The 'defined contribution' joyride to retirement (**Palo Alto Weekly,** Feb. 27, 2002.)

by Austin Lemoine

How to maximize your retirement savings

This century promises to be an era of unparalleled achievement. People will live longer, healthier and more productive lives.

But will they have enough money to retire?

Short of hitting the Lottery jackpot or striking it rich with an IPO, a "yes" answer to that question depends on your ability to save for retirement – and your seriousness about it.

"Ability" means the wherewithal to put aside money for the future – it takes chicken to make chicken salad.

"Serious" means how aggressively you take advantage of, and how prudently you manage, the self-directed retirement-investment programs available.

The best self-directed savings vehicles are the "defined-contribution" plans – the 401(k), 403(b), 457 plans and individual retirement accounts, or IRAs. In a defined-contribution plan, you choose how much money to save and how to invest it.

Savings grow tax-deferred but you bear all the risk that your investments might go bad or produce returns that are inadequate to support your "preferred retirement lifestyle."

There are a few simple guidelines that can help you navigate the defined-contribution waters. I'll use the 401(k) plan as a good example, but the same concepts apply to other defined-contribution plans.

Guideline #1: Increase the money you put aside for retirement at every opportunity, up to the maximum allowable that you can afford. At the least, commit to increasing your contributions every time you get a raise. The federal Economic Growth and Tax Relief Reconciliation Act of 2001 made significant changes to the pension provisions of the Internal Revenue Code -- including increasing the amount people are allowed to contribute, and expanded portability of retirement plans. (Consult your tax advisor or a Web site such as www.mpower.com for more information on specific changes.)

Saving more is a hedge against lower market returns. And it's important to start saving now. The longer you wait, the greater the "real" return on your savings (that is, the rate of investment return minus the inflation rate) you must earn to sustain a 20-year retirement at the income level you want.

Guideline #2: Open an IRA account (say at a discount brokerage) when you change jobs. Roll over your departing-employer 401(k) assets to that IRA and do it again every time you change workplaces.

Why? You'll have more investment options, and they will be more diverse and less costly with that IRA than with your employer-sponsored 401(k). (But reserve that IRA for 401(k) rollovers and don't add to it with after-tax dollars.)

As a 401(k) participant, you receive the market return from your investments less plan expenses. Those expenses include mutual fund management and administrative fees (expense ratios) and possibly other non-investment-related fees. (Expense ratios average about 1.5 percent for stock

mutual funds.) Such expenses can be reduced drastically by rolling 401(k) assets to an outside IRA and opting for lower-cost investment alternatives.

Mutual fund fees can exact a heavy toll on your returns over time, as the following example from *Forbes* magazine shows. Two employees contribute the same amount annually into mutual funds. Each fund returns 9 percent a year, but one has an expense ratio of 0.2 percent and the other, 1.2 percent. After 35 years, the less expensive fund has a balance 23 percent higher than the other!

You may need professional counsel more as your retirement assets grow.

Guideline #3: Diversify your investment holdings. Poor investment-allocation decisions can degrade investment performance. It's not unusual for 401(k) plan participants to own just one or two stock mutual funds, or to invest in several managed funds that all mimic a single market index, such as the Standard & Poors 500.

Even riskier and potentially more costly is that many companies encourage (some say coerce) their employees to buy company stock in 401(k) accounts by making company-matching contributions in stock. The Enron disaster is a worst-case scenario.

(See our article "Is there an Enron in your retirement?" which is posted on this Web site.)

Guideline #4:Check your expectations against reality and prepare for lower-than-average market returns, not higher. Investor expectations and perceptions of risk are significant factors in making the wisest investment decisions. During October and November of last year, the Vanguard Group conducted a national survey of 500 participants in 401(k) plans. The results are revealing.

After two consecutive years of stock-market declines, most respondents expect only single-digit returns for a year or two but are counting on long-term annual returns of at least 15 percent. About half the respondents were "unable to form realistic expectations of future stock-market performance."

About 27 percent could not estimate long-term stock returns, which have been about 10 to 12 percent without adjusting for inflation. Some 22 percent of respondents predicted with almost bizarre unreality that annual returns over the next two decades would range from 30 percent to 100 percent.

In his 1998 book, "Stocks for the Long Run," Professor Jeremy Seigel concluded that since 1802 U.S. stocks have provided a consistent 7 percent real return over long horizons. Assuming a 3 percent average annual rate of inflation, that translates to nominal

long-term stock-market returns of 10 percent. It's prudent to set that 10 percent historical figure as an upper limit on stock return expectations going forward.

There's nothing you can do to influence market returns, which means that you must either adjust your expectations or change your behavior. As pointed out above, saving more is a solid hedge against lower market returns.

You may fantasize that you can achieve higher-than-average returns in your retirement portfolio by making riskier investments, and that you'll get away with it. But that's a bad bet, akin to putting your retirement lifestyle on the table for a longshot outcome in Las Vegas.

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