Don't make this gigantic Social Security mistake

Paul Solman, correspondent for PBS NewsHour and co-author of "Get What's Yours"
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For shame, for shame if you are among the millions of Americans making, or soon to make, the most common of all Social Security blunders: using "break-even" analysis to decide when to take your benefits and, as a result, claiming early.

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What is break-even analysis? It is considering two different retirement options and calculating the age at which the income is the same. Too many people use it and conclude they can start collecting earlier than they should.

Collecting too early can cost you, on average, thousands of dollars a year.

And yet the average age at which Americans still take their standard benefits is 64, despite the fact that waiting until age 70 produces a much larger monthly paycheck.

[The Social Security horror stories just keep piling up]

No intention here to castigate those who simply cannot afford to wait, of course. America has become a sharply divided economy over the past several decades, with the bulk of Americans experiencing little or no real income growth and saving far too little.

Here's why waiting until at least 70 to collect is one of the best life insurance policies on earth: Using simple arithmetic, if you were to start drawing your reduced retirement benefit of, say, $10,000 a year at age 64, you'd have taken a cumulative sum of $60,000, inflation-adjusted, by age 70. But by waiting until 70, your "maximum" benefit earned figures to be about 50 percent higher -- $15,000 a year. (It might be higher still if you keep working at age 66 and raise your Social Security earnings base.)

So, at a minimum, you'd be getting an extra $5,000 a year, starting at age 70. Five thousand a year more for just 12 years and you'd have earned back the $60,000 you'd left on the table in years 64–70. You'd have "broken even" at age 82. (And no, you don't have to factor in inflation, since all Social Security benefits are adjusted for the cost of living.)

Note that if you believe Social Security's own — in my view, conservative — mortality projections as of five years ago (the most recent ones published), life expectancy for a male, if he makes it to age 64, is 82.4; for a woman, 85. The punchline: On strictly "break-even" grounds alone, you're better off waiting. Add in the value of the insurance, and the calculation isn't even close.

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"But wait," you might be thinking; "I would be earning money on that $60,000 if I invested it myself. That's worth something, isn't it? Shouldn't I be calculating the break-even point, based on a reasonable expectation of the returns I can get on that money if I invested it?"

Yes, market returns matter. But Social Security is providing you with a guaranteed, inflation-protected return for every year you wait that's better than any alternative investment out there. Break-even analysis, whether or not you incorporate that "opportunity cost" (as economists term it), is simply the wrong way to think about the decision, despite the fact that many — indeed, far too many — people are absolutely convinced otherwise, as are many software programs, including "leading" commercial ones. And as recently as 2008, the Social Security Administration told its public claims representatives to use a break-even framework to help potential retirees decide when to begin taking benefits.

Viewing Social Security as an investment is economically block-headed. Instead, think of Social Security as an insurance policy. By waiting to collect benefits until age 70, you are, in effect, buying extra insurance —insurance against what is perhaps the greatest danger of retirement: outliving your savings. Yes, you are leaving money on the table. (That's the "cost" of the extra insurance.) But you are "buying" protection against penury in old age.

When it comes to death, your greatest fear should not be dying itself, but the very opposite. It should be the fear of immortality. Or, failing that, fear of an epically long life. That's because if you're the typical American who has saved less than $10,000 on average by the time you're within 10 years of retiring, the longer you live, the greater the danger of your "golden" years turning to lead, weighed down by poverty and its attendant anxieties. According to one survey, more than 20 percent of Americans believe they will die in debt.

If you're old and poor, you will face rejections by rising numbers of doctors who won't take Medicare or Medicaid. Your children may face crippling debt to buy you a long-shot cure that no insurance—public or private—will cover. You won't leave the house without a companion for fear of falling, yet won't be able to afford one, or even an Uber.

Still insist on evaluating an insurance policy as an investment, based on break-even analysis? Consider your house. Does it make sense to buy homeowner's insurance on a break-even basis? To do so, you would compare the money it costs you in premiums to buy the insurance to the cost to you if your house burns down, multiplied by the vanishingly small chance that it will. If this so-called "expected value" of the policy is less than the premium, the insurance "investment" fails the break-even test. For the purposes of this essay, I performed this exercise with my own home. The cost of the insurance: $1,000 a year. Its expected value? $170 a year. (For numbers nerds, that was a $500,000 total loss times its likelihood per year: .03 percent.)

Now, we guarantee that the expected payoff from "investing" in your homeowner's policy is also less than the premium the insurance company charges you. In short, you can't come close to breaking even buying homeowner's insurance. The obvious reason is that the insurance companies charge "loads" to cover administrative and other underwriting costs. Thanks to these loads, the total payoffs from homeowner's insurance, life insurance, car insurance, health insurance, etc., are always far less than the premiums charged. (Why do you think Warren Buffett's main business is insurance?) Look, if you focus solely on the break-even, you should never buy any insurance at all.

But that would be crazy. You don't analyze standard insurance this way because you are focusing, properly so, on the worst-case scenario—your house burns down, your car is totaled, you get cancer.

Very few of us can afford to play the odds of catastrophe. And you're in no better position when it comes to Social Security longevity insurance.

Social Security provides insurance against this worst-case scenario. This insurance is safe against inflation and against default. It's also dirt cheap. There is no close substitute for it in the market.

Don't let these 3 Social Security myths mess up your benefits

Now if you're still stubbornly tempted to take Social Security benefits at age 64 and invest them on your own, please consider that you're not liable to beat even the average market rate of return.

Let's assume you're the average investor since, on average, those of you reading this probably are. Well, over the 20 years from 1991 to 2011, the average American investor actually lost money, after accounting for all costs and inflation. The reason would seem to be following the crowd — buying when stocks and bonds are flying high, and selling when they tank and sink to new lows. This, of course, is exactly the opposite of investing's Golden Rule: Buy low, sell high. But on average, we cannot be trusted to do so.

The average American's rate of annual loss is only –0.4 percent, however, so you shouldn't subtract anything from that $80,000 you'd have been paid by Social Security for waiting four years. But unless you're sure you can beat the average investor, which probably means you're illegally trading on insider information, you shouldn't add anything, either.

Even if you love taking risks and therefore ignore our point about insurance, you should protect yourself against self-delusion.

In the spirit of the truism that repetition is the soul of understanding: The greatest danger you as a prospective retiree faces is outliving your savings. The best way for millions of people to avoid a miserable financial future is to wait to collect Social Security.