TIAA

Income Insights:
Mental Accounting in retirement

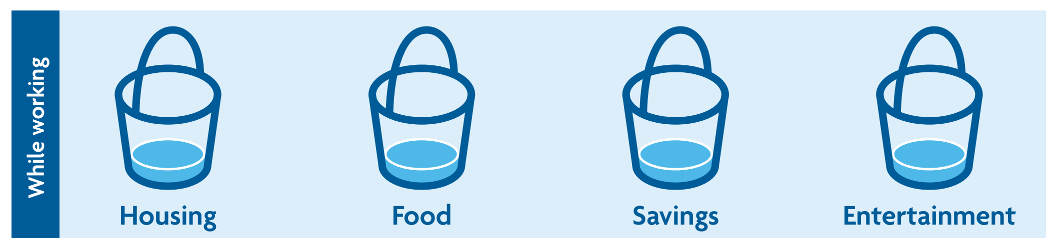
We code, categorize and evaluate our activities.

Mental Accounting in retirement

Decision making can be exhausting. Analyzing the pros and cons of each potential outcome, then weighing their respective chances, would likely cause each of us to need a nap by the time lunch arrives. Luckily, our minds craft a system that enables us to make countless decisions about money without breaking into a sweat.

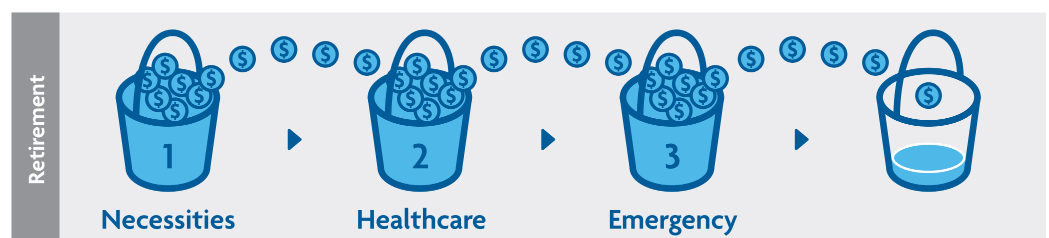
This system, more formally referred to as Mental Accounting, is an economic concept that suggests people code, categorize and evaluate activities based on a variety of subjective criteria, ignoring that funds are transferable.[1] Mental Accounting holds the possibility of delivering tremendous benefits. With the right architecture, it can save us precious time, economize our thinking and increase our self-control.

Many of us develop an initial Mental Accounting system with our very first paycheck. We allocate some portion of that check to the many buckets we feel responsible for. Common categories include: rent, food, loans and, of course, entertainment. Over time, as our responsibilities change, our Mental Accounting system also evolves.



Mental Accounting in retirement requires one simple change in mindset.

Allocating our one paycheck to many different buckets works well for us until we reach retirement, and the paychecks stop coming in. Rather than have one paycheck contributing a small amount to many buckets, be more strategic by prioritizing your buckets and then funding each one in its entirety before moving on to the next.



Mental Accounting is intuitive

If the concept of Mental Accounting resonates with you, you are not alone. Most of us rely on Mental Accounting to one degree or another. Given the number of decisions we need to make each day, let alone over a lifetime, Mental Accounting can be a powerful tool that can either be used passively to reduce stress or proactively, enabling us to be the architect of our own financial security, especially when it comes to spending in retirement. Mental Accounting holds the possibility of delivering tremendous benefits. With the right architecture, it can save us precious time, economize our thinking and increase our self-control.

If you have not invested the time necessary to develop a Mental Accounting system based on logic, then saving time, conserving energy and achieving better self-control may still be illusive. Updating your Mental Accounting architecture can help bring these benefits within reach.

Start with logic for a happier life in retirement.

Designing a Mental Accounting system

When it comes to designing a Mental Accounting system, our analytical side has a definite advantage, yet the phase leading up to retirement is arguably one of the most emotional periods of our adult lives. Many of us underweight the psychological adjustments we will need to address, which can include: the loss of personal identity, reallocation of time among friends and loved ones, and disengagement from various intellectual pursuits. In many ways, waiting until retirement to think through spending strategies is akin to planning for parenthood while you're in labor.

Finding a period when we are less emotional is the first step toward setting the stage for a well-designed Mental Accounting outcome. Not surprisingly, our most logical decision making happens when the analytical component of our mind takes the lead. This type of decision making takes place in the prefrontal cortex, which is associated with complex decision making, problem solving, critical thinking and self-monitoring. Conversely, when we lead with emotions we overweight social considerations, focusing on the perceived value that others attribute to us rather than the economic value we could otherwise enjoy. Naturally, there are tremendous benefits to using all that our minds have to offer.

