Ditch 401(k) plans with lousy features

High-expense funds, tiny match should drive you to Roth IRA instead

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Q: *My husband's 401(k) plan is with a small company. His only fund choices have high expense ratios and do not perform well relative to their peers. Several are heavy in tech stocks. Examples are: Alliance Tech Fund (expense ratio 2.31 percent), Aim Charter (expense ratio 1.86 percent), Merrill Lynch Intermediate Bond (expense ratio 1.38 percent), Oppenheimer Quest Opportunity (expense ratio 2.11 percent), and so on. His company match is only 1 percent.*

Because his choices are so poor and the high fund expenses eat up the company match, would we be better off opening a Roth IRA instead? I believe that we'll be in the same 27 percent tax bracket when we retire in 35 years. On the other hand, the 401(k) contributions reduce our taxes significantly.

Another option we've considered is maxing out my 401(k) with the money we would have put in his. I contribute 10 percent of my pay ($7,000), and he contributes 15 percent of his pay ($5,000). We could put an extra $4,000 in mine and put the extra $1,000 in a Roth.

A: You're right on the mark about making a change. The automatic saving feature of 401(k) plans makes them very attractive. Unfortunately, some plans are horribly constructed. Your husband's plan is a good example: The combination of high fees and low employer match is deadly.

Every plan should offer a low-cost equity index fund, a low-cost fixed-income index fund, and an inflation-protected option such as a Treasury Inflation-Protected Securities (TIPS) fund. Your husband should stop contributing immediately, and let his employer know why. In fairness to his employer, however, small-company 401(k) plans tend to be expensive.

Of the four funds you mentioned, only one ranked in the top half of its competitive peers heimer Quest Opportunity, according to fund-watcher Morningstar, performed better than 54 percent of its peers.

While your tax bill will go up if your husband stops participating, switching to a Roth IRA will allow you to skirt the issue of whether your future tax rate will be higher than your current tax rate because your Roth account's withdrawals are tax-free.

This is important because an increasing number of people are being taxed on their Social Security benefits when they retire. Current retirees can put 73 cents of purchasing power into a 401(k) plan this year, but will take out only 50 cents of purchasing power next year when they retire. This happens because the effective tax rate on their withdrawals can be as high as 50 percent. That's nearly twice the 27 percent rate that many families are trying to avoid when they contribute to a 401(k) plan. This tax affects more people every year.

Does Participating in a 401(k) Raise Your Lifetime Taxes? (by economists Jagadeesh Gokhale, Laurence J. Kotlikoff and Todd Neumann) showed that workers with incomes under $100,000 were likely to suffer an increase in lifetime taxes and a reduction in lifetime consumption as a result of participating in a 401(k) plan. Why? Success in the 401(k) plan would cause their Social Security benefits to be taxed.

This means that most working Americans need to broaden the base of their retirement security. A rule of thumb is that employees with typical 401(k) plans, which include a 50 percent match, should "capture the match." Then they should switch to a Roth IRA. In your case, that's also a good reason not to "double up" and put more into your 401(k) plan.

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