Episode 18: Spending Trends in Retirement

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. Today's episode features Michael Finke, a professor of wealth management and the Frank M angle Distinguished Chair in economic security research at the American College of financial services. He is a nationally known researcher in retirement income planning, and as a frequent speaker at financial planning conferences around the country. I think it was named one of the 25 most influential people in the field of investment advising in 2020 and 2021 by investment advisor magazine. The only consumption smoothing discussed in this episode has nothing to do with spending in retirement, or does it? Let's hope it's the former.

Alex Murguia 01:19
Welcome everyone to retire with style. I'm Alex Murguia.

Wade Pfau 01:24
And I'm Wade Pfau. And I'm very happy to introduce our guest this week, who's actually now our first time guests at retirement of style. It's Michael Finke, Professor of wealth management at the American College of financial services. And we just had him as a guest in our past episode, but you know so much to talk about that we thought it was worth having a second episode to dive more into some of these topics. In particular, Michael, we'd really like to talk more about retirement spending with you in what consists what that consists of how that might change over time, and so forth. And to start that what came up with our last episode a little bit was this idea of retirees having, and it goes by a lot of different names, I usually use the terms essential and discretionary expenses. I think recently you've been using the more the terminology of inflexible and flexible expenses in retirement. So can you just talk about some of the research you've been doing in the area of defining retirement expenses more generally?

Michael Finke 02:25
Yeah, Wade, you know, we by the way, just as a background, when we look at retirement spending, one of the datasets that we very often use is the Health and Retirement Study, which has a consumption element in it. So the people actually have to fill out what they're spending money on before and after retirement is longitudinal, which means we can look at how they spent money before retirement, we can look at how they spent money after retirement. And first of all, one of the most interesting things is that there's not much of a difference in how they spend money before and after retirement. You know, JP Morgan has also done some research on this that's actually track people's spending over time. And I think when it comes right down to it, we're creatures of habit. So we tend to

live in the same house, we pay the same property taxes, we go to the same grocery stores we go to, you know, we we go shopping, we go to the same places, generally speaking, our expenses are about the same that we may go on vacations more frequently in retirement, we may have some adjustments in how we spend money. But the year after we retire looks a lot like the year before we retire. Now, what JP Morgan has found is that some people go a little bit of crazy, they spent a ton of money early on in retirement. But generally speaking, what happens is that evens out over time. So people, you know, they buy their RV, and then they decide to cut back on spending later on, they don't have or maybe they go on a lot that you're European vacation, and then they go back to normal life afterwards. So spending, if you want to plan on what your lifestyle is going to look like, it's probably going to look a lot like the lifestyle you had before retirement. That's also a good way of figuring out whether you have enough is you know, and I know that there's a there's a PhD economist, also financial advisor who runs a place called sensible financial, his name is Rick Miller. And what Rick says is that you have enough saved for retirement, if you can cover your desired lifestyle with safe investments. So if you can cover your desired lifestyle with the money that you already have saved up, then you you you have enough, then anything above that is essentially gravy. And essentially, if you can cover the lifestyle you had before retirement, that with the assets that you've saved, then you have enough, a lot of us don't have enough to cover that exactly, but it's important to pay some attention to it. The other thing we find is that the amount of money that we spend before retirement, there is this idea that you might need to replace 80% of your gross income before retirement. That's unrealistic for a lot of higher income retirees. Why? because they may have been taking care, they've taken advantage of their catchup contributions, there's, they're saving 20% of their income already. They're not spending that money, they've got payroll taxes, they've got a lot of things that they don't have to spend money on after retirement. So actually, what we find is that maybe closer to a 55, or 60%, replacement rate is really more accurate for someone who's making say, $200,000 a year, they've got to replace a lot, or at least they should hope to replace a lifestyle of about $120,000 per year. Now, part of that lifestyle. And we had this discussion previously about flexible, and what I like to call flexible and inflexible expenses, I call inflexible expenses inflexible, because I want to make sure that the asset solution, or the product solution that we have to cover those expenses does not require some sort of a risk premium, some sort of a bonus, because you can't cut back if you don't get that bonus for taking investment risk. And what we find is also about two thirds of total spending is in these inflexible categories. Now, everybody has their categories of inflexible spending, you know, and my definition of what's inflexible may be different from your definition of what's inflexible, obviously, I've got to pay property taxes on my house that I want to live in, in retirement, I'm gonna have maintenance expenses, I've got to pay my utilities, my insurance, those are all inflexible I got to eat, no matter what happens, I'm going to cover those other people might say that other lifestyle expenses are also inflexible. So for some people, you know, pet grooming, is an inflexible expense, which means that you shouldn't necessarily cover that part of your lifestyle, with any sort of a strategy that involves reliance on market returns, because if you don't get them, then you're gonna be forced to cut back. Is golf an inflexible expense? Or is it a flexible expense? For some people, that's a big part of their enjoyment in retirement, they're not going to cut back if the market is not doing as well. So for them, that's how they should define what's inflexible, and what's flexible? And I think it is, it's a conversation, whether you're doing your own retirement income planning, or whether you're working with an advisor, it's a conversation you absolutely need to have is, what's part of your budget, do you want to lock in with either with safe investments or some other type of a strategy to make sure that you don't have to cut back on that part of your budget, you don't have to worry about ever having to cut back on that part of your budget, and what part of your expenses are truly more flexible? In a way? I know you and I have talked about this, now that we're really focusing on maybe the first five years of retirement when we're talking about replacing that same lifestyle that we had before retirement. But other people, David Blanchett, in particular have done a lot of research on spending and retirement over time. And they find that spending is not constant over time that you do change as you get older.

