Strategies

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Keep Your Eyes on the Prize

You may be feeling the pinch of the struggling economy and want to take a loan from your retirement account to help make ends meet.

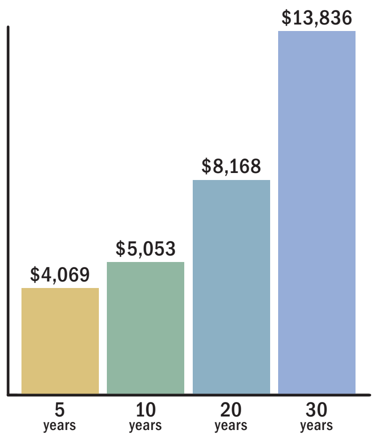
Don't do it! There are real tax consequences involved, not to mention other pitfalls that could short-circuit your long-term retirement plans.

Big losses for small gains

Tapping your nest egg prematurely means giving up the tax-free compounding of the money you borrow. Think that doesn't mean much because you're paying yourself back? Consider this: Say you borrow $10,000 from your account, money you would expect to earn an average annual return of 6% if you left it alone, and repay it at 4% interest over five years. If you're 30 years from retirement, that loan could cost you $13,836 in potential earnings—more than the amount you borrowed.

Missed potential earnings

How much larger could your nest egg grow if you leave it alone vs. tapping it prematurely? Here's how borrowing a modest $10,000 can affect your financial future.



Assumes a 6% average annual rate of return on investments and a five-year repayment term at 4%.

Double taxation

While most retirement plan contributions are made with pre-tax dollars,[1] loan payments are made with after-tax dollars. What's more, when you retire, you'll pay taxes on the withdrawals again.

Default risk

If you leave your job for any reason, you're still on the hook for the loan, which may become immediately due. If you can't repay the loan, you'll pay taxes on the balance and in some cases a 10% early-withdrawal penalty.

Understandably, life happens. But try to make borrowing from your nest egg to pay for it a last resort. ■

[1] Roth 401(k) contributions are post-tax.

FAST FACTS

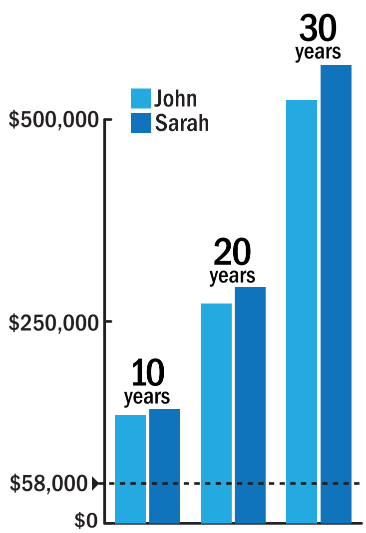
The $10 Difference

Thanks to new legislation, a lower Social Security tax is putting a little extra money in your paycheck. Should you invest it in your retirement plan? Yes! Increasing your contributions by even a small amount can brighten your retirement outlook.

Let's examine how much John and Sarah save over time. They're 35 years old and have a retirement account balance of $58,000,[1] respectively. John contributes $40 a week to his plan, while Sarah contributes $10 more—$50 a week.

By the time they retire, Sarah's nest egg is nearly $44,000 larger than John's.[2]

The Impact of Contributing More



[1] Average 401(k) account balance at year-end 2009. "401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2009," Employee Benefit Research Institute, November 2010.

[2] Assumes a 6% average annual rate of return on investments.

Asset allocation and diversification are two of the most important investing strategies.[3]

Q What is diversification?

A It's a fancy way of saying don't put all your eggs in one basket, not even a basket that looks secure. You can diversify by investing in different asset classes and in different types of investments within those asset classes. For example, a diversified portfolio may consist of both stock and bond funds, with the stock portion invested in large-cap and mid-cap funds and the bond portion consisting of both corporate and government funds.[3]

QUESTIONS & ANSWERS WITH

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Q What is asset allocation?

A Asset allocation is the process of designating percentages of your investment dollars to stocks, bonds, and cash equivalents[4] based on your financial goals, time horizon, and tolerance for risk. For instance, you may allocate 80% of your investment dollars to stock funds and 20% to bond funds.[3]

Q How do asset allocation and diversification affect risk?

A Neither investing strategy eliminates risk. But by putting your money in an assortment of investments that, historically, are unlikely to all move in the same direction in terms of value and performance, you may be able to protect your portfolio from a single, devastating loss in one investment. For instance, stock funds may fare well when bond funds are performing badly, and vice versa.[3]

[3] Asset allocation and diversification do not assure or guarantee better performance and cannot eliminate the risk of investment losses.

[4] This category seeks to protect against loss of principal while providing returns comparable to money market funds and short-term Treasury instruments. An investment in a cash equivalent investment choice is not insured or guaranteed by the FDIC or any other government agency. Although the investment seeks to preserve the value of your principal, it is possible to lose money by investing in the investment choice. These investment choices have generally provided a dependable level of stability and liquidity; nevertheless, the investment is still subject to credit risk and to liquidity risk.