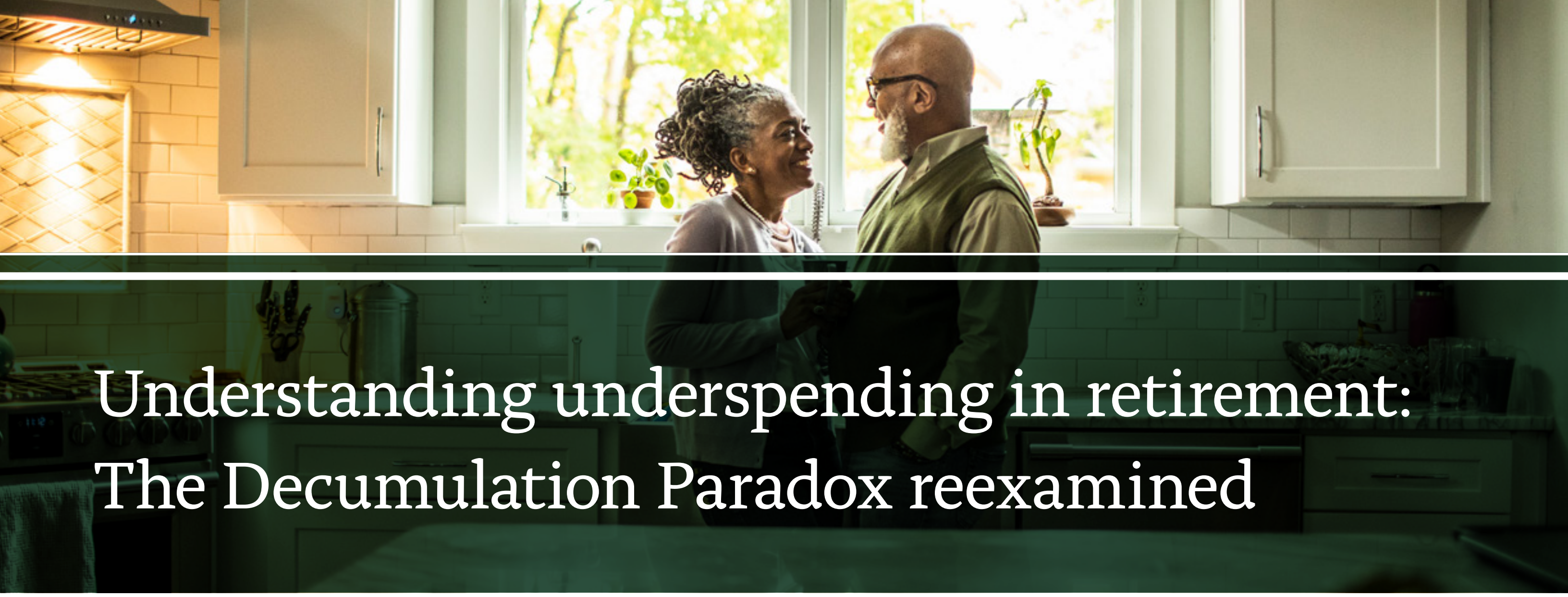

Understanding underspending in retirement: The Decumulation Paradox reexamined

Most Americans devote their working years to saving money to support a long, happy retirement. Surprisingly, few retirees who have built up their savings are, in fact, spending the retirement nest eggs they've worked so hard to create. Instead, many retirees are only spending guaranteed sources of income such as Social Security and pensions or other sources of money from dividends or interest earned on their investments. Still others are continuing to save money in retirement. Financial professionals can help retirees implement strategies that turn accumulated wealth into a steady stream of retirement income to help them confidently spend more and achieve the retirement lifestyle they saved for.

Why aren't retirees withdrawing money from their retirement portfolios?

Underspending is the result of a variety of behavioral tendencies that hinder retirees from making completely safe financial choices and cause them to "self-insure" their retirement. There are practical solutions that financial professionals could use to help retirees overcome these biases, improve their quality of life, and lead more fulfilling retirements. Below are some key behavioral trends in retirement spending.

1. Most retirees do not systematically withdraw from their retirement portfolios.

Retirement planning is loosely based on spend down strategies like the "4% rule" and variations of it, which found that 4% was a "safe" withdrawal rate for retirees as it provides steady income and depletes portfolios at a rate that provided a low chance of running out of money.[1] Actual retiree spending appears to be at odds with this rule. Findings from a 2023 New York Life study show that only 16% of retirees withdraw from their portfolios on a regular, systematic basis and 30% do not withdraw any money from their savings accounts and investment portfolios at all. While the 4% annual withdrawal strategy (or some similar variation of spending down assets) is theoretically optimal and often the starting point of retirement income planning tools, only 3% of retirees who withdraw implement an approach where they take a specific percentage of their total assets.[2]

Retirees are on average continuing to save in retirement and are unnecessarily controlling their spending.

Even when retirement expenses are higher than originally planned for, retirees are still reluctant to utilize portfolio assets.

According to the Society of Actuaries, they reduce their costs rather than deplete their assets whenever possible.3 This behavior is consistent with their working years when they were accumulating assets. The New York Life study mentioned above found that retirees are more likely to reduce discretionary spending (73%) or adjust their budget (67%) than draw down money from savings or their 'nest egg'. In fact, among the one-in-three (31%) retirees facing higher-than-expected expenses, only 38% are withdrawing money from savings or their 'nest egg' to cover these additional costs.

