Retiree Spending Risk

Retirement planning looks a lot different today than it did 50 years ago. While traditional planning focused solely on the accumulation of savings to fund retirement, modern retirees need to focus on prudently spending down savings.

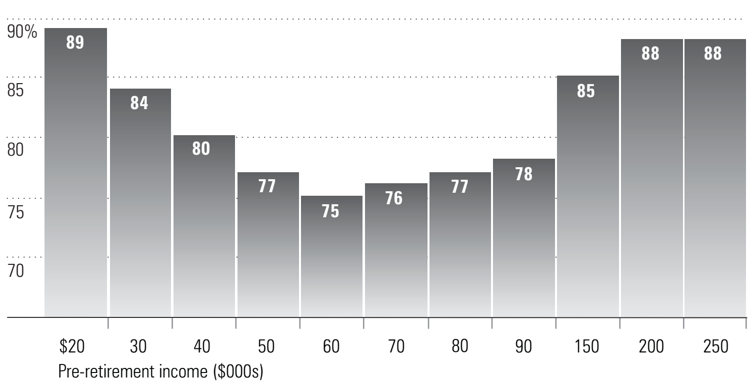
Research shows that today's retirees are living longer, healthier lives and are spending more money on entertainment, travel, and health care. Many financial planners believe that retirees who wish to pursue a very active lifestyle face the risk of spending too much money. Overspending places excessive strain on a retiree's investment portfolio, thereby increasing the danger of outliving his or her assets. By controlling expenses, retirees can preserve their nest egg no matter how long they live.

How much income do you need in retirement?

When discussing retirement expenses with their clients, many financial planners use the concept of a replacement ratio, or the percentage of pre-retirement gross income needed in retirement to cover expenses and preserve a pre-retirement standard of living. Many financial planners suggest a replacement ratio of 70% to 90%. For example, if you have gross income from all sources of $100,000 before you retire, an 85% replacement ratio would equate to $85,000 of income to cover your expenses in retirement. This ratio is essential in helping you to identify the specific sources of income that will support your needs such as Social Security, pensions, part-time employment, or your investment portfolio.

The 2004 Retirement Income Replacement Ratio Study by AON Consulting and Georgia State University cites five reasons why income needs, on average, decrease in retirement: income taxes decrease, FICA taxes disappear, Social Security income is often tax-free or taxed at a reduced rate, saving for retirement is no longer needed, and many job-related expenses are eliminated. The image below shows the average replacement ratios at various pre-retirement income levels.

Retirees need to replace a significant amount of income in retirement[1]
Average replacement ratios at various pre-retirement income levels



It is important to think about the lifestyle you would like to lead in retirement. If you desire an active lifestyle with expensive activities such as golf or travel, you might actually spend *more* in retirement. Replacement ratios of 130% or more are not uncommon in retirees' early years, as people with idle time often find it easy to spend.

How should we think about a spending budget in retirement?

How you budget and plan for your retirement is a personal choice. Some people like to develop detailed line-item budgets and track every expense. Others may be fine just thinking about high-level expense categories. Studies have shown that typical out-of-pocket health-care expenses make up about 40% of retiree expenses; housing-related items make up around 25%; travel and leisure make up another 25%; and other items like food and clothing make up about 10%. The actual amounts you spend will depend on factors like your health status, insurance coverage, lifestyle goals, and estate plans.

When evaluating your budget, distinguish between *essential expenses* (e.g., mortgage, insurance payments, basic food, and utilities) and discretionary, or *lifestyle expenses* (e.g., entertainment, dining out, and travel). Many financial planners suggest that in years in which your portfolio suffers losses, you should consider cutting back on lifestyle expenses and reducing withdrawals from your portfolio.

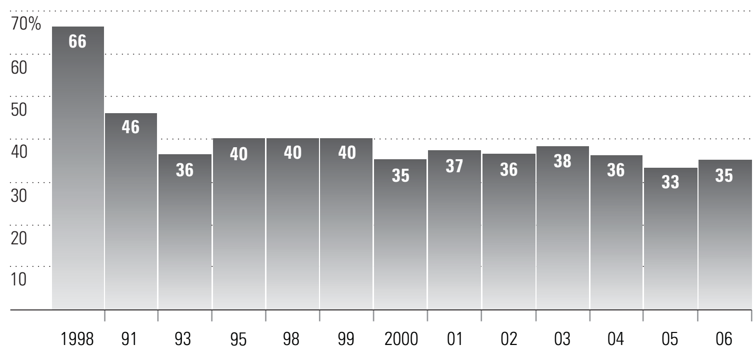
Extraordinary expenses also can make a huge impact on your spending and should factor into your planning. You might want to explicitly budget for things such as a new car or gifts to children and grandkids. For this reason, many financial planners suggest that retirees 1) track their spending in detail during the first year of retirement and 2) keep enough money in a highly liquid account, such as a money market account, to cover your near-term and emergency expenses without having to liquidate assets at a bad time. Periodically, you would replenish this account with systematic transfers from other accounts.

How much should we expect to spend on health care in retirement?

