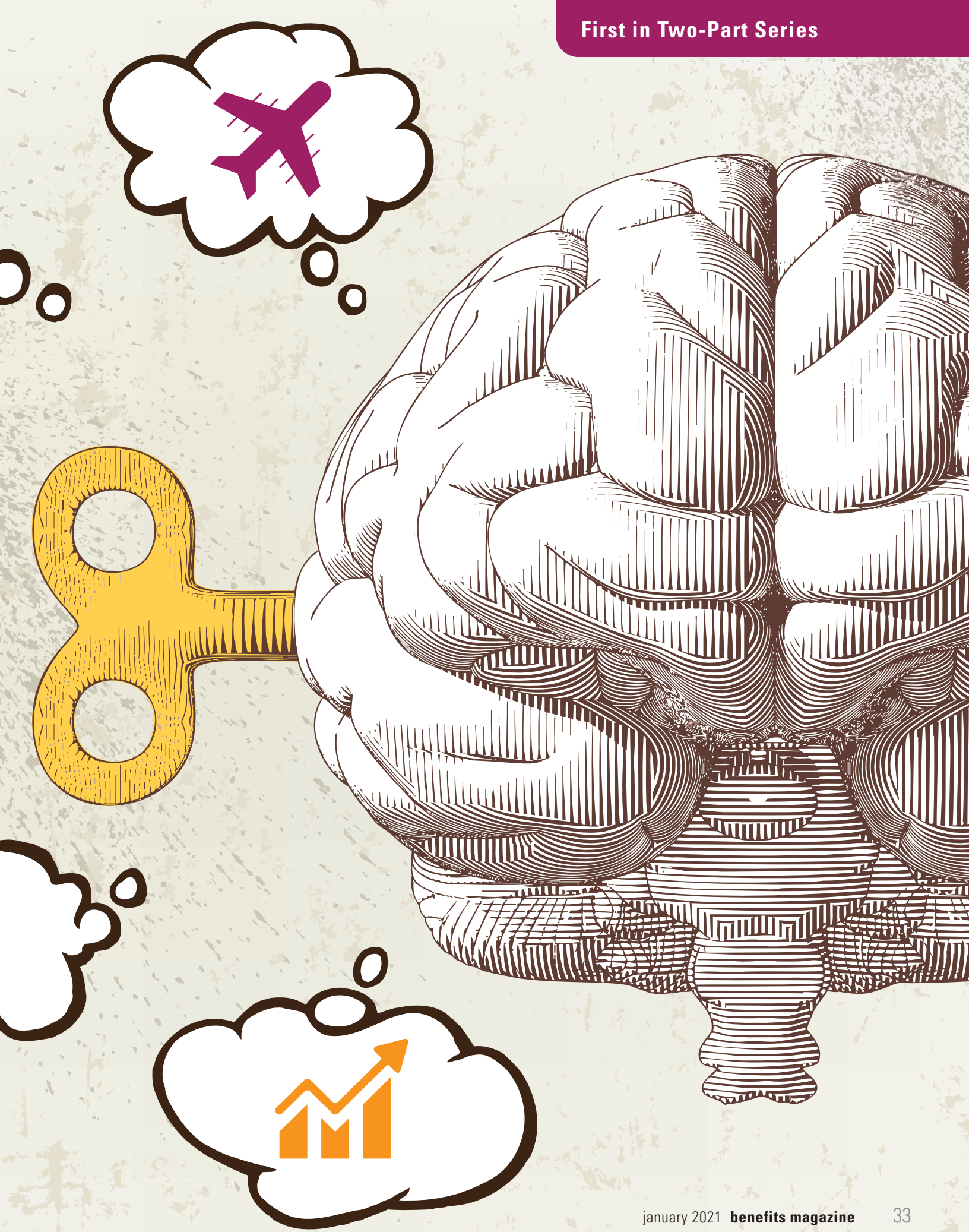
benefits
MAGAZINE

CRITICAL DECISIONS:

Planning for Retirement Income

by | **Steve Vernon**

Preretirees face critical decisions when determining how to generate the most retirement income possible from their financial resources and how to make it last. In this first article of a two-part series, the author reveals the five most important retirement income decisions for preretirees. A second article will look at how defined contribution plan sponsors can help plan participants with those decisions.



