Episode 208: Your Retirement Spending Questions Answered: The 4% Rule, Sequence Risk, and Glide Paths

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Retirement income, 4% rule, sequence risk, glide paths, discretionary spending, essential spending, safe withdrawal rate, time segmentation, variable spending strategy, annuities, Social Security, dividend income, total return, income protection, reliable income.

SPEAKERS
Briana Corbin, Alex Murguia, Wade Pfau

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 00:38
the sequence of returns risk. It's a mouthful and a major retirement planning challenge. This week, Wade and Alex unpack what it really is, why it matters, and how to manage it, covering everything from buffers to glide paths to the 4% rule, this isn't just theory. It's strategy you can use.

Alex Murguia 00:59
Hey everyone, welcome to retire with style. I'm Alex, and I'm here with my good buddy, Wade Pfau, and we're gonna hit it off with another edition of our Q and A's right.

Wade Pfau 01:13
Wade, that's right. That's right. And the theme trying to put together questions into a theme. It's kind of sequence risk, discretionary spending versus essential spending. That's kind of the underlying theme today.

Alex Murguia 01:28
Think about a big Thanksgiving feast when they have that basket with all the foods in it and the cornucopia of Delights.

Wade Pfau 01:35
Yes, go ahead and a copia, a cornucopia of questions.

Alex Murguia 01:40
Here we go. There we go. All right, so let's, let's hit the ground running. First one from warts and gomage. It could be French, I don't know. This one dealing with four 4% rule and rebalancing. I have seen the 4% rule, and now I see buckets and rails and sequence of risk. None of these, though, go into at least broadly what was or is used, or is the formula used in extracting funds from a portfolio. Is there any details on the selling formula used on all of these cases or in the grandfather of all the 4% rules, well,

Wade Pfau 02:26
I'd say that the buckets have a pretty clear rule on where you're spending from, but, but yeah, this gets into in the previous episode retirement, one of the limitations of, like the the 4% rule, but really all the the research and the safe withdrawal rate space was that it didn't really consider taxes. Well, this question gets at another extension of if you're not really even considering taxes, you're not really worrying about where you're spending from, because one of the basic assumptions of 90% plus of the safe withdrawal rate research is you're always rebalancing to your targeted asset allocation every year as well. So it doesn't really matter, do I draw from the stocks, or do I draw from the bonds? Because I'm taking out what I need, and then I'm rebalancing to the target asset allocation all at the same time, and I'm not worried about the tax consequences of that. So I'm not really paying attention. I guess, just technically, if stocks are up, you're pulling more from the stock side as a part of getting rebalanced. If stocks were down, you'd be pulling more from the bond side to get yourself rebalanced. But it's ultimately, I'm distributing and rebalancing at the same time, and I'm not worried about the tax consequences, and therefore, I'm not really paying attention exactly to whether I'm distributing from the stock side or the bond side. That's how most of the safe withdrawal rate research works. Now with bucketing, it's different, because bucketing is getting you away from just that total return investing approach. It's my short term buckets are bonds, my long term buckets are stocks, so I'm spending from bonds, and then if the conditions look appropriate, I'm going to rebalance by selling from the long term growth buckets to replenish the short term buckets. And I'll have some rules guiding when I do that, but it's pretty clear when I'm reallocating from stocks back into my my bond buckets. Well, you can see that that's the difference for bucketing, really.

Alex Murguia 04:23
But in the buckets, though, Wade, I think you have to clarify bond, funds or bonds?

Wade Pfau 04:28
Well, yeah, when we talk about time segmentation as retirement income style, we do mean like your short term buckets are really laddered bonds held to maturity to meet upcoming expenses. But in real life, there's no clear definition on what people mean when they talk about time segmentation. So there may be practical uses where the short term buckets have bond funds in them. They're probably relatively short maturity short term bond funds, so hopefully they don't have a lot of interest rate risk. But. But yeah, it's still the same idea. You're selling bonds to cover expenses, and then when deemed appropriate, you're selling stocks to replenish the short term bond buckets. And again, whether it's a bond fund or a bond, individual bond isn't overly important for this particular point.

