Do You Have a Good 401(k) Plan? - Transcript

Tom Mullooly: Welcome to the Mullooly Asset Management podcast. This is episode number 274. I am one of your cohosts, Tom Mullooly, along with me is Brendan Mullooly.

Brendan M.: Ready to talk for 401ks. Right?

Tom Mullooly: If you're a 401k investor, this podcast is for you.

Brendan M.: That pretty much applies to everybody these days. If you have a retirement plan through work, 401k could just be, you know, we're using that as the general reference point. But, if you're a teacher 403b, a government employee 457. These are all workplace retirement accounts, all the same things, so when we refer to 401k, it's kind of a catchall for these different things.

Tom Mullooly: That's right, and while your plan may have a certain few tweaks that differ, you know, your 457 plan or your 403b at work might differ in a small way. Generally, this is for you.

Brendan M.: Yeah, and we were guided to this topic by Christine Benz of Morningstar.

Tom Mullooly: Friend of the firm.

Brendan M.: She was on Tim's podcast, Living With Money.

Tom Mullooly: That's right.

Brendan M.: That was a great episode. Would recommend going to check it out. I know we've referenced a lot of her work before, and she just writes really great stuff more in the personal finance side of things for Morningstar, but really, I mean, she's knowledgeable all over the spectrum.

Tom Mullooly: One of the very, very first lines in her piece that came out that really just kind of jumped off the page at me was 401k menus aren't universally high quality.

Brendan M.: Yeah, definitely not.

Tom Mullooly: I think the problem that a lot of people aren't aware of is that, if you work for a big company and they've got 10,000 employees, 50,000 employees nationwide or globally, whatever, if you work for a company that's a huge organization, the odds are they're going to have a pretty good plan. But-

Brendan M.: Good meaning, this is my opinion, good meaning low cost, not necessarily like hundreds of options.

Tom Mullooly: Right.

Brendan M.: I don't think having hundreds of options is actually a good thing, despite the fact that-

Tom Mullooly: Usually not a sign of a good plan.

Brendan M.: No, I think most people would think that having hundreds of options is a good thing, but I actually disagree with that.

Tom Mullooly: Most people in the United States, at least, work for a small company, meaning they're working for an organization that has 100 employees or less, and those plans are pretty random.

Brendan M.: All over the map. You may find a good one and you may find a really bad one, and again, my rule of thumb here, we're saying good and bad, not necessarily saying that the funds in the plan themselves are good or bad in terms of how they'll perform for you over time. Not really that, because we can't predict the future. We don't know what funds are going to be good or bad. But, one way to look at things that has proved somewhat predictive if you look at work from places like Morningstar, is that lower cost funds perform better than their higher cost counterparts over time, just because of cost, because math.

Tom Mullooly: Because math, right.

Brendan M.: Right. Lower cost means that more of their returns are staying in the fund in your pocket, rather than compensating a manager who likely isn't beating their benchmark anyway.

Tom Mullooly: Right.

Brendan M.: Good and bad in this sense, when we're talking about a 401k plan or the investment options within it, I would say we're using that as shorthand for high cost or low cost to determine whether the plan is good or not.

Tom Mullooly: Right.

Brendan M.: Which, may not be intuitive. I think I take that for granted, so just wanted to clarify that and remark because that's what I'm referring to.

Tom Mullooly: So, one of the errors or mistakes that Christine mentioned in the article was not considering asset allocation before implementing, before making your investment choices.

Brendan M.: Yeah. I'm not sure how else to make the decision. I guess one of the other things that Christine brought up was relying too heavily on past performance.

Tom Mullooly: Right.

Brendan M.: If you're not getting guidance on your 401k plan, and you log in, I think that one of the most harmful things that these websites will show you is the last one, three, and five year performance for all these funds, and I think that the intuitive thing to do is to just pick whatever the best one has been over the last, or all of those periods, one, three, five years. When, in reality, that may lead to a very undiversified portfolio. It also may lead to a portfolio that's ready to just get punched in the face by a mean reversion, especially when we're talking about asset classes.

Yeah, I think you need to take the mix of, just at a high level, stocks and bonds into account when you're making a portfolio, and largely that should be guided by when you anticipate using the money in the future. That may or may not correspond with your target retirement from this career or your age. I mean, you want to take all these factors into account, but ultimately I know we have a lot of conversations that boil down to, when is this money going to be used?

Tom Mullooly: Right. A moment ago we talked about, if you work for a large organization, 5,000, 25,000, 50,000 employees, some of these companies are publicly traded. The company retirement plan is actually a good storage space for the equivalent of shelf stock, where the company is putting shares, ownership in friendly hands.

Brendan M.: Yeah.

Tom Mullooly: What does that mean to, or how should an individual looking at their company plan deal with company stock?

Brendan M.: It's really tricky, and I know that a lot of plans are ceasing the practice of offering company stock within their plan for this very reason. Because, when you work at a company, you probably have positive feelings about it and you may think that you know more about what the stock will do in the future than what anybody actually does now, and that's not an insult anybody's intelligence. It just means that the future is highly unpredictable and maybe working at a company doesn't give you an edge, even if you think it does. People will load up and company stock, and that's putting, most likely when we're talking about a 401k plan, your life savings, the future of your retirement into one company, which otherwise is a practice that's prohibited by the menus of 401k plans. It's unwise.

Tom Mullooly: Yeah.

Brendan M.: Obviously, in hindsight it works out for some people.

Tom Mullooly: It works out for a few people, but it doesn't work. It's not a rule of thumb where you can put money in and say, this is going to work, because it doesn't.

Brendan M.: It may not. I mean, look at all the companies. I think we've referenced this on the show before, if you look at the companies in the Dow a couple decades ago, how many of them are still there? How many of them have shrunk considerably or been merged away or failed entirely? Those were, you know, the biggest 30 companies out there.

Tom Mullooly: Right before Enron collapsed, it was the seventh largest company in the S&P 500. Even the big ones can fall apart.

Brendan M.: Yeah, so sure, piling into one company certainly gives you the possibility of hitting a home run. I also think it raises your odds of striking out in a major way too, and I'm not sure that that's a risk that the average investor saving for their retirement a needs to be taking. It may not feel as risky as we're making it out to be because of your familiarity with the company, but you really want to consider how much, if any, you're allocating to company stock within something like a 401k plan.

Tom Mullooly: Especially since some folks may be getting part of their compensation in company stock on top of that.

Brendan M.: I mean, let's say that that's not occurring. You're getting your compensation from this company.

Tom Mullooly: Right.

Brendan M.: That's enough.

Tom Mullooly: Yeah, your paycheck comes from there.

Brendan M.: I mean, if something happens to that company, not only is your 401k going to tank because the stock is down, but you might lose your source of income if the company's doing really poorly.

Tom Mullooly: And that would be bad.

Brendan M.: Yeah, that's catastrophic. That's worse than the 401k aspect of it. You know?

Tom Mullooly: Paycheck gone, 401k too.

Brendan M.: Yeah.

Tom Mullooly: Yeah.

Tom Mullooly: Over the last 20 years, more and more companies have now made their 401k accounts for their participants available online. Feature or benefit?

Brendan M.: I mean, I think that people should have access to this stuff, but like anything, I think you can have too much information and I think that accessing your accounts feverishly or on a weekly basis, let's say, I'm not sure that you need a weekly check in to your 401k account.

But, the rate that people check into their investments is going to vary depending on who they are and what they can handle.

But, yeah, I think being able to log in and check on this all the time, and then also potentially act on what you see on a second to second basis, I mean, a lot of times you'll have to enter a trade and they're mutual funds 99 times out of 100, so you're going to have to wait until the end of the day through your changes to go into effect. But, yeah, being able to trade daily, I'm not sure I would trot that out as a pro. I don't think it's a con, either. I just I definitely don't think it's a pro. It's something in between. I don't know.

Tom Mullooly: Yeah, now I can't speak for anyone else but me. I don't look at my 401k. My 401k account is managed by someone else, you. I know that the most important number for me regarding my 401k account is to hit that max every year.

Brendan M.: $25,000.

Tom Mullooly: Right.

Brendan M.: Yeah.

Tom Mullooly: I'm over age 50, so I can go from $19,000 to $25,000. That is the most important number for me, is saving the right amount of money. People are, they get really hung up on, what did I earn in my 401k? What'd you save? We have a folks that call us and they'll have money in a 401k that's going in out of their paycheck, and then they'll want to set up additional accounts on top of that. We'll ask them, "Hey, what's that money for?" "Well, I just want to sock away some extra money. I don't really have a need for it." We tell them all the time, they should be maxing out their contributions to your retirement plan first before setting up additional accounts.

Brendan M.: Yeah, and I would say in most cases, because I think that one thing we referenced at the onset was that these plans are not created equally.

Tom Mullooly: Yeah.

Brendan M.: Assuming that you have a good, and again by good I mean low cost, 401k plan, I would recommend maxing that plan out before moving on to other different types of investment accounts that you could use. If your plan is kind of crummy, and you've determined that by looking at the costs that are baked into it, you may want to just throw money in there and get a match from your company, and then move somewhere else, like an IRA to save, and then come back to the 401k after that if there's still room left to go. There are some different ways to approach it depending on the quality of your plan, I think.

