Episode 96: Using Investments to Manage Inflation

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. Hedge. Or not to hedge. And what does hedging actually mean?

00:45
Alex Murguia
Hey, everyone. I'm here with Bob French and a very special guest, Wade Pfau, to talk about all things inflation. I'm here with Bob French and a very special guest, Wade Fowl, to talk about all things inflation.

00:59
Wade Pfau
I've been demoted.

01:05
Bob French
There's only two hosts. Wade, I don't know what to tell you.

01:08
Alex Murguia
You didn't check your emails before the start of this. If that was the case, Wade would be so happy to be like, I'm out of here free at night. He'd become way. We all need, you know, absorb in your knowledge here. And so we're talking about inflation, and Bob speaking about inflation. Wade's been working out.

01:35
Wade Pfau
Trying to inflate those muscles.

01:38
Bob French
I was wondering who was going to be making that joke, and I kind of knew it was going to be you, Alex.

01:43
Alex Murguia
Wade's been working out. Wade's been working out. Actually, I've been doing it with my kids as well over the last two months or so. But Wade's on the kick. Right, Wade?

01:52
Wade Pfau
No, I was at a conference, and I don't think we've had Jamie Hopkins on the show yet.

01:57
Bob French
We should.

01:57
Alex Murguia
No, we haven't.

01:58
Wade Pfau
I've been on his show, but find out. He does 100 push ups a day, and that's all he does. He never goes to the gym, and he's getting incredibly buffed. So I'm inspired to follow.

02:10
Alex Murguia
You know what? I say that about Bob all the time, regardless if it works out or not.

02:15
Bob French
Wade, what?

02:17
Alex Murguia
It's been one of the pleasure. I'd work here for free just to do zoom meetings with Bob. Wait, what? We're

talking about inflation. All right, let's go back to inflation. I think we've probably exhausted our small talk for the first inflation.

02:41
Wade Pfau
We should talk more about it. The specific working title is approaches to Dealing with Inflation. You did a workshop recently with the Retirement Research Academy on this very topic, right?

02:53
Bob French
Yeah, no, absolutely. Earlier this week or well, when this comes out, last week, for those of you who are in the academy, you had that workshop. The recordings are already up there for you. But no, we did a really deep dive on how you can go about dealing with inflation within your retirement income plan, because it is something that needs to be in there, and as we're going to be talking about today, a whole bunch of different approaches that you can be using. And just like everything else within planning, there's certainly some wrong ways to do it, and we'll touch on some of those, but there's a whole bunch of right ways to do it, and it's just a question of what works for you. How do you feel comfortable dealing with these sorts of issues. What trade offs are you good with?

03:47
Alex Murguia
But before that Wade, I didn't get this.

03:49
Wade Pfau
We'll summarize that just with so we'll talk about Social Security, which is always the standard for that. And then investment based approaches, tips, ladders and annuities is kind of the outline for what we're going to discuss today.

04:02
Alex Murguia
But before that Wade, I didn't get this. When you do push ups, do you do them with your elbows out or you do your elbows in like those CrossFit pushups? Which ones? Elbows. Elbows out.

04:16
Bob French
I don't know.

04:16

Wade Pfau
The elbows in method. I don't know.

04:20
Bob French
I think you just described the elbows in method there.

04:23
Alex Murguia
What about you, Bob? You look like a health nut.

04:28
Bob French
Oh, yeah.

04:32
Alex Murguia
And please write in. We'll take an informal poll for you listening to the podcast. Please write in the comments what pushups you do. There we go. Now we got a challenge going on. I'm going to ask Wade every podcast, did he do push ups from the previous week? Right way?

04:50
Wade Pfau
It's going to take me a little while to work up to 100 a.

04:52
Alex Murguia
Day, but that's 100 a day. Well, you mean 100 in one shot, too?

04:56
Wade Pfau
You're not like not successive, like not.

04:58
Bob French
Ten throughout the day?

05:01
Wade Pfau
Yeah. Jamie does it 50 a day, twice a day, at least. That's kind of what he's settled into. I don't know.

05:11
Bob French
Does he actually do this?

05:13
Wade Pfau
Does it go all the way or.

05:14
Bob French
Does he just say he does?

