Episode 236: Are Annuities Better than Bonds in Retirement?

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Retirement income, financial planning, annuities, bonds, inflation, retirement income challenge, funded ratio tool, long-term care, Medicaid, Social Security, discount rate, annuity payout rates, health insurance, direct primary care, asset allocation.

SPEAKERS
Speaker 1, 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 retirewithstyle.com/style and sign up to take the industry's first financial personality tool for retirement planning, Alex's case for the retirement income challenge: forget Italy, skip the beach, come build a financial plan. Wade's amendment: just join from the beach. And this is the energy of this show. It's also genuinely a great episode on inflation, Qlac and the backdoor Roth strategy.

Alex Murguia 01:06
Hey everyone, welcome to Retire with Style. I'm Alex, and I'm here with my trusted co-host, Wade, like clockwork, just like clockwork. And we're continuing our Q and A from our YouTube Live session that we did a few weeks back, we had so many questions that we couldn't get through them all, so we decided to have follow on podcast on it. If you wanted to catch the Youtube live that we did do, just go to Youtube, where we have our own Retire Without channel. It's subscribers are getting higher and higher every day, so we're very excited about that. We got a lot of things planned for it, so please go over there, smash the subscribe button, and you'll follow us for new things as they come about. In addition, another announcement we'd like to make as a reminder. Wade, you want to talk about the retirement income challenge?

Wade Pfau 02:00
Yeah, this will be our last podcast episode before the start of our next retirement income challenge, which will begin. It'll be during the week of july 13, 12pm to 2pm Eastern each day, not on Friday. It will be running throughout the week, though, and it's an opportunity to just help build your retirement income strategy in terms of, well, review the RISA and talk about the RISA, but and focus really on building a financial plan with our funded ratio tool, which is we've already had the March retirement income challenge wasn't 100% finished then, it is 100% finished now, and we're really looking forward to having a great experience for everyone with the funded ratio tool.

Alex Murguia 02:39
Yeah, and everyone knows us with about the reset, but we're very excited about the funding ratio, because we think it really represents the next step from a financial planning perspective, and frankly, I mean, the reality is we know what's out there for consumers, we study the market, and there's a few sort of places that folks can go from a financial planning calculation perspective, but we feel what we've done with the funded ratio is and blended with the RISA is above and beyond what's out there, and frankly, it's during Retirement Income Challenge Week, so it's free for everyone. So I strongly encourage everyone to skip beach day during the summer, and at least for two hours, and for over the course of a few days, and attend the retirement income challenge. Your retirement will thank you.

Wade Pfau 03:28
Or join from the beach, use your camera, and make everyone jealous.

Alex Murguia 03:32
Wow. Hey, well, hey, did you just think of that right now? Yeah,

Wade Pfau 03:37
there's no reason you can't join the retirement income challenge from the beach.

Alex Murguia 03:41
No, no, you're right, you're right, you're right. Matthew, we have done that the last time. Remember, we were in Cape May together. Yeah, I don't know

Wade Pfau 03:47
if we should be at the beach during that folks joining in. It's no problem. All

Alex Murguia 03:52
right, all right, all right, all right. So, let's get to the questions. Then I'll start off. This one's from George, and he writes, my in-laws have only a few $100,000 of total assets between their home and IRA. If they end up needing prolonged long-term care, it seems likely they would eventually deplete those assets. I understand Medicaid can cover long-term care once someone has spent down their money, but does that usually mean access is limited to lower quality facilities, or can someone enter a facility of choice as a private pay resident and then remain there after their assets are exhausted, with Medicaid covering the cost at that point? I think, but can't be sure. I remember Alex saying it may be an advantage to start off as a fully paying customer, and that you can often switch to Medicaid funding. Everything I'll speak to, my particular situation, I may have referenced that with my mother, and the facility was I was able to do that with my mom. I was in the process of finishing up doing. That with my mom, but Medicaid is, you know, they're able to cover that none, and it hasn't - there hasn't been a degradation of service or anything like that, but I think in terms of anecdotally this could be a situation where results vary, at least as it pertains to my situation. Wade,

