Episode 244: Why Being Safety-First Doesn't Mean You Need an Annuity

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SPEAKERS
Briana Corbin, Wade Pfau, Alex Murguia, Speaker 2, Speaker 1

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. Today's episode opens up with Alex closing the lines because, in his words, the sun is glistening off of his bald forehead. From there, it's straight into inflation risk, annuity choices, and how to bridge Social Security without wrecking your withdrawal rate. Wade survives unscathed.

Alex Murguia 01:00
Hey everyone, welcome to Retire with Style. I'm Alex, and I'm here with my good buddy Wade Fow. How are you, Wade?

Wade Pfau 01:08
Hey, doing good. How are you, Alex?

Alex Murguia 01:10
Pretty good, man. Pretty good. How was your weekend?

Wade Pfau 01:14
Huh? Same old, same old. But how about you? It sounds like you did something pretty exciting this past weekend.

Alex Murguia 01:20
Yes, yes, I fulfilled my lifelong dream. No, I I went to New York with my wife and mother-in-law, and if you've never traveled with your mother-in-law, you know you don't know what it is to be alive. No, no, no, she's a great lady. We saw the MLP pickleball championships in New York this weekend. Yes, I am a nerd just like that. We saw the finals. We're we're all into it. Christy and I saw went to St. Petersburg, which is I don't know if you ever been to St. Petersburg. It's a pretty cool town to me. It's like an Austin vibe, but you know, not the music, but it's that kind of hippie

artsy kind of crowd-not hippie, but hip, artsy kind of crowd-it was pretty nice actually. It took me by surprise. St. Petersburg, and so we said, "Ah, let's go watch the finals in New York, and we did that in Central Park. Weather was fantastic. Yeah,

Wade Pfau 02:19
St. Petersburg, Florida, or New York? Yeah, yeah, yeah.

Alex Murguia 02:22
Earlier in the year, I went to St. Petersburg, Florida. No, I went to Russia to watch pickleball.

Wade Pfau 02:27
It was

Alex Murguia 02:30
fantastic. They're known for caviar and drop shots.

Wade Pfau 02:34
Harder to visit these days. Well, how about next weekend?

Alex Murguia 02:38
Next weekend, I am doing my first senior pro PPA tour tournament open open division. So I'm about to get my butt handed to me, but that's fine. That's how you learn. I've got a partner that's better than me. I mean, he's 50 plus, and so I'll see if I can tread in those waters. See how I do after the tournament. See if I'm in that range. But I'm excited. It's gonna it's gonna be interesting. It's in Cary, North Carolina. So see how that goes. I don't know where Cary, North Carolina is. Do you have you ever heard of it?

Wade Pfau 03:13
I've heard the name. Is it part of the Research Triangle or right around there? I don't know. The folks have no idea. It's about

Alex Murguia 03:20
it's about four hours from from Alexandria, Virginia. That's that much I know, but we'll see what happens, man. I'm I'm excited. I I'm not expecting to do well, but maybe I can show a little bit, and that that'll be interesting. But yeah, Wade, you're gonna lose me to the world of pickleball, and the audience will love it for it. Will love me for it? Because hey, you'll be able to spread your wings and fly. Yeah, you'll be

Wade Pfau 03:46
in those national championships before long.

Alex Murguia 03:48
We'll see. We'll see. Well, one of the teams we're playing won the whole one like an I think they won the the 2024 like national something or other. But again, you know, we're the old folks. We're in the 50 plus. One step at a

Wade Pfau 04:02
time,

Speaker 1 04:02
huh? One

Wade Pfau 04:03
step at a time.

Alex Murguia 04:04
Thank you. One step at a time. One step at a time. But have you guys started school yet? Not you, but your kids.

Wade Pfau 04:12
Yeah, yeah. For a few weeks now, actually. It's in Texas. They start in mid August when it's still on elementary schools.

