Retirement Plans and Health Care Expectations: A Survey of Preretirement Adults

By
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Introduction

> "Grow old along with me!
> The best is yet to be,
> The last of life for which the
> first was made."
>
> *Rabbi Ben Ezra,*
> Robert Browning

Robert Browning's enthusiastic call to join him in aging has always been a great fascination. Indeed, what could be more of a contradiction to modern attitudes about becoming elderly than to claim "the best is yet to be"? What can be more of a challenge to how we approach the relationship between being young and being old than to claim that the last of life is "for which the first was made"? What can the possible rewards of the golden years be that transcend the glorious enthusiasms, unfettered optimisms, and just pure physical conveniences of being young? Or, was Browning simply trying to sucker us all into a *fait accompli,* the hopeful outcome of which is the envy of the very youth that the aged often envy so much.

Whatever joys there are in retirement (and in the aging that accompanies it) come in part from the sense of security that one would hope to have achieved by the time the energies of youth are no longer available for producing income. Whether one accomplishes that or not is in part a function of how well he or she has followed a strategy for creating a financial base in retirement and how well he or she has anticipated the needs to which his or her wealth will be put. In short, it is matter of planning for both how one will create wealth and how one will spend it. Failures in either category have significant impacts on the quality of life one

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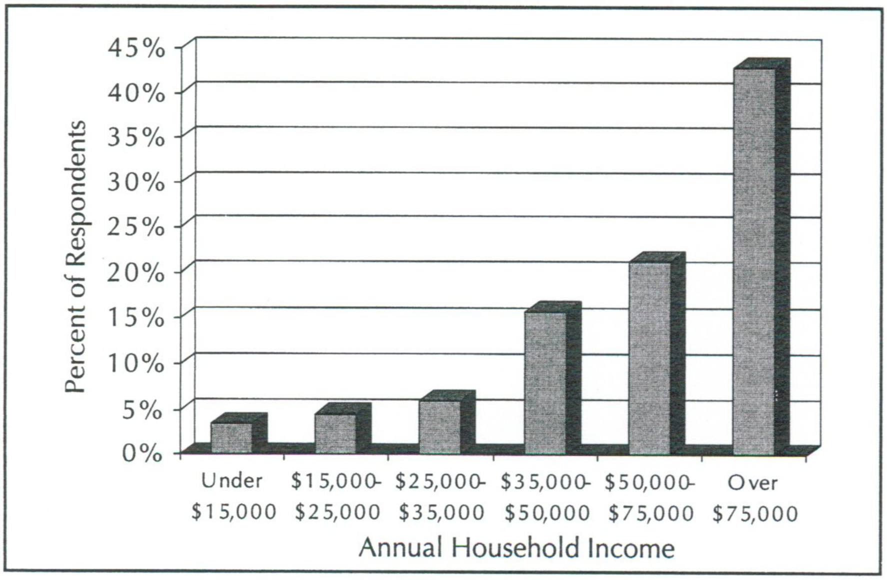
Chart 1



can expect, either because wealth grows more slowly than it must, or because the costs of living are greater than one expected. A significant category of costs that have a large impact on the lives of retirees is health care. Rising costs and burgeoning numbers of people requiring health care have placed pressure on individuals to take greater account of their health care needs as part of preretirement financial planning. For many people, health care is the single largest cost item they will pay on a routine basis in retirement. How well are preretirees anticipating health care costs, and are their expectations about the growth of financial markets realistic in light of their potential financial needs?