Alex Murguia 05:22
Okay, for what point would it be, particularly interest

Wade Pfau 05:27
rate risk, where bond funds really aren't the the whole idea of time segmentation is you want reliable income, and you get that by holding individual bonds to maturity to meet upcoming expenses, you don't get reliable income from a volatile bond fund that's exposed to interest rate risk and has a maturity that's not necessarily matched to the duration of the expenses you're trying to fund.

Alex Murguia 05:54
So if I'm listening to you, clearly, effectively, the word formula is the key word in this question, and what was, or is the formula for extracting funds from a portfolio. If I'm listening to you, the formula is effectively whatever it is, as long as your allocation remains in line with what was, what it was originally intended for, yeah, like, that's the formula, kind of

Wade Pfau 06:19
targeting 6040, it's all at the same time, since you're not paying attention to taxes anyway, at the same time you just, you take the distribution and rebalance so you're not really paying attention to what you're drawing from. You're just going to be rebalanced again at the end.

Alex Murguia 06:35
I don't know what else the formula could be, right? I like in the wording of the question, what?

Wade Pfau 06:41
Well, that if you're not automatically rebalancing there, and this is where there's limited research that would look at, when do I want to cover expenses through distributing from the stock side, and when do I want to cover expenses through distributing from the bond side, which, again, was very clear in time segmentation, but even in a total return environment, you can do that, and then you'll just have a dynamic asset allocation.

Alex Murguia 07:09
Okay, so next one, let's go into sequence risk. Thomas asks sequence of return. Risk is real, but it is overhyped for the average investor, I love Dr files research and have his primary book. However, banging that S O, R, R drum without the proper returns risk, oh, sorry, bang, sorry, sorry, banging the sequence of return risk drum without proper context of the low practical risk for more for most investors, causes people to be overly conservative. I would love to see Dr FAU share what the sequence of return risk odds are for the typical 65 year old retiree and the typical portfolio, my guess is that the practical risk is no greater than 15 to 20% not zero for sure, but not 70% either. Also the sequence of return risk typically plummets for the typical investor, assuming they delay bridge to maximize Social Security when Social Security starts, this would support Dr files rising equity glide path option. So what do you think? Dr FAU,

Wade Pfau 08:22
yeah, yeah. I'm not 100% sure when what these numbers mean in terms of, like, is your is, and using it

Alex Murguia 08:30
as an example, like, even if it's more than it's his intuition. Like, I don't think it's more than 70% I don't think it's less than whatever.

Wade Pfau 08:39
And then I guess it's the risk of getting hit by a bad sequence of returns?

Alex Murguia 08:43
Yeah, that's high. Yeah, that's how I reading this. Yeah. I'll say it another way for that sentence. I would mean that to read for the typical 65 year old retiree and typical portfolio, my guess is that their practical risk, like falling into a bad sequence of return sequence is no greater than 15 to 20% not zero. You know, it's out there, but it's not like 70% like they make it out to be. When I'm reading this, I'm getting the sense that you're kind of creating your own kind of scenario and then assuming that's the universal truth of that. And there's a danger in that kind of thinking. But I'll let you, you know, in terms of the numbers being the question is a valid question. I mean, like, the 70% this or that, those are just made up numbers, but I think he's anchoring to that, and that's the danger. That's a danger in and of itself. But go ahead, wait for the actual meat and potatoes of the question. Yeah.

Wade Pfau 09:37
I mean, like, and also, it might be misrepresenting a little bit how people talk about sequence of returns risk, unless it's really just a pure sales marketing campaign for annuities or something. I don't think anyone makes it sound like there's a 70% chance you're going to get hit by a bad sequence of returns in retirement. It's in the historical data. Surge. It's really, you're hit by the worst case market returns in history. You know what?

Alex Murguia 10:04
You know what this could be referencing to that it makes in your study, you point out the r square, you know the importance of the first few years, has a it's in the 70, right? It's, yeah, it's gonna determine like 70 something percent of the variance. And maybe that's what's being confused with the actual probability that you're going to have a sequence of return risk, right?

Wade Pfau 10:27
Yeah, the market returns in the first 10 years of a 30 year retirement will explain about 70 to 80% of what the safe spending rate was for that.

Alex Murguia 10:36
That's not saying sequence of return risk is you're 70 to 80% at risk. That's completely right thing.

