A 401(k) Loan is Not an Investment - Transcript

Tim Mullooly: Welcome back to the Mullooly Asset Management podcast. This is episode number 253. This is Tim Mullooly and Brendan is here with me today. We've got a couple good articles that we wanted to share our input on.

Brendan: Yeah. Young guns podcast today.

Tim Mullooly: Yeah, yeah.

Brendan: Which of these do you want to start with?

Tim Mullooly: Let's start with the one from Nick Maggiulli.

Brendan: Nice.

Tim Mullooly: Last week, he posted this post about, it's called The Money We Don't Talk About.

Brendan: He pretty much just like, he had some stories at the beginning to share about like the crux of the post was that we hate talking about money and why are we this way?

Tim Mullooly: Right, yeah. He started out by talking about this speech and these numbers that Elizabeth Warren had said and she said, "More children in America will live in a home that will file for bankruptcy than divorce." You'll always hear about how high the divorce rates are, but you don't really ... I, personally, like, you don't hear about people filing-

Brendan: So and so got divorced. You don't hear that often like, so and so is bankrupt or filed for bankruptcy or anything like that.

Tim Mullooly: Right.

Brendan: Right?

Tim Mullooly: Exactly. That's shocking.

Brendan: The point that she made was just that you can hide money problems or bankruptcy far easier than you can hide your family splitting up or something like that and people will go to great lengths to cover up money problems.

Tim Mullooly: Yeah. That was, like you said, the whole overarching topic of the post was about why money is so taboo and why people don't like talking about it. Nick, after he talked about that Elizabeth Warren piece, he said that he opened up his DMs on Twitter and asked people what is a financial situation that they were never able to talk about? Obviously, it was still confidential. He didn't give any names, but he was like, "I got so many replies from people with so many different financial situations that they've never talked about before."

Brendan: Right, and think about who ... I'm sure Nick has followers all across the spectrum, but most of them are within our industry.

Tim Mullooly: Right.

Brendan: I mean, Nick works at an advisory firm, for those who don't know or follow him. The people that were messaging him I would presume have a tilt towards the finance oriented.

Tim Mullooly: Yeah.

Brendan: Even amongst our community, there are just things that we're unwilling to discuss or air out in public for whatever reason and I think the thing that Nick got to was that we use money as a way to measure status in our society. One of the best ... at the end of the post, the best part I thought was that Nick said, "Most people would say if they were asked, that they don't use wealth or money as a status signal." Nick said he would agree and I think most would. You shouldn't measure a person by something like that. It should be based off of how they are as a person, but I think it's baked into all of us because while most would say that they don't, I think the way that we act in the real world towards one another says that we do use wealth as a status signal, even if we actively try not to.

Tim Mullooly: Right.

Brendan: I think it's baked in. I think it's part of the human condition.

Tim Mullooly: Yeah. Absolutely. He said, I think ... he said, "Watch what they do, not what they say."

Brendan: Always a good one.

Tim Mullooly: Yeah, even if it's not related to this topic, just in general, but the point being like people will say the right things, but in reality, people use money as this signaling. Like, you drive around in a fancy car, you wear a nice watch, or have these nice clothes to kind of signal to other people you're financially successful even when that's not the case. I feel like that's been getting more and more magnified on social media with Instagram and stuff. You see people posing in front of fancy cars and it's like-

Brendan: It's why they do that.

Tim Mullooly: Right.

Brendan: It's not even their car.

Tim Mullooly: Exactly. Yeah.

Brendan: They pay money to take pictures in an airplane or something-

Tim Mullooly: Right.

Brendan: ... as if it's like their own private jet or something of that sort and the reason that people do these things is because society uses wealth as a measurement mechanism whether any of us want to admit to it or not.

Tim Mullooly: Yeah.

Brendan: It's not to say you're a bad person for doing that. I think it's something that we-

Tim Mullooly: Everyone does it.

Brendan: ... all do to some degree, so it's not to make anybody feel bad. It's just an interesting concept to think about I think helps to explain why money is such a taboo topic.