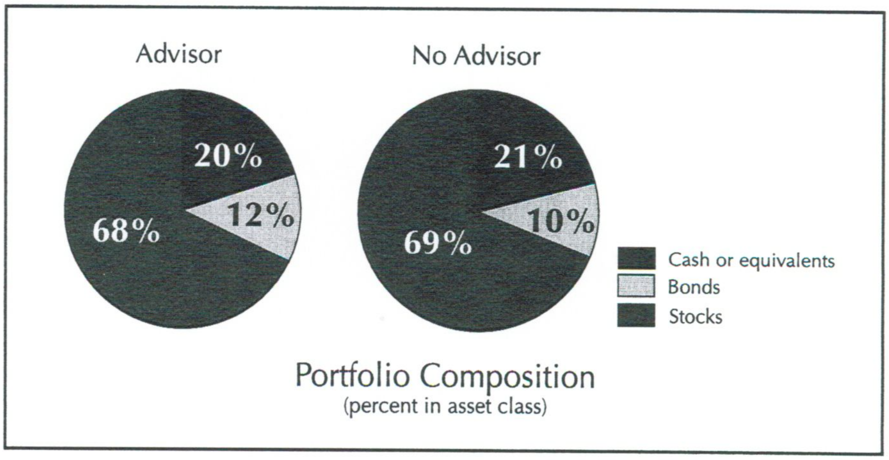
Some answers to these questions can be gleaned from partial results of a recent survey of preretirees in the age range of 45 to 55 years.[1] The survey was conducted by telephone using list-sample techniques in the spring of 2000.[2] A total of 396 households were contacted and agreed to answer questions about a broad range of issues relating to preretirement financial planning, including their concerns about retirement, anticipated uses of wealth in retirement, expectations about the future of the economy, and expected health care costs. Respondents were also asked whether they used the services of a financial advisor, as well as their income level and the amount of income they expected in retirement as a percentage of current household income.

The sample had more male respondents than female respondents (57.6 percent versus 42.4 percent). The vast majority of the sample was of white ethnicity (86.9 percent), with about one-half the African-American representation that one would expect from the U.S. population as a whole (6.1 percent). Almost three-fourths (72.4 percent) of the sample had at least some college education, while over half (51.3 percent) had a four-year degree or more. Income levels were generally high, with over 40 percent of the sample having an annual household income of more than $75,000 (*see* Chart 1).

With regard to retirement planning, two-thirds reported having a portfolio of long-term investments, such as stocks, bonds, and mutual funds. However, somewhat less than half (43.1 percent) reported using the services of a financial advisor or planner. Females who reported having a portfolio of investments were more likely to have used a financial planner (68.5 percent) than were males (51.0 percent).

Respondents who reported having long-term investment portfolios generally indicated that their portfolios were weighted heavily in stocks and stock funds. Chart 2 shows portfolio compositions by asset class. On average, stocks and stock funds comprised two-thirds of respondents' portfolios. Portfolio compositions by asset class did not significantly differ according to whether or not the respondent reported using a financial advisor.

Chart 2



The sample of respondents is an interesting one because it represents a group for whom retirement planning should have reached some importance. Old enough to be in the peak of their income-earning years, they have the opportunity to create wealth but are still young enough to take advantage of long-term economic trends. From a demographic perspective, they are the "leading edge" of the Baby Boomers and are those within that cohort who will retire first. Not only do they burgeon in numbers, but in economics as well. They are the best educated and richest group to have lived in the United States, and perhaps in the world.

Planned Uses of Wealth in Retirement

One reflection of how this group sees its future is captured in how they anticipate using their accumulated wealth in retirement (*see* Chart 3). In keeping with the current social and political spotlight that has been cast on health care, most respondents found this use of retirement wealth critically important. However, the interesting result is not so much that these preretirees were most inclined to use their wealth for basic financial support and health care, as the relatively small number of people who plan to use their wealth for purposes beyond themselves. Bequeathal (*e.g.*, gifts to children, charity) was among the uses of wealth deemed least important. Though people talk much these days of accumulating wealth and building estates, the reality appears to be that their plans are to consume within their own lifetime whatever they have accumulated during their income-earning years. The notion of estate building in the traditional sense of leaving a financial legacy to one's progeny and future generations is largely absent from what we might call the broader middle class concept of wealth, though people's views about their estate may change as they age and reconsider how they would like to be remembered. If the contents of Chart 3 are truly reflective of where the wealthiest generation is with respect to thinking about the future, the future does indeed have a somewhat short-term definition.