05:17
Wade Pfau
I think he's doing it.

05:19
Bob French
I don't know. Good for him.

05:21
Alex Murguia
And does it go all the way down? No, you do those, like, butt up push ups and they're not the same.

05:29
Wade Pfau
It would at least take a few minutes to do this, but there's something I don't remember the exact numbers, but it was like 100 push ups in 80 seconds or something. So then I asked that very question. It's hard to go all the way up and down if you're doing it that fast. I don't know.

05:44
Alex Murguia
In 80 seconds.

05:47
Wade Pfau
I'm not making that up, but something like that. I'm making it up a little bit.

05:50
Alex Murguia
Well, if Nick definitely a lot more.

05:52
Wade Pfau
Than one push up per second. I remember that much.

05:55
Alex Murguia
If Nicholas Cage and Angelina Jolie can steal a car in 60 seconds, damien can definitely do easier to do a push up than under push ups in 80 seconds. Bob, what's that reference to? Come on now. And it's not a 70s reference. There you go. You see, that has to be like a late ninety s two thousand or something like that.

06:18
Bob French
I must have been in high school. I'm trying to remember exactly when it came out.

06:21
Alex Murguia
Yeah, I thought high school would be a little foggy for you, to be.

06:24
Wade Pfau
Honest.

06:30
Alex Murguia
In Maine or wherever the hell you are.

06:33
Bob French
I was in New Hampshire. I was New Hampshire.

06:35
Alex Murguia
Even better. It was a little touch and go there for a few years for Bob.

06:45
Bob French
We are definitely going to be getting.

06:50
Alex Murguia
All right, inflation. Sorry. Go on.

06:54
Wade Pfau
Yeah, bob, let's start with Social Security.

06:59
Alex Murguia
This is a podcast, but if you saw what it's like and Bob just, like, spilled his drink all right, take two or three inflation.

07:13
Wade Pfau
Social Security. Let's start with Social Security because it's, for most people, the most significant source of inflation adjusted income that they're going to have.

07:23
Bob French
Yeah, not even just inflation adjusted income. The most significant source of income they're going to have in their retirement income. It is an incredibly powerful kind of baseline level. And the nice thing is, it kind of covers the most essential of your spending. A little while back, and I've referenced these numbers a number of times in different places. Marlena Lee over at Dimensional, she did a study looking at replacement know how much of your pre retirement income do you know in retirement? And as part of that, she really wanted to get at basically how much do your investments need to cover of that? And she broke it out between the amount covered by savings and the amount covered by Social Security. And what she found is that, by and large, aside from, say, that top quartile of people pre retirement, the people with the highest 25% of earnings pre retirement, it represented at least half of their spending in retirement, the other half being half or less, being the stuff they've saved up through time.

08:43
Bob French
It's not that much less even in that top quartile. So that's incredibly important. You get that. And that is inflation adjusted income. That is real income. So the message there is make sure you maximize it. Make sure you optimize it. And Wade, you've done a whole workshop on this, but the rule of thumb is, unless you need that income earlier or you have some real reason to believe you aren't going to be living that long, probably just wait until you're 70 to maximize that income through time.

09:24
Wade Pfau
Yeah. And to be clear, for the average American entering retirement, that's really the end of the podcast episode, because they're not going to have a lot of other resources beyond Social Security.

09:34
Alex Murguia
Thank you, ladies and gentlemen. Episode 96 in the books. There we go.

09:40
Wade Pfau
But for listeners, you may be in a position where you do have opportunities to go above and beyond Social Security and to look for inflation protection with other assets as well. But what you said, Bob, was right. It's just as a starting point, the biggest source of income people have is generally their Social Security benefits. If you look at the present value of their lifetime benefits, for a higher earning couple, it can be in excess of a million dollars, and that may be a lot larger than any other asset they have. So step one of thinking about inflation, maximize your Social Security. Make sure you're making smart decisions in relation to Social Security. Now, Bob, the next thing on your list for inflation protection you want to talk about crypto and commodities, fun stuff.

10:28
Bob French
This is the stuff that just doesn't work.

10:31
Alex Murguia
One of the things that doesn't work as a hedge against inflation or doesn't work as a general matter, or both.

