# Episode 15: How Volatile Markets Affect Your Investor Psychology and What You Can Do About It

**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. Changes in platitudes, changes in attitudes, nothing remains quite the same. Or does it?

**Wade Pfau** 00:50
Hey, everyone, welcome to another exciting episode of Retire with Style. I'm Wade.

**Alex Murguia** 00:55
And I'm Alex.

**Wade Pfau** 00:57
And this week, we're gonna be continuing the conversation that we started with the last episode about this idea of we're now in a downturn in financial. And that can cause a lot of havoc and concern. And what we talked about in the last episode with Bob French is our guest was just what's happening in the financial markets right now, and how to think about that more from the purely rational, assuming people know exactly what they need to do in terms of rational thinking. But there's an important behavioral aspect to that. And that's an area that Alex really has his focus on this idea of behavioral finance of the emotions of, even though you may know, in a coldly rational sense, to respond to a market downturn, the psychological makeup we have as investors doesn't always translate into being able to coordinate well with this coldly rational calculation that we may be doing with the other part of our brain. So Alex, we really want to have this opportunity in this episode to consider some of these kinds of behavioral quirks that exist, and how people can put into the context, our own planning, how to manage and overcome these types of quirks so that they can, as best as possible, stick with the strategy or stick with the plan that they have. And as the best approach, ultimately, in the long image, this kind of market volatility environment. So what should investors be thinking about in terms of behavioral biases? When it comes to dealing with market downturns and financial market declines? Are we as humans evolved to handle this sort of thing?

**Alex Murguia** 02:40
Well, results vary would be my initial answer away with regards to everyone. But you bring up a good point at the very beginning. And that was last week's episode we spoke about, look, this is what

descriptively is happening with the markets. And the end result is, effectively this is what you've signed up for if you wanted to participate in these market returns. The reality is, that's very easy for us to say. And it's one of these things that's difficult for us to implement. And if so, you were being a little too cute by half by leaving it at that. And so the realization is, let's really try to dig into the importance of discipline. And at this stage, if this is a topic that's of interest, everyone investments, everyone has, to some extent been exposed to behavioral finance and the terms terms like loss aversion. It seems these are kind of Jeopardy questions at this point. But what's interesting now is that the emotional tenor of what's happening is heightened simply because of the extreme volatility that you've had. And largely on the downside, even though you get respites here and there, it's largely been on the downside. And so I there's just this greater association right now with these terms, and the ability to recognize them with yourself. And so we we just let's review some of these main concepts of why to some extent, we tend to be maladaptive behavior, bad, maladaptive investors. Now, a little quirk is the idea here, because we did this in the last episode, we don't believe you can forecast. And it's one of these things that it's tough because you listen to these podcasts about the market downturn, and ultimately somebody wants to hear well, what should I do next? What should I do next? But that what should I do? Next question is based on some forecasting, or you know, to some extent, there's this platitude of just nothing and sit back. And while one of those may be more truthful than the other, the way it's delivered is kind of insensitive, maybe maybe too strong of a word, but I think it runs that danger. And I think it's important not to point out that you don't know necessarily need to figure out what's going to happen next to be successful, I would frame it in terms of think about what the next best step is within the process and implement that. Because if you're running with a good process, then in you know, ultimately you're giving yourself the best chance for success. But again, these are one of these things that's easy to say, what why is this comment, difficult to implement? Why is this important? Well, ultimately, I said earlier, we're simply not wired for investing. We're not and to take a step back even thought Wade.

**Wade Pfau** 05:36
I mean, I think that's like a really important starting point. I've always kind of been interested in this, like evolutionary argument of like early humans saw danger. What were they doing in response, it wasn't necessarily staying the course, not panicking, not doing anything. But that's ultimately like a short term danger, your basic human responses, like the fight or flight mechanism, you kind of get stressed you, you run away, if necessary. And that doesn't necessarily work with financial gets, which is a relatively recent development in human evolution. So if you want to come in a bit more on that kind of

**Alex Murguia** 06:19
100%, I don't know the exact numbers, right. But I think we've been around something like 300,000 years and rough numbers. And if depending on who you ask, right, how long have the markets been around? Wade, you have a better sense of that than I do? What would you say?

