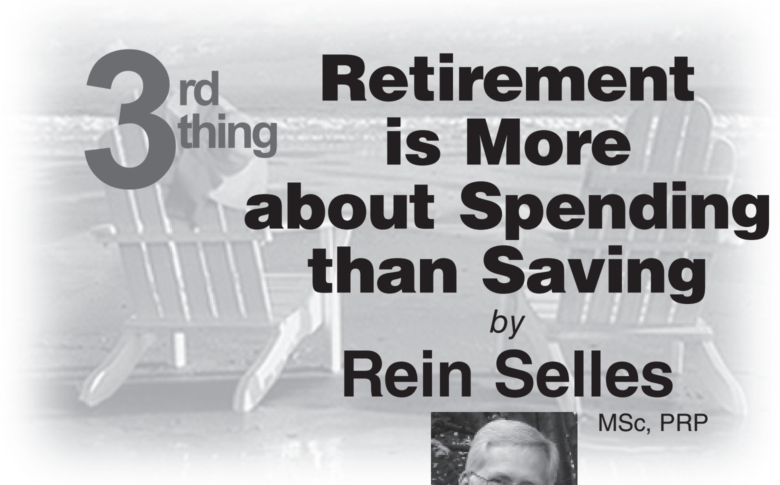

# 3rd thing Retirement is More about Spending than Saving

*by*

## Rein Selles

MSc, PRP

RSP season in Canada runs from January through February each year and represents a period of advertising that is intended to encourage Canadians to save for retirement. In the months leading up to this period, banks and insurance companies will commission polls to test Canadian perceptions and behaviours around saving for retirement. Unless you lived in a log cabin deep in the woods, there is no escape from the message - "*YOU NEED TO SAVE*." Ironically, if you did live in that cabin in the woods, you probably wouldn't need to save!

**How much do you think you need to save for retirement?** Using the numbers below as representative of all savings needed (registered and non-registered assets) to fund retirement, which number best represents the amount you think you need in order to retire?

| | | |
|---|---|---|
| More than | $1,000,000 | ______ |
| | $1,000,000 | ______ |
| | $900,000 | ______ |
| | $800,000 | ______ |
| | $700,000 | ______ |
| | $600,000 | ______ |
| | $500,000 | ______ |
| | $400,000 | ______ |
| | $300,000 | ______ |
| | $200,000 | ______ |
| | $100,000 | ______ |
| Less than | $100,000 | ______ |

**When you picked the number did you include:**

| | Yes | No |
|---|---|---|
| 1. The capital value of your pension plan through work? | ____ | ____ |

*If you participate in a Defined Benefit Pension Plan, chances are you may not know either the value of the benefit you are earning or the capital necessary to fund the benefit (also called the commuted value). Try this rule of thumb: For each $100 of monthly pension you expect, you would need $18,000 of savings available at retirement to fund it.*

| | | |
|---|---|---|
| 2. The capital value representing the income you would receive from Canada Pension Plan at your retirement? | ____ | ____ |
| 3. The capital value representing the income you would receive from the Old Age Security program at 65? | ____ | ____ |

*The point I want to make about these three assets is that you have no control over any of the savings since contributions are required by law or, in the case of Old Age Security, given as a gift in recognition of residence in Canada.*

*****************************************************************

| | | |
|---|---|---|
| 4. The equity in your current home? | ____ | ____ |
| 5. The value of other capital assets such as farm, recreational property or income property? | ____ | ____ |

*Every time you make a mortgage or loan payment that decreases your debt, or when the market increases the value of your property, you also save.*

*****************************************************************

| | | |
|---|---|---|
| 6. The estimated value of any estate that may come to you in the future? | ____ | ____ |
| 7. The amount you plan to win in a lottery if everything else fails! | ____ | ____ |

*I include these last two because two polls in Canada in 2002 found that: 11% of those buying lottery tickets were doing so as a retirement plan (COMPAS), and 20% were waiting for an inheritance so they could retire (DECIMA).*

## WHAT IS THE PROBLEM WITH THE MESSAGE, "SAVE, SAVE, SAVE?"

In some respects Canadians need encouragement to save - particularly as the amount of personal debt increases. A survey by CGA-Canada found that a quarter of Canadians don't save any money at all, even for retirement. The accounting group indicated that Canadians are increasingly relying on borrowed money to finance day-to-day living expenses. (*Canadians In Debt Denial*: CGA's, CBC News posted on-line Thursday, October, 2007)

On the other hand, there are Canadians saving for retirement who, in reaction to the savings message, continue to accumulate wealth despite the fact that they may have "*enough.*" As children of parents who were defined by the Depression Era, the possibility that there may "*never be enough*" can drive some Canadians to work long past their normal retirement age.

