Episode 213: Retirement Without Guesswork: The 4 L's and Funded Ratio Strategy

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Retirement income plan, financial personality, four L's, longevity, lifestyle, legacy, liquidity, essential expenses, discretionary expenses, funded ratio, asset liabilities, safe withdrawal rate, Monte Carlo simulation, retirement income challenges, investment strategy.

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 retire with style.com/style, and sign up to take the industry's first financial personality tool for retirement planning.

Alex Murguia 00:41
Hey, everyone, Alex here, and I'm here with Wade Pfau, and we're gonna run a series of episodes on the podcast, retire with style, featuring Wade's book. We're gonna dig down and see what makes it tick and how it could benefit you. We hope you enjoy this episode and the one's to follow,

Wade Pfau 01:01
and that book title is retirement planning guidebook. Oh, yeah,

Alex Murguia 01:09
that being the case. Wade once you're in retirement, you have a concept called the 4l of retirement. Do you want to speak about that a little bit?

Wade Pfau 01:18
Yeah, so the four L's, they're the financial goals of retirement, and that's we're starting to think about. Do we have enough to retire? Well, we want to be able to fund our financial goals. And those are the four L's, or longevity, which are your essential expenses that you want to be able to cover no matter how long you live. That's how they get the longevity name you've got lifestyle. These are more discretionary types of expenses that you'd really like to be able to fund, because you can then have the best overall lifestyle in retirement. But they're not absolutely necessary. There's is an element of being discretionary. You've got your legacy goals. This is what you'd like to leave for the next generation. And then you've got liquidity. This

relates to the the spending shocks or contingencies, the things that may or may not happen that you want to be able to cover if they do happen. And so having liquidity, having reserve assets available to manage the unexpected in retirement. And so the 4l again, longevity, lifestyle, legacy and liquidity. Those are the financial goals. They really they translate into your expenses, the liabilities you're trying to fund in retirement. And then retirement becomes about, well, do I have sufficient assets to meet my 4l financial goals? And if I do, great, then that's how you know you're on track to retire.

Alex Murguia 02:40
There's, there's a couple of things, the way it's framed in the book, that I really have come to appreciate as our work with with client, and that one of the typical things discussed in a discovered meeting, which should be is asking clients what their goals are, what they want to accomplish. And then you kind of they, they state what it is, and then you follow up with why. And then they answer that one. Then follow up again with why they state that. And you follow up against again with why. You try to drill as deep as you can with regards to what it is they want to accomplish. Right? The beauty of the four L's, in my opinion, is that whatever goal you have, you know, everyone has, well, they're like snowflakes. There's so many of them, right? But whatever goal we have, you could break it down into primary colors. And to me, I feel the 4l does just does that in a nice way. It's effectively, to me, longevity is what the things you don't want to go bad, yeah, and things you don't want to go south on, you know, longevity liquidity as well. Whereas lifestyle and legacies are more preferential things than discretion. Can you talk about how you address essential and discretionary expenses within retirement? Simply because some folks will say, hey, everything is essential. There's an argument to be made as Yeah, I still want to go vacation twice a year no matter what, and so that better happen. Even though it's discretionary, I consider it essential. To me, it's it's more hierarchy of means essential, or, you know what you need to live, etc. What, based on your experience from the first edition to the current edition, has your thinking changed on the 4l between discretionary and essential, and how they make up effectively, the primary colors, if you will, your retirement income goal.

Wade Pfau 04:28
Yeah, those, those four L's, your retirement concerns could be addressed to like, well, how concerned are you about meeting each of those goals? And you're right, the longevity and lifestyle. Longevity is about essential expenses, lifestyles. About discretionary expenses, some folks can't make the distinction. It becomes really everything, everything is lifestyle, everything is longevity. We can see that really it's more characteristic of the total return. Approach is you don't have that kind of concept of. Of distinguishing between essential and discretionary goals. You want to achieve everything, and so ultimately, you might take more of an investment oriented approach to try to maximize that lifestyle and retirement. Think it really is a characteristic of more income protection type approaches where you do make that distinction between essential and discretionary, because you really want to have reliable income, assets that don't rely on market growth, that provide some sort of protection to make sure that you've got your essentials covered, no matter how long you live. And then that gives you capacity to take risk. On top of that, you can take the risk for the discretionary goals. You can invest for upside in growth to have a even better overall lifestyle. But you have the confidence to do that, because you know how you have your essentials covered, and if you're more total return, maybe you're not as worried about that issue not having your essentials covered, because, again, you really view everything as being essential. But then also, there's an element of you really are comfortable with the idea that markets will perform as needed so that your overall

