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How much will you spend in retirement? | 2 April 2018

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We believe investors can improve how they plan for future expenditures.

- Focus on expected expenses instead of income replacement.
- Do not assume expenses will always systematically increase by inflation.
- Utilize an age-banding approach based on phases of retirement.
- Pay particular attention to the impact of healthcare expenses throughout retirement and long-term care expenses in the second half of retirement.

When planning for retirement spending, one popular approach is to calculate an "income replacement rate" to estimate expenses at the start of retirement and then assume that spending will increase by inflation for the duration of retirement. The replacement rate approach, while useful as a first approximation, in our view, can be improved upon during the retirement planning process. In this report, we discuss why retirement spending doesn't follow a straight-line path, some of the major uncertainties associated with forecasting spending in retirement, and ways to use age-bands to improve spending estimates.

The problem with replacement rates

Income replacement rates are fairly straightforward conceptually. Once you retire, there are some expenses that decrease or disappear entirely, like taxes and saving for retirement. Because you no longer have these expenses, you don't need to replace all of your income to maintain the same standard of living. For instance, if you save 10% of your pre-retirement income and pay 20% in taxes, you might only need to replace 70-75% of your preretirement income (depending on your tax rate in retirement) to maintain the same standard of living after retirement.

There are many studies available that look at estimated replacement rates. They generally find that higher-income households have lower replacement rates (since they have higher tax burdens that will decline in retirement and also tend to save a higher percentage of income), but that replacement rates level out as income increases. One of the most popular replacement rate studies, Aon Consulting's Replacement Ratio Study[1], found typical replacement rates range between 76-94%, depending on a range of demographic and income criteria.

Replacement rates are a reasonable initial approximation of retirement income needs, but shouldn't be a primary planning tool for any household. Since replacement rates are generalizations based on averages for retirees, they are too imprecise to be useful for any particular household. Small differences between your particular situation and the "average" replacement rate could have significant long term implications for your retirement plan. Current income is also a poor guide for future spending, since the composition of how we spend changes at and throughout retirement.

What do retirees spend their money on?

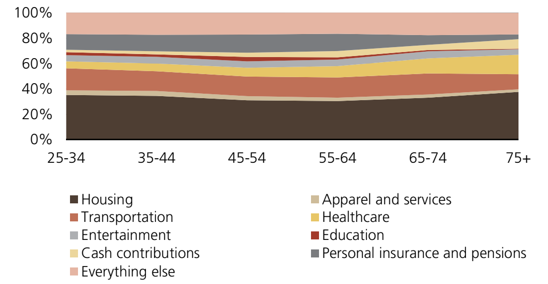
There are three important factors to think about in regards to how you will spend in retirement. First, the composition of your spending will usually change over time. Second, the volume of spending that you do will likely decline in inflation-adjusted terms. Finally, expenses associated with long term care have a significant impact on spending once you are in your mid-80s.

The Bureau of Labor Statistics' (BLS) Consumer Expenditures Survey provides helpful insight into how the composition of our spending will likely change in retirement. We've simplified the BLS data into nine categories across six age groups (Fig. 1) that allows us to see general trends across the life cycle. Focusing in on pre-retirement (age 55-64) versus post-retirement spending (Fig. 2) makes it clear that that are some dominant trends: housing and healthcare make up an increasingly large percentage of households spending, whereas spending on personal insurance and pensions declines substantially post-retirement.

The picture for other categories is a bit more muddled and makes a case for a "phased" view of retirement. Transportation increases as a percentage of overall spending for the 65-74 age band before declining in the 75+ age band. The same pattern holds for entertainment. Cash contributions, defined by the BLS as " cash contributed to persons or organizations outside the consumer unit, including alimony and child support payments; care of students away from home; and contributions to religious, educational, charitable, or political organizations[2]", appear to decrease before increasing significantly as a percentage of overall expenditures.

Fig 1: We consume less education and more healthcare as we age

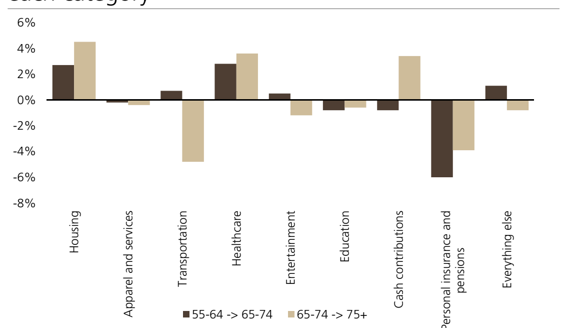
Expenditures as percentage of overall spending



Source: Bureau of Labor Statistics, UBS

Fig. 2: Expenditures evolve throughout retirement

Change in percentage of consumption dedicated to each category



Source: Bureau of Labor Statistics, UBS

As the composition of spending shifts, the total volume of spending changes as well. Using data from the Consumer Expenditures Survey along with the RAND Health and Retirement Study, research at Morningstar[3] found that retirement spending follows more of a "smile" pattern, with spending decreasing in real terms by about 1% per year and then increasing again later in retirement (Fig 3). This data generally refutes the notion that spending will increase along with inflation throughout retirement.