The message the financial industry is sending to Canadians is missing a level of balance. If you know that savings may be critical to income replacement, your knowledge of how you spend will help you understand the level of savings needed.

## THE LIFESTYLE (SPENDING) APPROACH

Retirement, as a lifestyle, should be measured as more than one single period of time. While you may be retired for a period longer than your working life, your lifestyle will still change over that period. With longer life expectancies for the baby boomers, retirement may represent a period of 35 to 45 years. Unlike the retirements of our parents which were much shorter and characterized by at least one chronic health condition, baby boomers can expect a much more diverse lifestyle in their own retirements. It may be more effective to plan with three stages. The choice of a specific age range of 15 years for each stage is intended as a guideline rather than a fact.

### Active Retirement

**Stage One** is the period from retirement to 69. It is the time in our retirements when we can expect to be most **ACTIVE**. In fact, it is not very different from current mid-life (40 to 54) since anything is possible. It is not surprising then, that many of today's retirees see the value of continuing work in Stage One as part of their retirement lifestyle.

The language of Stage One can be heard in this statement,

> *"I'm so busy now, I can't find the time to do all the things I want to do."*

### Stable Retirement

**Stage Two, STABLE** retirement, often begins between 70 and 84. The term "*stable*" refers to the fact that many individuals at this stage develop lifestyles that reflect a pattern (e.g. shopping on Tuesdays, banking on Fridays, etc.). Much of the patterned behaviours can be attributed to a need to conserve energy to maintain activities of daily living. Having a routine requires the minimum of thought and yet allows the individual to enjoy life. For many, Stage Two can be the most enjoyable period of retirement and can continue through to one's death.

### Limited Retirement

**Stage Three**, the last stage (85+) of retirement, occurs under two circumstances: loss of health and/or loss of financial security. In either case, the individual's lifestyle choices become **LIMITED**. In order to maintain one's lifestyle (i.e. living in one's own home), the individual may require some level of support. This support could come as formal support from government or agencies, or through informal means by family and friends. When this support is not available or too costly, lifestyle choices become limited.

By viewing retirement in these three stages, retirement planning becomes very interesting.

### Financial Planning for Retirement

When are you likely to need the most income? Stage One since you will be doing the most! When are you likely to have the most disposable income? Stage Two, since the need for income decreases as lifestyles become simpler. There is a real fear that Stage Three may represent a period of higher spending given the need for assisted living or greater nursing care. Some planners will approach this as a legitimate risk that could be managed with a form of insurance that pays out a block of tax-free capital while you are alive called Long term care insurance. (See page 103)

### Planning Your Housing

When would be the best time to move? Well, it depends. If your house is ready for retirement, the maintenance and repair cycle is not likely to begin for 10 or 15 years. So, perhaps the best bet is to move just before Stage Two while the energy is still there to handle the stress.

What kind of house would you look for? A Stage Three house, of course - one that allows you maximum independence (no stairs, wide hallways, large bathroom, lots of natural light, etc.). The worst time to move is in Stage Three since it represents a forced choice - no choice at all.

### Relationships in Retirement

When are you likely to see the most people? Stage Two, because people seek out relationships in recognition of their own aging. If those close to you are lost by death, you quickly learn to value those who are still alive. In Stage One, you are too busy with your active lifestyle! When will you need people the most in your life? Stage Three when support is required.

The idea of "*staging*" plans is to give you a sense of how lifestyle and financial requirements might come together in a plan. At the same time planners will recognize that not everyone can be neatly assigned a label.