Wade Pfau 08:00
Right. Yeah, David. So there's this idea that's been around for a long time of the go go years, the slow go years, and the no go years, which just mainly speaks to how some of the discretionary or flexible spending decreases throughout retirement, David Blanchett talks about the idea of the retirement spending smile, which is important to think about, because when you compare to the 4% rule, you know, for many reasons, 4% may be overstating a truly sustainable spending rate. But one area where it may be overly conservative is it assumes lifestyle grows with inflation throughout retirement. And with David Blanchett spending smile concept of actually measuring how spending changes over retirement spending does not keep up with inflation, it tends to decline from 160s, down into somewhere in their mid 80s. It continues to decline in real purchasing power terms. And then with late in life, long term care or health care expenses, it starts coming up again. But it never gets even close to the constant inflation adjusted spending assumption. And he's talked about this point I ran the simulations like it's Bill bacon's 4% rule was applied to his spending smile. I think I estimated that you could retire with 17% Less assets based on the actual observed spending pattern compared to assuming constant inflation adjusted spending. So it's a really important issue. And and you were saying with the research that you're doing, you found about two thirds seems to be inflexible, 1/3. Flexible. How were you like, what, are you looking at different categories? Or how are you specifically thinking about that? And then also, does that feed into maybe what you're classifying as flexible, the point you're making is for some retirees, they might disagree with that conclusion, and say that that is also an inflexible expense.

Michael Finke 10:00
Yeah, that's exactly right, Wade. So when I was looking at the data, I went into the Consumer Expenditure Survey, which is a very detailed survey of consumer spending conducted by the Bureau of Labor Statistics. And what I did was like by hand, and entirely subjective, you know, I didn't look at which categories were exactly the same over time, I looked at spending categories that I said, you know, what insurance is inflexible, you know, going out to eat is is flexible, I'm going to hand pick each one of these categories and assign them either as inflexible or flexible, I may have been a little bit imprecise in the sense that maybe some spending in an inflexible category is truly flexible. And on the inverse, there may be some in some flexible categories that may be less flexible. But generally speaking, it seemed to and David, actually, David Blanchett has done more advanced methodology than my sort of hand collection methodology. And he's come up with pretty much the exact same answer, thankfully. Because I always offered more than my own answer, but it does seem like about, it's about two thirds, it's obviously inflexible in retirement. And I think that has important implications. When it comes to what percentage of that spending, even though it's going to decline over time that flexible spending is going to decline, you're always going to have that foundation of inflexible, expensive, so you're always going to have to cover those over time, some of them will go up with inflation, some of them won't go up as much with inflation. So for example, property taxes may be kept in whatever state you live in. In that case, those expenses are what I like to call nominal inflexible

