Episode 170: The Importance of Your Planning Assumptions: Part 2

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SPEAKERS
Brian Bass, Briana Corbin, Wade Pfau, Alex Murguia, Speaker 2, Speaker 1, Bob French

Bob French 00:00
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Briana Corbin 00:41
We are back now. You didn't think we'd leave you hanging in the middle of a Monte Carlo simulation? Did you the boys are diving right back in this time. We're tackling the 4% rule, stress testing financial models and making sure that your retirement plan can actually handle real life. Let's pick up right where we left off.

Alex Murguia 01:00
Wade and Brian, I want you guys to talk a little bit about this. This is a whole podcast episode in and of itself. So bear that in mind that this is not the purpose of the question. It's more just a kind of a little teaser, if you will, for folks to think about. But when you're creating return assumptions, as opposed to telling everyone, okay, these are our return assumptions, et cetera, et cetera, there's there's two schools of thought, historical returns or expected return, before I lead the witness on anything I like, Wade to talk about that, what His thoughts are around that. And then Brian, for you to talk about that, but maybe with the Klein example angle, if you will, as opposed to, you know, hey, look, this is what the master Wade,

Wade Pfau 01:46
yeah, that's so today, it's less of a kind of upfront topic, because bond, bond returns, our bond yields are more in line with their historical numbers. But we've, in the past 10 years, we've had points where, well, at the extreme, the 10 year treasury was down to point 6% but some software just plugs in average historical returns for their assumptions, so they may be telling you your bond returns are going to be bouncing around five or 6% on average, which is really mathematically impossible if interest rates are at one to two to 3% and that that that's kind of a source of this huge discrepancy, like, if you're testing the 4% rule in the US historical data, 4%

distribution rate from an investment portfolio with a, say, 50% stock allocation always worked historically. If you then, instead of using the actual historical data, but you run a Monte Carlo where you plug in the use the historical data to calculate average returns and volatilities and so forth, that might lower it to a 95% success rate, but still pretty good with those historical numbers, if you decide to take a haircut off of the returns to account for In the past, how bond yields were so much lower than the historical average bond returns would suggest that could lower the success rate again with historical data, maybe you got 95% success. You could get 65% success if you just take a haircut off the returns to account for the lower interest rate environment. And that's another example of this kind of situation where what you put in has a huge impact. And so you do have to just try to be careful and thoughtful about their assumption. The assumptions you use don't blindly enter historical average returns, especially on the bond side, if interest rates make it almost impossible to get historical average returns, and we had to go through 2022 to get to a more normalized world when bond returns had double digit losses in 2022 as interest rates came up. Because as interest rates go up, you have losses, capital losses on existing bonds that you own that got us through the storm. Now interest rates are more normalized, so looking forward from today, maybe you can make more of an argument that historical returns are okay, but they weren't okay when you were starting from a much lower interest rate base, and to get to a more normalized base, you had to endure some pretty heavy losses with your bonds.

Alex Murguia 04:18
Thank you, Wade, what I would say to that. And Brian, this could be, you know, when with your, your your, your segue right now is the plan is a living document, so don't get too caught up in okay, this is the return right now, and this is what's going to be 30 years. Expect the rinse, repeat on the on these, on these exercises. To me, the plan is your personal benchmark, ultimately, and that's what the focus should be. But going through what we just discussed right now about historical return versus expected returns, and sometimes it's just these major inflection points that you need to slap yourself into reality in terms of what's true or not. How does this discussion happen with clients? You may not talk about the different asset class returns. The correlations, but ultimately a return assumption is presented and discussed. And what are some pushbacks? What are some aha moments that clients have, or what are some questions that they don't ask, that they kind of should be asking?

