Income Savvy® Insights

Enhancing retirement satisfaction.

An exclusive whitepaper for AIG Life & Retirement by

Michael Finke
Ph.D., CFP
Professor of Wealth Management
The American College of Financial Services

Wade D. Pfau
Ph.D., CFA, RICP
Professor of Retirement Income
The American College of Financial Services

We see the future in you.℠ — AIG Life & Retirement

Retirement income: solving for the unknown

Unlike many retirees of the past, today's retirees face the daunting prospect of spending from an investment nest egg to fund a lifestyle in retirement, given only 20% of those currently in their 60s will receive a pension.[1]

Estimating how much a retiree can safely spend from their nest egg isn't easy. After all, none of us know how long retirement will last, and we don't know the returns that can be earned from our investments in the future.

Imagine running a race without being able to see the finish line. Should the runner sprint from the start when the race could be a marathon? Exhausting yourself far from the finish line is a sure way to run out of steam too early. On the other hand, a runner who is too conservative will be left behind.

The retirement income conundrum

"The prospect, amounting almost to a terror, of living too long makes necessary the keeping of the entire principal intact to the very end, so that... the savings of a lifetime, which the owner does not dare to enjoy will pass as an inheritance to others."

–Professor Solomon Huebner,
Wharton School of Finance and Commerce

What if there was another option that allows the runner to set a brisk pace early but protect themself if the race turns out to be longer than anticipated?

Financial engineering allows today's retirees to spend the money they've set aside to live well in retirement without the fear that their nest egg will collapse before reaching the finish line. Instead of trying to estimate the right pace of spending in retirement without knowing how long retirement will last, a retiree can spend more freely early in retirement while insuring against a loss of income later in life. **This protection is made possible through the use of risk pooling—a risk management process utilized by insurance companies that serves as the financial foundation of the annuity.**

When planning for retirement, all retirees should consider what they want to achieve with the savings they've carefully built over a lifetime. Is the goal to pass the savings on to others? Or is the goal to fund a particular lifestyle? If the goal is to fund a lifestyle, how can a retiree use their accumulated savings to create a satisfying retirement free of the worry of outliving their money?

In this white paper focused on retirement income, we will examine data on retiree spending to highlight the important psychological benefits of discretionary spending early in retirement—and the value protected lifetime income from an annuity can add to one's enjoyment of retirement.

[1] 2016 Health and Retirement Study.

Understanding retiree spending and retirement satisfaction

Why are many retirees unwilling to spend?

The fear of running out of money in retirement has real and important consequences on retiree spending. Retirees who have diligently saved for retirement often feel uncomfortable seeing their nest egg gradually decline as they spend their savings over time. Even if the purpose of saving was to live well in retirement, many retirees have difficulty accepting the reality that these savings can and should fall over time. **The fear of depleting savings can be a psychological barrier to getting the most out of retirement.**

What do American retirees who have saved at least $250,000 in financial assets do with their savings over time? The following figure illustrates the change in assets among retirees in the 1998 Health and Retirement Study, a nationally representative survey of 20,000 retirees that tracks the same respondents every two years. It shows the changes in average wealth between 1998 and the most recent survey year available (2016) among a group of 150 families that retired in 1998. These results are consistent with prior research[2], which finds little evidence that retirees allow their savings to fall below the initial value of their nest egg at retirement.

