Real World Graduation: Question 36

Edward D. Duvall

23 Jun 2018

Question 36

The 401(k) system was set up such that people could save and invest their money prior to paying taxes, let the money grow over time, then pay the taxes later when they started withdrawing it as early as age 59.5. However, early withdrawals are permitted for certain hardships with no penalty. Hardships are defined as large medical bills (as long as they do not exceed what can be deducted on your income tax), disability, and the splitting of a 401(k) account due to a divorce. Otherwise, early withdrawals are penalized at 10% of the withdrawal amount, and all income taxes on the amount withdrawn are due immediately. Aside from hardship cases, under what circumstances should the average person consider an early withdrawal from their 401(k), even though they have to pay taxes and penalties?

a) To buy a house, or make a down payment on one
b) To buy a car
c) To use the money to invest in the stock market (buying individual securities)
d) To pay for a honeymoon or other vacation
e) Both a) and c) are valid causes

http://edduvall.com
edward.d.duvall@gmail.com

Edward D. Duvall is the author of The Federalist Companion: A Guide to Understanding *The Federalist Papers* and *Can You Afford That Student Loan*.

Answer to Question 36

This is a trick question. None of the reasons given are good ideas for early withdrawal from a 401(k).

Answer a) and b) are wrong because it is better to rent a home if you can't afford to buy one out of current wages. Secondly, it is not wise to buy a car, which depreciates continuously, with money that is better used in your long-term interest.

Answer c) is wrong because the vast majority of regular people are not competent to invest in the stock market buying and selling individual stocks. Even the experts who do it full time do not produce consistent returns. The best strategy for a regular person is to invest in market-averaging mutual funds. The experts who run the mutual fund buy and sell individual stocks on your behalf. For example, an S&P 500 mutual fund invests in those companies based on their market share or profitability. Let the experts work for you.

Answer d) is wrong because a short-term pleasure is less important than long term stability and security.

The 401(k) was devised to give working stiffs a chance to accumulate some actual wealth by contributing small amounts regularly and investing the money in stocks or bonds over a long period of time (30 to 40 years). Although the stock and bond markets fluctuate from year-to-year, over the long run, even modest amounts of regular contributions can add up to a large amount of money for retirement. The average return on a 401(k), so long as you don't mess with it, will far exceed the payout (if there is any) on your "Social Security retirement benefits". So the correct answer is: never take anything out of your 401(k); it is intended, and is best used, as a means of deferring gratification now (when you are able to work) so that you will have enough to live on in your later years (when you won't be able to work).

A good rule of thumb when you are working is: never take points off the board. That means that you never take money out of your 401(k), 403(b), or Traditional IRA, or Roth IRA until you are about to retire, except for medical emergencies. Otherwise, those withdrawals will have a large negative effect on the accumulation of wealth in those accounts.

http://edduvall.com
edward.d.duvall@gmail.com

Edward D. Duvall is the author of The Federalist Companion: A Guide to Understanding *The Federalist Papers* and *Can You Afford That Student Loan*.