401 (k) America's Retirement Mistake

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REBECCA WALSER, JD, LLM, CFP®

401(k) was an ACCIDENT!

In 1974, when defined benefit plans (i.e. pension plans) were the norm, the Employee Retirement Income Security Act, known as ERISA, was passed to ensure that companies were funding their pension obligations. Large employers wanted a way to supplement the retirement benefits of their executives by allowing those executives to defer part of their earned income from current taxation by putting it in a retirement savings account to be taxed upon their retirement. **THUS, THE 401(k) PROVISION – DESIGNED TO BE AN ADDITION TO AN EXECUTIVE'S PENSION – DESIGNED FOR A HIGHLY PAID WORKER – WAS NEVER INTENDED TO BE THE RETIREMENT VEHICLE OF THE AVERAGE AMERICAN WORKER!**

When pension plans went virtually extinct with the influence of international trade and the shrinking of unions, what was meant as a supplement for executive pay became the only means for middle to low income workers to save.

Rick Stengel, Managing Editor of TIME

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Any solid Retirement Strategy needs to incorporate stable returns, provide liquidity for access to capital and offer tax advantages for definitive spending power... Page 3

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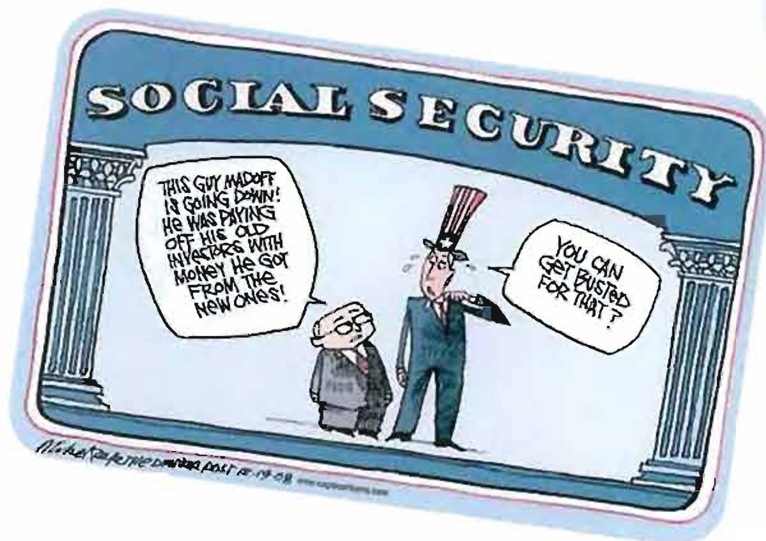
America's Retirement System

THE TWO PILLARS – SOCIAL SECURITY AND PRIVATE 401(k) ACCOUNTS

Born out of the ravages of the Great Depression in 1935, Social Security was designed to provide a base of protection to prevent elderly, retired workers from poverty. Expected to be augmented by private pensions and savings, it was not intended to be the sole source of retirement funds.



Statement from U.S. President Franklin Delano Roosevelt upon signing the Social Security Act, August 14, 1935:

> "We can never insure one hundred percent of the population against one hundred percent of the hazards and vicissitudes of life, but we have tried to frame a law which will give some measure of protection to the average citizen and to his family against the loss of a job and against poverty-ridden old age."

FAST FORWARD TO PRESENT DAY 2019

Social Security now makes up over half of all retirement income for 2 out of every 3 retirees and ALL RETIREMENT INCOME for more than 1 of every 5 retirees.

Has it worked?

Designed as a supplemental retirement savings vehicle for the higher income worker, it was assumed that such a worker would be investment savvy enough to pick the appropriate funds but middle to lower paid workers did not have previous investment experience or exposure and were given no guidance by their employers. Additionally, the entire mutual fund industry lobbied Congress to prevent disclosure of their fees by arguing that their products were used by sophisticated investors that knew what they were doing and regulation would just create red tape that would take away from the consumer's investment. This lead to unknowledgeable investors picking funds that were not suited to their risk tolerances with most all plans offered through employers charging hidden fees that have since proven to be quite corrosive! Overall, do-it-yourself plans were never intended to replace pensions and still half of American workers have no 401(k) plan at all.

