Episode 78: Can you mix retirement income with accumulation? Breaking down living benefits, RILAs, and annuities as an accumulation tools

00:00
Bob French
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.

00:24
Wade Pfau
You.

00:40
Bob French
It's the 4th of July. You're getting ready to eat hot dogs and burgers. And what are Wade and Alex doing talking about annuities? Let the fireworks ensue.

00:52
Alex Murguia
Hello everyone. Welcome to retire with style on this beautiful 4th of July. Hope you're all enjoying hot dogs and the American dream. And thanks to our founding fathers, we have the ability to do so. Right, Wade?

01:09
Wade Pfau
That's right, absolutely. Happy 4th of July, everyone.

01:13
Alex Murguia

Yeah, and don't worry if you're listening to this during the day. We still got the fireworks with this podcast as we discuss drumroll living benefits with fixed indexed annuities, registered index linked annuities known as Rylas and annuities as an accumulation tool for the crescendo that's usually played with the 1812 Overture. What do you think of those fireworks for today, Wade?

01:45
Wade Pfau
Yeah, it's a little bit of a grab bag. There are a few different topics that don't really warrant having entire episodes devoted to them. And it's a little bit of a contrast because we're talking about living benefits first, but then we're shifting into just overview of annuities without living benefits. So it's going to be an exciting episode. The fireworks are definitely going to be flying.

02:07
Alex Murguia
Let's start out with some sparklers. Let's start out with some sparklers. Well, actually do you planning on doing anything for the July?

02:15
Wade Pfau
Hopefully having some sort of barbecue and that sort of thing.

02:19
Alex Murguia
Oh, really?

02:20
Wade Pfau
The fireworks where we live will be on Saturday. Well, past tense now. Future past tense. Saturday was our big fireworks extravaganza.

02:29
Alex Murguia
There you go. All right.

02:31
Wade Pfau
We will have a parade on the morning as this episode comes out. I may be marching with my son's Cub Scout pack in the 4 July parade.

02:40
Alex Murguia
Really? That's pretty cool. Are the kids be watching or are you flying solo on that one?

02:47
Wade Pfau
Sounds like they'd rather watch instead of participate. But I thought they'd be excited to participate. I don't know, we'll see.

02:53
Alex Murguia
Come on, man, just get them out there. Don't even is it the trick? In all my years of parenting, don't ask, just take them. Assume the sale, man, assume the sale. No, actually I'll be in Canada. I'll be in Ottawa of all places next week.

03:08
Wade Pfau
Hope you get there by July 1 with Celebrate Canada tea.

03:11
Alex Murguia
No, I miss that. But I'll be there July 3. I'm taking my boys. My boys are interning. They're going to be interning with our tech team over in Ottawa. So they're going to get the ins and outs of learning figma and all of that stuff. So we'll see what happens. We'll see what happens. They're getting tired of creating the LinkedIn video so they're actually going to roll their sleeves up and do some work. But that being the case, well, we haven't had chitchat in a while, our chitchat portion, right?

03:44
Wade Pfau
No, when I was in Japan, I was too tired to think about chitchat.

03:48
Alex Murguia
All right, I'm back. So kick back, get that lawn chair, get that hot dog, put mustard and ketchup, a beer or Coke, what have you, and put your earbuds in and away we go. Fired off. Wade.

04:08
Wade Pfau

So first topic is living benefits for fixed indexed annuities. We talked about living benefits for variable annuities in past episodes. Now, I guess a couple of episodes ago at this point it could work the same way for fixed indexed annuities. But I generally want to describe a different system that's out there as well, because it's probably more common to find this other system with the fixed index annuities. And so with the variable annuities we talked about, you have the benefit base, you could have a roll up rate, and then if you achieve new high water marks, you could also have step up opportunities. The way I want to describe that's different because it's more common in the fixed indexed annuity world since there may be less opportunity for step ups beyond any sort of roll up rate. The way the living benefit might structure the guaranteed income is more there'll be a withdrawal rate linked to the age that you purchase the annuity.

05:07
Wade Pfau
And then if you're deferring the start of income, the withdrawal rate will tend to increase over time. So maybe to give an example of that, suppose I'm in my early sixty s. I get a fixed index annuity with a living benefit at the particular age I am when the contract was issued. Say the payout rate is four and a half percent. But I'm not starting income. I'm going to have a deferral period before I turn on my lifetime income. And so just in this hypothetical example each year I delay the start of my lifetime income. The withdrawal rate will increase by 0.3 percentage points. So then with ten years that would be a three percentage point deferral increase in the withdrawal rate. So if it started at four and a half percent, I delay ten years. Then I turn on my lifetime income instead of worrying about benefit bases and roll up rates, my payout rate, instead of being four and a half percent, would be seven and a half percent.

