5 of the Biggest Money Mistakes Retirees Make

By Lisa Scherzer | The Exchange – Fri, May 24, 2013

When you're young, you can afford to make some financial mistakes. The closer you get to retirement, however, the more costly those missteps can be. And whereas past generations often just waited for their pension checks to come each week, nowadays retirees have to handle most of the saving themselves and figure out how to allocate that money for a longer life span.

We spoke to financial advisers about some of the most serious slip-ups and how they can be overcome. Here are five:

1. Mistiming Social Security benefits

When to begin claiming Social Security benefits is "your most important financial decision," according to "The Social Security Claiming Guide," published by the Center for Retirement Research at Boston College. Your monthly benefit is based on a combination of your work history, earnings and age at which you file for benefits. You can start collecting Social Security at any age between 62 and 70, but at its most basic, the later you claim Social Security, the higher your monthly benefit.

Most people start collecting benefits at 62 or right when they retire – and end up losing out. After your full retirement age (which for most people is 66), you can boost your monthly payments by 8% for each year you delay claiming, up to age 70.

If you delay benefits from age 62 to 70, your benefit increases by 72% or 76%, according to Morningstar research published in January. (Note that your benefit doesn't increase if you wait to claim beyond age 70). The report also found that the return you'd get by optimally timing your benefits is likely to be greater than the return you get by taking benefits early and investing the money, especially in today's low interest rate environment.

2. You're too optimistic about your health

Dollar amounts associated with retirement health-care costs are daunting – and Americans consistently underestimate them. A 65-year-old couple retiring this year will need $220,000 to cover health care for the rest of their lives (if the husband lives to 82 and the wife to 85), according to a Fidelity Investments report issued this month. (That's an 8% decrease from last year, when the estimate was $240,000, but the drop was due in part to lower-than-expected Medicare spending in recent years, and lower projected Medicare spending in the near future, Fidelity said.) A study published last week by the Society of Actuaries, using Health Care Cost Institute data, estimated that a 65-year-old couple today expecting to live to age 90 will need $441,200 ($220,600 for an individual) for health care costs.

One reason why so many are ill-prepared for this expense is because soon-to-be-retirees overestimate the percent of health care costs covered by Medicare. A 2012 Nationwide survey said Americans “don’t really understand how Medicare works” and “too many assume their employers will continue to pay their premiums during retirement or Medicare will cover all health care expenses.” Medicare covers most services deemed "medically necessary" but it doesn't cover everything. Generally, it doesn't cover vision, hearing and dental care, or nursing home care.

3. You're forced to sell at the wrong time

One of the biggest risks with a retirement portfolio is being forced to sell holdings when the market is slumping to meet your spending needs. That’s why Harold Evensky, CFP and principal of Evensky & Katz, a wealth management firm, recommends clients not tie up their nest egg completely in long-term investments.

“We recommend a year’s worth of cash flow, in money-market and short-term bond funds,” he says. If the market tanks and your investments are off 20%, you don’t have to sell. Evensky popularized what is now termed the bucketing approach to retirement investing. This strategy calls for investors to carve out a portion of assets designated for at least one year’s worth of near-term living expenses that is held separate from long-term assets. The idea is that you take out money from the first bucket for everyday expenses and you don’t have to worry much about short-term volatility in your long-term investments.

“Your paycheck and grocery money are coming out of the reserves. Then you’re not going to be forced to sell at the wrong time,” Evensky says.

4. Mishandling IRAs

Some retirees get tripped up by not recognizing the differences among types of IRAs. And they end up making the mistake of taking distributions from their Roth IRAs before their traditional IRAs, says Avani Ramnani, CFP at Francis Financial. While both types of accounts allow annual contributions of $5,500 in 2013, they get different tax treatment. Roth IRAs are not subject to required minimum distributions (RMDs) and are able to grow tax free through the owner’s lifetime. So they can be an “excellent means of passing down wealth to heirs,” and if retirees have the means, they should avoid taking distributions from Roth IRAs, she says.

Another misstep is waiting too long to begin taking distributions. Some think it’s better to put off paying taxes on the distributions for as long as possible (distributions on traditional IRAs are taxed as ordinary income in retirement). The problem with this is by the time they have to start taking RMDs at age 70 1/2, the distributions are so large that it may push them into a higher tax bracket, says John Gajkowski, CFP and co-founder of Money Managers Financial Group. Retirees should examine what their taxable income is going to be in November-December and see what tax bracket they’ll be in. Oftentimes it makes sense to take money out of an IRA before 70 ½ and stay in a lower tax bracket, Gajkowski says.

5. Paying off your mortgage in full

Lots of retirees and near-retirees convince themselves that paying off the mortgage, once they’ve built up a sizable nest egg and put the kids through college, is the best way to gain financial security. But there’s a trade-off: For one, you're reducing your investments in more-liquid assets in favor of an asset that's not liquid at all. It also leaves retirees house-rich and cash-poor, says Bill Bengen, president of Bengen Financial Services.

“Better returns are usually available elsewhere,” he says, with the caveat that investors need to be careful how they invest the proceeds of a mortgage loan now because of the inflated value of financial assets. Also, of course, some retirees who have the available funds could be tempted to spend unwisely.

For peace of mind, Bengen recommends retirees consider setting up a separate account with an amount equal to their mortgage balance, and invest it conservatively. This provides assurance that the mortgage can always be paid down if that seems best. As the mortgage balance declines, retirees can gradually take out principal (plus earnings) from this account to supplement spending.