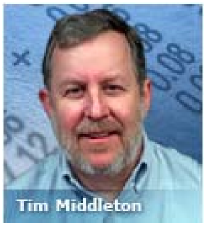

Mutual Funds 1/30/2007 12:00 AM ET

Fixing the 5 biggest 401(k) blunders

The smallest mistakes you make now can cost you dearly in retirement. Here are the common mistakes -- and five ways to get your savings on track.

By Tim Middleton

The Pension Protection Act of 2006 is supposed to fix the 401(k) system, which is the principal retirement tool for Americans. It's meant to bring more workers into the system and to help direct their investments more intelligently. These are laudable goals, but more rules aren't going to fix the basic problem.

The average American commits five big blunders in planning for retirement, and their cumulative effect can turn potential millionaires into permanent paupers. It doesn't take an act of Congress to correct them. It takes the kind of sensible planning you already do to buy a car or, in Peter Lynch's famous example, a refrigerator. That famed stock picker said investors pay less attention to their portfolios than their appliances.

The five big mistakes are failing to save hard enough; neglecting to maximize returns while controlling risk; relying too heavily on the stock of their employers; fumbling rollovers; and scalping themselves with heedless borrowing from their own nest egg.

Compounded over a lifetime, the smallest mistakes can have life-changing results. Ignoring expenses can clip 10% right off the top. I'll show you one example where a thoughtful choice involving just a few thousand dollars in your 20s can buy you a second home in the sun when your old bones need it most.

Consider this a 12-step program stripped to the bare essentials. Five steps can take you from dreading your financial future to enjoying it.

Get in, max out, catch up

According to Fidelity Investments, the largest operator of corporate 401(k) plans, more than a third of corporate employees don't even join their plans.

The 2006 pension act, signed into law last August, allows employers to automatically enroll you into a plan, forcing you to opt out, rather than in, which is a start. But then there's this issue: Most plan members don't save enough. The average rate is 6.9%, Fidelity says.

That's on what another pension consultant, Hewitt Associates, says is an average salary of $52,120, which works out to be $3,596 annually. But you can contribute up to $15,500. Double this contribution and it is still just half the permitted limit. Contributing enough to get the company match is a no-brainer, but failing to contribute more could be more costly in the end.

Brian Pon, a financial adviser with Financial Connections Group in Berkeley, Calif., says clients come to him for advice because the whole issue of retirement planning overwhelms them with its seeming complexity. "Some kind of analysis paralysis sets in," he says. "Is now the best time to invest? The question really is, 'Is now the best time to save?' and the answer is yes."

Even worse, only about one worker in 10 over the age of 50 takes advantage of the "catch-up" provision that allows them to contribute an additional $5,000.

If you don't think you can afford to max out your company plan, consider opening a Roth IRA in addition to it. Because contributions are not tax-deductible, "the Roth could act as an emergency savings vehicle, since contributions can be withdrawn tax-free and penalty-free at anytime," notes Chad Smith of Financial Symmetry in Raleigh, N.C.

Also, a Roth at a good, inexpensive mutual fund company will probably provide more investment options than a company plan.

Maximize growth, control risk

One-quarter of all plan participants have their entire account in a single investment option, Fidelity says, and it is often a low-yielding stable-value account which provides no opportunity for the growth of capital.

"The overwhelming mistake that I see 401(k) participants make is that they fail to diversify and employ proper asset allocation," says Jeffrey N. Bogue, a financial planner in Wells, Maine.

According to Fidelity, 22% of participants hold only equities, which cost them 30% or more of their nest egg in the bear market of 2000-2002. A well-diversified portfolio includes bonds and other income-oriented investments to help avoid calamities like that.

But 13% of 401(k) participants err in the opposite direction, owning no equities. With average life spans extending well into the 80s, even retirees need to keep at least a third of their assets in equities to keep up with inflation. The Pension Act liberalizes the rules by allowing plan sponsors to recommend model asset allocation. A sturdy rule of thumb is 60% equities and 40% income.

