

Bing

MoneyPopular now: [average tax refund](#), [jp morgan profit](#), [groupon ipo](#)[Make msn.com your home page](#)

Extra 1/12/2009 12:01 AM ET

Do 401k plans still make sense?

Like

One person likes this. Be the first of your friends.

The stock market rout has ignited a crisis of confidence for millions of Americans who manage their own retirement savings.

By [The Wall Street Journal](#)

After watching her account drop 44% last year, Kristine Gardner, a 35-year-old information-technology project manager in Longview, Wash., feels no sense of security.

"There's just no guarantee that when you're ready to retire you're going to have the money," she says. "You either put it in a money market which pays 1%, which isn't enough to retire, or you expose yourself to huge market risk and you can lose half your retirement in one year."

Many retirement experts have come to a similar conclusion: The 401(k) system, which has turned countless amateurs like Gardner into their own pension-fund managers, has serious shortcomings.

"This is the biggest test that the 401(k) plan has seen to date, and it has failed," says Robyn Credico, the head of defined-contribution consulting at Watson Wyatt Worldwide, noting that many baby boomers are ready to retire. "We've put people close to retirement in a very challenging position."

The most obvious pitfall is that 401(k) plans shift all retirement-planning risks -- not saving enough, making poor investment choices, outliving savings -- to untrained individuals, who often don't have the time, inclination or know-how to manage them.

[Workers step up raids on 401\(k\)s](#)

But even when workers make good choices, a market meltdown near the end of their working careers can still blow their savings to smithereens.

"That seems like such a fundamental flaw," says Alicia Munnell, the director of Boston College's Center for Retirement Research. "It's so crazy to have a system where people can lose half their assets right before they retire." Congress has begun looking at ways to overhaul the 401(k) system. At hearings in October, the House Education and Labor Committee heard from a variety of witnesses. Some proposed setting up "universal" retirement accounts, which would cover all workers.

One such plan called for establishing accounts that would receive annual contributions from the federal government and would offer a guaranteed, but relatively low, rate of return.

Another proposed automatically investing contributions in an index fund that holds stocks and bonds, with the mix getting more conservative as workers approach retirement.

Other witnesses proposed less drastic changes, such as providing better education.

Video on MSN Money**'Even more wonderful in a down market'**

Knight Kiplinger, editor-in-chief at Kiplinger's Personal Finance Magazine, praises the 401(k) concept and urges investors to stick with their plans despite the recent losses. (Dec. 23)

About 50 million Americans have 401(k) plans, which have \$2.5 trillion in total assets, estimates the Employee Benefit Research Institute in Washington. In the 12 months after the stock market's peak in October 2007, more than \$1 trillion worth of stock value held in 401(k)s and other "defined-contribution" plans was wiped out, according to the Boston College research center.

If individual retirement accounts, which consist largely of money rolled over from 401(k)s, are taken into account, about \$2 trillion of stock value evaporated.

Broad shift to 'ownership society'

The losses are hitting as baby boomers, the first generation to rely heavily on such plans, are beginning to retire. Workers age 55 to 64 who have been in their current plans for 20 years or more saw their 401(k) account balances, on average, drop roughly 20% last year, according to the Employee Benefit Research Institute. Since those figures include new cash contributions to the plans, they understate investment losses.

Participants in 401(k) plans contribute chunks of their pretax pay to an account, which may be invested in stocks, bonds, money-market instruments and other holdings. Each employee typically decides on his or her own mix. At many companies, if an employee contributes to the plan, the company also kicks in some money.

For many workers, 401(k)s have come to replace "defined-benefit" pension plans, which pay a specified amount to employees who retire after a set number of years.

As such, the plans represent a key component of the broad shift in recent years toward an "ownership society," in which individual Americans are expected to play a bigger role in managing large financial risks such as saving for retirement and paying for health care.

In most plans, "it's been the Wild West of 401(k) investing," says Jerry Bramlett, the president and chief executive of 401(k) record-keeping firm BenefitStreet. "You show up at work, they give you a list of funds and send you on your way."

[Continued: Cheaper than defined-benefit plans](#)

Defenders of 401(k)s say the plans shouldn't be judged prematurely. The 401(k) "is doing what it's supposed to do, which is generate retirement savings," says David Wray, the president of the Profit Sharing/401(k) Council of America, an association of employers who offer such plans. "When the entire American work force has 30 or 35 years in the 401(k) plan, then you'll see very substantial balances."