Wade Pfau 05:18
yeah, so generally there could be an advantage to being able to self-pay when you enter the facility, although it's not necessarily because when you later switch to Medicaid, you'll still get the same quality services. This would really depend institution by institution. What rules do they have in place? Medicaid may have a lower payment rate than what you're paying out of pocket,

and therefore the nice room that you start in, you might be switched to a less nice room after the change over to Medicaid, but really you got to check the rules of the facility. It's just entering the facility in the first place. It might be easier if you can self pay. That's even a reason why you might want a small long-term care insurance policy, which might also include a cost of a care coordinator who can help manage finding the right facility, and so forth. It just, it may be easier to enter, like you might have more options for entering facilities if you can self-pay at the beginning. Now, recognizing at some point, if you're there for long enough, it may be necessary to switch over to Medicaid. I don't mean to imply that that's an assurance that you'll continue to get the same facility care as you got during the self-pay period. You might get less quality care at that point, but you could look into that, and maybe some facilities are out there that provide the guarantee, or whatever the case is, that no, if you need to switch to Medicaid later, no problem, you still will receive the same, stay in the same room, receive the same, all the same benefits that you had during the self-pay period. I just, I don't know how common it would be for that to be the experience versus no, we're going to move you to a different room. You may not get as many of the like optional additional benefits that you receive during the self-pay period once you switch over to Medicaid.

Alex Murguia 07:12
Okay.

Wade Pfau 07:14
Okay.

Alex Murguia 07:15
Here's another one. Another question coming from Pay me rich. What are your feelings about.. I don't know, how would you pronounce that? It's probably.. oh, pay me rich. I see it now. I was thinking, like Emmerich, you know, like the French name Emmerich or something like that. I thought his, the last part of his name was Emmerich, and the beginning was like, "Hey, but I get it now, Pay Me Rich. That's like a freaking Simpsons thing. Yeah,

Wade Pfau 07:50
that's like calling up Mo, "Hey, is Pay Me Rich there?

Alex Murguia 07:54
What are your framework for retirement in parentheses annually recalculated virtual annuity.

Wade Pfau 08:06
Okay, so yeah, well, like, what are my feelings on the annually recalculated virtual annuity method for retirement income? The quick overview answer would be, I think it's fine, and you, if you want to do that, good for you, it's going to be a lot of work, and so I don't know if it's really worth the effort, but yeah, it works, and it's going to lead to a variable spending strategy. But now, to explain what that is, the idea is instead of buying an annuity, you kind of use an annuity on the basis, annual basis, of deciding how much you can spend, so like right now, if I put all my assets into the annuity with the current payout rate on the annuity, maybe it says I'd be able to spend $105,000 that year. Well, then I just spend $105,000 that year from my investment portfolio. I don't actually buy the annuity, and the next year I go and repeat the process, and so then this is it's a lot like the RMB method in a way that as you get older the payout rates on annuities will increase because there's a shorter time horizon, so you're getting a higher payout

rate over time, and you apply that as a percentage, so an increasing percentage applied to your and your portfolio investment portfolio, and also with interest rate fluctuations. If interest rates go up, you might have some losses on your bond funds, but the payout rates on the annuities will go up, and that might partly balance out if you've got the durations matched, might balance out entirely, but generally it will probably lead to, on average, an increasing spending amount over time in excess of inflation. It's kind of like the RMD method, where you tend to start with less spending, it increases over time, perhaps in your mid to late 80s, even 90s, and then as you get later than that, the spending might come back down again. Now that's not necessarily an. Attractive spending pattern for everyone. Most people might prefer more aggressive spending in early retirement during the go-go years, less spending later on. So, you may not necessarily get that with the annually recalculated virtual annuity, but if you like the idea of an actuarial method for retirement, which is to increase spend an increasing percentage of what's left as you age. The annually recalculated virtual annuity method will give you a way to do that, and basically it would just mean each year you go find out, like, what are the payout rates on immediate annuities based on my age, and then based on my account balance, how much annuity income could I buy, and then I don't actually buy the annuity, I just use that as a guideline for how much to spend that year,

Alex Murguia 10:45
so

Wade Pfau 10:45
it's going to lead to fluctuating variable spending. It's an actuarial method, so you shouldn't run out of money with it, but yeah, it's it's an option.

