Episode 9: Is there a role for Risk Tolerance Questionnaires within the RISA® Framework?

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. One person's risk is another's reward. I think that's right. Well, let's listen and find out with our hosts. Wade and Alex.

Alex Murguia 00:51
Hey, everybody, thank you for joining us on retire with style. I'm Alex and I'm here with Wade. Wade Pfau

Wade Pfau 01:03
What are we gonna be talking about today?

Alex Murguia 01:05
Well, hey, that's that's a great segue we know today, what we have on chef is we spent the previous episodes talking about these new fangled retirement income beliefs, and how they identify your retirement income personality, and then by extension, your strategies. And, you know, with that we took the the recent matrix and how probably the safety first and optionality commitment orientation are two factors that can, you know, be put together and help identify your strategies and style. But, you know, with all of that, something that we didn't speak about is risk tolerance and or loss aversion and how that factors into this, if at all, Wade, what do you think about that?

Wade Pfau 01:52
Yeah, it's an important topic, because, well, first, we probably should take a step back and explain what this risk tolerance business is all about. But then we really want to dig into, like, naturally, people want to think that the RISA is somehow a risk tolerance for retirement. And that's, that's not what it is. But we want to really dig into why they're different, and why they're not incompatible with each other. But why the reset really needs to come first in the conversation before you even think about something like risk tolerance.

Alex Murguia 02:21
Yeah, no, I think you're right. I think it's one of these the right tool for the right job, if you will. Wade, and I had a little contribution in an advisor perspective article. And one of the things we said, which really gets to the heart of it, is that now there's not yet they're using a risk tolerance questionnaire to establish your retirement income strategy as a starting point is like, you know, doctor checking your pulse to

measure cholesterol. And there's nothing wrong with checking your pulse, but it's just not the right test for this situation. And we feel the RISA is actually a more effective decumulation tool. You know, and now, as we get into this, when we talk about this, we realize there's there's certain issues with risk tolerance questionnaires, that we're not going to really address here. I mean, they're, you know, questions come up with regards to their predictive validity with their predictive validity and with their reliability. But for the sake of this episode, let's just assume, you know, that those these are all tenable assumptions. And we don't need to worry about that we really want to stick to how our risk tolerance questionnaire compares to the RISA when it comes to developing a retirement strategy, if you will. And and just real quick Wade with regards to that. One, why why is that why why do you feel there's a different need, you know, as you're getting ready for retirement, to take a step back?

Wade Pfau 03:45
Yeah, well, first, we probably should even explain what a risk tolerance questionnaire is, for anyone who may not even know what this is referring to. But to simplify in a general manner, if you're talking to a traditional investment manager, or you are talking to a robo advisor or something like that, it's all centered around this idea of modern portfolio theory, which is simply you build a diversified investment portfolio. And generally, there's a belief in the stock market and stocks for the long run that over the long run. Ultimately, this sort of worldview would suggest investing aggressively or as aggressively as you can. But we know not everyone can tolerate the volatility of a very aggressive investment allocation. And so the risk tolerance questionnaire, it was a tool that's been created to try to identify how much short term market volatility can you handle and still be comfortable. And so if you're someone who can tolerate the risk, maybe you can handle that 90 or 100% stock allocation. If you're somebody who really can't tolerate that type of risk, then the answer that comes out of doing that sort of risk tolerance questionnaire would be well, maybe you should only have a 20 or 30% stock allocation. But the investment manager will use the risk tolerance questionnaire to just identify how much short term market volatility can you handle, and then put you in an investment strategy that's as aggressive as you can handle with the idea that over the long run, the more aggressive you are, and the more long term growth you should be able to accomodate

Alex Murguia 05:19
on that. When you mean investments, we're really talking about a stock market bond portfolio. Yeah, the

Wade Pfau 05:27
The asset allocation between just generally risky assets like stocks, and then in the investment world and not in the retirement world, risk free assets, like bonds, and hold to maturity, you know, what you're gonna get.

