Episode 34: Even In Volatile Markets, Find Out Why The 4% Rule Distribution May Be Too Low

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. We'll start with the bad news. You may underspend in your retirement and not live your best life as a result, the good news, your kids will enjoy it for you. On second thought,

Wade Pfau 00:54
Hey, everyone, welcome to another episode of retire with style. I'm Wade, and I'm joined by Alex and today we're going to continue the conversation on the 4% rule and its assumptions and start with a new track on why actually everything else being set aside with assumptions, the 4% rule could be too low in some cases. And there's six factors we'd like to look at it, I think we can get through the first four factors today. And then later on, we get into variable spending, which could easily be multiple episodes. So we'll just have to play that one by ear. But at least what we're going to start with today reasons why the 4% rule might actually be too low, include the 30 year assumption may be too long in some considerations, that retirement spending won't keep pace with inflation throughout retirement, that people will use a broader portfolio diversification then assumed by the simple asset classes of the 4% rule. And we'll also touch upon buffer assets, which is something we did talk about with the four ways to manage sequence of returns risk. It's kind of one of these things that it's doesn't fit perfectly anywhere, but will and it's not necessarily a total return strategy. But we'll we'll at least address briefly about buffer assets to date as well. And that'll be the first four issues make it fit Wade, we'll make it fit. And then in subsequent episodes on this theme, we'll talk more about variable spending strategies as well as how having reliable income from outside of the portfolio such as Social Security, pensions, annuities, can actually help support behaving differently with your investment portfolio potentially being more aggressive, both in terms of well asset allocation as well as spending. But that'll be the next subsequent episodes. Before we get started on that. Alex, what's what's new in your world?

Alex Murguia 02:51
Since the last podcast, I think this little cup of Cuban coffee is the new thing that's in my world. We're right there's there's a suspension of reality, right in this podcast.

Wade Pfau 03:04
You can kind of see it again. kayfabe on this. So we're doing two episodes back to back

Alex Murguia 03:10
What is that. Is that like the fourth wall or something?

Wade Pfau 03:13
Speak for what goes on behind the scenes. you're inhaling our inner world live.

Alex Murguia 03:19
Yeah. I framed that as we're breaking down that fourth wall right and on. TV. My wife is home. So that's new, and I got myself a cup of coffee. What about yourself? Wade,

Wade Pfau 03:36
well, same old, same old. The weather it's getting cooler. Refreshing time a year?

Alex Murguia 03:43
Well, that's right. Actually, you can tell it's for this this week. Most definitely. It's especially

Wade Pfau 03:48
during tank lock here this podcast, which I'll probably be about two weeks after the recording time. But yeah, we're really letting you in behind the scenes here right now.

Alex Murguia 04:00
Sorry, Wade, I Oh, can we continue? Did you have something else planned that I meant

Wade Pfau 04:06
to talk about how the s&p 500 dropped 4% yesterday, but or two days ago. But uh, by the time I say oh, but we want to keep this evergreen that this isn't gonna actually play right away. So everyone's forgotten about the time they hear the episode.

Alex Murguia 04:23
Well, the title of why the 4% rule may be too low coming off a market like 4% drop, you know, may may may be resonating with people because we're gonna switch it up and be optimistic and talk about why it may be too high.

Wade Pfau 04:40
Yeah, this is good news. The cup is half full. Yeah. Yeah. And actually the perfect keep the theme going there. What we ended the previous episode with was, well, what if 30 years is not a long enough assumption for the retirement Horizon? Well, you can flip that what if 30 years is too long, and this is my guy. I've gotten questions from financial advisors who will say something like, my client is 85 years old. It seems like probably the 4% rule isn't right for them. But I thought it was a universal rule that you always apply. So I'm not really sure. Could you clarify that for me? And indeed, an 85 year old if they're, I guess, in this context, just retiring, because the 4% rule is only meant to apply to the first year of retirement. Yeah, they may not have to plan for a 30 year retirement horizon. And if the retirement horizon is less than 30 years, there's not a 4% rule in that context either to round up so with Bill

bankings assumptions around the 50/50 portfolio, the historical safe Max, you could say that 30 years is 4% 20 years, 5% 15 years, 6% 10 years. 8%. So you kind of get that that's the sustainable withdrawal. The is the worst case, the highest spending rate you could have used in the worst case, historical rolling of that year, many years periods in history. So in the worst case, 10 year rolling historical period 8% Well, 8.16% was the worst case scenario. In the worst case, 15 year historical period. 6.01% was the worst case scenario. In the worst case, 20 year period. 4.98% was the worst case scenario, and in the worst case, 30 year period, that's our our 4% Rule friend 4.03%. So it was the worst case scenario.

Alex Murguia 06:35
So what are you saying that if your horizon is 10 years, Dave Ramsey, you may have finally gotten it right.

Wade Pfau 06:41
Yeah, that's what he says was the safe withdrawal rate for each veteran 10 years? But that's, I don't know, there's not that much more to say about it. I mean, in the previous episode, we started getting into the forum D rules. But even that it's pretty much as simple as this. If, if 30 years is longer than you need to plan for the No, you're not constrained to using something like the 4% rule.

