Episode 113 RWS Live (not really) Answering your RISA and Asset Allocation Questions (Part 7)

SUMMARY KEYWORDS
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SPEAKERS
Bob French, Wade Pfau, Alex Murguia

Bob French 00:00
The purpose of retire with style is to help you discover the retirement income plan that is right for you. The first step is to discover your retirement income personality. Start by going to risaprofile.com/style and sign up to take the industry's first financial personality tool for retirement planning. Another week, another set of your questions? Keep them coming,

Wade Pfau 00:45
Hi everyone. Welcome to retire with style. I'm Wade, and I'm joined by my co host, Alex. And we're ready for another episode going down the path of answering your questions on a number of different topics. I think we're Episode Seven into this series on the q&a was originally going to be one live episode. But thank you so much for all the questions. We're continuing to move forward. And Alex. Today we're going to be talking more about the Risa and allocation related questions. So I think you have a lot more to say when it comes to answering some of these, you'll finally get your opportunity to shine. And

Alex Murguia 01:18
are you saying I don't have a lot more to say than the other ones? Is that is that? Amazing? Yes, yeah. This is recorded, so I'll be juggling live. Everyone can see me juggle at the same time while I'm answering these. So it's amazing. It's an amazing thing. You

Wade Pfau 01:35
know that this is I went to IKEA the other day. And they had these nice clear picture shells. So if anyone's watching on YouTube, this is the first one where my books are no longer sitting on the table behind me. They're actually poised nicely on the wall there. So looks good.

Alex Murguia 01:51
Nice. Are you sure it's not? You didn't take the furniture bathroom? Is it like a shampoo rack that you put against the wall?

Wade Pfau 02:00
Not actually, I guess it could work in the shower too. But no, that's not working.

Alex Murguia 02:04
No, it's nice. You used to have like behind

Wade Pfau 02:08
me, they are sitting right on the table.

Alex Murguia 02:12
It's perfect. Perfectly over your

Wade Pfau 02:13
right shoulder, my shoulder.

Alex Murguia 02:17
Any books on the other side, though? It looks like it's missing something. Something?

Wade Pfau 02:20
It's like the angel and the devil assymetry

Alex Murguia 02:24
a cemetery. Cemetery works? Yeah, you should put your books on that side. And on the other side, you put all of Dave Ramsey's in, Kent, getting

Wade Pfau 02:35
money makes you

Alex Murguia 02:36
your your hedge. Like swivel relative to what direction? The answer is going. All right. All right. All right. All right. All right. Let's get let's get to it other than how's your pushup journey coming along? or pull up? What do you buy more?

Wade Pfau 02:54
One? I don't know if I said that in the last episode. But yeah, yeah, at a time now.

Alex Murguia 03:03
Do the do a deadlift that

Wade Pfau 03:06
every time I tell you, I also have to lift my knees to be able to do them. And it's just not the thing. And you can bend them with?

Alex Murguia 03:14
Oh, my God, or Alright, fine, bend them and get like core work at the same time is come on, man. All

Wade Pfau 03:21
right. Well, I'll read the first question. Because, like we noted, you're gonna have a lot more input into these. So Alex, question number one. How do you recommend reconciling portfolio

structure when one spouse has clear safety, first orientation, and the other spouse is clear total return orientation. So it's kind of you got a total return receipt, of course, retirement income, state awareness, total returns for one spouse income protection for the other spouse? What do you do?

Alex Murguia 03:54
You can just check episode one, three.

Wade Pfau 03:57
We did have a whole episode where we covered all six of the combinations of retirement income styles. And add a little more color to that or you

Alex Murguia 04:11
see how the table on the turntable that takes me off

Wade Pfau 04:15
one word answers here. Yeah,

Alex Murguia 04:17
how the tables, other tables. Now you know how I view it. No, no teasing. Yeah. And one of the three we we go over this quite a bit. We go through every iteration, where total return risk grab total return income protection, total return time segmentation, and we just go around the whole carousel, if you will. But a couple things I would say is that right off the bat when one spouse has a clear safety, first orientation, and the other spouse has a clear total return. Just to reiterate, there's two factors here that determine strategy. So if you just A safety first. It could be safety first with optionality, which is time segmentation. And that's very different than safety first, and commitment orientation, which is income protection. So I get it shorthand, hey, safety first. And but it's, it's more nuanced than that not because we want it to, but because it just is. Right. And so with that being said, if you're looking here, safety first, but that other spouse wants more of a bucketing time segmentation approach, then effectively, there's a couple of ways to go around that I mean, it begin with think about what bucketing is. Ultimately, bucketing is really setting aside assets on a temporal basis, some sort of timezone, if you want some sort of timeline that you have, so you can allocate, so you can earmark it for essential expenses that are more immediate in nature, what's immediate, you know, that just depends on your timeline, it could be one year, it could be three years, it could be five years, it could be six years effectively, right. But ultimately, while you're doing that bucket, the rest of your assets are in the market, right or in the market being stocks and bonds, but those bonds are maybe more for portfolio volatility as opposed to your drawing income, right. And so you're betting on any, you're ready betting on the market to be able to increase in value, you know, beyond the bucket beyond the bucket time zone, so they can then refill those buckets as you use them up. So to some extent, there is some sort of Interplay already, between time segmentation and total return, it's just in time segmentation, you're you're you're earmarking assets, to be able to address shorter term needs. And those assets are usually in some sort of dividend kind of producing things where government bonds, but you're not considering that as part of your allocation. For all intents and purposes, because of your laddering, you're using the dividends and you're using the principle once it comes due. That's another key piece of of bond ladders that I think people need to realize that you're not just relying on dividends, you're relying on the dividends, but you're also budgeting for, for what's it called you for principal replacement?

