

Episode 193: Retire with Style Live: Part 1

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Retirement income, buffer assets, market downturns, cash reserves, annuities, reverse mortgage, principal protection, risk management, income protection, Tontine, blockchain, financial planning, investment strategy, historical returns, market valuation.

SPEAKERS

Alex Murguia, Wade Pfau, Briana Corbin

Briana Corbin 00:00

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Briana Corbin 00:14

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Briana Corbin 00:38

Okay, so it turns out we weren't actually done with listener questions. This week's episode comes straight from yesterday's YouTube Live, where Wade and Alex took on everything from 10 year cash buckets to blockchain powered tontines. Yeah, I know.

Wade Pfau 01:00

Okay, we're live. Hi everyone. Welcome to retire with style the live YouTube edition. We're excited to be here today to answer your questions. I'm Wade. I'm here with Alex.

Alex Murguia 01:12

Hey, everyone

Wade Pfau 01:13

who's working on his technology, but I think everything's up and running now. So let's go ahead and get started and welcome everyone to the show. We did have some questions that came in advance that we can start with. And please feel free, of course, to ask questions in the comments of the YouTube Live session. And we have both Amber and Brianna on the line who are going to pass those questions to us. We don't see the YouTube directly because there's a few second delay there, so it would cause a lot of distortions if we were going to handle that type of multitasking that's next level, but we will be getting your questions fed to us through the chat here on the podcast app. So welcome everyone and Alex, there's some a number of questions that did come in advance. Some of them are paragraph or multiple paragraphs in length. But let's go ahead and get started with some of those questions. All right,

Alex Murguia 02:01

let me get started with the first one here, and it's good one to get ease into this Monday live session here, gentlemen, you have an excellent podcast, and I was wondering if you'd consider addressing the following topic. I often hear podcast hosts talk about keeping five years in parens, or even two or three years of safe money to weather a market downturn. While I understand the concept, I'm puzzled by references to previous market downturns lasting no longer than five years. My research indicates downturns can last much longer than that. For example, you know, here's the following breakdown, the 29 crash and depression 25 years, I'm gonna assume these numbers are correct. The last decade, the .com bust and global financial crisis were part of that. The market reached its previous level in May 2013 and over 20 years after the initial crash. So it did nothing for 12 years the market, I assume, based on the Dow, the this pre this period included a 54% loss, just for kicks, inflation, Vietnam and Watergate during the 70s, took more than nine years to recover from a 51.9% decline. In fact, as a famous times cover the death of equities. I think that was in 1978 or something like that. Or, yeah, 1973 the oil embargo, bear market. Markets wouldn't fully recover until 1980 make it one of it one of the longest then modern recoveries, the .com bubble, NASDAQ Hunter, took over 15 years to recover the global financial crisis, the market ultimately recovered in 2013 wouldn't it make sense, given these extreme yet not uncommon cases, for a retiree to hold cash bonds and be able to write it out for a longer time frame, perhaps 10 years. Okay, wait, I need to catch my breath. Why don't you start off? Well, I did Ricola,

Wade Pfau 04:01

yeah, a lot to unpack there, but Right, this question's about the idea of, I generally would call this a type of buffer asset, this idea that you have a pile of cash sitting on the sidelines to help weather market downturns, so that you don't have to sell from your portfolio at a loss. Now, in one of my older books, I did have a section called the stock market's Greatest Hits, where I did talk about some of these kinds of numbers, just looking purely at the stock market, when there's a downturn, how far did the market fall, and then how many years did it take to recover? Looking at global data, the numbers? Well, I think this question may be referring to some different indices and so forth, but I had like the US from the start of 1929 the year the Great Depression began, it would take until 1936 to recover. In 1973 that what we talked about in this question here, with the oil embargo and so forth, it took 10 years to recover after a 52% drop. But yeah, in other countries, you. See bigger situations than that. The record was Austria after World or at this from the start of World War One, with a hyperinflation they experienced. It took 89 years for their market to recover. But we could spend all day talking about those kinds of numbers. Oh, I thought we were awake. There we were,

Alex Murguia 05:19

like, Genesis to run? Yeah, I think

Wade Pfau 05:23

there's probably about 60 examples I could run through. No. But that being said, the point is, yes, the stock market can be down for an extended period of time. How do you think about managing the risk related to that in your retirement? I think what this question is hinting at, partly is when it comes to the retirement income style awareness, Alex, nice shirt, by the way, that the RESA is the retirement income style awareness.

