Delaying Retirement But Not Your Retirement Dreams

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 normal 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 in retirement 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, even 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.

"We advocate a 'practicing retirement' strategy," says Christine Fahlund, a senior financial planner for T. Rowe Price. "While this approach involves working longer, it can provide more discretionary income during these transition years to start seriously pursuing your retirement aspirations well *before* you thought you could.

"And by continuing to work and delay receiving 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 a Practice Retirement℠ strategy could work, let's consider the hypothetical couple John and Mary Smith. They are each 60 years old, have a combined income of $100,000, and have $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 chart below, assuming a 7% preretirement return on investments and a 6% post-retirement return).

• **Retire at 62 as planned:** If the Smiths begin Social Security benefits at 62, they would receive $30,700 a year (plus annual cost of living adjustments, currently averaging about 2.8%). Additionally, they could expect appropriate annual withdrawals from their retirement

Strategies for "Practicing Retirement" During the Transition Years

		Annual Income and Savings First Year of Full Retirement for Both Spouses					
Practice Retirement℠ Strategy	Cumulative Income* Age 62–69	Social Security	+	Savings Withdrawals	=	Total Annual Income	Savings Balance at Retirement
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	=	$67,900	$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.

savings of $21,100 (plus annual inflation adjustments of 3%) from age 62 on. All dollar amounts are shown in current dollars.

However, their $51,800 (in current dollars) 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.

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 expected. So they decide to continue working a few more years and delay taking Social Security until they retire.

Stop Saving

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 reenergize them.

One of the primary reasons this Practice Retirement 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.

Since 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 $67,900, 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 since 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% and have a nest egg of $691,300.

• **Retire at 70:** If the Smiths decide to continue working until 70, without making any additional contributions to their retirement accounts, they could withdraw $34,900 from their savings annually plus their initial Social Security benefits of $54,100 for a total annual retirement income of $89,000—an 89% replacement rate and significantly greater than the amount at 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, since they were still working, they did not necessarily have as much extra time to pursue their interests as they would have liked.

If willing to trade money for time, they might consider working part time beyond age 62. This strategy might provide them with the extra income they need to pursue a semiretirement lifestyle while not jeopardizing their financial security when they fully retire.

For example, using the same assumptions, if the Smiths both worked part time until 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 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 a practicing retirement strategy. Moreover, Ms. Fahlund stresses that those who do must 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," she adds.

While these scenarios call for no further retirement savings to boost income, Ms. Fahlund says 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," Ms. Fahlund says. "But a Practice Retirement 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."