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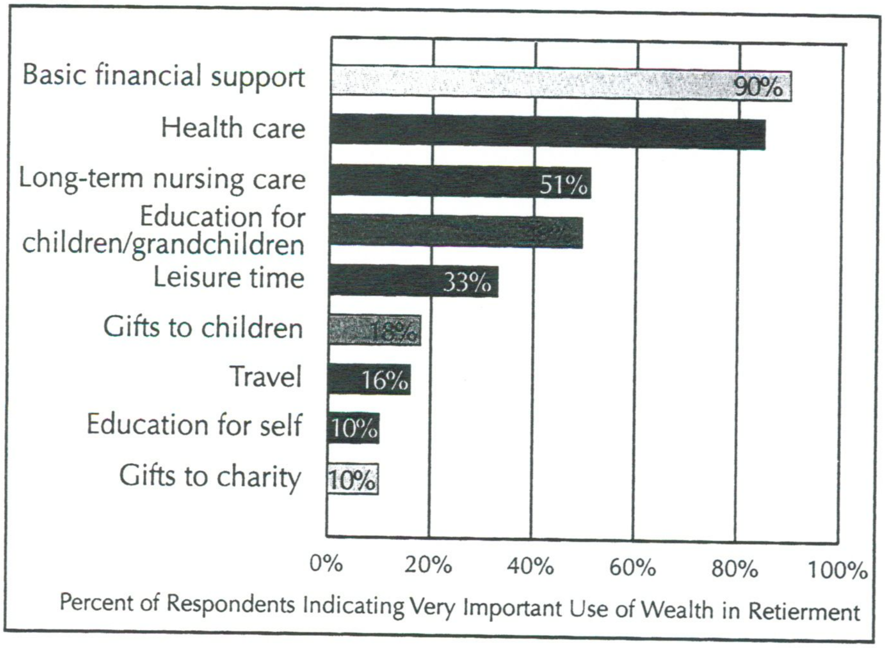
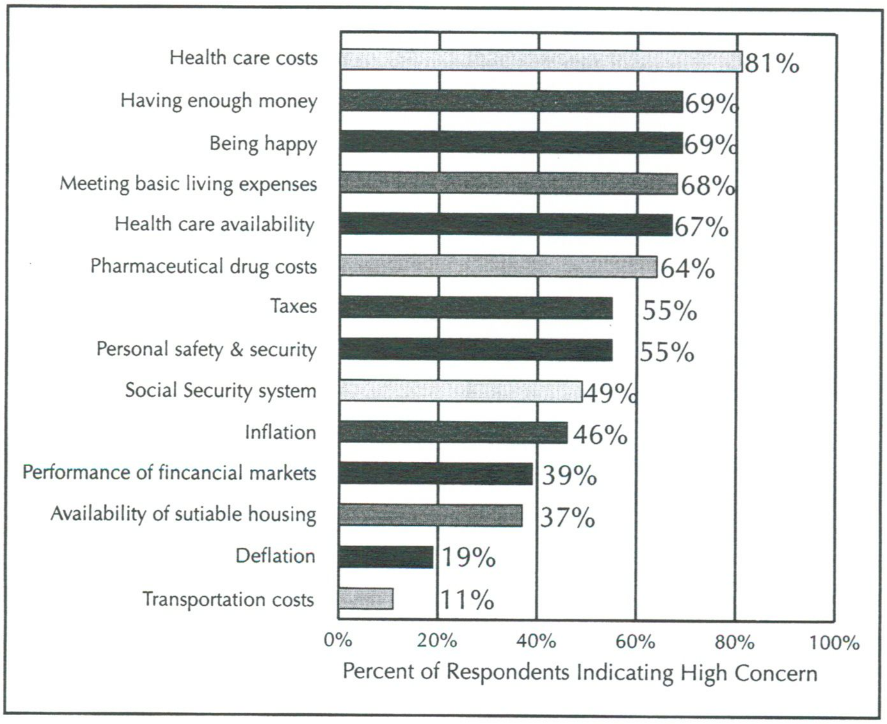
Chart 3