## HOW WILL SPENDING CHANGE?

Given that lifestyles are likely to change, spending will change accordingly. While spending changes will differ individually there are general patterns that have emerged when comparing retirees to the rest of the population. Based on a Statistics Canada Review in 2005, Alberta Seniors and Community Supports reported a number of distinct differences in spending between seniors (over 65), the majority of whom are retired, and working families:

~ *Overall (average) spending by seniors ($40,956) represented 49.5% of expenditures of Albertans under 65 ($82,689).*

~ *Approximately 76% ($30,954) of senior households' average total expenditure went towards consumption expenditures compared to 70% ($57,691) for other Albertans. (Note: Consumption expenditures include: food, shelter, household operation, household furnishings and equipment, clothing, transportation, health care, personal care, recreation, reading materials and other printed matter, education, tobacco products and alcoholic beverages, games of chance, and miscellaneous expenditures.)*

~ *While seniors spent more on shelter (21%), those under 65 spent more on personal taxes (22%). Taxes only accounted for 14% of overall spending for seniors.*

- *Non-seniors spent more on home maintenance and repair ($488 on average) than seniors ($355) and such maintenance was reported less frequently by seniors (32%) than those under 65 (45%).*

- *Despite all the stories regarding the cost of health care in retirement, seniors in 2005 spent an average of $1,733 per person, an amount $487 <u>less</u> per person than that spent by Albertans under 65.*

- *Finally, while retirement may represent an opportunity to spend for the "fun" of it, the study reported that, "Seniors spent considerably less on recreation than Albertans under 65 in 2005. Seniors spent an average of $2,416 per person on recreation, compared to $5,658 for non-seniors."*

## PLANNING INCOME AND EXPENSES

The question, "*How much is enough?*" can best be answered by, "*What do you need?*" What you need may not be a single number. Consider the following:

**Your Basic Lifestyle** reflects an amount of spending needed over your lifespan (regardless of what stage you are in). The amount includes those areas that are critical to survival - food, shelter, utilities, insurance, health care, and transportation. No matter what lifestyle you lead over the course of retirement, this level of spending will rank first and will be your priority for planning.

A critical area within Basic spending is <u>continuous drug coverage</u>. If you are in a group supplementary health plan, review your options at retirement. The concern is that any existing medical condition that requires drug treatment may mean that your application for coverage can potentially be denied.

Other benefits gained through employment may also change:

- Group life insurance may cease unless converted to a personal policy at cost. The option to convert group coverage to a personal policy, while guaranteed regardless of medical condition, could be very expensive so have a professional insurance broker compare options for you.

- Disability insurance will end at retirement. Depending on age and whether you apply for CPP retirement benefits, your disability coverage through Canada Pension may still extend into retirement IF you plan to earn an income. At 65, eligibility for disablity insurance will end.

~ Vision/dental plans generally cease unless the employer offers a bridge benefit to age 65. Check with your optometrist and dentist as to the need for insurance in these areas. It certainly doesn't make sense to buy insurance when the premium is greater than your annual cost of service.

## Primary Income

Your Basic spending should be matched by a form of income that represents sources which:

~ Pay through your lifetime; and,

~ Adjust with inflation (by law or by arrangement).

The income sources that best reflect these objectives are **pensions** from employment or those you create using capital (annuities), Canada Pension Plan and Old Age Security. Because it is your goal to always have this level of income, the objective will be to "*fix*" the payment. Hence the term "*fixed income*".

Too much primary (or fixed) income can create other problems in later life. While the good part of fixed income is that the next cheque always arrives, the bad part is that the cheque always arrives - even when you haven't spent the last one!

**Your Discretionary Lifestyle** consists of those areas of spending over which you have a choice. They are most often associated with the quality of life and include travel, recreation, second vehicles or RVs, gifts, charitable giving, and some types of insurance. These expenses are most likely to change through the various stages of your retirement and may decrease with age.

## Secondary Income

Because discretionary spending is <u>variable</u> through retirement, income design needs to be flexible and have two priorities:

~ It should be created in consideration of tax (as income increases, tax rates may also increase); and

~ You will need to be prepared to be personally involved in the decision making.

