Retirement Focus

How to Avoid Overspending in Retirement

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Introduction

With the recent challenges in the U.S. economy, particularly in the housing and financial sectors, many pre-retirees are concerned their nest eggs won't be enough to maintain a comfortable retirement.

Despite that concern, many Americans within sight of retirement have expectations that don't match their actions or reality.

- 43 percent of Americans have less than $10,000 saved for retirement.[1]
- 59 percent expect to receive a pension but only 41 percent can actually identify a pension to which they are entitled.[2]
- Pre-retirees (age 50-59) expect to live about 21 years after retirement and plan to spend almost 10 percent of their savings in each of those years.[3]
- 80 percent expect their standard of living to rise in retirement.[4]
- 47 percent of retirees have a written withdrawal plan and only 28 percent have a written budget for spending during retirement. [5]
- 49 percent of Americans are somewhat or very confident they have enough money to live comfortably throughout their retirement years.[6]

While you're still working, your incoming salary or wages may help you recover from market declines or other setbacks to your retirement portfolio. By the same token, substantial job income can camouflage overspending during your working years. During retirement, when new dollars from a job have stopped coming in, you may find that your retirement portfolio cannot produce an income equal to your pre-retirement earnings power. You may be living according to a budget for the first time in your life.

The purpose of retirement income distribution planning is to help retirees spread their nest egg across their retirement years. Uncontrolled spending can threaten those plans, with significant consequences such as selling your home or taking other drastic steps to survive.

Past Behavior Predicts Future Behavior

Americans tend to "want it all and want it now," according to Dan Moisand in his article "The Retirement Spending Debate."[7] "Juxtaposed with the fear of outliving one's assets is a concern about never getting to enjoy one's assets."

Patterns of spending beyond your means, however, typically manifest long before retirement. Failure to address those tendencies may not become apparent until retirement, when your cash flow from salary or wages can no longer mask the problem.

"People may get by during their working years based on their earning power. There's always that next paycheck coming in," said Sharla Jessop, financial advisor with Smedley Financial Services Inc. "During retirement, when they are limited to the budget their distribution plan can support, they may have difficulty adjusting and be prone to periods of overspending."

Spending patterns before retirement also can lead us to be comfortable with carrying debt. A survey by CESI Debt Solutions found that almost two in five Americans admit to accumulating credit card debt during retirement – and are not concerned about paying it off before they die.[8]

As part of retirement income planning, you will need to distinguish between core expenses and non-essential expenses – or more simply, needs versus wants.[9] While many people may understand the difference on an intellectual level, the presumably positive emotions they experience when they spend can make it difficult to maintain self-discipline.

"Because all clients are human beings, by definition they are both logical and emotional," said Fritz Brauner, financial advisor with The Brauner Company. "Dealing with the logical side is relatively easy. It's the emotional, psychological and behavioral side that often presents a challenge."

Not all overspending has its roots in an emotional or psychological need. In some cases, it may be a lack of learning a skill set that becomes necessary in retirement.

"Overspending can happen for a variety of reasons, and we shouldn't think the problem will be limited to those lacking impulse control and self discipline," said financial advisor Sharla Jessop. "Many of our clients always made good money during their careers and as a result saved a lot of money during their accumulation years. This doesn't mean they have ever lived on a budget, something that will be critical to success during their retirement, when their ability to work and earn extra money to offset excessive spending may no longer be a possibility."

If overspending threatens your retirement, you have three basic choices: 1) compromise on retirement goals, 2) work longer or 3) stop overspending. Because years of overspending may make it difficult to entirely curb those habits, you may need to use a combination of these approaches. You may also need help from a financial professional.

Choice #1: Adjust Retirement Goals & Expectations

Stephen L. Deschenes labeled the effect of uncontrolled discretionary spending during retirement as lifestyle risk. "Lifestyle risk relates to how most people want to enjoy certain hobbies and activities during retirement but may have to cut back their standard of living because they haven't adequately planned for the income needed to support their desired lifestyle. Sun Life's Unretirement Index found lifestyle risk to be a real concern for a lot of individuals. Eighty percent of those people who plan to work at the age of 67 stated it was to earn enough money to live well."[10]

When one of Brauner's clients, following significant drops in his IRA balance in 2000-2002 and again in 2007-2009, refused to lower withdrawals or increase income to avoid the possibility of running out of money, he told Brauner, "When I retired from the phone company, I promised myself I would never work again."

"He had decided that working again once he had retired was something he was never going to do, no matter how dire the situation," Brauner said.

A retiree who moved from California to Florida told Brauner, "If you live in Florida, you have to have a boat." The client bought an expensive boat, which came with higher expenses and less income. When gas prices soared some years later, he couldn't afford to use the boat and tried to sell it – but couldn't, because other boaters were facing the same dilemma over gas prices. The client realized too late the need to adjust his retirement expectations – owning a boat – in accordance with the spending rate his retirement distribution plan could support.