Alex Murguia 05:40
And the other the other caveat, and you said it, but maybe to say it another way, is what they're ultimately asking you is figure out what your line is. But from a point of pain tolerance, they're trying to they're trying to see how far they can push you until you scream, Uncle, you know, effectively from our portfolio. And that's, we think that's suboptimal, especially when you're beginning to decide on a retirement income strategy, because you're just not concerned about it while you are concerned. But it's

not the same concern isn't market volatility over the long term, its longevity risk and liquidity risk, and, you know, and liquidity risk for general liquidity issues like reserves and healthcare, and we spoke about this at length in previous episodes, and feel free to check those out. But there's these new risks for retirement. And, you know, the risk tolerance questionnaire, which has its basis, its foundational underpinning on loss aversion is just not in tuned to really assess those risks. appropriately.

Wade Pfau 06:43
Yeah. Alex, maybe you can tell everyone what you mean by loss aversion or what what the risk times questionnaires measuring, because again, I think these are terms that are not part of the everyday vernacular,

Alex Murguia 06:54
ya, ya, no. And by risk tolerance questionnaires in simplest form, if you have a 401 K plan, or if sometimes, you know, you're with an advisor, or even you're reading an article, there's these sets of questions that effectively asked you in so many ways, how well can you sleep at night, as the market is, is suffering, it's slings and arrows of outrageous fortune, right? And, you know, you go through answering these questions, and they take all these questions, and it effectively says, this is the portfolio. This is the individualized portfolio. that's right for you, you know, based on your your questions about volatility, appreciation. And so that's kind of what you see. And they spit out a portfolio, but it's based on the underpinning of loss aversion. And that's effectively I'm not going to do it justice, because that in itself is a whole bachelor's degree, if you will. But effectively, it's stating that the valence of a loss is roughly two and a half times that of a gain. So you feel a loss and an asset, matter, or relative to the gain. And, you know, sometimes you hear the term Prospect Theory thrown around. And it's, it's kind of talking about loss aversion. It's called Prospect Theory, really, because there's a reference point that that you know, that you're making your decision on. And so how you usually see this in a risk questionnaire, besides asking about how well you sleep, is you're presented with a series of questions that have 50/50, you know, they're cloaked in a 50/50 probability gamble between a potential loss and a game. So you know, the game is anchored, if you will, but the spread, you know, as they ask you more and more questions, the spread between the gain and loss widens to the negative, for example, they'll say something like, Hey, you have a 50/50 chance of winning $100 or losing? $10? Would you take that bet? No, and most people would say yes. And then they'll increase the number of like, you know, winning 100, losing 25, winning 100, losing 50, winning 100, losing 75. At a certain point, everyone has their line, and they say stop. Now, I said, this and 50/50 Gamble's are with relatively small sums, you know, and so it's hard to translate that into a portfolio, but these questionnaires generalize it into a portfolio and instead of saying, losing 100, winning 50, you know, etc, etc, or winning 100 Losing 50, they do it within the context of a portfolio of value. And the investment volatility is obviously the gain and loss. And so there's a line that everyone has, and they effectively map that line to a portfolio allocation, and hence, you have a risk tolerance questionnaire. Now, within the industry, those have been used for a variety of reasons. And, you know, like Wade said earlier, if you're accumulating and you're not necessarily drawing assets from the portfolio, it really is a matter of how much volatility can you stomach because over the long term, time diversification plays out and you're better off remaining invested in something that you can stomach. And what I mean by time diversification is that, you know, over the long midterm stocks go up relative to them going down. So you can kind of assume that that will take place in the future. But that's an assumption. Not

Wade Pfau 10:11
Yea, some academics disagree with that. But certainly anyone with a probability based mindset would believe in the idea of stocks for the long run, which is what Jeremy Siegel calls one of his...

Alex Murguia 10:20
No, but you're right, with the caveat. But you know that they believe in that time diversification piece. And so it'll work out. And what was a Wade to kind of lost track there a little bit?