At some workshops participants will express concern as to how retirees cope with costs associated with changing health - particularly when confronted with the needs of aging and frail parents. Based on my experience, much of the adjustment in spending is done by reallocation of dollars from the Discretionary level to the Basic level. A participant reassured one of my workshop groups with the story of his father, a widower, who lived in an assisted living project in northern Alberta:

> "*My father pays $1,700 per month after tax to live in his facility and there is not one further cent he has to spend. All of his needs are taken care of and he is still banking the rest of his retirement income.*"

There will be situations that can create a tremendous drain on income and capital. Here are some hardships that I have witnessed with retired individuals and families:

- ~ A family that was supporting a child custody battle on behalf of their daughter. Almost all of their retirement capital had been devoted to this cause. Luckily they couldn't touch his pension plan, so they still had an income at retirement.
- ~ A family that supported the post-secondary education costs of all three of their children through graduate and post-graduate degrees. At retirement, while the couple had no retirement savings, there was tremendous pride in the achievements of their children.
- ~ A couple where one member of the family was confined to an Alzheimer's Unit while the other continued to maintain a personal residence and associated costs. The combination of double housing costs meant that there was little left over for any discretionary spending.

## THE SAVINGS EQUATION

Should you save for retirement? Let's review the process you would use to make that decision:

1. You have determined your basic cost of living (in today's dollars) and measured your ability to pay those costs by the estimated pension income you will receive or can create at retirement, <u>after tax</u>. You know that this

income is assured for your lifetime and has the capacity to adjust either fully or partially with inflation.

2. You have begun to develop your interests in such a way that you can set priorities for spending that will make retirement fun. The amount of fun you will actually have will depend on these issues:

a. Will you work in retirement? Earned income from employment, self-employment or revenue property can supplement income that is not yet available from pension plans due to early retirement. Note that the minute you work for pay, <u>you may not need as much income from savings.</u>

b. The employment income that continues for your partner may make a significant difference in maintaining lifestyle without needing to access your retirement savings.

c. Will you retire past the normal retirement age of 65? The irony of our retirement income system is that the older you are when you retire, the more potential primary income (pensions) you may be paid. In some two-pension income families, pension income may not only pay for the basics but may also cover all of your discretionary requirements. This can present a real problem for the withdrawal of savings from registered vehicles like RRSPs because of the potential tax that has to be paid on RRIF income earned after age 71. Test this with your own parents, if alive, to see if they ended up with **too much money** as they got older.

The need to save is directly related to the goal **to retire early**. The earlier the planned retirement, the more personal savings may be needed.

Can everyone retire? I believe so but not the way the media suggests. **Malcolm Hamilton**, the senior actuary for William Mercer, in an address to the Retirement Planning Association of Canada in Calgary in 2002 put the planning task in the following way:

"*Life is filled with risk including:*

~ *the stock market*

~ *your health*

- ~ *social programs*
- ~ *tax policies*
- ~ *inflation*
- ~ *interest rates*

> *You can't manage these risks if you are determined to retire at a certain age, with a certain standard of living.* ***Live frugally, save what you can, retire when you can afford to, and manage to a budget thereafter.***"

So the key is to stay flexible. Be the tree that bends with the wind and you may live to retire at a ripe and rich old age.

# The Budget - Blasphemy?

## Patricia French

As a financial counsellor, I see value in making and using a budget. Certainly, some financial authorities denounce the idea by insisting few people budget well so why bother. I have reviewed and helped create budgets for countless clients and in the process have come to one significant conclusion - most of us do not know where our money goes. As a result, most of us do not know what we need. I believe that lack of financial self-awareness leads people one of two directions. Some worry about not having enough and save aggressively or work longer than necessary to appease their fears. Others blindly trust that when the time comes to retire, reductions in spending will occur to magically match their retirement incomes.

> "*He who does not economize will have to agonize.*"
> ~ **Confucius**

Knowing what you spend now can give you a sense of how you will experience the transition to retirement. Earlier retirees are unlikely to experience an immediate dramatic decrease in spending. That may happen over time; but initially, work-related expenses may be the only substantial cost break.

Learning how you spend is an indispensable trick to help ease you smoothly into retirement. Tracking expenses is an omitted step in most financial plans. One reason that budgeting does not work for most people is they make a list of expenses based purely on their best "*guesstimate*." Sadly, we're poor guessers.

We also build a budget with only basics, like mortgage, utilities, and groceries, but overlook recreation/entertainment, repairs/maintenance of homes and vehicles, clothing, medical, and other irregular expenses.

If I only had a dollar for every time I've heard, "*I just don't understand why my budget is not working, my income is good*". It's not about what we earn, it's what we keep.