Furthermore, if we consider how people manage their financial lives in contemporary society, we can see that one of the greatest risks to the concept of "future" is to the very definition of future itself. By and large, those who seek to secure their financial future do so by investment in markets. Yet, when we observe the investment behavior of market participants, we see that what many people do when they "invest" is actually more akin to speculation. Though people tout the long-term expectation of financial markets as a reason to invest, their expectations of market returns are based largely on only the most recent years, which have generally been high. Moreover, when people judge how well markets will do in the future, their judgments bear little relationship to the actual potential for returns, and are strongly rooted in images and perceptions.[3]

In contemporary society, long-term investing is often a matter of months, rather than a matter of years. For many people, the concept of a time horizon has become

Chart 4



drastically shortened to the point that the notion of a future beyond a matter of a few years is psychologically meaningless, at least in the context of investment.

Retirement Concerns

As people approach their retirement years, with their wealth in hand, what do they anticipate will be their challenges? What will dominate their interests and their concerns? Though people expect to accumulate wealth, they expect to worry about how to spend it (*see* Chart 4).

Although people appear to have strong concerns about some types of costs, such as health care, and with having enough money in general, their concerns are not uniform across all categories of life's basic needs. For example, people worry much less about transportation costs than about taxes. But, it is interesting to note how concerned people are about "being happy." With some inferential leaping, we can conjecture that perhaps at the core of it all, people recognize the limits of material wealth to provide them what they perhaps most want. Some support for this conjecture comes from an additional result of the survey: fewer than five percent of respondents expected support in retirement from children and family. These results provide yet another indication of the growing tendency of adults in retirement to live apart from their children.

Financial Expectations

Building wealth is a long-term enterprise, the outcome of which is dependent upon the growth rate of financial markets and the rate of economic inflation. Over the past few years, market returns have been relatively high and there has been considerable optimism on the part of investors. Much of this optimism is shared by preretirees in this sample who had portfolios of long-term investments. Table 1 shows respondents' estimates of the near-term and long-term rates of inflation, as well as their expectations for growth in their portfolios, both gross returns and returns adjusted for inflation. The results are grouped by whether the respondent used the services of a financial advisor or planner (*i.e.*, "advisor" versus "no advisor"). Also shown in the table are inflation and market expectations provided by a group of 256 professional financial advisors collected as part of a 1998 study.[4]

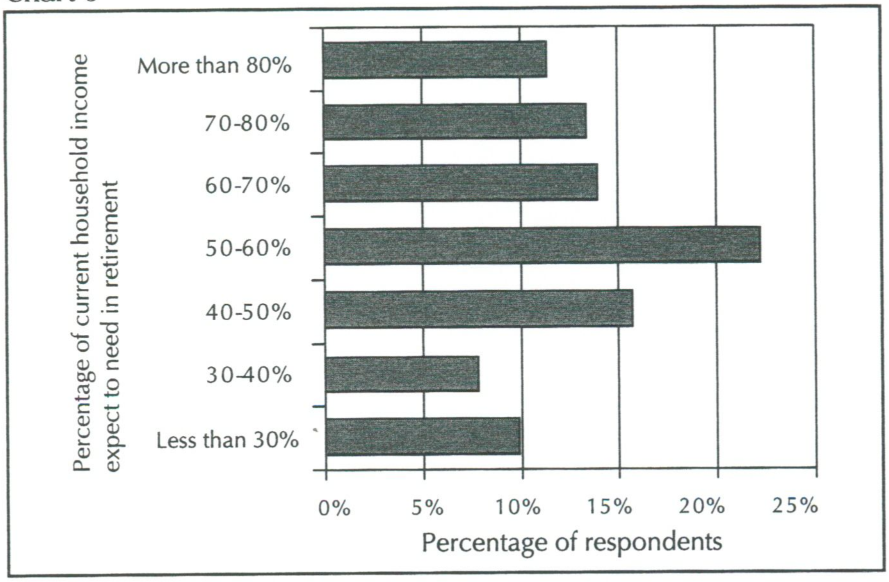
Although survey respondents were inclined to see the long-term rate of inflation as higher than were professional advisors, they were much more optimistic about poten-

