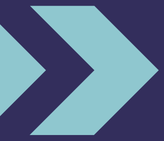


Retirement Spending Pattern - Implications for Retirement Income Sustainability

timeline

How does a typical expenditure pattern change in retirement?

The answer to this question is central to retirement planning. It's not only how much money one needs to accumulate for retirement, it's also crucial to estimate what a sustainable income really is.

Sadly, we have no crystal ball. Neither do retirees. And while it's crucial to for advisers to ask clients about their hopes and aspirations for retirement, most retirees have little idea how their expenditure will change as they get older. Thus, insights into how retirement expenditure patterns change over time are crucial to establishing how much savings a person requires at retirement and how long a savings pot will last.

A good starting point is to examine the data on how expenditure changes during retirement. The data does have its limitations, but it's a good starting point for retirement planning assumptions and most certainly more effective than plucking figures out of thin air (an approach the industry has been far too comfortable with).

A number of studies offer valuable insight into what a typical retirement spending pattern might look like.

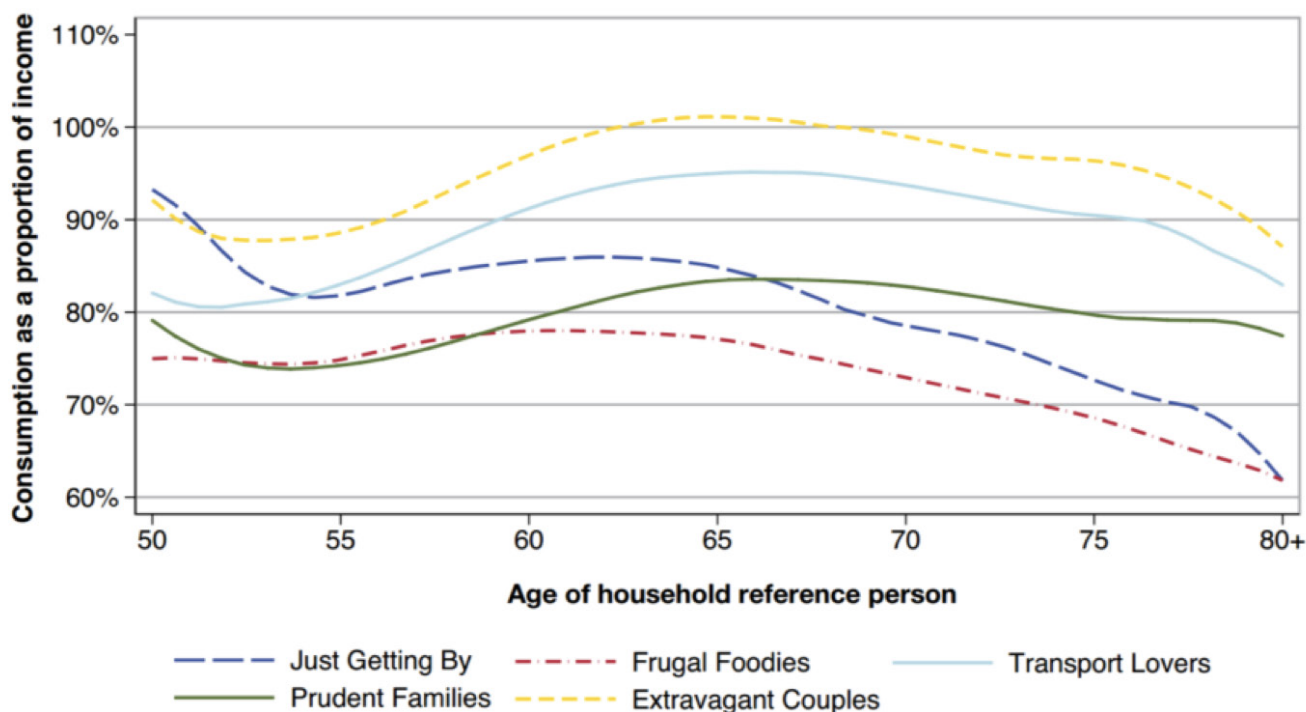
The first is a paper by the International Longevity Center (ILC,UK) titled