Many older workers approaching retirement have only modest retirement savings. For example, one study by the Stanford Center on Longevity shows that one-third of older workers approaching retirement have no retirement savings, and the median balance for those with savings is about $200,000. As a result, middle-income preretirees can't afford to make mistakes when planning how they will deploy their retirement savings and build a retirement income portfolio.

Preretirees will need to make critical decisions that help them squeeze the most retirement income from their financial resources over a retirement that may last 30 or more years. Studies have shown that they often feel uncertain about these decisions, and economic turmoil—such as the downturn caused by the COVID-19 pandemic—serves only to increase that uncertainty.

Two recently published research reports prepared by the Stanford Center on Longevity (SCL), in collaboration with the Society of Actuaries (SOA), provide valuable insights into these decisions. These reports identify and analyze a straightforward retirement income-generating strategy that can work effectively for most middle-income retirees and can be implemented using virtually any traditional individual retirement account (IRA) or 401(k) plan. It's called the *Spend Safely in Retirement Strategy,* or the *Spend Safely Strategy* for short.

One of these reports—*Viability of the Spend Safely in Retirement Strategy*—develops a framework that preretirees can use to make critical retirement decisions, including how to build their portfolio of retirement income. The framework includes the following five decisions regarding retirement income that most middle-income preretirees should address.

1. When and how to retire, including whether to work part-time for a period of time
2. When to start Social Security benefits
3. How to deploy retirement savings to generate retirement income
4. Which living expenses, including the cost of housing (which is often retirees' largest living expense), to reduce in order to live on less income in retirement
5. Whether to deploy home equity by realizing capital gains and reinvesting the proceeds to generate retirement income or by purchasing a reverse mortgage

This article will explore each one of these decisions, drawing upon analyses from the two SCL/SOA research reports.

Decision 1: When and How to Retire

Figure 1 shows a projection of total retirement income in the initial year of retirement at various retirement ages for a hypothetical 62-year-old married couple. Their household earnings are $100,000 per year, and they have $350,000 in retirement savings. This assumed savings amount is higher than the average and median savings levels accumulated by current older workers.

The analysis considers the following five scenarios.

1. Both members of the couple retire completely at age 62, and both immediately begin taking Social Security benefits and drawing down retirement savings.
2. Both keep working part-time until their Social Security full retirement age (FRA) (66 years and six months for this couple), at which time they both start taking Social Security and drawing down their retirement savings. *Working part-time* is defined here as earning enough to pay for their current living expenses but not continuing to contribute to retirement savings.
3. Both continue working full-time until their Social Security FRA, at which time they both start taking Social Security and drawing down their retirement savings. In this scenario, the hypothetical couple continues to contribute 10% of their pay to retirement savings.
4. Both keep working part-time until age 70, at which time they both start taking Social Security benefits and drawing down retirement savings.

5. Both continue working full-time until age 70, at which time they both start taking Social Security benefits and drawing down retirement savings.

