Calculating the Financial Impact of Working Longer

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Economic and market pressures have forced many baby boomers to rethink their retirement schedule. A recent study can help step near-term retirees through the recalculation process by quantifying your possible Social Security benefits, asset allocation, and income needs to arrive at a Plan B retirement date.

"How much longer do I have to keep working?"

This is a familiar question as baby boomers who once thought retirement was right around the corner now see it as way down the block or entirely out of the neighborhood. Whether their lack of preparedness arises from insufficient savings or recent portfolio losses, many boomers are coming to terms with the fact that they will have to work longer than previously planned.

The question is, how much longer will they need to work, and what impact will those extra paychecks have on their retirement income plan?

A 2008 study by T. Rowe Price quantified the financial impact of working longer using basic assumptions for a typical 62-year-old pre-retiree. This illustrates the general impact of working and saving longer, or use it as a guide to do a more customized analysis incorporating your personal information.

In laying the groundwork for this discussion, there are four big decisions that are usually within your control when it comes to retirement income planning:

1. When you stop working
2. When you start taking Social Security
3. How you manage withdrawals from savings
4. How you allocate your assets

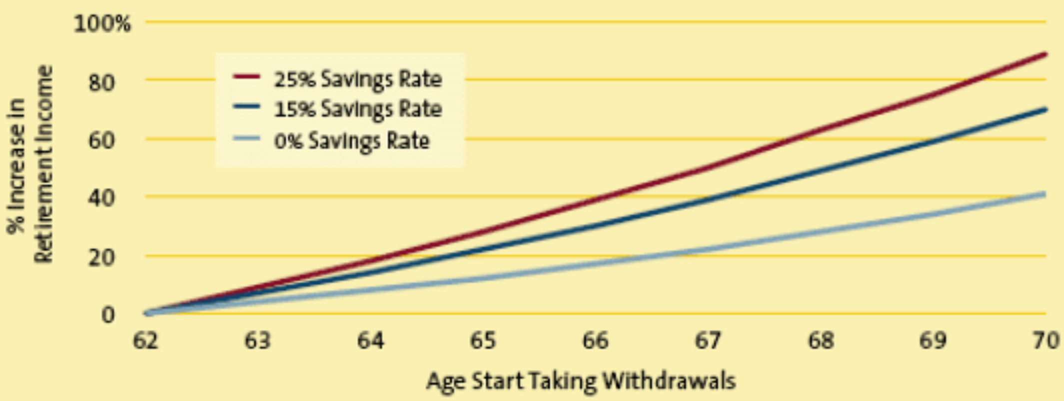
The first two can have a significant impact on the amount of income in retirement, while the second two affect the sustainability of that income. Of the four, the decision that has the most impact is the date you stop working. In fact, the study pointed out that people who are just a few years from retiring and who have not saved enough will probably not be able to make up their shortfalls solely with increased savings levels or by investing more aggressively. There simply is not enough time for the assets to compound.

Working longer

But working three years longer—from age 62 to 65—and saving 15% of annual salary could raise annual income from investments by 22%. Working five years longer could raise annual income from investments by 39%. Working five years longer and increasing annual savings from 15% to 25% could provide 50% more retirement income than if the client had retired at age 62. These results assume the client earns $100,000 per year and already has $500,000 in savings.

The Impact on Retirement Income of Working and Saving Longer

Cumulative Percentage Gain in Retirement Income From Investments at Two Savings Rates (Current Dollars)



This chart shows the cumulative percentage increase in retirement income from an investment portfolio for each year the individual continues to work beyond age 62, depending on whether 25%, 15%, or 0% of wages is invested each year. All figures are in current dollars. The study assumes an annual salary of $100,000; $500,000 in tax-deferred savings at age 62; an annual inflation rate of 3%; an asset allocation of 40% stocks, 40% bonds, and 20% short-term bonds and cash; and a 90% probability that income will be sustained until at least age 95. Portfolio performance is based on a probability analysis described on page 18.

So, for example, if this individual worked until 65, his or her annual retirement income from investments would be 28% greater than if he or she had retired at 62, assuming he or she saved 25% of his of her salary each year. Even if none of the annual earnings were saved, the individual's income would be 12% greater at 65 because he or she did not have to tap into his or her retirement savings while continuing to work.

