Episode 41: Can Your Retirement Experience Count On Stocks For The Long Term?

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. On a very special episode of retire will style we'd like to welcome Michael Finke a to our inaugural Research Advisory Board. Over the course of the next month, he along with four other distinguished professionals will discuss their perspective on retirement income planning, and how the resource represents an exciting new chapter in that endeavor.

Wade Pfau 01:01
Hi, everyone, welcome to Retire with Style. I'm Wade, and I'm joined with my co host, Alex. And we're also joined today by a very special guest who's a returning so to speak with the show, Michael Finke, Professor of Wealth Management at the American College of Financial Services. And again,

Michael Finke 01:22
it's did I just step over your intro? I apologize.

Wade Pfau 01:27
No.

Alex Murguia 01:28
No No, Worries. We go live.

Wade Pfau 01:31
I was babbling I was trying to think up an intro for you. But you have a podcast of your own as well. That's now in its third season. Well Managed.

Michael Finke 01:43
With David Blanchett now of P. Jim, formerly of Morningstar. We're podcasts. You guys have a more popular podcast, which

Alex Murguia 01:54
Well I don't know about that. Well ask you something. Now. Do you guys have as much trouble as we do with the intro?

Michael Finke 02:02
This is the best intro we've ever had, honestly.

Alex Murguia 02:09
All right. All right. All right. And I'm glad I'm glad we're beating you in your podcast number that makes me happy may frustrate you. But it makes us happy. Right? Wade.

Wade Pfau 02:20
Yeah, it's it's hard to get data on that sort of thing. But I like to tell myself, this is a popular podcast.

Alex Murguia 02:31
As you guys can tell, listen in. I mean, way to Michael go way back to France. Even David, and I've recently come to know, Mike over this last year, specifically, great guy, great, great people. So welcome. And frankly, I'd like to just the beginning part, we have a good article to talk about that Michael recently introduced. But I'd like to start off on a business note that I'd like to welcome Michael to our advisory board for the RISA, the retirement income style awareness company that weighed in, I started, you know, off the back of the Risa. And this is something that we've been putting together for the last year, we may had a major announcement yesterday, the podcast is going to be public tomorrow. So it isn't kind of Back to the Future kind of comment. But Michaels is on this advisory board. And we're counting on him to really help us with the research aspect of what this research agenda of the research started. And we couldn't be happier. I mean, there's only so there's only a handful of people in the retirement income space that we really looked at. And you know, for guidance, and Michael is definitely at least the fourth or fifth. Right, right. Witness. Michael is definitely up there. Definitely up there. So we're

Wade Pfau 03:50
everyone else declined

Alex Murguia 03:52
Yeah, everyone else declined. No, no, no, no, we're like, thrilled to have Michael, join us. And, and, Michael, again, before we begin that, a few words may be some people get your take on, you know, how you how you even first heard about this. And, you know, and why you decided to join us and continue this journey with?

Michael Finke 04:15
Well, thank you, Alex. It's a very prestigious group. And I'm not sure how I was asked to join. But thank you very much for allowing me to be part of this journey. It is, you know, it's obviously something that I've been fascinated with for a long time, which How do you think about beginning to develop the right approach to creating a retirement income for yourself? Obviously, this is something that a lot of Americans are going through right now. They've got this big lump sum of money that they've saved in their 401k. They're going to figure out what to do with it. They've got to figure out how to use the right approach for them. Is it something that's going to emphasize safety? Is it good, or is it something that's going to emphasize growth? And I think what you guys have done is think in a more advanced way than anybody that I know of about how to actually assess whether or not one approach to retirement

income is best for you, or whether you should take another approach. And it's one of the things I like about it is that it's it's objective, you know, you it doesn't push one approach over another, it's just there to help people understand how their preferences align with a potential solution. So it is a very exciting idea. It's something that I think has not been measured previously, and oftentimes gets measured incorrectly using things like risk tolerance, which really has nothing to do with your preference for how you want to use your money in retirement to create a lifestyle. So it is something that is as a researcher, it is fascinating to me, it really does appear from looking at the data that it is a unique preference, that our preference for how we want to build an income in retirement is personal. And it differs among people that it's almost impossible to predict based on a lot of other financial indicators.

