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Rethink Your Retirement Income

Many retirees can live well on less than what the financial-planning industry tells them. Here's how to look beyond the formulas and find your real number.

By KELLY GREENE

The only hard-and-fast rule for how much retirement income you will need is that there is no hard-and-fast rule.

The financial industry's typical rule of thumb—which states that retirees need to save enough to be able to replace 75% to 85% of their preretirement income every year after they stop working—isn't really useful for many people.

New research shows that many retirees can live well on less than that but others rack up higher expenses through travel, expensive hobbies or medical costs that can't be avoided.

The 75%-to-85% ratio may work for younger workers who have no way of knowing precisely what their incomes or expenses will be as they head into retirement.

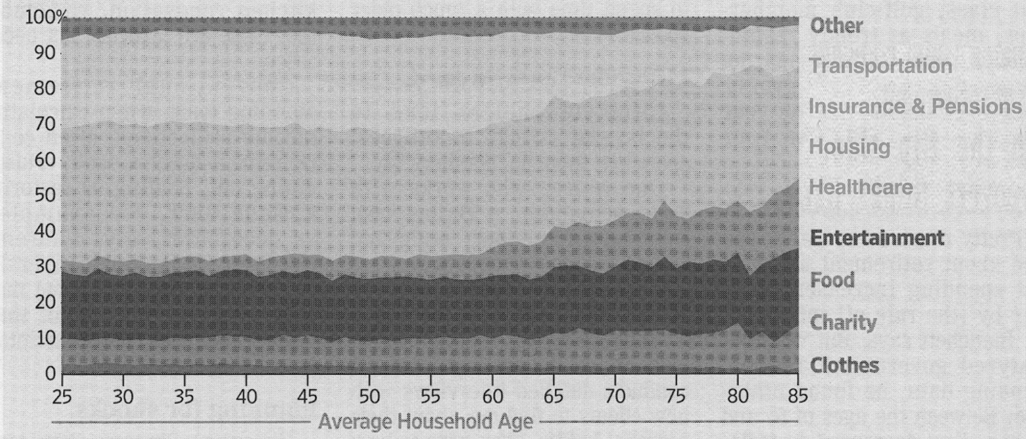
But if you're closer to the finish line, it's crucial that you figure out for yourself how much you personally will need in "replacement income"—or the percentage of your working income you'll need in retirement—so you can get a better idea of whether your savings, any pensions and Social Security can provide it.

Lifestyle choices lead to the largest swings in retirees' spending.

"You really need to fine-tune it," says Cindy Levering, a retired actuary who serves on a retirement-research committee for the Society of Actuaries, a professional group in Schaumburg, Ill. "There are so many things that are specific to the individual, it's hard to generalize."

Where the Money Goes

Average percentage of total expenditures, by category



Sources: Labor Department; Morningstar

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The actual replacement rate swings widely by household, with many people overestimating the real costs of retirement by as much as 20%, says David Blanchett, head of retirement research at Morningstar in Chicago, which issued a report on retirement income earlier this month.

The best way to determine your actual costs? Sharpen your pencil. When Bud Bierly, a 62-year-old retired school administrator in Athens, Ga., decided to figure out when he could afford to retire, he worked with financial planner Christian Koch, of Atlanta. Together, they calculated that Mr. Bierly and his wife could live on about 75% of their preretirement income—even including mortgage payments, which many retirees don't have, and some travel.

Mr. Bierly says they didn't leave anything to chance. "We did not take the conventional approach," he says. The couple added up their expenses, including contributions to health savings accounts and long-term-care insurance premiums. Then they compared those costs with their pensions, Social Security and annuities.

"We had so many pieces of the puzzle to put in place," but after crunching the real numbers, "we felt like we could meet all of our obligations," Mr. Bierly says.

Want to figure out how much of your own paycheck you would need in retirement? Here are some of the most important factors to keep in mind.

Your savings habits.

If you're a dutiful saver, or if you have children who will be at home until you're practically retired, the paycheck you need after you quit working could be significantly smaller than the one required to pay your bills now.

And remember: Whatever you put away for retirement while working effectively lowers your preretirement income and, in turn, affects your retirement-income calculations.

Say you're putting 15% of your paycheck into a retirement piggy bank today. That's 15% of your income that you won't need to factor in when you start tapping those savings to pay for living expenses.

The same thing applies to the portion of your salary currently going to Social Security and Medicare taxes. Altogether, "that could be 20% off the top that's gone," Mr. Blanchett says. Lowering your needed income that significantly also

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The standard rule of thumb: Aim to replace 75% to 85% of your preretirement income.

Older workers may be able to meet their needs with as little as half of their preretirement income.

Don't forget to budget for travel, costly hobbies or gifts to grandchildren.

Put aside a cushion for shocks from illnesses or extreme longevity.

could lower your income-tax rate in retirement, creating more savings.

Other expenditures, large and small, may also be lower in retirement: train tickets and other commuting costs, gas, car wear-and-tear, dry-cleaning bills, lunches out, child care and college savings, for example. And with more Americans having children in their 40s, the end of tuition payments could coincide with the start of retirement.

On the flip side, if your job covers things like flying first class, golf-club memberships, meals at trendy restaurants, newspaper and magazine subscriptions, an on-site gym or other perks, having to pay your own way could increase your costs, Mr. Blanchett says.

Inflation and life expectancy.

"Pretty much every paper you read about retirement assumes that spending increases every year by [the rate of] inflation," Mr. Blanchett says. But when he analyzed government retiree-spending data, he found otherwise: Between the ages of 65 and 90, spending decreased in inflation-adjusted terms.

