How to Tell if Your 401K Is a Good or a Bad One

By Tim Lemke | 5 August 2016

If you work for a company, there's a good chance that your employer offers a 401K plan. (Some organizations offer 403b plans, which operate similarly.) These funds give you the chance to invest in a series of mutual funds and other investments, with the added benefit that any money you contribute is deducted from your taxable income.

Not all 401K plans are the same, however, and there is a wide range in the amount of expenses and the quality of investments offered.

It's not easy to immediately know if your 401K plan is a good one, and whether it's worth putting money into. But here are some things to examine.

Do You Get a Company Match?

Arguably the most positive aspect of a 401K plan is the ability of companies to match a certain percentage of employee contributions. Typically, a company might agree to contribute up to 5% of a worker's earnings, if the worker does the same. This match is essentially free money, so it usually makes participating in the 401K plan a no-brainer, even when the plan is otherwise subpar.

If your company does not contribute to your 401K plan or offer a match, you'll want to examine other characteristics of the plan to determine whether it's worth it to contribute. You may find that contributing to a traditional or Roth IRA is a better alternative.

Examine the Investment Options

A 401K plan is only as good as the investment options in them. There's no perfect menu, but a strong plan is anchored by one or two mutual funds that mirror the broader stock market. These are called "index" funds, because they are designed to mirror the performance of a specific index, such as the S&P 500. A good plan will also have some large-cap, mid-cap, and small-cap funds, and the ability to access international and real estate investments. Older investors will want to see a selection of quality bond funds.

You'll want to look for a diverse array of investments, but there is a point at which more options aren't necessarily better.

"More funds can just confuse you," said Ralph Grauso, founder of ASC Financial. "You don't need three different types of large-cap growth funds."

Check the Fees

One of the most common criticisms of 401K plans is that they often contain funds with high expenses. The best 401K plans should offer access to the lowest cost funds available.

Management fees, plan operating expenses, and other costs can take a chunk out of your returns without you even being aware. Over time, that can lead to tens of thousands of dollars in lost earnings. A survey by AARP noted that 80% of 401K plan participants don't know what they are paying in fees. Most information on fees is available by reading plan and fund documents, but you may still have to do some digging.

"If you're investing for 30 years or more, those fees are going to take a huge chunk of your money," Grauso said.

Grauso said it's best to find funds with expense ratios of less than 1%. Index funds are particularly low in cost because they are not actively managed, and often perform better than managed funds anyway, he said. Look for low-cost index funds from a broker such as Vanguard, and stay away from niche funds with high costs.

Study the Fund Performance

Ultimately, you want to put your money in funds that will generate a nice return and help you develop a sizable nest egg. Predicting future performance is not possible, but you can get a good sense of the quality of a fund by examining its long-term performance.

Look at five-year and 10-year returns, and compare them to a comparable benchmark. (For example, a large-cap fund should be compared to a large-cap index.) It's also worth comparing funds to the overall performance of the stock market and the S&P 500. If the fund has historically generated returns that are in line with or better than the overall stock market — especially after fees are taken into account — that's a good sign. Stay away from funds that appear to underperform the market and their respective benchmarks.

Who Is the Custodian?

When employers set up 401K plans, they partner with a company that actually manages the plans and many of the investments. Usually, it's with a brokerage firm such as Fidelity, Vanguard, or Charles Schwab.

The best 401K plans will be managed by companies who have the expertise and ability to offer quality investment options with low fees, easy online account access, and research. It is worth noting that these custodians manage not only the plans, but many of the mutual funds in them, and that is often viewed as a conflict of interest. If it seems like the custodian is favoring their own underperforming plan in favor of a better plan from another company, that's a bad sign.

Look for Institutional Class Shares

There are many high-quality mutual funds that are unavailable to average investors unless they can meet very high account minimums. But, investors can often access these funds through their 401K plans, because companies can guarantee a sizable combined investment from their employees. Mutual fund companies will often waive fees and other expenses if certain investment levels are met. These funds are often advertised as "institutional class," or "premium class," and usually it translates into very low-cost funds for the investor. Fidelity's 500 Index Fund Premium class, for instance, has an expense ratio of just .045%.

Is There a Self-Directed Option?

A typical 401K plan will allow investors to put their money in any of about a dozen mutual funds. But some will offer the ability for account holders to take a more active role, through self-directed brokerage accounts. This is a good option for those wishing to have more direct control over their investing, though evidence is mixed on whether this actually results in higher returns for the investor.

Is It Wrapped in an Annuity?

Many 401K plans have an annuity option, in which earnings are disbursed in the form of monthly payments. This is a nice option to have, as it ensures a steady stream of income in retirement. However, some plans are "wrapped" in an annuity contract that is often expensive and with minimal benefit to the investor.