

Employee Costs and Risks in 401(k) Plans

The rapid growth of employer-sponsored 401(k) plans has been facilitated, in part, by the many advantages offered to participants. However, employees also may encounter many costs and risks in attempting to maximize their account balances over the course of participating in a plan.

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Among the most important investment decisions made by many American workers is whether to contribute toward retirement through a 401(k) plan. According to the nonprofit Employee Benefit Research Institute, 55 million U.S. workers are enrolled in 401(k) plans totaling \$1.5 trillion, with an average account balance of almost \$50,000.¹ These plans offer employees a number of opportunities, including tax advantages, company matches to employee contributions, portability, and loans and withdrawals from account balances. At the same time, experts in pension issues have identified certain costs and risks that employees face when participating in employer-sponsored 401(k) retirement plans.

Costs occur when employees' pre-tax contributions, company matching contributions, or account growth are delayed because of participation or eligibility requirements. They also occur when employees do not contribute enough to receive maximum matching company contributions or when account loans or withdrawal options are exercised. In addition, they occur when record-keeping costs are high. Investment risk—including market, inflation, interest rate, and credit risks—may be higher than average because of a lack of investment education and experi-

ence. The consulting firm, Ernst and Young, considers employee investment education a must in dealing with prolonged stock market declines.² Another risk involves the lack of investment diversification. A House Democratic Committee analysis noted that 401(k) plans are not held to the same type of diversification requirements as are traditional defined benefit pension plans.³ In addition, the form of distribution of account balances can create or extend risks for 401(k) plan retirees. This article reviews the features of 401(k) plans, the inherent costs and investment risks associated with such plans, and the incentives used to encourage employee contributions.

401(k) plans

Section 401(k) was added to the Internal Revenue Code in 1978, enabling employees to place a portion of their before-tax salaries into employer-sponsored retirement savings plans. A 401(k) plan is a type of defined contribution retirement plan whereby employees contribute their own money to the plan and usually determine how the funds are invested.⁴ Employee contributions may be matched by the employer. Under defined contribution plans, the employee bears the investment risk. Favorable investment results increase future benefits, while poor re-

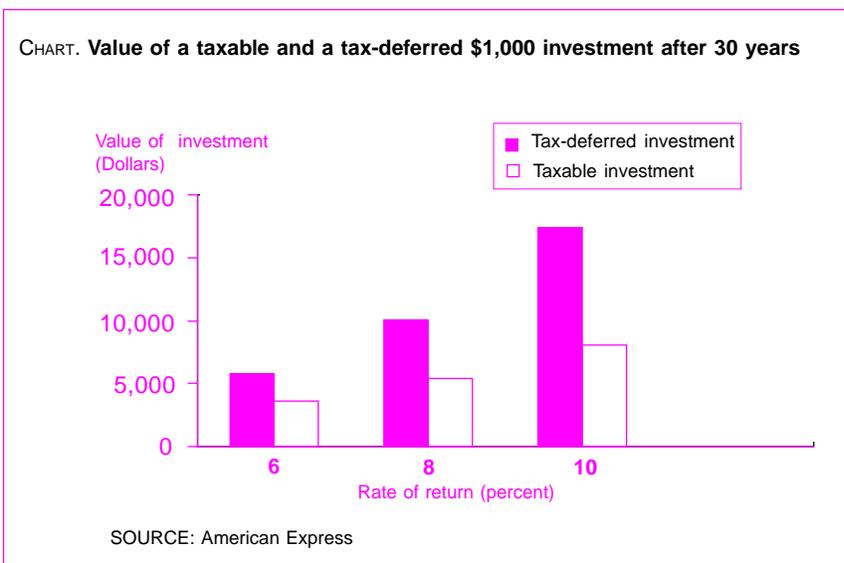
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sults reduce benefits. (In contrast, employer-sponsored defined benefit pension plans are those in which the company makes contributions, and a predetermined formula—usually tied to the employee's earnings or length of service, or both—establishes the retirement benefit. Therefore, in a defined benefit plan, the employer accepts the risk of providing the participant's future benefits.)

Features of 401(k) plans

Tax deferred status. Investment earnings from 401(k) plans are not subject to Federal income taxes until the funds are withdrawn from the account.⁵ Generally, employees' contributions also are made on a pretax basis, thereby reducing their current income tax. The tax deferral status of 401(k) accounts facilitates faster growth of the account balance.⁶ The advantage of tax-deferred growth in a 401(k) plan is shown in the accompanying chart. At a 10-percent rate of return, a tax-deferred investment of \$1,000 over 30 years would return more than twice as much as a taxable investment.