Brian Bass 05:15
I think what's been really interesting over time to see is the methodology by by which firms are building these CMAs out the capital market assumptions. I've seen the duration changed on their backwards looking math, and is no space like how far backwards they're looking for

Alex Murguia 05:38
a second? No,

Brian Bass 05:39
no. So I've seen, I've seen firms cherry pick how far backwards they look when they're building outs, right? If we're in 2025, we're looking backwards. If we're using the last 10 years of returns, those forward looking returns are gonna be really, really high. So I've seen five years in I've seen 10 years. I've seen some that, you know, use all the way back to the beginning of market assumptions, which is more appropriate, right? But it's really, really important to understand looking backwards, it's easy to build amazing portfolios that were up, you know, I can beat the

market looking in the rearview mirror. It's very easy to do. So I just go back and pick funds or pick, you know, specific asset classes or indices that were the highest performing. I build you out a cool portfolio, and I spit that out and show you look our forward looking returns are, you know, 4% higher than this firm. But guess what? That's not real. It's not real. It's not realistic. It's not appropriate to do that, really. And ultimately, what those shops are doing is painting this, you know, rose color, rose colored view of the world, when, in reality, they probably, they probably know that's not going to happen. So the important part of what we do is, is really, you know, showing our methodologies and walking through kind of how we build out our capital market assumptions, you know, the way we think about the world, the way we look at things, and then we stress test it, just to show, hey, you know, this is, this is going to be our baseline. But if we do better, this is what your plan looks like. And if we do worse, this is what your plan could look like. You know, that gives you kind of a range of outcomes that is a little bit more tangible and a little bit more palatable to say I need to make a decision on how I'm going to spend for the next 10 years. Does it make sense to use, you know, ridiculously high return just because maybe that would happen again? Or do I want to maybe throttle back my lifestyle, given the fact that we might not get, you know, what we've seen the last 10 years,

Alex Murguia 07:24
that's fair. And what's the response usually for that, when you present that in that method,

Brian Bass 07:28
a lot of people are a lot of people are reasonable. A lot of people don't want to go to that, you know, maximum spend type plan where we're looking to get every single dollar out of it. It's, it's kind of, you know, it goes into that balancing act of saving for tomorrow, while also making sure we kind of optimize our our lifestyle today. And there are all kinds of levers and models that we can use to kind of help to de risk around some of those decisions in those conversations too. It's not just, Hey, we throw this in, and this is going to be your spend going forward. You know, it really goes into a lot of the modeling of our cash flows, and how we want to look at our life and what stage of life we're in. You know, there's a lot of different ways to to approach the financial plan, more so than the math, but it is really, really important to understand how the math works, because that's what you're ultimately going to be basing your decisions around. Today. What do you

Alex Murguia 08:17
think here? Because when, when I was hot and heavy and seeing a lot of clients, the question that came up a lot was not, we're not necessarily the return assumptions and the like, for better or for worse. A lot of folks give us the benefit of the debt you know, which you know, buyer beware, I would tell every consumer. But what was interesting to me was the extremes of the scenarios that people wanted to run, where it was like, Listen, if my plan, if I have an 80% chance of success right now, and I don't like that, you know what, put a 12% return, then, you know, put a 12% return, and let's get that plan up to to work, you know, these overly optimistic kind of things, right? But then the flip side of it, which I think is just as bad from from the person, because at the end of the day, you're saving up money to be able to live a certain lifestyle in retirement. And I get that we're creatures of habit, so if you were this order, if you will, it's hard to just break yourself from that. But where I find my where I would find myself trying to be a little more persuasive. Sometimes it was getting people to spend more money simply because they were putting in these scenarios that were nuclear holocaust scenarios. And at the end of the day, you don't want to live the last 2530, years of your life in the basement, drinking soup cans,

if you will. And so what is that? What do you find there? How do you sort of the danger of this overconfidence or unnecessary fear that people have? How do you go about trying to provide just prudent advice?