TIME MAGAZINE – NOVEMBER 2009

Problems with the Fundamentals

REQUIREMENT #1 -STABLE RETURNS

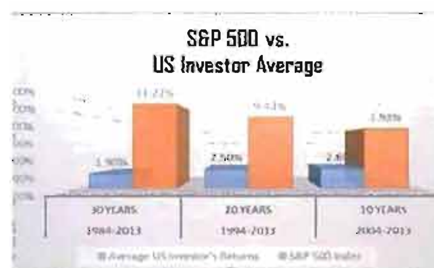
From 1871 through 2014, the Compound Annual Growth Rate of the S&P 500, which includes price appreciation and stock dividends, has been 9.11%. While that sounds good, the average return for a US investor in blended equities and fixed income mutual funds was just 2.6% over the last 10 years, just 2.5% over the last 20 years and only 1.9% over the last 30 years. The reason is because investing takes detached, rational, non-emotional behavior, attributes which are hard to come by when it's your money you are watching drop in value on a daily basis in a down market.

In addition to the demonstrated fact that US investors do not achieve S&P 500 returns because of their emotional investment behavior, the returns required to get investors back to their beginning asset balance after a significant loss is astronomical and often takes years to accomplish, a phenomena known as negative compounding. For example, a 30% loss requires a subsequent 43% gain just to break even. A 40% loss requires a 67% gain, and a 50% loss requires a 100% gain just to get back to even. This negative compounding takes a great deal of the power out of the punch of high return years.

During the period between 2000 and 2003, many investors lost nearly 40% of their account value. It then took the next 3 years from 2004 through 2007 just to get back to their account value before the drop. Then, in the Great Recession of 2008 and 2009 - the worst market since the Great Depression- those same investors lost another 40% all over again in 2008 alone, while the S&P lost 57% total.

This kind of market volatility is unsuitable for retirement assets, especially for anyone who has less than an extended time horizon left until retirement. Imagine saving in your 401(k) since 1985 when you were 35 years old and, after accumulating close to $1 Million dollars and being just seven years out from your planned retirement in 2019, your million is reduced to $600,000. That 40% loss will now take a minimum of a 67% return just to return your account back to its $1 million original balance. Assuming that could happen in the seven years before your 2019 retirement, you would then have to worry and hope that no additional losses occur after such large gains even though it's a fairly consistent market pattern for large gains to be followed by large losses.

Warren Buffet's Rule Number 1 is "Never lose money." This rule cannot be followed utilizing direct investments in the market – it is simply too volatile! If the 401(k) was used as a retirement supplement, as it was designed to be, to augment an otherwise solid and safe retirement strategy, then its volatility would be more acceptable.



S&P 500 vs. Average US Investor

The Average US Investor's returns versus the S&P 500
CONCLUSION: For over 30 years, Americans have not reached S&P return levels.

Negative Compounding

The power of negative compounding has a profound effect on your 401(k) strategy since it may take years to earn back what was lost in a big down swing.

FAST FACTS

38%

The stock market lost about 38% in 2008 alone.

Less than 1%

Less than 1% of Americans have $1 Million saved in their 401(k) account.

Contact your advisor to schedule a personalized analysis of your existing retirement strategy and plan.

REQUIREMENT #2 – LIQUIDITY

Imagine you have over $100,000 in home equity in your primary home, you own a second property that you have rented for the last 3 years to a reliable tenant, plus you have a six month expense reserve fund held at your local bank. Additionally, you have put away $150,000 into your 401(k). Then, in 2008, the housing market crashes and you are laid off from your job as the office manager of a national home builder. Your tenant, who you met through work contacts, is also laid off since he worked in the construction industry. All at once you have lost your job and your rental income. Because you are now supporting the payments on two houses and not just one, you run through your six months of expense reserves in three months. Now, you have no savings left and you still have not found work. You call your 401(k) plan administrator about accessing your 401(k) balance but they tell you that the maximum loan available is only $50,000 and if you don't start repaying it within a short time, it will be considered a taxable distribution plus there will be a 10% tax penalty since you are not yet 59.5 years old. You scream "but I lost my job" and they say, yes, you can get a loan or a hardship withdrawal but you will have to either start repaying it quickly with interest or you will have to take a hardship withdrawal that will be taxed and penalized. Because you can only borrow a maximum of $50,000, you cannot afford to keep your payments going on the second home. When you finally do secure another job, your second home is going into foreclosure and you cannot afford to catch up the missed payments with all the interest and fees the mortgage company has tacked on. You lose your second house and your credit in addition to paying taxes and penalties on the 401(k) distribution since you could not afford to repay the 401(k) loan back soon enough. This was a real story in 2008 that holds very valuable life lessons. Both real estate assets and qualified plan assets are highly illiquid – meaning they either are not easily convertible into cash at or near their fair market value, FMV, like real property, or their access is restricted to certain limited amounts, under only certain conditions, and such amounts are taxed and penalized. Your entire financial life could crumble because you are asset rich but cash poor. Because life happens, having your money tied up in such a way that cannot see you through the storms of life will exacerbate a difficult situation, compound its effects and is therefore, clearly a poor strategy.