expenses can be covered. There's no real need to distinguish between essential and discernary goals, because you're not going to invest differently for the goals. You're going to have a pot of assets you draw from to meet those goals as they come up. So yeah, that I think you can make that sort of distinction. That is, when we talk about longevity and lifestyle, we're assuming people and distinguish between the two. But yeah, certainly that's not always the case.

Alex Murguia 06:33
Yeah, you know, we've mentioned it a couple times that you know, everyone, everyone wants essential expenses covered. It's just your total return it, and I'm going to generalize here, usually your asset base is such that it can cover a lot of things. Hence, you're not necessarily concerned about essential expenses. You're not concerned about covering those costs because you have more than enough in the same way that we've mentioned in examples. We're not concerned right now about breathing, right? Well, we need air, but we recognize we need air, but we're not concerned about it. We're more concerned about, hey, what are we going to do after this podcast episode? Are we going to eat Korean wings or not? You know, that kind of wait to say

Wade Pfau 07:18
Right, right. Like we need air to survive, but so it's essential, but we're not necessarily focused on making sure we have sufficient air at all times. Although we can create scenarios where we don't have the air, but for the most part, it's available as needed without too much effort, thinking that you can

Alex Murguia 07:37
exactly and so I think, I think that's a good distinction. You kind of, you're kind of, are addressing goals within the 4l and but the 4l are framed as, what are you concerned about, as opposed to what are you aspiring to. So some are saying, I think framing it in that manner is helpful, because you're, you're, you're, like, eliminating potential risks right off the bat, and what's left over is peace of mind, he asked me, and I think that's ultimately what you get at from this buff moving on from that, how does someone know that they're on track for retirement, from a financial perspective?

Wade Pfau 08:15
Great question. That's chapter three. And well, what we've been talking about for a while is also part of chapter three, but the heart of chapter three is quantifying your financial preparedness for environment. And I describe the concept of the funded ratio to do that, where I've already talked about the four L's, those are your financial goals. Well, those are your liabilities that you're trying to come and if you think about assets and liabilities, you think of your retirement plan as a balance sheet, yet the present value, like the value in today's dollars, of what you need to be able to fund your retirement goals, well, that's the cost of your retirement. So how do you know if you're on track to have a successful weekend with a financial perspective? Was to figure out what that cost of retirement is, and then get out of your assets, whether it's investment accounts, whether it's future earnings from employment, and if you include future earnings from employment as an asset, well, you have to actually work and to achieve that, but maybe you'll find you have enough assets without any further work then you you have financially, you have the capacity to retire and and so I described the funded ratio, and we close a tool on that. We be the repair and income challenges we'll be having another one coming up relatively soon as we've made some big updates to our financial signees funded ratio software. So watch for those

retirement income challenges coming. But I really described the approach for that in chapter three, looking at from the perspective of assuming we're not going to get a super high investment recurring. We're thinking more in terms of a bond, like return on our assets, and then this counting up. Calibrating and calculating. Do the the cash flows we have to fund our retirement? It could work Social Security, pensions, annuities, investment account balances, everything available to fund retirement expenses. Is that sufficient to fund those retirement pools that we'd have in mind? And if it is, that means they're funded for retirement. Your funded ratio is 100 is 100% or higher. You have more assets and liabilities, and that's how you know that you're on track. And again, if you include future work as part of your assets, well, you may be on track to retire as long as you complete that future work, but you can really assess your situation with and what that future worked in and really understand better your financial preparedness for refinement.

