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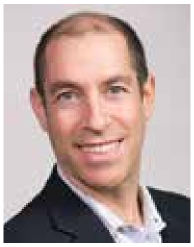

Ian A. Post, CFA

401k/403b Decision Time

Max out early or spread the contributions throughout the year.

By Ian A. Post, CFA

One of the crucial early year decisions facing professionals is how much to contribute to one's employer-sponsored defined contribution plan.

A subtler, and less frequently addressed question revolves around the *timing* of the contributions. Generally, people go at this two different ways:

- Load up contributions early in the year with the idea that they can get something painful out of the way early and enjoy higher after-tax paychecks for the rest of the year.

or

- Spread the contributions evenly through the year which keeps things simple, consistent, and reduces the potential impact of a market meltdown on a large lump-sum contribution.

Are these approaches simply a matter of personal preference or are there real advantages to one strategy or the other?

All else being equal, from a financial theory standpoint, maxing out contributions earlier is preferable. The reasoning can be seen as follows: Suppose your expected return on your 401(k) portfolio is 6% a year. That expected return can be broken down to a daily expected return, 0.164% a day in this example, so the sooner you get the money in, the sooner your money gets exposed to the 0.164% daily expected return.

Of course, all things are rarely equal and the big caveat here is how your company's matching formula works. Most employers now offer some level of matching contribution for their employee retirement plan participants.[1]

A standard matching formula might look like this, 100% match up to 6% of compensation. So for example, if the employee's annual gross salary is $240,000 (gross bi-monthly paycheck is $10,000) and the employee contributes $600 (6% of $10,000) per paycheck, the company would also contribute $600 for that pay period.

The detail to look for before deciding when to max out your plan is if the employer offers a "gross-up" or "true-up" matching contribution. Without this feature, maxing out early can cost you free money. The following example illustrates the issue:

Suppose you make the maximum 2016 contribution of $18,000 by making six $3,000 bi-monthly contributions over the first three months of the year. The matching contribution in each of those six periods is $600 (6% of $10,000) for a total match of $3,600. Compare this to the total *potential* annual match of $14,400 (6% of $240,000) or $10,800 less. What happened to the other $10,800? If the company doesn't make true-up matching contributions, the $10,800 is gone!

If the employer does offer a true-up, an additional matching contribution ($10,800 in the above example) would be deposited in the account at the end of the year. (As a side note, according to a recent IRS study on trends in defined contribution plans[2], some plan sponsor employers whose plan includes a true-up feature, are not making the required end-of-year contributions so if your plan does have this feature, make sure you are actually getting the required end-of-year contribution).

Not taking the true-up feature into consideration can be a critical retirement savings mistake especially if it happens year-after-year. Check your employee benefits manual or speak with a benefit manager and see how your company handles true-ups. Make sure you know how your employer handles this before deciding on the timing of your 401(k) or 403(b) contributions.

[1]Plan Sponsor of America, *56th Annual Profit Sharing and 401(k) Survey, 2013 – 95.3% of defined contribution plans made matching contributions in 2012.*

[2]IRS, *EP Team Audit (EPTA) Program - EPTA Compliance Trends & Tips - 401(k) Plan Trends, 2015"*…At the end of the year, Sponsor X does not true-up (annualize) the match because Sponsor X did not understand the definition of the computation period as drafted in the Plan X."