Retirement Planning Software, Inc

December, 2006

Retirement Income Planning, Part 14*: Are We Missing the Boat on Retiree Expenses?

To state the obvious: if there were no retirement expenses, there would be no need for retirement income. Therefore, if we don't understand what the expenses are, and if we cannot project with reasonable accuracy what they will be in the future, no amount of sophisticated manipulation on the income side is worth much. This paper explores what we're doing wrong, and how to do it better.

Necessary vs. Discretionary expenses: Less than meets the eye

One currently popular distinction that practitioners and software developers are making in this market is between necessary and discretionary expenses. Sometimes the distinction guides investment strategy: use guaranteed income to cover necessary expenses, but invest more aggressively with funds earmarked for discretionary items.

Unfortunately, there are no general categories of expense that are purely necessary or purely discretionary, and there are no bright lines that separate the two, only gray areas.

Take housing, for example. Everyone needs a place to live. But almost everyone could live someplace cheaper. In fact, most people could, if necessary, live healthy and even reasonably comfortable lives in much smaller and less expensive quarters. A lot of elderly people could (and many do) move in with a child or sibling. These may not be preferred moves, but the fact that we don't make them is, in general, "discretionary."

* Part 1 of this series discussed in general form the urgent and wide-ranging planning needs of people facing retirement. In Part 2 we further explored the follow-up question: can a comprehensive financial planning approach really work for retirees and, if so, how? Part 3 examined investment risks and strategies, and argued that most retirees should be investing conservatively rather than for asset growth. Part 4 identified serious problems with the use of Monte Carlo models in retirement income planning, and suggested an alternative approach. Part 5 discussed the optimal time to annuitize. Part 6 dealt with the question of what retirees need from the planning process, suggesting inadequacies in current approaches. Part 7 outlined what "holistic" planning should mean for retirees. Part 8 set as its goal to define what Income Planning will look like in 2010. Part 9 discussed new product developments in this area, and weighed their importance and their limitations. Part 10 explored the different ways in which calculators could deal with risk. Part 11 dealt with the special case represented by early retirement offers. Part 12 suggested that financial companies stop trying to find the One Best Solution and experiment with a variety of tools and methods in approaching this market. Part 13 was directed specifically at employers and plan sponsors, explaining why they should be interested in this topic, and what to watch out for.

The same goes for food and medicine. We have to eat, but most of us could cut our food budgets in half and probably eat healthier than we currently do. In the old days, people would just live with irritating symptoms rather than take expensive drugs. We may choose not to do that now, but we could.

By the same token, it is "necessary" that we have some discretionary expenses. Can we live without any entertainment at all? Is it really an option to give nothing to our grandchildren or to our church? If we have some hobby or activity or interest that costs money, but is the whole reason we want to get up in the morning, is that really a "discretionary" expense? As Voltaire said, "the superfluous is a very necessary thing!"

The fact is that almost all expense categories are necessary to some degree, but the degree to which we indulge in them is discretionary. And any decision based on the notion that some are strictly necessary, others strictly discretionary, is suspect, to put it kindly.

We could try to preserve the concept of providing guaranteed income for "necessary" expenses by coming at it a different way. What we would really need to know is: what is the least amount of income you could get by on if you had to? There is no simple way to get to this number, though. No analysis of current expenses will provide it, and if you ask the question plainly, most people would not have a good basis for answering it, because there is no single number that, even in theory, offers a definitive answer.

The fact is that almost all expenses are necessary to some degree, but the degree to which we indulge in them is discretionary.

Fortunately, there is no need to preserve that concept. Using guaranteed income to pay for necessary expenses and investment income to cover discretionary expenses was never a particularly sound financial planning concept. Its main virtues are that it sounds sensible (even though it isn't, particularly), and that it can be used to justify the sale of products and services some financial companies want to market. But there are other ways to come at these markets, and using distinctions that are fundamentally very fuzzy is probably not the best way to do it.

Projecting future expenses

Here's an easy way to project future expenses: take current total expenses, and inflate them by, say, 3% a year. Here's a way to project future income, too: take total current income and assume a 3% increase every year. We don't do that with income, though, because we know better. Why do we do it with expenses?

There are at least four things we can do to make household expense projections significantly more useful:

1. **Divide expenses into categories**, so the categories can be *inflated at different rates*. Housing and medical expenses, for example, tend to increase faster than general inflation. If retirees plan on paying for their grandchildren's college education, that's another fast-rising expense.

   If everyone had the same balance of housing, medical, education, and miscellaneous expenses, we could perhaps use the same average inflation rate for every client. But this is not at all the case. Retirees living in fully paid-for homes are in a very different situation from those with mortgages or those who are renting. Those with expensive medical conditions are usually facing a lot higher inflation than those who are healthy.

