Episode 33: More Reasons Why The 4% Rule May Still Be Too High

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. You can have a healthy sustainable withdrawal rate plan, pay little to no taxes and live a long time. Problem is you may not be able to have all three at once.

Alex Murguia 00:52
Hey, everybody, welcome to Retire with Style. I'm Alex and I'm here with my trusted companion. Wade Pfau. And we're here to talk about what? Yeah, right, thank you. We're here to talk about what we thought was gonna be a two parter on what the full on why the 4% rule may be too high ended up being a three parter. Today being the third part, Wade, but before we get going any interesting stories to satisfy our audience members that love our personal anecdotes?

Wade Pfau 01:27
Well, yeah, it was it I was, I've been listening to our past episodes and realized in the first one of these, we thought it was going to be a four episode series to get through reasons why the 4% rule might be too high or too low. This is the third episode in the series. And we're still not to the halfway point yet. So it's four is gonna be an under estimate of how many episodes we need.

Alex Murguia 01:49
Well, I think it's too late to warn them on that one way, the problem is, you just you just know too much big guy, you just know too much.

Wade Pfau 01:56
Now, I think a topic is going to take five minutes to talk about and then it ends up some had taken 20 minutes or more. So we're gonna keep pushing forward with it, though, make sure we do give the adequate discussion necessary for these topics. Perfect. I don't know if that's what you're looking for with small talk or not?

Alex Murguia 02:13
Well, how to know who knows, right. But just just something the setup. Here we go. So we're ended today with a couple of points, but just to kind of do a quick review. And you can, you can obviously see the previous here, listen to the previous episodes. One of the reasons, you know, the reasons we've been pointing at the 4% rule may be too high. So far, the first point has to do with your allocation. And

how sometimes, you know, risk aversion plays into that, you know, for this to work, part of it is the allocation ranges are between 35% equity to 80% equity, and folks are some folks when you get older and age or maybe hesitant to do a 50% stock plus allocation, especially, you know, we want to make these episodes timely and evergreen, at the same time, which is difficult. But, you know, we've just seen extreme market volatility, which can easily have been given retirees pause for concern regarding their allocation. But the reality is, is one of the assumptions for the 4% rule is to maintain a fairly healthy stock allocation, that is probably more so than what target date funds that institutions create would would be amenable to. And obviously, they're getting to different points, those target date funds are just taking into consideration your age, and using that to to create an allocation whereas the sustainable withdrawal rate is taking a different tack. And hence, you know, they really, you know, it's this probability based optionality component where there's this faith in the markets to over the long term over some reasonable time period, create a positive rate of return that can sustain the distribution. The next one was US historical data. A lot of this is just based on us historical data. And that's ultimately limited. Wait, cut his teeth, frankly, looking at the international data set. And Italy won the prize for being the lowest sustainable withdrawal rate. What was it?

Wade Pfau 04:17
Italy had the lowest success rate for the 4%. withdrawal rate. I don't know if we specifically mentioned that in the episode, but it was point 1% And that was due to the hyperinflation and everything that went on during the World War Two period in Japan.

Alex Murguia 04:33
There you go. And, and you expanded upon its implications with regards to World War Two, or did we not get into that?

Wade Pfau 04:41
Yeah, we got into that. And we probably don't want to make this review too late, or else we have a whole episode just reviewing. The next one was like, Yeah, two episodes ago for those topics.

Alex Murguia 04:52
So we have, you know, the allocation historical data is actually quite limited. The next point was retiree investors in June. don't tend to underperform market index returns. And as much as you don't think that's going to be you, odds are it will likely be and myself included and weighed. We're not We're not above it. But it's just, it's just what the data shows. The next one that which was we discussed last time is when you focus on investing for income, and you back into a dividend yield from a stock or some sort of yield from a from a bond, you may not be doing that that's not the optimal way to do it, you should be thinking about the portfolio as a whole and creating your own yield from just selling selling assets, as opposed to trying to map it to a to a dividend, because a lot of things can go wrong when you do that. And then we discuss that in detail in the last episode. So those are four so far. Today, we're going to talk quickly, quickly, but we're going to discuss three more, which is taxes, how we kind of want a margin of safety, we don't want to be at zero in our on our expected death date. Because that's even though that's really, really good timing. It's, it's a tough pill to swallow. And the investment horizon may actually be much longer than 30 years. Wait, do you want to take us through the taxes and unpack that?