Alex Murguia 07:20
Yeah, but I also think just to leave it at that, just, look, we're dealing with a soft science. And so there are no hard and fast rules for anything. I think that's something that you may have picked up here. That's why we're agnostic to various strategies, frankly, because there's many ways to get it, right. This is not thermodynamics, where when input goes and when input has a commodity, etc. And so I'm going back to the advisor that wrote wrote you a letter or an email or whatnot, saying, Hey, I thought this is like kind of the standard rule. And this is a something, you know, some sort of Axiom. No, that's the farthest thing from the truth. The reality is, it's just that starting point, kind of weather gauge, if you will. And if you're 85 years old, you're definitely not looking at a 30 year horizon, if you are, you know, more power to you. But most likely, you're not. And even if you're 105, still going strong, you're not, you're not active, you know, and from a spending standpoint, so you can relax the assumptions a little bit. Not a little bit. Yeah, significantly. So, I mean, it's it's not it's nothing to sneeze at, if you go from a 4% rule to a 6% rule, by you know, cutting in half the horizon 30 years to 15 years. That's a 50% increase. That's that's a lot.

Wade Pfau 08:37
Yeah, and that's it's the shorter the horizon, the higher that withdrawal rate, I mean, at the extreme, a one year planning horizon, of course, the safe Max is 100%. And then you just take it from there, two year planning horizon, it's going to be Well, it'd be under 50%. In the worst case scenario, that's kind of

Alex Murguia 08:56
this goes back to even your payment. I mean, intuitively, it's your payment calculation. Your payment flow calculation is one of the Levers, one of the main Levers is horizon. And it has a significant, significant effect that the shorter the time horizon is. That's right. It doesn't go linearly. It almost like goes yeah, it's not linear at all. It carbolic. Yeah.

Wade Pfau 09:17
Yeah. Yeah. So I think that covers the first of the four issues we want to look at today. The second one is retirees may not necessarily require that constant inflation adjusted spending. So that there we're not assuming that your spending grows with inflation every year of retirement. We've talked about this on the podcast already, because we had David Blanchett on a past episode. And one of the many things he's well known for is the retirement spending smile, which is just this idea that you don't, you're spending doesn't grow with inflation throughout retirement it it doesn't keep pace with inflation. It could even be 20 to 30% Less by your 80s Compared to your 60s. It may pick up again later in life due to rising health expenses or long term care expenses. But it still ends up being quite a bit less than if you had just increased spending with inflation for every year of retirement. There's a couple of different directions we can go with that. It's just, you know, one thing that listeners should should know the terms because you do hear him from time to time, there was a book written in the late 1990s by Michael Stein, where he coined the phrase, the Go Go years, the slow go years, and the no go years. And roughly speaking, he would say like, well, if we think of the traditional retirement age at 65, the gogo years are, say, 65 to 75. That's the early retirement period, when you're as healthy as you ever gonna be when you're doing all these things, that kind of everyday is a Saturday, traveling the world doing everything that you've always wanted to do this leisure, you may spend a lot during the gogo years. And then he says the slow go years, ages 75 to 85. That's where you start slowing down, you're not necessarily doing as much traveling, you're not engaging in as expensive of hobbies, you're spending more time at home, maybe going to the discount at the Old Country Buffet, instead of going to the nicer Steakhouse, that that sort of thing that just reduces the bills and reduces the amount that you're spending in that time period. And then the the no go years, ages 85 and older, you don't have a lot of like leisure or discretionary spending necessarily, at that point, you're kind of staying at home, taking it easy, that maybe some other health expenses are picking up there. But your other aside from Health and Long Term Care, you're not spending as much at those ages most of the time. And that that's a very different assumption than what the 4% rule is, which was that your your spending, whatever you're spending that 65 It's going to be that same amount plus inflation in every subsequent year throughout your entire retirement.

Alex Murguia 12:05
The the point, I would two more points, I would add to that, you know, spending crosses a whole variety of, of sectors, you know, there's spending for leisure, they're spending for home goods, they're spending for food, they're spending for health care, and they all have different levels of inflation. And so from that vantage point as well, you know, essential expenses may lag from an inflationary standpoint to more recreational ones. And so that sort of exacerbates that sort of spending smile. But the other piece to Wade, I would say, and and we'll just take what's happening now, currently, where we're in this period of high inflation, and put it marry it to a practical use case, if you will, you know, at McLean, we have clients that come in for meetings, and many of our clients are in this accumulation mode. And so we have a retirement spending plan for them. And the folks that are in a total return strategy. We're not necessarily saying well inflation based on the latest CPI numbers, it's it's it's a percent. So we're gonna increase your paycheck your retirement income paycheck by 8%. You know, there's not that expectation that will you can if you absolutely, absolutely need it, and you're on a plan to see if it's viable, but it's, you know, it doesn't run on clockwork like that there. You know, folks just don't naturally

spend that much, you know, relative to the lessor even though inflation was what it was. It's not tied one on one with their own particular spending. Wade,