Brian Bass 09:53
Yeah, and arguably, both are really bad outcomes to your point about living in the basement, eating so. When you have a ten million portfolio because you're so terrified that it's going to run out, it is, it's a hard conversation. It's, it's not something that we typically push someone to make, you know, knee jerk reactions or huge deviations from their norm to do. But ultimately, it's, Hey, you know, we modeled out your current scenario, and it's at 100% and there's not one single scenario where this runs out of money at the end. Why don't we talk about, you know, why don't we run, you kind of a worst case scenario plan where we can show you the maximum spend and what you're doing now. And somewhere between those two is the delta happy place, right? It's maybe it's another extra 1000 bucks a month, or maybe it's an extra $1,500 or $5,000 depending on how much you know, money and how money and how big the portfolio is. But just to have an idea of this, is the range that you should could be living in. And let's start making some decisions around that, having some conversations. Does it make sense to increase andor decrease the spend? We can model it differently. We can, you know, maybe we take a few more vacations at the beginning of retirement and a few less at the end of retirement, we can, we can finagle the cash flows to where you know, you can put a framework around those decisions, where it not just, I'm pushing you to go spend some money, because that ultimately is is uncomfortable if you frame it just a little differently, and 100%

Alex Murguia 11:16
I was viewing it not necessarily that we know better than them, and you will enjoy life a lot more doing that. I'm not getting into it from the standpoint of that existential dilemma and trying to help that, because I think that's beyond the purview of what we can do. We can nudge but, you know, at the end of the day, I'm not so sure that's our real but I do view it from a pure numbers standpoint of efficiency of resource, and it's almost of this allocation of capital, because if everyone, all of a sudden, was able to more efficiently spend accordingly, you know, in a realistic way, in retirement, I think resources would be put to better use in society. I know it sounds weird the way I'm saying it, but I'm thinking of it like that. I don't know. Wade, what's your take? Sounds like

Wade Pfau 12:02
you're the benevolent dictator. From economics,

Alex Murguia 12:08
my tenure. Am I tenure? Am I tenure? Am I tenure?

12:12
Hopefully you're a benevolent

Wade Pfau 12:13
dictator. No,

Alex Murguia 12:15

but you know, I'm saying like it's, it's one of those things that, you know, it's a bad use of resources if it's all stockpiled in the basement.

Brian Bass 12:24
Oh, yeah, yeah. It's also the utility of, I mean, some, some people just, they don't, there's no additional dollar that's going to provide any more happiness to them than what they're already currently doing, which is perfectly fine. So it's, you know, it's, it's really, it's understanding both sides of the table of where we are in mathematically. Yeah, this is dumb. Why are you sitting on this much money? You should go spend more. Or, Hey, you're wildly overspending. We need to rein this in. Versus their side of the table is, you know, I'm perfectly happy where I am. I'm fat and happy. Maybe I like to sit in the basement drink soup. It's yeah, no, no.

Alex Murguia 12:55
It's not maladaptive to your everyday living. Who am I to say? Right? It's just one of the right things. Miserable, yeah, I just want to make sure they're maximizing. Wade would be in the camp of not maximizing.

Wade Pfau 13:14
Knowing him, you could spend more. But if you don't really enjoy anymore, then it's it's here you're an ant the ants and grasshoppers. Okay, if you've been an ant your whole life, you don't switch and become a grasshopper when you retire. So it's no problem with it. But you know, if you're maladaptive, you could spend more, and you really would benefit from spending more, but you're afraid to that's kind

Alex Murguia 13:38
of the rub for me, but I get it, Brian, another question for you, and I'd love to hear your take Wade, is because some folks would say, well, the 4% rule is based on Monte Carlo. And so I, you know, I see the Monte Carlo, I can pick up a copy of Wade's book, newly released. Did you talk about it in your in the guidebook? Or no, just spending strategy.

