The Hanover Advisor

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401(k) Pitfalls to Avoid

In a world where pension plans are becoming less common, Americans are increasingly relying on employer-sponsored, defined contribution plans like 401(k)s and 403(b)s to cover their retirement needs. According to the Investment Company Institute, Americans held $7.2 trillion in 401(k) accounts as of September 2023. That is roughly one-fifth of the total U.S. retirement market, and a big jump from 2011, when 401(k) assets added up to just $3.1 trillion. Recent changes to federal regulation mean most workers are automatically enrolled in their workplace's 401(k) plan, and while this is a good step to get more people saving for retirement, it also means that employers may find themselves enrolled in something they do not understand. Here are a few pitfalls that 401(k) participants can fall into and tips to help get the most out of your 401(k).

1) Focus on time in the market…

The most powerful tool in a retirement saver's arsenal is time. Even if you are early in your career and don't feel like you have much to save toward retirement, the power of compounding means that even small contributions can grow to hefty sums if left alone. The trouble for some 401(k) owners is that they tend to lose sight of a 401(k)'s purpose—saving for retirement—and instead treat it like an emergency savings fund.

Relying on a 401(k) for emergency expenses can be costly and complicated. First, many plan sponsors do not even allow "hardship withdrawals," but even if yours does, when you withdraw savings from your 401(k) account, you are subject to taxes and, if under the age of 59½, could face penalties on what you remove. The IRS levies a 10% penalty on withdrawn funds unless they are needed to cover the IRS's definition of an "immediate and heavy financial need," which includes expenses to repair your home after a disaster, burial and funeral expenses, or certain medical expenses, among other reasons. Some 401(k) plan sponsors allow for loans, which can be more straightforward, but are required to be repaid. Failure to repay the loan within the specified deadline results in the loan being treated as a regular distribution, meaning that taxes and penalties will apply.

Even if taxation and penalties can be avoided, however, taking a distribution or loan means that you will lose out on the compound interest that the withdrawn savings would have accrued had the sum stayed invested in your 401(k). You may be able to make up for the balance withdrawn, but you will never be able to get back the time that those funds would have spent in the market accruing gains.

2) …and avoid trying to time the market.

Many 401(k) participants can fall into the trap of being too aggressive with their retirement savings in hopes that they will be able to time the market. Most participants are not market experts, and even the so-called experts can be wrong about the right time to buy or sell assets. One of the biggest benefits of a 401(k) is that they are relatively hands-off. Regular contributions from every paycheck are invested to generate long-term gains. Focusing on short-term performance, fretting over down periods in the market, or attempting to time your contributions to the swings of the market can be a recipe for disaster.

Instead, a more prudent approach would be to give your savings the time they need to grow in your 401(k) account as part of a thoroughly mapped out financial plan. This is a much safer bet for ensuring you have enough money when you are old enough to retire. Any questions you have about market timing and conditions should be discussed with a certified financial advisor who you trust. Never make major 401(k) buying and selling decisions on your own.

3) Take full advantage of employer matching.

The SECURE 2.0 Act of 2022 only expanded automatic enrollment for 401(k) plan sponsors, but just because you are enrolled in a plan does not mean you are taking full advantage of what it offers. One of the most important things 401(k) plan participants can do is to find out the maximum employer match you can receive and how much you need to save in your 401(k) to become eligible. The most common 401(k) match is 50 cents for each dollar saved up to 6% of pay. If your employer offers a 401(k) match, make sure you save enough to take advantage of it, otherwise you are leaving free money on the table. Capturing a 401(k) match is one of the fastest and most painless ways to boost your 401(k) balance.

