Episode 21: How to Get Those Unknown Expenses in Retirement Right, Pt 1

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. If you can adjust for unexpected expenses in retirement, does that make them expected? And what's that about Schrodinger cat again?

Alex Murguia 00:48
Hi, everyone. I'm Alex.

Wade Pfau 00:50
And I'm Wade.

Alex Murguia 00:52
And today, we're going to be beginning our next story arc. And it's centered around budgeting for retirement. And so this is an interesting episode, as we'll begin to talk about the building blocks for building a budget. What do you think? Wade?

Wade Pfau 01:09
Right, yeah, this is going to be an exciting couple of episodes getting into the whole issue of retirement budgeting. But it really speaks to, I think, the fundamental question people have when they whether they're on track to retire, which is, are they financially prepared to retire? And it's a question you really can't answer if you don't have the how much you might be looking to spend in retirement. So that's what the conversation is going to be all about is trying to figure out how much do I need to spend to achieve a comfortable lifestyle in retirement?

Alex Murguia 01:42
Yeah, you know, how do we quantify these retirement goals? Everyone talks about goals based planning goals based investing is this sort of catch word now? And it's nonetheless it's true. But really, what you're getting at is how do you quantify these goals? And that's interesting. And before we get into this, Wade, and I know I, you know, when we discussed the, what's the topic for today and the outline, I think something would that would be interesting for folks, is you and I treat this a little different from a budgeting standpoint. I mean, I don't necessarily budget if you will, I kind of make a point to save everything I can first and I think we'll touch base on this at the end of the episode on a safe savings

rate, but I really just try to save as much as I can as a percent of income. And then whatever's left over I use and that's effectively my budget, but you treat it differently, don't you?

Wade Pfau 02:39
I do. And actually, I think the podcast episodes are gonna mostly focus more on the way I think about it. Your expenses, so that you can then project forward from what you have spent, to get a sense of what you might want to spend with the adjustments that would come along with. And of course, a lot of this is unknown. If you retire, you may not be spending the same way as when you are pre retirement. But at least starting with a sense of how much do I actually spend kind of building that up looking at different spending categories and so forth. But certainly both options are valid. And it's really just a matter of what someone's most comfortable with, you can either kind of back out, okay, whatever I earned and didn't save, I spent and that's my budget, or you can kind of build up piece by piece, how much am I actually spending? You get the same answer, ultimately, on the total expenses?

Alex Murguia 03:34
Well, I mean, you're you're more precise, you can make the case that in your case, it's more measured. And there's a there's precision, but it's not a false precision, there is actually more precision your way. It's just, you know, we have different temperaments. At the end, as folks have listened to this podcast, I think it becomes apparent that Wade and I are, you know, we're not cut from the same cloth, if you will. And there it is. But Wade, since this deals largely with how you kind of budget and frankly, for those in the know, we're really using Wade's book, the Retirement Planning Guidebook Handbook to kind of go through this process. And this is one of the chapters of Wade's book. So I kind of want to disentangle this and tease it off from you, Wade. And the first question I have for you would be thinking about goals, goals, define the expenses or liabilities to be funded. And what would you recommend for for folks that are listening in how they should be thinking about that?

Wade Pfau 04:37
And so there's a bigger question, budgeting and to briefly give that overview before specifically getting into the budgeting, retirements about an asset liability matching problem, deal sets to fund your goals. And we're really focused on the goals in today's episode, which are the liabilities of retirement the financial The goals I have for retirement, that in retirement, and we talk about retirement research or this idea of the goals being the four L's of retirement, longevity and lifestyle, or the retirement budget, longevity is more your core spending lifestyles, more about the discretionary expenses that will give you the appropriate satisfaction with an overall lifestyle in retirement, then you have your sequels, which is what you want to leave to the next generation. And then liquidity goals, which are the reserves for the unexpected, the surprise spending shocks or contain additional funds, you want to have set aside to feel comfortable that if you are hit with various spending shocks in retirement, you'll have sufficient resources to handle those while also being able to meet your retirement budget. And the goals. It's really the spending, the spending goals in retirement, the financial goals of retirement, which are these four l liabilities, and that were most well, we'll talk about the liquidity and legacy briefly. But we're really focused on the idea of the retirement budget, which would be the combination of longevity and lifestyle. But