Understanding Retirement Journeys: Expectations vs. reality.[i]

In this paper, Dr. Brancati and her colleagues conducted a detailed analysis of two large datasets, the Living Costs and Food Survey and the English Longitudinal Study of Ageing (ELSA) to gain insight into income and expenditure patterns of the elderly. The research found that spending in retirement declines progressively in real terms. As people get older, they spend less. A household headed by someone aged over 80 spends, on average, 43% less than a household headed by a 50-year-old. And when you include the amount of money people pay for their mortgage as household expenditure, then the decline becomes even steeper with households headed by someone aged 80+ spending 56.4% less than households headed by a 50-year-old

Amazingly, this trend remains even when accounting for different lifestyles. The authors note that even the "**Extravagant Couples"** — those who spend nearly 40% of their total expenditure on recreational goods and services — spend more than their income in the first decade or so of retirement, as do those who are **"Just Getting By,"** while the **"Prudent Families"** and **"Frugal Foodies"** consistently spend below their income over the duration of retirement.

Figure 1: Consumption by consumer segment



Age-based consumption by consumer segment

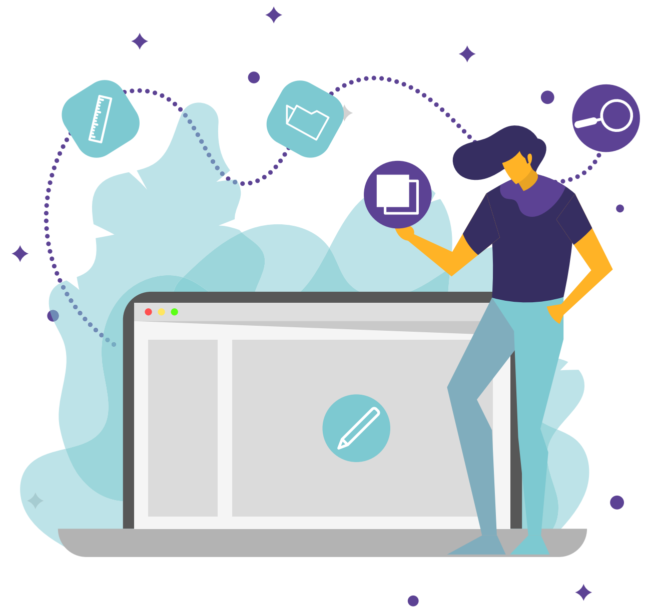
Source: ILC (2015) Understanding Retirement Journeys: Expectations vs. reality

Contrary to widely held beliefs within the industry, the research found that the average retirement expenditure patterns in retirement do not in fact follow the so-called U-shaped path

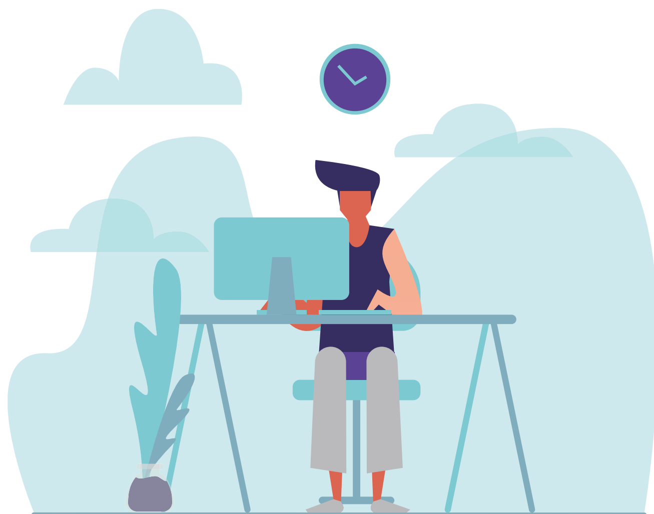
i.e., consumption does not dramatically rise at the start of retirement or pick up towards the end of life to meet long-term care related expenditures. The researchers note:

