Episode 98: RISA® Styles and Inflation Management

00:00
Bob French
The purpose of retire with Style is t.

00:06
Bob French
The first step is to discover your retirement income personality.

00:40
Bob French
All good things come to an end, but not inflation.

00:44
Alex Murguia
When venido tol mundo. Adiro. Wasn't sure if you were going to translate the last name or not here.

01:03
Bob French
I was wondering if you were going if you're actually going to translate the last name or not. Here.

01:08
Alex Murguia
Hey, Roberto. Franci. Gometamono. Gometamo.

01:14
Wade Pfau
Impressive. Hopefully folks are still listening in, though, and not thinking that.

01:22

Alex Murguia
Hey, man, so many times I get to impress Wade, so I'm going to let me just soak in Calgon, take me away as I soak into that bath of Wade's compliments. So, wade a burning question. All of our listeners want to know, all of them being all three of them want to know how many push ups? How many push ups are we up to?

01:49
Wade Pfau
I'm getting back on track again today, but I have back on track. I got my vaccines. I got a round of vaccines that left me unable to do push ups for a couple of days.

02:02
Alex Murguia
That's a want you got to work on my way. You got to want them, man.

02:06
Wade Pfau
I'm still on track. We're going to get up to 100 a day soon.

02:11
Alex Murguia
All right? How many days in a row? Well, how many days in a row have you done?

02:14
Wade Pfau
And I'm doing real push ups. I wonder if you're doing.

02:21
Alex Murguia
I don't know if you're on YouTube. Are these real gains? How many days have you gotten?

02:31
Wade Pfau
Well, I've not had a day with 100 yet. But.

02:36
Alex Murguia
Hey, we're just happy you're here. We're just happy you're here at the gym, that's all. We're just happy you're here.

02:40
Wade Pfau
That's right.

02:41
Alex Murguia
It's a no judgment zone. Just like, what is it, planet Fitness or something like that. All right. No, well, I've kept it up, man, and I've done 100 real ones. My kids are there and they always bother me. Not in a row, though. I do like 25 or 30. 25 or 30 is kind of where I'm at a time. Yeah, because I'm working on the negative.

03:02
Wade Pfau
I'm working on the negative 20 and around, and then you get up to 20 or 25. Four or five times a day, you'll.

03:08
Alex Murguia
Be there so people won't recognize this. What about you, Bob? Are you doing anything or just eat, consuming calories?

03:17
Bob French
I do work out. I'm not doing 100 push ups a day. I'm not on this train.

03:22
Alex Murguia
What are you doing?

03:23
Bob French
Just general stuff. I'm running and what my trainer tells me.

03:31
Alex Murguia
You know what that means? You know what that means, Wade? Not a damn thing is what he's done. A full day for him is, oh, I closed my loops, or I'm halfway through my loops or something like that. Do you have an apple? You use an apple?

03:43
Bob French
I don't use an Apple Watch.

03:44
Alex Murguia
Me neither. I can't stand the hegemony.

03:46
Bob French
I don't know what I do with know. I don't know the benefit of having all that stuff on my wrist when I've got my phone in my pocket.

03:55
Alex Murguia
No, it's too much. It's too much. And plus when I type, I always take off my watch because it bothers my wrist. Maybe I'm not doing the keyboard correctly and it's taking off. Put it on. Who has time for that? Right? Wait, that's right.

04:09
Wade Pfau
Yeah.

04:09
Alex Murguia
But do you use Apple? I do. Oh yeah, you see Wade and I you see that's why it's and me, Bob.

04:12
Wade Pfau
I do not care for it.

04:13
Alex Murguia
Oh yeah, you see wait and I you see that's why it's and me, Bob. And you have to be a guest because I don't want to send you a text and it's the wrong color.

04:25

Wade Pfau
Yeah, my kids have iPad.

04:29
Alex Murguia
Just dropped like.

04:33
Bob French
I almost did. But it is incredibly annoying. Your texts are green. It's just the worst thing in the world, you know?

04:41
Alex Murguia
Believe it or not, it is a thing amongst my boys where they have apples and it's not just that they're green. It's like to be in conversations, like in threads or whatever. It's something about it that I think something that's weird.

04:54
Bob French
I don't know where it is, but.

04:55
Alex Murguia
Yeah, it's kind of like a middle finger to everyone else. But there it is. Right?

05:03
Wade Pfau
Speaking about middle fingers, supposedly Apple is hip and if you're cool, you use Apple and if you use Android, you're old fashioned. So I guess I'm fashion. But I can't stand Apple products.

05:15
Alex Murguia
Actually, I think the Samsung that I have is actually better than an Apple. But it's almost like even if it wasn't, I'd probably do a Samsung anyways because I think I'm naturally a bit of a contrarian. Like like I don't want to do what everyone is doing just because that kind of thing.

05:30

Wade Pfau
Yeah. I just never noticed how to do this. Only one mountain.

05:35
Alex Murguia
I'm not a sheep like Bob. That's right. All right.

05:40
Wade Pfau
Anyway.

05:46
Alex Murguia
What are we talking about today, gentlemen?

05:49
Wade Pfau
Well, we're going to wrap up our series on inflation that Bob has been very big part of helping us out with this. We want to go through the retirement income styles. It's somewhat a way to review what we've been talking about. But specifically, how do you manage inflation with each of the four retirement income?

06:08
Alex Murguia
Before that? Yes, it sounds excellent. Before that, I got a godfather reference. No, I was at a conference in parts unknown right, indiana and I was sitting at the table with these two ladies and were advisors and were talking for whatever, and they mentioned The Godfather as being a bad movie because it's really a guy movie at heart. And that's all it is, that kind of thing. And I was like, I disagreed. Obviously it's a work of art. Well, not the third one.

