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Financial Focus

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Smile in Retirement

By Clinton Orr

When planning for retirement one of the most important variables is how much will we spend? Our retirement budget has a considerable influence on our overall retirement plan. Often folks will use a rule of thumb, a common heuristic is 70% of your pre-retirement income is required to maintain your lifestyle in retirement. For example, if I earn $70,000 a year prior to retirement, I will need $49,000 a year in retirement. However, research has shown that unfortunately retirement spending is not that straight forward.

There are numerous studies that show total spending declines in retirement. Two Canadian examples are the 2015 BMO Financial Group study as well as the 2016 Sun Life survey, both of which found that average spending in retirement was less than the amount spent when working. There are US and international studies that have reached similar conclusions. I work with retirees and would agree that total spending decreases in retirement. There are numerous reasons for a drop in total spending: often there is no longer a mortgage, we are not contributing to pensions or investments, as well since total income is lower the tax burden is often less. However, I would argue living and lifestyle expenses (travel, entertainment, house maintenance, property tax etc…) remain the same or in some cases increase. In working with retirees, I find there is a decline in total spending, however the drop is often not as large as expected.

The underlying assumption in the above discussion is that your spending will be consistent during retirement. That assumption is not realistic, it is unlikely that you will spend the same amount at 65 years of age, as you will at 75 or 85. Research by David Blanchett, published in the Journal of Financial Planning in an article entitled “Exploring the Retirement Consumption Puzzle”, suggests while on average total consumption declines in retirement, the rate of decline is not consistent, it varies during retirement. There is a decline in spending during the early years of retirement, however spending reaches a point of inflection and increases during the later years of retirement – a U shaped pattern, or smile.

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I believe the "retirement spending smile" makes intuitive sense. In the early years of retirement there is often greater spending on leisure, travel and entertainment. The extent of those activities decreases during the middle years of retirement and in the later years there is typically an increase in spending as medical expenses rise.

Every retirement is unique. While helpful, the above data might not be a perfect fit for your retirement. When creating a retirement plan I encourage folks to focus on their budget, specifically looking at their current budget and what they believe will be realistic in the first few years of retirement. When we do the retirement calculations, we assume costs will be a little higher in the later years, to account for the spending smile. It is important to remember that retirement planning is not a one-time activity. Life happens, and as discussed above, spending patterns change, regular review and updates are suggested.

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