Wade Pfau 06:14
Yeah, absolutely. And so the simple issue with taxes is the 4% rule doesn't incorporate them, it doesn't include any taxes. And of course, in the real world, there are taxes. And if you're thinking about well, the 4% rule seems like a reasonable idea, because I want to have consistent spending through threat of retirement. By that concept, you probably mean you want consistent after tax spending, if the tax bill is bouncing around, but your overall spending is constant, that means this, the amount you get to spend net of taxes is going to be bouncing all around. And the 4% rule just leaves taxes out of the equation. So it if everything was in a Roth account, you're you're okay, there, you're covered, because you don't have the Roth distributions going into your adjusted gross income. But for any money in a taxable account, or a tax deferred account, you have to deal with the fact that taxes are going to be paid. And that's going to impact spending. And now it is hard to talk about everyone has a different tax situation. So it really is hard to generalize. But one thing I tried to do recently to help provide some guidance around that was just a very simple example of, we'll look at all the assets are held in either a brokerage account, an IRA or a Roth IRA, and then looking at different asset levels $1 million, $2 million $3 million, also having a Social Security benefit. But then beyond that, no other financial considerations, and looking at what do taxes do to the sustainable withdrawal rate. And I hope that that can just help provide some sort of insight or guidance around the impact of taxes,

Alex Murguia 08:01
and Wade just since just to level set for the entirety of our audience, although many would know the implications when you say brokerage, Ira and Roth IRA, or, you know, or even a 401k, if you will, effectively, there's three classifications for these accounts. A normal, like brokerage account, usually is a taxable account. Okay, so you're gonna be paying taxes on an ongoing basis on gains, an IRA and dividends and interest Yeah, exactly. And dividends and everything that comes out of that, an IRA 401k, a four or a three a 403. B, those kind of employee accounts, those are tax deferred accounts, you pay taxes on, you're going wait, you're you're sort of not paying taxes when you're putting it in, but when you take it out, you're gonna pay taxes on it from an income standpoint, okay. And then

Wade Pfau 08:56
You get the tax deduction when you contribute, but then everything comes out as ordinary income, and you'll be impacted by required minimum distributions starting at age 72.

Alex Murguia 09:05
And just because we brought it up required minimum distributions, what's a quick definition for that one Wade?

Wade Pfau 09:12
That is the the IRS is letting you defer your taxes, but they don't want you to defer it forever. And so they've created rules that eventually you do have to take the money out, you don't necessarily have to spend it, but you do have to pay taxes on it. And then if you're not spending it, you could then reinvest it into a taxable account. And I said that RMDs start at age 72. There is currently legislation that may pass before the end of 2022. That's going to make that number eventually obsolete. But as of the recording, age 72 is when RMD start.

Alex Murguia 09:46
Okay. And then the Roth we have a it's known as a tax exempt fund. Why is that tax exempt Wade?

Wade Pfau 09:54
So you don't have to or you do pay taxes on the contributions going and you don't get to do got that from your current year taxes, but then all the growth and all the distributions assuming it's a qualified distribution, which requires meaning some basic rules, but it then all comes out tax free. Any, any qualified distribution from your Roth account does not go into your adjusted gross income. So it doesn't impact taxes, will ordinary income taxes or Social Security, taxation of benefits, or the Medicare surcharges. And some of these top like we're introducing the idea of taxes right now. But we can later in the series have an entire conversation around tax planning and what all this stuff is in more detail, introducing some of these concepts at this point.

Alex Murguia 10:41
Yeah, we're doing it right now, for definition, as we get into it, we want to make sure that when we say a brokerage account, that's hand in hand with a taxable account, when we say an IRA account, or even a 401 K, rollover or whatnot, that goes hand in hand with tax deferred, and Roth IRA, those are tax exempt accounts. And there's a whole literature behind the ordering of these and so forth. But for the purposes of this podcast, it's just to indicate that, you know, taxes, take a bite. And we're just gonna

Wade Pfau 11:12
In the example I'll talk about now, the ordering the whole, what's a tax efficient distribution strategy isn't relevant, because I'm making a simple example where you only have money in one kind of account. So you don't have to worry about well, when do I take from the tax deferred account? When do I take from the taxable account and so forth? That will have an entire story arc on that at some point in the future?

Alex Murguia 11:36
Okay, yeah, I feel like this is like the Avengers. We're kind of introducing characters coming back.