Wade Pfau 14:01
Oh, yeah, I talk about the 4% rule. And of course, you do something that interests everyone. It's not a practical spending Yeah, that's what, that's what

Alex Murguia 14:09
I'm getting at here. People love talking about it. Everyone talks about it. But since we're talking about Monte Carlo, and the Monte Carlo is used to assess the success rates of the 4% rule, and I'm amazed by how many individuals write to us. You know, retirement researcher and just in general, about the spending rule strategies and the like, what's your take on the 4% rule? Brian, leave it at that.

Brian Bass 14:37
It's not something I've ever discussed in practice. It's more so you'll have questions come in from clients about, hey, 4% where are we at? What's my actual spend rate? You know, it's, it's kind of one of those things that's turned into kind of a guidepost of, hey, you're spending this. What's 4% of your portfolio? Value of this? Does this make sense? Great. You know, ultimately, that's kind of not even where we. Start our conversation. It's just kind of one of those things that's floating around out there that people have heard about, they've read about, and they think

is, you know, it's a lot less concrete than it used to be, you know, 10 years ago, that was really, really important to people now. So as research has come out and, you know, Wade his work has come out, and people have started to read his book, more and more, they realize that there are so many better ways to do this. And to your point about, you know, utility and maximizing your lifetime savings and all those things, it's there's so much better stuff, so many better ways to address this than just a, you know, slap on 4% of my portfolio and move

Alex Murguia 15:34
on, yeah, and pull it every year. Like, I don't think anyone does that. I don't know if you guys chime in, I personally don't know of any advisory firm or advisor that actually runs the 4% rule for other client. And I say that because I think there are a lot of individuals that based on the questions and the popularity on this topic, I think there's a bunch of self directed individuals that are actually following it religiously. It seems to me,

Bob French 16:05
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Wade Pfau 16:33
I don't know if any. I mean, as soon as you're using any kind of software that includes cash flows that you're inputting your financial goals, you're immediately moving away like underlying the only relevance of the 4% rule is just in general, what's the sustainable level of spending. But on a pre tax basis, it's like impossible that your portfolio distribution is gonna grow with inflation perfectly. Every year, you just have bumpy cash flows, whether it's I'm delaying Social Security and so I'm going to spend more now, but then spend less after I started Social Security or any other kind of income sources that vary over time. Maybe I have a pension that doesn't increase for inflation, plus my spending goals are not fixed. I may cut back spending as I age. Taxes, even if I'm trying to have constant inflation adjusted spending every year, I'm not going to have my taxes be constant inflation adjusted every year. There's just different income sources are taxed differently, and that's going to vary over time. So as soon as you're using software that has you introduce so the whole calculating a probability of success you've moved away from the 4% rule having relevance like you can recreate the 4% rule in the software, but it's a very simplified, okay, I've got a Roth IRA with a million dollars. I'm 65 I'll build a plan through 95 and I want to take out $40,000 plus inflation every year, and I run that financial plan. That's how I would see the success rate on the 4% rule. But nobody has that simple plan. Any plans going to have more complications as part of it?

Alex Murguia 18:09
Yeah? Brian, does it even it's a non issue relative to the actual practice of what I'm getting it.

Brian Bass 18:16
Okay? Yeah. And ultimately, too, I've had exactly zero people come to me on January 1 the following year and say, hey, my spend is going to be two and a half percent higher than it was last year. Please adjust my cash flows to to recreate that. It's just not how life works. You know, typically people spend, and they see what they spend, and if they need to make an adjustment, they make an adjustment. It's not, you know, my the price of every single one of my goods and

services went up by two and a half percent. I need two and a half percent. I need two and a half percent more money this year. It's just not the way it works in the real world for most people. Some people really get into the weeds of their stuff, and that's the way they like to do things. But most people get into retirement and they have better things to do with their time.

