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How to Get Your 401(k) Ready for Retirement

Here's a six-step plan for investors within 10 years of leaving the workforce

By MICHAEL A. POLLOCK

If you're planning to retire sometime in the next 10 years, here's some crucial advice: Take a very hard look at your 401(k).

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Investing Tips for Those Nearing Retirement

While employer-sponsored savings plans such as 401(k)s usually are a great place to stash money during most of your working years, they may not be as great if you're getting ready to call it quits.

Although plans are broadening their menus of investment options, many are still heavy on stock funds and don't offer many conservative choices to preserve wealth. That is critical after a multiyear run-up for stocks and at a time when traditional bond investments are looking quite risky, too.

What to do? Here's a six-step plan to address your 401(k) if you're within, say, 10 years of retirement:

1: If you haven't done it lately, review your 401(k) investment mix.

Typically after people enroll in employer-sponsored plans and make initial investment choices, they forget about how their money is allocated in the plan—sometimes for years. In the interim, a portfolio may become heavily skewed toward stocks. "As you approach retirement, you want to become more diversified and more risk-averse," says Donna Norwood, a senior executive in Fidelity Investments' defined-contribution business.

Unsure where to start? Take a look at target-date funds, which are widely available but not always used. A Vanguard Group survey found that although 84% of the plans it manages offered target-date funds at the

end of last year, only about half of plan participants owned them.

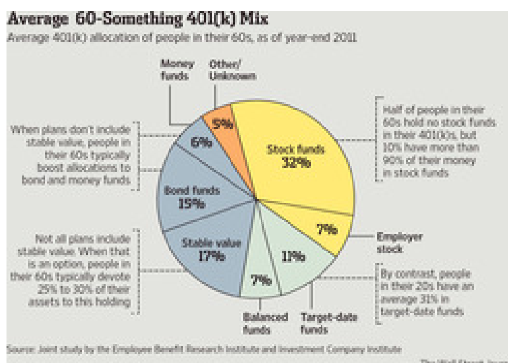
Peter & Maria Hoey

Target-date funds are managed to gradually shift money from stocks to other types of assets as fund holders approach their expected retirement dates. For example, a fund with a 2055 retirement target date may hold more than 80% of its money in stocks, while one dated 2015 likely has reduced its equity allocation closer to 50%.

For pre-retirees, if a fund dated 2015 or 2020 has more stock exposure than you feel comfortable with, pick one with a date that has already passed, such as a 2010 target-date fund. It probably holds a larger portion of bonds and other assets that typically don't move in sync with stocks.

2.: Beware of the rate sensitivity of fixed-income funds you own in your 401(k).

Bonds traditionally were the safe-haven choice for near-retirees, and many 401(k) plans long have offered an intermediate-maturity bond fund as an option.



But yields have risen in reaction to expected changes in Federal Reserve policy, and medium- and longer-maturity bonds pose more risk than ever. Bond prices and yields move inversely, and as rates rise, bonds and bond mutual funds can lose principal value.

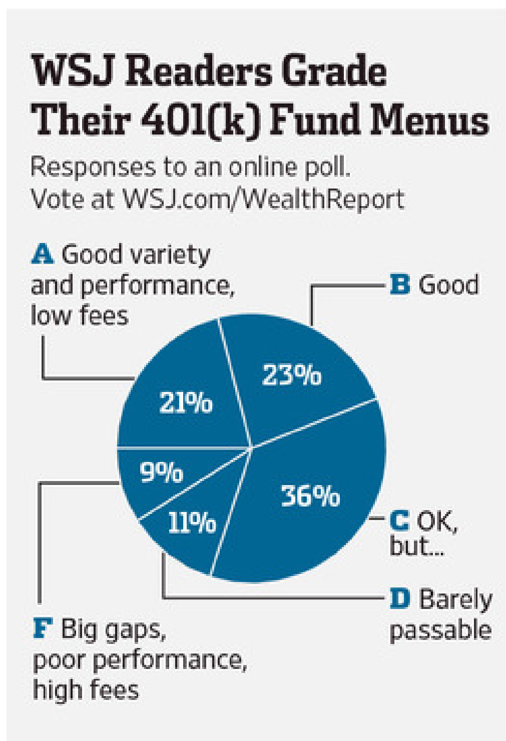
How much? A fund that focuses on intermediate maturities might have an interest-rate sensitivity, or so-called duration, of around five years. Using basic bond math, if rates were to rise broadly by one percentage point, that fund's principal value could drop by as much as 5%.

