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How People Misjudge Discretionary Income in Retirement

What people think of as 'discretionary' before they retire often becomes, at least to them, quite necessary in actual retirement, says WSJ Wealth Expert Jonathan Guyton. *PHOTO: GETTY IMAGES/ISTOCKPHOTO*

By **JONATHAN GUYTON**
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When it comes to planning for retirement, people are typically told to first make sure they have enough money to meet their basic needs and then try to have some left over for those nice, but not necessary, extras.

As a result, the typical advice goes something like this:

Retirees should cover basic, ongoing living expenses with Social Security and any pension benefits. If these sources aren't enough, they are sometimes advised to cover the rest by using assets to purchase guaranteed sources of inflation-adjusted income, most often by using bond ladders or fixed annuities which have a zero value at the end of life.

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Other financial assets can then be earmarked for those discretionary (nice, but not necessary) expenses and be invested more aggressively for growth. In its most extreme form, advocates for this approach suggest investing a great majority, if not all, of these assets in stocks or other equities.

This approach, often called essential vs. discretionary, seems logical and reasonable, and would work flawlessly if people were spreadsheets and not human beings. But human we are, and this advice can have significant, unintended consequences.

For starters, what people think of as "discretionary" before they retire actually becomes, at least to them, quite necessary in actual retirement. As one of our clients put it, "If I can't keep doing these in retirement, it's not worth it to retire." He has a point.

It's understandable when retirees are not ambivalent about the quality of life funded by these so-called discretionary expenses. It's easy to see how what seems "discretionary" in the abstract can seem quite "essential" when it involves your hopes, intentions, promises and family.

There's another problem: Investing such a "discretionary fund" too aggressively can make its value so volatile that retirees may unwittingly hitch their ability to live out "'bucket list" items to the stock market's short-term fluctuations. That's because when stock markets have their eventual big declines, this fund could fall so much that retirees feel they have no choice but to change their plans. Even though they know deep down that markets will recover, it's their health in retirement that may not remain long enough for retirees to wait.

Back in mid-2011, the Journal of Financial Planning (for whom I serve as a retirement columnist) surveyed advisers who used various strategies for retirement income generation about how many clients made "significant changes" to their lifestyle in the years just after the Great Recession. Results were published in its December 2011 issue.

The results were striking: 64% of advisers recommending an essential-versus-discretionary approach saw more than 20% of their clients undergo a significant lifestyle change, even though their income for essentials did not change. By contrast, just 36% of advisers who never use this approach saw that high a frequency of significant lifestyle changes; and one-third had fewer than 4% of clients experience such a change.

What did these advisers know and do differently? In short, they took a more balanced, flexible approach. And they recognized that assets for discretionary expenses most likely to occur earlier in retirement need to be invested more conservatively–not more aggressively–than assets invested to fund spending throughout all of retirement.

Specifically, keep the amount you plan to withdraw for discretionary expenses over the next six to eight years in a low expense, no-load mutual fund that owns short-term U.S. government bonds. Today, with interest rates on the upswing, its average maturity shouldn't exceed two years. Then diversify the rest in stocks or equity funds.

So, if your assets for discretionary spending are $100,000 and you plan to use $60,000 of this by 2025, then only 40% should be in stocks. This way, a big market drop won't sink your dreams or your bucket list.

To paraphrase Will Rogers, sometimes it's the return of the money that matters more than the return on it.

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