Alex Murguia 10:54
Can you run me through an example with simple math, like I have a million dollar portfolio? Go well,

Wade Pfau 11:00
yeah, I have a million dollar portfolio. I'm 65 years old male, and I don't know what payout rates are right now, but suppose I use a

Alex Murguia 11:09
payout rates, what does that mean

Wade Pfau 11:10
on a on an income annuity, immediate annuity, like SP, a single premium immediate?

Alex Murguia 11:15
You were by a million dollar annuity.

Wade Pfau 11:17
Yeah, yes, I go online, I say, okay, I'm 65 I'm a 65 year old male. I have a million dollars for my premium. Say the payout rate on the annuity for a 65 year old man is just to make up the number, 7% I could purchase $70,000 of income annually from an annuity. Well, instead of actually purchasing $70,000 of income, I just tell myself, okay, that means I can spend $70,000 this year, and then I just continue to manage my portfolio. It's an investment portfolio. I'm just,

instead of using something like the 4% rule, I just use the annuity payout rate to decide how much I'm going to spend that year.

Alex Murguia 11:55
Okay, so you're still going back to.. I'm glad you said the 4% rule, because the moment.. I don't know if you said it just because you're thinking of just numbers for the sake of numbers, but a $7,000 distribution, well, a $7,000 you said 7000 or 70,000

Wade Pfau 12:09
the 70,000 $70,000

Alex Murguia 12:12
distribution from a million dollar portfolio, you know, quite substantial, you're talking in the 7% range, right, so what,

Wade Pfau 12:21
yeah, so it's not like the 4% rule assumes you never adjust spending other than increasing for inflation. This one every year there's less sequence risk whenever you use a percentage-based distribution strategy. So every year, if you revisit it, so maybe next year I'm now 66 the payout rate is 7.2% so I would spend 7.2% of what's left in my

Alex Murguia 12:45
percentage of what's left. Oh, yeah, you can use a more aggressive spending rate,

Wade Pfau 12:51
this kind of percentage-based distribution strategy. The

Alex Murguia 12:54
markets go down, so it's a bad market year. You took the first year, you took 70,000 so that portfolio now is 930,000 and then effectively next year you do the same exercise, and this is for easy math, it says 5% then 9.3 divided by two 4.7 something 4.65%

Wade Pfau 13:19
no, like the next. So, suppose your portfolio does a bad year. Your portfolio dropped $800,000 the next year. You're older, and say interest rates didn't change too much. Now, the payout rate on the annuity is 7.2% So, next year your spending is 7.2% of 800,000 If last year was a great year in the market, and your portfolio is now worth $1.2 million You're spending, you're allowed spending for the year is now 7.2% times 1.2 million. You've got a variable spending strategy.

Alex Murguia 13:51
Yeah, and so for people, you can see how now the actuarial, the actuarial tables are kind of dictating the spend down. If it's RMD, then the government sort of tables are dictating your spend down.

Wade Pfau 14:02
Yeah, and so it kind of works like an RMD method, where it's just an increasing percentage as you age, but the RMD method is really based on an odd actuarial table. It's like two people where one person is 10 years younger than the other, and really it's based on assuming no

returns on the underlying assets, so this is really a more sophisticated and probably more accurate way to gage your spending using actual annuity payout rates that are linked to current interest rates.

Alex Murguia 14:34
The other, the other piece you said is that this was difficult to maintain, at least I think you said that at the beginning, difficult, yeah, although I guess, in terms of, oh, I got to get online this year and check it out.

Wade Pfau 14:45
Yeah, it's not that hard. It's just on january 1 of each year, you go check out the annuity payout rates for your age and whether it's one or two people, and so forth. And then you determine your account balance, and then you tell yourself, okay, I'm allowed to spend this much this year. Yeah, I guess it's not that hard. It does require annual updating calculations.

Alex Murguia 15:06
No, I got you. I just wanted to.. I'm trying to people listening in, like I don't want to scare them or encourage them. I just want them to know what was meant by, you know, what it takes. All right,

Briana Corbin 15:20
every week on Retire with Style, we share ideas to help you retire with confidence. The Retirement Income Challenge is where those ideas become your plan. Over four live sessions, Wade and Alex will help put what you've learned on the podcast into action using your RESA profile and our funded ratio tool. You'll build a retirement income plan that's designed specifically for you, and I've got great news: enrollment is now open, and it's 100% free to join us. So head over to retirewithstyle.com/ric to register today. Again, that's retirewithstyle.com/ric or you can check the show notes below for the link and more details. We'll see you in the challenge.

