WESTBOURNE
INVESTMENT ADVISORS

INVESTMENT PERSPECTIVE — FOURTH QUARTER 2024

"Someone's sitting in the shade today because someone planted a tree a long time ago."

– Warren Buffett, on the importance of long-term allocation

In our last *Investment Perspective*, we explored various pitfalls of investing that arise from cognitive biases and emotional factors, which can lead to irrational decisions. One significant behavioral finance pitfall is "Regret Aversion," the fear of making an incorrect near-term decision. This fear can cause investors to shy away from necessary risks or avoid adjusting their portfolios, even when doing so would be logically beneficial in the long run. This issue is especially relevant in the context of long-term retirement plans like 401(k)s.

We frequently advise clients on their employer-sponsored retirement plans. In this Investment Perspective, we offer general guidelines and considerations for long-term retirement funds, focusing on 401(k)s and IRAs, while also applying these concepts to all long-term investing. Although this *Investment Perspective* is longer than usual, we aimed to comprehensively cover the topic in one place, making it a valuable reference for both now and in the future.

401(k): The Purpose

Why participate in a 401(k), you ask? A 401(k) serves to invest your earnings today into a long-term account for retirement. These retirement investments may span decades, during the savings and accumulation years. The primary advantage of investing in a 401(k) lies in the tax savings and deferral features of both Traditional and Roth options.

The 401(k) has largely replaced the traditional pension funds of the Baby Boomer generation, shifting the responsibility for retirement savings from the Company Sponsor to the Individual through self-directed investing. Long-term investments harness what Albert Einstein referred to as "the Eighth Wonder of the World" – the Power of Compounding. While this discussion focuses specifically on 401(k)s, these principles apply to other retirement plans, such as 403(b)/TSA plans and various types of IRAs (SEP, SIMPLE, Individual, etc.).

401(k): Long-Term Allocation…a True, Sad, and Cautionary Tale

We recently met a 65-year-old retiree who, at age 30, had checked the "conservative" box on his company's 401(k) plan onboarding questionnaire. Without further questions or follow-up, a system-generated model automatically assigned an extremely low allocation towards stocks (~50%), favoring non-volatile bonds. Over the course of his career, this innocent, but misguided one-time "check of the box" resulted in the retiree missing out on the biggest bull market of all time, <u>literally costing him many hundreds-of-thousands-of-dollars in retirement</u>.

If you have 401(k)s or other retirement accounts outside Westbourne's purview, let's discuss your allocation strategy – we'd be happy to look over your shoulder and recommend allocations for the long-term.

Factors to Consider with Your 401(k)

There are numerous factors to consider in a typical retirement plan, and we'll provide some high-level considerations. We ultimately recommend a conversation with *Westbourne* and your Tax Accountant, as necessary. But for now, let's discuss a few of the major aspects of 401(k) retirement plans:

A. Traditional 401(k) vs. Roth 401(k)
B. Get the Match!
C. Allocation is Critical
    - Index Funds, e.g., The S&P 500 Index
    - Target Date Funds

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- International Investment Options

D. The IRA Rollover
E. Should I Borrow Against my 401(k)?
F. Rip Van Winkle effect...the long-term Perspective

A. What is a 401(k)? Traditional vs. Roth

A 401(k) is a retirement savings plan offered by employers that enables employees to save and invest a portion of their paycheck. There are two primary types: Traditional and Roth, differing mainly in tax treatment of contributions and withdrawals.

<u>Traditional 401(k):</u>

- Near-Term Tax Treatment: Contributions are made with pre-tax dollars, meaning you can deduct them from your taxable income for the year you contribute. This reduces your taxable income in the year of contribution.
- Withdrawals: Pay taxes on withdrawals during retirement at your ordinary income tax rate.
- Required Minimum Distributions (RMDs): As of December 2022, taxable RMDs begin at age 73.

<u>Roth 401(k):</u>

- Near-Term Tax Treatment: Contributions are made with *after-tax* dollars, meaning you pay taxes on your income before contributing. This doesn't reduce your taxable income in the year on contribution.
- Withdrawals: Qualified withdrawals (after age 59½ and the account has been open for at least five years) are tax-free.

<u>Summary:</u>

- <u>Traditional 401(k): Tax break now, taxes later upon withdrawal.</u>
- <u>Roth 401(k): No tax break now, tax-free withdrawals later.</u>

A Traditional 401(k) may be preferable if you expect to be in a lower tax bracket during retirement, offering immediate tax benefits by deferring taxes until later. Conversely, a Roth 401(k) may be advantageous if you anticipate being in the same or higher tax bracket in retirement, allowing for tax-free growth and withdrawals.