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Tim Mullooly: The article that we wanted to talk about talks about 401(k) loans and it came from The White Coat Investor. The title of the article is 401(k) Loans Are Not An Investment. This is a topic that we wanted to talk about because it was a really good article and it had some hard numbers in it that kind of drive home the point that we get asked this question a handful of times every year from clients about taking loans from their 401(k)s or workplace retirement plans. It's good to have these numbers in your pocket to kind of explain why it might not be the best idea.

Brendan: Yeah. I think that the 401(k) loan, in terms of the hierarchy of places I would advise the average person to look for funds, it's not high up on that list. It's towards the bottom and good financial planning will hopefully put you in the position where this doesn't become something that you have to think about.

Tim Mullooly: Right.

Brendan: I thought the interesting thing about the question on The White Coat Investor was that this specific person was thinking of or was trying to make the case that the returns they would receive from taking a 401(k) loan would be bond-like in the sense that they are paying themselves interest. I think the fundamental misunderstanding here is when you own a bond, it is paying you interest, not you paying yourself.

Tim Mullooly: Right.

Brendan: The example that The White Coat Investor did on this blog was like, just to keep it simple, this isn't how it works in the real world, but if you have $10,000 in your 401(k) and $600 in a brokerage account. Then you took $10,000, you borrowed $10,000 from your 401(k) and you put it into your brokerage account. Then, you have $10,600 in your brokerage account. Then, a year later, you have to pay yourself back with interest. Let's say it's 6%, pay that $10,600 back to your 401(k), your return on that is zero.

Tim Mullooly: Because you started with $10,600 just split between the two accounts.

Brendan: Right.

Tim Mullooly: Now, you're finished a year later with the same amount of money.

Brendan: Right. If you consider-

Tim Mullooly: As opposed to getting that $600, if it was from a bond and you were getting that $600 of interest, you'd be getting that from the bond, not from yourself.

Brendan: Yes. Think about it. It's a balance sheet, I don't know what they call it. You're just sliding things around in your balance sheet-

Tim Mullooly: Right.

Brendan: ... I guess is what I'm getting at because your wealth did not increase as a result of you taking a 401(k) loan. You just had your money in a different spot and it's still showing up on your balance sheet in the same amount. You're not any wealthier because of it. Whereas, as you make the case, if you are getting interest from a bond, you are receiving more money, so you have more than when you began because you are getting this interest from someplace. It's like taking money out of your left pocket-

Tim Mullooly: Exactly.

Brendan: ... and sticking it into your right pocket and saying that your right pocket earned the return of 6%. It's like, yes, well your left pocket is minus 6%, so it nets to nothing.

Tim Mullooly: Exactly. I think that it's worth explaining in that sense because that is a phrase that we've heard from people, think it might be a good idea to take a loan. They're like, well, I'll be paying myself back interest. I don't think they really understand the math behind it and it's kind of just like mental accounting in the sense of you're not really gaining any more money. You're kind of just putting it in a different place.

Brendan: Yeah. It may be above some steps in the hierarchy to return to that initial point. It may be preferable to some other alternatives that you might have or it may be the only alternative.

Tim Mullooly: Right.

Brendan: I'm not willing to say that it never, ever should happen, but there are a lot of stops along the way that I would make first and a lot of recommendations I would make to somebody creating a financial plan to hopefully avoid having to dip into money, like your 401(k).

Tim Mullooly: Yeah. There were two other points in that article that I wanted to point out. The first being that the interest that you're paying yourself back can be double taxed.

Brendan: It is.

Tim Mullooly: It is double taxed.

Brendan: Yeah. Good point.

Tim Mullooly: The article made the point to say not the entire loan is double taxed.

Brendan: Right.

Tim Mullooly: Just the interest you pay back. In that last example, just that $600 that you pay back would be double taxed because you're-

Brendan: Explain the double taxation now.

Tim Mullooly: Right.

Brendan: When and where is this money being taxed?

Tim Mullooly: 401(k), in most cases, a regular 401(k) you're putting money in pretax and you're taking it out ... when you take money out of the 401(k), it's taxable income.

Brendan: Right.

Tim Mullooly: It's taxed on the way out. When you're paying a loan back, the interest payments on that loan are paid with after-tax dollars, so that money you're paying the interest to has already been taxed once. It goes back into the 401(k) and then, when you take the money out in retirement, it gets taxed again.