Wade Pfau 10:42
Yeah, by definition that getting hit with a negative sequence of returns, it's really kind of calibrated to either the worst case historical market scenario and getting worse than the worst case historical market scenario and or just if you're using Monte Carlo simulations, if you're targeting a 90% success rate, it's like the A 10% chance you end up with something worse than that. So I think it's already calibrated to be a relatively low risk again, except maybe aside from sometimes folks on the insurance side and their marketing will maybe make it sound like the risk of negative sequence of returns is higher than than that, but no, I think, yeah, it's it's a concern. The other issue here too is sequence of returns risk is somewhat an artifact of the logic of the 4% rule, which is, you always spend the same inflation adjusted amount, no matter what your portfolio is doing, you don't ever cut spending as your portfolio plummets towards zero. So we've talked a lot about there's four broad ways to manage sequence of returns risk, and if

you're using the 4% rule, logic is just you spend less, you got to get that spending low enough that you don't get yourself into a downward spiral if your portfolio declines in value. But the other options are use a variable spending strategy. You adjust your spending in response to portfolio performance, or you have some mechanism for monitoring volatility, whether that's annuities or time segmentation or the rise in equity glide path. There's more questions on that later in the episode. Or actually was in this question, yeah, something that trying to reduce volatility in the portfolio when you're the most vulnerable to a loss, triggering a downward spiral from your retirement, or using a buffer asset, something outside the portfolio that can provide a temporary spending resource so that you're not selling from the portfolio in a decline. So indeed, in practical terms, you can develop strategies to manage sequence of returns. Risk. It is a unique risk. Well, it exists pre retirement, but it gets amplified in retirement when you're spending from the portfolio. So it really is something pre retirees may not really have thought about how sequence of returns risk would impact their long term investment performance. It's something that really impacts you more when you're spending from the portfolio. It's one of the unique risks of retirement. It's something to be aware of, and it's something you'll want to have a strategy to help manage. But yeah, it's certainly not the case that there's a 70% chance you're going to going to get hit by a negative sequence of returns that leads you to have the worst case spending rate in the history. Yeah, they're more it's a background risk.

Alex Murguia 13:33
The other, the other piece here that I I want to make sure it's clear, because I want to make sure it's not a red herring, you know, in this sense, but however, banging on the sequence of return risk drum without proper context of the low practical risk for most investors causes people to be overly conservative. I want to just this opens up a kind of an interesting thought for me, which is, I don't agree that this is why people end up being more conservative? You know, maybe. But I think people, though, you know, people's withdrawals, are more conservative, not because of sequence of risk, because but rather longevity risk, especially if you're taking a total return approach, which based on the cadence of this question, I assume this, this investor is a total return person, and it's not to protect from sequence of risk, although there obviously could be variables there, it's really more as a result of the longevity part of it, yeah, people are conservative

Wade Pfau 14:34
longevity and market risk. But there's a fair point to that statement, which is because so much of the discussion of spending in retirement is linked to the 4% rule logic of you need constant inflation adjusted spending, and so then it just becomes a debate about, how low does that spent? Constant inflation adjusted spending have to be so that you don't run out of money that can make. Sequence of returns, risk seem more dangerous than it really is. And again, because there are other means to manage the sequence risk. And again, a variable spending strategy helps quite a bit. So if the conversation around this could default to variable spending strategies, sequence of returns, risk would not be as big of issue as it is in the world where the default strategy is constant inflation adjusted spending. So I think there's a fair point being made with that statement in that context. But we can't dismiss sequence of returns risk. It is a real thing. It's it can, on occasion, be overstated, but yeah, it's part of building a robust retirement income plan means having an approach to managing sequence risk, and there's a lot of levers you can use besides just being conservative with your spending. And so finding the right balance between your yeah

