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# 401k STRATEGY GUIDE

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## INTRODUCTION

401k plans are now the primary funding vehicle for the majority of working professionals. Gone are the days of defined benefit pension plans, at least in the private sector. The burden for a successful retirement rests squarely now with each individual participant. How do you make your 401k work for you? We'll address that question in this strategy guide.

The implications of the transition from defined benefit to defined contribution plans are substantial. Companies are generally sophisticated institutions. They understand economic and investing principles and can apply those to managing pension assets. Companies also benefit from the large number of participants when determining how long they will need to make pension payments. On the other hand, individual participants in a 401k may — or may not — be knowledgeable investors and are unable to know how long they need the money to last (i.e. how long they will live). As a result, many pre-retirees are in the dark as to how much money they will need and are unsure how to develop a strategy to reach their goals.

By combining an understanding of 401ks and their underlying options with a sound investment strategy, 401k participants can put themselves on a more secure footing to reach their retirement goals.

## 401k BASICS

401ks and other employer sponsored retirement plans are covered under **ERISA**. ERISA, or the Employee Retirement Income Security Act of 1974, is a federal law that sets minimum standards for most voluntarily established retirement plans in private industry. These plans allow both employee and employer contributions for the purpose of accumulating wealth for retirement. In fact, normal retirement distributions from your 401k cannot be taken until age **59 ½** (accept under certain exceptions), less they be taxed with a **10%** excise penalty.

Generally, participants make contributions with pre-tax dollars, so contributions are not taxable income in the current year.

Employers often (but are under no obligation to) provide matching contributions. Employers may also make discretionary contributions to the plan. Funds grow tax deferred over time, meaning you do not pay income tax on capital gains, dividends or interest as it is earned within your 401k. Upon retirement, distributions from your 401k (or IRAs) are taxed as ordinary income.

You should make a point to download and review the **Summary Plan Description** document for your firm or company's retirement plan each year. This document will outline the methods by which contributions can be made to your plan.

Be sure to defer at least the minimum amount if your company offers a match, though saving a greater percentage of your income may be required based on your risk tolerance and retirement income objectives.

Some 401k plans provide a Roth feature. Roth 401ks, like Roth IRAs, are taxed differently than traditional 401ks (simply referred to as a 401k).

In a Roth 401k, participants contribute to the plan with after-tax dollars (for both employee and employer contributions), but receive tax-free distributions upon reaching retirement.



The primary question of whether to contribute pre-or post-tax to your 401k is really a question of tax arbitrage. Tax arbitrage is a complex word for a simple concept — you want to minimize the impact of taxes on your retirement assets. Early career professionals with low current income but high (expected) future income should consider contributing to the Roth in low income years, whereas high income earners may want to defer paying taxes at today's tax rates by contributing pre-tax funds in hope that future income taxes will be lower. It is important to note that the IRS requires distributions from a 401k upon reaching age **70 ½** (see IRS Publication 590 for details). Roth 401ks and Roth IRAs, however, have no minimum distribution requirement during the owner's lifetime. There maybe planning opportunities prior to turning **70 ½** to minimize future required distributions in your 401k and IRAs by working with a tax professional to convert pre-tax assets to Roth IRAs.

Many 401k sponsors allow excess contributions to plans beyond the normal deductible thresholds up to the maximum retirement plan limit. Upon retirement, the after-tax portion of the 401k can be rolled into a Roth IRA, while the deferred contributions along with all growth can be rolled into a Rollover IRA.

This effectively allows the 401k participant to max fund the deductible portion and build up an after-tax Roth component as well.

This is helpful for high income earners who would not have the ability to contribute to a Roth IRA otherwise.

## MECHANICS OF COMPOUNDING

Would you rather **A)** be given **\$1,000,000** today with a guaranteed **10%** return over the next month, or **B)** be given **\$0.01** today and have your investment double each day for **30 days**? If you start with **\$1,000,000** today and earn a **10%** return over one month, you would have **\$1,100,000**. If you choose the second option and your **\$0.01** doubled every day, at the end of one month you would have **\$10,737,418**. The idea of why compounding is so effective has to do with earning "**interest on interest.**" In scenario **B**, that is exactly what is happening.

$$FV = PV * (1 + i)^n$$

In finance we call the application of compounding in financial calculations the "**Time Value of Money**". To determine a future value, start with today's present value, add contributions along the way, and earn an interest rate (or return) over a specified period of time. Each of these variables have a direct positive relationship to increase the final value.