Alex Murguia 18:55
Got it agreed, so let's wrap it up with what folks can do. So we discussed, you know, the pros and cons of Monte Carlo. And again, we're not, by no means. We're dismissing it. We think it's a very valuable tool. We think of planning as a directional exercise, where you rinse, repeat. It is a living document, if you will. You know that being the case, folks listening in, what are some recommendations that they can do for for just questioning what's what's going on around, what's going on around their plans. And I think you've, you've touched on some on some of those, but, you know, as we wrap up so people can just, you know, get a quick, uh, bullet point list of, okay, this, these are things that I should be looking at,

Brian Bass 19:41
I think for us, I mean, one of the, one of the benchmarking tools we use is we go back to that initial portfolio value, and these are, these are, you know, clients 1020, years, 30 years in, and we make sure that our performance of of the investment side of things is matching up to what we had in the plan. And that's something we do, kind of. Not on an annual basis, simply because we don't know the standard deviation drives wild returns throughout any given year of a portfolio, right? But it's just kind of paying attention. Did we get kind of close to that mean return that's driving the initial assumptions of that plan? Yes, no. If we're significantly away from that, we got to kind of go back to the drawing board and figure out a, what went wrong and B, what do we do about it? But ultimately, the returns are one piece of it, and kind of important, but the more important stuff is really the goals. Are our goals still online? Are my cash flows that we have modeled out still relevant to me as we move down, you know, through time? Because if, if things have changed one year to another year, then if we don't change the model to reflect that, then it's kind of a wasted, a wasted exercise,

Alex Murguia 20:42
yeah. And another thing I would say is, you, I'm going to put words in your mouth, just to lead you a little bit. But I think as well, the importance of stress of stress testing and using a range of assumptions, you want to speak about that a little bit. Wade Brian, no, I

Brian Bass 21:00
would just say the stress testing is huge, because it shows you, hey, you know, we're our model. We're modeling this. And if this doesn't happen, you know, how comfortable are you with, you know, this outcome versus that outcome, because it'll show you on the stress test what your new percentage success rate is. Let's say inflation's, you know, you model it at two and a half, and we run it at three and a half, and your success rate goes from 90 to 75 or, you know, 80 or whatever. Are you comfortable with that outcome? And then no, if it's no, you have to discuss ways to kind of fix that problem, right? There's leverage to pull, to address the each individual pieces of that, of that stress test, whether it's returns, whether it's longevity, whether it's, you know, inflation, whatever the case may be. And then you have those conversations, does it make sense to try to address this risk? And then, how do we go about that? Wait,

Wade Pfau 21:51

yeah, I guess just the other thing is, it is naturally you want to gravitate towards whatever is reporting the highest success rate. But you got to just keep reminding yourself this is just the number, just because Plan A has a higher success rate than Plan B, that doesn't really tell me anything until I've done a deeper dive and I've looked at the assumptions, and I've done that stress testing, really, I'm comfortable with the assumptions being made, and I may not necessarily pick the advisor offering the highest, highest success rate at the end of the day, because there's a lot more that goes into it than just the final number that can be gained, as we've talked about throughout the episode.

Alex Murguia 22:33
No, I agree. I think stress testing is where it's at because no one is not even us. No one is going to figure out what happens right next. You come up with what we feel are prudent assumptions, not meant to convert prospects, because that's that's ultimately the wrong way of going about your life, if you will. It's just meant to provide a realistic sense of things. But within the stress testing, it's perfectly fine to do. Here's best case, here's worst case, here's a case without this primary goal, here's a case without this secondary goal. You know, that kind of thing, and to me, that's where the planning is done. It's it's understanding the balance of the risk reward that you need to take to identify what goals are are optional and what goals are essential to what you need. Because, to me, risk is a preference, right? And so the stress testing helps you maybe localize that a little bit better.

