When Should You Claim Social Security?

by Wade Pfau, Ph.D., CFA

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INTRODUCTION

Social Security claiming strategies have long been a source of speculation and pain for investors and advisors alike. When and how to claim are the source of much debate. I give my thoughts in the following pieces, but I want to begin with an article outlining the recent changes to Social Security as the April 29 deadline to “file and suspend” is fast approaching.

KEEP SOCIAL SECURITY CHANGES IN PERSPECTIVE

November 3, 2015

As you may have heard, Congress made some notable changes to Social Security last week. I've received more emails asking about these changes than any other event in the retirement income world.

I'm eager to provide some perspective about what these changes mean. While the news is certainly not going to be pleasant for anyone, I'm confident that very few retirement plans will be seriously derailed.

You see, editors generally choose the headlines of news stories, not the writers. This has led to some rather inflammatory headlines that make the situation sound potentially worse than the reality. Yes, the initial House bill, which passed last week, would make the changes retroactive for current beneficiaries, but the final version of the bill will grandfather in those who are already using the relevant strategies, meaning they will remain unaffected by changes.

Social Security claiming strategies have been a hot news item for the past several years. In fact, Laurence Kotlikoff's book, Get What's Yours: The Secrets to Maxing Out Your Social Security, was the #3 best-selling book at Amazon earlier this year.

In particular, the Senior Citizens' Freedom to Work Act of 2000 created some likely unintended loopholes to get an extra windfall out of Social Security. Legislators intended to lessen the Social Security penalty for people who work through age seventy. Loopholes soon developed that allowed retirees to take advantage of the new provisions even if they had already left the labor force. Removing these loopholes has been on the reform agenda for a while now, and they finally reached the chopping block.

Strategies related to "file and suspend" and "file a restricted application" will be phased out.

To be impacted by the new rules, you and your spouse must have planned to delay Social Security benefits. If you did, it is quite important to note that you had sufficient financial means—either through continuing to work or because you already have a large enough nest egg—to be able to afford to delay Social Security in the first place.

Most Americans cannot afford to delay Social Security, so these strategies were not an option anyway. In 2014, only 9% of new Social Security retirement beneficiaries delayed claiming past full retirement age. This discussion is not relevant for the other 91% of the population.

Furthermore, if you are part of a couple in which both members will be turning sixty-six within six months of the bill's signing (by early April 2016 or so—the date is still not set), you can still take advantage of traditional strategies. This is a change from the initial House bill passed last week.

Younger people who planned to use one of these strategies are the ones who will have to make adjustments to their future budgeting plan.

For those delaying Social Security, the option to collect an extra four years of a spousal benefit for a couple—from ages sixty-six to sixty-nine, from the earnings record of the couple's high earner who is otherwise delaying his/her own benefit until age seventy—may not exist anymore. The first chapter of *Get What's Yours* is called, "Getting Paul Nearly $50,000 in Extra Benefits Over Tennis." The example Kotlikoff provides here—delaying until seventy and knowing the sophisticated ways you could extract extra spousal benefits before seventy—is at stake.

Someone can still file and suspend Social Security retirement benefit upon reaching full retirement age of sixty-six. This allows the person to continue delaying *his own* benefit until age seventy, which would subsequently allow for 32% higher benefits, in inflation-adjusted terms, for the remaining life of the beneficiary and any survivors entitled to a benefit from that record. Inflation-adjusted longevity insurance is extremely valuable and should not be overlooked. This value from delaying Social Security is still available. It has not been impacted by the rule changes.

The added *spousal* benefit is being removed. Since 2000, a spouse could obtain a spousal benefit from the high-earner's record starting at age sixty-six, even when the high earner suspended his own benefit. For spouses with low lifetime earnings, this could be a matter of starting the spousal benefit four years earlier than otherwise possible (sixty-six, rather than seventy). For spouses with enough lifetime earnings to be entitled to a decent retirement benefit of their own, this provided a way for the spouse to also earn the extra credits for delaying their own benefit until seventy, while simultaneously collecting four years of spousal benefits.

Once the changed rules are fully implemented, these two opportunities to collect four extra years of a spousal benefit will be gone. *Spousal benefits can no longer be generated from a record in the "file and suspend" category*. For higher earners, this could add up to missing out on about $12,500 per year, or $50,000 total.

Alicia Munnell, Alex Golub-Sass, and Nadia Karamcheva wrote an article about these strategies for the Journal of Financial Planning a few years ago, in which they estimated that eliminating these strategies could eventually save upwards of $10 billion per year for the Social Security Trust Fund as the strategies become more widely known.

These strategies are mostly being used by highly educated and financially sound households, but some pain could come with the loss of this income. I know many households that have budgeted in these additional spousal benefits as an income source in the coming years. This is a clear example of "public policy risk," in which changing tax and entitlement laws can throw a wrench into the planning process.

This change probably will not lead to the difference between retirement success and retirement failure. Still, a change like this warrants revisiting your financial and retirement plan to get an idea about the overall impact. It also does not eliminate the case for delaying Social Security. It just eliminates one of the *extra* bonuses from delaying Social Security.

Social Security still requires significant reform, but it is by no means on the road to disappearing. Other structural changes will be needed in the coming years, but Social Security will still be around. With these reforms, Congress has shown some resolve to start taking small baby steps toward changes that will eventually keep Social Security more financial secure for years to come.

CALCULATING SOCIAL SECURITY BENEFITS

October 31, 2015

I will discuss the philosophy of claiming strategies in the next section, but it is meaningful to first consider how retirement benefits are calculated.

The Social Security Administration has now followed the same approach for calculating benefits since 1979.

