

Estimating the True Cost of Retirement

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Abstract

A common approach to estimating the total amount of savings required to fund retirement is to first apply a generic “replacement rate” to pre-retirement income, such as 80 percent, to get the desired retirement income need. That need is assumed to increase annually at the rate of inflation for the duration of retirement, which is generally assumed to be some fixed period, such as 30 years. Using government data along with a fairly simple market and mortality model, we explore these assumptions to more accurately estimate the true cost of retirement.

We find that the actual replacement rate is likely to vary considerably by retiree household, from under 54 percent to over 87 percent. We note that retiree expenditures do not, on average, increase each year by inflation or by some otherwise static percentage; the actual “spending curve” of a retiree household varies by total consumption and funding level. Specifically, households with lower levels of consumption and higher funding ratios tend to increase spending through the retirement period and households with higher levels of consumption but relatively lower funding ratios tend to decrease spending through the retirement period. When consumption and funding levels are combined and correctly modeled, the true cost of retirement is highly personalized based on each household’s unique facts and circumstances, and are likely to be lower than amounts determined using more traditional models.

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