Retirees Grapple With 401(k) Choices

By Olivia S. Mitchell

It's one of the major financial decisions confronting older workers: What should I do with my 401(k) plan once I retire?

People typically have two options: They can roll over their retirement savings into an individual retirement account. Or, they can leave the money in their former employer's plan. (Of course, they can always cash out, but this often is the least attractive path for people seeking to delay paying taxes and avoid potential penalties.)

The decision needs to be considered carefully, given that there are important, but little appreciated, consequences that flow from each choice. A recent study I conducted with John Turner and Catherine Reilly covered some of the key considerations driving this decision. Here is a look at the advantages of each option.

Rolling over to an IRA

▶ More investment options. One of the primary benefits of rolling over a 401(k) into an IRA is access to a larger menu of investment options. IRAs typically provide more choices than available in a 401(k) plan, including exchange-traded funds. Some ETFs charge relatively low fees, particularly index ETFs, yet relatively few employer-sponsored retirement accounts include these products to date.

In addition, a retiree seeking to buy individual stocks and bonds could do so in an IRA, as 401(k) plans tend to favor mutual funds. And IRAs can hold "unconventional" assets, including precious metals, physical real estate and hedge funds—investments not typically included in employer-sponsored plans.

▶ Streamline your accounts. People with several 401(k) accounts from past employers can streamline their financial lives by rolling them all into one IRA. This can make it easier to manage your portfolio and track your investments.

It is true that most 401(k) plans allow you to roll retirement savings from past employers into your current 401(k). Still, if you also have money in an IRA, that money will still remain separate.

Streamlining the number of retirement accounts also can simplify finances for your spouse or children, when the time comes for them to help you with important decisions about eldercare, nursing homes and estate management. This also can matter when the time comes for them to deal with your estate.

▶ More flexible payouts. IRAs usually offer more flexible payout options than 401(k)s. For instance, your former employer may restrict how much, and how often, you can withdraw from your 401(k) account, and whether the amounts withdrawn can vary over time.

By contrast, retirees can withdraw what they like from their IRAs, without needing to demonstrate hardship to take a distribution. Note that IRA distributions must be included in taxable income, and a 10% tax penalty applies for withdrawals made before age 59½.

With an IRA, you also can purchase an annuity that will generate a steady income stream for life, while few 401(k) plans currently include payout annuities in their investment menus. This is changing, however, as rules under the Secure Act and Secure 2.0 Act now allow plan sponsors to embed payout annuities into 401(k) menus, and several companies are moving to offer such products.

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Sticking with your 401(k)

▶ Costs and fees could be lower. Employer-sponsored 401(k) plans tend to offer less-costly pricing on investments and advice, compared with IRAs. For this reason, leaving assets in the company retirement plan could help retirees earn more on their investments.

Most 401(k) plans are likely to offer access to low-cost target-date funds that automatically adjust the investment mix as participants age.

Another point in favor of the 401(k) is that employers are increasingly working to hold on to 401(k) accounts, even after their employees retire.

▶ Greater fiduciary protections. Keeping your retirement money in your 401(k) plan provides a level of fiduciary protection not offered by many financial advisers. That's because the company offering the 401(k) must legally act in the best interests of plan participants. Specifically, employers are legally required to oversee plan investment choices and costs for retirees remaining in their 401(k) plans.

▶ You can tap the money sooner. For people needing to access their retirement assets sooner rather than later, 401(k)s often offer an important advantage. This is because many employer-sponsored plans will let you withdraw 401(k) money as early as age 55 without paying a penalty. For IRAs, the earliest access age without a tax penalty is 59½.

▶ Overwhelmed with options. An abundance of investment choices can overwhelm the majority of retirees who aren't financially literate, leading some to make poor investment and spending decisions. For example, my past research documented that many people age 50 and over don't understand the basic principles of risk diversification, asset valuation, portfolio choice and investment fees. And, my research has showed, the most vulnerable to such shortfalls are women, the less-educated, nonwhites, and persons age 75 and over, who often have less retirement savings.

For such individuals, the relative simplicity of sticking with the 401(k) would be preferred, versus rolling over into an IRA.