When Retirement Comes Early

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Scott Bishop is a financial planner in Houston, a city that has seen thousands of job layoffs this year in the wake of the collapse in oil prices. Many of the job cuts have hit executives at the big Houston-based oilfield services companies, so Bishop has seen his share of clients facing the prospect of an early—and unplanned—retirement.

"I'm talking with a lot of nervous, scared clients," says Bishop, director of financial planning at STA Wealth Management.

Financial plans typically assume a normal retirement age in the mid-60s or beyond, but life events have a way of intervening. Half of all retirees say they left the workforce earlier than planned, according to the 2015 Retirement Confidence Survey conducted by the Employee Benefit Research Institute. The key culprits include health problems or disability and workforce downsizings.

Events like that aside, early retirement might just look like an attractive option for affluent clients in their 50s or early 60s, but the risks are substantial and need to be weighed carefully.

The major risk is having to stretch savings over more years of retirement. There are also fewer years of saving at the high levels just before retirement. Couple that with possible lower-than-expected market returns, asset allocation problems and uncertainty about safe withdrawal and spending rates, and the risks to the plan become all too apparent.

"It can be much more expensive to do than you might think," says Dirk Cotton, founder of JDC Planning and a blogger on retirement research. Cotton recently won the 2015 RIIA Practitioner Thought Leadership Award for a paper on sequence of returns—just one of the risks that impact early retirement.

Of course, sufficient wealth can take clients out of the risk zone, but Cotton thinks the risks can be great even with wealth as high as $5 million. For these clients, the best advice may be to get back to work, even if that means working in a part-time or consulting capacity.

If your client needs motivation, consider an analysis developed by Cotton. (See charts, below.) The numbers look at a hypothetical individual retiring at age 55, 60, 65 or 70. It considers the cost of retirement to age 95, and the impact on their portfolio and Social Security income. Finally, Cotton shows what the retiree can spend annually to sustain a 95th-percentile chance of sustainability to age 95.

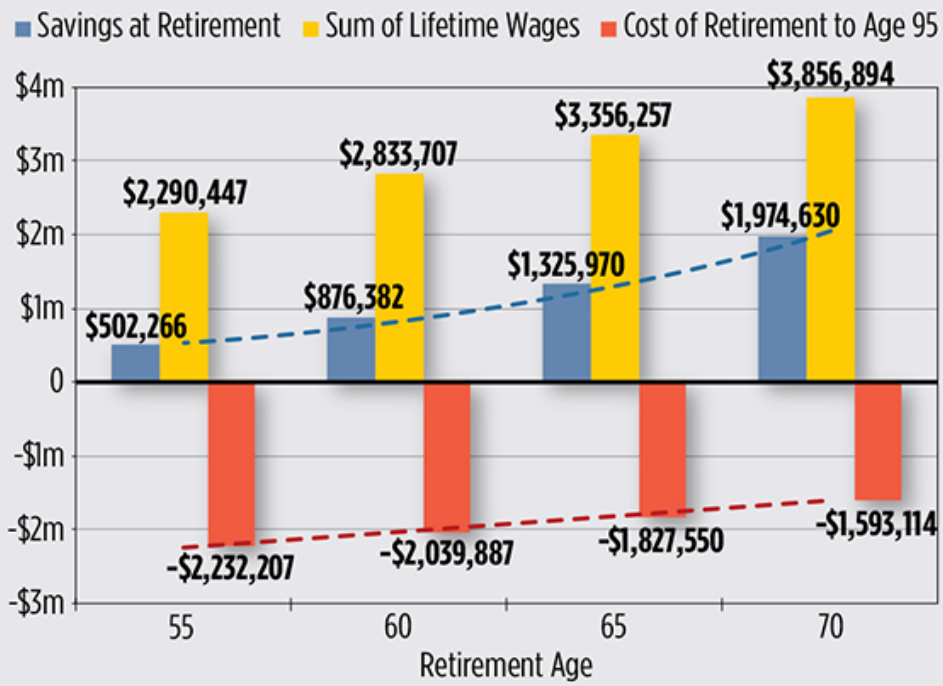
Four scenarios are created. In each, retirement occurs at a different age (55, 60, 65 or 70). For the first three scenarios, retiree collects Social Security benefits of $29,508 per year beginning at age 67; in the final scenario, s/he collects $33,984 a year in benefits. S/he spends the remainder from savings to total $80,000.

Terminal savings values are the median outcomes of Monte Carlo simulation for saving 10 percent of annual wages and investing with a mean return of 6.8 percent and a standard deviation of 11.5 percent.

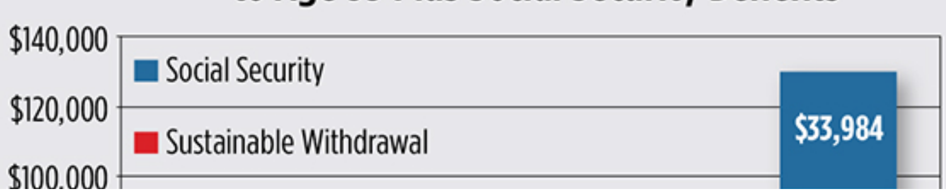
Savings are invested after retirement with a safer allocation that returns 4.6 percent with a standard deviation of 7 percent; Monte Carlo simulation is used to determine a 95th-percentile sustainable withdrawal amount. This amount can be more or less than target spending of $80,000.

