

7 Steps to Estimating Your In-Retirement Cash-Flow Needs

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New retirees frequently rhapsodize about the joys of tossing of their alarm clocks into the trash and filling their days with whatever activities they find gratifying. But if they're honest, most new retirees find the financial aspect of the retirement transition to be a little jarring.

On Morningstar.com, we've talked at length about the challenges of extracting cash flow from a portfolio in the current era of ultralow yields. But estimating actual cash-flow *needs* is a tricky business, too. While retirees are often counseled to estimate that they'll spend 75% to 80% of their working incomes in retirement, [a paper by Morningstar's head of retirement research, David Blanchett](#), demonstrated that there can be huge variations in income-replacement rates among retirees--with factors such as pre-retirement income and savings rates serving as key swing factors. Based on Blanchett's findings, higher-income, higher-saving households may well need just 60% (or even less) of their pre-retirement income during retirement, while lower-earning, lower-saving households may need closer to 90%.

Ultimately, it may be difficult to forecast your actual income-replacement needs with a great deal of precision. Even as you attempt to anticipate every in-retirement expense to the penny, unforeseen expenditures such as healthcare costs can buffet spending around on a year-to-year basis. But because anticipated income needs are such a key ingredient in the retirement-income puzzle, it's helpful to come up with as realistic a figure as possible while also being realistic that your own expenditures are apt to vary over time.

Here are the key steps to take as you do so.

Step 1: Find a Realistic Baseline

A key starting point when determining an income-replacement ratio is your working income. If you're close to retirement and seek to maintain a standard of living in retirement that's similar to what you had while you were working, using your current salary as a baseline is reasonable. But if you're younger--say, in your 40s--it may be wise to nudge up your baseline income for retirement-planning purposes, because your current income may not be reflective of what you'll want to spend when you eventually retire. Not only are you apt to receive cost-of-living adjustments as the years go by, but career gains could also lead to a higher salary over time, which you may want to "replace" in retirement. As Blanchett noted in his paper, the average college-educated individual will make a 50% higher salary at retirement than he or she did at age 25. Gains in salary over time are less pronounced for people with lower levels of educational attainment.

Step 2: Subtract Your Savings Rate

The next step in arriving at your customized income-replacement rate is to take a look at what percentage of your salary you're saving--or expect to save by the time you retire--and subtract that from your baseline salary amount. One of the reasons

that higher-income individuals typically have lower income-replacement rates than lower-income people is that the former are able to save a higher percentage of their salaries during their working years; they need less of their salaries to fund basic living expenses. A household saving 20% of its income will see its income-replacement rate drop to 80% right out of the box, even without factoring in any planned lifestyle changes, such as downsizing homes. If you're several years from retirement, it may be that you'll kick up your savings rate if your income grows. (See above.)

Step 3: Subtract Any Tax Reductions

Because they're no longer paying Social Security or Medicare taxes, many people realize tax savings when they retire. Those gained savings tend to be more pronounced for higher-income workers than lower-income ones. More affluent households may see a bigger percentage drop in taxes in retirement than lower-income households because they have greater control over their taxable income now that they're no longer earning a paycheck; the less they pull from their portfolios, the less they're taxed on. Moreover, even as both types of households are drawing income from their portfolios to fund in-retirement living expenses, the higher-income household is apt to be able to have more levers available to keep taxes down--for example, drawing just enough assets from traditional, Roth, and taxable accounts to stay within the lowest tax bracket. Table 1 in Blanchett's paper illustrates the interplay among income, savings rates, and income-replacement rates.

Step 4: Subtract Any Anticipated Housing-Cost Reductions

Housing costs are another line item with the potential to change substantially in retirement. Is your plan to come into retirement without a mortgage, for example? Or perhaps you intend to relocate or downsize in some fashion? Even though the main goal of downsizing may be to add the home-sale proceeds to your retirement kitty, it can have the salutary effect of reducing property taxes and lowering outlays for insurance, utilities, and maintenance. As a senior homeowner, you may also be able to qualify for a reduction in your property taxes, depending on where you live.

Of course, not every household sees a drop in housing costs during retirement; some retirees stay put in their primary residences while also purchasing second homes that actually add to their total housing-related outlays.

Step 5: Factor in Lifestyle Changes

Retirement-planning guides often urge retirees to factor in changes in other expenses, such as commuting, clothes for work, and meals out while on the job or due to busy work schedules. For some households, these expense changes may be minimal, but for others they may be more substantial. In his paper, Blanchett cited previous research pointing to food costs as one of the expense items likely to decline the most in retirement; one paper showed a 5% to 10% drop in food expenditures for households following retirement, while another showed a 6% decline. Not only do retirees have more time to prepare food at home than they did while they were working, the researchers conjectured, but they also have more time to shop for grocery bargains.

As with housing costs, lifestyle-related outlays aren't guaranteed to decline in retirement, so don't assume a reduction in yours without crunching the numbers. If a heavy travel schedule or an expensive hobby are on your retirement to-do list, you might see any cost reductions on line items like food offset by increased expenditures elsewhere.

Step 6: Add Higher Healthcare Costs

Thus far, we've focused on ways that retirees might expect to see their expenses drop in retirement. But there's one major area where they're likely to increase, and that's in the realm of healthcare. [A recent Fidelity study](#) showed that the average out-of-pocket healthcare outlay for a retired couple was \$260,000, and that figure doesn't even include long-term care expenditures. (Fidelity estimates that a 65-year-old couple would need an additional \$130,000 to insure against long-term care expenditures.)

Blanchett's paper also showed that healthcare expenditures are a bigger share of the consumption basket for elderly households in the Bureau of Labor Statistics' Consumer Price Index calculations; on average, older adults devote almost twice as much of their outlays to healthcare expenditures than is the case for the general population. Blanchett also notes that increases in healthcare costs at large are a key reason that the CPI-E has tended to be about 5% higher than the general inflation rate.

Not only have healthcare costs outstripped the general inflation rate, but they also tend to trend up through retirees' own life cycles. Higher healthcare costs later in life are the key reason Blanchett identified what he calls "The Retirement Spending Smile." That's the tendency for household expenses to be on the high side just after retirement (when spending on travel and leisure is apt to be high), dip in midretirement, then head back up toward the end of life as healthcare costs increase. If you're someone who's going without long-term care insurance, in particular, recognize that your household's total healthcare-related outlay could spike dramatically toward the end of your or your partner's lives.

Step 7: Add a Fudge Factor

Working through each of these line items may get you closer to your actual income-replacement rate rather than relying on rules of thumb such as 75% or 80% for income replacement. At the same time, it's worthwhile to approach the exercise with the knowledge that there's much about your future spending that you can't foretell. Long-term care costs are the biggest wild card for people who don't have long-term care insurance or for those who have policies that are capped at specific benefits. Many seniors have also been called upon to help their adult children or their families, unexpectedly increasing their financial outlays in retirement. Homeowners, too, can incur costly and unexpected repair bills at random times. All of these factors can send your expenditures out of line with what you thought they would be. The potential for those unanticipated expenses argues for nudging your own income-replacement rate a bit higher to allow for some wiggle room in your planning.

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