'Our findings suggest that typical consumption in retirement does not follow a U-shaped path — consumption does not dramatically rise at the start of retirement or pick up towards the end of life to meet long-term care related expenditures. At this point, it should be noted that our data is restricted to households only and therefore excludes those actively living in care homes who may be paying for it from their remaining assets. Yet we can explore the extent to which care expenditures eat into household budgets across different ages. Analysis of the data suggests that even for the 80+ age group, only a minority (6.4% of households) are putting money towards meeting long-term care needs. This doesn't mean that U shaped consumption in retirement is a misnomer, but perhaps implies that it is atypical.'

While the two datasets used in the research are restricted to households only — and therefore excludes those actively living in care homes who may be paying for it from their remaining assets — the research explored the extent to which care expenditures eat into household budgets across different ages. Analysis of the data suggests that even for the 80+ age group, only a small percentage (6.4% of households) allocate money towards meeting long-term care needs. This doesn't mean that the U-shaped consumption theory is false, but perhaps just indicates that it's atypical. The author notes that,



'while research on retirement spending commonly assumes consumption increases annually by inflation (implying a real change of 0%), we do not witness this relationship within our dataset. We note that there appears to be a "retirement spending smile" whereby the expenditures actually decrease in real terms for retirees throughout retirement and then increase toward the end. However, overall, the real change in annual spending throughout retirement is clearly negative.'

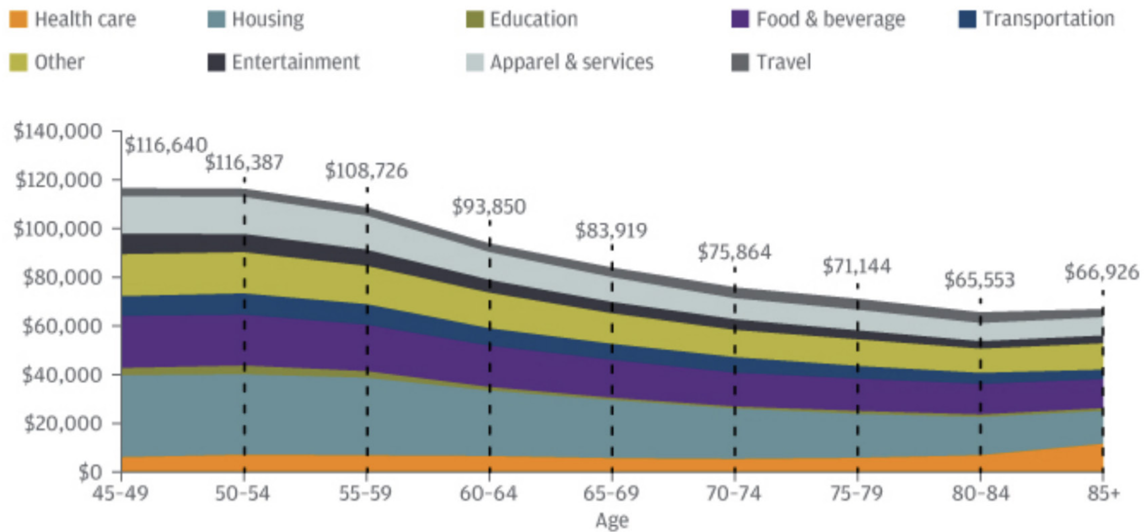


The findings above are reinforced by a number of other studies. In particular, a study[ii] in the US by Morningstar's head of retirement David Blanchett, who examined the RAND HRS dataset (Health and Retirement Study) a panel household survey (combining both cross-sectional and longitudinal data) specifically focused on the study of retirement and health among individuals over the age of 50 in the United States.

A common theme emerging from these pieces of research is that expenditure seems to decline progressively as people get older. Financial advisers, who tend to serve the wealthier end of the spectrum often argue that the picture is different for high net worth households. But is that the case?

