[Fundamentals of Financial Planning: Saving and Your Retirement Plan]

Speakers: Tom Mullooly and Brendan Mullooly

Brendan: Hello and welcome to the Mullooly Asset Management podcast for January 16, 2013. This is Brendan and today Tom and I are going to be talking about saving money and your retirement plan.

So, Tom, saving is really a lost habit and I think you have something to say about that. You read an article recently in the Washington *Post*, right?

Tom: Yes. And the statistic that they quoted in the article was that 1 in 4 participants in a 401K plan are now taking loans from their 401K to pay current expenses. That's a pretty scary stat, but we've found in our own practice here that the actual number, what we've seen, is over 30% and close to approaching 40%. Again, that's just our own personal universe, what we've seen happening with our own clients. And that screams out a few things. First, we're finding out that people are living beyond their means. Now look, everybody does that from time to time, but it really isn't a good idea. If you're not meeting your monthly expenses, you really have to reconsider where you're spending money and maybe you're trying to put too much away in a retirement plan. You really have to reexamine all that and speak with someone who can help you with financial planning to get a better grasp on where the money is going every month. Like some folks say, they get to the end of the month and there's more month than money.

And the other problem that you run into is when you do take a loan from your 401K, you really are hurting yourself and we can spend some time talking about that as well.

Brendan: Yeah, let's get into the details of these loans that people are taking.

Tom: Right. The terms and conditions of 401K loans are pretty universal. You can find them across most plans. It doesn't matter if it's a deferred compensation plan or a 401K plan at work, there's usually two types of loans that you can take from a retirement plan. The first one is to use as a down payment or toward closing costs when you're buying your first home. And that's really not a terrible thing to do because it allows you to pay this money back over a 15-year schedule, and that's really a good, buying a home is always a good thing.

The other way you can take a loan, and unfortunately, this is where most people who have loans are found, is you can take a personal loan from your retirement plan, if it allows it, and you can pay it back over five years. You can usually take the lesser of $50,000, or 50% of the balance in your retirement plan.

So say you have $80,000 in your retirement plan at work. You could take $40,000 as a loan. Here's the problem. In speaking with some folks who have taken loans from their retirement loans in the past, I'll just bring it up in conversation, "Hey, I noticed you took a loan, is everything okay?" And they'll say, "Oh, yeah, I wanted to pay off that boat loan or I wanted to pay off my credit card debt because the interest rate was over 20%."

Let's talk about this. You know, you can pay Mr. Visa anything above the minimum payment on a monthly basis. So if you get a bonus or if you have some kind of overtime, you can pay back a lot of that money all in big chunks. But once you convert that variable loan from a credit card into a fixed loan, like a 401K loan, you've now traded in the ability to stretch this out over a long period of time and pay Mr. Visa back different amounts each month, whatever you can handle, you've now transferred this into a fixed 5-year loan, that's 60 equal payments. And you may be screwing yourself in terms of what your obligation is going to be on a monthly basis.

But, you know, a lot of times we'll hear people say, "Yeah, but, you know, if I'm taking a loan, I'm paying myself." I mean, we've heard that from clients who are considering taking loans. And that's true. But again, let's dig into that a little bit. You are paying yourself and the interest rate that most people are charged is prime rate plus 1%. So right now you're looking at something just over 4% in loans. So you're going to lock in and pay yourself on that chunk of money in your retirement plan, say 4-1/4% for the next 5 years. So we don't know what the market's going to do over the next 5 years. If one of those years the market goes up say 35 or 40%, you have really destroyed any kind of return that you could've gotten because you've locked this money up, you can't take that money and invest it into some mutual fund that's going to grow, it's on the sidelines now while you pay yourself 4-14%.

Brendan: Do you have to pay taxes on this money?

Tom: That's a great question. You don't have to pay taxes on it if you take it out and pay it back and follow the schedule. However, once you miss payment, you're in default of your loan terms and so the whole thing becomes, you're in default, and you become, that distribution becomes taxable. So not only are you going to—say you take $30,000 out and you pay back 5 of it, and then you can't make the payments any more. So now you have a balance of 25,000 left on your loan. Once you're in default, now that $25,000 becomes taxable. So it's probably going to push you into a higher tax bracket and you're now looking at a $2,500 tax penalty on top of everything else next year when you pay your taxes.

