401….A?

I helped out a family member with his 401(a) recently and thought I'd take the opportunity to write about this little known and poorly understood retirement account. The more well-known 401(k) is actually a type of 401(a). I write the letters in parentheses because they actually refer to section 401 of the IRS code under subsections (a) and (k). Other retirement plans like 403(b)s and 457s are similar. In actual practice, however, most people consider 401(a)s and 401(k)s to be two different beasts.

401(a)'s Are Mostly For Government Employees

401(a)s are generally offered to government employees. In my family member's case, it was to replace a previous true [defined benefit pension plan](). The municipality he works for decided to have the employees rather than the municipality run the investment risk, so he gets a 401(a) instead of a pension. The municipality still puts a significant sum in there each year, so in many respects, it's still quite a good retirement plan. It was interesting to see how the paperwork described the contributions to the plan. It requires the employee to make a mandatory contribution of 8% of his salary, then matches it with 5% of his salary. In addition, it claims that it is also putting in another 17% of his salary into a fund to pay for his retirement health plan, health reimbursement account, death and disability, and “unfunded future liability.” Okay, whatever.

There are no voluntary contributions into his particular retirement 401(a) account (although there is a 401(k) and a 457 as well), so it’s all employer money (plus the mandatory employee contribution, which is essentially the same thing.)

ERISA Doesn’t Apply

The set-up above is fairly typical for a 401(a). A 401(a) isn’t generally covered by Title I of ERISA, so the state gets to make the rules. Remember that the point of ERISA is to protect the participant. It covers things like vesting rules, fiduciary actions like choice of investments, and disclosures. Instead, 401(a)s are regulated by state law, which is usually not as strict. So you can assume it will take longer to vest in your benefits (5 years in my family member’s case), the investments won’t be as good (read higher expense ratios), and they won’t tell you what the fees are (I couldn’t find them anywhere on the web.)

Contributions Not Optional

Contributions may come from either the employer or the employee, but unlike a 401(k), the employee contribution is usually mandatory. Frankly, I think this is probably a good idea, since most people don't save if they're not forced to, but it does limit your financial flexibility. The good news is my family member belatedly realized he actually has been saving over 15% of his income toward retirement even though he didn't fully realize it. Between his 8% mandatory employee 401(a) contribution, the 5% employer 401(a) match, the 2% 401(k) match, and his own voluntary 401(k) contributions, he's actually saving well.

Beware the Fees

Beware of these cousins as well as fees

My family member was surprised to learn he had an investment adviser he was paying. His fees for the last quarter were $60 (50 basis points). That's not too bad….except all it seems like the adviser has done was pick a few funds in the plan and put the money into them. Even that is probably worth the $60, except the asset allocation made no sense at all. The two biggest components were a Russell 3000 Fund and an S&P 500

Fund, which have a correlation of approximately 0.99 between them. The remaining funds were a hodge-podge of actively managed funds. He was surprised to learn his asset allocation was 95% stock, which worked out pretty well since the 4 years he has been investing (without his knowledge that he was investing) were during a pretty good bull market that the media seems to have just recently figured out. In a few minutes, I had made him $240 a year by firing his adviser and putting him into a reasonable asset allocation of funds. I told him $240 is better than a kick in the teeth but was nothing like the $15K a year I saved my parents by helping them see that their adviser and his fees were having a rather negative effect on their retirement investments.

The good news for my family member is it turns out somebody at his HR department seems to have their head screwed on right since the actual plan fees (in addition to the ERs) are just 11 basis points plus $35 a year. Almost all of his ERs are under 0.20% a year, with the exception of the small-cap fund, an actively managed international fund, and a socially-responsible fund, but even those were under 0.75% a year. It’s not quite the Federal TSP, but it beats the pants off 99% of the 401(k)s out there, including mine.

Do you have a 401(a)? What’s it like? Sound off in the comments section!