Milwaukee Journal Sentinel
JSOnline.com

BUSINESS

Sunday, October 1, 2017

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Focus on your 401(k) account performance

401(k) ADVISER
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Besides not saving enough, one of the most common mistakes preventing 401(k) participants from achieving their retirement income goals is failure to pay close enough attention to the performance of their account.

To put this issue into perspective, for someone who is 25 years old and able to save $4,000 per year until age 65, the difference between earning an average annual rate of return of 4% ($380,102), 6% ($619,048), or 8% ($1,036,226) can have a serious impact on their quality of life in retirement.

If you're the kind of investor who operates on what can best be described as a "set it and forget it" investment strategy, you need to understand your apathy can have serious consequences. Let's review the steps you should take to ensure your money is working as hard for you as you worked for it.

STEP ONE – FIND YOUR RATE OF RETURN

Determining your account's actual rate of return should be easy. It's generally made available online by your plan's recordkeeping service provider. Calculating a time-weighted rate of return for an account with periodic contributions is no small feat, so expect your employer's retirement plan administrator to do it for you.

STEP TWO – FIND A PROPER BENCHMARK

The next step, determining if your account's rate of return is satisfactory, is more difficult. What makes this step difficult is there's no generic rate of return or benchmark everyone should be beating.

The rate of return you earn should be commensurate with the amount of risk you're taking. It's a pretty simple concept: markets typically reward risk takers with higher returns than conservative investors. The more risk you take, the higher the long-term rate of return you should expect.

Risk is best defined by the percentage of your account exposed to a short-term stock market sell-off. Someone who's willing to absorb a 50% temporary decline in their retirement account and has at least five years before needing the money for retirement, should be invested nearly 100% in the stock market. Table A puts forth a helpful rule of thumb in understanding your optimal asset allocation based on the amount of downside stock market risk you can tolerate.

Once you've determined the amount of risk you're willing to take, use readily available benchmarks to compare your account's performance. Table B displays which benchmarks are best to use. An alternative to building your own custom benchmark is to use your plan's target date retirement funds as your account's performance benchmark. Find the target date fund with the most similar stock to bond ratio and compare its return to yours.

STEP THREE – GETTING BACK ON TRACK

If after comparing your account performance to its proper risk-adjusted benchmark you determine your current investment strategy is not delivering adequate results, there are three courses of action you can take that should help: lower the costs of your strategy, adjust your strategy to include more risk, or improve the quality of your investment management.

Replicating your current investment strategy with lower investment management fees may be the simplest course of action if it's available. That's why employer plan accounts are so often a better environment than an IRA for long-term retirement investors, because a plan is able to use its size to negotiate lower investment management fees. Be wary of "managed account" services. In our experience, they add very little value over a traditional target date fund, and are often meaningfully more expensive.

Increasing the amount of risk in your portfolio is another way to potentially boost returns. The key is selecting your portfolio strategy, not by the return desired, but by the amount of downside risk you're willing to tolerate. If your conservative approach is not getting you to where you need to be, and you're able to stomach larger short-term declines, increasing your exposure to stocks should boost portfolio results over the long run.

The final approach, improving the quality of your investment management strategy, can be tricky because it can lead to market timing and return chasing. Do not let an attempt to improve returns turn into a market timing misadventure. Swapping an underperforming fund for a hot one almost always ends badly. Instead, work on improving your portfolio diversification and stick with it.

Finally, if you decide you don't have the time or interest to work on this, consider switching to your plan's target date fund. After all, most target date funds have a tremendous amount of resources dedicated to determining an optimal glide path from stocks to bonds, and an ideal allocation among U.S. and foreign assets.

For most, your 401(k) account is key to your financial security in retirement. You owe it to yourself to periodically review how it's performing. The rate of return you earn is second only to the amount you save in determining how much you will have waiting for you in retirement.

The material in this column is provided for informational purposes only. Neither the information nor any opinion expressed constitutes a solicitation for the purchase or sale of any security. Francis Investment Counsel does not offer personal tax or legal advice. Michael J. Francis is president and senior investment consultant of Francis Investment Counsel LLC, a registered investment adviser based in Brookfield. He can be reached at michael.francis@francisinvco.com.

Table A

Long-Term 401(k) Investor Risk Guidelines		
Risk Tolerance: % of Account Willing to Risk	→	% of Account to Allocate to Stocks
50%	→	≥90%
40%	→	70%
30%	→	50%
20%	→	30%
10%	→	≤20%

Table B

Benchmark Returns (Annualized) as of 8/31/17					
Investment Type	Market Index	1 yr.	3 yrs.	5 yrs.	10 yrs.
US Stocks	S&P 500	16.2%	9.5%	14.3%	7.6%
US Bonds	BbgBarc US Agg Bond	0.5%	2.6%	2.2%	4.4%
Foreign Stocks	MSCI ACWI ex USA	19.4%	2.8%	7.8%	2.2%
Target Date	S&P Target Date Indexes↴				
	2060 (92% stock)	15.0%	6.6%	11.2%	N/A
	2050 (88% stock)	14.4%	6.5%	11.0%	5.6%
	2040 (80% stock)	13.2%	6.2%	10.3%	5.4%
	2030 (69% stock)	11.3%	5.6%	9.2%	5.2%
	2020 (55% stock)	8.9%	4.9%	7.7%	5.0%
	2010 (37% stock)	6.4%	4.0%	5.8%	4.4%

Source: Morningstar Direct

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The information presented in this opinion has been modified from the printed story which appeared in Milwaukee Journal Sentinel on October 1, 2017, titled Be sure to check your portfolio periodically. Specifically, modifications were made to the title and references to tables A and B along with their inclusion for the reader's expanded understanding of the concepts provided in the original article.