Santa Barbara Independent WHO. WHAT. NOW.

401(k) These Days

Is It Good Money After Bad—or Not?

By Kevin Bourke

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Mike from Santa Barbara asks whether he should continue contributing to his 401(k) at work. After all, it seems like he keeps adding money, yet the balance keeps going down. His question is extremely important because what we're really discussing is a quality of life issue. Will Mike have enough money to retire comfortably, and how does his 401(k) fit into the plan?

I can see where Mike's coming from, since it may seem like he's "throwing good money after bad." But let's dig a little deeper and see what's really happening. Is his money really disappearing into a void? Or is there some benefit to him continuing to contribute to his employer's retirement plan?

Money Talks

What Mike should do is back away from the economic news today, set his latest statement aside, and look at the big picture. Why is he in the retirement plan, what were his original thoughts when he started, is this long-term money, and should he reassess his risk tolerance?

Since the ultimate goal is to accumulate monies to supplement retirement income, should market fluctuations impact whether a person contributes or not?

The answer lies in an investment term called Dollar Cost Averaging (DCA). DCA refers to the process of investing a set amount of money on a systematic basis, come rain or shine. A 401(k) is a classic example of DCA since it involves investing a set amount regularly every paycheck.

What is the benefit of DCA? Since the dollar amount invested regularly stays the same, it allows a person to accumulate more shares when investment prices are lower, and less shares when prices are higher. The market goes down? You get to buy more shares with the same amount of money. The market goes up? No problem, you purchase less shares at a higher price.

When you just add up the numbers, it doesn't seem to matter much. For example, if the price of an investment went from $10 to $9 to $11, the average price is $10, right? Not exactly. When investing, the math works a little differently. It looks something like this:

- $100 invested when the investment unit price is $10 buys 10 units
- $100 invested when the investment unit price is $9 buys 11.11 units
- $100 invested when the investment unit price is $11 buys 9.09 units
- Totals: $300 invested equals 30.2 units purchased
- $300 purchased 30.2 units. Average cost? $9.93

Surprised? Can you see why Mike might be better off continuing to invest even when investments go south for a period of time? In some cases, market volatility can actually work in favor of employees contributing a fixed amount to their 401(k) plans. Note that such a plan involves continuous investment in securities regardless of fluctuation in price levels of such securities. Investors should consider their ability to continue purchasing through periods of low price levels. Such a plan does not assure a profit and does not protect against loss in declining markets.

So should Mike discontinue his retirement plan contribution? I don't know Mike's situation, so it's hard for me to give a definite answer, but it doesn't seem to make sense for him to stop now. In fact, investing now might fit the definition of "buy low." If anything, Mike might consider raising his contribution percentage to take advantage of current market conditions.

There are some caveats, of course. If Mike were losing sleep, if he were close to retirement, if market volatility was causing family friction, or if he realized he just can't live with the level of risk he's taking, these might be some of the reasons for him to rethink his strategy.

The lesson? Don't get caught up in the heat of the moment, not when it comes to investing.

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