Wade Pfau 11:43
Retirement Income universe, exactly. You want to write there's a lot of interconnecting things that go on here. And so you do have to find what's the best path to work your way through all this. But yeah, so if the money's in a Roth account, and that's all you have Roth assets and a Social Security benefit, unless your Social Security benefit is high enough that the formula used to calculate taxes on it ends up leading to more than the standard deduction, which is kind of unlikely, you're not going to have to pay any taxes in retirement in that scenario, with just Roth account assets and a Social Security benefit. So you still, if you believe in the 4% rule, it's still 4%, because there is no tax consideration with money held in a Roth. And that's true for any level of assets. Now, there could be a state taxes at some point, but uh, there's not going to be any income taxes. And so a set of assumptions that will lead the 4% rule to work in a no tax world would also work in a Roth if all the money was in a Roth.

Alex Murguia 12:50

Okay, what happens if a million dollars is in a brokerage account as opposed to a Roth account, as opposed to looking at?

Wade Pfau 12:58
Yeah, it's gonna lead to fluctuating taxes over time. And it's not going to be as drastic as a tax deferred account. But indeed, you can start to anticipate what's the sustainable level of inflation adjusted spending, I could use net of tax, to be able to also have enough assets to pay all my tax bills. And this is also assuming we're in a no state income tax state. So it is just federal income taxes, if you had a million dollars in a brokerage account, and in this scenario was a $43,000, coming from Social Security annually, your 4% rule would be you'd have to spend about 3%, less, I don't mean three percentage points there. But if we had the 4% real work without taxes, it would be a 3.88% withdrawal rate with taxes. And so spending would be reduced by 3%. To account for taxes.

Alex Murguia 13:51
What's your inflation assumption on the just so?

Wade Pfau 13:56
Yeah, so this will be asked and actually going back past episodes, everything's interconnected. We talked about the PMT function. This is based on a PMT function where we have we're assuming a two and a half percent inflation rate, and then a 1.31% real return on assuming everything was invested in bonds. And that allows the 4% rule to work, it gives you 30 years of inflation adjusted 4% spending rate and never initial assets.

Alex Murguia 14:24
Now, before everyone kind of gets back on their chair after hearing our assumption was two and a half percent, when they went in when inflation right now is tracking, you know, significantly higher than that, you know, at a certain point it gets to a steady rate, we're thinking about the entire lifecycle of the person and so you know, there are there are some assumptions that just need to be made. And the idea is not to discredit this as Oh, but inflation is 8%. So forget this. It's really most more to see an apples to apples comparison with the different account types and how that they're affecting it.

Wade Pfau 14:56
Yeah, yeah, markets do expect inflation to come back back down. And that's still a kind of long term projected average. But right, this is a simpler calculation. It's just if the 4% rule worked without taxes, well, we taxes due to the 4% rule is really all we're trying to

Alex Murguia 15:12
keep everything else at the same now. So proportionally, you'd see a similar thing. And so yeah, the million dollar

Wade Pfau 15:17
we might as well continue with the brokerage account first, before we switch to tax deferred. So Gotcha. If you had a million dollars in the brokerage account, you'd have to reduce spending by 3%, to account for your taxes $2 million in a brokerage account, spending two and a half to be reduced by

6.9%, to account for taxes, and then $3 million in a brokerage account spending would have to be reduced by 8%, to account for taxes. And so in the context of the withdrawal rate, 4% would become a 3.68% withdrawal rate to account for taxes.

Alex Murguia 15:53
Why is that? Why does it increase? I just want to make it clear to everyone because you know, we're doing this with the benefit of seeing a chart, why is it that the spending actually decrease, and it's not proportionally the same thing with a million dollar account and a $3 million account?

Wade Pfau 16:08
Well, that's just the nature of the progressive tax system in the United States, where as real, really all the income we're assuming here is ordinary, like interest bond interest, and as you have a more interest coming out of the account, part of that is getting pushed into higher tax brackets. And so that's increasing kind of the average tax rate you're playing paying over time, you're, you're, you're going to have a higher tax bill as that income goes up. And also, it could be pushing more the Social Security benefit to be taxable, as well. And all kinds of when we get to the tax planning discussion later, in, retire with style, the nonlinearities of the tax code is what creates all kinds of complications. And we're seeing a little taste of that, in that these tax changes are not linear, they're not a straight line, it's, it's based on a whole lot of underlying factors interacting with each other.

Alex Murguia 17:01
Yeah, and to even do it another way, just to because it's all bad news, I mean, the moment you have, the more nominal you can take out, even though percentage it it may be lower. So the Million Dollar Portfolio at a 4% in a taxable account, you're looking at $38,800, a $2 million account, 4%, etc, you're looking at 74,400, and a $3 million dollar account, you're looking at 110,400. So nominally, obviously, it's more because you know, 4%, or 3 million, etc. But that being the case, as a percent of the initial withdrawal, rate, it it is lower.

