What to know when managing your 401(k)

Scarborough Capital Management
Resource Series

SCARBOROUGH
CAPITAL MANAGEMENT

Table of Contents

Introduction

For the majority of American workers, the 401(k) plan has become their single largest source of retirement savings.

If you participate in a 401(k) plan, the good news is that you have more control over your retirement money. *The bad news though is that you have more control over your retirement money*.

For people who do not have the time or the financial knowledge, properly managing their 401(k) can be a daunting task. Moreover, if you do not manage it properly, the 401(k) can become at best, a savings account and at worst, a high-risk gamble with your retirement money.

While there is no step by step process for guaranteed financial success, following these best practices will put you in a better position to make the most out of your 401(k).

Determine your investor profile

Investor, know thyself! Before you can determine your asset allocation strategy, you must first be able to clearly define your own goals.

Everyone has different dreams about retirement and you may have some pre-retirement goals to save for.

Separating them into different pools of money can allow you to seek out varying investment options to help you fund each goal.

Also, how psychologically comfortable are you with market downturns? Will you be able to tolerate the inevitable ups and downs of the stock market?

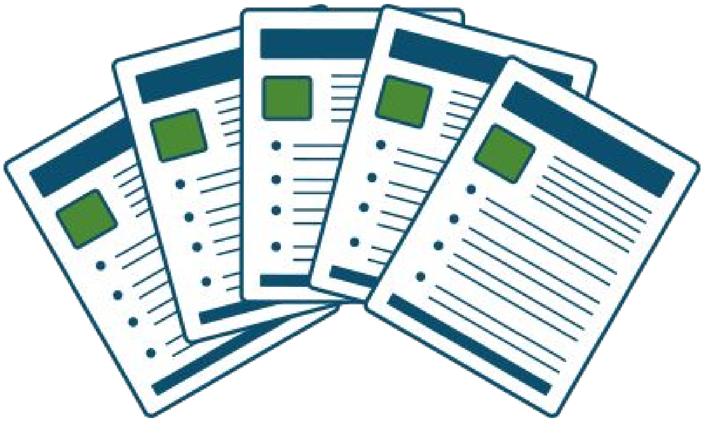
Consider these variables when tailoring your plan.

Know your plan's options

Every 401(k) plan has unique characteristics. To maximize your plan you need to know all of your options.

Your plan documents, distributed by your benefits department, will outline options such as hardship or in-service withdrawals, loans, vesting schedules, limitations to moving money, etc… Read this document carefully or have a financial advisor review it with you.

If your 401(k) does not meet your investment needs, you may be able to move some of the money to other vehicles, such as an Individual Retirement Account (IRA), where you may have significantly more investment options to consider.



Fully participate

The dollars in your 401(k) plan may represent 20-80% of your income at retirement.

The government, and by extension, your employer, are giving you the opportunity to take advantage of two very powerful financial concepts: the ability to save money on a tax-advantaged basis, and the compounded growth of these dollars.

If your company offers a 401(k) plan, you need to be contributing as soon as you can and as much as you can.

It's a great first step in taking charge of your financial future.

In order to help you increase the size of your nest egg, as well as to

Fully participate

In the complex world of finance, we call this "free money." If your employer is willing to give you money, you need to take it!

encourage reluctant employees to save for retirement, many employers offer matching funds.

In the complex world of finance, we call this "free money." If your employer is willing to give you money, you need to take it!

The only catch is that you need to contribute some of your own money in order to receive the company match, so it's often advisable to contribute at least as much as you need to in order to get their matching dollars.

Allocate appropriately

Asset allocation is the principle of deciding how to spread your investments across various asset classes, such as stocks, bonds, and cash.

There are subcategories within each class, such as small, medium, and large cap stocks. The idea is to diversify your holdings in order to potentially increase returns while diminishing risk.

A variety of factors determines the appropriate allocation for each individual—when you need the money (not automatically dictated by your retirement age); how much money to have now and expect to need later; what kind of risks you are willing to take; and what other assets you have invested outside of your 401(k).

Diversification and asset allocation do not guarantee positive results. Loss, including loss of principle may result.

Allocate appropriately

Perhaps the most important factor is your time horizon—the more time you have, the more aggressive you can be.