2. Retirees' spending constraints do not align with their preferences for income over wealth preservation.

Retirees' reluctance to draw down portfolio assets, and spend less than they can safely afford, is in many cases leading to further wealth accumulation in retirement. What is perplexing about this behavior is that assuring a comfortable standard of living in retirement appears to be the highest priority for most retirees. Findings from the 2022 Insured Retirement Institute (IRI) Fact Book show that retirees across all wealth levels prioritize a comfortable standard of living in retirement over protecting current level of wealth. IRI showed that 41% of retirees view maintaining a comfortable standard of living in retirement as their most important financial goal.[4]

While retirees wish for, and can afford, a higher quality of life, most are unwilling to spend money to achieve it.

Additionally, according to the results of the 2023 Retirement Confidence Survey, almost two-thirds of retirees place greater importance on having stable income (ensuring a consistent amount of income throughout their lifetime) rather than preserving their wealth (maintaining the original principal amount/balances).[5]

Affluent retirees could safely spend more, but most don't.

This reluctance to spend down portfolio assets is leading to a "consumption gap," whereby retirees are spending less than what their portfolios can safely support. According to research conducted by Blanchett and Finke, retirees are consistently spending about 75% of what they could spend from available assets, and underspending increases with age. There is a solution that empowers consumers to spend more.[6]

Who is spending? Guarantees help retirees comfortably spend more.

Given the widespread underspending behavior and the behavioral biases (e.g., loss aversion, mental accounting, etc.) that may be partially responsible, you may be wondering who is successfully spending more. **Multiple industry studies have shown that people with more guarantees in retirement tend to spend more than those with less certainty.** Research conducted by Madamba and Utkus found that retirees whose incomes are primarily guaranteed (i.e., from Social Security and pensions) spend roughly three-quarters of their income and retirees who rely more heavily on non-guaranteed sources of income (e.g., portfolio assets) spend about two-thirds of their incomes.[7] Similarly, EBRI conducted a study in 2012 which found that having long-term care (LTC) insurance had a significant effect on spending by retired households.[8] The analysis concluded that in 2009, people with LTC insurance coverage had median total household spending of roughly $47,000, whereas those without LTC insurance spent only $32,000. These findings held even when running a regression controlling for income and wealth.

Findings show that households with more guarantees on income are likely to spend more than those with less certain sources of income or generally facing more uncertainty.

Finke and Blanchett's analysis (referenced above) found that when comparing households with the same level of wealth, those who allocate a larger portion of their wealth to guaranteed income tend to spend considerably more annually compared to retirees who have a greater proportion of their wealth in investments. The New York Life research (reference above) found that holding wealth constant, retirees receiving annuity income spend 8% more than their counterparts without annuity income. In addition to simply spending more in retirement, annuity owners are more likely to say that spending money in retirement is satisfying (60% vs. 49% of non-annuity owners).

Spending and saving behavior suggest people are containing spending to "self-insure" their retirement.

The research demonstrating the value of guarantees implies those without guarantees are "self-insuring" retirement against the collection of risks that retirees face, including longevity, sequence of returns, medical/long-term care, and unexpected other expenses. We contend that in addition to the behavioral biases mentioned earlier, self-insuring one's retirement is leading to this underspending behavior and is an inefficient means of protecting against these risks. **Self-insuring these risks is like foregoing homeowner's insurance and choosing to set aside potentially hundreds of thousands of dollars to build a new home if a catastrophic event occurs.** A much more efficient, and practical, approach is to pool that risk by purchasing insurance. Doing so allows one to spend more freely, knowing their potential liability is limited and known in advance. This is no different in retirement, where retirees can reduce or eliminate risks they will likely face (e.g., longevity, market, long-term care) and confidently spend more by utilizing insurance products as part of a broader retirement plan.

Financial professionals are well positioned to help retirees overcome many of these behavioral tendencies and improve their quality of life. By implementing strategies that turn accumulated wealth into a steady stream of retirement income and incorporate guarantees, retirees can confidently spend more and achieve the lifestyle they want and deserve.

While retirees should theoretically be indifferent to how they receive income from their portfolios; the observed behavior indicates this is not the case as retirees are more inclined to spend dividends than capital gains or principal. Simply put, advisors who work with clients who are living below their means may wish to consider these solutions as a behavioral technique to encourage increased spending.

Any steady stream of income may promote greater spending but incorporating guaranteed lifetime income and the guarantees offered by other annuities and insurance products (e.g., long-term care insurance) into retirement portfolios may help improve outcomes by mitigating certain retirement-specific risks (e.g., longevity, sequence of returns, long-term care) that are expensive to self-insure. Not only are there quantifiable benefits of these guarantees, but these guarantees provide an additional "peace of mind" benefit that will help people overcome behavioral biases that may cause them to constrain spending and live below their means in retirement.

This is an excerpt of a white paper by New York Life experts Todd Taylor and Kelli Faust.

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2. Morning Consult/New York Life, May 2023.
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5. 2023 EBRI Retirement Confidence Survey
6. Guaranteed Income: A License to Spend by David Blanchett, Michael S. Finke :: SSRN
7. Spending And Saving In Retirement by Anna Madamba, Ph.D. and Stephen P. Utkus, 2016
8. Understanding the True Cost of Health Care in Retirement by Nicholas Halen, Kelli Faust, Todd Taylor :: SSRN