ARE YOUR ALLOCATIONS RIGHT FOR SOCIAL SECURITY?

Retirement Income Source®

Are Your Allocations Right for Social Security?

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Nothing exists in a vacuum, meaning that even if you've determined the best time and method of taking your Social Security benefits based on your age, objectives, and lifelong earnings, it won't matter unless you properly coordinate your benefits with your overall retirement income plan. Most people agree that Social Security is not enough to live on in retirement; it needs to be supplemented with other sources of income. Therefore, it is essential to help ensure your other savings and investment vehicles are as reliable as Social Security and capable of meeting the same financial objective: providing income that you can't outlive.

Retirement income for any purpose, including living expenses, major purchases, or satisfying RMDs, should ideally come from interest and dividends on your savings and investment vehicles, not from principal — just like your parents probably told you. Spending down on principal in retirement has never been a good strategy, but today it's a more slippery slope than ever, especially in the early years of retirement. That's because average life-expectancy rates are higher today than they've ever been, and most people need to plan for 30 years of retirement. To see the potential danger there, consider a 30-year retirement like a 30-year mortgage in reverse:

When you first start making mortgage payments, you're not paying back much principal at all. Instead, you're paying primary interest and just a small amount of principal. But as the years go on and the balance gets paid down, you pay a little less interest and a little more principal. The process continues until, after 30 years, your mortgage is thankfully paid off. Now, imagine the process in reverse. Take a pool of savings worth $1M, generating 5% interest, or $50,000 a year. If you take even a little bit more than that $50,000 each year, just a small amount of the principal, that sum will be depleted within 30 years in much the same way that a mortgage is paid off — or potentially a lot sooner than 30 years depending on market conditions.

Your Options

So, with that in mind, what are some of your savings and investment options today for generating income through interest and dividends to supplement Social Security? Well, although banks and money markets are paying better interest rates today than they have in some time, that could change quickly—especially given how active the Fed has been in manipulating rates ever since the Financial Crisis. For many years following the crisis, bank accounts and CDs earned a paltry 2% annual interest at best, which doesn't make for a very substantial income source. Just to make that 2% generate $20,000 of income you'd need $1 million in principle.

So, if banks and money markets aren't a practical option, what is? What about investing for growth and drawing your income from principle? Well, let's say you've decided to delay taking your Social Security benefits until age 70 to receive a higher amount, but you decide you're still going to retire at age 62. In this case, you not only have to consider how best to supplement your Social Security income once it kicks in, but how you're going to fill that eight-year "income gap" until Social Security kicks in once you've stopped working.

Now let's say you decide to leave your $1 million in stocks or stock mutual funds for those eight years, hoping for steady growth, but then another major prolonged market drop occurs like the two that have taken place since the year 2000. With the first drop, from 2000 to 2007, the market fell by nearly 50% and took more than seven years to get back to its previous high. Then from 2007 to 2013, the market took almost a 60% drop and took just under seven years to recover. Here's how the math works in this situation:

If you're a 62-year-old retiree taking $40,000 a year to fill your income gap for eight years, it means that each year the market drops you'll end up selling more shares of your stock or stock mutual fund to get your same withdrawal. That means even when the market comes back within seven years or so, by the time you hit age 70 you still will not have even come close to getting all your money back. You might have only between $300,000 to $400,000 left at the end of the eight years and will have ultimately cannibalized your nest egg.

'Cancerous' Strategy

This kind of "cannibalizing" of principle is a common mistake that retirees and people close to retirement make: the error of reverse dollar cost averaging. Most people know what dollar-cost averaging is and have wisely used it while saving over the years, typically by investing in a 401(k). The purpose of dollar cost averaging is to get your average cost or purchase price down to help you buy low and sell high, which is the cornerstone of smart investing.

So, if you were to set out to buy $100 per month of a mutual fund and the first month the fund was worth $10 a share, you would buy ten shares. But what if the unthinkable happened and the second month the fund dropped to $5 a share? Well, if you stuck with your plan, you'd then have to buy 20 shares to get $100 worth. So, after two months, your average cost per share would seem to be $7.50, but, in actuality, it would be lower: $6.66. That's because you bought twice as many shares at $5, and half as many shares at $10. Dollar-cost averaging helps you get your average costs down.

The problem, however, is that once you're at a point where you're not saving into your fund but drawing from it to supplement or fill a gap with your Social Security income, the same principles apply but in the opposite direction. You start reverse dollar cost averaging.

Taking the same example, let's say that in the first month you liquidate $100 by selling 10 shares, and in the second month the unthinkable happens and the fund drops in half. Now, to withdraw your $100, you need to sell twice as many shares, therefore you sold 20 shares. So now what's your average sales price per share? Again, the math is the same: now, instead of taking your purchase price down from $7.50 to $6.66, you've taken your sales price and pushed it down. You've been forced by the need for income to sell low.

Dollar-cost averaging is one of those things that works great in one direction and is horrible in the opposite direction. Whereas dollar cost averaging is a great strategy for young savers, reverse dollar cost averaging is one of the most cancerous strategies you can embark upon.

Investing for Income

In our experience, for most people, the right allocation for supplementing and helping to maximize your Social Security is one in which you invest directly for income, using the universe of conservative-to-moderate income-generating financial strategies. These include, among other tools, actively managed individual bonds and bond-like instruments such as annuities, preferred stock, BDCs, and REITs. For investors with a higher risk tolerance, your options might also include actively managed stock strategies geared toward dividends rather than capital gains.

Making the strategic shift from investing for growth to investing for income in the transitional years just before retirement can help ensure you maximize the value of your Social Security benefits and create an overall reliable stream of income that you can't outlive. That's income you can spend to meet your goals and enjoy your retirement or—if you don't need it—that you can reinvest to grow your portfolio organically or "the old-fashioned way."

Getting started is as easy as contacting a qualified financial advisor who specializes in this universe of income-generating alternatives.

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