Healthcare and long term care costs, of course, represent major reason for increased spending once we reach our mid-80s, but there's a lot less certainty around the magnitude and timing of those expenditures than expenses earlier in retirement (Fig. 4). Our report, "Long term care: What to do now[4]," found that while a healthy 65-year old couple has an 85% chance of using some type of long term care, expenses will range significantly. The breakdown shows 64% of couples will spend more than USD 100,000, 25% will spend more than USD 500,000, and about 10% will incur expenses above USD 1 million.

Using retirement phases to improve estimates of future expenses

The UBS Investor Watch report "80 is the new 60" found that investors expect to go through three distinct phases of retirement, which were categorized as (1) Transition: Still working, but in a reduced or different capacity, (2) My Time: a period focused on travel and leisure, and (3) The Last Waltz: when they will lead a relaxed, simpler life during which health issues will become the focus[5].

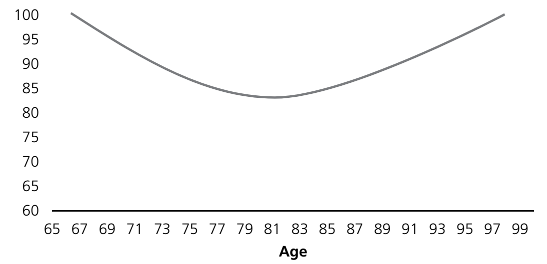
Other research has found similar phases to retirement, and the expenditure data discussed earlier provides additional evidence that priorities and lifestyle shift during retirement. By translating phases of retirement into "age bands" investors can integrate retirement phases into their expense planning. Doing so can improve and simplify the planning process while also helping to crystalize goals and objectives at various points in retirement.

For example (Fig. 5), a family might enter the "Transition" stage at 55 and intend to stay in it – spending roughly the same amount of money per year – through age 67. Then at age 68, they begin the "My Time" stage, which would involve higher expenses due to travel and leisure. They also assume that they'll reduce their activity level a little bit less each year as they get older. Finally, their "Last Waltz" stage starts at age 80, at which point they plan to move to a continuing care retirement community (CCRC). They have a reasonable estimate of how much their living and long term care expenses will be at the CCRC, and build in an assumption that those ongoing costs will increase at a rate of inflation+ 2%.

Of course, every family is different. Some retirees don't have a Transition stage. Others might extend shorten or extend "My Time." The details of an expense plan should be specific to every household, but

Fig. 3: The retirement spending "smile"

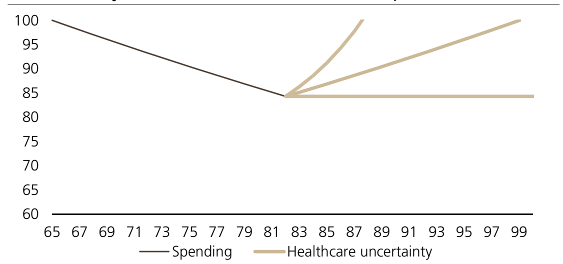
Stylized inflation-adjusted spending path, initial spend USD 100



Source: UBS

Fig. 4: The retirement spending "smile" with healthcare uncertainty

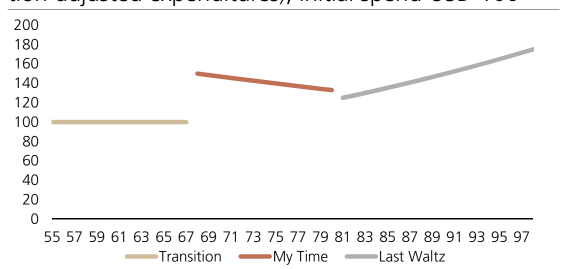
Stylized inflation-adjusted spending path showing uncertainty due to healthcare, initial spend USD100



Source: UBS

Fig. 5: Three phases of retirement for a hypothetical family

Spending shifts across three phases of retirement (inflation-adjusted expenditures), initial spend USD 100



Source: UBS

the retirement phase framework can be useful for everyone as they attempt to add precision to their plan.

In Conclusion: Planning better

Drawing from the research and evidence discussed above, we believe investors can improve how they plan for future expenditures.

1. Focus on expected expenses instead of income replacement.

2. Do not assume expenses will always systematically increase by inflation.

3. Utilize an age-banding approach based on phases of retirement.

4. Pay particular attention to the impact of healthcare expenses throughout retirement and long term care expenses in the second half of retirement.

We believe an approach that incorporates all of these components is likely to provide real benefits when constructing a retirement plan. It's also important to remember that plans are meant to be updated. Families can, and do, change their objectives. The plan provides a basis and starting point for making those changes, and understanding the tradeoffs along the way.

[1]http://www.aon.com/about-aon/intellectual-capital/attachments/human-capital-consulting/RRStudy070308.pdf
[2]https://www.bls.gov/cex/csxgloss.htm#expn
[3]https://corporate.morningstar.com/ib/documents/MethodologyDocuments/ResearchPapers/Blanchett_True-Cost-of-Retirement.pdf
[4]Available at: https://www.ubs.com/us/en/wealth/research/your-wealth-and-life.html
[5]https://www.ubs.com/microsites/ubs-investor-watch/en/home.html

Appendix

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