

Episode 214: When Spending More in Retirement Makes Sense

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Retirement income, 4% rule, financial personality, international experience, inflation risk, portfolio diversification, tax considerations, time horizon, buffer assets, variable spending, asset allocation, safe withdrawal rate, retirement planning, financial derivatives, bucketing strategy.

SPEAKERS

Alex Murguia, Wade Pfau, Briana Corbin

Briana Corbin 00:00

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Alex Murguia 00:41

Hello, everyone. Alex, here, I'm here with Wade, and in this episode, we're going to be discussing the retirement planning guidebook. Wade has a new edition coming out, and we want to discuss the nuts and bolts of it to see how this book will be able to bring value to your retirement income plan.

Alex Murguia 01:01

Wade now to build off of that. What are the reasons why the 4% rule may be too high or maybe too low? And I'm saying this because whatever number you say, you're going to have a group of people that will come up and sort of talk their book and say, No, this is too high because of this, or this is too low because of this. What are the usual suspects in terms of variables that they point out?

Wade Pfau 01:25

Yeah, yeah. So that's a big part of Chapter Four is actually walking through these issues and to just summarize what they are. But if you really want to dive in, the book goes into a lot more detail, reasons why the quote, unquote, 4% rule might be too high. Include, first just the international experience. That was the first study I did in financial planning. Bill began's 4% rule studies based on us historical market data, and I found that using market data from 20 developed market countries, essentially the 4% rule worked with US and Canadian data, but rates were much lower in the other 18 countries in the data set. And so if you're concerned that the international experience may be relevant, then the 4% rule may not look as safe as you thought based just on us historical data.

Alex Murguia 02:13

So if you're in Czechoslovakia listening to this podcast, you'd be worried,

Wade Pfau 02:17

potentially, that that's not even one of the countries in but indeed, the like Australia is an interesting case where the US had a really great 20th century, but Australia actually had, like, higher average stock returns in the US and less stock volatility, or at least higher bond returns too. They had a really good financial market performances. Know how to live, yeah, but they with the stagnation around 1970 with the high inflation and stagnant growth. The US maybe got lucky that 4% survived that period, but in Australia, was closer to 3% and I think there's just the element of randomness with how things work out.

Alex Murguia 02:59

Remember, in our interview with Ben, he pointed out inflation, yeah, Ramani all of this,

Wade Pfau 03:04

yeah, that was, I talk about that in the book now, because I think that was the most intriguing insight from his 2025 updated look at his research, was how important inflation is, and you can see that in the international data, Like for countries that experience the hyperinflation, the withdrawal rate is point 1% point 3%

Alex Murguia 03:25

because, remember, once you select the initial amount, it's adjusted for inflation. And so that's what gets you, yeah, yeah.

Wade Pfau 03:32

So it's that's actually on the list of reasons why the 4% will may be too low, and that reason is if you retire at a time where inflation is moderate. He in his new book when he talked about the 4.7% universal safe Max. But then he talks more specifically about if you retire at a time where inflation is less between two and a half and 5% he's comfortable talking about a five and a half percent safe withdrawal rate, and that's because it's you really views the sequence of inflation, or the inflation risk to be more significant than the moderate risk, and just being able to retire at a time with moderate inflation should set you on a path where you don't have to be as worried. And I think there's a lot of credibility to that viewpoint. You can see that with the international data as well, where it is the countries that had higher inflation experiences that tended to also see lower withdrawal rates and

Alex Murguia 04:28

inflations are reflected in interest rates ultimately, so you can make them What about return assumptions? And a lot of the research is done without tax considerations, without fees, they assume you can get the, you know, the s, p returns, 10% the assumption is you're going to get 10% what are your thoughts around that? Well, yeah,

Wade Pfau 04:51

yeah, the basic research assumes you earn the underlying index market returns, such as note fees to reduce the withdrawal rate, and you have to re. Balance to a relatively aggressive asset allocation bill. Bengen, in his original studies, said retirees should hold as close to 75% stock as possible, and in those circumstances, less than 50% stocks. In his 2025 book, I think he was

using 55% stocks as a baseline case. But since publishing the book, he's talked about in our episode that we interviewed him. He thought he maybe went too low with that, and he's really focused now more on maybe 65% should be the stock allocation of choice. And so with that, you have to rebalance every year to that aggressive allocation. You have to earn the index market returns so there's no fee drag, and there's no behavioral drag on your portfolio performance is you're always rebalancing and disease.