06:43
Wade Pfau
Right?

06:45
Alex Murguia
And then I started watching White Lotus with my wife, like, last week, season two. And there's a bit where they go into The Godfather, how it's like a guy movie. It was like repeating what I heard, and I was like, oh, that's where they got it from. So, Bob, does art imitate life or does life imitate art?

07:06
Bob French
I don't know, but I've never watched The Godfather, and because I never will.

07:10
Wade Pfau
It's a violent movie.

07:14
Alex Murguia
Yes.

07:15
Wade Pfau
Okay.

07:16
Alex Murguia
Inflation. Inflation.

07:19
Bob French
This is not going where you wanted it to, is it?

07:22
Alex Murguia
I just wanted to throw that in there a bit is I figured there's some people that are like, let's get to the topic. And I'm kind of messing around a little bit. I'm breaking that fourth wall with our listening.

07:31
Wade Pfau
See those one star reviews starting to flow in.

07:36
Alex Murguia
My cup runeth over inflation? I'll take it away. Yeah.

07:43

Bob French

So I think a good place to start with this is actually before we even get to the quadrants, it's incredibly important to recognize we all to a very big first assumption. We all get Social Security. That's going to cover a lot of people's, most people's essential expenses, and that is inflation adjusted inherently. There's some small groups of people who don't get Social Security, railroad workers and some other folks, but by and large, everyone does. That is kind of the baseline for most everyone's retirement plans. That is the baseline for how most everyone is going to deal with inflation. And that's always a good place to start these conversations. And I know we've mentioned it in, I think, every past episode where we've been talking about this, but that's for a reason that is incredibly important here.

08:51

Wade Pfau

Yeah, it's huge. It's a big chunk of inflation adjusted lifetime income. And the other thing we should just mention up front, too, is not everyone's spending needs are going to increase with the overall consumer price inflation throughout their retirement. A simple assumption in the 4% rule is your spending always grows with inflation. But we do know that people voluntarily it's not just because they run out of money, they voluntarily reduce their spending, or at least their spending doesn't grow with the overall inflation rate as they go through retirement. We have the go years, the slow go years, and the no go years. People just naturally spend less as they age other than, like, David Blanchett's spending smile with how your spending declines. And then late in life, health care expenses may start to go up, but still, overall, you're spending less on a lifetime basis compared to if you always just increased your spending for inflation.

09:44

Wade Pfau

So between that issue and Social Security, it's not as though you need to make sure that every asset you have is somehow linked to the consumer price index.

09:55

Bob French

Absolutely.

09:55

Alex Murguia

Well, that's a good way to talk about yesterday, too. I mean, not yesterday, whenever we recorded last week sometime actually weeks ago. Yeah. Two weeks ago? Yeah, a few weeks ago. We need to work more. No, but it came up right where we got caught up in. Okay, does this asset class track inflation and this over engineering of making sure every single thing is an inflation hedge and that's not necessarily a need?

10:20

Bob French

Absolutely. So with those two massive caveats in place that you've just got something that isn't a big something that's inflation adjusted by dint of paying into the Social Security system, and your spending is not always going to track inflation, you're not going to be jumping out of airplanes when you're 80 years old. Most likely you're going to slow down. You're not going to spend as much money. We can get into the conversation of all of that other stuff that we do want to talk about from an inflation perspective. So let's just walk around the quadrants here, I guess. So starting with total return.

11:09

Wade Pfau

Yeah. And probably most listeners are familiar with the retirement income styles. If you're a new listener, welcome. So the retirement income style Awareness. We talk about four different approaches to thinking about how people think about building their retirement strategies, and we'll go through those. And as we begin with each style, we'll just give a brief mention of what it means not to bore the audience who already knows, but we'll start with total returns. And total returns. That retirement income style is more comfortable relying on market growth, wanting to keep optionality for their assets, and is generally comfortable using a diversified investment portfolio to source even essential spending beyond Social Security. They don't really feel a need for protected income sources like annuities or individual bonds or bond letters. They're comfortable with an aggressive diversified portfolio to provide the growth they need to source their spending in retirement.

12:10

Wade Pfau

So that's what the total return style is. And with that being said Bob sorry to interrupt you with what you were saying.

12:17

Bob French

No, that was a pretty important interruption, I think. But I would say total return is pretty straightforward in terms of dealing with inflation. You invest your money, you put your money in the stock and bond market, the financial markets generally. And as we talked about in previous weeks, I guess that's two weeks ago. Now, over time, the expected return of risky financial assets is higher than inflation. And if you are investing for any meaningful length of time, the chance that you will outgrow inflation is pretty darn high. It's not 100%, but that's kind of the nature of the beast. When we're talking about that total return quadrant, you're banking on those expected returns basically panning out. So you're able to just build into your plan that your distributions will grow with inflation. That's just part of your plan. There's nothing special that needs to be done or anything like that, Bob, to.

13:30

Alex Murguia
Add to this, because this goes back to what you said previously when were talking about, you know, you're bringing up assets. Bob used specifically the word outgrow, not hedge. And that's important because you're right. I mean, look, total return is the real concern there is. Are you constructing the portfolio that is set to outgrow hedge a little bit? Whatever inflation, if you can't, you're not going to get anything. What were speaking about last time, your best bet is just to get a diversified portfolio according to your risk capacity. See how I said that capacity according to your risk capacity intolerance in which we'll ultimately outgrow inflation. I think to me, that would be the goal. Not necessarily think about it as hedging, I have this, and when this goes down, this will go up, that you can get into this mental sort of academic exercise.