Alex Murguia 06:02
No, that's that. Thank you for that. And just, you know, I mean, Michael, and I, in way we've had discussions on already, you know, where things could be tweaked here and there or are taken in another direction. So we're very, very excited with with his input going forward. And again, we could at the beginning, but you know, we're thrilled to have him as part of this. Wade.

Wade Pfau 06:26
Yeah, that was a weird technical glitch. I got cut off of our podcasting, too. But I'm back. So if you were asking me a question, I didn't hear it.

Michael Finke 06:36
Yes, wait.

Wade Pfau 06:39
I am back.

Alex Murguia 06:42
Never need to say anything. Wae, it's a podcast, no one can see that you were cut off?

Wade Pfau 06:48
Well, you said Wade, is that you'd asked me a question. I was like,

Alex Murguia 06:53
No, I just meant that you have anything more to add with regards to Michael's appointment, then, you know, contribution to, to, to this craziness that we've called the reset.

Wade Pfau 07:03
I mean, absolutely. Like Michael really was the first person we started talking with when we were developing this just because he is such a well known name and has contributed so much to the retirement income research more broadly, that definitely the opportunity to have him involved is absolutely wonderful. And we're thankful and grateful that he's he's part of the the advisory board with us.

Alex Murguia 07:25

That's the Yep, it's awesome, man, we'll put a link to that announcement on the show notes. And also, January 23, we're going to start kind of peppering this Wade in myself, we'll have a master class on retirement income and your advisory practice. This one is obviously geared towards advisors, we do a lot for consumers. And we will have that sometime later on in the court in the first quarter of 2023. But January 23 24th, Wade and I will be having a masterclass on retirement income and how you can incorporate into your practice. So I do encourage you to sign up, that'll be on the show notes, and it will be limited. So the first 2000 people, we can we can accept simply because we don't want to pay for the licensing of the software. So there it is, I strongly suggest you sign up. And with that, Michael, you wrote, you know, I want to say a month ago, a month and change ago, a pretty cool article that I think actually lends itself well that this lends itself well to this whole retirement income. Just thought, if you will, in terms of how you want to think about it, how it's formed, and how people, if you take a different angle, it may look like something else. And you're challenging here in a very smart way, this sort of platitude or it could be a platitude, depending on how it's used. Right? invest for the long term and call it a bit. You want to expand upon that. And we'll begin chipping away at it.

Michael Finke 08:57
Yeah, let's start at the very end. Geez. Oh, go ahead. Yeah. Once again.

Wade Pfau 09:03
No, no, no I. But in terms of like when I talk about the primary Risa factor, the risk premium versus the risk pooling. I usually say that with the same data that you're talking about, in your article, the Morningstar data going back to 1926. Historically, the s&p 500 has outperformed long term US government bonds by about 6% a year on average. And so that's the risk premium, the idea that you take on market risk with equities and over the long term that should benefit you. And usually with a lot of how software works for financial advisors on so forth, that it's sort of a fixed risk premium that's baked in. And what your article is getting out is how that sort of assuming a 6% average risk premium really hides a lot of volatility around that where there can be long periods of time where the risk premium can be much lower and a lot of long periods of time where it can be higher. And so that's the really fascinating aspect. To, if that helps with an intro to your

Michael Finke 10:06
Thank you, thank you Wade, if we think about what risk means, when you're taking investment risk, from the traditional perspective of an economist risk means that there's going to be a wider variation in outcomes. So what does that mean? When it comes to retirement income, it means that there's going to be a wider variation in the amount of money that you spend every year. So if you imagine, when you're saving for retirement, you go to a bank, you put $1,000, in the bank, you say, invest in stocks, or invest in bonds, and then you come back to the bank five, or 10 or 20 years later, and you pull your money out. And the amount of money that you have to spend depends on the performance that you've got in those stock or bond investments over that five or 10 or 20 year period. And oftentimes, when we're projecting how much we're going to be able to spend in the future or how we should invest, we sort of assume that if we take more risk, we will have more money to spend. But that's not actually consistent with the economic idea of what it means to take risk. What it means to take risk is that you have to be more willing to accept a wider range of spending outcomes. So one of the things I wanted to study in this paper is historically, what does that look like if you had invested $1? How much did that

grow to over the next 20 years if you'd invested in safe investments, like CDs, or short term treasury bonds, if you invested in intermediate term bonds, or long term bonds, or stocks, and oftentimes, if you just look at those historical averages, you would assume well, of course, if I have a 10 year time horizon, I'm going to be able to spend more money if I invest all my money in stocks. And the reality is that it has not been that consistent historically. But we really went through this magic period in the middle of the 20th century in the United States, where if you had a long time horizon, your stocks would have just absolutely trounced bonds. And that really only happened twice in US history, we had this great period between 1934 and 1953, where $1 invested in stocks never grew to an amount less than $7, since 1990,

