Episode 190: Buffer Assets, Bad Timing, and Better Plans

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SPEAKERS
Wade Pfau, Briana Corbin, Alex Murguia

Briana Corbin 00:00
The purpose of retire with style is to help you discover the retirement income plan that is right for you. The first step is to discover your retirement income personality. Start by going to risaprofile.com/style, and sign up to take the industry's first financial personality tool for retirement planning.

Briana Corbin 00:19
Retire at 45 live to 105 sounds great until sequence risk shows up uninvited. This week, Wade and Alex tackle your trickiest questions about early retirement market timing and why just winging it probably isn't a strategy.

Alex Murguia 00:58
Hey everyone, welcome to retire with style. I'm Alex, and I'm here with Wade, and we've got a whole series of Q and A's to answer today. Wade,

Wade Pfau 01:12
yes, and that has been a continuing theme with the podcast, although these are going to be newly recorded episodes in terms of the chronological order of things that did a webinar on July 15 about four ways to manage sequence of returns risk. And it was we had a lot of attendees, so we had a lot of questions that we didn't have time to get to in the webinars. And thought we'd do a Q and A's related to that here at the podcast.

Alex Murguia 01:37
Yeah, no, that sounds great. And as everyone knows, as our listeners know, we have a membership site retirement researcher.com and there we offer many of our members, but also folks that have signed up to receive our newsletters, webinars, and so that's something that I would always keep an eye on. We have some exclusive to our members, our paid members, but we also have many webinars that we provide to our listening audience that are signed up for retirement. Researcher, right way?

Wade Pfau 02:10
That's right, yeah. And I think we're aiming to do another one of those in September, so I'm sure we'll, we don't have a date yet, but we'll let everyone know as we get closer to then. Okay,

Alex Murguia 02:19
and the most recent one we had, it was on sequence risk, right? The four ways to manage sequence of returns risk. And from there, we've got loads of questions, but beforehand, could you maybe just give a little summary of what was discussed? Yeah, it's

Wade Pfau 02:36
probably worth mentioning what the four ways to manage sequence of returns risk are, because of the Q and A's that we have, we've kind of questions related to each of the four different ways. So it makes sense to start with what those are well, and even more clearly, what sequence of returns risk is. It is the idea that, especially when you're retired, it does exist pre retirement, as you're adding new cash flows and savings. But when you're retired, if there's a market downturn and you're forced to sell from your portfolio, you have to sell at a loss, you have to sell more shares, you have to sell a bigger percentage of what's left to meet a fixed expenditure. And then, even if the overall market recovers, the fact that you've been selling from a declining portfolio makes it harder for your portfolio to recover with the overall market. So retirees do become much more vulnerable to market returns in their early retirement period. That sequence of returns risk and the four ways to manage sequence of returns risk all relate to looking for ways to not have to sell at a loss effectively. So method number one, I call it spend conservatively. It's not the funnest approach, but it's the whole logic of something like the 4% rule is an example of the spend conservatively concept. It's if your spending is low enough, you're the percentage of the portfolio you have to sell to meet expenditures is lower, and then it becomes harder to get into a downward spiral, where, as the portfolio starts to decline, you have to sell a bigger percentage of what's left. Portfolio has a harder time to recover. You then have to sell a bigger percentage of what's left, and you get into a downward spiral towards zero. Well, if you just don't spend very much to begin with, that does help manage the risk of the sequence of returns. And so with that kind of discussion, it's always around, well, how low does the spending rate need to be to reduce the exposure to sequence of returns risk? But that kind of discussion builds in. It's just a research simplification, but it actually amplifies sequence risk, because it doesn't build any sort of flexibility. It's just, I want to know how low the initial spending amount needs to be, but I'm never going to then adjust that amount, except for I'll take inflation increases, but I won't ever reduce spending if the market's down or anything like that. I'll just keep spending and spending that. Creates more sequence risk, and it just becomes a question of, how low does spending need to go? Now we also talked about examples of each of these techniques in the webinar, and the one I use for this one, it's spending from your investments. So I talked about how delaying Social Security could help you reduce the lifetime distribution rate from your investments, even after carving out a Social Security delay bridge, like, for instance, an eight year bond ladder if you're 62 to help get you to age 70 without increasing your sequence risk because you had to use a higher withdrawal rate until your Social Security benefits begin. Method number two, be flexible with your spending. And that's the whole world of variable spending strategies. If markets are doing well, I might increase my spending. If markets are doing poorly, I might decrease my spending. And for that, I use the example of our we have at the retirement researcher Academy, as Alex mentioned, with retirement researcher, we have a membership website, and we do have a payroll calculator there that allows you to analyze variable spending strategies. So I provided a brief introduction to that in the webinar,

