Delaying Retirement, But Not Your Retirement Dreams

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Article Highlights

- Investors in their early 60s can retire early, delay retirement, or work, but choose not to continue saving for retirement.
- By stopping new retirement savings contributions, income can be freed to start pursuing retirement aspirations.
- This strategy boosts Social Security benefits while easing the transition from working to retirement without withdrawing from savings.

Many investors today who had planned to retire early at 62 when they became eligible for Social Security benefits—albeit at a reduced rate compared with retiring at full retirement age—are discovering that those benefits, combined with their retirement savings, cannot support the lifestyle they expected or provide the financial cushion in retirement they desire.

Often, they are disappointed to realize they may have to continue working and saving for several more years to catch up. This strategy leaves preretirees in transition with a choice: retire early with insufficient savings and income or delay their retirement dreams until after they retire.

For some preretirees there may be another, more desirable option. An analysis by T. Rowe Price demonstrates that, if those in their early 60s decide to keep working, but discontinue making contributions to their retirement plans—spending that money instead—they can start fulfilling some of their retirement dreams sooner and still be in a stronger financial position down the road.

This new transitional strategy involves working longer, but it can provide more discretionary income during transition years to start seriously pursuing your retirement aspirations well before you thought you could.

And by continuing to work and delaying receipt of Social Security benefits, you are positioning yourself to have potentially higher payments—adjusted annually for inflation—for the rest of your life. This strategy can be much more positive for those in transition.

A Case Study

To illustrate how this new strategy could work, let's consider the hypothetical couple John and Mary Smith. They are each 60 years old, and they have a combined annual income of $100,000 and $500,000 in retirement savings. They have been saving 15% of their income ($15,000) each year in their 401(k) plans and want to retire in two years.

Here are some possible scenarios (as reflected in the accompanying chart, assuming a 7% preretirement return on investments and a 6% post-retirement return; all dollar amounts are in current dollars at age 60).

Retire at 62 as Planned

If the Smiths begin Social Security benefits at 62, they would receive $30,700 a year (plus assumed annual cost of living adjustments of 2.8%). Additionally, they could expect approximate annual withdrawals from their retirement savings of $21,100 (plus annual inflation adjustments of 3%) from age 62 on.

However, their $51,800 (in current dollars) in annual retirement income would be only 52% of their $100,000 preretirement combined earnings—much less than T. Rowe Price's 75% general retirement income replacement guideline.

Figure 1. Scenarios for the Transition Years

Retirement Scenario	Cumulative Income* Age 62–69	Social Security		Savings Withdrawals		Total Annual Income	Savings Balance at Retirement
		First Year of Full Retirement for Both Spouses					
Both Spouses Fully Retire at Age 62	$413,100	$30,700	+	$21,100	=	$51,800	$571,400
Both Spouses Fully Retire at Age 66	$671,300	$40,700	+	$27,300	=	$68,000	$665,400
Both Spouses Fully Retire at Age 70	$800,000	$54,100	+	$34,900	=	$89,000	$775,000
Both Spouses Work Part Time From Age 62 to Age 70	$400,000	$54,100	+	$34,900	=	$89,000	$775,000

**Sources of income include salary and/or Social Security plus savings withdrawals, in current dollars at age 60.*

The table shows how much annual pretax income and savings at retirement this couple would have under various retirement scenarios. Each scenario assumes: the couple had $500,000 in retirement savings at age 60 and $100,000 in annual earnings ($60,000 plus $40,000) with 3% yearly inflation adjustments; 15% of earnings are contributed to a retirement plan annually until age 62 and no contributions thereafter; no Social Security benefits or savings withdrawals are drawn by either spouse until his/her retirement; savings earn 7% annually before retirement and 6% annually after retirement; amounts represent current dollars at age 60, assuming a 3% discount rate; Social Security benefits rise 2.8% annually after initiation; savings are withdrawn at a rate of 3.7% for age 62, rising by 0.1% for each year retirement is delayed; the initial withdrawal increases yearly by 3% inflation. Social Security benefits are from the Social Security Administration website's Quick Calculator (assuming 0% relative growth factor).

Sources: T. Rowe Price Associates and ssa.gov.

In addition, their savings of $500,000 at age 60 would only rise to $526,000 by age 70.

The Smiths conclude that retiring early will not support the retirement lifestyle they had expected. So they decide to continue working for a few more years and delay taking Social Security until they retire.