Alex Murguia 12:23
over a 20 year period

Michael Finke 12:27
since 1990. And there have been a number of 20 year periods since 1990 $1, has never grown as high as $7 over the course of the next 20 years. So in other words, we have this period between 1934 and 1953, where on average, $1 invested in stocks grew to $13 never grew to less than $7, over 20 years. And then we have this more recent period, where $1 never grew to $7. And yet, when we look to the future, we look at those historic return data from this period in the United States. That is not reappear reappeared for a long time, and is likely not to reappear again. And oftentimes when we use historical data, for example, when we try to simulate how much we can spend in retirement, using different types of strategies that involve taking investment risk, we can overestimate the amount of return that we're gonna get from investing in risky assets like stocks, and then we can underestimate the true spending risk that if you invest in stocks, and stocks do not perform well, you're gonna have to cut back on your lifestyle.

Alex Murguia 13:42
You know, you know, when you when you're saying this final, something that that came to mind, good pointing at two to two point there is two time periods where stocks individually perform, right, the bonds, right. And, and I think, you know, looking back at this, there have been two time periods where the opposite has happened, wasn't in 1979, or something like that, that after 10 1015 years of underperformance, you got good news, we polish the depth of equity. You know, it's kind of an inverse thing where there's never been a problem. And then a few years after '08, right, I want to say even 2016 2015 or something like that a similar sort of long period happened, where stocks, there was a long period of underperformance as well, it's kind of funny how we had you're pointing out there was these two big periods of outperformance and, you know, just anecdotally up on my top of my head without looking at the numbers, there have been two signals at least two significant long term periods of underperformance too.

Michael Finke 14:42
Yeah, and you don't even have to look that far back. You can look at say the beginning of 1999 through the end of 2000. And it was roughly a two year period where if you'd invested at the beginning of any one of those months in stocks over the next 10 years, you would have had less money than what you started with over a 10 year time horizon. In fact, it got as low one month, if you invested in the wrong

month, you would have had 70 cents for every dollar that you invested in stocks over the next 10 years. That really wasn't that long ago. I think a lot of people, you know, especially after the run up that we've had in the stock market since 2009, they start to believe that stocks only go up by 10% per year. But what we've seen is that, you know, valuations go up a lot, but it doesn't necessarily mean that we can expect those kinds of returns on the stock market for the next 10 or 20 years.

Alex Murguia 15:37
So I'm a I'm a client that walk into an advisors office, and he or she shows me this chart, this Ibbotson chart that shows you stuck to the long run where there's this chart that you'd be a moron not to put it on, but not put it in stocks, simply because you're seeing this 70 year period. You're saying Not so fast? Correct? Because of the because of what you just said that.

Michael Finke 16:00
Yeah, you know, much of that growth was that outperformance of stocks that occurred between in the mid 20th century in the United States. And then between 1979 Actually, in 1999, that was a second period 20 year period of a big run up in the stock market. But since 1990 really hasn't happened over 10 or 20 year periods, we just haven't seen that same amount of success now, where the problem really happens is when advisors use those historical data to project the safety of investing in stocks going forward. Because they assume that stocks are going to continue going to continue that outperformance that happened in the 20th century in the United States, it's probably not going to happen again. And I know that this is something that weighed for a long time has been criticizing is that, you know, if you just look at us data in the 20th century, you've got a pretty small window into what stocks could actually do. And if you look globally, then you see that yeah, stocks pretty much behave exactly the way economists would say that they would behave, which is that they sometimes outperform on average, they outperform, but sometimes they perform worse.

Wade Pfau 17:14
Yeah, and you make a few interesting points in the article as well about how like things may have changed, in particular, that could cause the risk premium to just not be as easy to realize in the future as it becomes easier to invest. Like for much of the 20th century. You couldn't just log into your brokerage account and and shift funds between different accounts. That was there was a more complicated process, and there were fewer households involved. And so could you talk a little bit about how sort of this changing institutional structure of investing maybe leading to a lower risk premium in the future?