1. *Determine Eligibility.*

To be eligible for benefits, a minimum amount of taxable earnings must be recorded for at least forty quarters (ten years). The Social Security statement shows the lifetime taxable earnings for a worker. This statement used to be mailed annually, but now goes out every five years. You can find a copy of your statement online at **http://www.ssa.gov/myaccount**. It's good to check this document to ensure Social Security has a proper recording of your earnings history, keeping in mind that the earnings listed are only up to each year's maximum taxable amount ($118,500 as of 2015).

2. *Calculate Average Indexed Monthly Earnings (AIME).*

The AIME is the average of the top 420 months (thirty-five years) of earnings, up to maximum taxable amounts, with past earnings through age sixty indexed to higher amounts to account for economy-wide average wage growth. For someone whose career was shorter, this can include months with no earnings. For someone who has already logged thirty-five years of earnings and continues working, payroll taxes continue, but new wages must be higher than wages from the top 420 months in order to have an impact on benefits.

3. *Calculate Primary Insurance Amount (PIA).*

Next, the PIA is calculated to determine the amount of available benefits at the full retirement age (FRA). The FRA is sixty-six through 2020, at which point it will begin a gradual increase toward sixty-seven for those born in 1960 and later. This calculation translates the AIME using a progressive benefit formula that provides a higher percentage of the AIME to lower waged workers and less for higher waged workers. The PIA formula provides a 90% replacement rate for the lowest range of the AIME, a 32% replacement rate for the middle range, and a 15% replacement rate for the upper range. The average benefit is about 40% of average wages in a given year. Andrew Biggs of the American Enterprise Institute has pointed out why this widely publicized 40% number is **not how most people think about replacement rates**. He calculates that the average benefit replaces about 53% of average inflation-adjusted lifetime earnings. Because of the progressive nature of the benefit formula, those with less than average earnings—or higher earnings for a smaller number of years—would experience higher replacement rates, while those with a lengthy record of above-average earnings would experience a lower replacement rate.

4. Translate PIA into a benefit amount based on claiming age.

The PIA provides the benefit available at the full retirement age. Benefits adjust upward or downward depending on when they start relative to the full retirement age.

For each month of delay beyond the full retirement age, the benefit increases by 0.67%. This sums to an 8% increase in benefits per year (not compounded). For each month of early uptake relative to the FRA, the benefit reduces by 0.56% per month for the first thirty-six months of early uptake, and by an additional 0.42% for any months beyond that. These adjustments were designed to be actuarially fair—claiming early means more years of benefit receipt while claiming late means fewer years—so it shouldn't matter when you claim your benefit. However, those calculations for actuarial fairness were made long ago and they no longer hold for today's retirees. Retirement benefits can be claimed as early as age sixty-two, and delay credits are provided up to age seventy. The following table summarizes how the claiming age adjusts the PIA to determine the actual retirement benefit.

Adjustments By Age		
Claiming Age	Full Retirement Age = 66	Full Retirement Age = 67
62	75%	70%
63	80%	75%
64	87%	80%
65	93%	87%
66	100%	93%
67	108%	100%
68	116%	108%
69	124%	116%
70	132%	124%

5. Account for additional spousal and dependent benefits.

A worker's record can also be used to support spousal, dependent and survivor benefits. Dependent benefits are available to children under eighteen, children who became disabled before twenty-two, and even parents who rely on the earner for more than 50% of their income. Divorcees who were married for at least ten years are also eligible for benefits based on an ex-spouse's record. These adjustments for additional benefits are provided up to a family maximum, which is the highest total amount of benefits one worker's earnings record can support (divorce benefits exist outside these limits).

6. Adjust benefits for inflation.

It is easier to refer to Social Security benefits in terms of their value expressed in dollars at age sixty-two. In other words, this is the real inflation-adjusted value of benefits. In practice, Social Security benefits will grow in nominal terms to reflect changes in consumer prices. In particular, Social Security benefits adjust for the Consumer Price Index for Urban Wage Earners and Clerical Workers (CPI-W) starting at sixty-two, which is the age of eligibility for retirement benefits.

PHILOSOPHY OF SOCIAL SECURITY CLAIMING STRATEGIES

November 5, 2015

Social Security claiming strategies can be extremely complicated. Treaties on this topic, some of which are listed in the table below, provide page after page of details, nuances, and exceptions.

When you consider all the possible strategies for a couple, there are literally millions of potential claiming strategies, given that they can claim for ninety-six months each between the ages of sixty-two and seventy. Very few people in the world fully understand all of the Social Security rules accumulated since 1935. In fact, many case workers at Social Security offices are not trained in all of the nuances of the system and may tell you that you are unable to do something you actually can do.

So while it is best to prepare in advance for a visit to the Social Security office, and even to take written explanations with photocopies from the Social Security rules suggesting that what you want to do is allowed, it is not necessarily practical or a good use of your time to become an expert in all the nuances of Social Security claiming.

For this reason, it is vital to use robust software as an aid to maximize the Social Security claiming decision for your personal situation. The costs for using software could help to provide more than $100,000 in net gains over your lifetime. You may use such software either directly on your own, or you might choose to work with a financial advisor who maintains a license to test their clients' circumstances in such software.

There are many software programs available for Social Security claiming, though they do not all necessarily cover all of the possible angles, especially with regard to matters like the Government Pension Offset or Windfall Elimination Provision.

Two software programs which do a good job to cover all of the relevant contingencies in the Social Security rules are "Social Security Solutions" and "Maximize My Social Security." These software programs are listed in the following table, along with some high-quality books providing a more extensive treatment of Social Security claiming strategies.

Additional Resources for Individualizing a Claiming Strategy

BOOKS (Ordered from Least to Most Technical)
Social Security Made Simple, Mike Piper
A Social Security Owner's Manual, Jim Blankenship
Get What's Yours, Laurence Kotlikoff, et al.
Social Security Strategies, William Reichenstein & William Meyer
Social Security Handbook, Social Security Administration
CLAIMING OPTIMIZATION SOFTWARE
Reichenstein and Meyer, "**Social Security Solutions**"
Laurence Kotlikoff, "**Maximize *My* Social Security**"

Rather than repeating all the details found in these books about Social Security, I will instead provide a much more basic introduction to claiming Social Security. My explanations do not account for more complicated situations and special exceptions such as benefits for divorced spouses, what happens in the case of remarriage, joint claiming strategies when spouses are not the same age, the interactions of disability and retirement benefits, the impact of additional earnings after Social Security benefits have been claimed, and further modifications for survivor benefits such as the eligibility age of sixty.