**Wade Pfau** 06:36
Oh, I don't know how you exactly define the market. But like modern style, stock markets, and things were really just maybe the past 500 years, exactly. Societies that had something going,

**Alex Murguia** 06:48

maybe the Dutch were innovators. Yeah, but for the most part, you're looking at 300 years, 300,000 years of evolution, versus let's just say, for argument's sake, because 100 years now, you know, doesn't really matter when you're comparing it to 300,000. Let's just say 500. To be safe, right? 300,000 years of, you know, getting beaten over the head with lions in the savanna versus 500 years, I think you're 100%, right. We're wired, ultimately, to be very, very cautious. It's not like if you hear a noise in the shrubs of the savanna, you're gonna run a risk reward analysis and, and the like, you're just gonna run and ask questions later.

**Wade Pfau** 07:28
And that's where natural when you see a downturn in the financial markets, is it's triggering that same sort of, like response in our minds, where what we're used to doing, evolutionarily speaking, is runaway and panicking. And then what that translates in and in, in our strategy, and that's not necessarily the way to get the best long term gains out of a financial market investing based approach.

**Alex Murguia** 07:56
Exactly. And so these, these are one of these things. And we're pointing this out, not necessarily to point fingers at anyone at all, Wade and I go through the same slings and arrows that you do with regards to this, I'm just pointing out that it's difficult for us to fight 300 years, 300,000 years of how we're wired, versus, you know, the baby and the ETrade commercials. It's just one of these things that it's it's it's, it's not an even, it's not an equal way he did set of valence is here,

**Wade Pfau** 08:30
right, and there's else. For me, it's definitely stressful whenever the markets go down. And we recently saw like a 3% or more downturn and in one day, which just adds to the further compounding of what's been happening. And it's hard not to feel stress about that. But I'm still far enough away from retirement myself that I can frame that more just at a personal level as a buying opportunity. Though I recognize if I were closer to retirement, and I didn't necessarily anticipate having future savings to to make purchasing at a discount in the financial markets, I might not be able to have that same sort of response. And as people are getting closer to the retirement, they net red zone around retirement or that risk zone, it can be a lot more stressful than it is for for people who may still be 15/20-20 plus years from retiring.

**Alex Murguia** 09:22
Exactly. And the other caveat, I would add to this and it's because this is the retire with style podcast, not the investing for accumulation podcast is that there are many strategies with regards to retirement income. And so there are strategies in which you can immunize yourself to some extent from from needing to be tethered to the stock market to stock market success to have a successful retirement income plan. But we have plenty of previous episodes where we review it over and over and over and over. So I'll leave it there.

**Wade Pfau** 09:57
Right this is going to be the biggest issue for those with it Total Return strategy that the assumptions behind that strategy tell you, it will, it's supposedly your preferences, you are comfortable relying to perform over the long term. And to be to have that comfort, you do have to weather that short term

market volatility. So if that resonates with you, great, but then this is the time where that's really put to them. If that doesn't resonate with you, indeed, there are other retirement styles available that don't require being tethered to the market, at least for the basic retirement spending...

**Alex Murguia** 10:32
know, if you're an accumulation it, it is what it is. Now, that being the case, there's that where we're, you know, we're it hesitant humans. To a large extent, the other, the other sort of generalize statement that I feel comfortable making, is that, from an evolutionary standpoint, our brains need to be efficient, our brains take up a significant amount of caloric intake. And, you know, the real two and 20 rule is effectively your body, you know, the brain is 2% of your body. But, well, for weight, it's 5%, your brain is 2% of your bodyweight. But if you use 20, it uses 20% of the energy. So think about how taxing the brain is. And so for us to have, you know, evolved effectively, we have needed to take mental shortcuts, you can't process every single decision that you make. So adaptively, the brain has started, you know, has been wired, to take these mental shortcuts, these heuristics, I think, when you look at the data, and I'm doing this, you know, don't quote me on this, if you will, but it's something like over 30,000 decisions a day, that's about one every two to three seconds, you're literally making one decision every two to three seconds that you don't really even realize. And that's simply because you can't, if you were in going back to that Savanna thing, if you heard noise in the in the brush coupled with this hesitancy, you're not gonna you're not gonna run all of a sudden, the equivalent of a portfolio optimization strategy to see what's the best angle, what's the best direction to run relative to the distance, and when pressure and the like, it just doesn't work like that, Wade.

**Wade Pfau** 12:19
Yeah. When danger lurks, you don't have the time to run the pros and cons and make a rational decision. They're hearing that you need some sort of mental shortcut, and that it's a mental shortcut it that danger as quickly as possible.