Alex Murguia 06:11

that's good. Wade, I mean, set another way, what you're, what you're saying here, if I'm understanding you correctly, is that there are a couple of tasks at hand, when you're creating this budget. The first one being is how do you create a realistic budget based on the pat the past spending that you did? And there's two methods that we'll discuss, but how do you create that realistic budget? How do you also because we're talking about retirement, and we'll flesh this out. But and this has to do with the four hours you just mentioned? How do you anticipate the retirement spending that you're going to have in the future to meet the ongoing desires, because what you spent while you were working is going to be different while you're retired? And so how do you anticipate those changes? I think the other piece that touches upon the four hour is just to make it clear to everyone is how do you account estimate? What have you for potential expenses, that that are going to happen when you have various contingencies, such as the unexpected health care need a tree falls on your roof? That those kinds of examples? How are you going to anticipate that because by default, by definition, unanticipated expenses are unanticipated, you know, they're gonna have and you just kind of don't know when the the other item is legacy, right? How do you want to leave behind the legacy. And there's two ways to be to be thinking about that what we found from the Risa as we always said is, sometimes those are just whatever's left over, that's the legacy goal that I have. The other. The other piece is sometimes people want to budget in something explicitly to provide to the next generation. And I'm going to introduce a concept because I think this leads to the next piece, Wade, is you can specifically, you know, create assets, to be able to match these contingencies, these, these, these these goals that you have, specifically, let's say if you really wanted to fund some sort of legacy goal and be exact about it and not worry about whatever's left over, you want to come to a specific number. Now there's insurance for for things like that. And so from that vantage point, wait, I think it's a good segue into, you know, we spent the first parts of this podcast talking about your retirement income style, which is selecting strategies that resonate with you, right, but you have to overlay the financial feasibility of all of those. And as you build up your assets, that's kind of what you're beginning to do, right? Where you're kind of now have to begin to solve for that retirement income puzzle by optimizing, you know, the, the balance between the objectives and in your style and the actual solutions available. Do you want to talk about that a little bit? Wait, and I'm thinking about this, this this the graph that you had, in your book, the Retirement Income Challenge, which looks like a bullseye. And I'll let you flush that out?

Wade Pfau 09:04
Yeah, so I made early on and looking at retirement planning the this idea of a bull's eye chart that I tried to use to summarize the retirement planning problem. And for anyone who's interested to see that chart, it's available in the show notes for the pop. So if you'd like to see that visual, it's also as Alex mentioned, and it's in the Retirement Planning Guidebook as well. But it's a bull's eye chart where we there's four concentric circles. The inner circle is in the process, what is retirement income planning or the retirement income challenge all about? It's about using financial tools, converting our or using our financial assets with different tools or strategies to meet our financial goals and to manage the risks confronting those confronting those goals. So the second circle around that process are the financial goals of retirement, which again, are simply the four L's longevity lifestyle like liquidity. And then the next circle around that is all the risks that are facing are impacting those potential goals. One of our earliest episodes that we had was going through all those risks of retirement. So Well, that's about them again now. But these are the risks of retirement that longevity, not knowing how long one might live, market volatility and the impact that can have on one investments, as well as the sequence of

