Intelligent Money

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Special Notes of Interest:

- Social Security benefits are calculated on the basis of a worker's best 35 years of inflation-adjusted earnings.

- The maximum benefit for a worker retiring in March 2003 at Social Security's *full retirement age* of 65 and 2 months is $1,741 per month

Current thinking from Haven Financial Advisors

Electing Social Security Benefits Early

Planners field a lot of questions from clients in the area of Social Security retirement benefits. While the calculation of Social Security pensions for most is automatic, the point at which to begin collecting is a major choice variable in the retirement plan. Both qualitative and quantitative factors bear on this decision and they are examined here.

Today 60% of American workers opt for early retirement benefits. Individuals may elect payments prior to their full retirement age (FRA) if they are willing to accept a reduction of benefits. People born in later years must accept larger discounts.

The FRA increases gradually from 65 to 67 for individuals born between 1938 and 1960. As an example, those turning 65 in 2004 will not be able to collect full benefits until aged 65 and 4 months. Early retirement age remains at age 62 but the reduction in benefits increases with the FRA. The table below describes scheduled changes in the system:

Individuals approaching age 62 must weigh a number of factors. Among the most important is their desire and ability to continue working past age 62. For those that anticipate employment beyond early retirement age, there is little incentive to take benefits early. The reason is that earned income beyond $11,520 offsets social security benefits. For every $2 earned above this low threshold, social security payments are reduced by $1. Even a part-time career can eliminate benefits. Moreover, an active income generally means that a larger fraction of Social Security is subject to income taxation.

While difficult to estimate, an individual's life expectancy is a key factor in determining the relative value of early retirement benefits. Women outlive men and those that are healthy at age 62 generally survive those that are not. The longer one lives, the greater the value of the larger monthly benefit beginning at FRA.

At Age 62, the average man lives to age 79.5 while the average woman lives to 83.5. That's a significant difference in light of the reduction factors applied to early retirement benefits.

Comparing early and deferred benefits requires some estimate of a discount factor. Cash flows at different stages of life must be measured against one another.

Year of Birth	Full Retirement Age	Reduction in Benefit if elected at 62
Before 1938	65 Years	20.0%
1938	65 and 2 months	20.9%
1939	65 and 4 months	21.7%
1940	65 and 6 months	22.5%
1941	65 and 8 months	23.4%
1942	65 and 10 months	24.2%
1943-54	66 Years	25.0%
1955	66 and 2 months	25.9%
1956	66 and 4 months	26.7%
1957	66 and 6 months	27.5%
1958	66 and 8 months	28.4%
1959	66 and 10 months	29.2%
1960 and later	67 Years	30.0%

Social Security Benefits (continued)

In my view, core social security benefits are not at risk. Social Security retirement payments constitute the primary income stream for nearly two thirds of retired Americans. The Federal government ultimately has the ability to print the money to fund the Social Security trust with or without reform. In other words, accrued Social Security benefits are an obligation as secure as government bonds.

Consequently, I assign a discount factor similar to a long-term government bond. Right now that is about 5.0%. Others may consider benefits to be a more risky proposition and thereby assign a higher discount factor. It is important to note that as the discount rate increases, so does the relative value of early retirement. On average, early retirement benefits are received closer to the present.

It is often useful to perform breakeven analysis on the early retirement decision. In principle, such calculations weigh the values of the red and green income streams below. In a recent article in the *Journal of Financial Planning*, Clarence Rose and Keith Larimore calculate some useful benchmarks for prospective retirees. Using a discount rate of 4.0%, they calculated breakeven life spans for

several cohorts of retirees. The results are summarized below:

| Year of Early Retirement	Full Retirement Age	Indifference point between early and full retirement age
2000	Age 65	83
2005-2016	Age 66	84 and 5 months
2022 and after	Age 67	Age 85 and 3 months

There are other factors relevant to the election of early retirement. Spousal and survivor benefits are affected by the decision and should be taken into account. The foregoing analysis is only intended to highlight key issues. The Social Security Administration has an online tool to assist individuals in assessing the quantitative aspects of Social Security Benefits. It is found at

www.ssa.gov/OACT/quickcalc/calculator.html

The site calculates early retirement, full retirement, survivor and disability benefits with earnings input from the individual. The earlier these issues are faced, the more informed the retirement decision becomes. Financial planners can be of considerable assistance here.

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■ Income stream at full retirement age
■ Income stream if elected at age 62

Age 62   Age 65   Age 80
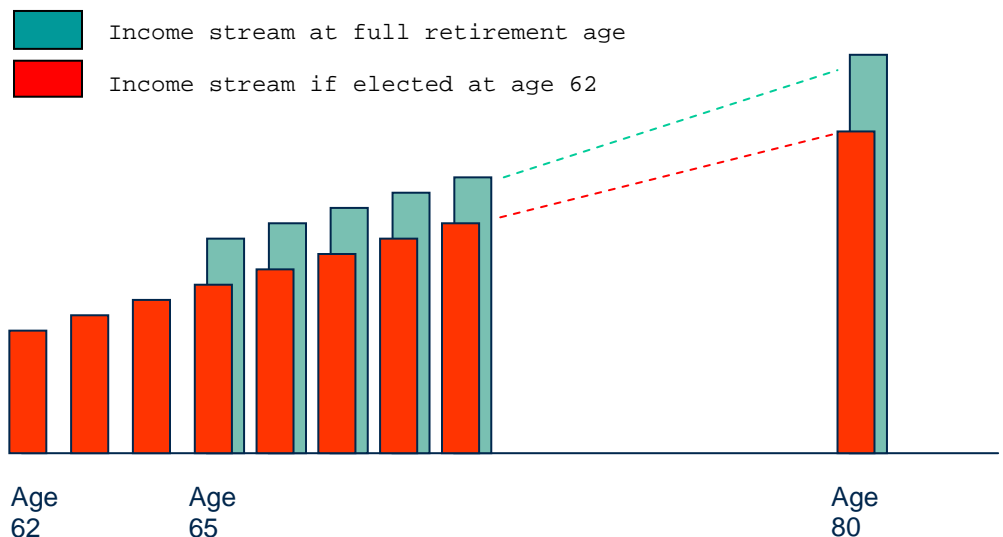
With every passing year, the relative value of deferred benefits increases