Sound Financial Bites 066 - Paul Adams

Episode Transcription

"Your 401(k) assets are long-term bucket money."

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 client living across America, our host, Paul Adams now brings directly to you.

Well, hello. I'm Paul Adams, and it is so good to have you listening to this podcast today. I can't tell you how much this podcast has been on my heart, and I've been reflecting on it during my morning routine for the last week. I'm at the very end of a week's long vacation with my family and given that I've recorded the first two episodes before I left the office, it's really been on my mind to make sure that I bring to all of you now what you can do to be sure to optimize the participation in your 401(k).

Because, when you listen to episode number 64 and 65 where we discuss the fact that your employer has an interest in you maximizing your 401(k), that the IRS has an interest in you maximizing your 401(k), and the financial institutions definitely have an interest in you maximizing your 401(k), in today's episode, where we're going to spend our time is making sure that you are the greatest benefactor of your participation in your 401(k) so that that takes best care of you, and your family, and your endeavors to design and build a good life.

Here's what we're going to touch on today: high level and first is going to be how would you make an assessment of your overall situation? Before you go any further into investing in a 401(k), how to invest in a 401(k), whether or not you should money, all of that I'm going to come back to.

How much you should begin contributing to the 401(k), how that money should be invested, and then how should I choose the taxation of the money? So, If you're taking notes on this episode, those are the four main components you're going to want to think about are an assessment of your overall situation, how much you should begin contributing, how should you be investing, and then how to choose the taxation of that money.

Given, before diving deep today, I just spent a couple of episodes talking about who else has a vested interest in how you participate in your 401(k). It's important that we'll just be clear that none of those people are evil, none of those people have it out for us. What's true though is if we better understand what their motivations are behind why it works for them for us to participate in a 401(k), it makes even make more sense to us about why we would and how we can build our strategy not because those other people have an interest the 401(k) is not good for us, but rather because those other people have an interest, we can take really, really good care of our own interest.

Let's first talk about how your money is separated not just from an asset allocation perspective, but from a timing perspective. In our next episode, we're going to go into - so, this is going to be episode number 66 - the timing of your money in Buckets of Money. We haven't talked about that in quite some time, and I think, in light of this 401(k) series, it's going to make a lot of sense to branch into the Buckets of Money conversation.

But, suffice it to say, and a little bit of teaser for that next episode, your 401(k) assets are long-term bucket money, and it's important to think about, because all the assets you have are going to get used for something, but they're not all going to get used today, and they're not all going to get use in 20 or 30 years, come retirement, or maybe sooner for some of our listeners, but the timing is important. It's asset location from a timing perspective, asset allocation from an investment perspective. But, where is your money now?

You're going to have to look out at all of your assets and make some key distinctions. One is -- and I don't want you to guess at this. I want you to really take some time, sit down with your spouse, and if you want to, use a Google Sheet, use Excel, use your online planning tool that we've given you if you're a client of ours, and just for a moment, get clear on your net worth. If you've drawn one up a month or two ago, or if your online platform has not been aggregating, I want you to really be sure you're getting the numbers accurate.

"I do not want you to think about your employer match as free money."

First, start with your net worth. Your net worth is going to include everything: your home, a vacation home, an RV, a boat, everything, everything, everything. Once you have that number, then what I want you to do is take enough time to get clear on what are your assets. Assets, as defined in the way we talk about them going, all the way back to the wealth coordination account episode, that's episode 44 - so, if you haven't listened to that, I would encourage you to get back to it - but an asset is anything that puts money in your pocket now, or has the ability to put money in your pocket in the future.

So, that's not your home, that's not the RV, that's not the boat, that's not all your stuff in your house, that's not your jewelry. That is things that put money in your pocket now or have the ability to put money in your pocket in the future without changing your lifestyle. So, that might be your mutual funds, stocks bonds cash, 401(k), all of it plus income producing properties, etcetera.

Once you have that asset number, you're, "Okay, I've got my net worth, which is one number, then I've got my asset number," then what I want you to do is pause here and look at how much of your assets are actually wrapped up in plans that are 401(k)-type plans, IRAs, Roth IRAs, any of those plans that put you in a position you cannot access the money until some predetermined future date: age 59 and a half, age 65, whatever, whatever your predestined thinking is, "I'm not going to access this money until I'm 70 you pick, but at some point in the future, I am going to access this money, but it's going to be quite a while," and there may be significant restrictions on when you can access it.