Wade Pfau 10:32
What talking about the risk tolerance questionnaires. And so there are a lot of potential concerns. It's an active area of research of whether these risk tolerance questionnaires really do any good in the first place. Whether like if the stock markets more volatile, do people express less tolerance for risk? Versus if the stock market recently has been doing very well? Do people answer these questions in a more tolerant manner of risk and so forth. But we can, in this discussion today, set all of that aside, because when we talk about the issues or concerns with risk tolerance questionnaires for retirement, we're not even referring to any of the known existing issues people talk about when they say these risk tolerance questionnaires may not be very effective. We're really talking about a completely different issue, which is, do these risk tolerance questionnaires actually work to identify the concerns people have when it comes to retirement income, and that's an issue that really hasn't been part of the conversation before. It's just assumed that these work. And like, I think, Alex, what you were getting into was just this general idea of why do these response questionnaires get used in the first place? That's why good financial advisors like him so much?

Alex Murguia 11:43
No, no, no, yeah. Wade, it's like, you really know me? No, you're absolutely right. It's the workflow. It's, you know, sometimes you ask yourself, well, how did they get added to the pod, they permeated the industry, if you will, and they're, you know, let's say somebody's entering retirement, it's just a tailor made workflow that you can onboard, frankly, you can onboard a client, a prospect that that time fairly well into an offering that you already have, and it provides a great compliance documentation,workflow as well. Now, again, we're putting aside the validity and all of those issues, but it you know, it's you're able to paper why somebody is in a specific portfolio, with the assumption that that's the right retirement strategy. And that's an assumption, that that's the assumption we take issue with here. From the vantage point of, you have to first decide what retirement strategy is appropriate, you know, based on what new retirement risks you want to take off the table. And so what we did in our in our study that was sponsored by the alliance for lifetime income, we actually took all of these RISA factors, and retirement concerns that we previously discussed, but we measured loss aversion and loss aversion is a foundational component to all of these risk tolerance questionnaires. And so that gives us a good sense of potentially you know, how good these questionnaires are at in terms of capturing the specificities with regards to these retirement concerns.

Bob French 13:18
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Retirement Income Challenge, from 12 to 2 on April 25, and 26th. At risaprofile.com/style. Working with Wade, Alex and Michael Thinker, you'll learn how to talk to your clients about the RISA, how to interpret your clients RISA results, and how to target your advice to their styles, and help them reach the retirement that they deserve. Learn more, and sign up now at risaprofile.com/style. That's risaprofile.com/style. We'll see you there.

Alex Murguia 14:08
Wade, you want to talk about the study results here and what we found?

Wade Pfau 14:12
Sure, sure. And just a little more context about that first, like why these risk tolerance questionnaires existed. In the 1950s, Harry Markowitz developed modern portfolio theory, which basically just said, diversify that when you look at an individual investment. It's not how risky that investment is on its own. But how does it contribute to an overall portfolio and that you could have a volatile investment but if it's negatively correlated with other assets, it might contribute really well to a portfolio and so you build a diversified investment portfolio and again, back to the idea that you seek the risk premium from the stock market, so you try to be aggressive. Now he won a Nobel Prize for that in 1990. And then afterwards, he was asked, well, how does this modern portfolio theory that he developed apply to household and investors. And he said he never thought about it before. But after reflecting on it for an evening, he recognized modern portfolio theory was never meant to apply to household investors that it was just like something for infinitely lived mutual funds and other institutional type investors. And he pointed out, you really need something different for retirement, and that in some ways that 1991 article he wrote just after winning the Nobel Prize, and then saying, the whole investment management industry that developed on the back of modern portfolio theory, using it to identify investment strategies for households. That was never the intended purpose. And so we've always been looking for something else. And that's where right we now can have some empirical evidence about this, which is Alex's question in terms of when we look at the concerns people have for retirement? What does a risk tolerance questionnaire help to identify like, what kind of risks are people willing to take on? Or what are they even concerned with? And ultimately, what we find is, the risk tolerance questionnaire is not all that helpful. Compared to when we look at the factors in the Risa, we can actually see a relationship much better between the recent factors and the types of concerns people may have for retirement. And I do think we've talked about those concerns. In past episodes, we described them as the four L's, although this particular research really has brought in that more into five L's as well. But these concerns are longevity. It's really this your basic expenses in retirement, how worried are you about the risk of outliving your ability to fund your basics, liquidity, which we just treated as liquidity, but this study is revealing, there's really two kinds of liquidity, general spending shocks, and having reserves to help manage general spending shocks. And then also specific concerns about health long term care related type of spending shocks and having liquidity to manage those. And then lifestyle, the your discretionary, like having the best situation retirement, being able to manage not just essential spending, but discretionary spending as well to maximize your overall lifestyle. And then legacy, although the studies reveal that generally people are not as worried about legacy, so we don't need to dig as much into that yet, then