expenses, food at home, I would consider it to be an inflation, increasing expense, is that part of your inflexible category? It's also one of the reasons why I'm a big fan of delaying Social Security, because I think that you want to be able to cover as many of those inflexible expenses that are going to rise with inflation as you possibly can. But it's important to pay attention to things like you know, do you have a mortgage, in which case, if it's a fixed mortgage, that's a nominal, inflexible expense, you don't need to worry about adjusting that for inflation over time, and all retirees are gonna have a mix of both of those. But as you said, people tend to spend less, you know, they buy their RV, they buy their new car when they first retire. And they may never buy another car throughout retirement. There may be, you know, the durable expenditures from that flexible category that are very high, you may be going on those big world cruises early on in retirement, but what tends to happen is that you get yourself into a habit of a lifestyle habit. And that doesn't necessarily involve a whole lot of flexible spending as you hit your mid 70s, especially. And then what happens, you know, the other part of that smile is that healthcare expenditures tend to rise. But one of the things that David noticed in his research is that when health expenditures go way up, what tends to happen is that people are not spending a whole lot of money on other stuff. So if you get sick, you're not going on as many vacations, you're not buying as many new cars, you're in the hospital or you're in a long term care facility, and you're probably spending all of your budget on that type of an expense. Now, where it gets a little crazy is some people will have these very long term long term care or long duration long term care expenses. And that can absolutely eat into a financial plan. Because you know, you may end up having a million dollars worth of expenses that you hadn't planned on, and especially if it's one spouse who gets it goes into a long term care facility, the other spouse has to bear the burden of that loss of well.

Bob French 13:37
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Alex Murguia 13:58
Just to level set for my own benefit here. So roughly speaking, if somebody's listening in and they're thinking about their retirement budget, and it happens to be whatever, $100,000 more or less 75,000 is probably for inflexible spending, to kind of what you

Michael Finke 14:16
Yeah, I'd say probably 70 would be truly inflexible.

Alex Murguia 14:22
Yeah, okay.

Wade Pfau 14:27
And I mean, to that's a good starting point. But then, of course, if people are actually working through this sort of budgeting exercise of looking at their past spending, they can make some judgment calls there as well of maybe, I know, just for an example, suppose they'd been spending $1,000 a year at a restaurant and they might say, Okay, we could make some cuts there. Maybe let's say the inflexible part of that is 5000 The flexible part of that is the 3000 just making judgment calls with no

Alex Murguia 14:59
i I think that's Michael's baby back ribs budget at chili. Yeah.

Michael Finke 15:06
We've talked about this my wife's budget.

Wade Pfau 15:10
Olive Garden, are you gonna go to

Alex Murguia 15:14
bottomless soup and salad? He can't pass up a good deal.

Michael Finke 15:21
You know, Alex, when I talk to retirees, and a financial company actually interviewed or hired me a few years ago, there was actually part of a project that Wade and I worked on together. Sure. I interviewed retirees, and I talked to them about how they spend money on retirement. And very often, they were so proud of the fact that they weren't spending very much money, they would tell me these stories about how they would go in early and get these two or two for one dinners. And, you know, they're not spending now their savings and retirement, they're so proud of that. And then I would ask something like, well, you must really want to pass on that savings to your kids. And they would say, Well, no, you know, it's not our main purpose with that money. And I'm like, Well, there's only two options here. There's no third option, you can either spend it on lifestyle, or you can pass it on. And I think one of the problems with retirement planning is that people are just not deliberate enough about beginning the process by saying, I want to spend this part of my savings. This part I'm willing to pass on this part is lifestyle. 100%, how do I get back lifestyle that I can, from the money that I've got, recognizing that my spending patterns are probably going to change over time. And if I recognize that, then people probably could be spending a lot more money in their late 60s, early 70s, than we might expect. So, you know, Wade and I are very often the voices of gloom and doom. When it comes to retirement income planning that we say, well, people are being overly optimistic with a 4% rule. But in reality, they probably could be spending a lot more than that. And living better early in retirement when you are physically and cognitively capable of getting the most enjoyment out of your money.

Alex Murguia 16:57
A couple of observations I and I agree. I fully agree. You said something in the very beginning that, you know, you say it in two seconds, but I think is impactful for years and years. And that's you're creatures of habit. And effectively, during the accumulation stage. You're effectively squirrel squirreling away money, you're reinvesting it, you're doing such and such. And just because you reach retirement, that habit doesn't necessarily disappear, this habit of you know, of harvesting savings of trying to put stuff away. And I think it just continues and so Wait, in the last episode, you were talking about behavior coaching, I think it would be better suited to help people on an existential basis know that they can actually spend more money than necessary and enjoy retirement, there's no sense in spending this phase in your life always being apprehensive. So I think there's that there's that behavior, stuff that's just locked, then the other piece of this goes back to strategy, but without opening the whole kind of

