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FINANCIAL GUIDANCE SINCE 1964

MONEY *notes*

Tapping into retirement savings should be a last resort

For more than a year now, the U.S. economy has found itself in a difficult economic situation marked by persistently high inflation and rising interest rates. More recently, corporations have begun to announce layoffs and the specter of a coming recession looms.

As you would expect, this all serves as a challenging backdrop for investors. Their cost of living is up dramatically, as is their cost of borrowing, while their investment values are down thanks to negative equity and fixed income market performances over the past year.

Between 2020 and 2022, during the height of the pandemic, an unprecedented amount of government-funded economic stimulus combined with a major reduction in consumer spending resulted in a surge in U.S. household savings. While these extra financial resources enabled many individuals and families to survive during the pandemic, we are now at a point where persistently high inflation and rising interest rates have caused people to dip into, and even deplete, their savings. As a result, a growing number of workers have begun tapping into their 401(k) and 403(b) employer-sponsored retirement plan accounts – some are taking loans while others are relying on hardship or non-hardship withdrawals – in order to make their financial ends meet each month.

According to a recent Vanguard study of more than five million plan participants, all three of these indicators steadily rose throughout 2022 – suggesting that liquidity is becoming a serious concern for a growing number of households. Perhaps most concerning was the marked increase in the number of hardship withdrawals last year – now at an all-time high and more than double the historical average.[1]

What are hardship withdrawals?

Although not allowed by all employer-sponsored retirement plans, employers may allow participants to take hardship distributions from their retirement accounts specifically for an immediate and heavy financial crisis (e.g., to cover medical costs, pay a child's tuition, or facilitate the purchase of a primary residence).

Usually, hardship distributions are subject to income taxes (unless taken from Roth contributions). It is possible they will also be subject to a 10% early distribution penalty. In addition to facing a hefty tax burden, those taking a hardship withdrawal also face an even more insidious enemy. If you are considering a hardship withdrawal, please keep in mind that this is not a loan! Unlike a 401(k) plan loan, you are not allowed to 'pay yourself back' at some point in the future when you take a hardship distribution. Instead, the money you pull out (along with its future tax-deferred growth and earnings potential) is permanently lost. In other words, a hardship withdrawal costs you much more than you may initially realize.

Finding a better solution

As with all aspects of financial planning, the better you prepare in advance for an unexpected liquidity need, the more freedom and flexibility you will have down the road. Retirement accounts should only be considered as '*break glass in case of emergency*' assets after all other options have been exhausted. Why? Because each and every time you dip into your retirement plan assets, you increase the risk of significantly reducing your ability to achieve the retirement lifestyle you have worked a lifetime to enjoy.

Instead of depleting your retirement savings and jeopardizing your retirement, consider these other options:

- **Build an emergency fund** – Of the options listed below, this is, by far, the better way to protect yourself from having to raid your retirement account. Now more than ever, it is critically important to have a fully-funded emergency fund set aside for unexpected expenses. Ideally, you will be able to accumulate enough money in a separate, stable, and liquid account (e.g. a savings or money market account) to cover at least six months of living expenses. This will help protect you from having to tap into your retirement savings should a large and unexpected expense arise.

  To speed up the process of building your emergency fund, deposit any windfalls you receive (e.g., income tax refunds or annual bonuses) into this account. Generally, these funds fall outside of your regular income and expense budgeting and you can save them without feeling any economic pinch.

- **Leverage illiquid assets** – before turning to retirement accounts, consider leveraging some of the more illiquid assets you own (e.g., your home or your taxable investment portfolio) through an equity line of credit or portfolio-secured line of credit. It is a fairly simple way to access a relatively quick and sizable infusion of cash at reasonable borrowing costs, without sacrificing your future in the process. Of course, you should realize the interest rates associated with this type of borrowing can fluctuate upwards (or downwards) over time as interest rates change. Also, there is a possibility you can get "upside down" in this type of loan – where you end up owing more than the assets is worth. This occurs when the value of your underlying asset – such as your home – decreases in value due to real estate market fluctuations occurring after you have taken out a loan.

- **Tap into cash value** – unlike term life insurance, certain types of permanent life policies accumulate a 'cash value' over time. In many cases (depending on the policy and insurer), you may be able to make a tax-free withdrawal of the policy's cash value or potentially borrow against it.

- **Fund 529 Plan accounts diligently** – according to the College Board, the cost of a 4-year undergraduate degree at a private university (tuition, room, and board) now averages more than $213,000.[2] Consistently saving money in a tax-advantaged college saving account – like a 529 Plan account – will go a long way towards ensuring you have a sizable amount of money set aside for higher education expenses. Keep in mind, though, that if your child's education expenses exceed the amount you have saved, you should not be tempted to make the all-too-common mistake of bleeding your 401(k) to pay those additional expenses. Remember, you

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will need your retirement assets to last through what will most likely be a 25 – 35 year retirement. Also, draining your retirement account when you are probably already in your 50s and closing in on retirement, means you will have little time to rebuild your retirement assets or to have those assets benefit from many years of compounding before you need to start using them in retirement.

Of course, as with most financial matters, there are no absolutes. Situations may arise where it makes sense to access retirement funds – but this would be through a plan loan feature (if available) and only on a temporary basis. For example, you may face a short-term liquidity issue where you need to fund a large expense for 60-90 days before cash becomes available. Similarly, perhaps you need a bridge loan to cover the down payment on a new home prior to receiving funds on the sale of your existing home. In these instances, a 401(k) loan – where you quickly repay the loan to your own retirement account with interest – may be the most viable option.

At some point during your life, an unexpected financial crisis will probably arise. Being fiscally prudent and avoiding excessive debt prior to that event – regardless of what it is – will help give you maximum flexibility to address it. Regardless of the strategy you pursue to generate the needed liquidity, ***your retirement should always take precedence!*** Before taking any action, reach out to your trusted BLBB Advisor (215-643-9100). He or she can offer insights, wisdom, and guidance to help prevent you from making a costly misstep and ensure your retirement plan remains on track.

[1] "Vanguard Investor Pulse," October 2022

[2] "Trends in College Pricing," College Board 2022

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