

Why You Should Rethink Taking Money Out of Your 401(k)

Thinking of purchasing your first home? Are your kids on their way to college? You may be thinking about tapping into your 401(k), many Americans are.

Taking money out of your 401(k) could cost you a lot more than you might think. Taxes, penalties, and compound interest are working against you.

Early Distributions

Consider this example:

Kevin is 25 years old, has a 401(k) at his current job worth \$6,000, and has recently changed jobs. He is told he has several options for how to handle his 401(k). He locks his sights on the cash out option because he wants to outfit his bachelor pad with a state of the art entertainment system. A 20% mandatory tax will be withheld in addition to an early withdrawal penalty of \$600. So if he chose this option so he would be left with just \$4,200.

If Kevin chose to forgo the instant gratification of the upgraded pad and rolled the \$6,000 over into an IRA he might be better off. He would save \$1,800 in taxes and penalties. At 65, assuming an average annual return of 7%, Kevin's \$6,000 could have grown to \$89,847. That's huge!

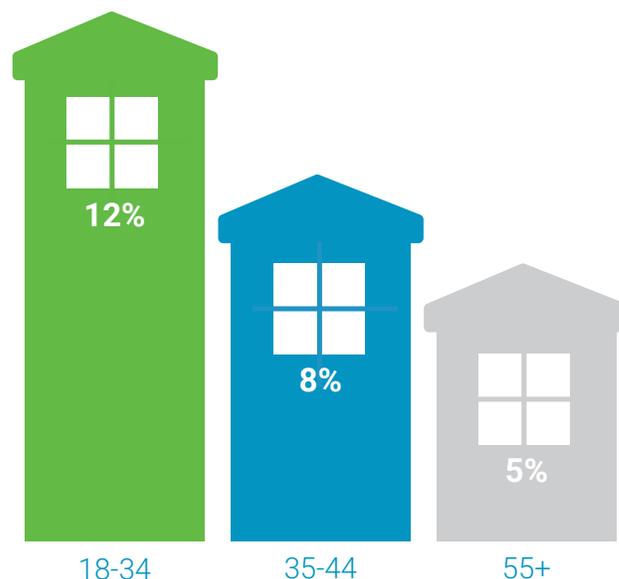
Scarborough's 401(k) Pulse survey showed that younger Americans, ages 18-34, are dipping into

their 401(k) retirement funds to purchase their first home.

Of that age group, 12% did so, followed by 8% of those ages 35-44, 10% of those ages 45-54, and 5% of those older than 55. Of those who did dip into their 401(k) to buy their first home, 61% said they would do so again.

In addition, 20% of all respondents said they have or plan to use their 401(k) to help pay for their child's college.

Did you take money out of your 401(k) to buy your first home?



And once you start taking early distributions from your 401(k) it could be hard to stop. The survey results bear this out. Of all age groups surveyed, 61% said they would use their 401(k) to purchase their first home again.

But you might ask...What if I just borrow from my 401(k)? Sadly the same negatives apply.

401(k) Loans

Consider this example:

Kathy is 40 years old, makes \$60,000 a year, and has \$60,000 in her 401(k) account. She needs to make some upgrades to her home and is considering borrowing from her 401(k). She considers borrowing the \$15,000 from her 401(k) at 6% interest for 5 years. To make the loan payments she could reduce her monthly 401(k) contribution from \$750 to \$460 and would continue to receive her employer match of 5%.

How much could the loan cost her by the time she retires? How about \$85,883 if this money had been continuously invested at an average return of 7%. And if she stopped making contributions while she was paying off the loan the opportunity cost could sky rocket to \$295,678.

401(k) loans come with added strings. If you leave the company your loan balance is generally due within 60 days. Failure to pay triggers taxes and penalties because it will then be an early withdrawal.

Avoid Tapping Your 401(k)

We recognize that it is harder today, especially for younger Americans, to save. Why? Recent graduates are exiting college with more debt than in the past. Unemployment rates for recent graduates are higher than in the past. The ability

to find a good-paying job that enables them to pay down student debt, save for a home and save for other things such as emergencies, vacations etc., is harder now than it was in the past.

We recommend utilizing these tried and true tips to get on the right course.

- First create an emergency fund so you don't have to use debt for those unexpected minor cost.
- Pay down non-mortgage debt and keep the balance less than 30% of your credit limit
- Then save three to six months of living expenses so you will be prepared if something big happens

It is very important to understand the ramifications of taking money out of your 401(k). Our hope is that this brief guide will cause you to think twice or seek the advice of a professional when considering doing so.

Need help managing your 401(k)? Scarborough Capital Management can help. Contact us today to learn how our advisors can help maximize your existing 401(k) for as little as a dollar a day.

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