returns risk when you're actually spending from those investments, changing interest rates, credit risk, especially with bonds and so forth, long term care which potentials and in shock that retirees faces having to pay for institutional living in retirement through long term care. rising health care costs, compounding inflation, which certainly has picked up recently as a bigger potential risk for retirees, the death of a spouse and the financial implications that can surround that. Emotional considerations, supporting adult family members, the potential for the great divorce in retirement and the financial impact that divorce can have when create shifting from one household to to changing public policy changing tax rules, just spending more than budgeted excess withdrawal risk of frailty or other issues related to cognitive decline that could increase expenditures and unanticipated ways. The potential for elder financial abuse changes in housing needs in a way that wasn't anticipated. And just the reduced earnings capacity, retire, it can be more difficult to return to the labor force or to earn the same salary as before. And so we have those risks. And then so we have the financial goals, we have these risks that are making it hard to meet those goals. And then we just use our assets with different tools to try to fund those goals into confronting those goals. And those tools, there's a lot of them in the chart, but they're effectively, it's well, more simply stated, rather than naming all the tools there, you have reliable income assets, diversified portfolio, and reserve assets, and you're trying to position assets to meet those goals. And it doesn't always have to be purely financial. Because some assets are just family support, community support, things that don't have necessarily a monetary value attached to them. But what they really do is, rather than increasing the asset base financially, they reduce the potential spending shock that if you have people who can help take care of you to avoid having to move into an institutional setting with long term care, then your potential spending shock related to long term care is, and that's how you can think about those types of assets as reserves to help manage this type of potential spending shock in retirement. And so that diagram is a simple Bullseye summary of the retirement income challenge, and how to think about positioning assets through these different tools to meet the goals and manage the risks.

Alex Murguia 13:10
I would add Wade, that I encourage everyone to actually go to the show notes and download the the retirement income challenge, if you will, target bull's eye, I do believe it does a couple of things that fit the theme of what we've been talking about throughout this podcast. Because when we state, you know, these are the tools available. What we're doing with the RISA is kind of pointing out the potential tools that resonate with you. But you always have to have that overlay that economic overlay to make sure and if you don't have that, it's very easy to just pick and choose randomly. And so the budget piece, what it does is it helps to use that bullseye theme, it helps close the loop on okay, this is what your resume is what resonates with you not can we further remove that uncertainty by running the numbers and seeing if not only does it resonate with you, it's a good economic fit. Because like I said, it's easy to get lost in choice, right? The paradox of choice because there are there are solutions for for many, many things. And so the trick becomes being the you know, choosing one that resonates with you but also choosing one that serves its stated purpose economically. And so a budget helps remove that sort of economic uncertainty around which way to go. You need to get that economic part rate if you will. Wade.

Wade Pfau 14:41

Yeah, when you get into the financial overlay from the RISA it the REITs or the what we're talking about now with budgeting as we really want to quantify longevity and lifestyle, and how much of a distinction one makes between those so that you have your longevity lifestyle budget It's and then you calculate what's the potential total lifetime cost of funding, your longevity, core retirement expenses and your lifestyle discretionary expenses. And then you start looking at the assets available and you look at do I have enough reliable income, including Social Security, pension income, annuity income? Which will bonds or other kinds of principal protected type annuities as well, potentially. But do I have enough reliable income to fund my longevity expenses? And if I don't, that's really then where the RISA kicks in? Well, how do I want to fill that gap? And if you're more of a total return investor, you don't really specifically care as much about that question you instead look more at do I have enough reliable investments to fund my total longevity plus lifestyle. If you're any of the other styles, retirement income styles you do care more about? I don't have enough reliable income to fund my longevity expenses, then I want to look to fill that gap through if I'm time segmentation prep through more of a bond ladder approach, if I'm income protection, through more of a fixed a type of an approach, and if I'm risk wrap, through more of a deferred, a variable annuity, generally type of an approach with lifetime income protections attached to that. And so that's where the reset starts, and combine into the financial question of do I need to do anything with my strategy to fund my retirement spending?

Bob French 16:38
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Alex Murguia 17:04
No, I think that's that's that's spot on. I mean, and the simple act of creating a budget begins to answer that question. So it's that important step. It's a reason why it's chapter would three in your book way? Yeah. Chapter Three. Yeah, it's the reason why it's chapter three and chapter seven, because you kind of need to know what you're working with, to move on. Now, Wade, in that vein, what are some difficulties that people may be thinking about with their budget, like budgeting for retirement? What are the things that make it difficult based on the research? And and frankly, just on our experience talking with clients, what have you seen?

