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Sharp Investing

Is your 401k *really* safe? Part Two!

By Daniel R. Sharp, Ph.D.

This article is a continuation of our series on a strategy to minimize the various risks in 401k's while still creating wealth for your retirement. In part one (February) we looked at diversification risk; this article will focus on the remaining three risks.

The next biggest risk after diversification risk in a 401k is the **risk of not meeting investment goals.**
Many investors that minimize investment risk in a 401k increase the risk of not meeting their investment goals.
An analysis of their 401k and where it is now (point A), and where it needs to be at retirement (point B) dictates how much investment risk is necessary to achieve the goal.
If the 401k needs to grow at 8% to achieve the goal, yet is invested in a guaranteed interest fund yielding 3%, the risk of not meeting the investment goal is very high. This is a very common mistake in that many investors view their 401k's as too important to put into risky investments, not realizing that by going ultra-conservative they are virtually guaranteeing that their 401k will fall short of the growth necessary for a comfortable retirement. A calculated risk designed to realistically meet investment goals is a necessary component to any long-term portfolio.

The next most important risk is **market risk,** or the unavoidable risk of participating in various investment markets.

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Tax Time 2002: Retirement Plan contribution limits are going up!

You can achieve your retirement goals earlier with help from the Tax Relief Act of 2001. Benefit from new rules this year that allow larger contribution limits. Taking advantage of these changes will help ensure you don't leave extra money on the table for Uncle Sam and can help you achieve your retirement goals earlier. The Tax Relief Act of 2001 begins raising

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Investors must be willing to accept appropriate levels of market risk in order to achieve the historical returns necessary to get them from point A to point B. Most 401k investment choices are slanted towards growth and technology funds, which offer higher risk and below average market returns over the long run. The goal of an investor should be to achieve the highest return for the least amount of market risk, which historically has been achieved through investing in value stocks. Many 401k's do not offer value funds or the ability to invest in individual stocks - which is the strongest argument to rolling a 401k into an IRA when an employee leaves a company.

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The **risk of fraud** is actually much smaller than any of the other risk factors discussed to this point. Fraud risk falls into three areas: management falsifying operating results, management selling stock or options based on inside information, or management actually raiding client 401k funds illegally. A small employer with a 401k runs a greater risk of a rogue owner or manager tapping into employee 401k's. Watching management's track record on purchases and sales of company stock and options is more important than listening to them hype their own stock. Many officers of large corporations exercise options periodically as a tax strategy - but if there is unusually high activity compared to historical norms it can be an early warning sign. Falsifying documents can occur at the highest levels of a corporation. The best way to protect yourself against this type of fraud if you aren't an expert in financial statements is to minimize your exposure to your employer's stock (no more than 20% if at all possible).

401k's are probably the best way to create retirement wealth due to their tax deferred nature and corporate match of contributions.
Many times investors will be restricted either through limited investment choices or high holding requirements of employer stock. Maximizing your diversification, obtaining exposure to value funds and stocks, and minimizing your employer stock below 20%, and then watching the actions of the officers of the company, are the best methods to keep your 401k safe.
Given the opportunity, rolling your 401k to a self-directed IRA gives an investor more investment choices and less risk and is almost always a good idea. **$**

Qualified Retirement Plan New Contribution Limits

Plan	Age	Previous Limits	2002	2005	2006	2008	>2008
Traditional & Roth IRA	Under 50	$2000	$3,000	$4,000	$4,000	$5,000	Indexed to Inflation
	50 or older	$2000	$3,500	$4,500	$5,000	$6,000	
SIMPLE	Under 50	$6500	$7,000	$10,000	Indexed to Inflation	Indexed to Inflation	Indexed to Inflation
(salary deferral)	50 or older	$6500	$7,500	$12,000			
401K,403B, 457	Under 50	$10,500	$11,000	$14,000	$15,000	Indexed to inflation in increments of $500	Indexed to inflation in increments of $500
(salary deferral)	50 or older	$10,500	$12,000	$18,000	$20,000		
Educational IRA (“Coverdell”)	NA	$500	$2,000	$2,000	2,000	$2,000	$2,000

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contribution limits in 2002 for most retirement plans that were originally established and mostly unchanged since the early 1980's. Most retirement plans have specific contribution dollar limits for several years (see the table on page 2), but then all eventually become automatically indexed to inflation.

