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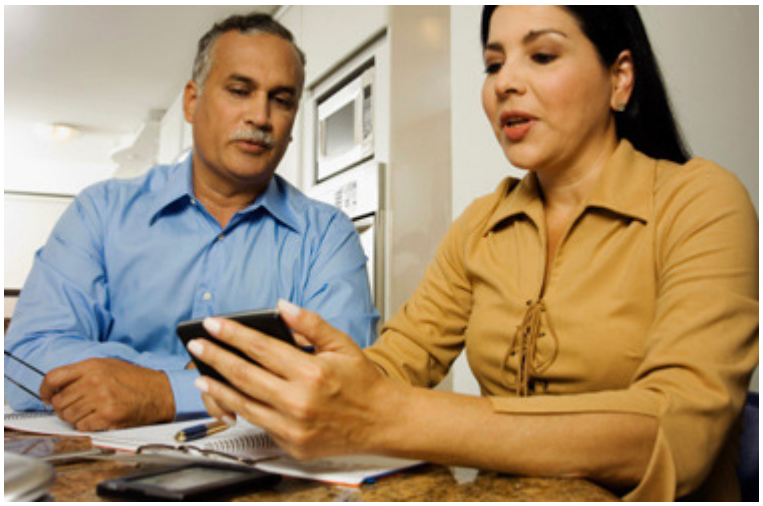
A Retirement Spending Blueprint Will Protect Your Nest Egg

Accounting for every possible expense can help you create a withdrawal strategy that ensures your savings will last a lifetime.

From *Kiplinger's Retirement Report*, August 2013



As you contemplate retirement, you've probably heard that you should plan to live on 80% of your current spending after you leave work. Forget that rule of thumb.

The only way to get a realistic picture of how much you're likely to spend in the future is to create a retirement budget now. You can even plan for the unexpected—say, the adult child who may need a large cash infusion at some point. Mulling every possible expense could help you create a withdrawal strategy that will protect your nest egg from the vagaries of life. And the budget exercise is "a great opportunity to start thinking about how you want to spend your time in retirement," says Judith Ward, senior financial planner and vice-president of T. Rowe Price Investment Services.

The first step is to take your current take-home pay and make adjustments, perhaps subtracting commuting costs while adding money for travel. This "top-down" approach will give you an idea of how much you may need soon after you retire.

To dig even deeper, use the "bottom-up" method, by developing an estimate for each spending category. You can use a detailed budget worksheet that covers most expenses. This from-scratch approach provides a better starting point for projecting how expenses could change over time. Even if you're already retired, creating a budget, and updating it regularly, can help you stay on track for years to come.

James Miller, president of Woodward Financial Advisors, in Chapel Hill, N.C., asks clients who are within two years of retirement to fill out an expense worksheet. The 100 line items include payments for gasoline, life insurance premiums, food, charitable giving, dining out, cable TV, pet care and club dues. "It's crucial that the expenses are accurate," Miller says. "If your expenses are off by 5% a year, it may not be a killer, but if they're off by 10% or more, that could make a big difference compounded over 30 years."

Review all of your expenses for an entire year, not just for a few months, says Steven Medland, a certified financial planner with TABR Capital Management, in Orange, Cal. "Many expenses are paid out once a year, such as homeowners insurance," he says.

Some expenses, such as a mortgage, will end, but you may need a new roof at some point. You may cut back to one car, but you'll likely need to replace it.

You can review your credit card bills and checking account. The most accurate way to track expenses is to use software such as Quicken or an online budgeting tool such as Mint.com.
Also, split your expenses between the essentials and the discretionary. Peg McMahon, 66, uses two Mint.com accounts, one to track her personal costs and the other for household expenses she shares with her partner. "It turned out we had underestimated what we were spending on groceries and cat food," says McMahon, who lives in Kansas City, Mo., and works as an information technology technician for Sprint.

McMahon expects to retire in several years. By noting every expense, she says, she'll have a better idea of what she will need in retirement and what she can cut out. After seeing how much she was spending on books, she stepped up her visits to the library. McMahon hopes to cover all essentials, such as food and an Internet connection, with Social Security and pensions. "One of my desires is to live now on what I will have in retirement and sock the rest away," she says.