Alex Murguia 17:23

real quick, legacy is like, you know, how you want to be impactful for future generations. And the reality we find that folks are more likely there's something leftover, fine, but that's not something we're going to be to to intentional. Well, now that difference between folks, but that's the the average.

Wade Pfau 17:40
Yeah, it's not that the driving motivation for the typical retiree. Okay, so then getting into the study findings. So the question is, like, do the research factors help to explain the concerns people may have, and do risk tolerance questionnaires helped to explain the concerns that people have. And what we found is the risk tolerance questionnaires, they can help to explain the lifestyle, which generally makes sense in that regard that if you're trying to maximize the returns on your portfolio, just for the potential to be able to spend more and enjoy the highest potential lifestyle, of course, taking on the risk that if that the market doesn't cooperate with you, you may not get the lifestyle you're looking for. But risk tolerance questionnaires do help to identify lifestyle. They do have a little bit of a link to general concerns about liquidity. But that's it, they really don't do a very effective job with any of the other retirement concerns. Whereas the RISA factors do help to explain the concerns like we're talking about risk tolerance, how much risk are you willing to take with regard to your concerns for longevity, for the liquidity for health expenses, and long term care for the liquidity for general health expenses, and that's where risk tolerance does explain that a little bit, but the risk factors have a much stronger explanatory power. And in the same for lifestyle, that though the risk tolerance questionnaire does help to explain lifestyle concerns, the recent factors also have a stronger ability to explain lifestyle concerns at the same time as well.

Alex Murguia 19:21
Yeah, I mean, it's interesting, what you see here is that said another way, yeah, longevity, which is fear of running out of money, which is the main concern that you have when developing a retirement income strategy and liquidity with regards to health which is concern one B, with regards to developing a retirement income strategy. Those those sensitivities are really captured by the recent profile by one's one sensitivity and probably the safety first and optionality come in and orientation. The recent matrix does a far superior job. Portfolio loss aversion doesn't doesn't even come up. It's not signal Again at all.

Wade Pfau 20:00
And what that means is... Yeah, what it means is just if you're risk tolerant, or you're risk averse, so if you're comfortable investing aggressively, or you're not comfortable investing aggressively, that just has no connection to your concerns about longevity or liquidity for health expense.

Alex Murguia 20:17
Yeah. Another question that could come up by somebody listening in would be well, what about risk capacity, because you know, there's risk tolerance, risk capacity. And composure even is an up and comer with regards to this kind of thing. And we did, we did control. So we did account for net worth, which we're going to make the argument is a capacity proxy. And controlling floor we control we control, we accounted for age, relationship status, networth capacity proxy, right, their retirement status and gender. And the RISA was still significant. Across all these factors, portfolio loss aversion remained insignificant across longevity, and liquidity. And frankly, net worth was actually a significant variable as well. So you know, there, there are other factors that play into this. But the reason I was able to even

