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Expert View

3 Big Mistakes Millennials Are Making With Their 401(k) Accounts

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With Labor Day behind us and 401(k) day coming up this Friday, it's a good time to make sure you're taking as much advantage as possible of one of the key benefits that can help many American workers comfortably retire from the labor force: the 401(k) plan. This is especially important for Millennials, who in many ways have the most to gain from contributing to their 401(k) accounts. Here are some of the biggest mistakes we see them making:

1) Not contributing. Our most recent generational research report released earlier this year found that Millennials were less likely than their Generation X and Baby Boomer counterparts to participate in their 401(k) plan. While young people may feel retirement is too far away to worry about, they are losing the opportunity to get the magic of compound interest working for them sooner.

Let's say you earn $40k a year, contribute 10% to your 401(k) plan, receive a 3% match from your employer, and earn a 6% average annualized rate of return. If you start at age 22, you would end up with over $1 million by age 65. But if you wait until age 30 to start saving, you end up with only about $617k. Getting that early start means over $300k extra in your nest egg, which could mean being able to retire earlier or live better in retirement.

If 10% sounds too steep, start small and use your advantage of time by gradually increase your contribution rate each year. You may start with 1% and then increase it to 2% next year and so on. Many people don't even notice the difference in their paychecks but after a few years, they're contributing more than they ever thought they could. Your 401(k) plan may even have a feature to have this done automatically for you. In fact, Fidelity Investments ® found that half (50%) of Millennial savings-rate increases were due to this type of "auto-escalation."

What if you have the more immediate goal of saving to go back to school in a few years and don't want your money tied up in a 401(k) plan? Consider contributing those savings to your 401(k) and then rolling it into an IRA once you leave the company. You will then have the option of using that IRA for qualified education expenses without penalty and if you're not working at all, you'll likely be taxed on it at a very low rate. If you do plan to use it within the next 5-7 years, just be sure to invest the money somewhere conservative like a money market or stable value fund. Whatever you end up not needing for school, you can later invest more aggressively for retirement.

2) Not investing appropriately. Speaking of investing, our research also found that Millennials are the least likely to have general investment knowledge (65%), to feel confident that their investments are allocated appropriately (31%), to have taken a risk tolerance assessment (36%), and to re-balance their portfolio (24%). Perhaps this is why a UBS study found they were more likely than Generation Xers or even Baby Boomers to call themselves conservative investors despite having the longest time horizon until retirement. In fact, a Bankrate.com report showed that 39% of those under age 30 chose cash as their preferred way to invest money they don't need for at least 10 years, which was three times the percentage that chose stocks and the most of any other age group.

Despite this conservatism, over 65% of employees in their 20s had over 80% of their retirement account balance in equities according to an ICI/EBRI report. This is disconcerting because many Millennials may be tempted to bail out of those equities during periods of market volatility, especially if their conservatism and lack of investment knowledge and confidence in their asset allocation makes them particularly skittish seeing losses in their account. However, selling stocks would only turn a temporary paper loss into a permanent real one. If they move money into cash, it will likely take much longer to recover.

One solution is to start with a simple investment like a target-date retirement fund, which you can set and forget since it's a fully diversified one-stop shop that automatically becomes more conservative as you get closer to the target date. Your 401(k) provider may also offer advice tools like Financial Engines and Schwab's Guided Choice that provide more personalized advice at no additional cost to you. One study found that forms of investment help like these increased 401(k) returns by 2-3 percentage points a year on average. That can be especially valuable if that extra return is compounded over a longer time period until retirement.

However, keep in mind that even the best fund or advice tool won't stop you from selling your investments in a panic. That's where financial education can come into play. See if your employer offers unbaised financial education or guidance programs.

3) Cashing out 401(k) plans too early. It's one thing if you're cashing out your 401(k) to retire early. (In that case, consider taking "substantially equal periodic payments" to avoid the 10% early withdrawal penalty if you retire before age 55.) However, Fidelity discovered that 41% of those ages 20 to 39 cashed out of their 401(k) after leaving their job. It's highly unlikely many of them were retiring before 40.

Cashing out a retirement plan can result in tax penalties and lost investment earnings. Some of this may be due to ignorance of the consequences or irresponsible spending, but a lot of it may be due to genuine need. After all, the Georgetown University Center on Education and the Workforce found that 40% of all the unemployed are Millennials (only 37% are Generation X and 23% are Baby Boomers) and our research shows that less than half of Millennials have an emergency fund.

Before focusing on saving for retirement, it's important to build a strong foundation of cash savings. A common rule of thumb is to have enough to cover at least 3-6 months worth of necessary expenses. That will give you savings to use so you can keep your retirement money invested.

One option is to put those savings in a Roth IRA since you can withdraw the contributions any time and for any reason without tax or penalty. If you withdraw the earnings before age 59 1/2, they may be subject to taxes and penalties (there are exceptions for things like education expenses and a first-time home purchase) but the contributions come out first. The best part is that anything you don't withdraw can grow to be tax-free after 5 years and you reach age 59 1/2. Just remember to keep the Roth IRA assets somewhere safe like a bank account or money market fund until you've built up enough emergency savings somewhere else. At that point, you can invest the Roth IRA more aggressively for retirement.

With Labor Day memories fresh on your mind, don't forget the longest "long weekend" of all is when you're financially independent and only work when (and if) you choose to. For Millennials in particular, the 401(k) plan can be a key tool in making that a reality sooner than you may realize but you have to take advantage of it by contributing, choosing investments wisely, and avoiding raiding it before you retire. Don't let youth be wasted on the young.

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