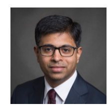
What Aspects Are Important When Planning for Retirement Spending Fluctuations?

Preparing for spending increases could improve likelihood for success in retirement.

KEY INSIGHTS

- Data show that spending generally decreases in retirement, but many retirees could also experience varying spending increases.
- Essential (nondiscretionary) expenses—housing in particular—are the primary sources of spending variability in retirement, but this tends to vary with income.
- Maintaining sufficient liquid assets, while continuing to invest for growth, could help retirees adjust to spending fluctuations and bolster retirement outcomes.



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During retirement years, retirees are likely to experience both increases and decreases (i.e., fluctuations) in their spending levels. Being prepared to adjust to such variability in spending can increase your odds of success in retirement.

While data show that spending generally decreases in retirement, the reality is that many retirees experience meaningful ups and downs in their spending over time, not a steady decline. These fluctuations in spending can have significant implications when evaluating potential retirement income solutions, particularly in determining how much liquidity one should maintain in a portfolio.

Our study analyzed data from the Health and Retirement Study (HRS) and its supplement, the Consumption and Activities Mail Survey (CAMS).[1] We found that, on average, annual household spending declined by about 2% during retirement.[2] But this decrease is not uniform for all retirees.

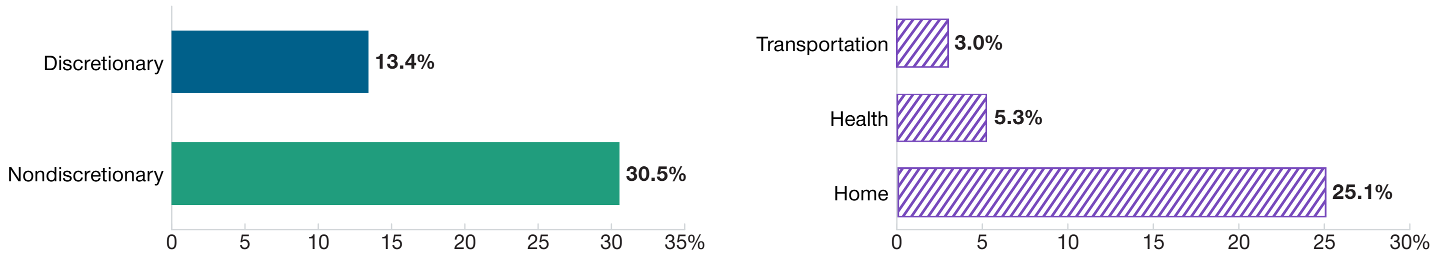
Based on our analysis, there is a considerable risk of experiencing large increases in spending at some point in retirement. Over a two-year period, 1 in 2 retirees (50.1%) experienced a spending increase of 0%–25% between ages 65 and 90. Over 1 in 4 (28%) retiree households experienced a 25%–50% spending increase, and more than 1 in 5 (21.5%) households experienced spending increases between 50% and 100% during retirement.

[1] Both the HRS and the CAMS are biennial studies conducted in even and odd years, respectively, by the Institute for Social Research (ISR) at the University of Michigan. Our study followed a group of 1,306 households from 2005 to 2019 who were present in the 2005 CAMS, were between ages 65 and 90, and have been surveyed in at least 3 consecutive waves of the CAMS. The most recent wave was released in August 2021, with 2019 data being the most recent available at the time of our analysis. Measurement or reporting error is a serious concern for studying volatility of spending, and we impose several restrictions on the sample to mitigate the effect of measurement error.

[2] T. Rowe Price estimates from the HRS (2005–2019). 2019 data were the most recent available data at the time of our analysis.

Spending Variability Was Driven by Nondiscretionary Expenses

(Fig. 1) Variation in annual total spending explained by spending changes in different categories*



Source: ISR, CAMS, 2005–2019. Data analysis by T. Rowe Price.
*We used panel regressions to estimate the variation in total spending that can be explained by different components of spending.

Spending Categories

Discretionary Spending

Trips and vacations; household furnishings and small equipment; charitable and political contributions; cash or gifts to family or friends; dry cleaning and laundry services; home cleaning services; supplies and services for gardening and yard; personal care products and services; tickets to movies, sporting events, and art performances; gym and other sports activities; hobbies and leisure equipment; and dining out and takeout food.

Nondiscretionary (Essential) Spending

Mortgage, rent, utilities, homeowners' or renters' insurance, property taxes, home repairs and maintenance, housekeeping supplies, auto payments, auto insurance, auto maintenance, clothing and apparel, health insurance (including supplemental insurance), prescription and nonprescription medication, health care services, medical supplies, food and beverages (excluding dining out), and gasoline.