even even accounting for all these factors that Risa is still providing a lot of signal with regards to the types of risk somebody wants to take off the table in retirement. Interestingly enough, the younger you are, the more you're worried about it. I think as you get older, you kind of fall into, you know, a better crystallization of holidays, you're gonna address it simply because you're right there looking at it, and the uncertainty starts getting removed. But yeah, even in the ones that portfolio loss aversion was somewhat significant, and such as liquidity for general, and lifestyle concerns. The RISA is the studies show the recent still more robust in terms of explanatory power over just general portfolio loss aversion. So it was quite, quite interesting to us in the sense that the RISA is just picking up these longevity concerns and health reserves concern, while retired, retirement sort of risk, these risk questionnaires are silent on it. And that's interesting, even for lifestyle, I wish I would have thought the reason may not have been significantly related to lifestyle, since it's focused on retirement income, for more essential kind of expenses. And lifestyle just tends to imply a little more discretion. And, you know, there I thought the risk questionnaire would have would have taken over, but no, not at all. I mean, it's significant, both of them are significant. But still, you know, results show that the risk is just more robust. And again, this is across a national sample. It's not just a, you know, very focused group. And again, and again, I'll say it, while controlling for age, relationships, status, net worth, retirement status, and gender, it was still quite robust. And so it's interesting, what we're realizing here is that, you know, even even while these factors take a slice of that Retirement Risk pie, the the RISA matrix is still providing great signal with regards to how you want to implement the strategy. Now, it's more than just this. Remember, there's a recent matrix. And so within the RISA matrix, there's four quadrants, such as Total Return, risk wrap, income protection, and time segmentation. So the further question that you want to assess is, are all of these strategies relevant with regards to how you want to take risk off the table is retirement risk off the table? What Wade was alluding to earlier, is that a risk tolerance questionnaire is presupposing. Everyone's in a, in a total return strategy? Because ultimately, you're kind of gonna have some sort of investment portfolio to provide some sustainable withdraw. So you really want to ask yourself as a further analysis is, how does each quadrant identify with these retirement risks within the research? You know, is there a difference between total return and income protection and risk wrap and time segmentation? Is there a difference individually between all of them in and of each other? Because then that helps them make the argument that each of these strategies are valid strategies that need to absolutely be considered. And we cannot any longer just presuppose everyone into a into a total return. And incidentally, I use presuppose now every time we kind of use that once and Wade, I can't shake that word, whatever reason. you might want to get into details since I had a little bit of a monologue there.

Wade Pfau 24:39
Yeah, this was a really interesting aspect of the results was when you look at each of the four retirement styles, you can actually see differences between them like statistically significant differences in how they will have concerns vary among the styles and, and like Alex was saying, the risk tolerance questionnaire it exists in the total returns world. And it really because it was an accumulation based tool and wasn't ever designed for retirement. But so much of the total returns world is like that secondary factor we've talked about. In retirement total returns, people tend to maintain an accumulation mindset. Whereas income protection, people tend to have a distribution focus, which means they're worried less about maximizing the risk adjusted return on their portfolio, and worrying more about ensuring they can have a predictable income stream from their portfolio. So when we look at how do these concerns vary

by the different strategies, what we actually see is like for longevity, just like the risk tolerance questionnaire, doesn't measure longevity concerns. Well, it turns out total returns individuals from whom the the whole risk tolerance world exists in the first place. They're the least concerned about longevity. So it kind of makes sense that they didn't worry about measuring it, the problem is that they then try to put that sort of framework on everyone, rather than just keeping it within the total returns world of I see,

Alex Murguia 26:03
Thats important. Wade, I think that's the crux here of of the entirety of our mission, which is they're pigeonholing every single investor into this quadrant. And that becomes an issue, this quadrant in and of itself will return as a very credible strategy, just not for everyone. And I didn't mean to take away your stream of thought. I guess I did, because I did interrupt. Right. But I wanted to just emphasize this because I think it's quite important.

Wade Pfau 26:31
In the total returns world, the concerns about longevity are the least. And you can't though you cannot just extrapolate extrapolate that and say, Well, no one cares about longevity, because total returns is about a third of the population. The concerns about longevity, that concerns about outliving your ability to fund your essential spending, that concern is the greatest and it for the income protection. And it's also higher for the time segmentation group that people with a time segmentation strategy tend to be more concerned about longevity, almost as much, although less in a statistical way, but almost as much as the number one there, which was the income protection, and then the risk wrap quadrant and the total returns quadrant, all have relatively less of a concern about longevity. So it's like, the more safety first you are for that research factor, the more you tend to be worried about longevity, it's a it's a finding. That's important because, again, longevity is a concern that a lot of people have, and it's something that should be measured. And you can't just bypass that and jump directly into that risk tolerance questionnaire, which is Harry Markowitz confirmed, it was never meant to apply. Well, the modern portfolio theory of which the risk tolerance questionnaire is designed to, to manage was never meant to apply to the household in the first place to