Most models would assume that someone spending $50,000 the first year of retirement would need $51,500 the second year (if the inflation rate were 3%). But Mr. Blanchett found that the increase is closer to 1%, which has big implications over decades, "because these changes become cumulative over time," he says.

Life expectancy is another tough factor to predict. Rather than using a 30-year retirement for both members of a couple, Mr. Blanchett estimated the probability of a retiree living to different ages, based on the Society of Actuaries 2000 Annuity Table.

He then combined those probabilities with a Monte Carlo simulation—a process in which hundreds or thousands of potential scenarios are tested—to estimate the probability of both members of the couple being alive and running out of money.

Under those conditions, Mr. Blanchett found, a couple could safely withdraw 5% of their combined savings each year in retirement—rather than the standard 4% traditionally recommended by financial planners—with the same probability that they wouldn't run out of money while in retirement. And if they are willing to assume that their spending will go down, as Mr. Blanchett found, they could withdraw even more than 5% a year in retirement.

If longevity—or its opposite—is common in your family, you should take that into account when deciding how much you can tap each year. And count on greater financial needs for, say, a younger spouse retiring early to spend time with a much older spouse.

Lifestyle: the wild card.

Lifestyle choices lead to the largest swings in retirees' spending, financial planners say.

One retiree who works with Todd Schneider, a Dallas-area investment adviser, budgeted $40,000 for golf-related travel his first year of retirement. But the bill came to a whopping $69,000.

Other costs can be more insidious, Mr. Schneider says. He now conducts detailed interviews with new clients to find out about their personal habits. "You have to be a real detective," he says.

Among the questions he asks, and anyone facing retirement may want to consider: Are you going to have a vacation house? Do you drink wine? How much do you spend on it? Do you have pets? Collect art? Go to many movies? Gamble in casinos? Give lots of gifts to your kids, or charity?

"I don't find most people stop giving once they retire. Sometimes they're giving more," Mr. Schneider says. "And people's hobbies are going to be more expensive as they have more time. We try to put in perspective for them what their goals are for the next year, three years, 10 years and the rest of their life, so they can put the brakes on if they need to."

Food may not cost you as much as it does while you're working. Although much has been made in recent years about retirees' fine-dining habits, with a number of retirement communities adding foodie-focused restaurants and wine cellars, economists have found in at least three separate studies that spending on food drops significantly in retirement—by anywhere from 5% to 17%.

Meanwhile, the quantity and quality of the food retirees are eating is the same as when they were working, the studies found. How is that possible? One group of researchers attributes the decline in food costs to the additional time that retirees have to cook at home and shop for bargains.

What's optional.

When you're considering how you want to spend your money in retirement, from cruises to grandchildren's preschool tuition or a kitchen renovation, remember that those are luxuries, not necessities.

Conventional retirement-planning tools, when calculating income projections, often count retirement dreams—golf, cruises, dining out, boating or restoring antique cars, for example—as necessities, says Laurence Kotlikoff, a Boston University economist. He contends that most retirees need only 50% of their preretirement income to maintain their living standard.

Planning for shocks.

Expensive illnesses, long-term care and extreme longevity can suddenly throw retirees' estimated income needs out of whack.

When the Society of Actuaries interviewed middle-class retirees in focus groups earlier this year, "they were managing very carefully, adjusting their spending where they needed to and trying not to draw down" their savings, Ms. Levering says. "But they were not planning for shock events."

Rather than planning for higher spending, the actuaries recommend delaying retirement by a few years, or scaling back work gradually, while creating a bigger cushion, the group said in a research report released Dec. 9.

But note that many surveys have found retirees who wanted to keep working were pressured to take buyouts or suffered health problems that forced them to retire.

An alternative suggested by T. Rowe Price Group in Baltimore is a transitional phase of work for people in their 60s, during which they spend much of the money they would have saved for retirement on travel or other activities they are eager to start.

It still makes sense, though, for such workers to contribute enough to workplace retirement plans to capture any matching contributions offered.

And what if you wind up raising a grandchild? Mr. Schneider has worked with several retirees who have adopted their grandchildren, substantially increasing their living costs, not only for education but also energy and food, he says.

As a result, Mr. Schneider asks new clients as part of their interview whether they have any relatives with tenuous finances whom they would take care of in a bind.

Where you live.

Property taxes, state and local income taxes, and any taxes on investments play a big part in how much income you'll need in retirement—and they could vary significantly based on geography.

"If they move to Florida, they're not going to have any state income tax. If they live in New York with a state pension, the income is tax-free, and for private pensions, the first $20,000 is tax-free," says Beth Blecker, chief executive of Eastern Planning in Pearl River, N.Y.

Comparing tax-friendly states for retirees is tricky, since property-tax rates might be low while income taxes are high, or vice versa. Also, some states give retirees breaks on Social Security or pension income, while others don't.

(Wolters Kluwer's CCH unit, a tax-information provider, breaks out the various taxes in each state in a chart at cch.com/wbot2013/010retire.asp. It expects to update the information for 2013 by late January.)

The other big factor: Whether you'll have a mortgage bill. If you plan to pay off your house when you retire, then you won't need as much income to cover that expense.

Keep in mind that if you relocate from a more expensive region, where housing, taxes and other costs are higher, to a cheaper one, your utility bills may fall as well.

In Georgia, the Bierlys bought a house that should be paid off in the next few years. After that, Mr. Bierly says, "we'll be debt-free, and our money will go that much farther."