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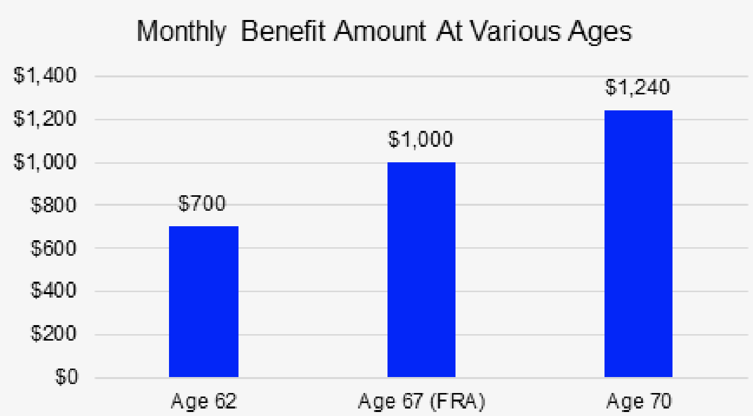
WHEN TO CLAIM SOCIAL SECURITY - PART TWO

One of the most common questions we hear from pre-retirees is “When should I draw Social Security?” This is a common question with good reason! For many retirees, Social Security represents a large portion of their potential retirement income. Even for those who don’t necessarily need Social Security to maintain their lifestyle throughout retirement, the desire to maximize Social Security benefits after paying into the system for decades is understandable.

The following article is the second of a four-part series identifying some of the key factors that go into making an informed decision on Social Security. Before reading this article, it’s important to have a grasp on the basics of Social Security which can be found in our prior newsletter article (jvlwealth.com/social-security/). By the end of this series, we hope you’ll see that there is a lot that goes into the decision on when to take Social Security.

AN INTRODUCTION TO BREAKEVEN AGES

The Social Security Administration (SSA) provides retirees who are eligible for retirement benefits the choice of when to begin collecting benefits. In most cases, retirees can begin drawing benefits as early as age 62 and as late as age 70. In order to make it worth it to wait until age 70, retirees who delay earn additional credits to their monthly benefit amount for every month they wait beyond their full retirement age – up to 24% of additional benefit for those whose FRA is age 67. On the other hand, benefits can be reduced by up to 30% if drawn at age 62 as a penalty for drawing early. [1]



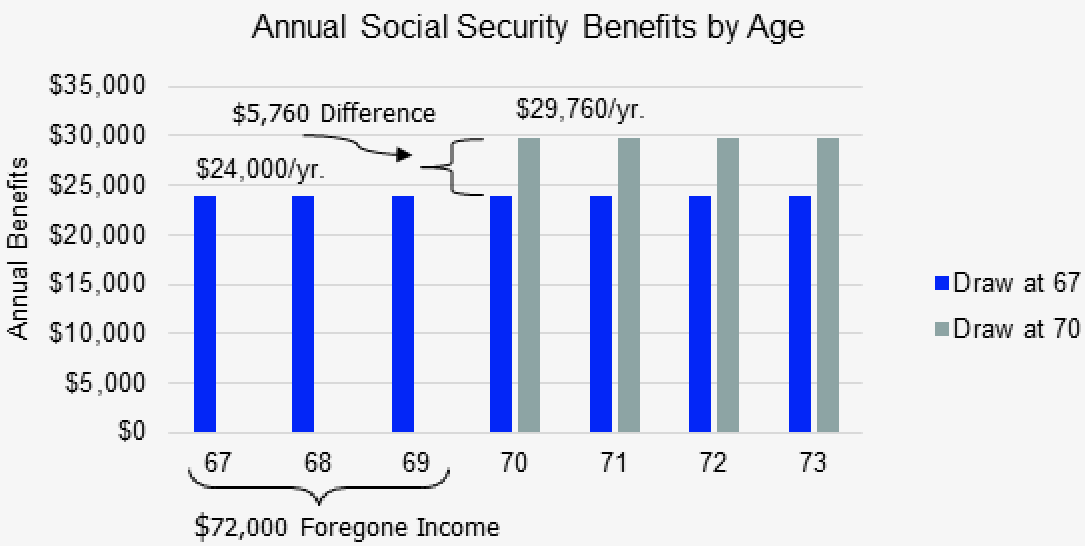
So, what would cause you to delay or not delay? On the one hand, claiming benefits early means that you get additional years of benefits, albeit at a lower amount each year. Delaying benefits earns you a much higher benefit amount, but you are required to fund your lifestyle with other assets for up to 8 years while waiting. The difference in timing/benefits between these two options is what creates a breakeven age.