Tom Mullooly: Do you want to spend a little more time talking about the costs in the plan? Because, we meet a lot of people who say, "I don't have any costs with my 401k at work. I just put money in and it does its thing."

Brendan M.: Yeah, so the costs in a 401k plan are going to be baked into the investments most of the time. Sometimes, you'll see a administrative charges directly in your account, and this will always show up in your statement, but you really want to assess what the expense ratio of each mutual fund option in your plan is. Sometimes, it's best to get it directly from your plan and not to assume that, oh, this is fun to X, Y, Z, and to look it up on something like a Morningstar and assume that that's the expense ratio you're paying in your plan, because it could be a lot lower than that if you have a really great plan and maybe they've negotiated to get fund X, Y, Z for even cheaper than is available on the market. It could be a lot higher than that. I mean, I've seen plans with Vanguard funds that have baked in, like, half a percent into them because the plan stinks.

Tom Mullooly: Right.

Brendan M.: You've seen them too, like, they're out there. Don't just assume that because-

Tom Mullooly: Oh, it's Vanguard.

Brendan M.: Yeah, you've got a menu of Vanguard funds, it doesn't mean you're paying four or five basis points for the funds necessarily. I think you want to look into it a little more, and sometimes it's not super clear. Sometimes you can't find that information readily on the website or in the literature that you're getting.

Tom Mullooly: Yeah, and let's talk about that. I mean, you may get an annual report once a year in the mail and it just looks like a phone book.

Brendan M.: Yeah, good luck. Good luck with that.

Tom Mullooly: Yeah.

Brendan M.: It's boring stuff, but that's probably where the information we're talking about is, and so if you can stomach looking at it for a little while, that is where the digging should occur when you're looking for something like costs and you can't find it on the website.

Tom Mullooly: You can find some eye-popping information, and they're required to give that to you. That's actually a new development in the last few years. Prior to that, they weren't even required to send out annual reports with the fees. Can you just spend a moment, before we move on, just clarifying for people what basis points means, because you had said a moment ago, "Hey, this investment might be four or five basis points."

Brendan M.: Yeah, that's industry jargon. 100 basis points is equal to 1%, and so when we're talking about four or five basis points ...

Tom Mullooly: It's cheap.

Brendan M.: That's very cheap. If we're talking about 75, it's towards the more expensive end of things. I mean, that's ...

Tom Mullooly: Three-quarters of 1% per year.

Brendan M.: Exactly.

Tom Mullooly: Coming off the top.

Brendan M.: Right, right. And, it can be for different things. Like I said, a fund might have 0.1, let's say 10 basis points, 0.1% may be the expense ratio for a fund, but the 401k plan to offer it to its employees may have baked in an extra 25 basis points or one-quarter of a percent in administrative fees that wouldn't apply to you if you invested in this fund otherwise, outside of the plan. You need to look at that kind of stuff, because you can't just take it at the surface level.

Tom Mullooly: I know that it seems like every year the limits on what we can put into a 401k plan seem to move up. But, how do you know if you're keeping up with the threshold? I mean, you may have gotten into your company's 401k plan when the threshold was $7,000, year long time ago. You know? You never changed anything. You continue to put $7,000 a year when the limits are now $19,000, and if you're older, you may be able to put even more in.

Brendan M.: I mean, I can't speak to everybody's plan, but the way that I've seen it in most cases is that you're putting a percentage of your income into the plan. That's how you set your deferrals. I think that that's wise because the percentage is going to adjust, not only to your income over time, but I mean, that's the most important aspect of it. I don't think that you can necessarily, I've never seen a plan where you can go in and set like max. You have to do it as a percentage of your income, so you kind of have to do a little bit of very basic math to determine like, if I make X, then what percentage of that will get me to the maximum?

Tom Mullooly: I also think that a lot of people overlook the fact that they start getting paychecks early January, and if you get 26 paychecks a year, you can kind of figure out the math in the back of the envelope on how much is coming out, whether it's a percentage or a dollar amount. But, once you start getting away from that, if you miss the first pay period, you didn't alert your payroll person. Say you didn't catch this until March and you still want to max out, you actually have to do more in the remaining nine months to get you to the max number by the end of the year.

Brendan M.: Yeah. A question we get a lot is whether you should do, like this exercise. Do the math to determine how to make, let's say you're getting paid biweekly, so you're going to get 26 paychecks, meaning 26 contributions to the year. Should you do the math to figure out how to get 26 payments that add up to the maximum? Meaning you're going to average in, hit the max, but you're going to hit it on December 31st?

Tom Mullooly: Right.

