

## Are 401(k) Loans A Good Idea?

### SYNOPSIS

- Many Americans view their 401(k) retirement fund as an easy way to borrow for short-term financing needs.
- Despite the temptation, the dangers of borrowing against a retirement fund are too great and should be avoided at all costs.
- Instead of trading one debt with another that's far more serious, address the real problem that created the need for the loan.

### THE 401(K) LOAN

I recently spoke with an investor who had explained that his son was considering borrowing against his 401(k) retirement fund, which was set up by his current employer, to pay off some of his high interest credit card bills.

Most 401(k) plans are set up in a way that allows employees to borrow up to 50% of the value of the fund with a maximum of \$50,000. The appeal of such a loan is that the interest rate is usually quite low, particularly relative to the average credit card, and the borrower is actually paying interest back to himself (since he is both the lender and borrower).

While I applauded his son's desire to lower his interest expenses, I forced this investor to promise to me that he would not allow his son to ever borrow against his 401(k). Taking out such a loan represents one of the worst financial decisions imaginable for five key reasons:

1. **After-Tax Dollars:** One of the best features of a 401(k) is that they get funded with pre-tax dollars. When a 401(k) loan gets repaid, the borrower must use after-tax dollars, thereby forfeiting the tax advantage. What makes
2. **Missing Out:** The money removed from the 401(k) is no longer being invested, which means that the amount removed will not grow and/or compound over time. Furthermore, many employers won't allow future contributions until the loan is repaid, which makes saving for retirement even more difficult.
3. **Don't Quit or Get Fired:** If the borrower were to lose his job for any reason, he has to repay the entire loan amount in full, usually within 90 days. Otherwise, the loan is treated like a distribution, which means the full amount will be subject to income tax and a 10% withdrawal penalty if he's under the age of 59½.
4. **Repayment Closer to Retirement:** The older the borrower, the less time that individual will have left to pay back the loan before retiring.
5. **Defeats the Purpose:** Borrowing defeats the purpose of the 401(k) because that fund exists for the sole purpose of preparing the borrower for retirement. No matter how urgent he may think his present situation may appear, it will be nothing compared to what he'll experience if he's in his 70s or 80s without adequate funds.

matters even worse is that the borrower will then have to pay tax again when money is withdrawn in retirement. Hence, it's effectively making the borrower subject to double taxation!

*Borrowing from a 401(k) can only hurt you in the long run.*



Simply put, there is absolutely no excuse to ever borrow against a 401(k). Find another way to raise cash because this is never a viable option.

## IMPLICATIONS FOR INVESTORS

The popularity of 401(k) loans surged after 2008, mostly due to the fact that borrowers were no longer able to use home equity loans as easy as in years leading up to the financial crisis.

According to the IRS, over \$5.7 billion in penalties were collected for early withdrawals in 2011. As stated above, the penalty for early withdrawal is 10%, which means that Americans must have withdrawn \$57 billion from their retirement saving before they actually retired!

It's also important to note that these loans rarely address the real problem. In the case of this individual who wants to replace one debt with another, high credit card bills are almost always indicative of bad spending habits. Simply hitting

the reset button on all that plastic has not taught him any fiscal wherewithal, and the only way he will get his feet back on the ground is by stop spending so much money.

Admittedly, life is not fair, bad things happen to good people, and everyone makes mistakes. However, trying to fix one mistake by making a much bigger one that risks your well-being in retirement is akin to flirting with financial suicide.

*The bottom line* is that no matter what the reason or how dire the situation, borrowing from a 401(k) can only hurt you in the long run. Don't ever do it.

Sincerely,

A handwritten signature in black ink, appearing to read "Mike Sorrentino", written in a cursive style.



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