Community First Bank & HFG Trust White Paper Series

401(k) Selections – Make the Most of Your Retirement Savings

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With disappearing pension plans, a diminishing Social Security trust fund, and increasing longevity, personal retirement savings are more important than ever. Having access to a retirement plan such as a 401(k) through your employer is a great tool that you can use to prepare yourself for a financially secure retirement.

The first section of this article will provide a quick review of some retirement saving and 401(k) plan basics, and the balance will provide guidance on how to approach selecting investments in your retirement plan. As this is an overview, it is worth mentioning that a financial advisor can be a great resource in helping you understand your plan, prepare for retirement, and build an appropriate investment strategy for your situation.

SAVING FOR RETIREMENT

Just Start

Time is such an important factor when it comes to saving for retirement. The first step in preparing for a successful retirement is to start saving now. Even if you can only begin with a small amount, starting early and increasing your contributions over time as your budget allows will make a big difference in how prepared you are to maintain a comfortable lifestyle in your golden years.

Tax Benefits

Retirement plans are great because they provide important tax benefits. Contributions to retirement plans such as 401(k)s and IRAs are made pre-tax. This means the amount you contribute will be excluded from your taxable income for the year, allowing you to pay less in tax. Better yet, the growth and earnings inside the account are tax-deferred, meaning you pay no tax until you withdraw from the account in retirement.

In the case of a Roth 401(k) option or Roth IRA, contributions do not reduce your taxable income because they are made after tax; however, the funds do grow tax free. Assuming the Roth rules are followed—such as having the account for at least five years—no taxes will be owed from that point on. This is a great option for younger savers and those in lower tax brackets who expect to be in a higher tax bracket later.

Employer Contributions

If your plan offers a company match, take advantage by contributing enough to get the full amount. Employer contributions are a great benefit that will boost your retirement savings over the long run.

INVESTING

Investing your retirement savings wisely over the course of your career could mean the difference between retiring on your own terms and being forced to work longer and/or live on a restricted budget for the rest of your life.

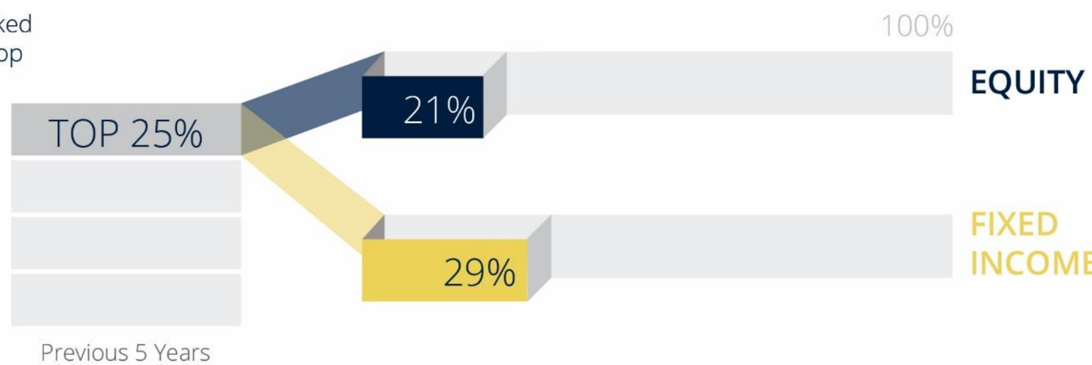
First, let us review what ***not*** to do when making investment selections or changes, then we will discuss some time-tested principles for retirement investing success.

DO NOT…

Chase Return

Selecting investments based on past performance is not a good strategy. The investment options with the best one-, five-, or 10-year returns are not necessarily the investments that will do best over the next one, five, or 10 years. In fact, there is a good chance they will not be the top performers.

Percentage of Top-Ranked Funds that Stayed on Top



FUNDS REMAINING IN TOP QUARTILE OF RETURNS IN THE FOLLOWING 5-YEAR PERIOD (2009 - 2019 AVERAGE)

Source: Mutual Fund Landscape 2020, Dimensional Fund Advisors. See Appendix for important details on the study.
Past performance is no guarantee of future results.