Wade Pfau 17:43
Then we can talk about the tax deferred. So this would be money in an IRA and a 401, K and so forth. And the tax implications are a lot bigger. And I hope, kind of while you, when we start talking about tax planning, you know, you'll see a lot out there about, of course, it's great to get the tax deduction, and certainly in higher earning years, or peak earning years, it probably doesn't make a lot of sense to contribute to a tax deferred account. So you can get that immediate tax deduction when you're paying taxes at a higher marginal tax rate. But if you got too much assets and those types of an account, that can really hit you in retirement, because that is all coming out as ordinary income, your entire distribution is going into your tax bill. And that can have a bigger impact. Like we said, with a million dollars, if it was a million dollars in a taxable brokerage account, you'd reduce spending by 3%. If you had a million dollars in an IRA, you'd actually have to reduce spending by 14%, to account for all the taxes that you'll have to pay in retirement. So that would take the 4% rule down to a 3.41% withdrawal rate to accommodate taxes on a million dollars in an IRA plus your Social Security benefit.

Alex Murguia 18:59

The only thing I would say Wade, and this is more for clarity for folks that are listening, and I'm kind of sensitive to them listening to us, you know, effectively just spit out numbers. Conceptually, it's not that something is unfair. Remember, if you're putting it in a tax deferred account, you're not getting taxed on the front end. And so if you're making a certain salary that's at a high tax bracket, you're getting, you're able to nominally save more upfront. And theoretically, that should be compounding at a faster rate than if you were to get taxed on it that year before contributing and then putting in a Roth assuming that you qualify and the like. And so there's a breakeven to this in terms of Hey, is it better to put it in a Roth right now? Or is it better to put it in a tax deferred? It depends on your on your tax rate, but it's, I just want to make it clear because sometimes I get the sense listening to folks or reading questions, where it's like there's this inequity of these accounts and really what what what What's happening in an IRA is the government is kind of lending you the tax liability, the present day tax liability, so you can just leave it invested. But lightweights said they will ask for it back, you know, into retirement. And many times, even though the numbers here, a million here a million there. You'd be like, Why would I, you know, this tax deferred is no good. That's not necessarily a case because it's theoretically, it would be much easier to accumulate an account to get to a million dollars in a tax deferred account than you would in a tax exempt account, all things being equal, because more money is saved and compounding. Wade, do you want to maybe say, a little clearer, just in case

Wade Pfau 20:37
I, I guess it's a good point, I don't want anyone to misunderstand the implications of this, the fact that you'd have to reduce spending by 3%, for a taxable account, and by 14%, for a tax deferred account, doesn't mean you should have all your savings in the taxable account. But in reality, people are going to diversify between the different types of accounts. And the whole kind of conversation is around, we know we have to pay taxes, we just want to work within the rules to pay the least amount of taxes that we're required to pay, not not illegally avoiding taxes, but just working within the system to pay the least amount of taxes. And then that involves, if I'm think that this year, my marginal tax rate on my last dollar of earnings is high, that might be a good time to put into the IRA. Because I believe in the future, when I take it out of the IRA, I'll be able to pay a lower tax rate on that distribution, I want to figure it out, I know I need to pay taxes, I just want to pay taxes at the lowest possible rates. And so that's the basic logic that goes behind the whole conversation around tax planning, both with where to save pre retirement, but also where to spend from post retirement.

Alex Murguia 21:49
And the last point, I would say, and this goes back to almost like the four L's, but it's almost like a pre retirement four L's, why would anyone put money in brokerage account? You know, since there's a tax deferral on one of them, and there's, there's a tax exempt on the other, well, you may need to have access to cash, you just may need access to cash, you know, beforehand. And many times, you know, the best way to do that is through a brokerage a regular taxable account, because life comes out x

Wade Pfau 22:16
because of the penalties for early distributions before age 59 and a half. And plus, if you're a really diligent saver, you may max out all your savings capacity, the government provides these tax advantages to incentivize retirement savings, but they put limits on it. So you, you can't just put as much as you want into the different types of tax advantaged plans. That's why you may have to put

something in a brokerage account as well, in addition to it being more liquid for you, you're not having to face or 10%, early withdrawal penalty and so forth.

