Episode 35: Beyond the 4% Rule - Part 1: Different Portfolio Retirement Income Strategies That May Work Better For You

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. In this episode, Wade and Alex go with the flow and discuss the key assumptions on integrating a more dynamic withdrawal strategy to your retirement plan.

Alex Murguia 00:50
Hey, everybody, I'm Alex. And I'm here with Wade, and welcome to Retire with Style. Wade, what are we talking about today, man?

Wade Pfau 01:00
That's right. Today, we are talking about additional reasons why the 4% rule might be too low. And in particular, we're getting to the topic of variable spending, where you don't just stick to having the same inflation adjusted spending amount throughout retirement and how that can have a big impact. And in particular, this is going to be a two parter. We'll talk more about how to think about evaluating different variable spending strategies in this episode. In the next episode, we'll actually talk about different variable spending strategies. So quite an agenda.

Alex Murguia 01:31
Quite an agenda. But before we get to that agenda, let's add some variety. Right. What do we have any any chit chat? Chit Chat talk today? Are we we spent? We spent?

Wade Pfau 01:45
We are out of chit chat?

Alex Murguia 01:48
That is a that is a nice shirt. Is that light starch? Or did you just put it on right out of the dryer.

Wade Pfau 01:56
It looks like it has been ironed at one point. I haven't been wearing these shirts too often. But I do have a local speaking engagement tonight. So that's why I'm dre-

Alex Murguia 02:06
Oh, really

Wade Pfau 02:06
a little more dressed up than usual?

Alex Murguia 02:09
Yeah. Is that been kicking up since post? COVID?

Wade Pfau 02:13
Oh, it has? Yeah. Especially October next month, or actually, by the time this airs may already be right around October 1. It's going to be my first travel month. It really looks like a pre pandemic style travel month. Not the busiest month I've ever had, but certainly it wouldn't look out of place pre pandemic for sure.

Alex Murguia 02:35
Yeah, I remember I remember it was it was kind of tough just like lock you in on meetings. And don't forget the collar stays man. Don't forget the collar stays. They make all the difference.

Wade Pfau 02:46
Yeah, they do. But these shirts I think have the shorter ones. Sometimes they're longer sometimes they're shorter. Haven't been right now but I'll be wearing a tie because otherwise,

Alex Murguia 02:55
I think those missed conference shots keys I've ever gotten. I think Orion Orion years ago gave us these collar stays and I treat them like Bitcoin codes. I take them everywhere. Just in case. All right. All right, man. Is that good that that's a fight

Wade Pfau 03:16
to get through the airline security. I always worry about those. I've never had any issue with them.

Alex Murguia 03:23
Yeah, this is a plastic resin. No, I don't know what the hell yeah.

Wade Pfau 03:28
Yeah, one time. My son had a well kind of like Hot Wheels. But it was a bullet train did a little bit bigger than wheels, metal. And an extra at the airport. It kind of shows up looking pretty dangerous. So they had to search his my four year old son's bag to find out he had a bullet train Hot Wheels type car. Wire, and

Alex Murguia 03:50

I'm sure when you go through security, the word the name file just lights up all sorts of alarms, I suppose. Although, although, in the interest of everyone weighed led me on to getting the TSA Pre approval. Oh, yes, Mike. You haven't? You haven't lived until. Until you do that?

Wade Pfau 04:12
Yeah, Alex travels quite a bit and it takes 30 minutes one day to get TSA PreCheck and instead of doing that he spends hours in the normal security line. I I never understood that. But finally you've entered the 21st century.

Alex Murguia 04:26
Wait, you're just cutting me up in front of everyone. Just cutting. Goodness gracious.

Wade Pfau 04:34
TSA PreCheck

Alex Murguia 04:35
of all the things you've said that's the best advice I've gotten from that's the one that resonated the most with me. The TSA PreCheck

Wade Pfau 04:48
airports TSA PreCheck and then have to wait 20 minutes for you to go through there.

Alex Murguia 04:54
Such an elitist he walks by you know looking at me with with this disdain look

Wade Pfau 04:59
I take stuff out of my bag donor shoes off screen.

Alex Murguia 05:04
Okay. All right variable spending strategies.