Wade Pfau 13:43
Yeah, yeah. And just given an example of trying to put some kind of number around this too, like, I ran the numbers on from David Blanchett retirement spending smile. And I don't remember if we even discussed this on that episode, but just a brief moment to repeat it, if we did already discuss it. Looking at his kind of typical retirement spending pattern for somebody who's spending about $100,000 a year in retirement from age 65, into their mid 80s. Their spending drops in inflation adjusted terms by more than 26%. And then that's when it starts picking up again. But then I took that pattern and applied it to kind of the the bill bangin safe Max formula with all the same assumptions except that instead of using constant inflation adjusted spending, you're using this spending smile pattern of spending. And because spending declines over time, your initial spending rate can be higher specifically 4%. Went up to 4.7% that you are safe Max with with a spending smile. That was 4.7% instead of 4%. Which means something it means you could have retired with 15% Less invest Spend assets than otherwise. And so it's important to kind of get a sense of just understanding the constant inflation adjusted spending strategy is a conservative spending strategy. I mean, it's a conservative assumption. But maybe it's overly conservative in many, not in all cases, but in many cases, and so it's, it's worth thinking about the budget, and whether it is reasonable to assume that certain expenses will decline with age, and that you can account for that in your budgeting or not.

Alex Murguia 15:33
I think that's a great point. And if you're on a podcast, you know, you have your podcast player up, I suggest you hit the rewind, 15 seconds twice and listen to it again, because I think this point, really strikes home with you know, I see it with clients, again, this this is a more this gives people a lot of clarity in terms of what to expect, you know, as they're spending within a total return approach. I think it's dead on. If you're looking for more personal advice, please know that our show is sponsored by McLean Asset Management. Learn more at McLeanam.com. That's McLeanam.com. McLean Asset Management is a wealth management firm where we help you design and implement the right retirement plan for you.

Wade Pfau 16:24
Yeah, so that's good news. That's, that's an important reason why the 4% rule could be too low in that context. What else we got away? Yeah, yeah, we're kind of flying through these. So the next one is that the the 4% rule is based on simple asset classes, it's generally and this was, you know, reviewing building and research. Initially, it was large cap US stocks, or the s&p 500. intermediate term US government bonds with about a five year maturity. Now, that's going to be the sweet spot for bonds always that you get the highest sustainable withdrawal rates with those intermediate term government bonds. But if you start adding other asset classes, you can bump up the withdrawal rate and one of Bill begins early studies in this area. And it's actually a few, like read his interviews and so forth. He doesn't talk about the 4% rule, he actually talks about the four and a half percent rule, because he put a very healthy allocation to small cap stocks, not not like a market capitalization weighted, it was approximately 40%, small cap 20%, large cap 40% bonds, and that got his historical safe backs up to about was 4.59% or about, you know, rounding to four and a half percent in that context. And that's the

first of many examples of just having this conversation around. Yeah, if you use a broader asset allocation, that gives you a better combination of risk and return, it doesn't necessarily have to increase the return. But if you lower the volatility of the portfolio, that's going to help push you to higher withdrawal rates. And so, of course, it varies by user, but a broader asset allocation could certainly be used as a justification for a higher spending number, potentially.

Alex Murguia 18:18
Not just a couple of points here, with regards to the allocation because I think I think it was two episodes ago, three episodes ago, we we made the point of people sometimes get too cute with their allocations in terms of an origin, an over engineering kind of component. And so from from the vantage point of what you're saying, I think what's important is that we're not, you know, established, there's two types of ways to look at allocation, right? There's strategic allocation, and tactical allocation, strategic allocation is isn't I'm gonna look at the investment literature, and I'm gonna, I'm trying to assess to the best of my abilities, you know, how to how to create a diversified portfolio among different asset classes. Now, an asset class in at least in my definition, is, you know, a sector within the market that has an expected return, you know, that has sort of has some sort of signal in terms of how you're going to be compensated for diversifying into that particular asset class. And if you look at the market history, there's certain factors that that provide these compensated market driven returns, as you know, being in the market, there is exposure to value stocks versus growth stocks, you know, the jury's out, some people say they're really maybe no small cap premium, after all, but let's just assume there's a small cap premium, you know, small cap stocks versus larger cap stocks, there's momentum, there's a little bit of a momentum factor but there's also quality of earnings versus versus just having the general market the sort of exposure. So if you overweight to quality, size and value, not overweight, but you have exposure to those asset classes within the markets international and domestic Now you've created a portfolio in which you are sort of being compensated for these different dimensions of risk. And so just want to make that clear when we're looking at different types of asset classes as opposed to the technology sector, or, you know, transportation sector, those aren't necessarily you're not necessarily being compensated for exposure to those sectors above and beyond what the general market would bring you. In fact, you may be actually creating more volatility than necessary. And so from the vantage point of what way to saying, it really bears mentioning, you want to diversify your portfolio across the different dimensions of compensated risk within the market. And doing it in such a way that you can reduce the volatility not diversification doesn't necessarily mean your portfolio volatility will go to zero, you know, simply because you're bringing in uncorrelated assets, that's, that's a very tough thing to do. Especially if you're in the market already, you're not going to find that uncorrelated Eldorado kind of sector. So you want to just make sure that you have that sort of healthy exposure to them, and you'll, you'll get compensated for it. That's, that's, I just want to point that out, wait, and this is not an investment podcast episode or anything along those lines, I just want to point out that from a strategic standpoint, once you do that, that's really you've done a lot tactical allocation. Remember, that's a strategic asset allocation, a tactical allocation approach would be isn't that something I would espouse and way you can speak for yourself, but I don't think you would either. That's where it's like, hey, things are cheap, right now. I'm gonna go all in in the market, hey, I don't like where inflation is heading, I'm gonna get out of the market. Or, hey, look, I see where things are going, I'm gonna go all energy, I'm gonna put all you know, I'm gonna reallocate I'm gonna get out of technology, and we're going to enter the energy sector. That's, that's something that if you're again, you're going to be

