

State Department Federal Credit Union

Topics of Interest

What is a 401K?

A 401k is an employer sponsored retirement plan and is grouped into two categories-defined benefit and defined contribution. With a defined benefit plan, the employer promises to pay a defined amount to retirees who meet certain eligibility criteria. With a defined contribution plan, the plan defines the contributions that an employer can make and not the benefit that the employee will receive at retirement.

A defined benefit plan usually links the benefit to the amount of service and is based on the final average salary. Employees can usually predict the monthly retirement income they might receive with this type of plan and might also be given the choice of a lump-sum benefit at retirement.

A defined contribution plan is not a defined benefit so the employee cannot predict a monthly retirement income. If an employee leaves the company, they usually receive the proceeds in a current or deferred lump sum or annuity.

Companies are prohibited by law from tapping into the money in their 401k. But if your company goes bankrupt and you have 401k money invested in their stock fund you will likely lose that money.

How does a 401K work?

If your company offers a 401k retirement plan, you are given the option of selecting the funds you choose to invest in from a list of funds provided in the 401k. Your company will provide you with a list of the funds they use for their plan and give you the opportunity to decide which you want to invest in and the percentage to invest. Your employee contribution will automatically be deducted from your pay check before taxes.

Each employee can contribute up to a certain percentage of their pay into a 401k and some employers will match a percentage of your contributions. Your contributions along with any matched contributions are then invested into your selected funds. These funds will grow without being taxed and can be withdrawn when you reach the age 59 ½. At this time, you must pay income tax on the withdrawn funds. There are ways you can withdraw your funds before reaching the age 59 ½ but these withdrawals usually require a penalty along with payment of taxes.

How should a 401K be balanced?

Money magazine has an excellent set of charts for 401k allocations in its September Special Report. The suggested allocations at three life stages are:

Aggressive--for those with 35 or more years until retirement

- 50%--large cap stocks
- 15%--mid cap stocks
- 15%--bonds
- 10%--small cap stocks
- 10%--international stocks

Moderate--for those with 20 years until retirement

- 35%--large cap stocks
- 35%--bonds
- 10%--mid cap stocks
- 10%--small cap stocks
- 10%--international stocks

Conservative--for those within 10 years of retirement

- 40%--bonds
- 30%--large cap stocks
- 10%--mid cap stocks
- 10%--international stocks
- 10%--cash

401k plans are very popular and an excellent way to plan for your retirement. As with any other investment, you do need to carefully watch your portfolio and make wise investment choices.