Will New Retirees Rush to Spend Their Savings?

By Editor Test *Wed, Feb 23, 2011*

A study by MIT's James Poterba (left) and others shows that current retirees tend to hoard 401(k) and traditional IRA assets, along with home equity, against possible future emergencies.

Retirement researchers have often wondered what Boomers will do when they finally get hold of their 401(k) or 403(b) or IRA assets. Will they burn through the cash and be flat broke at 75? Will they be spendthrift grasshoppers or frugal ants?

It’s too soon to know how Boomers will manage their savings. But a new study of existing retirees suggests that those with under $90,000 in their accounts may spend it quickly, but people with more than that are likely to hoard their savings.

“Our central finding is that PRA [personal retirement account] assets, like home equity, tend to be conserved in the early retirement years,” write James Poterba of MIT, Steven Vesti of Dartmouth and David Wise of Harvard. “Only a small proportion of households draw down PRA assets precipitously either before or after age 70½.”

Indeed, if there were no Required Minimum Distribution of qualified savings at age 70½, the current cohort of affluent older Americans seems to obey the conventional wisdom that it’s best to spend tax-favored assets last—after guaranteed income and taxable assets.

“There’s been concern that individuals would draw the money out as soon as they got there, and the assets wouldn’t last long during the retirement period. But the evidence is that the withdrawal profiles are relatively modest. Some are making large withdrawals, but the average is modest. It also looks as though the RMD rules are biting,” MIT’s Poterba told *RIJ*.

The paper, “The Drawdown of Personal Retirement Assets,” says that only about 20% of retiree households report withdrawals from traditional IRAs and 401(k)s before age 70½. After that, the proportion reporting withdrawals jumps to 60%.

Even then, “the overall proportion of assets withdrawn continues to be a small proportion of the PRA balance. This withdrawal ratio averages between one and two percent between ages 60 and 69, and rises to about 5% at age 70½. It fluctuates around that level through age 85.”

“Our evidence is consistent with the view that most households conserve PRA assets for a ‘rainy day,’” the paper said. “Households may want to preserve these funds for contingencies such as entry to a nursing home or other large expenditures”—much as they resist tapping home equity except as a last resort.

But many of today’s retirees have defined benefit pensions that allow them to defer the use of 401(k) assets, MIT’s Poterba told RIJ. Future retirees, few of whom will have DB pensions, may not have that luxury, he conceded.

Future retirees may also have larger average balances, since they've spent more time in the 401(k)/IRA era that began in the mid-1980s and which progressed hand in hand with two huge run-ups in stock prices (along with a couple of major busts).

"While I think that what we report provides a good snapshot of people of current retirement age, the key challenge in looking forward is that people will have had more years to save in 401(k)s," Poterba said.

"This is a population first that did not work all of its working life when 401(k)s were ubiquitous," he added. "They're reaching retirement with smaller balances, and they have a higher rate of DB coverage than successor generations, so more of them I suspect are people who were able to take 401(k) plans as a supplemental plan."

The study is also skewed in the sense that not low-income Americans are a lot less likely to have PRAs. The paper shows that only 8% of the people in the bottom 10% of wealth, health and income status have PRAs, while 80% of people in the top 10% do. (It's well known that only about one half of American workers have access to any workplace retirement savings plan.)

People with smaller account balances are more likely to spend down those balances quickly in retirement, the paper showed. Early retirees (ages 60 to 69) with less than $90,000 in their PRAs were likely to withdraw at least 10% of their assets per year. Those with $20,000 to $30,000 in their accounts spent down an average of 22% a year.

The paper also showed that, "among households headed by someone between the ages of 60 and 69, roughly 10% of PRA owners make an annual withdrawal of 5% or more of their PRA assets, and about 7% withdraw more than 10% of assets.

"At ages 72 and older, after required distributions begin, 59% of households withdraw less than 5% of their PRA balance in a typical year, and 77% withdraw less than 10% of balance. On the other hand, 11% of those over the age of 72 withdraw more than 20% of their balance."