strategy. If you're invariably in this total return approach, even if you have like a 95% success rate, and you know, you see these, these pages of data coming at you. I get the sense from working with clients that they still think, okay, that's the advisor, sort of conclusion, but now I need an extra layer of security in my head. So I'm gonna, I'm gonna spend a little less because you never know, you know, it's one of those things. It's not like the advisors conclusion in a Monte Carlo plan is okay, well, now it's closed, case closed. No, I think it's just this. Okay, that's one layer. Now I'm gonna put my own layer of safety behind it, which is me being overly conservative. And so then you get to those conversations you have, they're proud of themselves for for not spending because of the behavior that's embedded. But then there's also this, and I've got my own safety net. But you know, 1015 20 years go by they're now 80 years old. And they can't they don't even have the the ability, the physical ability to really span and they've they potentially live their retirement age. As Herman is too strong of a word, but not unfulfilled to a large extent.

Wade Pfau 19:07
And Michael, too, there's an analogy I use that I'm pretty sure I picked up from you. So that might be worth going back to the original source of it, that the idea of the Ant and the Grasshopper, the old Aesop's Fables, but I believe I've heard you talk about applying that to a lot of individuals who listen to podcasts about retirement are more likely to be like the ant rather than the grasshopper. And it can be very hard to change that mindset after retirement right.

Alex Murguia 19:35
Wade for the benefit of those who haven't heard that you may want to explain.

Wade Pfau 19:40
That is yeah, I was gonna let Michael

Alex Murguia 19:46
my bad my bad Wade.

Michael Finke 19:48
We actually wrote a paper on this a few years ago, where we followed retirees who before retirement were the ants. So you know, the parable, the Ant and the Grasshopper is that, you know, the ants say is up for the winter saves up food for the winter. The grasshopper dances the summer away has a great time. Winter comes, the ant has plenty of food, the grasshopper is starving. The grasshopper asks the end for some food? The answer is no the grasshopper starves. So this is, this is what I think a children's story used to be in the pre PC era, it was supposed to teach you that, you should always have that habit of Thrift, it's morally superior, if you if you don't save for the future, you will die, which is, you know, a wonderful thing to teach children. But I think we all we all retain this, this sort of Protestant work ethic, this habit of thrift. And we we save, we spend, we're so proud of the fact that we're spending less than our income, and then we get to retirement. And very often the hands continue to spend less than their income. So they get Social Security, or they may get some sort of income that they manufacture from their investment portfolio, but they don't want to spend down their savings. And that's, that's because of the psychological barrier that many of us have to seeing our nest egg gets smaller in retirement. But that's not rational. Like, why did you save the money in the first place? If you

were just going to sit on it, and you don't have a very strong desire to pass it on to others? Then why Why did you bother saving all that money? Why don't you have more fun with the money when you were working? Why don't you go on more vacations, it's really a, it's a psychological problem that a lot of us share, probably a lot of people listening to this podcast, share this psychological problem, I'm not superior, I have the same problem myself, I'm gonna have to force myself to spend the money that I save for retirement to live a better lifestyle. But you've got to get over it like you've got when you're in retirement, you've got to be more like a grasshopper, if you're really going to get the most out of that money. Because, as Wade saying, what ends up happening over time is that we do lose our capability of being able to enjoy the money that we that we saved, I mean it when we're 90, we're not going to be able to do as much fun stuff as we could when we were 70. You know, we're not capable. And even cognitively, we lose some of our capabilities. And the money just doesn't provide as much enjoyment. I gave the example once of that that guy who at the age of I think like 94, decided to marry Anna Nicole Smith. He's a Texan. I believe that's true, too. And, you know, I think what happened was, he didn't necessarily wanted to pass on all of his wealth to his kids. And he was 94. And he realized he had way too much. And he decided, you know, what, I've only got a few years left, I want to spend it with Anna Nicole Smith. So that's, that's an example I think of a failure to plan in retirement, probably she could have had a little bit more fun if he would have done that in his 60s and 70s, than it is 90s. And we got to get used to that idea that the money is there to be spent to provide a lifestyle and we can't just continue to be answering retirement.

Alex Murguia 23:03
I think there's a little known fact his name was put in the Dallas Cowboys Stadium Ring of Honor.

Michael Finke 23:09
Oh, really?

Alex Murguia 23:09
No, no kidding.