When a retiree chooses to delay retirement benefits, they are giving up income in early years for the promise of a higher benefit later. Although you receive less for the first few years, the increased monthly benefit amount as a result of delaying means that over time the delayed benefits will “catch up” to the reduced early benefits.

Retirees who delay earn additional credits to their monthly benefit amount for every month they wait beyond their full retirement age – UP TO 24%

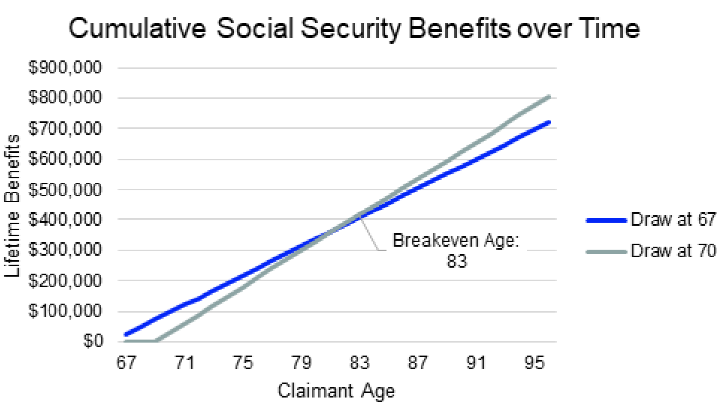
BREAKEVEN AGE - A SIMPLE EXAMPLE

Let's assume you have a monthly benefit of $2,000 at a Full Retirement Age of 67 per the chart below. If you claim Social Security benefits at 67, you receive $24,000 of income each year for the rest of your life. If you delay benefits until age 70, you forego the $24,000 for the first 3 years (a total of $72,000), but receive $29,760 per year for the rest of your life – an increase of $5,760 per year. Each year of making an additional $5,760 slowly "earns back" the $72,000 you sacrificed in the first 3 years.



This time period to earn back benefits creates a breakeven age – the age through which you must live in order to earn more cumulative benefits by delaying Social Security compared with drawing at an earlier age. In this case, if you live until age 83, you will have earned more total benefits by delaying Social Security than if you claimed at age 67, as illustrated in the following chart.

What does this analysis tell us? Theoretically, if your life expectancy is longer than the projected breakeven age, you should delay Social Security benefits to earn the most from the Social Security system. Likewise, if you have reason to believe that your life expectancy is shorter than the breakeven age it may be prudent to draw benefits sooner.



What's interesting to note is that at the time of its implementation in the 1980s, the 8% per year delay represented an "actuarially equivalent" credit amount. Based on average life expectancy and average inflation-adjusted return at the time, it would have made no difference for the average person if they drew at full retirement age or age 70 – their expected value of lifetime benefits would have been the same. [2]

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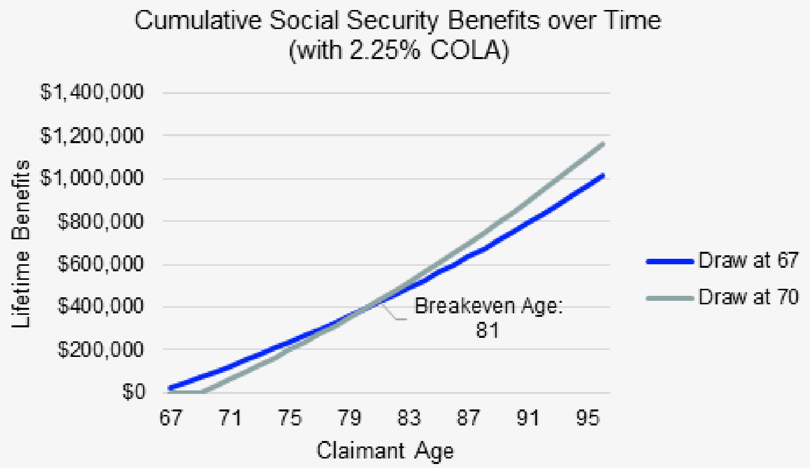
LIFE EXPECTANCY

The above analysis is highly simplified, but reveals a key point in evaluating Social Security claiming strategies. Because Social Security is guaranteed for life, a longer life expectancy means increased benefits, all other things equal. A useful starting point for estimating life expectancy can be found using the Social Security Administration Actuarial Life Table which provides life expectancy for individuals of all ages based on the most updated actuarial statistics. In situations where known factors impact your individual life expectancy (i.e., family history of longevity, terminal illness, specific health factors), an updated estimate of individual life expectancy will have a major impact on the decision of when to claim Social Security. [3]

The average Cost of Living Adjustment **HAS BEEN 2.6% SINCE 2003** with an 8.7% increase in 2023 [4]

THE IMPACT OF INFLATION

The above analysis excludes a variety of factors that have an impact on the breakeven age, most notably inflation. Since 1975, the Social Security Administration applies an annual Cost-of-Living Adjustment (COLA) to all benefit calculations, including benefits that are currently being delayed. By combining the Cost-of-Living Adjustment with the 8% annual delay credits retirees recoup the cost of delaying more quickly in situations when inflation is higher. By adding a COLA of 2.25% to the above example the breakeven age drops from 83 down to 81, as seen in the chart below.



