How Real Retirement Spending Patterns Change Traditional Retirement Withdrawal Strategies

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Nerd's Eye View at KITCES.com

Advancing Knowledge in Financial Planning...

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Retirement Income Planning Approaches

- Simple projections
- Historical analysis
- Monte Carlo

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Simple Projections

- Replacement rate
- Constant real spending
- Straight-line investment growth
- Variation in some spending categories

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Historical Analysis

- Safe Withdrawal Rate (SWR) approach
- Captures historical volatility
- Focuses primarily on distribution
- Project retirement saving/spending annually
- Ignores *earning* and *spending* volatility

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Monte Carlo Simulation

- Incorporates random variables
- Most commonly investment returns
- Probability of success in accumulation and decumulation
- Returns typically assumed to be independent of one another

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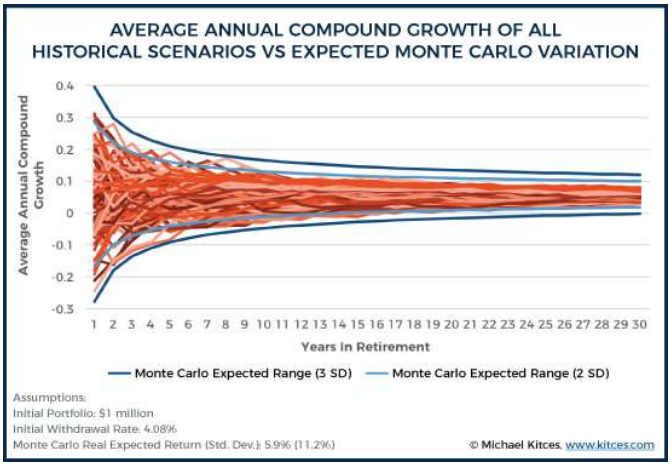

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Traditional Retirement Spending Assumptions

- Fixed rate of annual growth (COLA)
- Ignores spending volatility

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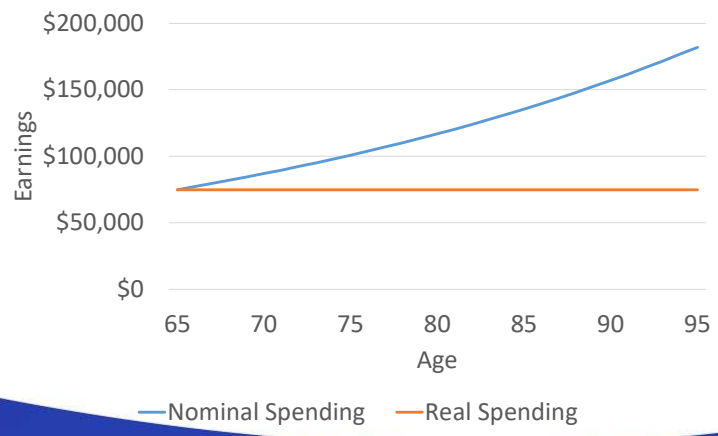
Traditional Retirement Spending Assumptions



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Prior Research: Historical Retirement Spending

- Ty Bernicke (Bernicke & Associates)
  - 2005 study in the *Journal of Financial Planning*
  - Consumer Expenditure Survey
    - Cross-sectional
  - Real retirement spending declines by 15% every 5-years
  - Retiree in late 70s spending less than ½ of what they were spending in late 50s

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Historical Retirement Spending

- Center for Retirement Research (Boston University)
  - Consumer Expenditure Survey
  - Real retirement spending declines by 1% per year
- David Blanchett (Morningstar)
  - RAND Health and Retirement Study
  - Spending rate changes at various rates throughout retirement

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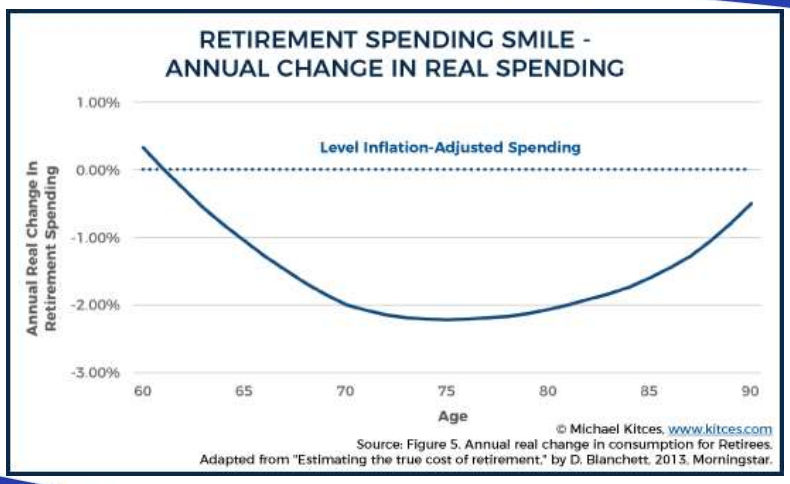

