

Money and You: The pros and cons of 401(k) plans

by *Carrie_Schwab_Pomerantz*

As a passionate advocate for financial literacy, I've been a staunch supporter of aggressive, disciplined retirement investing. I've been particularly vocal about the benefits of 401(k) plans (and their cousins, 403(b) and 457 plans), the tax-deferred, payroll-deduction-based retirement accounts sponsored by employers.

Why? Because in today's world, most jobs don't offer traditional pensions; the old paradigm of working for a company for most of your adult life and enjoying a reasonable defined benefit retirement package has all but disappeared. And second, because Social Security benefits simply won't be enough to ensure a comfortable retirement for most people.

Creating wealth for retirement is the No. 1 challenge for almost every working American, and I tell everyone who will listen to take full advantage of their 401(k) plan when they enter the work force. If they can't participate in a 401(k) plan, they should open an IRA or a Roth IRA, as well as a SEP-IRA if they work for themselves.

So I was - momentarily at least - taken aback when someone recently asked me at a party, "Are 401(k) accounts really as great as people think? Surely there's some downside to them."

I got on my soapbox right away, talking about the retirement challenge and the many benefits of 401(k) plans. But later I realized that people are right to be skeptical about conventional wisdom, and I mulled over the possible counterarguments someone could make about 401(k)s. I remain convinced that the positives outweigh the negatives; however, I also believe that the best way to make an informed decision is to understand the pros and the cons of any choice.

THE BENEFITS

I don't think I need to convince anyone that there is a need for retirement planning and investing, so I'll start by outlining the many good points of 401(k) plans:

- Extra money: Most company-sponsored plans offer some kind of match to help boost your tax-advantaged retirement savings. Say you want to save 10 percent of your pretax income in your 401(k); your company might match half of that, dollar for dollar or \$0.50 on the dollar. Terms vary, of course, but if your company is willing to contribute to your tax-deferred retirement account through a match, you should take it.

- Tax advantages: The government clearly believes it's in the public good for people to set money aside for their retirement, which led to the creation of IRAs and employer-sponsored plans like the ones I'm talking about. When you invest in a 401(k) plan, you're reducing your current tax bite because contributions are made with pretax dollars.

So if you're in the 35 percent tax bracket, a \$1,000 401(k) contribution saves you \$350 on your taxes; that contribution only "costs" you \$650. You'll also defer taxes on all investment gains and income, because you only pay taxes on 401(k) assets when you withdraw the money.

Note that some IRAs and their newer cousins, Roth IRAs, offer tax deferral of investment income but no immediate tax deduction. And remember, of course, that if you withdraw funds from your tax-advantaged accounts before the age of 59, you'll probably incur an additional penalty.

- Discipline: For some people, it takes a lot of discipline to forego current consumption to make an investment in their future, but 401(k) plans make it easy. You tell your employer how much you want to contribute, up to a limit, and the money is automatically deposited into your plan account. Most people find they don't miss the payroll deduction that much.

- Control: You're always in control of your 401(k) investments. You can pick your own asset allocation and invest the funds accordingly. If you change jobs, you can roll the money into a self-directed Rollover IRA and invest it yourself. It's your money and it always will be.

- Opportunities: Most plans today offer a wide range of investment opportunities, so you're almost certain to be able to execute a strategy that's right for you. Some plans even offer full brokerage services through their plans, enabling you to invest in virtually any fund or listed security.

But there are some cons.

It's virtually impossible to argue against extra money (the company match), but there are at least three potential negatives of 401(k) plans. First, some plans do offer only a limited range of investment opportunities, though this was more prevalent in the early days of 401(k) plans than it is today. Second, tax deferral might work against you. The future of tax rates is unpredictable; rates might be higher when you retire and start withdrawing the money. To make things even more complex, current tax rates on realized capital gains rates are substantially lower than those for ordinary income. Long-term buy-and-hold investors could face a much smaller tax bite by investing in a taxable account than in a 401(k) or IRA.

Finally, while you can salt away quite a bit (up to \$15,500 in 2007 plus another \$5,000 if you're 50 or older),

the current limits might not be enough for you. Don't assume that your 401(k) assets will ensure a comfortable retirement, even if you're contributing the max.

These could be real concerns, but they shouldn't persuade anyone not to take advantage of the 401(k) plan structure. Your 401(k) should be the cornerstone of your personal financial foundation. Use it to the fullest by participating as soon as you can and by contributing the maximum your employer will allow (but at least enough to take full advantage of the company match). It's one of the most powerful tools you've got at your disposal as you plan and prepare for your golden years.

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