06:05
Wade Pfau
And that's a more typical way you'd see the living benefits with a fixed indexed annuity work. Now, the reason you may not necessarily see step up opportunities as often is just to get a new high water mark. You need the upside potential to exceed any sort of contract costs which would only be related to this living benefit or once you turn on the lifetime income, the distributions as well. These days, kind of the example we're using in this discussion is an FIA with a cap rate of 12%. So you might actually in the early years, if you're getting good market returns and you're hitting that 12% cap, you could get some step up opportunities there early on, but you don't necessarily have the enough growth potential where as soon as you have a year where you may not get your full cap rate credited to the account, you might start to fall behind.

07:01
Wade Pfau
And then it would become difficult to subsequently achieve a new high water mark.

07:06
Alex Murguia
Wade, I want to stop you right there. I could be off and you can feel free to say, no, we're good. I was

listening to what you were saying and again, I'm thinking about consumers listening in and yes, there's consumers that are well, first. But the reality is annuities can get complicated and you're using roll up rate and step up rates, those terms. Do we need to revisit just the definition of the, of the step up rate and the roll up rate, just to make sure that's clear?

07:39
Wade Pfau
Yeah, we could it doesn't hurt. The roll up rate was that when you have the explicit benefit base, it's a fixed rate of return, that the benefit base would increase each year during the deferral period. It's what causes the confusion sometimes with variable annuities that say you have a roll up rate of 7%, sometimes people think they have a guaranteed rate of return of 7%, and that's, as we talked about, that's not what a roll up rate is. It's simply increasing the benefit base by 7% a year. And then when you turn on the income, your withdrawal rate, the payout rate of the annuity is applied to that benefit base. And so the roll up rate does help you get a higher income. What's different about step ups is there's no fixed step up rate or anything. It's simply connected to does the contract achieve a new high watermark on dates that you're allowed to look for that?

08:39
Wade Pfau
So if it's a one year term every year on the anniversary, has the contract achieved a new high value so that the benefit base would be higher? In the context of if there is a benefit base or if there's well, with a fixed index annuity because of principal protection generally, you're going to be close to your before you turn an income, you're going to be close to being at the high watermark level. But do you achieve a higher value for the contract? That's never been experienced in the past, and then your benefit base would reset.

09:14
Alex Murguia
To my value and that high watermark is achieved if that underlying index increased or not.

09:22
Wade Pfau
And so before you turn on income, it's easy to achieve new high water marks because you just need enough growth that the contract grows. Now it can't shrink, but if you have an optional guaranteed lifetime withdrawal benefit, there is a fee for that would reduce the contract value say in the example we'll talk about eventually, I'm using an example of a 1.1% guaranteed lifetime withdrawal benefit fee. So that would reduce the contract value by 1.1% a year. So as long as you're gaining a little bit more than that in terms of credited interest, you would be achieving new high water marks.

10:04
Alex Murguia

The other point I'd like to say, and we said this in a previous episode, and I want to make sure it's relevant here, it may not be. You said, let's say it's a four and a half percent payout at issue and it increases by 0.3% for each deferral year. The question that somebody could be asking is there a right number of years to let defer before you accept it? Is there magic to that? When I asked you something similar last time, you had said no, just take it as soon as it's available because it's priced fine, it's priced accordingly, et cetera. If someone was listening to that statement when you said every year you extend it's 0.3%, and then after ten years it's seven and a half percent, someone could be thinking, well, should I by habit always defer as much as I can or not?

10:53
Wade Pfau
No, the answer is always, usually start income sooner rather than later. But there's no reason to start income if you're not retired yet, like you don't necessarily want to.

11:04
Alex Murguia
I know, I know.

11:05
Wade Pfau
So given the caveat that you're retired, there's no real point to continue deferral for those types of credits. It's okay to go ahead and start income. And what you do want to do is comparison shop and always at least look at a deferred income annuity with the same situation of whatever age I am when I purchase, how long I'm intending to defer, what is the payout rate that the deferred income annuity would provide? Compare that to what the fixed index annuity would provide. The fixed index annuity payout rate might be less. But then also then you have to further elaborate on well, will the contract value grow in the fixed index annuity such that even if the payout rate was a little bit less, when you multiply that by that higher contract value benefit base but I don't necessarily use the term benefit base. That could still provide more income?