Michael Finke 17:52
Yeah, why does Why do economists think that on average, you need to get a higher return to induce investors to buy stocks. It's because people don't like that variation in spending over time. But there's been a mystery and the mystery has been, why our stock returns so high historically, in the United States, it's actually called the equity premium puzzle. And one explanation is that people are just dumb. Another explanation is that it used to be hard to invest in a diversified portfolio of stocks for the average investor. If you think about the way the world worked back in 1970, if I wanted to buy stocks, I would have to go to my stockbroker, and I might have to pay 70 bucks to get them to trade shares of stock. And I they would, they would buy me shares of stock, and it would cost a lot of money to put together a

well diversified portfolio of a number of stocks. So oftentimes, when people invested in stocks, they only bought maybe five or six different stocks, which meant that their portfolio was not very efficient, which meant that you had to give them a bigger reward for taking investment risk. But today, we have mutual funds that are far more popular than they were in the past. Any anybody, including any employee now invest in mutual funds through their 401k and target date funds. The costs are instead of 75 bucks a trade they're there next to nothing. So it is so much easier and cheaper for the average American to buy stocks. And if that's the case, you would expect that maybe a component of that mysteriously high return of stocks is no longer a barrier. And the other the other thing is that stocks actually the the taxation on gains in stocks is the long term taxation is far more attractive now than it was even 30 years ago. So you reduce taxes, you reduce what's known as transaction costs, all of a sudden, it makes people want to enter to the stock market, they bid up the prices of stocks, but that means the expected return is going to be lower.

Wade Pfau 20:02
I see Alex talking, but he's muted at this point.

Alex Murguia 20:07
Okay, thank you Wade there. It's all right. What I said previously didn't matter. Now. So I was thinking of a counter to that. But obviously, I haven't thought of it as, as much as you have your assuming because of sort of illiquidity piece is removed, investors were, you know, the frictions of trading investors were given some sort of premium for this illiquidity. And now that those frictions are removed, that expectation is gone. I, I don't know. I mean, maybe, but I can't, you don't buy this sort of risk, risk. Stocks are riskier than bonds. Hence, investors are just natural, regardless of the frictions, investors are naturally going to expect a higher return over time, or at least over some periods of time, and the fact that they don't occur every year, and they were only present in two periods. Okay, so what they were present in two periods, and that's when you were rewarded for holding the stocks versus versus bonds, just simply because there's still a risk story there. And could you make the case that if frictions are removed, you know, isn't necessarily a good thing. Maybe there was a premium before because frictions were there. And it didn't allow people to train a lot. And as you know, you know, the more you're, the more you trade, the more mistakes you kind of make, and that in itself, that can be a crutch. Again, just this is my quick response here. And maybe I ran in circles on some of these arguments. But I would still think there's a risk story there. I mean, the fact that it doesn't happen consistently isn't itself is in itself, some sort of risk story. And I'm not so sure removing frictions, you know, lends itself to reduce premiums. Again, this is just an opinion, not a matter of fact, by any means.

Bob French 21:54
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.

Michael Finke 22:16
You know, one of the things you can look at is, how much are investors willing to pay for $1 of profit that the company makes on average. And what we saw is that, in the modern era, investors are willing to pay a lot more for $1 of profit, that suggests one of two things, either they're more comfortable

investing in stocks, like the transaction cost of investing in stocks have gone down and or they're more risk tolerant than they were before. It doesn't really matter in terms of what the reason is, what matters is that when stocks are more expensive, the premium that you get from investing in stocks is probably going to be lower. And in fact, I find that we look at that, and and I find that that that premium, the amount of money that people are willing to pay for $1 of profit is an incredibly strong predictor of how well in the future

Alex Murguia 23:16
100% I totally subscribe to that, I think you see that. It makes sense. And that's the whole premise of this right? And even, you know, a stock ownership has increased over the world or the country, etc, etc, that kind of implies that there's this increased appetite, at least for that type of exposure. And in then you're right, if the P E ratio goes up, you know, systematically over time that that implies that there is the borrower willing to pay more per dollar worth of earnings, etc, etc. You've done some work with that, too, right. With regards to the Cape ratio. Have you seen that being some sort of precursor to expected earnings expected returns going forward?