Wade Pfau 05:08
Yeah. And just as a quick reminder on that, so we're talking about reasons why the 4% rule is it may be too low. We've talked about how real world retirees spending may not grow with inflation throughout retirement, how retirees might use broader portfolio diversification, how they may have a buffer asset outside the portfolio that they can coordinate with, how 30 years might be too long of a time horizon. And then now the two issues that we have left, but the real really quietly, closely related, so it's hard to say one without the other, but it's the variable spending, retirees may be flexible to adjust spending in retirement. And also retirees have other reliable income from outside their investment portfolio, such that even if they deplete their investment portfolio, it's less harmful, it's not catastrophic. And therefore, by having that capacity to bear market risk, they might decide to behave more aggressively, spend more aggressively, invest more aggressively with the understanding, because it's tied into this idea of variable spending, maybe you can make some cuts to that portfolio distribution and not destroy your

retirement. So that's where we are today is the variable spending and the fact that the how that relates to having resources outside the portfolio as well.

Alex Murguia 06:27
Now, the the point of departure, I just want to make sure that everyone, you know, is on board here is we've been talking about sustainable withdrawal rates, but we've been talking about them in terms of right, the constant spending strategy so far the 4% rule or those those spending strategies are known as constant spending strategies, even though the dollar amount may change from year to year because it's uh, you know, the the 4% rule take it takes that nominal amount and then adjust for inflation. So it'll be different year after year, they're still referred to as a constant spending strategy. Okay, and

Wade Pfau 07:01
constant real spending that Yeah. And adjusted spending is constant.

Alex Murguia 07:06
But nominally nominal. Yeah, absolutely, absolutely. But nominal changes. This Now we're entering the world of variable spending strategy, which is another way of looking at it. And so Wait, are you gonna say something?

Wade Pfau 07:21
Well, yeah, and maybe some more clarity there as well. Earlier, we talked about things like David Blanchett spending, smile, and so forth. That is a variable spending strategy. But that would be a pre planned variable spending strategy where you know, in advance, it's not based on how your portfolio is performing, but based on just your spending needs, that you won't have constant inflation adjusted spending. Now we're adding in this element of, you don't necessarily know exactly how much you're going to spend in the future, because you will make adjustments based on how your portfolio is performing. So it's variable spending in the sense that you're actually responding to your portfolio's performance and adjusting your spending when your portfolio's Well, you might spend more when your portfolio's not doing as well, you may make some cuts, that's what we mean by variable spending.

Alex Murguia 08:10
Okay, thank you. I just wanted to make sure we we lay the groundwork for that. And there's a few extra components to this, that, that require analysis. And because there are many different types of spendy bearable spending strategies, which will we'll went into I mean, in this episode, what we're trying to do is wait very much just to lay the groundwork for how to make apples to apples comparisons. Among all of these spending strategies. Would you say? That's a correct assessment?

Wade Pfau 08:37
Yeah, yeah. In this episode, we'll just we need to provide some context about how you can even compare, because if you compare two different variable spending strategies, they may have very different spending experiences, and how do you decide among them? Or how do you sign between them? So we need to lay some some groundwork for how to think about evaluating different variable spending strategies.

Alex Murguia 09:01
Okay, what's some criteria around that?

Wade Pfau 09:04
Well, yeah, I mean, to start with, there's a few different things you can be thinking about. So how much does the strategy respond to the market performance? Like the the 4% rule would be there's no response, it's, it doesn't matter if markets are doing great markets are doing poorly, you're gonna keep spending the same amount. But the first kind of thing to consider is like, how much deviation will they'll be market's doing well, versus markets doing poorly? How much do you want this spread between how much spending might adjust between those different types of scenarios? You might also look at, are you more interested in a strategy that starts with a higher spending level? And because of that may have more likelihood to decline over time, at least in inflation adjusted terms? And that might be something that appeals more to a front loading preference, or are you someone who is more comfortable starting at a lower base, but then being more likely to eat increase that spending over time. And that might be more of a backloading preference.

Alex Murguia 10:05
And so I'm glad you said that way. Because I had it on my kind of things I wanted to introduce is, if you're listening to the words where we're actually using to describe variable spending strategies, you know, you think about probability base, right? And that's obvious because we're in the market, and it's probabilities. But really optionality comes to the forefront now, when you're talking about this flexibility of spending strategies, and you mentioned front loading, as well, the secondary Risa factors, but one of the primary risk factors is commitment orientation, and optionality, this really drives home the point of optionality because you are and distribution focus this distribution focus. I mean, this accumulation focus versus distribution focus. And optionality is you're willing to have that variable paycheck. You know, there's a big picture that you're playing, that's, that's the, that's the plan that you have this bigger picture, right? And you're willing to, to concentrate on a bigger picture in exchange for this variability of income, you're, you're fine with the variability of income. And that optionality you need that, that that construct, to be able to implement that?

