Social Security is a Better Deal than You Think

(Contributed by Jim Saulnier, CFP® and Justin Fundalinski, MBA)

For quite some time now there has been a movement afoot to "privatize" Social Security. The argument for privatization promotes the view that individuals would be able to generate far greater lifetime income if they did not have to contribute to Social Security. The premise is based on the belief that if workers were allowed to direct what would have been their Social Security contributions into their own investment account (perhaps a 401(k) or similar tax qualified retirement account) they could later use that money to buy a stream of guaranteed income through an income annuity and generate far greater lifetime income than currently offered through Social Security. Unfortunately, the privatization argument tends to ignore the critical difference in how Social Security calculates your lifetime stream of guaranteed income and how a private insurance company prices guaranteeing a retiree a lifetime stream of income.

This movement to privatize Social Security seems to grow in popularity when equity returns are strong. Unfortunately, concentrating solely on equity returns ignores the other half of the equation. Once you retire, current investment returns are meaningless to your cost of a guaranteed income stream. Far more important to that cost are ***current interest rates*** (more on that later).

Absent from the privatization argument is the critical difference of how Social Security calculates your lifetime stream of guaranteed income compared to how a private insurance company prices the cost of guaranteeing a retiree a lifetime stream of income. This dichotomy recently became abundantly clear when a new retiree asked us to help him calculate his retirement budget. Unique to his situation was a lack of any Social Security benefits or employer pension. For the majority of his working years he did not contribute to the Social Security system because his employer had opted out of the program back when the government allowed certain employers to do so. Instead, his employer allowed this person to direct what would have been contributed to Social Security into a retirement account. The employer matched the contributions and over his working years the account grew to an enviable value of more than a million dollars.

In this article we will share with you the difficulty in generating a lifetime stream of guaranteed income in today's low interest rate environment.

Social Security VS Private Annuity – How Benefits Are Calculated

We consider Social Security benefits and lifetime income payments from a **Single Premium Immediate Annuity**[1] to be "**secure income**."[2] Where they differ is how each payer determines the amount of

[1] A **Single Premium Immediate Annuity** is often referred to as a "personal pension". In exchange for a lump sum of money an insurance company will provide you a lifetime stream of guaranteed income. If you live long enough and receive all your money back payments will continue for the rest of your life. Structured properly, they will also pay your beneficiary any money not returned to you should you pass away before receiving all your money back.

[2] Our definition of **Secure Income** is an income stream that (1) is predetermined and known; there is no ambiguity with how much income you will receive throughout your retirement; (2) your income can never be cut, it can only increase and (3) the income is not backed by your assets alone, it is backed by a third party

income you will receive for the rest of your life. When you retire, the Social Security Administration bases your benefits on an index of your highest 35 years of earnings. Current interest rates have no bearing on how much your Social Security benefit will be.

On the other hand, an insurance company providing a retiree a lifetime stream of guaranteed income via an income annuity couldn't care less how much that retiree earned while working! Instead the insurance company will base the majority of the cost of that retiree's income benefit on how much they think they can earn in the bond market based on current interest rates. The **lower** interest rates are at the time of purchase the **more** it will cost to buy a lifetime stream of guaranteed income.

Since 2008, interest rates have been at historic lows - and therein lies the problem for the retiree in this story.

How Much Secure Income Do You Need?

The cornerstone of our retirement planning philosophy revolves around a simple concept. Retirees should put in place an income plan that will cover 100% of their "**required expenses"**[3] with a lifetime stream of inflation-adjusted guaranteed income. The retiree in our story needs $55,000 a year of inflation-adjusted guaranteed income throughout his retirement. Normally such an amount isn't difficult to generate because most working people have a modest amount of "secure income" such as Social Security benefits and/or employer sponsored pension income. A retiree need only cover the difference (if any) between their secure income and their required expenses with an income annuity. But as we mentioned before, the retiree in our story was not eligible for any Social Security or pension benefits. He now needs to use his retirement savings to buy an income annuity to cover his ***entire*** required expenses.

Pricing a Lifetime Stream of Secure Income

We helped the retiree in our story solicit quotes from insurance companies asking how much he would need to pay to buy a lifetime stream of guaranteed income for him and his wife (both are in their early 60s) beginning at $55,000 and increasing by CPI annually until mortality. The results shocked us. The quotes provide by various insurance companies varied between $1.3 to just over $1.5 million to secure this income stream! These quotes were more than the retiree had!

The retiree in our story had fallen victim to the Federal Reserve's efforts to stimulate economic growth by lowering interest rates to historic levels since 2008. Had interest rates been at levels last seen just a decade ago, the cost of purchasing his lifetime income would have been significantly less. In all likelihood, his Single Premium Immediate Annuity would have cost less than half of his total portfolio.

How much Social Security could the retiree have received?

Adding to the retiree's difficulty was his lack of any Social Security or pension income. We cannot calculate with complete certainty what the retiree in our story would have received in Social Security benefits had his employer not opted out of the system. Nonetheless, we can come close in an

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[3] A **Required Expenses** is an expense if you don't cover you will suffer an *economic, financial or medical* hardship. Required Expenses by their very definition are difficult to cut or reduce and must be fully covered until mortality with inflation adjusted guaranteed income.

estimation based on his historical earnings. At age 66 (Full Retirement Age) this retiree would have had Social Security Retirement benefits of approximately $30,888/year. His wife (who remained at home caring for the family and therefore did not pay into the Social Security system) would have been eligible for a spousal benefit of $15,444 at her age 66. All total the retiree in our story most likely would have been eligible for a combined Social Security benefit of $46,332/year beginning at age 66. Furthermore, with a little planning they could have "optimized" their benefits via several claiming strategies and increased their annual Social Security benefit to $56,216 by age 70. Whether the retiree claimed at age 66, or optimized his benefit at age 70, it is our contention that their Social Security income would have covered most, if not all, of their required expenses at the beginning of their retirement. This would have then allowed them to now use their retirement savings to fund their **desired expenses**[4].

So what's better?

When we look at all this information we have to ask a pointed question. What's better…?

- Having an enviable 401(k) that is valued over a million dollars without any Social Security benefit and the option to buy a secure stream of income.
- Or, having a modest 401(k) with secure income provided by Social Security to cover required expenses.

Because our retirement planning philosophy centers on helping people cover 100% of required expenses with any combination of secure income (pension, Social Security, or income annuity) we are not biased on how the income is generated from as long as it is secure. So the short answer to the question is – It depends where the secure income is coming from and what current interest rates are.

To be able to secure sufficient guaranteed lifetime income for our retiree in the current low interest rate environment, we demonstrated that it would cost significantly more than our retiree had saved. Had interest rates not been at historic lows, or had the retiree been a participant in the Social Security program this would have been a very different story.

We have always liked Social Security. We specialize in helping people optimize their benefits and receive as much from the program as possible. Because Social Security bases your income benefit on your historic earnings and not current interest rates it can insulate you from the risk of retiring in a low interest rate environment. We admit Social Security is complex, it's confusing, and it's severely underfunded. But it remains a superb social insurance program and in our opinion a much better deal than many people realize.

[4] A **Desired Expenses** is an expense if you don't cover you will suffer an emotional hardship. Desired Expenses by their very definition are easy to cut or reduce and therefore can be covered during retirement from your investment and savings. When market conditions are good you an increase your desired expenditures when market conditions are bad you can cut them.