Okay? Because you're not going to be able to just live off, oh, maybe now interest rates have gone up. But you know, before it was like, what are you gonna do with half a percent a year of dividends, just not going to cut it. So there's already some sort of balance there. Now, if that if one of the spouses was time segmentation, and the other spouse was total return, I would drill down into liquidity preferences. And what I mean by that is that there's there's two, there's two major risks in retirement that we've seen, that are different than when you're accumulating. One is longevity. And that doesn't play as much here that plays more in the next one. And I'll have you know, we can chime in on that one. But the one that we're looking at here between time segmentation, which is again, safety first both optionality and total return, which is probability based with optionality is you're looking at liquidity. How important is that to the couple? You know, how is that risk? How much of a salient risk factor is that for you, and liquidity is like shorthand for spending shocks, spending shots can be both normal, I have to replace a roof all of a sudden, or a lot of times healthcare needs, a chronic illness was just you're just diagnosed with a chronic illness. And now, you know, new things happen, right. And so based on your sensitivity to two, in my estimation, based on your sensitivity towards that liquidity risk, if you have high, if both of them kind of have high, then I would tilt more towards maybe having that bond ladder run a little longer, or it could be my guess. So it doesn't have to be a bond ladder. But having that time segmentation approach lasts a little longer. It's supposed to three years, maybe make it seven, right? So you have a little bit more of a middle ground between the two. If that's not a salient, then maybe squeezed that bond ladder a little bit just for essential expenses for two to three years. Again, I'm just spitballing here to some extent, but that's the directionally that's how I would be looking at it in terms of finding a middle ground. Now, if you meant safety first with commitment orientation, which is more severe, maybe a strong word, but more dedicated to safety first, and locking it in forever and ever.

Wade Pfau 09:32
Wait, I'm assuming? Because yeah, it makes a factor with a quadrant, but I'm assuming they didn't. But it's,

Alex Murguia 09:40
it's good in general, just to kind of reiterate that so everyone hears it as well. Wait, why don't you take it away since I've spoken. So

Wade Pfau 09:47
now we're talking about the two. This would be the most common combination that you have total return and income protection. So total return was probability based on optionality, income protection and safety for First hand commitment orientation. And yeah, there's a number of different potential options there. The first would just be, in a way I think of income protection, almost like a, a kind of total returns approach. With total returns, you still have some reliable income, including Social Security, and so forth. It's just you don't really worry about filling your gap with income protection, you want all your basics covered with reliable income. But then once you have that in place, you can really frame the remainder as okay, this is my total return portfolio for lifestyle type goals, I can have more flexibility with that I can now invest that more aggressively. And so just a basic income protection approach, framed properly might actually appeal to both in total return and or at least be palatable to the total return, while also appealing to the income protection. With that as well, that sort of walking down that path, thinking about the annuities as part of the bond allocation so that the total return individuals not necessarily have just having to sacrifice stock market, potential upside gains, to be able to create that floor,

it's drawing from the bonds, not from the stocks, just thinking about a kulak qualified longevity annuity contract as a way to get that life deeply deferred longevity insurance protection for late in life expenses. And it's less costly to build an income floor late in life, because you've got a long time horizon before that. And you just the possibility of not living that long as well. So reduce the cost. And then the other option is actually just the option value of waiting. There has been some research about you don't have to buy the annuity, but you keep it in mind as a possibility. And so you just wait as long as possible. But it's always in the background that if markets were to suddenly tank or something, you have some sort of threshold that would trigger. Okay, I bet are locked the same time in so it's, I've got the idea of purchasing an annuity, I'm not actually going to do it. But I am going to monitor the situation. And if if things change, I may look into actually locking that in. And I think those are four general ways to to reconcile or to find some sort of compromise between total return and income protection.

Alex Murguia 12:15
Okay, wait, I'm writing this down. Just trying to catch up. Can you repeat what you said? Just no, no, no, no, no, no, we can, we can always hit the back button. Another

Wade Pfau 12:25
nice. High School, five paragraph essay answer.

Alex Murguia 12:30
No, I think you'd agree. You've got very good because I obviously know. But the reality is, I don't have this kind of, you're speaking quite often right? And it comes across because you're very just to the point where I'm always worried about rambling on a little bit. Now you did great. Then you keep that keep in mind the cue like because I think there's something here when it comes to the next question. as well. Just a little bit, at least in my head potential

Wade Pfau 12:58
episode at least. There was no use. Yeah, there's Yeah. Somewhere on our.

