EDUCATION

# A Case Study in Retirement Planning: Why It Can Pay to Delay

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Gail Buckner, CFP®
Vice President
National Financial Planning Spokesperson
Franklin Templeton Investments

If you are like many busy working people with many responsibilities and stresses, you probably have little time to think about retirement. But as the wise Ben Franklin once said, “If you fail to plan, you are planning to fail.” Here, Gail Buckner, CFP, our personal retirement and financial planning strategist, presents a case study of a fictional couple that represents the real challenges many people face in financing their retirement—and the planning strategies that can help solve them.

When thinking about how to convey the importance of retirement planning, rather than simply crunching the numbers or providing you with an elaborate presentation, I thought it might be worth offering a personal case study I think many individuals can relate to. While this example is purely fictional, the challenges are very real, as are the figures presented and assumptions based on the current Social Security program.

**Mitch and Karen: A Case Study in Retirement Planning**

Mitch and Karen are 58 and 55 years old, respectively. They are a happy and hardworking couple who have raised two responsible, smart and loving children, Lisa and Mark. Lisa is in her first year of graduate school; Mark is a college senior. Thanks to summer jobs and significant financial help from mom and dad, both children should be able to keep their student loans at manageable levels.

Mitch has been the primary earner of the family. Karen quit her job when Lisa was born. Once both children were in school, she returned to work as a teacher’s assistant at their elementary school. The job didn’t pay much, but it allowed Karen to be home at the same time as the children. When Lisa and Mark started high school, Karen also resumed working in retail.

Karen and Mitch consider themselves to be relatively frugal. Mitch is quite handy. Over the years, home improvement projects often took up his weekends. He has always mowed his own lawn, while Karen and the kids pitched in with the yard work.

Mitch and Karen are rightfully proud of the children they have raised. They are also glad their kids are not going to be saddled with tens of thousands of dollars in student loan debt.

But as they approach their 60s, Mitch and Karen have realized they have paid a price for the choices they have made: while they have little debt, they have relatively little saved for their retirement. Mitch has worked for his current employer for 10 years, but since the kids started college, he could only afford to contribute the minimum needed to receive the company match in his 401(k). His account is worth about $132,000.[1] Savings from previous employer plans were rolled into an individual retirement account (IRA). However, on more than one occasion, money was withdrawn to cover some college expenses for Lisa and Mark. The rollover IRA currently has a balance of $65,000.[2]

Karen has never worked in a job that offered a retirement plan. In retrospect, she and Mitch recognize they should have at least funded an IRA for her, but there always seemed to be a more pressing need for the money—the mortgage, braces, medical bills, school supplies, clothes, home repairs and modest vacations, mostly to visit family. Currently, whatever Karen earns from her two part-time jobs goes to help Lisa and Mark with college expenses.

Once the kids are living on their own in a couple of years, Mitch and Karen plan to ramp up their retirement savings. However, time is running out. They have already foregone decades of potential investment gains and compounding. At this point, they have a combined $197,000 earmarked for a retirement that is roughly a decade away.

Thank goodness for Social Security! Mitch's most recent estimated benefit statement projects that he will receive a benefit of $2,000/month if he waits until his Full Retirement Age (or FRA for short) at 66 & 8 months to file. Karen has an FRA of 67. Due to time spent out of the paid workforce, she has only contributed to Social Security for 29 years. In addition, because she needed a flexible work schedule, she accepted lower-paying jobs when she returned to the workforce. Therefore, her benefit is smaller, estimated to be $800/month.

However, if both Mitch and Karen continue to work, their monthly benefit can increase. This is of particular importance to Karen because Social Security bases your benefit on your *35 highest years of income*, adjusted for inflation. As a result, for each year that Karen continues to work, an earlier year where she earned $0 will drop out of the equation. This will result in a larger benefit.

It would take a real commitment, but if Karen and Mitch were able to continue living on their current tight budget, they could stash away a substantial sum of money for retirement. In a couple of years, both of the kids will be out of college and (hopefully) supporting themselves. Until then, Mitch will contribute $6,000/year to his 401(k)—just enough to get his company's matching contribution of $3,000. After that, he plans to increase his contribution to $18,000/year[3] plus the company match until he retires in 2025.[4] At that point, he will start receiving Social Security. To make it easier to monitor his investments and take withdrawals, Mitch plans to roll his 401(k) into his IRA, bringing the total to a bit more than half a million dollars!

When Mitch retires, so will Karen. She'll be 64. Her Social Security spousal benefit is larger than the one she herself earned, so she will receive the higher amount. However, because she is starting Social Security before her FRA, the amount she is entitled to will be reduced.

Karen and Mitch expect inflation to run 2% per year. This is how much they estimate their required income and Social Security benefits will increase. They assume their investments will continue to earn a return of 6% per year.