Alex Murguia 05:47

When you're talking about like 65% allocation, it doesn't mean like 50% of that is in Nvidia meta. It's, it's in a relatively indexed approach, non forecasting approach,

Wade Pfau 06:01

yeah, he uses market indices for that. Now he's got some aggressive or not interesting asset allocations where he has a class, the asset class that's kind of funky, but indeed, they are indexed asset classes with no fee drag, and that's an important part of getting that 4% rule assumption.

Alex Murguia 06:20

And so if you're an active investor, thinking 4% is good, it may actually be too high, simply because you could think of yourself as the next Warren Buffett. But the reality is, if you're looking at the mirror, and the image looking back at you isn't Warren Buffett, that's not you. And tread lightly, is what I would say there. But what about taxes, as well as an argument for, oh, this is too high.

Wade Pfau 06:45

4% Yeah, another kind of an assumption of the studies on safe withdrawal rates, usually they ignore taxes, which it's hard to incorporate taxes. To be fair, I've got the technology now to

Alex Murguia 06:58

try to do a uniform across everyone, though, yeah,

Wade Pfau 07:01

yeah, but taxes have an impact. It's if, well, if all your money is in a Roth, then taxes don't have an impact. If all your money is in an IRA, it's really assumption. You can take out 4% but your tax bill has to be covered through the 4% distribution. Now, I think that's a little bit problematic, because the 4% Well, assumes you want inflation adjusted spending in retirement. I think what that really would mean is you want after tax inflation adjusted spending. Nobody's going to have an inflation adjusted tax it's just really impossible to even design a scenario where that would happen. So by having the inflation adjusted pre tax spending, you're going to not have inflation adjusted post tax spending. Taxes are going to eat away at what you can spend and then in a taxable brokerage account that's all out the window, just because every year the portfolio is kicking off interest and dividends, and you'd really have to count that as part of your distribution. Any taxes you're paying on those you can reinvest the interest in dividends, but any taxes you're paying really, you would have to do the math to incorporate that into your spending rate as part of the analysis. And that would also not be the same after tax spending at that point. So taxes can have a big impact. And I look at examples in chapter four of how if I had \$1,000,000.02 million dollars, \$3 million in either an IRA taxable brokerage account, Roth, IRA, and then I also have a social security benefit alongside that, what is the sustainable withdrawal rate I could use

on an after tax basis that would leave enough to also pay all the tax bills and I show what those numbers look like in those simple cases, to just get some idea about the kind of impact that taxes can have.

Alex Murguia 08:48

Okay, and in terms of one more point, why they may be too by the sustainable withdrawal why the sustainable withdrawal rate may be too high, let's talk about time horizon. What are your thoughts

Wade Pfau 09:02

on that time horizon? The 4% rule was specifically calibrated to a 30 year retirement, and naturally, the longer the retirement, the lower the withdrawal rate. But I think people kind of miss that point. Sometimes I've had financial advisors ask me, like, I have this 85 year old client, am I supposed to use the 4% rule with her at that point, your time horizon, realistically, is probably not 30 years, so you could probably use a higher withdrawal rate. Now that would be a reason why the 4% rule is too low. But the other way, 30 years may not be all that conservative of a time horizon, especially for the fire community, financial independence. Retire early, or even if you're retiring in your mid 60s, 40 may be the new 30 for the number of years you might enjoy in retirement. And if you start looking beyond 30 years, then you are starting to look at, if you believe the 4% rule was right for 30 years, you're going to have to take a haircut on that. Take. At the retirement assets extended out over 40 years.

Alex Murguia 10:03

Let's go to the flip side. Now that was enough of the Debbie Downer. All right, what are some other reasons for why the 4% rule may be too low?

Wade Pfau 10:14

Yeah, yes. Another important one is just the idea of portfolio diversification. The 4% rule assumes a pretty basic portfolio the and even you can see with Bill Bingham's new book, The original 4% rule, this assumed s, p5, 100 and intermediate term government bonds.

Alex Murguia 10:32

Now in in that defense, I think just the historical data wasn't available, going back 75 plus years.