**Alex Murguia** 12:33
Yeah. And it's not just the danger piece. It's also the everyday decisions. How am I going to put on the shirt, you don't literally tell yourself anymore, okay, the left hand goes here, the right hand goes there. You know, a quick thing is for man out there, shave with your opposite hand, and see how jarring it is on day one. It's just one of these things, right? You don't even think about it anymore. Except for Wade, who's been sporting a beard lately, right way. So, so, so we got this sort of flight or fight, we, you know, if we weren't, if we weren't fighting, we may not have been around, frankly, relative to our rivalries that we had back then there is this, we need to have these mental shortcuts, these heuristics for our brains, for us to function, if not, we'd be paralyzed and analysis all the time. And mental shortcuts will ultimately lead to biases, which we'll we'll cover in a bit. And the last sort of triumvirate of these things, in our view is that we're social beings. We're social beings. And Wade, do you want to talk about that one a little bit?

**Wade Pfau** 13:43
I'd be happy to and I'm kind of looking at some notes you put together but I wasn't entirely sure what angle you were going with that?

**Alex Murguia** 13:50
Okay.

**Wade Pfau** 13:52
Let us know, how does being impactful here.

**Alex Murguia** 13:55
It's this, this goes back to you read this a lot in these behavioral finance books. And the like, is that, look, we're social beings. And a part of our large success is just this ability for our gregariousness. You know, this community building. The story is if you put one person in an island versus one monkey, and you come back a year later, the monkey is probably alive and we're not you put 100 monkeys and 100 humans in that island. It's a different story, to a large extent. And so there's this there's this need for us to work in harmony together for the survival of the species, and it's helped us be adaptive. And so when you think about markets, when you have these upswings and downswings, you kind of look at what's around what's going on. Right? You don't want to be if you're not the fastest gazelle, you know, you kind of want to be in the middle of the pack. Have you heard? Yeah, exactly. And so that's where that's where I was getting at with that with that point. And I think these are these are important points. So if you do Take a step back, forget about what's happening in the Ukraine, it's human tragedies, I don't mean to minimize it in that sense. But from the standpoint of the markets, you know, there's inflation, there's all of these, this wall of worry that you'll always have no matter what, there's always a perpetual wall of worry. But if you think about it, how you react to this, you know, you're externalizing it. But if you can just think about how you react to this, with the standpoint of flight or fight, with the standpoint from the standpoint of these heuristics prevent these proclivities for heuristics that we absolutely need to survive. And then this, this sort of social being inclination that we have simply for our survival, you're you're you're swimming upstream here a little bit. And so this, this is why we don't want to come across as tone deaf by saying, Hey, this is what you signed up for, enjoy the volatility, because this is what gives you future returns. While that's true, it doesn't quite sit well with everyone.

**Wade Pfau** 16:02
Yeah, fair enough. And I see your point about the social being that once someone starts panicking, that can start to cascade. And so then, if the media is like, has all these scare stories going on about financial markets, that are difficult to overcome that sort of desire to follow the herd, and to be able to stay the course with your strategy.

**Alex Murguia** 16:27
And absolutely, and again, all these things, they're not bad. This is what has made us the apex person, the apex creature on the planet. These these these tendencies, they have absolutely contributed to us being the apex creature on the planet. Unfortunately, they kind of go against what you need to be a successful investor. Now, is this something just by listening to this podcast, Voila, you've changed? Of course not. Of course not. You know, you've lived so many years of your life, you have that going against you. And you have just the, you know, how you've been how we as a as a race have evolved. I mean, we've been around for 300,000 years, investing in this manner, at best 500 years, let's just say really 100. It's one of these things, that it's just difficult that for us to fight against. And that's it. So how

does this manifests itself in these behaviors, if you will? Now, that was just the top level kind of pillars, if you will, but this is where there was a whole science around this with regards to behavioral finance.

**Bob French** 17:43
Worried about how the markets have impacted your investments and retirement plan, speak with a financial advisor from McLean Asset Management to make sure that you're positioned correctly. Just go to McLeanam.com/start, to get started, that's McLeanam.com/start.

**Wade Pfau** 18:01
Yeah, and I come from the economics world where for most of the 20th century, the idea was people made purely rational decisions. And then behavioral finance comes along and starts to make all these points that human decision making isn't always purely rational, there are there's this need to create shortcuts in the decision process, which then can lead to the biases. And so let's, let's start talking about what some of those contributions of behavioral finance are that can help us better understand what we may be dealing with when trying to manage our investment strategies in a period of market volatility.