REQUIREMENT #3 – TAX ADVANTAGED

BAIT & SWITCH... Ever heard of a bait & switch scheme? You are led to believe you are getting tax savings by not paying income tax on the income you defer into your 401(k) plan and you are told this makes sense because you will fall into a lower tax bracket when you retire. But does this make sense? When you are working and raising children and have a home and a mortgage (if you still itemize), you have mortgage interest, you may have tax credits for your minor children, you have education expenses that can be deductible, and if you have a 401(k) you have retirement contributions that you are also currently deducting from your gross taxable income, so you have many deductions that reduce your otherwise taxable income. If you own a business, you have additional deductions.

When you retire, you hopefully have paid off your mortgage, your children are grown and their educations are completed and you have ceased all retirement contributions. You have planned appropriately, so you should be able to maintain the same relative lifestyle you had during your working life. No one sets out and plans to intentionally reduce their standard of living significantly in their retirement years. So, when you lose all of your previous deductions, and you maintain a somewhat stable level of income in your post retirement years, the logic that you will be in a reduced tax bracket does not ring true. What is true, when analyzing the numbers side by side between what you saved in taxes from all the years you deferred income into your 401(k) and what you will pay in taxes during retirement, when you can least afford it, on all the money you socked away PLUS all the investment gains it earned over a thirty-year period is that there is no comparison – it is not even close! Most Americans would be shocked to learn that you will get back all of your tax savings within your first several retirement years and then you will continue to live with this tax mistake for the rest of your life by paying regular income tax rates on every retirement withdrawal you take until you completely exhaust and deplete your retirement account. Let me be clear here as many people often confuse long term capital gains rates and ordinary income tax rates.

Every single penny of your 401(k) retirement account and your Traditional IRA account is subject to taxation

at *ordinary income rates* (the highest tax rate in America), *as if you earned* that money in the year of your withdrawal from an employer. The lower long-term capital gain rates do not apply to qualified retirement accounts. Adding insult to injury, your fully taxable retirement income actually makes your social security benefits taxable and increases your Medicare Part B costs, thereby magnifying and multiplying your tax mistake on each part of your retirement plan.

Fallacy regarding the Advantages of Pre-Tax Wealth Accumulation

After Tax Investment Compounding		Pre Tax Investment Compounding	
10,000 / year		10,000 / year	
Pay Tax on 10,000 at 25%		Pay Tax Later at Withdrawal	
Net $7,500		Net Investment $10,000	
Invested at 5% Annual Return		Invested at 5% Annual Return	
25 Years		25 Years	
5% Annual Return		5% Annual Return	
$7,500 Net of Tax Invested Per Year		$10,000 Gross (Pre-Tax) Investment Per Year	
Future Value Tax Free:	$ 383,351	Future Value Fully Taxable:	$ 511,135
		Pre-Tax Distributions over 25 Years	$ 20,445
After Tax Distrib - 25 Yrs	$ 15,334	AFTER 25% Tax Distributions:	$ 15,334

Many believe that there is some kind of magic sauce around pre-tax wealth building. They have seen financial firms show the higher balances of the pre-tax account versus an after-tax account and they are led to believe that the bigger balance is theirs' for the keeping. What these comparisons never show is what happens once you apply the tax withdrawal – which is clear.