Alex Murguia 27:54
two things. Wade. I'm glad they asked Harry Markowitz, that question the day after he won the Nobel Prize, just in case he merited it anyways, for for even on the institutional side. And the second point is that, interestingly enough, even once you're on the safety first side of the matrix, there's the there's still a further separation. A what makes somebody time segmentation. And what makes somebody income protection, right income protection is I want to floor of income for the remainder of my retirement. Whereas time segmentation, you're looking at it in funding windows funding buckets, if you will. And interestingly enough, you know, because they want more optionality. Whereas income protection, I'm fine with commitment. Interestingly enough, the level of longevity concern differs statistically different between them, they they're both safety first. But there's a split, there's a nice demarcation between the relative level of optionality commitment, and it makes perfect sense right way that if you're if your income protection, you have a little greater sensitivity to this longevity concern, hence, you're fine making the jump to having an income floor in perpetuity, or as time segmentation. You know, you have slight, you know, on a relative basis, it's less than income protection. So you're fine with committing to

these funding windows, but just with greater optionality. And that reflects, I think, you know, pretty well, a lower level of longevity concern. I don't know. I think that's kind of cool. Your thoughts Wade?

Wade Pfau 29:34
Yeah. And it's getting back to that whole issue of the behavioral aspect of time segmentation of how can you develop a strategy when you're concerned about longevity, where you're not wanting to commit to any sort of long term solution. So you're How do you manage an investment portfolio in a way that helps to meet your longevity concerns and the the explanation that came out that guides the time said entation quadrant is use your fixed income assets to cover the short term expenses and, and then just have this hope or this belief that by leaving your growth portfolio alone, it will grow before you it's kind of this idea of stocks for the long run again, but it will grow before you have to tap into it. And that's how you reconcile these competing, this safety first concern, but with this desire to still maintain the optionality and with this strong concern about covering your longevity expenses,

Alex Murguia 30:32
the other the other, just the little nuance here, we've mentioned in the previous podcast, but when you're talking about applying bonds for your fixed income, you're making a difference here between bond funds and individual bonds that you can duration match.

Wade Pfau 30:48
Yeah, that isn't just like an accumulation world, there'll be this statement that bond funds and individual bonds are not different, because you just you match up the durations and everything's fine. And it is mathematically possible to do that in retirement is just dramatically more difficult when you're spending from the offset. So we are really for most practical concerns, talking about individual bonds with with the best way to build a time segmentation strategy,

Alex Murguia 31:15
you're just taking them out to maturity and with the expected cash flows there. And it could be other structure products that have specific timeframes as well doesn't just have to be individual bonds. But there's things with contractual characteristics. And now, interestingly, even on the probability side, there's a significant difference between both of those strategies being total return and risk wrap. And just as a quick primer risk wrap is you have that probability, but you have this market potential, but you're giving yourself guardrails, if you will, especially on the downside, half of guardrail, if you want. Now you have you have them on both side. But yeah, especially on the downside. And as you see here, the longevity concern is less for total return on a relative basis relative to risk wrap. So it's pointing out, it's almost pointing out why the strategies kind of have have worked graded to begin with,

Wade Pfau 32:15
yeah, they're all different from each other. And if you rank them from most concerned about longevity to least concerned about longevity, it's income protection, then time segmentation, then risk grab, and then income protection.

Alex Murguia 32:28

Yeah, it's sort of saying there are four different strategies that that that attack risk in retirement differently. You know, because the argument could always be made well, is there really a difference between time segmentation and risk grab? Why bother? Or is there a difference between this and that it's just, you know, no, there's there's definitive differences here, or, you know, quantifiable differences better said here, and you see the same pattern with how you want to treat reserves specific to healthcare needs. And again, these are two very salient issues in retirement, longevity, I don't want to run out of money. I mean, that's, that's the bingo, you know, in terms of this is what the largest concern is, and healthcare risk that will, that will cause spending shocks, those kinds of things. Those are the two largest I could propose those are the two most salient concerns in retirement. And again, risk questionnaires fall silent on this completely. And the RISA actually is not only significant at a general level, but can pinpoint what specific strategy makes the most sense to address the risks that this person feels are the most salient.

