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Viewpoint

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Delayed Entitlement: The Changing Economics of Retirement

It's a foregone conclusion that Baby Boomers' retirements will be very different from the retirements of their parents. We don't yet know how different, but mounting evidence suggests it may be significant enough to affect not only the near-term economics of entitlement programs, but also the overall employment picture.

To understand how, we need to explore the impact of the most recent financial events on Baby Boomers. The conventional wisdom is that as the leading edge of Boomers converged on age 65, their associated retirements are well underway and the economic and societal effects of this demographic-driven, transfer-payment-promised contingent are just beginning. Following that logic, in the next three to five years we should face a rapid and unprecedented expansion of entitlement expenditures.

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Not so fast. We are starting to see evidence that the recent global financial crisis and consequent period of low interest rates (as well as other factors) are having an impact on Boomers' retirement decisions. The evidence indicates that the conventional wisdom may be wrong. If it is, and Boomers instead are delaying retirement for three to five years, their actions could significantly affect in the near term and especially over the next five years: We may have a reprieve from the substantial increase in age-related social contracts.

The changing definition of retirement

Before we go deeper into this analysis, let's first establish some perspective: Baby Boomers, born between 1946 and 1964, started "retiring" – i.e. turning 65 – last year. In reality, as the average retirement age has hovered – for years – in the low 60s, according to the Center for Retirement Research at Boston College, some Boomers have been retired for a few years. Since Boomers number about 80 million, according to Census 2000, even small numbers retiring (estimated to be 10,000 per day) constitute a significant market segment.

We also know that "retired" means something different than it once did. Today's retirees may be forced into it by some corporate action that either eliminates their job or offers them a buyout too good to pass up. They may also retire for health or lifestyle reasons. Some of these people continue to work after they have retired, perhaps in a second career.

Given this evolution in retiree behavior, we now have to consider some critical unknowns retirees face. Let's start with interest rates. Financial repression – keeping rates so low for so long that real rates on savings actually turn negative – has led to an extremely dire situation for retirees and near-retirees. Many of these investors rely on traditionally more conservative, interest-bearing instruments (corporate bonds, Treasuries and bank CDs) to provide income in retirement. It wasn't that long ago that rates like 4% to 6% seemed like a sure thing. This is no longer true. Now that rates are close to zero, near-retirees may no longer be confident in their traditional sources of low-risk income, causing them to re-think their retirement timing.

The other important unknown is the future of Social Security. As PIMCO's own Jim Moore shows in a recent article *(The Shrinking Social Security Trust Fund: Are We Really Surprised?* Viewpoint, April 2012), the projected exhaustion date of the Social Security Trust Fund has been brought forward by eight years, and financial repression coupled with low economic growth suggests the Fund could run out of money 10 years earlier than currently forecast.

Much of the anecdotal feedback we have from advisors is that many of their clients under 55 aren't counting on receiving anything substantial in the way of Social Security payments. Therefore some of the solvency remedies under discussion in Congress, such as raising the eligible retirement age, are not particularly troubling. In fact, a higher retirement age is largely considered a "fait accompli."

Then there is the subject of means testing, an issue that draws out strong feelings. A common refrain is: "That's my money. I paid into the system my entire life, and it's not fair that some or all of that doesn't ultimately come back to me and my spouse." Certainly in the early days of the program Social Security payments were described as guaranteed lifetime income, or a social insurance contract. Sometimes they are still described that way.

This passion is understandable and has been prevalent for many years: President Franklin Roosevelt once said: "We put those payroll contributions there so as to give the contributors a legal, moral and political right to collect their pensions. … No damn politician can ever scrap my social security program."

Given the overwhelming negative reaction to means testing you wouldn't think it would have much of a chance of being enacted, but it already has, it's just called by another name. A significant "means testing" program has been in place since 1983 – it's called taxation of benefits. This means-testing first came as part of a law enacted to "save" Social Security and called for up to 50% of the income payments from Social Security, subject to certain income thresholds, to be taxed as ordinary income. And that wasn't the end.

Fast forward to today, and we have a law in place that taxes the benefits beginning with joint annual income of $32,000 and hitting the maximum of 85% at $44,000. To add insult to this tax law injury, the income threshold includes your adjusted gross income plus non-taxable interest, plus one-half of your Social Security benefit.

A March 2011 study conducted by the Center for Economic and Policy Research showed how the back-door means testing method had already eliminated the

benefits for higher-income recipients. In fact, 90% of the benefits go to people with incomes of less than $50,000.

Make no mistake, Social Security is aggressively means tested today

So we have considerable survey information, census and economic data, all pointing to reasons why near-retirees would want to delay retirement; but the challenge has been to determine if these current conditions are affecting Baby Boomer retirements. Since the global financial crisis we have suspected that older Boomers were reconsidering retirement, i.e., delaying. Now we have reliable information that appears to indicate that the front wave of Baby Boomers may not be retiring at the rates originally projected and expected.

A just-released Gallup survey indicates that the expected retirement age of the non-retirees surveyed has increased by seven years since 1996, with three of those years getting tacked on just since the financial crisis. Stated another way, when asked in 1996 when they expected to retire, they (on average) said age 60. When asked now, they answered age 67. An April 2012 survey from the MetLife Mature Market Institute and a July 2011 survey by Ken Dychtwald and Sun America Financial Group offer similarly striking insights. Now, we know people don't always retire when they expect to, but that's not the point. The point is that attitudes and expectations have changed.

We're not quite ready to call it a firm conclusion, but we are ready to say that there is reason to believe that the front end of the Baby Boomer retirement wave could be three to five years behind what would have been otherwise expected. Such an outcome would likely have major implications for not only those workers directly affected (who continue to work) but also for their advisors (as these workers rethink their income plans and investment postures) and for the overall economy (which could enjoy a delay in the initiation of the long-anticipated avalanche of Boomer Social Security payouts).

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