12:03
Wade Pfau
And that's how you'd make the comparison between different options. But generally the idea of increasing, getting these deferral credits, it's not usually worth it to delay just because you can get more deferral credits. And also those deferral credits may end at some point. If you're thinking to not turn on income for more than ten years, the fixed index annuity might ultimately you've got to compare, but it may not be the best option for that type of scenario.

12:30
Alex Murguia
And the other piece, just again, this is one of these for abundance of clarity because of the annuity world, if

you will. We're speaking here not about the annuitization of the annuity. We're speaking here about the guaranteed living withdrawal benefit. Yes, we're talking about activating the writer if you want. Say it again.

12:50
Wade Pfau
Yes. We're doing a lot of callbacks to previous episodes. Annuitization is rare. When you have the simple income annuity, the single premium immediate annuity or the deferred income annuity, you annuitize those contracts. That is an irreversible decision that behaviorally many people are not comfortable with. So that's why since the 1990s, the insurance world has created deferred annuities with living benefits that allow you to turn on lifetime income without annuitizing the contract. So you're not annuitizing the contract. You still have liquidity for the underlying contract value. If you want to get your money back, you would sacrifice the guarantee by getting your money out of more than you're allowed to distribute, but you have that flexibility to do so if you want. And the way the living benefit works, you're spending your own money. But if by doing that you spend the contract value down to zero, that triggers effectively a type of annuitization.

13:55
Wade Pfau
Or the annuity enters a settlement phase where the insurance company is now on the hook to continue paying that guaranteed amount defined by the contract through that withdrawal rate as it was applied to the high water mark.

14:13
Alex Murguia
But the amount of income that someone's getting right now that you were describing this example is from the rider, which is another way to say the guaranteed living withdrawal benefit.

14:23
Wade Pfau
The rider allows you to take out a certain amount each year and as long as you take out that amount or less, the contract will protect that amount of future spending and then you're spending your own money up to the allowed amount. But the idea is if you spend down your contract value to zero, then the insurance company is on the hook to continue paying that same allowed amount each year for the rest of your life.

14:49
Alex Murguia
So then conceptually, and I'm going to lead into where you're going with this conceptually here, the assets haven't been annuitized, so you still have liquidity with regards to them. And the writer could be fairly healthy from the income you can receive because it's based on the performance of the index that the initial

contract was based on. That in itself may provide something that's very competitive to other types of annuity that are somewhat a little more irreversible at times.

15:30
Wade Pfau
Right? In theory, the highest payout rate should come from the SPIA dia world, the single premium immediate annuity or deferred income annuity because you don't have any upside potential with those and you don't have any liquidity with those. It's that irreversible annuitization.

15:49
Alex Murguia
Those are the annuities you annuitize. Yes, that's right.

15:55
Wade Pfau
That was our LinkedIn commercial for that episode. And since you don't get any of these extra benefits, the trade off is you should get a higher guaranteed income. That being said though, there is this behavioral element with the fixed, indexed annuities, where with an immediate annuity, because you have no discretion, you can't make any mistake, you're going to get that monthly check, you don't have to do anything and that monthly check is delivered to you so you can't screw it up with a fixed, indexed annuity. Sometimes people pay for the protection. They pay for the living benefit, but then they don't distribute the amount that they're allowed to distribute. And if they don't distribute the amount they're allowed to distribute, that makes it less likely that the account will ever deplete. And if it's less likely that the account will ever deplete, it's less likely that the insurance company will ever be on the hook to pay you the benefits that they're collecting.

16:53
Wade Pfau
The writer fee to be able to insure and protect you. So then through competition, because some people are behaviorally not using these in the most effective way, they can offer a higher payout rate than the SPIA or the Dia. And Moshe Molesky was one of the first people to point that out. It's been quite a while where I think his mother's neighbor was talking to her about a fixed index annuity that beat other options, and he couldn't believe that was possible. But after looking into it, he saw that, yes, it's really this behavioral aspect where people are not using the FIA as efficiently as they could. And so the more informed consumers doing that can benefit from higher payout rates, potentially, or at least in theory, fixed indexed annuities. They give you liquidity and upside potential, so they should give you a lower downside guarantee.

17:47
Wade Pfau

In reality they may also give you a competitive higher or pretty much the same type of payout rate as the SPEA or the Di is doing for.