Alex Murguia 22:51
And so, so then to just to leave it here, like taxes do take a bite, you know, kind of comment, Roth IRA, let's just take a Million Dollar Portfolio, because let's assume most of our listeners, you know, that's that's a reasonable amount. Although that could sound like it, let them eat cake statement, and I realized that but for the purposes of here, you know, a million dollar in a Roth IRA spending is not reduced, because you've already paid taxes, effectively, and the government is incentivizing you to put it in the Roth because of that, and you take it out tax free brokerage account, the spending reduction effectively, because you will be paying taxes is 3%. So 40,000 goes to 38,800. In Ira tax deferred account, the spending reduction is 14%. So it's that much more because you've never paid taxes on this, you know, and so it was led to it was allowed to invest and compound accordingly. But once you take it out, the spending reduction is reduced by 14%. So the 40,000 goes to 34,400. And so from that vantage point, it's you know, taxes do account for what a sustainable withdrawal rate is, within your portfolio. So if you're listening to this, and you've been, you know, you've been Oh, 4% You know, what, I feel comfortable, I've heard all this and etc. And I still feel comfortable with it. Know that if you're in a tax deferred account, and I have to think a lot of our readers or listeners have that simply because of 401 Ks, and 403 B's. It's you know, that 4% is closer to 3.4. You know, in addition to everything else that we've discussed, so why should why it could be too high.

Wade Pfau 24:32
Yeah, yeah. So with the IRA to like, I never know what's a good kind of round number to use $1 million, makes all the accompanying math easier. But I know that is a very high number. For some people. It's it's also a low number. For other people. It's really hard to have a good kind of representative case study to talk about. Just to finish out this example, if it was $2 million in an IRA. The 4% rule, you'd have to reduce it by six 1.5% to account for taxes down to a 3.34% withdrawal rate. And if it was $3 million, and then Ira spending would have to be reduced by 19.2% to a 3.23%. withdrawal rate to account for the taxes in retirement.

Alex Murguia 25:20
The good news is you have $3 million.

Wade Pfau 25:23
Yeah. Well, if you didn't have to pay taxes, you'd be spending 100. And well, you'd be able to take a distribution of $120,000 a year. Because the taxes you only get to spend $97,020 a year out of your tax deferred account, net of taxes.

Bob French 25:43
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Alex Murguia 26:09
Okay, so that's about all the tax talk I can handle.

Wade Pfau 26:15
Introducing taxes Well, later on, we'll come back and talk more about tax planning for retirement. But yeah, that's kind of introducing its implications for the 4% rule. And the idea, again, was the 4% rule ignores taxes, that's not a very realistic assumption. The reality is, you're gonna probably have to spend less after I can't if you're talking about net of tax, sustainable spending numbers.

Alex Murguia 26:38
Now, the next the next topic Wade, I think is akin to and I do this on occasion where I'm driving. And all of a sudden, the light goes on, on my dashboard, telling me that I only have a range of 40 miles left. And the distance on Waze is telling me that my next destination is 35 miles away. Right? Or it's telling me it's 42 miles away? What do you do? What do you do? Do you fill it up? Or do you go on it? And I think that's, that's that's kind of a nice analogy for retirees seek a safety margin. What do you think?

Wade Pfau 27:15
Oh, yeah, yeah, this scenario is great for understanding the whole concept of a safe withdrawal rate, you're in a desert, you're thinking about are you going to have enough gas to make it to the next gas station, that's the 4% rule. If your scenario there, the 4% rule, just you're gonna, you're okay, you're not going to worry about this, you will make it to that gas station without any trouble,

Alex Murguia 27:41
you may turn off the air conditioning.

Wade Pfau 27:45
You may have to go at 15 miles an hour, because the faster you drive, the lower your gas mileage, but you're gonna make it somehow. And that's not necessarily a realistic assumption that the 4% rule assumes you're playing this game of chicken with your portfolio. That all right, it looks like I'm in trouble. It looks like my portfolio is heading down to zero. But that's okay. Because I'll be dead before I hit zero. That's the assumption of the 4% rule. And whether or not that's an appropriate assumption, of course, is case by case. But but that is the assumption. I think it's a little more.

Alex Murguia 28:21
It's all we did on the day I hit zero.

Wade Pfau 28:25
Yeah, that check to the undertaker bounce, that's the goal of retirement planning, right, the first check to bounce would be the one going to the funeral home. Now, if you're not comfortable with that, it means you don't want to assume that you're willing to let the portfolio hit zero by the end of the planning horizon, which should mean you want to build in some sort of safety margin. And we talked about that with the PMT function in earlier episodes. If you want a safety margin, you have to spend less, because

you have to preserve something for that safety margin. That's that's the story with it. I don't know how we could try to drag that out for another five minutes. But its...

