Prioritizing investments

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From Bogleheads

*This article contains details **specific to United States (US) investors**. It does not apply to non-US investors.*

Investors are faced with a variety of choices on *where* to invest their money; for example, a taxable account, a 401(k), or an IRA. Knowing which accounts to invest in first will maximize return with a minimum of taxes. **Prioritizing investments** indicates the appropriate order in which investments go into these accounts.

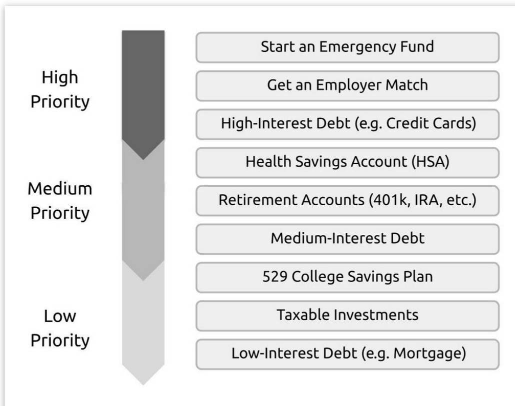
Take care to ensure that any investment priority decision aligns with your Investment Policy Statement.

This page describes the approximate order of accounts (and debts) that income should be contributed toward while working and accumulating assets. The corresponding order for withdrawing assets for spending in retirement is described in Retirement draw-down priority.

Funding priority

Here is a general account funding priority that often works well for many people[1][2][3] (not all points will apply to everyone). Refer to Figure 1.

Figure 1. Investment priority



It is important to realize that these steps are not cast in stone. The above list should be considered with some flexibility for your needs and personal preferences.

Table 1. Investment priority - details

Priority	Investment priority	Approximate after-tax return
1	Start building an emergency fund	N/A

Have enough cash on hand to cover unplanned expenses. While the exact amount depends on your situation (such as income stability), a common rule of thumb is to start with one month of expenses, and as you satisfy other financial priorities, grow it over time to around 3-12 months of expenses. (See: Emergency fund.)

Priority	Investment priority	Approximate after-tax return
2	Contribute to a work-based retirement plan (for example, 401(k) or 403(b)) enough to get the full employer match	50-100% immediately

Not getting a match is like letting your employer keep part of your salary.

If your employer offers an Employee Stock Purchase Plan (ESPP), it may also belong in this step; see below for details.

Priority	Investment priority	Approximate after-tax return
3	Pay off high-interest debt	10-30%

Typically these include credit cards and other unsecured loans. Paying off a high-interest debt is a guaranteed high return on your investment, the next best thing to free money.

Priority	Investment priority	Approximate after-tax return
4	Contribute to a Health Savings Account (HSA)	8-10%

HSAs offer tax-free contributions, growth, and withdrawals when used for qualified medical expenses. You can view HSA contributions as being matched by the IRS.[4] If you are in a 25% tax bracket, it costs you $750 to put $1000 in your HSA, and once it is there, it will not be taxed at all as long as you spend it for medical care, so this is as good as $1000 in a Roth IRA.[4][note 1]

After age 65, the HSA can also be used for non-medical expenses, with such withdrawals taxed at your regular tax rate. So if you are unlucky and are too healthy after 65, the HSA is still as good as a pre-tax retirement account.[4] Unlike pre-tax retirement accounts, HSA contributions made through an employer are also payroll tax-deductible.

Use of an HSA requires participation in an IRS qualified high deductible health plan (HDHP) at work. Look at your particular health care needs to decide if you may be better off with a traditional health care plan or an HDHP plus HSA. If the latter, then using the HSA as an investment account can be advantageous.

Priority	Investment priority	Approximate after-tax return
5	Contribute to available retirement accounts (for example, IRA, 401(k), 403(b), 457(b)) without a match	8%

Retirement accounts offer either an immediate tax deduction and tax-deferred growth (traditional) or life-long tax-free growth (Roth), plus asset protection and estate planning benefits. These accounts have annual contribution limits which are lost if not used.

You may have to choose among IRA vs. employer plan and/or traditional vs. Roth accounts. Consult those articles for more details.

Deductible IRA contributions are subject to income limits, but the income limit for contributing to a Roth IRA may be circumvented by the Backdoor Roth process.[note 2] Employer plans may also offer mega-backdoor Roth contributions, but these should be made only after normal contributions.[note 3]

A **governmental** 457(b) behaves similarly to a 401(k) or 403(b), except that 457(b)s have no early (before age 59½) withdrawal penalties. If a governmental 457(b) has reasonable investments and low fees, it usually makes sense to contribute to one *before* other retirement accounts. **Non-**

governmental 457(b)s and non-qualified retirement plans function very differently than most other retirement accounts; see below for details on whether and how these should be used.