violating anything that Wade is most likely saying, with regards to how a diversified portfolio can help you extend, if you will, a sustainable withdrawal rate, because the original study was just looking at the US s&p 500. Wade.

Wade Pfau 22:11
Yeah, no, I think that's a great way to think about it. And it's a you don't need to overdo it with the the asset allocation. But, you know, certainly, most people are going to use more than two asset classes. And, and it is it's the risk return trade offs. And if you can get the risk better under control through diversification. Yeah, it's an avenue towards at least having the potential that you could spend more than the 4% rule, just because you are using broader portfolio diversification. And we're not saying that, necessarily overdo it, or over engineer it. But, you know, two asset classes is for the most part, probably under doing it in most cases.

Alex Murguia 22:51
And the other piece that you said, and I think it mentioned and again, we didn't, we don't, don't usually go into too much, because, you know, it brings in this news factor. But with regards to bonds, as well, I mean, Wade has said this on numerous occasions, but the intermediate term bonds are the sort of sweet spot. And what that means that obviously, it's return per unit of risk, right, there's an expected return per unit of risk that you're taking. And as you go further on the yield curve, and the yield curve is effectively, you know, six month t bills have a certain year, right? And it increased, that yield increases as you extend the maturity, you know, six months, a year, three years, five years, seven years and 10 years, 1530 years, right, let's say something like that, right. And it, you know, there's a steady increase until about, let's say, five to seven years, historically speaking, five to seven years, and then it kind of levels out, you know, there may be a little bit more at the 10,15,30. Sometimes there isn't, and that's when they say there's an inverted yield curve, and that's portending of recession or something like that. But the point is, once you get past that five, seven year period, the standard deviation on those bonds increases significantly. So relative to the extra risk you're taking. And so from that vantage point, you know, when we're looking at this, and when we're looking at diversifying across fixed income, you're really looking at, you know, not extending the term, you know, and by that, I mean, the, the length of time of these bonds beyond five, seven years as for the purposes of this, of this approach, you know, specifically because there's no extra return and within the total return construct, remember, the whole purpose of fixed income is to be a ballast to your entire portfolio, because you're trying to reduce that, that volatility so you can take the sustainable withdrawal rate. It's hard enough to create a safe withdrawal rate from a volatile portfolio. Hit hustle working within that construct, you really have to reduce that volatility. And that's why, you know, in the previous episode, we talked about investing for yield and things along those lines, you really want to get to what you really want to disabuse yourself from that. You know, from an allocation standpoint when you're creating this sustainable withdrawal rate. I added that point of the bonds Wade, because I think you you mentioned it a couple times. But I think the importance of that merits the strobe light kind of attention.

Wade Pfau 25:08
Yeah, absolutely. Yeah. So now we've talked about broader portfolio diversification. Another, Alex and I were talking about whether or not to bring up this other point as well. But you know, you could ever changing the glide path of the asset allocation as well could be another avenue here. And in particular,

Michael Kitsis, and I wrote an article about a rising equity glide path in retirement, that became quite popular with the media, because it's kind of intuitive. It does have some behavioral considerations. I know David Blanchett doesn't like it. And for a long time out, so is that one of these examples, after having a few drinks at a conference, he'll start explaining why he didn't like it. But at that point, I'd had enough drinks me or David, David. But I'd have enough drinks, like the teacher and peanuts aren't where I I never know what he was talking about at that point. But uh, he published an article in The Social Science Research Network in July called spending elasticity and optimal portfolio risk levels, which explains his critique of the rising equity glide path. And yeah, I mean, it, because of the assumption, everything's got assumptions if you start varying assumptions, so we can get into that as well. But yeah, as part of this asset allocation conversation, we should probably make reference to the rising equity glide path.