Michael Finke 23:15
They're calling it these

Alex Murguia 23:20
No, no something that came to mind and wait, I'm thinking about longevity aversion. And if you have a certain strategy, if you have a total return strategy, where you're drawing from a portfolio, you know, you could be listening to this, and my cheeky response could be Michael, but I'm not going to take it to zero on the day I die. I mean, I need to leave something there. And so I'm always going to have more assets than I need, because I need to have that kind of base to draw from no one's gonna be at 90 thinking, Okay, I only have $200,000. Left, I'm on track. You know. And so I think that that opens up the this longevity aversion piece when you're in your 60s and 70s. And, and maybe if you consider the strategies, it could open up this ability to spend more freely and I think you've done some work with regards to this, this confidence in spending once you have contractual income in place, for some at least.

Michael Finke 24:21
Right? So a lot of even the ants, if they get an income in retirement, they don't feel as guilty spending that money as they do spending money from their investment portfolio. So, you know, if you have to take money out of your IRA to fund spending, it doesn't feel as good as simply spending money out of let's say, you get a pension, and every pension is gonna pay you $50,000 a year on top of Social Security. Do you save that pension money or do you spend most of it I'm guessing that people even the ants are okay with spending most of that money in retirement. So one of the things that you could do psychologically is you can take money from a lump sum form and turn it into an income stream form, you can actually buy yourself a private pension by buying, say, an income annuity that will allow you then, and that's one of the reasons why I say you gotta get over this idea of holding on to that value of your nest egg. Because if the goal is really to live a better lifestyle, then why not give yourself a license to actually be able to spend that money. And one way to do it is by essentially buying a pension buying some sort of a, an income that you know, is never going to run out. And then you feel like you can always spend the money. I've actually done surveys, where I find that retirees, if the market falls, they start cutting back on things like going out to dinner with friends, or going on vacations. Those are the things that consistently predict life satisfaction in retirement. And if your retirement plan, your retirement income plan is not set up in a way that allows you to feel comfortable spending the money no matter what happens in the markets, then again, you're failing, because you're not as happy in retirement as you could be.

Wade Pfau 26:00
Maybe another kind of point we could bring up here too, is when we we have this idea of the four L's the longevity, which is in flexible spending lifestyle, the Flexible Spending legacy, and then liquidity is this idea of just having reserves for the unexpected spending shots and is another concern that you see aside from not liking to spend the next take is just not having a sense of what are the spending shocks I might experience. And therefore I don't really know how much do I need to set aside for spending shots? And therefore I don't know how much I can comfortably spend, because I don't know how much I need to leave to deal with an emergency. Is that a nuance that you've also picked up with some of those, like, consumer based interviews that you've been? Yeah, there

Michael Finke 26:48
is actually a really interesting study that was done recently in Sweden. And it was a comparison of spending among retirees in Sweden to retirees in the United States. And in Sweden, they have government provided Long Term Care protection. The hypothesis was that Swedish retirees would spend more, because they had that protection, they didn't have to hoard assets, because of the possibility that they may have to cover an extended long term care visit. And in fact, that's exactly what they found that by having that protection, it freed them up to be able to spend more in retirement. And isn't that a better way to live. And that's one of the advantages of any sort of insurance that protects against the spending shocks in retirement, is you can just buy away that anxiety. And then you're free to spend the remainder of your savings without having to constantly worry that you need to hoard in order to cover that potential unlikely but very significant expense.

Wade Pfau 27:47

And even while for this issue of like thinking about how much do I need to set aside, of course, like insurance could be part of that long term care, insurance and so forth. But even setting that aside, just trying to be more intentional with, okay, let's plan for if if I could comfortably manage five years in a nursing home, I'll carve that out. I'll set that aside. And in terms of how I think about it, now maybe I can feel more comfortable spending the remainder because I know I've now quantified the decision of how much this might cost or how much I want to feel comfortable having set aside to manage this type of risk. Of course, I guess people can always get into the issue of well, maybe I plan for five years. But what if I really need six years. But if you could define a scenario that you're then comfortable, okay, I can manage that. That might also be able to help people spend more intentionally with the other assets. That's our hope, at least with how we kind of frame some of this conversation when we talk about things like the funded ratio for retirement, which actually going back to a point you made at the beginning, when you mentioned Rick Miller, this idea of if you can fund your goals without taking market risk, it's not to say that you don't you shouldn't take market risk. But that can be a great benchmark. And that's, I think, an important way, when we talk about a funded ratio for retirement. Do you have enough assets that if you invested, we like to use tips for that treasury inflation protected securities, so they provide an inflation adjusted return? Could you fund all your liabilities, including in flexible and flexible spending, if there is a legacy goal that you specifically want to quantify, and then what you want to set aside for reserves to cover the unexpected spending shots? If you're funded, that means you don't have to take market risk to fund those goals. And then I think that can really help people to start to think about framing the issue of do I want to take market risk? And if so, do I want to take it only for the discretionary wealth above and beyond what I need to I want to take market risks with with more of the more beyond that as well, but, but I think that was a great point that you made earlier in the conversation. Jim?