Table 1[a]

	All	Advisor (n = 171)	No Advisor (n = 226)	Financial Advisors (*n= 256*)
Expected inflation rate:				
"next year"	4.6%	4.1%	5.0%	2.4%
"average annual rate next 10 years"	6.0	5.2	6.7	3.4
Expected rate of return on portfolio:				
"next year"	15.8[b]	16.7	14.7	9.2[c]
"average annual rate next 10 years"	16.6[b]	18.1	14.7	10.5
Net rate of return on portfolio adjusted for inflation:				
"next year"	14.4[b]	14.3	14.4	—
"average annual net rate next 10 years"	15.5[b]	16.3	14.2	—

[a] From Survey of Financial Planners and Advisors (*see* MacGregor et al., 1999).
[b] Only those respondents indicating that they "expect to receive income from a portfolio of long-term investments such as stocks, bonds, or mutual funds" (n = 261).
[c] Financial advisors were asked to estimate the "percent growth in the S&P 500" for both time periods.

Chart 5



with an annual income under $50,000, 29.6 percent expected 50 percent or less of their current income in retirement. For those with an annual income over $75,000, the percentage expecting 50 percent or less in retirement rose to only 31.7 percent. At the other end of the income distribution, the relationship was only marginally stronger. Those with an income under $50,000 were more likely to expect over 70 percent of their current income in retirement (32.2 percent) than were those with an income over $75,000 (21.8 percent).

tial 10-year annual rates of return. Long-term market expectations were in the 14-percent to 16-percent range, even adjusted for inflation. Although professional advisors generally estimated returns to be very near the historical market average (*e.g.*, 10 percent), preretirees were quite optimistic that their returns would be (on average) about 50 percent above that. Preretirees who indicated that they used the services of a financial advisor were as (or more) optimistic in their market assessments as those who indicated that they did not. The implications of these differences between professional advisors and preretirees are significant. For example, assuming a 15-percent versus a 10-percent growth (a 50-percent difference) in the value of a portfolio over a 15-year investment period yields a difference of almost 100 percent in its future value. For respondents in the middle of the age range surveyed (*i.e.*, 50 years) who have approximately 15 years until retirement, if the growth assumptions of the financial advisors are on the mark, this translates into the potential for realizing roughly half as much wealth in retirement as they may have assumed.

Expected Income in Retirement

On average, respondents expected to retire quite early. The average age that respondents expected to begin drawing income from retirement assets was slightly under 62 years. Male respondents expected to begin using retirement assets slightly sooner than females (61.6 years versus 61.4 years). Respondents generally expected that their assets would have to last them approximately 23 years on average. Those without a long-term investment portfolio expected their assets would have to last them less than 22 years on average.

Respondents expressed wide-ranging estimates of the amount of money they would need in retirement as a percentage of current household income (*see* Chart 5).

Less than a quarter of respondents thought that they would need 70 percent or more of their current income in retirement, while one-third anticipated needing 50 percent or less. The relationship between expectations about income in retirement and current annual household income was only modest. Of respondents

Projections of Health Care Costs

Health care and its costs will be an important concern for retirees for years to come. Although most individuals have some form of health insurance, it is also the case that health insurance rarely covers all of the costs of an individual's health care needs. Not only does health insurance cost money, but many policies carry deductibles. Some health care needs, such as pharmaceuticals, dental, and optical care, may be only partially covered, or not covered at all. In addition, health care needs change over time: the amount of health care a person requires at age 52 is often much less than that required at age 72.