Alex Murguia 04:18
I mean, like high school, junior high, that kind of yeah, all

Wade Pfau 04:21
of them,

Alex Murguia 04:22
really,

Wade Pfau 04:23
and then they get out late May. So yeah, they they

Alex Murguia 04:26
started last few weeks. My kid, my my, I have one more senior. The Virginia Tech Virginia Tech started. I want to say two weeks ago, but yeah, last week my my baby boy

Wade Pfau 04:39
started his senior. Look what you

Alex Murguia 04:41
did to my baby boy. My baby, my baby boy. He's a senior now. My wife took that final picture. You know how, you know, when they're in kindergarten, they take a picture in the porch first day of school, and they do one of those every year.

Speaker 1 04:54
Yeah, I know that.

Alex Murguia 04:56
And did you do one this year?

Wade Pfau 04:58
Yeah, yeah, we. That's more something. My wife, in particular, gets those boards for them to hold and stuff. But yeah, we do that every year.

Alex Murguia 05:05
There you go. I have a question for you. Then, please tell me you do a vision board at the start of every year. I would love for you to do a vision board. That'd be the that'd be hilarious. No, huh?

Wade Pfau 05:17
We don't do one of those.

Alex Murguia 05:19
You don't do those. You look like the type. All right, all right, right. Enough small talk, right?

Wade Pfau 05:29
Yeah, we're we're still in midst of our Q and A series, and I understand we're even going to be having a a live YouTube live coming up.

Alex Murguia 05:38
Yeah, that's right. We're gonna do YouTube live Q and A turn around tax questions, I believe, as people are doing tax prepping right now, and that'll we figured that'd be a good springboard into you know we do the retirement income challenges. I'm I'm talking like if you don't know this already, but for the benefit of our audience, we do that retirement income challenge, and we're gonna pepper that this upcoming fall with what are we calling it? Tax planning. Yeah, the

Wade Pfau 06:06
tax map. We're gonna open up that tax map for the retirement income challenge, and that will be the week of november 2. But November 2, YouTube live kind of coming up September 9 at 12 Eastern.

Alex Murguia 06:19
september 9, YouTube live. I I believe we're pitching it around tax questions, but doesn't have to be. And then that'll be a nice sort of shot across the bar for our tax challenge or whatever we call it. How's that for for marketing?

Wade Pfau 06:41
There you go. Yeah,

Alex Murguia 06:43
I missed my call. As always,

Wade Pfau 06:44
that's a great topic. And actually, we did office hours today at the academy, and we went. We did a deep dive into the tax map calculator.

Alex Murguia 06:52
Yeah, what happened? You got into it for a long time. How long was that office hours? Yeah, we started this podcast earlier.

Wade Pfau 06:57

Yeah, we started a well. I developed a case study because folks were still kind of trying to wrap their heads fully around how to do all the inputs, and then someone else presented a case study of their own, and yeah, we just worked through how to think about lifetime tax planning. Now, did they present the case on their own with you knowing they were going to present a case study? Well, it had come up in the forums before, so it was really okay. Yeah, that's nice.

Alex Murguia 07:21
No, that's one of the benefits of the you know the academy is is no, it's access to professionals, and you know we all talk through issues. I think it's great, but all right, let's get to the questions here.

Wade Pfau 07:36
Yeah, and these questions today still came from our last retirement income challenge, and so, the theme today continues to be about. I think there's an element of for folks or more income protection. Some questions related to how to think about that.

Alex Murguia 07:52
Wait, I'm gonna close it.

Wade Pfau 07:53
You fix your winter there a

Alex Murguia 07:55
little bit. It's the the the sun is glistening off my bald forehead. Too much for me to bear.

Speaker 1 08:01
All right. All

Alex Murguia 08:02
right. So the first question: single premium immediate annuities (SPAs) and fixed indexed annuities (FIAs) tend to be appropriate for the safety first quadrant of RISA. If someone has a safety first RISA already, how do you suggest that a person thinks and deals with inflation risk?