While 401(k) participants have been through stock slides before, now they are also grappling with declines in home values and tighter consumer credit. What's more, health care costs are rising fast, and people are living longer.

These converging pressures are prompting many 401(k) savers to postpone retirement and adjust to a lower standard of living.

Calculator: [How much do you need to save for retirement?](#)

Some are rolling the dice in an attempt to make up for losses.

Jeff Goodman, a 38-year-old computer programmer in Indian Trail, N.C., watched his 401(k) slide more than 40% last year. He's not happy with the plan's investment options, which have almost all been hammered in the downturn.

He's contributing only enough to get the company's matching contribution. About two months ago, he opened a brokerage account and started trading stocks and options. He lost roughly \$3,000 on a complex options trade. Still, he's not convinced the 401(k) is the best savings vehicle. "In a recessionary time, you just can't do the buy-and-hold thing anymore," he says. Part of the problem, critics say, is that the 401(k) is trying to fill a role it was never designed to play. The plans were born with little fanfare in 1978 when Congress added section 401(k) to the Internal Revenue Code. Initially, many employers saw them as a supplement to company-funded defined-benefit plans and Social Security -- and a way for executives to stash some of their compensation in tax-deferred accounts.

But the legislation marked the beginning of the end of professionally managed pensions that provided guaranteed benefits to retirees.

As big employers recognized that 401(k)s are substantially cheaper than defined-benefit plans, the employee-managed accounts moved from supporting role to center stage. Many workers didn't even participate in the voluntary plans, which meant that employers didn't have to make matching contributions. What's more, employers aren't required to contribute to the plans at all.

Video on MSN Money



[Market slide highlights 401\(k\) issues](#)

Eleanor Laise of The Wall Street Journal explains how longstanding problems with 401(k)s are getting renewed attention as investors sustain heavy losses. (Nov. 2)

The plans appeared near the beginning of a long bull market. For years, strong stock market returns smoothed the transition from guaranteed pensions to worker-driven plans, masking careless investment choices by individuals and high fees charged by some companies that administer plans.

But according to Boston College's retirement research center, Americans were becoming less prepared for retirement. Four of 10 working-age households were at risk of being financially unprepared for retirement in 1998, according to the center, up from less than one-third in 1983. By 2006, the figure stood at 44%.

Some big employers cut back

Not saving enough has always been a big problem for 401(k) participants. The tough economic times are exacerbating that tendency. In 2007, the median account balance for 55- to 64-year-olds in defined-contribution plans such as 401(k)s administered by Vanguard was just \$60,740, and only 10% of all participants saved the maximum dollar amount in the plans.

Over the past year, about one in five workers age 45 or older has stopped contributing to a 401(k), IRA or other retirement account, according to a recent survey commissioned by the AARP, an advocacy group for older people.

Peg Kelley, a 58-year-old small-business consultant in Watertown, Mass., didn't contribute anything to her 401(k) last year. Instead, she's focused on paying down credit-card debt and building an emergency fund in case the bad economic times turn worse. She's also still paying off an \$8,000 loan she took from her 401(k) plan four years ago to buy a new car.

Afraid of reliving the dot-com market meltdown, which knocked \$100,000 off her retirement savings, she moved her entire 401(k) from diversified stock and bond holdings into cashlike investments early last year.

"I'm not going to get rich on my 401(k)," she says, "but also don't want to get poor because of it." She had hoped to retire early, but now she figures she won't quit work before age 65.

Matching contributions from employers are a major incentive for workers to contribute to their plans. The typical matching contribution amounts to 3% of pay. But some employers are cutting back. General Motors and FedEx, for example, are suspending 401(k) matching contributions.

One proposal floated at the congressional hearings was to require companies to make contributions.

[Continued: A scarcity of low-cost options](#)

Plan participants typically are presented with a complex investment menu that includes some risky and expensive options. In 2006, Congress passed pension legislation that encouraged employers to automatically enroll workers in 401(k)s -- except for workers who opt out -- and to invest their contributions in broadly diversified products.