Choosing between an employer retirement plan and an IRA

If the company plan offers good, low-cost funds, it may be preferable to contribute to the company plan *before* contributing to an IRA; see: Comparison between IRAs and employer plans.

Also, your marginal tax rate may influence the decision: those subject to higher marginal tax rates should consider higher contributions to a tax-deferred plan (for example, traditional 401(k) or IRA) rather than a post-tax plan (for example, Roth 401(k) or IRA). See Traditional versus Roth for more guidance.

If you prefer traditional to Roth, and traditional contributions to the employer's plan are needed to reduce your Modified Adjusted Gross Income (MAGI) for traditional IRA purposes enough to allow a full or partial IRA deduction (see IRA Deduction Limits), consider contributing to an employer plan before an IRA.

Employer plans with high cost funds

Many company plans contain high-cost funds which make them unattractive. If you have such a plan, look for one or two index funds or a bond fund that can be used. If your company offers matching funds up to a certain contribution level, it is **always** wise to use the company plan. If there is no match, the power of tax-deferred compounding and automatic contributions still favors using the plan with limited contributions.

Also, if you leave your current employer you will most likely be able to rollover the assets in your poor-quality company plan to either a better company plan, or to an IRA.

<table>
<tr><td>6</td><td>Pay off medium-interest debt</td><td>6-9%</td></tr>
<tr><td colspan="3">Typically these include student loans, car loans, personal loans, and Home Equity Lines of Credit (HELOCs). The choice to pay off debt or invest is based mostly on the expected after-tax rate of return. When the returns are similar, secondary factors sway the decision; see: Paying down loans versus investing.</td></tr>
</table>

<table>
<tr><td>7</td><td>Invest in a 529 college savings plan, if applicable</td><td>8% for education</td></tr>
<tr><td colspan="3">A common adage is "you can borrow for college but not for retirement."[5] When you decide your retirement is secure enough, and believe you will be paying a significant amount for your children's education, some use of a 529 plan would be appropriate. At that point, your 529 plan contributions would come before taxable investing. 529 plans offer tax-free growth (like a Roth IRA) when used for qualified education expenses, and may offer state tax benefits for contribution.

How much to save for college is a complicated question with no one right answer.[6][7][8] If your budget can support it, saving at least up to your state's limit for tax incentives (if any) is a good goal. If you later withdraw money for non-education expenses, you will pay income tax plus a 10% penalty on the gains.[9] There may be less costly options for disposing of unused 529 funds, such as changing the beneficiary to grandchildren or other relatives,[10] or rolling the money into a Roth IRA subject to some restrictions and lifetime limits.[11]</td></tr>
</table>

<table>
<tr><td>8</td><td>Invest in taxable investments</td><td>5-7%</td></tr>
<tr><td colspan="3">As you consider all these steps, keep in mind that your asset allocation (ratio of stocks to bonds), which sets your portfolio's level of acceptable risk, is the single most influential decision you can make on your portfolio's performance. Your chosen asset allocation (% stocks / % bonds) may direct you to skip some of these steps.</td></tr>
</table>

<table>
<tr><td>9</td><td>Pay off low-interest debt</td><td>2-5%</td></tr>
<tr><td colspan="3">Typically these include mortgages and other secured debt. Paying off low-interest debt on good terms should be a lower priority than most other funding options, but a higher priority than investing in low-return investments with no tax advantages.</td></tr>
</table>

Less common accounts

Employee Stock Purchase Plan (ESPP)

If your employer offers an Employee Stock Purchase Plan (ESPP), it may be very beneficial to use, though a lower priority than getting a retirement match. A typical ESPP allows you to buy shares of your employer's publicly-traded stock at a significant discount from the market price. After a contribution and holding period (usually six months), you can withdraw the shares and sell them on the open market for a profit.[12] If the plan allows shares to be sold immediately, there is little to no market risk for the stock and the plan is like free money, albeit with an interruption in cash flow and some extra paperwork. Once you have gone through one contribution period, proceeds from the plan will offset contributions, and your cash flow will be neutral with an excellent rate of return. Details vary, so check with your company's benefits department.

However, if the plan requires shares to be held for a significant time after the contribution period, that exposes you to significant concentrated market risk and also lowers the rate of return, and the benefit of the plan is more questionable. In any case, voluntarily holding onto company stock for longer than necessary to get the plan benefits is usually not advised, due to the concentrated risk of simultaneous crash of the stock price and loss of your job.