More detailed explanations for any of these situations can be found in any of the books listed above.

Keeping matters as simple as possible, eligibility for retirement benefits requires reaching age sixty-two and having at least forty quarters (ten years) with sufficient Social Security-covered earnings.

For single individuals with no dependents, Social Security claiming is an easier endeavor, though it is probably worthwhile to still double-check your strategy using one of the high-quality software programs listed above. If for no other reason than to make sure that you have not missed out on any special opportunities, such as a possibility for a divorce or survivor benefit.

A single individual need only decide on a claiming age. Unless you are in such dire circumstances that you simply do not have assets to fund a delay in benefits, or unless you have a valid medical opinion that it is unlikely you will live beyond eighty, it is important to seriously consider the possibility for delaying benefits in order to support a permanently enhanced lifestyle and to obtain the full insurance value from Social Security.

For couples, the claiming decision is more difficult, especially when both spouses are eligible for benefits based on their own earnings records. Each of you is potentially eligible for benefits based on:r

- your own work record (your spouse is also eligible for a benefit based on your record),
- plus a spousal benefit based on your living spouse's work record,
- plus a survivor benefit based on a deceased spouse's record.

As only one benefit can be received at a time, practically speaking, it is important to coordinate the best claiming approach between spouses. Because of survivor benefits, the case for the higher earning spouse to delay benefits becomes even stronger. The relevant age for the higher earning spouse extends beyond your own age of death to your age when the last surviving member of the couple passes away.

For a couple, joint survivorship is higher. Additionally, if the higher earning spouse is significantly older, their benefit could generate survivor benefits for many years, making Social Security delay extremely attractive. To reiterate, the higher earner claims based on number-of-years benefits will be generated by their earnings record for the longest living member of the couple.

Matters are different for the lower earning spouse, including the claiming decision, which is also impacted by how different their lifetime earnings and PIAs are. There are many circumstances when the lower earning spouse might claim at a younger age, with considerations about how each of the spouses may receive some short term benefits from the lower earner's record.

Generally, the case for delay until seventy is weaker for the lower-earning spouse, because the relative length of these benefits is only for when both spouses are living. After one spouse has passed away, only the higher earner's benefit is relevant: either the higher earner lives and continues receiving their own retirement benefit, or the lower earner lives and switches to a survivor's benefit based on the higher earner's record.

It is also important to consider matters like deemed filing, restricted applications for Social Security benefits, and the file and suspend strategy. However, in November 2015 the government passed new legislation to phase out some of the more creative claiming strategies along these lines, and eventually it will no longer be possible to collect spousal benefits from their record of someone suspending their own benefit.

These explanations provide only a simple introduction to the complex world of Social Security claiming. It is worth repeating that testing your situation with a high-quality comprehensive Social Security calculator is incredibly worthwhile, even if it requires minimal expenses. Such software could provide a strategy that garners significant additional benefits over your lifetime. This is a matter for which a basic investment of time and energy can lead to meaningful improvements for your retirement finances.

JUSTIFYING A DELAYED CLAIMING AGE FOR SOCIAL SECURITY

November 10, 2015

With an understanding of how benefits are calculated, the important question to consider becomes how to develop a Social Security claiming strategy. When should you apply for benefits? Disagreement exists on this topic, and I will review arguments from both sides. First, I'll look at the case for delay.

Social Security as Insurance

Blaise Pascal was a seventeenth-century French philosopher whose "Pascal's Wager" posed the argument that it is best, for self-serving reasons, to believe in God. If God does not exist, then a misplaced belief in God will have relatively minor consequences. However, if God does exist, then the impact of belief in God becomes much more consequential: eternity in heaven for believers and eternity in hell for non-believers. The consequences of the decision strongly favor a belief in God.

Pascal's Wager, as it relates to Social Security, concerns itself with the consequences of longevity risk. We can think of four general outcomes for Social Security:

1. Claim early and experience a short retirement,
2. Claim early and experience a long retirement,
3. Claim late and experience a short retirement, or
4. Claim late and experience a long retirement.

What are the consequences of these different outcomes? It is surely unfortunate to experience a short retirement. In relation to Social Security, claiming early in this scenario would have gotten the most out of the program. But claiming late would have resulted in minimal harm. Less would be obtained from Social Security, but there would have been less pressure on the portfolio anyway, and a decent amount may still remain for heirs. A short retirement is less costly, so heirs will still receive plenty of leftover assets even if Social Security is delayed.

Consequences become more severe with longer retirements, so this is where the focus of decision-making should be placed. If claiming early, you may be setting up conditions for a permanently reduced standard of living in retirement. A long retirement combined with Social Security delay supports a permanently enhanced lifestyle. Greater emphasis should be placed on what happens in longer retirements, because the financial consequences are more severe, and this scenario is when delaying Social Security will have a clear positive impact.

Pascal's Wager for Social Security		
	Claim Early	**Claim Late**
Short Retirement	Worked Out	Minimal Harm Done
Long Retirement	Permanently **Reduced** Lifestyle	Permanently **Increased** Lifestyle

Pascal's wager insinuates that Social Security should be viewed as insurance, rather than as an investment. Social Security retirement benefits are inflation-adjusted and government-backed. With lifetime cash flows, they mitigate your longevity, inflation, and market risk. If you are more risk-averse and would prefer to invest more heavily in bonds, which do not provide longevity protection, the insurance value of Social Security becomes even stronger because there would otherwise be less potential for upside growth.