Wade Pfau 10:38

Yeah, yeah. Start to diversify beyond that, if you get a better risk reward trade off, you don't necessarily have to increase the portfolio's return. If you can reduce the volatility through diversification, that starts to get the number higher. That's with the the asset classes he used in a new book. You got it up to 4.7% is that universal number? And yeah, it's really just a story of depending on your investing approach, a more diversified portfolio could easily support something higher than a simple two asset class portfolio.

Alex Murguia 11:10

And I think this goes back to what we had spoken about previously, which is these things aren't done in a vacuum, and you're not playing a game of chicken with the markets you ultimately are looking as you go, and you're making course corrections along the way. And there may be a relatively asset class that's investable, that wasn't available 20 years ago, that all of a sudden changes the dynamics. And yeah, through the magic of diversification, yeah, you do get a better

return to universe that you're taking a smoother line. Means higher annualized returns, would mean higher ability to take a withdrawal. That makes perfect sense. What about the use of derivatives?

Wade Pfau 11:48

Yeah, yeah. Well, that's don't have to talk a lot about that. It's a relatively short section, although it gets into the the some of the new types of annuities out there, but the idea of, like, overlaying financial derivatives on your investment, oh, yeah, so that you have different trade offs between downside risk exposure and upside

Alex Murguia 12:05

growth is derivatives me, because I said that they understand me, and everyone listening should know what that mean.

Wade Pfau 12:11

Well, there, there are options that will give you the flexibility to without owning the underlying asset, get a return derived from the asset. There's different kinds of options. Probably don't need to get into Options theory

Alex Murguia 12:25

in this episode. There are financial instruments that could potentially enhance the withdrawal rate or, well, they came by the specific outcomes, if

Wade Pfau 12:37

you will. Yeah, they change the dynamics between downside risk and upside potential. Like by removing some of the downside risk you Well, you'll have to also take away some of the upside growth opportunity. But if you're targeting a high probability of success, it's the downside risk that has a bigger impact, and so you could potentially spend at a higher rate and still maintain a 90% chance for success, for the plan, something like that. That's that's the basic idea of thinking about how you can the traditional asset classes have a bell curve distribution, so a long tail of negative returns, a long tail of positive returns, most of the returns in the middle. And the idea of financial derivatives is you change the structure of that bell curve. And by removing some of that downside risk, even if you sacrifice some of the upside growth potential, it might help to support a higher sustainable spending rate in retirement.

Alex Murguia 13:30

By providing by cutting off the tails of the distribution, you get a more certain turn into a comes out of cost. But still, it could justify why the distribution is on the lower side.

Briana Corbin 13:42

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Alex Murguia 14:20
bucketing

Wade Pfau 14:22

as a variable. Yeah, so bucketing or time segmentation, and this is a more controversial one, but advocates and bucketing is one of our viable retirement income approaches. This approach looks at the investing problem quite differently from total returns. It wouldn't say I'm going to be 60/40 stocks and bonds, because the 40% bonds is going to reduce the volatility of my portfolio to get something I'm comfortable with, no bucketing. Would say if I put 40% into bonds, it's because that's what I need to fund the next eight years of fixed income expenses, and that's what I feel comfortable with. And then my stock allocation is whatever is left over. After I create that short term spending bucket that I'm comfortable with now, when you do that, it means you're no longer tethered to a particular asset allocation. It's bonds are what you need to feel comfortable meeting upcoming expenses, stocks or whatever is left over. And that can lead to a more dynamic asset allocation that in particular, with most bucketing strategies, if markets are going down, you stop extending your fixed income buckets, you stop rebalancing from stocks into bonds, and then you're that creates a window where hopefully those stocks can recover before you're self forced to spend from them again. So it can lead you to have a higher stock allocation when markets are going down, and behaviorally, we know that's not what people usually do. But if bucketing, if the psychology of bucketing, if you're comfortable with that, maybe it does help you have a more dynamic and potentially aggressive asset allocation in retirement. Yeah, so, but

Alex Murguia 15:58

for those listening in what you're effectively saying is, as the bonds mature, you're using the principal and the dividends together to fund your retirement. So as you're doing that by default, you're using fixed income to subsidize that, and so you're naturally getting a higher Yeah, unless you're continually replenishing it with market growth. Let's say there's a few years, there's no market growth, you could potentially be increasing proportionally, speaking, your equity allocation. So you may be thinking on more risk than you thought of earlier. Oh, my God, right,

Wade Pfau 16:30

yeah, yeah, it's just with with bucketing and time segmentation, you're not rebalancing to a fixed asset allocation every year, your asset allocation is more dynamic because it depends more what's going on with your portfolio. And if you're comfortable with that, you could argue that that can support a higher spending rate.