THE MATH DOES NOT LIE – When comparing pre-tax to after-tax investments, as long as the RATE OF RETURN and the TAX RATE are exactly the same throughout the time period compared, then there is no benefit to deferring tax payments until later. The net upfront difference in earnings is leveled back to zero since taxes are collected on the higher balance and taxes are NOT charged on the growth of the after-tax earnings. However, if taxes go up, then investing after-tax dollars which are NEVER taxed again will handedly beat the pre-tax account. Weighing the options, we have no difference versus the potential to devastate your wealth and retirement plan. The WINNER is CLEAR – after-tax wealth building is the way to go!

TAX TRICK OR GOVERNMENT BAIT & SWITCH

THE TAX BAIT & SWITCH OF "QUALIFIED" PLANS

Save Tax Now on Contribution

Pay Tax Later on BOTH your original savings & all its GROWTH!

Government Bait & Switch

We are all led to believe that TAX DEFERRAL = TAX ADVANTAGE in the Traditional Retirement Planning world of 401ks and IRAs but nothing is further from the truth. Taxes deferred during your working years MUST BE PAID when you withdrawal the money in retirement, subjecting your hard earned retirement balance to whatever tax rate the Government has in effect at that point in time! And just, where are tax rates headed?

QUALIFIED PLAN MEANS

Uncle Sam is

your Retirement Plan's

Silent Partner!

Government is your Retirement Partner

Using "QUALIFIED" plans as your retirement strategy is setting you up to keep Uncle Sam involved in your financial picture for the rest of your life and it means you won't really know how much income you will have since the government can change tax rates at any time.

THE WORST PART ...

59%

Average TOP Marginal Tax Rate from 1913-2013

401(k) – WAIT, It Gets Worse!

53% of Americans don't have a 401(k) account, the 3% average Employer Match is the lowest in the advanced world, and of those that do invest, most do not put aside nearly enough to fund the retirement lifestyle they want while many access their funds well before retirement –

There are two reasons that combine to form the PERFECT STORM that consumes most American's 401(k) retirement income way before their twilight retirement years! First, most Americans do NOT save nearly enough to provide income for their lifetimes and second, given the increased life expectancy associated with modern medicine combined with the underestimated impact of income taxes on your retirement balance, your retirement money will erode exponentially more rapidly than expected! In the April 2018 Financial Planning Association's Professional User's Guide of Money magazine, there is an article titled, "5 Secrets to a Richer Retirement" which boasts that the number of 401(k)s with a million dollar or more balance has doubled over the last 2 years! While the article touts what the top savers have done to achieve such a "great" accomplishment, I am more concerned about what the article means for the rest of the 401(k) savers... since **less than 1% of the 52 million 401(k) holders have reached the million dollar mark.** Fidelity Investments, one of the largest 401(k) plan providers, reports 72,000 have million dollar plus accounts. If less than 1% have reached that mark, more than 99% have not. When you consider that, based on actuarial methodology, you should save at least 10 to 12 times your peak salary level in your retirement account, and some advisors recommend as much as 20 times, you can see how short America is on saving... Using all available Census Bureau data, the peak median earnings for Americans is $79,550 and occurs between 45 and 54 years of age. If you take that $80k and multiple it by 10, it suggests that *median American should have a minimum of $800,000 in their 401(k) on the low side.* Yet, the average Fidelity account balance was a meager **$91,300** at the end of 2017.

Let's take the goal of $1M in your 401(k) by retirement. If you start saving at age 30, you would need to save $14,980 each year until retirement. Starting at age 40, you would need to max out your 401(k) contribution at the current level of $18,500 and contribute an additional $5,560 in a taxable savings vehicle, and do that each year until retirement. If you started at age 50, you would need to save $24,500 in your 401(k) each year, making use of the catch-up provisions, and then save an additional $16,340 in a taxable savings vehicle, meaning you would need to put aside a total of $40,840 each year until you retire. *This assumes no market losses and consistent growth at a minimum of 4% annually.

Now that we have figured how to save $1M starting at 30, 40, and 50 years of age, what will that mean in annual income during retirement?

Well, you need to understand that in order for your million to last for the long run, you will have to take very low withdrawal rates. If you limit your withdrawals to only $30,000 each year, you have a 93% chance that your $1M will last you 30 years. But, if you take $40,000 each year, you only have a 69% chance that your $1M will last you 30 years. Combining this $40,000 annual withdrawal amount with your projected social security will provide for around $67,000 in total annual income. Enough for some, but far too little for many Americans. If your pre-retirement income exceeded $200,000 annually, you need to put away 15.5 times your income and shoot for $3M. So, not only are over 99% of Americans not reaching the $1M threshold, even if they did, that retirement balance, combined with their projected social security payments, will NOT afford them the retirement income they desire!