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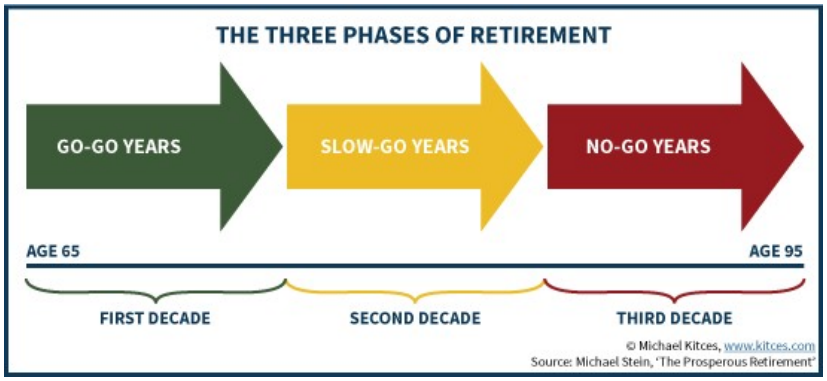

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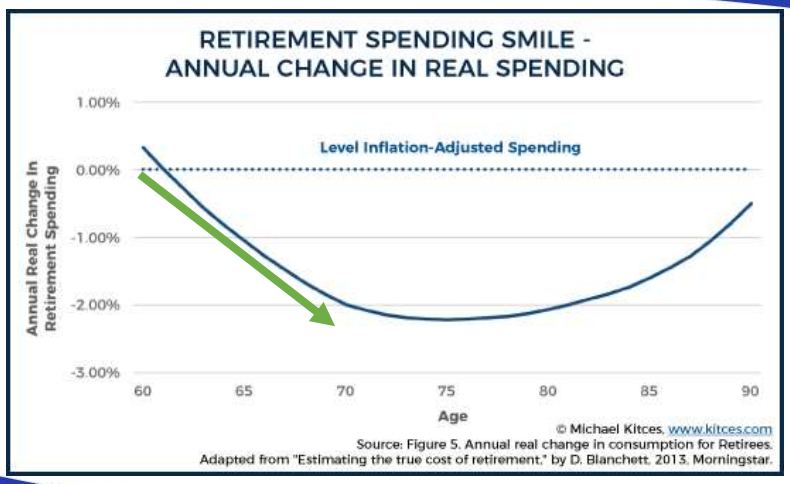

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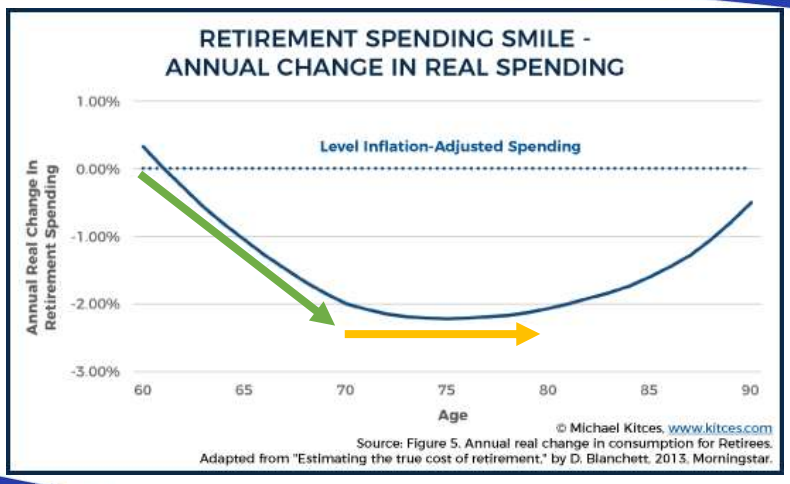