Wade Pfau 11:14
Right. And that's where, like, so we've talked a lot about the 4% rule concept and how it's really not a usable strategy, like something academics would say about the 4% rule is, if you want a volatile investment portfolio, which the 4% rule assumes, you need your spending to also be volatile or to fluctuate to be variable. If you don't want variable spending, you really don't have any business using a volatile investment portfolio. And so in the broader context of the total return strategy, because it's probability based, because it's using the market, and because you want that optionality, it really does suggest, there should be some open mindedness to the idea of using a variable spending strategy. And if you don't have follow up with that, let me

Alex Murguia 12:11
work on trying to work on

Wade Pfau 12:14

balancing your checkbook over there.

Alex Murguia 12:21
Trying to work on my give and take my listening skills, I was reading a book and it said, Hey, you have two years, for reasons implementing it

Wade Pfau 12:33
very well. But the other kind of issue to to be thinking about just in terms of like broader issues of how do you want to evaluate different spending strategies is, how much volatility Do you want to allow within the spending strategy? Now, generally, a strategy that might have bigger fluctuations in spending might allow you to have a higher average level of spending, because it's taking on more risk, but the risk spending may go up, but it also may go down by more. And is that something you're comfortable with versus a strategy that may not fluctuate as much with the spending, but nonetheless, would have a lower average level of spending over that retirement horizon? And that that's the the three kind of broad issues to be thinking about. And then we get into as the issue of how do you compare different variable spending strategies. Now, the 4% rule, safe MAX type concept or anything with constant inflation, just as spending, we hear so much about like a probability of success, which is measuring how frequently the portfolio does not deplete in that retirement. Now, some episodes back, we had David Blanchett on the show. And I don't remember the exact conversation. But I know one of the big points he often emphasizes is he hates the probability of success. So I'm hoping he talked about that, in our episode, probably did. And initially with that, is just that for some of these variable spending strategies, you can't even use a probability of success. Because if the, if it's a very variable strategy, it's going to keep cutting spending before the portfolio hit zero, so that the portfolio never technically hit zero.

Alex Murguia 14:14
Can I interrupt you Wade, just take out the ticket a little bit, because we introduced the concept of why he didn't like wasn't a big fan of the probability of success. And we said in previous episodes, but let's just assume we may have a new listener or someone forgot as well. Ultimately, when we're talking about probability of success, you know, within a stochastic model within a Monte Carlo simulation kind of method, what you're, what you're doing is you're running, you have an expected return and you have variability around that expected return. So it can create many different types of runs, many different simulations. And so let's say you put in your portfolio expected return with a volatility component, and how much money is going to go in and out, you know, or during that lifestyle. And so you do 100 1000 of these, now let's just make 100, you do 100 Of these, right? Out of the 100 runs, you know, and let's say and one more point, let's say the end number that you want the portfolio value at the end, you never want to be below zero. Because you don't want your ending value to ever be below zero. You can put whatever number you want, but let's say below zero, right? And let's say you do this 100 times you run 100 simulations, and 90 of them, and above zero, and 10 of them and below zero, or zero and below, right. And that would be a 90% success rate in terms of 90% of them, were good, 10% of them are bad, but think about this. And from a binary standpoint, it's either yes or no, they either succeeded or not. Right, there's no magnitude of failure, the 10 that didn't succeed, maybe they failed by $1. Maybe they failed by $1. Right. And so and maybe that the 50 of them that succeeded, succeeded by $3. There's really no difference between those runs. And but because it had this magical number of zero, then above and below, and but I don't think it's, you know, I don't think anyone's psychologically

any more comfortable winning, you know, ending with $3 in the bank, then with negative $1. In the bank, it's really the same outcome. And so from that vantage point, that's a problem. You know, well, I agree with David there that, you know, there's always the saying, Look, you rather be approximately right, that definitely incorrect, you know, I get that comment. And it's a good barometer to spirometer, to see where you're going. But from the point of view of Monte Carlo and success rates, you really have to take that into consideration, because that's a huge, huge caveat. You know, what's the magnitude of the failure for the ones that failed? And, and you know, that that's where it's, it's an issue, as opposed to it being more of a progressive thing. Like, you're 80% of the way there, you're 90% of the way there. That's not what Monte Carlo is answering other things answer that like a funded ration and things like that. Wait, sorry, I just wanted to do the little, you know, what's called when a book there's a little page that's like, great, that you can reference it's color