Alex Murguia 13:04
Well, I'm coming at it from here. They were Yeah, you're right. And there's another one. But this is more an indirect when it's just you sparked that when you set it up when you were answering this that one? But here's a question. Many estimate that a couple of needs up to 300,000 set aside in retirement for health care. I want you to chime in on a couple or each individual just as an aside. Is this in addition to buffer cash to make it to age 70 FOR CLAIMING Social Security? So if I am six years from age 70, which is 64. Does that mean I need six years of expenses set aside in cash plus the health care of 300k? If so, how should I invest? Right away? Yeah.

Wade Pfau 13:50
And this is really mixing two different things. I don't think they're really good together. But yeah, we'll kind of break this down piece by piece. So first talking about the estimate, around $300,000 for a couple from age 65 To cover the lifetime health care expenses from that point forward for the average couple of age 65. Yes, that's an estimate. You do see, there's a fidelity study that comes up with something like that. There's a study from YB ri, the Employee Benefits Research Institute, and that is for a couple average couple of age 65 What it's going to take to cover all healthcare related expenses, and this does not include long term care. This is simply healthcare. So Medicare premiums, out of pocket costs. Non covered health needs steadily, I

mean, not covered by Medicare. All that adds up on average to about 300,000. But that's part of the annual budget. That's it's not a $300,000 reserve for unexpected health care expenses. This is simply if I take as part of my budget, the Medicare premiums and everything else every year in retirement, it's going To ultimately its present value of those lifetime costs is about $300,000. So you don't really have to think about that differently than other parts of the budget, all your annual expenses. If you calculate the present value, she may come up with a bigger number than that. But that's simply, this is what we found over time.

Alex Murguia 15:19
You know, what I'm thinking? I think it's some people read that those stats, and if you get it, right, but you know, we're in that sort of headline, sort of mentality, I'm just as guilty. And maybe when you see that you think you always need to have that 300,000. Because eventually, you may break a leg, eventually, you know, there's this one event, and you're saying, no, that's just the Medicare expenses take into its present value, it's not necessarily generally your expenses into its present value,

Wade Pfau 15:47
it's estimating about 11 to $12,000 a year for the couple for health care expenses. And when you add that up over the lifetime, that's how you get Remember, there, you're okay,

Alex Murguia 15:58
the thing that I was gonna say, and this is beyond what you finish your point, wait,

Wade Pfau 16:03
yeah, that's on the healthcare side, we still have the social security part. But go ahead.

Alex Murguia 16:08
Okay. Let me do the healthcare one, just to add this real quick. And because this is what I wanted to add, for those of you that are listening in and are like younger, I mean, something to start considering if you can't within your employees and HSA plan. You know, from a healthcare standpoint, I don't know about you it for but for me, personally, I'm 51. I'm maxing it out from the family. And I think this year, the Max went up, it's at 8300, I think I think I just did those elections at 300 for the year. And the reality is, you can you can wait, you know, till you catch them in it, but that goes in tax free, you know, it really is tax free on going in and going out. So that's, there's nothing like that right now. And frankly, you can use receipts, I can technically keep my receipts right now. And when I start using it, I can offset it, you know, late like 20 years later, when I activate it, I can pretty much kind of like use the receipts now to be able to take money out of it. And to some extent me personally, I'm doing that, seeing where I am, when it becomes active, and then I can decide, but just FYI, that's something to really take advantage of, because I don't know of any vehicle that that is as good from a from a tax efficiency standpoint. In fact, it's not tax efficient, because there's no tax

Wade Pfau 17:30
deduction of tax deferral and tax free distributions for eligible medical expenses. Since the triple whammy of

Alex Murguia 17:36

Yeah. Are you? Are you maxing on our company plan? HSA? Of course? Or should I have asked that? Is that like considered?

Wade Pfau 17:47
I don't know. Well, yeah. Our our employer, there only is a High Deductible Health Plan option. So it's an even have a way to you need a high deductible plan to use an HSA. But we don't have any choice in the matter. But I would do it anyway.

Alex Murguia 18:04
Yeah, so FYI, that's, you know, for those that are younger than you know, for those that still have, you know, are accumulating or in the accumulation phase, and they're thinking about, what am I going to do about healthcare in the future, because long term care policies are kind of tricky, et cetera, et cetera, et cetera, HSA, you know, a heavy dose of that early and often.

Bob French 18:26
Are you up for the challenge? We've just opened registration for retirement researchers Retirement Income Challenge, starting on Monday, March 4, at noon, Eastern. During this free four day challenge with Wade, Alex and I, you'll get to take the Risa and discover how you approach retirement income, run and analyze your own funded ratio to understand where you stand relative to your retirement goals. And if you put in the work, come out, knowing how you can put yourself on a course to bridge that gap. We only have a limited number of seats in the challenge. So head over to Risa profile.com/podcast. To learn more, and sign up today. Again, that's Risa profile.com/podcast. See you in the challenge.

Alex Murguia 19:20
Now the Social Security part of the question, wait, I'm sorry, I just wanted to throw that piece in.