Brendan M.: Or should I do it a front loaded and get in there as soon as possible? It's an interesting question and it's worth discussing. My answer is always, over the long term, front loading it and getting it into the account sooner will be helpful because it's going to have more time to grow. But, in terms of, because I think that the way people are normally asking it is what's going to be better for performance, and that is a total crap shoot depending on the path the market takes that year.

If the market goes straight up all year, relatively speaking, like there are no big pullbacks and it's really just a march, march higher all year long. Then, doing a lump sum investment on January 1st obviously would have been the best for performance because you were buying at the lowest point of the year. However, if it takes kind of a meandering path, and maybe it's up and then it's down in the middle of the year and then up again, then totally different story in terms of what helps the most.

Short of being able to predict the future, I kind of like the idea of just doing it equally over the year so that your paycheck remains level over the year, because another thing to take into account is if you hit the maximum, let's say in June, July, or August, let's say over the summer based on the percentage you're sending in, you hit your maximum, that's it. Your paychecks just automatically are going to get a little bigger after those months for the remainder of the year. My preference would be, personally, to have the same paycheck 26 times throughout the year.

Tom Mullooly: Sure.

Brendan M.: I don't want one to be higher or lower depending on whether my 401k has been maxed out yet or not. I would prefer it that way. Nice and neat. But, I guess that's more personal preference, really. But, there's no good answer to that question of like which method is better.

Tom Mullooly: Do you want to spend a moment talking about Roth options in 401ks?

Brendan M.: Yeah, I think that for younger people, you can send some money in after tax, and depending on how much money you're making over the course of a year, may be advantageous. A little bit different in the sense that you can send money in after tax. There are no income restrictions, and so if somebody just wants to maybe diversify the base of money that they have in a 401k, maybe they have a bunch of pretax money and they can't contribute to a Roth IRA otherwise because they make too much, but they want to send in their 19k to an after tax a 401k, a Roth 401k because they think it'll be helpful to upon retirement then roll that after tax money into a Roth IRA that they otherwise couldn't have had, it can make sense and more plans are starting to offer this after tax option.

Tom Mullooly: I think this is a question that we get asked a lot about folks that come in, they may earn a nice buck and they are beyond the threshold where they could contribute to a Roth IRA. But, they may have this option that you just discussed, a Roth 401k at work. One thing to keep in mind is that the total dollars committed in a year to a retirement plan at work can't exceed that. The current threshold's $19,000 if you're under age 50, $25,000 if you're over 50. You can do it. You can't do ...

Brendan M.: Both.

Tom Mullooly: Both on top.

Brendan M.: Right, and if income was a question already, then you certainly can't do a traditional IRA. But at that point, if somebody really wants to make both and the 401k is the only vehicle available to them because they make too much, I don't think there's anything wrong with doing both. But, as you said, it's only going to amount to $19,000 total. Another interesting thing with 401ks that we found recently is, some people online refer to it as like a super Roth.

Tom Mullooly: Yeah.

Brendan M.: Which, is not actually a Roth 401k at all. It just means after tax contributions to a 401k plan, and not everybody's plan offers this. I think from what I've read online it's about 50/50, and probably better plans meaning lower cost plans from larger employers are more likely to offer this than others. But, worth asking about because, let's say you're over 50 and you've sent in the maximum, meaning you've sent in your $25,000 for this year. You can actually send in far more money than that. I think you can go up to $61,000 or $62,000 overall depending on your plan, and you can send in those dollars, but you could just send them in after tax. You can continue deferring throughout the year if your plan allows you to do this super Roth option, this after tax 401k contributions is more likely how your plan admin is going to recognize the phrasing. Probably not calling it a super Roth.

Tom Mullooly: No, probably not. But great feature that's out there.

Brendan M.: Yeah, if you can do it, I mean, there's very few ways to send in that much money to a tax deferred account, short of using your 401k. If you can continue adding to it, I mean, the person who can put away that amount in a year is probably also making too much to do IRA contributions that are deductible or Roth IRA. If it's between after tax 401k contributions or adding to a brokerage account, if flexibility is not a concern in terms of needing access to this money, if it really is for your retirement and you're just trying to really make a push in the last 10 years of your career or something, really great option and if your plan offers it definitely worth looking into.

Tom Mullooly: Absolutely. Good stuff, Brendan, thank you very much for helping us walk through this article. We'll link to it in the show notes so everybody can look through it. We only scratched the surface.

Brendan M.: Yeah, there were 20 things here. We didn't hit on all of them. We kind pi-

Tom Mullooly: I think we hit on five or six. That's about it.

Brendan M.: Yeah, we kind of picked on a couple and meandered off the beaten path too, so good stuff from Christine Benz, and we'll definitely link up to this article.

Tom Mullooly: Thanks for listening to episode 274, and we will catch up with you in the next episode.