Alex Murguia 16:02
Next question, planning this is this is from Dy Park. Planning on retiring as soon as I turn 62 next year, should I consider I be considering leveraging DCP along with ACA to provide solid health care once I am no longer on employee provided coverage. We're assuming DCP means Direct Primary Care Membership Base.

Wade Pfau 16:31
Yeah, that's a note I added in. And folks, when you do send us questions, it would help if you define your acronyms, because DCP can mean a lot of stuff in the health insurance world, so my best guess of what was meant is that this is those newer kind of concierge,

Speaker 1 16:47
yeah,

Wade Pfau 16:47
you pay an annual membership and then you get care from that doctor for the year, and then

Alex Murguia 16:52
ACA,

Wade Pfau 16:53
and ACA, I do know that one, that's the Affordable Care Act, that's

Alex Murguia 16:57
for general,

Wade Pfau 16:58
it is nice if you spell out your acronyms the first time you use them,

Alex Murguia 17:02
okay. And then the follow-up question is, my wife is older and qualifies for Medicare under my employee provided coverage, should she also incorporate DCP along with Medicare?

Wade Pfau 17:14
Okay, so yeah, to take these one at a time, like we've got an individual who's retiring before they're eligible for Medicare, so they use the Affordable Care Act. Should they use, like, this DCP, direct primary care membership-based care, along with the Affordable Care Act to provide solid health care? I guess there must be an underlying assumption here that you're going to choose a really high deductible version of the Affordable Care Act that's mainly for more like emergency type care, and then all your basic healthcare needs would be through the DCP membership concierge plan. I think that could work fine. I don't see any particular problem with doing things that way. Then the next question, though, my wife sold her and qualifies for Medicare and is under, well, currently was under my employer-provided coverage. Should she also incorporate DCP along with Medicare for this one? You know, the whole point of DCP from the doctor's perspective is they don't want to deal with insurance companies anymore, and in particular, that means they're probably not going to accept Medicare, but Medicare would pay for that. If you go to a Medicare, like, if you feel you have the resources and you really like this doctor that you're working with, you're really just paying out of pocket for that care that could have been covered by Medicare. And yeah, you'll definitely want to have Medicare coverage. I guess my point is, I don't think it's necessary when you have Medicare available to also use direct primary care on a membership-based reason, but if you have the resources and you don't mind spending the money and you really prefer things that way, I think it's up to you to do that. It's just I don't see any financial reason that it would be better off to do that,

Alex Murguia 19:02
yeah, in the similar reason that you thought if they did have the Affordable Care Act, they have a high deductible plan, because then what makes sense otherwise,

Wade Pfau 19:10
right? right, like if you had low deductibles in your Affordable Care Act plan, you'd also be double paying effectively, because the Affordable Care Act would have covered your primary care physician, but instead you're paying out of pocket to a separate primary care physician.

Alex Murguia 19:29
Okay, I

Wade Pfau 19:30

guess the whole assumption is that your insurance doesn't cover this membership-based. It has to be, right?

Alex Murguia 19:35
It wouldn't make sense otherwise. Yeah,

Wade Pfau 19:37
and that's it's becoming more common, as just I think a lot of doctors don't want to deal with insurance anymore.

Alex Murguia 19:43
I got just, just take Centrum. Actually, my

Wade Pfau 19:45
primary care provider moved into one of these models recently, so I guess I heard about that.

Alex Murguia 19:52
Are you going to continue? What are you going to do? No,

Wade Pfau 19:53
no, I'll just find a doctor that I

Alex Murguia 19:56
didn't mean to invoke HIPAA here, Wade here. It

Wade Pfau 20:00
find a new one that our McLean insurance will cover,

Alex Murguia 20:03
really. Yeah, all right, all right, all right. Anything else with that question?

Wade Pfau 20:12
No, not that. That's it.