Retiree financial wealth remains largely unchanged over time

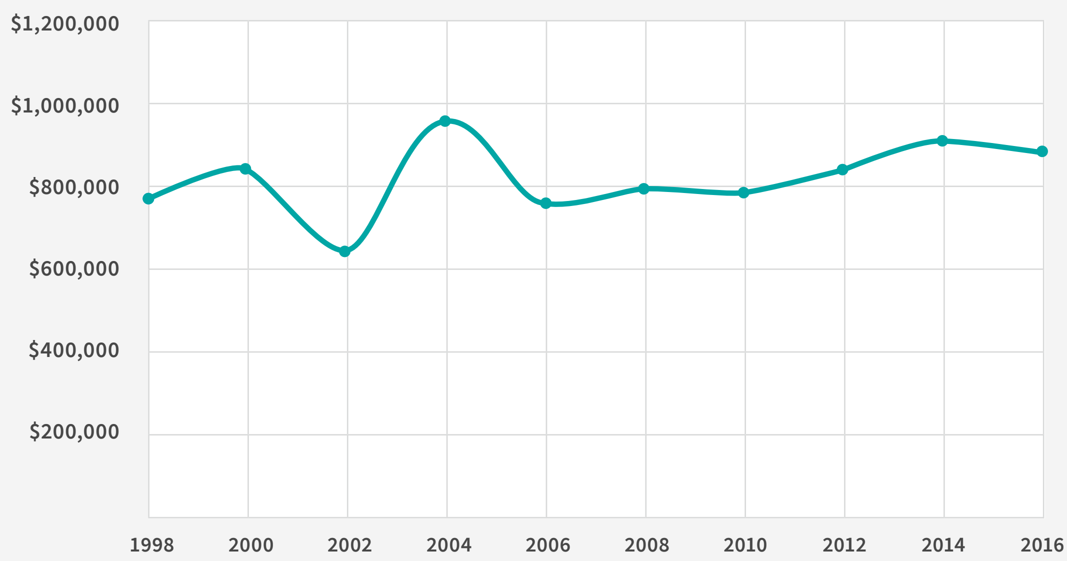

Figure 1: Average Financial Assets of 1998 Retirees over Subsequent 18 Years

The data show that these retirees had, on average, about $800,000 in savings in 1998, $800,000 in 2008, and just over $800,000 in 2016, which may suggest an unwillingness to spend down accumulated assets in retirement.

[2] "Spending in Retirement: Determining the Consumption Gap", Christopher Browning, Yuanshan Cheng, Michael Finke and Tao Guo. *Journal of Financial Planning,* 2016, 29(2), 42-53.

While the unwillingness to spend down personal savings may have had a modest impact on a retiree's lifestyle when most retirees had pensions, **today's retiree faces the prospect of spending too little if they are uncomfortable seeing the value of their nest egg fall.** This is particularly true for retirees who prefer not to take too much investment risk when interest rates on safe investments cannot provide adequate income.

Discretionary spending on "fun" activities can be a key driver of retirement satisfaction

If the purpose of saving for retirement is to live well, would it be possible to create an income plan that allows a retiree to spend freely without the fear of running out of savings? Can the unwillingness to spend down savings deprive the retiree from the joy of spending to fund discretionary lifestyle activities such as dining out with friends or taking a cruise?

A retiree who spends too little may not be living as well as they could. Spending data suggests that retirees do tend to follow a predictable pattern referred to as the go-go, slow-go, and no-go years.[3] Today's healthy retirees may maintain their ability to enjoy their pre-retirement lifestyle well into their 70s, and an active lifestyle into their 80s. Spending, however, does tend to fall gradually in retirement.

The following figure models average spending by age using actual retiree spending data by year of age in 3-year increments. The model fits a straight line to the observed decline in total spending among retirees with at least $100,000 of financial assets.

Why does spending decline as we age? The simple answer is that our bodies change as we get older, and as we become less mobile we tend to spend less on certain activities. This is particularly true for leisure pursuits, which are consistently the strongest predictor of life satisfaction in retirement.[4]

We can use data to better understand the importance of spending on leisure activities, and the role of lifetime income certainty on a retiree's willingness to spend more on leisure. Figure 3 on the page that follows shows average spending on the components of leisure that we term fun spending—vacations, dining out, clothing, hobbies, and tickets to games or shows.