Wade Pfau 17:45
Well, there's a couple issues that can be going on. And the first is if people simply haven't been budgeting, a lot of people don't necessarily have a good sense of how much they

Alex Murguia 17:54
Wade, why are you looking at me when you say that? Why are you looking at

Wade Pfau 18:04
you are making a conscious effort to save I don't know, a lot of people don't even think about these types of issues at all. And when we started thinking about budgeting, kind of the first step in that is to

get a sense of what we have been spending. And that can be a complicated process. We'll talk about ways to make it easier. There's certainly help with categorizing expenses, although even their automated ways of categorizing expenses may require a lot of adjustments to something that you feel comfortable using. But you then start to get a sense of well, how much have I been spending. And that's the first complication, then the second complication would then be when you retire, your expenses are going to change. And you don't necessarily have a real good sense about what those changes might look like. So you have to rely on research about retirement spending patterns, partly to get a sense of what does tend to happen in retirement, but also just thinking through, if you have these different spending categories, you can start to think, Okay, some of these categories, I'll probably spend less than retirement, others, I'll probably spend more. But you have to start making that type of an adjustment. And that can be particularly complicated if you're thinking to move in retirement, because probably anyone who's moved before knows, whatever you were spending a patient is going to be different at the new location. It's just whether it's a different cost of living in the area for them to impact the overall expenses, or just there's this some things are be cheaper, some things will be more expensive, and it's hard to know.

Alex Murguia 19:42
And Wade, how does that how did that affect your decision to retire in California?

Wade Pfau 19:48
Yeah, that would be a case of probably increasing expenses relative to a lot of the other parts of the country, especially

Alex Murguia 19:56
For the record we'd moved to Texas A few years ago. He knows what he's doing. tax wise. No, I gotta wait Wade that I think that gets us into the kind of the types of budgeting that that are that are available. So I mean, effectively what I'm hearing, to, to reiterate a little bit is years of records, you know, you're having years of records, let's say, you know, so you budgeted between mid 30s through 55. And even though you have years of record, and you have a sense of of those expenses, I think you're saying prepare those, you know, expect those to change now that your retirement because now that you're retired, because there's just going to be different spending habits, it's a different game, as much as retirement is different from an investing standpoint, retirement is different from a spending standpoint, it's effectively what you're saying, correct?

Wade Pfau 20:51
That those years of record that you've been maintaining, are helpful, but they're not going to be the full story because things will change in retirement. And as you could observe, your spending probably changes quite a bit on a year to year basis in a way that a lot of the simplifications don't really get at and there may not really be any normal spending pattern. And partly, it becomes thinking about averages over time, adjusted for inflation, but then also how those averages might change when retiring.

Alex Murguia 21:25

All right, so in terms of types of budgets, first one that you kind of see, and it's a quick and dirty, if you will, is replacement rates. My definition and maybe it's overly simplified, it's just what are you spending now discounted by a certain percent. And that's what you're going to expect to spend in retirement.

Wade Pfau 21:48
The replacement rates could be defined that way. Usually, it's even a simpler issue than that, which is, what are you earning now, and assume you'll spend a percentage of that. And the most common number you see, and we're just to be clear, we'll talk about this as a starting point. But ultimately, I don't know how helpful this approach really is. Although if you go to any kind of simple retirement calculator online, you're very likely to have your retirement expenses, estimated with a replacement rate, which is they'll ask you what's your salary, and then they'll assume it could vary, but the most common number you might see would be an 80% replacement rate, which is just, if you enter that your salary is $100,000, they'll estimate that you're going to spend $80,000, a year in retirement, that you spend 80% of your earnings. And that's based on a study done through the University of Georgia going back to the 1970s, although it hasn't actually been updated since 2008. But it just looked at average spending pre and post retirement and found that people were spending about 80% of what they earned. It wasn't necessarily for hire, Inc. Now, this, these numbers are not adjusted for inflation, but they presented their results up to $90,000 of annual earnings. And we're generally finding anywhere from say 78% to 81%, for different earnings levels, as well as single a couple that were generally in line with what people were spending. I mean,

Alex Murguia 23:23
it seems representative, though somewhat of middle America from that I'm not I'm not saying that the study is very credible, or anything like that. But you know, I do think that try to get some sort of a representation across the US. But that being the case, the pros are it's very simple. I mean, just you're making 100 grand plan on spending 80,000.