**Alex Murguia** 18:41
Sure, well to quote Kei, Keith Jackson, from his Rosebowl days, the granddaddy of them all, is loss aversion. Really, when it comes down to it. Remember our preference for having an abundance of caution that we spoke about earlier out in the Savannas? Well, the reality is, is you have loss aversion, this is something that it's just this this baseline where the pain of a loss is greater than the joy of a gain. And that's, that's simply put, it was adaptive, and creatures that exhibited this humans that exhibited this, were able to carry on more than others because they would have been killed by some, some attacking creature in the bush, if you will. So it's one of these things that's just promulgated itself. And it's, it's good from an adaptive standpoint, but from an investing standpoint, you can see how if you just experience this 20% decline as of this recording, you know, from officially a bear market kind of sense. Well, it's one of those that you're fighting upstream against this feeling that you're feeling right now.

**Wade Pfau** 19:47
Yeah, I think like to maybe a point there is so once the downturn at the start of the pandemic and got over the rest of 2020 was a really good year for markets. 2021 was a really different markets were now knocked down 15 to 20%, somewhere in that ballpark right now for the year to date. And that was loss aversion. We frame that as a team to 20% of my wealth, that can make me feel terrible. But if we could instead frame and maybe your brokerage accounts will show this, you may still have overall gains in your account. And so if you could frame instead of well, I'm, I still have money I just lost relative to the high murder, high watermark that I was at, that maybe can make you feel better. That's at least I think, internally. Think about it as well, I don't focus so much on how much I've lost relative to the highest account the value that I ever had, but rather, the fact that I'm still ahead overall, and maybe I can sleep better at night that way.

**Alex Murguia** 20:47
I think that makes great sense. Wade, that's a great framing exercise. The other piece here is that a reason maybe they that's not being done is due to another bias, which is recency effect, right? And

what that implies is you take what's happening now. And you extrapolate that into the future, you just assume okay, this is what's going to happen from now on. And so there's less if you really succumb to that there's less of this desire to do what you said, Wade, which is Hey, but I'm still up. You know, this kind of house is money kind of kind of tendency here, here, they're assuming Well, you know, what, it's a new thing. Based on what's happening right now, inflation is going to be crazy for the next for the next cycle, or two or three or four. And, you know, it's easy to then think, Okay, well, at the start of 82, was this sort of generational cyclicality towards lowering rates? And obviously, it bottomed out, you know, maybe sometime last year, and now we're back on the upswing, you know, for effectively another generational cycle. I'm making this up, frankly. But this is what you start thinking about. When when you think about this recency effect? Is this right there where you start thinking, Okay, well, inflation is here, you know, what, if inflation goes back up to 12%, or 18%, when 19, like 1982 rates, I gotta get out. And all of a sudden, you start assuming what you're assuming are facts. And you run into trouble. And that's what the recency effect is, when you just extrapolate what's happening now, and you just assume to be factual is going to happen into the future, you run into problems.

**Wade Pfau** 22:36
Yeah, and it's so it's kind of how people tend to think about financial markets, what goes up, will continue to go up. What starts going down will continue to go down. When the reality is, there's a lot more nuance to that, and what goes up may may become a random will continue to go up, it may level off, it may go down. It's not just that the recent past couple of months of what's been happening in financial markets, reflects the long term potential. I think, when we were talking with Bob before, he was providing a number of examples from the historical data where at some point within a calendar year, markets may have been down 10 or 15%, but still ended the year with high gains, not to say that that will happen this year, necessarily. But it just reflects this idea of with recency bias. I think people are overly worried that maybe markets are down 20% And the year 40% down. And of course, that could happen. But there's no particular reason to be overly worried that that will happen. That is the recency bias that leads us to make that sort of extrapolation.

**Alex Murguia** 23:44
That's such a great point, Wade, and you can see how I'm going to bring up another one. And they're all related. As we also saw in our study, they're not as clearly demarcated as we're making them out to be there's this general cloud of, of heuristics, if you will, but you can see how you bring in overconfidence. Now, there's this overconfidence bias, where we assume that we that, you know, we know more than everyone else, it's the Lake Wobegon effect. Everyone's above average driver, etc. And here, if you have this recency effect, you saw what's going on previously, you start to think you're able to properly handicap what's going to happen next. And you begin to any of you couple that with, I know more than everyone else. There were the main premises and we'd said this in the previous episode. Listen, the markets are imperfect that maybe they're overpriced. Maybe they underpriced, who knows. But they're the best estimate in an aggregate of what the pricing is, right? And so, if you have this over if you're, if you have this overconfidence, you're also thinking, you know, what, I, I do think inflation is going up. I'm not extrapolating that into ad infinitum, but you know what I'm going to be able to tell when to when to go back in. So I'm going to go out now, I'm going to wait for inflation to do its thing. Once it's settled, I'm going to be able to identify it, and I'm going to come back in and reap those benefits. We get people that do that all the time. I'm not trading in and out every day, but I'm going to

count the cycles and figure this out. And that, I think Sharpe did a paper, William Sharpe, and it was something like you have to be right. In the low 80s, I don't know 81 82% of the time, to be able to beat the market on these kinds of tactical bets. It just doesn't happen. You may have gotten it once. And if you got it once, I would say usually congratulations. But that's probably the worst thing that happened to you. Because all of a sudden, you know, the Nobel awaits, right? You think you figured it out. And it's just a matter of time. At that point. It's like you're in the casino, you put your money on eight, you got it, you put your money on eight, again, you got it, you know, the casinos not worried. The casinos that word, they know, it's gonna average out, Wade, you're gonna say something, right.

