Forbes / Investing

5 Surprises Of Retirement Income Planning

By David A. Littell and Jamie Patrick Hopkins, Avenue Contributors

As older Americans move into retirement, they face many decisions. Retirement income planning — making a plan to coordinate these decisions to ensure enough income to pay the bills and prepare for uncertainty — is critically important. But Americans may not be as knowledgeable as they should be to face these decisions. Only 20% passed The American College's recent Retirement Income Literacy Quiz.

"In the Retirement Income Literacy Survey, only 48% of people realized that a life annuity is a better choice than a lump sum if one is concerned about having enough money to meet basic expenses in retirement."

To improve your knowledge, here are five surprises about retirement income planning you should know:

1. **Selecting the right investments is *not* your most important retirement decision.** For roughly two-thirds of retirees, more than half their retirement income comes from Social Security. The average Social Security benefit of $1,200 a month translates to more than double the retirement assets the average person has saved on their own going into retirement. This means that for the average American, choosing when to claim Social Security benefits (as well as when to retire and how to use home equity) has a much greater impact on retirement security than how to invest financial assets. The misunderstanding of the relative importance of various retirement decisions was demonstrated in The American College's Retirement Income Literacy Survey. Only 30% of people age 60 to 75 recognized that deferring Social Security by two years or working two years longer would have more impact on their retirement security than saving 3% more in the five years prior to retirement.
2. **You can retire before you start collecting Social Security benefits.**Many people mistakenly believe that choosing when to retire and when to start Social Security benefits are a single decision. There is tremendous value in deferring Social Security, however, and those retiring should consider deferring benefits past retirement age.Deferring Social Security between ages 62 and 70 increases benefits by 7 to 8% for each year (the benefit at age 70 is 76% more than at age 62). And this is an inflation-adjusted annuity paid for as long as you live. Too many Americans don't know this. In the Retirement Income Literacy Survey, only 54% realized that deferred benefits increase each year up to age 70.Deferring Social Security is generally the least expensive way to "purchase" more guaranteed lifetime income. For a married couple, if your spouse lives longer than you do, he or she would also benefit from your decision to defer, assuming you had the larger Social Security benefit.For those who'll retire prior to receiving Social Security benefits, the challenge is affording retirement while continuing to defer claiming. Options include working part-time, using other retirement resources, tapping into home equity through a reverse mortgage or even partially funding deferral with smaller Social Security benefits.

3. Paying more taxes today may be better than waiting until tomorrow. The conventional wisdom is to pay as few taxes this year as possible by deferring or avoiding taxes for as long as possible. But there are important exceptions to the rule when it comes to retirement planning.When saving for retirement, many workers make 401(k) contributions on a pre-tax basis to defer taxes until distributions are made. Many choose to defer distributions as long as possible to maximize tax-deferred saving and help generate increased retirement savings. However, in some cases, it can be beneficial to take some withdrawals sooner than required.For example, take a retiree who has not started claiming Social Security and has some assets to live on that aren't in a tax-advantaged retirement plan. That retiree may suddenly be in a lower tax bracket than before, providing an opportunity to take some withdrawals from a tax-deferred savings vehicle — such as traditional IRA or 401(k) account — at a lower-than-normal tax rate. These taxable withdrawals may be used to meet living expenses, or better yet, converted to a Roth IRA at a lower tax rate.Even prior to retirement, individuals should be looking for years in which they have lower-than-normal tax rates as opportunities to do Roth IRA conversions (their tax rates may be lower due to charitable deductions, leaving work for a period of time or getting started in a new business, for example). Converting to a Roth IRA or making new contributions to a Roth IRA can help minimize the risk of future changes in the tax law and Roth IRAs may be able to offer tax-free investment growth.In addition, with a Roth IRA — unlike a traditional IRA — there are no Required Minimum Distributions during the life of the owner.Only 36% of respondents to The American College's Retirement Income Literacy Survey age 60 to 75 understood that Roth conversions were advantageous when tax rates were lower than normal.

4. You can't afford to spend this year's great investment returns. One retirement planning challenge is to understand that taking withdrawals from an investment portfolio with volatile returns means that you have to be conservative in how much you take out each year.In the past, when yields from bonds, dividend-paying stocks and other fixed-income investments such as CDs were higher, a retiree could invest primarily for income and hold onto his or her principal. With today's low fixed-income returns, however, retirees are forced to invest for total return and must generally spend interest, dividends and gains from sales of assets to meet their retirement income needs.While your volatile retirement assets might average an 8% return over the course of your retirement, that doesn't mean you can safely withdraw 8% of the value of the portfolio each year and not run out of money. The ups and downs of the market require that withdrawals are conservative to make sure that the account is not depleted in case returns are negative in the early years of retirement. Traditionally, the safe withdrawal rate was found to be only 4% of the initial retirement portfolio, assuming a 30-year retirement. But other research using today's investment returns has found that even 4% may be too high to be safe.In The American College's Retirement Income Literacy Survey, when people were asked how much could be safely withdrawn from a portfolio, only 31% chose 4%; many guessed more could be withdrawn but some answered less.

5. Giving up some of your assets may be good for you. When an individual retires after participating in an employer-sponsored retirement plan, the employee normally elects to take a lump-sum distribution (if available) rather than an annuity that would pay a set amount month after month. But most people don't appreciate how complicated it is to manage withdrawals from a portfolio and create their own retirement income stream.It requires making investment decisions, asset allocations and choosing how much to withdraw

each year without depleting the portfolio. And regardless of how good your decisions are managing your investable assets, there's no guarantee your money won't run out. Furthermore, all these decisions may become more difficult with age.When people have full access to their money, there is also the temptation of spending too much — for all sorts of good reasons — or freaking out when the market is down and selling investments at the wrong time.Building lifetime income streams can ensure a base level of income that is available to meet critical needs regardless of market conditions. Research also shows that people with more guaranteed income in retirement feel more confident and are happier. Choosing an annuity distribution or buying a commercial annuity can also leave the retiree in a better position to be more aggressive with his or her remaining investable retirement assets.But in the Retirement Income Literacy Survey, only 48% of people realized that a life annuity is a better choice than a lump sum if one is concerned about having enough money to meet basic expenses in retirement.

-David A. Littell is Retirement Income Program Director at The American College. Jamie Patrick Hopkins is Retirement Income Program Associate Director at The American College.