Subjectivity takes a toll in Mental Accounting

Both emotions and subjectivity play a central role in Mental Accounting. By understanding a few of the most common cases where subjectivity can be found in Mental Accounting, you can quickly learn to be more responsive to their trappings, leading to happier outcomes.

Our value of saving $5 for the same 20 minute drive changes.

Subjectivity: Discounts

Money is almost never easy to come by, so many of us get tremendous pleasure when we uncover discounts. However, our perceived value of the same opportunity to save is not constant. In a landmark study, Kahneman and Tversky posed the following question:

Discounts on a calculator

Imagine that you are about to purchase a **calculator for $15**. The salesman informs you that the **calculator is on sale for $10** at the other branch of the store, located 20 minutes away.

Would you make the trip to the other store?
A majority of people answered **yes**.

Respondents	Save $5 on $15
Yes	55%
No	45%

Discounts on a jacket

Now imagine that you are about to purchase a **jacket for $125**. The salesman informs you that the **jacket is on sale for $120** at the other branch of the store, located 20 minutes away.

Would you make the trip to the other store?
Here, a majority of people now answered **no**.

Respondents	Save $5 on $15	Save $5 on $125
Yes	55%	23%
No	45%	77%

Source: Science, New Series, Vol. 211, No. 4481, January 30, 1981, Tversky and Kahneman.

In both cases people need to drive 20 minutes to save $5, yet the responses are inconsistent. We value the discount differently with respect to a reference point, in this case, price. The analytical component of our thinking knows that the savings is the same in both cases; but when the emotional component takes over, saving $5 for a higher priced jacket isn't quite as appealing.

We act like a $100 bill is different from a $100 ticket.

Subjectivity: Sunk costs

We attribute an irrationally high value to things simply because we have already invested our time, energy or resources into them. We routinely consider historic, unrecoverable costs when making decisions.

Lost a $100 Broadway ticket

Imagine you paid $100 for a ticket to a Broadway show. You arrive at the theater only to discover you lost your ticket.

Would you pay $100 for a replacement ticket?
A majority of people would **not** purchase a new ticket.

Respondents	Lost the ticket
Yes	42%
No	58%

Lost a $100 bill

Imagine that you **planned to buy a ticket** to a Broadway show for $100. You arrive at the theater only to discover you **lost $100 in cash**.

Would you pay $100 for a replacement ticket?
A majority of people **would** purchase the ticket.

Respondents	Lost the ticket	Lost the cash
Yes	42%	76%
No	58%	24%

Source: Kahneman and Tversky, 1984.

Logically, when we open our wallets and look inside, we should be indifferent between a $100 bill and a $100 ticket to a Broadway show. Two pieces of paper, each independently valued at $100, should be enough to convince us that we have $200. However, the subjectivity embedded in Mental Accounting leads us to believe that buying another Broadway ticket increases the cost to $200, whereas losing a $100 bill is attributed an entirely different account labelled something like “lost funds.”

The way we treat money changes based on how we came to acquire the funds in the first place.

Subjectivity: Origin of funds

The logical side of us knows that money is money, but we often forget that money is exchangeable. The way we treat money changes based on how we came to acquire the funds in the first place. We think about an inheritance from our grandparents differently from the money we earn in our paychecks. We treat unexpected funds, like winning the lottery, differently than we would an annual tax refund which we could predict much more easily.

There is a wide spectrum that runs from pure logic to pure emotion. The level of risk we are willing to take for each bucket changes based on the values we associate with where our money comes from.

This is why gamblers say things like “I’m playing with house money,” but we use prudence when considering our hard-earned paychecks. It also helps explains why we open new accounts just to keep our inheritance separate from the funds we earn while working. Our Mental Accounting system codes money differently based on where it came from, which might prevent us from achieving the best long-term outcomes.

Consider the source	Category	Risk	Logical
Earned income	Paying bills	Moderate	Near 100%
Lottery winnings	Frivolous fun	Very high	Near 0%
Inheritance	Long-term asset	Conservative	Split

Source: TIAA.

When we overspend in one bucket, we tend to reduce future spending only in that category rather than transfer funds around.

Subjectivity: Destination of funds

Theoretically, it’s easy to believe that once we finally have money to spend, we’ll have a logical system in place to make the most of it. Unfortunately, this is not always the case. It is easier for us to think about food money, vacation money and, of course, retirement money if we think about them as separate buckets. Once we have our buckets in place, we find it very difficult to transfer funds from one bucket to another.

In fact, when we overspend in one bucket we tend to reduce future spending only in that category rather than transfer funds around, even if it is simply a Mental Accounting entry. This is why people sometimes miss a meal even though their new car fund has enough money to cover a tasty dinner.

