Registered Investment Advisor Firm

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To Draw or Not To Draw

No, I'm not talking about the town clock striking "high-noon" as the white hat and black hat square off on each other – waiting to see who goes first.

I'm talking about your decision when it comes to "Do I start drawing my Social Security, or should I draw from my savings and delay taking my Social Security benefits?"

Here's your answer – IT DEPENDS.

The sequence of how you tap your investments depends on your personal situation, and how you draw down savings, whether held in taxable or retirement accounts are interdependent on each other.

While the best claiming strategy is to delay benefits until age 70, not everyone can afford (literally) to wait beyond the age of 62, or until the age of 70.

So where should you draw from if delaying is not an option?

If you work with an advisor that is not trained in claiming strategies, you will probably discover their advice is to draw from any taxable accounts first, then start drawing from tax deferred or tax-exempt thereafter.

The reality is, it's just not that clear-cut. There are multiple probabilities that should be examined and it clearly depends on how much money you've managed to save and (drumroll please) how much you spend!

If you're working with an advisor that does do Social Security claiming analysis, you may be leaving money on the table.

Part of the analysis requires a consideration of your tax status. If you have sufficient resources allowing you to delay drawing on your social security, drawing from your tax deferred savings first may be the best choice if you expect to have a lower marginable tax rate in "retirement."

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It is not uncommon for some advisors to advise drawing down from your taxable accounts first because liquidations would most probably be taxed at the capital gains rate instead of your marginal tax rate.

What this strategy fails to consider however is the probability of a lower tax rate, as well as smaller "required minimum distributions" when you reach the age of 70 ½. In addition, a lower rate and smaller distributions have the possibility of reducing the amount your Social Security benefits will be taxed as well.

Let's assume you're 62, which is the earliest age at which you can claim your worker's benefit, and you have the choice of taking $9,000 a year now or $12,000 a year if you wait until age 66 (or 67 depending which year you were born), the age at which you will qualify for a full Social Security benefit.

By taking your SS at 62 vs. your full retirement age, you lock in a 25% reduction of your benefit from what you would be entitled to at your Full Retirement Age (FRA).

So, if inflation runs at 2% a year, the $9,000 payment you started receiving at age 62 would have grown to $9,742 by your FRA. So had you waited until your FRA to claim benefits, you would start with a benefit of $12,989, or $12,000 plus four years of inflation increases at 2% per year.

So if you plan to take benefits early, your SS payment would be $9,742 at your FRA. That's $3,247 less than the $12,989 you would be entitled to, had you waited until your FRA to begin.

But "not so fast" you say. You're a savvy investor and didn't spend all the money you received from SS, you invested it in a diversified portfolio of 50% stocks and 50% bonds and earned 5% a year on your four years of SS benefits. Investing those funds you have an account valued at $41,918.

So are you better off with the lower SS payment plus the $41,918, or waiting for the higher payment for life at your FRA?

There's a number of ways to calculate the outcome, and you guessed it – many rely on your needs and spending habits. But let's look to see how long that $41,918, plus future investment earnings on it would last if you withdrew just enough each year so that the withdrawal plus your lower SS payment would match the higher full-age benefit.

Withdrawing $3,247 the first year at age 66, $3,312 the second, $3,378 the third, etc., you would find that your reserve of invested early SS payments would run out at age 81. That would be your "break-even" age for this strategy.

So at age 81 you'd have nothing left of your investment and you would have your SS benefit permanently reduced paying approximately $13,111 ($9,000 plus inflation adjustments). This amount would be approximately $4,371 lower than the $17,482 payment ($12,000, plus inflation) you would have received by waiting until your FRA.

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Each year beyond your FRA you can wait to claim your SS benefit until you reach the age of 70, your SS benefit increases by approximately 8% per year.

See – IT DEPENDS.

Answer Forum

This month I received a great question from a loyal reader who asked:

> "Wondering if you might revisit diversification in view of the fact that many of us simply invest in a few managed funds and assume that takes care of the need to diversify."

The benefits of diversification are widely known and accepted, but can be hard to quantify without a standard measure of performance that also accounts for risk.

One common metric is called the "Sharpe Ratio" which is your annualized performance divided by your annualized standard deviation, or the chance you will lose money. The higher the Sharpe Ratio, the better.

In theory, there is one single, optimally diversified portfolio at any time that will yield the highest Sharpe Ratio. Portfolio managers typically represent this visually on a graph called the "Efficient Frontier."

Calculating the Efficient Frontier takes strong software to calculate, but it does a decent job of mapping "projected" returns based on huge numbers of combinations of diversified asset classes.

A basic, diversified portfolio might include several investment categories such as stocks, bonds, real estate, commodities and cash.

Your allocation to each of these broad categories should be based upon your investment goals, your tolerance for risk, and your time horizon for needing the use of the money. Each of these categories can be further segregated into domestic, international, large cap, small cap, growth and value to just name a few.

You might use stocks, bonds, mutual funds, ETFs, private equity and a whole host of asset types in building a diversified portfolio.

In short your asset allocation should be an outgrowth of your financial plan.

Because the term "managed funds" was used, I must assume we're talking about something other than a passive index. Here "managed" would mean there is a fund manager who is making buy/sell decisions on behalf of the fund.

True diversification requires that asset classes not be correlated with each other (move in tandem with each other) and if you own three funds that specializes in large cap stock, and their top three holdings include between 3% to 7% of Microsoft, Apple, Cisco, you own three funds that essentially all own the same underlying securities.

Are you diversified?

If you have any questions or concerns about your diversification contact either

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Bob Davis or myself, and we'd be happy to give you a second opinion.

So with "managed funds" a consideration should also include an analysis of "stock intersection" to make sure you are achieving true diversification within your asset classes.

Davis Investment Group

Davis Investment Group is a fee-based Registered Investment Advisor firm servicing the needs of clients across the United States.

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If you have questions or would like further information on this month's topics or any other financial or investment related subjects, including Social Security claiming strategies, please contact me directly at (925) 360-6819 or through my email address at: Bud@DavisInvestmentGroup.biz

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