18:00
Alex Murguia
Those of us keeping score at home. What do you think when that inflection point comes when they're thinking about it and let's bring it back to the Risa, right? Let's say you're income protection, right? You take the Risa and you're in the income protection quadrant. Do you comparison shop FIAs spears and Diaz or not?

18:26
Wade Pfau
Yeah, absolutely. You're more likely an income protection you're going to be interested in that fixed annuity world more so than the variable annuity world and so yeah, that's what you're looking at. The Speas and the Dias and really those just immediate annuities and then the fixed indexed annuities with living benefits are the main tools. You're going to want to compare and contrast and make your decision around how am I doing?

18:51
Alex Murguia
Wade. Am I getting it?

18:53
Wade Pfau
You're nailing it.

18:56
Alex Murguia
Like Nadia Komanich coming off the pole vault.

19:02
Wade Pfau
Yeah, you're a much better interviewer than me as probably our listeners are noticing from some of our other episodes.

19:08
Alex Murguia
No, not even. Trust me, they don't want to be other way around, I'll tell you that much. Hey, it's not that funny, man.

19:21
Bob French
Are you a financial professional looking to learn more about the Risa and retirement income best practices. Well, if you are, you should join our retirement income masterclass on Monday, August 28 and Tuesday, August 29. You can sign up@risapprofile.com advisors. That's risaprofile.com advisors.

19:42
Alex Murguia
All right, maybe you want to talk.

19:44
Wade Pfau
About how they manage risk for the insurance company for these guarantees.

19:49
Alex Murguia
Look at you giving me a soft ball. Well, I mean, remember from the beginning, right? The last podcast that we had, remember, we're doing two sets of podcasts, this one on the annuity trajectory, fixed indexed annuities. Remember, the keyword is fixed, right? And it's fixed in the sense of it's fixed at zero. I won't go below that. And so they come with principal protection from that vantage point. So that's one way to simply manage risk. You want a little bit of that upside, but here you're able to lock in the risk being anything below zero, right? Less than zero. Like the book adjusted guaranteed payouts. You get your payouts.

20:35
Wade Pfau
Yeah, a little bit more on that one. The living benefits on fixed indexed annuities may be less expensive than the living benefits on variable annuities. Because of the variable annuity, the insurance company has to manage both market risk and longevity risk. With a fixed index annuity, the insurance company only has to manage the longevity risk because they know the worst case scenario. Because of the principal protection and all the bonds that are principal, there's no.

21:05
Alex Murguia
Downside volatility to manage.

21:07
Wade Pfau
Yeah, they know the worst case market scenario. They'll know exactly when the contract value will deplete

because it would just be credited interest for zero every year. Then they can track out, okay, how long will the money last? That's the worst case scenario. They don't have to worry about if the market is down 2030, 40% or anything like that. So that does make it easier to manage the risk the insurance company takes to provide that income guarantee. They only have to worry about longevity, not about the market risk.

21:38
Alex Murguia
Any other ways to manage risk other than I mean, you can adjust the guaranteed payout rate. Yeah, playing around before I was rudely interrupted, right?

21:47
Wade Pfau
You were just flying through that but wanted to add a little detail. There's not much to add about. Yes, they can play around with the guaranteed payout rate as well. Any other ideas, Alex?

22:01
Alex Murguia
Let me see here which lighter we buy here. Oh, yes. No, you can increase option on living benefit rider fees as well. You begin to be able to look at this in windows of time and you can get an increase on that.

22:18
Wade Pfau
Based on and then the other thing and we talked about that idea of the options budget where once you've purchased enough bonds to protect principal with the remaining funds. The insurance company keeps part of that for themselves, and they use that to purchase the upside exposure. They could tweak that to keep a little more for themselves, a little bit less for the upside exposure. And then the other thing we talked about is it's necessary for the insurance company to adjust these parameters at the end of each term because the whole process starts over each term of the contract. They have to buy enough bonds to protect principal. Well, as interest rates change, the amount needed to do that will change. And then the cost of financial derivatives is changing over time. They have to with the remainder, purchase the upside exposure. And because of that caps or however the upside is defined, that needs to be able to evolve over time to deal with changing market conditions.