because it was coincidentally. We hadn't planned it at the time, but the day after that webinar, I did a workshop for our Academy members on how to use our new and improved payroll calculator, and looked at eight different variable spending strategies and how you could compare and contrast and analyze and look for an approach that you feel comfortable making adjustments to your spending over time in retirement. The third approach is reduce volatility. I should have mentioned with that spend conservatively. That's usually tied to an aggressive asset allocation. You invest aggressively. When Bill began created the 4% rule, he said, Hold 50 to 75% stocks in retirement, but yet you never adjust your spending in response to that market volatility. So the third technique relates to, well, let's manage volatility of the investments in some sort of strategic manner. Now there's a lot of possibilities there, whether it's a bucketing time segmentation strategy, whether it's using annuities. The example I did use for that was the idea of the rising equity glide path, where you have a lower stock allocation at the start of retirement, but you gradually increase it over time as a way to reduce your vulnerability to volatility in those early retirement years. And then the fourth approach is buffer assets, something outside your portfolio, not correlated with your portfolio, that can provide a temporary spending resource after market downturns, so that you don't have to sell from your portfolio at a loss, and to try to create synergies around allowing your portfolio to recover by having that temporary spending resource from outside of the portfolio. Now, our next episode in the series of the Q and A's will be all about buffer assets, because we got a lot of questions on them. But the three buffer assets, although some of the questions relate to, could we add a fourth? But the three I talk about are a cash reserve, just having a pile of cash on the sidelines using a Home Equity Conversion Mortgage, the most popular kind of reverse mortgage, variable rate, reverse mortgage with a growing line of credit or borrowing from the cash value of permanent life insurance, particularly whole life insurance. So those are the four ways to manage sequence of returns risk, four broad categories spend, conservatively, flexible spending control, volatility buffer assets. They do have a lot of subcategories, and we do have a lot of questions that came in from the webinar.

Alex Murguia 08:30
All right, Wade, thank you for that synopsis there. Let's get to the first one then, and it's titled nuance question here, can you address the potential for multiple sequence of return risks? I retired at 48 so I wasn't just concerned about the risk when I retire, but also at later ages, since I plan to live to 100 thus having 52 years in retirement.

Wade Pfau 08:58
Yeah, great question to get us started. So Thank you Rich for that question. And yeah, so to be clear about the and I mentioned this in the summary sequence, risk is amplified if you don't adjust your spending in response to market performance. And so that's why those early retirement years become the most important in terms of flexible spending strategies, if you just spent a constant percentage of what's left of your portfolio every year, there's actually no sequence risk for your investments. They're not vulnerable to being depleted. You could have a lot of risk with how much spending fluctuations you experience. But So getting into the context of if you're retiring at 48 it's almost like you want to be thinking about a variable spending strategy. You can't and we can talk all day. The 4% rule idea is based on a 30 year retirement horizon, thinking about people in their 60s. If you're retiring in your late 40s, as Rich mentions, you may have a 50 year retirement horizon ahead of you. It's really. Hard to harder and harder to imagine having constant inflation adjusted spending over time. A variable spending strategy would make more sense. But if you were strictly following a constant inflation adjusted spending

