Bridges to Social Security

by Jonathan Guyton, CFP®

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If you're like me, your ongoing professional reading helps you notice both trends in "advice," where something seems amiss, and articles that illuminate a new and important insight. I will focus on the former in this column and the latter next, which will run the *Journal's* October 2015 issue.

Social Security claiming strategies have received much attention in the trade and consumer press over the last few years—and not a moment too soon for those previously unaware of its opportunities and nuances. To somewhat oversimplify this attention's key message, a retiree can significantly increase her or his retirement income by delaying when benefits are claimed. This is clearly true when someone chooses to work longer. The relative increase in benefits dwarfs that from other income sources such as higher retirement plan accumulations or a bigger pension.

You Want to Retire Now?

But what if someone wants to retire now? What are they to do while awaiting that higher Social Security income several years hence? And just how beneficial is this? It is these aspects of this planning issue that I'd like to explore more closely with a simple case study.

Pamela is 66, has a PIA of $1,000, and $600,000 of retirement plan assets she has diligently saved. She wants to retire now but realizes, given her good health, that it could be advantageous to delay claiming Social Security until age 70 when her real benefit would be $1,320. Pamela wants to evaluate her maximum sustainable retirement income in light of her options. Based on her reading and advice she's received, she is comfortable using a 4.5 percent initial withdrawal rate, which would generate a $27,000 income from her nest egg. If she claimed Social Security today, her total gross annual retirement income would be $39,000 (Approach A). Pamela has concluded this will allow her to live as she chooses in retirement.

If she delayed claiming Social Security, Pamela could draw $39,000 of real income from her nest egg for the next four years before reducing this to $23,160 when her $15,840 of annual Social Security begins at age 70 (Approach B). While this will increase the percentage of her income from Social Security to more than 40 percent, which is attractive, it provides no more gross income than claiming at 66. It would, though, lower her adjusted gross income [AGI] by about $5,000 relative to Approach A from that point on because both retirement plan distributions and her modified AGI would be lower—an approximate $1,000 after-tax income gain.

However, Approach B requires Pamela to take distributions for her first four years of retirement at a 6.5 percent initial withdrawal rate, some $110,000 in total withdrawals by then. Although her real withdrawal amount would drop 14 percent ($3,840) below that of Approach A at age 70, it will take until age 83 for Pamela's total withdrawals to fall below the constant $27,000 real annual amount.

More importantly, the underlying evidence and research that gave her comfort with Approach A cannot be appropriately applied to give Pamela the same confidence in Approach B. For several reasons, the two withdrawal patterns are simply not comparable. And resetting distributions to a 4.5 percent withdrawal rate based on the portfolio's value at that point will maintain her $39,000 real income only if its value still exceeds about $560,000. Approach B creates a disconnect between evidence and implementation.

To remedy this, consider Approach C. Its foundation is to generate, over the entirety of Pamela's retirement, the 4.5 percent initial withdrawal rate income that gives her the confidence to retire today in the first place. Based on Pamela's medical history and good health to date, it also delays her Social Security until age 70 when benefits are $15,840 annually. Until then, Pamela's assets must bridge the gap and provide the same real income that Social Security will eventually pay.

These four years of real income total $63,360. Approach C sets this amount aside and invests it very conservatively. (An analogy in this case is that the allocation of these assets would essentially match that of an undergraduate college fund, where the four years of payments is starting now.) The assumption being made is that the annual returns will equal the rate of inflation. This "bridge" portfolio can then match Pamela's $1,320 monthly income at age 70 by providing the same COLAs between now and then that her future benefit will receive. The bridge portfolio will thus exhaust itself just as Social Security begins.

Ideally, these assets are transferred/journaled to separate accounts—and even a separate portfolio household. This makes it easier for both Pamela and her financial planner to monitor and track how things are going as these four years unfold. In particular, seeing that this component of her retirement income plan is working according to plan can further increase her confidence in its ongoing and longer-term aspects. More importantly, should a period of equity declines occur during these four years, Pamela will easily be able to see how the assets supporting this aspect of her plan are unaffected.

The Power of a Bridge Portfolio

Such a bridge portfolio could also be applied in more comprehensive situations involving a couple and/or with multiple defined benefit income streams with multiple start dates. This is particularly true when retirement occurs at an earlier age and usually takes into account the gradual phasing-in of full Social Security benefits.

For example, in the case of a same-aged 60-year-old couple where the wife claims benefits at age 62 and the husband at age 70, there could be three different phases to their bridge portfolio's income generation:

Phase I. Bridge portfolio income is for two years in the amounts of their ultimate combined benefits.

Phase II. Bridge portfolio income is reduced for the next four years by the amount of the wife's age 62 benefit.

Phase III. Bridge portfolio income is further reduced when the husband claims a spousal benefit based on his wife's earnings record. After these 10 years, the husband claims Social Security based on his own record at age 70, at which time the bridge portfolio will have exhausted itself.

In such a situation, some planners may feel comfortable including a small equity component in the bridge portfolio's allocation for a while, and assuming that its average real return over its 10-year life is something above zero.

Once Pamela's bridge portfolio is carved out, her remaining $536,640 retirement nest egg is available to generate $24,149 of annual income, beginning today, at the desired 4.5 percent initial withdrawal rate (at Cornerstone, we call this the Core Portfolio). This gives her $39,989 of total income, $989 (~2.5 percent) more than in Approaches A and B. It also produces an AGI reduction similar to Approach B, making her total spendable income enhancement ~5 percent over Approach A. This enhancement would be less (more) had a higher (lower) Core Portfolio withdrawal rate been applied.

What conclusions can Pamela draw to aid her Social Security decision-making? First, waiting until age 70 offers the dual benefit of increased net income with a higher portion supplied by Social Security relative to claiming at her age 66 FRA. And although Approach B rests on a less-than-empirically sound basis, Approach C incorporates that empirical foundation while increasing her sustainable pre-tax income by ~2.5 percent and her net income by roughly double that.

Finally, Pamela may be somewhat surprised that this advantage is not greater. However, that has less to do with the various financial planning aspects of her situation and more to do with the by-products of any half-truths she may have heard. Her thoughtful deliberations have paid off with enhancements to her retirement income of ~$2,000 each and every year. She will soon have crossed her bridge to Social Security. ■