

# Financial Matters

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## Retiree Spending Risk

Steadfast Guidance

Your Prosperity



### Retiree Spending Risk

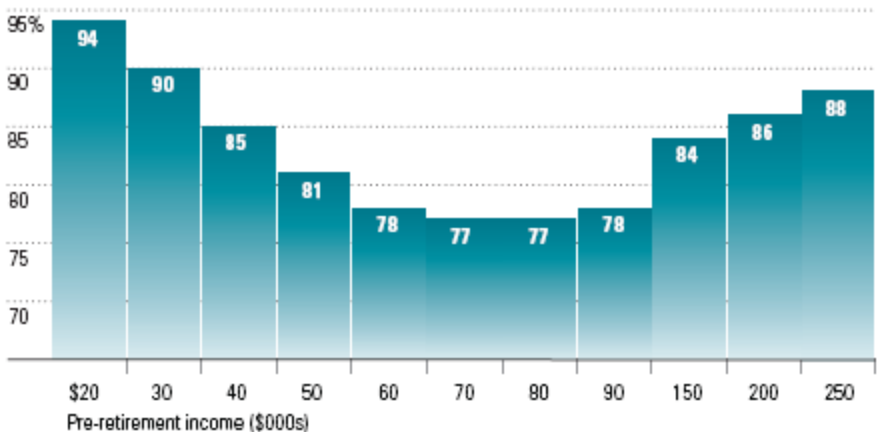
Retirement planning looks a lot different today than it did 50 years ago. While traditional planning focused solely on the accumulation of savings to fund retirement, modern retirees need to focus on prudently spending down savings. Research shows that today's retirees are living longer, leading healthier lives and spending more money on entertainment, travel, and health care. Many financial planners believe that retirees who wish to pursue a very active lifestyle face the risk of spending too much money. Overspending places excessive strain on a retiree's investment portfolio, thereby increasing the danger of outliving his or her assets. By controlling expenses, retirees can preserve their nest egg no matter how long they live.

### How much income do you need in retirement?

When discussing retirement expenses with their clients, many financial planners use the concept of a replacement ratio, or the percentage of pre-retirement gross income needed in retirement to cover expenses and preserve a pre-retirement standard of living. Many financial planners suggest a replacement ratio of 70% to 90%. For example, if you have gross income from all sources of \$100,000 before you retire, an 85% replacement ratio would equate to \$85,000 of income to cover your expenses in retirement. This ratio is essential in helping you identify the specific sources of income that will support your needs, such as Social Security, pensions, part-time employment, or your investment portfolio. The 2008 Retirement Income Replacement Ratio Study by Aon Consulting

cites five reasons why income needs, on average, decrease in retirement: income taxes decrease, FICA taxes disappear, Social Security income is often tax-free or taxed at a reduced rate, saving for retirement is no longer needed, and many job-related expenses are eliminated. The image

**Retirees need to replace a significant amount of income in retirement<sup>1</sup>**  
Average replacement ratios at various pre-retirement income levels



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replacement ratios at various pre-retirement income levels. It is important to think about the lifestyle you would like to lead in retirement. If you desire an active lifestyle with expensive activities such as golf or travel, you might actually spend more in retirement. Replacement ratios of 130% or more are not uncommon in retirees' early years, as people with idle time often find it easy to spend.

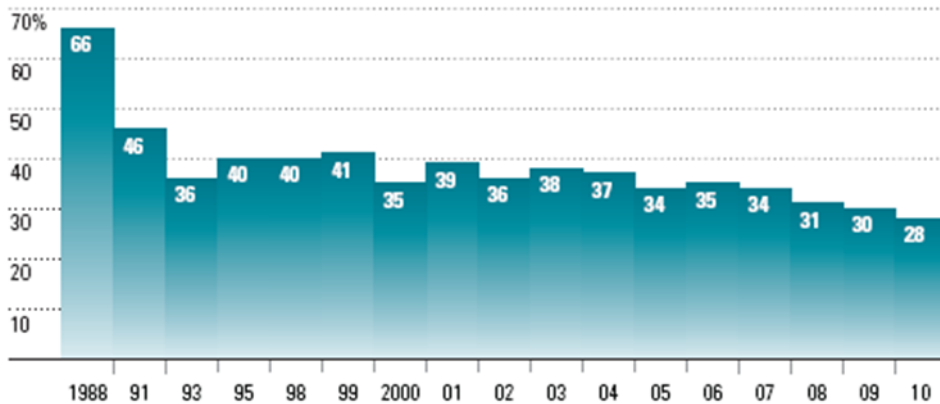
## How should we think about a spending budget in retirement?