Richard Jackson, a Dallas-based principal at advisory firm Schlindwein Associates LLC, suggests aiming for an average rate sensitivity of less than three years in any bond funds. He believes interest rates are headed higher, and when that occurs, people who own longer-maturity bonds "could experience more pain than they expect."

Shift some money into a short-maturity fund if one is available. Or reduce the overall rate sensitivity of your fixed-income holdings by mixing a bond fund with a money-market fund or stable-value fund. While money funds pay near-0% yields today, rates will rise quickly if and when short-term rates in the marketplace climb. Stable-value funds, which provide for guaranteed return of principal, may pay annualized rates ranging from more than 1.5% to 3%, says Anton Bayer, principal of Up Capital Management Inc., Granite Bay, Calif.

3: Look for greater variety within your 401(k).

When advisers construct portfolios for clients, they often include a mix of U.S. and international stocks, multiple types of bond exposure and, increasingly, "alternative" investments such as commodities and a variety of hedge-fund-like strategies.



Check the lineup of funds in your 401(k) for offerings that might possibly zig when conventional stocks and bonds zag. For example, a fund that holds real-estate securities or Treasury inflation-protected securities might make sense as a small holding that helps round out your portfolio.

Also, look inside any target-date funds your plan offers. In recent years, fund companies have added some more varied fare inside those all-in-one funds, and that could be a reason to use one.

4: Use IRAs and other accounts to complement your 401(k).

If you've switched jobs, you may still have a significant amount of money in a past employer's 401(k) or in an IRA to which you transferred those savings. IRAs can be particularly handy in providing access to types of assets that aren't available in your 401(k).

"If there aren't good fixed-income options inside your plan, you might hold all of your equity exposure there, while having all of your fixed-income allocation outside it," says Mark VandeVelde, a partner at Hefty Wealth Partners, Auburn, Ind. For example, you might use an IRA to own a "strategic income" fund, a type of fund that can invest in any area of the bond market and shift its investment holdings to limit rate risk, he says.

You may even be able to transfer some dollars from your current 401(k) to an IRA before you retire. Many plans permit withdrawals—sometimes called "in-service distributions"—usually after age 59½, though you may be able to withdraw funds at 55 if you have left a job. You might be able to roll those dollars into a new IRA without having to pay tax or any penalty, but any withdrawals should be planned carefully to avoid unintended tax consequences, advisers caution.

One trade-off for the greater investing variety of an IRA: Mutual-fund fees may be higher than the fees on the institutional-class fund shares offered in larger 401(k)s.

"Make sure you look at the big picture and that every investment, regardless of where you hold it, adds up to the overall allocation you want," Mr. VandeVelde cautions.

5: Check whether your 401(k) plan includes a brokerage window, or self-directed account.

A self-directed brokerage window is an account within a 401(k) plan that allows the user to trade virtually anything that can be traded, including individual stocks and low-cost exchange-traded funds, which aren't widely available as investment options in workplace-savings accounts. This is another avenue to add different types of investments to your portfolio, including alternative funds.

There are, however, extra fees associated with using these brokerage accounts. There's also the

temptation to speculate on hot stocks with your hard-won retirement savings—which is one reason why some plan sponsors don't offer this option.

Brokerage windows are available in about a third of Fidelity-managed plans and 60% of the plans overseen by the retirement-plan-services unit of Charles Schwab Corp. Despite the potential for abuse, most people who tap that option in Fidelity-managed plans are more savvy investors who understand how to use it effectively, says Fidelity's Ms. Norwood.

6: Consider getting professional advice.

At both Fidelity and Vanguard, you may be able to get a complete financial plan at no charge.

Fidelity representatives will coach plan participants without charge on using its Web-based tools to create a plan, either by phone or at its walk-in investment centers.

Participants in Vanguard-run plans can get financial-planning assistance at no charge if they are 55 or older and if their employer has contracted for the option.

Typically such financial plans take into account all of the assets an investor owns, including those outside of a 401(k) plan, as well as the investor's financial circumstances. It is important to also consider things such as how long the investor plans to work and how much people have saved ahead of retirement, says Catherine Gordon, head of the institutional research and advice team of Vanguard Investment Strategy Group.

Some plan sponsors enable participants to get custom advice for an additional fee—sometimes ranging from about 0.5% to 0.75% of assets annually—from an advisory service such as Financial Engines Inc. or GuidedChoice Inc. Hiring your own adviser or planner is another option.

Advice may be worth the cost as you enter that final stretch of retirement investing, when it is particularly important to hold on to what you've saved.

Retirement saving "is kind of like flying—the most dangerous parts are the takeoff and landing," says William Simon, a managing director at investment firm Brinker Capital, Berwyn, Pa.

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