Wade Pfau 17:13
box or something? Yeah. For the Yeah. And that's kind of the point is, if you fail, it's you might have failed by $1. Or you might have failed by $100,000. The the probability of success just, it throws away a lot of information by only defining each outcome as yes or no fail or not fail. Which actually, I was using a bit of a bad analogy, because yeah, that's a definite problem with the probability of success measure. But I was in the context of variable spending. Another problem is just simply that you can't use the probability of success because a true variable spending strategy would never let the portfolio hit zero in the first place. Instead, it's because it's lowering your spending, rather than letting you're keeping your spending up, but letting the portfolio drop to zero.

Alex Murguia 18:02
let me give a little call out box for that one, too, just because I think again, if people are haven't been listening in, it's good. So if you're using a constant withdrawal spending strategy, this is where, okay, you have a nominal amount you adjust for inflation, but that amount remains the same. Right? So let's assume there's never inflation, inflation is zero every year, right? And you take out 10 $10, the first year, and there's no return on the investment, eventually, you will run out of money, you know, as you take out $10 $10, let's say 100,000, out, whatever, eventually you hit zero. And you go out if you're doing a variable spending strategy, which is a percent of the portfolio. Technically speaking, let's say you take 4% of the portfolio the first year 4% of the portfolio the next year, 4%, the third year 4%, the fourth year, if you're not gonna run out of money, technically, even if you're taking out three cents.

Wade Pfau 18:59
Right, right. Or even if you're cutting up that last penny, yes, technically, from the perspective of software, it never hit zero. Yeah, exactly. Yeah, never, it never you, you can't have failure in that context. Which is why we have to look at something different. And that's where some years back, I created this idea of a payroll, which isn't used as the metric to evaluate the strategy. It's all these other factors we were talking about before, like the direction of spending, the volatility of spending. That's really like how much spending varies between different portions of the distribution. That's really how you evaluate the strategies, but to compare them on an equal footing to have the same amount of downside risk. I go to the payroll. And in a way that probability of success is a kind of payroll but it's more limited. It's like a very specific example versus a broader general theory. So that the payroll is Pay stands for probability that your wealth drops before below a certain age amount by year why of

retirement. So an accepted probability that wealth falls below a, by your why a retirement. And when you decide on a payroll to use, you can start to compare that calibrates the downside risk of each strategy. And then you can evaluate the strategies on these other metrics that we've mentioned.

Alex Murguia 20:29
So where you what you're able to do here is take all of these variable spending strategies and give it uniformity, for analysis. You know, so you mean, you know, and this is important. I mean, there's many folks that read, you know, you pick up a journal, you pick up a magazine, you pick up, even the Wall Street Journal will start having these kinds of articles, hey, this person has this superduper variable spending strategy that you know, etc. And there's 10 of them, and they all look good. And you want to sort of make sense of them all. The payroll gives it that, that sort of, there's something in software that sort of uniforms it all out for you. I think the most amazing advancement with a payroll Wait is that you are actually able to pick out an acronym that spells up pay.

Wade Pfau 21:14
Yeah, that's really cool. I initially I was kind of the XYZ role, but then later figured out pay.

Alex Murguia 21:24
So again, pay the p is the probability that you accept the A is the amount of wealth and why is the certain number of years and is a female, dear.

Wade Pfau 21:38
But like I was also saying, so bill paying and safe Max idea is an example of a payroll, it's just an example of a payroll leak that isn't broader for evaluating variable spending. But the 4% rule idea to just recall that idea it was based on the historical simulations, rolling historical data, those 67 numbers that Alex thought weren't enough, based on those 67,