Alex Murguia 20:14
Okay. Next question from ABQ Gold of the common ways to mitigate sequence of returns risk, including time segmentation, bond allocation, annuities. I'm interested in whether you think one is superior to others, just as a math problem specific to my case, long combined and anticipated longevity with high traditional IRA balance. I mentioned the traditional IRA balance, since I'm wondering if that context makes a standard bond allocation inefficient in terms of the absolute amount of cash-like investments needed. Why did you give it a go away?

Wade Pfau 20:59
Yeah, I mean, so there's two general ways to answer this question, like what's better, time segmentation, bond allocation, which I guess is kind of the total returns interpretation, or using an annuity with lifetime income. So the first part of that answer would just be what's your retirement income style, and then go with that approach, but since they're specifically asking, you know, mathematically speaking, what's the better approach? And yeah, that's where bonds

are very inefficient as an asset class to support retirement income. The efficient frontier for retirement income is annuities and stocks.

Alex Murguia 21:37
When you say bonds, bond funds are individual bonds, or both. I just want to make sure that distinction is made.

Wade Pfau 21:42
Well, I'm thinking more so bond funds, but really it doesn't matter. But individual bonds and bond funds - neither one provides longevity credits the way that annuities do. They're annuities are effectively bonds that also give you longevity credits, so when you have longevity risk, an annuity is better calibrated, it's a bond that's better calibrated to managing your longevity risk. So, mathematically replacing bonds with annuities should, for the most part, support better retirement planning outcomes, and that's what the question's asking. Mathematically, what's best? But okay, that was the math side. It's just, do you want to talk a little bit more about just, I think a lot of people aren't persuaded by the math, and that's because they have a particular retirement income style, and at the end of the day, what matters is their preferences, and yeah, you think about that question,

Alex Murguia 22:34
if people would be persuaded just by the math alone, they, yeah, they'd be equity, it wouldn't be a stock to bond allegation, it'd be a stock to private pension allocation, right? Private pension being an annuity, but you're right. I mean, the world isn't reconciled on us on a spreadsheet, and so to the degree that you feel comfortable, to the degree that you'd like to have certain characteristics available to you throughout retirement, time segmentation is a very valid strategy, and so is the total return approach.

Wade Pfau 23:05
Yeah, and then also I guess, like, they're specifically having this nuance of a big IRA balance, so if I guess, then with, if you're going to be like 6040 stocks and bonds, does that mean you just have too much bonds? Yeah, that's possible, and that's where maybe with the time segmentation you think more about, well, if I want to have five years worth of expenses covered in bonds, if that's a relatively small percentage of my overall assets, that could justify having a higher overall stock allocation. That we mentioned asset dedication recently, and that's how they think about asset allocation, instead of saying I got to be 6040 it's how much bonds will it take for me to build a comfortable front end fixed income bucket, and then at that point the rest can be in stocks, and so I back into my asset allocation based on my retirement spending needs, not I start with determining my asset allocation based on, like, a risk tolerance question. That's a good

Alex Murguia 24:03
point. I just want you to just, since we're here, and it's mentioned that, you know, they mentioned annuities, and they mentioned high traditional IRA bounds. Can you talk about how annuities are taxed within an IRA, if they're, you know, the whole sort of defer within the deferral, just the whole, how are people confronted with the annuity within an IRA?

Wade Pfau 24:28

Yeah, that, that's not a big concern, like outside of, in an unqualified, so taxable environment, annuities can provide tax deferral, so that particular benefit gets neutralized in an IRA, because you get tax deferral anyway, so it's just when distributions are taken, they're taxed as ordinary income, just like any distribution from the IRA. So

Alex Murguia 24:49
I'm just not saying how annuities are kind of discredited right away within an IRA, because they're like, you're already getting tax deferral, you're not going to get double tax, you would already get it in a taxable account, why put it in an I. Ira, that you know that that kind of argument,

Wade Pfau 25:01
yeah. And there's no, no issue there, other than, you know, for in the marketing literature, if somebody's pushing, oh, you get tax-deferred benefits from annuities. Well, an IRA already gives you tax deferral, so that's no longer a unique benefit from annuities. So don't focus on, oh, this is a great tax benefit, but it's not better or worse, it's taxed the same way as just distributions are taxed as ordinary income from an IRA, whether it's an annuity, a bond, or a stock.

