What rate of return should I expect on my 401(k)?

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An employer-sponsored retirement plan such as a 401(k) can be a valuable tool in accumulating savings for the long-term. Plans differ from employer to employer, but each company that offers a 401(k) plan provides an opportunity for employees to contribute money through paycheck deferrals as a percentage of wages. Also, each plan offers a number of investment options in which individuals can allocate those contributions. Oftentimes, employers provide a match on employee contributions, up to a certain percentage, creating an even greater incentive to save. Employees benefit not only from systematic savings and employer matching but also from the low-cost nature of 401(k) plans and their investment options.

Although each 401(k) plan is different, contributions accumulating within your plan, which are diversified among stock, bond and cash investments, can provide an average annual return ranging from 5% to 8%. This average rate of return is based on the common moderately aggressive allocation among investors participating in 401(k) plans that consists of 60% equity and 40% debt and cash. A 60/40 portfolio allocation is designed to achieve long-term growth through stock holdings while mitigating risk with bond and cash positions. It is important to note that performance within a 401(k) plan is not guaranteed based on past returns, and investors experience different results dependent on the investment options and allocations available within their specific plans. For instance, if you invest in a more aggressive portfolio, you may expect higher returns over time. However, the volatility within your account may also be much greater than within a more conservative investor's account.

Your 401(k) rate of return is directly correlated to the investment portfolio you select while contributions are being made. This asset allocation should be determined based on your specific appetite for risk, also known as your risk tolerance, as well as the length of time you have until you need to begin withdrawals from your retirement account. Investors with a low appetite for risk are better served by placing investments in less volatile allocations that could result in lower rates of return over time. Conversely, investors with a greater risk tolerance are more likely to choose investments with more potential for higher returns but with greater volatility.

It is common for an individual with a long time horizon to take on more risk within a portfolio than those who are near retirement. The Target Risk Asset Allocation portfolios available in your plan have become a popular choice among 401(k) plan participants. These model portfolios combine the funds available on your plan's investment menu along the risk and return spectrum, from conservative to aggressive, allowing participants to select the one that is right for them.

It is not possible to predict your rate of return within your 401(k), but you can use the basics of asset allocation, risk tolerance and time horizon to create a portfolio to help you reach your retirement goals. Each of these factors influences the overall rate of return within your 401(k) account and should be reviewed regularly to ensure your account meets your investment preferences and accumulation needs.