Source: T. Rowe Price Associates

Delaying Social Security

Working longer also allows you to delay taking Social Security. Delaying benefits three years—from age 62 to 65—results in a ***27% increase*** in the purchasing power of a your Social Security benefits, from $17,772 per year to $22,644. Delaying to age 70 nearly doubles the purchasing power of benefits to $33,408. And this does not take into account annual cost-of-living adjustments (COLAs).

Taking all three steps—working longer, saving more, and delaying Social Security from age 62 to 70—would almost double your total retirement income from investments and Social Security in today's dollars. So if you had been looking at retirement income of, say, $37,772 ($17,772 Social Security plus $20,000 from the investment portfolio) you could actually enjoy a retirement income (in today's dollars) of around $75,000 starting at age 70.

If you aren't willing (or able) to keep working to age 70 and do not need to double your retirement income, the following options would each raise retirement income by about 30%:

- Retire in three years, at 65, by saving 25% of annual salary
- Retire in three and a half years, at 65½, by saving 15% of annual salary
- Retire in four years, at 66, by spending rather than saving additional earnings

Taking withdrawals

The withdrawal simulations used by T. Rowe Price support the standard practice of starting withdrawals at 4% of the account value and increasing the amount by the inflation rate each year. This would provide an 89% probability that assets would remain at the end of a 30-year retirement. Raising the initial withdrawal rate to 5% would reduce the odds to 40%-65%, depending on the asset allocation strategy used.

Instead of basing their scenarios on historical returns, T. Rowe Price used their own long-term return estimates for each asset class, along with various assumptions about volatility and correlations among asset classes. Although they recognized that a truly diversified portfolio theoretically includes real estate, commodities, precious metals, currencies, and other elements, their models included only stocks, bonds, and short-term bonds, since these are the asset classes owned by most investors. The underlying long-term return assumptions were 10% for stocks, 6.5% for intermediate-term investment-grade bonds, and 4.75% for short-term bonds. Five hundred scenarios were run using various asset allocation strategies and volatility assumptions.

While the "4% rule" was confirmed, an important takeaway is the notion that retirement withdrawals should be carefully monitored and adjusted if necessary. "If retirees suffer poor portfolio returns in the first few years of retirement, they should consider lowering their withdrawal amounts temporarily or at least holding their annual withdrawals flat for a while instead of increasing them for inflation," the study noted. This would be more advantageous than reducing the level of equities.

Asset allocation

The asset allocation decision was said to be less important than the other three decisions, but the study cautioned retirees against holding too few equities. Instead, "moderate exposure to equities is recommended for diversification, growth potential, sustaining real income, and providing a 'cushion' to cover unexpected expenses during a 30-year retirement." Even retirees in their 80s are encouraged to hold at least 40% of their assets in equities, and to keep no more than 30% of their assets in cash or short-term bonds. This makes sense given the return assumptions used in the study. But as we know, real life can turn out to be different.

Putting the four decisions in perspective

The bottom line is that all four of these decisions—when to stop working, when to take Social Security, how much to withdraw in retirement, and how to allocate assets—will determine, independently and together, your financial success in retirement. The best results come from working longer, although delaying Social Security, taking minimal withdrawals, and holding more equities also contribute to retirement security.

But no one wants to work forever, deprive themselves of needed income, or subject themselves to excessive market risk. So your job is to find the sweet spot where you can retire comfortably and be relatively assured of having enough inflation-adjusted income to last your life expectancy. It's a tall order and may require you to receive some unwelcome news ("I have to work how many more years?"), but having all the numbers and decision points laid out for you is vastly superior to not knowing.

If it's any consolation, Christine Fahlund noted in the T. Rowe Price study that delaying retirement does not necessarily mean delaying gratification. One novel strategy that can both boost retirement income and make working longer more palatable involves spending more—while still working—on hobbies, travel, education, or other retirement dreams rather than investing the additional earnings from work. Now there's an idea that should appeal to boomers who lament having to work forever. Give yourself permission to spend more of your hard-earned wages, and you may so enjoy the comfortable lifestyle that the extra income affords that you may want to work forever.

REFERENCES AND FURTHER READING

"Working Longer and Other Ways to Optimize Retirement Income," T. Rowe Price

"Here's a Plan: Work Longer," Forbes

"The Benefits of Working Longer," Boston Globe

"Time Is on Your Side," Market Watch

"The Myth of 2016," Barron's

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