At the same time, they want to enjoy their 60s to the fullest, so they decide to discontinue making contributions to their retirement plan after age 61. This provides them with an additional $15,000 a year to spend while they continue working. With this extra income to enjoy life, working longer may not seem as much of a burden—it may actually re-energize them.

One of the primary reasons that this new strategy is effective is that each year the Smiths work and delay taking Social Security benefits, their benefits increase about 8% (in today's dollars)—almost doubling in purchasing power by age 70.

Because these increases are based on Social Security formulas and not on investment returns, preretirees have a level of assurance that, even if the markets take another turn downward, their Social Security benefits will not.

Retire at 66

If the Smiths both work full time until age 66, their retirement income (from savings and Social Security) would be about $68,000, or 68% of their preretirement earnings—much closer to the 75% guideline.

Their retirement income is now 31% higher than if they had retired at 62—even though they discontinued making retirement contributions. Moreover, their retirement nest egg by 66 would have grown to $665,400 because they did not withdraw savings while working.

If they worked one more year to age 67, they would be very close to achieving their retirement income replacement rate of 75% with a nest egg of $691,300.

Retire at 70

If the Smiths decide to continue working until age 70, without making any additional contributions to their retirement accounts, they could withdraw $34,900 from their savings annually. This, plus their initial Social Security benefits of $54,100, would provide a total annual retirement income of $89,000—an 89% replacement rate and significantly greater than the amount at age 62. Moreover, their retirement nest egg would have grown to about $775,000 by age 70.

Making Trade-Offs

In these scenarios, the Smiths had more money to "play with" in their 60s, and they still put their retirement on sounder financial footing. On the other hand, because they were still working, they did not necessarily have as much extra time to pursue their interests as they would have liked.

If they are willing to trade money for time, the Smiths might consider working part time beyond age 62. This strategy might provide them with the extra income they need to pursue a semiretirement lifestyle without jeopardizing their financial security when they fully retire.

For example, using the same assumptions, if the Smiths both worked part time until age 70, they would have less to spend in their 60s, but their annual income and their retirement nest egg at age 70 would be the same as if they had both worked full time until then. This is because they were able to

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the capital gains rate, with a maximum of 15%.) It suggests that strong psychological or emotional factors are at work. If dividends can be considered a zero-sum game, or a worse choice in historical tax environments, then why has dividend yield investing been so attractive in the past?

Much of the attraction undoubtedly stems from the classic wisdom voiced by experts, family and friends: Never invade principal. This tenet of responsible investing is ingrained so deeply and so effectively, it's difficult to dispel. For many wealthy individuals, it's a core belief that helped them create their wealth in the first place. Manufacturing dividends feels like robbing the nest egg; harvesting company profits a bit at a time does not. And so emotion trumps theoretical investment rationale.

In Defense of Total Return

As more investors enter retirement and need to replace substantial proportions of their income by using their investment portfolios, a dividend yield strategy is likely to fall short. There may simply be no alternative to adopting some form of total return investing. Even more worrisome for the never-invade-principal adherents: The time may come when prudently drawing down a portfolio becomes necessary to fund living expenses.

When we consider the risks of a dividend yield strategy discussed above, a total return approach that relies on a combination of dividends and capital gains to fund income-replacement needs is compelling. ▲

Table 1. Average Dividend Yields

Index/Stocks	Yield (%)
Russell 1000 index (1979–1985)	5.6
Russell 1000 index (2010)	2.2
Top 100 Russell 1000 index dividend-yielding stocks (2010)	5.1

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delay Social Security benefits and avoid making withdrawals from their savings, which continued to grow.

Some Caveats

Not everyone, of course, will be in a financial position to pursue this new strategy.

Moreover, those who do should avoid tapping their retirement nest egg and delay taking Social Security benefits while they continue working. They should also try to put their financial house in order before they fully retire by paying off their mortgage and other debts and purchasing any big-ticket items they expect to need in retirement.

While these scenarios call for no further retirement savings to boost income, preretirees should strive to continue contributing at least enough to qualify for an employer match in their 401(k) plans, if available.

Finding the right time/money balance, as well as the balance between spending and saving while working, will involve trade-offs.

But this new strategy is likely to give some investors more financial opportunities to pursue their lifelong dreams and enjoy their 60s while also building a stronger foundation for retirement. ▲

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