So let's look at how the TVM concept applies to creating wealth inside your 401k.

You may have been saving inside your 401k for most of your career, or, you may be just starting out. Either way, your 401k portfolio value today is the starting — or present — value in your calculation. For the majority of working professionals, systematic contributions are the way future goals will be realized — slowly and gradually over time. There is no "**magic percentage**" that meets everyone's retirement objectives, and participants are understandably looking for more direction than "**more is better.**"

It is important to understand that when we talk about saving, we are really talking about behavior. Yes, a solid foundation of saving for retirement should be established early in one's career. But it is also important to think about how savings rates may increase over time. If you are saving **10%** of income, and your income increases from **\$150,000** to **\$200,000**, your savings has increased by **\$5,000**, but your spending has increased by **\$45,000**.

What about splitting saving and spending equally for each additional salary increase over your baseline lifestyle?

Using our prior example, that would mean a savings and spending increase by the same amount of **\$25,000**.



It's always easier to save money you "don't" have instead of cutting back on expenses to create the capacity to save - though many find ways to do the latter. The most frequent example is for mid-to late-career professionals to increase savings once children are "off the payroll."

“

*Behavioral finance is the study of how emotions and psychology influence our financial decision making.*

”

Examining the psychology of saving introduces many interesting insights into human behavior. Saving money, losing weight and exercising are all things that we know are good for us to do, but are difficult in practice. Why? Understanding the concept of temporal discounting may help. Picture there are two “you’s”—the “you” of today and the “you” of tomorrow. Temporal discounting basically says as things move further away from the present, they become less important because the “you” of today wants to make decisions that line up with the priorities of today.

Retirement is one of those issues that we know is important, but it's so far away in time that it becomes less relevant today. What are some ways to work through temporal discounting? Well, one way is to change what you value so long and short-term priorities line up.

For example, let's say you just received the **\$50,000** raise we discussed earlier.

What if you valued self-discipline and financial prudence and wanted to make decisions consistent with these values? Then making a choice to save **\$25,000** would satisfy the “you” of tomorrow and the “you” of today equally.

As we continue our discussion on compounding and the time value of money, we have two remaining inputs—time and rate of return. We'll talk about time here and leave the rate of return discussion for our next section on the basics of investing.

**Time** is indeed a scarce resource. We trade some of it, or a lot of it, to earn a living. Let's go back to our compounding example and take a detailed look at the role time played in wealth creation in scenario ‘B’:

DAY:	0	5	10	20	29	30
WEALTH:	\$0.01	\$0.32	\$10	\$10,486	\$5,368,709	\$10,737,418

First, you can see that well into day **20+**, without an understanding of where things were headed, one could start to feel as though they should have taken the **\$1M** with **10%** interest. Time is important when compounding simply because it takes a while for benefits to really start to show through. But there is an additional point we should discuss. Notice the difference in wealth from period **29** to **30**, where **\$5.3 million** becomes **\$10.7 million**. Now think how this applies to your planning horizon. When accumulating wealth, you want to give yourself as many of those doubling periods as possible. In our example, that last compounding period added **\$5.3 million** in wealth! Starting early is the best way to do that.

To make this a bit more practical, consider the rule of 72.

Many readers may be familiar with this equation as a back of the envelope method to calculate an investment's doubling period (we assumed a **100%** daily return in our example above, doubling every day—not quite practical!). For example, assuming a **7.2%** annual rate of return, a portfolio would double from its starting value over a period of 10 years. Now overlay that 10-year period from age **50** to **60** and you can see how these cycles matter for retirees as they plan for future distributions to cover living expenses.

$$\text{Time (Yrs) to Double} = \frac{72}{\text{Rate of Return}}$$

So, in summary, developing positive habits around spending priorities to create savings and doing this as early as possible will provide a firm foundation to manage financial resources over your career.