strategy, the time horizon doesn't really matter so much, if anything. And this will, this is a point that will be part of an answer with some of the other questions that came in as well. The longer the time horizon, the smaller the withdrawal rate you should be using to sustain those assets over the longer time horizon. And actually, a lower withdrawal rate reduces sequence risk, but you're still going to be the most vulnerable in those early years. Now, if you make an adjustment, if you change your spending later in response to market performance, that can alleviate the sequence risk. And then you could quote, unquote, start over from that point looking forward. But just strictly speaking, if you're retiring at 48 and you're using the spend conservatively strategy, you've got to use an even more conservative spending rate, your spending is going to be low. You're going to therefore have less sequence risk, but you're still going to be the most vulnerable to those market returns in those early years if you don't have any sort of other adjustment factor. Now, maybe another adjustment factor is the potential to return to work, or at least have part time work at some point, you could almost think of that as a quasi buffer asset if you really think there's potential to return to work during a market downturn. Of course, it may be harder to find job openings and so forth at that time, but that's kind of how I would approach it. It's not that there's going to be multiple periods of sequence risk if you're using a spend conservative strategy, but it's really more you probably don't want to be using a strict spend conservatively strategy over such a long retirement horizon.

Alex Murguia 11:50
All right. Way. This is a next question from Lynn, and this has to do with to me, it reminds me of the research you did on the magnitude of failure and the actual disproportionate impact that when you just retired could have on your spending. But here goes the question. I often hear that the sequence of returns risk is greatest in the first five years after retirement. I don't quite understand this. Suppose there were two people, a and b, with identical assets in identical locations, their age is identical. Both of the same age have the same life expectancy, withdraw identical amounts from identical assets at identical times. This sounds like us, by the way, way and and in general, a and b are completely identical. The only difference between them is a retired 10 years ago and B has just retired. Why doesn't the sequence of returns impact both of them the same way during the five years after B's retirement? Why is risk greater for B than for a?

Briana Corbin 13:00
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Wade Pfau 13:38
Yeah, it's a great question from Lynn, and actually, this question sparked a lot of discussion in the chat during the webinar, as various folks were trying to answer it, and kind of a lot of back and forth. Now, during the actual webinar, I wasn't able to review questions, so I could only see this after the fact, but there was a robust discussion about this question, and I think it's because it's kind of a bit confusing in terms of creating a hypothetical scenario that isn't necessarily possible, or at least there's got to be something different, strictly speaking, the way the

question's asked, person A retired 10 years ago. Person B retired today. Now do the dynamics of the markets and everything else, they're exactly in the same position today in terms of,

Alex Murguia 14:27
I will say, 10 years more of salary that the person B got.

Wade Pfau 14:30
Well, yep, so the past 10 years happened. Person A has been spending from their portfolio for the last 10 years. Person B's been earning a salary for the past 10 years. So the the kind of, the magical leap here is, after all that, today, they're both in exactly the same position. Okay, so today, looking forward from today, they both need the same withdrawal rate to meet their expenses. They're both the same age. They both have the same time horizon. If all that's true, and that's what the. Question, saying, like, if all these things are true, then yes, they have identical sequence risk, because you can always kind of reset and say, looking forward to from today, and if they have the same withdrawal rate today, they have the same sequence risk. But that's kind of an odd hypothetical to be talking about, because it means they would have had very different situations. 10 years prior to retiring, Person A has been spending from the past 10 years. Person B has been working for the past 10 years. Person A was vulnerable to the market returns from the previous 10 years, in a way that person B was not vulnerable since they weren't retired. Yet, if markets did fine over the past 10 years. Like, like, if we think of it more, if we try to make these people comparable, it's like they had the same amount of wealth when they retired. And then we could talk about the comparability, the way Lynn asked the question, yeah, now has the same amount of wealth as B 10 years after a retired.