They are delighted to learn they will receive $40,203/year from Social Security—nearly half of the $85,000 in income they estimate they will need (recognizing that they haven't accounted for taxes yet in these estimates). They plan to withdraw the additional income they'll need from Mitch's IRA.

After doing some rough projections, Mitch is shocked to realize that under this plan his IRA will be exhausted in the year he turns 81! He and Karen will then be completely dependent on Social Security![5] They will have to drastically reduce their lifestyle.

That's when they decide to see a financial advisor.

**Getting Real**

After running the numbers several different ways, their advisor confirms Mitch's findings: if they both retire when Mitch is at his FRA, they will exhaust their retirement savings in roughly 15 years. Since they don't feel they can save more than what they have planned, they have two choices:

1. Drastically scale back the retirement lifestyle they want, or
2. Mitch works until age 70

The advisor points out that the second option would have several benefits. Because Mitch would be earning enough to cover their current expenses, he and Karen would not need to touch his retirement savings. In addition, by continuing to make his current contribution to his 401(k), his account would grow to more than $700,000 by the time he starts taking withdrawals. Finally, Mitch's Social Security benefit will be significantly larger if he waits until 70 to start receiving it, thanks to the "Delayed Retirement Credit."[6] Instead of $2,454/month, he would receive $3,213/month—31% more. Getting a higher benefit from Social Security means he has to withdraw *less* from his IRA to make up the income they want. In just the first year, the annual withdrawal from Mitch's IRA would be $5,933 *smaller.* This really adds up over time.

The option above will also allow Karen to retire when she wants. Beginning Social Security three years before her FRA would reduce her benefit to $765/month. Once Mitch files for Social Security, Karen becomes entitled to a spousal benefit—albeit a reduced one due to the fact that she filed "early." Still, her monthly check would jump from $796/month in the previous year to $1,065/month.

**Potential Pitfalls**

This plan is not without risk. One of them could lose their job. And, returns on their investments might not be as high as expected. There's also the chance one or both will experience an unexpected health problem.

Although both are open to the idea of Mitch retiring later, it might not be feasible. The Employee Benefits Research Institute's (EBRI's) annual "Retirement Confidence Survey" found that the number of pre-retirees who expected to retire after age 65 increased from 16% in 2001 to 37% in 2016.[7] In addition, 6% said they *never* plan to retire.[8]

There is a significant gap between expectations and reality, however. The survey also found that only 15% of current retirees were able to keep working past 65.[9] Major factors for retiring earlier than planned include a decline in their own health (55%), changes at their place of employment such as downsizing or layoffs (24%) and having to care for a spouse or other family member (17%).[10] In other words, when you are relatively healthy and in your 50s or don't feel you have sufficient savings to retire, "work longer" seems like a viable option. Unfortunately, it is not always possible.

Karen and Mitch will meet with their advisor regularly to monitor their situation and make needed adjustments. But, at least they have a realistic plan that can work—thanks in good part to Social Security. As you can see from this example, there are many factors to consider when it comes to retirement. Since January is a month for resolutions, if you don't have a retirement plan, perhaps formulating one should be one of yours!

Learn more about developing a strategy to fund your own retirement: www.franklintempleton.com/whatsnext.

And, ask your professional advisor to run your personal scenario though the independent third-party LifeYield Social Security Optimizer tool, which can help you and your advisor consider your personal goals and circumstances, and begin to determine when the right time to start taking Social Security benefits might be.

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1. Based on average 401(k) account balance for individuals in their 50s with 10–20 years of tenure. EBRI Issue Brief No. 423,"401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2014," Fig. 13 (April 2016).

2. Based on average IRA account balance for individuals ages 55–59. EBRI Issue Brief No. 424, "2014 Update of the EBRI IRA Database: IRA Balances, Contributions, Rollovers, Withdrawals, and Asset Allocation," Fig. 5 (August 2016).

3. This is the annual limitation for 401(k) contributions for 2017. This amount may be adjusted each year for inflation. See https://www.irs.gov/uac/newsroom/irs-announces-2017-pension-plan-limitations-401k-contribution-limit-remains-unchanged-at-18000-for-2017.

4. Since Mitch is over age 50 and qualifies to make the extra annual "catch-up" contribution to both his 401(k) and IRA, he could save even more than we assume. However, this example assumes he cannot afford to do this. See https://www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-401k-and-profit-sharing-plan-contribution-limits.

5. Assumptions: IRA investments return 6% per year. Required income and Social Security benefits increase at the rate of inflation, 2% per year.

6. For every 12 months past your Full Retirement Age that you postpone the start of Social Security, your benefit increases 8% until age 70.

7. Source EBRI Issue Brief No. 422, "The 2016 Retirement Confidence Survey: Worker Confidence Stable, Retiree Confidence Continues to Increase," pgs. 27–28 (March 2016).

8. Ibid, p. 29.

9. Ibid, p. 28.

10. Ibid, p. 29.

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