Five (Easy) Steps to Setting Up a 401(k)

Have you been meaning to enroll your company's 401(k) but keep putting it off? You're certainly not alone. Many people, it seems, need a friendly nudge to get going in the right direction.

That's what economist Richard Thaler theorized, and it seems that many companies and retirement savers agree with him. Thaler received the Nobel Memorial Prize in Economic Sciences for his contributions to behavioral economics, which incorporates psychologically realistic assumptions into analyses of economic decision-making.

In Thaler's groundbreaking paper Save More Tomorrow: Using Behavioral Economics to Increase Employee Saving, he and coauthor Shlomo Benartzi outline some prescriptive approaches to get people to save more for retirement. Because people tend to lack self-control, are averse to losing money, and procrastinate, it's difficult for many people to set up a 401(k) plan in the first place, let alone make regular, meaningful contributions to it.

Thaler and Benartzi opined that many people need a nudge--first to get started (through auto enrollment) and then to increase their contribution rate (through auto escalation). Companies are increasingly taking their advice and automatically enrolling employees in defined contribution plans (with the ability to opt out). If you've been automatically enrolled, take some time to review your plan elections and savings rate (but don't opt out!). If you aren't contributing to a 401(k) plan but you've been meaning to start, these five steps will (hopefully) make it easier to get started.

Step 1: See if your plan has automatic enrollment, and if so, if the contribution rate is high enough.
"Auto enrollment" means your employer is withholding some of your pretax salary and investing it in a 401(k) plan for you. Not surprisingly, auto enrollment helps increase employee participation in 401(k) plans: According to the Department of Labor, studies suggest that automatic enrollment plans could cut the rate of non-401(k)-contribution in half--from 30% to 15%.

A recent Vanguard report agreed that auto enrollment did effectively increase participation rates, but it also found the deferral (or contribution) rate tends to be lower among employees who are automatically enrolled.

The takeaway: Make sure you're saving as much as you can. If your company has auto enrollment, don't just assume you're saving enough for retirement and call it a day. Check the salary-deferral percentage. Understand that a low contribution rate--3% is common--isn't enough for most people. In fact, though 10% of one's salary was an oft-cited contribution goal in the past, many financial planners now say 15% is a better target.

Step 2: See if you can "auto escalate" your contributions.
Along with auto enrollment some plans offer "auto escalation," which means that your savings rate automatically increases--often 1 percentage point per year and maxing out around 15%. If your plan doesn't offer auto escalation, you can do it yourself: If you anticipate receiving a pay increase, that's a great time to up your savings rate. Go into your plan settings online and increase your savings rate beginning with the first paycheck following your raise. (This helps counteract the loss aversion behavior--if you never see the additional money in your paycheck, you won't miss it.)

It makes sense to revisit your contribution rate annually to make sure it still makes sense given your current circumstances. And if you're eligible for catch-up contributions, know that you can begin making those extra contributions on Jan. 1 of the year in which you turn 50; you don't need to wait until your birthday.

Step 3: Find out whether your company offers a match, and contribute at least that much.
When deciding how much to contribute to a plan, determine whether your company provides a 401(k) match, and aim to contribute at least that much. For example, say your company will match up to 5% of your contribution at a rate of $0.50 for every dollar you contributed. Contributing less than 5% means you're effectively turning down some money that your employer is offering you.

Step 4: Make portfolio maintenance easy by selecting a target-risk portfolio or target date fund.
If you have been automatically enrolled in your plan, your assets are invested in a qualified default investment alternative such as a target risk portfolio or target -date fund. A target risk (model) portfolio is a mix of the funds available for your plan tailored to your return needs and risk tolerance. A target-date fund is a mutual fund or collective investment trust made up of stocks, bonds, and cash equivalents whose asset mix gets more conservative as the target date approaches. (For instance, a target-date fund for an investor retiring in or around 2050 will be more equity-heavy than an investment intended for someone retiring nearer to 2020.)

With so many investment options on a 401(k) plan menu, it is hard to know what to choose. That's why I recommend that investors who don't have the time for, or interest in, investment research or portfolio maintenance find a solid, low-cost target risk portfolio or target-date fund and call it a day.

These choices provide maximum diversification and also prevent you from making one of the cardinal mistakes of investing – putting too many eggs in one basket, especially into those funds that have led the performance list over the last few years. Such funds don't take on too much risk by being concentrated too heavily in any one area. Further, an investment professional allocates the underlying asset classes with an eye toward asset correlation and optimizing the portfolio's risk/return trade-off.

Step 5: Set up your beneficiary information (and keep it up to date).
Make sure you set up your beneficiary designations. Ideally you would want to review these on a regular schedule, maybe annually. At the very least, make sure you revisit your named beneficiaries after major life events, such as marriage, divorce, birth of a child, or death of a loved one. (Also make sure your beneficiary information carries over if your employer changes plan administrators.)