How well have preretirees prepared themselves to meet the costs of their health care needs in retirement? What do they project these costs to be? Respondents were asked to estimate the percentage of their retirement income (on a monthly basis) that they expected to spend on health care, as well as how much they expect to spend on health care in retire-

Table 2

Quartile	Mean income in retirement	Estimated percent income on health care	Yearly health care expense	Monthly health care expense
Q1	$14,414	17.3%	$2,496	$208
Q2	29,218	13.2	3,851	321
Q3	44,707	13.7	6,129	510
Q4	67,189	11.5	7,707	642

Note: All estimates and calculations are in current dollars.

ment compared to what they spend now (*see* Chart 6).

Typical responses to the percentage estimation question were in the range of 14 percent overall. Those who did not have a portfolio of long-term investments expected to spend more than those who have a portfolio. However, having a financial advisor or not made little difference in estimates of the amount of retirement income required for health care costs. For the most part, respondents expected to spend about the same amount or slightly more on health care than they do now.

One approach to gauging the reality of respondents' thinking about health care is to examine the implications of their estimates in terms of actual expected costs. Respondents' income expectations in retirement can be expressed in terms of a monetary amount by multiplying their percentage estimate by their current household income. The average income expected in retirement calculated by this method across all respondents was $40,181, in current dollars. However, this amount varied widely depending on current household income and on expectations about the proportion of current income needed in retirement. Dividing the calculated income distribution into four quartiles and then computing the average within each quartile reveals a high variability in retirement income expectations. Those in the lowest quartile (*i.e.*, lowest 25 percent) expected on average an annual retirement income of $14,414, while those in the highest quartile expected on average $67,189. Averages for the two middle quartiles were $29,218 (Q2) and $44,707 (Q3).

Some sense of the reality of health care cost expectations can be gleaned by calculating anticipated health care cost expenditures based on respondents' percentage estimates for health care expenses in retirement. Table 2 summarizes calculated income in retirement by quartile, and shows the average income within each quartile, the average percentage of income expected for health care, as well as calculated expenditures on health both yearly and monthly.

At the lowest levels of expected income in retirement, preretirees expect to spend only about $200 per month on health care. Even those in the second quartile expected health care expenses on the order of $325 per month. At the highest income levels, health care expense expectations on a monthly basis exceeded $600. Even without accounting for inflation, these amounts are, for many people, very likely to be too low and may fail to take into consideration additional costs for prescription drugs and other health care needs that increase as one ages (*e.g.*, optical care, dental care, prosthetic devices).

Do those who use financial advisors fare any better at projecting health care costs? Table 3 shows monthly health care expenses projected in the same way as Table 2, separately for those who reported using a financial advisor and for those who reported not using one. For both groups, the mean income in retirement by quartile was nearly equal. As the table shows, the two groups were nearly identical across the four quartiles in their projections of health care expenses in retirement.

Implications for Practice

Whatever is in store for all of us in "the last of life," it is a virtual certainty that careful financial management is key to accessing the joys of retirement that many of us have come to desire and even expect. However, when we look at how preretirees (at least this sample of households) view their financial future, we see both elements of hope and causes for

Table 3

	Mean income in retirement		Estimated percent income on health care		Yearly health care expense	
Quartile	No Advisor	Advisor	No Advisor	Advisor	No Advisor	Advisor
Q1	$14,109	$15,539	17.7%	15.6%	$2,497	$2,424
Q2	29,199	29,243	13.6	12.7	3,971	3,714
Q3	44,261	45,140	12.4	15.0	5,488	6,771
Q4	67,308	67,105	11.5	11.4	7,740	7,650

concern. More and more, individuals are exercising self-determinacy in constructing for themselves a financial future, many with the help of a financial professional. Their priorities with regard to meeting living expenses and health care needs appear appropriate. Even their concerns about happiness are, from a psychological perspective, good ones to have and may lead to serious exploration and consideration of ways to achieve life satisfaction that are not tied so strongly to material goals.