Alex Murguia 10:45
So the beauty of the funded ratio, if I'm understanding you correctly, what you're doing is you're taking the present value of your assets and all future earnings. So let's say the present value of all of that in today's dollars is $500 just to say something. And then you're taking the present value of all future liabilities, which is potential healthcare expenses in the future and the light, and discounting them to the present. And let's say that's $500 right? If that's the case, then $500 of assets divided by $500 on liabilities puts you at a funded ratio of one, five over five to one. And so effectively, what you're saying is, right now, you technically there's no margin for error, but that being the case, you technically have enough assets to cover your liabilities. We would think that's constrained, because you want to give yourself a cushion, but that's the thinking. If it was the other way around, you have $1,000 of present value assets versus $500 in present value liabilities, then your funded ratio is two. You have significant cushion, and you've kind of technically at that point, to use a phrase that we've heard before, is won the game, and once you win the game, what options do you have?

Wade Pfau 12:09
Yeah, if you're overfunded for retirement, you can potentially spend more. You can raise your goals to be able to spend more. You can stop working if you're dramatically overfunded, and part of that was future employment and may not be needed. So you have some flexibility there. And then also when it comes to the investing side, you can think about just being funded for retirement is not a guarantee that you won't be underfunded at some future point. If you're investing in the markets and markets go down, that will hurt your funded ratio. So you can think about, well, do I want to lock in use more reliable income sources to make sure that I can maintain 100% fundedness for my expenses and retirement? And if I do that, then the rest of the wealth is really discretionary surplus wealth that I can just for growth, and invested for growth and upside, it's not needed to fund those goals and ultimately translate into a bigger legacy in the long term, or or maybe at some point, I decided to spend more as well. You can do that, or you can keep everything exposed to the market. That's really more what the total return individual might prefer. So you do take that risk, that you could switch from being overfunded to underfunded if markets are down. But you're willing to take that risk, because with that additional exposure of it row, you can improve the funded ratio all the more you need by our main button, and spend more, again, higher when you're overfunded. You can recalibrate your goals to spend more that will then reduce your fundedness, because you're introducing new liabilities, but you have the flexibility to make those adjustments, because you have sufficient funding for your retirement.

Alex Murguia 13:53
Two points here Wade with regards to this funded ratio that you discuss in your book, and we do have a software program that we we've done so this is, you know, folks can do it themselves, specifically in the retirement income challenge that Wade had mentioned. But what would be a good ratio? We said, you know, 500 over 100 is one. That's, you know, that's, you're technically okay, but you're at raise within margins relative to 1000 divided by 500 that's two. You're in great shape. You have a lot of optionality. What would be a good number that you know, that you've discussed in your book that gives you a sense of things are really on track.

Briana Corbin 14:33
That's right, folks, it's here. The third edition of Wade files retirement planning guidebook has officially dropped to dive into what's new. Wade is hosting a live webinar called tax planning for retirement in 2026 and that's happening on Wednesday, January 28 at 1pm Eastern. He'll walk you through the key strategies from the book, unpack what's changing in 2026 and show you how to get ahead of the curve. Before the tax code does it for you. Don't miss your chance to get smarter about your retirement plan and maybe even lower your future tax bill in the process. Register now at retire with style.com/podcast that's retire with style.com/podcast or check the links in the show notes below. We'll see you there.

Wade Pfau 15:22
It's somewhat arbitrary, but usually to say, like, if you have funded ratios 110% or 115% that da 1.1 or 1.15 then you can start feeling more comfortable the funded ratio, kind of it's a flip from traditional financial planning software that it goes to Monte Carlo simulation to report a success rate with Monte Carlo Carlos software, if I want, say a 90% success rate, there will be a fixed rate of return assumption that corresponds to really what I'm assuming. They get that. But the software doesn't tell you what that is. The funded ratio does come from the other perspective, where I don't know what the probability of success is. That I know, like, if I'm funded with assuming a bomb, I could turn on my assets, that probably corresponds to something like a 90% success rate. I just don't know exactly what that is. But by explaining this, because as you become more overfunded, you're eventually working to a higher and higher probability of success for the plan, even though we're not telling you specifically what that success rate is, but by the time you're getting to 110 or 116% that's gonna be corresponding to a pretty high success rate from traditional Monte Carlo based planning software.