So, figuring out how much of that money is actually long-term assets. Once you know how much is long-term assets, how much is set aside for that long-term amount, then I want you to do one more calculation. I want you to do the math on at least a 30% tax rate. Maybe you want to do a little higher, given the amount of assets you have, and the amount of taxes you pay. But, I want you get clear about how much of that money is actually available to you after tax.

This is one big problem with 401(k) is that your 401(k) statement does not come to you with clarity that you have $500,000 and the IRS has a - I'm going to use 30% for the sake of this conversation, maybe higher - but $150,000 interest in your half a million dollar 401(k). That is the money that they will, one day, be paid. So, when you realize, "Wait a second, all this money is not

"Think of your employer match as the money that's going to pay the IRS."

mine. Some of it belongs to somebody else," then you really gain some clarity about where your money is and where you should be sending it next.

Now, because everybody's situation is different, if we haven't seen your specific balance sheet, if we're not coaching you through our process, I can't give you a simple rule of thumb, because some of you may be in corporate America only 35 years old, but you plan on being out of that by age 45, and you want to be able to have enough money to start the new business, like that could be one person's situation. Another person might be age 55 making $2 million a year, and they will retire in a lower tax bracket. So, I can't tell you how much you should or shouldn't put in right here on the podcast, or how much you should have in these long-term accounts.

But, I think the thing that we should realize and reflect on is how often we just blindly start putting money in because everybody says it's a good idea when we haven't even paused long enough to think about how much net worth do we have and how much money do we currently have on our balance sheet that's accessible or that has to be waiting around for the long-term, and we certainly haven't reflected on how much of that money is going to belong to the IRS. It won't be long until it belongs to them, because they are going to take their portion of that little business that you're invested with them.

Unlike a mortgage, where as you own a home for 30 years, the mortgage goes down, and down, and down as it amortises out. The IRS has an interest in your 401(k), but the bigger the 401(k) gets, if taxes only remain the same, their interest remains the same, so their portion is getting larger, larger, larger in real dollars because they own a percent interest.

One last thought that I want you to reflect on is do you think you're going to be in a higher or lower tax bracket one day? For most of our clients, they want to build much more wealth for the future than they have today. So, from where you are now, your current income, do you see yourself wanting to have more wealth or less than you have in the future, and is that going to put you in a higher or lower tax bracket. Once again, the person making $2 million a year at age 55, and they plan on being at age 60, and they really have a whole strategy that's going to produce $600,000 a year of income, that person that's producing $600,000 for retirement will be in a lower tax rate. That's one set of calculations.

But, if you're 35 years old right now listening to this, and you and your spouse together make $400,000 a year, odds are you're going to make much more money over time. You're going to get merit increases, pay raises, promotions. Or, if you're a business owner, you're going to grow that business over time, and you're going to be making much more money later. Even if you stay the same, but inflation takes hold, you're going to be making much more money later, and likely wanting to retire on a higher income than that which you were making in your 30s and 40s.

In fact, if you're in your late 50s listening to this right now, and you've had a properly progressed career, you could probably look back to past times where you put money in your 401(k), and while putting money in your 401(k) in the early years, you can look back and go, "Oh my gosh, back then I had two kids at home, a mortgage, I owned a business, I was in a relatively low tax rate, but I took that money out of my tax rate then and now I'm destined to have to pull that money out at age 65 or I'm going to be required to pull it out at age 70 and a half. They will force the money to us. If we don't take the money, they will charge us a 50 - that's right - 50% penalty. I want you to be aware of all of that as you're thinking about this.

First, get grounded. Interrogate reality here a little bit and make sure you're clear on what your net worth is, one. Two, how much of that net worth is assets and get your asset number, and then last but not least, what I want you to do is realize how much those assets are already tied up in long-term vehicles like IRAs and 401(k)s. This would include your 403(b)s etcetera, so that you just have clarity before going onto the next step here. Because, knowing how much you have and knowing how much of it after tax. So, net worth, amount of net worth, the amount of that that is your assets, and the amount of that that is in these long-term assets, and then part four is do the math and subtract out the taxes so you're aware of how much you're building with this partner called the IRS in those accounts.