Social Security also provides spousal and survival benefits, as well as benefits for dependent children. Importantly, survival and disability benefits are also available for pre-retirees, providing extra insurance value before retirement actually begins. Any discussion of Social Security as an investment should not forget about this insurance value.

It is a bummer to die early. But regret about Social Security claiming doesn't exist after death, and when we die is a variable we don't have much control over beyond doing our best to take care of our health. The real concern and focus is to avoid a situation in which you outlive your assets. A bit of patience with regard to Social Security can help you better manage your longevity risk.

ARGUMENTS FOR CLAIMING SOCIAL SECURITY EARLY

December 1, 2015

Believe it or not, legitimate arguments exist for claiming Social Security early. Sometimes individuals simply need the funds to survive and have no other income alternatives to cover delaying benefits until seventy. Delaying retirement would be a better option, but it is not always possible. Claiming early in such circumstances may be unavoidable, resulting in a permanently reduced lifestyle.

Another situation in which it is reasonable to claim early is for individuals with legitimate medical reasons to believe they will not live to age eighty. In this instance, it is important to consider survivor and dependent benefits based on earnings history. Age of death is not the only factor in determining the optimal household solution.

Some strategies also legitimately call for the spouse with smaller lifetime earnings to start benefits earlier in order to maximize lifetime household benefits. The higher earner might also occasionally claim earlier in order to take advantage of benefits for dependent children or dependent parents. With so many options and so much money at stake, I cannot emphasize enough the importance of testing individual situations using comprehensive Social Security planning software that includes all relevant variables.

Other reasons can be used to justify claiming Social Security early, but I generally find them less compelling. For instance, some have made the rather dubious claim that an investment portfolio can be expected to produce higher returns than those offered by Social Security delay.

This uncertain quest for upside growth means giving up a valuable, lifelong, inflation-adjusted income stream. To make risks comparable, the appropriate investment would be TIPS. To generate the returns needed to beat Social Security delay would require a high risk tolerance and aggressive asset allocation, not to mention plenty of discretionary wealth. People tend to be overconfident about their investing prowess, making it easy to fall into a behavioral trap.

The Social Security claiming decision can also be viewed in terms of the breakeven age you have to reach before the delay decision pays off. This causes some to feel like they're gambling their savings by delaying, considering that they could die before the strategy pays off.

Interest rates play a large role here—higher interest rates will delay the breakeven age because money received today would be able to grow more quickly. In other words, because higher interest rates allow that money to grow more quickly in the mean time, less money would need to be set aside today for future payments.

The following table shows the basic concept behind breakeven analysis for an individual with a full retirement age of sixty-six whose PIA is $30,000. The analysis is provided in real inflation-adjusted terms for two discount rates. Breakeven ages are eighty and eighty-four, depending on the choice of discount rates.

Breakeven Age for Delaying Social Security						
			Future Values - Cumulative Benefits			
	Benefit Amounts		Real Discount rate = 0%		Real Discount rate = 3%	
Age	Claim at 62	Claim at 70	Claim at 62	Claim at 70	Claim at 62	Claim at 70
62	$22,500	$0	$22,500	$0	$22,500	$0
63	$22,500	$0	$45,000	$0	$45,675	$0
64	$22,500	$0	$67,000	$0	$69,545	$0
65	$22,500	$0	$90,000	$0	$94,132	$0
66	$22,500	$0	$112,500	$0	$119,456	$0
67	$22,500	$0	$135,000	$0	$145,539	$0
68	$22,500	$0	$157,500	$0	$172,405	$0
69	$22,500	$0	$180,000	$0	$200,078	$0
70	$22,500	$39,600	$202,500	$39,600	$228,580	$39,600
71	$22,500	$39,600	$225,000	$79,200	$257,937	$80,388
72	$22,500	$39,600	$247,500	$118,800	$288,175	$122,400
73	$22,500	$39,600	$270,000	$158,400	$319,321	$165,672
74	$22,500	$39,600	$292,500	$198,000	$351,400	$210,242
75	$22,500	$39,600	$315,000	$237,600	$384,442	$256,149
76	$22,500	$39,600	$337,500	$277,200	$418,476	$303,434
77	$22,500	$39,600	$360,000	$316,800	$453,530	$352,137
78	$22,500	$39,600	$382,500	$356,400	$489,636	$402,301
79	$22,500	$39,600	$405,000	$396,000	$526,825	$453,970
80	$22,500	$39,600	**$427,500**	**$435,600**	$565,130	$507,189
81	$22,500	$39,600	$450,000	$475,200	$604,583	$562,004
82	$22,500	$39,600	$472,500	$514,800	$645,221	$618,465
83	$22,500	$39,600	$495,000	$554,400	$687,078	$676,618
84	$22,500	$39,600	$517,500	$594,000	**$730,190**	**$736,517**
85	$22,500	$39,600	$540,000	$633,600	$774,596	$798,212

SOCIAL SECURITY AS AN "INVESTMENT"

November 12, 2015

The alternative to treating Social Security as insurance is to view it as an investment, or as a gamble on how long you live. This can be problematic. The investment approach focuses more on the breakeven age for when it finally pays to delay benefits. As I said before, with inflation-adjusted discount rates of 0% to 2%, the breakeven age is eighty to eighty-four. Though these ages are within the range of life expectancies for sixty-two-year olds, they *appear* to be high, and clients start to worry that they may not live long enough for delay to pay off. They worry about losing out on potential benefits if they die early, rather than about running out of assets if they live a long time.

In addition, sometimes it is financial advisors who get ahead of themselves, thinking that they can invest the early Social Security benefits better and provide more lifetime wealth to their clients. I've seen advisors write that it doesn't make sense to delay Social Security, because the advisor can invest that money and earn their clients a *10.5% compounded return*.

