SOUND Financial Bites with Paul Adams

Sound Financial Bites 064- Paul Adams

Episode Transcription

> *"The IRS really wants you to put money in a 401(k)."*

Welcome to Sound Financial Bites, where we help you with bite-sized pieces of financial and life knowledge to help you design and build a good life. The knowledge that has been shared from stages at conferences, pages of national business magazines, and clients living across America, our host, Paul Adams, now brings directly to you.

Hello, and welcome to Sound Financial Bites. My name is Paul Adams. It is so great to have you with us today, to have you listening on the podcast. You all are in different places today. You are tuned in while you're washing dishes, on a run, in the gym, driving a car, wrangling kids. And what I just feel honored by is that you're listening, right now, doing everything you can to further your financial knowledge and put yourself in a position that you're going to have the best opportunity possible to design and build a good life.

Now, we're going to be tackling a unique topic. The topic is the three major groups, the three institutions, the three people that are totally behind you and wanting you to use your 401(k). We're going to have another section of this podcast that's just going to talk about what you can do to work around these and use your 401(k) to your best benefit, but we really need to talk about who's behind your 401(k). Who's behind your 401(k)? Who are the people that want you, more than anything, to be able to engage and put money in your 401(k) over time?

Now, through this series, we're going to talk about how the employer, the people you work for, want you to put money in your 401(k), how the financial institution, whoever it is that's in charge of the 401(k), that they want you to put money in the 401(k). Believe it or not, although it's couched as a way to save money for you on taxes, the IRS really wants you to put money in a 401(k). And after we get through those three major topics, we'll circle back and have another episode that's really going to spend time with how is it you are going to have the best ability to navigate around those three large group concerns who want you to participate for their own reasons.

This is not like any of them are evil, but there are certain incentives that each of those groups have that have them wanting you to do everything possible to max out your 401(k). Once you understand those rules it's a lot easier to make sure you're not maxing out your 401(k) by simply putting in the most money, but that what you are actually doing is maximizing your use of that financial tool in the context of your entire financial life, because this is part of the design conversation. If you're going to design anything, one of the things you have to do is pause long enough to make sure that you know what the mechanisms are there at work, and what's happening in the background. Like if you don't understand how pressure would work on a roof when there's snow, you couldn't really design a roof that you'd put together that would stand up to the snow. So, we're talking about the mechanics for these three major topics, and then we're going to circle back and talk about how you solve around these mechanics.

Let's start with your employer. Your employer, the people that you work for really want you to use your 401(k). Now, where did 401(k)s come from originally? You know, I think people have heard this but it's easy to forget or get lost in it, but 401(k)s were originally a replacement for pensions. So, a pension, for those of you that are young enough that you've never worked for an employer that had a pension, what they would do is they say you work with us long enough, and what we are going to do is continue some percentage of your income for the rest of your life. So,

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you stay with us for 35 years, and we're going to give you 80% of your income. Like, they would do an average, like your top three or top five years, and that top three or top five years would then be the percentage that you're getting based upon the years of service, and so we're going to give you 80% of that last five years' income for the rest of your life. There are still some occupations that have this: firefighters, police officers, college professors, teachers, and some government employees, but even in many of those institutions have peeled back the benefits on the pensions in trade for a 401(k).

Now, let's pause for a moment and talk about how expensive the pensions were. You see, I did the math on my mom's pension. My mom began working for the federal government when she was like 21 or 22 years old, and she worked through her entire career, retiring after 38 and a half years. 38 and a half years working with the Department of Energy. She worked her way through the ranks, and as I was a kid, we moved around the country as my mom got different promotions, and she really retired at the top of her game. Once it was shared with me that my mom may have been one of the more powerful women in the federal government, if you took out the women that were not appointed or elected. But, at the end of the day, she was still a government employee with government employee-type wages. She was doing quite well at the top of her game, in that regard, but it wasn't like she was a CEO of a publicly-traded company.

"Even if somebody lived conservatively, we are still stuck inside a corporate America strategy [The 401(k)]."

But, near the time that she retired, I had, of course, already been in the business, the financial business for some time, and I went back and did some math. What I figured out: To equal the amount of money that my mom had in pension, what she would have had to have done to just equal the pension savings that was set aside for her and the equivalent amount of cash flow that she now has for the rest of her life, that would've required that, from day one of her income, starting all the way back 38 years prior, they would have to pay her 80% more, 8-0-percent more than they actually paid her, and she would've had to go ahead and pay taxes on that, and then save 100% of it and have perfect investor behavior to equal what they gave her in pension. Now, think about that for a moment. The federal government would have had to pay her 80% more and she would've had to have perfect discipline to save at every single year.

Now, my mom is an amazing, amazing woman, but it's not likely that every single year, when emergencies came up or whatever else would happen, that she would make the 80%, then pay the taxes, and save 100% of what's left. That's the kind of huge benefit these pensions were and there wasn't a lot of flexibility. You see, if you're on a pension for a large company, that company has to make this huge contribution every year. They have to look at their pool of employees. We employed all these people for another year. There's another year of vesting, which books a liability to the company balance sheet, because that's a liability to the balance sheet that they have to pay these pensions, and they have to make enormous contributions every single year, and they did not have a lot of flexibility about making those contributions. But, when they stopped making these contributions they didn't just start paying people 80% more. They just put in a 401(k) with a match.