"We do want to contribute enough to get the match."

Let's move on. We talked a little bit about grounding ourselves on what you currently have. Now, let's move onto contributions. Everybody wants to know, "How much I should put my 401(k)?" I'm going to give you a few very rapid-fire thoughts here. Number one, I do not want you to think about your match, your employer match as free money. Some of you are business owners, and as you're listening, I think you're going to be able to pick out of this exactly how this applies to you. But, one, your match is not free money. And if you're a business owner listening to this, I also want you to think about this also, you're not giving this money away for free to your employees. There's obligations there, and when you have an obligation, if somebody is giving you something. but there's an obligation in return, that is not free.

What are the obligations? Number one, this is money that this money is going to have to stay in this account until age 59 and a half, or there's going to be taxes plus a penalty paid on, number one. That's one obligation. Number two is that your employer has some kind of vesting schedule on the match that they're giving you. Oftentimes, it requires five or one year wait to even contribute to the 401(k), and then a five-year vesting schedule after that. It's not free money. There's some obligation return. We can take advantage of it, absolutely take advantage of it. But, we need to drop the language that's free money, and you should just go get it. In fact, it's not free money; it's money that has obligations that we might be perfectly willing to obligate to. It's just not free.

How should you think about the match? I'm going to give you two ways to think about it. One is this is money that, one day, is going to help pay the IRS, because you're going to have to pay the IRS someday. Think of your employer match as the amount of money that's going to pay the IRS, and two that this money is not yours at all unless you've been there five years. Think about those two things.

Now, in contribution to your 401(k), we do want to contribute enough to get the match, absolutely. Put enough in on a monthly basis, whatever percent it is, to be able to gain the match if and only if going all the way back to step one -- I'm going to have all this in the show notes. You're going to be able to request the download, have it emailed to you on these main bullet points. If you're driving right now, don't worry about it. You can go to our show notes, click on it, go to the download page, put in your email address and get this sent to you.

Here is the big deal. You may need to pause and say, "I shouldn't put any money in my 401(k) right now. Yes, I'm going to lose a little bit of a match, but gosh bless it, I did that assessment Paul asked me to do, and there it is. I've got no emergency savings at all." Then, maybe what you should do is not put anything in your 401(k), or only put 1% in your 401(k) so you don't have to wait until an open enrollment again and save all of the other money in your short-term cash so that you have an emergency fund to make sure you can get your family through tough times without hardship, withdrawals, and distributions from your 401(k). It might be time to get one step of short-term financial responsibility handled. More on that in our buckets conversation on our next episode.

There can also be a problem in over-contributing to your 401(k). There's two types of over-contributing. One is if you're taking a great deal of money out of your current tax bracket to defer it all for later and yet you're doing a good job of saving, building your career, building other assets, and you might be in a higher tax rate later on, that's one way we can have a problem later of over-contributing.

"You should have a Roth option inside your 401(k)."

But, the other way we can over-contribute is the couple that just throttles on all their contributions. Let's say primary breadwinners making $400,000 a year, and they work for a big enough and successful enough company that they can maximize their match etcetera. But, they're going to get their $18,000 in the plan - that's the amount for somebody under the age of 50. They're not catch-up contributions. They're throttling on all their contributions and are all done in the first two months, and then their paychecks go up.

Well, if that happens and their paychecks just pop up, what happens, usually, with that increase in income, that increase in cash flow, is it just gets lost in the sauce of life. And because it gets lost in the sauce of life, we're much better off staying at a consistent personal savings rate that's going to our wealth coordination account to buy assets, and simply dropping the 401(k) contribution, so that, by year's end, you have contributed the amount that you intended with. It might be 4 and a half percent for that executive that's making $400,000 a year.

Next bullet, how do we invest the money? The easiest way to do this is we want to match. If you have investment strategy with your investments outside the retirement, we need to match the loss tolerance you set up with your outside of retirement plan investments. Now, if you haven't done this yet, if you haven't work with a professional, this is what we do. We walk people through our design-and-build process. We're happy to have a conversation with you about our philosophy and show you how we do that.