Alex Murguia 15:56
and people are hearing this a lot, I I think it's positive, because it's, it's, it's a relatively new term, and by new term, I mean in the last 10 years, it's like, and you said a joke at the beginning, but I don't think you're too far off. It's the folks that are pushing annuities. Only sequence risk is another arrow they can put in the they can pull from the quiver to say, aha. This is why you need to protect yourself at all costs, from distribution, from a portfolio only, and what you're saying, and what I think this is the what Thomas is feeling here is that, hey, it's not as bad as you guys are making this out to be. Yeah, all right. Next question from Peter, and this has to do with sequence risk and discretionary spending. Even if your daily needs are covered, you still have risk related to discretionary spending that for many people, is desired earlier in retirement. It's not going to be much comfort if you have to reduce your discretionary spending early on, and then by the time you can afford to spend, you no longer able to do things you wanted to spend the money on in the first place. So I'm trying to manage my sequence of return risk in such ways as to reduce the likelihood of needing to reduce my discretionary spending in the first 10 years of retirement. Maybe discretionary isn't discretionary, and it's quasi Central. Maybe you need a hybrid spending category.

Wade Pfau 17:26
Wait, no, I think this question makes a lot of sense, but yeah, it's immediately. This is why the 4% rule logic is not the way to go, because what that gets you into if you're never going to adjust your spending, other than for inflation, you have to spend less early on and then what that generally means, if you're not in a worst case scenario, if you're not impacted by sequence of returns risk, your portfolio just grows and grows, and then you could spend a lot more in your 80s and 90s. But no one wants to live frugally in their 60s, when they're healthy and have the ability to spend tons with World Travel and everything in their 80s and 90s, when they may not really be able to do it at that point anyway. So we got to move away from the 4% rule logic, and I think this is providing a framework to do that if you get your essentials covered through reliable income sources, you can be a lot more aggressive on the discretionary expenses. And we have a payroll calculator at the retirement researcher Academy where you can look at variable spending strategies, and some of them, you're going to spend more aggressively early on, and that's going to generally cause you to have to spend less later on, but that, if it's for discretionary that's okay, that may be what you're looking for. You want, like, 10 years of high discretionary spending, and you're willing to make big cuts to the discretionary spending after that, but it's not going to jeopardize your retirement, because you still have a floor of reliable income so that your your basics are covered no matter what's happening with your investment portfolio. So you you pick a variable spending strategy that's more aggressive early on, that will lead to less spending over time on average. But that's that's what you're looking to do here. You want to enjoy those go go years, anticipating you may have some slow go and no go years, and that you don't need constant inflation adjusted spending for all of your retirement expenses throughout the entire retirement horizon. So filling that, you know, the

Alex Murguia 19:27
floor and then piggyback on like spending styles, right where they don't. You know, people don't spend the same amount every year. They by default. You naturally do have a variable spending style,

Wade Pfau 19:39

yeah, first build a floor and then expose the upside and pick a variable spending strategy that gives you the kind of pattern you're looking for. And in this case, it sounds like you're looking for big expenditures early on with a willingness to make cuts later on, if necessary, because it's for the discretionary piece.

Alex Murguia 19:58
Okay? Next. Question

Wade Pfau 20:00
you want again, yeah, that's just, that's, that's a different strategy than the 4% rule. That's a variable spending strategy, and that's whether, and I'm tying it to income.

Alex Murguia 20:10
Wait, wait, sorry, every once in a while I think your mic, I think you're shifting away from the mic. It's, it was little tougher for to hear you.

Wade Pfau 20:16
Well, yeah, I was just saying, I mean, this is fundamentally a different strategy than the 4% rule. It's there's elements. I'm talking about it more as income protection, where you have a floor of reliable income, and then you just spend aggressively for the discretionary expenses. But even in a more of a purely investment based framework, you're picking a variable spending strategy that allows you to spend more early on, because you you have a willingness to spend less later on, and I think that's the questions getting at. You'd be happier with that, then with the opposite, which is where you don't spend early on, and then you could spend a lot later on when you're not really able to enjoy it. That's not a good outcome either,

Alex Murguia 21:01
but that's a good point. I think a lot of folks, frankly, don't maximize their enjoyment, utility, or whatever you want to say because of that sort of hesitation,

Briana Corbin 21:14
are you getting close to or are you in retirement? Well, investing during retirement is a little bit different than during your working years. Your investments are there to help you pay for retirement, and now is when they need to earn their keep to make sure you're on the right track. Download retirement researchers, eight tips to becoming a retirement income investor by heading over to retirement researcher.com/eight tips again. Get your copy of retirement researchers eight tips to becoming a retirement income investor by going to retirement researcher.com/eight tips. That's the number eight tips.

