

# Retirement Matters



Equities added to their impressive start in 2017 with continued strong performance in the third quarter. The S&P 500 Index produced a third quarter return of 4.48%.

In the United States, large capitalization equities as of September 30th continued to prove to be the most successful. Large cap growth investments led the way, returning 5.61% over the three month period. Growth oriented equities outperformed value throughout the quarter. Small cap growth equities outperformed small cap value by 0.65% and large cap growth equities outperformed large cap value by 0.72%.

International developed markets continued the strong performance in the third quarter after an extended period of underperformance. The MSCI EAFE Index posted a 5.40% return for the quarter. Additionally, emerging markets added on to their rally. The MSCI EM Index returned 7.89% in the third quarter.

In September, the Federal Reserve announced it will start to reduce its balance sheet in October 2017 by \$10 billion monthly. Additionally, the Fed Fund Futures indicate another increase in interest rates is likely in December 2017. The bond markets, as measured by Barclays US Agg Bond Index, returned a nominal 0.85% for the third quarter.

The chart below shows the major indices and Morningstar category style returns for the quarter, one-year, three-year, and five-year time periods ending September 30, 2017.

	QTR	YTD	1 YEAR	3 YEAR	5 YEAR
<b>BBgBarc US Agg TR USD</b>	0.85	3.14	0.07	2.71	2.06
<b>S&amp;P 500 TR USD</b>	4.48	14.24	18.61	10.81	14.22
<b>Russell 2000 TR USD</b>	5.67	10.94	20.74	12.18	13.79
<b>MSCI EAFE NR USD</b>	5.4	19.96	19.1	5.04	8.38
<b>MSCI EM NR USD</b>	7.89	27.78	22.46	4.9	3.99
<b>Morningstar Large Value</b>	4.89	8.02	16.38	8.95	12.12
<b>Morningstar Large Growth</b>	5.61	22.28	21.9	11.81	14.59
<b>Morningstar Small Value</b>	4.75	4.21	15.55	10.07	13.58
<b>Morningstar Small Growth</b>	5.4	17.66	19.38	11.35	13.37

## Key Features of Loans and Hardship Distributions

A 401(k) or 403(b) loan is borrowing money from one's retirement savings to pay for current expenses, such as a new car, a new home, etc. A hardship distribution is money taken from one's retirement savings account that must be used for an immediate and heavy financial need, as defined by the employer. Both loans and hardships are unique to each 401(k) or 403(b) plan because plan sponsors have the option whether to allow one, both, or none at all. Furthermore, plan sponsors have the ability to design the features of loans and hardships. For example, in regards to loans, plan sponsors have some discretion over the repayment terms of the loan, interest rate calculations, and the number of loans allowed. For hardships, plan sponsors have the ability to determine whether or not a situation may be considered a "hardship." Plan provisions may vary significantly, so you should contact your local human resources representative or a CBIZ advisor to learn the terms specific to your plan.

### Loans

Loans have a mandated maximum value of the lesser of \$50,000 or 50% of your vested balance. Sometimes, plan sponsors may place a minimum on the amount a participant may withdraw. The interest rate on the loan is determined based on the plan provisions as well. Most often, the interest rate is calculated as the prime rate plus 1.0%. The prime rate is the lowest interest rate at which commercial banks lend out money.

Repayment of your loan is made with after-tax dollars through payroll deductions. This is unlike your 401(k) contributions, which are pre-tax deductions. Participants may take loans without any tax consequences, as long as the loan is paid off in its entirety. If you default on your loan by failing to make payments, the loan will be considered a taxable distribution. You will be taxed on the outstanding loan balance and possibly incur a 10% penalty if you are under the age of 59½. If you are terminated from service with your employer and have an outstanding loan, your employer may require you to pay back the loan immediately. If you do not repay the loan, the outstanding loan balance will be treated as a taxable distribution with a possible 10% penalty.

### Hardships

Similar to loans, hardship distributions are allowed at the plan sponsor's discretion. The IRS defines a hardship as an "immediate and heavy financial need," and plan sponsors have the discretion to determine when participants meet this definition by using one of two methods.

The first method is through "fact and circumstance." A participant will need to prove to the plan sponsor that his or her situation is an "immediate and heavy financial need," and the plan sponsor then determines whether this situation meets the IRS definition. The second method follows the standard "safe harbor" regulations as outlined by the IRS. The plan may include the following reasons in its provisions:

- ▶ ▶ *Medical care expenses for you, your spouse, your children or dependents*
- ▶ ▶ *Purchase of an employee's principal residence (excluding mortgage payments);*
- ▶ ▶ *Tuition and education expenses for post-secondary education for you, your spouse, your dependents or beneficiary*
- ▶ ▶ *Prevention of eviction or foreclosure of one's primary residence*
- ▶ ▶ *Funeral expenses for you, your spouse, parents, dependents or your primary beneficiary under the plan*
- ▶ ▶ *Damage repair to primary residence that would qualify for the casualty deduction*

With a hardship distribution, you must also show that you have exhausted all other available options. For example, if loans are allowed within your plan provisions, you must first take a loan before being eligible for a hardship distribution.