Alex Murguia 16:48

What did you change your allocation throughout? Because as much as you were assuming a 4% rule, you're picking a certain number year one, and then you're just making inflation adjustments, but you're kind of married to the anchor from year one a little bit as a starting point. It Can the same be said about an allocation. And I'm thinking about glide paths and things like that.

Wade Pfau 17:07

Yeah, yeah. So the the 4% rule generally assumes a fixed asset allocation throughout retirement. Michael kitsies and I did that research on the idea the rise in equity glide path, and I

described that research in the book. That's the idea that to help manage that sequence of returns risk, you start potentially with a lower stock allocation at the beginning of retirement, but then you gradually increase it over time, and then that gives you the benefits like the true worst case scenarios that retirees experience are, you've got bad markets in early retirement, and then hopefully markets eventually recover. Well, if that's the worst case scenario you face, rising equity glide path helps to manage that risk, and so that's something that resonates with a lot of readers. I hear a lot of positive feedback from people, but it also it's not going to be for everyone, because it means you get more aggressive as you get older, and not everyone's going to be comfortable doing that. So I don't push the the rising equity glide path is here's here's what you should do in retirement. But I think it's an interesting approach, and if it resonates more power to you, the

Alex Murguia 18:09

only I think sometimes it gets misinterpreted by saying you're going to get this aggressive allocation. I think ultimately, let's say, if the conservative allocation for you, based on risk tolerance and capacity and the like, is, let's say a 5050, allocation, right? I don't think they're raising the rising aggregate guide class will get you to a 7030 allocation. And the first number is equity. So 70 equity, 30 fixed income, 5050. Is even expect. But I think what it means is you start maybe artificially low, like 3070, to effectively get to what that natural allocation is for you, 5050, and at that point, I don't see that as, yeah, yeah, aggressive. It's just getting to your baseline, if you will, right?

Wade Pfau 18:55

And another component of that is, I already mentioned how Bill Bingham said, Never go less than 50% stocks in retirement? Well, the reality is, most of the target date funds people are using these days are less than 50% stocks at the target date. So what we're saying, really, and in the case study, in our original research article, we assumed you're like, if you're going to take the true fixed allocation approach, you'd be 6040 stocks and bonds start retirement. We said, well, what if you just started at 30% stocks, but work your way back up to 60% stocks. So you're right. It's not that you keep going up to 90% stocks or anything. It's whatever you would have been for the whole retirement. You just start lower and work your way back up.

Alex Murguia 19:35

I think that provides cover with the fragile decade. What about changing spending more than just like the more than the sustainable droid, but I mean just variable spending?

Wade Pfau 19:47

Yeah, yes. So that's the longest part of chapter four, is on the different variable spending strategies. We've already talked about that somewhat, so maybe you don't need to go into it in depth. But yeah, well, we already, we talked a lot about. Constant inflation adjusted amount. We talked about the fixed percentage strategy. Some of the other variable spending strategies we look at are the bingens, floor and ceiling rule, the Guyton. Jonathan Guyton, style decision rules for guardrails around spending, an inflation rule about when you take the inflation adjustments in retirement. Michael could see his ratcheting rule got in there. Also the using an RMD based approach, where you look at the required minimum distribution tables, and you don't use strictly the tables, but you modify those tables, but you get then you spend a percentage of what's left each year, but a percentage that's increasing with age to account for the shorter remaining time

horizon. And I really assess how those different approaches work with the same underlying assumptions and with the same Yeah. What advice about

Alex Murguia 20:47

that part is that, to me, reading that brought to light that look effectively, there's levers you can pull, right let's just say, for human sake, there's four levers you can pull, a floor, a ceiling, previous use, returns, etc, and and and, depending on how you like to deal with it, pulling certain levers could definitely, if you're willing to, you know, take some off the table, put some back on, take some off. Takes a month. You can have actually a very effective strategy in that manner. I think you made it conceptually very clear, as opposed to trying to memorize every strategy to me, my takeaway was like, there's certain levers. Yeah, if I pay attention to these levers, I can make my own Alex variable withdrawal strategy, if you will. I think you conceptually, directionally, you can get there if you really understand how you address the model. Yeah.

