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A NEW LOOK AT RETIREMENT PLANNING

Planners Rethink Retirement Income Assumptions

There's a new school of thought on retirement planning that challenges the prevailing assumptions that retirement income must be constantly adjusted for inflation.

Most planners agree that spending patterns change over the course of retirement. A 65 year old retiree has different interests and needs than a 90 year old retiree. The prevailing research used for retirement planning relies on a budget with constant inflation-adjusted (increasing) withdrawals. A new method of research drawing attention is ***age banding***, which uses information about actual retirement spending to give a more realistic framework to retirement budgeting.

Reality Retirement Planning: A New Paradigm for an Old Science by Ty Bernicke, published in the Journal of Financial Planning explores this new approach. Bernicke's study agrees that retirees increase spending over time with inflation, but they also voluntarily spend less as they age. For example, many retirees lose their interest or ability to spend as much on clothing, vacations or restaurants. Bernicke used evidence from the Consumer Expenditure Survey (CES) to show that older retirees spend less than younger retirees. Using 2010 CES data, evidence shows that those who are over 75 spend 40% less than those who are 55-64 and 26% less than those who are 65-74.

Using Bencike's historical worst-case maximum sustainable withdrawal rate as a spending guide implies retirement could begin with 25% less wealth than constant inflation assumptions. But on the other hand, Bernicke's analysis does not take into consideration that real **health care** spending increases over time due to greater need and because health care has a higher inflation rate than the CPI.

Considering the Variables

Somnath Basu's research, *Age Banding: A Model for Planning Retirement Needs* published in Financial Counseling and Planning, uses four inflation-adjusted spending parameters—taxes, basic living, health care and leisure—for incorporating changing spending needs into retirement planning.

Taxes: The inflation rate for taxes is 3%. At age 65, the lifestyle adjustment factor for taxes is assumed drop to 50% of their pre-retirement level, as payroll taxes are no longer paid. Overall, taxes drop by 50% at retirement but then stay at this same inflation-adjusted level.

Basic living expenses: Adjusted for 3% annual inflation, basic living expenses are assumed to fall by 30% at retirement, and then by another 20% at age 75, and then by another 10% at age 85. By age 85, real spending on basic expenses has fallen to about 50.4% of its pre-retirement level.

Health care: This component has a higher base inflation rate of 7% plus health care needs increase with age. Costs adjust upward by 15% at 65, by 20% at 75, and by another 25% at 85. By 85, real health expenses are assumed to be 3.7 times larger than their pre-retirement value.

Leisure & Entertainment: Leisure increases by 50% at retirement as clients set out to enjoy life, then drops by 50% at 75 and another 75% at age 85. By 85, even with a higher inflation rate, leisure spending is only 40% of its pre-retirement level in terms of the overall price index.

What does this mean for retirement planning?

Age banding provides a useful tool for planning long-term budgets for clients because it captures both the differential inflation rates and the changing lifestyle dynamics affected by age. The data suggests that spending does decline, but there is also risk that a rapid growth in health care expenses might lead to an overall increase in spending needs at the highest ages.

So which is the better baseline assumption to use: constant inflation-adjusted spending or decreased spending as one ages? Applying both differential inflation rates and age-based lifestyle adjustment factors, provides a solid framework that planners can use to budget for their clients' retirement in a more realistic manner and possibly with less wealth. However, whichever retirement planning approach your advisor uses, it is important to remember that any retirement plan can be disastrous if a client inadvertently retires with insufficient savings.

Retirement income planning is a major focus of our work with older clients but it is an essential part of planning for clients of all ages. If you would like analysis of your situation, please contact us today to begin a review.

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Questions or comments? Email us at ahs@egifinancial.com or call 330-535-0881.