14:28
Alex Murguia
I think more important is just make sure the expected return has an X plus one relative to inflation, and it's getting you there. But go back to that episode if you need to, but when you construct that portfolio, make sure you have a healthy doll up of things that will be able to do so. Because I don't want to give anyone the impression, oh, I'm in a portfolio that's 10% equities, 90% fixed income, and the fixed income is all in, I don't know, a five year T bill kind of thing, and I'm going to take my distributions off that because that's the total return. No, the building blocks of that portfolio is what you need to pay attention to, and then your distributions are as needed if you chose to go that route. Wade, anything there I may have missed? Or bob, does that sound about right?

15:17
Alex Murguia
Yeah.

15:20
Bob French
With some of those numbers we looked at in the past, that 10% stock portfolio, 90% five year treasury bond portfolio, or treasury note portfolio, technically, statistically, that will still outperform inflation, not by that much and with a lot of variance, but over the long term, you would actually probably outperform inflation. The question is, can that portfolio still be able to provide the growth needed, the real growth needed, the inflation adjusted growth needed to keep up with all of your planned spending? So it's always going to be this push and pull. It's always going to be you just need to run the numbers. You just need to run the plan and see what the probabilities of success are. See what failure looks like, see how everything kind of fits together, and make sure that you're comfortable with what all of the numbers are telling you, that you are comfortable with that level of risk built into your plan.

16:29
Bob French
Because you're never going to find a total return plan that's 100% safe, that doesn't exist. But you need to be comfortable where you are on that spectrum.

16:39
Alex Murguia
Yeah, and we did a whole arc on total return. And Wade, I'm going to ask you a question here so we don't need to get into the different types of styles. But at the big picture, I would like to just discuss the allocation piece. And Wade, you've looked at it and the biggest mistake someone could make here, aside from worrying about just make sure you're taking the proper amount of risk, et cetera, is the allocation when they over engineer it. From the studies that I've seen, how much of a difference is there between a 30% equity portfolio versus 70% fixed income relative to like a 70 30? There's a range in which I say this being a little cute, granted, but there's a range where it doesn't really matter. All that know, but you don't want to go below it because then it does matter.

17:32
Alex Murguia
Do you want to just touch base about that?

17:35
Wade Pfau
Yeah. In the historical simulations with US data, kind of the work Bill Bengan had done, what we see is the 4% safe withdrawal rate idea worked with anything between 35 and 80% stocks. If you got less than 35% stocks, you just didn't have enough growth potential. Even with an all bond portfolio, historically, 2.4% was the safe spending number. And then once you start getting over 80% stocks, the volatility of the stock market did lead you to dip below 4%. Not by much, but on occasion historically. And then I've looked at the international data as well, and at least in 18 of the 20 countries having at least a 50% stock allocation tended to support the highest spending. In the worst case scenario, there were only two countries that you had your best outcome going under 50% stocks. So in historical data generally, this sort of total returns approach is pointing to not being too conservative with your portfolio.

18:37
Wade Pfau
Definitely not. 10% stocks is not really what we're talking about at all. Bill Bangin in his first article said retirees should hold 50% to 75% stocks and as close to 75% as possible. And that's something that really the precise numbers can vary from situation to situation. But the concept is there. Total returns requires being comfortable with a somewhat aggressive portfolio in retirement.

19:04
Bob French
Right. That message is 100% right by the numbers. But it's easy to go too far on that statement as well. It doesn't necessarily mean have a really aggressive portfolio. 50% is fine. If we look at the financial markets as a whole, it's real easy to forget the market portfolio is two thirds stock or excuse me, two thirds bonds, one third stock. So the total return portfolio, kind of the total return quadrant is almost by its nature going

to be tilting more aggressive even with what people generally consider to be a conservative portfolio. And you don't want to push it too hard because, again, as Wade mentioned, you're going to be taking at least some of your essential spending from risky assets. It's going to be a lot more painful for you in that total return quadrant to have a down market when you're trying to spend out of your portfolio than a lot of the other quadrants.

20:19
Bob French
So it's always going to be again, that push and pull thinking through these trade offs.

20:25
Bob French
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20:47
Alex Murguia
So then, Bob, is it fair to make this statement when it comes to keeping up with inflation from a total return approach? Get a healthy mix of stocks and bonds and you should be fine, right? Absolutely. Don't lose sleep over do I need gold for 3% or these sort of false sense of precision and allocations. At the end of the day, get a healthy exposure to growth assets, risky growth assets, and a healthy exposure to fixed income access relative to your overall risk tolerance, but don't try to be over precise. And the biggest issue and notice how we're getting back to at the end of the day it's about allocation, right. The biggest issue is to me, the people that fail are the people like, I'm going to put Bengan in the mix here where eat your own cooking, right? Where he went to cash or he went to extremely conservative.

21:47
Alex Murguia
Now he could have a ton of money, so what does he care, right? But no, who cares, right? I can self fund everything in cash, bless you, congrats, whatever. But effectively the danger comes where people like people when you get this sort of level of preciseness or you get to forecasting, you go to cash for a while, then I'm going to go back to my portfolio, then I'm going to go to cash, then I'm going to go back to my portfolio. Because what inevitably happens is you miss it and then all of a sudden then opportunity costs, inflation and everything really hits you over the head. The worst thing you could do too is get it right the first two times because then you're a self described genius. At this point, you right now, yeah.

22:39
Bob French
I think we've had an episode on market timing or we've certainly discussed it pretty extensively, but one of

the things I always talk about is there's a reason 60 40 is the bog standard stereotypical retirement portfolio. It strikes a pretty decent mix in terms of having enough in that growth portion of the portfolio, but also tempering it enough with bonds, obviously depending on what those bonds are and obviously depending on your reaction to all of the volatility that is still inherent there. But that's where a lot of people end up falling out. That seems to be a sweet spot for a lot of people. So that's at least where a lot of people can start from and move from there.