Alex Murguia 05:49

By the way, proper haberdasher, yourself there,

Wade Pfau 05:53

retirement researcher,

Alex Murguia 05:55

your sartorial instincts are on point.

Wade Pfau 05:59

That's right. But in terms of that, so what was I saying? Oh, yes, so probability based is the idea that you're comfortable relying on market growth, that probably markets will grow, and so that's where you'll get if the podcast that you're listening to, if they have more of a probability based orientation, they're comfortable with the idea that, yeah, I mean, it's possible the market could be down for a very extended period, but generally, they're expecting, with a diversified portfolio, including probably some international diversification, markets, should recover within five years or so, in general, or probably, so to speak, if you're more safety first in Outlook, you may just not be comfortable with that. And so getting that into the question of, well, should I have a 10 year cash buffer? That may be a situation where you're you're kind of getting pushed into a total returns based, probability based retirement income style that you're not really comfortable with, because having 10 years of spending in cash is going to be a significant drag on returns over time, and if you compare that to other options available, well, whether it's other buffer assets, so this might be a situation. Maybe if you have, if you're living in a home, a reverse mortgage, line of credit, growing line of credit could be an option. Maybe if you have permanent life insurance, those are the other kinds of buffer assets that would let you spend in this manner, but without having to have 10 years set aside in cash beyond that as well. Maybe it's more of a time segmentation approach where you build a 10 year bond ladder, rather than having a 10 year pile of cash on the sidelines. Or whether it's also using annuities with lifetime income protections, those are ways that may help you feel more comfortable that you're able to manage market downturns without being significantly, really out of the market with kind of a very inefficient, giant bucket of cash.

Alex Murguia 07:52

Yeah, my, my quick two cents to that is, you're not wrong in that, in that vein, I think what you're referring to when you hear podcast folks say it, or pundits like that, or even advisors, is there's this time diversification concept where, if you look at over any 12 month rolling period from, let's say 1927 to 2023, any three year rolling period, any five year rolling period, any 10 year rolling period, any 15 year rolling period, any 20 year rolling you know, you increase it. Off the top of my head, I don't know the exact numbers, but let's say, over any one year period, 12 month rolling period, it's like you have a 50% chance of outperforming the risk for rate or being positive right. Over a five year period, it goes to 60% over a 10 year period, it goes through like 70% it goes ever increasing, and it doesn't go to zero to point. So you can have all of these examples of windows where there was risk, I think only when it's like 20 plus rolling monthly, you know, years of rolling monthly returns, you get that. But you're right. And as Wade pointed out, ultimately, if you're thinking about this and thinking but there are times when not having cash would have given me undue anxiety because I needed it and, you know, the light, then I think you're thinking about it the right way. And I think Wade is, wait, wait. So Wade's alternatives make a lot of sense, depending on which way you want to go. Now, if you're listening to Wade's answer, and if you're listening to your question, and that person is thinking, Yeah, but my

goodness, if I have 20 years worth of cash, or 10 years worth of cash for any given period to for the just in case thing, I think on average, the opportunity costs are going to kill me. And I don't want to do that, right, right? Wade, that's, you know, I'm sure there's some folks listening to that question, and we're thinking in that vein, don't you think,

Wade Pfau 09:49

yeah, yeah. And it's really kind of the asset allocation question, and getting pushed into an approach that you're not comfortable with could lead to just really feeling like. Do need 10 years of cash on the sidelines? And there's probably a better way to structure things than having 10 years of cash on the sidelines. Okay, there we go. Like now there was a live question that came in that's related to this question. While we're on the theme of buffer assets,

Alex Murguia 10:16

I'll read it out loud, and you can be thinking about an answer here. Yeah, it's from Enrique. Enrique ki gay. Here we go. The future implications for taxes on the aging baby boom.