## INVESTING BASICS

Everything else up to this point seems fairly straight forward—save more/have more, or, start earlier/have more. But now we have to address the issue of return earned on your portfolio. As you can see from our earlier compounding example, assume a high enough return on a portfolio and everything turns out great. But unfortunately that is not the reality we live in. Let's start with an overview.

**The basic building blocks of investing are stocks, bonds and cash (T-Bills).** With cash, the best you can hope for over the long term would be a rate of return about equal to inflation (so your real, or after inflation, return would be 0%, or negative). Bonds are debt instruments, so you are effectively lending your money to a corporation, government, or municipality, in return for your money back plus a fixed (or variable) return. If the issuing entity becomes unable to repay you (in the event of insolvency), you stand in line — hoping for a return of some or all of your investment. Bond holders look to earn a return over cash for taking on this credit risk along with the added compensation for locking up their money over the security's duration (called a term premium).

The riskier the credit condition of the issuer and the longer the term of the debt instrument, the higher the expected return for the security.

When investing in stocks, you are taking fractional ownership in operating companies.

You have no real claim on the assets of the company (stock holders are last in line in liquidation, while bond holders stand closer to the front). What you share in with stocks is the return on the company's assets driven by sales, earnings and dividends.

As investors move up the risk ladder from cash to bonds to stocks, they should expect a higher future return for taking more risk. It is important to note that while these returns are expected, they are not promised. The future is uncertain and investing is inherently risky because outcomes are not guaranteed. Investing involves deploying capital with the expectation of future economic benefits, realized within a specified time. Paradoxically, when investing in stocks for the long-run, things generally work out in your favor, but in the short-run anything can happen. What are "fair" expectations for the three asset classes we've discussed? Historical real average returns on these assets are close to **6%** on stocks, **2%** on bonds and **0%** on cash, assuming **3%** inflation.

The table below shows best and worst real (after inflation) returns over various holding periods for our three assets. Returns shown below are cumulative returns over the specified period. For example, the worst return for U.S Stocks over 10 years has been **-45.3%**. That is an average loss of **-5.85%** per year over 10 years!

WORST CASE SCENARIO (%) OVER DIFFERENT HOLDING PERIODS (INFLATION ADJUSTED)						
#YEARS	1	5	10	20	30	40
U.S. Stocks	-64.0	-50.8	-45.3	5.9	235.5	352.1
U.S. Gov't Bonds	-27.7	-45.0	-48.9	-53.2	-52.2	-65.4
U.S T-Bills	-16.4	-27.8	-42.1	-47.8	-43.3	-39.2

BEST CASE SCENARIO (%) OVER DIFFERENT HOLDING PERIODS (INFLATION ADJUSTED)						
#YEARS	1	5	10	20	30	40
U.S. Stocks	181.6	346.6	472.6	1238.0	2739.4	5140.9
U.S. Gov't Bonds	51.0	152.7	208.8	501.3	957.0	480.3
U.S T-Bills	13.4	53.2	57.3	78.8	78.4	82.0

Source: Ibbotson (1926-2013)

Segmenting best and worst returns after inflation by asset is helpful for our discussion in several ways. First, it shows how markets are dynamic and don't move in such a way as to produce average returns each year. Consider the following example. You and your business partner are both planning for retirement in 20 years.

Both of you agree to the following arrangement — for the first 10 years you will cover all of the rent and associated office expenses so that your business partner can invest **100%** of their income for retirement, and then you'll invest your income for the following 10 years while your colleague pays all the expenses.



Both of you invest 100% of your money in U.S. Stocks. The first 10 years turns out to be the best historic 10-year period for stocks and your colleague actually earns **19.07%** per year. Completely sold on the idea of investing in stocks, you start your 10-year period only to experience the worst 10-year historic outcome of a **-5.86%** annual loss! The average annual return between the **-5.86%** loss and **19.07%** annual gain is in line with a **6%** average return, but both of you have completely different 10-year outcomes.

That is why it is helpful to keep a long-term perspective when thinking about strategy within your 401k.

The application here is that when you include the period of retirement accumulation along with your timeline for distribution beyond your career, it is not difficult to have a total time span of 50 years or more. In investing, a few years really is not a very long time at all!



