▶ Don't Make These 401(k) Mistakes!.......... 1-3

▶ You Have To Picture It To Plan For It 3-4

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FOCUSED ON WHAT MATTERS MOST.

Don't Make These 401(k) Mistakes!

As advisors, when it comes to money, we see it all. Everything from bizarre, not-so-common financial arrangements, schemes and situations, to the more mundane and commonplace missteps that we're all capable of making. When it comes to 401(k)'s, those missteps can add up fast and make planning for retirement much more difficult than it should be. Here are a few of the most common and impactful mistakes that we see.

1 Choosing investment options based on performance

When it comes to choosing investment options within a 401 (k) plan, it makes sense that you'd use whatever resources provided to you by your employer to help you do it, but in order to avoid becoming an expert on financial jargon, most people go right to the summary list of plan choices to evaluate their options. That list usually has the names of the funds along with their historical performance or track record over different periods of time, say 1, 3, and 5 years. If you pick a few of the top performers, you'll probably end up with a bunch of similar funds. If stocks have had three great years, and bonds three bad years, there's a good chance by choosing your investment solely based on performance you're going to end up with all stock funds. When stocks have a bad stretch, you'll find that all of your holdings will be among the worst performing on the list of choices.

Instead of packing your portfolio with the best performers, make your selections based on factors such as years until retirement, tolerance for loss, and a general evaluation of the market. If you have an advisor who can help you arrive at an appropriate portfolio allocation based on these factors, that's of course ideal. If not, use whatever resources are available to you through your employer. Consideration should be given to the use of retirement date funds that do the allocating for you based on when you plan on retiring, but be careful that this cookie-cutter approach doesn't put you in a mix of investments that's more aggressive than you can handle. There's no way the mutual fund family providing this service could know your tolerance for loss and general comfort level with various investments.

Finally, being truly diversified usually means having some investments in the mix that haven't performed all that well lately. Being protected when markets turn south requires that not everything go down at the same time. Since we can't have it both ways, this also means that some investment choices will lag behind when markets go up. That's a good thing. Don't let lower recent performance keep you from properly diversifying.

2 Allocating your plan based on a colleagues selections

"If this is what Jim chose, then it must be good." Not necessarily so. Jim may be making the same selection mistakes we just discussed resulting in a portfolio that's far riskier and less diversified than he thinks. In addition, Jim's situation and loss tolerance may be different than yours. If he can ride out a 20% market correction in his account and you can't, then you may be compelled to sell your stock funds and move to more stable investments just prior to the market bouncing back. If the market continues lower for a long period of time, this might not hurt you. However, it's more likely that the market recovers while you're still in a more conservative portfolio, thus hurting your longer-term performance. Having the right mix (for you) from the start can help you avoid this situation.

3 Taking out a 401(k) loan for something that isn't an outright emergency

Just because your 401(k) allows you to borrow against the balance, it doesn't mean it's a good idea. 401(k) loans have to be paid back through your paycheck over a maximum of five years which essentially creates a car payment for the amount borrowed. It's safe to say the new monthly payment will be less than comfortable. If the loan can't be repaid, you'll have to pay taxes and an additional 10% penalty if you're under age 59.5 to the IRS on the amount you borrowed and haven't paid back. Ouch!

Additionally, losing your job after taking a 401(k) loan will require you to pay back the loan in full, typically within 60 days, or face taxes and penalties on the amount borrowed. So before doing it, make sure you're in dire need. Also make sure that all other options have been explored and ruled out.

4 Not rebalancing regularly

A diversified portfolio today doesn't necessarily mean a diversified portfolio 5 years from now. If some categories have a really good stretch of great performance while others don't, the mix you started out with can change dramatically. In order to make sure that your portfolio doesn't undergo a personality change over time, it's important to periodically rebalance it back to the original mix. Whether it's every six months or once a year, the important thing is to do it consistently. If the mix has changed significantly over a shorter period of time than you typically rebalance, then consider doing it early. Some plans offer automatic rebalancing at no additional cost. This is typically a great option to take advantage of as most people tend to have plenty of other demands on their time more pressing than 401(k) rebalances. The whole point is to maintain a mix of investments that suit your circumstances and tolerance for loss over time.

5 Not maxing out your employer match

There is no greater sin in the financial planning world than not taking full advantage of your employer's matching contribution. If they match up to six percent of your salary, then make sure you're putting in at least 6%. Most employers will match some percentage of your contribution up to a certain level, then another percentage up to a higher level. For example, an employer that matches 100% of the first four percent, then 50 cents on the dollar up to six percent is effectively matching 5%. Don't make the mistake of only contributing 5%. You'll need to contribute 6% of your pay in order to get the 5% match.

