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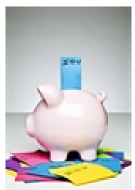
The Economics of Borrowing from Your 401(k)

When times are tough, that pool of dollars sitting in your 401(k) plan account may start to look attractive. But before you decide to take a plan loan, be sure you understand the financial impact. It's not as simple as you think.

The basics of borrowing



A 401(k) plan will usually let you borrow as much as 50% of your vested account balance, up to $50,000. (Plans aren't required to let you borrow, and may impose various restrictions, so check with your plan administrator.) You pay the loan back, with interest, from your paycheck. Most plan loans carry a favorable interest rate, usually prime plus one or two percentage points. Generally, you have up to five years to repay your loan, longer if you use the loan to purchase your principal residence. Many plans let you apply for a loan online, making the process quick and easy.

You pay the interest to yourself, but…

When you make payments of principal and interest on the loan, the plan generally deposits those payments back into your individual plan account (in accordance with your latest investment direction). This means that you're not only receiving back your loan principal, but you're also paying the loan interest to yourself instead of to a financial institution. However, the benefits of paying interest to yourself are somewhat illusory. Here's why.

To pay interest on a plan loan, you first need to earn money and pay income tax on those earnings. With what's left over after taxes, you pay the interest on your loan. That interest is treated as taxable earnings in your 401(k) plan account. When you later withdraw those dollars from the plan (at retirement, for example), they're taxed again because plan distributions are treated as taxable income. In effect, you're paying income tax twice on the funds you use to pay interest on the loan. (If you're borrowing from a Roth 401(k) account, the interest won't be taxed when paid out if your distribution is "qualified"--i.e., it's been at least 5 years since you made your first Roth contribution to the plan, and you're 59½ or disabled.)

...consider the opportunity cost

When you take a loan from your 401(k) plan, the funds you borrow are removed from your plan account until you repay the loan. While removed from your account, the funds aren't continuing to grow tax deferred within the plan. So the economics of a plan loan depend in part on how much those borrowed funds would have earned if they were still inside the plan, compared to the amount of interest you're paying yourself. This is known as the opportunity cost of a plan loan, because by borrowing you may miss out on the opportunity for additional tax-deferred investment earnings.

Other factors

There are other factors to think about before borrowing from your 401(k) plan. If you take a loan, will you be able to afford to pay it back and continue to contribute to the plan at the same time? If not, borrowing may be a very bad idea in the long run, especially if you'll wind up losing your employer's matching contribution.

Also, if you leave your job, most plans provide that your loan becomes immediately payable. If you don't have the funds to pay it off, the outstanding balance will be taxed as if you received a distribution from the plan, and if you're not yet 55 years old, a 10% early payment penalty may also apply to the taxable portion of that "deemed distribution."

Still, plan loans may make sense in certain cases (for example, to pay off high-interest credit card debt or to purchase a home). But make sure you compare the cost of borrowing from your plan with other financing options, including loans from banks, credit unions, friends, and family. To do an adequate comparison, you should consider:

- Interest rates applicable to each alternative
- Whether the interest will be tax deductible (for example, interest paid on home equity loans is usually deductible, but interest on plan loans usually isn't)
- The amount of investment earnings you may miss out on by removing funds from your 401(k) plan

See disclaimer on final page

Healthy Personal Finance Resolutions for the New Year

The start of a new year may also be a good time to meet with a financial professional. A financial professional can help you:

- ***Determine your income, assets, and liabilities***
- ***Identify financial goals***
- ***Understand specific products/services***
- ***Monitor your overall financial plan***
- ***Adjust your plan if needed***

The new year is the time when many individuals start making resolutions to live a healthier lifestyle. And while resolving to eat better and exercise more is a good thing, you should be sure to make resolutions that pertain to the overall health of your personal finances as well.

Develop a budget and stick with it

A good way to start the year on the right track financially is to make sure that you have a budgeting system in place. Start by identifying your income and expenses. Next, add them up and compare the two totals to make sure you are spending less than you earn. If you find that your expenses outweigh your income, you'll need to make some adjustments to your budget plan (e.g., reduce discretionary spending).

Once you have a budget, it's important to stick with it. And while straying from your budget from time to time is to be expected, there are some ways to help make working within your budget a bit easier:

- Make budgeting a part of your daily routine
- Be sure to build occasional rewards into your budget
- Evaluate your budget regularly and make changes if necessary
- Use budgeting software/smart phone applications

Set financial goals or reprioritize current ones

The new year is also a good time to set new financial goals and reprioritize your current ones. Take a look back at the financial goals you set for yourself last year--both short- and long-term. Perhaps you wanted to increase your cash reserve or save money for a down payment on a home. Maybe you wanted to invest more money towards your retirement. Did you accomplish any of your goals? If so, do you have any new goals that you would now like to achieve?