*" Investors should prepare for at least two declines of 25-30%, maybe even 50% over the course of a decade... they're kind of scary, often terrifying, but typical. " <sup>1</sup>*

JACK BOGLE - Founder of Vanguard

Even if markets provide historic average annual returns, there is still the risk that the investor will not receive them. This is the biggest danger to not sticking with your investment strategy. Market movements provide continuous feedback to investors. Today's technology makes it possible to make wholesale changes based on new information at a moment's notice. All these factors challenge participant's ability to maintain discipline, an essential ingredient to investing success.

In summary, there are few certainties in investing. While time helps mitigate risks, it cannot completely eliminate them. The cost of conservatism in **401k** investing is the requirement to save more, while the cost of being aggressive is volatility and uncertainty.

## 401K MENU OPTIONS & FEES

With a pension plan, participants receive a promised monthly benefit payable for the remainder of their lives. With a 401k, participants grow and manage their pool of assets by selecting from a menu of available options, so underlying asset class exposures and investment fees impact final asset values. There are **three primary categories** offered within 401ks to select from.

**First**, there are **Target Date Funds (TDFs)**. TDFs offer a **"one size fits time"** solution. Participants electing this option select the target date fund corresponding with their age and expected time to retirement. As the expected retirement date draws near, the TDF automatically shifts assets out of stocks and into bonds. If you participate in your 401k but have not taken the time to select your investments, chances are a TDF has been selected for you, since they have become a **Qualified Default Investment Alternative (QDIA)** following the passage of the **Pension Protection Act (PPA) of 2006**.

There are drawbacks to TDFs. For one thing, not all TDFs are created equal, and asset class exposures can vary substantially among similar offerings over time (changes in a fund's asset allocation over time is referred to as the fund's glide path). For example, consider the current allocation to stocks between the following TDFs, both with a target date of **2025**: <sup>2</sup>

	Great-West Lifetime 2025 Fund I	Fidelity Freedom 2025
% Stocks Today	37%	73%
% Stocks Retirement	25%	60%



Additionally, underlying fees for TDFs can vary widely. According to one study conducted by Morningstar<sup>3</sup>, annual expense ratios for TDFs ranged from **0.16% to 1.39%**. If you choose to go with a TDF, the key take away is that you should first perform your own due diligence to ensure appropriate underlying fees and asset allocation thresholds over the fund's lifetime.

The **second option** within 401k plan menus is selecting from a list of underlying mutual funds. Typically, this includes traditional asset allocation building blocks: U.S. Equity funds, Non-U.S. Equity funds, Fixed Income funds and Non-Traditional (or Alternative) funds. This is the standard 401k arrangement where participants act as their own portfolio manager by developing an asset allocation strategy. Participants make strategic decisions on how much to save, where to deploy new contributions and when/how to change the overall allocation. Options are typically limited to a short list for each category. Often times, index-based strategies provide the most efficient asset class exposures at the lowest cost. Standard expense ratios can vary based on the underlying assets of the plan, so a wide range of **0.10% - 1%** covers most options covered by 401k plan assets.

The **third option** is a 401k brokerage window.

Not every firm offers a brokerage option, but many do, particularly in the professional services industries, such as law and medicine. According to a recent study by Vanguard<sup>4</sup>, **22%** of plans with a brokerage window were law firms, though only a small minority of covered participants utilize them, presumably due to a lack of understanding of how they work. With a brokerage window, 401k participants have the ability to invest in assets other than the pre-determined fund menu of TDF or asset allocation type funds. Investment options within the brokerage window are much more extensive than those offered under typical plan menus, and often include the ability to purchase individual securities and **Exchange Traded Funds (ETFs)**. In addition to increased choice, brokerage windows may also offer lower overall investment costs to participants.

## PORTFOLIO STRATEGY

Now that you know the mechanics of how 401ks work, the basics of investing and a broad description of your investment options, the question remains, "**How should risk tolerance start to inform asset mix in your portfolio?**" This question often becomes overly complicated, so let's try and make this very practical.

The most risk averse **conservative investor** should solely utilize Treasury Inflation Protected Securities (TIPS) bonds and to plan and save more.

TIPS are issued by the U.S. Treasury so there is minimal default risk, and since they are tied to CPI, real purchasing power will be preserved against inflation over time. Again, with a low real return from this strategy, investors pursuing this should plan to do the heavy lifting by increasing their savings rate, planning to work longer, living off less in retirement, or some combination of those options.