10:40

Bob French
One and a half of them don't work. So we got three on the list here. One and a half of them work just as part of your investment portfolio. The other ones just don't. I wanted to include this because these are some of the most common things I hear with regards to inflation. The list is commodity. Can you hedge inflation with commodities? Can you use crypto? That's the one that just straight up doesn't work across the board. And I know Alex, you've got comments on that one, but we'll walk through it and then the third one is actually real estate and there's some really interesting conversation to be had around that one.

11:23
Alex Murguia
And commodities, gold specifically, or commodities in general?

11:27
Bob French
Commodities in general, everyone will come with gold, silver, oil, whatever it might happen to be. The inherent logic is that actually the same commodities are just stuff. They're just a thing. It's a lump of metal or a barrel of oil. It's something that's being acted upon. It's what inflation is happening to, basically. And when you look at the long term data, when you just look at the ideas around it and then it's confirmed by long term data, the expected return of commodities is basically inflation. And when you look at the numbers, if we're looking at since 91.

12:16
Alex Murguia
The.

12:16
Bob French
Commodities index, the Bloomberg Commodities Index had a annualized return of 2.9% over that same period, the US CPI's return was 2.6%. It's just that the commodities had call it stock, like volatility. So you're not getting any higher return. You're taking on a ton of risk and we're not seeing any actual hedging against inflation. The correlation is not particularly good. It's about a 0.2 correlation, meaning that these things are not moving in the same way you're not getting any additional protection from inflation, from commodities.

13:04
Alex Murguia
I think this is important because I keep on saying and look, regardless of whatever pitchman is on TV, or if it's Sunday, you're like skimming through the channels and you see these gold bullion commercials, silver commercials, or Billy Maze is selling like whatever, some sort of thing on TV that has to do with gold or whatnot.

13:28
Bob French
Anything on TV anymore, Alex?

13:30
Alex Murguia
I think he died actually of a heart attack or something like that. Yeah. Who's the guy that does like the.

13:37
Bob French
Liquid, the Sham wow guy?

13:40
Alex Murguia
No, that's a good one too. The liquid thing that you put a hole in a boat and you float it.

13:47
Bob French
Why am I I'm not sure where you're going.

13:49
Alex Murguia
You can have a hole in a boat, put a spray on it and.

13:52
Bob French
It like oh, the Flex Seal guy.

13:53
Alex Murguia
Flex seal, yeah. Even if he sells gold, it doesn't matter. And what Bob said is important, check it out. If the CPI inflation, and we had that yesterday, it's more like the Cpfu kind of thing, right? But if the CPI is at 2.5 look above. If the CPI is at 2.5, right? And commodities index return effectively two and change, it's the same kind of return. Roughly speaking, it's the same kind of return. But the variability of that return is 68% of the time. Inflation is going to be about three and a half percent on the upside and maybe one and change on the lower end of it, like the range is like one and four and a half, right? That's what he means by the standard deviation. So even though the average is two and a half, the range is like one four and a half.

14:44
Alex Murguia
Whereas the range on commodities for the same return is effectively potentially, what is it, 17 or negative eleven, any expected year. That's crazy to get to end at the same return. So something that moves with that much variability, statistically speaking, cannot hedge against the other one. It's just too much dispersion.

15:08
Wade Pfau
It's a much more volatile experience that on average gives you a slight edge over inflation. But effectively, as Bob was saying, it's basically the same volatility as stocks, but a much lower expected return.

15:20
Bob French
If I'm taking that volatility in my portfolio and not getting a specific inflation hedge, I kind of want the thing with the higher returns. I'd much rather include something that I'm going to get paid.

15:37
Alex Murguia
The other thing that Bob says, I think it's actually as important. Commodities are an input. They're used by companies to produce products and that kind of thing, but they don't make anything, right? So it can't hedge, it doesn't function. It's used by companies. So that's the good thing about commodities. But it's an input. It doesn't do anything. So there's no hedging going on or anything like that.

16:03
Bob French
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16:26
Bob French
So, I mean, there are arguments for why it can be reasonable to include in a portfolio. I'm not a big fan of it. I don't think the diversification benefits justify the lower return that's associated with it. But people I respect incredibly disagree with that. So that's where the half came in, where I said one and a half of these are potential. The one that is just straight up not is cryptocurrency. Now, I haven't been hearing it quite as much because there hasn't been quite as much.