Have Health, Will Travel Now

The difficulty is figuring out what your costs will be down the road. Many retirement researchers and financial planners agree that annual spending for most retirees tends to decline over 30 years, after adjusting for inflation. "As people age, they don't travel as much and they are not as concerned with spending on fashion," says Ty Bernicke, a certified financial planner in Eau Claire, Wis. Bernicke conducted a major study in 2005 on the spending decline.
Financial planners often refer to three stages of retirement spending as "go-go, slow-go, no-go." First, there are the heady years of travel and new hobbies, when spending can surpass the preretirement lifestyle budget. In a person's seventies, retirement settles into a routine, with lifestyle spending declining while health care costs begin to creep up. After 85, some healthy octogenarians do embark on expeditionary travel, but most seniors spend little on leisure, clothes and other discretionary expenses, many financial planners say.

In the last stage, health care costs consume a greater share of a retirement budget—18% for those over 85, compared with 9% for those 50 to 64, according to an analysis by the Employee Benefit Research Institute. That analysis, however, did not include most spending on long-term care—the real wild card in projecting future costs. "Spending on travel and entertainment does decline with age, but you have to assume that both declines will be offset with increases in other categories," says Wade Pfau, a professor of retirement income at the American College, an institution for financial professionals, in Bryn Mawr, Pa.

In designing a realistic budget, retirees need to factor in inflation. Assuming a 3% annual increase in costs, groceries that now cost $5,000 will run about $10,500 in 25 years. (For an inflation calculator, go to www.calculatorweb.com/calculators/inflationcalc.shtml).
Retirees who want to go a step further can factor in different inflation rates for different types of spending—and then make adjustments based on spending habits by age. Research by Somnath Basu, a finance professor at California Lutheran University, in Thousand Oaks, Cal., looked at a 30-year retirement divided into "age bands"—65 to 74, 75 to 84, and 85 to 95. He divided spending into four general categories: taxes, basic living, health care and leisure. He then assigned an inflation rate for each category—7% each for health care and leisure, and 3% for taxes and basic living.

Basu also adjusted each spending category for each age band. For example, he assumed that taxes, adjusted for inflation, would drop by half, with the end of payroll taxes and a decline in taxes on salaries, and then would remain steady. Basic living costs (which include transportation, housing and food) were assumed to drop by 30% after retirement, fall another 20% at 75 and then by another 10% at 85.

Leisure activities increased by 50% in the first years after retirement, and then dropped precipitously. Meanwhile, health care posted a rise of 15% at retirement, another 20% at 75 and 25% more at 85. His conclusion: You can't assume that overall spending will decline over the years.

But Michael Kitces, director of financial planning at Pinnacle Advisory Group, in Columbia, Md., says such increases in health care "can't go on indefinitely." And, he says, "you will drive yourself nuts" if you try to apply a different inflation factor for each line item. (If you'd like the challenge, go to www.bls.gov/cpi/cpieart2009.pdf for percentage changes in consumer prices for people age 62 and older from 1998 to 2009.)

Kitces also says that the Medicare program will continue to protect retirees from much uncertainty over costs. A married couple today typically pays more than $8,700 a year for premiums for Medicare Part B, a Part D prescription-drug plan and a Medigap supplemental insurance policy. Medicare, Kitces says, has "eliminated almost every unexpected expense." Medicare doesn't pay for everything, so plan for out-of-pocket costs for vision and dental care.

Of course, long-term care could upend even the most careful planning. "Long-term care is a nightmare liability of unknown size at an undetermined time," says Charles Simon, a certified financial planner at Taconic Advisors, in Poughkeepsie, N.Y. If you can, buy a long-term-care insurance policy, Simon says, perhaps by shifting the premium money you're spending on life insurance that you may no longer need.

Housing will be your budget's biggest line item. Housing costs as a percentage of spending remains the same over the years—at about 35% on average, according to the U.S. Bureau of Labor Statistics' Consumer Expenditure Survey. If you plan to "age in place," you should figure out how much it could cost to make your home senior friendly, by remodeling bathrooms or the kitchen. Expect

rising costs for homeowners insurance, utilities and lawn care. And don't forget property taxes. "Retirees think the house is paid off, but property taxes can be hefty and they will go up," Ward says.

If you're thinking of downsizing in five years, Ward says, "be realistic about what it will cost to buy something else and how much you will get for your house." Moving expenses, and even small renovations, perhaps new carpets, at the new home will take a bite.