Employer matching funds. Some employers provide matching contributions as an employee benefit and as an incentive to encourage their employees to participate.⁷ The employer contributes a certain amount to the participant's account (usually between 25 cents and \$1) for each dollar the employee contributes, up to a specified limit. Data from the Bureau's 1997 Employee Benefits Survey (EBS) of medium and large private establishments showed that, in plans with specified employer matching rates, 42 percent of participants had their contributions of less than 6 percent of earnings (typically 3 to 5 percent) matched by employers. Another 48 percent were in plans in which the employer matched 6 percent of earnings. The most common rate of employer match (applicable to 47 percent of participants) was 50 cents for each dollar contributed by the employee. Other common employer matching rates were either less than 50 cents for each employer dollar contri-



bution (23 percent of participants) or dollar for dollar of employee contribution (15 percent of participants).

Investment choices. Most participants in 401(k) plans can choose, within certain limits, how to invest their own contributions. According to the EBS, 86 percent of employees participating in 401(k) plans in 1997 were permitted some choice in their investments. Investment options included company stock, common stock funds, guaranteed investment contracts, government securities (such as U.S. Treasury bills and U.S. savings bonds), money market funds, and corporate bonds. The number of choices in these plans varied from 2 to 10 or more, with the most common being 4 choices (21 percent of participants). Employees usually are allowed to split their contributions among the various options—typically in multiples of 10 or 25 percent. For example, a participant may choose to invest 50 percent in company stock and 50 percent in government securities. Also, plans often permit participants to change their investment choices periodically, most commonly four times per year. In 1997, 65 percent of 401(k) plan participants also were permitted a choice of investments for their employer's contributions. In most cases, however, employees had less of a choice in how employer contributions were invested than they did in how their

own contributions were invested. Where no choice was allowed, the plan typically specified that the matching contribution be invested in company stock.

Portability. If the participant changes employers, plan funds can be rolled over or transferred into an Individual Retirement Account (IRA) or another employer's qualified retirement plan. The participant is not liable for income taxes due to the transfer; taxes still are deferred.

Loans and withdrawals. Many plans allow participants to access their account balances before retirement. Generally, loans on 401(k) accounts are paid back with interest (at a fixed rate determined at the time of the loan) through after-tax payroll deductions. Data from the 1997 EBS show that 51 percent of 401(k) participants were eligible for loans from their plans. In addition, 33 percent of 401(k) plan participants were able to take penalty-free hardship withdrawals for the death or illness of a family member, educational expenses, sudden uninsured losses, or the need to prevent eviction from the employee's primary residence. If funds are withdrawn, they are taxable in the year of receipt, although hardship provisions allow the participant to avoid any penalties that might otherwise be imposed because funds were received

prior to retirement age.

Distribution options. At retirement, 401(k) plans commonly (91 percent in 1997) allow for a lump-sum payment. Many participants can choose from among a lump sum and other options, such as a lifetime annuity or installments over a specified period.

Costs and investment risks

Besides the advantages offered by participation in a 401(k) plan, employees also may encounter certain costs and investment risks. Eligibility requirements, discretionary employee contributions, and matching company funds all can cause an employee to incur costs. In addition, investment risks, diversification or lack thereof, high record-keeping costs, the exercise of loan and withdrawal options, and fund distribution choices all can affect the level of an employee's retirement benefits.

Eligibility requirements. Minimum service requirements frequently are imposed on new participants in 401(k) plans. In 1997, 76 percent of full-time employees in medium and large private establishments participating in 401(k) plans had a minimum service requirement (for 53 percent, this requirement was 1 year of service). Plans with minimum service requirements impose a cost on workers by delaying the accrual of benefits. For example, investing \$300 per month for 30 years with a 6-percent compounded annual return would result in an account balance of \$301,355. However, a 1-year minimum service requirement would reduce the number of years to 29 and the final account balance to \$280,362.

Maximizing discretionary employee contributions and the employer match.

Another potential cost occurs with 401(k) retirement plans when the participant does not make sufficient discretionary contributions to achieve the maximum employer matching contribution. Furthermore, because 401(k) plans typically are only partially funded by the employer, the discretionary savings

of participants should be maximized to better fund the employee's retirement. For example, if a participant contributes \$200 per month into a plan with a 50-percent employer matching contribution, the account would total \$301,355 after 30 years, assuming a 6-percent compounded annual rate of return. If, on the other hand, the employee contribution is \$100 per month with the same 50-percent employer match, the value of the account would be \$150,677.