The Employee Benefit Research Institute estimates that a couple both age 65 could require as much as $295,000 to cover health insurance premiums and out-of-pocket expenses if they live to their life expectancy. If they lived to age 95, the estimate jumps to $550,000.[2]

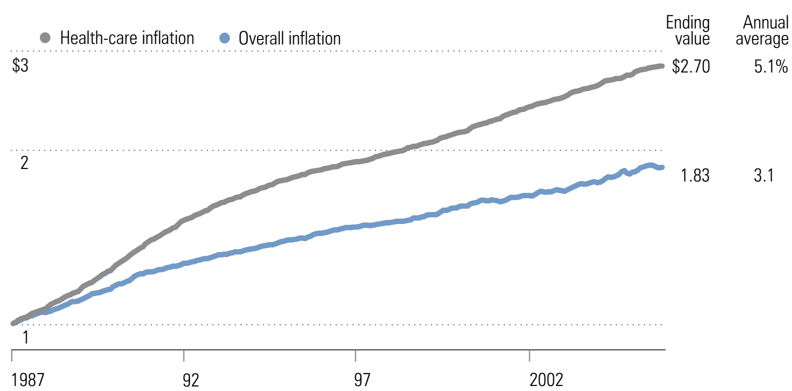
Historically, many workers received health-insurance coverage in retirement through their employers. But due to significant increases in health-care expenses, employers are reducing retiree health benefits, as shown in the following image. The percentage of large employers (200 or more workers) that offer retiree health-care benefits has been falling—from 66% in 1988 to just 35% in 2006. Many experts expect this trend to accelerate. Retirees have also depended on retiree health benefits provided by an employer to help fill the gaps in Medicare coverage. Even when employers continue to offer a retiree health benefit plan, a recent survey from Kaiser/Hewitt[3] indicates that employers are cutting benefits in other ways, such as increasing premium contributions, copayments, deductibles, and out-of-pocket limits. Benefit cuts are placing an even larger burden on retirees, making health care a more significant portion of their budget the longer they live.

Employers are cutting retiree health benefits[4]
Percentage of large firms offering retiree health benefits 1988–2006



One of the major concerns facing a retiree is rapidly rising health-care costs, or health-care inflation, which is significantly higher than the overall rate of inflation, as shown in the graph below. So as you age, not only will you likely need more medical care, the cost of medical care will become increasingly expensive and you're likely to cover a greater portion of each bill out of your own pocket.

Health-care inflation has far outpaced overall inflation[5]
1987–2006



It is apparent that health-care inflation has far outpaced overall inflation over the past two decades. Since this trend seems likely to continue, retirees should try to develop a financial plan that helps address this problem.

How much does long-term care cost?

In addition to typical medical expenses in retirement, you should also consider the cost of long-term care arrangements should you need professional care in your later years, either in-home or in an assisted living facility. There's a good chance you'll need assistance, and it won't be cheap.

Questions to ask your advisor:

- Given our needs and lifestyle goals, what is a reasonable replacement income in retirement?
- Have we accounted for all anticipated expenses in retirement?
- Can our portfolio support these expenses sustainably? If we need to cut back our expenses, where can we tighten the belt?
- What are our medical expenses likely to be, and what medical insurance options should we consider?
- Would we be able to afford long-term care assistance? Should we consider long-term care insurance?

Fourty-four percent of women and 27% of men aged 65 should expect to reside in a nursing home at some point in their lives. The average stay in an assisted living facility is two years for women and 1.3 years for men, although patients who suffer from Alzheimer's disease often require as many as eight years of assisted living.[6]

According to the 2006 Metlife Market Survey of Nursing Home & Home Care Costs, the average annual cost for a private room at a nursing home in 2005 was $75,190. If you seek assistance at your home, the average cost nationally of a skilled home aide is $19 an hour and can run as high as $60 an hour in some locations. Assisted care costs can add up quickly and devastate a retirement portfolio.

In most cases, long-term care health insurance coverage provides benefits for nursing homes, assisted living facilities, and home care. If you can afford the premiums, you may want to consider purchasing long-term care insurance.

[1] Source: The Aon Consulting/Georgia State University 2004 Retirement Income Replacement Ratio Study.

[2] Source: Employee Benefit Research Institute, Savings Needed to Fund Health Insurance and Health Care Expenses in Retirement, Issue Brief No. 295, July 2006.

[3] Source: The Kaiser Family Foundation and Hewitt Associates Survey on Retiree Health Benefits, December 2005.

[4] Represents large firms with 200 or more workers that offer health benefits to current workers. Source: The Kaiser Family Foundation and Health Research and Education Trust Employer Health Benefits 2006 Annual Survey.

[5] Source: Overall Inflation—Consumer Price Index; Health-care inflation—Consumer Price Index-Medical Care Inflation, Bureau of Labor Statistics.

[6] Source: Brown, J. & Finkelstein, A. (2004). Supply or demand: why is the market for long-term care insurance so small? National Bureau of Economic Research Working Paper Series, *Working Paper 10782.*