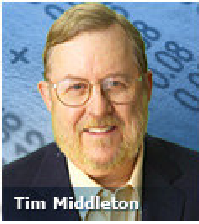

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Is your 401(k) plan a clunker?

You probably already know you're in the driver's seat for funding your retirement. Here's how to tell if you're in a good plan -- and what you should do if you're not.

By Tim Middleton

First the good retirement news: New legislation makes it likely more Americans will be swept into the 401(k) system, providing greater financial security for them and a profit windfall for the financial-services industry.

Now the bad news: This doesn't help you out one bit. You're already in the system, and for you, nothing has changed. Unless you're in a gold-plated plan -- and even in the Fortune 500, that can't be taken for granted -- you're stuck with a tin cup.

"The 401(k) industry is a racket," asserts Joshua P. Itzoe, a principal of Greenspring Wealth Management in Towson, Md. It's rigged in favor of employers and investment firms with fees that are excessive, investment alternatives that are lousy and with nobody around to help employees avoid dumb mistakes.

And corporate plans are Hertz compared with the rent-a-wrecks available to the public and to employees at nonprofits, including a large number of teachers. Their plans, known as 403(b)s, often feature "horrific fees and terrible choices," says Steven Podnos, a principal of Wealth Care, a planning firm in Rockledge, Fla.

Below, I'll give you a checklist of questions to ask to see if your plan is a loser and a set of steps to fix what's broken. First, a bit of background of how corporations and the government created the mess.

Shirking responsibility

Retirement benefits of some kind are a tradition in the United States. But they are voluntary, and businesses with fewer than 100 employees are least likely to offer them, according to David Wray, president of the Profit Sharing/401k Council of America. He says big corporations began decamping from pensions in the 1980s, claiming government regulation made them too expensive and unpredictable.

Defined-contribution plans like 401(k)s can cost employers nothing, although many companies subsidize their expenses and offer to match a portion of employees' contributions. Until last year many workers, especially young and poorly paid employees, never even enrolled in the plans that were available.

The Pension Protection Act of 2006 changed that by allowing plans to enroll employees automatically and to gradually increase their contributions unless employees specifically opt out. It also allows employers to offer more investment guidance.

A huge fraction of 401(k) participants know nothing about investing and have tended to choose the worst options -- low-yielding stable value accounts and risky company stock. Since last year, more and more plans are offering target-retirement funds and making them the default for new enrollees.

Video: The ABCs of mutual funds

This is good because it gives plan participants a better shot at making significant investment earnings, and therefore creating more retirement income. "You automatically go into an age-appropriate asset allocation, and that allocation will change over time, better balancing the risk and return of the portfolio," says Jamie Cornell, senior vice president of Fidelity Employer Services, the largest operator of 401(k) plans.

I wrote about target-retirement funds recently. They can be an excellent one-stop solution for people who don't want to manage their investments personally.

How bad is my plan?

None of this benefits participants in existing plans, except the possible addition of target-retirement funds. And none of this speaks to the quality, economy and knowledgeable management of a company plan. There you're on your own.

Continued: 4 questions to ask

There are some easily answered questions that can help you evaluate the health of your plan:

1. Is there a company match?

If there is, this is free money you would be foolish not to claim. A common approach is to match your contributions to a maximum of 3% of your salary. Typically you put in 6% and the company adds half that. Take it if it's there. If not, the plan might still be attractive, because contributions limits are higher than for IRAs.

2. Can you look up information about the investment options in the newspaper?

If they aren't mutual funds, which have five-letter ticker symbols ending in X, what are they? Separate accounts can be good; they can have lower expenses than funds and be just as good otherwise. But they can also be annuities, which wrap unneeded and expensive insurance around ordinary mutual funds. If so, they'll be expensive, which leads to this question:

3. Are fees fully disclosed and easy to understand?

Small plans might charge $20 annual account fees, and all investment vehicles have fees attached to cover costs and, usually, make a profit. Fees of less than 1% are good; up to 1.5% can be fair; more than 2% is dreadful.

4. Are the choices good?

Available options should cover the basics, from foreign- and domestic-stock funds to bonds. They should deliver returns on a par with or better than the index they compare themselves with. And they should be monitored so poor choices are replaced with better ones.

Getting out

All is not lost if you're stuck with a bad plan, however. Employers have to have investment committees that oversee their plans, and those committees are legally beholden to participants, not employers. There is a trend toward more and better choices, including target-retirement funds for those who don't want to direct their own investments.

You can always opt out, partially if not completely. Once you've contributed enough to get the company match, you can invest the balance in deductible or nondeductible IRAs, or in variable annuities, which are well-suited to this purpose (and only this purpose).

A traditional brokerage account is another option, and you should probably have one of those even if your company plan is good. The tax-deferral features of 401(k)s are great for income investments like bonds but bad for growth investments like stocks. Bond income and 401(k) income are taxed the same; capital gains are taxed less. The maximum capital-gains-tax rate of 15% will almost certainly be raised by the next (Democratic) administration, but so will income-tax rates, which are 10 to 20 percentage points higher. Using current rates, a $10,000 investment over 20 years in a growth mutual fund that goes up, say, fivefold, would be subject to a maximum tax in a conventional brokerage account of $6,000 (15% of the $40,000 gain). In a 401(k), the whole $50,000 would be taxed at 25% or more -- a minimum tax bite of $12,500.

If you think a plan is faulty, volunteer to serve on the investment advisory committee. If you cannot bring about the changes you want, write a letter to the regional office of the U.S. Department of Labor outlining your concerns and asking for aid. You'll boost your chances for success if other employees join you in expressing concerns.

"Employees can definitely challenge high fees and poor choices," notes Margaret O'Meara, head of an eponymous financial advisory firm in Red Bank, N.J. "The executives in charge of the plan have a fiduciary duty to make sure that they are not paying excessive fees for the plan and can be personally liable if the plan is not fair."

Not for profit, not ready for prime time

The rules for 403(b) plans are different. These grew up at universities and large nonprofits, where conventional pensions are common and the plans are viewed as supplements. Employer matches are rare.

The largest operator is TIAA-CREF, and its plans are usually excellent. But smaller public and nonprofit plans, such as those for primary and secondary school teachers, are often run by insurance companies, where costs are as much as four times those of TIAA-CREF.

The Department of Labor does not oversee these plans, and generally the representatives of the employer know nothing about investing. Therefore it is sometimes possible to opt out of a bad plan through something called a 90-24 transfer, named after an Internal Revenue Service ruling that allows them.

Video: 4 great funds to buy now

"If the 403(b) plan allows for 90-24 transfers, then the participant can transfer out to a self-directed 403(b) that they can invest with better investment products and lower expenses," advises Dana J. Hornquist, a financial planner in Milaca, Minn.

Otherwise the alternatives are the same as for private-sector workers: IRAs, whether deductible or nondeductible, annuities and brokerage accounts. This kind of annuity, the kind held outside of formal retirement plans, is expensive but allows the affluent to save more than IRS rules allow.

The self-directed pension system has matured greatly in the last two decades, but negligent employers and avaricious mutual-fund and insurance companies continue to bedevil it. This is your money, however, and the more of it you do not surrender to high fees and poor options, the more you will have when you need it. It's worth fighting for.