Not according to a research by JP Morgan Chase[iii] (2015) who examined the data on spending patterns for 613,000 US households led by men and women age 55 and up, who have debit and credit card relationships with Chase.

The research found that, even for HNW households in the US (over $1million in investable assets), spending in retirement tends to decline as people get older. Care costs jump in later life but are compensated for by declines in other discretionary expenses.



The report notes that, 'the drop in spending at older ages holds across wealth levels.' As the chart above illustrates, 'the average spending patterns of various age groups for Chase households with $1 million-$2 million in investible assets. We looked at retiree spending at $2 million–$5 million and $5 million-plus wealth levels, and the same patterns can be seen, with only minor variations.'

Finally, a research study[i] conducted in faraway Australia, by actuary firm Milliman further reinforces our UK and US-based sources, showing that retired couples' expenditures fall by more than one-third as they move from early retirement (age 65 to 69) into older age (85 yr+). Data shows the low, mid and high-income retirees all experience similar declines in expenditure throughout retirement.

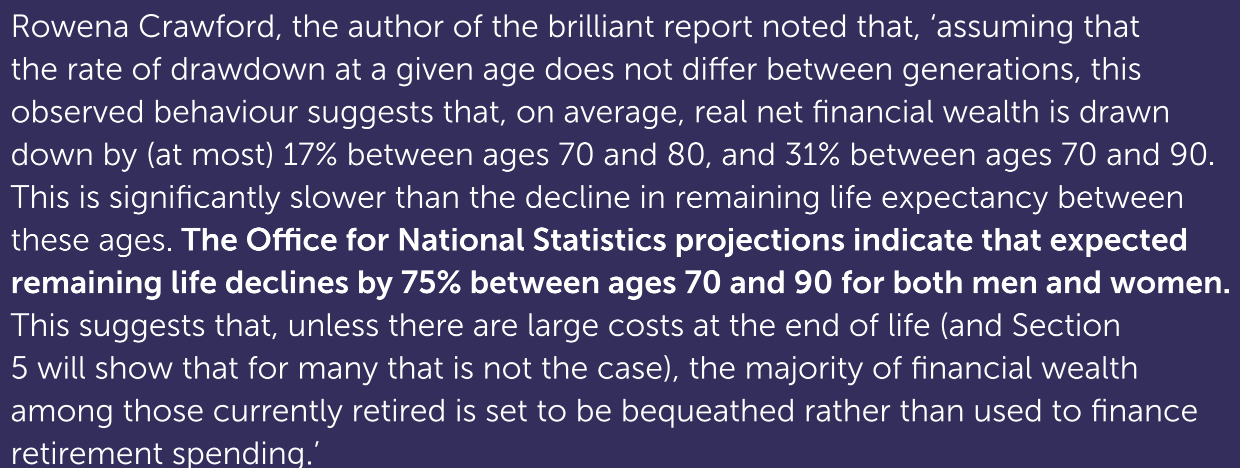
Importantly, the research also suggests that the decline in spending is driven by behaviour and not declining income. In other words, the declining spending in retirement isn't because retirees are forced to adapt to lower income. Instead, this tends to be a behaviour change that goes hand-in-hand with ageing.