Michael Finke 30:01
Well, that's the way insurance companies think, when they have a general account portfolio, they allocate safe investments to fund their expected future liabilities. So they have actuaries who can estimate when they're gonna have to pay out on life insurance policies and annuities, they figure out how much they're going to have to spend in the future, and then they invest in bonds that will mature and cover that exact dollar amount in the future when they need that expense. But some insurance companies have a surplus, and they invest, they make sure that they can cover all of their expected future liabilities. But then with a surplus, they can take greater investment risk, and the amount of investment risk they take is, is really a function of how flexible they want to be with that portion of their investment portfolio, how much do they want to be able to grab for the potential of a higher return, but also accept the possibility of losing a significant amount of that extra. But I think it's a great way of thinking, I think that starting with, can I cover everything that I need in retirement, then making sure that those liabilities are taken care of with low risk assets, and then thinking about what is the best strategy for my, the access above the amount of money that I have to reserve at the beginning, that's, to me a better a better approach, I really like Rick's definition of what it means to have what's known as risk capacity, you have the capacity to take greater risk, because, and that's another big fallacy that I think, you know, wait, it just, I cannot believe it, when I hear it. This idea that you have a required rate of return that's needed to meet your financial goals. And if you're very far away from meeting your financial goals, then you have to take more investment risk. That is that is so stint with economic theory and our experience of financial markets in the past, when you take more risk, all it does is it increases

the range of potential outcomes. And you know, even whether you're saving for an income five years in the future for retirement, or whether you're saving for those future spending goals, when you take greater risk, you have a greater variation in the potential lifestyle that you're going to be able to lead in the future. And it's never appropriate for someone who's not close to meeting their lifestyle goal to suggest that they take even greater risk, because that means that their downside is going to cut even further into their inflexible expenses.

Wade Pfau 32:36
It's that taking that Hail Mary pass and hoping it pays off. And it's an incremental increase in the chance to plan works,

Alex Murguia 32:42
but also So Michael, you're saying if I only buy five lottery tickets not to buy 10?

Michael Finke 32:49
It's a lottery ticket approach to financial planning. It is the idea that, you know, if you're far away from meeting your goals, then why not throw the Hail Mary, rather than readjusting what those goals are, and being realistic and telling people

Alex Murguia 33:03
Wade,for those, like? Pascal's probably, you know, like the dilemma, I think it has a name to it, that if you're so far away, you might as well just gone it, you know, in some weird way. It's one of those sayings that I can't remember off the top my head right now, but it has a, it has a term, actually. But yeah, I

Michael Finke 33:26
think it's, you know, your, your, the thing is, like, it's like, you're the gambler, you're sitting at the table, you know, you're you're you start out with 1000 bucks, your debt, and you're now down to $500. And the only way to get to get back to where you started is to take even more risk. And you're not thinking Well, the reason I got down to $500 is because I took too much risk, and it was not a good idea. You know, it's it's trying to get back to where you started. But that's just not the right way to approach investment planning. And I hear it all the time, you know, this whole concept of a required rate of return to meet your financial goals, I wish we could just get rid of it as a profession. It doesn't make any sense.

Alex Murguia 34:05
I think it sounds kind of quantitative, it sounds like something an advisor would would say, you know, and you can put it on an Excel and back into what that number would be. And then magically create an allocation based on historical returns and say, You see, we can get you here like this, as opposed to 23% reads we'll we'll bump it up to 34% reads, you know, you start playing around like that and it gives this false sense of security and precision with more bad than good. I think a better angle would be kind of I'm gonna give you a softball would be okay, let's assume let's try to get some of these foundational pieces in place. And wait you were talking a little bit about maybe funding something for a five year period or something like that, but you know, this is where a kulak can can work wonders. No, no, no, but I'm sorry. I know it's kind of a running joke with with Michael and his sort of circle but you He's right.