23:29
Alex Murguia
Now, you say bogs portfolio, you said that all the time and I always just the bogs standard. I don't have the energy, no idea where that comes from to ever ask you that. I just like assume a nod and let's just move on.

23:41
Bob French
I assume it means Wade box.

23:43
Alex Murguia
Yeah.

23:44
Wade Pfau
Wade Box, Boston Red Sox.

23:45
Bob French
No, it's not.

23:47
Wade Pfau
No.

23:47
Alex Murguia
Why would that have to do with 60 40? Did you eat chicken weight before you started this podcast?

23:53

Wade Pfau
Lemon chicken?

23:53
Bob French
No, it was the beers.

23:55
Alex Murguia
Yeah, exactly. No, but you don't know where that name comes from. It's somebody's name.

23:59
Bob French
I assume the bog standard just means kind of normal.

24:03
Alex Murguia
It must have been some guy working for Samsonite. Their pension fund.

24:07
Wade Pfau
Bog. Like bog down in the bayou.

24:13
Bob French
I don't know. I've never put enough thought into.

24:18
Alex Murguia
Wade's, throwing out John Fogarty song titles all of a.

24:19
Bob French
Time I'm on, I will have answer for you.

24:21

Alex Murguia
Wait's, throwing out John Fogarty song titles all of a.

24:29
Wade Pfau
There is more nuance too. Before we move on from total returns.

24:33
Alex Murguia
It'S.

24:36
Wade Pfau
Not just asset allocation, but in the intellectual history of retirement income, there was this safety first concept that if you want to have a volatile investment portfolio, you should prepare for volatility with your spending. If you want constant spending, you shouldn't have volatility in your portfolio. And we see that idea with the retirement income style awareness where total returns if your total returns, it generally means you're more comfortable with flexibility for your spending. You have more of an accumulation mindset. You don't focus on predictable income. And so another lever built into the total returns concept is if I have an aggressive investment portfolio, I better also generally be comfortable. And I probably am more comfortable making spending cuts or not having my if inflation ends up being higher than expected, I may not be able to keep up with inflation. And that's more built in that you're going to be more comfortable with that idea as part of being total returns.

25:36
Wade Pfau
And so then that's another lever too, because part of the whole issue of sequence of returns risk is being forced to sell at a loss. Well, if you just don't increase your spending with inflation, you're not forced to sell as much of your assets. And that becomes another way to help manage this sort of inflation risk as well. See that? I blew.

25:59
Bob French
Absolutely.

26:01
Alex Murguia
I'm still soaking in that intellectual history. Sorry. Yeah.

26:04
Bob French
As much as the allocation is a big story, that frankly is probably the bigger story, being able to make those changes and accepting that you may need to make those changes in the future, that's almost the whole story.

26:21
Alex Murguia
And it's a viable strategy. It's just recognize the game you're playing.

26:26
Bob French
Exactly. But with that, let's move on to time segmentation. That's quadrant two here.

26:32
Alex Murguia
Well, you're breaking Wade's cardinal rule, Bob. What's that?

26:36
Wade Pfau
Wade?

26:37
Alex Murguia
Do you know what that?

26:38
Wade Pfau
Oh, we've got to define the term. But you didn't get go.

26:43
Alex Murguia
No, you always go from total return to income protection. Bob is going counterclockwise on the matrix that is unheard of in this podcast.

26:55
Bob French

Going back to middle school math. The quadrants are numbered top left with total return. That's quadrant one, top right.

27:05
Alex Murguia
Absolutely right. You know, you're absolutely correct. All right, fine. But, you know, I went clockwise when we started doing the stats. It was like, Wade, it's the opposite.

27:24
Wade Pfau
We were like, that.

27:26
Alex Murguia
It was like, wait, it's the opposite. I don't know if you remember that, Wade. Remember, it was like the coding. It threw off our stats coding because were like, wait a while to.

27:36
Wade Pfau
Get the hang of your convention. I was having a cross reference because everything the quadrants were identified with numbers, and I was having a crop reference what those numbers?

27:49
Bob French
Okay, so should we talk income protection now or mix it up and.

27:55
Wade Pfau
Probably easier to go with time segmentation.

27:58
Alex Murguia
Okay.

27:58
Wade Pfau
It's a cousin of total returns, and.

28:02
Alex Murguia
It maintains the intellectual history.

28:04
Bob French
That's right.

28:07
Alex Murguia
Wade's. Phrase of the day.

28:14
Bob French
Well, actually, Wade, why don't you do the definitions here?

28:18
Wade Pfau
Okay, so time segmentation is shifting away from total returns because you start thinking about your portfolio earmarking different sections for different purposes based on time. And so it's bucketing. I'll have these different buckets, and I'll have a short term bucket where I'll put my bonds to cover short term expenses. I may have a medium term bucket, which is more mixed, and then I have a long term bucket, which is where I tend to put my stocks that's the growth portfolio earmarked to cover long term expenses. So I may still end up with, say, a 60 40 portfolio, but it's just framed differently in my mind. My 40% bonds is all earmarked more for upcoming expenses. My 60% stocks is earmarked more for longer term expenses. And then I do have to maintain some sort of rule around when I'm going to draw from the long term buckets to replenish my short term buckets as I spend them.

29:10
Wade Pfau
But then that gives me some flexibility to make decisions around when I do that sort of replenishing. If my portfolio looks like it's in trouble, I might let those growth portfolios ride and not refill my short term buckets, hoping for some recovery before I completely deplete my short term buckets. So that's what time segmentation is.