Wade Pfau 21:54
Okay, okay, I'll ask the next question here. I want to make sure I'm in the right. Okay, yep, hello. Thank you for your excellent podcast and books. Mine is probably more of a question for your podcast than a whole episode. The question is, have you analyzed the use of dividend income for discretionary expenses to help reduce volatility and sequence of returns risk? This assumes essential expenses are already covered by contractual sources. Dividend sources would be a portfolio of individual stocks, preferred stocks, REITs, ETFs, closed end funds with proven track records of paying consistent andor increasing dividends. Growth stocks would still be present in the portfolio as well understanding the dangers of chasing yield. So part of this analysis would

be to help provide guidance on limiting stretch for yield, like a healthy overall portfolio income target in the present interest rate environment would be in the three and a half to four and a half percent range. Thank you both for consistently detailed and thoughtful guidance from Gary.

Alex Murguia 23:00
Okay, Hey, Gary, thank you for the question. It comes up, you know, quite a bit. And what we would say is dividend sources would be a portfolio of individual stocks, preferred stocks, REITs, ETFs and closed end funds. I you know, with regards to preferred stocks right away, that it's kind of a hybrid between stocks and bonds, and you'll see research has shown it a diversified portfolio. If you have a 6040, portfolio, let's say kind of preferred may not be needed in that sense, simply because you get characteristics of both. And then there's just, you know, things get lost in the wash when you bring preferreds in the mix. That being the case, we're not, we don't we personally, people differ in this. But I think as a best practice, especially within our profession, in terms of the larger, independent wealth management firms, you really don't see. I haven't come across many advisors at all, frankly, at this level, that really look at a portfolio and look at a portfolio from a yield perspective, look at holdings from a yield perspective. The but it's, I think personally, it's a carryover from the 50s and 60s and 70s and 80s, even where that was the thing, right? Make sure you have good dividend stocks, blue chip stocks that pay healthy dividends, etc. I get your point about stretching. And we do see that when people start looking like that, then the sort of the yield creeps up and up and up, and that becomes almost like the number one factor when creating a portfolio. And that's just a Road to Perdition ultimately. And there's been all these books about like, dividends, this and that. But at the end of the day, if you're creating distributions, you can create your own distributions from the entirety of the portfolio by taking a systematic withdrawal. In many ways, it may be more tax efficient for you. Than to just be relying on dividends. So on many levels, it's it's more efficient to simply just take a withdrawal from a portfolio, because you're effectively creating your own dividend, and you're not reliant on some board, you know, in some company, all of a sudden, saying, This year, this is a dividend, and hopefully you can back into your lifestyle from that, right? The other piece, why we're not big fans of this is that it's it just overly concentrates your portfolio. There's certain industries that are dividend rich, and from that standpoint, there's going to be significant opportunity costs by not investing in a broader market, and frankly, a lot more concentration risk and doesn't have to be lost. It could be, you know, the concentration risk then leads to opportunity cost, simply because you are in the railroad transportation sector, right? And that did nothing relative to other industries. So I we just don't focus on interest rates. I mean on on dividend yields. With regards to what's a reasonable amount, we focus on what's a sustainable withdrawal from our portfolio, if we're taking a total return approach, it's a question that comes up reoccurring, and it's totally understandable, why? Because you see that a lot. I mean, frankly, I'm sure there's just dividend ETFs out there, and what they're trying to do is appease the folks that are just sticking with this dividend mindset. But all I can say, from a best practice standpoint, it ends up being an inefficient way to draw funds from a portfolio. You're better off from a globally diversified portfolio. That's that's actually a better investment option than focusing on dividends. And then from the standpoint of sustainable withdrawals from a portfolio, I think you can match that for your lifestyle, as opposed to backing into something based on what dividends are being paid. At the moment, Wade anything to add to that?

Wade Pfau 26:48
No, I think that's a reasonable answer. And especially I think your answer would apply if they're really stretching for yields. So if they're saying, Oh, let me put together a portfolio yielding six or

7% that could be a case where your answer really strongly applies. This one does seem more nuanced in terms well,

Alex Murguia 27:06
because Gary seems like the question seemed very well thought out. He's not just saying, hey, let's gun it for dividends, but you do see, over time, people creep it creeps higher and higher and higher. So there's a danger in that. But you know, let's give Gary the benefit of the doubt.