Alex Murguia 29:05
Oh, we can. No, the only thing I would say is, yeah, it's kind of a simple concept, you know, and just keep that in mind. I mean, you're following the 4% rule, you're kind of making that assumption. Now, by building an A safety margin. There's two ways Wade, I would like to introduce you can do it by look, I have a super secret $100,000 account, then that I'm not touching and that that serves as the fire hydrant break glass in case of emergency. Right? You have that kind of thing, which I would say you're just really mentally compartmentalizing your your assets, because you technically then are taking less than 4%. But whatever, right. The other piece is, if you're in the total return member, you have a strong probability base, you know, tilt, but you're also viewing things with optionality high level of optionality. And so if you're in a total return You know, another way to think about the safety margin is, hey, I'm just going to reduce my spending if things get tighter, so I can give myself that cushion, you can give yourself the cushion, because you have some super secret account that you don't tell anyone about, you know, kind of thing, or you don't even look at it, you don't even want to look at it every few years, because you don't want to know it's there. Or you you're just comfortable with, you know, taking less because you're willing to you have that optionality you're willing to, you're willing to move it around how much you take towards the end, Wade.

Wade Pfau 30:30
Yeah. And also, I think if you're probability based, you're also more willing to rely on the sense of, Well, the 4% rule is supposed to be the worst case scenario. So maybe in the worst case scenario, I would hit zero. But in any other scenario, except that worst case scenario, I could have a lot of money left. And so that's my safety margin, that, for all practical purposes, the 4% rule is going to provide a safety margin. And so I don't necessarily, therefore need to build in an additional safety margin. I think that's really the reason why Michael Kitsis has said that it's your floor, this idea of a floor and upside, the 4% rule is a floor. And because it will work in all but the quote unquote, worst case scenario, you're going to have upside with it as well. That's not usually what is meant by a flooring approach. And flooring is much more of a safety first concept. But that's how a probability based thinker might try to bring that sort of concept to life within a probability based world.

Alex Murguia 31:32
I don't personally subscribe to that. But I guess that's why I'm not a probability base and based purely based Yeah, exactly. And, you know, we don't because of everything that we've spoken in the previous episodes, those are assumptions that I'm not heroic enough to subscribe to.

Wade Pfau 31:53
The base, but I'm probability based commitment oriented rather than

Alex Murguia 31:56
you give me another way, you create a floor with an actual contract. Yeah.

Wade Pfau 32:02

As opposed to my my intention. Yeah. As opposed to,

Alex Murguia 32:06
actually, you don't want to even have to have that you you'd rather just the probability hits you don't even want to think about before but you have it just in case. These you know, your total return your view of the 4% rule is yeah, that is my floor. That is my bottom.

Wade Pfau 32:21
Yeah. And so that is my safety margin, that 4% is my safety margin. It's just that the explicit assumption of the 4% rule is that in the worst case scenario, you will hit zero after a 30 year retirement period. And that's the only idea there is, well, if you don't want to necessarily assume you're gonna hit zero at the end of 30 years, you might need to build in an additional safety margin, and if so, that would suggest a lower withdrawal rate.

Alex Murguia 32:50
Okay, and you said 30 years that kind of is a nice segue to the fine out there. I say the final point of why the 4% rule may be too high.

Wade Pfau 33:00
Right, right. Yeah, that was a good segue. So that your 30 year retirement. And if you're thinking that your retirement planning horizon might be more than 30 years, there's no 4% rule for that. Now, this is an important issue, because within the fire community, that financial independence retire early community, I get a sense that a lot of members of the fire community are total return oriented, and they love the 47. Community for the folks that I just said the financial independence retire or

Alex Murguia 33:35
sorry Wade, sorry Wade.

