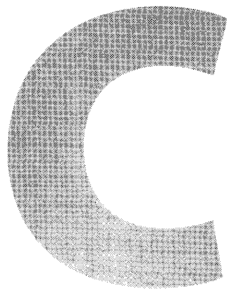
Learn from 401(k) rollover mistakes: How to help your clients make informed decisions.

By A J Macdonald



lients with a 401(k) plan from a previous employer may find it advantageous to rollover the assets into an IRA. This can be a great opportunity for financial advisors to provide advice and guidance. However, advisors should be aware of the common — and not so common — 401(k) rollover mistakes to avoid errors and their costly repercussions.

As a financial advisor and former credit union administrator involved in thousands of 401(k) rollover transactions, I've seen all kinds of mistakes, ranging from inadvertent to uninformed, to downright inept. Most of these mistakes could have been avoided had an experienced financial advisor been involved.

'The Wrong Box' and Other 401(k) Adventures

Take the example of the retiree who made the simplest of errors and paid quite a price for it. Intending to rollover $600,000 from his 401(k) plan into an IRA, he checked the wrong box on the transfer form and had the proceeds paid to himself instead of directly to the IRA trustee.

He was out of town when the check arrived at his home. His wife opened the mail and, not wishing to leave such a large check lying around, promptly deposited it in the couple's joint savings account. The husband assumed the check had been deposited into his IRA account, but when his next statement didn't reflect it, he belatedly discovered what had happened. It was exactly 62 days later, which meant not only had his former employer deducted 20 percent of the funds for federal withholding tax, he now faced a 10-percent penalty, because the 60-day limit for transferring the funds into an IRA had elapsed. Besides his needless financial loss, he and his wife didn't speak to each other for several days.

Another individual requested that his former employer transfer 401(k) funds into his IRA. No wrong box checked this time; he correctly stipulated the funds be transferred to the IRA trustee. Seemingly, he did everything right. The same cannot be said for the staffer at his former employer who mailed the funds to the IRA trustee. She accidentally put not one, but two checks into the envelope and mailed it. The second check represented the 401(k) rollover of another ex-employee and was made out to a separate trustee.

One might assume, upon opening the envelope and finding two checks made out to two different trustees in the name of two different investors, the trustee at the brokerage firm managing the man's IRA would have sensed something was wrong and tried to solve the mystery. Not so. Procedures at the brokerage called for immediately depositing all 401(k) rollover checks into the client's IRA, so that's what she did — with both checks.

The fellow's financial advisor spotted the inaccuracy on his IRA statement and was able to unravel the error. Fortunately, the situation was reversible and no penalties were assessed, but had the advisor not caught the mistake promptly, significant tax issues and penalties could have been triggered.

Another preventable situation arose when a retiree wanted to deduct $50,000 from his 401(k) to buy a car. Working with his financial advisor, he went through the transfer process by phone with the firm that managed his account. When he checked his account balance on the broker's Web site a few days later, he was shocked; instead of a $200,000 balance, what he saw was a big zero! It turns out an employee at the brokerage firm cashed out his entire account, triggering a withholding tax of roughly $50,000 — ironically the amount he originally intended to borrow.

Again, the situation was reversible, but it led to some needless apprehension and a great deal of paperwork to correct what could have been an expensive problem. Incidentally, two days later, the client decided to have his advisor move all his money out of the 401(k) into another account managed by a different trustee. He no longer trusted the brokerage firm. Small wonder.

Ample Opportunity for Mistakes

There are three methods of withdrawing or transferring funds from a 401(k) account:

- Fill out paper forms
- Conduct the transaction on the Internet
- Conduct the transaction by phone

Whatever the chosen method, there is ample opportunity for mistakes to occur. Paperwork can be confusing for investors who may be conducting the only 401(k) withdrawal or transfer they will ever make. As we have already seen, simply checking the wrong box can lead to a horror story.

Internet transactions are subject to the same difficulties. Most employer-sponsored Web sites merely convert hard copy documentation into on-screen content. Investors unaccustomed to working online face increased odds of error.

Phone transactions, in my experience, are the most prone to blunders. In addition to the likelihood of investor error, toss in the potential for employee error. Put an unsophisticated investor and a low-paid company employee together by phone, and almost anything can happen, most of it bad.