Wade Pfau 10:28

Not that one, the one we're still up so it's a would using 100% buffered ETFs be considered a strong alternative as a buffer asset instead of cash or CDs? And that's a really popular question that we get.

Alex Murguia 10:43

Think of semantics. What we mean buffer is not what marketing means buffer kind of thing,

Wade Pfau 10:51

right in that regard, but so 100% buffered would be principal protection. It's kind of like how a fixed index annuity works, where you receive a portion of upside without any downside risk. And this is a question we always get, because I usually say there's three buffer assets, cash, reverse mortgage, growing line of credit, variable rate, home equity, Conversion Mortgage, and the cash value, permanent life insurance. And so would something that provides principal protection, like 100% buffered ETF also be a buffer asset. And I would say it could potentially be, but you just have to be careful about any sort of liquidity issues. The idea of the buffer asset is you need to be able to tap into it and get the cash you want within, say, a few days, or, like, within a reasonable period of time. So just make sure you understand the terms of the financial product. You may be sacrificing any potential upside growth if you're drawing from it before the end of the term, or there may be other types of fees related to if you're taking a distribution before the end of a term. Just how does it work if you're going to take a distribution before the end of a term. If you can pretty much tap into it and get that principal protection even in the short run, then yeah, I would be okay adding that to the list of potential buffer assets. But makes me a bit nervous, because a lot of times these types of tools don't have the same sort of liquidity and protection when you're not waiting until the end of the term that we'd really want to be looking for with what we want to call it buffer asset.

Alex Murguia 12:30

Okay, I'll read the one, the question that came in on top of that one, just because they're rolling in nicely. Now, the future implications for taxes on the aging baby boomers and declining ratio of retirees to workers is clear, retirees need to minimize taxes as part of their planning strategy. My question is, what do these demographic trends and tax trends mean to equities and interest

rates over the next 20 to 30 years? Should a retiree position their income and how should a retiree position their income and investment strategy?

Wade Pfau 13:08

Well, yeah, this is one of those questions that can be a bit tricky to answer. I know there's been some interesting studies that look at things like comparing market stock market growth to the percentage of the population over age 65 and kind of noting with demographic trends. When there's fewer workers more retirees, you should expect some sort of systematic stock market downturn. They've been able to fit that to the data pretty well. On the interest rate side, you know, we have this whole issue of government debt is rising, and at some point it's we're going to have to pay pay the bills, and that could require higher taxes and so forth. But trying to build an investment strategy around any of that, it can really be a fool's errand, because it's really impossible to predict any sort of systematic stock market fluctuations based on macroeconomic trends of this nature. Yeah, I'll hand

Alex Murguia 14:00

it over to counter. I would counter that the impact that that will most likely have in the capital markets is reflected in the current pricing. Just the fact that we're being asked this question means that it's a variable that's being heavily weighted in somebody's thinking about market prices, and so that is being handicapped in the current prices.

Wade Pfau 14:30

Yeah, there's that too, that anything that we know that's expected to happen is going to be reflected in today's price. Otherwise there'd be an opportunity to change the price today. In response,

Alex Murguia 14:40

I mean, and, you know, and now, from an optimistic standpoint, there are advances that happen, all of those technological advances all the time. And you could make the case, not since the dawn of the internet have we been in this Precambrian kind of state that we are right now, in terms of a next leap forward. And who's to say what? That's what that is going to all portend for the markets. How's that? Is that a good, optimistic bow tie on that one wait or

Wade Pfau 15:12

glass is always half full?

Alex Murguia 15:15

Did that make it feel good? That make it feel like yeah, let's go get lunch. Let's put your phone Chipotle. Get the guac. Get the extra guac.

Wade Pfau 15:28

Probably gonna run you \$15 with inflation these days, exactly.