Predicted spending by age

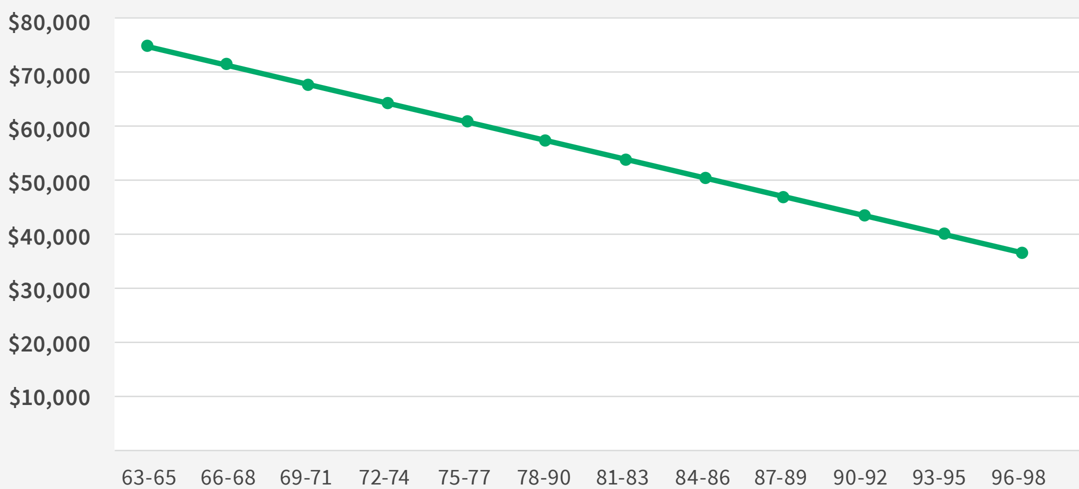

Figure 2: Change in Average Total Spending by Age (Min. $100,000 financial assets)

Source: 2016 Health and Retirement Study, households with $100,000 minimum financial assets

[3] The Myth of Steady Retirement Spending, and Why Reality May Cost Less - The New York Times (nytimes.com).
[4] Spending, Relationship Quality, and Life Satisfaction in Retirement by Michael S. Finke, Nhat Ho, Sandra J. Huston :: SSRN.

This sample is limited to retirees with at least $100,000 of financial assets and shows average annual fun (leisure) spending by wealth category.

Fun spending on travel, eating out, clothing, hobbies and shows by age and assets

Figure 3

Financial assets	\$100,000-\$250,000	\$250,000-\$500,000	\$500,000+
Age 60-69	\$9,256	\$8,018	\$10,200
Age 70-79	\$6,169	\$7,788	\$10,739
Age 80+	\$4,539	\$4,208	\$7,656

Among retirees within all wealth categories, fun spending in retirement declines sharply after age 80. Those with more financial wealth spend more in their 70s, but spending drops by 29% for those who have at least \$500,000 in financial assets after age 80 and by 46% among those with between \$250,000 and \$500,000 of financial assets.

Why do retirees spend less on activities such as travel and eating out as they move from the go-go to the slow-go and no-go stages? One explanation is that the physical changes that define these stages impact both our ability to engage in these activities and to receive as much enjoyment from them. Changes in these activities also impact spending needs. Figure 4 shows the decline in spending on fun leisure activities and the decline in two measures of age-related decline—cognition and physical strength.