Alex Murguia 22:01
you want to go into why they're not just to do a drive by

Wade Pfau 22:07
listen. But you have 0% probability that your wealth drops below $0 by the 30th, year of retirement. And so that's the implicit pay rule of building and safe Max, it's just to have a variable spending strategy, that a can't be zero. And that's the main issue. So you can accept, say, a 10% probability that my wealth drops below, say, $100,000 by year 30 of retirement. That's a payroll that calibrates the downside risk on different variable spending strategies, that gives you a way to evaluate them. And like I think kind of what you're alluding to. So like, one of the most famous examples of a variable spending strategy that we'll talk about more in the next episode is Jonathan guidance. And now, the guideline and cleaner decision rules. But when he first came out with that he was him about how you could increase the safe withdrawal rate? Well, there's an important caveat on that, yes, the initial withdrawal rate is higher. But that's because it builds in this capacity to cut spending throughout retirement. And that's where well, how do you evaluate the downside risk of that? Sure, I can start with a higher initial withdrawal rate if I have to cut my spending by 90% Later on, for example, but that's not necessarily going to be a better strategy. But how can you even start to compare the strategies? First, you have to accept a level of

downside risk that you're going to apply to all the different strategies, then you can start to compare the distributions of how the strategies perform in different market environments, how much spending might fall in different market environments, how much it might go up, what it does, on average, and so forth.

Alex Murguia 23:48
But when you say level of downside risk, again, just when you say level of downside risk, you mean, like, what is the nominal value of the portfolio that you don't want it to go below?

Wade Pfau 23:59
nominal or real, you could have a real amount or a nominal amount,

Alex Murguia 24:04
okay, but I just want to make sure it's not like I don't want the I don't want my portfolio to ever go down 30% a year. That's, that's not the downside risk we're measuring. It's the downside risk of the amount of money on your portfolios,

Wade Pfau 24:16
right? It's not the returns on the portfolio, it's I don't want the amount of remaining wealth to drop below a certain threshold. More than p percent of the time.

Alex Murguia 24:30
Yeah, by a given number of years.

Wade Pfau 24:33
Yes, by a wide number of years into that retirement.

Alex Murguia 24:36
No, that's pretty clever. Wade, I mean, I mean, in the truest sense of the word it you're able then to really give everything a an even an even standing. But you're also able to do it in a way that's relevant for that individual person. What I mean by that is, you may be like, I never wanted to go down. $250,000 I may be I never wanted to go down $150,000 Everyone has their own way. sort of level.

Wade Pfau 25:03
And that relates to the safety margin to that we've talked about a reason why the 4% rule might be too high as you might not want your portfolio to drop to zero. So the payroll in a way is incorporating a safety margin. But then all these factors interact as well like the, the longer the retirement horizon. So the bigger the white number may be, the smaller you're willing to accept for the a number because I might not want my wealth to drop below $500,000 by year 20, of retirement, but I might be willing to let it drop below $200,000 by year 40 of retirement. So either those could be payrolls, but then you just really need to decide on which one you want to use for the analysis so that you have that equal footing again, to start comparing different variable spending strategies. Okay. The other big thing to talk about in this episode is, well, how do you actually choose a payroll? Or, you know, what makes sense? Should that should you accept a 10% probability or a 20% probability that wealth drops below $500,000 or $200,000, by year 25, or by year 35? Kind of what goes into that? And so the a conservative pay rule

would be some combination of accepting a lower probability that the a the wealth drops below a higher amount by a shorter period at a smaller y number of years in retirement.

Alex Murguia 26:35
Can you take us through an example why just because this I can imagine people listening in, it's just a little tougher to conceptualize, you know, when we're talking about numbers like this. And incidentally, the you may be listening normal question could be, how do I, okay, payroll calculator, let me google it. You know, that kind of there's there's no payroll calculator out there. This is something that we've done internally, we do offer it, you know, as part of our retirement research to our retirement retirement to our retirement research or online community, that that is a paid service, though. So this is not something that's available just out there. What I would take away from this podcast is, you know, what are the levers that this helps me think about? In terms of creating this, if this is something that's of interest to you, then I encourage you to go to retirementresearcher.com. And check out the membership stuff. And I know, Bob does outros in which he, he discusses it. And there's a there's always a link on the show notes. But this is something that's internal to ourselves, but this is how we sort of analyze it. But there is value in discussing, it's simply because this is this is a way to make everything an apples to apples comparison.

Bob French 27:50
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.