Alex Murguia 25:30
Notice, all right. Wait, let's continue. Train keeper rolling all night long.

Wade Pfau 25:37
All right,

Alex Murguia 25:38
we got another one here. What discount rate would you use when evaluating Social Security as the annuity? I cannot make up my mind whether to use the 20 year tips like Mike Piper or a weighted portfolio allocation,

Wade Pfau 25:53
and there's been some controversy around this question recently. So, to be clear, I would agree with Mike Piper, and that's our whole basis of our funded ratio with the retirement income challenge. Next week, we're using like long-term tips yields, not necessarily exactly 20 years, but a long-term tips yield is the discount rate we use for all future income and expenses, and I think you know, in general, most academics would agree with that. There has been a loud cohort of individuals recently arguing that no, you should actually use, like, your expected investment portfolio return as a discount rate on Social Security, and I think if you're more of a total returns individual, I don't object to people necessarily doing that. I just would definitely not treat it as the default selection for discount rate. What we're talking about here is really generally your what you assume your investments are going to earn would be a higher rate of return than tips, treasury inflation protected securities. So it's really you're assuming your investments are going to earn a higher rate of return, so when you calculate the present value of your social security, it would be lower the higher the discount rate, and what this generally would do, as well as it makes it harder to justify delaying social security, because with a higher discount rate, the future long-term benefits from delaying social security, get discounted at a greater rate, and you'll start to say no, like with a high enough discount rate. At some point, I should just take social security as soon as possible, so that I can leverage my investment portfolio to earn a

higher rate of return over the long term. Now, I'm okay if somebody wants to use the weighted portfolio return as a discount rate, but I certainly don't think it should be the default selection. I think it's really important to think about the insurance value of Social Security, that this is an inflation-adjusted lifetime income for the higher earner in a couple with survivor benefits included, that you really can't replicate in the marketplace. There's no annuity that can do what Social Security can do in terms of the delay credits provided getting that 77% higher remaining lifetime benefit by delaying from age 62 to 70, so I think there's a lot of insurance value for that survivor benefit protected lifetime inflation adjusted lifetime income through delaying social security, and yeah, if you're going to use a higher discount rate, though, at some point it's going to tell you don't delay social security, and that's just framing it more of an investment problem, as I think I can earn a higher rate of return on investments, so I should take social security sooner, so that I don't have to spend as much on my investments, and that way, over the long term, I'll be better off. Yeah, if markets do really well, you might be better off by claiming Social Security early. But even in early 2023 I published a study with Steve Parrish, looking at historical data and comparing retirement outcomes delaying Social Security versus claiming early, and generally found that even with US historical data, there's a pretty strong case for delaying Social Security, purely from that kind of investment basis of it. It's tough to beat the delay credits from Social Security, so use a higher discount rate at your own risk or peril. I do agree with the idea of using TIPS as your discount rate universal, I mean, at the end of the day, if people want to use a higher discount rate, it's your life, and if your total returns, it's your retirement income style, but I think, as a general default, you want to use something more like tips,

Alex Murguia 29:38
I agree 100% I think sometimes people want to use a lower discount rate to justify why they want to take the money early and invest. That's a big generalization coming from me, but

Wade Pfau 29:54
also, like, I was a journal research journal editor for a period in the past. And then actually I recently reviewed an article along the same lines, there's always see these articles that come out that will just say something like historically the S and p5 100 earns 12% and therefore I'm going to use that as my discount rate, and therefore I should claim Social Security at 62 and certainly if your investments, if you know your investments are going to earn 12% a year. Yeah, you should take Social Security at 62 It's just a lot harder for retirees to earn that kind of rate of return on an ongoing and consistent basis.

Alex Murguia 30:32
Agree. All right, and with that, Wade, I think that concludes this episode of our Q and A, but we still got plenty more to go. Wouldn't you say

Wade Pfau 30:45
we sure do? Yeah, we've got probably a couple more episodes of questions still. So, yeah,

Alex Murguia 30:49
most definitely. Thank you for listening to Retire with Style. We'll catch you next week.

Wade Pfau 30:57
All right,

Briana Corbin 30:58
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