MAI Capital Management Insights

Factors to Consider When Deciding Whether to Max-Out Your 401(k) Before Year-End

By Mike Beaulieu, CFP®, CFA

Key Takeaways:

- Front-loading contributions can lead to forfeitures
- Stretching contributions over the full calendar year can reduce risk

For many Americans, an employer-sponsored savings plan such as a 401(k) or 403(b) could become their most significant financial asset and an important supplemental source of retirement income. Familiarizing yourself with some of the technical aspects of these vehicles could help you maximize their full potential and make a big difference in building a secure retirement.

The tax advantages of these types of retirement plans are the primary reason they have been so widely adopted. Participants receive an immediate income tax deduction on their contributions and any investment income and gains continue to be tax-deferred within the plan. This enables otherwise taxable dollars to be invested and compound over time. In 2021, the annual contribution limit for these retirement plans is $19,500 and early indications are that the amount will increase to $20,500 for 2022[1]. Participants over age 50 are permitted to make an additional $6,500 per year catch-up contribution[2].

Another attractive feature is that employers may contribute to your account, matching a percentage of your elective deferrals. Fully leveraging the impact of these matching contributions, however, requires some analysis. Those who max out their contributions prior to year-end, also known as front-loading, should consider a potentially costly drawback. According to FINRA, it is estimated that one-of-four employees misses out on free money each year[3]. The employer match provides an immediate and guaranteed return on that portion of your contribution, and that benefit should not be neglected. But it's all in the details. A common design for employer-matching plans is to use a pay-period approach. Unlike a true-up approach, where matching contributions are calculated on an annualized basis, the pay-period method calculates matching contributions on each employee, per pay period. Let's look at a real life example.

Maximizing the Match

Assume an employer offers the benefit of a 100% match up to 5%. Employee total annual compensation of $192K/yr between base and variable, paid twice a month ($8,000 per pay period).

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[1]The Internal Revenue Service (IRS) periodically updates this amount.
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[3]https://www.finra.org/investors/insights/401k-plan-matches

Option A: At the beginning of the year, employee sets contribution election to 10% ($800) per pay period. The employer match will be 5% ($400). Over the course of the full calendar year, employee contributions will total $19,200 ($800 X 24). Additionally, the employer matching contributions will amount to $9,600 ($400 X 24) for a total of $28,800.

Option B: Employee sets contribution election to 17.5% ($1,400) per pay period. At this pace, however, the annual contribution limit will be reached during the 14th pay period which occurs in July. At this point, no more contributions can be made which means the employer won't be able to match any contributions either. So although employee contributions were $300 more than in Option A ($19,500), the total employer matching contributions were actually 41% less - at only $5,600 ($400 X 14). In summary, the annual forfeiture amounts to $4,000. Repeated over several years and with compounding factored in, this could easily equate to a six-figure mistake.

A poll from the PLANSPONSOR National Conference revealed that 51% of sponsors do not offer a true-up match[4]. A true-up provision means that at year-end, the employer makes good on the full promise of its match, regardless of when employees reached the annual contribution limit. You can learn if your plan includes this provision by searching the employer-matching provisions within the sponsor's plan document or by contacting your HR department.

One situation where front-loading contributions may still make sense is when an employee is planning on switching mid-year to a new employer with a less favorable match. This could potentially increase the total employer matching contributions received for that one calendar year.

Another factor to consider when deciding whether to front-load your contributions is market timing, which could potentially result in missing out on better entry prices. This type of risk is best addressed by investing on a consistent basis - spreading out contributions equally over the entire time horizon, also referred to as dollar-cost averaging. Investors utilizing a dollar-cost averaging approach will generally lead to having a lower cost basis. The general assumption is that investment prices will tend to fluctuate and are expected to rise over time.

For example, assume a fixed contribution amount of $812.50 is invested at the beginning of each quarter for one calendar year.

Quarter (beginnning)	**Investment**	**Security Price**	**Shares Acquired**	**Total Shares Acquired**	**Total Value**
1	$812.50	$20	40.625	40.625	$812.50
2	$812.50	$22	36.932	77.557	$1706.25
3	$812.50	$15	54.167	131.723	$1975.85
4	$812.50	$17	47.794	179.518	$3051.80
		Avg. price of acquisition $18.50		Avg. cost per share $18.10	
Total (quarter end)	$3250	$20		179.518	$3590.35
Annualized Return		0%			16.09%

The above scenario illustrates how a fixed investment amount on a consistent basis automatically acquires more shares during periods when prices have declined, and conversely purchases fewer shares during higher price periods. This effectively relieves the need to time the markets. The result is that the "average cost" per share is lower than the "average market price" of securities at time of purchase. And while the security's price return over the holding period was 0%, the compound annual growth rate on investment was 16.09%.

[4]PSNC 2017: Plan Design Elements of the Future | PLANSPONSOR

We encourage sharing this information with your family and friends in an effort to both illustrate the long-term value of making elective deferrals to your employer's 401(k) plan and also to more fully understand the factors to consider about the timing of those contributions.

authored by: Mike Beaulieu, CFP®, CFA, Senior Wealth Advisor & Team Leader, MAI Capital Management
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