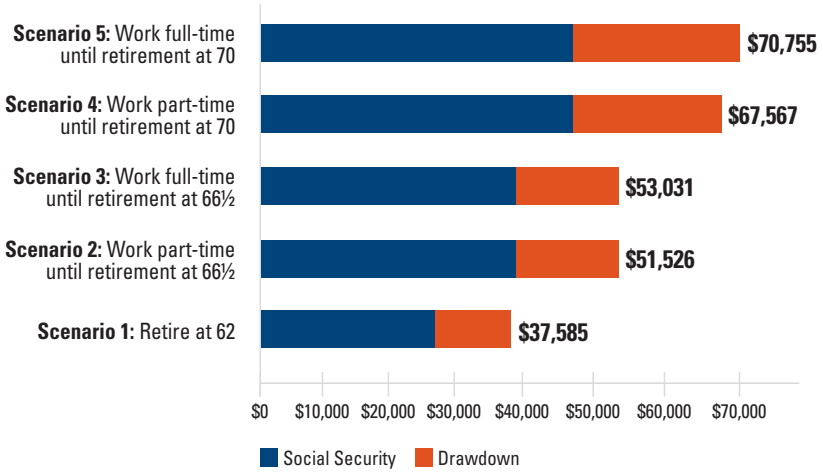
Figure 1 shows that this couple's projected total annual retirement income almost doubles when they delay retirement, from $37,585 when retiring at age 62 to $70,755 when retiring at age 70. As a result, the period between ages 62 and 70 can be considered the "retirement opportunity zone," since the decisions they make during this period will significantly impact their retirement security.

For the example in Figure 1, the annual amount of retirement income generated by savings was calculated by assuming the retired couple would withdraw amounts equal to the Internal Revenue Service (IRS) required minimum distribution (RMD) rates. The same methodology was used to calculate their retirement income before the age the actual RMD rules are required (age 72 if you were born on or after July 1, 1949). In other words, they would make withdrawals from savings before the RMD rules apply, using the RMD methodology to calculate the amount of the annual withdrawal. There are also other viable methods of generating retirement income; these will produce different amounts of retirement income in the initial year of retirement and throughout retirement.

Note that this analysis just focuses on the impact of the retirement age on the amount of retirement income that this couple might receive. There are many other considerations that can influence the decision when to retire, such as eligibility for Medicare at age 65, and the availability of affordable medical insurance.

FIGURE 1

Delaying Retirement Can Significantly Increase Initial Total Income



Source: Viability of the Spend Safely in Retirement Strategy.

Decision 1, Continued: Whether to Work Part-Time in Retirement (at Least for a While)

With Scenario 2 in Figure 1, both members of the couple deploy a downshifting strategy, working just enough from age 62 to age 66½ to cover their current living expenses, which allows both Social Security and savings to grow. Under Scenario 3, both members of the couple continue working full-time and contributing to savings. There isn't a significant difference in the eventual retirement income between these two scenarios: $51,526 vs. $53,031. This result illustrates that most of the advantage of continuing to work results from the delay of starting Social Security and a delay in withdrawing from savings. Continuing to contribute to savings, while definitely helpful, adds relatively less to the eventual retirement income. Scenario 4, in which the couple downshifts by working part-time from age 62 to 70 produces results that are similar to Scenario 5, in which the couple works full-time until age 70.

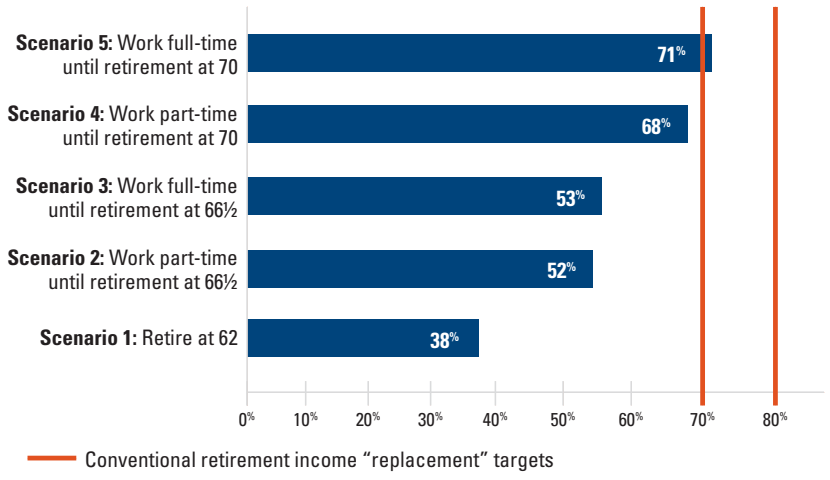
These analyses show the potential advantage of a downshifting strategy for older workers who don't want to or can't continue working full-time but haven't saved enough for complete retirement.