Alex Murguia 16:40
The the other piece I liked about the funded ratio that you discussed in the book, and this is more, think of this as more of a balance sheet approach to financial planning, because it's assets and liabilities. Right? Assets over liabilities? Well, a couple things actually now that you said that is, we're taking that, that sort of actuarial basis to sort of to develop a financial plan, but we're removing this need of trying to guess what the markets are in the future and then applying the standard deviation to that, etc, etc. But what I like is that the number that comes out say, let's say your funded ratio is 90% or your funded ratio is 110% you're getting a concrete number on the degree of fundedness in your plan, which is different from a Monte Carlo score. When they say something is at 90% probability. I think even whatever that probability is, I think that still lends itself to a more conservative spending strategy, because you're mentally trying to always leave yourself a cushion for the just in case. So you mind how you address those two things in the book. First, the that sort of what that number is actually telling me. Like a 90% funded ratio

tells you how much you have to get to, how much you have to get to being funded, but then a 90% success rate is telling you something very different.

Wade Pfau 17:55
Yeah, 90% funded ratio score is not the same as a 90% success rate. It means the present value of your assets add up to 90% of the present value of your liabilities, and so you are underfunded. Now you have options. You could either work more, work longer, spend less, or assume a higher rate of return on your investments and hope for the best. That can all be ways to get you back on track, but you really have that concrete element of how much assets do I have relative to my liabilities? Yeah, with the bond of carload, if you have a 90% success rate, well that's pretty good. That means in 90% of the simulations, you can meet all your spending goals and not deplete the underlying investment base in retirement. It means, in 10% of the simulations, your investments would deplete before the end of retirement. Now you may have other income from outside of the investments that cut are part of the goals, but the financial planning software might not really go too deep into that particular side aspect of things, but usually, if you just make some minor adjustments along the way, you can get that Monte Carlo saying back on track in some way. But yeah, if you're really just trying to target a very high success rate, you're ultimately going to be assuming a much lower rate of return than we are assuming in the funded ratio. People will say the funded ratio, we're too conservative, because we assume, specifically, we assume you'll earn a tips like yield that treasury inflation protected securities, they give you a real yield less inflation on top of that, and they'll say, No, the stock market will outperform that. So you can assume a higher rate of return. But this is where, with the Monte Carlo software, you're carrying a 90% success rate, you might accidentally be assuming a lower return than tips. You just don't know, because the software doesn't tell you that, yeah,

Alex Murguia 19:48
because the only way you're going to get high, high scores are you have to overcome effectively, nuclear scenarios. And to do that, it's going to you the return. Earnest options have to be extremely low to be able to say, yes, you can survive such and such. So I do agree that funded ratio is the way to go to get the full litmus test of your retirement income plan.

Wade Pfau 20:10
Yeah, and we're excited to get our new funded ratio tool out there and to have a retirement income challenge at the time of recording. We haven't quite set the date yet, because we are just making sure there's no bugs, that everything's working right as it should. But, yeah, we're excited. One of the features that the new attended ratio will have is it lets you do scenario analysis, including it let you adjust the discount rate. So if you're more total returns oriented and you really want to assume a higher rate of return, then then tips. Yeah, go for it. You can adjust your discount rate and say you, for most folks, that will improve your funding. I explain really a great background for building a recurring income challenge is to read Chapter Three of the retirement funding guys. But I talked in depth about the idea that usually, if you assume a higher rate on a higher fiscal rate is a specific thing for this industrial return in the program, usually that will improve your funded status. There to be rare exceptions where it doesn't, such as if you have a big inheritance summing your 90s, you might accidentally find that a higher discount rate lower your funded status. But for most people, their expenses are more back loaded in environment. The a lot of their asset base is account values, their investment account balances.

And then whenever that happens, higher discount pay, higher Vega return will improve the funded status of the plan.

Alex Murguia 21:35
So two words for you, but in the use the application show notes,

Wade Pfau 21:41
yeah, by the time this episode's actually at least, hopefully you all have a specific date for you on Eric, I mean change and just final steps of making sure everything works perfectly of the software.

Alex Murguia 21:54
Now wait, we're getting into sort of expectations with regards to returns and the like. That's not a little expectation from the standpoint of how much you can take out as a sustainable withdrawal rate from a portfolio. What? What would you consider to be the safe withdrawal rate for recovery?

