KEATING
WEALTH MANAGEMENT

Retirement Plan Fund Selection 101

Overview

Many clients seek our advice on selecting funds from their employer-sponsored retirement plan menus. Whether it's a 401(k), a 403(b), a 457 or another type of plan, there are typically dozens of fund choices, each with its own disclosures and fees. The idea of reviewing all these funds to find the "right" investment mix can be overwhelming, so many people simply accept the typical default choice of a "target date" fund—which can be a costly mistake.

Fortunately, retirement plan fund selection need not be complicated. This guide outlines the simple, three-step process we use. By investing your retirement savings entirely in equity index funds[1]—80% domestic and 20% international—you'll be able to set it and forget it.

3-Step Retirement Plan Fund Selection

1st Decision	2nd Decision	3rd Decision
Choose Asset Class	Choose Funds	Allocate
Equities: 100%	**Index**	**Domestic: 80%**
Balanced	Actively Managed	**International: 20%**
Bonds		
Target Date		

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 a costly approach, because attempting to shield against the equity market's temporary volatility also deprives investors of the permanent incremental returns offered by equities.

Over time, equities have been the best way to preserve and grow purchasing power. Since 1926, equities have delivered a 7% real annual return for large-company stocks and a 9% real annual return for small-company stocks—double and triple the 3% real annual return for bonds. For long-term growth capital, including retirement funds, remaining 100% invested in equities is especially important.

Equities are more volatile than bonds, but volatility is not risk. Volatility is a short-term disturbance, whereas the long-term returns from equities are enduring.

[1] *Our publication "Asset Allocation Made Easy" details how investors should spread their assets among stocks, bonds and cash. Since retirement funds are long-term investments, they should be allocated 100% to equities.*

2nd decision

Choose 100% index funds

We believe 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 3,900 individual U.S. equities, with exposure to stocks of all sizes in all industries. Typically, equity index mutual funds are the lowest cost options on the menu. And every dollar not paid to a fund manager or for administrative expenses means an extra dollar of return for you.

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. It's simple, and you will understand exactly what you own and why you own it.

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. Given a world population of nearly 8 billion people, only about 4% of whom live in the United States, international equities offer the opportunity to share in the profits of companies serving the remaining 96% of the world.

But what percentage of an equity portfolio should be allocated to international equities? Different perspectives and methodologies have led to varying opinions in academic and Wall Street circles about the optimal allocation, with recommendations ranging from 15% up to 50%.

We recommend an 80/20 split between one domestic and one international equity index fund. While not derived from precise mathematical calculations, this allocation ratio falls within the range of expert recommendations and is easy to understand and remember. Note that any international allocation below 10% would provide negligible diversification benefits to the overall portfolio.

Choose one domestic index fund

When we review your retirement plan options, we'll identify the fund that most closely tracks a total, capitalization-weighted stock market index and recommend it as your single domestic equity index fund.

Choose one international index fund

The simplest way to own the leading businesses of the rest of the world is through a fund such as the Vanguard Total International Stock index mutual fund (VTIAX). With this type of fund, you can own thousands of individual non-U.S. equities, with exposure to companies based around the world.

We'll review your plan's options to identify the fund that most closely tracks a total, capitalization-weighted international stock market index (excluding the U.S.) and then recommend this choice as your sole international index fund.

Understanding the difference between 401(k) and Roth 401(k) plans

Most workers now have the option to contribute to a Roth 401(k) in addition to a traditional 401(k) for their retirement savings. However, many people are not taking advantage of this opportunity. The Roth 401(k) can be a valuable savings tool, especially for younger workers.

The key difference between the two plan types is tax treatment. Contributions to a traditional 401(k) are made with *pre-tax dollars*, while contributions to a Roth 401(k) are made with *after-tax dollars*. When it comes to withdrawing the money in retirement, payouts from a traditional 401(k) are taxable at ordinary income rates, whereas payouts from a Roth 401(k) can be tax-free.