**Wade Pfau** 26:03
And that's where sometimes people pression because like, there's millions of investors. And if you just think of calling a coin flip heads or tails, when you have millions of people doing that, some small percentage of them will be able to correctly predict heads or tails 10 times in a row. And then we suddenly think, oh, these people know what they're doing. But then it's all every time they make that prediction is still just a 50% chance of being right. And that's where ultimately, the the luck aspect of it may catch up to make that realization that it wasn't necessarily skill. And there's another cousin of this overconfidence bias, which is just people also have a tendency when we look back at historical actions. After the fact, it seems like oh, that was completely predictable, I understand why that particular event happened. And therefore, because of that, I can now be more confident about forecasting or predicting when such things will take place in the future as well, which may lead to that greater issue of overconfidence.

**Alex Murguia** 27:06
No, absolutely. I, you know, I thought you're gonna go with this. Wait, I thought you were going to talk about baseline rates and gamblers fallacy, which is because we were talking about, you know, getting in getting out, this is where, so, so think about this, right? How the cards are stacked against you. And by you, I mean myself as well. And I mean Wade as well. Right? I even Bob because we like to kick Barbara. But if you really think about this, there's a loss aversion tendency. There's this recency tendency, there's this overconfidence, tendency, but we also have we, you know, you throw in gamblers fallacy, which is this idea that you can you think you're detecting patterns where none really exists. And this happens all the time where you start thinking, okay, it's gone down on three, the markets gone down three days in a row, it's we're going up on a Friday, you know what, and then over the weekend, there's going to be information, I'm going to, it's going to continue to go down because it's gone down over the last three Fridays, over the weekend, because whatever, and this happened in the pandemic, you know, new news would come out over the weekend. And so you know, what, no trade, you know, their idea was no traders were, were holding their positions over the weekend, you know, some silliness like that. And think about all the previous biases, you throw in this, this idea that you think you can spot patterns when none really exist. It's just a recipe for a complete disaster.

**Wade Pfau** 28:28
Now, another aspect that we did touch upon already was this idea of the herd mentality, but then that can further contribute to like, if everyone's kind of following what everyone else is doing, you can get into these boom and bust cycles of fear and greed, where when the market is going up, and coupled with these other biases, a recency bias and so forth, that following the herd, everyone's really into the

market, and in the short run that can that can, in the short run, help it to continue to go up. But then at some point, some sort of fear sets in and that can reverse the direction, and everyone starts to panic and abandon the market. And so then it can overshoot in the other direction. And over time, it might have some sort of long term reasonable growth rate. But there's a lot of volatility in the short term, that some of these behavioral explanations about financial market volatility, really focus on. It's just people's behaviors can amp the investment volatility, and so that's another important consideration of understanding these sort of cyclical market dynamics. Yeah, then biases to do you want to talk a bit about the endowment effect. I don't think we've