23:20
Alex Murguia
But I think you're saying something interesting here from the standpoint of institutional risk management. So again, you go back to the example from the last week. Let's say you have $100 to play with, right, effectively. And let's say the interest rates are 5%. It's not going to be exactly because I should have done like 101 or something like that, but let's just say it's $100 to play with. Interest rates are 5%, right? And so what the insurance company does is they buy usually the bonds are like strips, so the bonds will mature at

100, but you buy them at 95 kind of thing based on a 5% interest rate. So you spend $95 in bonds and that will assure you that at that endpoint in time you'll have $100. And it's math at that point. That's how they and assuming it's government bonds, that risk free bonds, et cetera, that's how they can guarantee that you're going to get the $100 at the end of the period and know that you'll have zero.

24:20

Alex Murguia

You won't get less than zero. You'll get back the principal. That's how they do it. That's the magic behind it. Now, the $5 and again the options budget is predicated on the interest rates, right? But effectively the $5 is the options budget, defined as that's how much they have to play with to go to the option market and buy. Now exposure to the indexes via options and the options are dated probably they're going to be most likely aligned to the endpoint, right? But the insurance company is not going to spend the full $5. They're going to spend maybe a dollar and a half, a dollar 50. So they'll buy $3. I'm just making it up. Wade, I don't know you know what I mean? That's how much they're keeping themselves to themselves. Yeah, if I said it the wrong way. They keep a dollar 50 to themselves for those wonderful commercials that you see on TV now for the admin and stuff like that.

25:15

Alex Murguia

I'm sure there's some marketing, right, and they'll spend the 350 going to the options market and buying the options for the exposure and whatever that budget is. That lets them say 80% market exposure. 70% market exposure because they're limited by how much wiggle room they have around that even though that may sound overly complicated, it's not in the conceptual sense of things. And it's pretty stable, that sort of dynamic. It's not some magical thinking kind of thing in which they're engineering these returns. Right? You can take solace in that way.

25:57

Wade Pfau

Yeah. And sometimes self directed investors will talk about how you could just create your own fixed indexed annuity. And that's true. You can follow that same approach yourself. You got to deal with the options market. But then you can't not on the living benefit. No, you can't recreate the living benefit on your own. That requires risk pooling that an individual can't do by themselves. You can replicate the return structure on the fixed index annuity on your own, but you cannot replicate the living benefit lifetime income protection on your own, I would think. Yeah.

26:30

Alex Murguia

And you can replicate it to the degree that not with $100, maybe your.

26:35

Wade Pfau
Budget.

26:41
Alex Murguia
You'Re talking now orders of ant did significantly greater than 100. But there's some safety in that. Again, it's not a Joan Didion or whatever. There's no magical thinking behind it. Where these mortgage backed securities and there's these levels of mortgages, and if one falls, it's a domino. That's not what you're talking about here. It's kind of pretty vanilla, really, but there it is, right?

27:08
Wade Pfau
Yeah. That's the fixed, indexed annuity.

27:12
Alex Murguia
Great. What else we have those are the sparklers, or is that the Roman candle? Do we just shoot off the Roman candle? Let's get the black cats now. Register index linked annuities.

27:28
Wade Pfau
Add some risk. Now we're risking blowing our fingers off or blowing our eye out or something here, because now we're adding wow.

27:37
Alex Murguia
Wade, that got morbid real fast. What kind of child did you have, man? Wow.

27:46
Wade Pfau
Sparklers to getting maimed or using the potato guns.

27:52
Alex Murguia
Did you ever have those are crazy. Oh, my good I tried to catch one once. I remember someone shot it up in the air, and for some reason, I thought I could catch a potato. I wasn't close, so I survived.

28:10

Wade Pfau
Registered index linked annuities, they became popular just much more recently, as you can see, with the fixed indexed annuity, the interest rates really matter. When interest rates got extremely low, now they're rising again, which we're in a better world now, but when they were, when we like in 2020, when the ten year treasury rate was down at 0.6%, you don't have any upside after you protect the principal. And so you were seeing cap rates on fixed, indexed annuities in the ballpark of, like, two or 3%. Even now, today, I tend to use 12% as the baseline number for, like, a 12% cap. But back when there was a 2% cap, that was not necessarily exciting for people. And so what the registered index linked annuity does, it allows the owner to accept some downside risk, but in exchange to have more upside potential. And so back several years ago, FIA caps may have been at around two or 3% registered index linked annuities, might have had caps with like a 10% buffer.

29:17
Wade Pfau
And we'll talk about what that means. But caps in the ballpark of ten to 12% today. The example I use, fixed indexed annuity, principal protection, 12% cap, a registered index linked annuity with a 10% buffer, 28% cap. So we need to explain what that buffer is. But you're taking some downside risk, but in exchange you've got more upside potential. So it's really a way to give you a broader menu of options about that structured return. How much downside risk are you willing to accept and then how much upside potential are you able to receive?