Alex Murguia 26:32
I think it's an interesting, it's a topic, you know, personally, I always try to, whenever it comes up, I try to get to the next subject. Because it's like, Oh, my goodness, here we go again, because all the things and that's another thing, I guess it's more of all the things that I think you've written about. This is the one that strikes a chord with people in a funny sort of way. I mean, it's a lot of the stuff you have done is impactful. That's not what I mean. But I mean, it more like for some reason, some people really just hang on to this concept. Yeah. And it resonates. Can't let go of it. Yeah, like I've never seen before, is it they can't kind of let go of it. And it's interesting, like, we're gonna get questions about this. And I know Bob is like, Oh, my goodness, here we go. Again, somebody with a pricing glide path question. I'm almost what is your take on it? Before you go into it? What because I'm sure these you know, you wrote about it, and enough time has passed that you've been able to digest it? Right? What What's your personal take on it just aside from this podcast, kind of thing? Like, what do you think about it, and then we can sort of incorporate it into the pie.

Wade Pfau 27:34
On it was, it's an interesting way to manage sequence of returns risk that could kind of the 4% rule tells you to invest aggressively throughout retirement. And the rising equity glide path IDEA says, actually, as long as you're willing to get more aggressive over time, you can actually start with a lower stock allocation at the beginning of retirement, and then just behaviorally behavior. It's a whole nother issue, but mathematically, that can help manage the sequence of returns risk and retirement. And I still feel and like when I see when now, I can now understand David Blanchett critique, it's because of a different assumption. But we can can dig into all that. But that's that's all it was. It was just an interesting exploration that it's the lifetime sequence of returns risk is your the most vulnerable to market volatility around the retirement date. And so the rising equity glide path idea is pre retirement, it's what the target date funds do. So when you're young, you have a higher stock allocation. As you approach retirement, you have a lower stock allocation. But we've already talked about target date funds, they don't really do. They're not considering retirement income, they're either staying with a low stock allocation, or they're even getting lower throughout retirement. And what we were saying is actually from the context of managing Retirement Risk, rather than keeping that low stock allocation that you have at retirement, you could actually let it start to go back up over time as you go into retirement

Alex Murguia 29:04
two caveats. Because I don't want somebody listening thinking, Oh, I start with zero and in five years, I'm at 100% equity,

Wade Pfau 29:10
that would be an extreme version.

Alex Murguia 29:13
But I just you know, I'm saying that to make the point more than the case that what what is your what kind of is your in the study? What were you looking

Wade Pfau 29:22
Yeah the case study, we were where the analysis, kind of instead of being 60% stocks throughout your entire retirement, you maybe you start at 30% stocks and work your way back up to 60% stocks about in how many to retire 10 or 15 years into retirement.

Alex Murguia 29:38
Okay, so it's 15 years 30% You're doing 2% a year. Right? So it's a very measured approach. Something it's something else I want to drive home is it's not it's not tactical based on Oh, the market is I don't like how the markets are doing so I'm going to start low because you know, the winter is coming. You're doing Buying. It's simply because sequence risk. Remember the first few years, the five years before and the five years into retirement, you have the most are most impactful with regards to your distribution ability to take distributions from your portfolio. So effectively if you start with a conservative allocation around that window, that fragile decade, if you will, if you start with a very conservative allocation during that time period, you're kind of, but better seeing yourself from this volatility. Hence, once you get past that fragile decade, you know, you're kind of like you're in the clear is too strong of a word. But you're kind of in the clear from the fragile they get. So you can start, you know, with confidence, taking an allocation from this higher, I mean, taking a distribution from this higher allocation. That's the whole point that there's there's a sort of, I'm conservative, because this is my fragile decade, and I really can't afford the volatility. Right. And once I'm past that, I'm good. And so it may merit you explaining, how impactful is that fragile decade to your investment distribution success?

Wade Pfau 31:07
Oh, right. I mean, it's very impactful of one early study before many years before the rising equity glide path was just estimating that if he had a 30 year long retirement, the cumulative market performance during the first 10 years of retirement, explains 80% of what is a sustainable spending rate for that retirement. So it's, if you had a bad first 10 years, it really doesn't matter what happens after that you're going to be stuck with a low sustainable spending thing.

Alex Murguia 31:35
So explains 80% is another way of saying the first 10 years of your retirement while you're taking distribution, is going to explain 80% of the outcome that you will have

Wade Pfau 31:47

Yeah, so that the first 33% of your retirement duration. What happens is responsible for 80% of your entire retirement,

Alex Murguia 31:57
so it's disproportion

Wade Pfau 31:59
Disproportionate

Alex Murguia 31:59
disproportion, it's not equal. So by going and remember it in the previous episodes, we're saying, Okay, if you start with a 35%, you know, the bang and stuff is like anywhere from 35 to 80%, you're kind of in the ballpark, right? So let's say for argument's sake, you know, you want to kind of implement something like this, because you don't want to be subject to the vagaries of the market, right? So would wait is saying, Okay, start at 35% Take a distribution and ratchet it up 2% Every year, until you're at, I don't know, whatever. 65% 60%. At that point, you can afford to be 60% Because you got past your fragile decade. Wade, I want you to correct me if I'm if I'm wrong, I'm just trying to reframe this.