Employers rushed to add "target-date" funds to their 401(k) menus. Such funds gradually shift to a more conservative investment mix as a worker's retirement date approaches. Fund companies raced to roll out target-date products, often stuffing them with their own pricey mutual funds and adding an extra layer of fees on top.

As stocks climbed, some fund companies increased the stock allocations of their target-date funds, setting them up for a steep fall if the market headed south.

[Workers step up raids on 401\(k\)s](#)

Assets in target-date funds in defined-contribution plans more than quadrupled in the three years ending in 2007, to \$122 billion. But the funds haven't offered investors much protection. The average target-date fund dropped 32% last year, slightly better than the Standard & Poor's 500 stock index's 38.5% decline. Funds with a target date of 2010, designed for investors on the brink of retirement, didn't fare much better, losing nearly 25%.

Many 401(k) plans don't give workers straightforward, low-cost investment options, such as funds that track markets indexes, which often beat stock-picking fund managers over the long haul. Rep. George Miller, a California Democrat who is the chairman of the House committee looking into 401(k)s, wants to encourage all plans to offer at least one index fund. The plan offered to federal employees, he notes, is full of low-cost index funds.

"We see very often that the worst-performing funds are marketed at the highest cost to the least sophisticated investors," Miller says. "That's contrary to the national interest to get more people saving earlier and longer."

Nearly half of plans include an option to invest in company stock, according to a 2007 survey by Hewitt Associates. Many employers offer matching contributions exclusively in company stock, which often leads employees to invest more of their own contributions in those shares, retirement experts say. One of the "universal" plans proposed to Congress included rules against excessive investment in company stock.

The sharp market swings have led some investors to dump stocks at depressed prices, locking in losses that may severely diminish their retirement savings.

[Video on MSN Money](#)



['Even more wonderful in a down market'](#)

Knight Kiplinger, editor-in-chief at Kiplinger's Personal Finance Magazine, praises the 401(k) concept and urges investors to stick with their accounts despite the recent losses. (Dec. 23)

Last year, participants shifted around 5.7% of plan assets, compared with 3.3% in 2007. Most of the money went into low-return investments such as cash, bonds and funds designed to hold their value, says Pamela Hess, the director of retirement research at Hewitt Associates.

The chunk of 401(k) assets in stocks, roughly 54%, is now at its lowest level since Hewitt began tracking the data in 1997.

Luck of the stock-market draw

Many 401(k) providers have long argued that participants just need more education to make appropriate investment decisions. Some in the industry are giving up on that notion. "Let's face it, participant education has been an abject failure," says Bramlett of 401(k) record-keeping company BenefitStreet. In the plan that BenefitStreet offers its own employees, workers don't cobble together their own investment mixes; they can choose from just five premixed, diversified portfolios with different levels of risk.

Even if workers follow the golden rules of 401(k) investing -- saving early and diligently, holding a broadly diversified investment mix, never tapping their savings until retirement -- their success can still depend largely on the luck of the stock-market draw.

Boston College's retirement research center recently ran scenarios that assumed workers had contributed 6% of pay to a plan for 40 years, had invested in a target-date fund, had never touched their savings until retiring and had annuitized the assets at retirement. The chunk of pre-retirement income these savers could replace in retirement varied dramatically depending on when they retired. Those retiring in 1948 could replace just 19%; those retiring in 1999, 51%; and 2008 retirees, 28%.

Julien Pierre has been a model 401(k) saver. The 32-year-old Santa Clara, Calif., software engineer

started contributing to a 401(k) when he was 19, and he has made the maximum contribution for the past eight years or so. He has a well-diversified investment mix, including large-cap, midcap, small-cap and international stock funds.

He started last year with about \$220,000 in his 401(k), but about \$90,000 of that has been wiped out in the market meltdown. What's more, his employer recently announced thousands of layoffs. Though Pierre is still maxing out his 401(k) contributions, he sees his plans to retire early crumbling and thinks it may take years to determine whether his faith in the plan has been justified.

"I obviously don't feel very good about things," he says. "I'm not looking forward to working that many years."

This article was reported and written by Eleanor Laise for The Wall Street Journal.

One person likes this. Be the first of your friends.

[MSN Privacy](#) [Legal](#) [Advertise](#) [RSS](#)

© 2011 Microsoft |