Suze Orman's 3 Retirement Rules for the Young and Fabulous

By Suze Orman for Money Magazine, 11/07/17

I am a big believer in the idea that our biggest mistakes are often the ones we don't realize we're making. And millennials are often clueless about what they are getting so very wrong about their 401(k)s.

To be fair, everyone gets plenty wrong. But right now I want to focus on younger adults.

Years ago I wrote *The Money Book for the Young, Fabulous & Broke*. The feedback was such a gift; so many newly minted adults were happy—yes, happy—to have a road map on how to get all the money stuff right.

Flash forward more than a dozen years: I am aware today's young and fabulous are in serious need of some navigational help when it comes to their 401(k)s.

Let me be clear. Signing up is not enough. No gold stars for that. When I meet with millennials and ask who is saving for retirement through a workplace retirement plan, there is always a burst of raised arms pleased to let me know: You. Are. On. It.

But then I start asking a few basic questions: How is the money invested? Does your employer offer a Roth option? Are you getting the max match? The raised arms fold, and I am facing a sea of confused faces.

At best, the collective level of understanding is fuzzy, which makes some sense given that you didn't have to do much to get started—many employers automatically sign up new employees for their plans. There is much to love about automatic enrollment, but it's a costly mistake to assume all the preset features that come with auto-enrollment are the best options.

I want to be clear, there is no finger wagging in this. This is a no-blame/no-shame zone.
Here's how to fine-tune your 401(k) strategy to reap the biggest payoff down the line.

Step 1: Sign Up for the Roth

Many employers now offer two flavors of 401(k)s. Every plan offers a traditional 401(k). That's what your parents have used for retirement savings for years.

But starting about a decade ago, plans were allowed to offer a Roth 401(k) as well. Today about 60% of plans offer a Roth version, but less than 10% of young adults are saving in one.

The big difference between the two types is when the IRS comes swooping in for its tax bite. With a traditional 401(k), every dollar you contribute reduces your taxable income for that year. That's what's known as an upfront tax break. Make $60,000 and save $6,000 in a traditional 401(k), and you'll reduce your taxable income to $54,000. That might save you $1,500 in federal taxes this year. Not a bad deal, eh? Maybe.

But you need to realize that the IRS will come knocking for its cut once you're in retirement. Every penny you withdraw will be taxed as ordinary income.

The process is reversed with a Roth. There is no upfront tax break, so your taxable income this year will be higher than if you saved in a traditional 401(k). But every penny you withdraw in retirement is tax-free. Yes, free.

And this benefit is not just for you. Your beneficiaries will also be able to take this money out tax-free when you leave it to them. That's a huge tax break.

Roths really make sense when you're young and in a lower tax bracket, which means paying taxes upfront won't hurt as much. Even when you start bringing in more, though, I suggest sticking with the Roth 401(k). Why?

A law of money that I believe in with all my heart is: Invest in the known, not the unknown.

We don't know what the tax brackets will be when you retire. Right now they happen to be near historic lows. Bet that surprised you, given all the nutty chatter about how high tax rates are. Moreover, our country's increasingly large debt means tax rates may eventually need to go up—not down.

Roths also positions you to deal with the unknown curveballs that will likely come your way in retirement. You might need to make a big withdrawal from your 401(k) one year—perhaps to cover out-of-pocket costs for an illness, or to make your home the perfect place to age gracefully.

Yank a big chunk of money from a traditional 401(k) and you will pay tax on every penny, and that withdrawal can bump you into a higher tax bracket. With a Roth there's zero tax on withdrawals made in retirement.

Step 2: Take Full Advantage of the Company Match

Many employers offer to match an employee's 401(k) account, often based on a formula tied to what you contribute and what you make. For instance, the XYZ Corp. may choose to match 50% of your salary contribution up to a maximum of 6%. Translation: For every dollar you put into your 401(k) this employer will put in 50¢ up to a maximum of 6% of your salary. If 6% of your annual pay is $3,000, and you contribute at least $3,000, your employer will add another $1,500.

Think about what that means: You've just earned a 50% return on your $3,000 contribution. Can we agree that's seriously great?

All too often, plans set up young adults to fall short of earning the maximum possible match. Many plans that auto-enroll start the employee-contribution rate at a measly 3% of salary (or less). If the company's maximum matching is based on you saving 6% of your pay, then you've resigned yourself to grabbing just half of the maximum match you're eligible for with auto-enroll.

So please check with your HR department to make sure you are contributing enough to your 401(k) to get the full company match. Even if you have student loans. Even if you are paying off some credit card bills. You are to never pass up the full company match.

Grabbing the maximum company match is just the minimum. If you have a Roth option, your goal should be to get to a 10% to 15% contribution rate ASAP. Do that, and decades from now you will be in great retirement shape.

Step 3: Hands Off Until Retirement!

When you leave a job—whether you're let go or you're hightailing it to a more awesome opportunity—you have the opportunity to cash out your 401(k). That can be especially tempting when you're young. Chances are you've yet to save a ton, so, you figure, there's no harm taking the money now and using it for more pressing issues. Like paying down debts maybe. Or a much-deserved vacation before you start the new position. Or maybe to buy time as you figure out your next steps.

Please listen to what I have to say: huge mistake. You've just borrowed against your future. At exactly the wrong time! This is the stage of life when compound growth is most powerful. Empty the account, and you've got nothing to compound. Talk about an expensive opportunity cost.

The other problem: What you pull out is going to get smacked with a 10% early withdrawal penalty as well as federal and state income tax on every penny you withdraw from your traditional 401(k). Your earnings on Roth 401(k) savings will also be hit with income taxes.

Let's say you cash out $15,000. You might end up with just $11,000 after the tax and penalty. Leave the $15,000 growing for another four decades and it will be worth more than $100,000 assuming a 5% annualized rate of return. I am going to presume that just made you a believer in not cashing out.

I do recommend, however, that you look into moving your old 401(k) into an IRA. Once you leave a job you have the option of leaving the money where it is, moving it to your new plan (when permitted), or doing what is called an IRA rollover.

The only reason to stick with your old 401(k) is if it lets you invest in funds that levy super-low annual expense ratios. That's the haircut your account gets to cover fund expenses. Even if your new employer allows you to transfer the money in your old 401(k) to your new plan, in most cases you are going to be so much better off moving your 401(k) to a rollover IRA account.

That's because with a rollover IRA, you choose which financial institution you transfer that money to—preferably you'll go with a low-cost discount brokerage or fund complex such as Fidelity, Schwab, TD Ameritrade, or Vanguard, which can give you access to a wider menu of low-cost funds and ETFs.