Michael Finke 23:54
You know, I want to make the point, also, Alex, that there is a consumer problem here. And the consumer problem is that sometimes when you go to the investment store, and you look up on the shelf, and you see stocks, and the expected return on the stocks, is advertised at 10 to 12% per year, you pick it off the shelf, and you say, Yeah, I want that. But if, if in reality, what it gives you is five to 6% per year, and bonds are giving you 5% per year, then I'm like well forget that I'm going to pick the bond off the shelf. Now. Absolutely. Now, one of the problems that I see is that oftentimes, if if it's true that stock returns going forward are probably going to be lower, which I think a lot of economists would assume they are. If you look at many of the big financial firms like BlackRock and JP Morgan, their projections of stock returns are not that 1210 to 12%. They're they're giving I think people are realistic idea of what stock returns are going to be going Going forward, and it's more like maybe 6%. So maybe six or 7%, you've got one box of the stocks that you can pull off the shelf, you've got a box of bonds that are 5%, you can choose which one you want, but you at least you have a realistic idea of what the trade offs are. But if you position the stocks is 12%. And now bonds are, you know, five and a half percent, then you you may be inducing people to make the bad decision, a bad decision about risk.

Alex Murguia 25:29
I think you're 100%. Right. Two questions from there, you ultimately getting in and for listeners, I just want to get to the point, yeah, Mike was bring up this, you know, return per unit of risk that you're taking, there's an economy to that, and you want to make sure you're getting compensated accordingly, for the return per unit of risk. And when you compare an expected six, protect return in stock rather than expected, I don't know 5.75% returns in bonds when, you know, you'd go with bonds all day long, from an efficiency standpoint, something that people could benefit from, and we chime in, as well, I know you've done some work. Because I'm very, I'm very sensitive to someone listening to this thinking. But that's what people say all the time, they say they expect to return to 6%. And been saying they expect to turn in 6% for the last 20 years or whatever. But you know what, it's not always the case. And these guys don't know what they're talking about, etc, etc. I think it's important that these folks realize that you're not guessing 6%, because it's been 12. And so you just get a sense that it's high,

there's a certain way that you build up an expected return model and, and, you know, for the benefit of our listeners, it may be beneficial for you to just quickly kind of go over how that was constructed?

Michael Finke 26:42
Well, I mean, there's a lot of voodoo science that goes into expected returns, but you can just do it using valuations of stocks. So there's what's known as a cape ratio, which is the price that you're paying for smoothed earnings over the last 10 years, you don't want to just use one year of earnings, you want to use earnings over the last 10 years for a company. Because it's you know, the earnings tend to go up during an expansion they go tend to go down during a recession. So you look at the average tenure earnings, and then you look at the how much money you're willing to pay for that stock. And that ends up being a surprisingly consistent predictor of what returns are going to be in the near future, let's say over the next 10 years. And in fact, since 1995, it's predicted tenure returns with a 90% degree of accuracy. And that actually got really depressing towards the end of 2021. Because if you looked at how high valuations were at the end of 2021, it would have suggested that the 10 year return on stocks is probably about 2%. And that's not that's before inflation, so the real after inflation return would probably have been negative. And we don't know what the returns are going to be between 2021 and 2031. But I wouldn't be shocked if that's actually accurate. I'm like Mr.

Wade Pfau 28:02
What does that do for retirement?

Michael Finke 28:06
I mean, at first thing, I think a lot of people retired in 2021, who met their savings target, they're like, Oh, I got a million bucks, I should be fine. And then they kept, you know, 60 or 70% of that in the stock market, because the stock market had done so well. And here they are, and now they're a million dollars is turned into $750,000. And I'm starting to wonder whether it was really a good decision to retire. But I think if they would have considered the fact that they're probably not going to get a very high return from taking a lot of risk back in 2021. The market really wasn't giving us very much both when bonds or stocks back in 2021. That also suggests that at different times, you can retire into a period where your portfolio expectations are relatively low, you could retire in a period where your portfolio expectations are pretty high. You know, obviously 2000 At the end of 2022, that's a much better time to retire than it would have been at the end of 2021 with the exact same amount of money. So if you just had all your money in cash over the last year, you're much better off now because bonds are paying a much higher yield. And stocks are much cheaper than they were at the end of 2021. But for people who retired at the end of 2021 It looks all bad news.

