Your Dollars, Your Sense: Pros and Cons of a 401(k) Loan

RETIREMENT SERVICES

Most people understand that debt is something to be avoided and that long-term investments should be left untouched. But neither of those things changes the fact that sometimes a person needs money for the unexpected. In those situations, taking a loan from your 401(k) may seem like a good idea. But is it?

The Positives

- **Ease.** People who take 401(k) loans are borrowing from themselves. As a result, there is no credit inquiry, no lengthy application, and no impact on credit rating. Usually requesting a loan is as simple as a phone call or a few clicks on a website.
- **Payment Flexibility.** While most plans specify a repayment schedule, usually five years, there is no penalty for paying the loan down more quickly. Usually, the payments happen automatically through payroll deduction.
- **Inexpensive.** The median loan origination fee is $75 with an annual $50 service charge.[1] In addition, the interest rate is usually much lower than what a credit card would charge, and more important, the interest is paid to the plan. Borrowers are essentially paying themselves.

CONSIDERING A 401(K) LOAN? YOU'RE NOT ALONE

Almost **83%** of retirement plans allow participants to take loans.[1]

Nearly **1 in 5 people** take loans from their retirement plans.[2]

The average loan is **$9,700**.[2]

The median interest rate for a retirement plan loan is **4.5%**.[1]

Nearly **2 in 5 retirees**, who once took loans from their 401(k)s, regretted doing so.[3]

The Downside

- **Lost Opportunity.** Even though borrowers pay themselves back, that repayment only replaces what was in the account. Other than the interest, no new funds are added. And because one of the benefits of long-term investments is compounding, where invested dollars may earn more dollars through dividends and market growth, that opportunity is lost as well.

  Note: Some would argue that a loan is actually a better investment in down markets because the money won't be lost when stock prices fall. While this is true, over the long-term, the market has historically been up more than down and the increases have been greater than the losses.

[1] 59th Annual Survey of Profit Sharing and 401k Plan Loans, Plan Sponsor Council of America, 2016
[2] How America Saves, Vanguard, 2017
[3] Fidelity, 2011

- **Taxes.** The money used to pay back a 401(k) loan is invested after tax. This means that a borrower loses the tax deferral benefits of retirement plan savings and must pay taxes on the repayment as well as when he or she withdraws the funds in retirement.
- **Termination Risk.** A 401(k) loan depends on continued employment with the organization sponsoring the plan. If a borrower loses his or her job, or goes to work for a different employer, plan rules may require an immediate repayment of the outstanding loan. Any amounts not repaid by the plan deadline are immediately taxed and subject to an additional 10% early withdrawal penalty if the borrower is younger than 59½.

Loans to Purchase a Primary Residence

There are special rules if you use a 401(k) loan for the purchase of a primary residence. All the positives still apply plus the repayment time frame is usually longer. On the downside, though, borrowers would not receive tax deductions for the interest paid on the loans the way they would with other forms of credit and the impact of an even longer-term loan on retirement goals would be compounded.

Is a Loan Right for You?

A financial planner can help those considering a 401(k) loan evaluate their personal goals, credit, and options to make this determination. But a few rules of thumb can help. If you answer "No" to any of the following questions, you may want to reconsider taking a loan from your plan:

After you take the loan, will you maintain or increase the amount you are contributing to your retirement plan?

Are the fees and interest rates charged less than what you would pay to a third party lender? (Remember to consider how long you will need to repay the money and the loss of tax deferral benefits.)

Do you expect your investment portfolio returns to be less than the interest rate on the loan?

Can you comfortably repay the loan over the repayment period?

Do you expect to continue working for your current employer through the loan repayment period?

Your retirement plan service provider will have more information about taking loans from your 401(k). See the provider's website or the call the service center for information about your plan's specific rules, calculators that can help you evaluate your options, and articles that can explain more.

ON THE MARK:

WHAT’S HAPPENING IN THE ECONOMY AND MARKETPLACE

Growth Around the World

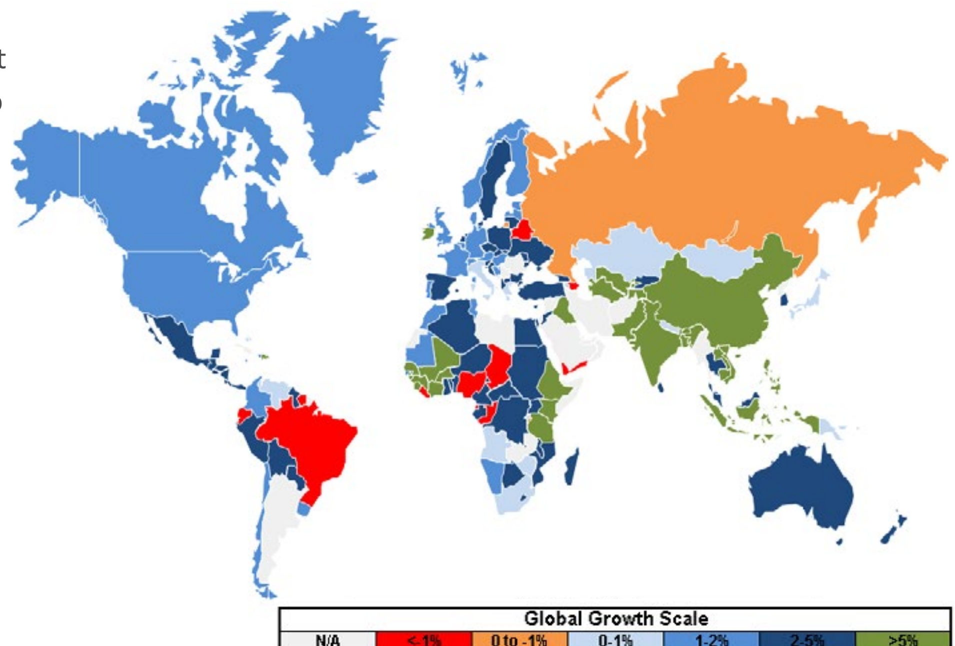
After years of low growth following the Great Recession, the world’s major economies have entered a period of synchronized global growth. While other economies grew more in the last year, the US has experienced the strongest and most stable economic growth since the Recession. The European Union (EU) fell back into recession during portions of 2011–2013, but has been recovering more recently. Central banks of major economies are also beginning to reduce the levels of monetary stimulus, which points to firmer growth abroad.

Given that the US and China account for close to 40% of the world’s Gross Domestic Product (GDP), it is no surprise that global GDP closely tracks what is happening in these two countries. The US has been the world’s biggest economy for more than a century, accounting for nearly 24% of the world’s GDP in 2016. But China is catching up and now sits in second place, accounting for almost 15% of the world’s GDP.

China’s growth rate continues to outpace the US’s with China growing at an average of 9% for the past 20 years versus the US modest 2.4% average growth. In fact, 71% of countries grew at rates above the US, but the size of the US skews global growth to levels in line with the US.

Many other countries across the globe are gaining traction in a more synchronized global expansion. Areas like the EU are increasing their rates of growth and are also at earlier stages of their growth cycles. Investors should review their portfolios to ensure they have an acceptable level of exposure to international markets, which can offer both diversification and return benefits.

- 2016 world GDP growth was 2.44%.
- The US, China, and the EU accounted for 61% of the $75 trillion 2016 world GDP.
  - US grew 1.6%.
  - China grew 6.7%.
  - EU grew 2.0%.
- The EU has seen the biggest improvement in GDP growth, from declines in early 2013 to 2% growth in 2016.
- Brazil and Russia are the only two major economies currently suffering from GDP declines. Both areas have been negatively impacted by commodity declines and political instability.



Source: The World Bank

Market Cycles and Active Management

After the Great Recession, passive investing garnered a lot of investor interest and amassed 28.5%[1] of the US's assets under management. But active management often shows a better ability to manage risk and offer better protection during downturns, and there has been some evidence of an active resurgence during the past 12 months. While active management has been out of favor in recent years, it still plays an important role in a portfolio.

Active Management in Market Corrections

Most passive funds are market cap weighted, which causes them to invest in the areas of the market that have grown the most. In contrast, active managers can assess whether that growth is likely to continue and focus on downside risk through active-management decisions. As a result, many active managers choose to take less risk than the index by buying higher-quality firms that may limit some downside risk. Two recent marketplace examples demonstrate the value of this approach:

- 2000s Technology Bubble
  - Indices increased exposure to technology stocks that had seen recent gains.
  - Average active managers protected more in the resulting crash; more cognizant of sector exposure and valuation than the index.
- Great Recession
  - Indices increased exposure to financials and energy leading up to the Great Recession.
  - Active protected better than the index.

Many investors pick a manager based solely on best performance. But a prudent investor understands that different types of investments, active and passive, work well in different markets. As a result, including the choice of both active and passive options can improve investment manager diversification.

[1]Moody's, 2017

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KC: 36626