Wade Pfau 19:23
Oh, well, and then the question was also about how do I invest each of these buckets? So just on the this 300,000 have lifetime health care expenses? That's just part of your general if you're counting that as a essential spending, which you may be, you may want to cover it with reliable income sources, part of your Social Security, annuity, bond ladder, that sort of thing. If your total

Alex Murguia 19:45
return, especially it's not a one time 300,000 Because

Wade Pfau 19:49
it's not it's not the spending shocker. It's not the reserve. It's not a contingency. Exactly. It is you're simply if you're the average person, so it's not even counting for contingencies. You may want a little extra for the unexpected, especially if you're using a Medicare Advantage plan or something that doesn't have as much like the Medicare supplements that can cover more of those out of pocket costs.

Alex Murguia 20:14
You're seeing it like it's no different than if you're, you're gonna spend 150,000 on your electric bill. And, yeah, I mean, right? It's like, when you 75 You're gonna get a bill for 150,000. It's, it's one of them idea.

Wade Pfau 20:26
Yeah. Then the socialist here delay Bridge is a different matter. And that's where if you're delaying Social Security, and you're already retired, it's okay to spend from your investments more aggressively while you're waiting for Social Security to begin, because once Social Security begins, you have a much lower distribution needs from your investments. However, if you're destroying that, from a portfolio, it does create more sequence risk because you have this high distribution rate in these early retirement years. So this idea of Social Security delay bridges is you carve out the missing Social Security benefits from your portfolio and create reliable income with them like an eight year bond letter or an eight year fixed annuity, not a lifetime income annuity, but just for eight fixed years, or a term payment over eight years from a reverse mortgage, something that gives you reliable income so that you're not exposing that larger distribution completely to the volatile investment portfolio. I think really, that's, that's the idea behind the Social Security labor edge, and it is very much different than the healthcare issue. Okay, so let me ask you the next question out, because this is more your wheelhouse. Within the Risa framework, how does one make allocation decisions between growth versus value stocks? And among large, mid or small cap stocks? It doesn't. All right, next question.

Alex Murguia 22:01
No, actually, it doesn't. The Risa was meant to just determine what strategy is in play. That's it. And the strategy being total return bond law, you know, time segmentation, but which is bucketing income protection or risk wrap? Right? That's all we could do with that. Now, when it comes to as a general matter, obviously, you have to by default, want to be in the total return strategy to then you know, further play that out. But just as a general matter, you can make the case that this is a risk preference, but not risk tolerance preference in the way you think about it. I mean, risk in the sense of let me begin with this. The we've said this before, but there is nothing wrong. In fact, you can make the case that the standard is just a general market portfolio, because that's how the world chooses to allocate its assets. Right. And so that's looking at global market index. And whatever it is, that's what it is, right? And so any deviation from that, what you're doing is you're making some sort of bet. Okay, now, you can there's reasons behind why you're doing it. But at the end of the day, that's what it is. And let's not try to couch it in any other terms, but because that's what it is. Now, there's reasons for deviating away from a total world market portfolio. The first one is you live in the United States. So do you want to reflect the same allocation as the global world economy? Probably not, you probably want to be a little more heavy in the US, because that's where you live, cash, conversions, currencies, etc, etc. It's just one of those things. Right? That's not to say you should

Wade Pfau 23:42
just link to US inflation. So yeah,

Alex Murguia 23:45
exactly. That doesn't mean you shouldn't have international stocks. But the international stocks is because you just want a full sample size of potential returns, as opposed to I think Germany is going to kill it this year. So let me go all Deutsche Mark, you know, that kind of thing. No, that's not how we mean it. Now, you know, how should you decide between growth and value large, admitted and small? That's in the you know, that's the whole investment theme that we haven't done yet. We did an arc on what not to do with investments, you know, that Bob was part of, but we didn't get into the Mao what phase of it and so we realized that but the quick and dirty I mean, from from my vantage point is let me just take large, mid and small real quick you

know, you could say you can take the the factor investing, right that there's three factors that explain 95% of all stock market returns, right, your decision between value and growth, small and large momentum, etc. Right. Now, you've seen over time that there's been questioning Okay, is this a risk premium? Is this not etc? Let's just put that aside for right now. Right. But even across large, mid and small cap, I would say mid caps do not belong in a portfolio. mid cap is if you have a total market portfolio, you're kind of tilting towards large. And then if you're exposed to small caps, you're obviously tilting towards small those are, that's where you get returned differences, you don't really get a lot of return differences. There's no premium, let me say, between mid and large, there's a premium between small and large, but not necessarily mid and large. And so if you have a portfolio that has, again, making this up 50% Exposure to large 50% Exposure to small, if you blend this together, you're kind of getting already mid cap risk exposure. And so you kind of just further defuse a portfolio unnecessarily by adding mid cap, there's no greater expected return on the mid cap side. And if you do large or small, combined, you're kind of getting that. That exposure anyway. So you're like, doubling up. This goes back to we've used this example, when it comes to the Risa. But think about you're creating colors, right? Yellow, yellow is large cap blue is small cap green, is kind of what you get when you combine those. And those those same green quote unquote risk exposures is what you would find in makeup. So me personally, forget mid cap from the portfolio. I think that's a marketing piece where hey, we can sell mid cap funds. Now, that kind of thing. Unless there's some personal reason that I can't think of right now off the top of my head, I wouldn't necessarily do it