Now, here's an interesting thing: They said, "Okay, you can put some of your money away, and we'll put away some of our money." So, you put some of your money away, we'll put away some of our money alongside yours, but what they didn't say, when they rolled all of this out, is we also are going to have the ability, on a year-to-year basis, to change how much match we give you. Now, they did have some vesting schedule, and a 401(k) at least has the likelihood that if I decide

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to leave this employer and I go to another employer, at least I can take the 401(k) with me, which was a huge advantage for the working American to be able to move from job to job, increase their productivity, and increase their income - huge advantage. Now, it was only an advantage if they use that opportunity to actually bolster their own personal balance sheet by saving that extra money and all the evidence points to the fact that that did not happen.

And so, the employers had the opportunity now to change the match and do other things that gave them the flexibility to not have to set aside the kind of money that was having to be set aside every single year in the pensions. This was the transition from the pension was to move to the 401(k). The pension kept you at this specific company through retirement but let's think about this for a moment: Why did they transition to a 401(k) instead of just giving the employee a lot more money? Now again this was done years and years ago. Your employer had no hand in this but let's just go back in a time machine. Let's go back to the 80s when a lot of these transition, early 90s, when nearly every pension went away. If we think about this for a moment, why did they say your money has to be locked up until age 59 and a half? Why is it going to this tax favored account? Why is it going to grow tax deferred? Well, you see if they just gave you 80% more compensation and they said what we want you to do is save this, in fact you can save it, here's an account to put it straight into. We'll put it in there for you.

"Before the pensions trapped you with an employer. Now, the 401(k) locks us into regular employment."

Let's say you get to your mid-40s and you're sick and tired of corporate life. If you have access to the money, let's say you're just decided to live conservatively. You said "I don't want to work in corporate America forever. So, what I'm going to do is I'm going to punch out or I'm going to go start my own company and go compete with my employer." But because it's locked in the 401(k) and we can't get it until age 59 and a half we may not be locked into a single employer anymore but by using the 401(k), again in our 4th episode here we're going to go deeper into it, but I'm telling you we put ourselves in the position that we are trapped in corporate America.

And so, unless we put some other things in our financial life and bolster them around the 401(k) we can be trapped in having to work until age 59 and a half because we've got to follow a lot of rules to get the money out. We may have taxes and penalties because if we wanted to leave that employer we would have to take out the million dollars, pay taxes in it all these years and pay penalties. Because that pretty well deters people from wanting to take the money out all in one shot, leave their employer, retire early and put themselves in the position where maybe they could go compete directly with the employer.

In the future episode, we're going to talk about how you solve for this but I think the important thing for everybody to remember is we are still in a pension like tool maxing out our 401(k) compared to a position where we have some restriction. There is a possibility of being able to work within appropriately trained TPA, and put yourself in a position where you could actually use your 401(k) assets to buy and start a business without liquidating it but most people aren't exposed to that. Most people don't have access to those tools or nowhere to get them.

You can see some of the players in that game. There is folks like guidedfinancial.com, you can Google start my business with a 401(k). There's ways to get that done but most people aren't aware of that. So even if somebody just live conservatively, save enough money we are still stuck inside of a corporate America strategy granting way maybe at a job that we don't love so that we're on a position that we have to continue to work because we can't access that money yet.

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Before the pensions trap you with an employer because you needed to stay there long enough to fully invest in the pension so you could retire and now the 401(k) just locks us into regular employment and what we should do is work along until age 59 1/2, 65 or whatever the society says about when we should retire.

Now a word on that briefly on retirement. For all of you listening, I would hope that what you never have to do is retire, meaning to retire like an old set of shoes or an old set of golf clubs that you have put them on a shelf and now they're useless but rather what you could do is just reach financial independence and put yourself in a position where you could just use your skills that you built over an entire career of 30-40 years becoming exceptional at what you do so that you can do it the way that you want to because financially you are independent. Everybody has this way of like you just grind away for 30 years, 40 years and then you're retired like you're not useful anymore and I would love a lot more people listening to our podcast to think about what it looks like to build the life that you want and actually just recast what it looks like after building financial independence.

The 401(k) in our next episode, we're going to get into why the financial institution wants you on the 401(k) and why the IRS wants you on a 401(k). I think we're going to be able to have this done a total of three episodes. This is going to be three parts but what you're going to see is why your employer wants you in a 401(k), why the financial institutions want you in the 401(k), why the IRS wants you in a 401(k). Then that last episode is going to be about what you can do to navigate around the pitfalls or the interest of some of these other parties when it comes to building your asset called the 401(k) on your balance sheet for you to be able to design and build a good life.

I hope you enjoyed today's episode. We're going to continue this in the next episode when we talked about financial institutions and the IRS, but before you go I want you to know that we've got a special giveaway for our listeners. There is a special download. All you need to do is go to sfgwa.com. If you're already on our email list, when we emailed you on this podcast there is a link to download this PDF that's going to give you some great insights on 401(k) specifically to help you better use the 401(k) that you have. All you gotta do is go to our website sfgwa.com. That's Sound Financial Group WA, like Washington, dot com, and slash 401k. Sfgwa.com/401k. Go in there give us your email. We will email you immediately the reports and I hope you enjoy it. I hope this allows you to make better use and better stewardship of your 401(k).

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