Brendan: Right.

Tim Mullooly: It gets taxed twice.

Brendan: Right, because there's no accounting mechanism to say this was-

Tim Mullooly: To separate, right.

Brendan: ... a payment and you separate it and a good point to consider. I mean, the interest, as opposed to the entire thing, like the principle being repaid to you, the interest is going to be the smaller of the two amounts, but on most 401(k) schedules, you're talking a five-year repayment plan at the prevailing interest rate, which is prime rate plus-

Tim Mullooly: Plus one. Yeah.

Brendan: ... one or two percent, which is ... it used to be a little bit lower than it is now.

Tim Mullooly: Not that much, right.

Brendan: Now, it may be in the ballpark of five, six, seven percent.

Tim Mullooly: Five percent.

Brendan: It's like it right in that neighborhood.

Tim Mullooly: Yep.

Brendan: Maybe still better than interest rates you could otherwise obtain, not sure that is situationally dependent, but it's not insignificant I guess is what I'm getting at and it's a good point to consider that that's another way ... Another aspect of this that doesn't get calculated is the tax inefficiency of that double taxation and how does that then affect whatever return you have calculated on this loan being positive or negative. I don't think that ever gets factored in.

Tim Mullooly: Right, yeah. Again, even though it might be a minuscule amount, it's worth knowing.

Brendan: It's a tax drag that you don't have to sign up for.

Tim Mullooly: Right. The last point that I wanted to talk about in this article before we move on was about how the 401(k) loan is not as bad as it used to be. Meaning that before the tax changes, if you were fired or left a job, you had 60 days to pay back any outstanding loans you had to your 401(k), which-

Brendan: What were the repercussions if you did not? Completely taxable to you-

Tim Mullooly: Right.

Brendan: ... which is something that people neglect to take into consideration when they're borrowing money from a plan. Depending on why you're borrowing money from the plan, let's put it this way, if you're going to borrow money from the plan because things are getting cut back at work or you're in danger of losing your job, you could really be hit with a double whammy there in the sense that you had 60 days to pay this off in a lump sum. That's a short window of time, especially for a person who has just lost their job.

Tim Mullooly: Right, exactly. With the new changes now, you have 21 months to pay it back, so significantly longer amount of time, which is good.

Brendan: A lot more lenience and gives you some runway to maybe plan out how in the world you're going to do this or if you're going to do it or if you're just going to recognize that taxable income. I mean-

Tim Mullooly: Right.

Brendan: ... not the end of the world, but certainly something you want to think about before going ahead with ... I mean, depending ... especially if you took the maximum possible loan out, like $50,000 of extra ordinary income that if you took out in a loan, I'm assuming you had to spend it on something, so it is no longer around. Where is the tax going to count, but where are you going to pay the taxes out of on that?

Tim Mullooly: Yeah, exactly.

Brendan: Tough.

Tim Mullooly: Definitely a couple good points to consider that most people probably don't when thinking about taking a loan from their 401(k) or other type of workplace retirement plan. The last article that we wanted to talk about today was from Ben Carlson over at A Wealth of Common Sense. The title of the article is Prudent Risk Management or Market Timing in Disguise? This was a question that got asked to them on their podcast, Animal Spirits, and Ben wanted to do a little bit of a deeper dive on the answer that they gave.

Brendan: The question actually pertain to a pension plan because that's what Ben does at his firm. He more speaks to these institutional type clients, but I thought that there was an easy translation directly to individual investors as well.

Tim Mullooly: Yeah.

Brendan: They were talking about how, on this particular investment committee for this pension plan, they'd recently discovered, due to some members leaving the committee, that their investments weren't necessarily aligned with the objectives of the pension. I'm going to relate that to the individual where somebody maybe runs a financial plan for the first time and finds out something they didn't know, which is that their investments are not in alignment with whatever their goals are and they need to make some changes, but it's not insignificant. We're talking a significant shift in your asset allocation-

Tim Mullooly: Right.

Brendan: ... in terms of the percentage between stocks and bonds, let's say.

