Top 10 Reasons to Join Your 401k Plan

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When Sandra Kessler quit her job in 1990 to go to graduate school, she got a pleasant surprise when her former employer handed over the 401k savings she planned to roll into an IRA.

She wasn't expecting much, considering she had only contributed 2 percent of her pay to the plan for two years. But the employer had a generous dollar-for-dollar match, and Kessler got a $5,200 check. "I remember being incredibly stunned" at the amount, she recalled.

She became a 401k convert. Today, at age 37, she is still a big fan, contributing 7 percent of her salary and getting the full match from her employer.

"We get the statements. I say to my husband, 'look how much is in there and we aren't missing it,'" Kessler said.

Because of the publicity surrounding Enron employees' lost 401k savings, some people may be leery about contributing to their own 401k plans. But the problems encountered by Enron employees were not the fault of the 401k savings tool -- they had to do with choices the employer and employees made concerning company stock in the plan.

Compared to other savings plans available to private sector workers, the 401k plan has many good points. Here are our top 10 reasons why you should join your plan.

Top Three: Saving Made Easy

1. It's painless. Your employer automatically deducts your contributions every time you are paid. You don't need to remind yourself to write a check. And, like Sandra Kessler, after a while most people don't miss the money.

401k strategy: Your 401k enrollment form may allow you to make contributions as a specific dollar amount or as a percentage of pay. Choose the percentage of pay, recommends Brian Mattson, consulting actuary with Watson Wyatt Worldwide. "That way, when you get a raise, you are giving yourself a raise to the plan," he said.

2. You get free money with an employer match. In 2001, over 70 percent of plans offered some kind of matching contribution to encourage participation, according to the 44th Annual Survey of Profit Sharing and 401k Plans, by the Profit-Sharing/401k Council of America (PSCA). If your plan is among them, don't pass up this freebie.

3. You get two tax breaks when you save in a 401k plan. First, your contributions are tax-deductible. The money you contribute doesn't count toward your gross income for the year, lowering your taxable income.

Second, your money grows tax-deferred. If you saved money in a savings account or brokerage account you would have to pay taxes on your interest or dividends at the end of the year. With a 401k plan, your earnings are rolled back into the plan and don't have to be listed as income on your tax return until you withdraw them. Your savings grow faster this way.

Three More: Good Strategies

4. Interest compounding. This can be a difficult concept for new 401k savers to grasp, but it's what makes a 401k plan a powerful savings tool. Put simply, your earnings are plowed back in to the account so you earn interest on your original principal plus interest. Over the short term, the gains can appear small. But over the long term, you can see exponential results.

For example, take the number two and double it, then double that number, and again. After you have doubled two only 10 times you reach 2,048. Interest compounding works the same way. Assuming an 8 percent average return, you can reasonably expect a one-time 401k savings contribution to double every seven years. If you consider most folks have at least a 35-year working life, their initial contributions could double at least five times. If you are adding to your original contribution each year and receive an employer match, you can see your savings have some real growth potential.

5. Dollar cost averaging lets you buy low, sell high. Sophisticated investors use this strategy. Instead of looking (and waiting) for the bottom price at which to buy, you consistently use the same amount of money to buy securities over time. When prices are high you buy fewer shares, but when prices are low you buy more shares. This tends to lower the average cost of all of your shares. Since 401k savers make a contribution with every paycheck, by default they use this strategy.

6. You can contribute more to a 401k than to an IRA. In 2002, federal law permits 401k participants to contribute up to $11,000 tax-deferred, or $12,000 if they are 50 or older. (Your plan's limits may be lower; ask your benefits office.) Comparatively, you are only allowed to save up to $3,000 in an IRA in 2002 (or $3,500 if you are 50 or older), and this amount may not be tax-deductible if you participate in a 401k, depending on your salary.

Final Four: Building an Account

7. It's an inexpensive way to create a professionally managed, diversified portfolio. Earning money in the markets is a tough, full-time job. Do you have the time to do that? The advantage 401k plans offer is that in most cases someone does have the time -- the managers of the mutual funds you invest in.

But, it costs a fee. If the fee is reasonable, it's worth it, says Dee Lee, co-author of The Complete Idiot's Guide to 401k Plans. "I don't have a problem with them making a bonus. If they make money, I make money," she said.

With a 401k, you also avoid the minimum investment that many mutual funds require of other investors. These can start at $500 and run up to $10,000 or more. If you want to create a portfolio with five funds on your own, you might need a minimum of $2,500. With a 401k plan, you can put money in the same or similar funds with no minimum investment.

Finally, most of the legwork to find appropriate investments is done by your employer. If you wanted to create an investment portfolio on your own, you would have to choose from more than 8,200 mutual funds and 7,700 listed equities, not to mention corporate and government bonds, savings accounts and money market mutual funds. By comparison, the average number of funds available for to 401k participants is 13, according to the PSCA.

Still, you need to do some homework to find the right mix of investments for you. Indeed, the reason many Enron employees lost much of their savings is that they overloaded their portfolios with company stock. Not only was their employer match made in Enron stock, but these employees also used their own contributions to buy Enron stock.

8. Loans and hardship withdrawals may let you withdraw money in an emergency. Many plans offer loans (which you repay) or hardship withdrawals (which you don't) as a way of getting your money out in an emergency. But, because this money is supposed to be for retirement, taking it out early comes with a big set of attached strings. It's best to investigate all other options first.

9. You can take your money when you change jobs. New retirement savings plan rules that took effect in 2002 make it easier than ever for workers changing jobs to roll their retirement savings into a new employer's plan or an IRA. Doing this simple procedure will keep your savings tax-deferred.

10. Social Security won't be enough. It's widely accepted that Social Security is only meant to provide a modest percentage of your retirement income (possibly one-third of your income). Financial planners generally say you'll need between 70 percent and 90 percent of your pre-retirement income to live comfortably in retirement. Where is that money going to come from? A 401k plan could be a good source.

The information provided here is intended to help you understand the general issue and does not constitute any tax, investment or legal advice. Consult your financial, tax or legal advisor regarding your own unique situation and your company's benefits representative for rules specific to your plan.