Financial Literacy Basics: Starting a 401(k)

Would you like to have a million dollars?

If you're like most people, you probably answered "yes"! Well, depending on when you start saving, you can actually save a million dollars during your lifetime using a 401(k) plan.

A 401(k) plan is a retirement plan. But if you start planning for retirement at a young age, becoming a millionaire is possible. If you're just starting out in the workplace or are still in college, retirement may seem a lifetime away. But financial experts emphasize that by planning for retirement when you are young, you can maximize the amount of money you save for later.

In other words, if you start saving at age 25, you will have 10 more years of your money working for you (making money) than someone who starts at age 35, and 20 more years than someone starting at 45. This is why it's so important to start saving early.

What is a 401(k)?

A 401(k) plan is a retirement savings account sponsored by your employer. It works by allowing you to set aside (contribute) a portion of your paycheck to be placed in a special type of account.

This account is different from a regular savings account because the money in it is actively invested in mutual funds, stocks, or bonds. These investments can earn money over time and increase the value of your contributions.

The most popular types of 401(k) accounts allow you to contribute money from your paycheck before taxes are taken out—these are traditional 401(k) plans. You only pay taxes on the money when you withdraw from the account. Because of this, most 401(k) accounts have restrictions on how much you can contribute and when you can access your money.

These vary by plan, but in most cases, taking money out of a 401(k) plan early (way before retirement age) results in a 10 percent penalty and other fees.

The History of the 401(k)

In case you were wondering, the term 401(k) has nothing to do with the amount of money you can contribute or remove from your account. It is simply named after Section 401(k) of the Internal Revenue Service (IRS) code.

This section allows workers to avoid paying taxes immediately on a portion of their income if they elect to receive it at a later date. When the rule was originally written in the late 1970s, it did not allow employers to put this "deferred compensation" into savings accounts for their employees.

In 1980, Ted Benna, a benefits consultant with the company Johnson & Johnson, was working out a problem for a client. Taking note of the tax provision, Benna conceived of an account to which an employer could contribute tax-free and that the company could contribute to in matches.

Benna asked the IRS to adjust its laws to allow such a practice. The IRS agreed and the 401(k) plan was born. The plan became so popular that by 2016, more than 90 percent of private companies offered a 401(k) plan.

The original 401(k) plan conceived by Ted Benna had only two investing options. You could choose a stock fund or you could choose a fund that guaranteed a return, similar to a money market fund. Today, the typical 401(k) comes with a menu of nineteen different funds.

Employer Matching

Some employers will also match the amount you put into your 401(k) account with a contribution of their own. That means that if you contribute $100 to your retirement plan, your employer will also contribute $100 too, with certain restrictions.

These employer contributions may also come with additional restrictions. For example, you may have to work for a company for a specific period of time before you can access its share (their contribution) of your 401(k) account. This is a process called vesting. You can find more information on vesting on page 14.

Employers can also choose to cap their matching contributions at a certain percentage of an employee's salary, in addition to the government's caps on the total amount of money that both you and your employer can put into a 401(k) each year.

If your employer matches your 401(k) contribution, **take advantage of it**. If you can, invest the maximum amount so you'll get the most out of employer matching. If you contribute $500 a month to your retirement account and your employer matches that amount, that's like getting $6,000 of free money every year. And, that $6,000 will earn interest every year, too.

If your employer does not offer a matching contribution, you should still save for retirement. You can choose to participate in your employer's 401(k) plan or you can create your own Individual Retirement Arrangement or IRA. See page 22 for more information on additional types of retirement plans.

Maximum Contributions

According to law, the maximum annual amount a person under 50 years old could contribute to a 401(k) in 2018 is $18,500. A person older than 50 years old is allowed a $6,000 "catch-up" contribution, for an annual total of $24,500. With total contributions from employers and other sources, the maximum annual amount by law a person could put into his or her plan in 2018 is $55,000.

When are Taxes Deducted?

In addition to traditional 401(k) plans, some employers give you the option of having taxes deducted from your money before you make your contribution. These are known as Roth 401(k) plans. The main difference between traditional 401(k) plans and Roth (401(k) plans is how your money is taxed.