Alex Murguia 29:32
No, no, my God, it sounds. It's reality. But you don't sound like doom and gloom. You just sound like somebody that put some money in FTX last week thats all and it's bleeding out now

Michael Finke 29:46
We have a little bit of a discussion about the whole crypto phenomenon back in 2020.

Alex Murguia 29:53

Go ahead go ahead let it rip

Michael Finke 29:55
I ended up getting swept up in it and it's related to this idea that people tend to be get really excited about stuff that goes up in value a lot. And they imagine, gosh, what if I would have just invested in that a year ago, I would be a billionaire. You know, we tend to get attracted by shiny things. I think in a lot of ways, crypto was the ultimate shiny investment. And yet, it really was not an investment because there was nothing there. It was just something somebody invented, and they were inventing more of them all the time. And it's, I think people get disenchanted. And I'm especially worried about young people these days, because I think young people had a lot of their beliefs crushed over the last year, when it comes to investing, this whole idea of investing starting to seem not very appealing to a lot of people is just a scam, you're gonna lose money. You know, and I think for those of us who have been in this game for a while, especially those of us who had lived through the tech bubble of 1999 1998, we've seen what can happen when people invest, with their emotions with their sentiment, and not so much with a very realistic idea of what the returns are going to be. And I actually fault a lot of people in the financial world for pushing what was essentially obviously a shiny thing that was going to get a lot of people in trouble. And I think, especially with retirees, if, if they got attracted to that shiny thing, then it really knocked their whole financial situation off balance.

Alex Murguia 31:23
No, I disagree. I look, I think to me, it's, it's still one of these emerging capital kind of industries, where you don't know how this thing is gonna end up if there's even ultimately utility for it or not. I don't know. You know, I don't know enough about it to speak intelligently in that manner. But you know, what, what got me Michael, was folks to saying, Well, who knows if it's good or bad, just put 1% of your net worth in it and give it a go? I mean, that's equivalent of like, to me saying, Look, who knows, but put 1% of your assets on the kitchen table, and let's burn it. And let's, let's see what happens. You know, what, it's just a bad use of capital. And I don't know, it just seems senseless in that sense. I don't know what crypto lands I you know, you know, the good answer is, I don't know about crypto, but I'm a big planet. I'm a big fan of the blockchain, you know, that kind of like, cover my ass and just say that kind of answer. And, you know, I don't know, it's not like, I'm gonna read some thesis on the blockchain right now. It's not something I need to do. But it seems it's an industry that's still in this nascent stage. Ultimately, whether there's utility that comes from it, a handful of people say that, yes, this will upgrade something, there'll be utility from these networks. But that's, that's not for me to say. And that's not what people listen to retire with stock. But 100%, I think what you saw here was a case study in behavioral finance, where I'm buying it because it's going up, and I'm going to sell it to somebody else who will buy it at a higher price. And that's that.

Michael Finke 32:55
My only disagreement is not a nascent industry that magic beans, tulips have been a very old

Alex Murguia 33:02
No but I'm, I'm kind of trying to be nice and giving people credit, look, they are trying to create the sort of network that is, you know, more technologically efficient than the current system, etc, etc. But again,

that's the extent of my knowledge. I seem to, I'm willing to, like accept that as a possibility. Let me say like that,

Wade Pfau 33:23
Bringing this back to retirement, we've had past episodes about the idea of the funded ratio. And, Michael, he's good. Yeah. And that's why we're number one. But with the funded ratio, you just you take the bond yield, and you use that and you just the way it works is you assume all your investments mean bond like interest rates, and you see if you're playing can work without taking market risks. Now, a big critique of that approach, especially for more probability base minded individuals is, if too low of a return assumption, why would you assume you're only going to earn bond like returns when you have this big risk premium that you'll get with your diversified portfolio? And if I'm really understanding what you're saying, Michael, it's kind of leading to this point that you don't necessarily want to assume a high risk premium. It's not to say that you're not wanting to invest in the stock market. But it's more a matter of if you get some greater upside. That's wonderful, but don't don't expect to get a big risk premium with your retirement. And so it makes sure your plan can work without assuming a 6% or whatever risk premium is part of the calculation. It also might lead to and this is with the different retirement styles. Now, I've written a lot about this idea of risk premium versus risk pooling with annuities are insurance and annuities can look pretty good even competing against the 6% risk premium, but I guess the point is, if annuities are competing against a one or 2% risk premium That makes risk pooling a much more powerful generator of income and retirement. And I don't know if you may have some thoughts on that point as well.