Home: Mortgage, rent, utilities, homeowners' or renters' insurance, property taxes, home repairs and maintenance, housekeeping supplies, household furnishings and small equipment, dry cleaning and laundry services, home cleaning services, and supplies and services for gardening and yard.

Health: Health insurance (including supplemental insurance), prescription and nonprescription medication, health care services, and medical supplies.

Transportation: Auto payments, auto insurance, auto maintenance, and gasoline.

Given the range of possible variations in spending increases, the amount of liquid assets retirees should hold in their portfolios to address any potential shortfall will vary. We typically suggest one to two years of your expected living expenses. Generally, it will depend on personal factors such as income, expected expenses, health status, family situation, risk preference, etc.

We found that, although spending levels were highly correlated to investable assets or household income, spending variability was not. In other words, those who have more assets may spend more, but the degree of change in spending was not dependent on the level of assets or income. This means that regardless of your level of investable assets or income, you can face a high level of spending fluctuation in retirement.

Are Spending Increases Temporary?

While an isolated one-time spending increase may be absorbed with minimal

impact, spending upticks that persist for a longer period can cause greater concern and may warrant additional planning. Our analysis showed that a significant proportion of retirees experienced sizable, long-lasting spending increases. For instance, 15% of households that experienced spending increases of 25% or more were still spending at the same elevated level (or higher) after four years.

If substantially increased spending levels persist, retirees may need to reevaluate their investment portfolio and adjust their withdrawal strategy. Lifestyle changes could also be required to meet new spending needs and minimize the risk of depleting their nest egg.

Increased spending on nondiscretionary expenses might require immediate cash. If retirees have insufficient liquid assets to address these needs, they may be forced to take untimely distributions from their longer-term investment portfolios. This, in turn, could lower their chances of enjoying a successful retirement.

Causes of Spending Variability

Generally, some level of spending fluctuation is expected in retirement and may even be desirable. For example, if the variability is due to discretionary spending decisions—such as taking a long-planned trip, making a dream purchase, or donating to a favorite charity—the spending increase would be less of a spending concern. However, it could still have other important implications, as we will discuss later.

On the other hand, if volatility arises from unplanned increases in nondiscretionary, or essential, spending, then it could become a true challenge and a cause of concern.

In our study, a larger share of the variation in total spending for retirees was due to changes in nondiscretionary or essential spending (Figure 1). Overall, categories such as home and home-related expenses accounted for the largest share of the variation, distantly followed by health-related expenses and transportation.

A more interesting story emerged as we examined spending variations across different income groups. While for most retirees—those with annual incomes of less than $150,000—overall spending variability was largely due to changes in nondiscretionary spending, for retirees with income levels above $150,000, the lion's share of variability was due to changes in discretionary spending (Figure 2).

As illustrated, the share of spending fluctuations attributable to changes in discretionary spending increased with income. This implies that the ability to generate higher incomes in retirement likely leads to higher discretionary spending for these retirees—a desirable outcome.

Discretionary Spending Improves Financial Satisfaction

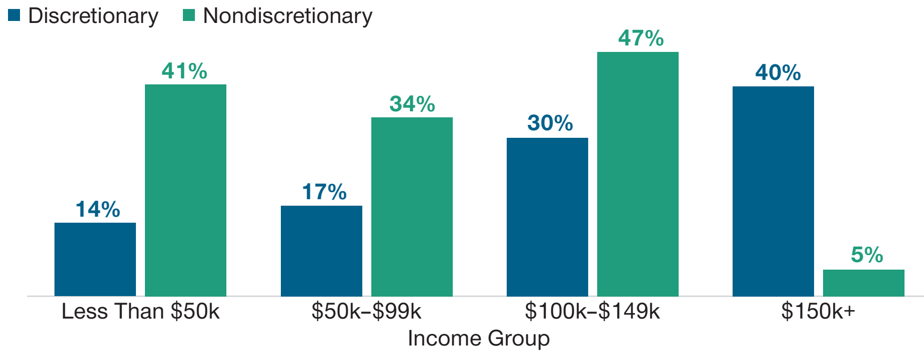
In 2019, the CAMS asked respondents how their level of satisfaction with their financial situation had changed in the past six years. We estimated how retiree spending on discretionary and nondiscretionary items had changed between 2013 and 2019 and how those changes correlated with the reported change in financial satisfaction (Figure 3). We used simple linear probability to test the strength of this correlation.[3]

We found minimal correlation between nondiscretionary spending changes and financial satisfaction. Those who reported that they were "much less satisfied" and those who reported that they were "much more satisfied" both experienced a drop of 5%–7% in nondiscretionary spending between 2013 and 2019.

[3] Correlation measures how one individual group may be related to another. A perfect positive correlation means that the correlation coefficient is exactly 1. This implies that as one variable moves, either up or down, the other variable moves in lockstep, in the same direction. A perfect negative correlation means that two variables move in opposite directions, while a zero correlation implies no relationship at all.