29:56
Alex Murguia
As an aside, it also shows you the how important this sort of idea or concept of the risk free rate is. Because I'm stating the obvious, but for folks, it just touches everything, right? It affected this whole dynamic between FIAs and Rylas, just the fact that as rates increase, boom, you have now so much flexibility around that. Although it hinders other things, but it has its tentacles on everything. This sort of basic concept in finance literally touches everything.

30:33
Wade Pfau
When interest rates are very low. It was kind of the statement you have to take more risk to have upside potential. And yeah, you see that in the annuity world and in that regard. So registered index linked annuity, it has a lot of different names. They're also called like, structured annuities, buffered annuities. Registered index linked annuity is not the most attractive name, but you get to abbreviate it as a RYLA. And so RYLA. Sounds nice. And Rylas, they're technically variable annuities because you're exposed to the risk of loss. That's what makes them different from fixed annuities. But otherwise, aside from the risk of loss and the fact that they're classified as variable annuities, they really work in the same general way. You're still using index annuity yes, as a fixed index annuity in terms of you're linking to a market index, and you're going to receive a structured return related to that market index that moves you away from the bell curve distribution of the market index into some sort of return structured around that.

31:46
Wade Pfau
That's not a bell curve anymore. That's got some limits or some impacts on what the downside looks like and what the upside looks like.

31:55
Alex Murguia
They're effectively adjusting the tails on both ends of the curve.

32:01
Bob French
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32:28
Wade Pfau
And there's different ways that Rylas can be structured. The simplest way is just with floors. An FIA has a floor of 0%. Principal Protection well, you could have, say, a RYLA with a. 10% floor. Negative 10% floor, which would mean you're exposed to losses to up to negative 10%. If the market was down 5%, you'd have a 5% loss. If the market was down 25%, you'd have a 10% loss. You have a risk of loss down to where the floor is. And the reason you might accept that is because now I only have to buy enough bonds with a negative 10% floor. I only have to buy enough bonds to protect 90% of the principal, not 100% of the principal. So that leaves me a lot more left over for the options budget to buy upside potential. Now, in all the simulations I've done, and I think this is generally agreed upon, the RYLA with the floor doesn't seem to test very well.

33:31
Wade Pfau
It's not necessarily all that attractive of an option.

33:36
Alex Murguia
Why is that?

33:38

Wade Pfau
I don't know. It's just the you don't necessarily get that much benefit from it in terms of how it changes the distribution of returns and then how vulnerable you are to the when you have losses, they tend to fall in the level between 0% and where the floor is. So you end up experiencing more of the losses. But then there's not that many cases where the losses are extremely worse than what the floor protects.

34:10
Alex Murguia
Got you.

34:10
Wade Pfau
And with the upside you give up there. It's just over time. It doesn't really play out well in the simulations.

34:17
Alex Murguia
And it's 10% loss. Kind of like the normal floor.

34:22
Wade Pfau
There could be others. You could have a 20% 20% loss.

34:28
Alex Murguia
Or negative thinking like A-5-I was thinking like negative 5%. Thinking going the other way.

34:35
Wade Pfau
Haven't really seen that one too much. I have seen like, a negative 40% floor, but then what's the point at that point? You're pretty if you're seeing a negative.

34:44
Alex Murguia
Ten point is too low.

34:45
Wade Pfau
Yeah.

34:45
Alex Murguia
And if you're saying a 10% is too low at a negative, what good was a negative 40 negative?

34:50
Wade Pfau
You might as well just invest in.

34:50
Alex Murguia
The market or no.

34:53
Wade Pfau
Then it's really just becoming in. No, I'm sorry. You're right. Yeah. Then you might as well just invest in the market because you're only protecting against losses that are beyond negative 40%.

35:03
Alex Murguia
Which, you know, we have this recorded weight. We have this recorded weight. I've got you.

35:09
Wade Pfau
I was mixed up there. You got it. You're right.

35:14
Alex Murguia
Hey, man, I've been listening to this podcast, retire with Style.

35:20
Wade Pfau
Yeah, I was thinking of the buffer, but were talking about floors still. So you're right.

35:26
Alex Murguia
That's why I said 5%. Why not 5%? It goes go the other way. All right, so buffers. So there's floors. What's a buffer and not a buffer asset that you always get me on?