**Alex Murguia** 29:46
Sure we can cover a couple quickly. But I think these were the main ones from the standpoint of and I will in a second but what I wanted to say if you take again, I'll say it because it's worth mentioning, especially in a podcast, you take loss aversion, Do you take the sense of recency effect? You take this overconfidence, bias? You consider, you know, can I really detect? Am I really detecting a pattern? Or are these just hunches? Right? You take just those four, if you will you couple them with what's happening right now. And it's one of these words a big caveat emptor, it's what you know, and we want to do this episode this week, because it's very salient. It's one of these things that you could read a book Right Thinking Fast and Slow or whatnot, a year from now and be like, Oh, yes, I get it. When, when, when things are going when things are at their boiling point, I'm going to be able to, to hold on to this idea and prevail. Well, the reality is, these are these moments right now. These are these moments right now that we're going through, and I think it's just important. Are there other biases? Absolutely. There's been, I think scientists have come up, they would say 100 or so. But the reality is, there's others as the endowment effect, which is, you kind of like to hold on to some you value, something more of it's yours. Hence, this would be the idea of holding on to losers, stocks that have gone down a little longer than necessary, the investment premise is no longer valid, just because it was yours. There's also affinity traps, where you kind of follow the advice of people that you're familiar with, not even necessarily people, you know, it could be just waiting myself simply because you've heard us now, a handful of times, just because of that repetition, we in, you know, subconsciously, you're not our voice, our opinions begin to carry a little more weight than if you've never heard us before. So it's one of those things. And this is where I would say Caveat emptor. With regards to CNBC, even if you're just watching it for current events, you kind of start hearing these people and you're like, wow, this guy is really on to something after a while. And it's really nothing more than the effect of him being you know, on a daily basis or her exposed. Now, I'd like to transition Wade, if we can on, you know what, what helps with this? Interview? Right? What What helps with this, because I would like to say everyone is sort of guilty of this, Am I guilty, every everyone just has this. And so it's not a thing about intelligence, you can't out think it, you can't out human it, because we are who we are, from that standpoint, but I do believe if you if you work within a framework, and you put yourself in the right environment, you begin to give yourself a better chance of success. And I said better chance, not not a guaranteed chance. Because I think that's very important. And working within a framework goes a long way towards doing this. And so Wade, I think it'd be helpful. If you spend a few minutes not not not a ton of time, but a few minutes on the underlying framework that that we that we make our retirement income plans around, because then I could follow up with just how a financial plan helps you implement a framework like this and, and helps immunize is too strong a word but helps kind of reduce the noise, if you will for you.

**Wade Pfau** 33:10
Yeah, and just being able to document in writing, what you're aiming to do might help you review those notes during. And that's the whole idea behind like an investment policy statement that you can even have a retirement policy statement that I know markets will be volatile this act, maybe I'll cut my spending a little bit. But I'll try not to do wild things like abandoning my investment strategy and so forth. But that's yeah, getting into the the framework we talked about. And researcher is really mapping the expenses that we associate with the retirement plan which relate to our goals, the four L's, the longevity, core expenses in retirement lifestyle, the discretionary expenses that give you the best overall standard of living, Legacy goals, liquidity for the unexpected spending shocks in retirement. And then just think about how are we going to map our assets to these different goals are different liabilities between reliable income, diversified portfolio and reserve. And so the reliable income is the important one. That's the spending that has some sort of protection behind it includes social security benefits. For those who have it's that includes a defined benefit pension. But then if there's a gap between the reliable income sources available and the core spending needs in retirement, how do you want to fill the gap? And then that's ultimately what retirement Oh, if you're a total return investor, you are comfortable filling that gap by drawing from the diversified portfolio. If you have a time segmentation approach, you're going to look more at having short term buckets of fixed income assets to cover that sort of gap. If your income protection or risk scrap, you might look at different types of annuity options with lifetime income protections to fill that gap. But having that framework in place to have a strategy that that gets you comfortable with funding your core expenses, potentially without market volatility associated with CR total returns, can then lay that foundation that your diversified portfolio no longer has to fund essentials. And therefore ik capacity to be more comfortable with market volatility just because your entire retirement is not dependent on you have the ability to maybe make a cut to the expenditure for more discretionary types of goals, to give your portfolio more opportunity to recover, and to not be exposed as deeply to that sort of sequence of returns risk about how a market downturn that have to sell from your portfolio to fund retirement spending can permanently derail that, that financial portfolio. So having that framework and thinking about how you want to your core retirement expenses, ideally, before the market downturn, can help prepare that foundation for you to then don't it's maybe too late for this market downturn, but these downturns are gonna happen in the future, and to be better prepared for the next go around in the future. And having that framework in place becomes very important.

**Alex Murguia** 36:26
No, I think that's great. And we went through the trouble of doing that right now. Because, again, the biases are there. And if you look at, you know, Dan Kahneman, the ones who, you know, when really started, write about it and point these out, I mean, the conclusion of him and many others is, look, this is what it is. But this is like gravity, you're not going to ultimately beat it just because knowing is there. And so, from a psychological standpoint, what matters is the environment in which you have yourself in to give yourself the best chance of success. And if you're working within framework, you're doing two things. You're also beginning to automate thinking process, you're giving your mind guardrails, effectively in which to make in which to make decisions around now those guardrails? It goes without saying, but this is not always the case of everything. You hear those guardrails, especially from a retirement income standpoint, need to have some empirical backing. Now, that's the first 12 episodes of this podcast. We're literally just laying that out, frankly. But the reality is you need a framework does