But, there are other issues making the 401(k) fall short besides just not saving enough! A recent employee benefits research study found that of 401(k) participants that earn over $100,000, 28% took loans against their account, 7% took hardship withdrawals, and 42% cashed out their plan when switching jobs. These actions resulted in total retirement income losses of 10%, 7%, and 27%, respectively.

And sadly, there is an approaching storm that will have far reaching implications for our public infrastructure, our extended family units and our society as a whole... The retirement of the Baby Boomer Generation will prove to be the greatest retirement crisis in the history of the world, according to Fortune magazine's Ted Siedle, in his March 2013 article, "The Greatest Retirement Crisis in American History," where the boomers will either be too poor to retire or too frail to work and will slip into poverty. Also, see Rebecca Walser's article, "The Coming Collapse To Social Security As We Know It" published on Fox Business, December 27th, 2018.

WEALTH UNBROKEN

"Arguably the most highly touted 401(k) plan attribute is the pre-tax treatment of invested cash flows... However, before blindly accepting the premise that pre-tax investing is a big investment advantage for you, keep in mind that when you withdrawal your money from your 401(k) plan, the entire amount that is withdrawn will be taxed at your personal income tax level. In retrospect, this may be a material disadvantage to you... Since these gains will be taxed as income under a 401(k) plan structure, your perceived pre-tax advantage on the front end will be offset to a certain degree by the tax disadvantage on the back end. Assessing tax implications is a very difficult endeavor, because your tax status may change over time, and the tax laws may change over time as well... Therefore, what looks like a good deal today, may very well be a bad deal tomorrow. Given all of the uncertainties associated with taxes, you probably should not base your decision to contribute to your 401(K) plan by taking into account any type of perceived tax benefits."

– Troy Adkins, *6 Problems with 401k Plans*, Investopedia, January 24, 2014

Read more: **http://www.investopedia.com/articles/retirement/11/6-problems-with-401k-plans.asp#ixzz3Y9LdXBmd**

SundayReview | OPINION

Our Ridiculous Approach to Retirement

By TERESA GHILARDUCCI

I WORK on retirement policy, so friends often want to talk about their own retirement plans and prospects. While I am happy to have these conversations, my friends usually walk away feeling worse — for good reason.

Seventy-five percent of Americans nearing retirement age in 2010 had less than $30,000 in their retirement accounts. The specter of downward mobility in retirement is a looming reality for both middle- and higher-income workers. Almost half of middle-class workers, 49 percent, will be poor or near poor in retirement, living on a food budget of about $5 a day.

In my ad hoc retirement talks, I repeatedly hear about the "guy." This is a for-profit investment adviser, often described as, "I have this guy who is pretty good, he always

> "Our national demographics, coupled with indisputable glaringly insufficient retirement savings and human physiology, suggest that a catastrophic outcome for at least a significant percentage of our elderly population is inevitable." [emphasis added] "The specter of downward mobility in retirement is a looming reality for both middle- and higher-income workers. Almost half of middle-class workers, 49 percent, will be poor or near poor in retirement, living on a food budget of about $5 a day... It is now more than 30 years since the 401(k)/Individual Retirement Account model appeared on the scene. This do-it-yourself pension system has failed. It has failed because it expects individuals without investment expertise to reap the same results as professional investors and money managers. What results would you expect if you were asked to pull your own teeth or do your own electrical wiring?"

– Teresa Ghilarducci,
"Our Ridiculous Approach to Retirement",
New York Times, July 21, 2012

The 401(k) Equals Retirement Failure (For Majority of Users)

The 401(k) fails to provide the secure retirement Americans want and deserve:

It was NOT designed nor intended to be the primary retirement vehicle for America. It does NOT have STABLE RETURNS because it is subject to severe market volatility over time. It is NOT TAX ADVANTAGED because it is 100% FULLY TAXABLE in retirement. It is FULLY TAXABLE at the highest rate in America upon withdrawal. It has little to no LIQUIDITY because it is subject to access restrictions and penalties.

The 401(k) is the WRONG Strategy for securing your retirement. Is it time for you to kick it to the curb?