Decision 2: When to Start Social Security Benefits

Social Security benefits provide the most risk protection of all sources of retirement income, protecting against the risks of longevity, inflation and investment losses as well as cognitive decline. When middle-income workers optimize their Social Security benefits through a careful delay strategy, typically a very large percentage—often two-thirds, three-quarters or more—of

FIGURE 2

Work Longer or Reduce Spendable Income?
Replacement Ratios



Source: Viability of the Spend Safely in Retirement Strategy.

their total retirement income is risk-protected. Comparing the relative sizes of the blue and red bars in Figure 1 illustrates these outcomes.

As a result, it makes sense to maximize this valuable source of retirement income. To help with this goal, preretirees can use one of several online programs that help analyze the optimal age at which to start Social Security benefits.

Decision 3: How to Deploy Retirement Savings to Generate Retirement Income

The baseline *Spend Safely Strategy* uses the IRS RMD payout rates to calculate the annual income that's generated from retirement savings. This strategy has a number of straightforward refinements and adjustments that can customize the baseline strategy to reflect specific goals and circumstances that retirees might have.

For example, retirees might choose to use a Social Security bridge strategy to increase the amount of their retirement income as well as the portion of their total retirement income that Social Security will deliver and is risk-protected. With a bridge strategy, retirees temporarily use their retirement savings as a substitute for Social Security to allow them to delay taking benefits until they reach the optimal age. This strategy can enable a worker to retire earlier but still receive the maximum Social Security benefit.

For example, in Scenario 3, where the couple works full-time until age 66½, one member of the couple would use a bridge strategy to delay taking Social Security until age 70. In this case, the total annual retirement income would increase from $53,031 to $57,637, without changing the retirement date. The increase in Social Security benefits that results from the delay more than makes up for the money withdrawn from savings.

Another refinement addresses retirees who might feel more comfortable with additional guaranteed, lifetime retirement income to supplement their Social Security income. In this case, they can use a portion of their savings to purchase a cost-effective single premium immediate annuity (SPIA).

To continue the current example for Scenario 3, if the married couple adopted a Social Security bridge strategy and, with remaining funds, purchased a SPIA with a 100% joint and survivor annuity, their total annual retirement income would further increase from $57,637 to $63,892. This amount is more than $10,000 higher than the base retirement income amount for Scenario 3.

While these two refinements have significantly increased total retirement income, they also reduce the amount of wealth that retirees can access if their circumstances change. Preretirees should consider this result carefully when deciding how much savings to devote to a Social Security bridge payment or to purchasing an annuity.

Other retirees may want to invest substantially in stocks for the potential to grow their retirement income. Since a large portion of their retirement income is already risk-protected by Social Security, they might feel comfortable assuming some calculated investment risk. The SCL/SOA research report *Viability of the Spend Safely in Retirement Strategy* contains historical analyses that illustrate this basic retirement investing dilemma: Most of the time—but not always—retirees can potentially increase their retirement income by investing in stocks.

Some retirees might have other goals that can be reflected in their strategy to generate retirement income. They may want to travel during the early years of their retirement while they're still physically fit, help adult children and their families financially, or donate to charities. In any of these situations, retirees can refine their retirement income strategy to accommodate these goals without jeopardizing their long-term financial security.

Decision 4: Which Living Expenses Can Be Reduced to Fit Decreased Income in Retirement?

Conventional retirement planning wisdom advocates that retirees need a retirement income that replaces 70% to 80% of their preretirement income to continue their standard of living in retirement. Yet most older workers haven't accumulated sufficient savings to achieve this goal.

Whether this situation represents a challenge will depend on the goals and circumstances of each retiree. Some retirees may still enjoy their retirement on reduced incomes, while others may experience hardship if their retirement income falls short of this goal.

Figure 2 shows that the hypothetical couple described earlier won't approach these goals unless they both work until age 70.

As a result, most older workers face a tough choice: work longer than they planned, reduce their standard of living or do some combination of the two. To help matters, they can also explore alternative methods to generate retirement income from their savings, as illustrated by the previous example.