Wade Pfau 32:40
Think back to the 4% rule, again, how it was based on the 30 year period from 1966 to 1995. Well, even in that historical context, 1982 is this big turning point, a retiree named can add to could have used almost a 10% withdrawal rate. It's like markets do great after 1982. But it was still the worst case scenario, the 1966 retiree, even though the second half of their retirement was the best case scenario. And that's the this rising equity glide path is just saying, you know, of course the true worst case scenarios you have 30 years of bad market returns, but nothing will solve that kind of practical worst case scenario, you have bad market returns early on, and then good market returns later on. And that's exactly what the rising equity glide path will help manage for you.

Alex Murguia 33:33
Let's take a moment to let the audience know that this show is sponsored by Retirement Researcher. You can learn more about Retirement Researcher at retirementresearcher.com And subscribe to our newsletter, where You'll receive weekly actionable information for your retirement planning benefit. Retirement Researcher is an online community devoted to helping you create the retirement income plan geared towards your goals. What was Blanchard's assumption? That's different? Yeah, then years ago, I'm just curious, I forgot

Wade Pfau 34:05
Well to explain it as simply as possible. It's retirees can be flexible with their spending, which is actually what we're going to be spending a lot of time on with the next episode. But if you assume retirees are flexible with the spending, that the assumption we use to create the rising equity glide path article was the same as the 4% rule around you want constant inflation adjusted spending? If you move away from the requirement of constant inflation adjusted spending, it weakens that case for a rising equity glide path.

Alex Murguia 34:34
Well, I would say this in your defense, and Michael, I mean, if David was there, he probably have a witty response, but he's not necessarily changing the assumption he's changing the landscape under which the investigation is being that you're introducing a whole new variable that people will change, you know, their their spending pattern, but we purposely are not doing that for you know, from an apples to apples kind of comparison.

Wade Pfau 34:58
We'll get into with the Next episode A the opposite of constant inflation adjusted spending as constant percentage just spend a percent of what's left every year. And there's actually no sequence of returns risk with that strategy. Therefore, it there's no need for rising equity glide path, because the the order of returns doesn't matter. So I think ultimately, I mean, the simplest way to explain it is he's kind of picking up some of that phenomenon in his argument of why he's not a fan of the rising equity glide path.

Alex Murguia 35:30
What do you what do you say to my comment that I've said before to you, that the equity, rising equity glide path, if you look at retirement income strategies, again, total return risk rap income protection, time segmentation? I almost view this as a hybrid, total return and time segmentation approach, because you're kind of taking an artificially low bond allocation to start with, and you're kind of using that as a buffer is too strong a word, because you're not artificially high. It's a duplication. Right? Yeah, sorry, sorry, you're using an artificially high bond allocation, which is kind of like a time segmentation thing where you're, you know, for, you know, that the first initial years to get out of that fragile decade, what are your thoughts around that? When I when I sort of said, Hey, Wade, the first time I read it, that's what I kind of saw.

Wade Pfau 36:20
And actually, what prompted the article in the first place was we'd read in a previous article, this Michael Kitsis, and I just looking more at using annuities in retirement. And what we kind of recognize there was, if you treat the present value of all your annuity payments, as part of your bond holdings, as you go through retirement and you receive the annuity payments, the present value of your remaining annuity payments get smaller. And so in practical terms, as long as your investment portfolio is not declining as rapidly, when you have an annuity in retirement, you have a rising equity glide path. And so part of the reason the annuity could help was because it created a rising equity glide path for you. And so then we just took that intuition and applied it to a pure total return world, or what if you just set your asset allocation to be a rising equity glide path? So that was the original motivation of it? And yeah, you could also interpret that as a time segmentation where maybe I'll set up a tenure bond ladder that I won't replenish, that will also give you a rising equity glide path. So yeah, yeah, that's,

Alex Murguia 37:29
yeah, that's how I kind of viewed it. What's the what are the biggest arguments that you get about that? Because this is kind of think about it. This is the opposite of a target date fund, you know, in terms of how they're coming across an allocation, at least for the fragile decade portion. What's your argument? What are the kind of the some of the arguments you hear that people kind of misunderstand? And what I'm getting at it, just to start it off? Sometimes people say, Oh, Wade, that's crazy. I mean, you're

espousing somebody go from 3070 portfolio to 100% equity portfolio in 10 years. And so they're going to be at five, and they're going to have this, you know, very, very aggressive portfolio.

Wade Pfau 38:16
Yet, right? I mean, so that could just be a misunderstanding, because you don't have to get so aggressive. But leaving that aside, behavioral piece, and I think even Moshe malevsky, tweeted something, I forget exactly what he said, but like, right, I'm gonna have my 90 year old grandma be 90% stocks. And yes, there is a behavioral element to this, that may not work. And I don't, I don't argue against that at all. I'm just not I'm not advocating for the rising equity glide path. I just thought it was a an interesting article to write. But yeah, if INRIA in real life, of course, if in your 60s, you get used to less portfolio volatility, it could be hard to introduce more portfolio volatility in your 70s and 80s. And if that's the case, then it's not really a practical approach to take.