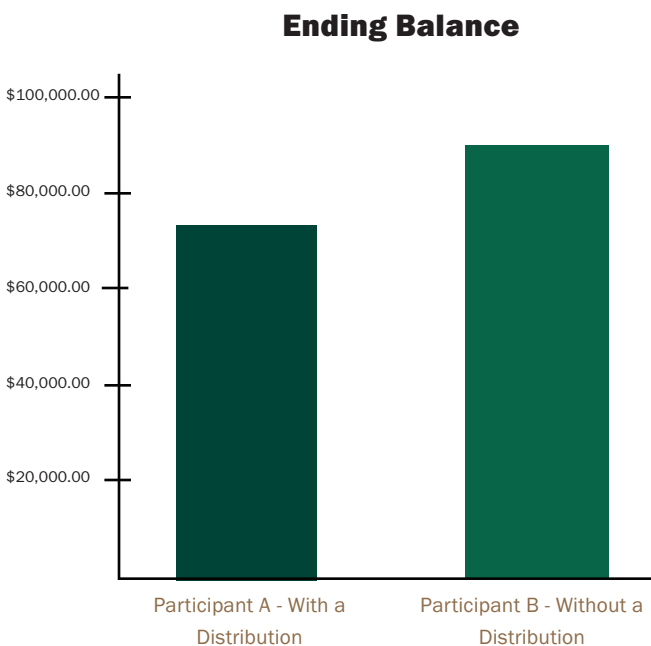
Because a hardship is considered a distribution, it is taxed as ordinary income and may be subject to an additional 10% penalty if you are under the age of 59½. Unlike loans, hardship distributions are fully removed from your

retirement account and cannot be paid back into your 401(k) or 403(b) in the future even if you no longer need it. In the next section, we provide an example of why this can be devastating to your retirement savings. Under the “safe harbor” regulation, plan sponsors must suspend your ability to make contributions for a period of 6 months.

### Why loans and hardship should be the last resort.

Many participants choose to take a loan from their 401(k) or 403(b) with the mentality that they would rather owe themselves than a bank. Even more participants take a hardship distribution because it is their money and “it’s just sitting there.” However, these thought processes neglect to address the negative effects loans and hardships have on your retirement savings.

Once initiated, a loan or hardship distribution immediately removes the benefits of tax-deferred growth for the duration the funds are absent from the account. Removing a portion of your retirement savings immediately lowers your initial investment and reduces the benefits of future compounding. When you pay back a loan, you are charged interest, for example, of the prime rate plus 1.0%. Many argue that paying yourself back plus interest covers the missed growth over time, but there is no guarantee that the interest will cover the full compounding potential. A loan or a hardship distribution taken from your savings may result in a dramatic decrease in your ending balance equates to \$17,908. This example shows that although the retirement. The chart below illustrates the negative effects both can have on the compounding growth of your portfolio.



In this scenario, Participant A took a distribution of \$10,000 from his \$50,000 beginning account balance. Assuming a 6.0% growth year-over-year, his account grew to \$71,634 during a ten-year period. Participant B does not take any distribution from his \$50,000 beginning account balance and over the same ten-year period, his account grows to \$89,542. The difference between these two accounts after ten-years equates to \$17,908. This example shows that although the original distribution was only \$10,000, it affected the overall account balance by almost \$18,000.

If we looked at this same example over a thirty-year period, the difference would be greater. After thirty years, Participant A’s account balance would have grown to \$229,740 and Participant B’s would be at \$287,175. This is a difference of \$57,435.

Loans and hardships can also indirectly impact your account balance. A study by Fidelity shows that participants are more likely to decrease their contribution rates after taking a loan. Contribution rates suffer during the repayment period of the loan because repayments are made with after-tax deduction from paychecks. Participants may not be able to repay a loan, continue to contribute to their 401(k) or 403(b), and cover day-to-day expenses. Sadly, contributions to 401(k) or 403(b) savings are usually the first to go.

When a hardship distribution is taken, plan sponsors must place a hold on your ability to contribute to your 401(k) or 403(b) for 6 months. The reasoning is that if you truly need the hardship distribution, you cannot afford continued retirement savings until you have covered this immediate need. Combined with your inability to replenish your account balance after the distribution, the barrier to contribute for a period of time further hinders the growth of your total 401(k) or 403(b) account balance.

There are also consequences if you are unable to pay off your loan in a timely manner or if you lose your job. Because you may be required to pay off your remaining loan balance if terminated from service, you should ensure that your bank account holds enough reserves to make such a payment. The same holds true if you default on your loan, as you will be responsible for ordinary income taxes and the 10% penalty tax if you are under the age 59½.

Hopefully, these negative effects combined illustrate the consequences of taking out a loan or a hardship distribution from your 401(k) or 403(b) savings account.

### What to consider?

Although loans and hardship distributions may be allowed in your plan’s provisions, we do not recommend using them except as a last resort. If you are considering a loan or a hardship, we suggest reviewing the following questions

throughout your decision making process:

1. **How confident are you that you will be with your company for the duration of the loan?**  
– If you are not confident, you may not want to take out a loan due to the potential repayment provisions.
2. **Have you exhausted all other options?** – If the answer is no, then a hardship distribution should not be in the cards for you.
3. **Is this a long-term or short-term issue that you need to fix?** – If this is a long-term issue, taking a loan from your retirement plan may only be a temporary fix. If you plan to use this money to fund a short-term project, and you plan to pay back the loan quickly, then a 401(k) loan may be a consideration. However, if you do not think you will have the funds in the foreseeable future to pay off the loan, then a 401(k) loan may hurt you more than it will help you.
4. **Can I afford to pay the taxes associated with the hardship distribution or a defaulted loan?**  
– If the answer is no, you should strongly reconsider this as an option.

Most importantly, we urge you to remember that your retirement savings account is for the future. You are saving today to replace your paycheck during your retirement years; it is prudent to plan for a long retirement and there are many variables such as inflation and healthcare costs to consider. If you remove a large portion of your balance now, you are dramatically affecting your future savings potential. Before taking a distribution or a loan, you should consider the impact it can have on your balance. If you have questions about this topic, or if you want to learn more about your plan's provisions, we encourage you to contact your plan sponsor, plan provider, or CBIZ Retirement Plan Services.



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