Retirement Spending—How Will Your Spending Change?

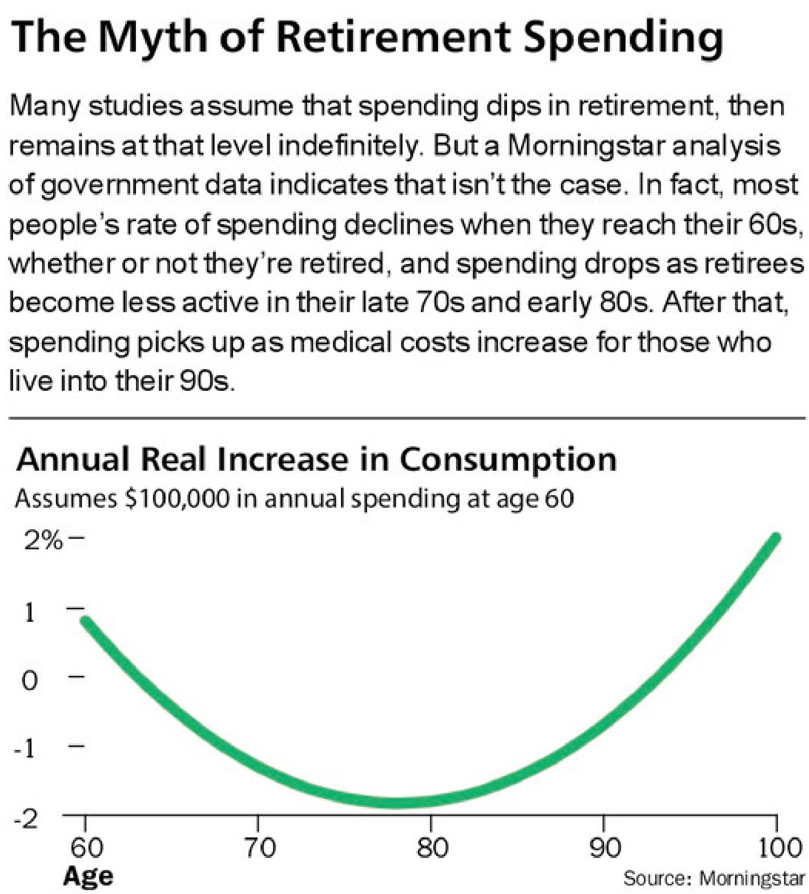
Numerous articles make the case that the average American is not saving enough for retirement and may be underestimating their future retirement spending. Wouldn't it be great to find that the opposite was true?

Don't get me wrong. The more you save, the better. A big nest egg is likely to make you feel happy and secure. However, some retirees have moderately sized nest eggs that are adequate for their retirement plans, yet they have an irrational fear of running out of money. This creates unnecessary stress and prevents many retirees from pursuing travel and other bucket list experiences.

The most important number in your retirement plan:

The most important number in any retirement income plan is an accurate forecast of how much you will spend. An article this past week in Barron's showed that the average household headed by someone over the age of 65 spent $1,000 less per month than all American households combined. This is partly because retirees are no longer supporting their kids and have eliminated work-related expenses. Retirees also spend about one-third less on transportation, and 20% less on food than working households.

This information supports the often-quoted guideline that retirees need to replace 70-90% of their pre-retirement income. However, this varies considerably based on each person's situation, especially whether their mortgage will be paid off early in retirement, how much they plan to travel, and their health status. Nevertheless, let's assume that you nailed your initial retirement spending estimate down to the dollar. Now the question is: How will your spending change over the course of retirement?



Goods and services purchased fall each year:

At the risk of oversimplifying this…if you look at an average retirement (which lasts 22 years) the amount of goods and services purchased falls by almost 2% per year. Suppose you are retired, and you purchase 98% of the goods and services you purchased the prior year, but the cost of those goods and services increased by 3% (the average inflation rate over the past 50 years). Your total retirement spending would grow by about 1% nominal terms.

You would overestimate your spending if you assumed that you bought the same amount of goods and services each year and inflated all your spending by 3%. Overestimating your spending by 2% does not seem like a big deal…unless you do so every year for 20-30 years.

The three phases of retirement spending:

The book ***The Prosperous Retirement*** shows that most retirees go through three phases: The Go-Go Years, The Slow-Go Years, and the No-Go Years. Spending drops for the average retiree in all three phases. It drops the least in the first phase of retirement when retirees are the most active. Spending drops the most in the middle of retirement, and then it continues to drop, but at a more modest pace in the final phase of retirement due to an uptick in healthcare costs.

I was working on a retirement plan for a client this past week and comparing different scenarios. The amount of spending forecasted 21 years from now was $177,000 when we used a 2.5% inflation rate vs. $141,000 with a 1% inflation rate. This client's plan was significantly more likely to succeed with a forecasted 1% inflation rate for retirement expenses, even when we added an additional $6,000 travel budget each year for the first 10 years of retirement.

Final Thought on Retirement Spending:

Running out of money in retirement would be tragic. However, so is missing out on the retirement you want (and deserve) based on an unfounded fear. A good financial plan requires an adequate spending estimate as well as realistic inflation assumptions. The standard assumption used by most financial planners is spending will increase by 3% every year in retirement. That overestimates spending in most cases. I use 2% in my client's financial plans.

THOUGHT THIS WAS INTERESTING

Every Little Bit Helps

My wife, Angela, is one of those people who will tell you she is exhausted and then her very next thought will be something like… "We should have a garage sale to raise money for victims of the California wildfires. I'll get all my Girl Scout families and our neighbors to donate stuff."

It's hard to keep up with her. Nevertheless, this past weekend, such a garage sale happened. Angela (and Gracie's) Girl Scout troop donated clothes, toys, and furnishings. It was freezing when we were setting up at 6:30 a.m. last Saturday, but a gallon of Starbucks coffee and hot cocoa for the kids sure helped. By 2:00 p.m., Troop 2927 had raised $850, which has since been donated to families from Paradise, California.

Great job, Girl Scouts!