Alex Murguia 15:34

All right. All right. So we got one here. What would a modern day from Luke? What would a modern day responsibly regulated Tontine look like if you could update laws and regulations and put your spin on it? I like this question a lot,

Wade Pfau 15:52

actually. So a Tontine, for those who may not be familiar with them, it's basically an investment pool that's going to act like an annuity, in the sense that you have folks who come together within a pool, and then the distributions from the pool go to the remaining survivors, so that as folks pass away, there's fewer people to distribute what's left to, and so you're able to distribute more over time. Now there's been the tontines that you see in Hollywood. And then there's the real world tontines, and they're quite different. If you've seen any movies or TV shows, I know there was a episode of Archer that had a taunting. It's usually

Alex Murguia 16:35

Simpsons had something. Simpsons may have had one too. We create a little series Wade, or we go to, like, some like, you know, ADL, sort of living facility, and we create some sort of suspense caper that, like, that'd

Wade Pfau 16:51

be awesome, yeah. But in the Hollywood version of the Tontine, it's usually the last one surviving gets everything, and so as the pool of remaining individuals is whittled down. That's the whole intrigue and suspense of the killer with the candlestick in the library, right, right? But, and in reality, you don't have to have it work that way. You need some sort of central administrator. You would want to keep the members of the Tontine pool anonymous to each other, but you need someone to kind of regulate that either everyone needs to be approximately the same age or in the same profession, have the same sort of mortality risk, or, if not structure, younger folks may get a bigger chunk of the pie and so forth, but have actuaries working behind the scenes to make sure that Tontine is fair, and then also it wouldn't continue that sort of distribution among remaining survivors until the very last person, one person remains at some point, as as the pool of remaining survivors is whittling down, at some point, you put the brakes on how you're going to distribute amongst remaining survivors, and with it being anonymous, I think you don't have to worry too much about the Hollywood version of these running amok in real life. So it could be done. And I think we probably, at this point, really have the technology to handle that pretty well. So I think maybe innovations that you see in the future, and there are other always companies out there that are working on creating tontines in the United States, I think for the most part, they're still considered technically illegal. But there's a lot of lawyers who are also writing articles about how, really, that's not a fair interpretation, or working to lay the groundwork to potentially have tontines in the future.

Alex Murguia 18:41

I would wait. I this is where, obviously a little bit of knowledge is a dangerous thing. But to me, this could be an interesting avenue for the blockchain, because all of a sudden you have records, right? The Tontine is effectively keeping record of who's last one, etc, etc. Imagine this. I mean, if ultimately crypto is programmable money, right at the end of the day, I don't see why you couldn't have sort of a ledger of all of this kept on the blockchain with certain cohorts within the content. I would think something like that would be a very interesting way to go, and I wonder if that would even be more scalable than how it's done now, where you need this big insurance company as a intermediary and so forth, again,

Wade Pfau 19:30

company, I think insurance companies don't like them, because you don't need an insurance company.

Alex Murguia 19:36

That's what sort of getting at like, sorry, that's exactly what I meant by that. Maybe I didn't word it properly, but that that's kind of what I was getting at. Like, interesting. It's a very interesting thing. That's why I thought, Oh, this is a good question.

Wade Pfau 19:50

Yeah, it's a way to create an annuity structure, more like a variable annuity, without actually involving an insurance company. Yeah, because

Alex Murguia 19:57

you can, you can program into the crypto, you know, whatever kind of lever. You want, I would think again, little bit of knowledge, dangerous thing, but directionally, I think you could do something like that.

Briana Corbin 20:09

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Alex Murguia 20:35

Okay, we got Howard here next one. How about combining safety first for essential expenses with pension Social Security annuities and use constant percent of portfolio for discretionary expenses, which fluctuates with market perform but will never outlive. Yeah, is that a question? I mean, I sounds good to me. Wade, just take it away. And he did even make the point to say discretionary. So he's he knows the difference between discretionary and essential. So,

Wade Pfau 21:10

yeah, so this is an explanation of the income protection approach. And if you ask an academic economist to write up an article where they create a model to demonstrate the optimal way to build a retirement income strategy. It's a slight variation of what Howard explained it. It's your first build a floor of reliable lifetime income to cover your basics, and then it would be using more of like an RMD style or actuarial variable spending on the remainder, where you increase the distribution rate with age to account for the shorter remaining lifetime, lifetime, rather than using a constant percentage distribution? Yeah, it's use an RMB related increasing percentage of what's left to cover discretionary expenses after you have a floor to cover your essentials. That's what academics would model out for you as the optimal way to build a retirement income strategy. And that's something we see in real life with the income protection approach when we talk about retirement income styles.