Wade Pfau 23:46
And the kind of technical way that you can even think about that as maybe make sense, although we'll get into a lot of cases where it won't make sense. But you're you have payroll tax, coming out at your earnings, you'll have income tax coming out of your earnings, you do have potentially a small category of like work related expenses that will go away after retiring. And then hopefully, you're saving something as well. And what that study is effectively suggesting is that kind of for the average American, once they consider the higher taxes associated with working plus their savings, plus work related expenses, percent of their earnings, and so they have another 80% leftover to actually spend. And then we just assume they continue to spend that same 80% After retiring at a time when the taxes would generally be lower, especially at these income levels that this study focused on and you're not paying Social Security payroll tax anymore at that point, less income taxes, not having to save for retirement anymore. And then also not having to pay work related expenses, like new suits or wardrobe and that sort of thing, specifically for work and that's where the 80% number really comes from.

Alex Murguia 25:01
You mean Wade, I won't have to show you the the Polos that I got for working from home.

Wade Pfau 25:08
Your new orange pumpkin color.

Alex Murguia 25:12
Wade and I were talking before the podcast, I usually have a lot of these blue polos. And we were in a meeting last week and somebody David Lau of all people comes up to me says, Hey, how many? How many blue shirts Do you have? Are you wearing the same shirt? I haven't had four of them. So I told them, No, I've got four of them. But it got in my head. Because this weekend I went shopping and I showed Wade. All the new colors of the of the working from home. bolos. Right, Wade.

Wade Pfau 25:40
That's right, I thought you're gonna just say you follow the Michael Kitsis approach of just wear the same thing every time. And then you don't have to worry about what you're going to wear and it makes you somewhat fall into? Not exactly, but life is definitely a lot easier if you have a closet full of the same shirt.

Alex Murguia 25:59
Less thinking less thinking doorways, I won't worry about unless I see you with black turtlenecks, then, then I'll start then I'll start wondering what's going on with the Alright, so that's, you know, it's easy, right? The replacement rates are easy. What are some of the cons with that, you know, let's say you get online and you do one of these calculators on whatever Dinkytown or whatnot, or, you know, your local custodian Schwab fidelity Vanguard, they have these calculators and they're using a replacement rate. What are some Caveat emptor is to keep in mind, if you're using this as your budgeting tool.

Wade Pfau 26:35
Maybe the first con to start with is it's based on an assumption that your salary has been pretty steady over time, so that it makes sense to say 80% of my salary. If I always earn the same salary every year, then it's easier to understand what 80% of that means. But the reality is, and this is something I could really observe when looking at Social Security earnings, records, data, people's comes fluctuate dramatically for on a year to year basis. And if you fall into the category of what you earn last year is not very predictive of what you're going to earn this year, and your income goes up and down over time, then it's the question 80%? Well, 80% of what it's not necessarily the we're basically assuming with a replacement rate, it's 80% of your pre route. But that assumes your pre retirement income is something meaningful that in that you've been earning that same amount over time. If you earn different amounts every year, you really don't know what 80% means anymore. it's hard to use this method?

Alex Murguia 27:41
What if I take a moving average or something like that, like a three year moving average, just to see some sort of smoothing component? Whatever it is?

Wade Pfau 27:48
Yes, you could, that would be a way to track replacement rate alive instead of being 80% of your previous year earnings, you could do 80% of your earnings over the past three years. Now you

Alex Murguia 28:01
see everyone that that was, That was my attempt to stump Wade, I don't know, we'll see if it let's see if I get away with it.

Wade Pfau 28:07
And you might want to adjust those earnings for inflation, especially now that we're seeing like, yeah, right might be spending and earning? Well, I don't know.

Alex Murguia 28:14
You know, it's interesting. I think when we started this podcast, I think we're by number 19, or something like that now, I think we started the first few episodes, talking about how inflation is low. Oops,

Wade Pfau 28:32
inflation adjustments that actually yes, my retirement planning guide book came out September 2021. And I do talk about all these inflation adjustments. But when inflation was averaging 2% a year, there are things that were easier to ignore. Now it's becoming more and more important to emphasize making some inflation adjustments, because what you spent in 2017 isn't going to have as much a connection that what you're spending in 2022, just because everything is a lot more expensive and 2022 than it was in 2017. And that's where that's kind of I'm hinting at this and we'll talk about in a more detail, adjusting those passwords for the inflation experience, which means, and I'm just making this number up right now. But if I spent $50,000 in 2017, perhaps the equivalent of that would be I said 50,000, maybe like $50,000 just because of inflation and the impact that it's had over the last few years.

