

Your 401(k) Plan Stinks: 3 Ways to Make the Best of a Bad Situation

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We see a number of changes physicians might make to improve their financial security, but 1 item is usually beyond their control: the 401(k) plan. Unless you are self-employed, there is practically nothing you can do about your 401(k)'s underwhelming investment options, ridiculously low contribution limits, or perverse tax consequences.

If your 401(k) is your main (or maybe your only) investment vehicle for retirement, we have good news for you: It is possible to work around your 401(k) plan's limitations so you can get back on track toward retirement.

Low Limits

Many physicians operate under the mistaken belief that, if they max out their 401(k) plan contributions, they will be all set for retirement. But did you know that the maximum amount of money you can elect to defer into your 401(k) this year is only \$17,500 (\$23,000 if you will be aged 50 years or older by December 31)? That's roughly \$1400 deducted from your paycheck each month (\$1900 per month if you are aged 50 years or older).

Have you ever met a physician who could live well on \$1400 a month? We haven't. In fact, the physicians we serve are planning to spend more like \$10,000 per month

in retirement, and that's after-tax. It would take a miraculously high rate of return to turn \$1400 per month pre-tax into \$10,000 per month after-tax, so many physicians are well on their way to a retirement disaster.

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To improve your odds of reaching your retirement goal, you can save outside your 401(k) plan. Even if you cannot deduct the contributions you make to a traditional IRA, you can still contribute \$5500 this year (\$6500 if you will be aged 50 years or older by December 31), and if you max out your own IRA, your spouse can also contribute up to \$5500 to his or her IRA (\$6500 if he or she will be aged 50 years or older by December 31) even if he or she is not earning an income. Depending upon your tax situation, it might also make sense to convert these contributions to a Roth IRA, doing what is known as a "backdoor" Roth IRA contribution. Once the money is in a Roth IRA, it can grow tax-free for

the rest of your life. Of course, this still might not be enough to allow you to retire comfortably, so you should consider investments outside of your 401(k) plan and IRAs.

Underwhelming Options

You probably haven't read the fine print behind your 401(k) plan, but you are betting that your practice manager has carefully vetted both your 401(k) plan provider and the investments offered inside your plan. Don't believe it! We have found that busy managers may lack the time or expertise to make well-informed decisions regarding investment-related fees or available investment options. If your plan charges more than 50 basis points (0.50%) on top of mutual fund operating expenses, your plan's costs are draining an unfair share of your retirement savings. To get this under control, you need to raise your voice, but be careful. We regularly see very expensive plans that persist simply because of office politics.

It's more common to see an investment lineup consisting mostly, if not entirely, of actively managed mutual funds. This is a sign of ignorance on the part of your plan fiduciaries. At a time when most prudent investors recognize that passively managed index funds have been shown to have delivered better results at a lower cost than the average actively managed fund, there's no good reason that your plan should continue to limit you to subpar investment options.

To work around these issues, look at your retirement investments holistically. Think about your 401(k) plan, your traditional IRAs, and your after-tax accounts (mutual funds and brokerage accounts) as if they were

all 1 “retirement portfolio.” Then use the least-bad investment options from your 401(k) and pair them with the best options available within other accounts that make up the balance of your portfolio.

Tax Time Bomb

You already know that physicians pay more than their fair share of taxes. But did you know that you are probably setting yourself up to pay more taxes on your 401(k) than you really should? That’s right. There’s a perverse little wrinkle in the tax code that can turn your 401(k) plan into a tax time bomb.

To understand this trap, you need to know a little bit about how investments are taxed. Withdrawals from your 401(k) plan will be taxed at your marginal income tax rate, which may be as high as 39.6% for federal income tax. At the same time, capital gains and qualified dividends from mutual funds held in taxable accounts outside your 401(k) plan are taxed at a maximum federal rate of 23.8% (which is 20% plus the new 3.8% Medicare surtax).

This means that your 401(k) nearly doubles the tax rate you pay on capital gains and qualified income by effectively converting these tax-fa-

vored returns into tax-trapped ordinary income. Consider holding equity mutual funds in a taxable account, or better yet, own them in your Roth IRA or the Roth subaccount of your 401(k), if you have one.

If your 401(k) is a lousy place to stash your stock funds, what should you hold there instead? Consider low-growth, income-producing investments, including bond funds and stable value funds. If you have an appetite

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for more aggressive fare, consider high-yield (“junk”) bond funds or emerging market bond funds. Outside your 401(k) plan, these investments may be taxed at your highest marginal rate, so it’s a good idea to protect their income by keeping it inside the tax shelter of your 401(k) plan.

Again, the best workaround for this tax trap is to view your entire retirement portfolio—including

your 401(k) plan, your IRAs, and your other accounts that are earmarked for retirement—as 1 portfolio. Choose to own the best investments in the accounts that make the most sense from the standpoint of expense, risk, return, and taxation.

Summary

Even if you are stuck with a stinky 401(k) plan, you can still make the best of a bad situation. All you have to do is take a look at the big picture, think outside the box, and make smart moves to put yourself on track for a solid retirement. ●

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