Alex Murguia 35:09
Well, no other than I would say is, Michael, if you can also tell people what risk pooling is within your answer to so they get a sense of it.

Wade Pfau 35:18
Yes. Vocab person.

Alex Murguia 35:23
cake once in an example that was great, yeah. Example.

Bob French 35:27
Curious if you should be looking at a Roth conversion or one a Roth conversion even is head over to McLeanam.com/roth, to get McLean's free ebook Is a Roth Conversion Right For You, and learn about when you might want to do a Roth conversion. And when you might not just head over to McLeanam.com/roth To download your free ebook today.

Michael Finke 35:51
So if I'm investing for the future, and I'm investing in bonds, I've got to plan out in retirement how long the bonds are gonna last? So are they gonna last 90 or 95, or 100. And when I'm thinking about how long my money needs to last, I have to start thinking about how likely am I to be alive. So let's say you're a 65 year old, healthy woman, you've got a 10% chance you're gonna live to 100, you've got to spread out all your bond investments to the age of 100. And then you look at mortality table and you

see, well, I've got a 50/50 chance of making it to the age of 90, why don't I just pull my money together with a bunch of 65 year old woman, we can spend as if we're going to live to the age of 90, and then whoever is still alive continues to get the money if some of them die before the age of 90. So if someone dies at 80, they're essentially going to be subsidizing someone who lives to 100. But if we all pull our money today, instead of us having to spread our money out over 35 years, which means that we spend less every year, we can spread our money out over 25 years, which means we get to spend significantly more. And we don't have to worry about running out. Now that that's with bonds, but we could try to do that with stocks too. So we could try to spread our money to the age of 100. And we could assume that we're getting a risk premium. So we can spend more every year. And we might even hope that we can spend more than if we invested in bonds until the age of 90, which we could do if we pooled our money with other retirees. And that risk pooling essentially allows us to spend more with our safe investments, the alternative is that we can try to get an extra rate of return from accepting investment risk, but we still have to spread out our money to the age of 100. But what that also means is that if we don't get that premium that we hoped for, we're gonna have to cut way back on our spending. And that's what risk means in retirement. This means that if I don't get the return I'm hoping for if I live too long, I'm going to have to cut back on my spending. So what Wade is saying is that you have these two approaches. One is safety, one is taking risk. And you might take more risk with the hope that that allows you to spend more, but you also have to be willing to accept the possibility that you might have to spend less. And this This is why I think the better approach is to focus on how flexible you're willing to be what we discussed in our previous podcast, and fund those expenses that you can't be flexible on using risk pooling or some type of a safe investment like bonds. And then when it comes to our more flexible spending, then you can decide if you want to take investment risk, which means that your spending is going to be more volatile, or do you want to again, pool with other retirees. And there's also ways of taking investment risk and taking advantage of risk pooling, which essentially means that on average, you get to spend more, but your spending might be more variable. Very good question.

Alex Murguia 38:59
No, but I think it's very, very thorough. I mean, honestly, go to your podcast app, hit, rewind, 30 seconds, hit rewind, 30 seconds twice, and listen to it again, because it's it nobody, you know, it's very, to the point. I mean, that's what it's all about at the end of the day. And it got me to thinking when I was looking at when I was listening to you, I was looking at the chart from your article about the growth of the dollar over the next 20 years. And you started in 1990. And I will put a link to the show notes I recommend you check out there but it's actually really good and it's very approachable. And one of the things from looking at that chart, and I'm doing this from the from the from the point of view of an advisor, somebody's coming into my office, and it got me to thinking there's a gentleman called Scott Baldwin fosway, great guy over at DFA and he wants to do the presentation where it's kind of similar to this where hey, how accurate are you going to be in your advice for the lifecycle of your Your advisory career, right? It's very interesting. Like, I think you may get a kick out of it where, okay, if somebody walks into your office, and you pull up the charts and tell them, Okay, this is what we're going to invest in an 80/20 portfolio or somebody's 30 portfolio, how often are you going to be right? How often is that client going to look back seven years, 10 years later and say, Dude, I'm still underwater, what's going on here? Because that's, at the end of the day, you know, you can you can provide best in class advice, but that best in class or not best, but you can provide the stocks for the long term advice. And

