KEATING
WEALTH MANAGEMENT

Retirement Plan Fund Selection 101

Overview

Many clients seek our recommendations in making fund selections from their employer-sponsored retirement plan menus. Whether it's a 401(k), a 403(b), a 457 or some other type of plan, the menu typically offers dozens of fund choices, each with its own array of disclosures and fees. The idea of reviewing all these individual funds in detail to find the "right" investment mix can be overwhelming. Many people become paralyzed and accept the typical default choice of a "target date" fund—which can be a very costly mistake.

Fortunately, retirement plan fund selection doesn't need to be complicated. This guide outlines the simple, three-step process we use. By investing your retirement funds entirely in equities[1], selecting only index funds, and then allocating 80% of your assets to domestic investments and 20% to international, you'll be able to set it and forget it.

3-Step Retirement Plan Fund Selection Process

1st Decision
Choose Asset Class

Equities: 100% | Balanced | Bonds | Life Cycle/ Target Date

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2nd Decision
Choose Index Funds

Index | Actively Managed

↓

3rd Decision
Allocate: 80% Domestic / 20% International

Dometic: 80% | **International: 20%**

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[1] *Our publication "Asset Allocation Made Easy" explains in detail how investors should spread their assets among stocks, bonds and cash. Since retirement funds are, by their nature, long-term investments, as a general rule they should be allocated 100% to equities.*

1st Decision

Choose 100% Equities

The conventional wisdom regarding asset allocation is to spread one's assets among stocks, bonds and cash, primarily to mitigate the volatility of the equity market. This can be costly advice, because the attempt to shield against the equity market's temporary volatility also deprives an investor of the permanent incremental returns offered by equities.

Over time, equities—not bonds—have been the best way to preserve and grow purchasing power. Since 1926, equities have delivered a 7% real return for large-company stocks and a 9% real return for small-company stocks—double and triple the 3% real return for bonds. And when it comes to long-term growth capital, including retirement funds, remaining 100% invested in equities becomes even more important.

Equities are more volatile than bonds, and the bumpy ride is the reason for the higher returns. But volatility is not risk. Volatility is a short-term disturbance, whereas the long-term returns from equities are enduring. Equities are a good investment because they go down temporarily and up permanently.

Avoid the Target Date Fund Trap

We never recommend "target date"or "life cycle" funds. These funds are named for the target retirement year (such as Target Date 2040) and are designed to periodically reallocate their holdings to a more "conservative" mix—inexorably upping the proportion allocated to bonds—as the target year approaches.

Since the average life expectancy of a new retiree is measured in decades, not years, maintaining a long-term asset allocation to equities is the best way to preserve and grow purchasing power over time. The fundamental problem with target date funds is that too high an allocation to bonds may cause a retiree to run out of money over the span of a retirement period that can last 30 years or more.

2nd Decision

Choose Index Funds

We believe that equity index funds should be the core holding in a retirement account because these funds are broadly diversified and low-cost. Over every cycle, equity index funds have consistently outperformed the vast majority of actively managed mutual funds.

In your retirement plan, choose to invest ***only*** in equity index funds.

For example, through a fund such as the Vanguard Total Stock Market index mutual fund (ticker symbol VTSAX), you can own over 3,500 individual U.S. equities, with exposure to stocks of all sizes. With large-cap stocks comprising about 80% of the portfolio, midcaps about 14%, and small- and micro-caps accounting for the balance, you can enjoy complete size and sector diversification.

The annual expense ratio for this Vanguard fund is 0.04%, compared to 0.94% for similar mutual funds.[2] Vanguard founder Jack Bogle reminds us of the importance of minimizing costs: "In the fund business, you get what you don't pay for." In other words, every dollar not paid to a fund manager or for administrative expenses means an extra dollar of return for investors.

Most equity investors own far more individual securities and funds than they need to achieve diversification. We recommend investing in one domestic equity index fund and one international index fund. That's it. Trust your instinctual desire for simplicity: You will understand exactly what you own and why you own it.

[2] *Source: Vanguard website, based on most recent data available from Morningstar, Inc.*

3rd Decision

Allocate: 80% to Domestic, 20% to International

We live in a global economy, and human ingenuity is not limited to the United States. There are dominant companies in developed markets such as Japan, the U.K., France and Germany, as well as in "emerging" markets such as China, South Korea and India. Given a world population of about 7.6 billion people, only about 4% of whom live in the United States, international equities offer the opportunity to share in the profits of companies that serve the remaining 96% of the world.

The key question is what percentage of an equity portfolio should be allocated to international equities. Different perspectives and methodologies have led to a diverse range of opinions in academic and Wall Street circles about the "optimal" allocation.[3]

We suggest 20%. To be sure, this is not a mathematically derived number. But round numbers are easy to understand and remember, and picking one avoids the fool's errand of trying to calculate a mathematically precise "optimal" allocation amidst widely diverging viewpoints.

In short, we recommend an 80/20 split between one domestic and one international equity index fund.

Choose One Domestic Equity Index Fund

When we review your retirement plan options, we'll identify the fund that most closely tracks VTSAX and recommend this selection as your single domestic equity index fund.

Choose One International Index Fund

As with our example for the U.S. market, there is a simple way to own the leading businesses of the rest of the world. Through a Vanguard Total International Stock index mutual fund (VTIAX), at an annual cost of 11 basis points (0.11%), you can own over 6,300 individual non-U.S. equities, with exposure to companies based in Europe (about 43%), Asia (about 29%), emerging markets (about 21%) and Canada (about 7%).

Also, as with our example for the U.S. market, we'll review your plan's options to identify the fund that most closely tracks VTIAX and then recommend this choice as your sole international index fund.

Quick Guide to Employer-Sponsored Retirement Plans

These plans, which include 401(k)s, 403(b)s, SEPs and SIMPLE plans, among others, offer employees an opportunity to have retirement contributions deducted directly from their paychecks. The employer (or an employer-selected plan sponsor) is responsible for operating the plan in accordance with all applicable laws and regulations. The plan sponsor decides who is eligible for the plan, how much they can contribute, and what investment options will be available, along with the availability of plan features such as hardship withdrawals and loans.

[3] *For a detailed discussion of these methodologies, please see our article "International Equities Allocation: How Much and Why?" Sept. 2018.*

You Have a Plan, Now Stick to It

Because retirement plans allow you to dollar-cost average your investments, buying small slices regularly through payroll deductions instead of contributing a lump sum, the temptation to try to time the market is largely eliminated. But it can still be tough to watch your balance decline during market turbulence.

It can be tempting to periodically tinker with your plan options or reallocate current balances if one of your investments is outperforming the other in the short term. Don't.

Your ability to stick with your plan, rather than succumb to panic and abandon it, is the best path toward reaching your retirement plan savings goals.

How Much Should I Contribute?

Precisely how much one should save varies considerably based on individual circumstances. The optimal savings rate considers age, income, current savings, planned retirement age and date- and dollar-specific financial goals.

As a rough rule of thumb, starting in your 20s, you should plan to set aside 10% to 15% of your income as savings for retirement.

The easiest and least painful way to save for retirement is to commit to making the maximum contribution permissible under your retirement plan. If this is not financially feasible, then you should instead arrange to increase your savings rate as your pay rises.

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