Finally, have your personal or financial circumstances changed during the past year (e.g., marriage, a child, job promotion)? If so, would any of these changes warrant a reprioritization of some of your goals?

Make sure your investment portfolio is still on target

You'll also want to be sure to review your investment portfolio to ensure that it is still on target to help you achieve your financial goals for the upcoming year. To determine whether your investments are suitable for reaching your financial goals, you'll want to ask yourself the following questions:

- Do I still have the same time horizon for investing as I did last year?
- Has my tolerance for risk changed?
- Do I have an increased need for liquidity?
- Does any investment now represent too large (or too small) a part of my portfolio?

Make it a priority to reduce debt

Any healthy financial plan is one that makes reducing debt a priority. Whether it is debt from student loans, a mortgage, or credit cards, it is important to have a plan in place to pay down your debt load as quickly as possible. The following are some tips to help you manage your debt:

- Keep track of all of your credit card balances and be aware of interest rates and hidden fees
- Develop a plan to manage your payments so that you avoid late fees
- Optimize your repayments by paying off high-interest debt first or consider taking advantage of debt consolidation/refinancing programs
- Avoid charging more than you can pay off at the end of each billing cycle

Review/take steps to improve your credit history

Having good credit is an important part of any sound financial plan, and the new year is as good a time as any to check on your credit history. Your credit report contains information about your past and present credit transactions and is used by potential lenders to evaluate your creditworthiness. A positive credit history is important since it allows you to obtain credit when you need it and at a lower interest rate. Good credit is even sometimes viewed by employers as a prerequisite for employment.

Review your credit report and check it for any inaccuracies. You'll also want to find out whether or not you need to take steps to improve your credit history. To establish a good track record with creditors, make sure that you always make your monthly bill payments on time. In addition, you should try to avoid having too many credit inquiries on your report (these are made every time you apply for a new credit card). You're entitled to a free copy of your credit report once a year from each of the three major credit reporting agencies. You can go to www.annualcreditreport.com for more information.

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Because retirement may be many years away, it's easy to put off planning for it. The longer you wait, however, the harder it is to make up the difference later. That's because the sooner you start saving, the more time your investments have to grow.

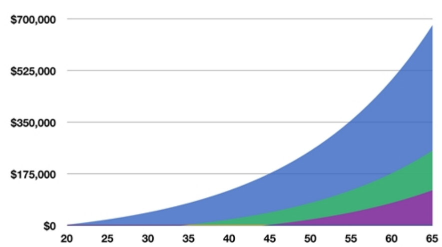
Four Retirement Planning Mistakes to Avoid

We all recognize the importance of planning and saving for retirement, but too many of us fall victim to one or more common mistakes. Here are four easily avoidable mistakes that could prevent you from reaching your retirement goals.

1. Putting off planning and saving

Because retirement may be many years away, it's easy to put off planning for it. The longer you wait, however, the harder it is to make up the difference later. That's because the sooner you start saving, the more time your investments have to grow.

The chart below shows how much you could save by age 65 if you contribute $3,000 annually, starting at ages 20 ($679,500), 35 ($254,400), and 45 ($120,000). As you can see, a few years can make a big difference in how much you'll accumulate.



Note: *Assumes 6% annual growth, no tax, and reinvestment of all earnings. This is a hypothetical example and is not intended to reflect the actual performance of any investment.*

Don't make the mistake of promising yourself that you'll start saving for retirement as soon as you've bought a house or that new car, or after you've fully financed your child's education--it's important that you start saving as much as you can, as soon as you can.

2. Underestimating how much retirement income you'll need

One of the biggest retirement planning mistakes you can make is to underestimate the amount you'll need to accumulate by the time you retire. It's often repeated that you'll need 70% to 80% of your preretirement income after you retire. However, depending on your lifestyle and individual circumstances, it's not inconceivable that you may need to replace 100% or more of your preretirement income.

With the future of Social Security uncertain, and fewer and fewer people covered by traditional pension plans these days, your individual savings are more important than ever. Keep in mind that because people are living longer, healthier lives, your retirement dollars may need to last a long time. The average 65-year-old American can currently expect to live another 19.2 years (Source: National Vital Statistics Report, Volume 60, Number 4, January 2012). However, that's the average--many can expect to live longer, some much longer, lives.