Spending in one category lowers future spending in that category

	Housing	Food	Transportation	Savings	Entertainment
Amount to spend	$2,000	$500	$300	$750	$500
Actual spending	$2,000	$700	$300	$750	?
Over/(Under)	$0	($200)	–	–	**$500!**

One simple change shifts from marathon training to a 50-yard dash.

Architect for a happier retirement

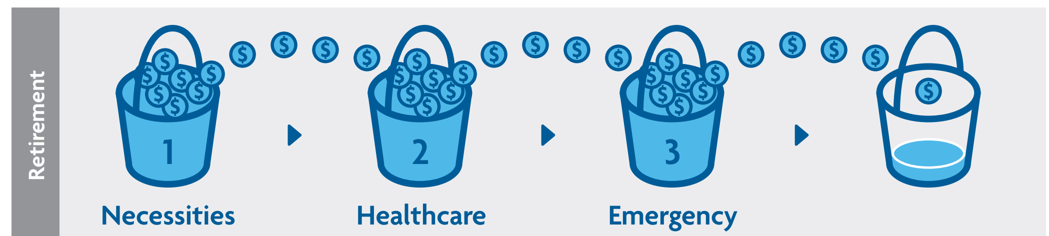
Unlike training for a marathon, Mental Accounting comes naturally to all of us. The choice we really face is whether we want to continue to rely on the knee-jerk system our mind created when we were young or slow down, and strategically develop a system that could enable us to maximize happiness.

Investing time and energy into developing a Mental Accounting system can place the rewards well within reach. This is particularly true as we enter retirement, when we have more assets to work with and less time to recoup for any mistakes we make.

By applying one simple change to our Mental Accounting approach, the entire process will feel more like training for a 50-yard dash rather than a grueling marathon.

Rather than allocating a portion of money to many different buckets, consider prioritizing and ranking several key buckets. Commit to completely fund one bucket before moving on to the next. This approach can provide key benefits such as: quickly knowing if you're saving enough, enabling you to apply different financial products to each bucket and offering transparency into which financial goals you may (or may not) be able to achieve in retirement.

Fund each bucket entirely, then move to the next.



Set yourself up for success by acknowledging a job well done and rewarding yourself along the way. Instead of waiting until the onset of retirement to assess how well prepared you are, consider labeling your buckets based on their relative importance. When a bucket is completely funded, you will have met an important milestone on your journey to financial security in retirement. The list below depicts categories and goals that many of us aspire to reach in retirement.

Order matters.

Category	Fund in order
Necessities	1st
Healthcare	2nd
Emergencies	3rd
Fun	4th
Bequest	5th

Guaranteed lifetime income can play an important role here.

Necessities

One possible place to start is with life's necessities. This initial bucket could include items such as shelter, food, transportation, etc. Everyone defines necessities differently, but the table below is a good starting point. Notice that within the necessities bucket, there is just enough detail to help stay on track, yet enough flexibility for you to incorporate the items you would never want to have to forgo.

Housing	Transportation	Personal items	Entertainment	Taxes
Mortgage/Rent	Car payments (Loan or lease)	Clothing	Dining out	Federal
Real estate taxes	Gas/Oil	Shoes	Club dues/ Memberships	State
Homeowner's insurance	Maintenance	Personal care products	Leisure travel	Local
Phone/Cable	Insurance	Personal services	Theatre and Art	
Utilities	Parking/tolls	Food		

Women in particular could face higher expenses in retirement.

Consider how difficult retirement would be if you needed to begin cutting items from this bucket. For many of these "must haves," we are unable, or at least unwilling, to live without them. For this reason, it's important to fully fund this bucket first and protect it from the volatile markets that could lie ahead. These expenses remain relatively constant, with a slight upward tilt to account for inflation. We could all benefit to have a customized necessities bucket designed exclusively to meet our own needs. Financial planners have the tools necessary to help move away from the averages and toward your unique situation. Women in particular should not rely on averages, as they could face higher necessity expenses in retirement as described in The Gender Retirement Gap.[2]

Several investment solutions, most notably guaranteed lifetime income solutions,* could serve as a good way to fund this bucket before moving on to the next one.

A 65-year-old couple will likely spend $250,000 on healthcare in retirement.

Healthcare in retirement

We have a tendency to underestimate healthcare costs in retirement. Many of us simply think about our current costs, and then forget that as we age, our medical bills are likely to climb. Naturally, there is an abundance of variation with retirement healthcare costs. EBRI publishes a detailed analysis every few years and serves as a great resource for expected expenses that fit your specific situation. According to their most recent study, a 65-year-old couple retiring today will spend $250,000 on healthcare in retirement, not including Medicare and long-term care. Common healthcare expenses in retirement include those listed in the following table.

