Five 401(k) mistakes that will haunt you

Your 401(k) may be your retirement salvation, so take care of it

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SAN FRANCISCO (MarketWatch) -- Plenty of us have seen older Americans enjoy a vibrant retirement funded in large part by a generous company pension. It's easy enough to get lulled into the sense that somehow our own distant retirement day will be similarly rosy.

But that's a pernicious daydream, and you shouldn't fall for it. Most of us are on our own when it comes to retirement, and even our Social Security benefits won't be as generous as those enjoyed by previous generations.

Even if you're one of the increasingly rarefied owners of a traditional pension, you can't count on the company to continue contributing to the plan, limiting your retirement payout if contributions do stop. See related story.

It's likely your 401(k) plan will "fuel your retirement engine," said Barbara Steinmetz, a certified financial planner with Steinmetz Financial Planning in Burlingame, Calif. Steinmetz reviews clients' 401(k) holdings along with their other investments.

Taking care of your 401(k) takes work, she said, but monitoring your plan "is a responsibility that's due your respect and attention."

Clients often don't seem to "feel they need to be responsible for this because of the length of time" until retirement, she said. Also, "they feel like this is a safe investment because it's inside the company -- and that is so, so wrong."

Here's how to avoid the five biggest 401(k) mistakes.

1. Forsaking the match

If your bank gave you $10 every time you deposited $10, would you accept that gift? Many people don't.

"The No. 1 401(k) plan problem is that people who can probably afford to don't put in at least enough to get the maximum match from the employer," VanDerhei said.

The most common formula is that the employer will match 50% of what you put in, up to 6% of compensation, and some firms are raising that to a 100% match. See full story.

With a 50% match, "if you can put in 6% of your salary, you get a free 3%. They give you 3% more of your salary," VanDerhei said.

Still, people don't do it. Even if you needed to take out a loan to contribute to your plan, you'd be better off, VanDerhei said. "You're getting a 50% rate of return in that year on your contribution. Usually loan interest rates don't go quite up to 50%," VanDerhei said.

Some workers hesitate to enroll in the 401(k) plan because they're unwilling to invest in the stock market, Steinmetz said. But "there are very few 401(k) or 403(b) offerings out there that don't have something that's pretty much a cash equivalent. You still could max your 401(k)" -- and get the company match -- even while investing in a low-risk money-market or stable-value fund.

Steinmetz said she doesn't advocate all low-risk investments, but at least it would get people saving on a tax-deferred basis, helping them to reduce their taxable income, plus allowing them to enjoy the company match.

2. Diversification errors in many stripes

Unfortunately, workers make a wide variety of mistakes when it comes to diversifying their 401(k) plan. One common one, even among savvy investors, is ignoring their complete investment portfolio.

Investors' belief that they must be fully diversified within their retirement plan often leads them to buy, say, a less-than-stellar international fund. But don't forget options outside the plan, including your spouse's retirement plan or other investments, she said.

"If you have a lousy foreign fund inside your 401(k), do you have to use it because you have to diversify? What if your spouse has a great one? Do you have to be perfectly diversified within your 401(k)?" she said. The answer is no. You have to be diversified in your portfolio overall, she said. And as long as you and your spouse are staying together, his or her portfolio counts, too.

Another mistake: Investing in mutual funds without realizing which companies comprise those funds' top holdings. "I had clients who had Cisco options up the kazoo. Would I want to put them in a fund that had a kazillion dollars in Cisco?" Steinmetz said. Many Web sites, including Morningstar.com, let you rank top holdings to ensure you don't fall into the overconcentration trap. See the MarketWatch mutual-fund comparison tool.

A similar diversification error: "People will simply buy a basket of funds in their plan," said David Kudla, chief executive and chief investment strategist at Mainstay Capital Management, in Grand Blanc, Mich., which focuses on retirement investment advice and has many clients in the automotive industry.

"They may be buying funds that are rated well by a rating agency or have good long-term performance -- and what they end up holding are several large-cap growth funds or small-cap growth funds rather than a well-diversified portfolio."

Here's another mistake, and it continues despite the Enron debacle: Too many workers focus on company stock.

"You still have more than 10% of the people who are in 401(k) plans that offer company stock as an option putting more than 90% of their account balance in company stock," said Jack VanDerhei, a professor at Temple University and a research director at the Employee Benefits Research Institute, which tracks retirement-plan behavior.

"You don't need to have a Nobel Prize in economics to figure out that's probably too much," he said.

3. Taking the money and running

Your 401(k) is set for a long-term goal. But too often people take the money and run every time they change jobs. That means a big tax hit and early-distribution penalty.

Some people truly may be facing an emergency, VanDerhei said, "but for the vast majority of people," it's not a good idea to pull out their retirement-plan money.

"A lot of these people end up only having the 401(k) account from their last employer when they retire because they've cashed everything else out," he said. "In almost every case, I would say you're going to be hard-pressed not to have a rollover be your best financial option."

4. Your own ATM machine

Where else can you get access to thousands of dollars of your own money with an easy phone call? Plus, given that you have to pay yourself back with interest, doesn't it make perfect financial sense? Nope. Here's why the 401(k) loan habit is a big mistake:

First, "you're robbing your retirement nest egg. When those assets are outside the plan, they're not earning the rate of return and compounding over time and growing your retirement account," Kudla said.

Second, he said, you're paying more than you think in interest. "The way the interest payments are handled, in many cases you're essentially taxed twice on a lot of those dollars," he said.

That's because the principal you pay back gets tagged as pretax, and often the interest is tagged that way as well, even though you're paying interest with after-tax wages. Then, all of it gets taxed again on distribution.

There are other reasons why 401(k) loans are a bad idea, Steinmetz said. Workers "think they're borrowing it from themselves and they're paying themselves back with interest," she said. "Unfortunately, normally they'd make more in the market then they'll get back in interest."

Second, you may lose or leave your job. No matter why you leave, once you no longer work for that company, your loan becomes a distribution, with all the penalty and taxes that brings.

"I've seen that happen three times with clients," Steinmetz says. "They don't think about it, they change jobs, they've got an outstanding 401(k) loan. They think they're getting away with it, then all of a sudden comes a 1099R, a distribution form. You can't put the money back in."

So, avoid the loans. "Some people look at their 401(k) as an ATM," Kudla said. "They take loan after loan out. At the end of 2005, there were $662 million in outstanding loan balances in the GM 401(k)," he said. "It's very critical to keep your 401(k) savings intact and look to other sources before going to a 401(k), except in an extreme emergency."

5. Freezing in the headlights

Maybe your retirement is coming up sooner than you care to think, so you're burying your head in the sand. Or, you don't know which mutual fund to choose, so you don't choose anything.

The big mistake here is either failing to tap the benefits of the 401(k), or setting up contributions and then walking away.

Of course, it's not all that surprising that this mistake happens. Who isn't busy enough as it is?

"The employees are so confused, they don't know what to do, so they don't do anything," said Michael Eisenberg, a personal financial specialist and founder of Eisenberg Financial Advisors in Los Angeles. But "even if you can only start with 2%, 3%, 4% of your salary, just start with something."

And if you're not sure how or where to start, seek financial advice. Many employers offer some kind of financial-education resources, and some offer access to investment advisers. Ask your human-resources department what's available at your company.

Another option: Seek out an independent financial planner for help with your overall investment plan.

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