An elderly woman had an unfortunate experience with one of the nation's largest brokerage houses. She had two accounts sponsored by her late husband's ex-employer, both managed by the brokerage: a 401(k) and an ESOP. Can you see this one coming? The woman intended to cash out her ESOP — the smaller of the two accounts. Put on hold for 15 minutes, when someone

at the brokerage finally answered and began asking questions, the woman became confused and unintentionally designated the 401(k) for closure instead.

When a check arrived for an amount six times what she expected, she realized what had happened, immediately called the brokerage house back and was promptly put on hold again. When the confused woman finally connected with a live person and explained the mistake, she was again put on hold while the employee accessed her account and conferred with a manager. The two listened to a recording of the original conversation to confirm that although obviously confused, the woman indeed had requested the 401(k) — not the ESOP — be closed and the money withdrawn. You can imagine the woman's reaction when the manager explained that the firm had only followed the woman's request and was not at fault.

Once again, errors were ultimately rectified with the assistance of a financial advisor, but not without considerable angst for the elderly woman who, to this day, is afraid to request or sign anything relating to her restored 401(k) account. The experience has effectively immobilized her from making financial decisions.

Investor Resistance

Advisors know there can be considerable resistance by investors to transfer funds from a 401(k), even when the advantages of doing so are apparent.

I know of a retired engineer — an otherwise brilliant man — who religiously contributed to his employer-sponsored 401(k) for more than 30 years until his retirement a few years ago. He refuses to transfer his funds, even though his principal has been steadily eroding. The company helped pay for his advanced degree and supported him in a claim battle with the company's health care provider. He never forgot the help he received and remains loyal to the now-struggling firm.

Most of his 401(k) is invested in company stock, which he is counting on for retirement income. Despite the steady decline in the value of his nest egg, and ominous prospects for the company's future, he refuses to liquidate his stock. As a friend, I can empathize with his fidelity; as an advisor, I would counsel him to put his financial interests first, while he still has interests to protect.

Ex-employer loyalty issues can be difficult to overcome. I currently do a lot of 401(k) rollovers from former employees of Kodak, a local employer. The company engendered widespread employee devotion during its heyday, but in recent years, the firm has not fared well, its stock hovering in the low $20s from a high of more than $100 a few years ago.

Ex-employees with Kodak-sponsored 401(k)s, fearful the company's stock will rebound given a dwindling market share, are reluctantly moving their funds into IRAs. Loyalty notwithstanding, it simply makes no sense to leave critical retirement funds in a company-sponsored retirement account where the company's outlook is not promising. The only potential disadvantage is that these individuals surrender their distribution option prior to age 59½, although even that issue can be sidestepped with a 72t.[1]

Like those who remain in bad marriages because they would rather endure a familiar terror than deal with the unknown, some investors continue to tolerate discontent rather than risk change. Whether caused by fear or misplaced allegiance, they often pay a heavy toll for their reluctance.

The employee of a major computer products company in Colorado had all of his 401(k) holdings in company stock. When the firm spun off a new company, his shares were converted. He didn't think much of it at the time; The parent company had done well and the new company's breakthrough products showed promise. When he left the company and decided to rollover his 401(k), he was referred to me by a client. I thought it was interesting that he had 100 percent of his funds in company stock.

"I'll tell you what's more interesting," he said stoically. "That $60,000 worth of stock was once worth over $600,000." I asked why he didn't pull it out sooner. "I was busy working and didn't pay real close attention to how far it had slipped. By the time I had lost half my money, I figured I would just ignore it and maybe it would eventually rebound. I was wrong. Now I've lost so much that I don't care what you do; just get me out of it."

Another reason for resistance among some investors is a previous bad experience with a broker or commissioned advisor. Many investors believe they are better off accepting subpar performance in their 401(k) account than risk their money in strategies promoted by advisors whose primary motivation may not be aligned with the investor's best interests.

Conversion Advantages

There are three basic 401(k) distribution choices:

- Take a lump sum distribution and pay the taxes
- Rollover into a new 401(k) plan
- Rollover into an IRA

There are obvious advantages to rolling over 401(k) funds into an IRA when leaving an employer or retiring. Assuming it is done on a direct, trustee-to-trustee basis, the entire amount is transferred to the IRA — no tax is withheld, nor is any current income tax due on the distribution — and allowed to continue on a tax-deferred basis. The IRA offers far more investment options, including many not available in 401(k) accounts. A more effectively diversified portfolio can be created within an IRA.

Investors have greater control in an IRA, not only over the choice of investments, but over administrative costs as well. Partial distributions are allowed, something many 401(k) plans do not.