Certainly, if realized returns are this high, then claiming early is advantageous. But the odds are not in favor of getting that sort of investment return over the eight-year delay period, especially in our current low-yield world. This type of overconfidence requires amplifying risk for an asset that should otherwise be treated as a true backstop and safeguard for retirement income. It is difficult to fathom how the additional upside potential outweighs the downside risks from claiming Social Security early and investing the proceeds in the stock market, except possibly for those who are so sufficiently overfunded that they don't need their Social Security benefits anyway.

Nevertheless, while I prefer thinking of Social Security delay as insurance, I think we *can* reframe the discussion to view Social Security delay as a rather attractive "investment" proposition as well. This involves understanding the additional credits provided by delaying Social Security benefits, which were meant to be "actuarially fair." For someone living to their life expectancy, it should not matter what age they claimed their benefits. The increase in benefits from delay should precisely offset the fewer number of years that benefits will subsequently be received.

However, these calculations of actuarial fairness for the delay credits were made as part of the 1983 Amendments to Social Security. The calculations are now more than thirty years old, and changes since that time suggest that delaying benefits can now provide net advantages. First, Social Security actuaries calculated the delay factors assuming that the real interest rate is 2.9%. In October 2015, the yield on 30-year TIPS was only about 1.2%. It was even less for shorter-term TIPS. Lower interest rates today mean we should expect lower returns on other types of investments, which favors delaying Social Security as a way to actually obtain higher overall returns for the assets on the household balance sheet.

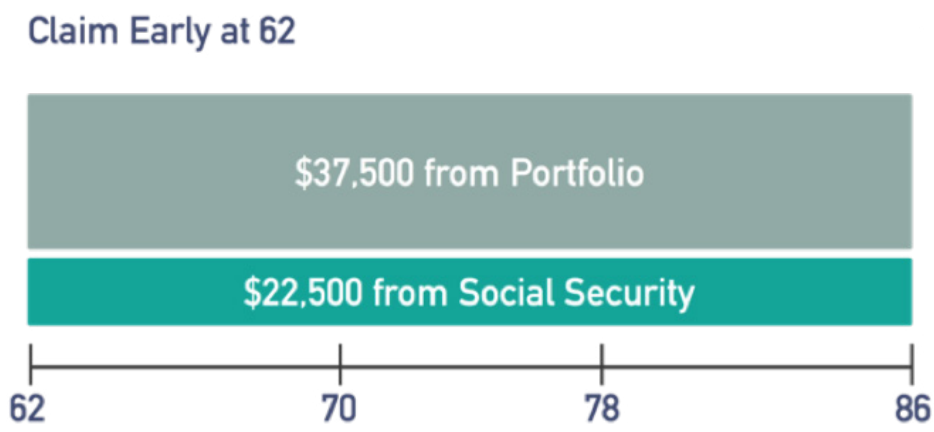
The other change relates to longevity. Longevity continues to improve and retirees are now living longer than they were in 1983. This also favors delaying Social Security, as it improves the odds of living long enough to enjoy positive net benefits from delayed claiming. Relatedly, actuaries considered aggregate longevity for the population of Social Security participants, and my more highly educated and higher earning readers represent a socioeconomic subgroup of the overall population that can expect longer than average lives.

A simple example can help illustrate how delaying Social Security can work as an “investment” that helps improve portfolio sustainability for retirees. What follows is not an effort to optimize any decision-making, but rather to observe the long-term impacts of two different types of claiming strategies.

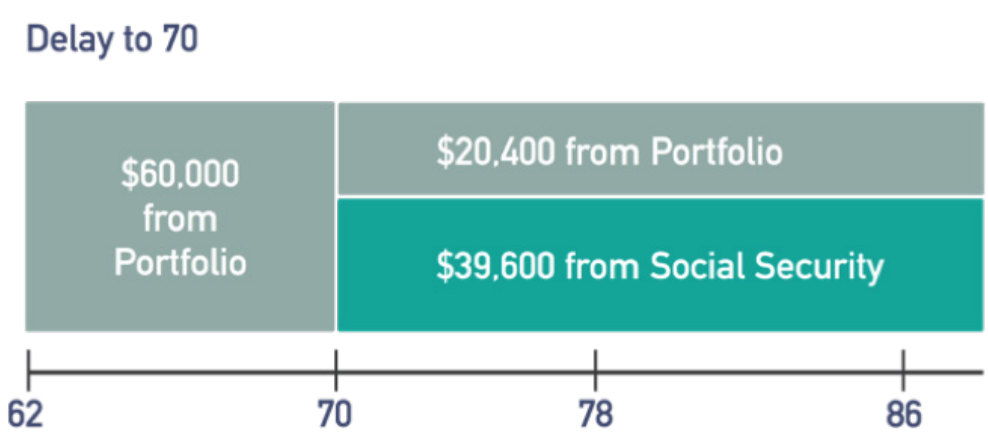
Consider a sixty-two-year-old who has already left the workforce. We will consider the case of a single individual with no dependents. This leaves out additional complications, though having a spouse entitled to survivor benefits would further strengthen the case for delay. This individual is simply thinking about the decision between claiming Social Security at sixty-two or seventy.

For the example, the overall annual spending goal is $60,000 in today’s terms. Future spending grows with inflation. Her full retirement age is sixty-six, and her PIA is $2,500 per month, or $30,000 per year in today’s dollars (all dollars are expressed as their age sixty-two values, though in subsequent years cost-of-living adjustments would be applied both to the overall spending goal and Social Security benefits). Should she claim at sixty-two, her benefit would be reduced by 25% to $1,875 per month or $22,500 per year. Should she delay until seventy, her benefit grows by 32% from the PIA to $3,300 per month or $39,600 per year. Inflation-adjusted Social Security benefits are 76% larger when claimed at seventy relative to sixty-two.