35:35
Wade Pfau
No, this is not a buffer asset. This is a buffer. We'll use 10% buffer as the example. But you could have a 40% buffer and then that's effectively what I've seen. That's the same as an FIA almost. But a 10% buffer, or any buffer, you eat losses. The Annuity eats losses up to that amount, and then you're exposed to any loss beyond that. So if I have a 10% buffer we didn't say that yet in this episode, but we did say it in past episode because this is all based on financial derivatives. We're talking about the price returns of the index, not the total returns. You don't get the dividend payments. So if you're linked to the SMP 500, the price return was negative 5% and you have a 10% buffer, you're credited with zero. The insurance company eats that 5% loss, gives you zero.

36:33
Wade Pfau
If the market was down 13%, the 10% buffer protected the first 10% of the loss, and you'd be credited with a negative 3% return for the year. If the market was down 27%, you'd be credited with a 17% loss. The Annuity eats the first 10% of losses. You're exposed to any loss beyond that. That's what the buffer does. But by accepting that risk, you get more upside potential. There's going to be more ability to that's. Like I said, the 10% buffer I tend to talk about with an example using a 28% cap. Whereas the FIA these days I talk about as an example, with a 12% cap, you get more upside potential. If the market's up 20%, the RYLA in this case would give you the 20% price return gain. The FIA would have capped you at 12%. So that's the trade off. And these do test a lot better in the types of simulations that I look at in terms of because there are more small negative losses that happen in the markets.

37:45
Wade Pfau
Protecting against those gives you enough juice that even though you don't get the full upside exposure, you can still have a pretty good performance. Now, when the stock market does very well, stocks are always going to be the highest performing asset.

37:59
Alex Murguia
So then, real quick, people thinking about this because they may have forgotten, oh, wait, what is the floor again? That kind of thing. So if you have a 10% floor, if the market goes down 7% yeah. No, you're down 7%. If you have a 10% buffer, the market goes down 7%, you're at zero.

38:21
Wade Pfau
That's right.

38:22

Alex Murguia

It's only anything above and beyond 10%. And so conceptually, you can see why that makes sense, that the results turn out better in the buffer than in the floor. Because as Wade said earlier, most of these losses happen in 5% here 7%, there, 8%, that kind of thing. And so you're constantly getting dinged that nominal amount in the floor as opposed to in a buffer, where you have that FIA kind of vibe for those return outputs. Wade, did I say anything off there? I just want to conceptually that's.

38:59

Wade Pfau

Right. Just another point to that as well. David Blanchett it was the first time I saw anyone do these estimates and then said oh, that was a good idea. Let me try that, too. Get similar kind of estimates. A Rilo with a 10% buffer behaves kind of like a 60 40 portfolio. So it's SP 560% 40% bonds. It's still a structured return, so it's not exactly the same. But when you kind of look at, well, what's the upside potential? What's the downside risk? The RYLA with a 10% buffer behaves a lot like a 60 40 portfolio, whereas a RYLA with a 10% floor behaves more like a 40 60 portfolio. But still not. That's only an approximation since there's no bell curve distribution with these structured returns.

39:49

Alex Murguia

Now, Ryla's, because I'm just thinking this and throw it out there, because someone could be thinking we talked about withdrawal benefits with Fiees and the like. With Ryla's, that's not as relevant. Why would that be weighed? Or it can be, but I just want you to kind of could you.

40:10

Wade Pfau

Say that question again with Ryla's, he.

40:13

Alex Murguia

Was looking at well, let me backtrack. Blanchett was looking at it, but Blanchett or yourself, I would imagine you didn't include a withdrawal benefit within your calculations. Within that. You're just looking at that exactly. You're just looking at the dynamic of the actual underlying function of the how the RILER behaves as opposed to there's no component there. Yeah, there's no component there. From an income perspective, as I guess the way I'm trying to say that.

40:42

Wade Pfau

Those are always separate conversations. That's how we did it with the FIA as well. We talked about how the returns are created, and then separately, you can add an optional lifetime income benefit to it. Same with the RYLA. But, yeah, right now, we're not talking about the income benefits. We're simply talking about the structured returns.

40:59
Alex Murguia
I asked it very clumsily trying to make that demarcation for everyone.

41:06
Wade Pfau
Absolutely. Yes. Okay.

41:09
Alex Murguia
Actually, how do you see RILAs being used a lot in practice, I guess, where I'm going with it, I'll just say it as opposed to asking a question, hoping you would answer it the way I want. Does this present the view of how annuities could be used as accumulation tools? Perhaps.