17:01

Alex Murguia
AI kind of took the headlines that.

17:03
Bob French
AI did take over, but in terms know weighted average, how bad it know crypto is just a bad idea. It's not an inflation hedge. It's pure hype, pure speculation. There may be some interesting technology stuff on the back end. I'm getting less optimistic about it as years go on and we aren't seeing anything moving, but maybe there's something not a good investment tool.

17:31
Alex Murguia
Well, I get this, and it's still in the speculation play, right. And you need some sort of cathedral thinking behind this and cathedral thinking and retirement income investors, never the two shall meet in that sense. And what I mean by that is you're in the very early stages of something that has big dreams. Right. And so what's the opposite of sanguine? I'm not against it to the degree that Bob is as an inflation hedge and all that, you can't tell there's not enough data, et cetera. Right. And will it ever do something? Look, the reality is, and Bob Wade and myself, we're not very learned people when it comes to the ins and outs of crypto. I mean, that's the reality of it. And so I don't just want to discount it because to some extent it's in vogue to say it's great, or it's in vogue to say these are nothing but, you know, kind of thing.

18:25
Alex Murguia
But I'll leave it at this. I think potentially there could be something there, but we don't know right now, honestly, as opposed to just discounting it. But as a hedge, the jury, you can't make that assumption at this point in the trajectory of crypto to say it's a hedge because three months ago the S P went down and Ethereum went up. That's stupid.

18:47
Wade Pfau
Well, and this is retire with style. Specifically. As a hedge for retirement, you have to worry about the sequence of returns as well. If it's much more volatile, which it is, that can create problems for retirees, where if you have to spend that asset when it's suffering a major loss, you can deplete your asset base a lot quicker. So when we talk about inflation hedges for retirement, it's not just a matter of does it have growth that keeps up with inflation on average, but how volatile is it in the volatility of crypto? Makes it dwarfs even less useful than any even if you give it some sort of benefit of doubt in the accumulation phase, that's further out the window in the retirement distribution phase.

19:33

Alex Murguia
Good point.

19:35
Bob French
And then the last one I wanted touch on here is real estate. This is actually one that's really common, especially outside of the US. They're not making new land type of stuff. And that's sort of true. We're building new houses, we're using more land, especially in the US. But this is another one where it's really a correlation story. So real estate does have call it stock like volatility. What kind of stock like returns to go along with. So it can be and we've talked about this in a number of other places, it can be a really good diversifier.

20:18
Alex Murguia
I want to be clear here, Bob. Are you talking about REITs? Are you talking about like real estate.

20:23
Bob French
As an asset from REITs, but the correlation, when you look at real estate prices as a city or a region, when you look at those types of indices from case schiller and stuff like that schiller, I don't think cases involved in those. The correlation between REITs and those more specialized ones is actually really high. So you can use them at least as proxies for each other and going to individual properties. Obviously we then have a lot more concentration risk. When you're buying a house or an apartment block or whatever it might happen to be, you then have the risk of your neighbor painting their house neon pink or whatever it might happen to be.

21:16
Alex Murguia
Have you been talking to my neighbors by the way? Because Christmas is coming up and I go crazy.

21:24
Bob French
Oh God, that does not surprise me in the slightest. But what we see when we look at the data around real estate is that there's no correlation between inflation and real estate. When you run the numbers since the late seventy s, the correlation comes out to zero. Zero four. That's just a really long way of saying zero. And what that means is you should get higher returns when the bad things happen. So in this case we would want a high positive correlation. When inflation is high, we want a high return on the asset that's going to hedge against inflation. Correlation to zero means that's not happening. You're going to get decent returns because real estate is a reasonable asset class to be in. But it's not hedging inflation.

22:23
Alex Murguia
And I'll say this when you want a correlation of zero. When you're bringing in diversified assets into a multiple asset class portfolio, you don't want necessarily a negative correlation. You don't want 100% negative correlation. I meant like you want something that acts independently, say like that. To me that's a better kind of outcome.

