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Avoid 401(k) mistakes and you're sitting pretty

IT'S YOUR BUSINESS
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Q: My wife's 401(k) was devastated when the New Jersey technology company she worked for hit hard times. Now, I am worried about the 401(k) offered by the New Jersey pharmaceutical company I work for. What are the common mistakes people make in their 401(k)'s and how can we avoid them?

The problem: mistakes made in 401(k) plans. Many companies are eliminating or are simply not offering traditional pension plans. Instead, they are shifting the responsibility of a retirement nest egg to the employees. Most employees are not skilled in managing one of their largest assets, their 401(k) account, and make costly mistakes.

Just a quick background on the 401(k) and how it works. Employers offer their employees 401(k) retirement plans so their employees can contribute a portion of their own compensation toward their own retirement. As an incentive, some employers provide free matching of employee contributions. Other employers match and make outright contributions through profit sharing programs. Unlike traditional pension plans, where employers are required to contribute to the employees' retirement accounts, many 401(k) plans require no contribution by the employer.

A traditional 401(k) allows employees to make pre-tax contributions through salary deferral. Contributions, interest, gains, dividends and the like are all sheltered from taxation until the assets are withdrawn. Employee contributions directly reduce federal income taxes. For example, an employee who earns $100,000 and contributes $20,500 to his or her 401(k) only pays federal income taxes on $79,500 of income that year.

Withdrawals are taxed as income in the year they are taken at that year's tax rate. Imagine a 20-year-old employee not paying taxes on contributions and gains for 50 years; then being taxed only on the amount withdrawn. How often do you have the opportunity to legally avoid paying income taxes, penalty and interest free, for 50 years? The employee contribution limit per year is $15,500 for those under the age of 50 and $20,500 for those 50 years of age or over.

Common mistakes New Jersey employees make:

• Forgoing a company match.

If your employer matches your contributions 25 cents on the dollar up to 6 percent, contribute at least 6 percent and earn a guaranteed 25 percent return. Better yet, defer a larger percentage and earn additional tax benefits throughout your career and thereafter.

• Withdrawing from your 401(k) before retirement.

Money taken out before the age of 59½ is assessed a 10-percent tax penalty and is taxed at the current tax rate (which is often higher than in retirement). Some 401(k) plans allow employees to borrow against their own balance, paying themselves back plus interest. Think of your 401(k) assets as your absolute last resort when you hit a financial jam.

• Investing too conservatively.

Just because this is retirement money does not mean the portfolio should be invested too conservatively. To the contrary, the longer your time horizon the more risk you should tolerate.

• Over-investing in company stock.

New Jersey is home to some of the largest pharmaceutical companies in the world, which employ tens of thousands of New Jersey residents. Many employees want to show their pride by allocating 25 percent, sometimes up to 75 percent of their 401(k) to their company stock. Think twice before making this mistake. If the company hits difficult times the stock and your 401(k) can plummet, even if the overall financial markets soar. Simultaneously, if the company is having difficulties your job could be at risk. A good rule of thumb is to limit company stock to 10 percent of your portfolio.

• Over-investing in one industry.

It was only five years ago that you heard family, friends and colleagues saying, "You can't lose money investing in technology stocks." We all know how that story ended — badly. Not only were there massive layoffs throughout New Jersey, but many companies ended up shutting their doors. Many employees already had technology exposure in their 401(k), yet increased the exposure even further by allocating money toward technology stocks and/or funds. The end result was doubling or even tripling their losses. Avoid over-exposure in any one industry — particularly the one your job depends upon.

Action Step — bearing in mind the above advice, contribute to your 401(k).

Contributing to a 401(k) immediately defers the taxation of any contributions and gains, provides a disciplined way to save for retirement and could provide a guaranteed return if your employer matches your contributions. If your employer does not offer a 401(k), ask to have one implemented. Like most investments, the earlier you begin contributing the more wealth you can create in the end.

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