2. **Track temporary and other special expenses separately**. Most people who retire these days still have a mortgage. If you fail to take account of the fact that the mortgage will be paid off someday, and that expenses will drop dramatically on that day, you are not even trying to do a good job of retirement income planning.

   Many other expenses also fall into the overall category of items that are not permanent, ongoing, inflatable expenses. To name only a few: life insurance policies that will be paid up or will expire, post-retirement travel, support of children still at home or in college, work-related expenses, current home improvements, non-mortgage loans, financial assistance to elderly parents, etc., etc., etc.

3. **Recognize that most expenses start to decline eventually**. Those of us long familiar with "the miracle of compound interest" are aware that the huge gains come in the late years. It's the same with inflating expenses: the numbers get enormous at older ages. But in the real world, most expenses don't work that way.

   In reality, most expenses don't inflate forever. A few do: housing, energy, medicine. But most other expenses tend to decline, and some even disappear, as people move into their mid-80s and beyond.

   A few do. Housing (rent or real estate taxes), energy costs, and medical expenses all tend to inflate indefinitely. But most other expenses tend to decline, and some even disappear. Although it depends on individual health and preferences, most people who live into their mid-80s start to spend less in most categories. Because of reduced energy, impaired health, and oftentimes lack of interest after a spouse and many of one's friends have already died, elderly people don't get out as much, they eat simpler foods, they stop buying new clothes, they don't care about new cars (if they still drive at all), and they usually stop sprucing up the house, or sometimes even maintaining it well. So while a few expenses go up, most go down, and in many cases the net effect is break-even – i.e., no overall inflation at all – for people who live truly long lives.

   Track expenses by the person, not just by the household. A few expenses are pretty steady, whether there is one person or five in the household. But most expenses vary not only by the number of people, but by who they are. One spouse may have expensive tastes and hobbies, while the other is frugal. One may need costly medical equipment or drugs or other therapies, while another just takes an occasional aspirin. One might be attached to the big house that the kids grew up in, the other might be just as happy in an apartment or condo.

   Again, this wouldn't matter, except that different people also have different life expectancies. If the spendthrift spouse with the high medical bills dies first, household expenses will drop dramatically at the first death. If the thrifty, healthy spouse dies first, expense reductions may be minimal. Nor is death the only issue. Many people retire these days with teenage or older children still at home. Assuming they will eventually move out, expenses will drop quite a bit. If you are trying to model future household expenses, therefore, you need to know how many people live there, what they spend, and how long they are likely to be around.

But isn't this, literally, asking too much? Can we really collect this kind of information, and then follow through with the appropriate analysis? Speaking from experience, we can confidently say, No, it isn't too much. It only requires a bit more diligence.

Why bother with expenses at all?

This question would be too silly to ask, except that it is implicit in so much "income planning" that is currently going by that name. The scheme is: never mind expenses, just look at the assets and ask, "How much could be withdrawn from this nest-egg every year?"

There are few situations where this is a useful question. Real people, who actually need to worry about the income they receive so they can use it to cover their expenses, almost never have smooth, or smoothly inflating, income needs. So it is almost purely academic what level of steady withdrawals could be made. Only by understanding the projected household expenses (and other elements of the family finances), can you identify what future withdrawals are likely to be needed, and whether the nest egg is sufficient.

Expenses as *the* most important factor

We may seem to be implying that expenses are just as important as income when planning for retirees. Not so. In fact, expenses are far *more* important.

In strictly mathematical terms, they are about equal: assets and liabilities are supposed to match. But when it comes to financial decision-making, expenses are more important because in almost all cases, retirees have more discretion about expenses than they do about income. Our best efforts on the asset/income side can only marginally improve a retiree's income. We cannot come anywhere near, say, doubling their resources.

But most people we serve could cut their expenses in half, if they had to. Of course they don't want to, but they could. There are far more options on the expense side than there are on the income side. If you deal only with affluent clients, none of this matters. But most Baby Boomers, if they can retire at all, are going to have to make tough choices on *both* sides of the equation. If we focus only on the income side, we won't be able to serve them. And then the assets that they do have, which may still be significant, will go somewhere else, to some company that *can* do the analysis right.

Still River Retirement Planning Software, Inc., provides both web-based and desktop software offering specialized calculations related to retirement plans and retirement planning.

Contact us at 69 Lancaster County Rd., Harvard, MA 01451
tel: (978) 456-7971 fax: (978) 456-7972 email: csy@StillRiverRetire.com