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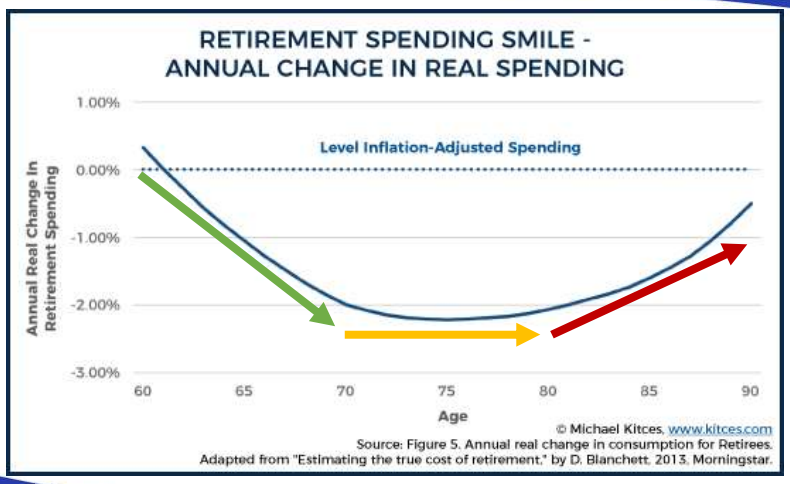

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Client Perceptions of Spending Changes

- Nominal versus real changes
- Declining real spending does not mean declining spending

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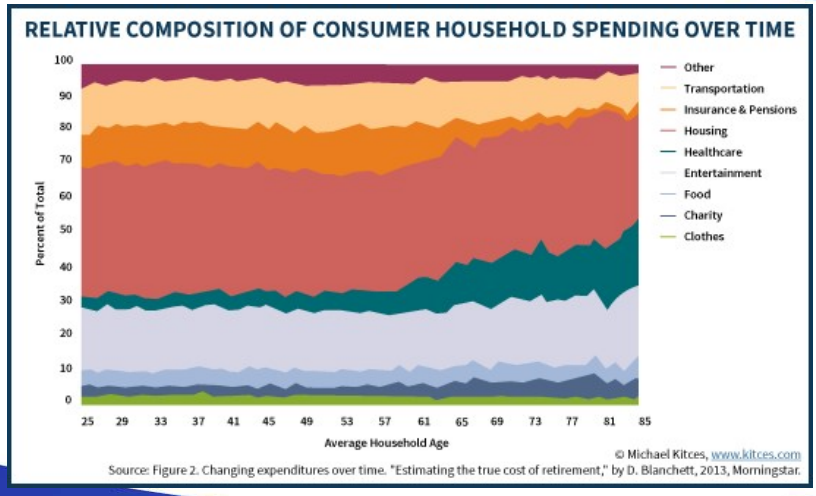

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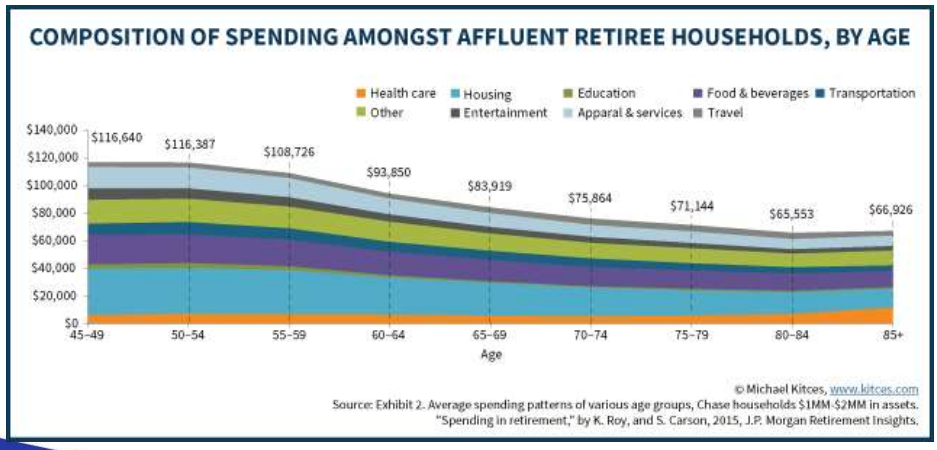

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Retiree Specific Adjustments

- JP Morgan Study
  - 40% of affluent retirees are "foodies"
  - 30% are "homebodies"
  - 5% are globetrotters