Wade Pfau 26:20
your retail team towards mid cap away from because the total market portfolio includes me. Yeah,

Alex Murguia 26:27
I'm talking about tilting, I'm talking about tilting, I'm not saying you shouldn't be in what I'm seeing is the risk profile, I wouldn't go out of my way to buy a mid cap stock index. If you already have large and small, I would play with those percentages, as opposed to oh, let me get let me do a third, a third, a third, that's useless, you might as well just do 80%, large cap 20%, small cap, you know, something like that? How would you tilt towards it, it's just relative to the degree that you feel those factors will be those risk factors will have a premium over the long term. And the reality is the long term there is 20 years plus, now, you can make the same argument with growth and value. from that vantage point, although we don't necessarily look towards growth, although that would have been wrong for the last 10 plus years, you know, but the reality is, the Risa is not designed to really help you distinguish, okay, this month now that your total return this month should go to growth as much or go to value etc. It's really more do you even want that strategy that is based on a market portfolio? All right now, wait, I would say this in your research, because this is retirement income. The main the main question between portfolio allocation when you're determining the optimal withdrawal rate, is it really the split between value and growth doesn't even matter? To me, the main question is just stocks or bonds. I mean, that's going to be the driver. Everything else is just kind of icing is too cute. But it's just it's not the main driver. Because once you're in stocks, the difference between value and growth or size and this and that isn't a salient from the from determining a safe withdrawal rate. But that's my view, right? You've done research. What do you think?

Wade Pfau 28:12

Well about? Yeah, I agree. It's stocks and bonds. And they'll begin to do this study is where he compared large cap US stocks and small cap US stocks and found historically, even though small cap stocks are much more volatile than large cap stocks, you could actually increase the the safe withdrawal rate by having a disproportionate amount into small cap stocks as well. So there's certainly the option to do that sort of thing. But right the RESA framework isn't designed to help you decide on these types of questions. It's really the bigger picture of how do I want to fund my core spending in retirement? Now there is a role for an investment portfolio with all four retirement income styles. And that's where when you get to building that portfolio, the research is not necessarily informing the question around wealth growth or value or large, mid small, those are asset allocation related questions that go beyond what the reset was intended to provide.

Alex Murguia 29:09
Is that in its asset allocation at the secondary levels, secondary, you know, the other the other thing, since we're getting on this, and this came up actually, last week, one of my friends was asking me this, what are my thoughts on equal weighted indices? And you're seeing this a lot in the news simply because the fence you know, used to be fangs two years ago, and then half of them changed their name right? And so thing didn't work. And now they're called like The Magnificent Seven because invidious and looking at and things like that. And so a lot of it is well, The Magnificent Seven has been performing like this versus an equal weighted index. And so these equal this equally weighted indices are now becoming this hot thing as evidenced by like, my friends are starting to ask me, which is the good one. This is not a q&a, but it's come up so I'm assuming this kind of question leads into it a little bit. Equal weighted indices are silly. They're very inefficient. It was a paper done a few years ago, by a few years ago, maybe 10 years ago by Robert or not who, you know, some folks consider him a good researcher, other folks consider him sort of a hack that recycles things that other people have done to a large extent and an equal weighted index is if you really think about it, it has a similar exposure to a small cap value type of index, because you're effectively not giving equal weighting to every stock. And so the smaller stocks and the stocks that are valued on a fundamental standpoint, they're cheaper, all of a sudden, they have a greater representation. And so to me, again, you might as well just get the market portfolio and then get get exposure to small cap stocks, small value stocks and small value stocks. And that's a much better way and more efficient way to do it, than to buy this equal weighted market index is just this marketing thing that's happening right now, it's a very inefficient way to manage a fund number one, and it you have difficulty and then controlling exposure to the risk premiums that are out there. It was just again, or not started this and in some of those markets, but he took you know, we have Bob here all the time, but he effectively took Bob's dad's research can fam on French, and recycled it as his own as in the in the in the way of, hey, there's an equal weighted market cap strategy, that's not the way you want to do it. Just FYI, if you're thinking about splitting, and sometimes you throw your hands up in the air and say, I'm just gonna get an equal weighted index, because that's the thing. Frankly, if that's the case, you're probably doing that because of this magnificent seven thing, and I want something to protect me in case they don't outperform, blah, blah, blah. Well, that's why you have value indices. That's why you have small cap indices. That's why you have small value. That's why I have international, etc. Again, I went off there a little bit, but it's been coming up among my friends. And so I'm just assuming, you know, listeners are hearing that as well.

Wade Pfau 32:07
I know your friend Manny has really benefited from your advice.