To meet her $60,000 spending goal, any amount above what is provided by Social Security will be funded by withdrawals from an investment portfolio worth $800,000. This creates two lifetime spending scenarios. By claiming at sixty-two, Social Security provides $22,500 of income, and $37,500 is withdrawn from the investment portfolio.



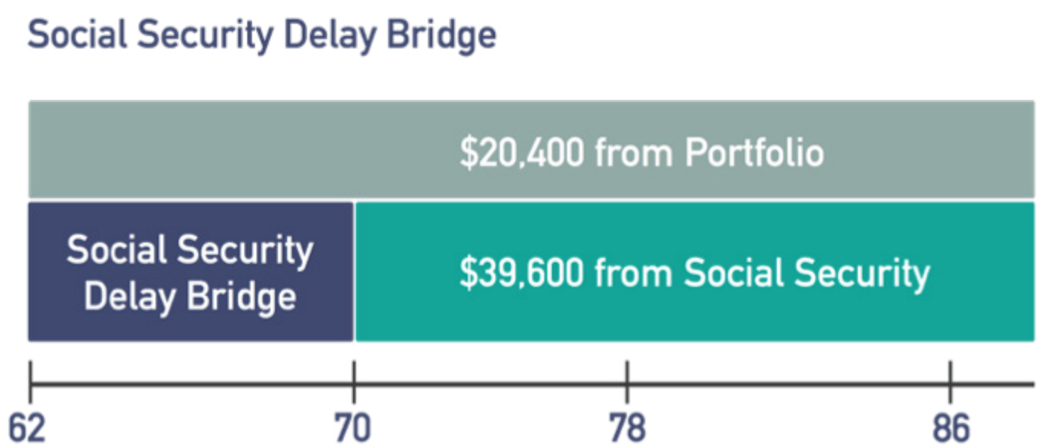
Meanwhile, when claiming at seventy , $60,000 will have to be supported by the portfolio for the first eight years of retirement. Starting at seventy, Social Security then provides $39,600 with the remaining $20,400 coming from the portfolio.



One way to compare these strategies is with the implied withdrawal rate needed from the portfolio after accounting for Social Security. By claiming at sixty-two, the inflation-adjusted withdrawal rate needed to meet the spending goal is:

Withdrawal Rate = ($60,000 – $22,500) / $800,000 = 4.69%

When claiming at seventy, there could be two different withdrawal rates for before and after seventy. However, it would not be wise to use a volatile investment portfolio for the full spending amount when Social Security is delayed, as that would magnify sequence risk. Instead, I use a conservative assumption that eight years of age-seventy-level Social Security benefits will be set aside from the portfolio at age sixty-two and earn a 0% real interest rate (building an actual 8-year TIPS ladder would provide a positive yield). At age sixty-two, this means that ($39,600 x 8 =) $316,800 will be set aside as a Social Security delay bridge, illustrated below, leaving the other $483,200 for withdrawals.



The required withdrawal rate to meet the spending goal throughout retirement is now:

Withdrawal Rate = ($60,000 – $39,600) / ($800,000 – $316,800) = 4.22%

In this example, Social Security delay allowed the withdrawal rate to drop from 4.69% to 4.22%. This improves retirement sustainability. The investment portfolio is less likely to be depleted and more income remains available through the higher Social Security benefit in the event that the portfolio is depleted. In other words, running out of financial assets is both less likely to happen and less damaging when it does happen.

Allowing for the same probability of portfolio depletion, spending could be increased by more than 11% to $66,682 in order to use the same 4.69% withdrawal rate as when claiming early. Then, 76% more income is still available than otherwise in the event of portfolio depletion. This is the permanently enhanced lifestyle possible with Social Security delay.

The basics of this example are illustrated below:

Impact of Social Security Delay on Retirement Withdrawl Rates		
	Claim at Age 62	Claim at Age 70
Spending Goal	$60,000	$60,000
Social Security Benefit	$22,500	$39,600
Portfolio Withdrawl	$37,500	$20,400
Investment Portfolio	$800,000	$800,000
Set Aside for Social Security Delay	$0	$316,800
Remaining Portfolio	$800,000	$483,200
Withdrawl Rate	4.69 %	4.22 %

The magnitude of the difference would be larger if the client's spending goal and asset base were smaller relative to the Social Security benefits, and vice versa.

For this strategy to work effectively, the overall spending goal cannot be too large with respect to the size of the financial portfolio. For instance, if the portfolio was $300,000, there would not be enough to create the delay bridge. A large enough portfolio would allow for Social Security delay to reduce the required portfolio withdrawal rate. If the portfolio is not large enough, it is more of a reflection that the overall spending goal is not realistic rather than an indictment of delaying Social Security. Though, as will be pointed out later, severely underfunded retirees without alternatives may be forced to claim Social Security early because they cannot otherwise fund themselves through age seventy.

The previous discussion demonstrated how delaying Social Security receipt can improve the sustainability of a retirement income plan, or otherwise support more spending power for the same success probability. It is necessary to withdraw more until Social Security starts, but retirees can then withdraw less after starting Social Security. The strategy is not fool-proof with only a volatile investment portfolio as a backstop—a bad sequence of returns early in retirement could cause the portfolio to drop in value, locking in losses. But assets can be carved out of the main investment portfolio in order to create a Social Security delay bridge. Another alternative for retirees is to use other buffer assets from outside the financial portfolio, such as home equity through a reverse mortgage or possibly life insurance, as another alternative for constructing this bridge.

POTENTIAL DIRECTIONS FOR SOCIAL SECURITY

December 8, 2015

> *I'm cynical; for my retirement planning I assume that I'll pay into Social Security until I stop working and I assume that I'll draw nothing out (i.e., all cost, no benefit). This is a 'worst case' so anything else with any benefit will be a pleasant surprise.*
>
> *– A reader at the Retirement Researcher blog*

A common argument for claiming Social Security early is that the program is about to be dramatically overhauled in a way that will leave retirees scrambling to get a little out of the system before it's gone. But it seems rather unlikely that any impending reforms would leave near retirees with significant reductions to benefits.

