What Is The 'Retirement Spending Smile' and Why Is It Important

As a financial advisor, it's crucial to help retirees plan for these changes to sustain their lifestyle. And understanding realistic retirement spending patterns are key.

And in the realm of retirement planning, one prevailing assumption seems to have become the standard – that as retirees progress through their golden years, their spending naturally increases in tandem with inflation.

This makes sense, in theory.

But if we delve deeper into the *realities* of retirement and spending patterns, you'll find that this assumption doesn't always hold true.

This is known as the **'retirement spending smile'** effect – a fascinating phenomenon that sheds light on the changing nature of retiree spending habits.

Picture this: retirees kick off their post-career journey with a burst of activity, embracing newfound freedom with lavish travels and leisure pursuits. But as the years roll by, priorities shift. Discretionary spending wanes, while healthcare costs take center stage. It's a journey marked by peaks and valleys, akin to a smile on a graph (a "U" shape).

Why? Because contrary to many economic and financial planning assumptions, the 'retirement spending smile' effect holds significant implications for estimating withdrawal rates, sequence risk, and optimizing spending throughout retirement.

And while there are many meaningful retirement strategies, it's worth looking into this one.

So, let's discuss the 'retirement spending smile' and the insights we can learn from it. . .

The Retirement Spending Smile Explained

In the ongoing discussion about retirement spending, David Blanchett's article "Exploring the Retirement Consumption Puzzle" - published in the May 2014 issue of the **Journal of Financial Planning**[1] - added a fresh perspective to the debate.

And while a bit dated, it's still worth going over.

Simply put, Blanchett took a deep dive into the paradoxical phenomenon of retiree spending patterns. Noting that, contrary to many conventional assumptions of increased spending, spending actually *decreases* as retirees go through their retirement years.

Blanchett's study is noteworthy for its long-view approach from tracking the spending habits of the same households over time throughout their retirement journey.

Thus, by analyzing ‘real’ household survey data – meaning inflation-adjusted - from 2001 to 2009, Blanchett provides insights that address issues encountered when comparing the spending of different age groups at the same point in time.

Blanchett identified a fascinating trend he dubs the "retirement spending smile," which varies slightly depending on the initial household spending levels.

For example, Blanchett illustrates this concept with an exhibit showcasing the spending trajectory of a retiree starting with $100,000 in expenditures at retirement.

On average, this household's spending journey during retirement paints an intriguing picture.

There was a gradual decline in real spending until they reached a low point at age eighty-four, bottoming out at $74,146 – **thus marking a significant drop of nearly 26% in real spending over time.**

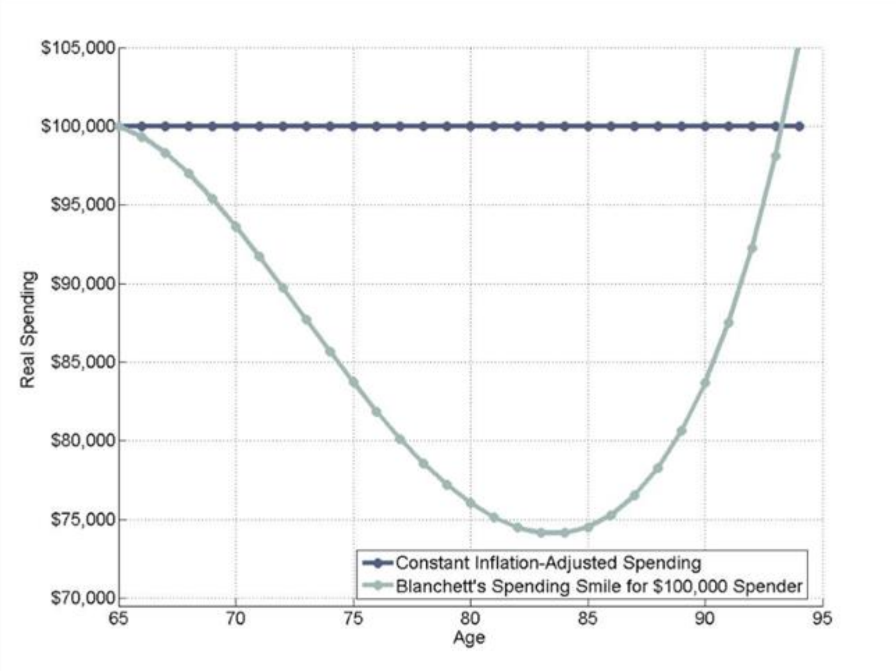
Thus, his analysis revealed that retirees tended to spend more on travel, dining out, and other discretionary indulgences during the initial stages of retirement. However, as retirees got older, there was a notable decline in discretionary expenses alongside a rise in healthcare costs.