Tim Mullooly: The way Ben said that he likes to think about it was he likes to use regret minimization which means he kind of laid out which would you regret more, staying put with the allocation that you have and the market continues to go up or make a change and then as soon as you make the change, the market takes a tumble and goes down. Which would you regret more?

Brendan: The way that he posed it, too, was let's say that you've been in a 50/50 stock bond portfolio and that you want to get to something more aggressive because your plan says that you need to take a little more risk. Maybe you want to go to like an 80/20 stock bond portfolio. Should you, as Ben put it, just like rip the Band-Aid off and go 50/50 to 80/20 like today, tomorrow-

Tim Mullooly: Right, all at once.

Brendan: ... in one shift? Can you maybe phase it in in steps and shift from 50/50 to 60/40 and then a little while later, 70/30, and then make your way to 80/20? Yeah, I think, especially when we're talking about a shift in the direction as this example is laid out, like you're moving from a conservative portfolio to a more aggressive one, I would say the spreadsheet answer probably tells you that you should just do it, rip the Band-Aid off and get it over with because markets tend to go up over time and-

Tim Mullooly: In the long-term it's not really going to end up having too much of an impact if you do it over the span of three months versus one day.

Brendan: Exactly. In fact, on average you will probably be costing yourself money by waiting to ... it's the same as dollar cost averaging versus a lump sum when you're initially investing money. The framework Ben puts it in is, like you laid out, if you go from 50/50 to 80/20 and then the market takes a downturn, like it did in the fourth quarter last year, like it immediately goes down 20% in a calendar quarter right after you make that shift, how are you going to be feeling about that psychologically? Are you going to be able to stick with it or are you going to want to dial back to 50/50 again?

Tim Mullooly: Right. It's kind of like hedging ... using the dollar cost averaging example there is kind of hedging. You're going to potentially get less in return than if you were to put it all at once and the market goes up from there, but you're saving yourself a little bit of emotional stress and peace of mind there by averaging in, sort of admitting that you don't know where the market's going to go in the short-term over the next couple months.

Brendan: Right. That emotionally it would be difficult to suffer the alternative set of circumstances, so we're going to take this, we're going to take this slow. I think the important thing for me is that you lay out a plan beforehand on which dates you are going to make this shift until it is fully completed because it will become very easy to say you're going to make the shift and then, say you go 50/50 to 60/40 today and then the same scenario unfolds to where we drop 20% over the next quarter before you make your next shift to 70/30. Are you going to want to make the 70/30 shift when we've taken a 20% tumble? It sounds great on paper because it's like, well, yeah. I mean, I'm buying at a discount then. That's exactly why I wanted to do this.

Tim Mullooly: Right, emotionally.

Brendan: I think it's really easy to sit here, to say it at the table and to pull the trigger and continue that shift that you agreed to beforehand is tough. I think that's where having somebody help you with this or having a committee that sets these things out concretely beforehand, I think it could be an advantage.

Just a final thought on this, too. If we're talking about two different things here, we could say either you're going to average in, like we're saying is probably best for 99% of people. You could be the person who says, "You know what? No, I'm a robot. The spreadsheet says I'm costing myself money. I'm going to go lump sum," and like, that's fine, too, if you can actually withstand that psychologically. I think that the worst of all these, which we haven't brought up, is saying that you do or do not want to make a dramatic shift like that because of a market forecast or opinion that you hold.

Tim Mullooly: Right.

Brendan: That's the worst of all of them. All right? Let's get that one out of the way first and foremost. You should make this decision that you're going to have a shift because the goals that you have don't align with the portfolio and then you should be willing to make that shift either all at once or on a predetermined schedule, so that it actually occurs over a reasonable period of time. Not because I think we've gone too far, too fast, and I'm waiting for a pull back. Don't do that kind of stuff. No good.

Tim Mullooly: Regardless of market conditions.

Brendan: Yeah.

Tim Mullooly: Yeah, absolutely. All right, so three really good articles to consider. If you want to read the full articles, we'll link to it in the show notes. That's going to wrap up episode number 253 of the Mullooly Asset Management podcast. Thanks for listening and we'll see you on the next one.