All returns and spending are in real dollars. The cost of retirement is calculated as the present value (PV) of an $80,000 annuity discounted at 2 percent for the number of years from retirement age to age 95.

Financial Impact of Early Retirement



95th %-ile Sustainable Annual Spending to Age 95 Plus Social Security Benefits



Several Challenges

The retiree hopes to spend $80,000 annually in retirement, or 80 percent of their pre-retirement income. That can be done sustainably, he finds, only by retiring at 65; the earlier dates produce substantial shortfalls.

“There are several challenges to retiring early,” Cotton says. “The cost is driven up by the increased expected length of retirement. Our best opportunity for growing wealth is in the decade before retirement when we have the most capital to invest, and that time is shortened by early retirement. And early retirement means more years to fund before Social Security or pension benefits kick in. That requires more spending early in retirement, which increases sequence of returns risk.”

Longevity projections are always a guessing game, but they get more tricky with an early retirement, says Cotton, who retired from corporate life at age 52. “When you retire early, you have this notion in your head that retirement will last 15 years, but it might be significantly longer or shorter than that.

“You could retire at 72 and live 15 years or more, but the odds you’ll do that are only 32 percent. But if you retire at 65, your odds of living 15 years or more are 63 percent. Retiring just a few years earlier can significantly increase your expected length of retirement and the associated cost.”

Another major worry is the risk of a catastrophic event that throws the retirement plan off track, such as a health emergency with large out-of-pocket costs or the need to use a nursing home. Odds of that happening are one-third higher with a retirement spanning 40 years rather than 30 years.

Planners also need to consider a range of more practical questions with clients weighing an early retirement:

401(k) account rollovers. The decision to leave retirement assets in a former employer’s defined contribution plan can be fraught with emotion, depending on the circumstances of your client’s departure. And encouraging a rollover can be tempting if it increases assets under management for advisors. But rolling over isn’t always the best move for the client.

A rollover can make sense if the 401(k) plan has poor investment choices or high fees, or if you’re looking to do a Roth conversion. But big 401(k) plans often feature very low fees, and the plans are subject to the fiduciary requirements of the Employee Retirement Income Security Act (ERISA), meaning they must put the interests of account holders first.

If your client has significant company stock holdings inside the plan and is over age 59 1/2, that’s another reason to consider a rollover and lump-sum distribution of the stock, Bishop says. If the stock is rolled out of the plan as part of a lump-sum distribution, the stock may qualify for more favorable tax treatment under the net unrealized appreciation rules, which allow for taxation at the long-term capital gains rate (rather than ordinary income rates) on the difference between cost basis and market value.

Pensions. If your client has a traditional pension, there may be a lump-sum payout option. That might be tempting if the departure is due to an unexpected job loss and cash is needed for living expenses, but pay careful attention to tax considerations, Bishop cautions.

“It could lead to a higher tax bill for that year if it bumps your client into a higher bracket, if not fully rolled into an IRA account, and could be subject to a 10 percent early distribution penalty if you are under age 59 1/2,” he says. Retirees under age 59 1/2 rolling over a pension would need a “creative tax plan,” Bishop notes, such as “substantially equal distribution” available under Section 72(t) of the tax code.

Also consider the math on and the timing of any lumpsum buyouts, which usually are not favorable to employees. Depending on their health and family situation, many will come out ahead by waiting until the plan’s full retirement age and then claiming the guaranteed lifetime annuity payout.

If an employer is offering a severance lump sum in a buyout package, Bishop often asks clients to check on the possibility of deferring part of the payment into the 401(k) or into other tax years to smooth out tax consequences.

Social Security. Filing for Social Security benefits is an option for clients at least 62 years of age, and it may be tempting. But the math favors delayed filing in most cases—even if it means tapping retirement accounts to meet living expenses. Research by William Meyer and William Reichenstein, founders of Retiree Inc., shows that delayed filing extends the life of typical retirement portfolios anywhere from two to 10 years in retirement, because the larger annuity income reduces pressure to draw from portfolios.

Health insurance. Options include COBRA, going on a spouse's health plan or shopping for a policy on the Affordable Care Act (ACA) exchanges. For early retirees shopping on their own, obtaining quality, affordable health insurance was one of the biggest challenges facing retirees too young for Medicare (age 65). The ACA has changed all that. "It was one of the biggest problems I faced in the first nine years after I retired," says Cotton, who has pre-existing conditions. "Either it was very expensive or the deductibles were so high, nothing was really covered."

Clients who retire unexpectedly and have already reached age 65 should file for Medicare immediately in order to avoid the hefty penalties levied for late filing.