Alex Murguia 22:07

Gotcha. We got here from Howard again, back to back up. I heard an interview, sorry. I heard an interview of Bill Bernstein, who indicated planning next 50 years based on returns in the US from 75 to 25 is nuts. I agree. But see, folks use these historical returns all the time. Your view, would you do participate in a Tontine of members of your firm of similar age?

Wade Pfau 22:38

Okay? So, yeah, those are two completely different questions that were,

Alex Murguia 22:40

yeah, well, you do the Tontine one just to finish that concept, and we get into the next one.

Wade Pfau 22:47

So the taunting one, if you mean literally, this is not a pyramid. We're too small. You need to rely on the law of large numbers. You probably for a large company, or at least going to have several 100, if not more, employees that are part of the Tontine. I think you really need that kind of size. If you just have 10 people getting together and creating a Tontine, I would be a little cautious about that, just because the risk of there's too few people to really have a good sense of what the mortality distribution would look like, and then we are losing the anonymity of the I know Alex is in the pool. So should he,

Alex Murguia 23:25

should he happen to be hit with a bolt of lightning? I will remember, remember the Godfather he went when he brings Michael back from from Sicily, he tells the whole table of the family, shall he be hit with a bolt of lightning? I will blame somebody in this room, so I'm watching you away.

Wade Pfau 23:48

So yeah, then with the other part of the question, William Bernstein indicating that basing market assumptions for the next 50 years on the past 50 years is,

Alex Murguia 24:00

I think the question here is, do you use historical returns versus, you know, expected kind of returns? And what does that mean? I had that's, that's the way, because you can always pick whatever years and this and that, then Wade you want to maybe go into how you use a build up model when you're doing your assumptions well. And this is something that, I mean, we talk about this almost at every investment committee meeting, and nauseam, it's almost like opening remarks.

Wade Pfau 24:28

Yeah, the thing that drives me nuts, like, if the market has a really good year, that's going to push up the historical average returns, and if you're just plugging those into the model, then you've got a higher expected return for the future. But, uh, I Yeah, generally speaking, like when we we created the funded ratio tool where we don't have to worry about forecasting a stock market return. We just look at whether the plan can work without taking financial market risk. And then, the way I like to think about, well, if you're going to simulate a stock market return, you. You add some sort of risk premium to the well, to your bond yield. What does risk premium mean the expected outperformance of stocks over bonds in your planning model, which historically, though it's nuts, where we're saying in this question, but historically, large cap, US stocks have outperformed long term US government bonds by about 6% a year on average, but with a 20% volatility now. Then, if you do run a Monte Carlo simulation on that, usually people are targeting a high probability of success, which implicitly means they're assuming a lower rate of return, because their return has to be low enough that 90% of the time you end up with something better. So I don't necessarily, I wouldn't call it nuts to do that. I think it's a reasonable way to look at things. But yeah, certainly I wouldn't want to plug in. I don't want to take the average historical return, assume you're going to get that every year, and plug that into a

spreadsheet. I always say that's nuts, but if you're doing that more in a Monte Carlo type setting, I don't necessarily object to it as much. But then again, I don't even necessarily think you need to do that kind of Monte Carlo based planning model. Just look at something like the funded ratio, where you have similar conservative rate of return, and see if the plan can work in that context.