Non-governmental 457(b) plan

Main article: 457(b)

Despite the similarity in name, non-governmental 457(b)s are very different from governmental 457(b)s and other retirement accounts; they are more of a deferred compensation plan. Compared to other retirement plans, non-governmental 457(b)s have several major drawbacks:

- The balance cannot be rolled into an IRA upon separation from the employer
- The distribution options may be poor, possibly forcing you to withdraw all your assets in the year you separate from the employer and concentrating all that taxable income in one year
- Assets in the plan are legally property of the employer until distributed to you, raising asset protection concerns

Read the plan documents carefully, particularly the distribution options, and consider your employer's financial health before deciding to invest in a non-governmental 457(b). It usually makes sense to use a non-governmental 457(b) only after other retirement accounts, if at all. If a non-governmental 457(b) makes sense to use, the lack of early withdrawal penalties can be useful in certain situations, such as early retirement.

Non-Qualified Deferred Compensation (NQDC) plan

Main article: Non-qualified retirement plan

Some companies allow some employees (often limited to those above some rank) to defer compensation until after leaving that company. As noted in the brief wiki section, Deferred compensation plan (non-qualified), and various forum topics such as Deferred compensation worth it? (search for "deferred compensation" to find others), details on these plans vary widely.

An NQDC plan may be particularly valuable to a highly paid employee because it allows you to defer tax at high marginal tax rates on amounts much greater than 401(k) and similar plans do. The plan will not, however, be valuable at all if the company goes bankrupt, or may be less valuable than expected if you continue to work elsewhere and must add NQDC distributions to your employed earnings.

Notes

Notes

1. ↑ If you are in a 25% tax bracket, it costs you $750 to put $1000 in your HSA, and once it is there, it will not be taxed at all as along as you spend it for medical care.[4] This means the deductible also gets discounted by your tax rate: this should be taken into account when comparing deductibles with non-HSA plans. Note that health plans with a Flexible Spending Arrangement (FSA) also offer tax deductions; however, the FSA is a *use-it-or-lose-it* plan, with balances normally zeroed out at the end of every year.
2. ↑ You should verify eligibility before making traditional IRA contributions: in particular, check the tax-deduction limit. For Roth IRAs, the backdoor Roth is a technique for making contributions when your income exceeds the eligibility limit. It is complicated in nature and may not be for everyone. Read the Cautions section of the article before proceeding and ask in the forum if you are unsure.
3. ↑ This technique is only available through select employer plans; it is complicated in nature and may not be for everyone. Read the Mega-backdoor Roth article to determine if your plan supports it, and ask in the forum if you are unsure.

See also

- Employer matching contributions
- Principles of tax-efficient fund placement
- Asset allocation in multiple accounts
- Paying down loans versus investing

References

1. ↑ "Investment order". Mr. Money Mustache Forum. December 8, 2016. Retrieved June 5, 2023.
2. ↑ "What order should I fund my investing accounts in?". White Coat Investor. May 5, 2017. Archived from the original on March 27, 2023.
3. ↑ "401(k), Roth IRA, then Back at 401(k)". The Finance Buff. October 22, 2006. Retrieved June 5, 2023.
4. ↑ 4.0 4.1 4.2 4.3 Bogleheads forum post: "Prioritizing investments- HSA goes where?", grabiner. February 16, 2014.
5. ↑ "5 reasons you shouldn't use retirement savings to pay for college". Principal. Retrieved Aug 26, 2024.
6. ↑ Bogleheads forum topic: "How much to save for college education - public and private", lightnoise. August 24, 2023
7. ↑ Bogleheads forum topic: "How much to save for 529 plan?", zrzhu111. December 20, 2020
8. ↑ Bogleheads forum topic: "What should the target amount to save up for college be?", someuser001. November 27, 2016
9. ↑ "What is the Penalty on 529 Plan Withdrawals for Non-Qualified Expenses?". Saving for College. November 3, 2023. Retrieved Aug 26, 2024.
10. ↑ "How to Superfund a 529 Plan". The White Coat Investor. February 8, 2022. Retrieved Aug 26, 2024.
11. ↑ "529-To-Roth IRA Rollovers: Taking Advantage Of The New Option To Move Education Savings To Retirement Savings". Kitces.com Nerd's Eye View. June 26, 2024. Retrieved Aug 26, 2024.
12. ↑ "Invest in your work and your future with an ESPP". Fidelity. Retrieved Aug 31, 2024.

External links

- Bogleheads forum topic: "Wiki - Prioritizing investments (proposed updates)", okwriter. July 9, 2021.
- "Investment order". Mr. Money Mustache Forum. December 8, 2016. Retrieved June 5, 2023.
- "What order should I fund my investing accounts in?". White Coat Investor. May 5, 2017. Archived from the original on March 27, 2023.
- "401(k), Roth IRA, then Back at 401(k)". The Finance Buff. October 22, 2006. Retrieved June 5, 2023.