He's right, you know, in a major way that you know, something like this could just amplify your spending in your earlier years in retirement, knowing knowing that you have something like this in place, you may want to go into that a little bit, Michael.

Michael Finke 35:14
Thank you so much for giving me the opportunity to talk about qualified longevity insurance. It's

Alex Murguia 35:19
your Sally Field moment. It's your Sally's. Yeah.

Michael Finke 35:24
Yeah, I was just looking for my cue, like, and I don't so. So take a moment and talk about

Alex Murguia 35:34
actually has a cap that seems to lag on it.

Michael Finke 35:36
to Amazon. So what is it, I think it's a good way to talk about this idea of longevity risk. And the the concept that it's so much cheaper to pool income later on in retirement, rather than trying to do it yourself. So you know, you're not going to be as likely to be alive after the age of 85. But you could be alive. So let's say you're a healthy 90 year old or sorry, a healthy 65 year old woman, you got a 50/50 chance that you're going to make it to the age of 90, you know, you've got a 27% chance, you're going to make it to 95, you got a 10% chance, you're going to make it to 100. So what is the best strategy is the best strategy to set money aside to cover those spending liabilities at the beginning of retirement, if that's the case, then you won't have very much money to spend today. Or you could pull that longevity risk with other retirees by buying, essentially a pension that begins at the age of 85. So you could for $145,000, today, you can maybe buy $40,000 of income that starts at the age of 85, that makes retirement income planning a lot easier, because you get that on top of Social Security, you're not spending a whole lot of money when you're 85. Anyway,

Alex Murguia 36:50
that's the key, you're not spending a lot, you're not moving around a lot. When you're 85, you're just not,

Michael Finke 36:56
you know, you're probably got some money, but at least it gives you a foundation of income to cover your basic expenses later on in life. But that frees you up it gives you a finite planning horizon early on in retirement. So if you retire at 65, I only got then 20 years, but I gotta worry about funding, I can either fund those with safe investments like bonds, I can fund them with stocks, I could maybe buy an income annuity that's going to didn't come up to the age of 85. And then that Culex gonna bump up that income at 85, to account for some of the impacts of inflation on my income over time. You know, it's a very efficient way to generate later life income and in a kulak form, you actually get an additional tax break if you buy one within your IRA.

Alex Murguia 37:40

Now, I would think everything that you've spoken about it and I think Wade, you said it earlier, you know, where what about the 4% rule on this, and that you can come across as being this doom and gloom person. But that's quite the opposite. What what I hope folks are picking up on with regards to retirement spending is that we're actually proponents of getting you to spend more, and there's actually quite efficient ways of getting you to spend more and why spend more, you know, more money is better than less money in terms of spending and it you know, it can bring about enjoyment. Obviously, there's a concept of funded contentment, and such and such, but the reality is, is that the way you'd be remissed, you get to 90 years old, and you realize, man, I didn't live the retirement that it could have, and I could have easily have done it. Because you've had to always leave quote, unquote, a mental reserve there for the just in case. And I think there's ways to accommodate for that, that are quite effective. And I hope this is coming across in this podcast that you're actually trying to use with your research, you're actually trying to better the human condition. And I know that sounds like a big sort of phrase and all but it's the reality. Wade, thoughts?

Wade Pfau 38:55
Yeah, fair enough. And it's the the 4% rule idea was just an issue of it brought this idea of sequence of returns risk and financial planning. But the problem is, it was never meant to be an actual retirement spending strategy. It was more of a research simplification. But because it doesn't allow for any adjustment to how the portfolio performs. It's actually the strategy that maximizes the sequence of returns risk. And so in doing so it forces utilities a lower distribution rate. And that's where there's so many directions, whether it is using some sort of protected income, whether it's having the flexibility to make adjustments, suspending there are mechanisms available that allow you to spend and enjoy at a level above and beyond the very limited constraints created by this sort of I'm going to only use a aggressive investment portfolio and consistently adjust my spending for inflation and never make any sort of adjustment to what's happening later in retirement. So it's it's a starting point, but it's something mean that we can do so much better than? And?

Alex Murguia 40:06
Yeah, this is we're pausing for Michael, I

Michael Finke 40:09
guess. Was your segue to Alex?