Like any skill, living within a spending plan takes practice for those who have never done it before. Financial advisor Patricia Laramore, owner of Premier Investment Advisory Services Inc., uses what she calls a "prenuptial." She helps pre-retirees create a budget and live within it for several months before they retire. By testing the spending plan for several months before retirement, the individual and the advisor get an idea of how realistic the spending plan will be during retirement.

"We ask them to organize six months of expenses and to create a budget based on a certain withdrawal rate from their current retirement savings," Laramore said. "We have them pledge to abide by the budget for the three months, and if they can, then they can actively consider retirement. At the end of three months, most of them say, 'What was I thinking? I can't retire yet.'"

The ability to track income and expenses and balance the two to the greatest benefit seems to be a skill set that has eluded many adults approaching retirement. Longevity trends, however, demand a more conscientious approach to retirement spending. If the word "budget" makes you uncomfortable, think of it as a "written spending plan" or "formal spending policy" that describes a thoughtful approach to expenses and spending expectations.

Creating a Spending Plan

In the article, "Pre-planning Advice," author Pamela Christensen lists four steps for preparing a budget: gathering information, tracking expenditures, developing and documenting the budget, and creating a follow-up plan.[11] While many professionals start with a monthly spending plan, starting with an annual budget may be more effective. According to U.S. News & World Report,[12] a study of college students showed they underestimated monthly expenses by 40 percent but overestimated their annual expenses by 30 percent – meaning their annual budget proved more accurate and conservative than their monthly budget.

Most processes for creating a spending plan include writing down each expenditure. A higher-tech option is to use only a debit card for one month, then use your bank's account management platform or an account aggregation website to categorize and total expenses. Another approach is to set as many bills as possible on autopay from your bank account. Then put aside a set amount of cash, divided per week or per month, to use for discretionary expenses. Receipts from those expenses go in the envelope, helping you visualize the exchange of cash for those expenses.

As the study of college students suggests, a single month's worth of expense tracking may not provide enough information to address overspending issues. For emotional overspenders, keeping a diary or journal in conjunction with tracking spending can help identify situations or feelings that trigger overspending. Developing a realistic spending plan, therefore, may require several months.

Just as a sound weight loss plan doesn't encourage fasting or completely cutting favorite foods from the start, a spending reduction plan may be most successful when undertaken gradually. Try choosing a certain type of expense to reduce or eliminate, like going from a cappuccino every day to once or twice a week, or setting a dollar amount, which works well with the discretionary cash envelope method described above. As you maintain your spending plan, you can use the extra money to make regular deposits to your savings or investment accounts.

Choice #2: Work Longer

If you find your retirement savings can't support your spending levels, you may decide to delay retirement. Laramore's "prenuptial budget" exercise typically results in her clients deciding to work longer and making more conscious decisions about their spending.

"It begins to move them emotionally and mentally to be content in retirement," she said. "Until the amount of money available for expenses can create contentment, they aren't ready to retire."

Viewing returning to work as the "safety net" if retirement funds become uncomfortably low may be unrealistic, particularly given today's employment market, Laramore said.

"We work with employees of large companies, who may have taken a large early retirement package," she said. "Many of them were highly compensated and highly skilled, and they view it as an entitlement to take a year or so off before going back to work. When they are ready to work again, they find they got attached to the income they made as a full-time employee of a major corporation. They are shocked at what part-time jobs pay. It's almost an affront to their ego."

Planning to work longer rather than curb spending has its risks. According to the Social Security Administration, three in 10 workers will experience, before they are ready to retire, a disability that prevents them from working. Even a temporary disability can have a dramatic impact on a retirement distribution plan: a study by Northwestern Mutual found that a 50 year old forced out of work for two years due to a disability could experience a 30 percent reduction in asset accumulation by age 65.[13]

Social Security Disability (SSD), which allows a person to begin receiving their retirement benefits before full retirement age, will likely not provide an adequate safety net – if you can even qualify. About 75 percent of SSD applicants are denied initially, and of those who appeal, about 90 percent of first stage appeals are denied.[14]

To mitigate the risk that disability will reduce or eliminate your ability to work as long as you hope, consider purchasing disability insurance or review the terms of your existing policy. The number of years you have until your target retirement date and your current accumulated retirement assets may affect the amount of disability coverage needed. Although many employers offer disability coverage to employees based on a percentage of the employee's salary, you may need more coverage to offset 1) the loss of income for immediate living expenses, 2) the loss of money that would have been invested for retirement and 3) the depletion of current retirement savings to cover unforeseen expenses related to the disability.