Wade Pfau 27:22
And also, just to be clear, if, if you have a total market portfolio, what would it be kicking off in dividends and income these days? Oh, yeah, exactly percent, two to three. If you can on that range, if you can live on that, yeah, you have, effectively, you can have a total returns portfolio. Just don't have to sell shares to meet expenditures. That would mean you are overfunded for retirement. It's kind of the scenario where you're living off the cash flows from the portfolio, and if you'd like, you could spend more, getting back to the previous question, but if you're comfortable with that, and you kind of frame it as I can live off the income being kicked off the portfolio, and I'm not having a stretch for yield to do that, it means you're overfunded, but you're happy, and you're going to potentially leave a large legacy at the end. And maybe that's part of the goals as well. This question, did they did have a floor of contractual income already in place, so that gives them more capacity to take on risk. But you know, your point applies. Just going for yield is not necessarily the most efficient way to go for that risk. You can spend some principal as well. But again, if you're comfortable living off, you've got basically a total market portfolio with a little bit of tilting for yield. And you're comfortable living off that behaviorally, I don't see a problem. It's really when you start stretching more dramatically for yield that you might be creating much worse outcomes for yourself.

Alex Murguia 28:47
Behaviorally, I don't see a problem, as long as you know you're not taking portfolio concentration risk with that right

Wade Pfau 28:54
which you would be doing. The more you stretch for yield, the more kind of becomes a risk if you're ultimately,

Alex Murguia 29:00
it's like swimming in the current. You know, eventually you may get caught up in it. It's very hard not to but, you know, assume Gary lives on the planet Vulcan, and he's a very rational being, right?

Wade Pfau 29:16
Not just the sweet, sweet yield. Must have more.

Alex Murguia 29:21
I the next one, it deals with the theme of rising glide path from Kaushik, I found the reverse equity glide path. Mentioned that wait a method, sorry, I found the reverse equity glide path method that Wade mentioned during a previous meeting. Really appealing is that something you see used in practice frequently, what are the factors to consider

Wade Pfau 29:47
and that maybe had come up with? Bill Bingen actually talked about the rising equity glide path in his new book, so it's one of the few parts of the book that's really got something i.

Alex Murguia 30:00
You said rising equity glide path. He wrote here, reverse equity glide path.

Wade Pfau 30:06
I think he also means rising with, okay. I didn't know

Alex Murguia 30:10
mortgage thing or something that I memo on, so I was, I was like, Okay, I think rising equity glide path,

Wade Pfau 30:19
yeah, I think otherwise. I have no idea what to say. I don't know reverse equity glide path has to be a rising equity glide path, because the it's a reverse of the declining equity glide path that we traditionally think of with age and bonds and that sort of thing. So the rising equity glide path helps to manage sequence risk because it has you with a lower stock allocation at retirement. But then, as you go through retirement, and as you have the ability to manage a negative sequence of returns, and you get later into retirement, where the market impact will be less, then you can increase your stock allocation again. Michael kitsies and I wrote about that, like start retire instead of being 6040 stocks and bonds throughout retirement, maybe you start from 30% stocks at retirement, but work your way back up to 60% stocks and say the first 10 or so years of retirement manages sequence risk doesn't hurt distribution rates or anything. So then the question gets into is this something you see used in practice, frequently, the pure total return version of it, where I specifically use an increasing stock allocation on my investments. I don't necessarily see frequently, although it does resonate. And so we hear messages like from Kaushik on numerous occasions, where this resonates with people, and they use it, I think, in practical terms, where we see it used more is indirectly, from the total household perspective, where if I build a like a bond ladder at the start of retirement, and I don't replenish it, and I keep the same stock allocation outside of that, I've just created A rising equity glide path for myself that way, or if I hold a steady stock allocation, but I also have social security benefits. I have an annuity. The present value of the Social Security and annuities will decline over time to the extent that it's like a bond. That's another way you get the rising equity glide path in practice. So I think indirectly, a lot of people end up with a rising equity glide path in retirement, but where they're directly using an increasing stock allocation on their investment account itself. I don't think that's as commonly seen.