until yourself, I'm going to be right on average. Right, but there's still gonna be a subset of people that throughout their life, you know, have been with you for 10 years, and then they're still waiting on that advice to hit. And it doesn't, you know, and I've always struggled with that as the wrong word. But it's as an advisor, if you if you're constantly telling the client, okay, well, look, 7030 portfolio, you do this 80% chance that you're going to make it, etc, etc, you give this advice enough times, yeah, you'll net out hopefully, okay. But the reality is, there's going to be a subset of people that are going to be with you for a very long time, and they're still going to be thinking, what am I going to see this? What am I going to see this? What am I going to see this. And so I look at your chart of growth of $1 over the next 20 years. And man, there are plenty of times where that growth of the dollar is below long term bonds. And so I'm I'm the advisor is going and doing their quarterly reports, and having these meetings with their clients, and then showing them Oh, look at your statements. And a lot of times the adviser is gonna have to say, Well, don't worry, it's coming, it's coming, you paid for the risk. Now get ready for the reward, you know, those kind of arguments? And I doubt I'm wondering, is anyone have ever given? Has anyone ever given serious thought to a study where it says, How accurate is your advice? If this is all you'd say, you know, how accurate has been your advice for the last, I don't know, 20 years, if all you've been doing is telling somebody, a total return is a way to go. And that's it.

Michael Finke 42:03
That's a great point. I mean, it's it's the advisor has to accept that there are going to be periods where they're going to be wrong for 20 years. And but I think they have to accept the consequences that, you know, this is, this is what I hope is gonna happen. But I have to live with the consequences of stuff not happening the way I hoped it would, you know, you can't this this whole retirement planning thing, it's nice to be very optimistic, you know, follow what I like to call faith based planning, in the sense that you have faith that the market is going to bail you out. But, you know, sometimes it doesn't, and you've got to be willing to accept the consequences.

Wade Pfau 42:50
On that cheery note, maybe hitting our time limit for this episode, I think

Michael Finke 42:56
he's gonna cut me off now.

Alex Murguia 42:58
We can't end like that Wade

Wade Pfau 43:05
a glass half empty glass half full,

Alex Murguia 43:08
I'm trying to hit home with is that look, you really need to have your spider senses in tune for what, what the client is kind of gravitated towards, that if you just pitch them on a slide deck, that's gonna start for the long term look, you know, it's in the bag, you'd be crazy not to do this, you're kind of fooling yourself, because there's going to be significant periods of time where that that story doesn't hit. And you're going to be making stuff up for the next 10-15 years, just to try to save face, when you set

expectations, and you say something, you know, you show them as opposed to the innocent chart, you show them the growth of $1 over the next one years, that Michael and David came up with. And you just say, this is the reality of things, this is the expectation of your, your trajectory with us. You know, this is this is kind of the best music Italian, then a person's making an informed decision. And, you know, we'll find out, you know, we're most likely gonna, we're here, she's most likely gonna laugh, but I think if you sell the returns, you're gonna die by the return. You know, and I think that's, that's very important in terms of not only your, your, you know, to your point, you know, I will be careless with advisors, right or wrong, it's really more about the investment experience that the client had. And, and that person, you know, was just trusting on faith. This whole novice starts, you're gonna turn around and look at corporate Central and all of that. I think it's more complicated than that. And I think yeah, you're doing when you walk into it. And that's all

Wade Pfau 44:44
There's a lot of advisors. I mean, there are a lot of advisors who really do say that the the job of the advisor is to convince the client to be as close to 100% stocks as possible to benefit from stocks for the long run. Yeah, this research that Michael's done, it's really pointed out that even 20 years may not be sufficient for the long run.

Alex Murguia 45:07
Agree, agreed. And there it is, it's really not much that it's really one of those that just buyer beware, it's a good article, we'll put it on there on the show notes and check it out. And you know, just to come full circle. Like I said, you know, we think about these things on a couple of levels. And I just like to thank Michael, for, you know, for joining us on this advisory board, and we're looking forward to his participation.

Wade Pfau 45:33
Yep. Thank you, Michael. And I don't know if I've ever mentioned it, but that article is in the advisor perspectives, and we will have that link in the show notes. So thanks, everyone, have a great we are in Thanksgiving week. So have a great Thanksgiving celebration, and we'll be back again next week. Thank you, Professor Michael, thank you for being our guest today.

Bob French 45:54
Thank you guys. 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.