Just as accumulation, distribution and spending should be part of your comprehensive retirement plan, if you expect to work longer you need a plan for making that happen. In the 2011 Retirement Confidence Survey, conducted by the Employee Benefit Research Institute, about 45 percent of retirees said they retired sooner than expected; of those, 63 percent did so because of a health problem or disability and another 23 percent because their employer downsized or closed. To reduce that risk, you may want to address these key areas:

1. Health and Wellness: A basic checkup, if not done recently, can help you realistically assess your physical ability to continue working. Changes to nutrition and exercise may be in order, along with management of conditions such as high blood pressure or borderline diabetes.
2. Career Management: As the retirement horizon moves closer, you may be inclined to coast on your past achievements or job skills. If you plan to work longer, keep your skills sharp by learning new technology and keeping abreast of industry trends. Don't wait until the threat of job loss looms to strengthen connections to centers of influence and develop new relationships with younger influencers.
3. Part-Time Employment: You may want to explore a part-time job or small side business while still working full time. You'll get a realistic view of the types of jobs available and what they pay. In the case of starting a business, mentors to entrepreneurs often suggest getting a structure in place and a toe in the water before quitting the day job.
4. Time-Off Between Jobs: If you have been with your employer many years before taking a large severance or early retirement package, it may be tempting to take a year or two off before getting back into the workforce. Make sure you understand the implications of that long vacation: a gap in employment history, skills becoming outdated and the chance to continue earning while still physically able. In addition, the employment market may change and jobs may be scarce when you are ready to return to work.

Working with your financial advisor to develop a "work longer" plan may help you avoid a forced retirement earlier than you planned.

Choice #3: Stop Overspending

If you suspect your overspending may have deeper roots, understanding these issues and seeking guidance from a financial advisor or mental health professional may help you begin taking control of your spending.[15] Individuals addicted to spending may experience the same challenges in attempting to change their behavior as those struggling with substance addictions: denial, ambivalence, preparation, action, maintenance and relapse.

Brauner cited one client who, after the market declines, faced running out of money well before her life expectancy but resisted reducing her monthly IRA withdrawals. The client finally said to Brauner, "So what you are saying is that I am taking a 'stick-your-head-in-the-sand' approach to my finances."

"The good news," Brauner said, "is that at least she recognized her behavior for what it was."

Work with your financial advisor to prepare an action plan, which may include developing your budget skills or speaking to a counselor about what may be driving your overspending. Think through additional actions if life events – such as a marriage, divorce or death – occur that could potentially derail your progress. Be prepared for possible relapses into old spending behaviors and, when they happen, talk to your advisor immediately about what caused the relapse and how to get back on track.

If you are already retired, ask your advisor to prepare a "summary of distributions" showing all your retirement withdrawals, with the unplanned distributions in red. Having a visual depiction of the impact of your overspending may help you understand how far you have deviated from your plan.

Conclusion

If you fear that overspending may threaten – or is already threatening – the longevity of your retirement distribution plan, you may be able to regain control by working with your financial advisor to adjust your retirement goals, increase your ability to keep working longer or change your overspending behavior.

Making compromises on retirement goals will likely require prioritizing your expenses using a budget or spending plan. Like any skill, creating and living within a budget requires practice, which is best undertaken before retirement. If you consider working longer an alternative to curbing spending, create a plan that optimizes your potential to continue working as long as you need to avoid outliving your retirement funds. Your plan should address managing your health, continuing career development and exploring part-time employment or business ownership.

Because overspending can severely threaten your retirement distribution plan, it's never too early to start examining your spending, developing your budgeting skills and addressing any underlying emotional issues. Your financial advisor can help with resources, tools and support to help keep you on track.

(Endnotes)

1 *43% Have Less Than $10,000 for Retirement," CNNMoney.com*

2 *Salsbury, Gregory, Retirementology – Rethinking the American Dream in a New Economy, 2010, pp 17-18*

3 *2009 Retirement Fitness Survey, conducted by Richard Day Research on behalf of Wells Fargo. Those interviewed – pre-retirees ages 50-59 and young retirees ages 55-70 – had at least $100,000 in household investable assets excluding real estate.*

4 *Salsbury, Gregory, Retirementology – Rethinking the American Dream in a New Economy, 2010, pp 17-18*

5 *2008 Wachovia Retirement Survey of 2,100 respondents age 55-70 with household assets of $75,000 excluding real estate holdings*

6 *Employee Benefits Research Institute 2011 Retirement Confidence Survey*

7 *"The Retirement Spending Debate," Dan Moisand, Financial Advisor, April 19, 2011.*

8 *"Dying with Debt: A Dirty Little Retirement Secret," Cindy Perman, CNBC.com, Nov. 22, 2010.*

9 *"What is Retirement Income Success?" Stephen L. Deschenes, Life & Health Advisor, April 8, 2011.*

10 *"What is Retirement Income Success?" Stephen L. Deschenes, Life & Health Advisor, April 8, 2011.*

11 *"Pre-Planning Advice," Pamela Christensen, Financial Planning, June 1, 2011.*

12 *"12 Money Mistakes You're Probably Making," U.S. News & World Report, Dec. 9, 2010.*

13 *"Retirement Planning and Disability," Jennie L. Phipps, Bankrate.com, Sept. 17, 2010*

14 *"Retirement Planning and Disability," Jennie L. Phipps, Bankrate.com, Sept. 17, 2010*

15 *"Motivating and Helping the Overspending Client: A Stages-of-Change Model," James Grubman, Ph.D.; Kathleen Bollerud, Ed.D.; Cheryl R. Holland, CFP, Journal of Financial Planning, March 2011.*

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