When an advisor attends to the details, there is less chance of error.

Qualified distributions for certain expenses — medical, disability and death, for example — can be taken without penalty in an IRA.

Non-spousal IRAs offer beneficiaries the ability to stretch out payments where desired, typically to reduce tax burdens. Some investments, such as certain annuity products, let the IRA owner control the distribution of funds to beneficiaries without the necessity of expensive trusts.

How Advisors Can Help

Many advisors are uncomfortable being aggressive marketers, even when clients stand to realize significant gains from their professional advice. As a group, we need to do a better job of explaining the advantages of working with an advisor.

One of the most obvious advantages is familiarity. For some of us, 401(k) rollovers are a core business. The likelihood of an error occurring when a financial professional attends to the details is far less than when an investor, often conducting the transaction the only time in his or her life, takes the responsibility. Like the oncologist who deals with a life-threatening disease every day, the news may not be what a patient wants to hear, but the doctor can present a plan with the best chance for a favorable outcome and has the experience to oversee it.

As financial advisors, we constantly watch the markets and economic trends. When trouble looms, we should be able to act quickly — and dispassionately — to help clients minimize the negative impact and maintain or recover their financial health. It's important for clients reluctant to transfer their 401(k) funds to realize the value in having greater control over their retirement portfolio. Many who accept disappointing results in their 401(k) in the interest of employer loyalty or fear of making changes fail to realize the devastating effect even occasional portfolio losses can have on their retirement principal.

Unfortunately, even when we help a client successfully rollover 401(k) funds into an IRA and improve investment performance, the outcome is not always positive. I helped a client who was the victim of layoff in the late 1990s. At the time, he had about $100,000 in his 401(k) that we rolled over into an IRA. By the end of 1999, the value of his IRA had increased to just over $200,000.

I thought I had done a pretty good job, but he was dissatisfied. He said his portfolio wasn't growing fast enough. He had heard about enormous gains made by a friend in high-tech stocks and decided he could do the same by self-directing his IRA portfolio. I continued to manage his wife's money while he converted the investment portfolio I had constructed into a few dot.com stocks.

He did well for a few months, running the portfolio value up to almost $300,000. I know because he called me several times during that period to tell me how well he was doing. When the market tanked in 2000-2001, he lost almost all of it. Eventually, he came back to me with a $25,000 balance and admitted he wasn't good at picking stocks; he said he got too emotionally involved and lost his focus.

In Northern Colorado, where my practice is located, the local economy has never fully recovered from the last market correction. I know other areas of the country are in a similar situation. A few major corporations dominate the employment environment. These companies and their stocks have taken some heavy hits in recent years, and their ex-employees with 401(k) plans struggle mightily with transferring their funds elsewhere. They feel they are abandoning their ex-employers. I sometimes feel I am walking a tightrope between helping them do what any objective assessment of their retirement portfolio would dictate, and offending their steadfast devotion to an ex-employer.

Some people are simply uncomfortable with the idea of active investment management. They have become so comfortable with their 401(k) investment choices that, despite inferior performance, they resist making a change. Despite regulations regarding employee education, many of these people never received adequate knowledge about investment choices to make informed decisions. Some chose investment products that may have been suitable 20 or 30 years ago and never reevaluated those choices since, despite lifestyle changes or the passage of time.

Going back to my medical analogy, people in their 30s rarely go to doctors because they don't feel the need for a medical checkup when nothing hurts. Older people are more aware of their health and accustomed to going to the doctor. Similarly, younger investors starting a 401(k) don't feel their choice of investments is important, nor do they worry much about asset allocation or risk tolerance. Few consider going to a professional for an occasional financial checkup. Their concern emerges as they approach retirement. Of course, at that point, like someone who has smoked all his life, the patient can heed medical advice to quit smoking, but the damage already done is irreversible and the options available to help the patient may be limited.

As financial advisors, we can't undo what has transpired in the past. What we can do is help investors take control of their circumstances from today forward by helping them make informed financial decisions. **w**

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[1] The 72t rule is called "equally substantial distribution". In some cases, IRA funds may be accessed prior to age 59½ without incurring the 10 percent early withdrawal penalty. These include college expenses, medical premiums if unemployed, medical insurance or disability. The penalty does not apply if the money is withdrawn in equal periodic payments, at least one per year, for a minimum of five years or until age 59½ is reached, whichever comes last.