Investment risk. Investment of 401(k) funds, like all other investments, involves financial risk in order to achieve returns. Generally, the more risk associated with a particular investment, the greater its potential for higher returns. The possibility that an investment will return less than expected is referred to as investment risk. The most common forms of investment risk are market, inflation, interest rate, and credit risk:

- **Market risk** generally can be defined as the possibility that decreases in the market price of an investment will result in a loss of principal for an investor. There are market risks on the macro level, such as the ups and downs associated with the stock market. On a micro level, market risk is present if employer stock is used to fund a 401(k) account. The value of the account may fluctuate in response to the financial prospects of the employer.
- The rising cost of goods and services over time can pose an *inflation risk* to 401(k) investors. Although investments with fixed or guaranteed interest rates, such as bonds or certificates of deposit, provide protection from market risk, such investments are subject to inflation risk because the fixed rate may not keep pace with rising prices over time.
- **Interest rate risk** can occur when an increase in the general level of interest rates causes the value

of existing investments to fall. Usually the risk applies to bonds and other debt-type instruments, the prices of which move contrary to interest rates. As interest rates rise, bond prices tend to drop.

- **Credit risk**, also known as default risk, is the possibility that the issuer of a bond or other debt-type instrument will not be able to complete its contractual obligations.⁸

To manage the financial risks inherent in 401(k) investments, employers have accelerated investment education efforts. Hewitt Associates, a human resource consulting firm, found that 86 percent of surveyed employers either have programs to educate employees in 401(k) investing, or are planning to implement such a program in the coming year.⁹ IOMA's report on managing 401(k) plans predicts that employers will use an upsurge in 401(k) plan technology to inform and educate participants with personalized services and features.¹⁰ Personalized rates of return establish participants' level of risk tolerance, and then suggest what portion of their accounts should be invested in specific funds such as growth, value fixed income, or other retirement options.¹¹

According to Hewitt Associates, 20 percent of employers are now using the Internet to educate employees and establish and maintain 401(k) plans.¹² Products such as Fidelity's web-based e-401(k) program for firms with fewer than 50 employees offer multiple mutual fund options, along with comprehensive low-cost record-keeping services to employers. One service firm has recently introduced a business-to-business web service allowing employers with 401(k) plans to collect bids, without being charged, from up to 15 service providers of their choice. Within 5 business days of using the service, the employer receives price quote summaries comparing bids from the first 10 providers to respond. Moreover, new software products are being

developed to allow small businesses to administer a 401(k) plan in-house.

Employers also are using various other methods to educate 401(k) investors. Personalized features gaining acceptance are: (1) Automatic account rebalancing, which maintains each participant's asset allocations in line with his or her original portfolio design; and, (2) self-directed brokerage accounts. In addition, more companies are offering individual and group financial planning seminars. Hewitt Associates found that, in 1997, almost twice as many employers offered one-on-one planning (41 percent) as had done so in 1995 (21 percent). Seminars also are becoming a more common way for employers to educate plan participants (85 percent in 1997 versus 77 percent in 1995).¹³ One large pharmaceutical firm, for example, offers 401(k) participants investment advice from Ernst & Young through the company cafeteria plan.¹⁴

Diversification choices. According to a 1999 survey by the consulting firm Towers Perrin, "39 percent of 401(k) participants are unaware of how their plan assets are allocated."¹⁵ One consequence of this passive account management is a lack of diversification in 401(k) plan investments. Investment diversification is important because it helps offset the risks unique to one type of investment by simultaneously spreading account funds among other types of investments. For example, the greater risk and volatility associated with investment in a stock fund can be minimized by also placing money in less risky money market or bond funds.

To achieve a well-diversified 401(k) portfolio requires account flexibility and an adequate number of investment choices. Employees may not always have sufficient investment options or the ability to transfer funds among investment offerings. Increasingly, em-

ployers are responding to the lack of diversification of 401(k) assets by offering more investment options and greater power for employees to move funds between accounts. According to Hewitt Associates, 401(k) participants had an average of 8 investment options to choose from in 1997, up from 6.3 in 1995 and 4.5 in 1993.¹⁶ Employees also have more opportunities to transfer 401(k) money between accounts. Hewitt reports that, in 1997, 64 percent of 401(k) participants were allowed to transfer existing balances among investment funds on a daily basis, up from 41 percent in 1995.

High record-keeping costs. Most 401(k) plans are subject to record-keeping and administrative costs. These charges can run as much as \$75 annually per account. *The Wall Street Journal* reports that 401(k) investment fees paid by employees ranged from 0.53 to 2.56 percent of plan assets. Assuming annual returns of 10 percent, the higher cost plans produce a cost by reducing total expected returns by up to 25 percent.¹⁷

Withdrawal and loan options. Participants in 401(k) plans may be allowed to withdraw all or a portion of their account funds prior to normal payout (usually at retirement). Besides the costs imposed by early withdrawals, tax penalties are imposed if the withdrawal is not for hardship purposes. Thus, the employee typically is liable for income taxes on the amount withdrawn, plus a tax penalty. In the case of a hardship withdrawal, the withdrawn amount is taxable, but no penalty is assessed.