The widespread belief that Social Security is bankrupt and about to disappear has existed for a long time. I can remember walking around Washington, D.C., in the late 1990s and receiving literature suggesting that more Americans believe UFOs visit us on earth than believe Social Security will be there when they retire.

I commonly hear from individuals who say they are planning for retirement assuming there will be no Social Security, and any benefits they do get will be icing on the cake. While I generally support conservative assumptions for planning purposes, I think this viewpoint is taking things way too far. For my own personal planning, my conservative planning assumption is that I will receive 70% of my presently-legislated projected benefits.

While Social Security definitely has funding problems, the situation is not quite so dire as to think it will disappear entirely or otherwise be converted into a pure welfare program. The general goal of reforming Social Security is to help place the Trust Funds into seventy-five-year actuarial balance.

The 2015 *Trustee's Report* estimates that the current Social Security system is not generating enough revenue to stay in balance past 2033, and that an immediate increase in the payroll tax of 2.62 percentage points (shared between employees and employers) would be needed for the Social Security system to maintain its solvency for the next seventy-five years. If no action is taken, Social Security benefits would have to receive an across-the-board 21% reduction so that the inflows of new contributions from workers could cover the outflows of benefit payment.

The presently legislated course for Social Security includes a continued increase in the full retirement age to sixty-seven, an OASDI payroll tax of 12.4%, the use of CPI-W to make annual cost-of-living adjustments, and the use of the average wage index for indexing benefits at the age of first eligibility.

There are several ways Social Security reform could proceed to get the program back on track to a seventy-five-year actuarial balance. Many reform options would have minimal impact on current or near retirees. Options include any increase in payroll tax rates, or a lift in the ceiling on maximum taxable earnings, which is $118,500 in 2015. With payroll tax increases, only those still in the workforce would be affected for the tail end of their careers.

A gradual increase in the full retirement age consistent with the 1983 reforms would also not affect those already near retirement. Another popular reform idea is to switch from “wage indexing” to “price indexing” when calculating Social Security benefits. Though this sounds somewhat technical, it would allow current or near retirees to escape the burden of reform. Instead, reform would compound over time so that younger individuals will eventually receive lower and lower benefits relative to their wages and payroll taxes. As an attempt to look out for young people, I oppose this reform for its particularly stark intergenerational impacts.

Finally, a reform that would not affect benefits is expanding the investment approach of the Social Security Trust Fund to include additional investment options beyond the current specially issued non-tradable Treasury bonds. This reform was discussed during the 1990s, though nothing ever came of it. Finally, the reform idea popularized by President Bush in the 2000s was to carve out a portion of Social Security payroll taxes to create Personal Retirement Accounts. This reform also did not make it far into the legislative process.

Reforms Impacting Current or Near Retirees	Other Reforms
Use a Smaller COLA	Increase payroll tax rate
Use more than top 35 years of earnings	Increase maximum taxable earnings
Link benefits reductions to longevity improvements	Gradually raise full retirement age
Eliminate "file and suspend" and related strategies	Switch from "wage indexing" to "price indexing"
Means testing for benefits	Expand trust fund beyond US treasuries

Other reform ideas could also impact current or near retirees today. A number of these reforms would lead to some benefit reductions in the near term.

For instance, Social Security benefit growth could be linked to a new price index that grows less rapidly, or the cost-of-living adjustments (COLA) could be set at 1% less than the consumer price index. The impact of this reform would be to gradually reduce the real purchasing power of benefits over time. The justification for such a reform is that the current CPI-W measure used by the Social Security Administration may overstate inflation and that people tend to spend less as they age. Objections to this reform include that it would leave the extreme elderly and widows more vulnerable to poverty, and it may be the case that expenses for some vulnerable elderly would rise faster than the CPI-W.

Other reforms which would lead to benefit reductions include increasing the number of years used to calculate the average-indexed monthly earnings. This would bring in more years with lower earnings to reduce average wages. Congress might also eliminate strategies like "file and suspend," which would impact the more well-informed beneficiaries who are aware of these more sophisticated approaches.

A popular reform internationally is to provide a more direct and automated link between longevity improvements and the full retirement age. The idea is that over time, the full retirement age would increase automatically as people continue to live longer, which would better calibrate the number of years they would live beyond this age.

Finally, a reform that could have a bigger impact on wealthier individuals who are about to retire is the introduction of means testing for benefits. Those with sufficient means, represented either through other income sources or wealth accumulations, would no longer be eligible to receive Social Security benefits. Such a reform would run counter to the entire history of the Social Security program, which has always sought a clear link between benefits and contributions. Means testing would convert the Social Security program into a welfare program. In this regard, it seems unlikely that such a reform could happen, though politicians discuss the possibility from time to time.

Other reforms that increase the progressive nature of the benefit formula or increase taxes due on benefits could provide stealthier ways to arrive at the same outcomes as means testing, but without formally making the link for benefit reductions.

While higher income individuals may have some justification to worry about means testing, it seems incredibly unlikely that a wholesale reduction in benefits would be enacted for the general population of current and near retirees. It is overly conservative for near retirees to believe they should start benefits ASAP to get whatever they can because they are worried that Social Security will soon disappear.

WHAT'S REALLY GOING TO HAPPEN WHEN SOCIAL SECURITY RUNS OUT OF MONEY?

October 14, 2015

A note from Wade: The following piece was written by Rob Cordeau, a colleague of mine at McLean Asset Management. I found it quite informative and thought it would fit nicely at the end of this discussion. Enjoy. -Wade

I just read through the 257-page, 2015 edition of the annual Social Security trustees report. Ok, maybe not the *whole* report. I skimmed over ~~some most~~ all of the boring parts. But I did actually read the first twenty-four pages—the *Overview*—which is where all the important stuff is anyway.