Choosing a Roth 401(k) requires payment of taxes upfront, making it more expensive in the short term. However, a Roth 401(k) allows for potentially tax-free withdrawals in retirement.

How should you decide between the two? If you expect to be in a higher federal and state tax bracket at retirement than when you are contributing, a Roth account is a financially sound choice.

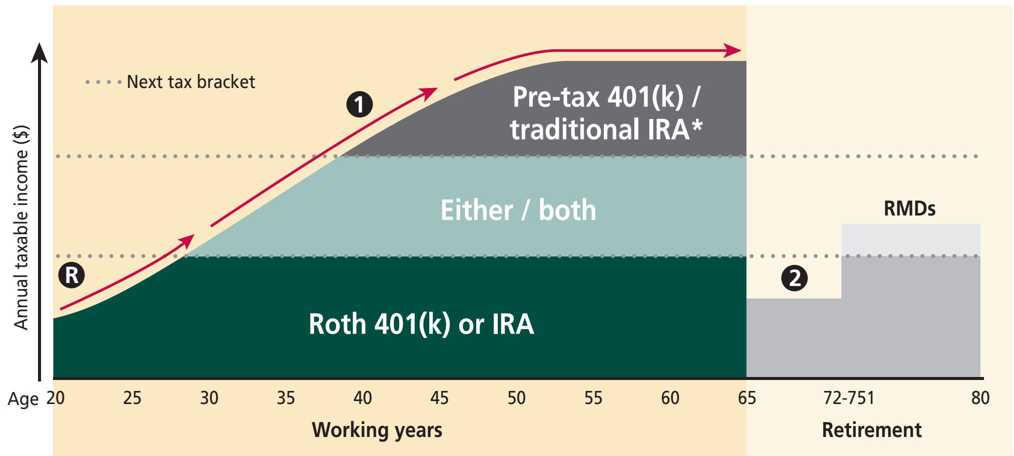
Predicting future tax rates accurately is challenging, because you need to consider your future earnings and the tax code itself—which changes far more frequently than most people imagine.

Generally, younger workers and those nearing retirement are prime candidates for a Roth 401(k). Younger employees can anticipate rising incomes and tax rates over time, making the tax-free withdrawals in retirement more beneficial. However, older workers may have a clearer picture of their future tax rates, and if they expect those rates to be lower in retirement, they may prefer contributing more to a traditional 401(k).

The following illustration from J.P. Morgan provides a conceptual framework for evaluating a Roth plan at different life stages and assumes that annual taxable income rises with age. Ultimately, you should consult with a financial planner/adviser to determine the most suitable option for your individual financial situation and goals.

Evaluate a Roth at different life stages

Changes in lifetime taxable income
Hypothetical wage curve



*If eligible to make a deductible contribution (based on your modified adjusted gross income).

[1] SECURE 2.0 increased the starting age for required minimum distributions from 72 to 75 over the next 10 years. The illustration reflects savings options into traditional and Roth IRA accounts, as well as into pre-tax and Roth 401(k) accounts. RMDs are typically due no later than April 1 following the year the owner turns their distribution age (72-75) and are calculated every year based on the year-end retirement account value and the owner/plan participant's life expectancy using the IRS Uniform or Joint Life Expectancy Table.

Source: J.P. Morgan Asset Management.

Tax diversification

Managing taxes over a lifetime requires balancing your current and future tax pictures. Make income tax diversification a priority to have more flexibility and control in retirement.

- R **Rule (R):** Contributing to a Roth early in your career and shifting as your income increases.
- 1 **Roth 401(k)** contributions in peak earning years if wealth is concentrated in tax-deferred accounts.
- 2 **Proactive Roth conversions** in lower income retirement years if RMDs[1] are likely to push you into a higher bracket.

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 guide, starting in your 20s, you should plan to set aside 10% to 15% of your income as savings for retirement.