You can create or perfect a spending plan with a little time and research. Three tactics will help you uncover your spending behaviour today, which will help you develop a budget that will work for you now and in retirement.

### Strategy I: Watch Now

Track your expenses for two to three months and write down everything. This takes only seconds and a little honesty. Record every dollar that goes through your hands, including change for the parking meter or grabbing a coffee. The advantage is you'll see where your money is going as it happens. The disadvantage is, you're prone to experience accidental budget tightening caused by having to write it down. Not a negative outcome, but once you stop keeping track it's natural to drift back to your old habits. Total what you spend in each category and log it on your spending plan.

### Strategy II: Look Back

Gather two or three months of bank, credit card and line of credit statements. This takes only an evening - a little time investment yielding thorough results. Most financial institutions make it easy to access statements on-line. With the exception of cash withdrawals, you will have a precise itemized list of everything you have spent. Every debit or credit card expense is identified by what, where, when, and how much. Group your expenses by category and input them on your spending plan. Don't forget bank service charges. The flaw of this method is the failure to track cash spending. Cash is easy to spend on the *little things*, like coffees and snacks, and you'll likely have no receipt to show for it. Add up the cash withdrawals and categorize them as your "*personal allowance.*" Don't be surprised if cash spending really adds up.

> "*Beware of little expenses; a small leak will sink a great ship.*" ~ **Benjamin Franklin**

With either method, there will be a certain measure of guessing, because many expenses are sporadic, and may not have occurred during your reference period. Make safe estimates of those irregular expenses, like travel, clothing, and home and auto repair.

Seeing your spending on paper is as much about reducing spending on items you don't value as making room for expenditures you do value. Did you spend nothing on entertainment? If you would like to make it a priority, determine an amount and add the figure to your plan. Stunned by your bank service charges? Research if you have the right service plan. You can compare different plans on the website of the Financial Consumer Agency of Canada **(www.fcac.gc.ca)**. When you know what you've been spending, you can make more informed decisions going forward. Ask yourself if your current spending will be affordable on your retirement income?

### Strategy III: Instant Gratification

Not convinced that making the effort to track will be meaningful? Then I propose a <u>financial challenge</u> to establish if you can afford your current lifestyle in retirement. Calculate the difference between your net working income and your anticipated net retirement income. As for the challenge... stockpile the difference between your pre- and post-retirement incomes in a separate account every month. If you need to dip into that stash, then you have more decisions ahead, and luckily time to do so. If you can consistently bank the difference, while maintaining your lifestyle, you can expect a stress-free transition to your retirement budget.

> "*My problem lies in reconciling my gross habits with my net income.*" ~ **Errol Flynn**

Budgets work. Take the time to put your spending under the spotlight. Experience the satisfaction of deciding what you need and knowing you can make it work, now and in retirement.

# How Do You Know How Much to Save, If You Don't Know How Much You Spend?

**Jim Yih**

While the message from the financial industry is the need to save more money, there are many cases where people are saving money blindly. In other words, they lose sight of why they are saving money in the first place.

## SAVING FOR A RAINY DAY

My father at the age of 79 is still saving for a rainy day and quite frankly, I'm not sure that rainy day will ever come. My perspective on this behaviour is that sometimes retirees have a tough time spending their hard-earned savings because money provides security and nobody wants to run out of money. On the other hand, the message coming from the financial industry is one that creates the fear that if you are not careful, you may run out.

I recently sat down with a retiree who was frustrated by the recommendations of his financial advisor. Every time he wanted to take money out of the portfolio, the advisor convinced him to let it stay put, because spending the capital would enhance the risk of running out of money. Chances are this lack of spending will cause him to die with more money, result in more tax on the estate and generate a larger gift to his kids so they can spend it in ways he wouldn't approve of in the first place.

What was your original goal in saving? I would argue that the goal was for lifestyle. In other words, to use it in retirement to make retirement the best years of your life. So, instead of saving your money for a rainy day, why not use it for a sunny day when you can really enjoy it!

