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Participant Perspectives

Fishing for Financial Security with a 401(k) Plan

You may think fishing and investing in a 401(k) plan are completely different, when in fact they have many similarities. Both the fisherman and the 401(k) investor must make several important decisions if they want to achieve maximum results. The fisherman must be aware of such factors as weather, wind velocity, supplies, and whether to use live bait or lures. The 401(k) investor must consider investment choices and beating inflation, as well as balancing risk and reward.

The Lure of Easy Money

Just as a fisherman carefully selects certain bait and lures depending on the circumstances, so should 401(k) participants choose their investments wisely. A retirement plan account is different from ordinary savings. You don't just make deposits and watch your interest grow. Instead, you choose where to invest your retirement money.

401(k) investment choices may include stock, bond, and money market funds. Investing in stock funds has the potential to deliver the highest returns over the long term. However, investing in stock funds also has the greatest risk potential.

Historically, bond returns have been lower than stock returns over the long term. However, bonds also have less risk of short-term declines in value. A bond is a debt security. Bond issuers promise to repay principal to the bondholders after making interest payments for a certain time period. The risk (for bonds that aren't issued by the U.S. government) is that the issuer will not redeem the bond at maturity. Such defaults are uncommon, but possible. Also, the market values of existing bonds are affected by changes in the interest rates being paid on newly issued bonds. So, investors in bond funds risk losing some of the principal they have invested.

A money market fund is a low-risk investment in short-term securities. These securities include U.S. Treasury bills, negotiable certificates of deposit, commercial paper, federal agency debt, and repurchase agreements. Money market investments are also called cash equivalents because they are easily converted to cash with minimal risk.

Tackle Inflation

How can you beat inflation and achieve real investment gains on your retirement savings? The answer is to earn investment returns that are higher than the inflation rate. Consider emphasizing portfolios of the investment types that have a history of long-term returns that surpass the rate of inflation.

Get Hooked

The rewards of investing are tangled up in a line of risks. The question of how much to invest in stocks, bonds, and money market securities depends on a variety of factors, such as your current age, the

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amount you will get from Social Security, your ability and willingness to accept risk, and your overall financial situation. One way to reduce your portfolio's potential risk while preserving opportunities for gains is to spread your account into a mix of funds that hold different types of securities (diversification).[1] The future isn't guaranteed, but these investment guidelines should help you make the most of your 401(k) retirement account.

Your situation is unique, so be sure to consult a professional before taking action.

On the Move

In our mobile society, it's nice to know that you can take the money you've saved in your employer's retirement plan with you if you change jobs. Or, your plan may give you the option of leaving your money where it is. Before you make a move, however, think carefully about what would be your best move.

Roll It Over

One option you may have is to roll your plan money over to your new employer's plan or an individual retirement account (IRA). If you choose the rollover option, consider arranging a "direct" rollover (trustee-to-trustee transfer) from your former employer's plan to the new plan or IRA. With a direct rollover, there are no immediate tax consequences and your savings would have the opportunity to continue growing tax deferred. [2]

Instead, you could make an "indirect" rollover. With an indirect rollover, you receive your money (minus 20% federal income-tax withholding) and have just 60 days to roll it over to an eligible plan or IRA. You'll be taxed on any amount you don't roll over by the deadline, and a 10% early withdrawal penalty could also apply. Note: You'll have to replace the withheld funds and include that amount in your rollover or it will become taxable to you (and the 10% penalty may apply).

Before making a rollover, be sure you understand the fees and expenses associated with the new account.

Leave It Alone

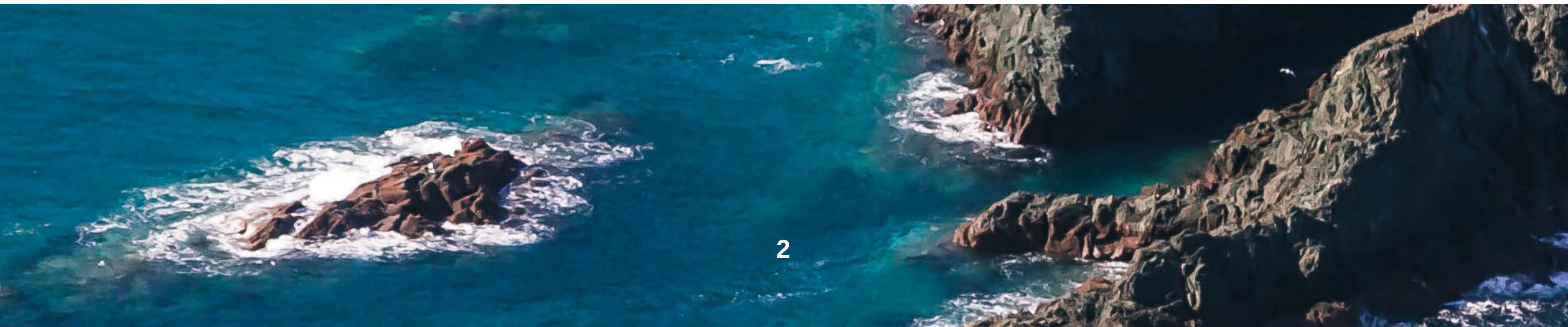
A second option may be to leave the money in your current plan. With this option, the money stays in your account, and you can continue to invest it on a tax-deferred basis. You won't have to pay current taxes or any penalties. So, if you prefer the plan's investment choices, leaving your money in the plan might be the right option for you.

Also consider this option if you leave your employer between age 55 and 59½ and think you may want to take plan withdrawals before you turn 59½. A special tax rule may allow you to avoid the 10% penalty on those withdrawals. (You generally have to wait until age 59½ to take money from an IRA without penalty.) Consult your tax advisor for details about the penalty and when it applies.

Cashing Out

A third option is to take a payout from the plan and not roll it over. If you need a quick source of cash, this option may be tempting. However, you'll experience a number of negative consequences:

1. Diversification does not ensure a profit or protect against loss in a declining market.
2. Distributions from a designated Roth account may be directly rolled over to a Roth IRA or a designated Roth account in another employer's plan.



- You won't receive the full amount of the distribution. The plan is required to withhold 20% from the payout for federal income-tax purposes. (Your actual tax bill may be more or less than the withheld tax.)
- You may owe a 10% early withdrawal penalty in addition to income taxes.
- If you spend your savings, you won't have them for retirement. Nor will you have any of the compounded investment earnings that money could potentially have earned during the rest of your working years.

Bottom line: Cashing out could mean having less money for your retirement.

If possible, make the choice to keep your retirement savings working for you in a tax-deferred account if you change jobs. Your situation is unique, however, so be sure to consult a professional before taking action.

Costs of Cashing Out

If you cash out a $40,000 pretax plan account when you change jobs, paying income taxes and an early withdrawal penalty could leave you with a lot less than you anticipated.

State and Federal Taxes	$10,000
10% Early Withdrawal Tax Penalty	$4,000
Cash Left Over	$26,000

This is a hypothetical example used for illustrative purposes only. It assumes a combined federal and state income-tax rate of 25%. Your combined tax rate may be different, and the 10% penalty may not apply in your circumstances.

Source: DST

Retirement for One

You and your spouse have always done things together. So what happens when one of you is ready to retire while the other isn't? You can avoid conflicts by discussing issues with your spouse long before either of you leaves the work force.

Income

The loss of one spouse's income could hamper your ability to maintain your current standard of living. Calculate the monthly amount the retiring spouse expects to receive from investments, Social Security, and any anticipated pension benefit. Then determine whether that amount combined with the working spouse's income will be enough to cover expenses.

Health Care

Will the retiring spouse have health insurance coverage through an employer's retiree health plan, the working spouse's plan, or Medicare? Health care may be a large expense in retirement, so you'll want to include it in your planning.

Lifestyle

Other aspects of your lifestyle may change when one of you retires. Talk with your spouse beforehand so you're both on the same page.

Get Ready to Test Your Retirement Planning Smarts

Retirement planning starts with your first contribution to a retirement account and continues throughout your working years. But how much do you really know about it? Find out by taking our quiz. Answers follow each question, but don't look ahead!

1. Shana and Doug both began working at Sooper Dooper Company at age 25. As soon as she was eligible, Shana started contributing $200 a month ($2,400 a year) to the company's 401(k) plan.

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She continued contributing until her retirement at age 65. Doug waited until he was 40 to begin making contributions. Then he contributed $400 a month ($4,800 a year)—twice as much as Shana—until he reached age 65. Their investments earned a hypothetical average annual return of 7%,[3] compounded monthly.

Who had more money at retirement, Shana or Doug?

Answer: If you chose Doug, you're off the mark by approximately $202,000! Shana's much earlier start gave her two huge advantages: time and the power of compounding (earning income on your original investment and on the earnings it generates). Although she contributed less than Doug—$96,000 compared with Doug's $120,000—Shana had $528,025 saved at retirement, while Doug had only $325,919 (before taking income taxes into account).

2. After working at Sooper Dooper Company for 20 years, Soco, Huong, and Calvin were all leaving for other jobs, so they had to decide what to do with the money in their retirement plan accounts. Soco elected to leave her money in Sooper Dooper's 401(k) plan. Huong requested a trustee-to-trustee transfer of his account balance to a rollover IRA (individual retirement account). And Calvin withdrew all his savings in a lump sum so he could pay off his debts.

How did their choices impact their federal income taxes?

Answer: Soco's decision to leave her money in her current plan meant that her savings continued to grow tax deferred until she withdrew her money at retirement.

And because he rolled over his account balance to an IRA, Huong's retirement savings also remained tax deferred. If allowed, Huong could also have avoided taxes on the distribution by rolling the money into his new employer's 401(k) plan.

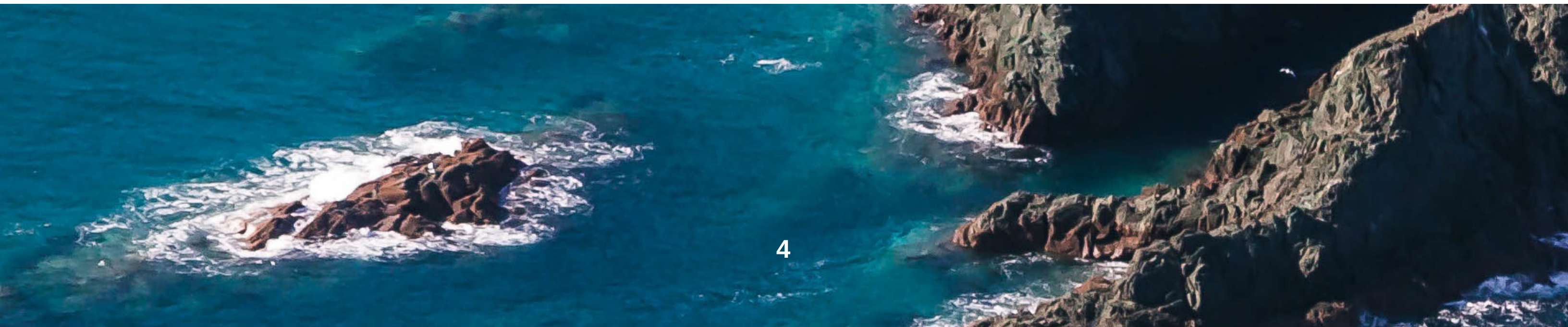
By taking a lump-sum withdrawal, Calvin received only 80% of his account balance—20% was withheld to prepay income taxes. And, in his tax bracket, this wasn't the extent of his tax liability. Plus, since Calvin was under age 59½ and wasn't eligible for an exception, he had to pay a 10% early distribution penalty. Calvin not only wound up with a lot less money than he'd planned on having to pay down his debts, but his retirement savings were also wiped out.

3. Since their employer doesn't offer a retirement plan, coworkers Jack and Helena decided to open IRAs. Jack chose an IRA that allows him to make tax-deductible contributions and enjoy tax-deferred earnings. He won't pay taxes until he withdraws his money. Helena's contributions to her IRA are not deductible. However, she can withdraw her contributions tax free at any time, and withdrawals of earnings will also be tax free after she's reached age 59½, as long as she's met a five-year waiting period.

Which type of IRA—traditional or Roth—are Jack and Helena each investing in?