How wealth changes in retirement

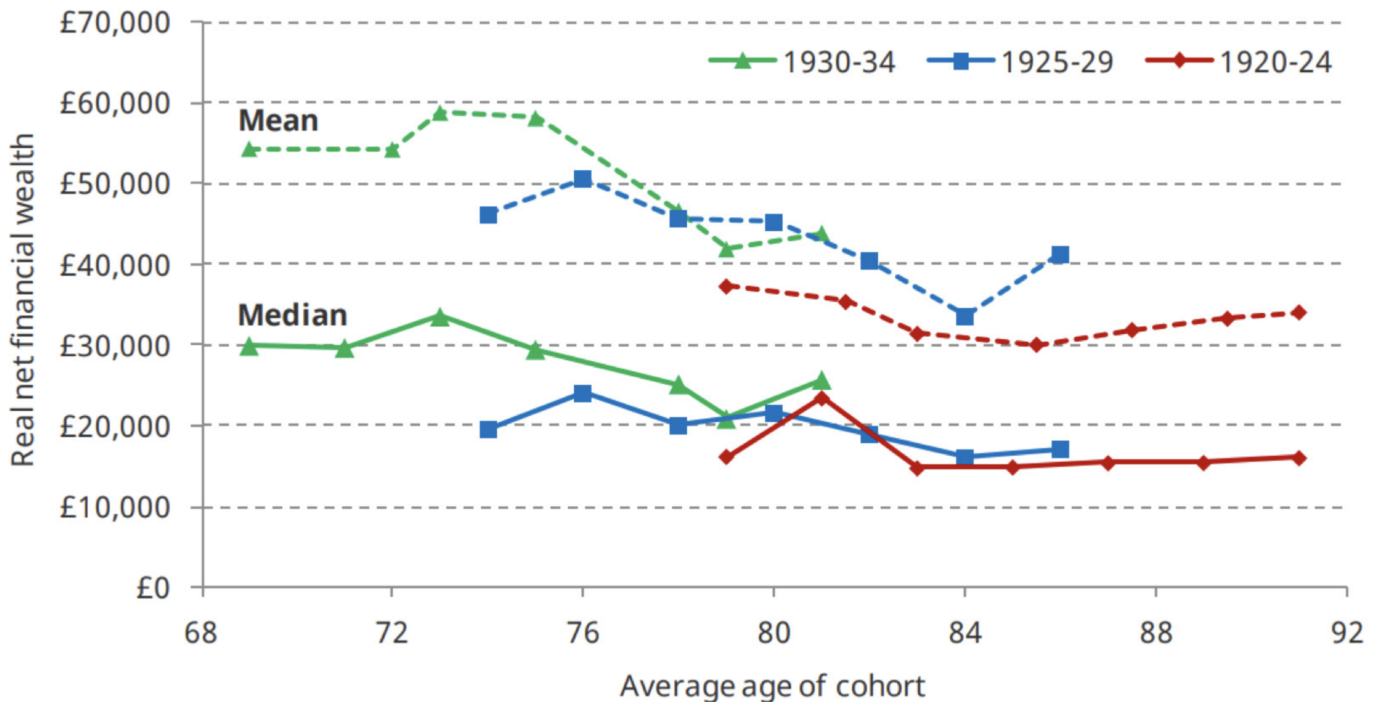
When Pension Freedom was introduced some 6 years ago, politicians and industry commentators feared that retirees would blow their retirement savings with little regard for their future needs. The media whipped up a frenzy about retirees splashing out on Lamborghinis and cruises, only to fall back on state benefits. If only someone had bothered to look at the data on how wealth tends to change during retirement, they would have saved us all the pointless aggravation.

Thanks to recent research[v] by the IFS, it appears that people are doing the exact opposite of what the industry feared. They are in fact spending too conservatively in retirement. The study looked at how property and non-pension-financial assets (savings, investments, etc.) are drawn down within three cohorts of retires aged between 69 to 91 over the 12-year period between 2002 and 2015.

Median real net financial assets declined by 14% for the youngest cohort born between 1930-34, by 13% for the next cohort born between 1925-29, and by 1% for the oldest cohort between 1920 -24.



Rowena Crawford, the author of the brilliant report noted that, 'assuming that the rate of drawdown at a given age does not differ between generations, this observed behaviour suggests that, on average, real net financial wealth is drawn down by (at most) 17% between ages 70 and 80, and 31% between ages 70 and 90. This is significantly slower than the decline in remaining life expectancy between these ages. **The Office for National Statistics projections indicate that expected remaining life declines by 75% between ages 70 and 90 for both men and women.** This suggests that, unless there are large costs at the end of life (and Section 5 will show that for many that is not the case), the majority of financial wealth among those currently retired is set to be bequeathed rather than used to finance retirement spending.'



