Episode 25: What is Your Funded Ratio? Part 1

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 reset profile.com/style and sign up to take the industry's first financial personality tool for retirement planning. Retirement Planning is simple, right? Well, I guess it depends on how far you let Wade, Alex, and I wander into the weeds.

Alex Murguia 00:49
Hey, everybody, welcome to Retire with Style. I'm Alex. I'm here with Wade and I'm here with our favorite reoccurring guest Bob French.

Bob French 01:00
Hey, everyone.

Wade Pfau 01:03
Welcome back. It was Bob, by the way.

Bob French 01:05
Yes, that is that is Bob.

Alex Murguia 01:09
So Wade, what are we going to talk about today? It was an uncomfortable pause. So let's just pick it off.

Wade Pfau 01:21
I was wondering whether we should mention that Bob wishes he had air conditioning now up in Maine.

Bob French 01:25
Yeah. old houses No, no air conditioning. And, you know, it's rough. It's up in the 80s. And it's just not acceptable here in Maine. So

Wade Pfau 01:37
Okay, enough small talk guys. We got

Alex Murguia 01:41

way, this is the point where we're supposed to say, Oh, my God is much hotter than that here. You know, blah, blah.

Bob French 01:48
Dallas, I was living here wide open for that.

Wade Pfau 01:51
Yeah. 108 degrees every day.

Alex Murguia 01:53
108? Yeah, but it's a dry heat. It's a dry heat.

Wade Pfau 01:58
Part of the Midwest, you know, alley now. So it's that humid heat. But anyway, today, but anyway.

Alex Murguia 02:13
This is like card talk before like retirement planning, I think.

Bob French 02:19
The intellectual discourse, everyone's tuning in for here.

Wade Pfau 02:23
We're ready to talk about the funded ratio, which is a really helpful tool to get an assessment of whether you're on track with a financial plan for retirement. It's an alternative to Monte Carlo based software, which if you've ever run a retirement plan, and it reported a probability of success, that would be well, probably a Monte Carlo based type software program. But the funded ratio just looks at it from a different perspective where you don't have to worry about simulating randomized returns for stocks and bonds, you simply assume a low risk type investment return. And you consider whether you have sufficient assets to meet your various goals, financial goals for retirement. So that's the main idea. And that's really what we're looking to talk about today. And we've got Bob French here as well, who helped with the retirement researchers and McLean Asset Management with creating a funded ratio tool. So he's got that experience as well. So thanks for joining us today, Bob.

Bob French 03:25
Thanks for having me.

Wade Pfau 03:27
And I suppose to really get the discussion going, we should probably talk about what we call it Retirement Researcher, the RIO map, which is the Retirement Income Optimization map, which is really just an illustration of the funded ratio without putting in any numbers. And so with the RIO map, it's it's about mapping assets liabilities, goals will goals or like liabilities, but let's Yeah, let's walk through that. And therefore Ls quiz Alex here, he knows what the four L's are. Come on. Do you remember at this point, yeah,

Alex Murguia 04:07
Bob, Bob, text me on the side? Well, the first one is love, then it's laughter then it's prayer. It's love what's, what's that book? What's

Wade Pfau 04:25
kitchen? I think

Alex Murguia 04:34
no, so the RIO map if you think of, you know, imagine, imagine a world right think on the left hand side there's a column right and let's call that your your four hours. And effectively it starts with longevity. We asked your Yeah, I'll just name them. You can explain to my longevity, lifestyle, liquidity and legacy. Boom, Wade didn't even hesitate baby. They didn't even hesitate. Thank you for the text, Bob.

Bob French 05:05
We can't see what you're looking at here on your computer the recording, it's

Alex Murguia 05:09
No and I know those are the four hours. Pray tell Wade, what did they say?

Bob French 05:14
Where are we going with this?

Wade Pfau 05:16
Well, we've been talking about budgeting in the recent episodes, longevity and lifestyle is about the retirement budget. So in recent episodes, we've been talking about the budgeting process for retirement. And to the extent that you can make a differentiation with your budgeting, longevity is more about your essential your fixed or your core retirement expenses does with the idea being you really don't want to outlive your ability to fund longevity expenses. And then lifestyle to the extent that it exists is something separate, it implies there's more discretion, things that to have the best possible retirement, you definitely want to do. But you do have some flexibility that if things are going really badly with financial markets, and so forth, you could cut back a bit on lifestyle, but together lifestyle and longevity, that's the retirement budget. And then legacy, of course, is pretty straightforward in terms of what you'd like to leave for the next generation. And liquidity gets into the idea of having additional assets available to cover potential unexpected expenses in retirement. And the way I describe those is kind of a few nuances. These could be concerns you have for retirement there your financial goals for retirement, but you could also define them as expenses for your financial because the hard expenses that you have. So when we create the real map on the left, as Alex was saying, we say assets, and then it's the four L's stacked in boxes that the funded ratio is going to quantify longevity, lifestyle, Legacy liquidity, then, and these are well in the I'm sorry, that first column, what you would call goals, then the middle column is going to be the assets. And then the right column is going to be liabilities. Now the liabilities are just the expenses associated with those goals. So we can say longevity

Alex Murguia 07:07
and numerical equivalents of the goals.

Wade Pfau 07:10
Right, right. Whatever the cost is. So the actual essential expenses is longevity, the actual discretionary expenses is lifestyle. The legacy is legacy. And then contingency expenses, contingency funds, like the unexpected things that can happen, the long term care and everything else. That's the liquidity. And then the middle column. That's, and those assets, we like to divide, and this is going to be relevant for the funding ratio as well between reliable income diversified portfolio and reserve assets. And, and that's the map, it's how do you want to structure your assets, to map them and to match them to your liabilities, so that you're meeting your financial goals for retirement and have sufficient assets to meet the different financial goals for retirement? That's the real man. And then the funded ratio is simply putting numbers. What is the dollar value of your longevity expenses? What is the dollar value of lifestyle expenses? What's the dollar value of legacy? And what's the dollar value of the contingencies? You want to be able to fund to have feel like you're ready to proceed into retirement?

Alex Murguia 08:30
So So So Wade, is it fair to say, conceptually, because someone's listening to this, and it's, you know, there's only so much you can kind of imagine in your head, right. So if you break it down to its, you know, building blocks, its proteins and amino acids, if you, you have assets, you have the assets column, and you have the liabilities column, right, and the liabilities are kind of the goals both since we're talking about numbers, now you have the assets, and liabilities. And so think about the funded ratio as a big division, the assets over liabilities. And so Wade, put me on the spot, Bob, which one's the denominator and which one's the numerator?

Bob French 09:08
The numerator on the top, that's it, my daughter just learned fractions.

Alex Murguia 09:19
But that's effectively what you're doing. It's the assets over your liabilities. And it's a sense of how much you are funding. And we're just giving you the framework in how we look at it. There's a overall funded ratio, and then we break it down by components, but that just wanted to conceptually take a little bit of a step back so you can envision it without having an aneurysm at the same time.

Wade Pfau 09:41
And you can also view it as a balance sheet we should see as well Yeah, an assets column and a liabilities column. Though, to be clear, it's a little bit different from depending on how sophisticated your balance sheets are. But we are including things like your future social security benefits that you don't have today, but we will consider them as assets. that are part of your reliable income on the balance sheet. So that

Alex Murguia 10:03
because there is a little bit of a, there's a little bit of a little bit of a theory here, you know, as opposed to practical, what you're saying is, if you could, theoretically have the present value of all your future income streams, you know, if you could kind of take that and get some sort of pension for everything, you know, although you can't if you could do that, or how are you relative to the liabilities that you will

have? In the future? You're kind of answering that question. And if it's a good one, then great. So that's why you include Social Security, even though you technically don't have the money you want to know.

Bob French 10:37
Well, I mean, at the same time, you're also including all of those future payments, all the future money going out the door as well. So it's really just keeping everything well, as we're talking about balanced here.

Wade Pfau 10:48
Yeah, and the issue is that money today is not worth the same as money in the future, right, that we're gonna summarize how to put all these dollar values either like inflows of income, like Social Security benefits, and also outflows, like, here's my budgeted expenses in 2045. And we're going to put try to put those together into one simple metric to talk about.

Alex Murguia 11:13
And before we get going, I just want to maybe just set the stage for the funded ratio and get to the details. I can imagine folks are listening in even advisors, frankly, listening in thinking, funded ratio, what the heck is that? I've heard of MonteCarlo plan. I've heard of the basic, you know, how to, you know, what's a million dollars in 10 years, you know, the basic straight line budgeting kind of thing. But what's a funded ratio? What did that come from? It? Does anyone else use this? I've never heard this before. And in my head, Bob, I'm thinking, this is kind of the de facto for corporate pensions and things like that.

Bob French 11:47
Yeah, absolutely. It is, you know, and it's something that I think it's fair to say we're seeing more and more folks using a funded ratio type of approach. And don't get me wrong, there's nothing particularly wrong. There's nothing bad about the traditional Monte Carlo approach. In fact, that's actually how we all met each other, we met building out a tool that does that Monte Carlo based financial planning, and it is a good tool in the right circumstances, what the, what the funding ratio does, is, it doesn't take you one step further, it takes it one step in a different direction. Because what the funding ratio is really doing is giving you a checkup on what your financial health is, at this point in time. So what you're saying is, you know, hey, we're looking at all of this stuff out in the future, we're looking at all this stuff that we want to be do be able to do we were looking at all of this money that we're planning on getting in? Does it all match up? Does it all kind of fit together? Does it make sense that I'll be able to make these future payments? You know, we're we're aligning over a couple of things. But, you know, we're really getting a general idea, does this work? And that's really the question that the funded ratio was really trying to answer here. You know, can we actually generally do this, and then filling in the details further on down the road, but making sure that everything lines up here? So the idea is, please?

Wade Pfau 13:23
Well, I mean, just even more than if you're using the same assumptions, the funded ratio will be equivalent to a Monte Carlo based financial plan, it's just coming at it from a different perspective, right? The Monte Carlo plan tells you a probability of success, there is a fixed rate of return, that will correspond with that probability of success, but it's just it's hidden, you'd have to reverse engineer it.

Yep, which you can do, but you have no idea what kind of return you're assuming with that probability of success. The funded ratio is coming in from a different perspective, where you pick a fixed rate of return assumption, and see if you're funded, and then there'll be a one to one correspondence, the more funded you are the higher probability of success, but in the same way, that the Monte Carlo plan doesn't report a fixed rate of return, the funded ratio doesn't report the probability of success and would have to be engineered. So they are absolutely equivalent, but it's just a different way to think about the same. Yeah,

Bob French 14:18
exactly. It's a different way of thinking about it. And it's answering a slightly different question as well. It's answering, you know, again, do my assets line up with my liabilities, whereas Monte Carlo is asking, you know, what do I need to do to make these things fit? So it's getting to the largely the same place but in a different way. And I think in kind of a more intuitive understanding of how to how to kind of understand what the point is telling us here.

Wade Pfau 14:47
Yeah, that intuition is important because I've really just completely shifted from MonteCarlo based to funded ratio just at a personal level. And as I was writing the retirement planning guide book, you realizing more and more that a funded ratio approach is much more easier to implement and understand, then a DeCarlo based financial plan

Alex Murguia 15:09
for the record, and I think Bob can vouch for me. I've been a funded ratio fan way before Wade has, yeah, that Bob

Bob French 15:17
He has, he has been harassing us with papers on the funded ratio for a long time now. And he's just beaten us into submission.

Alex Murguia 15:29
But ya know

Bob French 15:30
just as long as this on the record here. So.

Alex Murguia 15:35
So what's it about? I had to do the nuts and bolts on it. Yeah.

Bob French 15:39
So the nuts and bolts are pretty straightforward. Actually, it's, you know, as we've described, it's literally the present value of your assets over the present value of your liabilities, though, that term, the present value is one that you know, is probably familiar to some of you. Definitely not familiar to all of you. But, you know, Wade, kind of summed it up $1 today is worth more than $1. Tomorrow, you know, if I was to offer you $100 Today, or $100 in a year, everyone would take that $100 Today, Alex?

Alex Murguia 16:13
Yeah, I got it. I'm trying to think of the I'm trying to think of Yeah, right. I'm trying to think of the readers. I mean, let the readers listen. Okay, well, I mean, maybe we have transcripts, who knows? But all right. So I'm, I'm listening, and I'm thinking, How do I get the present value of my assets that start with my investments? You know, I'm gonna get granular here a little bit my investments, okay. And how do I get the present value of my investment accounts? What's the

Bob French 16:39
present value is literally your present value of your investment accounts? It's the number on your statements.

Alex Murguia 16:46
Okay, so, yeah, so in your head, if you're trying to do a funded ratio, and you're looking at your investments, they did the math for you. That's it. That's what it's worth right now. Boom.

Wade Pfau 16:54
Right? Yeah. And that's really getting into this, it's just there's two different kinds of assets, two different kinds of liabilities, you've got the kind where you've got an allowance today, you know, the exact amount today. And then you have cash flows, things that are coming in the future, or that are going out in the future. And so, as we've now stated, any sort of investment account, any sort of like mortgage balance or other liability, the present value of those are just simply they're, they're dollar values. What those balances are. Yeah.

Alex Murguia 17:27
Okay. So then Social Security? How do I do that? And maybe this requires, I don't know, a three minute explanation of present value, etc. But okay, how do I do the present value of Social Security? Well, I don't even know where to start, or where

Bob French 17:42
so you know, the place to start is there's, well, I guess, three numbers, three or four numbers that we really care about here. So the first two numbers are pretty straightforward. It's, you know, how much money is going to be coming in at? Or how big is that check that the Social Security Administration is going to be sending you? How long? Are we planning on doing that? How many of those checks do we think we're gonna get? So those are? Well, moderately straightforward, especially that longevity question. But the two other numbers we care about. The first is something called the discount rate. Basically, how much more we value money today than we do in the future. Or put differently, how much less we value that money that we're going to get in the future, how much we value having access to that money, right now. The second number is, well, inflation. So for those payments, either money going in or out, you know, if those payments are going to be adjusted by inflation, you know, social security, some sense what we're talking about, it is adjusted for inflation. So over time, presuming we have inflation, which is a pretty good assumption, those payments are going to increase. So we need to estimate what that increase is going to look like. It's probably not going to be as big as we have been seeing this past year. But, you know, we can estimate some number of that. So,

Alex Murguia 19:13
Bob, okay, I get the inflation and I'm trying to be a listener and Wade chime... because I think this very important chime in here, okay. What What the heck does that mean, I value money more now than in the future? How do I come up with an equation around that? Because that's my feeling.

Wade Pfau 19:33
Yeah, let me tell me a little bit, because that's, that is literally fine. There's an issue we're not getting into, which is just about the time preferences. But we're not even talking about that. It's more simply, if I could put my money in the bank today and then earn interest or, you know, this discount rate is kind of like the return assumption for the plan so that if I had the money today that I'm going to spend in the future I could put it into this account that will earn interest over time and be worth more in the future. Conversely, like, so if I had $100, today, I have $100. Today, if I'm going to receive $100, in 10 years, how much today, it's gonna be worth less, because I need less today, since I could if whatever 10 $100 In the future, that's today going into the bank account, earning interest to grow to be $100, in 10 years, the interest rate, you know, that could be somewhere like $85 $90, it depends on the interest rate. But I would not need as much today to fund $100 in the future. Because whatever the equivalent amount today is, would be able to earn interest at the discount rate, getting a future date. And so that's why cash flows in the future, as long as the interest rate or the discount rate is a positive number. Those cash values in the future are worthless today. And that's that's what the present value calculation is picking up.

Alex Murguia 21:04
That's what I wanted to get at just let people know that, look, there's a rate there and then you said this, and this comes up with a lot of folks. Hey, what what about my market assumptions on these investments? What do I think the markets gonna go down? What do I think of the markets gonna go up? How are you incorporating that into the analysis, and in my head, I'm thinking about, it's kind of the discount rate and the is almost a return assumption in and of itself. But

Bob French 21:32
let's take a moment to let the audience know that this show is sponsored by Retirement Researcher. You can learn more about Retirement Researcher at retirementresearcher.com And subscribe to our newsletter, where You'll receive weekly actionable information for your retirement planning benefit. Retirement Researcher is an online community devoted to helping you create the retirement income plan geared towards your goals

Alex Murguia 21:56
Go on

Wade Pfau 21:58
back to that point, right, the Monte Carlo, you get a probability of success if I want a 90% chance for success. Again, you can, though there's a randomized return that gets you to that you can calculate what a fixed rate of return the equivalent assumption would be. And that's the point about the funded ratio is, yeah, there's going to be volatility in the future. But if we think in general terms, let's just look at

in a simple like, we'd like to use tipsy yields. To allow for inflation adjusted liabilities, let's just assume all you earn is the tips, interest rate, plus inflation. So you patient and see if your plan works in that context. And so it kind of gives you that basis of can I have a successful retirement without taking market risk that we're telling you to invest all in tips, or that were otherwise telling you not to take any sort of market risk? But just as step one? How does your plan look without taking market risk? Because at some level, return if you assume a higher rate of return, there's risk involved in that. And you can't necessarily assume it depends how probability based you are and everything else, but you can't necessarily assume risky assets will earn more than less risky assets on a risk adjusted basis. So does your plan work without taking risks. And that's where they assume a stock like return, but we don't generally want to do anything like that. Because that back to the point that would correspond to a much lower probability of success. If we assume the tips interest rate as the discount rate, that should correspond to a high probability of success. Now, again, we would have to reverse engineer what exactly that probability of success is. But we can say it would be high. And that then does the plan work with a conservative return assumption such as just earning tips yields.

Alex Murguia 23:54
So then that's the discount. So Wade. Let me say it this way, then. So we talked about Monte Carlo. And we've said this in a in a future episodes in previous episodes as well. But yeah, right. This goes back, I think it's important. So if you think of Monte Carlo, what it's doing, it's running, it's creating these runs, let's say it does 1000 runs, right? And you either pass or fail. It's a binary outcome pass or fail, regardless of it's $1 $10 $1,000 $100,000. You pass or fail, based on the surplus or shortfall of your goals and plans and ability to fund it right? Then it takes the average of those or it just counts up, how many passed how many failed and there you go, you get your percent. So if 900 plans pass 100 fail, that's a 90% success rate 90 divided by 1000. I mean 900 to 1000. So that's a percent of success. The funded ratio is not it's not coming at it from that direction. It's really just saying If you could theoretically retire today, and cash in on all your assets to fund all your future liabilities, did you win the game? And win the game being? Do you have more than you need? You know, let's just call it like that this is not an existential sort of question. It's just dollars and cents at this one. Did you win the game? Theoretically. And so if the assets, if you divide the assets over liability, and you're over one, you know, you have $110, your liabilities are $100. Hey, guess what, you know, you're funded 110, you know, you're good shape. 1.1, right. That's telling you, if you could call it a day today and walk away, you bought on top, your Michael Jordan, you know, making that basket against Utah, and you're out, you know, that kind of thing. And so the if you're under, let's say, by the other token, you're 90, your your assets are at 90 cents, and your future liabilities are $1, you're under, right. But as opposed to a pass fail, it's giving you a progression towards how far you are to get there. And I think that's, that's hugely important. Because sure, you're in a quote, unquote, fail category if you wanted to find an analog to MonteCarlo. But you're not that far away. You know, and so it gives you a good sense of how to get there and to weights point about the market, hey, the market could go up and boom, that could bring you up, but the other side of that coin is market could go down. So we kind of remove the market stuff from here because we just want to get at the question of if you walk away from the game today, how are you? Yeah, you know, that's, that's conceptually what this does.

Wade Pfau 26:39

And if you're overfunded like your example of $110 of assets $100 of liabilities. That's telling you, you don't have to take risk. Your plan can work without taking risks. Now, you may want to take risks, but this gives you more context to think about that. When you take risk. There's always the chance that you could switch from overfunded to underfunded if the markets dropped 20%. You might now have a you were overfunded. Now you're underfunded. So it gives you a context around how much risk you want to take. And conversely, if you were underfunded if you're like a 90% funded ratio, your assets or 90% of your liabilities? Well, if you have more of a probability based mindset, that's where you might say, Yeah, I think I can earn more than a tips yield. So generally, and we haven't really talked about the full concept of present value yet. But when you have a higher discount rate, it will usually cause your assets to drop faster than I'm sorry, I said that your liabilities to drop faster than your assets. So a higher discount rate will usually increase your funded ratio. And that would be this idea. Well, no, I can invest and earn more than tip. So therefore, I'm not really worried about it.

Bob French 27:48
Yeah I really think of it when you're underfunded. It's telling you, here's how much work you have left to do. Here's how much you have to make up basically. And you know, because we are assuming such effectively a conservative investment approach, you know, and especially the one thing to call out is most people who are still in that accumulation phase, you know, you're still working and you're saving money, you will be underfunded, the, that's literally the whole point of that accumulation phase, that you are underfunded and you're working towards funding those retirement goals, you're still going to be putting money and you're still going to be likely hopefully, having that higher expected return that's going to help you make up some of that funding gap, if you will. So it's part of the process.

Wade Pfau 28:40
And the funded ratio does work pre retirement as well as you'll probably be underfunded, if you assume no future salary. But part of planning out am I on trajectory to meet my retirement goals is okay, if I work 10 more years, the present value of my future earnings becomes an asset. And maybe No, I don't have it yet. But assuming I do work to 10 more years like I incorporate into the plant example, am I funded or and then how much more work do I need to be funded? Because each year of work is adding the present value of that future earnings is an asset, helping my assets to grow?

Bob French 29:16
Absolutely, yeah. The only thing is, you know, if you're counting on market growth, you know, that's not going to show up in the funded ratio. But it's important to remember that is risk. You're counting on that risk paying off which, you know, the markets been nice over the past shoot almost century. But it was always nice, you know, that is risk that you're taking out there.

Wade Pfau 29:39
Right, right. If you're assuming the low discount rate like the tipsy yield. Hopefully your penetration is just growing over time because your assets the investment account, those account balances are growing faster than the discount rate because stocks hopefully over time offer that risk premium and grow faster than bonds. So as that happens, that'll help to bring you closer to being fully funded for retirement.

Bob French 30:07
Absolutely. But let's get back to that. Alex, I'm sorry, no, I was gonna say, let's get back to that funded ratio, I'm sorry, that present value conversation, because that is the fundamental idea of just what it is that's going on here. And, you know, we kind of talked about that discount rate, you know, the one we haven't touched on as much is that inflation rate, you know, through time, we only historically, we've had inflation, we certainly got a bunch now. And, you know, we've talked, you know, overall Retirement Researcher, we've talked a bunch about what inflation might look like, going forward, and the market seems to be predicting lower levels of inflation, but that's a whole separate conversation. But we want to bring those assumptions into this, you know, like I said, you know, we started this conversation talking about Social Security, you know, that isn't inflation adjusted, you know, cash flow, that those benefits are inflation adjusted. So over time, you know, the size of those checks that you get, the dollar number on there that you get, is going to be going up. And we want to bring that into the analysis. So you've got the discount rate, basically pushing the value of those cash flows down. But you've also got the inflation rate pushing them back up, at least to a certain extent. And where that balance point is going to lie, is going to depend on the numbers that you use the the assumptions that you use for your discount rate, and your inflation rate. And we want to bring both of those into that conversation here. But the core idea of that present value, is we want to bring well, all of the values back to the president back to a single point in time, so that we can reasonably compare, you know, the Social Security check you're going to get when you're 87. versus you know, your how much you're going to spending on groceries when you're 75. And being able to kind of shift all of those cash flows back to today.

Alex Murguia 32:15
A side note, and Wade, you may want to maybe put a blurb about this over, I think that one of the biggest shocks that I think consumers have when they do this, especially with regards to social security, is that I think a lot of our listeners, or at least the folks that interact with us on retirement research or an even playing, like Social Security is like, Oh, by the way, kind of asset. Right. You know, that it is what it is with regards to their their station. But I think even those folks are shocked when they see the present value of the Social Security payments. And all of a sudden, let me, let me let me make the right decision around here. Right. I want to make I don't want to make this a Social Security Podcast, because that's the tone arc. But I think that's kind of hits people in the face, right? In terms of, Oh, my goodness, this is actually quite a quite a hefty number way.

Wade Pfau 33:15
Yeah, yeah, absolutely. And that's because the when you do the funded ratio, you'd have to decide how long do you want, are you going to live? And you may use a conservative age like age 95. And so when you add up the present value of social security benefits to age 95. Yeah, I mean, for a higher earner couple, up to 10 potential to have more than a million dollars as the number of the present value for your lifetime Social Security benefits. And if it's not over a million dollars, for most listeners, it's probably going to be close to maybe 800 $900,000. It's not an insignificant asset unless you you, you laugh at a million dollars as being insignificant. I don't think most people would. It's for many, many Americans, it is a huge part of the retirement. And so as Alex says, that's where you may think it's not all that big deal about how to do the Social Security claiming, but yeah, this is a whole different conversation and podcasts. The difference between a bad Social Security claiming strategy and a good social security.

gee, can be a couple $100,000 over the lifetime. So it's worth spending an hour to earn $300,000 potentially less again, unless you just I think that's probably not worth the effort. I don't know if that's...

Bob French 34:34
Yeah your hourly rates around 300 grand,

Alex Murguia 34:36
you know, I will say this Wade, whoever feels that's fiddly. They're not listening to this podcast,

Bob French 34:44
or if they are, you know, we would love to have the conversation.

Alex Murguia 34:47
Yeah.

Wade Pfau 34:54
But that's an example of the present value. So Social Security, you know, could be 40 $50,000 plus inflation from your 60s through your 90s. It's gonna be

Alex Murguia 35:06
that's what the present value calculation at least made me realize. When I looked at it, I was like, Man, this flew under the radar, but oh my goodness, you know, let's take a bite, you know, in terms of liabilities any, any? Because Bob, you kind of you know do when we do our challenge you kind of run through hundreds of these any any reoccurring questions that come up about liabilities just because we spoke about assets quite a bit? Yeah. And we'll have a follow up episode to this to this one, we just wanted to lay the groundwork about the funded ratio.

Bob French 35:38
Yeah. So I mean, there's a couple things that pop up, you know, one of the things is always going to be kind of thinking through legacy expenses. You know, how, you know, one, it's really a question of, Do you want to include those in your plan? You know, is that something that's valuable to you? And if so, how do you include that that's generally going to be something there, the other one that really comes up is the specificity that people want to be using here. You know, I think our listeners, I think I'm safe in saying this, you know, they don't like specificity. They like being precise. But this is a tool that, you know, is really geared more towards the big picture. So, you know, we don't care, or the tool does not care, you know, exactly what your grocery bill is, when you're 93 years old, doesn't matter, you know, getting that number down to the cent. You know, what we want to be looking at is the big picture here, you know, making sure that everything kind of fits together. So that's really on the liability side. The big type of question, you know, really kind of getting at that specificity and Wade I think you wanted to say something there.

Wade Pfau 36:56
Yeah. On the liability side to the taxes. Yes, corporate tax calculations in our funded ratio to manage the Roth conversions and all that it's a basic, efficient retirement distribution strategy, but not

necessarily the optimal one is spend taxable tax deferred tax free. But then, you know, we in the retirement researcher community, we have some people who are significantly overfunded. And that can create a bit of an anomaly that at first, we're worried there was an error in the calculations, but it turns out, if you're significantly overfunded, you're gonna see a big tax bill and your liabilities. And that, it's kind of confusing, because all your assets are just the present value, we're not showing you the fact that when you're 95, you're $3 million of assets. Now, after covering all your liabilities might be worth $20 million, you don't get to see that growth of the assets, but you do incorporate the growth of all the taxes you're paying. And that's where it was kind of confusing at first. But if you're significantly over funded, you might be shocked at how much taxes go into those calculations. And

Bob French 38:02
then speaking specifically about the retirement research or funded ratio tool, you know, that it actually does include a, you know, it's not going to be doing your tax preparation for you. But it definitely does include a reasonably sophisticated model of what you're going to be paying in taxes throughout the years to the point where that was building out that tax model was effectively building the funded ratio, that's where we spend 95 plus percent of our effort there to get something that is reasonable...

Wade Pfau 38:36
taxes are the ones that get

Bob French 38:37
the taxes is the Are we our developer was beating his head on taxes for a while. So you know, we definitely include kind of that tax analysis in there. Because, you know, for a lot of people, you know, it will depend on, you know, the exact specifics here, but for a lot of people, your taxes are going to be one of your biggest expenses. And that's kind of the hidden expense a little bit there, that we definitely need to include in the analysis.

Alex Murguia 39:08
Okay, so, Wade above, but what I like to do, if you don't mind is maybe take take the rest of this conversation to the next episode, since we're kind of at the 40 minute mark, where we discuss interpretations and where we discuss how, you know, we talked about the real map at the beginning, we've been talking in a general sense of the funded ratio, right, like, overall assets and overall liabilities. But in addition to that, we'd like to drill down and look at it with regards to reliable income, you know, according to you know, with your essential expenses, your investment portfolio with discretionary expenses, your reserves with reserves, and we'd like to kind of break up the funded ratio as well because you could be over funded, but we want to see if you're over funded in all the right places, you know, kind of thing I'd like to do I think it'd be cool if we talked about that in a little greater detail in the next episode. What do you guys think? Sounds good.

Bob French 40:06
That'd be great.

Alex Murguia 40:07
All right. All right. Thank you everyone,

Wade Pfau 40:10
for joining another episode.

Alex Murguia 40:12
Yeah. Alright everyone. Thank you for joining us in this round and we'll catch you in the next one.

Wade Pfau 40:18
Yea next week. We'll continue with this discussion and finish our arc on the funded ratio. Thanks. Bye everyone.

Bob French 40:24
Wade and Alex are both principals in McLean Asset Management and Retirement Researcher. Both are SEC registered investment advisors located in Tyson's Virginia. The opinions expressed in this program are for general informational and educational purposes only and are not intended to provide specific advice or recommendations for any individual or on any specific securities. To determine which investments may be appropriate for you, consult your financial advisor. All investing comes with the risk including risk of loss. Past performance does not guarantee future results.