22:43
Bob French
Yeah. No if you're looking diversification, the magic of diversification is when you have low or negative correlation asset classes with the rest of your stuff. And that's actually why we talk about with real estate as being something that's pretty reasonable, pretty good, pretty common to include in your portfolio. It has a really low correlation with basically everything stocks, bonds, apparently inflation. And it can be a really good addition to a retirement focused long term portfolio. It ain't an inflation hedge.

23:22
Alex Murguia
This reminds me at some point though Bob, we should do something on real estate from the standpoint of people that buy properties.

23:28
Bob French
Yes.

23:28
Alex Murguia
Because I think sometimes what gets overlooked is that these outsized returns are coming from leverage, not necessarily the return of the underlying itself.

23:39
Bob French
Yes. There's also is the conversation around rental income. That's always a conversation that's worth having there as well. But we've kind of had our fun and pulled apart some of the stuff that doesn't work. So now it's probably time to take a look at the stuff that does work. And as Wade called out at the top there's really kind of three big approaches that we can use. So let's start with investments using your risky assets. The idea is again not an inflation hedge. Your investments ideally will outgrow inflation. Your expected return on your investments is higher than inflation and as such being able to support a growing distribution to cover that inflation, there's no magic here. It's just yeah, the returns are bigger so you can take out more.

24:43
Alex Murguia
Well there's also the comment of stocks have pricing power like companies better said companies have pricing power and so how does that play into inflation?

24:54
Bob French
Yeah, companies are the ones from a certain point of view, as we talked about last week, there's a lot of stuff going into this but from a certain point of view companies are the ones charging those higher prices. They're bringing in that money that's causing inflation is not the right terminology but they're bringing in more revenue from the inflated prices. They're also paying it out in terms of all of the costs of the goods they're producing. But there's definitely a piece of that. And when you go in and start decomposing expected returns of any financial asset, whether that's stocks, bonds, whatever, inflation is definitely a piece of that. That is one of the inputs in everyone's pricing models, how they think inflation will be moving from a number of different perspectives. And that's definitely something that goes in there. And one of the things that we see when we start looking at the data stocks, it's real obvious you're going to have over the long term stocks returns are really noisy over the long term.

26:13
Bob French
No one would invest in stocks unless the expected return was above inflation, significantly above inflation. But even once we start looking at bonds because very few retirees have a 100% stock portfolio, the real return, the inflation adjusted return of even one month US treasury bills is still positive. You would still over the long term outperform inflation even if all of your money was in one month treasury bills just rolling over. Now again, very few people would do that. They're going to be in some sort of portfolio that probably is going to have a little more risk than one month US treasury bills otherwise known as the risk free rate. But that gets just how strong and how powerful these investment tools can be in keeping you ahead of inflation.

27:18
Wade Pfau
And Bob though, that is still over a long term time horizon and actually the number you have here, the 0.3% real return was pretty much the same as commodities too but with much less volatility. But I think when we start talking about over different time horizons what are the ODS for these different asset classes to keep up with inflation?

27:40
Bob French
Yeah, that is the question because it's one thing to just say yeah on average I'm going to beat inflation. But if when you go to spend that money, you have not, you got a problem. And one of the things we looked at I

mentioned we did a workshop on this, we looked at some data from rolling returns going all the way back to 1926 and basically saying, what.

28:10
Alex Murguia
Does rolling returns mean?

28:12
Bob French
Yeah. And what we're doing is we're looking at different lengths of time, starting at each individual month. So if we're say looking at one year rolling returns, the data we're looking at starts in January 1926. Well, what happened from January 1926 to December 1926, and then February 19 626 to January 1927, all the way down the line. So effectively, what we're looking at is we're saying if were to pick a random month over this time period, what's likely to have happened? What would be the expected outcome? And what we're seeing is that let's say we're using a 60 40 portfolio. So 60% S and P 540%, five year US treasuries, kind of the prototypical stereotypical retirement portfolio. If we're looking at one year periods like that beat inflation 71% of the time and had an average outperformance of inflation by call it six and a quarter percent, three years moves all the way up to 79%, and we can keep going.

29:33
Bob French
But over a random 15 year period, there was close to a 96% chance that 60 40 portfolio outperformed inflation by an average annual amount of call it five and a third. That's a lot.