Wade Pfau 33:37
it. It's a online community like Mister Money Mustache, and people like that, who just talked about, it's the whole idea of saving as much as possible, so you can retire as early as possible. And therefore you're going to 30 years will not be an appropriate planning horizon. If you're retiring when you're 40 years old, assuming you're in decent health, well, 40 year olds today, they may be the odds of living 100 are not at all insignificant, like they may be looking at a 60 year planning horizon. And so the 4% rule was never designed to be for a 60 year planning horizon, it was specifically for 30 years. And going back, so that's the first episode we had in this area was about the PMT function. As we said, it's kind of the core of everything. Going back to the PMT function. The longer the planning horizon, the less you're able to spend, because you have to stretch the money out for longer. Yeah, and now within the historical data, but Alex is gonna get really upset because if you're looking at longer horizons, you have even fewer rolling historical periods to look at. So I don't even push this beyond 40 years primarily for that reason, but the wealth over 30 years with building and assumptions except for you take distributions at the start of each year instead of the end. Each year 30 years was for a 5050 portfolio. For point zero 3%, a 40 year planning horizon, that number falls to 3.71%. And if you keep going out to infinity, well, we don't have the historical data to do that. But it seems like with the way the trajectory of

the chart goes, maybe like three and a half percent would be the sort of what the US historical data would imply.

Alex Murguia 35:27
And now overlay that with tax implications. And it gets interesting, and the reason I actually asked you to, to, to kind of talk about the fire community as you explained it, but it's almost like this, it's, it's this huge, huge following. And we many of our listeners may be in that community. And, and it's one of these, that's where I think it's a little off, and maybe, you know, folks are upset that I say something like that. But yeah, if you're retiring at 40 years old, you know, God bless you, congratulations, there's nothing wrong with that. But if you're applying a 4%, sustainable withdrawal rate to that, now you're looking at, you know, a 50 year time horizon. And if you go if the 4% rule is reduced to from 4%, at 30 years to 3.7, at 40. You know, you've effectively now have a, you know, a 50 year time horizon, you know, continue, continue the further reduction, and it gets real tough, you know, if you're doing that, and the only thing Wade, I would say with the fire community, which I don't want to get into, I'll just say one, you know, kind of drive by comment is, is the whole human capital thing, I think there's so much human capital left to mind, you know, you may be better off just doing something you love doing as opposed to the job, so you can continue to mine human capital, and, you know, enjoy life, but also, you know, it's kind of an investment return in and of itself, your own personal you that you kind of ignore, but that's, that's another topic.

Wade Pfau 37:00
So talking about things from today's episode two, we talked about RMDs, because, uh, the tax implications, but it's probably worth talking a bit more about the IRS required minimum distribution tables, in the sense of how they relate to some of the historical safe fax numbers. So if you for your own IRA account, required minimum distributions begin at age 72. But if you inherited an IRA, you may have required minimum distributions at a much younger age. So the IRS does publish tables that allow you to figure out what those numbers would be for for younger ages as well. And well, later on, actually, as part of the next story arc of why the 4% rule might be too low variable spending or flexible spending strategies will be a big part of that in from that family. Just an example of that is guide your spending based on what the required minimum distribution percentage is for that particular age. Now what we see with the safe fax numbers is they tend to be younger ages, they tend to be higher than the RMD rates. But at around age 80, you get a crossover where the RMB rate published by the IRS is about the same as what the safe Max would be for an 80 year old who's planning to age 100 or so. In other words, for a 20 year, safe max number.

Alex Murguia 38:32
Wade, I want to set that up just a hair, I want to add a couple of points of context. And again, this is for folks that are listening to this, I think merit some consideration from an r&d standpoint, theoretically, what the government is saying, you know, to to, why is the government requiring me all of a sudden to pay required minimum distributions? Remember, you haven't paid taxes on on this money. In fact, they've kind of quote unquote, lent it to you, conceptually. So you can just invest and have greater nominal value compounding, right. At a certain point, they do want those taxes. And so at 72, barring changes in legislation, or what have you, they figure well, you're gonna live this long. And so if they're going to if you're going to live this long, I'm going to take a proportionate amount every year. So by the

time you pass, I've effectively collected all the taxes I've been doing. So the government is actually doing a calculation for you, just for this specific account in which they're taking what they feel is a reasonable amount. So by the time you were to pass they've collected on their taxes. And so we're just showing how that intersects with the safe Max rule.

Wade Pfau 39:46
Yeah, yeah, I think you're doing a better job. I'm assuming a lot of information already known that you're helping to clarify, although, all the hate mail can be directed at you from anyone with political leanings. When you said the government is lending your money when they are not to pay taxes?

Alex Murguia 40:02
Well, conceptually, you don't I mean, like I get it, it's almost like No, but it's very similar to tax loss harvesting. You know, it's just this kind of concept where you know, you're making those contributions before taxes. Yeah, trust me.