And don't forget as you allocate assets within your 401(k) to take your other investments into account. Working couples often have two plans, and "most have not spent the time to determine how to maximize the asset allocation between their two plans," says Paul Merriman of Merriman Capital Management in Seattle. "The potential return advantage can be as much as 1% a year." Choose from among the lowest-expense options in each plan.

Sell that company stock

Especially at big corporations, participants hold an average of 21.9% of assets in company stock, according to Hewitt Associates. Equity mutual funds spread risk across hundreds of companies; individual stocks are incredibly risky.

"I worked with several employees of AT&T and then Lucent Technologies who had unfortunately ridden their 401(k) plans to near nothing as the stock dropped from $70 to $3 a share," says Hal Schweiger of Capital Financial Advisers in San Diego. "The belief that a great company like AT&T is not vulnerable to this type of stock fluctuation is a costly problem."

The 2006 pension act gives plan participants more options out of company stock, and they should take them. But if you happen to be stuck with a bunch, there is a way to turn this lemon into a beverage. You can withdraw it from the plan at age 59 ½, pay the tax and then put it into a conventional taxable investment account, where future capital gains taxes -- a lower rate than pension income -- will be based on the value at the time of this transfer, not when you originally acquired it for, presumably, much less.

Rollover follies

Young workers, especially, are apt to cash out their old 401(k) plan when they change jobs. "Apart from the obvious problem of not saving for retirement, they don't realize that the 20% withheld on the distribution isn't the whole tax bite," notes Ronald E. Shaw, president of Evergreen Financial Management in Ann Arbor, Mich. There is also a 10% penalty to be paid, plus state income taxes.

Imagine you're 28 years old and the plan balance you're cashing in when you switch jobs is $5,000. If you take the cash, you'll get little more than $3,000 after all the taxes and penalties are paid. Imagine instead that you roll the money into an IRA at a cheap mutual fund company like Fidelity or Vanguard Group. You leave the money alone and it grows at the stock market's average return of 11%.

At age 70, when your other retirement funds are looking thin, this account will be worth $400,438, which assuming a 2.5% inflation rate is $135,000 in today's dollars. That's enough for a little place in Florida. You swapped it in your youth for a week in Fort Lauderdale.

So, unless your old plan is gold-plated, meaning very, very cheap, take the money out, by all means, but roll it directly into a low-cost IRA. Good mutual fund companies are cheaper than most corporate plans, and they provide more alternatives, including asset classes like real estate investment trusts that are absent from the typical company plan.

This is true in spades if your company plan is run by an insurance company and consists of annuities. My wife, a school principal, owns a version of **Fidelity Contrafund** (FCNTX) called Fidelity Investments VIP Contrafund Portfolio. It returned 10.9% annually over the five years ended Dec. 31. Contrafund itself returned 12.3%. The difference was extravagant fees for the annuity.

A $10,000 investment in the annuity grew to $16,780. In the fund, it grew to $17,866. The difference, of $1,086, is a whopping 10.8% of the original investment. Insurance companies argue that she received valuable insurance for this additional expense -- but she wasn't shopping for insurance. She's already got insurance. She got gouged, and so does every participant in an expensive retirement plan, which is most of them.

Eschew loans

The deal sounds mouthwatering. You can borrow against your 401(k) to buy a car and pay a lower interest rate than you would for a conventional loan. What's more, you pay the interest to yourself.

If you think that sounds good, you aren't thinking hard enough. First of all, the interest you're paying yourself is less than your money could have earned in a good equity investment over those four or five years. In effect, you'll pay for the car again in retirement in the form of income you won't have. And that's not all.

"If you lose your job or decide to change employers, you will have to pay it back immediately," notes Donald E. Whalen of Versailles Financial in Atlanta. That could be the event that forces you to cash out, with all the woes that can bring, later as well as now.

Time is inexorable. In five billion years, the sun will explode. But for money invested at interest, time is the most powerful wealth-builder there is. A 401(k) can provide a comfortable retirement, if you don't let mistakes gut it.

At the time of publication, Tim Middleton didn't own any securities mentioned in this article.