THE WHITE PAPER

Strategies for Managing Your Assets

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Think Twice Before You Raid Your 401(k)

With the recent release of the IRS's 401(k) contribution limits for 2015, attention turned, as it has in prior years, to the large number of plan participants who come nowhere close to contributing these amounts. Instead, many workers use their 401(k) accounts as a way to pay off loans and supplement their regular cash flow.

The amounts withdrawn are significant. According to a recent study by Vanguard, the average withdrawal represents one-third of the participant's account balance. Additionally, most withdrawals are not for hardship -- non-hardship withdrawals outnumber hardship withdrawals by a factor of 2 to 1, and the rate of new non-hardship withdrawals doubled between 2004 and 2013.[1]

Why are so many withdrawals occurring? One reason is to pay off debt, including student loans. Another may be to help make ends meet when people are between jobs. Fidelity reported earlier this year that 35% of participants took all or part of their 401(k) savings when leaving a job.[2]

No matter the reason, the long-term implications of early 401(k) withdrawals can be considerable. In withdrawing from the account, plan participants will miss out on tax-deferred compounding of that money, which can add up over time.

Alternatives to Raiding Your 401(k)

Withdrawing from a tax-deferred retirement plan to meet short-term needs should be a last resort. Before doing so, consider alternatives such as the following:

- Savings accounts or other liquid investments, including money market accounts. With short-term interest rates at historically low levels, the opportunity cost for using these funds is relatively low.
- Home equity loans or lines of credit. Not only do they offer comparatively low interest rates, but interest payments are generally tax deductible.
- Roth IRA contributions. If there is no other choice but to withdraw from retirement savings, consider starting with a Roth IRA. Amounts contributed to a Roth IRA can be withdrawn tax and penalty free if certain qualifications are met. See IRS Publication 590 for more information.

[1]*Vanguard Investment Group, How America Saves 2014, June 2014.*

[2]*The New York Times, "Combating a Flood of Early 401(k) Withdrawals," October 24, 2014.*

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