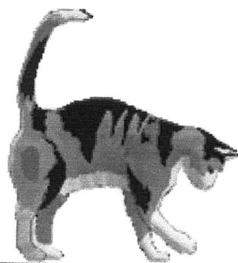

The Calico Cat

A weblog about business, economics, law, politics, and current events - nothing about cats

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Why 401k Plans Are Bad

401k history and background

Section 401(k) of the tax code was enacted in 1981 as a way for people to save money for retirement outside of the traditional pension retirement plan. Your employer deducts money from your paycheck, pre-tax, and the money is placed into some sort of investment vehicle (usually a mutual fund). Because 401k contributions are pre-tax, and there is no tax on interest or capital gains, there is a significant tax advantage to participating in a 401k plan.

When you change jobs, then you can rollover your 401k into your own IRA account, which is something I highly recommend. When you turn 59 1/2, you can start withdrawing money from your 401k or IRA account without incurring withdrawal penalties. But you have to pay tax on the money you withdraw. (Fair enough, it was put in there tax free.)

Most of the above information came from the Fidelity 401K website.

So why are 401k plans bad?

401k plans are almost revered as much as apple pie and baseball. But there is an insidious evil lurking behind them. So I'm being quite bold by going against the conventional wisdom and pointing out the dark underbelly of the 401k.

The problem I have with 401k plans is that they are investing on autopilot. Almost everyone with a job contributes to them, but they have absolutely no idea what they are doing.

At every company I've worked at, it has always been the same story. The employee is presented with a big smorgasbord of mutual funds. One of them is a conservative money market fund that invests in safe short term government securities. Almost all the other funds are equity funds (that would be stock market funds, for those unfamiliar with the word "equity").

The wisdom from Wall Street is that the mutual fund is much safer than investing on your own. But I have some strong doubts about that. All you have to do is look at the huge losses taken by high flying funds when the NASDAQ crashed in 2000. It was the running joke at the time that 401ks had turned into 101ks. Ha ha. Meanwhile my supposedly risky investments in small cap stocks have paid off handsomely and I've had positive returns every year during the big bear market. So whose investments were more risky?

When it comes down to it, the typical 401k investor has no idea how to select a mutual fund to invest in. He is completely and utterly clueless. Faced with a bewildering array of funds, he often follows one of the following strategies: (1) invest a little bit into each fund; (2) invest in the fund with the biggest returns; (3) invest in a couple of funds with the biggest returns (a combination strategy).

All of the strategies above have the effect of encouraging the 401k investor to pursue a risky investing strategy. With the first option, the most conservative, the 401k investor still winds up mostly investing in stocks, because the typical 401k plan offers one safe money market fund, and then a whole bunch of stock funds, so the invest evenly strategy results in most of the money being invested in the stock market.

The second and third strategies are far worse, because the 401k investor puts his money into the sector with the most momentum that is probably the most overpriced. And thus it becomes even more overpriced. But investments don't go up forever. The NASDAQ finally reached a point where it could go no higher, and then it crashed.

My opinion is that people who don't know how to select individual stocks are equally unqualified to

select mutual funds. But that's not what the mutual fund industry wants people to know. (And we know what a bunch of crooks they are, given the recent news stories.)

401k plans and the bubble

As mentioned earlier, 401k plans have had, and continue to have, a significant influence on pumping up stock prices. The stock market investor used to be someone who knew at least a little more about stocks than the average person. But today the stock market investor *is* the average person. (CNBC's Lawrence Kudlow likes to talk about the "investor class.") Everyone, no matter how ignorant about corporate finance, is urged to invest in the stock market through his company's 401k program.

Autopilot investing by everyman helped to push U.S. stock prices to their highest valuations ever (according to Yale economics professor Robert Shiller, author of *Irrational Exuberance*). And I think that one of the reasons that stock prices still remain historically high, despite all the bad karma from Wall Street, is that the 401k autopilot investing continues unabated. A few weeks ago, I wrote in my blog about the echo bubble we are currently experiencing. Blame the 401k plans once again.

Advice for 401k investors

If you have a 401k plan, and it's invested in stock market funds, *especially* stock market funds that have a strong emphasis on tech stocks (and if you don't know what kind of stocks your mutual funds are invested in then maybe you shouldn't be invested in stock market funds), then my advice is **GET OUT**. I repeat. **GET OUT OF STOCKS**. Put all of your 401k money into the safe money market fund (which hopefully every plan has at least one of) and wait.

The bottom of a bear market comes when everyone thinks that stocks are a bad investment. We are obviously far away from the bottom because everyone is still investing in stocks.

100% of my own 401k money is invested in a money market fund. I have plenty of non-401k money invested in stocks of my own picking, but I have no use for any of the stock funds that my employer has offered me. Unfortunately, I'm not lucky enough to have an employer who offers a self-directed 401k plan where I can pick my own stocks. So my 401k money is invested in the safe money market fund, which will maintain its value when the echo-bubble finally bursts.

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