Alex Murguia 39:07
No, but I would say in your defense, I think sometimes those that's kind of a straw man kind of tweet. You know, in deference to Moshe, I think the guy is, you know, he's the leader in the field that, you know, by, you know, there's him and everyone else, frankly, I think you'd agree with that.

Wade Pfau 39:25
distinction made between like researchers in the United States versus researchers in North America, because when you add in North America, Moshe trumps everyone.

Alex Murguia 39:36
Yeah, right. But I would say, you know, like what you said earlier, listen, you were talking about going from like 35%, which is abnormally low to you know, even if you do 2% A year for 10 years, okay, you're at 55% equity. It's that that's kind of range bound, and that's why I thought it was good to put some sort of range bound and to be clear, we're not advocating that we don't know your situation. We don't know your you know your age. Use or anything like that we're just trying to provide some sort of magnitude of what range you may be talking about Wade. When it comes to this rising equity glide path. We're not saying go from 30% equity to 100%. Equity.

Wade Pfau 40:12
Yeah, yeah. And it just speaks to a broader point too, because this comes up for me and other issues too, you know, part of doing research is, you see an interesting idea, you test it out, you write an article about it, you move on, but then sometimes it gets latched on to you as you become a lifelong advocate of whatever that particular article was about. And that's not necessarily the case, I'm, I'm certainly not a spending, I've dedicated my life to telling people they should use a rising equity line in retirement. It was one article. A couple of are kind of related, but it was just something that I thought was worth exploring, not not something I've dedicated my life to.

Alex Murguia 40:52
No, I mean, what I like about it is, and this is what the purpose of research is to move forward a research agenda. And you kind of you know, good publicity, bad publicity, to some extent, not that this was either but it had people's attention. And then whether good, I think it's good from a scientific

standpoint, somebody writes a counter argument, somebody writes or whatever, either way, it doesn't matter. I mean, wait as much as anyone is agnostic about these things. But if it moves the science forward, if it takes the dialogue forward, that's kind of what you want. And I think your the article did that.

Wade Pfau 41:30
Yeah, thank you. Okay. So he talked about the portfolio diversification. And that could also include just different glide paths in retirement, the last topic for this episode, and it's this one that's always hard to fit in, but it's buffer assets. And we talked about it as part of the four ways to manage sequence of returns risk, it's actually not necessarily a pure total return approach, it's, it could be just as much a part of any retirement style. But to remind listeners, again, a buffer asset is something held outside your portfolio that you don't really treat as part of your portfolio. And I know when we talked about it before, I said non correlated asset but to be more precise, usually they die ideas, it doesn't experience losses, it may not give you a positive return, but at least doesn't have a negative return, it's only can be zero or positive returns. So when the stock market goes down, the buffer assets not losing value. And it can provide a temporary resource that during when it looks like your portfolio's in trouble, okay, I'm not going to spend for my portfolio, I'm going to try to leave it alone, so it can recover, I'm going to temporarily spend from my buffer asset, and that helps manage sequence of returns risks so that if you have a buffer asset on the side, of course, you're introducing a new asset to the picture. But 4% is no longer as risky, because you've got this kind of release valve for sequence risk, you're gonna, you're not going to take every distribution from the portfolio, you'll occasionally take a distribution from your buffer asset, and therefore, that can support a higher withdrawal rate for the investment.

Alex Murguia 43:11
What are some what are some buffer assets, Wade, because we get this a lot. And you even though you've given the definition, I think a lot of times people will write in and they'll say, I have this buffer asset, and then it'll be something like a rental property or something. Right. And I, I think it's worth mentioning what you're thinking of exactly, or what an example is of a buffer effort that you're thinking of, because I still don't think a rental property does the trick, if you will.

Wade Pfau 43:39
And there's really only three that I would say are true buffer assets and the rest, you kind of have to get into arguments about the three buffer assets or cash, just having cash on the sidelines. Cash Value for a whole life insurance policy that you could take loans from, and a Home Equity Conversion Mortgage, AKA a reverse mortgage, a variable rate reverse mortgage, that has that growing line of credit. And that's the end of the lesson.

Alex Murguia 44:11
Now, you know, not to make this whole episode, but you've mentioned two things that get a bad rap a little bit. And it's the right situation for the right person, you know, etc, etc, etc. caveats. What do you mean by cash from, from a HELOC from a non perfectly though not sorry, sorry, yeah, I know, that's why I said reverse mortgage and what do you mean by cash from a reverse mortgage? And what do you mean by cash from a whole life policy?