Maxing out your plan too early can also rob you of matching contributions. If Joe, a 45 year old employee, making $120,000 per year contributes 20% into his 401(k) plan, he'll hit the $17,500 contribution limit in September. If his company matches 5%, he'll get $4,500 in matching contributions up until that point. When his contributions stop, so does the match. If instead, Joe stretches out his contributions through the end of the year, he'll get a match on all of his income rather than just 9 months-worth. By putting 15% into his plan each month, he'll hit the $17,500 limit in December and will receive the 5% match on every paycheck, resulting in $5,000 in free company money rather than $4,500.

Some 401(k)'s have "true-up" provisions which allow the employer to make up for any missed matches by treating contributions as though they were evenly distributed throughout the year. So whether you didn't put in enough in the first part of the year, or maxed the plan out too early in the year, the match is calculated based on what ultimately made it into the plan by the end of the year. If it's more than the total percentage of income the company will match, you'll get the whole thing. This is a very nice feature and it's worth checking into whether you have it in your plan.

6 Too much company stock

If you work for a public company, there's a good chance that they give you the opportunity to buy company stock within the 401(k). In some cases, they'll even match your contributions with it. Be careful not to accumulate too much of it as too much of any one stock can make your account much more risky than it should be. If 30% of your 401(k) is in one stock mutual fund and it drops by 20%, there's a very good chance that it bounces back. If a fund consisting of many stocks is down that much, there's a good chance the broad market is too. Company stock on the other hand can go down even if the market's holding up just fine because it's just one company. So a 30% position in one stock could drop 20% even if the market's rising. In addition, after dropping 20%, there's no guarantee that it's going to come back anytime soon. Any one stock can go to zero! The worst case scenario, and we've seen it, is when an employee has too much in his company's stock, then the company goes out of business. Not only have you lost a significant amount of value in your 401(k) plan, but you're also without income and looking for a new job.

Make sure to limit the amount of company stock within your plan to 5-10 percent. Even if you feel great about your company and its prospects for the future, don't overdo it. With thousands of publicly traded companies to invest in, there's a good chance there are more out there with similar or better potential for growth. There's rarely a good reason to take the extra risk and you don't get any do-overs with retirement. Stay diversified.

Avoid these common mistakes and you're well on your way to not only building up that retirement nest egg, but preserving it too. In the end, it's the little things that could make all the difference in your retirement planning.

You Have to Picture it to Plan For it

We enjoy creating plans and analyses for people to show them how they can reach their long term goals and live happy lives, but we also have to discuss uncomfortable subjects with clients sometimes. For the most part, those conversations center around losing an uncomfortable amount of your investment value and around traumatic physical events, like death or disability. The most difficult part of implementing solutions for worst case scenarios for most people is picturing it actually happening. We can think of at least two reasons for that: human nature and statistics. Yes, this hardly narrows things down, but allow us to explain.

If someone tells you "statistically, you have a 0.04% chance of dying this year" some people will react to the word "dying" and feel immediately uncomfortable and not want to spend too much time conceptualizing what would happen to their families. Others will see that as such a miniscule probability that they will not treat it as actually possible. Both of these types of people are more likely to not treat protection planning appropriately, albeit for different reasons.

Likewise, when someone points out your investment portfolio has only a 2.5% chance of earning -14% or less, many people interpret that as if it means it can't really lose more than that and it won't, and as a result may feel more comfortable taking on more risk than they should. Our brains weren't really designed to understand what "2.5% chance of earning -14% or

less" means without giving it more thought, so people anchor to that -14% figure, see the 2.5% chance as being really, really small, and call it a day. "I suppose I could handle losing 14% if that's the worst it could get." Here's a hint: that's not the worst it could get.

When planning for a worst case scenario, it is necessary to picture that scenario as if it really were going to come true. You have to fight through the urge to flee from an uncomfortable topic, and you have to understand that even statistically small events come true every day.

So when considering different amounts for insurance protection, don't automatically think, "Well, this isn't going to come true anyway, so I might as well save on the premium." It very well may be that the lowest cost option for protection provides an appropriate amount of coverage, but the way to start that thought process is "what would I want for myself and/or my family in the event of. . .". You have to treat finding this solution as if this scenario is actually going to happen instead of that it's not.

Likewise, when considering an appropriate investment allocation, don't look at what has happened with the stock market the last 5 years and think the possibility of large losses is now so low that it can't really happen, or if it does, this time someone will see it coming. The S&P 500 lost more value after the tech bubble burst from 2000-2002 than any other correction since 1950, and 5 short years later it started losing even more, just about when people were forgetting about the tech bubble. What we can do for clients in this area is instead of just leaving the conversation at a "2.5% chance of earning -14% or less", we can point out this portfolio would have lost an estimated -25% in 2008. That seems to reframe the possibility of loss to a degree clients can feel.

As unlikely or uncomfortable as a scenario may seem, you have to view it as if it were actually going to happen, or you're not truly addressing the situation. The peace of mind you gain in the present by knowing all situations are covered should not be overlooked when addressing worst case scenarios. Push through the discomfort and statistics. When you have accounted for all the possibilities of what may happen in your life, and planned accordingly, then you are truly able to feel confident in your future, no matter what life has in store.

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