Traditional plans tax both your contributions and any interest they have earned when you withdraw your money. With Roth plans, taxes are deducted from your paycheck as usual, and then the money is

deposited into the Roth plan. Since you have already paid taxes on your money, you do not have to pay again upon withdrawal.

When Can You Access Your Money?

Both traditional and Roth 401(k) plans come with specific rules as to when you can access your money.

Since they are retirement plans, you can't withdraw money, without penalty, until you are at least 59½ years old. Exceptions occur if you become disabled, or die before you reach 59½, which allows your family or beneficiaries to access the account.

You can also take your money out early if you declare a hardship or if the company you work for goes out of business, or terminates the plan.

Another rule that applies to Roth plans is that your money needs to be in the plan for at least five years before withdrawing it.

Choosing Investments

You get to choose the investments for the money that you put into a 401(k). If this seems like an overwhelming task, don't worry.

Most employers who offer 401(k) plans have a financial services company to manage your plan and help you choose from a range of investment opportunities offered by the financial services company.

Once you select your plan, your employer automatically deducts your requested contribution from your paycheck and sends the money directly to the company handling your 401(k).

Most investments are made in mutual funds, which are pools of money from a group of investors that are invested in a variety of stocks, bonds, and other securities. Mutual funds are professionally managed and have the advantage of being diverse investments. This means they are spread out over a wide range of investment options and less likely to lose money if one stock or bond does poorly.

Most Common 401(k) Investments

Money market funds

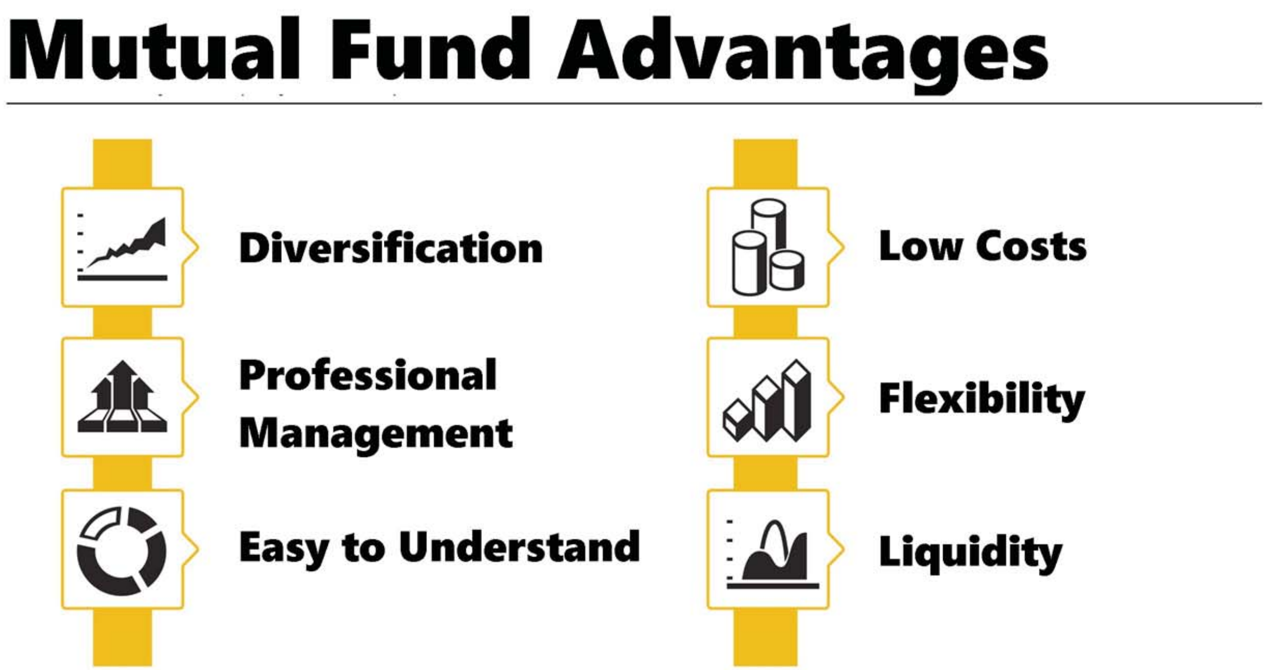
This type of mutual fund is considered one of the safest forms of investment. It comes with lower risk, but also has a lower return on your money.