Let Emotion Get the Best of You

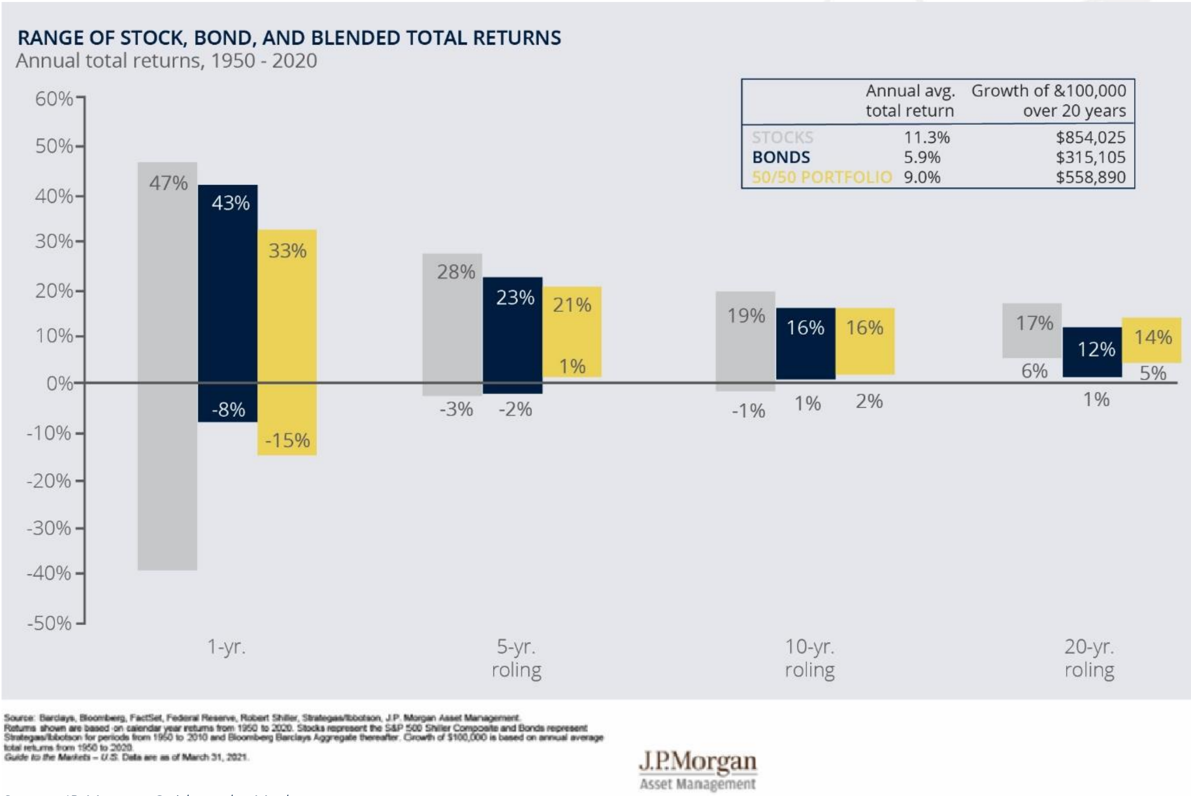
The two most common emotions that get in investors' way are fear and greed. When markets go through downturns, investors often panic (fear) and want to pull out until things get better. Similarly, investors get overly optimistic (greed) when markets are doing well and feel more comfortable turning up the risk or placing bets by overweighting individual sectors or areas of the market that are doing well. Keep in mind that markets go up and they go down, but sticking to your investment strategy during good times and bad will give you the best chance of success long term.

BUILDING A LONG-TERM INVESTMENT STRATEGY

With an understanding of what not to do, here are some tried and true principles to help you create a diversified, risk-appropriate asset allocation in your retirement plan.

Start with Risk

The first step to creating an investment mix is to determine how much risk is appropriate for your time horizon and how much risk you feel comfortable taking. The chart below shows range of returns over rolling one-, five-, 10-, and 20-year periods for stocks and bonds from 1950 – 2020. Stocks provide more long-term growth than bonds but are also more volatile. Notice one-year returns have ranged from +47% to -39% for stocks. The lowest 20-year average annual return, on the other hand, was 6%.



Source: JP Morgan Guide to the Markets

The more time you have before retirement, the more you can allocate to stocks, assuming you can withstand the ups and downs emotionally. As you approach retirement, reducing your risk by shifting some of your stock investments to bonds/fixed income is wise because you want to ensure that your income needs in retirement are covered, regardless of what is happening with the stock market. Your bond investments will provide this safety net as they are much less volatile than stocks. Remember though, retirement is not the end of your investment horizon. You will likely want to maintain an allocation to diversified stocks even after you've left the workforce as they will be your long-term return generator.

For perspective, an aggressive investment allocation for someone 10+ years from retirement will have 70 - 100% diversified stocks and the rest in bonds. Whereas a common allocation for clients nearing or in the early stages of retirement is 50 - 60% stocks.

Notice in the chart above, the 50/50 allocation is significantly less volatile over one-year periods than an allocation to stocks alone.

Diversify

Diversification is important for risk reduction. There are a few ways to diversify an investment portfolio, all of which can be done inside your 401(k) or similar retirement plan.

First, most 401(k) plans offer an investment menu consisting of mutual funds. Mutual funds are professionally managed investments containing, typically, hundreds or even thousands of individual securities (e.g., stocks and bonds). This allows investors to easily spread out their risk. Try to choose funds that are low in cost (under 0.50% annual expense is good). Index funds are a great option because they are low cost and broadly diversified. Actively managed funds are typically more expensive, less diversified, and fail as a group to outperform benchmarks about 80-90% of the time over periods of 10+ years.

Next, investing globally rather than purely in the US can help reduce your overall risk and volatility while enhancing return over the long run. We cannot know which country will provide the highest or lowest return year-to-year. There is not one country (the US included) that always comes out on top—even over periods of 10+ years. A common approach to global diversification is allocating the equity (stock) portion of your account based on market capitalization: approximately 55% in US, 33% in developed international, and 12% in emerging markets.

Finally, avoid being too concentrated in one area. Have a blend of large and small companies, value and growth companies, and multiple sectors (e.g., healthcare, consumer staples, financials, technology, etc.). Using broadly diversified, low-cost index funds makes this easy. For example, you may choose two mutual funds to fulfill your desired allocation to US stocks: one focused on large companies and one focused on smaller companies, both with a blend of growth, value, and multiple sectors.

Stay Disciplined

Once you have built your diversified investment allocation based on your desired risk level, avoid making changes based on emotion or speculation. One of the great things about making regular contributions to a 401(k) or similar retirement plan is buying more shares of your chosen investments when markets go down (i.e.: prices go down) and less shares when prices go up. This is called “dollar cost averaging” and it will give your savings a little boost over time.

SUMMARY

When it comes to saving for retirement get started as soon as possible and be consistent.

Investing your savings in a prudent way will help you reach your retirement income goal while maintaining your desired income through your lifetime. Focus on what you can control by building a low-cost, diversified allocation that is appropriate for your timeline, and stay disciplined.