Alex Murguia 32:14
This is actually another jump Pablo. Always have trouble saying John. He's like g n and I don't know. But okay, there we are away. Okay, that would

Wade Pfau 32:27
let me go ahead and read the next question too, because this is still more of an investment related one. And this one's longer. This is an essay. So here we go. I'm looking to retire in about five years at about age 61 year ago. This is important for later but a pin in that one year. One year ago, I put together a test portfolio comprised of 20, high yielding stocks or funds in eight or nine areas, REIT mortgage trust BDC, pipelines, consumer goods, telecommunications, mining, dynamic income intermediate bonds, the current yield is 10.3%. I know that it has only been a year, but the principal value has never declined. And it is currently up 10%, despite one holding, losing 50% of value. I'm not concerned with legacy nor keeping up with inflation. I anticipate heavier spending earlier in retirement. So if the real value of my withdrawals goes down, I'm okay with that. My question is, is there anything wrong with using this method for half of my non Social Security retirement income? I was planning a speech for the other half. I appreciate any input you can give. Thank you.

Alex Murguia 33:48
We appreciate the questions, you know, and these are these things that we can be nice and be like, Oh, that's a great strategy, but etc, etc. So with respect here, and I mean, the sincerity but I'm just going to cut to the chase because it's just easier that way. This is not a good strategy. It just isn't a couple of reasons why. The first one is you're extremely concentrated, it's not worth the risk. The second one is and forget the whole book of the dividend darlings or whatever the hell the thing is called that's that's silliness. That so there's a huge concentration. The other piece is that you end up searching for yield at the expense of a properly diversified portfolio. Right? You're pointing out here that your yield is 10.3. So what you know, who cares about the yield just 10.3 of your your principal went down 80%. And I know it's been a year but it's only been a year,

Wade Pfau 34:44
as you said, that doesn't also because the s&p 500 was at 24% last year.

Alex Murguia 34:51
20 great point. I don't even think about that angle. You're always better off. And I mean always. We don't speak in absolutes here. But you're better off in a market driven portfolio. And then you just take a distribution from that portfolio and you create your own yield. I think this idea of yields from stocks, look, a company has decisions to make at the end of the year, they can take the money reinvested in research projects, they can hand it out, they can hand it back to their investors, if they don't have anything to do with it. If they don't have anything that they can put it in, that yields a higher net present value, or they can effectively buy back shares with the extra cash, right? Just because someone decides to do dividends versus something else doesn't make it any better. I think as of this recording Facebook, they just announced the dividend, right? That doesn't necessarily think, oh, I want to get it because I'm retired and I'm gonna take this stock and get the yield. That's like really old thinking like 1950s, railroad stock kind of thinking, the reality is, get the market portfolio is diversified and take a withdrawal from it. If that's what you're going to do and create your own dividend effectively. There's tax reasons for

it, there is specificity of your own situation, why you want to do it, etc. There's nothing magical about dividend stocks. I I don't know why CNBC publishes these things all the time, or you see commercials just specifically for dividend investing. That's kind of not kind of that is an outdated way of developing retirement income. Somebody could be listening to me and saying, You're full of crap. But the reality is, the numbers are the numbers. And doing it that way is very inefficient relative to just taking a distribution from a portfolio, and not not even talking about just the portfolio management best practices. That's the there's no skirting around it. So I wanted to be very blunt in my answer, where do you want to soften the language so we don't get hate mail or

Wade Pfau 36:50
disagree with you. I mean, you're really you're moving away from the total market portfolio until less diversified portfolio. And I think you briefly mentioned taxes, but that would emphasize that as well, that when you're investing for income in this manner, it may be less tax efficient, you're generating more ordinary income from the portfolio through the dividends, through interest, and so forth. And long term capital gains get that preferential tax treatment. So that another benefit of that broadly diversified total return portfolio is the tax benefits as well. So you're taking more risk to do this sort of approach and can't really advocate for it. It's not one of the viable retirement income strategies that we list to talk about moving away from the market portfolio to invest specifically to generate income from the portfolio.

Alex Murguia 37:42
But wait, the dividend stocks, those stocks are safe?

Wade Pfau 37:45
Well, one of them give me 50. No, I

Alex Murguia 37:47
honestly I go ahead answer it. I think people would appreciate your and be as you know, off off the record, you have a certain saltiness What do you say to that? No, but wait, their dividend stocks? Well, I'm

Wade Pfau 38:01
here. So this portfolio may mean things may be a little bit rounded here, but he's talking about the portfolio being up 20% for the year, whereas the s&p 500 was up 24%. You're just taking the sort of active risk when you move away from the market portfolio, and it's not clearly going to pay off in any manner, science. It's just it's not my

Bob French 38:25
teacher. Let's take a moment to let the audience know that this show is sponsored by retirement researcher. You can learn more about retirement researcher at retirement researcher.com And subscribe to our newsletter, where You'll receive weekly actionable information for your retirement planning benefit. Retirement researcher is an online community devoted to helping you create the retirement income plan geared towards your goals.