Wade Pfau 21:37

And our and our retirement researcher Academy, we've now created the payroll calculator, which is our tool that basically lets you recreate the analysis for all those variable spending strategies in the chapter for the retirement funding input.

Alex Murguia 21:52

So and there's more about the Retirement Research Academy. Two words, what are they? Show Notes. Show it, right? Brianna, right. A couple more reasons why it could be too low. Talk about buffer assets. A little bit.

Wade Pfau 22:11

Yeah, yeah. So Buffer assets, they're the fourth way to manage sequence risk. Buffer assets are something that's outside the portfolio, not correlated with the portfolio, which is just a fancy way of saying, if your portfolio is down your buffer assets not down your buffet or asset provides a temporary spending resource to avoid having to sell from the portfolio at a loss, to give your portfolio a chance to recover. And the three buffer assets are cash, the original buffer asset from the 1980s as you have a big pile of cash on the sidelines. And the other two buffer assets cash value of permanent whole life insurance or the growing line of credit on a variable rate Home Equity Conversion Mortgage, better known as a reverse mortgage, and they provide temporary spending resources that I really dig into the analytics of buffer assets are usually expensive. Reverse mortgages and life insurance are both expensive, but the the synergies you create by giving relief to the investment portfolio so that you're not having to sell from it when it's in trouble, let that portfolio get back on track, so that the long term growth to the portfolio sets you up that you can can repay the the buffer asset, the loan balance of what you borrowed, pay that off and still have a net positive. Again, it's all about efficiency and retirement.

Alex Murguia 23:30

I yeah, I think having buffer assets in place open opens up windows of liquid, opens up windows of liquidity for you, which then frees up your ability to have a portfolio that's geared for higher returns, you don't need to have the adjusting pace conservative ideation around that. Yeah, yeah.

Wade Pfau 23:51

You you have, you have the ability to take on more risk, because you have a backstop. You're not.

Alex Murguia 23:55

Just want to make sure people know exactly, because sometimes we get questions coming in. Your definition of buffer assets is, as opposed to, you know, a lot of people think this is a buffer asset, and many times you're like, No, no buffer asset. It has to have these characteristics.

Wade Pfau 24:10

It's not part of the portfolio. It's not correlated with the portfolio, but IE, it doesn't lose value. It can grow, but it doesn't shrink, and it's highly liquid and available when you need it to tap into to cover your expenses, usually the main candidate. Sometimes folks will ask, can a fixed index annuity counts as a buffer asset because it has principled protection and the potentials of growth? I'm not as comfortable adding that one to the list just because usually there's either a surrender charge, if you take an early district or beyond the have some pre withdrawal, but then also you're not credited with any interest until the end of the term, and so you might miss a big interest payment if you tap in them. So maybe at some level, it could be a honorary candidate for a buffer asset, but I don't treat it as one of the three core.

Alex Murguia 25:00

For assets, all right? And then the last point, why maybe a little lower sustainable draw, is talk to me a little bit about optimal withdrawal rates.

Wade Pfau 25:08

Yeah, that's the other one. Now that's the whole issue, the safe withdrawal rate question. It's like, what's safe, what is not going to cause you to run out of money. But that inherently starts giving you to think quite conservative that you can't spend all that much and with the optimal withdrawal rate idea. That's just noting that, hey, in some cases, if you have lots of reliable income outside the portfolio, if you have the flexibility to adjust your spending without disrupting your lifestyle, if you have other reserve assets to help manage the spending shock and retiring it you might have the capacity to just spend at a much higher rate. It might lead you to run out of money, so to speak. It may not be a safe withdrawal rate. Might be a 50% chance that you run out of money. It was your investments. But in the right circumstances, that may be okay to get the maximum lifestyle in those early retirement years you might comfortably spend at a higher rate, even though it's not quote, unquote, the safe withdrawal rate, it may be the optimal withdrawal rate for your plan. Okay.

Briana Corbin 26:12

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