Wade Pfau 28:16
Yeah, we do have the payroll calculator at for the Academy members. And there's most of the commercial financial planning software doesn't deal with the variable spending. So this is, I don't know, if it's 100% unique, I think there may be other software out there that can also look at this sort of dynamic spending. But it's still pretty rare, at least. And so indeed, this, if you're not an Academy member, it's more how to think about variable spending and how as you pull these different levers, what it can do. And that's why when we talk about some different variable spending strategies in the next episode, behind the scenes, I'm evaluating them with this payroll calculator from the the academy, but I'll talk about kind of the the findings or the implications of that. But back to this issue of choosing a payroll. It's a lot that goes into it. It's so we're trying to think about, you know, how much downside risk Am I willing to accept for my retirement? And so some factors that go into that. And so we'll just kind of define this as what goes into using a more conservative payroll, so allowing for a smaller chance of depleting assets or of letting my assets fall below a certain threshold. Well, it's how much reliable income do you have? And so that's where this series of podcasts is about total return as a strategy. But actually, now that we're talking about variable spending, this is where all the different retirement styles, the total returns, the time segmentation, the income protection and the risk scrap. They all have a discretionary spending piece that uses distributions from an investment portfolio. So that's where they If you're using income protection, or if you're Stiles income protection, you have reliable income to cover your core spending need outside of your portfolio. And even if your total return, you at least will have

Social Security as a as a reliable income source. And that is important that impacts how much risk you're potentially taking to having a bad retirement experience if markets don't do well. So if you don't have as much reliable income from outside the investment portfolio, you don't have that cushion to help protect you from market volatility, because you don't have these stable income sources that are not impacted by market volatility. And because of that, you probably want to use a more conservative payroll, you want to take less risk with potentially depleting or like having a smaller safety margin of what's left for your investment assets.

Alex Murguia 30:53
And what what would be a conservative number here, because I can imagine that many folks listening in have trouble even knowing, okay, is a 10% probability that my wealth falls below 150,000. To conservative to aggressive to moderate what, what, what are some zip codes here that that people can start working with?

Wade Pfau 31:15
First, yeah, that 150,000, you mentioned maybe in the context of a million dollars starting point for retirement. Yeah, so like the 4% rule. Again, it's not, if you switch over to Monte Carlo, it's really kind of saying you're accepting a five to 10% Chance based on historical data, not based on kind of the fact that interest rates are lower, and so forth, but a five to 10% chance that your wealth dropped to zero by year 30 of retirement. Now, we can relax that a little bit, maybe say, you know, kind of a moderate tight pay rule, except a 10% chance that your wealth drops. So if you started with a million, say, drops below 150,000, inflation adjusted by year 30, of retirement. And if you wanted to make that more conservative, maybe you accept a 5% chance that your million dollars drops below $200,000. By year 30 of retirement, if you're wanting to be more aggressive, you might accept a 20% chance that your wealth drops below $100,000 by year 30, of retirement. And I used your 30 for all three examples. But you can vary that. So if you're more aggressive, maybe you switch your 30 to your 25. If you're more conservative, maybe you switch your 30 to your 35. So that's a hopefully giving a sense of kind of broad parameters there. Now, asset allocation fits into that as well, where the 4% rule tells you to use 50 to 75% stocks in retirement. So some sort of asset allocation in that range, a more conservative investor might not go that aggressive with their asset allocation, and maybe a more aggressive investor would go to the higher or slightly higher end of that asset allocation range as well.

Alex Murguia 32:59
And Wade for folks that are listening, How is this not the same as someone, as opposed to saying, I'm going to use the constant example a 10% probability that well falls below 100,000? Over a 30? year time horizon? How is that not just this is kind of framed in the negative? What about every frame that, you know, 100 minus 10? Is 90 a 90%? Probability? That wealth is above $150,000? Right?

Wade Pfau 33:30
Yes, yeah, they're the same thing. But right, the framing matters. That's back to that behavior.

Alex Murguia 33:35

just want people are listening. So I want people to think is that because because I'm assuming people get MonteCarlo scores from their advisors and say, 90% chance of success, this is not the same. And I want you to

Wade Pfau 33:45
I kind of explain Yeah, so we're kind of at a 10% chance of failure, that that would be a 90%. So a 10% chance that your wealth drops below $100,000 is equivalent to a 90% chance that your will stays above $100,000. And that framing of the good outcome might make a difference about how people internalize the concept. But yet, just mathematically, they're equivalent. And so you can work with either approach. So thank you for that insight, Alex,

Alex Murguia 34:23
your service way that your shows.

Wade Pfau 34:26
So another factor that kind of guides the decision around a payroll is just how much flexibility do you have with your spending? Can you make cuts to your portfolio distribution without disrupting your lifestyle, to the extent that your spending is more kind of essential, fixed, maybe growing with inflation, you may not have flexibility to use a variable spending strategy. And if you don't have that flexibility, you kind of you need a more conservative payroll to help protect you from how Having to make cuts to spending. So the flexibility around spending is very important. The more flexible you are, the more aggressive you can be with how you think about a payroll.