Alex Murguia 38:50
And that leads to the next one, which is really what are your thoughts on closed end funds to generate retirement income? Closing funds are also something of a bygone era. They now that was something that became interesting, not interesting, but in the in the news during COVID,

because of all the specs that were coming out, and then we're just kind of effectively closed in funds, just calling them specs, if you will, the ones that this is where you start yield chasing. Right? The reason it first of all, it's a very illiquid market. And so it depends how much you're going to put into it, etc, etc. But if you see there's not a lot of float out there. And the like, in fact, FYI this not Carl Icahn made his made his bones when he started Wait, I think they were called Green mailers. They would buy closed end funds that were selling at significantly less than the market value than their nav and he would get them to break up to break up and he'd make spread on the difference. Yeah, he did that over and over in the 70s I believe, but effectively. Close this fund is a mutual fund that sold on at NAB but it's a little different. It's a lot different than ETFs and things like that. And they focus on dividends because they're effectively trying to capture your attention with a dividend, right? The reality is they're thinly traded, they're usually active, and they use leverage the way they're able to, to provide 4% dividend yields 5% dividend yield 10% dividend yields is, there's leverage behind that. It's not, it's something you could you could easily do. I don't recommend it anyways, but that's something you could easily do. So there's no magic behind closed end funds. I don't really think that obviously, that could be a situation individually. Where that makes sense. Like, I'll give you one there was a there was a closed end fund called Cuba. Wait, or Hertzfeld. It was called Hertzfeld fun, and I think it was the ticker symbol was Cuba. And it was investing in companies that when Cuba would be liberated would do well, you know, that kind of thing. I'm a long term holder, and now. But now, the point is, there's something there, they use a lot of leverage. And that's why you see these yields that are way out there. But they usually trade below nav, and it's not something I would recommend as part of a normal portfolio. It's almost like a niche thing. That, you know, unless you're going to be Carl Icahn, and you're gonna identify the ones that are trading significantly less than nav, and you're going to become an activist shareholder to get them to break up so you can make the vague on the spread? I don't think that's you. I wouldn't bother with it.

Wade Pfau 41:26
The way Okay, fair enough. No additional?

Alex Murguia 41:31
Again, this is not financial advice. This is. For educational purposes. I'm educating you on what I would always educating you and he would do. All right. Are you tackle this one? Do you have a suggestion on how to implement a reverse guide? I'm sorry. Do you have a suggestion on how to implement a reverse glide path for someone in early retirement? Mid 50s? Well, let me just start on let you I'm sorry, I would just do the opposite of a glide path. And that's how you do a reverse glide path.

Wade Pfau 42:10
Yeah, I mean, I think the idea here is, if you're retiring early, you are going to have a longer time horizon. So you're going to be need to use a lower withdrawal rate than otherwise, using a lower withdrawal rate is one of the mechanisms for managing sequence of returns risk, the reverse equity glide path, and just so the reverse glide path is you start retirement with a lower stock allocation and work your way back up to where you would have been, versus having a higher stock allocation throughout retirement. But it's designed to help manage sequence of returns risk, while you're partly managing sequence of returns risk by using a lower withdrawal rate with an early retirement. Therefore, you may not need to like have as much of an impact with the reverse equity glide path, I think if you're retiring early, you're not going to have as big of dip and whatever that so in the when Michael Kitsis. And I wrote the articles about the reverse equity

glide path, we use the case study, instead of being 60% stocks the whole time, you go down to 30% stocks and work your way back up to 60% stocks. That was not a recommendation, or that was just a case study. But I think with an early retiree, you wouldn't even think about making that big of dip, if it was 60 to 30. Back to 60, was what you might have used as retiring in your 60s, maybe it's going down to 45% stocks with that early retirement instead of going all the way down to 30% stocks, and then working your way back up more quickly as well, just because, again, it's your managing sequence risk to the lower withdrawal rate. So you don't have to be as aggressive about staying with a lower stock allocation for longer. In those early retirement years.

Alex Murguia 43:49
I would I would even say this I you can circle back this answer to the first question that was how do you blend? How do you blend someone that's time segmentation and total return? The glide path could be a way to do it as well, right?

Wade Pfau 44:02
The like a not replenishing bond letter, you have a bond ladder for the start of retirement that you spend down and don't worry about replenishing. And that gives you a rising equity glide path as well.

Alex Murguia 44:13
Which then would you would satisfy those two profiles to some extent.

Wade Pfau 44:17
Okay, and Wade, you

Alex Murguia 44:18
want to finish it off with one more? I'm gonna read it yet. What

Wade Pfau 44:21
that next question? Keep in mind, there's two questions mixed in and they're on completely different topics. So pause halfway through the first part. But yeah, we'll do that one, or I can wrap things up.

Alex Murguia 44:32
All right, here we go. I remember when we started this podcast, you would tackle two questions at once. Now, if

Wade Pfau 44:38
they're not related.

Alex Murguia 44:42
I have to You're losing, you're losing that edge. I have taken the reset, and I'm very much in the middle of the four quadrants, but slightly inside the safety first square. How does this impact me?