Spending Variability Due to Discretionary Expenses Increased With Income

(Fig. 2) Percentage of overall annual spending variation explained by variation in discretionary and nondiscretionary spending, by income group



Source: ISR, CAMS, 2005–2019. Data analysis by T. Rowe Price.

However, increased satisfaction was associated with higher discretionary spending. Those who were "much less satisfied" in 2019 reported a 32% drop in their discretionary spending, while those who were "much more satisfied" had a 7.4% increase. It can, therefore, be argued that increased discretionary spending is a primary driver of financial contentment.

Prioritizing Basic Financial Objectives

The basic financial objectives we prioritize during the working phase of our lives generally can be divided into three parts: generating income for day-to-day expenses, maintaining liquidity (readily accessible savings for emergencies), and growing savings or assets. These same objectives still apply in retirement. While replacing the income from work will become the primary goal, the other objectives—maintaining liquidity and growing assets—do not disappear.

For retirees, our research suggests that:

Planning for spending fluctuations is key

Sudden large increases in spending on nondiscretionary expenses during retirement would benefit from a sufficient liquid balance that is easily accessible. Untimely distributions from long-term investments could jeopardize your retirement outcome.

Not all volatility is created equal

Fluctuations due to increased spending on discretionary items could lead to higher financial satisfaction. So retirement income solutions that could generate higher income and/or investment returns might help boost discretionary spending and overall fulfillment in retirement.

Housing is the largest contributor to spending variability

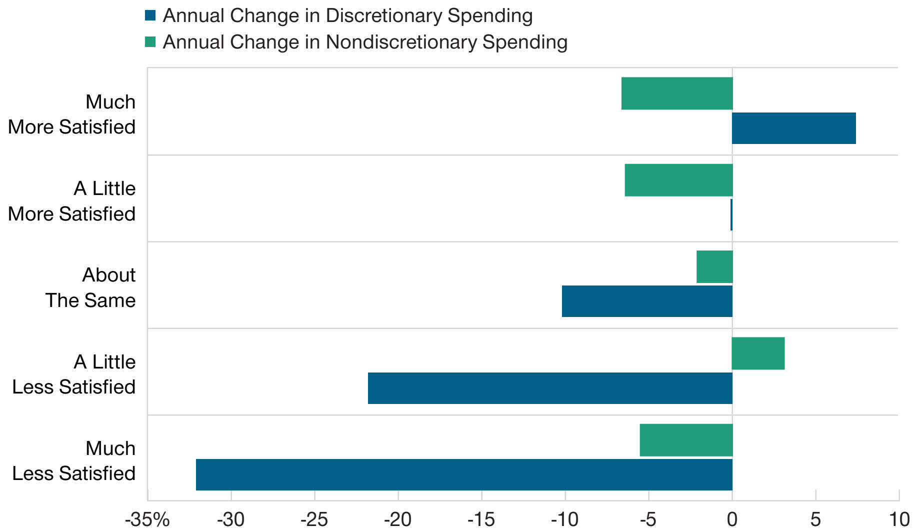
Health care expenses typically dominate our thinking when we consider spending fluctuations in retirement. But data show that housing is both the largest contributor to spending variability and, by far, the largest spending category throughout retirement.[4] Retirees should, therefore, consider strategies that minimize unexpected spending on their homes, such as completing major repairs before retirement, right-sizing their home, or setting up a housing emergency fund.

Maintaining liquidity can help alleviate financial stress during periods of heightened spending. The cash

[4] Consumer Expenditure Survey, Table 1300, 2021.

Increase in Discretionary Spending Was Associated With Higher Financial Satisfaction

(Fig. 3) Relationship between changes in financial satisfaction and discretionary and nondiscretionary spending



Source: ISR, CAMS, 2005–2019. Data analysis by T. Rowe Price.

cushion can be in a savings account or money market account or in short-term investments such as short-term bond funds, short-term certificates of deposit, or tax-free short-term funds.[5] Keep in mind that, unlike bank products, investments in mutual funds are not FDIC-insured and are subject to the loss of principal. At the same time, realizing higher investment returns can increase disposable income to allow for higher discretionary spending, which can, in turn, improve financial satisfaction. The key here is to find the right balance.

Final Thoughts

Spending is personal. Personalized asset allocation strategies that take into account an individual's various assets, unique spending needs, and risk tolerance could help address individualized needs. Allocating retirement savings appropriately and making adjustments to your retirement and/or spending plan along the way can help you enjoy a successful retirement.

[5] Judith Ward, CFP®. "Emergency Fund Planning: How Much Cash Should I Have on Hand?" https://www.troweprice.com/personal-investing/resources/insights/how-much-cash-should-i-have-on-hand.html
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