29:53
Alex Murguia
So is it fair to say, obviously, I don't think inflation we just suggested last week's episode, and inflation, right now, it's at its long term average kind of thing. So it's not like going crazy. But let's say, I don't know, four months ago when tensions were running high and so was inflation. The reality is, if you're looking at this, you don't have to do anything special.

30:18
Bob French
Exactly.

30:19
Alex Murguia
Or anything different by having ultimately a multiple asset class portfolio you're set, you don't really need to go crazy. Sometimes we think if we're not doing something, we're not trying, if you will.

30:35
Bob French
Right.

30:36
Alex Murguia
And when it comes to investing Bob's analogy about the soap, just leave it alone. Because the more you use it, the more you move it around, the more you like, the more you do something, the less you have.

30:50
Bob French
I generally say the more you touch it, the more you use it, the less of it you have.

30:53
Alex Murguia
All right? So think about it like inflation comes in. No, you don't need to do much, if at all. Just maintain the discipline behind what you already have going into it.

31:06
Bob French
Now, that being said, there are things you can do that explicitly protect your portfolio from inflation.

31:14
Wade Pfau
So there are tips before getting to that too, though. I think something that people hear a lot is stocks are an inflation hedge. This is probably really the point to talk about that, because it's in this context that statement is being made from the data you provided that over all the rolling one year historical periods, stocks outperformed inflation 70% of the time. Over five year periods, stocks outperformed inflation 77% of the time. Over ten year periods, stocks outperformed inflation 87% of the time. Over 15 year periods, stocks outperformed inflation 95% of the time. And that's the source of that sort of statement. Then it's really well, what do you do with that information? Are stocks an inflation hedge or not? Or just can you kind of give us a little more color on?

32:07
Alex Murguia
Yeah, I guess it's kind of a.

32:09

Bob French
Philosophical question of what do you think a hedge is? I don't think stocks are an inflation hedge, I just think they go up and they go up on average by more than inflation.

32:23
Alex Murguia
I agree with Bob, and this goes back to my point about you have pricing power. They just outrun inflation no matter what. And so, yeah, it doesn't necessarily go up when inflation's down or go down when inflation's know that kind of thing. From a hedging standpoint, it tends to outrun because the reality too is we just set all these numbers right and you can make the case. Well, maybe that's just data mining, right? It just happens to hit because you know what, Mickey Mano's rookie card I'm going to take every ten year period and see how that did relative to inflation. And could we make a statement mickey Mano's rookie card outperforms inflation and that's a better hedge or whatnot? Well, not really, right? There's no economic reason. And so I think we're laying the groundwork why stocks outperform inflation. It makes sense why it would do so.

33:15
Alex Murguia
It's not just because the data shows it. But I do agree with Bob that it depends. Yeah, you can get into the semantics. What does hedge really mean? It just outruns it in all kind of environments. And you know what? That's good enough for me.

33:29
Bob French
Yeah, you get the effect of a hedge without an actual hedge. You get what you want out of your investments, assuming you're comfortable spending from a risky asset. Yeah, obviously the specifics are important here, but yeah, the higher returns of stocks and other financial assets allows you to increase your spending to account for whatever inflation happens to be doing.

34:03
Bob French
Curious if you should be looking at a Roth conversion or what a Roth conversion even is. Head over to McLeanam.com/Roth to get McLean's free ebook. Is a Roth conversion right for you?

34:16
Wade Pfau
And learn about when you might want.

34:18

Bob French
To do a Roth conversion and when you might not. Just head over to McLeanam.com/Roth to download your free ebook today.

34:28
Wade Pfau
Yeah, maybe in the context of the reset a way to interpret that we'll just take in the ten year numbers. Over rolling ten year periods, stocks do better than inflation 87% of the time. On average, stocks outperform inflation. By 7% on annual basis, seven and a quarter percent. But then stocks over a ten year period, stocks underperform inflation 13% of the time. So if you're probability based, you're more comfortable saying, yeah, there's a pretty good chance that over the next ten years stocks are going to outperform inflation. And so I can rely on that to help my assets to keep up and surpass inflation and provide real purchasing growth over time. If you're more safety first. The fact that there's a 13%, that stocks are going to underperform inflation over the next ten years with that statement, again, just being these are the historical percentages around that I'm not necessarily comfortable basing my retirement at least my essential expenses on something where there's a good chance of 13% chance, whatever the good or not 13% chance that it will underperform inflation over the next ten years.