Wade Pfau 44:55
Why don't you answer that one? Because I'll be answering the second part of that question. too

Alex Murguia 45:03
I would say here is usually when you look at the recent profile, the top right is total return. And the bottom left is safety first. So if you didn't let me finish, I was gonna say safety first and commitment, orientation and income protection. You cut me off good, sir. You're right, you're right. You know, whatever. And so they're, they're on a diagonal. And actually people move on a diagonal like that. It really is, people move on this diagonal, so it's not on, you're, you're kind of in a sweet spot where a lot of people would be anyways, what that is saying, ultimately, there is it affects you in terms of try to start considering maybe annuities as Bond replacements, but probably not spears, but you know, an FIA or something like that, that is not as draconian, let's say, as a SPIA would be from the standpoint of commitment orientation, and maximizing mortality credits, get something that's a little more malleable, if you will, that has more levers that you can pull on. And I would, I would strongly consider them for, you know, pieces of your bone replacement. That's, that's kind of how it would impact you in terms of as a starting point for thinking about what strategies would work. Wade. Yeah,

Wade Pfau 46:29
I think that's way to go. You're right. Most people are going to be closer to the center, because it's all like a bell curve distribution that, yeah, directions. But yeah, you've got more room to compromise and to something that's tilting towards, I guess, when they say safety first, again, we don't know. I assume they mean safety first and commitment orientation, but so you're gonna be looking for those kinds of contractual protections, you may just not go overboard with how much you put into assets that give you those contractual protections.

Alex Murguia 47:03
Okay, question two. Last year, I purchased an immediate annuity with a portion of my IRA with fidelity. The monthly payments are taxable income. I am 68. When the RMDs from my RA starts in five years, when I am 73, will those taxable payments from that annuity count towards my RMDs? I have seen conflicting information on this question. So I looked up the right the relevant section in the secure 2.0. Act, Section 201. Wow, very thorough. And it appears from the language that the payments will not count, as RMDs will now count towards RMD. But I have also read that this language only pertains to 401 K's not IRAs, and in other write up sections is completely ignored. I am hoping you can weigh in on this. Thank you.

Wade Pfau 48:01
So yeah,

Alex Murguia 48:02
I feel like the kid in sixth grade, that you know, when you're reading books, and you read certain passages and they go, they go round robin

Wade Pfau 48:09
through the classroom, when I've interrupted you said that it completely changed the meaning. Now

Alex Murguia 48:16
it's funny when you read it, you kind of are like, you know, it's it's weird. Bob's good at that.

Wade Pfau 48:23
Okay, but yes, so the kind of what the question is asking is you own an annuity, an immediate annuity sp-a inside of this case, an IRA. So inside of a tax deferred account, how do I or RMBs relate to that. So let's walk through that process. So the secure act 2.0 made some improvements there. And it's not the Section Two a one section 201 is about making it easier to purchase different types of annuities inside qualified retirement plans and IRAs, both qualified plans and IRAs, 401, Ks and IRAs, you can now purchase more types of annuities. If that's not what's impacting this individual. I think really, this is a question about section 204. Of secure act 2.0. Which, so before secure act 2.0. If you buy an immediate annuity inside of a and to answer this part of the question, my understanding is it's just any sort of tax deferred retirement account. So it applies to both 401 ks and IRAs. I've never really seen anything that said it was only for 401 k's and not for IRAs. But the old rule was, you kind of separate your account into the annuity part and the remaining investment part. And you can't mix the two for RMDs that any money coming out of the immediate annuity, counted as RMDs for the annuity. But if that amount was more than the r&d would have been on the underlying premium or the present value of its payments, you couldn't apply any to the other part of the account so it could actually buying a speed inside of a retirement plan to penalize people because it forces them to take out more income, secure act 2.0 fix that. The secure act 2.0, you look at the present value that the annuity is worth, you calculate the RMD on that, if the annuity is kicking off more income than what that RMD would be, which it probably will in many cases, at least in the early retirement years, or I'm sorry, especially in the early retirement. No, I mean, generally, you can expect the annuity to kick off more than the RMD would be, leave it there, you can apply the access to other RMDs. So it's an improvement. It's something that helps retirees, so you should be in good shape with that. And again, I've never really seen anything that limited that to only qualified retirement plans. I do believe that applies to IRAs as well. The language I read in Section 204 just said, tax preferred retirement accounts. An IRA is a tax preferred retirement account. So I don't see why they wouldn't be included as an eligible place to do this.

Alex Murguia 51:09
It could have been the headline of the article just happen to pull out 401k As opposed to saying qualified accounts or something like that. But I digress. Okay. Wait, what do you think man?

Wade Pfau 51:20
Yeah, we got we had a longer episode didn't make up for that. Last week's episode was pretty short. So here we go.

Alex Murguia 51:29
It was high quality, quality last year. All right, I will catch will catch everyone on the flip side, we got another q&a to handle on safe withdrawal rates and annuities. It doesn't get any better than this right away. Thanks,

Wade Pfau 51:46
everyone. On retirement style

Bob French 51:50
vitae. Wade and Alex are both principals in McLean Asset Management and retirement researcher. Both are SEC registered investment advisors located in Tyson's Virginia. The opinions expressed in this program are for general informational and educational purposes only

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