Wade Pfau 22:12
Yeah, so this is a very popular question in the retirement community. It's also an area where a lot of the research I did to, like, get established in the repair and income planning space. Was about this, Hey, withdrawal rate. But I know now, and this is chapter four of the book, and I note at the beginning, in some ways, since chapter is not even necessary, you can read it if you want. And I know necessary, the book's necessary, and there's optionality on the chapter, but I know, like in the book, we're assuming, with the funded ratio a tips like return. We're assuming a real interest rate of q and a quarter percent, which, if you translate into the whole safe withdrawal rate discussion, it means our safe withdrawal rate with the funded ratio is 4.5% so that's like the 4% rule idea, but 4.5% it's just we don't even have to say that in the plunder ratio, because we're looking at your goals and we're looking at your assets, and you'll take the distributions as needed from investments to fill any gaps in the cash flows to fund those goals, and the same click to All rate questions, not necessarily all that important. Now that being said, the funding ratio does assume you know what your goals are. And I think in some cases, people really don't know what they want to spend in retirement. Their question becomes, what can I spend in retirement? And I suppose if that's how you approach it, that's where Chapter Four becomes important, because Chapter Four what is the safe spending rate from investments that whole conversation starts with the concept of the 4% rule, developed by Bill Bingen, and the chapter is really about working through all the assumptions that went into that 4% rule, talking about why the spending rate may be higher than 4% in cases, why it might be lower than 4% gave you one already. It's just with our assumptions in the funded ratio. If you're trying to fund over a 30 year retirement, which was the baseline length assumed with the 4% rule, you could use a four and a half percent withdrawal rate with our the equivalent in our funded ratio. But there's a lot of other assumptions to unpack, and so I can't really say what the specific safe withdrawal rate is, other than just saying based on the assumptions we're using, and we feel comfortable using as part of the funded ratio analysis, the safe withdrawal rate would be 4.5% but the value you use can vary, and so Chapter Four is all about explaining what you really need to understand about the underlying assumptions to decide on a sustainable spending strategy from your investments that's right

Alex Murguia 24:54

for you. Matt, what advice would you give to somebody that's reading the chapter and hold. On to a number like, what is the number that I need? I mean, morning, you know, Morningstar likes to publish a yearly number of, this is what the state withdrawal rate is this year. This is what the state withdrawal rate is next year.

Wade Pfau 25:11
They just come out, and just they came out with theirs. We studied us recently. I think they're at 3.9%

Alex Murguia 25:17
instead of, kind of, yeah, I find this sort of this. I appreciate the research that they're doing and the like, but I don't from a practitioner standpoint, I really don't care too much what numbers these folks come up with. I think to some extent, there's a ballpark, and you can go with it. But how do you feel about this sort of level of precision, and how do you address that in the book, from the point of view of the person from year to year, thinking, oh my goodness, I need to figure out what the safe withdrawal rate is this year. I need to figure out what the safe withdrawal rate is next year, that kind of thing, as opposed to maybe implementing certain, you know, withdrawal strategies after the initial year is started, has started,

Wade Pfau 26:00
right, right? So the one of the assumptions of the 4% rule is the withdrawal rate only applies to the first year of retirement, so you really just need to calibrate it to your first year of retirement. And then with the if you're really following the true assumptions of the 4% rule, you spend the same inflation, well, the same amount each year, but adjusted for inflation, and you don't worry about the withdrawal rate anymore. If your portfolio is growing, your withdrawal rate goes down as a percentage of what's left. If your portfolio is shrinking, your withdrawal rate goes up as a percentage of what's left. But you're not really even paying attention to that anymore. It's just 4% is the withdrawal rate in the first year of retirement. I call that when I get the longest part of Chapter Four is on variable spending strategies. And when I talk about other spending approaches, I refuse I refer to the 4% rule as the constant inflation adjusted amount strategy. It's one of, I think maybe seven or eight different options I look at in the chapter but, but certainly in real life, I don't think anyone truly adheres to that logic of the 4% rule, where they would play a game of chicken. If their portfolio is headed towards zero, they're just Oh no, it's okay. I don't have to cut my spending. I'm gonna die before I run out of money. 1976 is gonna happen. I can feel it in my phone. Things are gonna Yeah, things are gonna turn around. But in real life, people are going to make adjustments, and that helps quite a bit, though, because the assumption of the 4% rule that you never adjust your spending based on market performance, that creates the most sequence of returns risk, and that translates into lowering the withdrawal rate. If you're able to adjust your spending and have some flexibility in that regard, you can start with a notably higher withdrawal rate, and we see that when I compare the different spending approaches all with the same underlying market assumptions, you can see different variable spending strategies having significant positive contributions, not only well to the initial spending rate, but that's not the only factor to look at, but then also how spending evolves over time as well.

