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THE WALL STREET JOURNAL.
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PERSONAL FINANCE | April 13, 2013, 8:18 p.m. ET

Big 401(k) Mistakes ... and How You Can Avoid Them

By VERONICA DAGHER

What you don't know about your 401(k) could hurt you.

Millions of Americans are counting on their 401(k) to fund their golden years. But financial advisers say some people may be making mistakes with their 401(k)s that could hurt them now and cost them precious income in retirement.

Financial advisers weigh in on a few of these mistakes below:

1. Under- or over- contributing

While it's common to say "I'll start next year with my raise," people often continue to delay contributing, says Rob Siegmann, a financial adviser in Cincinnati.

That's a big mistake though as they'll miss out on the power of compounding, which can significantly boost their account balance over time.

By not contributing or under-contributing they run the risk of not having enough money to meet their retirement goals.

An especially critical mistake occurs when an employer match is left on the table, says Mr. Siegmann. "If an employer matches 5% on the employee's 5%, this should be viewed as a 100% return on your money," he says.

Wesley Bedrosian

Only saving enough to get the employer match is a common pitfall, says Jim Titus, a Charles Schwab financial planner in San Francisco. If possible, people should contribute the full amount. Even a 6% contribution rate will likely leave you short in retirement.

You can put yourself in financial straits if you contribute too much too soon, though.

William Condon recently worked with a man who was making $65,000 and maxing out his 401(k). The Boston MassMutual financial adviser said the 39-year-old had very little in nonretirement savings.

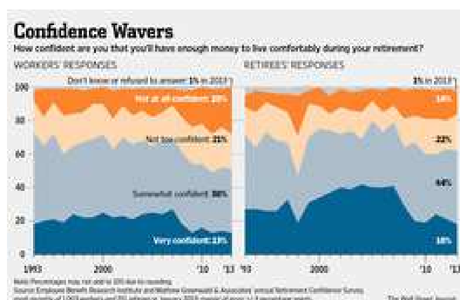
"It left him vulnerable," says Mr. Condon. Namely, the man didn't have enough cash on hand in case he had a medical emergency or needed to repair his car.

Mr. Condon suggested he set up an emergency fund of at least three to six months of living expenses. He also recommended that he put a portion of his monthly free cash flow into a brokerage account.

2. Ignoring fees

"The biggest misconception clients have about their 401(k) is that it's a free benefit," says Joseph Alfonso, a financial planner in Lake Oswego, Ore.

He says people often don't realize there are costs buried within the investment expenses of the funds in the plan, which can drastically eat into their account balance.



Department of Labor regulations recently went into effect that require plan sponsors to disclose the amount of fees workers pay for their 401(k)s, but many workers are still confused about or unaware of these fees, Mr. Alfonso says.

You can lower your investment costs by picking index funds since these typically have lower costs than actively managed mutual funds, he says.

And employees should complain to their employer if they feel plan costs are high, Mr. Alfonso says.

3. Taking a 401(k) loan
to pay off debt

Sure, it may seem convenient, but it can be a dangerous game.

Judith Ward, a senior financial planner at T. Rowe Price in Baltimore, has seen people attempt to get out of debt by taking a loan from their plan but not realize the consequences of doing so.

One person she knew left her company for another job within a year and was "stunned" by the amount of penalty and taxes she ended up having to pay on the money since she didn't pay the loan back in time.

"She's still in debt," says Ms. Ward.

Don't underestimate the opportunity costs of taking a 401(k) loan as the amount borrowed is out of the market and will miss out on potential gains and future compounding, she says. If you leave your job (by choice or not), you will have to pay back the loan with interest within a specified amount of time. If you don't, it is treated as a distribution and will be subject to taxes and a possible penalty depending on your age, says Ms. Ward.

In lieu of borrowing against a 401(k), Ms. Ward recommends making sacrifices in your current lifestyle to pay down debt. You also could call your creditors to make arrangements to pay down the debt.

Temporarily reducing 401(k) contributions or finding another source of income if possible also can help, she says.

If you are considering bankruptcy, you should know that your retirement-plan assets are generally protected from creditors—so it's in your best interest to keep funds in the plan, she says.

4. Ignoring allocation

"When investors don't properly allocate their portfolios they risk not being prepared for market ups and downs," says Christopher Chandler, a financial consultant with Charles Schwab in San Diego.

And not knowing or understanding what you own could leave you more exposed to downturns than you realize.

Debra Morrison has seen some people select an allocation when they enroll in their 401(k) plan and never rebalance.

If you select 50% stock and 50% bonds, for example, and don't look at the account balances at the end of each plan year and re-tweak the portfolio so that it remains at 50% stocks, 50% bonds, you are likely to end up with too much growth exposure and risk, says Ms. Morrison, a financial planner in Lincoln Park, N.J.

She also has seen investors make the mistakes of simply allocating the same weight to every fund in the plan or avoiding international investing. "The world offers massive opportunities in both the developed and emerging markets," she says.

Concentrating too much in your company stock is a trap some investors fall into, says Mr. Siegmann. He recommends clients invest no more than 10% in their employer's stock.

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