29:34
Bob French
And it definitely has. Best of Both Worlds is the wrong terminology, but it pulls from both sides of the fence

in terms of that total return and having that big chunk of risky portions of the portfolio that do have, again, that higher level of expected return, or at least that positive, real expected return, positive inflation adjusted expected return. But then it does have generally, it's going to be a bond ladder of some sort there, and that can very easily be a tips bond ladder that you can get your inflation protection on that income piece. Pretty straightforwardly.

30:23
Wade Pfau
Yeah. And just a broader point as we start getting into the Tips ladder again, is you kind of have two options about your inflation protection. Are you going to go the Tips route, or are you going to go the stocks route? And the Tips route provides you a contractual protection for inflation protection. The stocks route provides you with an expectation that stocks should grow in excess of inflation and that you'll probably be okay with that. So, yeah, we're now with a Tip slider using individual bonds that offer a real return plus inflation so that, you know, no matter how high the consumer price index measures, your asset will provide that additional return to keep pace with inflation.

31:10
Alex Murguia
So two points of clarity for someone listening in is we're talking now about individual bonds or a MIGA or something like that, but it could be some contract. But for the purposes of here, let's just keep it simple. We're talking about individual bonds, and so you are taking them to maturity in total return. We're kind of speaking in the world of bond funds, and you have one big thing, and you're pulling it out. Right. I want to disabuse somebody thinking, oh, but rates will go up, and so my bonds will go down. You're taking them to maturity, so they'll be at par, assuming there's a high credit quality, that kind of thing, not like we're not talking about junk bonds or anything like that. And so they're going to pay out in maturity. And you could add that inflation wrinkle, if you will, if you wanted to go the routes of Tips or whatever.

31:57
Alex Murguia
But Bob said something, I want to make sure it's caught up. Where do you want to put your inflation lever, if you will? Do you want to have it be in the bonds? Do you want to be in the investment portfolio, or do you want it in both? Right. It just depends. And Wade was pointing and Bob and Wade were kind of pointing out that, okay, you can earmark your short term cash, short term being, let's say, three years or less right. From something.

32:23
Wade Pfau
Right.

32:24

Alex Murguia
And unless inflation just goes like crazy, if you will, you may be screwed. Right. But the reality is, look what we just went through, and we spoke about it in previous episodes, inflation is actually hovering at was it two nine, Bob? Three?

32:38
Bob French
I forget the exact number, and I don't know what it'll be when this one comes out, but okay, but think about everything that's broadly, historically average inflation.

32:46
Alex Murguia
Yeah. It's not crazy. Like, maybe eight months ago, you were like, oh, my goodness. Right. And so a bond ladder thing, you still need assets to refill the buckets. Yes. Every, let's say, four to five years just to put out something. And so there you kind of need that risky exposure to be. Able to fill those buckets in a manner that keeps up with the spending, just putting it out there. So personally, if I'm going to worry about inflation, I'm going to contemplate that with the risky part of the time segmentation portion, not necessarily the bond part, but that's just my own personal preference.

33:33
Bob French
There a lot of different ways. And if you do decide to use non inflation adjusted bonds, that's perfectly reasonable and depending on the length of as your point, tax considerations, whatever of the latter, if it's three years, yeah, it's probably not the end of the world. If you're getting off into seven years, well, now it might be a little more of a consideration, but even at that point, there's nothing stopping you from buying another bond for that three year rung and kind of topping up some of the shorter term stuff. If we are seeing higher levels of inflation like we have the past couple of years. But again, as Alex mentioned, right now, forward looking inflation, as we've seen by comparing the Tips yield versus the nominal treasury yield, it's pretty darn low, certainly a lot lower than what we've seen again in the past couple of years.

34:35
Alex Murguia
And Bob, they're giving away iPhones. That's right. Wade, you were going to say something, I think it was about how the acumen of my.

34:47
Wade Pfau
Can'T fully I did sort of say you might use the Tips more with the time segmentation, but to the extent that you're using this in shorter term buckets, you're not getting that full inflation protection experience. The true inflation hedge for a 30 year retirement would be to build a 30 year Tips ladder. But of course, that can

also become very expensive to do. And so then it becomes ultimately a combination of some Tips, but also the reliance on still the idea that stocks will grow in excess of inflation to make sure that plan is going to work in the long term. Right?

35:24
Alex Murguia
Yeah.

35:26
Bob French
The backbone of that inflation protection, whether you're using Tips, whether you're using nominal bonds, is still that higher level of expected return in your risky portfolio. And one thing to keep in mind here, especially when we're talking about Tips, is that risky piece of the portfolio can get really putting depending on your mental framing. I take a slightly different mental framing than Wade does there. But you're putting a massive chunkier bonds in that bond ladder, a massive chunkier, non your less volatile assets in that ladder, which means for a lot of people, that risky portion may not be 100% stock, but it may not be that far off either. And it's really going to come down to what your mental framing looks like, how you want to put that together. And that can cover up a lot or cover up is the wrong term, but that can deal with a lot of inflation there.

36:32
Wade Pfau
And just another note, with time segmentation, part of the story of why it may, quote unquote, work, so to speak, is it gives you a dynamic asset allocation if your portfolio is in trouble, risky portfolio here you're spending those short term buckets and you're not replenishing them. You may be creeping up towards 100% stock allocation, especially if your growth portfolio is 100% stocks. So you have to be comfortable with the framing because of what it can imply with a fluctuating stock allocation as you go through retirement and higher stock allocation when markets may not be looking as good overall and when most people would tend to panic and move away from not that they should, but the panic is you shift away from stocks when markets are down because you get scared. This strategy has you stay in the.

37:23
Alex Murguia
And the other piece, and this is going to the flip side of that logic, I think, and Bob, I'm doing this off top of my head, but somebody has $10 million now, it's a different beast. Okay, Grant, but somebody could be thinking, you know, what the heck with this. I can underwrite everything that I need. I'm not going to spend this much, but I don't want to lose purchasing power. So I'm just going to fill my portfolio up with six month CDs and that's it. And it'll always recalibrate for inflation. I want to say Pharma said something that the best inflation hedge is like a six month bill or something like that.

37:58
Bob French
In fact, I think I've told this story a couple of times now where Gene Pharma obviously is at Dimensional Fund Advisors, and when they came out with their one year fixed income portfolio, which they use their variable maturity, so it's very rarely actually at one year, it's usually a couple of months long in terms of duration. He wanted to call it the inflation hedge fund. They obviously didn't let him do that. They don't let him make any marketing decisions. But that's really getting at that same idea. Having that constantly rolling portfolio does deal very effectively with inflation. It's that rolling piece of it. By bringing in the new inflation information.

38:47
Alex Murguia
That'S extreme optionality, by the way.

38:49
Bob French
Extreme optionality. The problem is you're also bringing in the new interest rate information, so you're taking on a massive chunk of interest rate risk along with dealing with that inflation. So, again, just like everything, there are trade offs implied here.

39:07
Wade Pfau
And that also sounds like a rolling bond ladder, that you're not actually spending it, you're just reinvesting it, whereas in retirement you spend your bond ladder.

39:16
Alex Murguia
That's why I said the only one that could do that is somebody that has an insane amount of money that is like, who cares?

39:25
Wade Pfau
Okay.

39:25
Bob French
Yeah. Anything more to say on Time segmentation here? I think it's really going to come down to you may

want to use tips in your ladder. Your risky bucket is going to do a lot of the heavy lifting. Hopefully everything works out.

39:44
Alex Murguia
The bonds hedge, the risky assets will outgrow. In an ideal world.

39:52
Bob French
Curious if you should be looking at a Roth conversion.

39:55
Bob French
Or what a Roth conversion even is.

39:58
Bob French
Head over to Mcclainam.com slash Roth to.

40:01
Bob French
Get McLean's free ebook. Is a Roth conversion right for you?

40:06
Wade Pfau
And learn about when you might want.

40:07
Bob French
To do a Roth conversion and when you might not. Just head over to Mcclainam.com slash Roth.

40:14
Bob French
To download your free ebook today. Dealer's choice on protection, which are the bottom two.

40:20

Wade Pfau
We got to do income protection before risk scrap, never before income protection.

40:30
Alex Murguia
Wow. He has that on stone tablets.

40:33
Wade Pfau
Yeah. Now, risk grab is an offshoot of income protection. So income protection is you want to have protected lifetime income sources to cover your basic spending in retirement. And once you have that in place, then you feel more comfortable investing the remainder in. At this point, it can be more aggressive. You have more risk capacity. Your lifestyle is less vulnerable to a market downturn. So an aggressive, diversified portfolio, you're marked more for discretionary goals, and your essentials are covered through protected lifetime income sources. And so once you get past Social Security, any pensions, any other reliable income sources that you have, if there's still a gap, rather than drawing from the diversified portfolio to fill that gap, as total returns would do, you may look to purchase annuity protected lifetime income to fill that. So Bob kind of handing it back over to you. The issue here is commercial annuities don't offer inflation protection.

41:35
Wade Pfau
What does the income protection person do?

41:37
Bob French
Yeah, so I'd probably say this is the toughest quadrant to deal with inflation on. So there are no to the best of my knowledge, and I'm 99.9% sure this is still a true statement, there are no income annuities that have inflation adjustments.

42:00
Alex Murguia
We spoke about that two podcasts ago. The only guy that last person all right, let me ask him. Wade, who's the last person that bought an inflation adjusted annuity? What did he do for a living? Let me make it even easier. This guy's not paying attention, Wade. This guy is just not paying attention.

42:18
Wade Pfau
I've mentioned this on a previous episode.

42:20
Bob French
Yeah, you mentioned this. He told a whole story about this one, Wade.

42:25
Alex Murguia
Bob was checking his emails.

42:27
Wade Pfau
Bob was checking his emails.

42:30
Alex Murguia
Yeah.

42:32
Bob French
That actuary is probably going to be.

42:34
Alex Murguia
The last one for a his. Bob's Neurotransmitters went crazy. He got it. Yeah, he was an actuary, the last guy.

42:45
Bob French
But maybe someone got religion in the past two weeks or so and put one out there.

42:51
Alex Murguia
They heard this podcast and said, there's an opportunity.

42:54
Bob French
That's right.

42:55
Wade Pfau
I would love also to note, sometimes this point gets mistaken because people will say there are inflation protected annuities, but they're talking about cost of living adjustments like you can get.

43:05
Alex Murguia
And you, like, knocked me out.

43:07
Wade Pfau
There we go. A fixed 2% increase every year. A fixed 3% increase every year. But though that provides you income growth, it's not inflation protection in the sense that if inflation ends up being higher, you're still getting the same past two years.

43:22
Bob French
When were looking at 8% or 9% inflation, you were still losing purchasing power.

43:28
Wade Pfau
Yeah. With your is it me to think I'm crazy, though?

43:31
Alex Murguia
I still think in the grand scheme of things, isn't a quota 3% good enough? It'll get you over the course of.

43:37
Bob French
Your life, probably, but the issue is plus Social Security.

43:43
Alex Murguia
Plus Social Security. And we're talking about essential spending. We're not talking about all spending. Sorry.

43:50

Bob French
The issue is that sequence risk, though. If you were someone who was retiring into the Pandemic, which a lot of people were, I'm sure a lot of our listeners, some of them retired because of the Pandemic. Well, they got whacked with that really high inflation rate, so they canceled their.

44:11
Alex Murguia
Netflix and then they buy it now again. I mean, so what?

44:15
Bob French
I'm sure you have one or two Irate listeners after that last statement, though.

44:19
Alex Murguia
No, but you can't have it. All right.

44:23
Bob French
That's what it mean. That is definitely one avenue to be looking at in terms of the Income Protection Quadrant or those cost of living adjustments do not come free, though those are relatively expensive riders to add on. But the whole deal of income protection, quite frankly, is pretty expensive in this Income Protection Quadrant, so that may be a good solution.

44:55
Alex Murguia
I'm going to call you on that and I can't explain it as well as Wade. When Bob says expensive, what does that mean, Wade? Because I don't want people to think.

45:04
Wade Pfau
Oh, it's not expensive in that the insurance company is taking a bigger overhead on them. They're still pretty much they're putting they're pushing your spending back, so they're going to have a lower initial payout rate. So for a given premium, you're going to get less today because it's built increases over time. And I guess that's what you like. I also wasn't sure what you meant by expensive, but I guess that's what you're getting at, right?

45:31
Alex Murguia

Yeah. I wanted to point out, it's not that the insurance companies are like, hey, here's a sucker, let's get them. It's not like that at all. It's more the environment is such that to price it out, they need to make those accommodations.

45:43
Bob French
Yeah, it's the same way that buying a Tips ladder is more expensive than buying a non inflation adjusted bond ladder. You're going to get a lower dollar value coming out for the same amount of money, I think is a fair way of phrasing this as I'm circling around the actual right answer here, but there's a couple of other things that you can be thinking about in the Income Protection Quadrant. One is you probably haven't annuitized everything. Generally, people are going to annuitize their essential spending, maybe, plus a little bit more, depending on the situation. And if you're comfortable with the inflation piece of your spending coming from your risky assets, that's definitely a viable way, though it is worth considering that can end up being a big chunk of your portfolio or a big chunk of your spending. Excuse me. Later on in life. That's a risky one.

46:51
Alex Murguia
I think that's net worth dependent. And what I meant by that is you said, I don't think most people will be able to fund all of their essential expenses with contractual income. And that's with Social Security in mind. It's like, think about it. If someone makes, I don't know, whatever, $50,000 a year, Social Security will be a significant part of their retirement income, that it will probably cover more as a percentage of essential expenses than someone that makes $500,000 a year. And so its results vary on that one. But the point is, look, try to line it up as much as you can with essential expenses. Sure. You have Social Security that'll cover a certain part. And yes, if you do decide to go in from protection, you try to do as much as you can economically, but expect that you will need to invest in risky assets to effectively maybe try to cover everything else.

47:47
Bob French
Yeah, that's a big piece here.

47:52
Wade Pfau
Yeah. And also, just in terms of how much annuity that you get, I don't think you necessarily need to overshoot what you're trying to achieve today because of this issue. That will, over time, the purchasing power of that reliable income will decrease. You can ladder in additional annuity purchases in the future. You may find that with this whole issue that your spending doesn't grow with inflation, you're still comfortable. You don't necessarily need to make those additional purchases. You could even set aside a Tips bond that you say frame as well. This will be used for purchasing an additional annuity in the future. And that way you can inflation protect at least the premium you'll be able to afford at a future date.

48:37
Alex Murguia
That's a great point. And Bob, this is Wade. Cover your ears when I said my thing and I said Wade, like, for him, I was worried that this is great, you awesome answer out of the park. But I thought he was going to say, yeah, and that's it. And then we're like, okay.

48:58
Wade Pfau
I've got more for you, too, on this one.

49:01
Alex Murguia
Fire away, my man.

49:05
Wade Pfau
Yeah. And it's just also to the extent that annuities can support more spending from a given asset base as you age, compared to bonds, to the extent that you're using the annuity as part of your bond allocation, more of your future spending would come from the annuity. Less needs to come from your portfolio.

49:24
Bob French
That's right.

49:25
Wade Pfau
If you're spending less from your portfolio, this whole issue of sequence of returns risk, it's easier for your portfolio to grow. So you're giving your portfolio a better chance at growing faster than inflation because you're not putting as much distribution pressures on it. And so that's another way where the income protection approach can still the annuity doesn't provide the inflation protection, but it can make it easier for the rest of the portfolio to provide the inflation protection.

49:53
Alex Murguia
That's that's why I wouldn't even get caught up with matching everything with inflation if I'm doing this. I'll take the Cola, call it a day if I want. But I'm looking at the portfolio at that point because another thing Wade didn't mention that he likes to say a lot is this is now you have true liquidity, right?

50:11
Wade Pfau
Yeah.

50:14
Alex Murguia
But we're running at 50 minutes to inflation. Bob was like, I don't know, we have enough for today.

50:22
Wade Pfau
Hold my beer.

50:24
Alex Murguia
Hold our beer.

50:25
Bob French
And this explains why Alex started speaking Spanish in the beginning.

50:29
Wade Pfau
Here he's trying to stretch out the episode. But we still have another quadrant.

50:33
Alex Murguia
Never.

50:34
Bob French
You have one more quadrant, the one.

50:36
Alex Murguia
We say that in Spanish. Trieju and volvere. Trieju. I don't know, something like that. Go ahead.