But, if you're currently using a professional or you know what your loss tolerance is, here's what I want you to do: have you your 401(k) match the loss tolerance, or sometimes called your risk profile, your loss tolerance with your money that's not in your 401(k). Now, why is this key? It's because, one day, you're likely to not be working for this company that's offering you the 401(k), and if you're not working for them one day, then what we know is you're going to have to roll the money out of the 401(k) to an IRA, or some other vehicle you can better control. You can better control the cost, you can better control distributions in case of emergencies, etcetera.

But here's the big, big problem: if you don't have a similar investment profile in the 401(k) and outside the 401(k), then when your 401(k) goes down in value, and let's say you're also getting laid off in that period of time, then we might have a 401(k) with a higher risk profile than our IRAs. The 401(k) drops down, and appropriately, we roll the 401(k) out into our IRA, and into our discipline strategy, or what we call academic allocation global diversification. You roll it out into that discipline strategy, and as soon as you do that, you might have locked in unnecessary losses from your 401(k). Maybe, you should have similar risk profiles.

For example's sake, let's say that's 80% stocks, 20% bonds. 80% equity, 20% fixed income, that is your portfolio. One of the easiest ways to do this that's going to handle key things: automatic rebalancing and automatic distribution among that allocation to your entire portfolio is a lifestyle fund. Now, I'm going to say this with a caveat. Many of your 401(k)s have way too much cost in your lifestyle funds. They are overpriced, they're not taking good care of the employees, the 401(k) institution. Your employer probably hasn't been exposed to the -- like, working with a client just recently, they just have been busy. They've been growing, they've been increasing their employee's incomes. They haven't had time to stop in the midst of all this growth to revisit the 401(k), and whether or not it kept up with who they're growing into as a company.

"We need to have an exit strategy for how do we exit the money out of the plan."

It's not their fault, but you can help your employer, and how you can do that is you just request from us, if you want to just email my team at info@sfgwa.com, let us know who you work for, your employer files public documents, and those public documents we can use, and we subscribed to some databases that will benchmark your employer and your plan against all the other ones in the marketplace to really find out where they lie. You can request that and get some idea of whether or not the expenses are too high inside your 401(k). But, as long as you have a low-cost lifestyle fund, and you're 80% stocks, 20% bond, then what you can do, if you understand that report is showing you that your funds are relatively low-cost, then what you can do is just drop it into a lifestyle fund that's 80/20.

Now, here's a trick with these lifestyle funds. They slowly, but surely, become more conservative as it gets closer to that future date. So, if 2035 in your 401(k) - now, I say "if" because each of these fund companies is a little different - If 2035 is your 80/20 fund, then you need to set time in your calendar once a year to go in and make sure it remains 80/20, because they will slowly drift to a more conservative portfolio, and it may or may not be a fit for you on a year-to-year basis, but that's important to work out with your financial adviser, with your financial coach, and making sure that that is on track for what you want.

If you don't have a low cost lifestyle fund that you can jump into, you're going to have to build an allocation based upon the funds that are available inside your plan, and the best way to do that is work with your, again, financial coach to help you make the best choice you can on the funds that are available inside your 401(k).

Alright, our last major point is going to be how should the money be taxed. Now, for some of you, you're going to say "Wait, Paul, what do you mean how the money should be taxed? I thought the 401(k), that's just how it is, there's no way to choose the tax," and some of you may also be listening, and this has been more common than you'd think is that people feel like, or have heard that their 401(k), by itself, is going to be tax-free at retirement, or automatically be lower tax, and that is just not the case. It is taxed as regular income - regular income, like when you earned it. So, no long-term capital gains, no lower tax exposure. It's taxed as regular income to you and your family in retirement.

Now, why is that so key? Well, one, we talked about, earlier, the problem that you could retire in a higher tax bracket, and that could be problematic. But, even not planning for how much of the money is going to be owed to somebody else's retirement could throw you way off in your plans for taking care of your financial sufficiency. So, one, just be aware, the traditional tax deductible side of the 401(k) is going to be taxed.

Now, for those of you that knew that the 401(k) was taxed already, and you're saying "Well I didn't know there was a way to choose to have it taxed differently." Well, we can. Your 401(k) likely has a Roth 401(k) option. Now, the Roth 401(k) has been around for a very, very long time. It's now in almost every major employer’s plan.