So as long as you stick to the schedule and pay the money back, there's no taxes at all. However, once you miss a payment, you really wind up hurting yourself. So like everything else, it kind of takes discipline to figure out what your monthly expenses are, what you can safely put away into a retirement plan and, you know, personally I'm not a big fan of these loans from retirement plans. We have, you know, we've seen the whole landscape change over the years into these 401K's where you can take loans.

Brendan: Yeah, they're really becoming the primary means for retirement, because we're seeing pensions disappear now.

Tom: You're absolutely right. You know, when I got started in the business in the mid '80's, there were still a lot of people who had pension plans. In fact, according to this Washington *Post* article, 4 out of 5 workers, 80% in 1980, were covered by a pension plan. 401K plans started around that time and today we've seen the transition almost complete, that story reports that 1 out of 5 workers are covered by a pension. Personally, Brendan, I think that number's kind of high. I actually think it's less than that. So I would say somewhere between just 10-20% of workers today are covered by a pension.

And so like you said, Brendan, you really are on your own in terms of providing for your own retirement. Now, it's interesting, when Social Security was created back in the 1930's, the average life expectancy was 67 years old.

Brendan: Yeah, not any more.

Tom: Not any more. So you work until you retire at 65 and you were around for a couple of years collecting Social Security, and that was the end of the game.

Today, people are living well into their 80's and sometimes into their 90's and beyond and you're talking about retiring at age 65, that could be 30 years of living on this money. And if you haven't accumulated a lot of assets by the time you're 65, you could be in a serious predicament.

Brendan: Right. Because Social Security today is not going to cover you for 30 years potentially and we've seen pensions disappear and like we just talked about, the 401K is really all you have. So what could happen if you take a loan against your 401K?

Tom: Well, let's talk about an example that's happening right in front of our eyes here. We had a client who retired a few years ago. We're not talking, you know, 15 or 20 years ago, she retired about 5 years ago, she had a quarter of a million dollars when she retired, in her retirement account. And almost immediately after she stopped working, her health really began to deteriorate and then she went on dialysis and so while her dialysis costs are picked up by the Federal government by one of the healthcare programs, what we found is that she needed more and more help. She needed, you know, she had more medical bills, more doctor visits, more expenses related to her healthcare. She used to have someone coming in once a week to check up on her, then it was a couple of times a week, then it was every day. Now she's at the point for the last 2 years where she has needed someone to live with her 24/7 and this is not someone in their 90's, this is someone in their, you know, this happened in her late 60's, when she turned 70.

And so she started taking money out of her IRA, she started taking out a little bit here or there. First she started with 5,000, then it was, you know, 5,000 again a few months later, and it grew and grew. Last year, in 2012, she withdrew $93,000 from her retirement account just to help pay her medical expenses. We know for a fact that at the rate she's going, she will be out of money this year, 2013. It's very, very scary if you are tapping into your 401K for your current expenses today, number one that says you got to reexamine where your money's going. But number two, you may also be short-sheeting the bed in the sense that you may not have enough money in that retirement account to live on when you need it most.

So, you know, we have to, as investment advisors on our side of the desk, we have to be prepared for the fact that, you know, nearly half of our clients may be looking to tap into their retirement account for current expenses. Kind of changes things when you're approaching how to invest that money.

Brendan: Yeah. Got to be a little more conservative with it.

Tom: You're right. In fact, the quote that they used in the Washington *Post* article said, "Would you invest this money in the stock market if you knew your client would be tapping into this money in a short period of time?" And the answer is, "Absolutely not." You know, can you imagine if we put $25,000 into a mutual fund and 6 months later a client calls and says, "Hey, I need that $25,000 in my IRA, I need to get that." This may not have grown at all.

Brendan: Didn't really give it a chance.

Tom: Didn't really give it a chance at all and you may be in a situation where you may actually even be down on it.

So you really have to pay attention to what you're doing in terms of your retirement and all your investments. And so what we always want to remind people during these presentations is that none of the securities that we mention in these presentations represent a past specific recommendation of Mullooly Asset Management. And this presentation is not a recommendation to buy or sell any of the securities that we happen to mention.

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Brendan: Okay. That's going to wrap up this week's podcast. Glad that we could get together and talk about saving money and retirement plans. And we'll see you all next week.