Alex Murguia 40:17
I kind of just teeing it up for you folks. No, I other than saying I agree with Wade, I mean, look, the reality, the only thing I would say to what Wade said is, somebody could be listening. And there's this sort of, okay, there's sequence of return. And what we're focused on on the negative side of the distribution of sequence of return, you know, what, I'm probability base, and I want to gun it. And I'm feeling lucky to, you know, the Clint Eastwood approach, which is, I'm going to focus on the right side of that distribution, and get the positive effects of the sequence of return risk, and I smokin him, you got him? I mean, I don't have a definitive answer for that.

Wade Pfau 40:53

I can phrase that as a question for Michael, because it's one of his favorite words, the sequence of returns risk. That's an idiosyncratic risk market, the market does not reward you for our mean, it's not a risk that it's very much idiosyncratic. You can't diversify your exposure to sequence of returns risk, right. And

Michael Finke 41:13
longevity risk is another example of that, that, you know, you can you can be exposed to longevity risk, but it's not going to allow you to spend more in retirement. So it you know, you're exposed to the possibility of running out if you live to the age of 100. But that doesn't necessarily allow you to spend more every year because you're exposed to it. In fact, you can spend more if you decide not to expose yourself to that longevity risk. It's why economists say that some form of annuitization is a no brainer that there is this annuitization puzzle that people don't take advantage of the opportunity to pull that idiosyncratic longevity risk. And it's, you know, part of this, this, I think the new thinking about retirement income planning is, what are the risks? What are the most efficient way to deal with each one of those risks? How can we set someone up to be able to spend as much money as possible, with the least amount of worry. And that's really what it means, you know, that's why we assess things like preferences and retirement so that we can come up with an idea of how much risk are you willing to take in terms of your lifestyle? And then we how can we put together some type of a plan, that's going to give you the greatest enjoyment that you can from retirement. And I think that's actually one of the biggest problems with a defined contribution system is that people get to retirement, they have this big nest egg, they don't feel comfortable spending it, and they're actually less happy than they could be where they would have been if they would have simply gotten a pension. So they can decide how much they want to keep in a pot of money. How much do they want to put into a lifetime income where they can take advantage, get rid of that longevity risk that they're not compensated for taking, and put together a better plan that's going to allow them to feel comfortable actually spending the money because you only get one trip through? You only get what was the term that Mike swagger used one whack at the cat? Yes. And essentially, one sequence of investment returns, you know, one, maybe 30 year time horizon through retirement, you want to be able to maximize your enjoyment every single one of those years. So you want to create some sort of a financial plan that's going to give you access to the resources that you need to be able to maximize your enjoyment in retirement. That's the whole goal of retirement income planning.

Alex Murguia 43:29
100%. And I think that goes into the if you flip it around, right? I I've seen that I've been I've read up on it, where if someone has a pension, and you tell them you're going to flip them into all of a sudden investment portfolio, they don't want that, you know, as opposed to you know, they have a DC plan and going into you see this sort of anchoring into the pension. And by the way, I thought you were gonna quote Confucius not swagger in terms of every man has two lives until he realizes he has one.

Michael Finke 44:01
Alex, you have a much better classical education than it Yes. Yeah.

Alex Murguia 44:06

I don't know about that. I think that wraps it up. Michael, we got you in. This is the second 40 minute plus episode with you. Did you think you could do this the other day?

Michael Finke 44:18
No. Well, you know, I'm I'm a hacker. We can I can talk for a long time about this. But I we probably have a few more episodes in this actual

Alex Murguia 44:26
Well, yeah, I was gonna ask you know, we'll wrap it up. But I was gonna ask about consumption smoothing since you mentioned Rick Miller, but I thought you know what, that's that's. That's another thing in and of itself.

Michael Finke 44:39
At the edge of their seat. Oh, I've got an entire episode on

Alex Murguia 44:45
Martin Fowler and Wade did you notice how Michael did a great job of bringing back preferences he did about it. He does a better job than us about bringing it back together. Right All right, well, thank you everyone and Michael, what can I say? You've been great. It's been an absolute pleasure. So I'll say my goodbyes.

Michael Finke 45:10
Thank you for having me now.

Alex Murguia 45:12
Oh, yeah. Wade, you want to take us home?

Wade Pfau 45:15
Thanks, Michael. Thanks everyone for listening and we'll catch you next week on Retire with Style. by everyone.

Bob French 45:24
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 the risk including risk of loss. Past performance does not guarantee future results.