WHAT ARE THE ADVANTAGES OF A 401(K)?

Financial planners often speak of there being a three-legged stool for funding retirement: government-provided benefits, employer-provided benefits and personal savings. But with Social Security's future in doubt and pension plans going the way of the dodo bird, it's a good idea to depend on your own resources as much as possible.

One of the best ways for you to save toward your own retirement and ensure your future security is through an employer-sponsored 401(k) plan. If you don't participate, you're missing a golden opportunity to save for retirement while lowering your tax burden on those savings.

Some of the features offered by many 401(k) plans include:

MATCHING CONTRIBUTION

Many employers will match a portion of your savings. It's like passing up free money if you don't participate. A common match might be 50 percent of the first 6 percent of pay you save. Under that scenario, someone whose annual salary is $35,000 and who contributes 6 percent to the plan ($2,100) would receive an additional $1,050 in matching employer contributions. It's pretty hard to find a 50 percent return on any investment. Even if your employer doesn't offer matching contributions, the tax advantages of a 401(k) still make this one of the best ways to save money for retirement.

TAX-DEFERRED EARNINGS

When you contribute a percentage of your pay to a 401(k) plan, you immediately start paying less to Uncle Sam. That's because your contribution comes out of your paycheck before income taxes are deducted. That means your taxable income is less, which in turn lowers your tax bill. Thus, you "defer" or postpone paying income tax on your 401(k) savings and any investment earnings they may accumulate until you withdraw the money at retirement. For many people, their income – and therefore income tax rate – is lower at retirement, so they're paying a smaller amount of tax on the money. Plus, if you happen to retire to a state that has no or very low state income tax, you'll be that much further ahead.

INVESTMENT OPTIONS

Most 401(k) plans provide a variety of investment vehicles from which you may choose. Typical investment choices might include:

- Money market funds
- Stable value accounts, including guaranteed investment contracts (GICs) or bank deposit accounts
- Bond mutual funds
- Stock mutual funds
- Your own company's stock

Each type of investment offers varying degrees of risk and reward potential. For example, money market funds and stable value accounts have very low risk, since they're often invested in certificates of deposit (CDs) or U.S. Treasury securities; however their earnings potential is much lower than other types of investments and they don't always keep pace with inflation. Stocks and bonds have a higher risk for loss of value, but they also have the potential to earn much more, especially over long periods of time.

Typically, you can mix and match your account balance among the different options available. Check your plan documents to see if there are any restrictions on when or how often you can request changes. With many plans, these kinds of changes can be done online, at your convenience.

Your tolerance for risk will vary, depending on your age, how early you begin saving for retirement, and other factors. Speak to a financial advisor who can help you analyze your 401(k) investment options and determine the right mix for your situation.

Many financial professionals advise against investing more than 10 percent of your account in your own company's stock, as a precaution against poor stock performance.

These examples assume that you only invest $5,000 a year for 10 years and then stop. If you were to contribute that amount consistently from ages 25 to 65, you would amass more than $1.35 million during those 40 years. And, remember, these estimates don't even factor in employer- matching contributions, which would make your account grow even larger – and faster.

TIMING IS EVERYTHING

The sooner you start saving for retirement, the faster your account will grow. Conversely, the longer you wait to get started, the harder it will be to catch up. Some experts say that for every five years you delay getting started; you may need to double the amount you must save each month to reach the same level of income at retirement.

Here's a hypothetical example: Say you contributed $5,000 a year to a 401(k) for 10 years – assume that your investment earned 8 percent a year and all investment earnings were reinvested in your account. Depending on how old you were when you made those contributions, you would see wildly different amounts at age 65 when you retire:

- If you started saving at age 25, stopping at age 35, when you retire at 65 your account would be worth about $787,000.
- If you started saving at age 35, stopping at age 45, it would be worth about $364,000.
- If you started at age 45 and stopped at age 55, its value would be only about $170,000.
- And, if you waited to start saving until age 55 and contributed until age 65, you'd only amass about $78,000.

LOANS

Many plans allow you to borrow from your account for specific reasons, such as buying a primary residence, paying for education or medical expenses, or in case of severe economic hardship. A loan usually must be paid back with interest within five years (although this may be extended for a home purchase), and as long as you remain employed by the company, you can pay it back without incurring any income tax liability. The interest you pay goes directly into your account.

Please note, however, that if you leave the company, you will be required to pay back the entire loan amount within 30 days, or face paying income tax on the unpaid loan amount as well as a 10 percent early distribution penalty if you're under age 59 ½. Be sure to read your plan documents carefully before taking a loan from your account

CONVENIENCE

Many people find that having money automatically deducted from their pay each month is more conducive to saving than relying on themselves to remember to put money aside.

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