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Optimal Timing Strategy for Claiming Social Security Benefits

M Wealth provides Member Firms with fee-based wealth management solutions for their clients.

To help Member Firms grow their wealth management businesses, M Wealth offers everything from value-added wealth services to turnkey asset management and investment consulting.

For most Americans, Social Security (SS) represents the largest source of retirement income. Even for highly affluent individuals, maximizing SS benefits can significantly impact their ability to meet their financial needs and goals. While online tools and websites can help a client determine when to claim SS benefits, it can be a very complex decision and is best made with the benefit of further analysis. During the M Wealth portfolio building process, we use an individual's SS benefits to help determine a proper asset allocation.

A recent white paper from Ibbotson offered insight into key factors to consider when determining the best time to claim SS benefits. In the paper, five separate tests are performed, each of which considers an important component in determining when to claim SS benefits: life expectancy, taxes, the cost of purchasing equivalent insurance, and the benefits of the surviving spouse. In addition, three timing scenarios are taken into account:

1. Receiving benefits early (age 62 vs. 66)
2. Delaying benefits past full retirement age (age 66 vs. 70)
3. Maximum realistic delay period (age 62 vs. 70)

Age 66 is full retirement age (FRA), when someone is eligible to receive "full" SS benefits. An individual can elect to receive SS benefits at age 62 or delay them until age 70. Postponing past age 70 is not optimal from an income perspective; SS benefits will not increase past that age. SS retirement benefits may be subject to taxation based on the total income of the retiree. Currently, no more than 85% of an individual's SS retirement benefits can be subject to federal taxation.

If a SS recipient's spouse has never worked, the spouse is eligible for SS retirement benefits, equal to one-half of the primary worker's retirement amount at the spouse's FRA. Whereas the spouse's benefit is based on the primary worker's benefit, the spousal benefit amount is not determined by when the primary worker claims SS, but rather by when the spouse begins claiming benefits. If the primary worker elects to receive benefits early, the spouse can still receive his or her full spousal benefits by waiting until age 66. If the spouse has worked, he or she will receive the greater of his or her own earned amount or the amount based on their spouse's benefit.

In determining the optimal timing decision, individuals or couples should understand the following considerations:

1. Ability to delay benefits: In order to delay SS benefits, an individual or couple will need sufficient assets to provide income up to when the delayed period ends.
2. Life expectancy: This is important for both the primary worker and the spouse. Generally, the healthier someone is, the more beneficial it can be to delay receiving benefits, since the retiree is expected to live longer during retirement. Along these same lines, a younger and healthy spouse also increases the potential value of delayed

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SS benefits due to spousal survivor benefits. Additionally, on average, women live longer than men.

3. Tax considerations: SS benefits have a unique tax structure that make them superior (if only slightly at higher income levels) to other retirement income, such as a traditional IRA. Slight changes in income can subject a retiree to a "torpedo tax," dramatically increasing the tax bill.

4. Benefit reduction considerations: The Senior Citizens' Freedom to Work Act of 2000 allowed seniors to "file and suspend" their benefits upon reaching age 66, which enables the benefits of a worker to continue to accrue delayed retirement credits (DRCs).

5. Spousal considerations: The age of the spouse relative to the primary worker is important as noted in number two above. This is perhaps one of the most complex considerations.

One of the factors to highlight affecting the SS claiming decision that was explored in this paper is a concept known as the "break-even return." The break-even return is the required compounded nominal return on invested benefits where the retiree would be better off delaying benefits 50% of the time. The break-even return for the 62 vs. 66 scenario was 7.0% for men vs. 8.3% for women.

Table 3: The Break-even Return to Be Better off Delaying Benefits for Various Life Expectancy Probabilities

	Probability of Being Better off Delaying Benefits										
		75%	60%	50%	40%	25%	75%	60%	50%	40%	25%
	Male						**Female**				
Choice	62 vs 66	-0.7	4.4	7.0	8.3	8.7	2.8	6.8	8.3	8.9	9.1
	62 vs 70	-8.5	2.0	5.6	7.7	8.5	0.3	5.5	7.6	8.5	8.9
	66 vs 70	-6.0	0.8	4.6	6.9	7.9	-0.4	4.1	6.6	7.9	8.4

Mortality based on the Social Security Administration 2007 Periodic Life Table

Focusing on the 50% probability—the return required for the retiree to be indifferent between delaying benefits—all but one of the three tests (66 vs. 70) had a required return less than the base target of 5%. Since the required return for 62 vs. 66 is the highest, this scenario provides the most benefit to retirees delaying their SS benefits claim. These results suggest a greater advantage when benefits are delayed from 62 to 66, followed by 62 to 70, and then 66 to 70. The effective "return" achieved by a retiree from making the optimal SS claiming decision is likely to exceed the return the retiree can make by taking benefits early and investing them, especially in today's low interest rate environment. Therefore, an investor would likely need to earn an annual nominal compounded rate of return, net of fees, of more than 7% to benefit from claiming early.

In summary, most retirees will experience the greatest benefit by delaying their SS claim until age 66 or later. Delayed SS benefits are especially valuable for women, married couples, and investors who expect to invest in relatively conservative portfolios during retirement. Delaying benefits can help an investor effectively achieve a rate of return that may be greater than what he or she is likely to earn from the market on a risk-adjusted basis.

For further details, a copy of the white paper is available on the M Wealth Management web site.

Source: Morningstar; Adapted from "When to Claim Social Security Retirement Benefits" by David Blanchett, CFA CFP ®

For More Information

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