Alex Murguia 15:59
Let me. Let me ask you, as opposed to becoming a logician and trying to figure out a equals b and b or c and a equal c, and all that kind of stuff, at the end of the day, Wade, I think what you're trying to convey. And please correct me if I'm wrong here with regards to sequence of returns risk. And this is getting down to the fragile decade. Why is that fragile and not not previous, not more previous to that, or more after that? Is simply because you know, as you're winding down, your human capital is shrinking, and so investments, you know, you're in accumulation mode so you can withstand, you can weather down, downward swings, because you're working, you're drawing from your human capital when you retire. The portfolio now has that extra burden effectively, and you've got to get over this hump. You got to give yourself this quote, unquote, let's say, margin of safety, of good number of market returns that are positive, and that takes years to put in. So while you're you know, five years from retirement, five years after retirement, your healing capital is depleted, hence you're going to have to rely on your portfolio. And you it's very important to get off to a good start. And getting off to a good start is purely based on just chance outcomes of what economic cycle you retired in, all right, and so that's what you're trying to get over, and that's why you need to get a couple of years couple of years in to get past that. And that, I think, is the gist of what you're writing about and saying, as opposed to, you know, playing these kind of, you know, let's see if we can break down the logic here games. Yeah,

Wade Pfau 17:34
and a the person who retired 10 years ago had that chance to get off to a good start or a bad start already. If the markets did fine over the past 10 years and they had a conservative spending strategy, their portfolio would have probably continued to grow, and so it would have

been higher than, well, not higher than be. We got to figure out where things matched up. But the point is, worry about

Alex Murguia 17:58
breaking down the logic of this question, because I think it's good. You're gonna you're gonna inadvertently confuse the more important point of what I think people should be taking away.

Wade Pfau 18:08
I guess the simple way to answer it is yes. Lynn, if A was in exactly the same spot as B 10 years after a retired, they now have the same sequence. Risk looking forward. It's just really hard to get into that spot to begin with. Yeah, the easiest way to answer it,

Alex Murguia 18:28
okay, because I think the gist is what we just conveyed, like, listen, it's about getting off to that good start and you give yourself that margin of safety.

Wade Pfau 18:36
Yeah, it's kind of like, if they had the same amount of wealth 10 years ago, they'd be in very different spots today. Yeah,

Alex Murguia 18:43
okay, so let's get another one in here. Lynn. Lynn comes back for more.

Wade Pfau 18:49
Yeah, this was part of the ongoing discussion, but I thought this was a good it was

Alex Murguia 18:55
fair enough. So perhaps another scenario might explain the confusion. Person, a retires at age 40 and is now 45 person B, just retired and is now 50. They have the same life expectancy. Wouldn't a have a greater sequence of returns risk than B, all else being ego, because A's assets will need to last longer

Wade Pfau 19:19
so and by them having the same life expectancy since A is younger, 10 years younger or no, what? Well, anyway, a was 10 years younger than b, so a needs their money to last longer because they're gonna they're both gonna live to age 90. A has a longer retirement horizon than B. So this gets back to what I was saying. Has making a point that comes up for later questions. The younger you are, the longer your remaining time horizon, the lower the withdrawal rate you have to use. But then so technically speaking, a may have less sequence risk than B if A is using a lower withdrawal rate. But I get Lynn's point. I. About, yeah, I mean, a definitely has more risk. It's not necessarily the sequence risk, exactly, but their money needs to last for 10 years, longer than Person B. So that does create more risk and more vulnerability for them. It just it may not be sequence risk, because if a is using a lower withdrawal rate, they might actually be less exposed to sequence risk if they were using the same withdrawal rate. Then, yeah, a has it's not going to be sequence risk, but a has a longer time horizon, so they're going to be more vulnerable to depleting their investments. It's longevity risk at that point. Longevity risk, yeah,

Alex Murguia 20:38
all right, so yeah, it is a good question in the sense that she pointed out, yeah, there's many risk in retirement. One of them is the sequence risk, longevity risk, and probably peppered in between that is liquidity risk. All right, okay, we'll get one more question here from John B. Johnny B, good. I assume John B if one has a sizable pension that covers all daily needs, how much portfolio risk with balancing would be acceptable? And so currently, with 35% bonds, short and intermediate, 30% large caps, 15% small caps, 15% International, 5% cash. Since 08 the overall return has been slightly above 8% using mostly index spots, could or should I change strategy?