35:38
Wade Pfau
And then it's just a different mindset or preference about how you interpret those numbers and what you want to do in response. So that's really for the probability based individual and it's not so much any sort of forecast about what the stock market is going to do other than you're at least a lot more comfortable with the idea that your investments will outperform inflation and you can rely on that to fund your retirement spending.

36:01
Bob French
Absolutely. And kind of that point is one of the ones that's really important that if you're using this, if you're kind of in that total return quadrant, you probably want to be thinking about variable distribution strategies here as well to account for those years when the stock market doesn't or the financial market generally does not cooperate.

36:22
Alex Murguia
Now, Bob, I'm just trying to think of an extreme example here and get your take on So and Wade chime in. You may have to dip into your bag of Williams Jennings Bryant quotes and things like that with regards to your cross of gold, but okay, so what happened in pre war Germany or something like that when inflation was just crazy and stocks didn't work? Why didn't stocks mean what happens in crazy situations like that?

36:58
Bob French
Yeah, Wade, I don't know if you have a more eloquent way of saying what I'm about to, but yeah, if the country's falling apart, you want to own that ingot of gold rather than a claim on Tesla and the company is not going to be around any further. No, the economy just doesn't work anymore.

37:04
Alex Murguia
I'm trying to get to that person listening, thinking, yeah, but sometimes stocks are just hell in a handbasket and you need to own things.

37:16
Bob French
Yeah, Wade, I don't know if you have a more eloquent way of saying what I'm about to, but yeah, if the country's falling apart, you want to own that ingot of gold rather than a claim on Tesla and the company is not going to be around any further. Sure, but to the extent that we live in a functioning economy and that we think that all of these companies, all of these financial assets are effectively going concerns, they're going to be around, they're going to be continuing to operate and for bonds pay out. Yeah. That's baked into the price those inflation expectations are baked into the price.

38:07
Wade Pfau
And just with hyperinflation environments, it's usually the nominal bonds, government bonds, they're going to be completely wiped out. Stocks, at least over a significant holding period, may eventually keep up with inflation in a manner that bonds never will. So there'll be the case for stocks in that regard.

38:30
Alex Murguia
So what I'm trying to get at to some extent and this is again for the extreme people that are thinking, well, the government's going crazy or whatever, look, as long as there's rule of law, property protection, this sort of movement towards innovation where money is greasing the wheels of capitalism. I think those kind of fears are somewhat unwarranted. And Stuck should be fine.

38:55
Bob French
And then one thing that's also worth calling out and I started to do was that there is ways that you can do explicit inflation protection within your investment portfolio using Tips and I bonds to a little bit lesser extent. Excuse me.

39:18
Wade Pfau
Yeah, and that's just the distinction there is. I mentioned nominal bonds a moment ago. They give you a fixed payout Tips and I bonds give you a real interest rate on top of the actual realized inflation experience. So when inflation goes up, the return goes up to keep pace with inflation.

39:38
Bob French
Absolutely. The reason I bring those up is we've been talking about investment portfolios and include a relatively high either just 100% stocks we've been talking about the S and P 500 index, or that 60 40 portfolio which includes a good chunk of stocks, good chunk of high returning assets in there. For those who don't have a huge amount of risk in the portfolio, they don't have a huge amount of return in that portfolio. You may want to include something that very specifically tracks inflation and that can be a really nice tool to kind of take some of that inflation risk off of the table. Because Wade, your seven risks of retirement, inflation is one of them. One of the questions we always ask with regards to your asset allocation and you're thinking about tilting towards or away from certain types of risk is are you more exposed to this risk than the average investor?

40:49
Bob French
Well, if we're talking about inflation and you're someone focused on retirement, the answer is yes. Absent some really weird situation, the answer is yes. So tilting towards some sort of inflation protection can make a whole lot of sense. That can be really powerful. And also getting back to the psychology aspect of it really comforting that even in a down year where things aren't going against things or going against your portfolio, I should say you still have this piece that's going to be protected from inflation. Now, the one proviso and Wade, I know you and I both got a ton of questions about this a few years back is I believe it was in 2021 where we had the bond market did not do particularly hot one of the things I always call out with Tips is Tips are still bonds. They're bonds with inflation protection.