However, upon a more careful examination of the details of their economic expectations for the future, the picture harshens. Anticipations of how well financial markets are likely to perform over the long-term appear to be too strongly influenced by recent market performance and do not sufficiently regress to levels more consistent with historical averages. Although optimism is generally a valuable resource for getting through life, excessive optimism is not, particularly when its implications may lead to erroneous conclusions about how much wealth one will have accumulated decades hence. There is a strong tendency in human judgment to rely heavily upon readily available and recent information, and respondents in the present study appear to apply such a strategy in assessing their prospects in the marketplace. From a counseling perspective, this suggests that financial advisors may need to be more assertive in interpreting for their clients the meaning of recent market history. Four or five years of well-above-average returns may encompass, for some clients, their entire investment experience, and a single "flat" year may seem wildly out of context. Research in risk perception has shown that events having an unusual appearance can serve as a "signal" that something is fundamentally wrong and perhaps too "risky." To those relatively inexperienced in making investments and who have been involved in the markets closely for the first time only in the past few years, almost any deviation from strong positive returns may seem unusual and signal that either something is amiss with the concept of market participation, or something is wrong with the advisor they have chosen. When investors' market expectations are so sharply out of agreement with those of professional advisors as we have seen in the results presented here, we can only point more assertively to the

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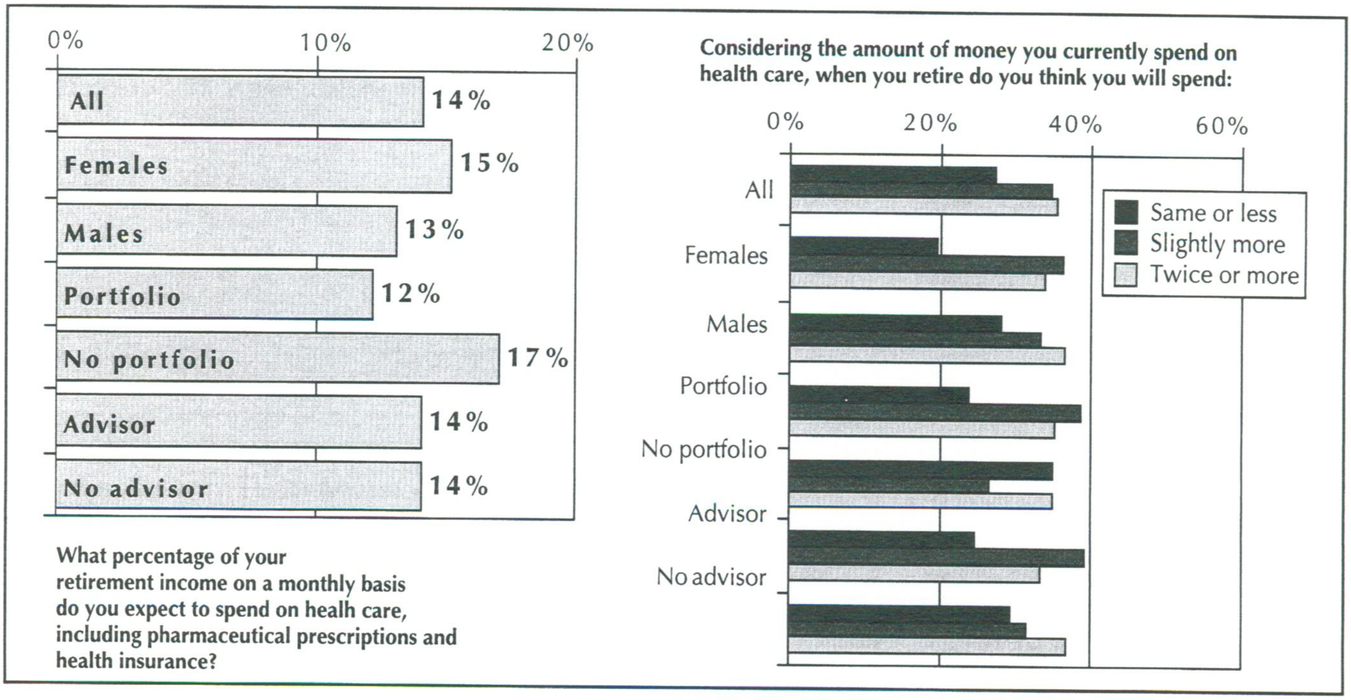
Chart 6



critically important role that advisors play in educating their clients, and to the need for even broader educational standards for all potential investors.