Ever since the first automatic Cost-of-Living Adjustment to Social Security in 1975, the average increase has been 3.8% per year. For the last 20 years the average has been 2.6%, including an 8.7% increase in 2022. For our purposes, we will continue to use an average inflation rate of 2.25% in our analysis.

BREAKEVEN AGES - CHANGING MATH

The fact of the matter is that retirees aren't only given the choice to draw at age 67 or 70. Instead, you can choose to draw at any month between the ages of 62 and 70. Because choosing to take benefits at any given age results in a slightly different benefit amount, there is a breakeven age between each combination of possible claiming ages. The table at right shows the breakeven age for each combination of ages for someone with a full retirement age (FRA) of 67 and a Primary Insurance Amount (PIA) of $2,000 assuming 2.25% inflation. [5]

Breakeven of delaying from one age to the other

	62	63	64	65	66	67	68	69	70
62		76	77	76	77	77	78	78	79
63			77	77	77	78	78	79	79
64				76	77	78	78	79	80
65					78	79	79	80	80
66						80	80	80	81
67							79	80	81
68								81	82
69									83

As you can see if this individual were to delay benefits from age 67 to 68, they would need to live through age 79 before the cumulative benefits of delaying surpass those earned if they had claimed at age 67 (red circle). Effectively, the "cost" of delaying one year is recouped upon the claimant reaching age 79.

What's interesting is that the breakeven age actually increases with each subsequent year that passes. Meaning, if you are 67 today and choose to delay one year to age 68, that decision has a breakeven age 79. However, the next year if you choose to delay from 68 to 69 the breakeven age is 81. And, finally, the decision to delay from age 69 to 70 has a breakeven age of 83.

Breakeven of delaying from one age to the other

	62	63	64	65	66	67	68	69	70
62		76	77	76	77	77	78	78	79
63			77	77	77	78	78	79	79
64				76	77	78	78	79	80
65					78	79	79	80	80
66						80	80	80	81
67							79	80	81
68								81	82
69									83

This leaves a bit of a puzzling decision for retirees. If we assume a known life expectancy of 82 years old (roughly the life expectancy of a 67-year-old male today per the Social Security Administration Actuarial Life Table), the decision to delay one year from 67 to 68 seems obvious (breakeven age of 79), as does the decision to delay three years from 67 to 70 (breakeven age of 81). However, once that retiree reaches age 69, the decision to delay until age 70 requires a breakeven age of 83, suggesting that the decision to delay benefits is not as clear.

In reality, it's important to remember that the decision to delay benefits is not a one-time decision. A retiree doesn't decide to delay benefits for three years, instead they're simply choosing to delay one more year to the next decision point. When viewed this way, the decision to wait from 67 to 70 isn't a one-time decision, but rather the combination of three separate decisions to delay one year at a time.

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SUMMARY

As we've seen in this article, breakeven ages are a result of different potential benefit amounts available to retirees depending on when they draw Social Security benefits. The up front "cost" of delaying is offset over time by the "reward" of a higher lifetime benefit amount. The resulting breakeven age helps us develop a prudent strategy on when to draw benefits when some key assumptions about life expectancy and inflation are included. In the next two articles, we'll see how spousal benefits and other factors can lead to a more accurate (albeit more complicated) analysis of benefits.

At JVL Wealth Strategies, we view the decision on drawing Social Security as one key decision in the broader context of a holistic financial plan. And, as with many decisions in financial planning, there is no "right" answer. Social Security is highly complex with multiple factors impacting the decision that's right for you and your family. If you know of someone who could benefit from our experience, please let us know.

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REFERENCES

[1] Information gathered from Social Security Website at SSA.gov/benefits/retirement
[2] Journal of Financial Planning, January 2023; "Which Social Security Claiming Strategy Generates the Highest Legacy Value?" Pfau & Parrish
[3] Social Security Actuarial Life Table accessed via www.ssa.gov/oact/STATS/table4c6.html
[4] Social Security Cost-Of-Living Adjustment data accessed via www.ssa.gov/oact/cola/colaseries.html
[5] Information gathered from SS Analyzer powered by Social Security Solutions