Second, determine the time horizon for retirement. Is it around the corner? Or maybe more than 10 years away?

The longer you have until you need the money, the more heavily weighted you should be in stocks. You'll have more time to recover any losses incurred during a market downturn.

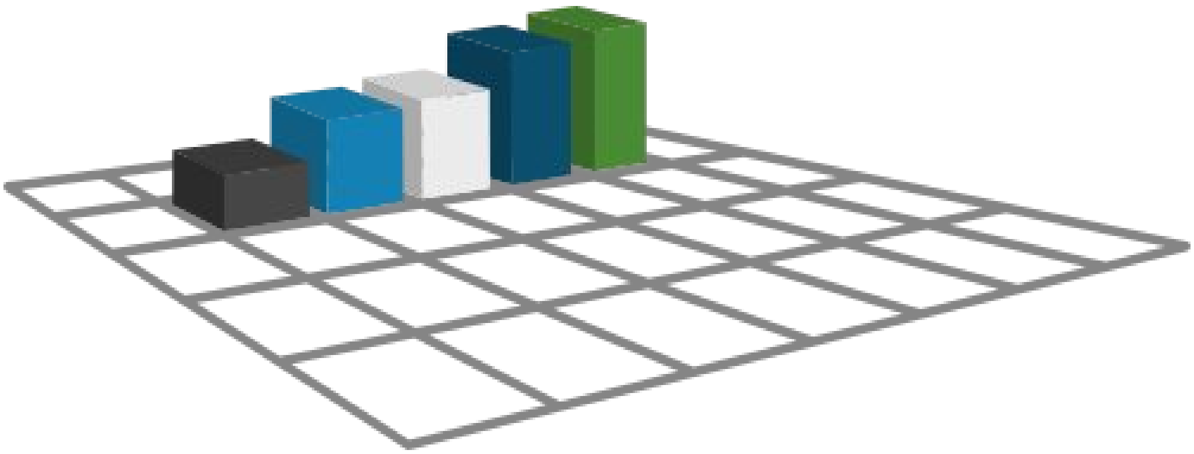
Allocation factors

- When you need the money
- How much money you need for both for now and later
- What kind of risks you are willing to take
- Other assets you have invested outside of your 401(k)

Reallocate tactically

While it's not advisable to move your money around daily, it's a good idea to check on your investments from time to time. If one segment of the market has significantly outperformed other segments, your portfolio is likely to be out of balance.

A hypothetical example: You want 70% of your money in stocks, but in the past few months stocks have grown to represent 80%. If you do nothing and the market goes south, you'll lose those gains and possibly more. Rebalance to make sure you again have 70% of your portfolio in stocks.



Limit exposure to company stock

Company stock can be a double-edged sword. Perhaps your bonuses are gifted in stock, or as a loyal employee who understands the business, you want to participate in the growth of the company by being a shareholder. Either way, it can be risky to have too much of your portfolio in one stock, as it creates a non-diversified portfolio.

The question to ask yourself is this: *Do you really want the fortunes of one company to control your destiny?*

Do you really want the fortunes of one company to control your destiny?

This is not to say that the company you work for is going to become the next Enron. That still doesn't mean the question of what would happen if the stock suddenly tumbled 10-20% isn't worth asking.