You also need to plan for the unexpected. There are events "that come out of left field," says Daniel Moisand, a certified financial planner in Melbourne, Fla. For instance, an adult child has a setback and goes to Mom and Dad. "The parents have to adjust their lifestyle, and it could be a traumatic adjustment," he says.

To avoid an unplanned dip in assets, many planners create two money pots: a core pot for ongoing cash flow and a reserve for large discretionary expenses. The core would include the basics, even money for hobbies, restaurants and entertainment. The discretionary fund would include cash for large planned expenses, such as a kitchen renovation, and for unexpected outlays, for that adult child for example. And while your core budget would include yearly travel expenses, your reserve may include funds for a blow-out trip or two.

Jonathan Guyton, principal of Cornerstone Wealth Advisors, in Edina, Minn., says his newly retired clients typically set aside 5% to 10% of an investment portfolio into a discretionary fund. On $1 million, the fund could hold $100,000 and the lifetime cash flow would be based on the other $900,000.

Guyton says the discretionary fund enables retirees to vary their spending patterns, especially in early retirement, while keeping portfolio withdrawals on track to last a lifetime. Otherwise, if you establish, for instance, a 4% yearly withdrawal from a portfolio but you repeatedly pull out extra, your withdrawals as a percentage of your portfolio will rise and it can throw the nest egg’s longevity out of whack, he says. By setting up a discretionary fund, Guyton says, "you can have a disciplined level of spending and withdrawing."

Will Your Nest Egg Be Enough?

Once you develop a budget, you will need to make sure your nest egg will create enough cash flow to cover your expenses. Ideally, Social Security and other guaranteed income sources will cover core expenses. Remember the tax bite: You will pay income tax on withdrawals from your traditional IRA and perhaps on 50% to 85% of your Social Security benefits. If you think your retirement income will not cover your projected expenses, you should continue to work or scour your budget for cuts.

Even if you have a nice retirement kitty, if you pull out too much money early, you run the risk of depleting your funds if you don't account for big costs later. For that reason, American College's Pfau says that inflation-adjusted withdrawals, starting in the first year of retirement, will keep a

portfolio on an even keel. Although costs could decline over time, they may not, as rising health care expenses replace declining outlays on discretionary activities. "You can't assume that spending will decrease with age, so using constant inflation-adjusted spending is the best for most people," he says.

But other financial planners say such a rule—often starting with a withdrawal of 4% of a portfolio—does not mesh with real life. Spending can fluctuate—your spending could surge in the year you buy a car and then drop. Market conditions can also force retirees to scale back spending—or free them to spend more.

Moisand says some of his clients don't even take inflation adjustments. "They keep a flat spending amount and then adjust if they feel they need more," he says. But other retirees want to live large early on. To keep potential overspenders in check, Moisand helps new retirees draw up a written "spending policy." Moisand says the document is not a contract, but an agreement that the retiree recognizes the risks and will cut back later if the portfolio shows sign of trouble.

Cornerstone's Guyton has developed a "dynamic" approach to withdrawals, which allows withdrawal rates to vary depending on basic spending needs and market conditions. He has created "guardrails" that will keep the portfolio on track for 40 years if withdrawal rates get too high or markets dip too low. Initial withdrawals can start at 5.5%, adjusted for inflation in subsequent years, as long as a retiree will slash spending during bad economic times.

Let's take Guyton's illustration of the couple who has the $100,000 discretionary fund and the $900,000 portfolio for core spending. Say the couple has $36,000 in Social Security benefits. At a 4% withdrawal rate, the couple could withdraw $36,000 from the portfolio. After accounting for $6,000 in federal taxes, the couple has $66,000 to spend.

With the dynamic approach, the couple may decide to take 5% from the portfolio, for $45,000, to finance a big trip in the first year of retirement. After a federal tax bite of $7,000, the couple has $74,000 to spend.

The couple can take a raise for inflation in subsequent years. The guardrail would require the couple to reduce the withdrawal by 10% if the withdrawal rate has risen more than 20% above the initial rate.

Assume a bad market year slashes the couple's portfolio to $730,000 by the end of the first year. If the couple wants to withdraw the same $45,000 in the second year, the withdrawal rate will be 6.16%—more than 20% above the initial 5% rate.

At that point, the couple must reduce the withdrawal by 10%, to $40,500—for an after-tax income of $70,500. That's a 4.7% drop in income from the year before. "If someone is willing to reduce their expenses when market conditions are poor, then they can safely start out taking from the core 1% more than they otherwise would have," Guyton says.