Alex Murguia 28:05
Okay, and with regards to the spending, do you feel on a year to year basis in your book? What? Well, let me ask it on the way, how often do you suggest, or don't even address it, that

someone should constantly revisit this based on what you've just said doesn't seem likely, but I want to make it clear to everyone that once the initial year happens, it becomes a nominal sort of sustainable withdrawal rate, as opposed to someone that takes a percentage every year from the like six to 4% every year, 4% every year. Do you discuss that within your book, the different types of strategies. I think you alluded to that you did.

Wade Pfau 28:43
Yeah, so the exact opposite of the 4% rule is the fixed percentage strategy. And if you took 4% of what's left every year, you use the same withdrawal rate every year, but your spending amount fluctuates, rather than constant amount, where you take the same amount every year, but your withdrawal rate fluctuates the fixed percentage, you keep the same fixed percentage every year, and that's the other extreme. There's no sequence risk with respect to your final account balance. There is with your spending path, but not with respect to your final account balance. And with the assumptions in the book I talk about, like calibrating the same downside risk, you definitely you can get up to a 9% withdrawal rate just because of that ability to manage sequence risk, but that's not a realistic strategy either, because the spending is so volatile, and that's where all the other variable spending strategies that I described in the book are looking at some sort of balance, where they make adjustments in response to portfolio performance, but they don't make too large of adjustments. And well, actually, I'm not that are far off base with the the new Morningstar study like that, the 4% rule, so to speak, but the assumptions I described came out at about 3.9% and that's because of the additional volatility of the portfolio. But then most of the other very. Spending strategies I'm looking at can get you up to that four and a half to five and a half percent range as an initial distribution rate. And that's again, because they build in some flexibility to make adjustments as you go along.

Alex Murguia 30:12
Would you say that ultimately, none of these things should be done without the context of the financial plan, such as the funded ratio. Because if you do that on a yearly basis, you just give yourself a review of a financial plan on a yearly basis. To me, it makes the distribution of what the sustainable withdrawal rate is and things like that a little bit a little mood. Would you agree?

Wade Pfau 30:35
Yeah, yeah. If you update your funded ratio every year, and if you're funded, yeah, well, if you're you use their funded status to decide, do I want to if I'm more overfunded, maybe I'll start spending a little more. If I'm becoming less funded, maybe I want to spend a little bit less. That would be a more natural way to implement a variable spending strategy.

Alex Murguia 30:54
That's how it's done in practice, I don't know of any advisor that just robotically inputs some sort of percent. It doesn't look at the financial plan in any way, shape or form. Ultimately, by doing that, it helps you, frankly, enjoy your retirement more, because if you do it the other way, I think you're always mentally leading this sort of, oh, just in case, money and so you end up dying with significantly more assets than you wanted and not having enjoyed the life you could have. Do you agree or disagree?

Wade Pfau 31:24
Yeah, yeah. Because part of what we learned with the retirement income style awareness and it sticks with the funded ratio, is this idea, I think when people just have a pot of assets that have

to cover everything, they start to worry like, Do I really have enough for a long term care event if I'm just drawing from a pot of assets for that? I don't know, and so I don't spend because I'm worried about long term care. So whereas the funded ratio, no I can, these are my reserve assets, this will fund the long term care. Now that's diversified portfolio is available to fund other expenses, and I can more confidently spend from that. And you'll see that with the funded ratio, but inherently, you don't really see that with the safe withdrawal rate approach, since the safe withdrawal rate approach fundamentally just assumes everything's investment oriented, and you're just going to spend from your investments as you go through retirement.

Alex Murguia 32:15
There you go Wade

Briana Corbin 32:17
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.