Turning from expectations about market returns to expectations about retirement expenses, we see in the results of this study a potentially serious bias toward underestimating health care costs in retirement. Given the relatively high importance that respondents in the study assigned to this use of wealth in retirement, we might expect these costs to have been overestimated. However, a number of factors conspire against people's ability to make this category of cost projection appropriately. First, health care costs are often not seen on a regular basis. For many people, health insurance payments are automatically deducted from paychecks and unless health care costs in a particular year are unusually high, itemization of health care expenses on federal tax returns is not done. Second, health care needs at ages 45 to 55 are considerably different from those later in life, where (for example) procedures needed may be assigned to provisions of a health care policy that impose higher deductibles (*e.g.*, surgery). Furthermore, some forms of vision and hearing care that retirees deem essential for their quality of life may not be eligible (or only partially eligible) for insurance coverage. A reasonable projection of health care costs for a retired household must take into consideration a broader accounting of health care needs that those associated with regular care, such as annual checkups. Important as well in this assessment is some consideration of an individual's personal health profile and history, as these factors influence the relative likelihood of health problems at different ages.

A potential role for financial advisors exists in aiding clients in making more accurate (or at least more reasonable) projections of health care costs, and linking the implications of health care cost projections to financial plans. However, although relevant health data does exist to develop stochastic models that can aid individuals in projecting potential health care costs, tools to do so are not currently available. A challenge for the future of financial advising and retirement planning is to extend the base of tools advisors apply in their practice to include structured and perhaps computer-based aids that provide individualized profiles and projections of health care needs and costs in retirement.

In Retrospect

Robert Browning penned his exuberant celebration of "aging" in 1864, three years after his wife's death. At that time, life expectancy in England was approximately 40 years for men, and a scant three years older for women, at 43.[5] The notion of "retirement," at least as conceptualized today, was enjoyed only by a privileged few who, because of their economic advantage, could afford the better nutrition, health care, and lifestyle that, in the approximately 150 years since has virtually doubled longevity and brought retirement within the grasp of most people living in modern industrialized societies. Today, we face a different challenge to retirement—lives that may extend to 125 years or longer, well beyond a "working life." Generations close at hand may live as many years in what we now call retirement as they did in the adult workforce. In these generations, the last of life will be that for which the first is made only if people are prepared to meet their financial needs for perhaps decades more than they produce an income. For the future, ensuring the attainability of retirement may be less a matter of extending longevity and more one of improving our ability to plan and prepare for the last of life.

ENDNOTES

1 Support for this research was provided in part by the AARP, Public Policy Institute, Washington, D.C.

2 List samples are drawn at random from a database constructed to match the general demography of the U.S. population. Though not precisely equivalent to a random digit dialing (RDD) sample, the results obtained from list-sample surveys are highly generalizable to the U.S. population as a whole.

3 Donald G. MacGregor, Paul Slovic, David Dreman, and M. Berry, *Imagery, Affect, and Financial Judgment*, Journal of Psychology and Financial Markets, Vol. 1, No. 2, 2000.

4 Donald G. MacGregor, Paul Slovic, M. Berry, & Harold Evensky, *Perception of Financial Risk: A Survey Study of Advisors and Planners*, Journal of Financial Planning, Vol. 12, No. 8, 1999.

5 W. J. MacLennan and W. I. Sellers, *Ageing Through the Ages*, Proceedings of the Royal College of Physicians of Edinburgh, Vol. 29, 1999.