As a public service for those of you struggling with insomnia, **here's the full report in all its actuarial glory**. But for those of you who don't wish to subject your brain to numerous sentences like this one: "A third approach uses stochastic simulations that reflect randomly assigned annual values for each parameter" (see page twenty if you think I'm making that up), I've summarized the results below in actual English and added a section on how we think this could play out.

How Did We Get Here?

It's a bit of a perfect storm for the Old-Age Survivors and Disability Insurance (OASDI) trust fund. Baby boomers retiring en masse means larger expenses for the fund. Fewer babies per family results in a smaller pool of workers to support those who require benefits. Increased disability claims and the great recession just add to the fun.

So Doctor, How Much Time Does She Have?

According to the latest report, the OASDI trust fund sits at nearly $2.8 trillion (just a smidgeon more than is in my savings account). Expenses already exceed tax revenues, but interest on the trust fund is still keeping the fund in the green each year. That's projected to change in 2020 when expenses will exceed both of the income sources (tax revenues AND interest). Trust funds will then be drained until 2034, when they are expected to run dry.

What Happens When The Money Runs Out?

Social Security will be living like you did in your twenties: paycheck to paycheck. With no more trust fund to pull from, only the tax revenues from current workers will be available to cover the benefits being paid. The estimate is that 79% of benefits could be paid at that point. That's a 21% benefit cut for everyone receiving benefits. The good news is that level is essentially sustainable. However, it drops off gradually, ending at 73% of benefits in the year 2089—the end of the report's seventy-five-year, long-range projection.

Should I Assume Social Security Will Be Gone When I Retire?

If you want to bet against statistics, then ignore your social security benefits. But the math indicates that even if *nothing* were done to alter the current system, you'd still have roughly three-quarters of your originally expected benefit. But how likely do you think it is that the entire retired population—a significant voting bloc—would allow a 21% reduction to their benefit? I know the over-sixty-two crowd is not usually the type to get out and protest, but an immediate 21% drop in America's pension plan would bring them out in droves! The resulting burden that would be placed on other social programs make this "do nothing" approach a non-starter.

What Would It Take to Fix It?

If you asked the current working population to pay the entire freight, the report says it would take an immediate and permanent increase to payroll taxes of 2.62% (1.31% for employees and 1.31% for employers). On the other hand, if you wanted to leave payroll taxes untouched, it would require an immediate 16.4% decrease in benefits for all current and future recipients.

How's It Going to Play Out?

Of course, no one knows exactly what will happen, but we do have some precedent here. The last time Congress made changes to the program, they used a gradual approach to delay the full retirement age from sixty-five to sixty-seven. The changes were phased in, with those close to retirement grandfathered in under the prior, more favorable age calculation. Gradual phase-ins are likely—especially if they impact benefit recipients.

Congress has multiple tools at its disposal:

- Increasing the 6.2% payroll tax employees pay (5.3% is for OASI + 0.9% is for DI)
- Increasing the 6.2% payroll tax employers pay
- Increasing the Social Security Wage Base (currently only the first $118,500 of wages are taxed)
- Increasing tax revenue in some other manner
- Extending the retirement age—again
- Adding a means-testing component for benefits
- Changing the Cost of Living Adjustment (COLA)
- Eliminating certain esoteric "claiming strategies" for SS benefits
- Decreasing benefits in some other manner
- Some combination approach that incorporates increased taxes and decreased benefitsw

The trustee's report strongly urged Congress to act soon to begin addressing these issues, because every year of delay means the resulting solution has to be compressed into fewer years, so it becomes more painful. Delaying important financial matters until the last possible moment (or beyond) appears to be a favorite local pastime in Washington, so I certainly won't go out on a limb and predict this will be addressed immediately. However, this is a growing concern among Americans, and it would not be completely shocking to see this problem addressed before the eleventh hour.

Congress will, however, need to address the disability (DI) portion of the OASDI fund very soon. It's technically a separate entity from the retirement, old-age and survivors fund, and it's scheduled to be depleted in Q4 of 2016.

The easiest, and therefore most likely, solution here is a change to the allocation split of 5.3% going to OASI and 0.9% going to DI. A typical kick-the-can-down-the-road approach would adjust the split of that 6.2% payroll tax to something like 5.1% and 1.1%, or whatever the ratio needs to be. It doesn't really resolve anything, but it doesn't raise taxes or decrease benefits either. On a combined basis, the OASDI fund would be in the same situation; obviously not a long-term solution, but precisely the kind of legislation that could actually pass.

How Do I Plan For Future Changes?

It's undeniable that something's got to give over the course of the next two decades. It may very well be some type of "combination approach," whereby workers and retirees will share the burden of righting the social security ship.

How should you plan for it? Aside from boosting the worker pool by making more babies, the most prudent approach appears to be to factor in a slightly lower benefit for Social Security income when running the numbers for your own retirement projection. I know, not nearly as fun as making babies.

Congress' romance with can-kicking is hard to deny. And there's still a bit more road in front of them before the 2034 Social Security cliff. So don't expect an immediate solution, but don't believe the misinformation either. Social Security is not going to disappear when the trust fund is depleted.

If you're already receiving benefits, enjoy the fruits of congress' procrastination. But if you're still contributing to the system, prudently assume your contributions might increase, and your benefits might be a bit less than under the present system.

But whatever you do—retired or not—promise me you won't read that annual trustees report in its entirety. I can't begin to imagine what 257 pages of that mind-numbing statistical mumbo jumbo would do to a human mind!

WHAT'S NEXT?

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About the Author

Wade Pfau, Ph.D., CFA

As Watermark's Director of Retirement Research, Wade Pfau helps clients reach retirement with confidence.

Wade also serves as Professor of Retirement Income at The American College in Pennsylvania and writes regularly at his blog, *Retirement Researcher*.

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