Wade Pfau 33:38
Yeah, you've used this analogy in previous episodes about the idea of air and of course, we need to air to breathe, but are you concerned on a day to day basis about getting the air you need to breathe? And generally speaking, people are not concerned about that. And that's with with the total returns, style people, of course, they are concerned that to some extent about they want to meet their essentials, they want to have reserves for health care, but it's not an everyday type of concern for them. So they have the measures, the least concerned about these issues, which again, it's back to well, if you're not concerned about these things, then maybe the risk tolerance questionnaire is okay. And that's where well the risk tolerance questionnaire is a total returns tool, or it's something useful for any investment portfolio, but for other strategies, the investment portfolio is more secondary, after you first figured out primarily how are you going to cover your essential spending and the wrist a total return strategy just doesn't have that concern about these issues. But then again, it's the same result where ranking from least concerned about health care and long term cares expenses to most concerned, total returns than risk wrap than time segmentation and then income protection being the most concerned about having reserves to cover the unexpected did care related and long term care related expenses.

Alex Murguia 35:04
And the other point when you were speaking, I, you know, I thought somebody could be asking him, I'm just trying to put myself in the listeners views, they could be asking, well, they're not concerned because it's net worth. So it's really a net worth thing. You know, they have the capacity to stomach it. And like we said in the results, net worth was a significant contributor. But even while controlling for net worth, the RISA was still seeing, you know, quite quite robust in being able to signal the relationship between longevity and these health care reserve concerns. So it's an add not a but kind of kind of answer that I would that I would provide. But really the question that begs asking now, on a larger level, because the whole purpose here is trying to help you determine our retirement income style and strategy that that that resonates with you, and you can implement, right? And so the question that does beg asking, and I can't, I can't help but think and get away from this, which is, the elephant in the room, the blue whale actually in the room is 65% of the people, as we mentioned, in other podcasts, 65% of the individuals, you know, identify with funding essential income in retirement from sources that have contractual obligations, and not a pure market portfolio approach. You know, really 35% of folks subscribe more to a total return approach based on how they want to source retirement income. I

mean, Wade, what the heck is going on here? Then? Why why is the industry so focused on presupposing, a total return approach and jam and people with risk questionnaires that go into a model portfolio? I think folks just think that's the way to do it. You know, I have some cynical answers. But you know, you'll hear them in a second. But you're much nicer than I am. So I'm asking you what's going on here?

Wade Pfau 36:58
Yeah, it's just with the way and this is really not necessarily international. But in the United States, so much of the attention over our history. And this is all recent history, since the 1970s. has been on investments and building an investment portfolio. And that's how you save for retirement. And then not necessarily thinking through these issues about what changes post retirement. And so keeping the same sort of tool is you keep that same investment portfolio and you just figure out, how much can you spend from it sustainably, but otherwise, you don't really recognize any sort of difference, you're still live in that sort of total return world, which and and you assume then, that everyone fits that and, and that's where, again, about a third of the population 35% of the population, that's fine, that that total return approach the end, I think, a lot of the advocates for the total return strategy or, or total returns, that's their own personal style. But it's leaving behind the other 65% of the population. That isn't necessarily that's not meeting their concerns. That's not meeting really what they need to feel comfortable with a retirement strategy. And that's where we increasingly need to move beyond that. It's not that we're saying total returns is wrong, it is a viable strategy. But it's not for everyone in specifically, it's not for about two thirds of the population. So that's, we need to go beyond just a risk tolerance questionnaire and find a way to better serve that as a starting point. How do you want to approach sourcing your essential spending needs in retirement?

