

## Avoid the Top Five 401(k) Mistakes

Retirement and financial advisors generally agree most people are not saving enough money for retirement. A significant and growing portion of a person's retirement savings is often invested in a 401(k) plan. Many people, however, do not understand how important a 401(k) plan is to securing a comfortable retirement. This article focuses on the five most common mistakes people make with respect to their 401(k) plans.

### 1. Not Enrolling in Your 401(k) Plan

The most common mistake is not enrolling in your 401(k) plan. It goes without saying that if you are relying on a 401(k) plan to fund your retirement, you must enroll in your 401(k) plan. Although many people give a variety of excuses for not participating in a 401(k) plan, studies show the overwhelming majority of employees (even lower-paid employees) can manage to save at least 3% of their compensation for deposit into a 401(k) plan. The bottom line is that there is rarely a good reason for not participating in your 401(k) plan.

### 2. Not Taking Advantage of Full Employer Match

Now that you have decided to avoid committing the biggest 401(k) mistake of not enrolling in your 401(k) plan, you need to know how to take advantage of your employer's 401(k) matching contribution program. Too many 401(k) plan participants leave employer money on the table. For example, consider a 401(k) plan where your employer matches 100% of your 401(k) contributions up to 3% of your compensation, and 50% of your 401(k) contributions on the next 2% of your compensation. In this case, failing to save at least 5% of your compensation for deposit in your 401(k) plan means you are losing out on "free money" your employer will make in the form of matching contributions.

Too many times a person will complain he or she cannot afford to contribute 5% of his or her compensation as 401(k) contributions. If you are one of these employees, you may not appreciate the tax consequences of making contributions to your employer's 401(k) plan. For example, every dollar of your compensation that you do not put in your employer's 401(k) plan will be subject to income taxes. That means if you are in a 30% combined federal and state income tax bracket, every dollar you contribute to your 401(k) plan will reduce your paycheck by only 70 cents.

### 3. Making Poor Investment Decisions

You are enrolled in your employer's 401(k) plan, and you are taking full advantage of employer matching contributions. The next step is to avoid making poor investment decisions. At a time when investing for retirement has become increasingly complicated, employees often do not have the time or money to become investment experts. An employee easily can become overwhelmed by the subject of investing for retirement.

You need to be aware that how you allocate your retirement plan assets (for example, deciding how much to invest in stocks compared to how much to invest in bonds or other investments) will determine more than 90% of your investment returns. In other words, asset allocation is the single most important aspect in determining how much earnings you will receive on your contributions (and any employer contributions) made to a 401(k) plan.

The easiest way to determine the proper asset allocation is to consider "lifecycle funds" available under your 401(k) plan. These funds are designed to make asset allocation

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## Top Five 401(k) Mistakes, *continued*

easy for you. If you are not completely comfortable with deciding how much of your 401(k) plan assets should be invested in stocks compared to bonds, a lifecycle fund may be right for you. With a lifecycle fund a professional money manager diversifies your retirement plan assets for you depending on how close you are to retirement. The further you are from retirement, the more aggressively your 401(k) plan assets will be invested. In contrast, the closer you get to retirement, the more conservatively your 401(k) plan assets will be invested.

### 4. Borrowing From Your 401(k) Plan

At first glance, borrowing from your 401(k) plan seems like a great idea. You borrow your own money, and you pay yourself interest. Before you consider making this common 401(k) plan mistake, consider the following:

- If you quit your job before you pay back the loan, you will have to immediately repay your loan. If you cannot immediately repay the loan, you will owe income taxes and possible penalties on the unpaid balance of the loan.
- Depending on the interest rate of the plan loan, and the amount you could be earning if you did not borrow from the plan, it is likely the interest rate you are paying yourself is less than the amount you would be earning if you had not taken a loan.

Don't make the mistake of borrowing from your 401(k) plan.

### 5. Cashing Out When You Leave Your Job

If the biggest 401(k) plan mistake you can make is not participating in your 401(k) plan, then it follows that it is a big mistake to receive a distribution from your 401(k) plan because you change jobs.

A significant number of 401(k) plan participants receive a distribution from their 401(k) plan when they change jobs. Many of these people receive a cash distribution of their 401(k) retirement savings rather than roll the savings over to an IRA or to another employer-sponsored retirement plan. Don't make this mistake.

A 401(k) plan is a retirement savings plan. Too many younger workers change jobs and treat their 401(k) money as "found money". Younger workers may believe that since they have decades before retirement, their 401(k) money is best used for a vacation, car, or something else other than retirement. The younger you are, however, the more it will cost you to receive a distribution from your 401(k) plan on account of a change in jobs. Consider an employee who has \$10,000 in his 401(k) plan, but who receives a cash distribution when he changes jobs at age 25. If he had read this article and decided to leave the \$10,000 in his 401(k) plan, that \$10,000 would have grown to nearly \$250,000 in retirement savings at age 65, assuming an 8% average annual return.

### Summary

In offering a 401(k) plan, your employer has provided a valuable retirement benefit to you. If you are not already participating in the plan, sign up as soon as possible, contribute enough to take advantage of the full employer matching contribution, invest wisely, and do not take your money out of your 401(k) plan as a loan or for other short-term wants or needs.

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