

Millions of company employees are being automatically enrolled in 401(k) plans. That's great news for fund firms but not necessarily for workers.

Aware that Americans weren't putting away nearly enough to support themselves comfortably in old age, Congress enacted legislation three years ago that permits employers to automatically enroll workers in 401(k) savings plans. Workers would have to opt out rather than opt in. Inertia would work in favor of savings.

At companies adopting the forced-march approach, employees have 3% to 6% of pretax wages diverted from their paychecks unless they go to the trouble of explicitly informing their employers that they do not want to participate. Of employers with at least 1,500 employees, half now have automatic enrollment plans.

In one sense the legislation is working like a charm. In 2005, just before Congress began encouraging automatic enrollment, seven in ten eligible workers participated in 401(k) plans. Now nine in ten do among companies with automatic enrollment. What's more, over half of those automatically enrolled are either younger than 34 or making less than \$40,000 a year, Fidelity Investments says.

What's not to like? Not a thing, if the goal is merely to boost 401(k) assets. Plenty, if the objective is to help workers save for retirement in the most effective way possible. That's because in the current environment 401(k) plans are a crummy deal for millions of workers. That goes doubly for young and low-wage earners. Following are some guidelines to consider before enrolling yourself, or your workers, in a 401(k) plan.

The Big Chill

Conventional wisdom has long had it that only a fool would fail to contribute to a 401(k), at least up to the point that his employer stops matching his contributions. Passing this up, the adage goes, is tantamount to leaving free money on the table.

That logic still holds if your employer offers a match. Unfortunately 5% of employers have frozen 401(k) contributions in the past year. In the absence of matches, and in light of the points below, a 401(k) might not make sense at all.

Better Alternatives

For workers in low tax brackets it may make more sense to put aftertax dollars in now and take them out tax free later in life via a Roth 401(k). That's assuming your employer offers this relatively new type of retirement account and attractive investment options inside it. For both types of 401(k)s, the contribution limit is \$16,500 this year, or \$22,000 for those age 50 and above.

And what if your employer has a no-match 401(k) but no Roth option? If you are in a low tax bracket, you might do well to opt out of the 401(k) and put the money instead into your own Roth Individual Retirement Account up to the \$5,000 maximum for 2009 (\$6,000 for those 50 and over). An IRA enables you to call the shots on where your money is invested. That means you can select an index fund or ETF with rock-bottom fees or go farther afield than most 401(k) plans allow and into things like real estate investment trusts or commodity futures. Single filers with modified adjusted gross incomes of less than \$105,000, or married couples filing jointly and together earning \$166,000 or less, can contribute to a 401(k) and make a full contribution to a Roth IRA. After that a Roth is limited or not allowed.

Younger workers in particular can benefit from funding a Roth IRA. As with a Roth 401(k), with the Roth IRA dollars go in after taxes are paid but come out tax free in retirement, when income, and income tax rates, are likely to be substantially higher.

"You have to factor in that you may have a lower tax bracket now than when you retire," says Mickey Cargile, head of WNB Private Client Services in Midland, Tex.

The Roth IRA also enables you to take out contributions at any time without paying a penalty, which can be useful for buying a house, sending a child to school or covering expenses between jobs. Withdraw money from a 401(k) before you turn 59¹/₂ and you'll pay a 10% penalty, plus ordinary taxes.

Risky Investments

After Congress passed automatic 401(k) enrollment, the Department of Labor drafted guidelines stipulating that employers can exempt themselves from legal claims of negligence by designating target date funds as their default investment vehicles. These funds wrap together other funds that invest in stocks, bonds and money markets with the aim of buying risky assets early in participants' careers and becoming more conservative as they near retirement.

Target date funds have proved a disaster in the recent financial crisis. Some that were sold to those planning to retire in 2010, and marketed as geared toward capital preservation, were heavily invested in stocks and lost 40% of their value last year. The Senate is investigating.

Under the law, employers have a fiduciary duty to offer employees prudent investment options. The problem is that as long as they go along with what other employers are doing it will be hard to argue that they were imprudent--even if everyone's 401(k) loses a significant portion of its value.

"No matter what Wall Street has persuaded Congress to do, the only safe investment that people should be defaulted into are Treasury Inflation-Protected Securities," argues Laurence Kotlikoff, an economics professor at Boston University. "People shouldn't have Big Brother taking risks for them."

Academics warn that a false sense of security is another risk in making it too easy for employees to save for retirement. Workers who invest in a 401(k) without lifting a finger are unlikely to spend much time looking into whether they're saving enough, frets Punam Anand Keller, a professor of management at Dartmouth's Tuck School of Business.

"People assume it's like Social Security, and that once they're enrolled, nothing happens to that money," says Keller. "It's a false assumption."

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Fee Fiascos

Whether you're enrolled automatically or not, once you're in a 401(k) there's no cap on how much the plan might skim off the top in fees. As FORBES pointed out recently ("[Group Stink](#)"), many plans, especially those sold to small companies, can eat up roughly half of real investment returns. (That's not hard to do. Your assets might return 4% after inflation and an expensive asset manager can take 2% of assets annually.) Many small company plans offer dubious investment options, like deferred annuities that charge insurance premiums but offer little in the way of benefits.

Companies that automatically enroll workers have a fiduciary obligation to ensure that fees are reasonable, says Jeffrey Martin, a tax expert at Grant Thornton. "But 'reasonable' is a subjective determination," he adds.

Among 26 target date funds aimed at workers who plan to retire in 2045, expense ratios range from a modest 18 cents per \$100 invested at Vanguard to \$1.53 at BlackRock.

"I don't know how many people look at fees in their accounts now. That's what the mutual fund industry is relying on," says Glenn Sulzer, a tax attorney with CCH in Chicago.

In the end, automatic enrollment is a greater boon to the mutual fund companies who stand to receive billions of dollars in automatic contributions than it is likely to prove to individual savers, says Boston University's Kotlikoff.

"The money is locked in and big mutual fund companies earn fees on it year after year without having to do any work," he says. "This whole structure doesn't guarantee financial security or retirement security."

Decisions, Decisions

It's usually a good idea to invest in a 401(k), as long as your employer is matching your contributions. If it's not, other alternatives may be preferable and offer more flexibility to invest or to make penalty-free withdrawals before you retire.

Source	Contribution limit	Highlights
401(k) / Employer	\$15,500/\$20,500 if older than 50	Contributions pretax; employer may match contributions
Roth 401(k) / Employer	\$15,500/\$20,500 if older than 50	Employee contributions taxed now; employer match taxed at withdrawal
IRA / Self-directed	\$5,000/\$6,000 if 50 or older	Withdrawals taxed in retirement
Roth IRA / Self-directed	\$5,000/\$6,000 if 50 or older	Contributions taxed now; some taxpayers with higher incomes can't contribute

Income refers to adjusted gross income. *Source: CCH.*

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