Alex Murguia 29:27
All right. What about what about folks that want to be early retirees and they're thinking about a replacement rate as a as a, you know, as as this sort of watermark for budgeting.

Wade Pfau 29:39
So for that financial independence retire early community, they might be using an 80% savings rate, and then naturally, they're not going to want to replace 80% of their earnings or they might want to but that requires spending significantly more than they were when they're working and also would make their retirement much much more expensive. Usually People want to smooth their spending over time. And that's a big critique that Larry Kotlikoff makes about some of the traditional like a replacement rate strategy. Now, you don't just want to automatically spend 80% of what you were earning pre retirement, you want to smooth your spending over time. And so if you were, if you're part of that fire community with a high savings rate, then it's quite clear, you're not going to be looking to replace 80% of your salary because you weren't living on 80% of your salary. Now, you were saving so much of it. So that's, then there's no meaning to talk about something like an 80% of your salary.

Alex Murguia 30:34
I think the other one that gets me and it's kind of obvious is that you can do 80%. But you know, and you said it from the standpoint of work related stuff like payroll, taxes, clothes, etc. But you know, things change like your mortgage, your your your children are raised already, you know, that that kind of thing

is no longer an issue, you want to maybe expand upon that those issues as well, because I think that's really, this is to me, the third strike when you're just looking at replacement rates.

Wade Pfau 31:08
Yeah, absolutely. So another reason why your replacement rate in retirement could be significantly less is, well, there's a couple issues there, it's, if you've paid off the mortgage, a big chunk of your monthly earnings was going into mortgage payments that you were not otherwise spending, and that you don't have to match that spending in retirement, that's what we're talking about here is okay, I have my earnings, I have my salary, what percentage of that am I spending? Well, I may be spending a part a portion of that to pay mortgage payments. Once those are done, it's not gonna automatically bump up my spending, I just means I'm living on less of my salary. And the other big one is children, children are expensive, but at some point, they grow. And now one of the spending shocks is surprises about having to help adult children start with their alternate and so forth. But without that particular spending shock, once the children are raised, once the college bills are paid, and so forth, that was a huge part of the salary going to that type of an expense that will then go away, and would then suggest being able to live on a much lower replacement rate in retirement because you don't have that major expense eating away at your earnings anymore, either. So in addition to those tax issues, it's mortgage payments and no longer having child related expenses. That could also lead to dramatic reductions in the post retirement budget.

Alex Murguia 32:34
Yeah, and I think, look, and for me, I started the episode by saying I don't really budget, this is pre retirement, I don't really budget, just because it's just not my temperament. And I'm fortunate enough that I don't need to from from the standpoint of trying to figure things out, but I am pretty measured about saving. And you know, and making sure that I save what I need to I save as much as possible, you know, investment wise, maxing out 401k Is etc, etc. And then even taxable account that, you know, all things considered, I'm assuming I'll be fine, you know, in a major way. And I'm not the only one, by the way, remember Michael Fink. He also didn't like that as well. So their way, but but that that being the case, I you know, I think once you get into retirement, there are just different dynamics. So I do see myself changing once I am into retirement because all the saving has been done, effectively. But a concept Wade, that I think is while you're in pre retirement that merits discussion, and we can end it on this and I think it flies under the radar a lot in terms of the research that you've done, which I find this actually fascinating, but it just doesn't get a lot of play. And that's the concept of a safe savings rate. And you've kind of mentioned and when you were talking about the fire crowd, I think you did you want to talk about that and how that that helps translate into a retirement income strategy at a certain point

Wade Pfau 34:07
Sure, sure. And so I think the reason it comes up now is just because it did use a replacement rate is a simplification is part of the process. But this was the article that actually made my career and got the mention and

Alex Murguia 34:20
that was a RISA Wade, RISA me. Come on, man. Until

Wade Pfau 34:25
now we're talking about 2011.