How you budget and plan for your retirement is a personal choice. Some people like to develop detailed line-item budgets and track every expense. Others may be fine just thinking about high-level expense categories. Studies have shown that typical out-of-pocket health-care expenses make up about 40% of retiree expenses; housing-related items make up around 25%; travel and leisure make up another 25%; and other items like food and clothing make up about

10%. The actual amounts you spend will depend on factors like your health status, insurance coverage, lifestyle goals, and estate plans. When evaluating your budget, distinguish between essential expenses (e.g., mortgage, insurance payments, basic food, and utilities) and discretionary, or lifestyle expenses (e.g., entertainment, dining out, and travel). Many financial planners suggest that in years in which your portfolio suffers losses, you should consider cutting back on lifestyle expenses and reducing withdrawals from your portfolio. Extraordinary expenses can also make a huge impact on your spending and should factor into your planning. You might want to explicitly budget for things such as a new car or gifts to children and grandkids. For this reason, many financial planners suggest that retirees 1) track their spending in detail during the first year of retirement and 2) keep enough money in a highly liquid account, such as a money market account, to cover their near-term

and emergency expenses without having to liquidate assets at a bad time. Periodically, you would replenish this account with systematic transfers from other accounts.

**Employers are cutting retiree health benefits<sup>4</sup>**  
Percentage of large firms offering retiree health benefits 1988–2010



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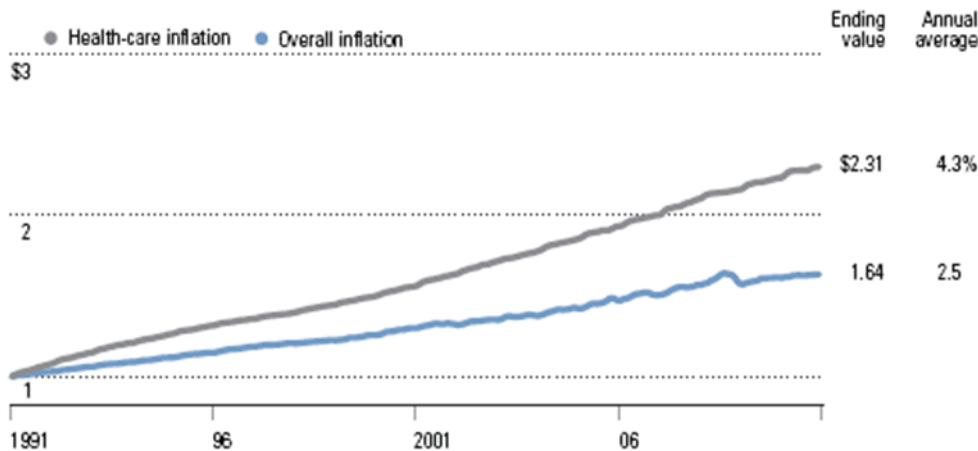


## How much should we expect to spend on health care in retirement?

The Employee Benefit Research Institute estimates that a couple both age 65 would require \$268,000 on average to cover health insurance premiums and out-of-pocket expenses during retirement, assuming em-

ployees do not subsidize premiums. That same couple would need \$414,000 to have a 90% chance of covering health expenses in retirement. Historically, many workers received health-insurance coverage in retirement through their employers. But due to significant increases in health-care expenses, employers are reducing retiree health benefits, as shown in the following image. The percentage of large employers (200 or more workers) that offer retiree health-care benefits has been falling—from 66% in 1988 to just 28% in 2010. Many experts expect this trend to accelerate.