A **moderate investor** can blend the safe attributes of TIPS with the return potential of stocks. For example, a 401k participant planning to retire in **25 years** and saving **\$40,000** a year could take **\$20,000** and buy a **25-year TIPS** bond and invest the remaining **\$20,000** in stocks. That way, there is an established income floor, and the potential to supplement income should stocks perform reasonably well. If they did this each year until retirement, they would have a 25-year bond ladder and a portfolio of growth assets upon their retirement date.

An **aggressive investor** can choose to minimize their current TIPS ladder or defer building it until a later date. This of course exposes the investor to the greatest risk of a worst-case outcome, particularly as their timeline until planned distributions shortens.



This is because a shorter timeline to distributions with an equity heavy portfolio exposes the portfolio owner to drawdown risks (think about the worst 10-year outcome for U.S. stocks of **-45%**). A sixty-five year old pursuing this aggressive strategy may end up losing significantly should equity markets meaningfully correct prior to **“locking in”** an income ladder through TIPS.

Given the use of hold-to-maturity TIPS bonds, plans with a self-directed brokerage window offers the ideal environment to implement this kind of approach. At the core of each of the above strategies is the idea of matching savings with a designated spending objective. Pension funds typically do this through a process called **liability-driven investing (LDI)**. With LDI, income needs and timelines determine the appropriate asset mix. This kind of portfolio may look quite different from a traditional portfolio constructed through traditional asset mix portfolios (such as **80% stocks / 20% bonds**, etc.).

There are a variety of extensions than can be used to apply the above process to make investment decisions. Since few 401k participants are likely following the kind of strategies we outlined, there may be transition issues with regards to timeline, income needs and risk tolerance that will need to be addressed.

## SUMMARY

In our 401k Strategy Guide, we reviewed the role 401ks now play in retirement saving. We discussed how contributions are made and outlined the tax differences between 401k and Roth 401k plans. We illustrated the math of compounding and emphasized the essential ingredient of time. We stressed the importance of psychology and managing behavior when saving and investing. We reviewed the basic building blocks available in 401k plans and outlined several ways to think through portfolio construction. With this understanding, it is our hope that the reader has a basic understanding of how to approach maximizing the value of their 401k plan.

## FOOTNOTES AND DISCLOSURES

1- John Bogle Quote 4/8/2013 via CNBC

<http://video.cnbc.com/gallery/?video=3000159394>

2-Great-West Lifetime 2025 Fund I Class T (MXALX) data as of 3/31/2015.

<http://www.greatwestfunds.com/prospectuses-reports.html>.

Fidelity Freedom 2025 (FFTWX) data as of 3/31/2015

<https://fundresearch.fidelity.com/mutual-funds/composition/315792663>

3-Morningstar Review of Target Date Funds (TDFs)

<http://corporate.morningstar.com/us/documents/MethodologyDocuments/MethodologyPapers/2014-Target-Date-Series-Research-Paper.pdf>

4-Vanguard: The Brokerage Option in DC Plans

<https://institutional.vanguard.com/iam/pdf/RNBKDCP.pdf?cbdForceDomain=false>

*Clients and prospects are advised that no guarantee of investment success can be offered. The future is inherently unknowable and the investing/financial planning process must therefore make assumptions with regard to future goals, savings rates, inflation and investment returns. It is recommended that clients and prospective clients update their plans annually as new information is available to aid in the planning process. The material contained in this report is for informational purposes only and should not be construed as investment advice. To ensure compliance with requirements imposed by the Internal Revenue Service, we inform you that any U.S. tax advice contained in this communication is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed in this publication. Forward Wealth Management and its representatives do not provide tax or legal advice. Please consult the appropriate professional counsel regarding your specific situation. A copy of the firm's ADV and Privacy Statement can be requested by emailing [info@forwardwm.com](mailto:info@forwardwm.com).*

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13850 Ballantyne Corporate Place  
Suite 500  
Charlotte, NC 28277

P: (704) 595-3386  
E: [info@forwardwm.com](mailto:info@forwardwm.com)  
W: [www.forwardwm.com](http://www.forwardwm.com)

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