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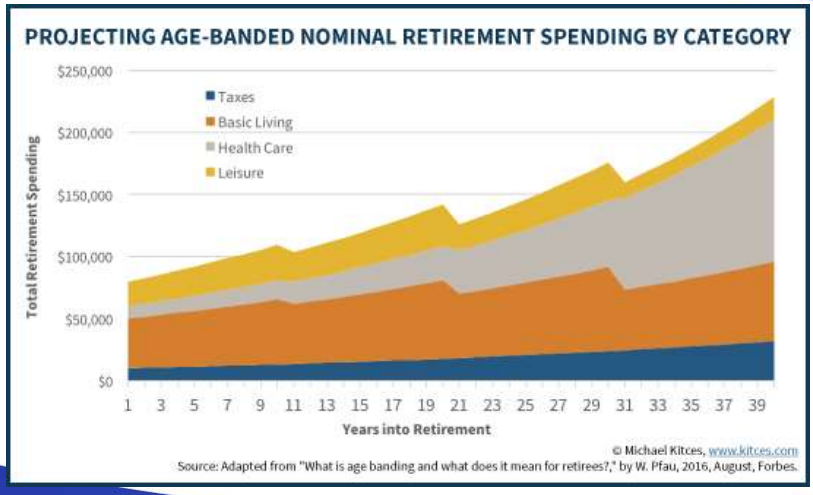

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Analysis: Impact of Realistic Assumptions on Safe Withdrawal Rates

- 30-year retirement horizon
- 60/40 portfolio rebalanced annually

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Analysis: Impact of Realistic Assumptions on Safe Withdrawal Rates

- Four spending patterns:
  - 1% annual real reduction for 30-years
  - 1% annual real reduction (1st decade), 2% annual real reduction (2nd decade), 1% annual real reduction (3rd decade)
  - 10% real reduction after each decade
  - 20% real reduction after first decade, 10% real reduction after the second

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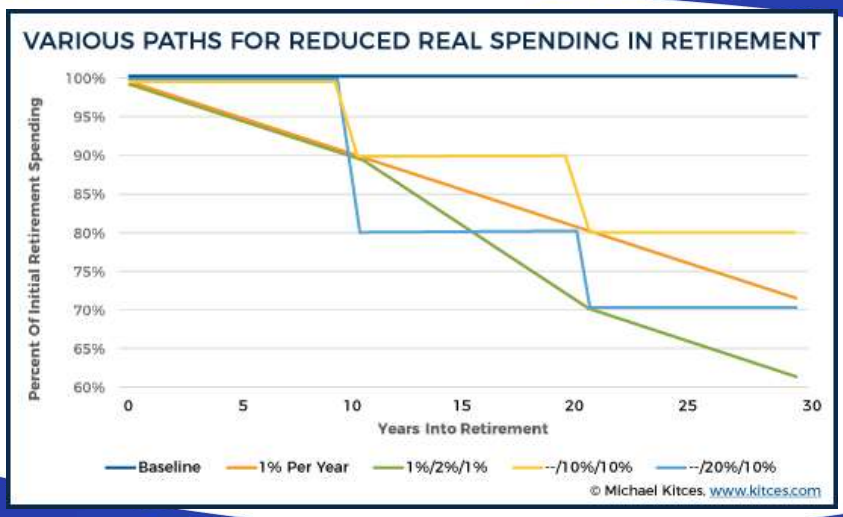

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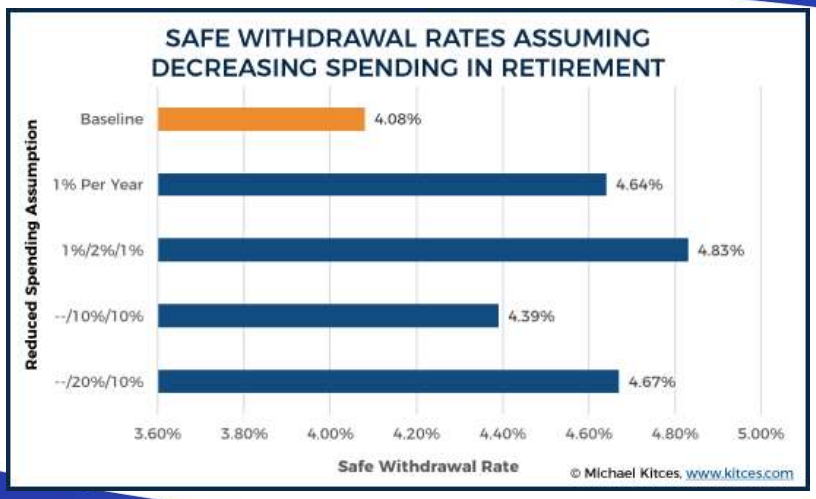