Wade Pfau 21:34
Okay? And John's question actually came in through an email to retirement researcher. It wasn't a webinar question, but I was trying to figure out where's a good place to put it. This episode is really about nuances of sequence of returns risk, and I thought this question brings up a good nuance of sequence of returns risk, and as how the question begins, if one has a sizable pension that covers all daily needs, how much portfolio risk with rebalancing would be acceptable. That individual doesn't have sequence risk. They have reliable income covering all their expenses. They don't really need portfolio distributions. So that gives them risk capacity. And it's like it almost becomes they've got a lot more flexibility about how much portfolio risk. Risk risk is completely a preference for them. Yeah, they don't need any risk because they've got their lifestyle covered already. They that means either they take no risk or they completely maximize their risk, just because it's all discretionary wealth. If they have legacy goals, at some level, they're really just investing that for the legacy purposes, maybe that whoever their beneficiaries are, could take more risk also they've got risk capacity,

Alex Murguia 22:47
daily needs could mean essential. And, you know, they still want to live life and enjoy life. You know, beyond essential, they want discretionary. So this is meant to fund their discretionary

Wade Pfau 22:56
Well, if it's funding the discretionary, the the academically optimal way to spend in retirement is you do cover your essentials with reliable income sources. So it's kind of the income protection approach from the RESA. And then you can use a variable spending strategy from the investments to meet more discretionary types of expenses. Now the more aggressively you invest for the discretionary expenses, the more volatility there may be for those discretionary expenses. But on average, you might expect to be able to spend more overtime that way, on discretionary goals, or on legacy or just on having additional reserves. So it's at that point really it becomes open to there's nothing we can say about should you change your asset allocation? It's more about what are you comfortable with, recognizing you have the capacity to be flexible with the approach you take.

Alex Murguia 23:53
Now they're asking within this the 35% is the 35% bonds too much, too little, versus large caps, small caps, etc. This is all. There's a whole host of other questions here that you would naturally ask just what types of bonds, what types of large caps, small caps, international, etc, to go into it. But and with

Wade Pfau 24:14

their asset allocation, 6040 overall stocks, 60% bonds, 40% Yeah. Just to simplify all the different asset classes that you listed up. So there's, we can't say you should change it. We can't, I mean, it's, it sounds,

Alex Murguia 24:33
I mean, there's a one of these. It depends. It depends on, uh, your style. But also I, I don't know what's in it, we could say, Yes, change it. But within the large caps, do you have value those kind of questions? Is there room for REITs? You know, International? Are the bonds pegged to the dollar or not? So there's this, there's some questions to ask before, you know, getting into this, but in light of the. Scheme of sequence of returns and the like. I think the bottom line here is that he's covered. He or she is covering enough for their daily bread, which is what's important, and we're going to assume the rest of the investments are for discretionary and at that point is Wade is saying risk is completely a preference for how much they want to achieve if they only want to go to Disney World once a year, until, until that's it? Well, I'm guessing they probably have enough, you know, with a moderately diversified portfolio. But again, that gets into what's discretionary and how impactful they want to be with their assets in this life and in the next.

Wade Pfau 25:40
Yeah, yeah. It's just the idea, the more aggressively they invest, the more variability there will be in the growth of that portfolio over time. But on average, you would expect, at least on average, a higher balance greater growth over time.

Alex Murguia 25:56
All right, wait, those are the Q and A's for sequence of returns risk, yeah. Are you feeling about that?

Wade Pfau 26:04
Yeah, yeah, that's that. So we've got more on the sequence of returns risk. This is kind of a short episode, but I guess that works, though. Yeah. We always say

Alex Murguia 26:13
we want to get them into about 20 to 30 minutes, and we always do 30 to 40. So I'm going to take this as a V A victory, unless you want to tell everyone to buy your Japan trip for the summer.

Wade Pfau 26:25
Yeah, that's now in the past tense with this recording, it's all good. Gonna put small talk at the end of the

Alex Murguia 26:30
episode. Yeah, yeah. His extended, Extended Cut, Extended Cut. But no, that's it, everyone. Thank you for listening, and we'll come back next week with a little bit more On buffer assets specifically, all right, everyone. Bye. Okay, you

Briana Corbin 27:13
you wade and Alex are both principals of McLean Asset Management and retirement researcher. Both are SEC registered investment advisors located in Tysons, Virginia. The

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