Many 401(k) plans have loan provisions allowing employees to avoid tax penalties by borrowing from their accounts, with interest, for a specified period. However, as with taxable withdrawals, loans taken against 401(k) balances result in the cost of lost appre-

ciation of the account balance. To illustrate, taking a \$5,000 loan on a 401(k) balance of \$10,000 with an annual compounded return of 6 percent results in a reduction in the total account balance from \$57,435 to \$28,717 after 30 years (assuming that the loan is not repaid).

Distribution choices. Depending upon the distribution method selected, 401(k) participants may incur the risk of negative tax consequences. At retirement, employees usually can request that their 401(k) funds be paid out in the form of a lump sum, a lifetime annuity, or installments over a specified period. Choosing a lump-sum distribution would require the employee to pay taxes on the entire sum as if it were income for that particular year. Receiving a lifetime annuity or installments would spread the income tax owed over a period of years, thus reducing the impact of the tax consequences. Choosing a lump-sum distribution also may result in the participant exhausting his or her 401(k) funds early in retirement. An annuity or installments would distribute payments over the retiree's lifetime.

Summary

The rapid growth of employer-sponsored 401(k) retirement plans has, in part, been facilitated by the many advantageous features offered to participants. Tax advantages, portability, the availability of loans and withdrawals and the choice of distribution options have encouraged employee enrollment in 401(k) plans. However, employees also encounter various investment risks and costs in their attempt to maximize account balances. Ultimately, it is mainly the employee who is responsible for minimizing the investment risks and costs associated with employer-sponsored 401(k) retirement plans. ■

¹ "Average 401(k) Balance Grew 26% From 1996-1998," *Employee Benefit Research Institute News Release*, Jan. 20, 2000, pp. 1-3.

² William J. Arnone, *Personal Financial Planning: The 401(k) Time Bomb*, on the Internet at <http://www.bcsolutionsmag.com/401TIMEB.htm> (visited Oct. 21, 1999).

³ U. S. House Democratic Leadership, "Pension Security: How Safe are 401(k) Plans?" on the Internet at <http://www.house.gov/democrats/401k.htm/> (visited Oct. 21, 1999).

⁴ The Bureau's Employee Benefits Survey classifies defined contribution retirement plans into savings and thrift plans, deferred profit-sharing plans, money purchase pension plans, employee stock ownership plans, and stock bonus plans. A frequently encountered feature of some defined contribution plans is a 401(k) cash or deferred arrangement allowing participants to choose between receiving currently taxable income or deferring taxation by placing the money in a retirement account. The plans usually take the form of either salary reduction or deferrals of profit-sharing allocations. Salary reduction plans allow employees to contribute a part of their pretax earnings to a retirement plan, and defer in-

come taxes on those contributions and their earnings until distribution. Savings and thrift plans are the most common salary reduction vehicle. Deferrals of profit sharing give employees the choice of receiving an employer's profit-sharing contribution immediately in cash, or deferring the contribution and postponing taxation until distribution; such arrangements are not common.

⁵ This is usually also true for State and local taxes.

⁶ "Benefits of a 401(k) Plan—The Advantages of Tax-Deferred Growth," American Express Retirement Services, Jan. 19, 2000, on the Internet at <http://www10.americanexpress.com/sif/cda/page/0,1641,1255,00.asp> (visited Mar. 3, 2000).

⁷ This article frames the discussion of employee risk in 401(k) plans in terms of the private sector. However, these plans also are offered to Federal, State, and local government employees.

⁸ Definition of risks is taken from "Types of Investment Risk," Klaers & Associates, Mar. 2, 2000, pp. 1-3, on the Internet at <http://users.inetech.com/ka/docs/investmentrisk.html> (visited Mar. 5, 2000).

⁹ "Hewitt 401(k) Survey Shows Employers are Offering More Investment Options, Plus Education to Help Employees Save for Retirement," *Hewitt Newstand*, Feb. 12, 1998, pp. 1-3.

¹⁰ "What the Year 2000 Will Mean For 401(k) Plan Sponsors," *IOMA's Report on Managing 401(k) Plans*, February 2000, p. 4. IOMA is a monthly publication of the Institute of Management and Administration, Inc.

¹¹ *Ibid.*, pp. 4-5.

¹² "Hewitt 401(k) Survey," pp. 1-3.

¹³ *Ibid.*, p. 3.

¹⁴ "What The Year 2000 Will Mean," p. 7.

¹⁵ Towers Perrin, "Your 401(k) Plan," July 14, 1999, on the Internet at <http://abcnews.go.com/sections/business/Finance/401kplans980714.html> (visited Mar. 7, 2000).

¹⁶ "Hewitt 401(k) Survey," pp. 1-2.

¹⁷ *The Wall Street Journal* as cited by John P. Greany in "Are You Getting the Shaft in Your 401(k)?" *The Retire Early Home Page*, July 1, 1999, on the Internet at <http://www.geocities.com/WallStreet/8257/shaft2.html> (visited Mar. 10, 2000).

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