Making the Most of Your 401(k)

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Although it appears more Americans are taking an interest in their retirement planning, many workers aren't taking full advantage of their companies' 401(k) plans. And those who are contributing to a 401(k) could be making better investment decisions.

According to a recent study by Hewitt Associates, a global human resources services firm, 70 percent of workers eligible to participate in their company's 401(k) plan did so during 2004. While this is a modest improvement from the firm's last study conducted in 2002, the rate of participation among young workers is discouraging, with only 46 percent of workers under the age of 30 participating in a 401(k) plan. Of those participating, about one in four had a total balance of less than $5,000.

While not participating in your company's 401(k) is a big mistake, those who are eligible and participating are making some mistakes of their own. Many employers match at least a portion of what their workers are investing in retirement plans. So if you're not contributing enough to receive your employer's full matching, you're essentially walking away from free money. Hewitt's study found that about one in five employees are not contributing enough to obtain a full company match, while one in three are contributing just enough to receive the match. In many cases, that can be about three or four percent of an individual's pay – which might not be enough to meet the financial security many are hoping for in retirement.

Asset allocation is another key to making the most of your 401(k). It's important to diversify your holdings, making sure that you have a mix of international stocks, small- and large-company stocks, and bonds. According to the Hewitt study, employees' diversification efforts are improving, but many still invest a great deal into company stock. Study results show that about 27 percent of employees held half or more of their total 401(k) balances in their employer's stock. This is concerning because it implies that many employees do not realize the implications of having a big portion of their retirement savings tied to the future of the same company that pays their salary and provides their benefits. For example, if the company were to experience lay-offs or other difficulties, not only could workers' income be affected, but their retirement investments could suffer as well.

In order to make sure asset allocations stay on track with investment goals, workers also need to be aware of the importance of rebalancing their portfolios each year to keep up with cycles in the investment market. Successful asset allocation strategies also involve evaluating financial goals when major events – such as getting married or having a child – impact your life. In 2004, only about 17 percent of workers made a transfer within their 401(k) account.

Your retirement fund will also warrant some attention if you decide to change jobs. Even if your old employer will continue to manage the 401(k) you started with them, it's usually better to roll over your retirement money into your individual retirement account (IRA). Additionally, when you make the move, make sure the money goes directly from one account to the other to avoid early distribution penalties.

While managing a 401(k) may sound intimidating, it really involves two simple components: assessing your goals and reevaluating those goals regularly. And when it comes to 401(k) plans, the old saying "time is money" really does apply. The sooner you start investing, or making changes to your investing habits, the more time your retirement savings have to grow.

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