Alex Murguia 32:37
I mean, what we see here is, I was going to make your your points, right? You know, really a rising equity glide path. And I'm we've mentioned it before to me, it's like a bomb a time segmentation strategy that you just don't like, re up right after one cycle. Now you do see, you see this, whether it's technically a rising equity glide path, you know, in the construct of distributions, probably not. But many times there's a client, or somebody that you know recently comes over, or somebody has a windfall and they want to put it into the market and but, you know, they want to, but they don't. And even, you know, regardless of what you say about, you know, going all in in one shot, or dollar cost averaging, or whatever, there's always a hesitation,

because it's just human nature. All of a sudden you have a windfall. It's a significant amount of your asset base. And everyone reads the books stocks for, you know, stocks go up or the long term, yada yada yada. But there's always that, yeah, but things are a little shaky right now. And so just, you know, as opposed to having in cash, there's an agreement of, listen, we'll start this off at, you know, your portfolio right now is making it up 5050 and what we're going to do is take this money and dollar cost average, it into the market. But we're not going to, you know, put it in at 5050 we're going to put it in at 7030 so when we're done with this, it ends up being 6040, I mean, we kind of use that in a way to get folks just into the markets, to get going, but in a manner that they're not losing sleep. And I see it like that as well, as opposed to just a pure distribution plan.

Wade Pfau 34:17
Yeah, he also asked about, like, what factors to consider, and that's the pure version of it, where you're changing your stock allocation. I think that's more of a total returns. If that's your style and it resonates with you, then I think you could reasonably consider using it. It doesn't resonate with everyone, because it's once you get used to less volatility in early retirement, it can be difficult to have more volatility at advanced stages, so that's where it's certainly not going to work for everyone, but if you kind of understand the logic, you understand how it manages sequence of returns risk and it resonates with you, then it's something you can definitely consider doing as part of your planning.

Alex Murguia 34:58
Yeah. All right, then we have here another question about the 4% rule. Is a 4% rule still a constant? I have seen it taken as low as 3% due to increasing life expectancies. Or does it vary depending on market conditions, etc? Yeah.

Wade Pfau 35:19
So a couple different directions there that like Bill bengen, the father of the 4% rule, defines it as based on us historical data. So in that regard, it would be a constant. It's just what was the worst case in history. Now he's it has all kinds of assumptions, asset allocation, time horizon, investment fees, taxes, other things too. If you change those assumptions, you can change the number, and that's why he talks like the pure based on the asset allocations he's using today, the pure safe Max. He talks about as 4.7% instead of 4% and then also, if you bring in inflation of the mix, he says, in a moderate inflation environment, five and a half percent is probably more realistic than 4% so it but it's still calibrated to market data. It's just what market data, what asset allocations Do you want to use now, where you start seeing numbers like 3% would be doing Monte Carlo simulations that link to current market conditions, and that's somewhat an artifact of, you know, back around the pandemic, the entire tips yield curve was negative. You could not support anything close to a 4% distribution rate with a 30 year tips ladder. And that's the idea. You take the interest rates at the time, you add a risk premium for the stock market, you run simulations, 4% was not safe for quite a while. Today, that's really fallen by the wayside. If you build a 30 year tips ladder today, it could support about a 4.6% distribution rate with an average real interest rate yield coming out at around 2.2 or 2.3% plus inflation. So running that kind of analysis today, you're not going to see those 3% numbers unless you started to really get aggressive about assuming mainly a large investment fee taken off of the returns, plus probably much more than 30 years, 40 years, like 40 years plus investment fees might still get you under 4% but I think the days of seeing 3% numbers are by the wayside due

to the fact that interest rates are much higher today than they were when that Research was coming up.

Alex Murguia 37:40
Alrighty. And then for the final one for today, has to do with Risa styles. And the question is, why is the retirement planning community so hung up about the traditional drawdown paradigm in mapping out a successful retirement plan and not focusing in on the paradigm of guaranteed variable income model, in which a lot of uncertainty and volatility of the drawdown paradigm is reduced or erased. I am seeing a trend in Gen Xers towards this type of planning. I am not a professional planner or influencer. The guaranteed paradigm could gain a lot of traction by educating pre retirees early in their quest, maybe as early as high school. Wait. Why don't you fire off?