In order to estimate how much you'll need to accumulate, you'll need to estimate the expenses you're likely to incur in retirement. Do you intend to travel? Will your mortgage be paid off? Might you have significant health-care expenses not covered by insurance or Medicare? Try thinking about your current expenses, and how they might change between now and the time you retire.

3. Ignoring tax-favored retirement plans

Probably the best way to accumulate funds for retirement is to take advantage of IRAs and employer retirement plans like 401(k)s, 403(b)s, and 457(b)s. The reason these plans are so important is that they combine the power of compounding with the benefit of tax deferred (and in some cases, tax free) growth. For most people, it makes sense to maximize contributions to these plans, whether it's on a pre-tax or after-tax (Roth) basis.

If your employer's plan has matching contributions, make sure you contribute at least enough to get the full company match. It's essentially free money. (Some plans may require that you work a certain number of years before you're vested in (i.e., before you own) employer matching contributions. Check with your plan administrator.)

4. Investing too conservatively

When you retire, you'll have to rely on your accumulated assets for income. To ensure a consistent and reliable flow of income for the rest of your lifetime, you must provide some safety for your principal. It's common for individuals approaching retirement to shift a portion of their investment portfolio to more secure income-producing investments, like bonds.

Unfortunately, safety comes at the price of reduced growth potential and the risk of erosion of value due to inflation. Safety at the expense of growth can be a critical mistake for those trying to build an adequate retirement nest egg. On the other hand, if you invest too heavily in growth investments, your risk is heightened. A financial professional can help you strike a reasonable balance between safety and growth.

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Can I be reimbursed from my health-care FSA for over-the-counter medications?

A health-care flexible spending account (FSA) allows you to pay for certain qualified medical and dental expenses with pretax dollars. With a health-care FSA, you can contribute pretax earnings to the plan (usually through a salary reduction agreement with your employer) and submit qualifying expenses to the plan for reimbursement. If you tend to spend a lot of money on medical expenses that are not covered by your health plan, contributing to an employer-sponsored health-care FSA is a good way to help pay for these expenses.

Although over-the-counter (OTC) medications used to be reimbursable from a health-care FSA, the Patient Protection and Affordable Care Act of 2010 amended the definition of qualified medical expenses for health-care FSA reimbursement purposes. As a result, OTC medications (except for insulin and medications that are prescribed by a physician) are no longer eligible for reimbursement.

However, many OTC medications are also available by prescription. You may want to ask your doctor for a prescription for any OTC medications that you use on a regular basis (e.g., pain relievers and allergy medications). You'll need to submit the prescription along with a receipt to your FSA provider in order to get reimbursed. Some FSA providers offer forms that allow your doctor to write a prescription once for any of the OTC medications that you'll need throughout the year.

Currently, there is no legal limit on the amount that you can contribute to a health-care FSA. However, most employers do impose a cap on contributions (typically $3,000 to $5,000). And beginning in 2013, if a health-care FSA is part of a cafeteria plan, annual contributions will be capped at $2,500 (starting in 2014, that amount will be adjusted for inflation).

Finally, when participating in an FSA, it's important to remember that you cannot carry over any money you contribute from one plan year to the next--in other words, if you don't use it, you lose it. As a result, it's important to choose your contribution amount carefully so that you don't risk losing any contributions at the end of the plan year.

Should I participate in my employer's wellness program?

Living a healthier lifestyle can greatly improve one's overall well-being and reduce health-care expenses. As a result, many employers are offering wellness programs to their employees as a way to reduce absenteeism and lower the cost of employer-sponsored health care. According to a 2010 Bureau of Labor Statistics survey, one-third of U.S. private sector workers had access to an employer-sponsored wellness program.

For employers, wellness programs not only reduce health-care costs by promoting healthier living, but they also have been shown to boost employee productivity and morale. The types of wellness programs vary among employers, but they typically cover a variety of healthy living issues, such as:

- Smoking cessation
- Exercise/physical fitness
- Weight loss
- Nutrition education
- Health screenings/assessments

Some companies even provide healthy living education, resources, and incentive tracking through an online "wellness portal."

In addition to helping you live a healthier lifestyle, a wellness program may offer financial benefits. Currently, employers are permitted to offer wellness incentives (e.g., premium discounts, cash rewards) to employees of up to 20% of the cost of their health-care premium. And beginning in 2014, under the 2010 Patient Protection and Affordable Care Act, employers will be able to increase the incentive amount to 30% of the cost of the employee's premium.

Keep in mind that with certain types of wellness incentives, such as cash bonuses or gift certificates, the value of the reward may be treated as taxable wages and therefore may be subject to payroll taxes.