
Go Ahead, Buy the Harley

By Editorial Staff Thu, Oct 8, 2015

New research in the Journal of Personal Finance shows why retirees can spend 20% more in early retirement than the 4% rule allows. In our latest research roundup, we also highlight research on aging, the demographic aspects of investment mistakes and Social Security claiming.

As an advisor, how do you react to a new retiree's natural desire to splurge? What if he or she yens for a granite-countered kitchen? Or a Harley-Davidson Sportster? Or a three-week spree in France? Well, according to new research, you don't necessarily have to play the spoiler.

Writing in the latest issue of the [Journal of Personal Finance](#), James Welch Jr., a computer programmer at [Dynaxys](#), shows that when you look at the way retirees actually spend their money, as opposed to focusing on portfolio survival over a 30-year retirement, retirees can justify spending about 20% more in early retirement than William Bengen's classic 4% rule would allow.

Welch postulates a 65-year-old who started saving at age 30 and now has a \$1 million portfolio (\$400,000 in an IRA, \$350,000 in a Roth IRA, and \$250,000 in taxable accounts). The paper assumes a 27-year planning horizon, a 2.5% inflation rate, 5% annual returns, and zero assets at death. It combines that with the retirement spending patterns described in four different analyses (listed below) to arrive at a new (but still sustainable) estimated rate of early spending. For instance:

Reality Retirement Planning (29.4% more). This model, based on what actual spending by Americans at different ages (according to the Department of Labor's Consumer Expenditure Survey) suggests that, starting at age 55, spending typically drops by about 15% every five years (2.86% to 4.44% per year) before leveling out at age 75. Average expenditure from ages 55 to 59 is about \$45,000. At ages 70 to 74, it's only \$27,517. Under this scenario, our hypothetical retiree could spend 29.3% more in early retirement than orthodoxy prescribes.

The Lifecycle of Spending (24.6% more). This model, based on the spending patterns of 1.5 million retired customers of Chase Bank, asserts that people spend an average of 0.545% less each year in retirement (assuming 2.5% inflation). In this model, clients can spend about 5% of their assets in the first year of retirement (24.6% more than the 4% rule would allow).

Age Banding Model (18.6% more). This spend-down model tries to improve on Bengen by assigning different inflation rates to different categories of retirement spending (basic living; leisure; health care) and weighting them accordingly. By distributing the weights differently at age 65, 75 and 85, the method raises first-year spending by 18.6%.

Changing Consumption Model (10.2% more). Attributed to David Blanchett of Morningstar, this model reflects the fact (based on the Health and Retirement Study of older Americans) that consumption by retirees tends to be nominally flat year-to-year in mid-retirement before rising again (because of medical expenses) in real terms at the end. This method, which Welch describes as the one “closest to reality”) implies 10.2% more income in the initial year.

There’s always a catch, of course. In this case, higher spending early inevitably reduces the base on which the rest of the portfolio compounds. The longer the person lives, the bigger the potential loss of growth. But the loss isn’t prohibitive, and many people might agree that spending money while you can enjoy it is preferable to saving for a distant expense that may never materialize. This study buttresses that philosophy with math.

Investment mistakes: Who made them in 2008?

In the Global Financial Crisis, the investors who were most likely to pull out of the market were either averse to losing money or were over-confident, concluded West Texas A&M University professor Shan Lei and University of Missouri professor Rui Yao, also writing in the current issue of the [Journal of Personal Finance](#).

You might be surprised by the types of people who made that timing mistake: They tended to be men, Asians, and business owners. The likelihood of making mistakes increased with investable wealth. Those with \$25,000 to \$99,000 were twice as likely to err and those with over \$1 million 2.4 times as likely to err as those with less than \$25,000.

The study analyzed survey data for nearly 2,800 investors from the 2008 Value of Financial Planning Research Study by the FPA and Ameriprise Financial. They controlled for education, income and other factors that influence investment behavior.

How to raise savings by 12%

“Present bias” (difficulty in planning ahead) and “exponential growth bias (an inability to understand compounding) are detrimental to retirement saving behavior, a new [study](#) led by Gopi Shah Goda of Stanford University’s Institute for Economic Policy Research found. If

these biases were eliminated, the study showed, retirement savings would increase an estimated 12%.

The findings were based on surveys where subjects were asked to choose between having \$100 now or more later, to compound the value of different assets, and to answer questions that gauged their confidence in their compounding estimates. More than 90% of those surveyed displayed one or both biases. People who are unaware of these biases were even less likely to save. The results persisted even when controlling for financial literacy, intelligence, and several demographic characteristics.

Low lifespan expectations and early Social Security claiming

Americans who claim Social Security before age 65 have an 80% higher self-assessed probability of dying before age 71 than those who wait until after they turn 65, according to a recent NBER working [paper](#) by Gopi Shah Goda and John Shoven of Stanford and Sita Nataraj Slavov of George Mason University.

The need for income, the researchers found, is not necessarily why so many people claim early. At least one-fourth of the sample population had enough IRA assets to provide them with sufficient income to fund a two- to four-year delay in claiming Social Security benefits.

A search for the fountain of age

Although people born in the late 1800s had much lower average life expectancies than people born today, some of them lived a very long time. A new [study](#) in the *North American Actuarial Journal* identifies the characteristics of people born at that time who lived to be 100 years old.

Those born into households in the western United States lived longer, possibly due to their distance from cities with high rates of infectious disease. Living on a family farm also contributed to longevity. In the northeast, men who grew up in larger households tended to live longer. Oddly enough, so did women who grew up in homes with radios. Siblings of centenarians also lived longer than average; researchers attributed that to environmental rather than genetic similarities.