Wade Pfau 38:24
Well, this is like the the fundamental question of retirement income. This is what makes retirement income different from pre retirement. Wealth accumulation. In retirement you have an asset liability matching problem you need to fund expenses over an unknown time horizon in pre retirement, the focus is generally more on just growing assets using modern portfolio theory to decide an efficient asset allocation, to give you the highest risk adjusted returns, to grow assets the specific number of years, and the time horizon plays less of a role, and There is no liability that you're funding. And so the basic answer to this question is, yeah, it's really saying that the default is total returns for retirement. But that's because I think just it's what people are used to in the pre retirement period. It's taking that pre retirement investment management approach and trying best as possible to fit that into post retirement, because there hasn't necessarily been a lot of thought about how risk changes post retirement, whereas, going back with research, the efficient approach for building a retirement income plan is you really think about having More reliable income sources to meet essential expenses, and then you just draw a variable spending amount from the investments to meet discretionary expenses. And so that's that's the income protection approach. The question is really getting at and maybe pointing out the younger generation, or even generation Xers. I don't know they're getting close to retirement at this point, but they may more naturally be inclined towards income protection approaches than older generations. I don't know if I

Alex Murguia 40:10
don't see that we haven't seen that way. I mean, when we do our cohort analysis, it seems I'll say this, there's a significant number of people, you know this, two thirds of the people want contractual income and or tilt towards that sort of non total return approach. And non total return approach are either time segmentation folks, income protection folks, or risk rep folks, all which contractual income plays a significant role. So two thirds of the folks already kind of are searching for that. So at the individual level, I think there's this desire for that kind of solution. Unfortunately, what happens is, based on what you said at the beginning, folks have been investing for accumulation for the majority of their lives, and many of them have have been facilitated through investment professionals that are effectively creating, you know, model portfolios in which have a certain growth expectations to meet a number when they retire. And unfortunately, what I think a preponderance of, what those folks do at the detriment of consumers, is they assume folks just want to continue with this type of investment approach and just flip on a withdrawal strategy on that, right? And part of that is because I don't think it's nefarious. I think it's more they're just not up to speed with the science of retirement income

planning, as opposed to just creating a diversified portfolio for growth, right? And so I think that's, that's why, you know, the retirement planning community is so hung up on it. I don't think they're hung up on it. I just think they don't know any better, you know. And I say this in a half kiddingly, half serious kind of way, right way, you know what I'm getting at here,

Wade Pfau 41:53
yeah, yeah. They just, they haven't thought about what makes retirement income different. And that's, yeah, retirement income planning is still a unique new field in financial services.

Alex Murguia 42:04
Yeah, whereas. But interestingly enough, look, look who's bringing this question up, somebody who's not a financial professional planner nor an influencer, no, and but he's intuitively picking up on, hey, why isn't this done more when it's such a thing that's out there? So that's a good pickup. Nugget. Nugget, new. Yeah, wait, I have one more question for you, if you don't mind. Oh, you're going off the ground. Yeah. Are you a professional planner? Do you consider yourself a professional planner first, or an influencer first?

Wade Pfau 42:39
I don't know that either one. I would consider myself more of an educator, but I would never use the term influencer for myself ever. So I guess in that regard, you have to be a professional planner.

Alex Murguia 42:55
You're too humble. You're too humble.

Wade Pfau 42:58
Now, if influencer is the term, oh, finfluencer, but I don't even have a Tiktok account.

Alex Murguia 43:03
So yeah, exactly, if you had a Tiktok account, you'd be a fine fluencer. But there we go. Bad joke. That's it. That's it for today. Everyone right? And we'll catch you in another q&a session coming up next week?

Wade Pfau 43:22
Yep, I'll catch you next week on retire with style.

Briana Corbin 43:29
Wade and Alex are both principals of McLean Asset Management and retirement researcher. Both are SEC registered investment advisors located in Tysons, Virginia. The opinions expressed in this program are for general informational and educational purposes only, and are not intended to provide specific advice or recommendations for any individual or on any specific securities to determine which investments may be appropriate for you. Consult your financial advisor. All investing comes with the risk, including Risk of Loss past performance does not guarantee future results you you