Alex Murguia 26:17

Okay. I agree. Uh, we have here our swim. Got Luke Howard, how about combining safety first? Yeah, that's the one we got. Okay, so we're by I heard an interview with the Don so Kaushik, are you aware of any independent study analysis on whether buffered ETFs can serve as a tool for risk diversification, especially in high market valuation or environment. Uh, from my end, there's off the top of my head, I can't recite any but check out Cliff Asness, he's he's really on this a lot, and he's done a lot of work on that. And ultimately what you see from white papers and the like, but what you ultimately see with like buffered ETFs, this is different than the way we were using the word buffered earlier, but with buffered ETFs and the like, including them in your portfolio will have a dampening effect on volatility. But the reality is, is that, let's say, if you're theoretically going to be in a 7030 portfolio, but you wanted to to get put 10% of what you would call equity portfolio into the buffered ETFs, or do some mental math with that to see what that would be in that hybrid kind of investment. I mean, you would get a similar return if you just have reduced the equity to 6535 you know, something like that, as opposed to 7030 and messing around with buffered assets, you kind of see that ultimately, that it doesn't really do much. You can just get that same level of volatility dampening by reducing the equity of your portfolio. Now, I would say balance that with your need for when you need that cash at that point. Maybe the buffer could make sense if you have the if your sequence of return, not sequence of returns, but when the urgency of when you need that cash flow is is major. Well, then maybe you bite the bullet with a buffer. But I don't think from an investment standpoint, I haven't seen anything that says, hey, this provides you a better risk return than if you were just to commensurately lower your stock the bond allocation. Wade have

Wade Pfau 28:34

you? Well, so buffered ETFs are going to have similar return experiences as structured annuities. I've done a lot of work in the structured annuity side, where, if you talk about registered index, linked annuity with a 10% buffer and a cap, I think that's kind of what we're talking about with buffered ETS. I think Kaushik asked a

Alex Murguia 28:57

question earlier, okay, 100% buffered like the, you know, do you get these hybrid kind of dampening ETFs?

Wade Pfau 29:05

But go on. No, no. I think he means basically, a buffered ETF is going to work either like a registered index linked annuity with a buffer and or if the buffered ETF has 100% buffer, that's equivalent to a fixed index annuity. And I have looked at from the annuity side, incorporating those into models, and really, especially the 100% buffer version, which equivalent to the fixed index annuity that as a bond replacement, can really do a lot for a portfolio in terms of and well buffered epfs Don't get tax deferral. The annuity does get tax deferral, but compared to taxable bond funds when you have that principal protection, so you're not worried about the interest rate risk, when you're getting some sort of return that's somewhere between zero and a cap, it could

be quite competitive with what your bond investments can do. So I think that can help enhance. A portfolio, so you'd see it being more as a bond replacement, as opposed to the equity, which is the way I took it initially. Oh yeah, generally, that's where those pictures so the point you were making. David Blanchett had a study, and I found similar things afterwards, like a 10% buffer on, say, the large cap US stock index, that's going to give you similar types of return and risk characteristics as about a 60/40 portfolio, 60% in the large cap stock index, 40% bonds. But

Alex Murguia 30:28

if there's income to be had, that could tip the scales over for the buffer, you know, if you're doing it for like the now, I'm thinking of the annuity piece of it, where, you know, you want to turn on the income component, if

Wade Pfau 30:40

he Yeah, if there's a living benefit or annuitize, but, and

Alex Murguia 30:44

it's kind of changes the way I would answer this, from that standpoint, thinking about it, from an income, retirement income perspective,

Wade Pfau 30:53

or just either from a retirement income perspective, or from the perspective of trying to manage risk in those pivotal years around The retirement data, and if you want a high probability of success having that downside protection can be beneficial, even if you're sacrificing a bit on the upside. However, if you are thinking of this more as a bond replacement, you're not necessarily sacrificing on the upside.

Alex Murguia 31:15

How would you I don't know if this matters, especially in light of high market valuation environment, which is speak for I think the markets are frothy right now, so maybe a buffer makes even more sense.

Wade Pfau 31:30

Yeah, well, we don't know what the markets will do. I've been nervous about the high market valuations for a number of years, but markets keep going up and that the same time, though, if that's something that worries you and you're it's certainly having a buffer could be a good alternative to just panicking and leaving the market and potentially missing out on future growth, because you the buffer would still if that helps give you the comfort needed to stay invested, because you know, you have some of that downside risk cut off, and then that allows you to keep a reasonable portion of the upside growth. If the markets do well, then you know can certainly be worthwhile. And if that also, if you think of it more as a bond replacement, but that helps you feel more comfortable keeping stocks in your portfolio, then then all the better as well. Perfect.

Briana Corbin 32:20

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