Forbes

The 4 Biggest 401(k) Mistakes People Make

By Wayne Connors Jul 11, 2014

The 401(k) plan has long been one of the most useful and advantageous cornerstones of any investor's retirement plan.

Taking advantage of it used to be as simple as parking your weekly contributions in the plan and watching as they — and your company's matching contribution — added up to a modest nest egg from which you could start drawing as soon as you retired.

Well, times have changed and so have some of the basic rules of 401(k) saving, which has led some investors to make costly mistakes with the plans.

These days, we change jobs more often, companies have shrunk or eliminated their 401(k) matches and fund sponsors have started charging hidden fees that can seriously cut into the savings potential of the plans.

With these factors to consider, let's take a look at the four biggest mistakes people make with their 401(k)s:

1. Leaving money invested in a former employer's 401(k) plan rather than rolling it over into an IRA All 401(k)s have administrative fees and over the long term, continuing to unnecessarily pay these fees will significantly reduce your total return. By contrast, most IRAs don't have significant administrative costs. This cost savings can add up to thousands of dollars.

Another reason to roll your 401(k) to an IRA when you leave your job is that most 401(k) plans don't offer funds covering every asset class category. Consequently, investors in them are unable to build broadly diversified portfolios. An IRA gives you access to a wider range of investment funds. Proper diversification is important because it contributes to about 96% of your portfolio's return.

Another reason to move your 401(k) assets into an IRA is that many 401(k)s mainly offer high-cost "actively managed" fund choices as opposed to low-cost "passively managed" index funds. But studies have shown that actively managed funds, in general, are not worth their additional cost and investors are better served by building a portfolio of less-expensive index funds.

2. Investing "to" retirement with a 401(k) instead of investing "through" retirement Many 401(k) investors make the mistake of becoming too conservative too soon. By retirement, they've reduced their plan's stock exposure to 20% when they should probably still have 40 to 60% in stocks to help carry them through retirement.

While reducing stock exposure as retirement nears may sound prudent, many 401(k) investors — and many target date funds in their plans — don't consider that people will likely live at least another 20 to 25 years after they stop working full-time. So they'll likely need growth in their portfolio to afford the lifestyle they've grown accustomed to over the years.

3. Timing the market instead of putting time in the market Many people make the mistake of moving their 401(k) plan investments out of stocks when the market has dropped. Big mistake.

According to DALBAR, a research firm in Boston, Mass., the average investor who has done this historically has achieved a much lower return than if he or she would had kept money in an S&P 500 index fund.

The most recent DALBAR study showed that for the last 20 years ending December 2013, the S&P 500 Index returned 9.22% annually, on average, while the average investor earned a return of 5.02% over the same period. This difference in performance is due to investors moving in and out of the market, which can add up to thousands of dollars.

4. Failing to rebalance their 401(k)s You might think of this mistake as the "Set it and forget it goof." If the stock or bond market rises or falls dramatically, you could find yourself inadvertently with a bigger or smaller percentage of your portfolio in one of those asset classes than you wanted. Failing to rebalance your 401(k) plan is dangerous for two reasons.

First, although stocks generally outperform bonds over the long term, they can be much more volatile in the short term. So you don't want to find yourself holding more of your 401(k) in stocks just before retirement than you planned, just because the market soared. Otherwise, you might see your portfolio collapse if the market tanks just as you need to start withdrawing money from the plan.

That's one reason why it's a good practice to rebalance your portfolio every year or two, gradually weaning your portfolio off stocks and increasing your exposure to the more stable bond funds.

The second reason failing to rebalance your 401(k) is dangerous is that a runup in the market would mean your gains will go right back into your stock funds. But smart retirement investors siphon off some of those gains and send them into more conservative assets.

Rebalancing also offers an additional benefit: when you do it, you'll always be essentially "buying low and selling high." Imagine that the stock portion of your 401(k) goes from 60% of the portfolio to 80%. When you rebalance, you will sell off the difference (selling high) and purchase what has underperformed (buying low).

What You Can and Can't Control

In conclusion, investors can avoid these common mistakes by remembering to *invest* in what they can control (their asset allocation, diversification and investment costs) rather than to *speculate* on things they can't control (the economy, the direction of the stock market and which mutual fund will perform the best this year).