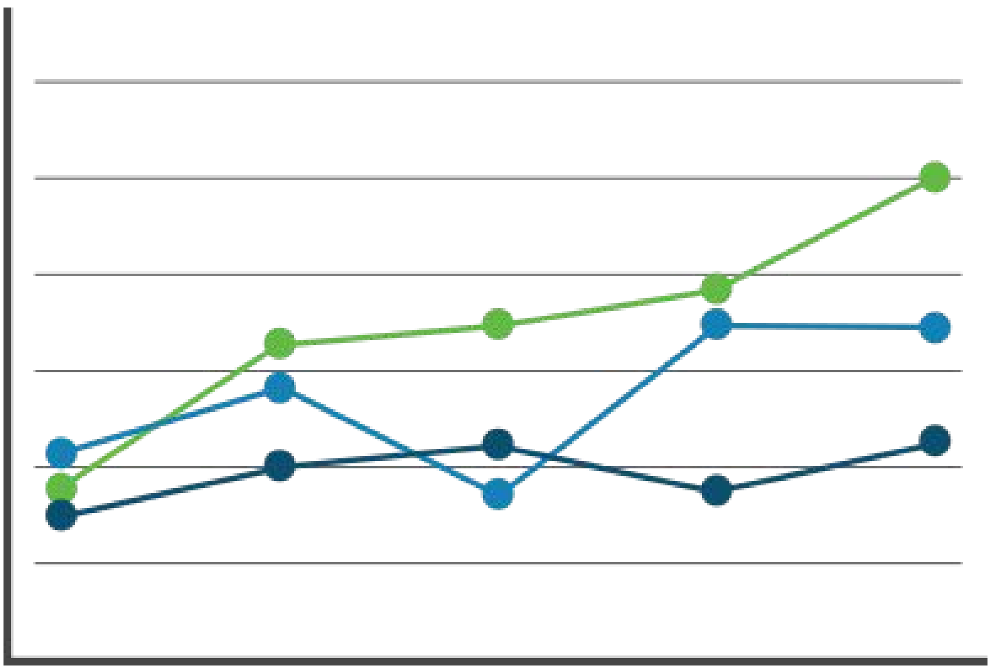
By playing out a hypothetical scenario with your financial advisor, you can be more informed of possible misallocations.

Don’t panic

Listening to the evening news and hearing about the market changes on a daily basis can cause even the most stalwart of investors to get nervous occasionally.

The market will be sure to experience downward dips and swings, which is why knowing how you’ll react to those swings is a factor to consider in your overall allocation.

Keep your eyes on the long-term.



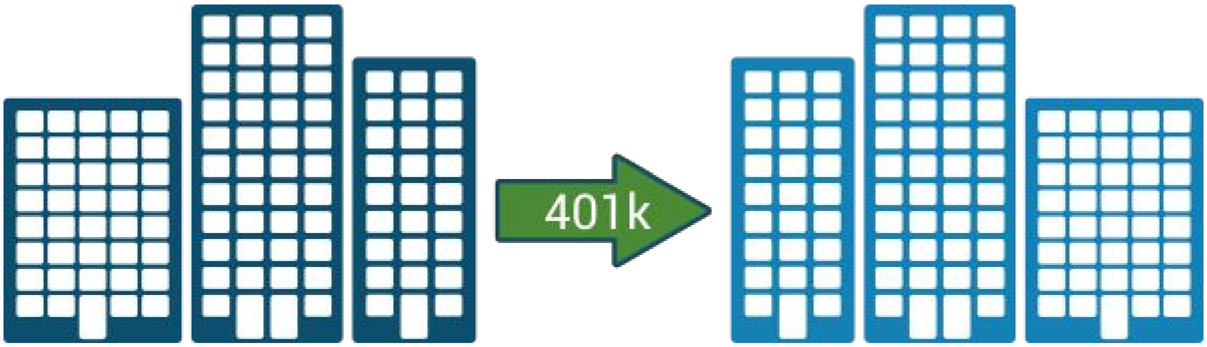
Consider tax consequences

If you leave your employer and decide not to leave your assets in your current 401(k), be sure to roll it over directly to an IRA or other employer's plan.

If you instead take a full distribution, you'll pay federal and state taxes on the entire amount.

And if you're not yet 55, you may also pay an additional 10 percent penalty.

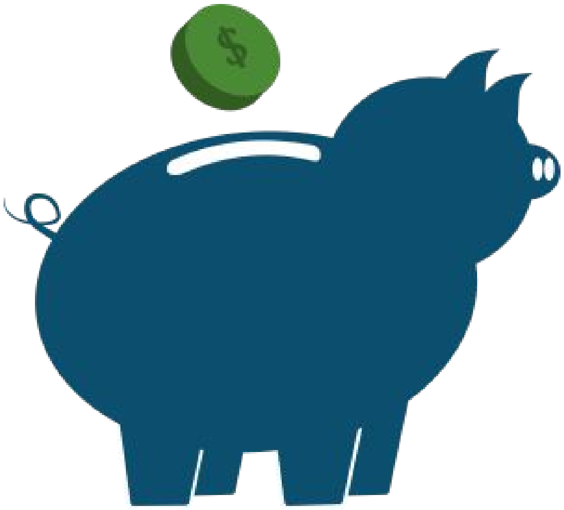
Meanwhile, if you're over 70 ½, you must follow the IRS rules for required minimum distributions (unless you are still actively working). Ideally you'll take only what you need when you need it.



