Morningstar Research Examines Retirement Costs

- Though a rule of thumb exists that individuals should plan on spending 70% - 80% of their preretirement annual income in retirement, COMPASS prepares customized retirement planning analyses for clients that incorporate their individual circumstances, including whether they plan to relocate to another state during their retirement.

Morningstar Investment Management published new research in December that examines the most common assumptions used to estimate retirement needs and lays out a framework for investors to take a more personalized approach to setting retirement savings goals.

"There are three common assumptions that many software tools and financial advisors use to come up with a retirement savings goal—a 70 or 80 percent replacement rate based on pre-retirement income, an income need that rises with inflation, and a 30-year retirement time horizon," David Blanchett, head of retirement research for Morningstar Investment Management, said. "When we looked at actual retiree spending patterns and life expectancy, however, we found that these assumptions don't hold true for many people and, on average, can significantly overestimate how much people will actually need to fund their retirement."

Many expenses disappear after retirement, such as Medicare taxes, Social Security taxes, and retirement savings. The paper first demonstrates the effect on replacement rate calculations of accounting for taxable and non-taxable expenses that are no longer paid after retirement. Next, using government data, the analysis explores the actual spending patterns of retirees, and finds that they grow at a rate lower than inflation through most of retirement and then accelerate in later years because of higher health care costs. While the difference between the actual spending growth rate and the inflation rate is relatively small, it has a material effect over time. When the researchers modeled actual spending patterns over a couple's life expectancy, rather than a fixed 30-year period, the data showed that many retirees may need approximately 20% less in savings than the common assumptions would indicate.

Results from this research show the actual replacement rate is likely to vary considerably by retiree household, from under 54% to over 87%. Retiree expenditures do not, on average, increase each year by inflation or by some otherwise static percentage; the actual "spending curve" of a retiree household varies by total consumption and funding level. Specifically, households with lower levels of consumption and higher funding ratios tend to increase spending through the retirement period and households with higher levels of consumption but relatively lower funding ratios tend to decrease spending through the retirement period. When consumption and funding levels are combined and correctly modeled, the true cost of retirement is highly personalized based on each household's unique facts and circum¬stances, and is likely to be lower than amounts determined using more traditional models.

"While a replacement rate between 70 and 80 percent may be a reasonable starting place for many households, we find that the actual replacement rate can vary considerably," Blanchett continued. "Take, for example, a high-income couple, living in a high income tax state like California, and saving a significant amount for retirement each year. If that couple retires in Florida or Texas, where there is no income tax, the replacement rate might be closer to 60 percent. By contrast, a low-income couple saving very little for retirement and retiring in California could have a replacement around 85 percent. It's important for investors to consider their level of pre-retirement household income, expenses that discontinue after retirement, and post-retirement taxation."

These findings have important implications for retirees, especially when estimating the amount that must be saved to fund retirement. A more advanced perspective on retiree spending needs can significantly change the estimate of the true cost of retirement.

Source: David Blanchett, CFA, CFP, Head of Retirement Research, Morningstar Investment Management: Estimating the True Cost of Retirement, Working Paper, Nov. 5, 2013.