Helping Employees Make the Most of Their 401(k)/403(b) Plans

Managing Expectations

Your future returns will help determine how much you must save, how you should invest, and when you can retire. But what numbers can you believe?

You don't have to be a financial expert to know that the quality of your retirement will largely depend on how much you save during your career. Save too little, and you risk falling short of your long-term goals. Save enough, and you'll retire on schedule and in style.

But just how much saving is enough? The answer to that question depends on how your investments perform over time. The amount you need to save largely depends on the rate of return you expect from those savings.

Even a slightly higher or lower average annual return can dramatically change your long-term financial prospects. Take an investor who hopes to accumulate roughly $500,000 by retirement in 30 years. The investor will reach her goal if she saves $335 a month and her investments earn an 8% average annual return. But she'll fall more than $90,000 short of her goal at a 7% return - and a whopping $163,000 short at a 6% return.

The investor will need to save more money each month to make up the difference. At a 7% return, she'll need to save an extra $75 a month (a monthly total of $410) to reach her $500,000 goal. At a 6% return, she'll need to save an additional $163 each month - for a monthly total of $498. In short, even modest differences in your investment returns can have a major impact on your required savings over time.

Reading the past for clues to the future

No one - not even the most experienced investment expert - can predict the precise returns of stocks or other assets. That said, you can make reasonable assessments based on factors such as historical returns and the mix of investments in your portfolio. Such assessments will give you at least a general sense of suitable investment options - and then you can decide on a savings rate that will help you reach your goals.

Chas P. Smith & Associates, PA, CPA's
1509 South Florida Avenue, Lakeland, FL 33803
Telephone (863) 688-1725; Fax (863) 688-0692
www.my401kpilot.com
email pgolotko@my401kpilot.com

Begin by taking a careful look at how various financial assets have performed in the past. While it's true that past performance does not guarantee future results, such information still can help you to gain an understanding of historical performance and trends.

So what does history tell us? The first lesson is that stocks, over long periods, have historically outperformed bonds and cash investments - and done so by wide margins. For example, blue-chip stocks delivered annual total returns of 10.4% from 1926 through 2003. Small-company stocks did even better, with 12.7% returns. By contrast, long-term government bonds gained only 5.4% annually, and cash investments picked up a mere 3.7% a year during the same period.

Need more convincing? Dr. Jeremy Siegel, professor of finance at the Wharton School of the University of Pennsylvania and author of Stocks for the Long Run, has looked at data dating back to 1802. He found that $1 invested in stocks back in 1802 would have grown to an astonishing $9.17 million by the end of 2003, versus only $16,451 for long-term government bonds and $4,613 in short-term bonds.

There's a catch, of course. While stocks have posted the highest long-term returns, they tend to be relatively volatile over shorter periods. The S&P 500 index of stock prices has suffered losses during 23 of the 78 years since the start of 1926, and suffered a worst-ever loss of 43.3% in 1931. Long-term government bonds have been more stable, declining during 17 of the past 78 calendar years, with a worst-ever loss of 8%. Cash investments have never posted a significant calendar-year loss.

You probably don't have to worry much about one-year returns. Young and mid-career workers plotting their retirements can still afford to think in terms of a decade - which means they're less vulnerable to short-term market fluctuation. What's more, the impact of stock market volatility has tended to diminish over time. When it comes to stock market investing, historically time has healed all wounds.

The diversification effect

It's nice to know that stock market volatility has diminished with time. Still, few investors of any age are comfortable riding out short-term stock market losses of 20%, 30%, or even 40% - even with the understanding that such declines might be temporary. That's why it makes sense to diversify your long-term portfolio, mixing stocks with bonds and other relatively more stable investments.

While neither diversification nor asset allocation ensures a profit or guarantees against loss, the right mix will provide a measure of stability, as well as growth potential.

Staying the course

You may need to adjust your plan on occasion, taking into account changes that may occur during the coming years. Your savings may grow faster than expected during some periods, putting you well ahead of schedule. At times, however, you may find that you've fallen behind due to dips in the financial markets.

Either way, don't overreact to such news. Some investors during the roaring 1990s believed they could afford to reduce their savings rates, thanks to dramatic gains in their portfolios. Some of those gains evaporated during the three-year bear market at the start of this decade, forcing those overly optimistic investors to rethink their plans for retirement.

By the same token, during the bear market some investors became so discouraged by losses that they stopped contributing to their 401(k)s. But bear markets can offer wonderful opportunities to buy out-of-favor stocks and other assets. Those investments can help your long-term returns get back on track once the market rebounds.
The moral: Financial market returns have a historical tendency to revert to the mean. That's a statistician's fancy way of saying that while financial markets do go to extremes, they have a powerful tendency to return to more normal levels. Investors who keep that tendency in mind could avoid costly mistakes during periods of market volatility.

Timing of bear and bull markets
Your ability to save enough for retirement also depends upon the timing of various market fluctuations. Consider a recent report by the Employee Benefits Research Institute (drawing on data from the Investment Company Institute). The November 2002 report - "Can 401(k) Accumulations Generate Significant Income for Future Retirees?" - tried to forecast future retirees' ability to replace significant percentages of their preretirement income by drawing upon 401(k) savings.

One conclusion: A bear market early in today's young workers' careers would reduce their income replacement rates by a modest 2.9 to 3.7 percentage points. A bear market late in their careers would reduce those replacement rates by a much greater 13.4 to 17.7 percentage points.

The same study found that a bull market early in today's young workers' careers would boost their income replacement rates by 3.6 to 4.5 percentage points during retirement. A bull market late in their careers would boost their income replacement rates considerably more - by 16 to 21 percentage points.

Other factors might also change your investment returns: For example, you might become more conservative as you grow older, reducing your equity holdings - which, in turn, would reduce your potential return. When you consider all the variables at work, forecasting returns is an inexact science at best.

What you can do
You can't control the performance of the financial markets. Nevertheless, there is plenty you can do to safeguard your retirement prospects - regardless of how the financial markets behave.

For starters, take advantage of promotions and pay hikes to boost your savings rate whenever you can, even if you think you're probably saving enough. For many workers, such increased contributions can help make up for a slow start or serve as a cushion if the markets stage a slump.

Take the hypothetical example of a single worker earning $40,000 a year. His employer will allow him to contribute as much as $13,000 a year to his plan - but right now, he can only manage to set aside $7,000. If he maintains his current savings rate for 30 years, he could potentially accumulate $869,376, before taxes (assuming an 8% annual return).

Not bad, but what if he starts out saving $7,000 a year and then boosts that annual contribution by $3,000 after five years, and kicks in another $3,000 annually after 10 years? He could potentially end up with $1,254,388, before taxes. Your ability to save consistently - and take advantage of the tax breaks your 401(k) provides - may ultimately matter more than the precise returns of the investment markets.

Consider this: The EBRI study found that investors with access to 401(k) plans throughout their careers could use those plans and Social Security to potentially replace 83% to 103% of their preretirement income, assuming stocks performed as well as they did during the period from 1926 through 2001.

Pretty good. But there's more: The study also found that investors would potentially be able to replace a healthy 72% to 92% of their preretirement income even if stocks matched their annual returns for the worst 50-year period in modern financial history (a 7.7% return from 1929 through 1978).

That leads to a comforting conclusion. "The most important determinant of how much you accumulate for retirement is not the financial markets' returns - which you can't control anyway…The most important factor is whether you participate in your retirement savings plan on a regular basis - and that is something you can control.

Call for a free half-hour analysis of your retirement account.

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