Alex Murguia 38:36
I think you hit it, what got me what you were saying is, you know, never assume malice, when incompetence could be, could be at play, to some extent, and maybe I'm being too harsh, but the heck with it, I think there's a little bit of lazy thinking. And, you know, I'm guilty as charged my for myself for, you know, a good part of my professional career. But I do, I do think there's a little bit of lazy thinking. And there's the there's a lack of just an appreciation from there's a transition from accumulation Based Investing to retirement income. And when you get to that retirement income, sort of docking station is, you know, we just conveniently treat it as a continuation of what was done during the accumulation phase. And frankly, the only difference is, hey, now we're going to take quarterly distributions, and why are you those assets? And frankly, that's what that's what every if you look at the wire houses and so forth, you know, your retirement come paycheck, your retirement income paycheck is just coming out of your own volatile asset base. And frankly, I don't think there's much consideration done for for the general population. Like I said, there's a certain segment that that's totally fine. It's a credible strategy. My issue is that it's a misalignment for a lot of folks, you know, now the other piece that I think is reason why it's taken off, is that you know, What's the what's the prominent model here business model with regards to financial advice, it's an assets under management approach. And frankly, you have the rise of the model portfolios, and especially with accumulation portfolios, and it fits very nicely, you know, a total return approach fits very, very nicely in an AUM billing in an assets under management billing model, where you're just charging a percentage of, of the overall asset base, it's just easy. And from there, you know, it's just a perfect business complement. So from a workflow standpoint, how easy is

that, I'm gonna give somebody a risk questionnaire, I'm gonna funnel them into a model portfolio. And I'm gonna take a take a sustainable withdrawal rate from that, you know, you have any any retirement income strategy you want, as long as it's total return, you know, and with that, you also have easy documentation. Think about it, your large institution, you have 1000s of advisors, you need to operationalize the whole business of providing advice for investments, what better way than to give you a questionnaire that slots you into a model portfolio? You know, and there you go. and off you go, I think, again, it is what it is, to some extent, but what we find is not everyone really is aligned with a total return approach. So to quote Natalie Merchant, whats the matter here? you know, kind of thing it shouldn't be, especially after just looking at the numbers, the numbers on the numbers, you know, frankly, and if you look at the Risa framework is just, it's just a significantly better starting point, than risk questionnaires for determining an individual's retirement income strategy. Full stop. That's not to say there's not a place for a risk questionnaire, but a starting point, you know, and once you determine that strategy fit, you can move on to other tools as appropriate, but not before. But until you know, it's been missing.

Wade Pfau 41:54
It can play a role. And I've written about I call it the retirement care analysis, which is the way to help identify an appropriate asset allocation. But that's kind of the way that works. That's the last thing you figured out, not the first thing you figured out. And that's where the risk times questionnaire can still play a role. But it comes much later in the process, not at the beginning of the process, the beginning of the process is just first think about what's your retirement income style, and then you can start to work from there. And then once you know whether how you want to fund your essential spending, you still have investments for the more discretionary piece. And that's where the risk tolerance questionnaire can help guide the asset allocation decision at the end of the process, not at the beginning of the process.

Alex Murguia 42:36
Exactly. So, my my, my quarrel is not with the tool, but with the order in which it is used, you know, at least as a general matter, but, you know, that's, that's, that's today's episode here, effectively a bake off right between risk questionnaires, and RISA. And ultimately, what we're getting at is, you know, there's new risk in retirement, you know, how well does a risk questionnaire account for that, versus the RISA and I think it's self evident that the RISA is able to capture these, these new retirement risks in a much more specific manner. That's very telling in terms of what retirement income strategy is a good fit. Wade do you want to send us home with some parting thoughts here?

Wade Pfau 43:21
Yeah, absolutely. Yeah, we don't want to set a record for the longest podcast episode. So I think we we've covered it pretty well. So thanks, everyone, and we'll see you again with our next episode as we further explore retiring with style.

Alex Murguia 43:34
Thank you, everyone.

Bob French 43:37

Wade and Alex are both principals in McLean Asset Management and Retirement Researcher. Both are SEC registered investment advisors located in Tyson's Virginia and 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.