wonders in terms of giving you this theoretical backing of guardrails? Now, once you have that in place, you open up yourself to the world of the financial plan, the financial plan is how do you want to navigate your investment experience and retirement income strategy within this framework? Right? We just went over the retirement income optimization framework, are there other potential frameworks that are out there? Absolutely. This is the one that works for us on many levels, and in the one, it's the one that empirically, we're actually quite happy with the robustness of it. And so we implement it, the RISA was created out of this framework, frankly, Wade gave us the language to create the RISA, if you will. And so a lot to a large extent, the financial plan, functions high, you know, helps us create, you have your preferences, the financial plan, assesses the economic feasibility of this within it. But from a psychological standpoint, it provides the context of why we're investing. It provides the context of how you're navigating through this framework. And that, that does a couple of things that are interesting, and helps us sort of deflect some of these biases that you're by planning, what you're doing is you're systematically working backwards from an end goal, right? You're saying where do you want to be? And now let's work backwards to make sure we get there. And that's, that's, that's an interesting concept. And it's if you read a lot of books that are coming out lately, I'm thinking any Duke for one, there's this term called back casting, right? And this is what this is you work back going in, you decide what you want to describe as a successful outcome. And you do the things that you systematically need to do to get there, such as your 401k contributions, or if you're in a retirement plan, how you take distributions from a certain asset, or how you're gonna, how are you going to fund some rolling ladder or whatnot. And so but the idea is that you you've already identified the end goal, the end goal can change over time. That's not the issue. But there is an end goal you're working from, and then you refer back from it. Wade, you know, it'd be interesting, simply because I know you're you're a big proponent. I know you're actively involved in your plan on many levels. How do you think about that for the better from a back casting perspective, if you don't mind bringing up your own personal situation?

**Wade Pfau** 40:04
Well, yeah, that's pretty much the idea, you kind of start with the the end goal in mind, which is kind of planning to live to 100. And at least being financially prepared to live to 100. Having any legacy goal in mind at that point, that this is the terminal wealth, still have available at that point. And then making sure that you're implementing a plan that with a conservative rate of return assumption, out to get you to that goal. And then when you have financial independence, it means you have you're at the point where you don't necessarily need to have more inflows of labor income you now have around that with your conservative return projection. And with your spending goals, including for various spending shocks in place, you can take tribution, if necessary, and still have wealth at the end to match that particular goal. So that

**Alex Murguia** 41:03
and I'll add to that, we'd never once mentioned the current market environment as playing a role in his plan. Nor did you also mention which maybe it would have been helpful to some I'm just thinking out loud, Wade is a is in the risk wrap category. And so he also has some contractual income in place in addition to the market sort of distributions that he could potentially take that adds to the security of, of any potential volatility into the future. Is that a correct statement on my part Wade?

**Wade Pfau** 41:35

Or that I will I just recently reached my 45th birthday. And most of the time, you can't even think about risk grab strategies before age 45. So getting there. Yeah, that's the idea. And yeah, the only way that current market environment impacts that thinking at all is because markets had been doing so well, that does cause me to want to make sure my plan, lower rate of return assumption, just due to this idea that I don't necessarily want to extrapolate, high market returns into the future. And but now, as markets are coming down, at some point, I might feel more comfortable tweaking the return assumption a little higher for, for subsequent use. But at the same time, you know, I'm falling behind, like my financial plan was based on assuming in 2022, I would earn a little bit over a 4% rate of return, it doesn't look like we're going to at least as of where we are right now, this year, but if I can average that over the long term, then that would get me back on track with the plane.

**Alex Murguia** 42:42
So those back casting the financial plan, you know, a lot of times a recommendation is a financial plan. And I you know, we say it provides context, but really what it's providing is this back casting idea. And from a from a emotional perspective, it helps counter the biases, you know, large, medium, small results vary based on you. But it helps counter that. The other piece that the financial planning process does is this idea of your future self, right. And this is where you bring up a point called temporal discounting to sound all fancy. And temporal discounting is is our inability, frankly, to, to see well into the future, how are you going to be? It's one of these things that you tend to act more in the immediacy of things it's beyond. It's beyond delay, gratification has nothing to do with that. It's more how you view yourself. And so if you think about it, and one of the best sort of I don't remember who said this, but if you're thinking about doing something, now, ask yourself this question, are you how will you feel about it in 10 minutes, in 10 months, and in 10 years? And I think by just asking the question, and the answer becomes obvious, in terms of should I get out of the market? Because of what's happening right now, you may feel well in 10 minutes, 10 months, maybe maybe not 10 years? Highly unlikely, like, was the eight ball we'd highly unlikely we'd be my answer. And so if you think about what the financial plan does, it kind of counters this temporal discounting, where it's hard to just conceptualize how will you be in 20 years and so this idea of your future self it's a term came up with with from Howie Hirschfeld, which is, you know, ask yourself how your future self will react to the decision you're making now? Because what that does is it externalizes your future self it externalizes Alex Murguia it externalizes weight of his accident that to himself. And it's almost like your future self is saying, Hey, what are you doing? And so the financial plan is a great tool to actually do this. You know, it's one of the you know, A better intervention results when you externalize yourself, you're gonna take it out of, you know, put yourself out have an outer body experience. And the financial plan does that to a large extent, again, something else that counters these biases. Remember, you need a framework, the real map, then the financial plan navigates to that framework. But by navigating through that framework, it addresses back casting, it addresses this future self idea and temporal discounting. The other piece, and Wade alluded to it earlier, is that it brings upon a rules based system for making decisions. It's one of those, you know, the, you want to remove the emotional component as much as possible from it, do you want to talk a little bit about this Wade?