If a retiree needs to reduce living costs, housing often represents the largest target for most people. By relocating, retirees might also achieve other goals, such as moving to a home or neighborhood that will be more supportive in their later years.

Decision 5: Whether to Deploy Home Equity

For most retirees, the home represents a greater source of wealth than their retirement savings. If retirees' Social Security benefits and income generated by savings aren't sufficient to pay for their living expenses in retirement, they may need to explore ways to deploy their home equity. One straightforward method is to sell their home, realize a capital gain, downsize to a less expensive home and then deploy the net proceeds to generate retirement income.

Another possibility is to use home equity to purchase a reverse mortgage. The SCL/SOA report *Optimizing Retirement Income by Integrating Retirement Plans, IRAs, and Home Equity* analyzes and compares three different methods to use a reverse mortgage to enhance retirement security. Any solution to deploy home equity is highly dependent on a retiree's financial circumstances, preferences for housing and willingness to incur the costs of a reverse mortgage.

Why Should Retirement Plan Sponsors Help?

Employers and retirement plan sponsors are in an ideal position to help their older workers make these critical decisions as they transition into retirement. There are a number of good reasons to help, including the following.

- If older workers are unsure whether they have saved enough money to retire or if they don't know how to generate retirement income from their savings, their default decision is often to continue working indefinitely. Eventually that decision might be unproductive for both the worker and employer.
- Enhancing a defined contribution plan to generate retirement income can be viewed as an inexpensive plan improvement; nowadays, benefit improvements might be rare!

takeaways

- How to maximize retirement income and ensure that it lasts over a potentially lengthy retirement are among the critical decisions preretirees face.
- Preretirees often feel uncertain about these decisions, and economic turmoil such as the downturn caused by the COVID-19 pandemic increases that uncertainty.
- When figuring out how to maximize retirement income, preretirees must decide when and how to retire, including whether to work part-time for some period.
- Delaying Social Security benefits can help increase retirement income and provide protection against risks such as longevity, inflation, investment losses and cognitive decline.
- Preretirees also need a plan for how they will deploy their retirement savings and should determine whether they can reduce expenses or should use home equity as a retirement income source.
- Employers and retirement plan sponsors should consider helping older workers make these decisions. By doing so, they may foster goodwill among workers, increase the cost-efficiency of their defined contribution plans and improve productivity.

bio

Steve Vernon, FSA, MAAA, is a research scholar at the Stanford Center on Longevity, where he conducts research on retirement income, financial literacy and behavioral finance. He also is president of Rest-of-Life Communications, where he prepares multimedia communications on retirement planning, including keynote presentations, workshops, webinars, email newsletters, online tutorials, DVDs, and traditional books and articles. For more than 35 years, Vernon has helped large corporations and plan sponsors design and manage their retirement programs. He is a fellow of the Society of Actuaries and a member of the American Academy of Actuaries.

- The employer demonstrates to all workers that they may be treated fairly as they approach retirement.
- If retirees keep their money in the employer-sponsored savings plan as a result of retirement income options being offered in the plan, they can continue to enjoy the protection offered by the fiduciaries who operate the plan. Also, they can realize the advantage of using institutionally priced savings and retirement options. It can be a more efficient use of their savings.
- Similarly, by retaining retirees' assets in the plan, the per capita administrative costs can be reduced for all participants.
- Finally, helping older workers more effectively plan for retirement is simply the right thing to do.

By helping older workers with these critical retirement planning decisions, employers and retirement plan sponsors can better manage an aging workforce and evolve their savings plans into true retirement plans.

Author's note: This article draws from an essay published by the Society of Actuaries in September 2020.

References

The SCL/SOA reports and essays identified below include the analyses that support the conclusions discussed in this article and also address the implementation issues and refinements to the Spend Safely Strategy. The last reference listed is a consumer-friendly book designed to help middle-income preretirees and retirees understand and implement the Spend Safely Strategy.

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