Wade Pfau 40:20
You're deferring your taxes to a later date. And you as a consumer, or as an individual can take advantage of that by then trying to target paying taxes at the lowest possible rate. And the government is letting you get away with that, so to speak, but it's to incentivize people to save for retirement. And I guess they're probably for the most part, most people are not being too strategic about this issue, so that they're not necessarily figuring out how to pay the least amount of lifetime taxes. But as listeners of this podcast, you will have a better sense of how you can take advantage of the rules to pay less taxes, potentially.

Alex Murguia 41:04
Wade, I think with that, I gotta start hitting my inbox since I actually have a little folder, just for free tagless style comments. But now like, there's no politics of like, I'm just messing around politics. But yeah, and so going back to the your takeaway from RMDs, is that there's a crossover, they kind of match at the beginning. Safe, Max is a little bit higher, the RMD is lower, but they kind of have that crossover in mid 80s. There's only that right? Would you say 88?

Wade Pfau 41:40
Yeah, in the 80s. RMDs are higher than the safe Max is for somebody who's planning ages 100. But then by age 90, again, there's the crossover happens, again, where the safe maxes are getting more aggressive than the RMDs at this more advanced ages. Because the RMD table now goes out to like age 120,

Alex Murguia 42:02
does it? Well, the other thing, I would say wait, and this goes back to almost like retirement risks, because I'd be remiss if I didn't says, Could you imagine being that he's old, and you're worried about, okay, what's the safe max at this year and trying to that's a lot of heavy lifting, I would think at that age, especially considering cognitive decline.

Wade Pfau 42:21

So just the RMD rate and the safe Max through age 100, are both about 8%. Just FYI. But you could use the RMDs to guide retirement spending, and especially if you are part of the fire community that's sort of flexible strategy that we'll talk about in future episodes as well. Does help manage sequence of returns risk and becomes important for those longer time horizons. And you do see that there's a relationship, the RMD rules are designed to get you to spend your account down during your lifetime. So extrapolating the logic to retirement income, is designed to help you spend down in your assets and while you're alive, and so you get the most enjoyment out of retirement. Now, there are some other quirks about it, it's tends to lead you to spend less when you're younger, you're spending tends to peak in your 80s and then comes back down again, later on, which is not necessarily the spending pattern that most people are looking for. So you might want to modify the RMD table with how you use it. But it is just something to think about to help guide retirement spending, it's linked to the academically efficient way to spend on retirement assets, is to spend that spend an increasing percentage of what's left each year. So it's not constant inflation adjusted spending. It's a percent of the portfolio. And it increases as you age, because your remaining time horizon is getting shorter. So the RMD tables pick that up.

Alex Murguia 43:53
The last point I'd like to make regarding RMDs. And you said earlier, but I think it bears repeating, because we've had plenty of prospects that you know, they're in McLean, and we're looking at their portfolios and distribution strategies and wait said there's been and I need to say it just to make sure everyone's heard it very clearly. You don't need to spend the RMD money you need to take it out and take the distribution but you can easily reinvest it if need be. Just

Wade Pfau 44:19
It's a hassle because you have to pay the taxes. But yeah, that's we talked about investing for income and how if you look on like a Yahoo Finance article about retirement and start reading the comments, maybe even a more popular comment is RMDs are forcing me to spend money I don't want to spend it you know, that's you have to pay taxes on it, but you, you can reinvest it, it's you're not required to spend it so to speak. You're never really required to spend money other than pay taxes.

Alex Murguia 44:53
The only time I'm required to spend money is when I take Wade out to lunch.

Wade Pfau 44:57
That's right. I'll be looking for that. The highest priced item on the menu.

Alex Murguia 45:01
Exactly. Exactly. The iceberg lettuce wedge, Wade are we good?

Wade Pfau 45:09
Yeah, I think we've now covered reasons why the 4% rule might be too high. And that was the bad news. So in the next episode, we'll start digging into some of the good news. Why, in spite of everything we've talked about, or it's really you got to balance all these factors together and see what the overall balance is. But there are there are a lot of reasons why the 4% rule, as traditionally defined might be

too low. When you start looking at some other assumptions that go into it, and we'll get into that in much greater depth. And I wanted to say two episodes, but we'll just have to see how that plays out. How many episodes is going to take to work to that list, but that'll be coming up next week.

Alex Murguia 45:44
We'll get started with that. All right, everyone, take care.

Wade Pfau 45:47
Yep. Thanks, everyone. Have a great week.

Bob French 45:50
Wade and Alex are both principals and 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 a risk including risk of loss. Past performance does not guarantee future results.