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Overall Impact

- SWR increase of 0.32 percentage points to 0.75 percentage points
- SWR increase of 8% to 18%
- $4,008 per $100k of retirement assets to $4,390 - $4,830 per $100k

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Alternative Approach to Adjusting Spending

- Market driven spending reduction triggers
- Small-but-permanent cuts vs. large-but-temporary

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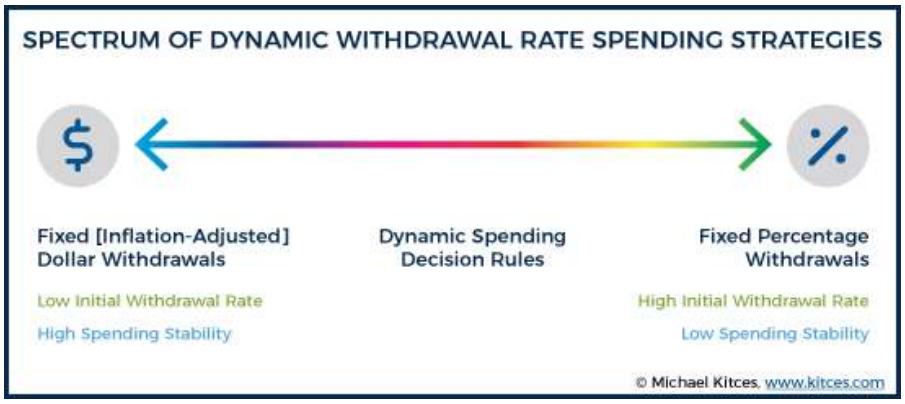

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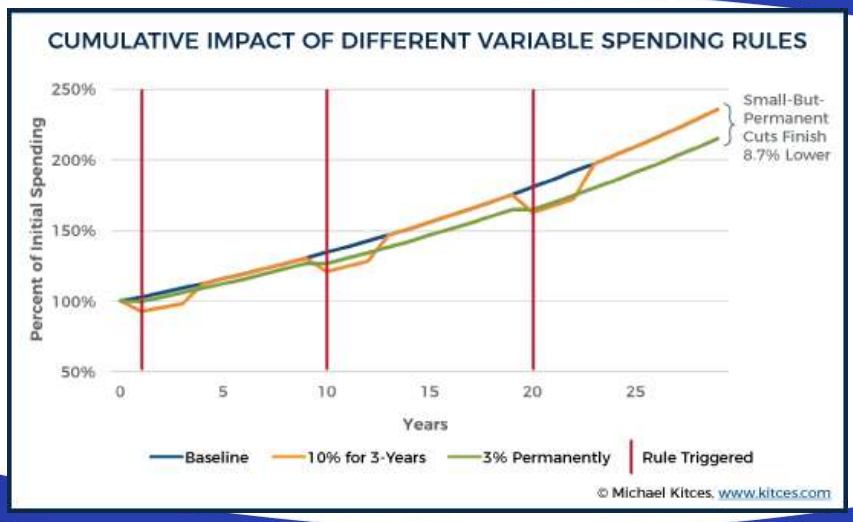

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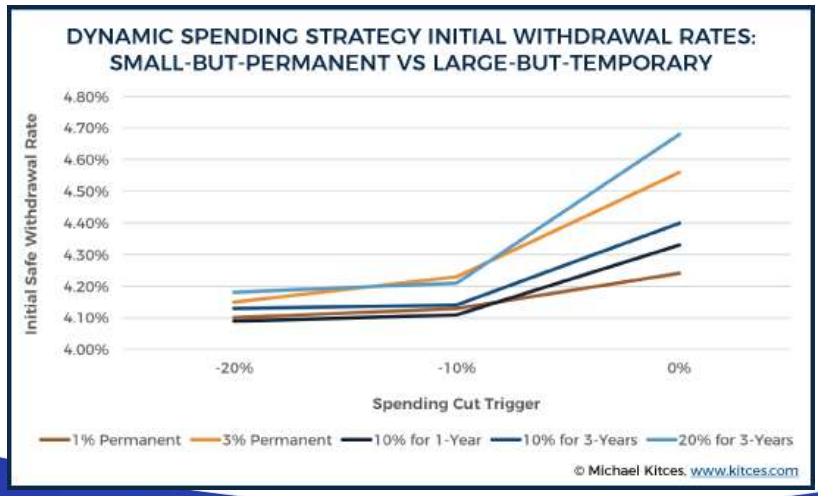