More notable was that this rise in healthcare expenditures typically *outweighed* the reduction in other spending categories.

Thus, the ‘retirement spending smile’.

Here’s a good **visualization**[2] of this.

Blanchett's Retirement Spending Smile



For illustration purposes only. The Estimated Path of Real Retirement Spending for a $100,000 Initial Budget at 65 vs. Constant Inflation-Adjusted Spending Strategy. Based on data from Blanchett, David. 2014. "Exploring the Retirement Consumption Puzzle." Journal of Financial Planning 27 (5): 34–42

So put simply, the four stages of the retirement spending smile are:

1. The Transition Stage: This phase involves transitioning into retirement, possibly by working part-time or taking on lower-paying roles. During this period, individuals may still have some income from work, but they are gradually adjusting to a reduced workload and increased leisure time. Spending patterns may vary as they adapt to their new lifestyle.

2. The Leisure Stage: The second stage marks the complete decline of work, allowing retirees to dedicate their time to leisure activities. During this phase, spending is likely to increase as retirees indulge in travel, hobbies, dining out, and other forms of entertainment to make the most of their free time.

3. The Health Decline Stage: As retirees age, they enter a phase where health issues and declining energy levels become more prominent. During this period, individuals may experience a gradual decrease in spending as they scale back on activities and expenses that require physical exertion. Healthcare expenses may start to rise as medical needs increase.

4. The End-of-Life Care Stage: In the final stage of retirement, particularly towards the end of life, there is a potential for a significant increase in long-term care and medical expenses. This stage often requires careful financial planning to ensure adequate resources are available to cover healthcare costs and provide support for end-of-life care needs.

The Implications of the Retirement Spending Smile Effect

There are a couple of major implications of the retirement spending smile.

For starters, when mapping out a retirement plan, it seems more prudent to tailor spending estimates to fit your circumstances.

As the retirement spending smile noted, relying on a static inflation-adjusted spending rate might lead to over-saving or unwarranted anxiety if you're not accounting for potential changes in your needs over time.

The Blanchett study underscores the importance for financial planners to anticipate some degree of spending reduction for the majority of retirees, unless their financial situation is exceptionally modest, leaving no room for cuts without compromising essential needs.

And secondly, this has repercussions on the economy as a whole because of diminishing retirement spending.

As I've argued before in **'The Perfect Storm: Why This May Be The Most Important Time For A Financial Advisor'**, there's a tidal wave of individuals hitting retirement age in the U.S. – roughly 12,000 per day until 2030. By then, roughly 20% of the entire U.S. will be retirement age. Meanwhile, the U.S. fertility rate continues sinking lower and lower.

Thus, if this wall of retirees spend less – as the Blanchett study showed – and there are not enough younger individuals to make up for their lost spending, it could be a significant drag on economic and productivity growth.

So, while helping in retirement planning, let's heed the lessons of retirement spending smile.

By embracing flexibility and foresight, we can chart a course that ensures financial security and stability in a client's golden years.

Thus, as always, just some things to monitor that may enhance your practice and depth of knowledge.

Sources:

1. https://www.financialplanningassociation.org/sites/default/files/2020-09/MAY14%20JFP%20Blanchett_0.pdf

2. https://www.forbes.com/sites/wadepfau/2018/09/20/what-is-the-retirement-spending-smile-2/?sh=3f2e5b9d2056

3. https://www.census.gov/library/stories/2023/05/2020-census-united-states-older-population-grew.html?

Disclosure: