

# Episode 36: Beyond the 4% Rule: Part 2 - Varied and Various Variable Distribution Strategies

**Bob French** 00:00

The purpose of Retire with Style is to help you discover the retirement income plan that is right for you. The first step is to discover your retirement income personality. Start by going to [risaprofile.com/style](http://risaprofile.com/style) and sign up to take the industry's first financial personality tool for retirement planning. Varied in various variable distribution strategies. You know what? I'm not even gonna try saying that five times fast.

**Alex Murguia** 00:48

Hey, everybody, welcome to Retire with Style. I'm Alex and I'm here with Wade. And the last episode, we went over some basic assumptions that we needed to begin to compare variable withdrawal strategies. Today, we're actually going to do the comparing right, Wade,

**Wade Pfau** 01:07

that's right, yeah, we're gonna really dive into the world of variable spending.

**Alex Murguia** 01:13

There we go. And that's a deep pool.

**Wade Pfau** 01:19

Now, there's a lot going on there. But actually, something we'll talk about here today is I've been trying to simplify this. So if anyone read, it's now a five year old book that how much can I spend in retirement, Chapter Six of that book was on variable spending, it was the longest chapter of that book. And I really tried to stick with all the main assumptions used in different variable spending strategies. In the subsequent years, I realized, that's just way too complicated. There's so many unnecessary, like the real versions of some of these rules get pretty wild. But we're going to talk more about a simplified way to think about the variable spending, which in real life, because there's not a lot of software that can even do this. I think it makes sense to talk about these in more general terms, so that you can understand the the basics at work and not get too caught up on. Well, if it hasn't been three years since this happened, then I can't do that. But I can only do that if some other threshold set and we can make it easier. But we'll talk about some main variable spending strategies.

**Alex Murguia** 02:21

But to do that, I think to lay the groundwork for the episode with and I want to do is, you know, what are some main assumptions that we're using to begin to analyze all of these, then we'll go through the strategies, discuss the pros and cons, and then we'll have a bake off to see where they land. So that makes sense what it

**Wade Pfau 02:39**

does, yeah, absolutely. All right. that regard, we'll we'll talk about six general strategies. And a lot of this analysis was based on just a case study I did with the payroll calculator that we mentioned in the last episode, which is an Academy member, retirement researcher Academy tool available. But so we don't have to get into, we're not going to focus on exact numbers all that much, we really want to look more at the relative differences between different strategies. So I don't think we need to lay out all the capital market assumptions, just know that behind the scenes, there's an assumed stock and bond return assumed stock and bond volatility, assumed inflation rate, and so forth. And given the context, this is always going to be the case with any sort of retirement calculator behind the scenes or some sort of assumptions being made about future market returns. And then given that we're going to test different variable spending strategies.

**Alex Murguia 03:39**

Now, the good news is you don't have to agree with our portfolio assumptions, capital market assumptions, as long as we apply those same assumptions to every strategy,

**Wade Pfau 03:49**

right, right, it's fine. We're applying the same payroll, and we're applying the same capital market assumptions to each strategy. Because another issue if you just start reading all the original articles on each different variable spending strategy, you can't really compare them to each other because everyone's using different assumptions. And so at least we are talking about this in the context of comparing each rule with the same underlying capital market assumptions, stock and bond returns and so forth. And with the same pay rule, that's calibrating the level of downside risks one takes with these strategies and,

**Alex Murguia 04:25**

and real quick, I know we discussed it in the last podcast, but not everyone listens to every podcast 30 seconds or less, you know, kind of what, how would you describe the the payroll? That is that is what we're using?

**Wade Pfau 04:39**

Yeah, the payroll is the probability you're willing to accept that your wealth falls below a particular amount by your why of retirement. So building and safe Max is an example of a payroll and it was with the 4% rule, we accept a 0% probability that our All falls below zero by year 30 of retirement. But you can't use zero for variable spending strategies, as we talked about in the previous episode, because some of these strategies, never let the portfolio drop to zero. So you do to make it more general, you need to use a positive number, you can't let the the amount of the wealth drop to zero. But once you have some threshold that your wealth can't drop below, then you now have a way to compare the different strategies, given that they have the same underlying downside risk associated with them,

because they're all gonna have different spending rates. But to know, to be able to compare the spending rates with each other, you need the underlying assumptions to be the same. And that's what the payroll does.

**Alex Murguia 05:44**

And we discuss it in greater detail. In the last episode, we just wanted to give everyone a little bit of a preamble before we got going.

**Wade Pfau 05:52**

Yeah, probably assume too much that everyone's listening to every episode. But if you haven't go

**Alex Murguia 05:59**

your mom, your mom listens to every episode.

**Wade Pfau 06:03**

That's right. Okay,

**Alex Murguia 06:07**

all right, let's rock and roll up.

**Wade Pfau 06:09**

All right, yeah. And so the payroll that I am using, as we begin this discussion of the different strategies was a 10% probability, that of the initial million dollars, you have your wealth falls below inflation, adjusted \$150,000, by the 30th, year of retirement. So that's the payroll I'm using to compare the different strategies we'll discuss.

**Alex Murguia 06:34**

And now we're gonna back into what the spending amount can be from. That's how we can assess them.

**Wade Pfau 06:41**

Yeah, and So strategy one, you're probably tired of hearing about it at this point. But it is the baseline it is the kind of the quote unquote, 4% rule. It's Bill Baggins constant inflation adjusted spending strategy. So it's we're going to define spending as a percentage of the initial portfolio balance, which gives us a baseline spending amount that we then increase for inflation. And it's not a variable spending strategy, it doesn't respond to portfolio Performance other than once the portfolio hit zero, spending drops to zero. Otherwise, it is the constant inflation adjusted amount. And we need it because we need something to compare the other strategies to

**Alex Murguia 07:23**

Now because it can drop to zero people usually take very concerned make very conservative assumptions on this, yet build themselves these buffers or margins of safeties that we've been talking about previously.

**Wade Pfau 07:37**

Yeah, I mean, so when we talk about a conservative constant inflation adjusted spending amount, benefits include you it is constant spending, which is nice to have that smooth known budget makes budgeting more predictable. With a low spending number, you generally have a high probability of success. And because you don't let your spending increase, this is going to be a strategy that tends to result in higher legacies than most of the other spending strategies. But that's because you're, you're going to be spending less on average, and that's going to then translate into higher legacies on average. But with with the negatives, or the drawbacks of this strategy, you are vulnerable to having that portfolio hit 00. For those who don't have other reliable income, this is a pretty risky approach to retirement. This is the unique cause of sequence risk, it's using an aggressive investment portfolio with a constant spending amount. That means if the portfolio goes down, you start spending an increasing percentage of what's left and that digs the hole that causes the sequence of returns risk to happen. Conversely, so that's in the bad luck scenario. Conversely, with a high probability of success, or a low P number for the payroll spending, really doesn't live up to its potential most of the time, you probably could have spent a lot more. And so that's a drawback. And so if your goal is unnecessary to leave the highest possible legacy, this may not be the right strategy for you, because it, it creates the risk of running out of money. But it also most of the time, just leaves a lot of legacy at the end, because you don't have the mechanism to enjoy that spending in retirement.

**Alex Murguia 09:20**

Yeah, and the risk of running out of money as luck. You you could you could just be very unlucky, you know, and you don't have enough but because you have this buffer, this sort of margin of safety or you're leaving in most likely, you're going to understand relative to what you could have. That's the bad news. The good news maybe is your kids will be happy with what's leftover. But it's hard to get that balance. It's really hard to get that balance because you never know. But that's part of the being in the total return quadrant. So what did the numbers point out with this one way?

**Wade Pfau 09:57**

Yeah. And so that's again, I don't want to put too much weight on number but just to have a point of comparison, given the stock and bond return assumptions we had. And given this pay rule where your wealth isn't dropping to zero, there is a safety margin there. So it's not directly equivalent to the 4% rule. But just to have a number to compare with. So this number, the 90% success, or the 10% failure, the payroll corresponds to a 3.13% initial withdrawal rate. And I again, I don't not saying that's my recommendation about a withdrawal rate number, that's just given the assumptions used to compare all these different strategies. This strategy comes out at 3.13%. And we can just on a relative basis, compare that to other strategies. And that's really the main purpose. So I don't want anyone to get too hung up on the 3.13%. But really, to just focus more on what happens with other strategies using the same underlying market assumptions and payroll.

**Alex Murguia 11:01**

Okay, what's, uh, how would you describe a fixed percentage withdrawal strategy?

**Wade Pfau 11:06**

Yeah, that's the exact opposite of the constant inflation adjusted amount, and that we've talked in past episodes about sometimes people confuse the meaning of the 4% rule, as fixed percentage, fixed percentage is, every year in retirement, I will take a fixed percentage of what's left in the portfolio. So if that number was 4%, it's every year of retirement, I'll take 4% of what's left in the portfolio. If the portfolio is growing, my spending goes up. If the portfolio is declining, my spending goes down. But this is the exact opposite of the constant inflation adjusted amount of strategy because with the amount, you're focusing on having the same spending amount each year, you don't worry about what percentage of the portfolio that is. With strategy number two, you're using a fixed percentage of what's left every year, you're not really worried about what amount of spending that is. So they are the exact opposite strategies.

**Alex Murguia 12:10**

I have to say this is this is immensely important. I mean, as opposed to me repeating it, I can't do it better than wait, I suggest you hit the rewind button three times, you hit 30 seconds, twice, and really listen to it again. Because it's, it's a very key concept to really just understand conceptually, what this whole withdrawal rate sort of game is, because I think that's it. Many of these strategies just play off of, of these concepts. There's a polar ends, but now there's many in between, as you'll see, so really try to understand what he said, because everything else is just a hybrid of both of these. Well, and the other point is, this is why we can't use a \$0 amount on on the analysis to make them all because Oh, percent of a percent will never be zero. You know, it's in the last episode, you can split that Penny continually, right? So that's why you pick 100,000 as an n number, 50,000 as an n number or something like that. That little quirk allows us now to assess them all together.

**Wade Pfau 13:20**

Right. Right. And so yeah, I mean, to Claire, highlight some of those points, again, benefits of this strategy are, it never depletes the investment portfolio. So there is no failure. No, technically, I mean, again, we might be slicing up a penny at some point. Technically, there's no failure with this strategy. This strategy does allow spending to increase if markets are performing at a reasonable level. Another important point that the late dirt cotton was really the first to point out was, with this strategy, there is no sequence of returns risk. It doesn't matter what the order of returns is, if you're using a constant percentage or fixed percentage strategy, you'll always have the same wealth balance at the end of the retirement horizon. So that's another way where it's the polar opposite of the kind of 4% rule logic which maximizes sequence risk. There is no sequence risk with this strategy.

**Alex Murguia 14:13**

Can I can I put an example behind that and, and I just want to make sure, especially with people listening, because it could be old hat to myself and to you. So let's say somebody took you know, 4% from a Million Dollar Portfolio, right? And the first year they're doing constant withdrawal, they're taking 40,000 market drops 50% Inflation is zero. The next year, they're still taking 40,000.

**Wade Pfau 14:37**

And so right if that was 8%

**Alex Murguia 14:42**

Yeah, and that's that's what he means by sequence risk, because the portfolio the market, just just decimated that portfolio. And so you put yourself out there, so it's, it's a percent right. This strategy, okay, you take 40,000 The first year fine. A Million Dollar Portfolio The market drops 50%. It's a \$500,000 portfolio. It's now a \$20,000 distribution. It's not a \$40,000 distribution, it's it's, it's 50%, less on the distribution side as well. Yeah. All right. So that's, that's what he means by eliminate sequence just because you're you're adjusting the the amount that you're taking out commensurate with the market, let's just say drop at this point. Because if it's good, then great, you know,

**Wade Pfau 15:27**

you have that safety valve to, to release the sequence risk, because if the market drops, or if your portfolio drops 50%, your spending is also going to drop 50% to very different assumption than the 4% rule or than the constant inflation adjusted amount rule. Now, that being said, because you have this release valve for sequence risk, average spending will generally be a lot higher. And the initial spending rate can be a lot higher with this strategy than with a constant inflation adjusted amount strategy. It's just, if you do use a higher initial withdrawal rate, you're probably building in a higher chance that spending might decrease over time. But whether or not it ever gets below what the constant inflation adjusted amount strategy would be, well, that's something you can evaluate further with software to that can analyze that. It's quite possible, it doesn't, or at least not in very often.

**Alex Murguia 16:27**

That's obviously the good news, right? Because you have that flexibility. You know, with many things, its best quality could be its worst quality. And it's related to the biggest disadvantage, which is if you really think about it, just stepping away from it. And I agree, wait, don't worry about the numbers, just worry about how the levers work, right? The biggest disadvantage with something like this is that paycheck is going to be volatile. I mean, you're, you know, think about 100%, commission oriented salesperson in any industry, right? Depends, this is going to be very volatile. It's just the nature of the beast, it's what you've signed up for, you know, when you're in that total return strategy with this variable spending approach. But hey,

**Wade Pfau 17:14**

yeah, and so that's where it might be harder for a total return person to use this constant percentage strategy, because they may not have as much reliable income and so forth. But at the same time, it's some an income protection style. If you build that protected floor of lifetime income, this might be a candidate of something you'd want to look at for the discretionary part of your retirements,

**Alex Murguia 17:38**

that's a great point, that's a great point, if you're using this for if your total return person and other than Social Security really don't want any contractual income, what you just went from, and you're using this for, let's say, just a majority of your essential and discretionary expenses, then you went from in the example we put earlier, you went from \$40,000, a year to \$20,000 a year. That's, that's, you know, I don't need to talk about the implications of something like that.

**Wade Pfau 18:04**

Right, that's rough if you don't have any other spending. But at the same time, if you had outside of that portfolio, you had a base cushion of \$100,000, of pensions and annuities. And in Social Security. Now, your spending went from 140,000 to 120,000. That may not be so bad it sets that's where it does relate very closely to what you have from outside the portfolio as well.

**Alex Murguia 18:28**

Yeah, remember, this is not retirement income, this is not investing for accumulation. So if your spending went from 40,000, to 20,000, because that's the strategy you decided to go on. And you're you turn on the TV and CNBC and they tell you Don't worry over the long term, this will go up, you know, Baba, the markets, a weighing machine, not a voting machine over the long term, you know, those kind of cute little quotes, it's not gonna make you feel any better. It's simply because your income, just just got half then for this year, there's going to be a lot of pain. It's just, it's just what it is when you sign up for that strategy. So just keep that in mind.

**Wade Pfau 19:04**

And in that regard, so we don't want to put too much weight on this. But when we said that constant amount strategy, you had a 3.1% initial withdrawal rate, with this strategy, the fixed percentage, calibrating the same payroll, I calculated, you could have an initial 7% withdrawal rate, but it's 7% of what's left every year. And in doing that, on average, and in good market environments, you can well, at least in good market environments, you could spend more than the constant amount strategy. On average, it might end up being pretty close over time. In bad market environments, you could have dramatic cuts to the spending much lower than you might have even been with the constant inflation adjusted amount because if you're taking 7% of a very small portfolio balances that point again, that may not be a whole lot of spending. And so this time In has a lot of volatility, a lot of especially downside volatility where you're spending might have to be cut. And so it's, it's really, it's the exact opposite. And it probably this is not going to be a popular strategy in practice, just like constant inflation adjusted amount won't be a popular strategy in practice, because then what we start to dive into is, how can we find a compromise between the stability of constant inflation adjusted amount, but the the ability to manage sequence risk of constant percentage or fixed percentage, that's where most of the conversation of financial advisors developing variable spending strategies, they're trying to find some sort of balance between those two extremes.

**Alex Murguia 20:45**

I'd also like to agree to 100% it to give you a sense of these two extremes. And again, it's not a matter of numbers don't take these numbers from the standpoint of the strategies and isolation and this is what it tells me I can do take him in terms of apples to apples how they differ, right? I mean, when you were looking at the constant spending strategy, and I'm just looking through the notes here, the average distribution amount was 60,000. But with a standard deviation of that amount at 14,000. That means, you know, 68% of the time, it's 60,000, plus or minus 15. Just to make the math easy, right? 60,000 plus or minus 15. With this one, you know, more or less, here, you're talking about a \$50,000, average and distribution, and a little less, but let's just say the same, but that standard deviation here is 39,000. So in any given year, you know, 68% of the time you're talking you're coming in at 58,000, plus or minus roughly 39,000. You can't it's almost impossible to budget, you know, especially if you're considering a huge amount of this, earmark for essential expenses. But these are the extremes. These

are the the important takeaways. Not this strategy is not realistic, or that strategy is not realistic. It's really more these are the extremes of what we're working with now.

**Bob French 22:08**

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**Wade Pfau 22:32**

Yeah, so let's now talk about some of the compromises. And that's where I'm hoping to simplify some of the conversation around this, of what is otherwise out there when you start reading about variable spending strategies. And so the first one of these compromises, is also a strategy that Bill Baingan was the first to talk about the founder of the 4% rule. And I call this like, \$1, floor and ceiling. So what this strategy will do is, you use a constant percentage of what's left, so it has that relationship to constant percentage, but you put in a ceiling and a floor around that. So I'll use the constant percentage of what's left. But if that causes my spending to fall below a particular level, then the floor kicks in. And I'll start spending a constant inflation adjusted amount at that floor, convert. And that would be if markets aren't doing as well, markets are doing great

**Alex Murguia 23:28**

more, just to make sure everyone knows the lingo we're using floor is okay, I start with a \$40,000 a year amount, but it'll never go below \$30,000. It'll never go below \$30,000. I just want to be clear, when you do a ceiling, it'll never go above \$70,000, whatever, whatever that number is, I just wanted a that's the lingo of and how we're using it.

**Wade Pfau 23:54**

Yeah, and so in the context of this case study I'd been looking at where constant amount was the 3.13% initial withdrawal rate, I look at a scenario where you could start with 3.59%, with this floor and ceiling, where your ceiling would be 20%. More than that, and your floor would be 15% less than that. So I'll use 3.59% of what's left every year. But if my portfolio is growing, so that 3.59% of what's left is more than an inflation adjusted \$43,000 or 4.3% of the initial amount in retirement, then I'm not going to let my spending rise above that level, the ceiling would kick in, and that's more than I anticipated spending but I'll just enjoy that. And if later in retirement, if my portfolio starts to lose value and the 3.59% is now less than that number, then I'll stop using the ceiling and I'll go back to the 3.59%. Conversely, if my portfolio is losing value, such that 3.59% Out of what's left ends up being less than \$30,500 or an initial 3.05%, then the floor kicks in, and I'll start spending that constant inflation adjusted amount of the \$30,500. Until if my portfolio recovers, then I might eventually kick back into the constant percentage, but it's, you're putting guardrails around the spending, it's your spending is going to fluctuate in this band between your ceiling and your floor.

**Alex Murguia 25:31**

So it's so think about it conceptually, again, what you've done is you're using the variable spending from as a percent of the portfolio. But as Wade said, these guardrails sort of lock you in, and so it has the constant component to it, you know, the the concept coming from the concept from the constant. So

it's a, it's a nice sort of in between. And so the game really becomes, what do you want that floor? What do you want that ceiling to be? And Wade just for, Because people could be asking, why did you choose 20%, more and 15% less,

**Wade Pfau 26:09**

that was really kind of calibrated with how Bill vengan describe the rule in his book, where he went through a bunch of these different strategies. But as it turns out, the ceilings actually not all that important. You really don't even necessarily need a ceiling. Because if the portfolio is doing well, you're unlikely to get into a scenario where you're later going to be dropping below the floor, the floor number is much more important.

**Alex Murguia 26:34**

Yeah, the portfolio does well, you've kind of gotten out of that danger zone. So you know, key the Kenny logins, but you got an out of that. And hence, it really is the the floor at a certain point that can come back and bite you.

**Wade Pfau 26:48**

And also, this is I like this as a variable spending strategy. In some sense, most of these strategies, in some sense dominate the 4% rule idea that constant inflation adjusted amount idea. It's the least efficient way to approach retirement. And this is a good example of where you can see that that with this type of strategy, you can generally spend quite a bit more than the constant inflation adjusted amount strategy. And even this strategy does create risk of portfolio depletion, whenever you have \$1 floor, there is a risk of portfolio depletion. But generally, that dollar floor isn't going to be all that much less, it was a constant amount, we were at the 3.13% withdrawal rate, with this floor that I used in this example, it would have been like a 3.05% withdrawal rate a little bit less. But generally, with just a little bit more downside spending risk, you have so much more upside spending potential. And so it's really in a way almost dominates the constant inflation adjusted amount strategy. And it's very attractive in that regard, at least relative to a constant inflation adjusted amount of strategy.

**Alex Murguia 28:02**

I agree with I think this one, just based on client interaction, and the like, I think this one reflects the most, it's not a mirror. But I think this one reflects the most of all the spending strategies we've talked about. And we'll talk about in terms of what what a professional relationship looks like when when an advisor is sort of managing distributions. Because it's, like it's recognizing right off the bat, there are no absolutes. And it's really something where you kind of make, you know, you're always course correcting. And I think that's that's in a funny sort of way. That's the key to a proper retirement income plan. You know, once you've selected a strategy, and you're going down the strategy, give you the one, you know, have one that allows you to course correct on certain areas. And if you're again, you're going to be in a total return style with optionality focus. I don't know this kind of seems to hit all those chords really well.

**Wade Pfau 29:05**

Yeah. Now the next strategy we'll discuss, in a way is really just a variation of the floor and ceiling rule, where we eliminate the ceiling and this is so it's called the ratcheting rule. It's based on Michael Kitsis, a

few years back, had an article about the ratcheting rule. And that's where I was kind of joking a little bit earlier. His version of the ratcheting rule is super complicated. You only increase your spending if your portfolio rise more than like 50% from where it started. And then you make a discrete increase to spending but you can't do that more than every three years. There's so much in that. That, sorry, that

**Alex Murguia 29:47**  
included does that

**Wade Pfau 29:48**  
years only

**Alex Murguia 29:50**  
in his in his defense the I think it's not so much just saying this is a reflection of reality and this what you should do, I think they're just looking for, hey, I think the So things that, that researchers look, and they're just trying to get a better understanding of levers. And they just say, Wow, this is something like this could work. I don't think it's anything more than that.

**Wade Pfau 30:09**  
Right. Right. It but and I do talk about the full version of that rule in that, how much can I spend in retirement book, but when I was looking at this, again, more recently to update, I just recognized, we can reflect what the ratcheting rules purpose and intentions are in a much simpler manner. And that is, instead of treating that the constant amount, remember just not that we're putting a whole lot of weight on these exact numbers, but it's more about their relative behavior. We talked about the constant amount of strategy in this context of 3.13%. Well, what we could do with this ratcheting rule is 3.13% is now the constant percentage that we use. But we also apply a floor at the 3.13%. So that.

**Alex Murguia 30:54**  
Wade, Wade, just again, I say this, because I'm trying to put myself in, in the listeners heads, and maybe they like it, maybe they don't. It is what it is. 3.31%, where did that come from? Again, you mentioned it at the beginning. But I want to make sure people realize that was the initial number that came out? Well, you you say it, I don't want to say

**Wade Pfau 31:16**  
whether they're based on the the market assumptions that I didn't fully explain what those were. But that was just beside the point that as long as we have market assumptions that correspond properly for each strategy, we can compare the strategies to each other. And based on that pay rule of setting a 10% chance that the remaining wealth drops below, an initial million drops below 150,000. inflation adjusted by the 30th, year of retirement 3.13% was just what calibrated giving you that 90% success rate for that payroll or that potential 10% failure rate.

**Alex Murguia 31:53**  
And so then we apply that to all of them.

**Wade Pfau 31:56**

Yeah, so what what we're doing now is the ratcheting rule may sound complex as I describe it, but I assure you, it's a lot simpler than the original Kitces version of the ratcheting rule. It's take that 3.13%. But instead of using that as constant amount, use that as constant percentage, but have a floor of \$31,300. So have that floor in place. So that and basically what it's saying is, you start your retirement spending at 3.13%. If your portfolio is growing, you take 3.3% Of what 3.13% Of what's left, you'll you'll be able to spend more. If your portfolio is declining, then the floor kicks in. And you're spending never, like if your portfolio is losing value, this rule kicks in to become a constant amount rule, you spend that 31,300 plus inflation. If your portfolio is doing well, this rule translates into a percentage, you spend more you send it a percentage of that higher portfolio balance. So your spending can go up with this, but it can't go down unless your portfolio had zero which any, anytime you put \$1 floor, you were on the risk of portfolio depletion. But you're not going to be it's just like the 4% rule idea or just like the constant amount idea, you're never going to spend below a particular starting threshold, your spending can only go up, it can't go down other than if it goes to zero.

**Alex Murguia** 33:25

So effectively, instead of creating a hybrid, it's just alternating back and forth between two Phillips.

**Wade Pfau** 33:33

It's a constant percentage when you're doing well, in a constant amount when you're doing when the portfolio is losing dropped below its initial value. And it can raise your average spending quite dramatically in that regard. So it's another strategy that pretty much dominates the constant amount of strategy, just because it doesn't really take on much more in the way of any downside risk. But it does give you a lot more upside potential your spending could grow quite quite a bit compared to where it started, on average, and so forth with this particular strategy. So you're not creating more downside risk. But you're just when Mark because the 4% rule idea is meant to be conservative. If markets are doing okay, the ratcheting rule is letting you take advantage of that and increasing your spending to enjoy more of that market performance without creating more risk on the downside. Or, I mean technically it has to create a little more risk but it's just so minuscule that it's it's hard to even see in the Monte Carlo simulations

**Alex Murguia** 34:39

I just find it interesting how the floor really plays into all of these two

**Wade Pfau** 34:47

Yeah, any hard dollar floor is gonna get you that's gonna be the focus but it's making sure you have a way to spend more when the when you're not getting hit by that really bad sequence of returns and so forth.

**Alex Murguia** 35:02

Okay. And then what's number five?

**Wade Pfau** 35:06

The same number five is the classic. And it's one of the most complicated variable spending strategies in existence. But I again, I tried to simplify it. But it's the Jonathan Guyton and William cleaner. I say,

inspired decision rules. If you've ever reviewed, he has there's four decision rules. And they've they've changed over time. But there's four basic decision rules. And what I'm trying to do is to simplify those decision rules, because it's kind of like with Michael Kitsis, where it's like, well, if it's a leap year you do this and something like that were to apply them precisely as they defined them.

**Alex Murguia 35:45**

And for the way, Michael and Wade are friends. They kid because they love to put it up.

**Wade Pfau 35:54**

But no, it's the original versions of the user, like, well look at your initial spending rate, if it drops by more than 20%. From that you increase your spending by 10%. And I'm trying to simplify that for how I'll explain it here today, but but keep the spirit of what those rules are. And so we should probably mentioned, what the decision rules are, and how kind of I'm providing a more simplified version of that. And so, again, context, the floor and ceiling rule we talked about before, that's based on a concept percentage strategy, but where you apply dollar ceiling and dollar floors, the bill the the guy 10 and cleaner decision rules. They're inspired from a constant inflation adjusted spending strategy. But where you apply guardrails that are more percentage based, so it's kind of a different approach to you're gonna use a constant inflation adjusted amount, but you're going to apply some percentage guardrails instead of the opposite, which is use a constant percentage amount, but then you apply some dollar guardrails. And so I hope that's clear what those guardrails are. So they have a capital preservation rule. And that capital preservation rule is, you don't want your withdrawal rate from what's left your current withdrawal rate, that percentage of what's left to grow too high. So you're gonna keep using this constant inflation adjusted amount. But if your portfolio is declining, that means your withdrawal rates going up. The capital preservation rule is, okay, we're gonna put a ceiling on that don't or I guess, yeah, ceiling, don't let your current withdrawal rate get too high. And so that's going to start to reduce your spending, because it's going to kick in to just don't spend more than this percentage of what's left. And that's going to help preserve your assets.

**Alex Murguia 37:51**

And notice how you set percentage of what's left.

**Wade Pfau 37:56**

Then you've got the prosperity rule, which is you spent a constant amount every year but if your portfolio's growing, your current withdrawal rate, your percentage of what's left is going down to prosperity rules is going to put a floor don't ever spend less than whatever percent of your portfolio that you decide. And then that means if your portfolio is doing well and growing, it's going to allow the spending to start to increase. The prosperity rule lets you take advantage of market growth, then you have the withdrawal rule, which is because this is a constant inflation adjusted amount strategy. The withdrawal rule is just telling you if the in cases where the capital preservation rule or the prosperity rule don't otherwise apply. Well, if the market was down in the previous year, skip the inflation adjustment for your spending this year.

**Alex Murguia 38:50**

Kind of a follow on by two years in a row.

**Wade Pfau 38:53**

Yeah, then you'd skip the spending inflation two years in a row. So it's another it's related to the camp. It's helping you preserve capital in a bad market environment. But it's one of these deals where it's okay, let's not take the inflation adjustment in certain years. Then they have their fourth rule is about when you spend from your stocks and from your bonds and so forth. But I, our payroll calculator doesn't vary the asset allocation, so we can't directly model that. And that's more of a minor detail, like playing rules here. capital preservation, prosperity withdrawal.

**Alex Murguia 39:32**

It feels like you're playing three dimensional chess sometimes, though. I know it's, it's simple, but it's just a lot of things to juggle. I'm almost my reaction here. And it's always this. If you're gonna go through all of this, you really got to start thinking, man, have you taken the reset like is the total return really right for you? Because it's, it's kind of like I'm in here, but then you have all these caveats that you have to implement and it just seems, I don't know.

**Wade Pfau 40:00**

Yeah, it's definitely you need some Excel programming skills to actually if you're doing it yourself investor, and this is what I'm explaining is a simplified version of it, because the actual guide to an inkling or decision rules are much, well, I want to say much more complicated. But there's a few more layers of complication than what I've explained.

**Alex Murguia 40:22**

It's not that it's one of those that it sounds like, you know, when you go to the doctor, and you're taking, you're taking all of the supplements once or something for this something for that something that you know, and it's this laundry list, and you tell the doctor, and the doctor looks at you and says, you know, what, just eat your fruits and vegetables and you'll be fine. You know, it's it sounds like that this kind of vibe, where it's like, if you're going to, if you're going to do a total return, and you're going to implement the variable spending strategy. You know, what? The, you know, even the ratcheting makes a lot of sense relative to this one. But you know, why don't you do \$1 of \$1 floor and ceiling and withdrawals and pick something reasonable? And call it a day? Right? Yeah,

**Wade Pfau 41:05**

exactly. Why the dollar and ceiling approach is probably my favorite spending strategy.

**Alex Murguia 41:11**

It's pretty straightforward. Yeah.

**Wade Pfau 41:15**

Because you can I think it, it does match better with what people probably do in real life, which is, yeah, if markets are doing well, you're gonna spend more if markets are doing poorly, you're gonna spend less, but you might have some kind of I don't want to go. I mean, in real life, your floors, probably a little bit more dynamic. But yeah, exactly.

**Alex Murguia** 41:35

You just played by here. I mean, if you're literally thinking out loud every year, Hey, am I gonna follow the HUD? Should I just my capital preservation rule? I know I can't forget about the prosperity rule. I don't don't forget about the withdrawal rule. If this is going through your mind, you've probably got other issues, then what your withdrawal rate is? Because it's just a lot of lifting. It's it's it worth the calories? I don't know. I'll leave it at that. I, you you folks know where I stand on that.

**Wade Pfau** 42:03

It's interesting, just because if you could say, what is the most famous variable spending strategy? It probably is the guy turning cleaner decision rules? And I don't know why that's the case.

**Alex Murguia** 42:16

first mover, yeah, I think some of that is just Yeah, and you know, you got a couple of publications out, but I would guarantee, my guarantee is too strong a word. But I would say, human nature, wins. And if you'll ask me human nature, which one of these makes kind of sense? It's not the extreme of sustainable withdrawal rate, it's not the extreme of percentage, you know, withdrawal rate, it's something in the middle. And that's the boiler and floor and ceiling withdraws. You know, and then it's just a matter of picking your preference of what how deep you want your floor and how high you want your ceiling. And even then the ceiling doesn't matter too much, because that's just gravy. It's where you want your floor. Right. And that's relative to, I think your floor is probably something relative to what your essential expenses are. If your total return person, you know, if you're, if your predicted income risk rap time segmentation, and you're using this for discretionary, then your floor is probably not that low. That that's, that's it full stop making a lot of assumptions there. But conceptually, if you understand it, I think you'll come to a similar conclusion.

**Wade Pfau** 43:28

Now, just to finish the discussion around gating and cleaner, and that's kind of how it was presented in their initial research.

**Alex Murguia** 43:36

Besides that, how was the play misses Lincoln?

**Wade Pfau** 43:40

Like can, it can increase the initial withdrawal rate, and that was the big starting point. So we talked about

**Alex Murguia** 43:47

figuring it out.

**Wade Pfau** 43:55

In that, but in that regard, it's even though it's based on a constant amount of strategy, once that capital preservation rule kicks in, it really becomes more of a constant percentage strategy. And that's, it can cause your spending to drop quite a bit. So we say like constant amount, we're staying around 3.1%. This is more an initial withdrawal rate of 4.6%. But remember, a constant percentage, we were up at

7%. This is just kind of a hybrid of use a much higher initial withdrawal rate. But that's because it builds in a lot more capacity for reduced spending in the future. And so it ends up in practice behaving a bit more like a constant percentage strategy, which is start with more, but have the run the risk of having to make much bigger cuts later in retirement. And that's when you see the strategy sold is oh, we can raise your initial withdrawal rate. That's all that's the reason it's because probably spending is going to have to be reduced by quite a bit later on. And that's why you need something like the payroll to start calibrating the downside risks that you strategy creates, because it's not part of the initial research that you can't compare the initial versions of these articles with each other because they have such different assumptions.

**Alex Murguia 45:10**

Yeah. Wade, I think all of these, let's say we discussed the concept inflation, fixed percentage, dollar floor and ceiling was ratcheting. And the guidance linger. What? When

**Wade Pfau 45:25**

there's one more, we should mention that it's not otherwise. But I already teased it. And it's just the the idea of some sort of required minimum distribution rule. That's right, that's right. With required minimum distributions, starting at age 72. But they have these tables for younger ages as well, because of inherited IRAs. What percentage of the portfolio do you need to distribute each year to pay taxes, the RMD rules are meant to be conservative, because it's based on a 0% return assumption, it's based on two individuals with one spouse 10 years older than the other spouse. And so you can modify those rules to calibrate them to the pay rule. But it's just the idea. It's, it's a cousin of constant percentage, but it's actually more academically appealing. Because it's as you get older, your time horizon gets shorter. And so you spend an increasing percentage of what's left. So that is another especially for discretionary spending, someone might want to take a look at that sort of rule as well.

**Alex Murguia 46:24**

I've never thought I'd say this, but I kind of agree with the government here, I kind of liked this one a lot, in a funny sort of way, simply because you said the academic piece you spend relative to the probability you're going to be alive kind of right. And it's, it's kind of figuring out for you, hey, you know, the government wants their money back in taxes. So they figure out, okay, you should be pulling out this much. I need this much. I need this much. You know, that kind of thing. So it doesn't for you, it does the math for you, they do the math for you, in a funny sort of way. So piggybacking off that, you know, hey, why not? Right. But out of all of these, as opposed to say, Okay, this one has this downside. This one has this upside, and there's numbers and all of that I think, I think people look to you. For it's almost like when you're going back to the doctor analogy, if this was your mom, what would you do? Kind of thing, right? Well, Wade, if you had to go this gun to your head, you have to pick a total return strategy. None of this. Oh, income protection risk wrap as my essential expenses? Forget that. You know, you have to pick one. What do you think? Are? You know, I don't know. Maybe that's too well, you'd like

**Wade Pfau 47:37**

if I had to pick one of these. And it's more for total return? Because RMD maybe it's more attractive for as a the lifestyle component of income protection or risk scrap, no cash return. Returns, they have to pick one. I think it's the bill baingan dollar floor and ceiling withdrawals that's got the best combination

of ease of use aligns with what how people actually probably think about retirement spending. has the ability to benefit from market upside with spending has a nice overall balance of features. So I'd go with the dollar floor and ceiling,

**Alex Murguia 48:18**

like a Volvo. You got the Volvo. See, I liked actually I agree with you. I think that that makes life easier. I think the only question that becomes what's the floor you feel comfortable with? You know, ultimately, even ratcheting rule I like because it's sort of giving yourself a raise. You know, I just don't

**Wade Pfau 48:43**

actually see modified dollar floor and ceiling rule.

**Alex Murguia 48:46**

Yeah, it's just giving yourself a raise, you know, you know, when you can when you get them, it's saying okay, now give yourself a raise now give yourself which is, ya know, there's some truth to that with practical application to client relationships. Because at a certain point, you are telling the client, hey, you know, you can take more out, you know, we don't need to have the floor they that we've established we included and and bump it up. But for ease of use? Yeah, I agree with you. I think the dollar floor and ceiling makes a lot of sense. And the reality is life. These are just rules frameworks, right? The beauty of a framework is that it automates things. And so that helps you from a behavioral standpoint, remain discipline. And so I love the framework of the dollar floor and ceiling, ratcheting rule you have to make that decision why give yourself am I gonna give myself a raise? Sure, there's a framework to do it, but you still have to press press the button, right? The dollar floor ceiling is cool. And then when life comes at you fast that you need to do the spending on something that was unforeseen for whatever reason, again, assuming you're just total return approach, you know what? Reassess from there but I I agree with you as well. I like this one too. Okay, so Like, Encyclopedia Brown does it again, way to go Wade is that it

**Wade Pfau 50:10**

kind of oh my goodness, this is actually the last episode of this. We've covered in the good. We've covered the 4% rule, or we've covered like total return spending from investment type strategies at this point. So we'll have to figure out what our next round of conversations is going to be about. But that was chapter four of the retirement planning guide book that was spending from investments in retirement. I think we we talked about quite a bit over this last, however many episodes and next we're gonna bring in an advisor from McLean. Brian previewing?

**Alex Murguia 50:47**

Sure, sure, Wade, you're saying that like Inigo Montoya from, from the Princess Bride when he when he finally gets the six fingered man and he says, I've been in the revenge business for so long. I don't know what to do with myself, or something like that. No, this this concludes the arc. On total return,

**Wade Pfau 51:10**

we'll revisit that we will we'll have a guest next week.

**Alex Murguia** 51:14

Yeah. Well, I was gonna say is like the art part of it. What we wanted to do is, we stressed the look, this is the research, right? We want to bring to date, what we want to bring you up to speed is what's the practical application of this? And this is I think you got echoes of it during today's episode quite a bit, you know, even asking, wait, this is your mom, what do you do, you know, point blank, as opposed to what's the 10th percentile and 80%? And all of that, what do you do? And so what we want to do is we're going to bring in Brian Bass, we've had him before, just to talk about the practical application of these what happens actually in the wild, as opposed to in a textbook. So I think that's very, very important. And we'll take it from there. Thank you, everyone, for taking us through this. The total return piece will conclude it with one more of these, which I think is it's actually, you know, very, very practical. And there it is. Wade.

**Wade Pfau** 52:11

Okay, yeah. Thanks, everyone. We'll catch you next week.

**Bob French** 52:13

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 a risk including risk of loss. Past performance does not guarantee future results.