## "YOU NEED $2,800,000 FOR RETIREMENT!"

A lot of people 'blindly save' because they are told to do so. This stems from financial calculators created by the financial industry - many of which are accessible on-line. These calculators can produce outcomes that may instruct people to save $2.8 million dollars for retirement. While that actual number may change, it is usually a number that is astronomically higher than expected. The size of the savings required may have more to do with the assumptions that went into the program than a person's real need. In other words, the output is only as good as the input.

Rather than saving blindly, try to gain a good understanding of all of the issues. This chapter outlines some important assumptions around saving that include non-traditional forms like employment pension, Canada Pension Plan and income from Old Age Security - all forms of income that last for your lifetime and may have provision to deal with inflation.

Instead of saving more money, maybe working longer is a good alternative. Labour force trends suggest that more and more people plan to work in retirement. At one time, if you worked after retirement you were considered a failure, because you did not save enough money. Today, work in retirement is not only perfectly acceptable, it is also becoming the norm.

When faced with a calculation that produces a large figure as a savings goal, check to see what assumptions for spending are being used. The financial services industry has a tendency to use rules of thumb. An example is the rule for income replacement. Advisors will use "70% of pre-retirement gross earnings" as a measure of how much income is enough to maintain lifestyle at retirement. My advice is to avoid rules of thumb wherever possible by knowing your spending today and how that might change in the future, at and during retirement.

## MY TWO CENTS

The bottom line is you can't really understand saving until you've taken some time to understand spending. The root of financial success lies in your ability to understand how you spend money now (today) and how that spending might change in the future. I still remember the words of my dad (the consummate saver),

> "*Always live within your means and you will never get in financial trouble.*"

Many people of his generation held this belief. In order to live within your means, you have to have some idea of your spending habits. With greater access to borrowing, it is very easy for adults to live beyond their means in the period leading up to retirement. There is a lesson to be learned from my father's generation. **Thomas Stanley**, author of the book the "*Millionaire Mind*", believes one of the traits of wealthy people is their ability to understand their spending habits.

### *Exercise Four*

# Making It Personal

## Calculating Basic Monthly Expenditures

The following expenses are most frequently associated with "*basic*" or survival lifestyle spending requirements. Note that where costs are annual, please divide by 12.

| | |
|---|---|
| Food | ________ |
| Clothing (Replacement Cost) | ________ |
| Shelter | |
| Rent | ________ |
| Condo Fees | ________ |
| Utilities | ________ |
| Repair/Maintenance | ________ |
| Insurance | ________ |
| Property Tax | ________ |
| Health Care Insurance (where paid) | ________ |
| Supplementary Health Insurance | ________ |
| Co-insurance Costs (Drugs) | ________ |
| Vision/Dental | ________ |
| One Vehicle | |
| Insurance | ________ |
| Gas & Maintenance | ________ |
| License | ________ |
| Debt (Mortgage when planned into retirement) | ________ |
| Other ______________________________ | ________ |
| ______________________________ | ________ |
| ______________________________ | ________ |
| ______________________________ | ________ |
| ______________________________ | ________ |
| ______________________________ | ________ |
| **TOTAL BASIC** | ________ |

*Exercise Five*

# Making It Personal

## Calculating Discretionary Monthly Expenditures

The following expenses are most frequently associated with "*discretionary*" or quality of life spending requirements. Note that where costs are annual, please divide by 12.

| | |
|---|---|
| Travel | __________ |
| Holidays | __________ |
| Insurance (pick which you will use) | |
| Travel Insurance | __________ |
| Life Insurance | __________ |
| Critical Illness Insurance | __________ |
| Long-Term Care Insurance | __________ |
| Cable/Satellite TV | __________ |
| High Speed Internet | __________ |
| Cell Phones | __________ |
| Clothing (Fashion) | __________ |
| Furnishings (Redecorating) | __________ |
| Household Incidentals (Newspapers, etc.) | __________ |
| Entertainment | __________ |
| Hobbies | __________ |
| Second Vehicle and/or RV | |
| Insurance | __________ |
| Gas & Maintenance | __________ |
| License | __________ |
| Gifts (Christmas, Celebrations, & Birthdays) | __________ |
| Charitable Giving | __________ |
| Season's Tickets | __________ |
| Memberships | __________ |
| Other ______________________________ | __________ |
| __________________________________ | __________ |
| __________________________________ | __________ |
| **TOTAL DISCRETIONARY** | __________ |