

Beginning Investor

A series providing guidance for new investors on how to become successful investors. See AAIL.com for the other articles in this series.

Setting Up and Managing Your 401(k)

Choosing mutual funds from within a 401(k) retirement plan, or similar defined-contribution plan, can be both daunting and frustrating. Depending on your employer's plan, you may have a large number of funds to choose from or a limited amount. If the funds are primarily institutional funds, they can be difficult to research. That's not to mention that you will be handed a large folder or directed to a website to find answers to many of the questions you might have.

Potentially adding to the confusion is the growth of default options. Many employers now enroll workers with a pre-specified contribution amount and pre-select a fund choice (typically a target date fund). The goal is to get employees enrolled and saving. Though effective for getting workers to set money aside for retirement, it may not be the best option for you.

Fortunately, there are some basic guidelines and strategies you can follow to take control of your 401(k) plan. You will still need to read through the plan documents and navigate through the plan's website, but with a little bit of effort, you can better position yourself to achieve your financial goals.

It Starts With Allocation

The key to constructing any portfolio is allocation. You want to include both assets that will grow your net worth and assets that will help preserve what you have already saved. This means combining stocks and bonds. These are your building blocks and your road map. Your very first decision is determining how much of your portfolio should go into stock funds and how much of your portfolio should go into bond funds.

A rule of thumb for determining a proper allocation for you is to subtract your age from 110. This means someone age 50 should have a 60% allocation to stocks ($110 - 50 = 60$), whereas someone age 25 should have an 85% allocation to stocks ($110 - 25 = 85$). It's not a perfect guide, however, because many factors influence your ability to tolerate investment risk. These include your expected life span, planned retirement date and wealth. Longevity risk—the risk you will run out of money before you die—is another reason why you need to think about having a significant exposure to stocks.

Our asset allocation models (www.aail.com/asset-allocation) suggest investors ages 55 and younger should hold 70% in stocks and 30% in bonds. If you are in your 50s and are considering an early retirement, you may want

to scale the stock allocation back toward 50%. If you are in your 20s or early 30s, be aggressive and increase the stock allocation. Our model guides young workers to allocate 90% of their retirement savings to stocks. The reason for this is that the longer the time period before you need to withdraw the money, the more financial risk you can take.

You can implement an allocation strategy by selecting funds that match the major investment categories. I'll explain more about this momentarily.

Maintain Your Diversification Benefits

Diversification (allocating your savings among several types of assets) will reduce the volatility of your portfolio and help you adjust the amount of financial risk you are incurring. In order to achieve these benefits, however, you have to be willing to take a long-term view and periodically adjust your holdings (a process known as “rebalancing”).

Over the short term, you may conclude that diversification is not working; this is normal. It will cause your portfolio to underperform during bull markets for stocks. It will not prevent you from losing money during bear markets. What diversification does do is reduce the long-term risk of the portfolio—you give up a little upside in exchange for not incurring as much downside. Where people often fail in managing their retirement savings is abandoning diversification strategies because of short-term market trends.

Rebalancing your portfolio once a year will help you maintain the benefits of diversification. It will also give you a strategy for proactively responding to bull markets and bear markets. This is because rebalancing is a “buy low/sell high” strategy. You take profits when times are good, and you buy when times are bad and certain asset classes (e.g., stocks) are cheap.

For example, say your portfolio allocation calls for 50% stock funds and 50% bond funds. You look at your portfolio and realize the allocation has shifted to 44% stock funds and 56% bond funds. To rebalance, you would take 6% of your 401(k) plan's total value out of the bond funds and shift it into your stock funds, bringing the allocation back to 50% stocks and 50% bonds.

The key to rebalancing is to check your portfolio regularly (once a year) and only tweak it when your allocations are five percentage points or more off target. Using the current example, if your allocations were instead 48% stock funds

and 52% bond funds, you wouldn't do anything. Your portfolio's allocations will fluctuate with the markets; this is normal. The goal of rebalancing is to set boundaries so that your allocations don't stray too far from your targets.

Choosing Funds

The other advantage of thinking about asset allocation first is that it gives you a road map to selecting funds. If you follow our moderate allocation model, for instance, you will need to select six funds: a large-cap stock fund, a mid-cap stock fund, a small-cap stock fund, an international stock fund, an emerging markets stock fund and an intermediate-term bond fund. In all cases, you want to select broad-based funds that target these categories as opposed to ones that target certain industries (e.g., energy) or follow a specific style (e.g., growth).

In choosing funds, read through your plan's documentation. If index funds are listed, those will typically be your best option since they will have the lowest annual fees and eliminate the risks of active management. If no index funds are available, read through the fund descriptions and pay attention to the fund expenses. You want a fund that invests in a large number of stocks and has a low expense ratio relative to its category peers.

Pay attention to all fees. Some of the funds may come with loads, either front (fee charged when the fund is purchased) or rear (fee charged when the fund is sold). Whenever possible, you want to choose funds that do not have loads. Each dollar you pay in expenses is a dollar you will never see again.

Performance does matter, but you should consider the long-term track record. Any single fund can have a good one-year return, but it takes good management to rank among the best in category for a five-year period or longer. Notice the words "best in category." A bond fund will have different return characteristics than an international stock fund, so compare a fund's performance to its peers, not to all the funds in your plan. Also look at how long the manager has been running the fund. If a new manager is at the helm, the fund's historical performance is attributable to the manager who departed. The new manager may be as talented, more talented or less talented than the old manager; until he has time to build a performance record, you won't know.

Our annual Guide to the Top Mutual Funds, pub-

lished in the February *AAIL Journal* (www.aail.com/guides/mfguide) provides detailed information on funds available to individual investors. If a fund in your plan is not listed in the guide, it may mean that it is an institutional fund. These funds are only offered through employer plans and to large investors, such as pension plans and wealth managers. As such, your research will largely be restricted to the fund's prospectus and documentation. This doesn't mean there is anything wrong with the fund; it simply means there is less information that you can easily access.

Target Date Funds

Your plan may offer target date funds. As I explain in the feature article in this issue on page 7, these are funds that invest in other funds. A target date fund follows an evolving allocation strategy designed for people retiring on or near a certain date, such as 2020. These funds take care of the allocation and rebalancing needs.

Some 401(k) plans automatically designate a target date fund as the default investment option. If you don't specify which funds you want to invest in, your contributions are automatically allocated to a target date fund. Even if you like the premise of target date funds, you should still review the fund your contributions are being allocated to to make sure it is appropriate for your financial goals. You may determine that a shorter-dated (more conservative) or a longer-dated (more aggressive) fund is right for you.

Contributions

Contribute as much as you can, as early as you can in your career. This year, you can contribute up to \$17,000 to a 401(k) plan on a tax-deferred basis. If you are age 50 or older, you can also contribute an additional \$5,500 as a catch-up contribution. Both amounts are subject to cost of living increases starting in 2013.

If you cannot afford to set aside these amounts, at least try to save enough to take advantage of your employer's matching contribution. If your employer automatically enrolled you in the 401(k) plan, look at the contribution amount. It may be preset at a level below the amount required to take full advantage of the matching contribution. If so, ask your human resources director to increase your contribution.

—Charles Rotblut, CFA, Editor, AAIL Journal