Money market funds invest in short-term securities, such as certificates of deposit (CDs) or treasury bills (T-bills).

A CD is similar to a bank savings account, except you agree to leave your money in the account for a pre-determined length of time.

A T-bill is like loaning money to the US government in exchange for an IOU. It does not pay interest until after a specific period of time. Since they are short-term investments, this period is always less than a year.

For example, an investor can purchase a $1,000 T-bill for $950. When the T-bill "matures," (meaning that it reaches its maximum worth) the investor is paid the full $1,000 face value of the bill.



Most of the money invested into 401(k) plans is used to purchase mutual funds. Mutual funds are collections of stocks, bonds, and other securities.

Largest Mutual Fund Providers

Aberdeen
Aberdeen Asset Management 1735 Market Street 32nd Floor Philadelphia PA 19103
866-667-9231
http://www.aberdeen-asset.us

AIG
AIG Harborside Financial Center, 3200 Plaza 5 Jersey City NJ 07311
800-858-8850
http://https://www.aig.com/getprospectus

Akre
Akre 2 W. Washington Street Middleburg VA 20118
877-862-9556
http://www.akrefund.com

Alger
Alger 360 Park Avenue South New York NY 10010
800-992-3863
http://www.alger.com

AllianceBernstein
AllianceBernstein 11345 Avenue of the Americas New York NY 10105
212-969-1000
http://www.abglobal.com

Allianz Funds
Allianz Funds 1345 Avenue of the Americas New York NY 10105
800-498-5413
http://us.allianzgi.com

American Beacon
American Beacon 220 East Las Colinas Blvd., Suite 1200 Irving TX 75039
800-658-5811
http://www.americanbeaconfunds.com

American Century Investments
American Century Investments P.O. Box 419200,4500 Main Street Kansas City, MO 64141
800-444-4015
http://www.americancentury.com

American Funds
American Funds 333 South Hope Street Los Angeles CA 90071-1406
800-421-4225
http://www.americanfunds.com

AMG Funds
AMG Funds 600 Steamboat Road, Suite 300 Norwalk CT 06830
800-835-3879
http://www.amgfunds.com

AQR Funds
AQR Funds Two Greewich Plaza,3rd Floor Greenwich CT 06830
203-742-3600
http://www.aqrfunds.com

Ariel Investments
200 E. Randolph Suite 2900 Chicago IL 60601
312-726-0140
http://www.arielinvestments.com

Artisan
875 E. Wisconsin Avenue, Suite 800 Milwaukee WI 53202
800-344-1770
http://www.artisanfunds.com

AXA Equitable
AXA Equitable 1290 Avenue of the Americas New York NY 10104
877-222-2144
http://www.axa-equitablefunds.com

Glossary

This glossary contains the most important terms used in this publication.

Interest
A small fee paid to you for allowing financial institutes to use your money.

Traditional 401(k)
A retirement savings account where contributions are taken out from an employee's paycheck without being taxed. Taxes are paid upon withdrawal of the money.

Roth 401(k)
A retirement savings account where contributions are taxed when they are taken out from an employee's paycheck. Taxes are not paid upon withdrawal of the money.

Stocks
Shares of a company signifying ownership by the stockholder. Stocks pay dividends to the stockholder based on the company's performance.

Bonds
Investments in which a person loans money to a company or organization. The company uses that money and pays the bondholder back at a certain percentage rate.

Mutual Funds
Investments in which investors pool their money together into a professionally managed investment. Mutual funds can invest in stocks, bonds, or other assets.

Growth Funds
Company stocks expected to outperform the stock market.

Value Funds
Company stocks considered undervalued and priced below expectations.