Fun spending and age-related physical and cognitive change

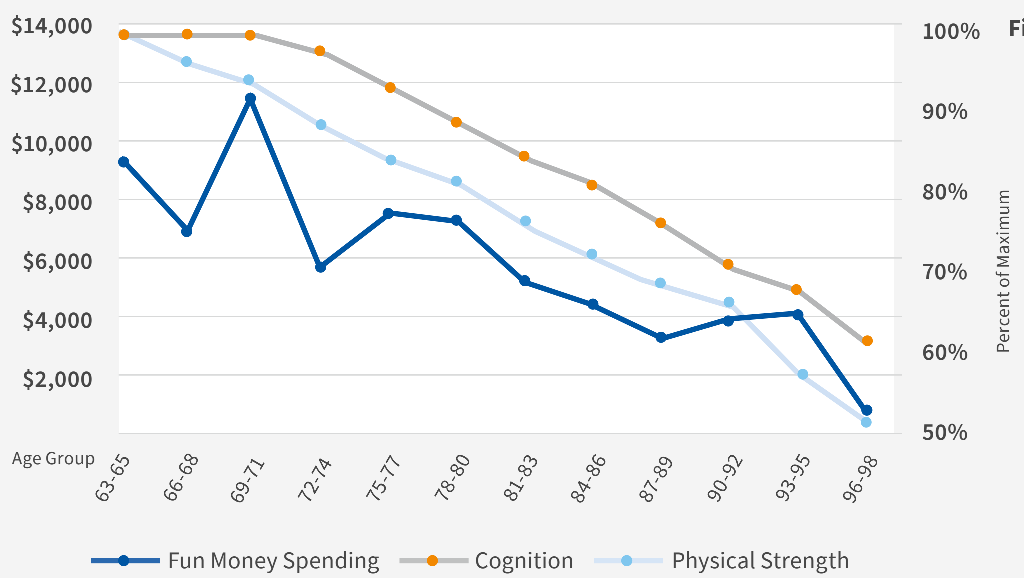

Figure 4

Controlling for household characteristics including education, marital status, and net worth, we estimate how much more retirees spend on fun expenses during their 60s. We also estimate how much more retirees spend on fun expenses when they have additional guaranteed lifetime income of $10,000 or more—beyond Social Security.

Effect of age and guaranteed income on fun spending

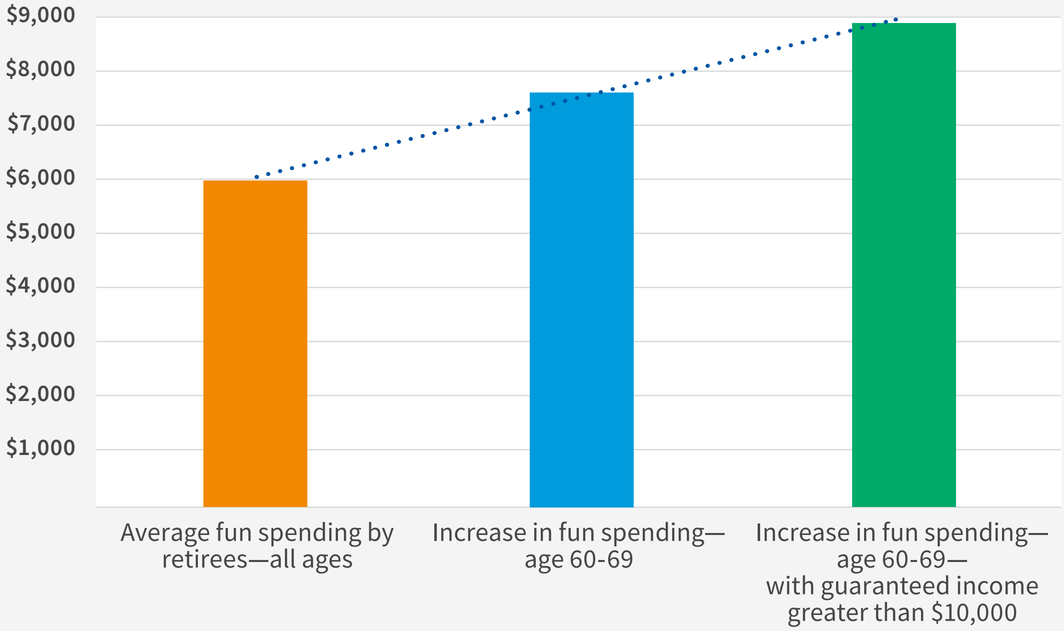

Figure 5

Although age affects how much retirees spend on leisure activities, they may also spend less if they do not have a source of additional guaranteed lifetime income. **If we compare fun spending among retirees who do have an additional source of lifetime income greater than $10,000, which includes any income categories that provide protected lifetime income until death (such as a pension), we can clearly see an increase in spending among those with more protected lifetime income.**

As Figure 5 shows, retirees spend $1,618 more on fun leisure expenses in their 60s than they do at older ages (this figure declines to $1,130 more in their 70s). Younger retirees spend more on leisure activities. **Retirees age 60-69 who have additional guaranteed lifetime income of at least $10,000 beyond Social Security spend $1,283 more than those who do not.**

We also estimate whether retirees who spend more on fun activities are happier in retirement. Using a question in the survey that asks retirees to rank how satisfied they are with their retirement (from not at all satisfied to very satisfied), we estimate the impact of a number of characteristics on the likelihood of being "very satisfied."

