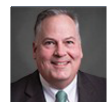
Do retirement plans still make sense? The successes and benefits of 401(k) plans

These tax-advantaged accounts remain the backbone of a retirement savings strategy, despite what naysayers might argue.



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KEY INSIGHTS

- 401(k) plans are an important and effective way for investors to prepare for retirement.
- Many retirement plans offer automatic savings and employer matching contributions.
- Target date investments, offered by 98% of retirement plans served by T. Rowe Price, make investing and diversification easy.

From time to time, you may see articles on the drawbacks of 401(k) retirement plans. While it is important to understand the limitations of any investment account, when pundits start claiming that 401(k) retirement plans don't make sense for most people, I feel the need to speak up. When I was a financial advisor, nearly all of my clients—across a wide variety of income levels—built their foundation for retirement with 401(k) plans. I would hate to see people read negative articles and decide not to participate in retirement plans. 401(k)s and other defined contribution plans have been instrumental in ensuring a secure retirement for Americans, allowing them to benefit from financial market booms.

401(k) retirement plans continue to be highly valuable for individual investors, providing a reliable foundation for retirement despite some skepticism. These plans play a crucial role across various income levels and are underscored by four major benefits:

1. Automatic saving

The behavioral benefit of automatically saving for retirement each pay period should not be understated. There is abundant research showing that people tend to stick with default actions, such as automatically contributing to a 401(k). Data from retirement plans served by T. Rowe Price[1] in 2023 showed that 83% of employees participated in their plan if it was set up for auto-enrollment. For other types of plans, the participation rate was only 33%. The gap is even wider for workers under 30. Fortunately, employers' adoption of auto-enrollment has steadily risen from 51% to 68% over the past nine years. These figures tell a story: People need help with saving, and retirement plans are increasingly helping them.

[1] All statistics about retirement plans are from T. Rowe Price Reference Point and refer to plans served by T. Rowe Price. troweprice.com/content/dam/retirement-plan-services/pdfs/insights/savings-insights/ReferencePoint_2024.pdf

Target date investments are goal-oriented and automatically adjust your risk level over time.

2. Tax benefits

Considering the downward trend in statutory tax rates over recent decades, do "tax advantaged" retirement accounts really help? Having conducted thorough analysis in this area, I am confident they do.

It's true that while you get a nice tax break on the money you contribute to a traditional 401(k) account, once you start making withdrawals in retirement, you will pay taxes on every dollar you take out. However, many people will have a lower effective tax rate in retirement than the marginal rate during their working years. That makes deferring taxes via a 401(k) plan beneficial. Even if your tax rate doesn't decrease in retirement, tax deferral generally works out better long term than a nonretirement account.

If you expect a higher tax rate later, Roth contributions may help you. Ninety-three percent of retirement plans now offer them, and 14% of participants made Roth contributions in 2023. You pay taxes on the money you contribute to a Roth, but after that, the principal and gains can be tax-free via qualified withdrawals.[2] If, instead, you grew your portfolio using a taxable (nonretirement) account, even with income low enough to avoid taxes on long-term capital gains, a Roth account would still be at least as good tax-wise. Ultimately, tax-deferred growth, with either traditional or Roth savings, can go a long way toward meeting your retirement goals.

3. Employer contributions

Taking advantage of an employer's 401(k) match may be the first personal finance advice you get upon entering the workforce. It's often referred to as "free money" and is a significant, straightforward, and common benefit. Ninety percent of plan sponsors with 5,000+ employees offer a match—plus over 72% of smaller plans. The most common match formulas incentivize employees to contribute at least 4% to 6% of their pay. Many employers contribute up to 3%, and matching formulas up to 4% or 5% are becoming more popular. Again, the trends have generally moved in the right direction.

One criticism of retirement plans is that some employees could use more help with other aspects of their financial lives. The SECURE 2.0 Act enables plan sponsors to promote retirement saving in conjunction with student loan payments and building an emergency fund. Congress seems to appreciate that the combination of behavior encouragement and a well-established platform is very powerful.

4. Help with investing—and staying invested

Have you ever been paralyzed by a bewildering array of toothpaste at the store? A similar feeling can come over retirement savers when it comes to investment selections. Fortunately, 98% of retirement plans offer target date investments, and they are often set as the default option. Target date investments are goal-oriented and automatically adjust your risk level over time. In addition, 87% of plans allow investors to automatically increase contribution percentages periodically, with nearly half of those plans setting auto-increase as the default. And, importantly, it is possible to get your money out before retirement if necessary, but there are large incentives not to do so. If you need help, your employer will likely provide education and guidance, regardless of your asset level.

While these four benefits for individuals highlight the personal advantages, it's also important to address broader concerns surrounding these plans.

Inclusivity of 401(k) plans

Critics often argue that 401(k) plans predominantly benefit high earners. However, data suggest that 401(k) plans have democratized stock market participation and enabled middle-income

[2] Assuming qualified Roth distributions. A qualified distribution is tax-free if taken at least 5 years after the year of your first Roth contribution AND you've reached age 59½, become totally disabled, or died. If your distribution is not qualified, any earnings from the Roth portion will be taxable in the year it is distributed. These rules apply to Roth distributions only from employer-sponsored plans. Additional plan distribution rules apply.

families to access professional financial management. Over the past 30 years, stock ownership among middle-income families has doubled, and retirement accounts are a significant portion of their financial assets. Advances in 401(k) plans have resulted in lower fees and accessible financial planning tools, greatly benefiting middle-income workers.

The future of 401(k) plans

Plans continue to evolve, driven both by innovation from financial institutions and public policy developments.

1. Retirement Income Solutions: With well-established innovations such as auto-enrollment and qualified default investment alternatives improving participation and investments, the focus now shifts to retirement income. To provide steady income for retirees, 401(k) plans are increasingly integrating various income options, including annuities and systematic withdrawals. However, offerings of educational support and a suite of retirement income solutions tailored to individual needs remain a work in progress.

2. Addressing Savings Challenges: Racial wealth disparities persist in the U.S., but 401(k) plans hold the potential to narrow these gaps by facilitating access to tax-advantaged savings. Efforts should focus on increasing savings rates and reducing early withdrawals, leveraging programs such as the Saver's Match to enhance outcomes for underserved populations.

Conclusion

American workers' retirement saving has been significantly enhanced by 401(k) plans. Of course, there is a range of quality and cost among plans. And all types of investment accounts have advantages and disadvantages. Continual innovation and collaboration are essential to expanding coverage, improving savings adequacy, and ensuring that 401(k) plans meet the diverse needs of the evolving workforce. Regulations around taxation and Social Security could still be changed to further improve Americans' retirement security. None of that leads me to believe that retirement plans don't make sense for savers today.

I want clients to prepare successfully for retirement, regardless of what types of accounts or investments they use. Retirement plans have helped a lot of people, and I encourage investors to continue reaping their benefits.

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All investments are subject to market risk, including the possible loss of principal. The principal value of target date investments is not guaranteed at any time, including at or after the target date, which is the approximate year an investor plans to retire. These investments typically invest in a broad range of underlying portfolios that include stocks, bonds, and short-term investments and are subject to the risks of different areas of the market. In addition, the objectives of target date investments typically change over time to become more conservative.

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