If you do not have a Roth 401(k) component, once again, request one of those due diligence and benchmarking reports from our office, info@sfgwa.com. We will get one to you that's going to give you the evidence necessary to go to your HR department say "We need to revisit this," because you should have a Roth option inside your 401(k). Very simple, think of it as, do you want to pay tax on the seed, or do you want to pay tax on the harvest? And every time, I would rather pay tax on the seed, if at all possible.

Now, even if you take on the Roth portion, your contribution's going in as Roth inside your 401(k), your employer's match is going to go tax deductible. So, there's really two sides to the plan. Now, every year, you could choose to do an in-plan conversion. At the end of the year, you could just take $10,000 of what's left in your 401(k) that is going to be taxable in retirement and switch it to the Roth side of the 401(k) so that now it's tax-free in retirement. You could do that every year strategically if you have the cash flow going all the way back to step one of optimizing your 401(k), which is, "Is it appropriate for you? Do you have too much in that long-term bucket already?" and our next episode number 66 is going to help you about that buckets conversation a lot.

So, you can send your money to the Roth side. I think that's nearly always a good idea, because we're also giving ourselves some tax diversification. If we have some really badly taxed years in retirement, we could choose to take the money out of the Roth side of our retirement plan instead of the tax-deductible side of our 401(k), or IRAs in retirement so that that money can flow in.

It goes back to, "Do you want to be in a high or lower tax bracket when you retire?" I would personally hope most of your clients would want to be in a position to have more cash flow and more income at age 65 and beyond in a way that's going to create a tax problem for them if they've done it 100% of it tax-deductible. There's certainly place for tax-deductible savings, but we need to be strategic. It's not just about how much money can we put in those accounts, but rather, we need to have an exit strategy for how do we exit the money out of the plan.

Let me give one last somewhat - this is going to be a little nerdy, but nerdy in a good way - about the benefits of having the money going into the Roth and 401(k) is that you also have the opportunity, and you guys can Google this. We've had it in our download about the backdoor Roth IRA, and how even if you're over the income limits for Roth IRA, you can still get money into Roth IRA. One way to do that is the in-plan conversion with the 401(k), but the other way is an IRA conversion coupled with backdoor Roth IRA contributions.

We don't have time to cover that here in our podcast today, but we've got some links to that in our download that we've been giving away the last couple podcast. I encourage you to go get that and download it, and if you tried to download that and you went to a webpage that didn't work, it's my apologies. I was informed after I recorded the first two episodes by Leah, our Chief of Staff, that our naming convention for our website would say that it needs to be sfgwa.com/p401k. So, take some time, download that, get us your email address, we're going to send it to you, it'll be waiting for you in your inbox, and that's going to give you some great thinking about this backdoor Roth and what you can do with it.

Let's do a quick review of what we talked about. One: you got to make an assessment of whether or not you should be putting any money in a 401(k) by first understanding where your money is and getting some sense of how it's all going to be taxed when you get there. Then, and only then, make an assessment whether or not you should be contributing, then look at how it should be invested, and think of it as having it match your profile of investment outside of a 401(k), such as in your IRAs. And if you have been at several employers, and you've just kind of left - maybe like a bear hiding food for the winter - all these little caches of money around at past 401(k)s, then those all need to be in one disciplined strategy together.

Last is choosing the taxation on your money and getting a lot of that money set aside for yourself in the future so that you have the ability to access it tax-free when the time comes, so that you have a large incentive that actually build more wealth in retirement than you have today as opposed to this somewhat perverse incentive to aim to be in a lower tax bracket in retirement, which is really not where most of my clients want to end their lives is in a lower position of wealth, or a lower income level than they were in while they were working.

There are times it can make sense, there's times it can even be strategically set up that way if you have an exit strategy for these plans, though it's not something that you want to aim for blindly just because people say you're going to be lower tax bracket. The thing is, if you're kind of in that realm that we usually work in, households making 300,000 to 1.5 million a year, you're not like going to be in the world that 90% of folks are in that they might well be in a lower tax bracket in retirement because they haven't been paying attention to their money all these years.

Simply by virtue of listening of this podcast, maybe being a client of our firm, you're already thinking about things around wealth building that 90% of society is not putting you on track to design and build a good life that's going to have you have a significant amount of wealth in your retirement, which is why we've got to think about where we're putting our money, and not just doing it by default, but rather doing it by a design.

I'm so glad you could join me today and I look forward to having you. On episode 66, we're going to talk about the buckets of money.

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