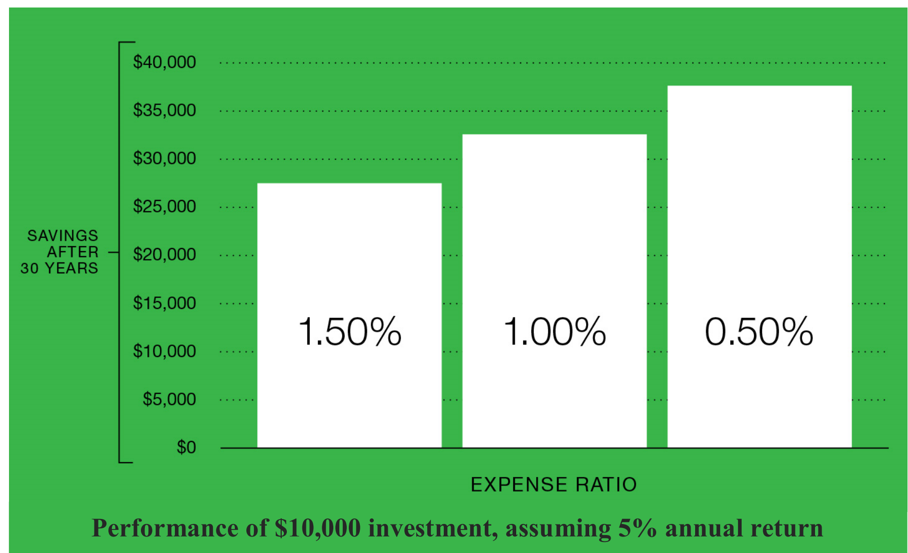
It is also important to be aware of how your employer's match is vested in your 401(k) plan. You do not get to keep the matching funds until they are fully vested in your 401(k) plan, which can take more than five years depending on the plan and your employer. If you leave your job before you are fully vested, your employer may allow you to keep some portion of the matching funds based on your years of service, but in some instances, you may be required to forfeit the entire unvested amount when you leave. In some cases, it can be worth thousands of dollars to continue to work for a company until you are fully

vested in the 401(k) plan.

4) Pay attention to fees.

401(k) plans are convenient, but that convenience comes with a price. The hands-off nature of 401(k) s can sometimes make it difficult for participants to know exactly how much they are paying in fees and expenses. There are three main types of 401(k) fees: administrative, service, and investment. You pay some of them as the participant, while other fees are incurred at the plan level. Administrative fees cover the cost of operating the plan and cover services like record keeping and customer service representatives. Service fees are accrued when you take advantage of optional plan features, such as taking out a loan. The largest component of the fees you'll pay in a 401(k) plan are those linked to the investments themselves. These include sales charges, management fees, or other administrative fees of the investment options. According to a 2020 study, a plan with $5,000,000 in assets and 100 participants will have a total average fee of 1.20%, or $604 per person. Investment fees account for the vast majority of that overall cost, $562, while administrative fees account for the remaining $42.

The investment fees that 401(k) participants pay can vary widely, ranging from as low as 0.2% and as high as 5%. These percentages may sound small, but they can make a big impact over the years. A fee that is just a fraction of a percentage point higher could mean tens of thousands of dollars less in total return from your nest egg. Researchers from Yale University say that anything above 1% is a "rip-off." The Department of Labor just requires fees to be "reasonable" and doesn't specify a certain percentage or total amount that 401(k)s can charge. Fees vary depending on the size of your employer's 401(k) plan, the number of participants and the employer's history. Larger companies with more employees tend to pay lower fees. Your fees also reflect how active the management of your plan's funds is.



Performance of $10,000 investment, assuming 5% annual return

Source: Bankrate.com

Figuring out how much in fees you are paying can be difficult. A TD Ameritrade survey found that just 27% of investors knew how much they paid in 401(k) fees, and 37% didn't realize they paid fees at all. Luckily, the U.S. Department of Labor requires 401(k) providers to disclose all fees in a prospectus that is given to you when you enroll in a plan, and which must be updated every year. These can be difficult documents to decipher, but when you receive a 401(k) statement or prospectus, check for line items or categories such as Total Asset-Based Fees, Total Operating Expenses As a %, and Expense Ratios.

Unfortunately, discovering the total fees your plan is charging does not necessarily mean you can do much to lower it. Short of boycotting the 401(k), there's not much you can do about fees charged by the plan provider or administrator, but if you discover they're egregious you could raise the issue with your human resources department. You can, however, take some action on the fees for the individual funds within the plan that you are investing in. Look in each fund's prospectus for the listed expense ratio, which is the sum of fees expressed as an annualized percentage. If you have a choice between two similar funds, such as two growth-stock funds, consider the one with the lower expense ratio.

5) Avoid going it alone.

A 401(k) plan is likely to be one of the cornerstones of your retirement planning, and while they can be convenient and straightforward, they can also be complicated and sometimes lull investors into a false sense of security that simply because they have a 401(k), they are on track for their retirement goals. One of the best things a 401(k) participant can do is work with a trusted advisor who can help ensure that your assets are being well managed. Plans typically offer financial advice and planning services, but these advisors are representatives of the company running the plan, which means they put the plan’s bottom line ahead of yours. Hanover is proud to offer 401(k) Aggregation Services that allow our qualified team to manage your 401(k), working to minimize the investment fees you pay, synergize your 401(k) and non-401(k) holdings to maximize tax efficiency, and present a holistic view of financial planning that gives you a clearer sense of how you are progressing to your financial goals. For more information on this service, contact Hanover today.

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