Of course, those who are retiring today may have a somewhat different spending pattern than the generations before them, due to the fact DB pensions will form a smaller part of their income, compared to the previous generations. And this gap is only going to widen. Nonetheless, the research provides important insights into how spending patterns change during retirement.

The implications of this are that the current spending rate would leave retirees with nearly 70% of their real financial wealth by the age of 90! And that's excluding property, which is generally by far the largest constituent of a person's assets.

Care and end-of-life costs

One important aspect of retirement expenditure is how financial wealth changes in later life. The report shows that from age 84 to 91, median financial assets remained fairly level. This again contradicts the aforementioned U-shape theory or J-shaped spending pattern in retirement. There is just no sign of a sporadic rise in living costs in later life for most people.

The author notes, 'the EoL[i] (End of Life) data suggest that in England there are not such large expenses on average. Just 6% of individuals faced some out-of-pocket costs for medical treatment outside the NHS in the last year of life. We do not have data explicitly on social care expenses, but the EoL data do tell us that only around 7% of individuals received assistance with daily activities from a privately paid employee in the run-up to death. Some 21% did stay in a nursing or residential home in the last two years of their life (32% of these stayed for six months or more), but not all of these individuals would have paid for this care privately. The majority of individuals (82%) did not have full insurance for funeral costs, but the median out-of-pocket cost for funeral expenses was only £1,700 in 2002–03 (though this is increasing over time).'

Plainly speaking, the worrying spectre of unmanageable care costs are somewhat of a bogeyman.

For those who do end up needing to fund care, property wealth remains a valid source of funding. The paper shows that over a third of homeowners at age 50 would willingly move by age 70, and over half would move by age 90, which granted is an above-average life span. However, within the study group, a small number of people stated financial reasons as the sole motivation to move. Adding to this, only one in five retirees end up selling their homes before age 90, without buying another one. For those aged 80 and over, an average (median) of £49,000 is released in the process of downsizing.

So what?

The more cynical reader might think, 'so retirees spending less as they get older, big deal?'. The substantive point here however, is that spending too little is as big of a problem as spending too much. We need to provide adequate guidance to enable people to spend both comfortably and confidently in retirement. As Bob Dannhauser, CFA insightfully noted:

'retirement portfolios can fail us in two ways: living cautiously might "leave too much on the table" when our money outlasts us, but spending too much can mean running out of money before we run out of life.'

Financial advisers and product providers will play a crucial role in helping people to establish a withdrawal framework that is not only sustainable but also provides the maximum level of sustainable spending. This framework needs to take account of how a person's expenditure is likely to change during their lifetime. It also needs to account for extraordinary individuals with non-conventional spending patterns.

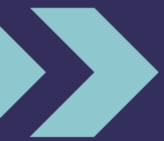
Understandably, this is no easy task, but the traditional withdrawal rate framework that assumes that withdrawal will increase in line with inflation through the retirement period needs to change.

Instead, the assumption should be that spending will fall by between 1 to 2% a year in real terms throughout retirement. This may also have implications for retirement product illustrations and financial planning services.

Regulators and policymakers should be interested in how retirement expenditure changes because this will inform evidence-based policy-making around sustainability of retirement income. Some regulatory changes might be required to ensure that retirement income product illustrations are suitable. More generally, the government should be interested in ensuring that retirees spend the freely and safely during retirement, not only to maximise tax take but also to boost spending within the economy.

The implications for retirees are that they can afford to spend more in the early part of retirement in full knowledge that their expenditure will fall as they get older. Some retirees may realise that they can afford to retire on less of a pension pot than previously thought. The end result of doing so will ultimately be greater happiness and confidence for retirees!

For years, the industry has indoctrinated retirees into thinking that their costs of living in later will go through the roof. However, life is for living and retirees need to bear in mind when planning for retirement that you can't take your money with you when you go.



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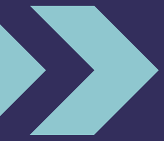

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