Speaker 1 23:32
Yeah, okay, here we go. Well, Said, That was good. Well said, solve the world's problems. There you go. Well,

Alex Murguia 23:41
you know, it's from practice, from being that benevolent

Wade Pfau 23:48
dictator, wait person how to allocate their resources. Yes,

Alex Murguia 23:52
yes. Thank you. Wade. You see that brother now he takes a shot at me. I mean, the Silent Assassin. Yeah. All right,

Wade Pfau 24:03
we do want to finish with our listener question, of course, oh yeah, wait. Fire away, stop you from closing up the show before Yeah, yeah. So we are trying to do a question that comes in each week. And this question is from Jennifer, who asked at the retirement researcher base camp, which is a site we have on Facebook. Here's what Jennifer asks, I love your podcast and listen to everyone. I suppose she means she, she loves you too, Alex,

24:30
maybe that's an assumption. That's an assumption

Alex Murguia 24:33
we're making. I think we need to stress test that stress

Speaker 2 24:37
with me, it's still a net positive. But that's that's as far as I'm willing to go.

Wade Pfau 24:45
But Jennifer's question in your recent podcast on the updates to Wade's book, Wade and Alex discussed that an increase to the discount rate will make your funded ratio improve. I think you mentioned that the current discount rate is twice what it was allowed. Last time you updated the fund ratio calculation and yeah, just yet to that point, the discount rate you're able to use in the funded ratio has grown dramatically in the past few years. Now continuing. Is there a simple rule that can be used about how the discount rate relates to funded ratio increases? Is it as simple as if your discount rate doubles, then your funded ratio doubles as well. That does seem too good to be true, that's the question. And yes, that would be too good to be true. Now we can't really provide a comprehensive answer, but yeah, like a simple rule around that in the retirement planning guidebook, I do have a table in there that shows how the funded ratio changes. It's a sensitivity table, just like what we were discussing about, as you change the discount rate, how much does the funded ratio change? And so to just give you a sense of what this might look like, the baseline discount rate used in the retirement planning guidebook was 4.8% and in the case study there, the funded ratio of the the simple plan we're looking at there, it was 113% if you increase that discount rate by one percentage point. So from 4.8% up to 5.8% that increases the funded ratio from 113% to 119% so a one percentage point increase in the discount rate increased your funded ratio by 6% hopefully, that can give you some idea about, you know, what these relationships can look like. A different set of assumptions would lead to a different relationship there, but, but approximately speaking, you definitely are not doubling your funded ratio with a higher discount rate. But you know, it can be a dramatic improvement, especially as we talk about a few years back, the discount rate might have been closer to 2% we could be talking 1020, even 25 percentage points increases. So your funded ratio before, if it was 90% if you run it now, it might be in the ballpark of 115% and this podcast episode is airing the week of our retirement income challenge. It's too late at this point to join that one, but if you want to get on our mailing list for the next one, it does include a week long access to an explanation about using our funded ratio tool and running your plans in Yeah, the discount rate is going up over time because interest rates are higher now. So thank you Jennifer for that question. Yes,

Alex Murguia 27:30
thank you, Jennifer. The other thing I'd like to add, since we're doing our call to action portion of the podcast is if anyone's interested in a financial plan or just discussing issues around that, we'll put a link that we can provide a free 50 minute call with Jason, who leads our financial planning department over at McLean. He's been, he's been on the podcast various times, and so we'll put that as well. If you have questions around what we spoke about, or just just generalities, feel free to give us a holler. We're more than happy to discuss. Alrighty, anything else, Brian? Take us away?

Brian Bass 28:07
No, that was great. Thanks for having me on. It was a pleasure. Thanks,

Alex Murguia 28:10
Brian. All good man. All right, everyone. Thank you for listening, and we'll catch you next week on

Wade Pfau 28:16
retire with style.

Speaker 2 28:17
There we go. There we go. Look at that. We're well on the machine. Brian,

Brian Bass 28:24
our energy, the enthusiasm. I love it, yes, yes. Wade and

Bob French 28:27
Alex are both principals in McLean Asset Management and retirement researcher. Both are SEC registered investment advisors located in Tysons, 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 risk, including Risk of Loss past performance, does not guarantee future results. You