Alex Murguia 35:09
And one of the keys here that you said in the last one, in terms of fewer reliable income sources, Wade made a point to say we make a distinction between discretionary and essential expenses. Right. And what Wade was saying previously, in terms of taking an account that reliable income sources was this in these other quadrants, or in the recent matrix, or assuming for core essentials, central expenses, you have reliable income, so everyone is going, you know, you're most likely, you're going to institute some sort of variable spending strategy, at the very least for discretionary. Now, this point is specific to total returns in the sense that within a total return construct other than Social Security, you're, you're looking at a spending strategy to fund both your essential and discretionary. And if you don't have that flexibility, as in, like, you may have a lot of essential expenses, you need to fund, you know, from your from your entire portfolio, because social security may not cut it for you, then that's going to affect here. How much flexibility you have in the sense of IE, how much can you go down over time? Right Way?

Wade Pfau 36:22
Yeah, yeah, absolutely. It's really that the kinds of issues you want to be thinking about? Yes, so the next one is maybe not entirely different from what we were just talking about with reliable income, but a sense of your reserves in the context of the funded ratio, how we think about assets is reliable income, diversified portfolio, and reserves. Well, if you don't have much in the way of reserves, you will likely lean towards having a more conservative payroll as well. So if you don't have a buffer asset, if you don't have insurance to protect you from different spending shocks, if you don't have like excess wealth,

you're overfunded for your retirement and so forth, then it's harder to take risk. And so you're going to lean towards calibrating your, your spending discussion to a more conservative type of payroll.

Alex Murguia 37:21
Yeah, and so what you're seeing here, so Wade is pointed out lower flexibility, fuel reserves, few reliable income sources. In the previous podcast, we kind of went through an item list of why the 4% rule may be too high, which, you know, effectively are these kinds of issues. And so if you are vulnerable to these kinds of issues, then you need to take a more conservative approach when it comes to analyzing your variable return strategies.

Wade Pfau 37:53
Absolutely. Now, another one that we can just mention briefly, because it is the a number in the payroll. But if you have a stronger desire to have a margin of safety, built into the plan, that would translate into using a higher a number and you don't want your wealth to drop below upper, you want to lower probability that your wealth drops below a threshold or you want I mean, you want to keep your wealth above a certain threshold. And so a desire to have a bigger margin of safety would translate into a more conservative payroll.

Alex Murguia 38:27
And the last one, I would say, or one of the key ones, because it's probably the why in the payroll is fear of outliving your assets. How, you know, if you do think you're going to live a very, very long time or the flipside is your assets or the way that dynamics work, the assets are low. You may outlive them, you want to pick a fairly conservative, you know, a fairly conservative, I don't know what time horizon

Wade Pfau 38:56
Yeah, that backloading preference. If you're more worried about outliving your money, that would translate into a more conservative pay rule, or again, broadening this discussion beyond just total returns. What we see with the Risa is a more concern about outliving your money, more of that backloading preference tends to correlate with income protection or risk wrap. And all these factors interact. Because if you're then using one of those styles, so that you have your basics covered. Well, now you have the the offsetting factor, you have more risk capacity at this point. So you might go with a more aggressive payroll, but just generally speaking, leaving aside assuming your total returns if you're a total return style, but you have worry about outliving your assets, that would translate into a more conservative payroll. Which, if it's not obvious in which we'll get to in our variable spending strategy would then translate into a lower spending level for that retirement plan.

Alex Murguia 39:59
Maybe This way.

Wade Pfau 40:01
Yeah, yeah, that gets us to the background of how about how to compare different strategies. The next step will be to actually discuss some of the main variable spending strategies out there. And that's what the next episode will be about.

Alex Murguia 40:15
All right, everyone, thank you very much.

Wade Pfau 40:17
Yeah, have a great week. I'll see you next week.

Bob French 40:20
Wade and Alex are both principals in McLean Asset Management and Retirement Researcher. Both are SEC registered investment advisors located in Tyson's Virginia. The opinions expressed in this program are for general informational and educational purposes only and are not intended to provide specific advice or recommendations for any individual or on any specific securities. To determine which investments may be appropriate for you, consult your financial advisor. All investing comes with the risk including risk of loss. Past performance does not guarantee future results.
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