Traditional IRA and **Roth IRA** contribution limits rise with an extra "catch-up" amount allowed for investors age 50 or older. A contribution to a **Roth IRA** requires minimum earned income equal to the contribution and maximum MAGI (Modified Adjusted Gross Income) of $110k for singles and $160k if you file jointly. The Roth proceeds are tax-free for life but contributions are never deductible from current taxes.

Anyone with single or joint earned income under age 70½ can make a Traditional IRA contribution, but tax-deductibility depends on your MAGI level and if you are covered by your employer's retirement plan. If you are not covered by an employer retirement plan and are single, the IRA is fully deductible regardless of income. If you are covered or file a joint return and your spouse is covered, then you must meet income limits in order to be able to deduct your contribution from current taxes. You may contribute to both a Roth IRA and a Traditional IRA in the same year but cannot exceed the limits shown in the table for any combination of IRA contributions. ***If you are not eligible to take a Traditional IRA deduction, or are in a very low tax bracket the Roth IRA is generally the more attractive choice. Tax-free is always better than tax-deferred.***

For the **self-employed** or those employed at smaller firms, SIMPLE IRA's have higher contribution limits as well in 2002 and beyond. The only qualification for a SIMPLE contribution is that the employee must have earned income at a minimum that matches their SIMPLE contribution. On top of the salary deferral limits shown in the table companies must provide a 1-3% match based on earned income up to the amount of the salary deferral.

Congress didn't forget about larger **corporate** retirement plans. Salary deferral for 401(k)'s, 403(b)'s and 457 (before company match) starts to rise in 2002 and becomes automatically indexed to inflation by 2006. There are also eased restrictions on rollovers from one corporate plan to another or to a Traditional IRA. Another improvement is that *matching employer contributions now will vest in three years rather than five.*

Students are also included in the Tax Relief Act of 2001. Educational IRA's (now called Coverdell Savings Plan) now have a $2,000 annual limit, with the contribution deadline extended to April 15th, like other IRA's rather than December 31st. A Coverdell can be opened if you have a MAGI under $190,000 and *can now be used for primary and secondary education as well as college.* A Coverdell contribution can be

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Value Investing: The purchase of companies, through the stock market, for less than their economic value due to temporary unpopularity (lack of investor demand). This is the opposite of growth investing, which is buying companies at a premium in the hope that other investors continue to push their prices higher and higher regardless of what the business is actually worth.

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made by the student's parents, grandparents, a corporation, or a non-profit organization, but is limited to a total of $2,000 per year per student. The Coverdell contribution is only tax-deductible for corporations (so those of you that are self-employed should funnel your contribution through your business) but withdrawals are tax-free if not exceeding actual educational expenses for that year.

State-sponsored 529 plans are for college only, but now the withdrawals, if used for education, are tax-free rather than taxed at the student's rate. There are no income limits to establish a 529, and contribution limits, while varying from state to state, are as high as six figures in some states. While not tax deductible, contributions can play an important role in estate planning and gifting strategies. However, unlike IRA's, the 529's are limited to that particular plan's investment choices.

The Tax Relief Act of 2001 has a little something for almost everyone, and starts to rectify some of the inflation-eroded contribution amounts that we have been limited to for almost twenty years. Investors shouldn't pass up the opportunity to fully fund their plans for more tax-deferred or tax-free savings and create more long-term wealth. A CPA can calculate your immediate tax savings and a Registered Investment Advisor can estimate how fully funding your plans can help you reach your retirement and education goals. **$**

Value Wins Again!

Over the past 12 months, the Dow is up 1%, the S&P is down over 3% and the NASDAQ is down over 10%. Value stocks are up more than 12% and have now significantly outperformed the market for more than 24 months. Strong value cycles tend to run five to seven years in length so this trend still has a long way to run.