**Wade Pfau** 45:48
Right, that's why they have like a retirement policy statement or an investment policy statement. If you document the kinds of actions you should take in a market downturn, having that documentation

available, as a reminder, the ideas, hopefully that will, will help you just have the follow the decision making that you created when markets were doing okay. And then knowing that that was more of that rational decision there. So that when markets are down, you're still following that sort of logic that you had created, and you're not allowing the emotions to overcome and control your decision making

**Alex Murguia** 46:33
The investment policy same as like that contract with yourself, right, or retirement income policy statement. But and even within the financial plan, it does something extra, which is, if you did a financial plan that's incorporating scenarios into the mix? Well, you can say hand over your heart, this scenario has effectively been baked into the plan. And even with this scenario, in consideration, I am XYZ I'm able to accomplish it, because you've already worked backwards from it. So the financial plan is a living document, it will change, right based on your preferences and the like, based on your preferences and goals. Like I don't you know, I want to do this now instead of that. But the reality is, is that it's giving you this rules based decision that has incorporated various good scenarios, poor scenarios, middle of the road scenarios into it. And you've decided on what's that proper balance of success versus failure, but not just success? If it were to fail, how much what's that magnitude of failure, which is just as an important concept as success. And, and so what we reviewed, just to wrap it up here, is, you know, the last episode, it was just about, hey, this is what's happening in the markets from a pure investment standpoint, but the reality is, is that how we react to it is just as important. So we wanted to take a step back. And just point out listen, as human beings, we've adapted in certain ways for the last 300,000 years that make us the apex creature in this planet. But by the same token, make us maladaptive be maladaptive investors, because the strengths and weaknesses conflict, you know, quite so that has also led to us having these behavioral biases, which, you know, we need them to survive. But again, conflict with becoming successful investors. Now, knowing them is just not enough. You know, or it's just not enough to change your behavior, because these are just, you know, that sort of nature nurture. There's a lot of nature involved in this. And so to some extent, what we can do is provide ourselves guardrails, to give the into decision making process, our guardrail is our framework, their retirement income optimization mat. And that's, you know, thank wait for that one, everybody. But that's how we go about navigating through these decisions. Are there other frameworks available? Absolutely. This is the one that works for us. Now, a financial plan within that framework, not only provides, you know, works within these guardrails of the framework, but it gives us it gives us kind of characteristics that help us counter some of the biases that we have the backcap it gives us back casting ability, which helps us work from back going, you know, with helps helps work from a goal, which then provides this strong contextual reason foundation. It provides us to externalize ourselves, which was happening right now with his future version of ourselves. And that counters is temporal discounting. Remember, ask yourself whenever you make these decisions, how will I feel in 10 minutes, 10 months and 10 years? And just asking that question, I think provides the answer. And the last part from the financial plan is this rules based engagement, which you've had multiple scenarios in there in which you've already run these breakeven analysis to sort of see what's optimal and what's not.Wade.

**Wade Pfau** 50:03
Yeah, so to wrap up, there was the old GI Joe cartoon in the 1980s that they used to say, you know, knowing is half the battle. So being aware of these behavioral issues is half the battle. The other half is

just, you know, the continual manage things and so forth. But hopefully this helps give you that that sense of this is all possible. So thanks for listening to Retire with Style and we'll catch you next time.

**Alex Murguia** 50:29
Thank you everyone. Bye.

**Bob French** 50:34
Looking to build your retirement plan, or just make sure that it still works for you, speak with a financial advisor for McClean Asset Management, just go to McLeanam.com/start To get started. That's McLeanam.com/start. 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 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.