Your Earliest Work-Free Years May Be Among the Priciest

Estimate Your Retirement Expenses

by Alexandra Armstrong, CFP

Last month, we projected retirement income sources. That's a fairly easy exercise. Now we get to the hard part: projecting your expenses. We're assuming that if you're married and working, you both retire at the same time. Actually, we're finding that many people continue to work part time, but most would like to know they could stop working should they want to or have to do so. Therefore, in this article we assume full retirement.

Author Michael Stein divides retirement years into three parts: the go-go years, the go-slow years and the no-go years! Although we wouldn't go that far, we certainly see our clients more on the move the first few years, spending money on traveling for pleasure and visiting family and friends. Then they may slow down and not travel as much. Finally, owing to the aging process and health issues, they're limited as to how much they can do. In this article, we're talking about your first phase of retirement.

The rule of thumb many financial planners use is that your initial expenses will be 85 percent of what they were when you were working. This is based on the theory that you won't need to spend as much on clothes for work, transportation, eating out and so on.

On the other hand, expenses you might have been able to charge off to business now will have to come out of your pocket.

Based on our observations over the years, we think a more realistic estimate, at least for the first year, is to estimate 100 percent of last year's expenses. You may spend it on different things, but the bottom line will probably be the same as you adjust to your new life.

For instance, you might want to take that long trip across the country that you never had time to take before; redecorate your home, since you'll be spending more time in it; or buy a new car, since you may be driving it more.

Typically, the following year, your expenses will probably be lower after you've adjusted to being retired.

To make these projections for your first stage of retirement, we would start by listing your expenses of the past year. Then we would make two columns beside them: one for what you estimate the first year of expenses will be and then the next year.

Fixed Expenses

In a table you'll find on BetterInvesting's website for this month's magazine, we've listed typical fixed expenses. In looking at expenses, the biggest one usually is your mortgage. People frequently ask whether they should pay off the mortgage when they retire. The answer is, "It depends," because it's a financial and emotional decision. From a financial point of view, if you're paying a relatively low interest rate, this is one of the few tax deductions you have left. Hopefully, the investments you would have to liquidate to pay off the mortgage might earn more than you're paying in interest.

On the other hand, if you owe a relatively small amount on your mortgage and the interest deductions are small relative to your payment, it might be a good idea to pay off your mortgage in its entirety. There's no denying it's a good feeling to be debt-free when you retire.

Another expense might be a home equity loan. This is a second mortgage that may carry a fixed rate of interest or it may be a line of credit with a variable interest rate. Home equity lines of credit are generally based on the prime rate.

Your current interest rate may be low, but your payment will go up when interest rates increase. Although this interest may also be tax-deductible, it might be a good idea to pay off this loan, as it probably is more expensive than your mortgage rate.

As you probably know, interest on auto loans isn't tax-deductible. This is a loan you might want to get rid of when you retire.

Look at your utility bills and see whether these will be changed in any way. What will you have to pay for health insurance, Medicare, etc.?

As for life insurance, you may have come to a point in your life where you can use the values built up in your policies to reduce the amount you currently pay out of pocket. (Consult your life insurance agent to see what you should do in that regard.) You'll note that we've included long-term-care insurance as a budget item in the table. If you haven't already signed up for this, we strongly recommend you consider this coverage.

Variable Expenses

After you list your fixed, predictable expenses, you should look at your variable expenses. These would include groceries, meals eaten out, clothing, dry cleaning, entertainment, travel, personal care (hairdresser, health club and drugstore), dues and subscriptions, cleaning people, medicine, doctors' visits and gifts.

The one expense we can predict you'll have that you didn't budget for will be money needed to help out your children and grandchildren or other family members. Somehow, sometime they'll need your assistance. It might be the down payment on the first home, education for the grandchildren or help after a divorce or job loss. If you're in a position to help, you may do so, but it can wreak havoc on your carefully constructed budget. If giving or loaning money is going to cause you some hardship, you may have to say no.

Taxes

We find people are pretty good at listing their sources of income and expenses but forget to include their income taxes. In most cases, your tax picture will change when you retire, depending on the sources of your retirement income. For instance, you may have had a relatively high income when working, so you invested in tax-free or low-dividend-paying growth stocks. Now that you no longer have earned income, you need to estimate how your income will be taxed. Once you get all your information together, your financial planner or accountant can estimate what your taxes may be in the future.

Conclusion

We'll warn you that no matter how carefully you calculate your future expenses and income, it won't come out the way you expect. Some income won't be as high as you thought. Some expenses are higher or lower than you anticipate.

In our next article we'll compare estimated income and expenses and see how it works out. Ideally you'll have money left over after paying expenses, but often this is not the case. In this case you'll obviously need to adjust your projected budget by trying to increase income and decrease expenses. We'll discuss this topic further next month.

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