Alex Murguia 34:27
I'm teasing.

Wade Pfau 34:31
This say it's a safe savings rate idea. It is part of the total returns research category, where something like the 4% rule is often called the safe withdrawal rate was the withdrawal rate that you can safely use in retirement. The safe savings rate research was just about taking a further step back and not worrying about the safe withdrawal rate specifically, but worrying about how much would I have to save so that I had sufficient assets to meet my retirement expenses. In all the historical simulations that you want, the same manner that the 4% rule was based on the worst case historical market performance, the safe savings rate was based on the worst case, historical market performance. And the scenario, the baseline scenario I set for that was just somebody who's 30 years away from retirement, they haven't started to save yet. So they've got 30 years to save. I did give them that constant inflation adjusted salary, which I mentioned earlier is not particularly realistic for most people. But if you had this constant earnings growing for inflation over time, for 30 years, how much would you need to save so that when you retired, you could then in the baseline, replace 50% of that from your investments, and I assumed you had Social Security too. So that was getting you up to if you're at a higher than average, or a 30% replacement rate with Social Security, another 50% from your investment portfolio, but to then be able to fund that level of spending over the next 30 years. So it's like you start saving at 35, you retire at 65, you lived to 95, how much? What percent of that salary would you have needed to save so that you did have enough money at retirement, so that you could go that that goal, again, that 50% replacement rate from your investments, you could spend that and not run out of money. And really what the big issue there was, it helped with the idea that the 4% rule concept or the safe withdrawal rate concept. Historically, the lowest withdrawal rates tended to come after bull markets, you had a big bull mark, hopefully, you have a lot of wealth at that point. But then that's where you might have had to use a lower withdrawal rate in retirement. And when there is a pre retirement bear market. The most famous example of this would be 1982. If you retired in 1982, it would have been hard to have much savings. Because those final years of your career, there's markets were doing terrible since the mid 1970s. But then, in hindsight, you could have ended up using close to a 10% withdrawal rate if you retired in 1982. And so the safe savings rate concept provides more than signs of Don't worry about a safe withdrawal rate. Those tend to happen just after bull markets, look at just how much would you have needed to save to meet your spending goals. And that puts a lot less volatility on the required savings rates to make those retirement plans work. And in the example I just mentioned, if you are using a 6040 asset allocation throughout your career, that save savings rate ended up being 16.6%. But if you save that consistently for those 30 years, even in the worst case, historical scenario, you will end that's what it's called, it was a worst case historical scenario, that would have been sufficient savings to fund your entire retirement spending goal through age 95. And so that's an application of something like the replacement rate, which really works on you are assuming a constant salary, like I was saying where that can make sense. But But this framework, it's really flexible. You don't have to make everything fixed in that regard. It's just have your scenario in mind. And so is going to be what assets, what will I

need to save into my investment portfolio to then translate into being able to fund those expenses, the savings rate concept is about

Alex Murguia 38:39
No, Wade I think it's fantastic. I think that's actually what got me started into the my path down budgeting laziness, in pre retirement, which is just make sure I'm saving the heck out of things.

Wade Pfau 38:53
Yeah. The software, the financial planning software that we helped, and you primarily created from the foundation. I did have the safe savings rate module. So maybe, yeah. Running your plan through that.

Alex Murguia 39:06
No, no, yeah, no, that, I don't know. It just worked for me. Like I said, like there's, there's a style for everyone that it just works for me right now. That being the case, there's there's an other type of budgeting strategy, but we're going to talk let's talk about that weight in the in the next episode, since we're roughly at the 40 minute mark. And that probably exceeds many folks is like daily walk, if you will, why they listen to podcast or drive or whatnot. Right. So let's get to that second type of budgeting method where you actually track expenses. In the next episode. What do you think Wade

Wade Pfau 39:40
yeah, we'll end here on a cliffhanger. And in the next episode, we'll do that bottoms up approach of talking about identifying different spending categories, looking at past expenses for those categories, and then trying to translate that into a reasonable retirement budget.

Alex Murguia 39:57
All right, everyone, thanks for checking in on retire with style. Take care.

Wade Pfau 40:02
Take care everyone.

Bob French 40:05
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.