41:27
Wade Pfau
Yeah. So Rylas may have some play with total returns because simply with the way they're structured, people might think about them as an asset class in their portfolio and the total return perspective as well. Or as a risk wrap approach, you might look at the RYLA because you do expect more upside growth potential over time, but with a living benefit attached to it so that you also have the protected guaranteed lifetime income. If someone's thinking, do I want an FIA, or do I want a RYLA? And in both contexts, always trying to frame these as more of a bond replacement instead of a stock replacement, the more probability based you are with your Visa style, the more you might look at the RYLA, the more safety first you are with your Visa style, the more you might look at the fixed index annuity.

42:23
Alex Murguia
Was that the 1812 crescendo?

42:28
Wade Pfau
Yeah, definitely. The RYLA is the riskiest. I think as we go towards the end of this episode, just kind of talk a little bit more about annuities as accumulation tools because there's a few other options too, that might be our big Crescendo annuities. I don't know. We is not the right I generally like to think of them more for their income protections. And that goes back to the original definition of annuity was something to be

annuitized to provide a stream of payments. But with the US tax code, annuities provide tax deferral. And that's led to all the creation around different types of where you might just think of annuities as accumulation tools and then also with these structured returns, they can be an interesting accumulation tool as well, just as a way to move from the fact bonds can experience losses. We saw that in 2022.

43:31
Wade Pfau
If you had the FIA, the S and P 500 also experienced a big loss in 2022, the FIA would have been credited with 0%, while the stock and bonds had double digit losses. So you can see where there can be that downside protection which in an accumulation portfolio can be attractive as well. But if we just list different annuities that you might consider in the context not for lifetime income, but more as an accumulation asset class, either for structured return or for the tax deferral benefit, you've got the multi year guaranteed annuities or MYGAs. Those are kind of the CD equivalent of the annuity world. It provides a fixed rate of return for a fixed term. You've got other deferred fixed annuities that you're not annuitizing the contract. They'll pay a fixed rate of return over a given term. They're really the same sort of thing as a MYGA.

44:28
Wade Pfau
You got the fixed index annuities, which can then give you that range of returns linked to the index performance. You've got the registered index linked annuities, which we just talked about, a wider range of returns linked to an index performance. Then in the pure variable annuity space, you could have a variable annuity with a guaranteed minimum accumulation benefit that will simply provide downside protection. So say if I hold this annuity for ten years, it might guarantee that in the worst case scenario, the worst I can do is I'll have a 5% gain and then I'll have any gains beyond that. And that would be I'm investing in sub accounts, so I do get dividends as well. I would just be paying a writer fee. That would cut into some of the potential upside from that. And then you've got the investment only variable annuities, which are annuities designed to be no frills, trying to have very low cost, low mortality and expense charges so that you can use them for the tax deferral with tax inefficient asset classes.

45:36
Wade Pfau
Now, all the income that comes out of the annuity is taxes, ordinary income. So you wouldn't want to put tax efficient stock market indices with long term capital gains to lose that benefit. But whenever you have a tax inefficient asset class, you might want tax deficit.

45:52
Alex Murguia
Or that would be like bonds, things like that.

45:55
Wade Pfau
Yeah. And if you ran out of space in your IRAs and Roth IRAs and so forth, then you might look at.

46:03
Alex Murguia
An investment variable annuity.

46:06
Wade Pfau
Yeah. You fill up your 401K allotments, and you still want more tax deferral, so that's another option is a low cost, investment only variable annuity. Yeah. For the 4 July. That's probably enough content for today. And some of the other things we're thinking to talk about might fit better in separate episode.

46:35
Alex Murguia
All right, wade. All right, wait. Well, everyone, I hope you've got in more than one hot dog or burger while we've been speaking. You deserved it if you made it through this one. But again, thank you for listening. Always a pleasure and enjoy the Fourth, everyone.

46:53
Wade Pfau
Absolutely Chaikovsky. Thanks, everyone. Have a great week.

46:57
Alex Murguia
All right, move over, Beethoven. Wade and Alex are both principals of McLean asset management community retirementresearcher.com.

47:02
Bob French
Wade and Alex are both principals of McClain asset management community retirementresearcher.com. 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 and are not intended to provide specific advice or recommendations for any individual or on any specific securities. To determine which investments may be appropriate for you, consult your financial advisor. All investing comes with risk, including risk of loss. Past performance does not guarantee future results.