Should A Participant Front Load Their Employee Deferrals?

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Many investors believe that as a rule it is beneficial to invest in the market as early as possible because the markets in the past have had a tendency to increase in value over time. Due to this positive bias, generally a participant is better off investing as soon as possible in order take advantage of those potential gains. But markets do not always go up; they may also go down, sometimes dramatically.

One of the concerns with front-loading employee deferrals in a 401(k) is that the markets would decrease in value early in the year and increase the losses. In order to protect investments from a sudden drop in the stock market, a participant can use a dollar-cost averaging investment strategy and split their total deferrals into the 401(k) on a regular basis throughout the year.

The second concern is how the matching contribution within the 401(k) plan works. Each plan works a little bit differently as determined by their employer, so it's important that participants understand how the matching contribution is calculated before ultimately deciding whether or not to front-load their employee deferrals.

Some plans will only match contributions during each pay period that participant contributes. So, if a participant does not make employee deferrals, then they will not get a match for that payroll period. In other words, if a participant front-loads their 401(k) early in the year, they may receive a reduced matching contribution for the year.

Let's assume that a participant wants to front-load their 401(k) and max out their employee deferral contribution by the end of March. Since they are only contributing to the 401(k) during the first quarter of the year, they would only receive the match on a quarter of their income. For example, if their compensation is $100,000 per year and the plan matches 5% of deferrals, the plan would only match on $25,000 of their compensation or $1,250 ($25000 * 5%) in matching dollars. The participant would be leaving $3,750 ($75,000 * 5%) on the table.

This can also be an issue if the plan limits the amount the participants can defer per payroll period. Some plans will only allow participants to defer up to 25% of their compensation. This provision may also limit the ability to front load employee deferrals. For example, a participant would need a salary of $27,334 per month in the first quarter of the year in order to defer the maximum of $20,500. Of course, if the plan does not have a deferral limit, then this would not be an issue.

How can we address this issue? The plan design set by the employer is key. The plan can be designed with an annual match or provide for a true up match at year end instead of just a per payroll-based match, if employers are concerned that employees are not receiving the full benefit they intended. This provision has to be elected in the plan document and is not an automatic option. This allows participants to time their deferrals any way they want during the plan year. In the example above, the participant would have received the $1,250 throughout the year and then would have received the $3,750 after the end of the plan year making them whole.

Plan sponsors need to evaluate their plan provisions every few years to make sure that the design is operating as intended and make changes to the plan document if necessary. Also, educating plan participants on their options in the plan should be on going. If you have any questions or concerns contact your Account Executive to discuss what match provisions your plan currently has and if changes need to be made.

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