Health-care inflation has far outpaced overall inflation<sup>5</sup>  
1991–2010



Retirees have also depended on retiree health benefits provided by an employer to help fill the gaps in Medicare coverage. However, since the mid-1990s, retiree health benefits have been declining, driven by the increasing costs associated with providing them. According to a January 2010 EBRI issue brief, fewer private-sector employers offer the benefits, and both private- and public-sector employers have been increasing retiree premiums and cost sharing. Also, certain legislative provisions connected with the recent health-care reform may further increase the cost to employers, making private-sector employment-based retiree health benefits practically certain to decline even more.<sup>2,3</sup> One of the major concerns facing a retiree is rapidly rising health-care costs, or health

care inflation, which is significantly higher than the overall rate of inflation, as shown in the graph below. So, as you age, not only will you likely need more medical care, but the cost of medical care will become increasingly expensive and you will be likely to cover a greater portion of each bill out of your own pocket. It is apparent that health-care inflation has far outpaced overall inflation over the past two decades. Since this trend seems likely to continue, retirees should try to develop a financial plan that helps address this problem.



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## How much does long-term care cost?

In addition to typical medical expenses in retirement, you should also consider the cost of long-term care arrangements should you need professional care in your later years, either in-home or in an assisted living facility. There's a good chance you'll need assistance, and it won't be cheap. Forty-four percent of women and 27% of men aged 65 should expect to reside in a nursing home at some point in their lives. The average stay in an assisted living facility is two years for women and 1.3 years for men.<sup>6</sup> According to the 2010 MetLife Market Survey of Nursing Home, Assisted Living, Adult Day Services, and Home Care Costs<sup>7</sup>, the average annual cost for a private room at a nursing home in 2010 was \$83,585. The national average for a semi-private room was \$74,825. The national average for an individual living in an assisted living community was \$39,516. In most cases, long-term care health insurance coverage provides benefits for nursing homes, assisted living facilities, and home care. If you can afford the premiums, you may want to consider purchasing long-term care insurance.



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## Questions to ask your advisor:

- Given our needs and lifestyle goals, what is a reasonable replacement income in retirement?
- Have we accounted for all anticipated expenses in retirement?
- Can our portfolio support these expenses sustainably? If we need to cut back our expenses, where can we tighten the belt?
- What are our medical expenses likely to be, and what medical insurance options should we consider?
- Would we be able to afford long-term care assistance? Should we consider long-term care insurance?

Call North Star Financial Group at 877-323-8877 to speak with one of our financial advisors to assess your financial situation and help guide you before and through retirement.

### Disclosures:

The information provided is for illustrative and educational purposes only and is not intended to provide advice or recommendations to address your specific financial situation.

<sup>1</sup>Source: Aon Consulting 2008 Replacement Ratio Study: A Measurement Tool for Retirement Planning.

<sup>2</sup>Source: Employee Benefit Research Institute, Savings Needed for Health Expenses in Retirement, EBRI Notes, Vol. 30, No. 6, June 2009.

<sup>3</sup>Source: Employee Benefit Research Institute, Implications of Health Reform for Retiree Health Benefits. EBRI Issue Brief #338, January 2010.

<sup>4</sup>Represents large firms with 200 or more workers that offer health benefits to current workers. Source: The Kaiser Family Foundation and Health Research and Educational Trust Employer Health Benefits 2010 Annual Survey, September 2010.

<sup>5</sup>Source: Overall Inflation—Consumer Price Index; Health-care Inflation—Consumer Price Index-Medical Care Inflation, Bureau of Labor Statistics.

<sup>6</sup>Source: Brown, J. & Finkelstein, A. (2007). Why is the market for long-term care insurance so small? Journal of Public Economics, 91(10), 1967–1991.

<sup>7</sup>Source: The MetLife Market Survey of Nursing Home, Assisted Living, Adult Day Services, and Home Care Costs, October 2010

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