Answer: Jack is investing in a traditional IRA; Helena has a Roth IRA. Both offer tax advantages—Jack's is immediate since he gains a tax deduction for his contributions, whereas Helena's will be realized later when she takes tax-free withdrawals. But, unlike Jack, Helena won't be required to take annual minimum distributions from her IRA after she reaches age 70½.

3. This example is for illustrative purposes and is not representative of any particular investment vehicle. Your investment performance will differ.



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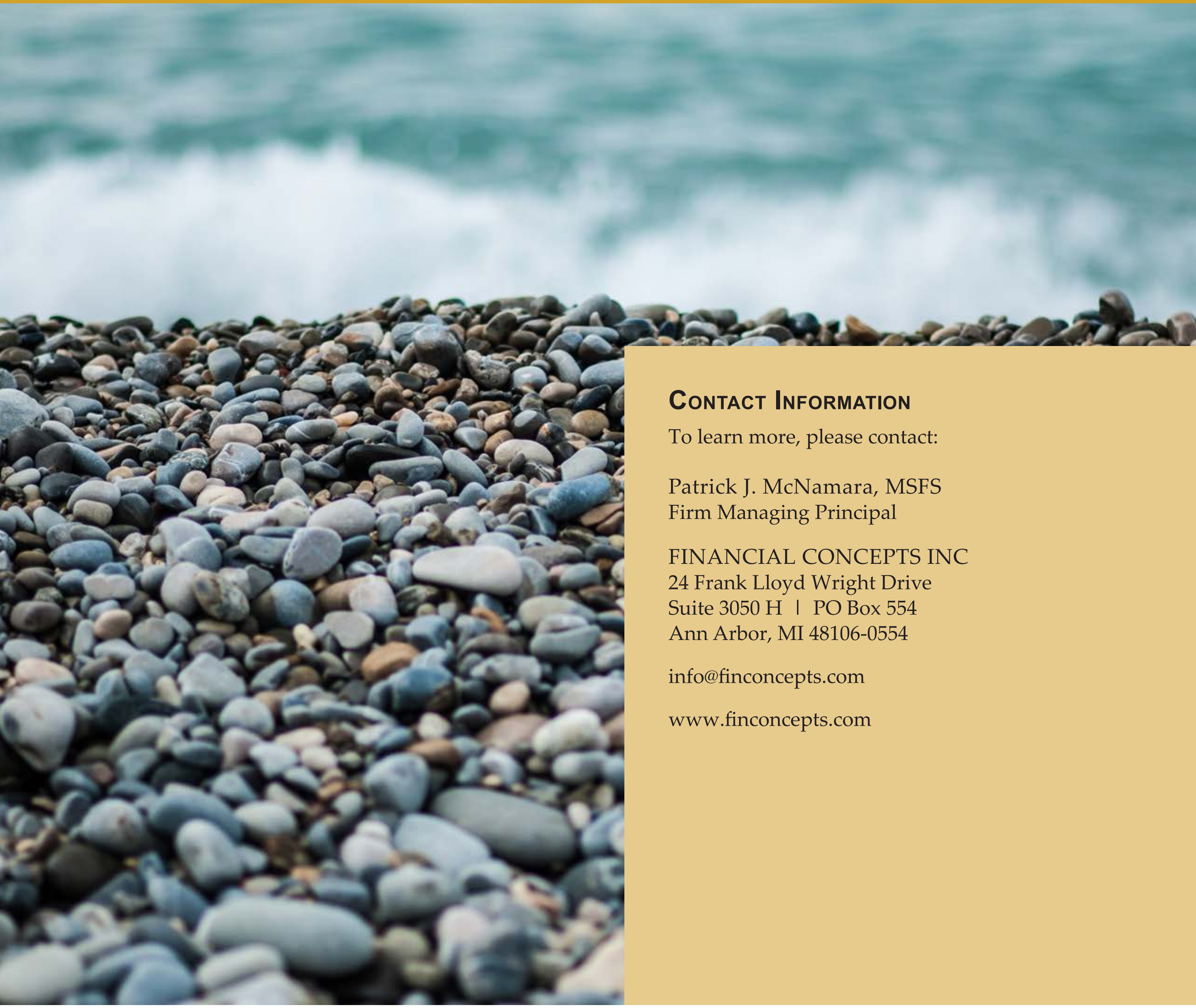

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