Optimizing Social Security Benefits

By Wade Pfau
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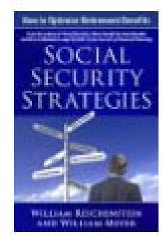
My dissertation was about Social Security reform, so I've read more of the *Social Security Handbook* than any human being should be forced to digest. Despite this background, William Reichenstein and William Meyer's new book, *Social Security Strategies: How to Optimize Benefits,* taught me a lot about how to strategize to get the most out of Social Security.

I've written programs to calculate average indexed monthly earnings (AIMEs), primary insurance amounts (PIAs), adjustments for the age of initial receipt, family maximum benefits, child benefits, survivor benefits, and so on. But I wrote those programs about 10 years ago and I've become rather rusty on these matters in the intervening years.

So I am glad that I understood the basic idea of the book, which is relatively straightforward through the end of Chapter 3. It covers the basics of Social Security and how a single individual can maximize his or her benefits.



The book does get vastly more complicated in Chapter 4, which is about couples. The problem is, for couples in which both spouses work, each spouse is potentially eligible for benefits based on their own work record (plus your spouse is also eligible for a benefit based on your record), plus a spousal benefit based on their living spouse's work record, plus a survivor benefit based on a deceased spouse's record. Divorcees can get something too, with different rules, if the marriage lasted at least 10 years, but those with multiple ex's or young kids should watch out for that family maximum benefit based on one earner's record.

I'm not going to try to explain Chapter 4 in detail, but its contents are important to me as the curriculum director for the Retirement Management Analyst℠ designation. Especially for lower- and middle-income Americans, Social Security may end up providing the vast majority of retirement income. And so it is very important to get Social Security claiming decisions correct. To be clear, Social Security claiming decisions are defined in the book as: "a decision as to when a single individual will begin their own benefit or when each partner of a couple will begin their own benefits and, when applicable, their spousal benefits."

As the authors show, a wrong decision on Social Security could end up costing retirees a couple hundred thousand dollars in lost benefits. But as the authors clearly show, becoming a factotum on Social Security matters is really complicated. It is asking too much for advisors to become deeply knowledgeable about these Social Security rules. But at least they should have a solid understanding of the basic principles and be able to figure out approximately correct solutions, and also have a working knowledge about how to use software that will allow them to show clients the outcomes from different claiming strategies, and to narrow in on a good claiming strategy for both spouses. The authors of the book offer software as a part of the website, www.SocialSecuritySolutions.com, but I haven't had an opportunity yet to test it for myself.

What are the basic principles?

First of all, there is no universal answer for anyone as to issues such as when to begin benefits. That is because retirees can make their decisions using two different criteria, and there is a tradeoff between which strategy performs best for the different criteria:

1. Retirees should pick the Social Security strategy which maximizes the net present value of their lifetime income from Social Security. And given the fact that current real interest rates are quite close to zero, this is more or less the same as choosing the strategy that maximizes the total lifetime amount (in real terms) of benefits received from Social Security

2. Retirees should take advantage of the fact that Social Security provides an inflation-adjusted annuity, with increased payments as the claiming decision is delayed through age 70. This helps protect against longevity risk, and it can help extend the life of one's financial assets as well. The idea being, even if you retiree at 62, you can delay starting Social Security until age 70, such that you spend down more of your financial portfolio between ages 62 and 70, and then spend from your portfolio at a lower rate after that. The authors show the benefit of delay using deterministic assumptions for asset returns and it is not a sure bet (a particularly bad sequence of returns around age 62 could possibly leave you better off with starting Social Security earlier) but their point is persuasive. More risk averse retirees should delay claiming Social Security, because the longer they live, the more they will benefit from the annuity properties of Social Security benefits.

Retirees must think about their life expectancy, and how important it is to protect one's income level in the event of living longer than expected. In thinking about these two criteria, Reichenstein and Meyer developed several lessons to help summarize the Social Security rules.

Lesson 1: For a single individual living to age 80, it does not matter what age (from 62 to 70) to begin Social Security. The total lifetime benefits received will be about the same, since Social Security is meant to be "actuarially fair" with benefit reductions and increases calibrated to life expectancies. But for retirees living "well beyond" (this term is defined and discussed in the text) 80, it becomes increasingly attractive to wait until 70. This is how Social Security provides protection against the risk of outliving one's assets.

Then, for the vastly more complicated case of couples, we get two more general lessons:

Lesson 2: For the higher earning spouse, the relevant life expectancy for the claiming decision is the life expectancy of the second spouse to die (which is higher than either spouse alone). The relevant life expectancy for the lower earning spouse is that for the first spouse to die.

And:

Lesson 3: If at least one of the spouses lives "well beyond" the age when the higher earning spouse turns 80, then the couple can usually maximize their joint lifetime benefits by having the higher earning spouse wait until 70 to claim his/her own benefits.

As a penultimate observation, as the authors note, for people aged at least 55, it is not a good argument to start benefits as soon as possible because you want to get what you can before Social Security "goes bankrupt." Even if the Trust Fund empties, Social Security is not finished. It is just that benefits would have to be reduced equally for everyone to match incoming contributions to the system. Your benefit would be reduced equally no matter when you started, and there is no chance to gain from starting earlier for this reason.

The book is worth reading. Without getting to the issues of benefits taxation and the earnings test in Chapter 5, you want to do your homework to develop a good Social Security claiming strategy. While the book is complex, it is worth working through carefully to figure out what will be best for your own case. I can't summarize it all, but the authors describe a variety of scenarios based on factors such as the ratio of PIAs between the low-earning and high earning spouse, the relative ages of the two spouses, and the projected life expectancy for each spouse. Decisions also relate to the relative importance a retiree places on maximizing lifetime benefits (when death is expected before around age 80) versus obtaining longevity protection for a lengthy lifetime. As suggested, these efforts could have major implications for making sure you don't unnecessarily leave oodles of money on the table. The authors describe these matters in as clear of manner as can possibly be expected given the complexity of these issues.

Related Reading: Michael Kitces' The Asymmetric Value of Delaying Social Security Benefits

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