Both account types have contribution limits, and many employers offer matching contributions regardless of which type you choose. Some individuals opt to diversify their tax exposure by contributing to both accounts, if allowed. While tax status is unique to each investor and will guide your decision, we strongly encourage participation in these retirement plans to leverage tax benefits and foster disciplined long-term saving and investing.

B. Get the Match!

Most companies offer 401(k) plans with employer matches, either dollar-for-dollar or as a percentage of the employee’s contribution, up to a certain threshold. Participating up to the match limit is a no-brainer for employees—it's essentially “free money.” Take advantage of it! Even if you withdraw early and face taxes and penalties, the matched contributions still provide a net benefit. Do not leave that money on the table.

C. Allocation is Critical

Plan sponsors of 401(k)s generally offer a menu of domestic bond funds, domestic stock funds, international bond funds, international stock funds, and hybrid funds called "Target Date Funds" (TDFs). We discuss a few of these, but our overall 401(k) allocation investment philosophy is as follows, and a few applications of these principles:

(i) Determine your near-term liquidity needs for the next, say, 3-5 years
(ii) Ensure that you have those near-term liquidity in *Fixed Income* (money markets, cash, bonds)
(iii) Longer-term assets should favor an allocation to *Stocks (Equities)*. Recall from past client letters that Stocks should outperform Bonds, as they have done historically, for those with a longer-term time horizon.[1]

- ✓ If you're 30, withdrawing funds from your 401(k) before age 59½ incurs taxes and penalties. Thus your 401(k) is truly a long-term investment; embrace or ignore the volatility and consider a 100% stock allocation.
- ✓ You are 63, nearing retirement at 65, will you need your entire 401(k) at that age? Likely not. You may require portions at 65, 66, 67, and beyond. This means even in retirement, part of your 401(k) remains long-term, despite some short-term use of the more liquid portion.
- ✓ If you're 75 and depend heavily on retirement assets for daily living, shift your allocation toward fixed income to better meet those needs.

Index Funds – e.g., The Standard & Poor's 500 (S&P 500) index

To ensure a substantial equity allocation in long-term investment accounts, broad market index funds are an excellent choice. Among the 401(k) plans we've reviewed, the S&P 500 index frequently appears as an investment option. As a comprehensive representation of the U.S. stock market, it's well-suited for long-term retirement accounts, a sentiment echoed by investors such as Warren Buffett and John Bogle.

The S&P 500 measures the performance of 500 of the largest publicly traded U.S. companies and serves as a key benchmark for the overall stock market. It encompasses diverse sectors, including Technology, Healthcare, Financials, and Consumer Goods. Key Benefits of Investing in the S&P 500:

1. Diversification: With companies from multiple sectors, the S&P 500 diversifies risk; poor performance in one area can be offset by gains in another.
2. Market Representation: The index reflects the largest and most influential companies in the U.S., providing a clear indicator of market health.
3. Historical Performance: While past results don't guarantee future success, the S&P 500 has consistently performed well over the long term.
4. Liquidity: Highly liquid, the S&P 500 allows investors to buy and sell easily, facilitating entry and exit without significantly affecting market prices.
5. Cost-Effective: S&P 500 indices typically come with low fees, making them a budget-friendly investment option.
6. Transparency: The index has clear criteria for inclusion, allowing investors to see which companies are part of it and understand its structure.
7. Risk Management: By including 500 companies, the S&P 500 minimizes the risk of a single company negatively impacting your portfolio, offering broad market exposure with reduced individual stock risk.

[1] Refer to our website www.wia1.com under INVESTOR DOCUMENTS, "What is a Stock?" for additional discussion.

Target Date Funds – There are Better Alternatives

Plan sponsors frequently offer a hybrid stock-bond investment known as Target Date Funds (TDFs). These funds have gained popularity in retirement accounts, designed to simplify investing by automatically adjusting the asset allocation based on a specified retirement date. For example, if a 32-year-old in 2024 selects the 2054 Target Date Fund, it will primarily consist of equities. As the target date approaches, the fund gradually shifts towards a higher bond allocation and fewer stocks.

While this allows investors to adopt a "set it and forget it" approach, it can also lead to significant misallocation over time. Here are a few advantages and disadvantages of TDFs:

<u>Advantages of TDFs</u>

- <u>Simplicity</u>: TDFs offer a hands-off approach to investing. You select a fund based on your expected retirement date, and the fund manager takes care of asset allocation and rebalancing.
- <u>Automatic Rebalancing</u>: TDFs automatically adjust their asset allocation over time. As you approach retirement, the fund gradually shifts from higher-risk assets (like stocks) to lower-risk assets (like bonds), reducing volatility.
- <u>Diversification</u>: TDFs typically invest in a mix of asset classes (stocks, bonds, etc.), which can help reduce risk compared to investing in a single asset class.