50:50
Wade Pfau
Any alliteration available. But risk wrap, you're comfortable with the market, but you also are comfortable committing to a strategy. And ultimately you want to put some guardrails around the market exposures that you take. You're more worried about outliving your money. So you do also think in terms of protected lifetime income. But that's where this is just like time segmentation is more behavioral, risk graph is more behavioral. And you could simply set up. You could use income protection, you could have an income annuity, you could have stocks, but with risk scrap, you might look at something more like a variable annuity that mixes this together, where you have the growth potential within the annuity while at the same time you have a living benefit that provides a protected lifetime income stream. And so what does the risk wrap person do to manage inflation risk?

51:42
Bob French
Pretty much the same thing as income protection and mixing a little more total return. As you said, Wade, it's somewhere in the middle there. You're going to be more comfortable taking from that risky bucket or you're going to be less unhappy of taking from that risky bucket. That someone that the income protection might have to do. And the variable annuity type of framework, obviously depending on that product, gives you a little bit more flexibility and a little bit more potential for growth there. So hopefully getting some more of that inherent, expected return, inflation protection, inflation outgrowth, if you will.

52:27
Wade Pfau
Yeah, and I think also people may need to be a little bit careful if they're risk graph and looking at the variable annuity because they're more probability based, they are more comfortable with the idea that the annuity may grow and provide step ups and that growth could keep up with inflation. But empirically, it is difficult for a variable annuity to achieve these new high watermarks of growth during the distribution phase. Because market returns have to consistently be higher than what you're spending, plus the fees providing protections, but fees plus spending, it's tough for the portfolio to keep up with that. So generally as you go through retirement, it's going to be hard to have those step ups in growth. It's hard for the annuity itself to keep up with inflation. And so depending on your overall asset allocation, because the payouts on variable annuities tend to be less than the fixed annuities, you're also not getting to ride as much on.

53:29
Wade Pfau
Well, if I have this income from the annuity, so now it's easier to spend less from my other investments, so they'll have an easier time growing, but you're still going to have to spend more from those other investments as well. And so behaviorally, what you're looking for here may not ultimately be the best way to keep up with inflation. And that is a consideration with risk wrap. I don't know. It's not like every

strategy is equally effective at keeping up with inflation. And that's where the behavioral nature of the risk wrap strategy could put it in a more challenging position. If your primary concern is this sort of inflation protection in retirement.

54:07
Alex Murguia
So if I'm hearing you correctly, once you take distributions, you're kind of locked in on where the values are. Even though you do have that market exposure, you'll still have trouble overcoming the hurdle of the distribution and of just a general expense to get that new level over time. Yeah, so it's before this takes place as you're accumulating is when you could see that upside, if you will, but on a level reset, but not the other way, not once you're taking money out. I mean, yeah, stranger things have happened, but it's not something to bank on. Is that a correct normal explanation?

54:45
Wade Pfau
Growth? Like if maybe the first few years markets are doing great and you're getting step ups, but as soon as there's one down year, even if the market then recovers, just like the sequence risk, it's hard for the contract value of the annuity to now achieve a new high water mark because you're spending from it. And you did have that year where you're spending a bigger percentage of it.

55:05
Bob French
And it's also the normal issue of when you go down, you have to go up a lot more if you lose 50% of your value. Well, you don't just have to make up 50% of your value to get back to the original starting place. Now you got to make 100% of your value. So we're also dealing with that just straight up math type of issue here.

55:28
Wade Pfau
Part of the sequence the same with total returns, but because of the additional fees that are providing protections with the annuity, it's that much harder for the annuity to overcome. The math that you just described.

55:46
Alex Murguia
And.

55:47

Wade Pfau
It'S a concern, I think that's known.

55:50
Alex Murguia
As the Kobayashimaru paradox, where's that from Wade? Come on, man. You would know.

56:00
Wade Pfau
I know you've been watching a lot of anime, so I don't know what.

56:03
Alex Murguia
You seriously, man, it's not anime. You know where it is.

56:08
Wade Pfau
Is that a alien somewhere in the universe?

56:11
Alex Murguia
All right, explain it to Way. Come on. Some of our readers have to know this. Wade.

56:18
Bob French
This is like the most basic Star Trek thing. Wait.

56:22
Wade Pfau
I'm not a Star Trek person.

56:23
Alex Murguia
Neither am I. I'm not, either. We got it together, Bob. We did it. Take a bottle. We did it. We did it.

56:37

Wade Pfau
Hey. Got him. The Godfather. At least.

56:43
Alex Murguia
We did it in under 100 episodes. We finally got him.

56:48
Bob French
It was close, but it is less than 100 episodes.

56:54
Wade Pfau
All right, it's a Training Active, the Star Trek franchise designed to test the character of Starfleet Academy cadets in a no win scenario.

57:02
Alex Murguia
All right.

57:03
Wade Pfau
Yeah, I had no idea what that was.

57:05
Alex Murguia
He cheated. Captain Kirk cheated, and that's how he passed. All right, well, on that note so where were we?

57:15
Wade Pfau
I think we've reached the end of.

57:16
Bob French
The productive portion of the conversation.

57:19

Wade Pfau
Wade.

57:24
Alex Murguia
God. Wait. That's why a star is born. All right, everyone. Someone's knocking at the door, so the dogs are going crazy, so I got only so much time left. I'll say my goodbyes and mute this out. Thank you, everyone. Right.

57:42
Wade Pfau
Catch you next time on Retire with Style. Thanks, Bob.

57:45
Bob French
Thank you.

57:48
Bob French
Wade and Alex are both principals of 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 a risk, including risk of loss. Past performance does not guarantee future results.