5 Ways to Idiot-Proof Your IRA

The Motley Fool
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The IRA concept is simple: Open an account, fill it with money, tell Uncle Sam whether you want to pay taxes on it now or later, and let it ride until retirement.

So simple, yet so many people manage to mess it up. So how can you idiot-proof your most important retirement investment? Here are five humble suggestions:

1. Stop ignoring the little things. Fifty-nine basis points is no big whoop, right? That's barely more than half a percentage point, for crying out loud.

Crying out loud is exactly what you'll be doing if you let little things like 59 basis points add up over the years. Take a $1,000 investment earning a compounded average annual return of 14.42% and one earning 13.83% — that's right, 59 basis points less. After 53 years, the investment earning 13.83% will amount to $961,000. Hold your touchdown dance. Add in that trickle of extra returns over the years, and you end up with $1.26 million. That's the difference between investing in **ExxonMobil** (NYSE: XOM) and **IBM** (NYSE: IBM). Both were great stocks for shareholders who held for decades. But Exxon turned out to be just a little bit better — $300,000 better, that is.

On the same note ...

2. Don't overpay The Man. You might want to blame your bad investment luck on the market or your dentist's not-so-hot stock tips. But while you're pointing a finger, remember that three others are pointing right back at you. (Then there's the thumb, which appears to be blaming the cat.) If you fail to factor in the fees you pay to invest — brokerage fees, fund management fees, even subscriptions to investment newsletters — then you aren't calculating your real returns.

Nowhere is fee-padding more evident than in the mutual fund industry (even if you're not paying capital-gains taxes on frequent trades made within the fund, as is the case when you invest within an IRA). The average actively managed domestic-equity mutual fund charges management fees of nearly 1.5%. You saw what half a percentage point did to your returns above. Imagine the bite that 1.5% — compounded annually — would take.

Even index funds aren't immune from fee creep. If you're buying a plain old index mutual fund like the total stock market index fund or one that tracks the S&P 500, make sure you don't get hoodwinked into paying more than 1% in fees for something you can get for as little as 0.2%.

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3. Avoid overdosing on accounts. Maybe you can't be too rich or too thin (though have you seen the Olsen twins lately?). But you can have too many IRAs. Let's say that every time you change jobs, you roll the 401(k) money from your previous employer's retirement plan into a self-directed account. According to Department of Labor stats, Americans switch jobs once every four years. In a 44-year career, that translates into 11 rollovers — potentially at different brokerage firms if you're not organized.

Account overload can cause confusion for even the sharpest investors. Failure to know where your money is may cause you to miss important distribution deadlines and get socked with major penalties. That's right: Uncle Sam makes you start taking moola out of your IRA at age 70 1/2. Should you neglect to do so, the IRS will take 50% of what you should have withdrawn — and you won't even get a handwritten thank-you note.

4. Keep your hand out of the cookie jar. Consulting firm Hewitt found that nearly half of workers cash out their 401(k) plans when they leave their jobs. According to another survey, the average age of workers who cashed out their plans was between the ages of 37 and 40 — decades before retirement. Hello? What part of "retirement plan" don't you understand? Retirement money is (please repeat) *for retirement*.

Uncle Sam agrees. If you touch that money before age 59 1/2, he will fully tax your distributions as ordinary income and slap you with another 10% penalty just to get the message across. If you're wondering, the right way to handle an old 401(k) is to transfer your assets into an IRA or roll them into your new employer's plan.

And finally, the No. 1 Big Kahuna way to idiot-proof your IRA ...

5. Don't diss dividends. Hotshot IPOs like **MasterCard** (NYSE: MA) and **Vonage** (NYSE: VG) may be all the rage today, but if you ignore dividends, you're snubbing superior returns for the long run. A Standard & Poor's study found that from 1980 to 2002, dividend-paying stocks returned an annual compounded 2.7 percentage points more than non-payers. In 2004, the spread was more pronounced: The dividend-payers of the S&P 500 outperformed non-payers 18.35% to 13.65%.

The reason for this market-thumping performance is that dividend-paying stocks tend to be quality companies with defensible moats that generate growing free cash flow. And these aren't granny stocks we're talking about, either. Perhaps you've heard of **PepsiCo** (NYSE: PEP), **Altria** (NYSE: MO), and **Johnson & Johnson** (NYSE: JNJ)? (OK, so that last one does conjure up images of grandpop, but still.) If in 1980 you had purchased $2,000 of each, today you'd be sitting on a portfolio worth close to $600,000 by deferring taxes and reinvesting dividends.

Idiot-proof your retirement

These are just five ways you can save your IRA, but there are more, to be sure. For example, if you're buying and selling stocks in your IRA account, knowing *when* to buy and sell is just as important as *what* you buy. I recently chatted with Motley Fool co-founders David and Tom Gardner about this very topic — you can download a free audio transcript of our conversation here.

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This article originally ran on Sept. 1, 2005. It has been updated.

Dayana Yochim owns none of the companies mentioned in this article, but she does drive a grandma car. Really. She bought her 1991 Camry with just 60,000 miles on it from someone's grandmother. You don't need bifocals to read The Motley Fool's disclosure policy. Our rules are written clear as day. Johnson & Johnson is an Income Investor recommendation.

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