<u>Disadvantages of TDFs</u>

- <u>One-Size-Fits-All Approach</u>: TDFs use a standardized glide path (the asset allocation strategy over time) that might not suit everyone's individual risk tolerance, investment goals, or retirement plans. TDFs also do not take other assets, held outside the retirement plan, into consideration.
- <u>Fees</u>: TDFs often have higher fees compared to other investment options. These fees can impact your returns over time, especially if the fund's performance does not justify the cost.
- <u>Glide Path Variations</u>: Different funds from different providers may have different glide paths, meaning the timing, the level of risk, and asset allocations can vary widely. This inconsistency can be confusing and may require additional research and understanding.
- <u>Lack of Customization</u>: Since TDFs follow a predetermined path, they may not account for personal changes in financial situation, health, or other life events that could impact retirement needs.

<u>TDF Summary</u>: While Target Date Funds offer convenience and professional management, they are not necessarily the best fit for every investor. TDFs may be replicated using a mix of stock and fixed income fund allocations, which allows the investor to make it more specific to his/her needs in retirement.

International Investment Options? Unnecessary

In the 1990s, a "balanced portfolio" typically featured a 70% domestic and 30% international mix of stocks and bonds. Since then, the global economy has integrated dramatically. China joined the WTO, and U.S. corporations became multinational, with the largest companies by market cap centered in the U.S. Take IBM, for example: while based in the U.S., it generates about 50% of its revenue internationally. Apple, Google, and most U.S. firms operate globally. The saying, "when America sneezes, the world catches a cold," highlights that international investments offer less diversification now due to globalization. Moreover, international investment vehicles often come with higher fees and less oversight than U.S. companies.

Bottom Line: Large-cap U.S. index funds, like the S&P 500, deliver ample global economic exposure with lower fees, better transparency, and historically superior returns. Thus, we generally recommend that investors bypass specific international investment vehicles in 401(k)s.

D. The Rollover

Typically, an employee is restricted from moving his/ her 401(k) while they are employed. However, upon leaving a company, the employee may move his Traditional/ Roth 401(k) into a Traditional/ Roth IRA without any tax consequences, provided the movement of funds is done directly between custodians. Moving 401(k) retirement funds <u>will always result in more investment options</u>, and we see no reason for an employee to leave funds "stranded" at the custodian of an old employer.

E. Should I borrow against my 401(k)? Most likely, no.

Many plan sponsors allow you to borrow against your 401(k). The reasoning goes like this: "You're borrowing money and paying yourself back the interest—it's a win-win! It's like FREE money!" We strongly disagree with this notion and recommend avoiding borrowing against your retirement savings unless absolutely necessary and no better funding alternatives are available.

Our view is that 401(k) funds are designed for long-term investment, not short-term liquidity needs. While borrowing against your 401(k) may save you a few percentage points of interest compared to a traditional loan (often tax-deductible), it comes with a steep cost: sacrificing the power of compounding. For instance, consider the S&P 500 in 2023 and year-to-date 2024. If someone borrowed from their 401(k) on January 1, 2023, at 6%, they might have saved a few percentage points of interest (even less when factoring in after-tax considerations), but they also *missed out on over 50% appreciation in stocks over the last 21 months* (through 9/30/24). That's a costly loan indeed. If you need liquidity, seek funding elsewhere.

F. The Rip van Winkle Effect…. forcing the Long-Term Perspective

Long-term investors often sabotage themselves, fixating on every market event and movement when they should focus on saving, investing wisely, and allowing the market to compound. Imagine if there were a mechanism to curb our worst impulses. Picture Rip Van Winkle as an investor, dozing for 20 years while his well-allocated investments thrived. After two decades of blissfully ignoring the stock market's ups and downs, he awakens to a transformed portfolio. While others worried about daily fluctuations, Van Winkle slept soundly, discovering his investments had flourished, making him wealthier and free from the stress of active market participation. We share this story to inspire long-term investment in vehicles like 401(k)s, encouraging a patient approach that requires only slight, gradual adjustments in allocation, without drastic changes to the fundamental nature of these investments.

We've Moved!

Our five-year lease of our old office expired, and we signed a new five-year lease and moved our offices 40 yards away in the same complex to another which offers a nicer view of Annapolis harbor at a fraction of the rent! Same phone numbers, same email addresses, just a different Suite number (Suite 409.) See the footnote for our new address and come visit us – we are still in walking distance of plenty of crabcakes. Cheers to a happy and healthy Fall.

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