41:58
Bob French
We had, I believe it was just over 9% inflation in 2021, but the bond market got creamed, and if you were holding long term Tips, you still.

42:10
Alex Murguia
Lost a lot of money, like over 20% or something.

42:15

Bob French
I think the bond market was down 20%. So the long term Tips lost somewhere in the teens. They're bonds. They're going to do what the bond market does just with that inflation adjustment put on top. And there were a lot of people really surprised when they looked at their statements and saw that type of thing because they were thinking, great, high inflation, my Tips are going to do awesome. Doesn't quite work like that.

42:47
Alex Murguia
The only thing I would say to that is, yeah, that's exactly where I was going. Bond fund versus individual bonds. The reality is they're priced individual bonds, had that same volatility, but you can hold it to maturity and you'll be kind of fine.

43:07
Wade Pfau
Yeah. Whenever interest rates go up, you'll wish you could buy a bond at the new, higher interest rate. But if you're a retiree and you're holding a bond to maturity, you know what you're going to get. Even though on paper it may be worth less because interest rates have risen, that diminishing value will return to its full value by the maturity date. And assuming the bond doesn't default, you'll be made whole and get what you expected.

43:37
Bob French
Yeah.

43:38
Alex Murguia
Detail.

43:39
Bob French
No, I mean, this is one of my favorite semantic arguments. The bond is going to even though you're intending to hold it to maturity, the market price is still moving. It's just you don't care about the market price at that point.

43:50
Alex Murguia
You don't sell your house every day.

43:51
Wade Pfau
If you're a bond trader, you'll get fired. But if you're a retiree.

44:02
Bob French
But, I mean, that's kind of the approach, that generalized investment approach. That's really kind of how people in the total return type of quadrant are going to be approaching it. Okay, so, Bob, just as a recap and Wade, as a recap, we spoke with three things that don't really work as advertised, and so far, we're up to one thing that sort of fits. The vast majority of folks have some level of risky assets and some level of income coming from their risky assets. And the whole idea here is that you can use your investments not, again, as an inflation hedge, but to outgrow inflation so that you are above and beyond and you can support whatever distributions you need to make from there to account for whatever inflation has been doing and still maintain that level of purchasing power for yourself.

45:02
Alex Murguia
Okay, so, Bob, just as a recap and Wade, as a recap, we spoke with three things that don't really work as advertised, and so far, we're up to one thing that sort of fits.

45:18
Bob French
I think this is how it works for us.

45:19
Wade Pfau
Yeah.

45:20
Alex Murguia
Is that a correct way.

45:22
Wade Pfau
Yeah. The three things that didn't work were the commodities, the crypto, and you had real estate, if I was listening. Real estate on that list. Things I was listening.

45:41

Bob French
We're definitely the sarcastic professor here today.

45:45
Wade Pfau
But things that do work. We've talked about Social Security. We have talked about the idea of a stock market or otherwise a diversified portfolio with a hefty allocation of stocks. We've talked about tips and I bonds. We did mention another one. I think we'll save this for another episode because there's a lot to unpack, but annuities and the role they can play in all this as well. So why don't we just save the discussion on annuities since there is a lot to unpack with it, whether it does or how it actually fits in with this inflation discussion. But, yeah, from today's episode, you've got your stocks, you've got your tips and I bonds, you've got your Social Security.

46:26
Alex Murguia
His inbox to zero.

46:31
Wade Pfau
I wish. All right, an ongoing struggle we'll pick up with annuities and also with more of a tour through the retirement income styles and how each can address inflation in retirement with the next episode. So thanks, everyone, for listening. And we'll catch you next time on Retire with style.

46:53
Alex Murguia
Thank you, everyone.

46:56
Bob French
Wade and Alex are both principals of McLean Asset Management and retirement researcher. Both are SEC registered investment advisors located in Tysons, 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 a risk, including risk of loss. Past performance does not guarantee t future results.