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Dynamic Spending Strategies

- Guyton-Klinger Decision Rules
- Kitces' Ratcheting SWR
- Finke, Pfau, and Williams (2012): Risk tolerant individual may prefer 5-7% withdrawal rate with a guaranteed income of $20k

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A Caution Against "Overfitting"

- Long-term patterns can be insightful
- A client's momentary situation may be capturing too much error/noise

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The Value of Heuristics and Bias

- Sometimes "less is more"
  - Observations are sparse
  - There is significant noise in observations

Total error= $(\text{bias})^2$ + variance + noise

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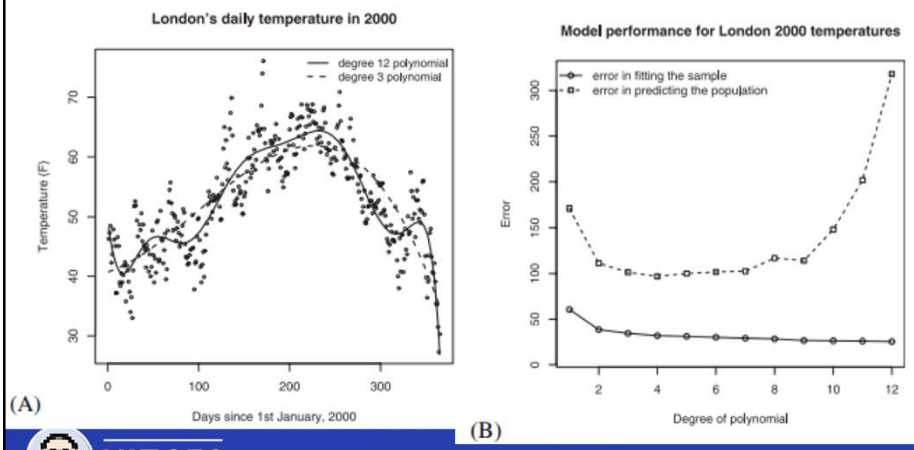

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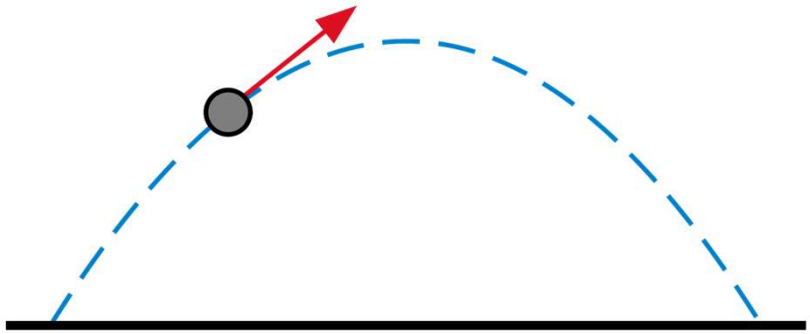

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The Gaze Heuristic

1. Fix your gaze on the ball,
2. start running, and
3. adjust your running speed so that the angle of gaze remains constant

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Catching a ball on an upward trajectory

1. Fix your gaze on the ball,
2. start running,
3. and adjust your running speed so that the image of the ball rises at a constant rate

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Value of Heuristics and Bias

- Sometimes less data/analysis can lead to better decision maker
- Heuristics/bias can allow us to ignore many factors yet still receive an equally (if not better) result

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Key Takeaways and Planning Implications

- Important to consider retirement spending trajectory in any type of analysis
  - Constant real spending is often *not* accurate
  - For affluent clients, tends to overstate retirement income need

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Key Takeaways and Planning Implications

- Opportunity to incorporate client-specific risk preferences
  - Willingness to accept/tolerate some uncertainty:
    - Can lead to higher withdrawal rates
    - Influences ideal allocation

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Key Takeaways and Planning Implications

- Financial planning tools can be lacking
  - Don't just accept the default assumption
  - Can inflate spending at rate lower than inflation
  - Can decrease spending in "chunks"

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Key Takeaways and Planning Implications

- Realistic assumptions can be limiting in many other areas
  - Savings assumptions
  - Income-growth over the lifecycle
  - Allocation
  - Taxes
  - Life expectancy
    - Good example, see Blanchett, Finke, Pfau (2017)

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Key Takeaways and Planning Implications

- Best assumptions are realistic to your client
  - To the extent your client's unique dynamics can be captured, that is often the best route

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Summary

- Real spending through retirement is not flat
- Vary at age/stage of life (and by category)
- Can substantially impact safe withdrawal rates
- Declining spending throughout retirement means that typical assumptions often overstate retirement savings need

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