Borrow judiciously - or not at all

Early 401(k) plans had no provision for loans, but they were later added as an incentive to encourage greater participation. The reasoning behind it was that if you know you can access the money if you need it, you'll be more apt to save.

Many people believe (often erroneously) that if the interest rate on the 401(k) loan is less than they would pay elsewhere, then it's a good deal. That may be, but it does not take into consideration the real cost of the loan – the opportunity cost.



The money in your plan cannot grow if it's not there! Before you take anything out, figure out what that money would turn into if you left it in over the life of the loan, as compared to what you'd be paying in interest elsewhere.

Sometimes what seems like a good deal isn't.

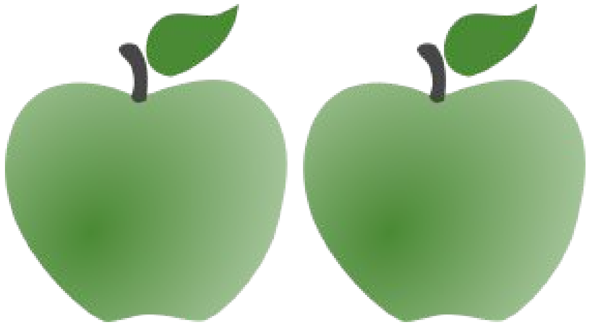
Ask questions

Managing a 401(k) or other retirement savings vehicles can be confusing. That's why it's important to be comfortable with asking questions if something seems confusing, or even too good to be true.

In a study, Duke University professor John Payne talks about something called "Evaluability." Payne says, "In their decision making, human beings do best when presented with apples-to-apples comparisons."

He explains that the problem with this begins when the data that is presented is highlighting only one aspect, leaving other important factors off the table, thus making it an "apples-to-oranges" comparison.

Until financial services information is universally spelled out in "apples-to-apples" terms, asking questions can help you avoid issues later.



Make decisions in a good mindset

In the study *Behavioral Finance and the Post Retirement Crisis*, Harvard University professor David Laibson wrote, “After age 60, the prevalence of dementia roughly doubles every five years. By the time people reach their 80s, more than half will suffer from either dementia or other significant cognitive deficits.”

Even if we don’t get one of these diseases, aging also slows down our ability to process numbers. We might shortchange ourselves if we wait to make important decisions about retirement until we actually *get* to retirement.

If we can make these financial decisions when our minds are fresher, we stand a greater chance of making good decisions we can live with well into our later years.

Balance your needs for income and growth

...in today's low interest rate environment, "risk-free" investments may also mean "growth-free"...

It used to be that you could retire and shift all your assets to fixed income investments, but in today's low interest rate environment, "risk-free" investments may also mean "growth-free" - or said another way, they may not even keep pace with inflation.

As you stop working in retirement, it's time for your assets to work harder than ever. Risk can be a healthy and important part of a carefully designed portfolio and income plan.

While there is no step by step process for guaranteed financial success, following these practices will put you in a better position to make the most out of your 401(k). And as always, be sure to talk to your financial advisor for questions on your own situation.

About Scarborough Capital Management

For over two decades, Scarborough Capital Management has provided comprehensive wealth management services to busy individuals and families who don't have the time to develop and manage a portfolio. What sets our company apart is our inherent interest in helping everyone from the mid-level employee to the top-tier executive preparing for retirement. Our services include a comprehensive array of financial planning support for people in all stages of life, including 401(k) and 403(b) Management, Thrift Savings Plan (TSP) Management, Wealth Management, Personal Pension Analysis, Social Security Analysis and Financial Planning. For more information about Scarborough Capital Management, visit www.scmadvice.com.

How to Contact Us

The professionals at Scarborough Capital Management can be contacted by:
Phone: 1-800-200-3870 ● Email: info@SCMadvice.com ● Online: www.SCMadvice.com

SCARBOROUGH
CAPITAL MANAGEMENT

SCMadvice.com
800.200.3870