Benefit of saving and investing early

Saving early and often—and investing what you save—are some of the keys to a successful retirement due to the power of long-term compounding.

The following chart from J.P. Morgan shows the growth of a retirement account with $200 contributed monthly to either savings or investments across four scenarios:

1 Consistent saver.
Assumes a total of $96,000 saved from age 25 to 65 (40 years) in cash accounts, earning 2.3% per year. The ending portfolio value is $158,300—with savings accounting for 61% of this value and an investment return of 39%.

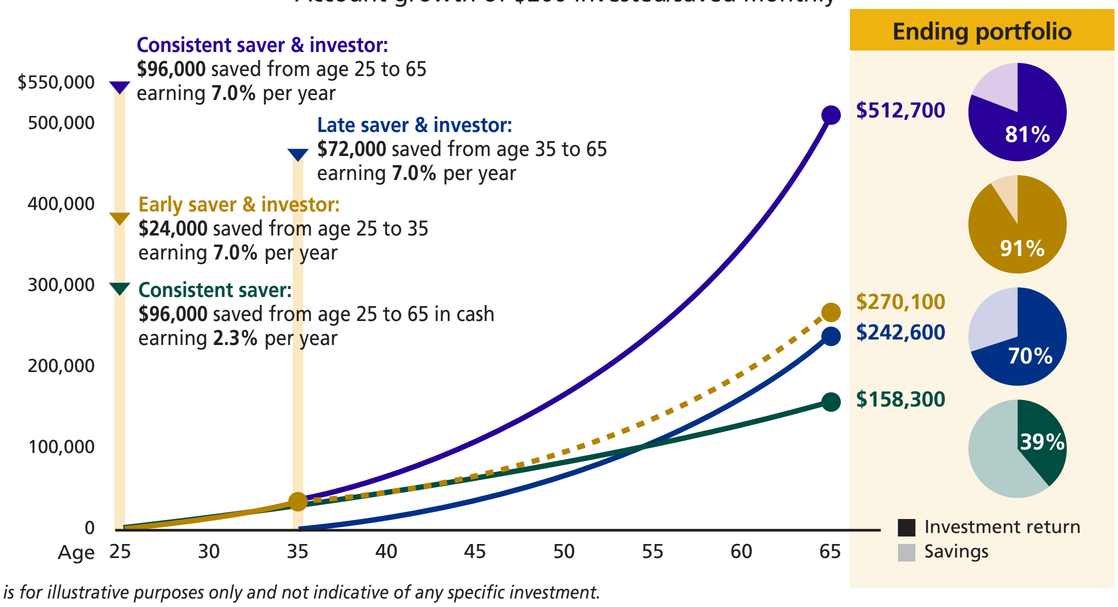
2 Late saver & investor.
Assumes a total of $72,000 saved from age 35 to 65 (30 years) and invested in a portfolio earning 7.0% per year. The ending portfolio value is $242,600—with investment returns accounting for 70% of the value.

3 Early saver & investor.
Assumes a total of $24,000 saved from age 25 to 35 (10 years) and invested in a portfolio earning 7.0% per year. The ending portfolio value is $270,100—with investment returns accounting for 91% of the value.

4 Consistent saver & investor.
Assumes a total of $96,000 saved from age 25 to 65 (40 years) and invested in a portfolio earning 7.0% per year. The ending portfolio value is $512,700—with investment returns accounting for 81% of the value.

Benefit of saving and investing early

Account growth of $200 invested/saved monthly



The above example is for illustrative purposes only and not indicative of any specific investment.

Source: J.P. Morgan Asset Management, Long-Term Capital Market Assumptions. Compounding is the increasing value of assets due to investment return earned on both principal and prior investment gains.

The easiest way to save for retirement is to make 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.

You have a plan, now stick to it

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 financial goals for retirement.

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8400 East Crescent Parkway, Suite 600
Greenwood Village, CO 80111

KEATING WEALTH MANAGEMENT

www.keatingwealth.com
(720) 408-5250