Insurance	Doctor visits	Medical	Uncovered	Unexpected
Medicare	Co-payments	Medic Alert	Specialists	Accidents
Supplemental	Cash outlays	Wheelchair	Quality of life	Rehabilitation
Dental	Transportation	Tests	Assistance	Dementia
Long-term care	Pharmaceutical	Personal nursing	Cosmetic	

Source: Employee Benefit Research Institute, October 10, 2015.

Since this bucket gets funded with a stated dollar amount, one approach gaining in popularity is funding a Retirement Healthcare Savings Account (RHSA). In addition to providing an explicit way to cover healthcare expenses in retirement, these accounts can have tax advantages making them more appealing to fund while working.

Plan for inevitable Budget Busters.

Emergencies in retirement

No matter how precise your preretirement budgeting is, we are all subject to life's little surprises. Budget busters like leaky roofs or new car tires can wreak havoc on the best laid plans. When emergency spending does arise, we suffer in two distinct ways. First, we have the headache of the problem itself. Second, we suffer the pain of watching our savings dwindle.

One clever way to overcome the pain associated with losing money for each emergency is to begin the year with an allocation to a charity or university. Then throughout the year as emergencies arise, simply cover the costs of those emergencies from the money you already intended to donate. At the end of the year, donate any remaining funds.

This bucket not only enables you to prepare for life's emergencies, it also reduces the painful feeling associated with losing money and enables you to make a contribution to the causes that matter most to you.

Get to this point and you have earned fun in retirement.

Fun, bequests and luxury

At long last, it's time to fund the last three buckets: fun, bequests and luxury. Even though they come last, these are usually the first buckets that jump to mind when we envision retirement.

Fun

Unlike the buckets that came before it, fun has some unique characteristics to consider. The word itself commands a very personal definition. Before deciding which activities will be paid for out of the fun bucket, make sure there is an understanding amongst your family members as to what should be included.

The cash flows we spend on fun in retirement are not usually a smooth, constant stream. For example, some hobbies, like adventurous travel, could require large sums early on in retirement and then trickle down to almost nothing as our mobility diminishes. Conversely, other hobbies, like gardening, could benefit from a long-term, stable cash flow since we could continue to enjoy the hobby well into our elder years. When thinking about how to manage this bucket, one approach is to create cash flow streams that matchup with our hobbies and funding needs.

Defining a bequest allows your loved ones to plan.

Bequests

Many of us think of our bequests passively. We implicitly decide that any savings remaining will go to our heirs and our strategy ends there. By creating a bucket explicitly dedicated to bequests, we are able to achieve two goals. First, the bequest bucket provides transparency to our heirs, enabling them to better plan for their own financial well-being. Second, it enables us to reduce the risk of not spending enough in retirement. Without explicitly funding this bucket, many people forgo spending believing they are making the best decision for their heirs. Often times, they are surprised to learn that their heirs would have more happiness watching them enjoying the fruits of their labor.

Luxury

A well-designed retirement savings strategy, coupled with the Mental Accounting strategy of funding one bucket in its entirety before moving on, could result in guilt-free spending from the final frontier, the luxurious bucket. Early on the allocation to this category is merely a drop in the bucket, whereas applying these simple principles to your retirement spending strategies could result in a happier retirement.

Collectively, fun, bequests and luxury represent the buckets where many people are most comfortable taking higher levels of risk. Marginal risk can often result in greater returns, providing a reward for a lifetime of savings and well-thought-out retirement planning.

"We can't solve problems by using the same kind of thinking we used when we created them."

–Albert Einstein,
TIAA participant

Happiness in retirement: Mental Accounting can be more than a drop in the bucket

Mental Accounting can deliver enormous benefits throughout the course of our lives. Unfortunately, we typically don't reap those rewards without applying a strategic, well-informed approach. Our subjectivity and lack of forethought contribute to our inability to access all that Mental Accounting has to offer.

By deploying the Mental Accounting strategy of fully funding one bucket at a time before moving on, the risk of outliving assets could be greatly reduced and the opportunity to reap the benefits from your hard-earned savings could be well within reach.

Visit **TIAA.org/incomeinsights** to learn more about how you can be the architect for your own financial stability, especially when it comes to spending in retirement.

About Diane Garnick

Diane Garnick is Managing Director and Chief Income Strategist at TIAA. An industry thought leader with two decades of experience structuring retirement and investment solutions, Ms. Garnick is responsible for advancing the strategy, development, and modernization of TIAA's lifetime income solutions across the firm's portfolio of products and services.

1. Journal of Behavioral Decision Making, 12: 183~206 (1999), Mental Accounting Matters, Richard H. Thaler, Graduate School of Business, University of Chicago, USA.
2. Garnick, Diane, Gender Retirement Gap (October 26, 2016). Income Insights, October 2016. Available at SSRN: https://ssrn.com/abstract=2888911

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