Wade Pfau 44:42
So the reverse mortgage has that growing line of credit that cannot lose value over time that you can borrow from as that spending resource and so the reason that a traditional home equity line of credit will not work as a buffer asset is they can be frozen or cancelled. And we've seen this in 2008, during the low wages quite a bit during 2020, during the pandemic, at the exact time, you'd want to tap into that resource, it's frozen on you. So a traditional home equity line of credit is not a buffer asset. But the Home Equity Conversion Mortgage, the reverse mortgage has protections that you are able to access that guaranteed you're not, it can't be frozen or canceled. The cash value of whole life insurance is kind of is interesting how these two very different financial products experience a similar evolution where they were talking about them in the same manner. And it was the same idea with the cash value of whole life insurance, it can't decrease in value, it can only either not grow or grow in a positive manner. And you can structure a policy loan from that. And the same way you're the reverse mortgages alone, you're borrowing from the home equity, with cash value, you're borrowing from the cash flow, or the from the life insurance policy. And that provides a temporary spending resource, now it's it, there'll be interest that then the loan balance will grow. But the idea is, this is a buffer asset, that by helping them manage sequence of returns risk, can hopefully better position your portfolio and odds are, it will better position your portfolio to recover and grow by more so that you can then pay off that loan balance and still have a net positive windfall at the end of retirement.

Alex Murguia 46:31
So an example, an example would be something like, Okay, I've just retired, I'm here to in retirement, I'm still in that fragile decade, sort of danger zone, you know, to borrow from Top Gun, or whatever you want to call it, you're still in that danger zone, and you're like, oh, you know what, I don't want to take distributions this year from my portfolio, because it's down 25%, whatever. So instead of that you take from the reverse mortgage, or you take from the life insurance policy, and you may have to do that for two years. But in that time period, that portfolio, you know, if your probability safety, failure, probability optionality kind of thing, your this is your style, right? You're betting on the portfolio recover, right, the portfolio recovers, it's recovered nicely, you're able to pay back the loans, and you're able to take a distribution from the portfolio. That's, that's the idea behind it.

Wade Pfau 47:24
and paying back. Because that's somewhat voluntary. It is, yeah, one potential strategy is to voluntarily pay back the loan in advance so that it doesn't grow with interest and instead got more borrowing capacity in the future. But that may not be there's some flexibility about whether or not you do that. There was something else I was going to say, oh, yeah, the like. So actually, when we talked about this, before some questions came in, well, what sort of rule do you use to decide when should I draw from the buffer asset, instead of drawing from the portfolio, a lot of different rules have been introduced. Some of them or something just along the lines of, okay, if the if your portfolio lost value in the year before the year prior, then this year, you'll spend from the buffer asset. If your portfolio had a gain in the previous year, then this year you'd spend from the portfolio. There's a lot of different rules like that I was I never published an article on this, but I did behind the scenes play around with this concept, and ended up using it for the reverse mortgage book, that updated third edition that came out this year. That a very simple rule, that also seems to work just as well as anything more complicated. And so it's, it's simply, when you retire, look at the What's your investment balance, add up your taxable accounts, tax,

deferred IRAs, Roth accounts, add it up, keep track of that number. In the future, whenever you want to spend or take a distribution, look at how much your investment assets are worth. If they're worth more than what you start had at the start of retirement, just in nominal terms, you don't have to even worry about inflation adjustments span from the portfolio. If your remaining portfolio balance is less than it was at the start of retirement, that's when you can tap into the buffer asset. And that simple rule works just as well as any more complicated rule that somebody could and has developed over the years. I see you're at a loss for words with that stunning.

Alex Murguia 49:35
I'm doing some mental calculation right now. I was thinking what you said how you're the simplicity of things and I think that's a reoccurring theme. And we'll get to this you know, in future episodes. I know that when we asked Brian to come on and just talk about how things are done in practical. We're talking here in theory right now. But how this is practically implemented, I think what you said you don't have to make things overly complicated. You know, I think simplicity and parsimony rules a day, when it comes to implementing a successful retirement income strategy. We're just pointing out levers right now, what are levers that work? What are levers that are valid? What are levers that aren't valid? Where are where are where there are potential dragons that that you want to be careful with? That I think that's when I was listening to you. That's what I was thinking that this kind of hits the theme of the overall podcast.

Wade Pfau 50:27
And this is going to become a big theme in our next episode as well, because we're going to talk about variable spending strategies. And that's an area where financial advisors get very creative and create very complicated strategies. And just something I've been working on recently, as well as trying to find ways to simplify all that so that there's just a few basic levers instead of some of the crazy things you have to keep track of if you're trying to implement the pure version of one of these variable spending strategies. So that that might be a good preview and this episode, because I think we're, we have covered the first four items on our list. So what's left other reasons why the 4% rule may actually be too low Are you can use a variable spending strategy, and you have reliable income outside your portfolio that makes it you're less vulnerable to a market downturn and therefore can be more aggressive.

Alex Murguia 51:22
And with that, thanks well, yeah, we got it in under 50. Big guy, what do you think?

Wade Pfau 51:28
we better hurry up and wrap this up. We're gonna hit the 50. I'll do that. Thank you, everyone. Have a great weekend. See you next time. I'm gonna talk about variable spending in retirement.

Alex Murguia 51:38
Catch you later. Bye. 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.

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