Our goal is to estimate whether retirees who spend more on fun activities are happier, and whether spending on these activities has a larger impact on happiness when retirees are younger. The results are shown in Figure 6.

Change in likelihood of retirees being very satisfied with retirement by spending on fun activities

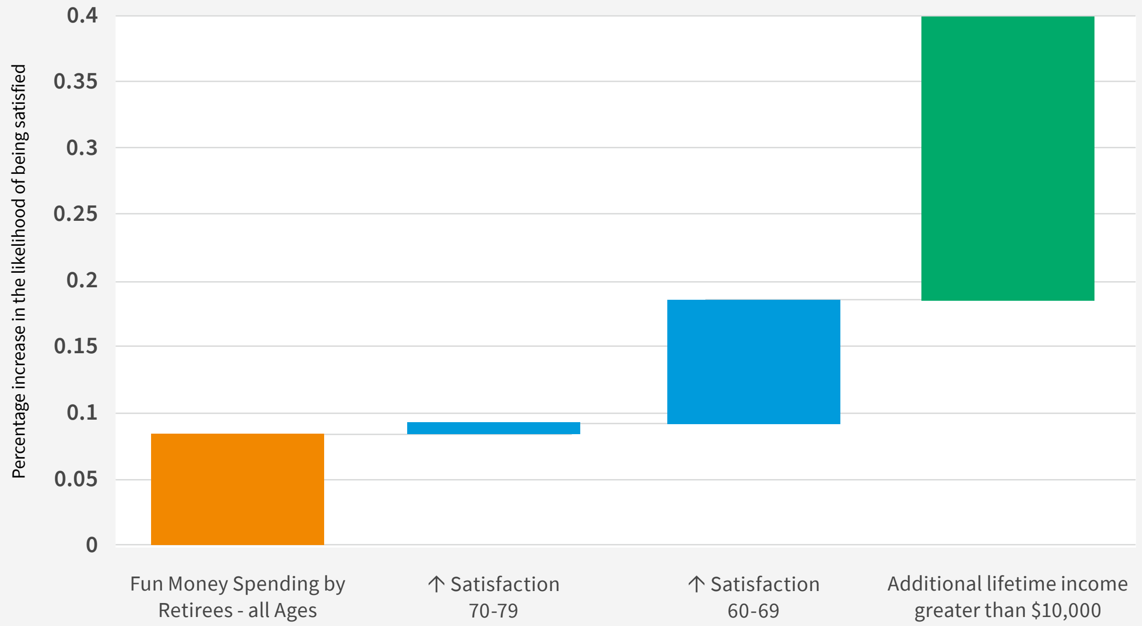

Figure 6

According to the analysis, retirees who spend more on fun leisure categories are more likely to be very satisfied with retirement at all ages. Further, retirees who spent more in their 60s on activities like vacations, dinners with friends, or buying a ticket to a show received more satisfaction from spending these dollars at that point than they did on such spending during their 70s and 80s.

Retirees who received at least $10,000 in additional lifetime income beyond Social Security were also significantly more satisfied with their retirement. A retiree could maximize happiness by spending more on fun activities in their 60s with the security of knowing they will never run out.

Conclusion

The spending and life satisfaction data reveals that retirees who spend more when they are young are more likely to have a satisfying retirement. If retirees will not spend their savings during the first decade of retirement because they fear the risk of running out when they get older, this has an important and negative impact on the amount of happiness they are able to generate with their savings.

All of us experience predictable physical changes in retirement that will affect not only how much we spend, but how much joy we receive from our spending. **Having additional protected lifetime income beyond Social Security allows us to more freely spend money on the discretionary lifestyle activities and expenses that may ultimately have the greatest impact on retirement satisfaction.**

To learn more about securing additional protected lifetime income for your retirement with an annuity, talk to your financial professional today.

M6060CWP.1 (12/21)