Wade Pfau 08:27
Yeah, and so the Risa, the retirement income style awareness, if retire with styles named after that, but that's the assessment tool we have to help you get that first step towards thinking about the right retirement strategy for you. And so, this person is more safety first oriented, more commitment oriented, income protection, looking to build that reliable lifetime income stream. And and so, when you have an income gap, SPAs and DAs, well, SPAs, DAs, FIAs, single premium mediated annuities, deferred income annuities, fixed index annuities with lifetime income benefits can all be options to fill that gap. Now, those annuity tools generally don't have inflation protection built into them, and so that's really the question: is well, how do you deal with inflation risk if you're using reliable income sources that don't have inflation protection? Well, step one: Social Security provides a very powerful inflation-adjusted lifetime benefit. So, usually, for a safety-first person in particular, delaying Social Security to age 70, at least for the high earner in the household, can help get more reliable lifetime inflation-adjusted income. And then beyond that, kind of. If you're truly safety first, thinking about using tips as part of the the investments, the Treasury Inflation Protected Securities, to provide that inflation

protection that you could draw from later in retirement, and then otherwise, I tend to argue that really even for safety first people, you don't necessarily need. The inflation protection built into like the the annuities that might be part of that planning. What you can do is think about level annuities that that don't increase their payments over time. We'll start with a higher payout rate, which allows you to put less money into that to get a a fixed amount of spending in those early retirement years. By putting less money into that, that leaves more in your investment portfolio, and because the payout rates on annuities are usually higher than what we think about as safe withdrawal rates from investments, that means you can use a lower withdrawal rate from those remaining investments to meet your overall spending goal, and that's a very powerful way to help manage sequence of returns risk and to lay that foundation for your other non-annuity investment assets to grow over time, and as a part of that growth, if you can, you can think about that as providing the potential for the inflation adjustments. Now, there's a risk element to that, but it's easier for investments to help support inflation over time as needed if you're using a lower distribution rate from those investments, so that's really how I think about it. Tips to the extent that you want true inflation protection, delaying social security, and then just laying that foundation to put less pressure on the diversified investment portfolio to make it easier for that portfolio to support any inflation needs over time now, and also it's the case a lot of times people spending doesn't fully grow with inflation over time. Social Security may cover that. There's that David Blanchett's retirement spending smile that inflation adjusted spending tends to decrease with age until potentially late in life due to long term care expenses and so forth, and and so you might find if you have reliable income that doesn't fully keep pace with inflation, it might still be adequate. If it's not adequate, you might then also layer in additional reliable income purchases over time as well.

Alex Murguia 11:54
Okay, I was listening to this, and I've got another question for you that has to do with this one because I um when reading this question, he sets it. He sets it up by saying, you know, Spias and Spias and FIA's are in the safety first quadrant, and then if someone has a safety first Risa, in my head I was already thinking he was going to say, you know, my Risa is a safety first. My resa's, you know, in that in that income protection bracket, I already have in quadrant. I already have these things. I don't need more. You know, I thought it was going in that direction, and your my answer would have been thinking that because some people may be asking if you're already in the income protection quadrant from doing the resa, that doesn't mean you should. If you already and you already have annuities and things like that, that doesn't mean you need more. It's just kind of sailing, telling you you probably have these annuities because this is your quadrant and that's what you pulled for. You know that that kind of thing. We get those questions all the time. But the other piece, Wade, as I read the second part of the question-it's almost like two two points in one-is how do you suggest this type of person thinks about and deals with inflation risk? And this is with regards to having an annuity. The question I was that was floating around in my head is what we get a lot of times when someone says, "Hey, is there an annuity that adjusts for inflation, and the answer is no, there isn't. But because you you just can't price them accordingly, because if you had to like create an annuity that tracks inflation, then think about the the range of potential returns that that an insurance company would have to lock in. The only way they can do that is by charging you such a premium that you know the only way they can de-risk that bet is to charge you such a premium that it wouldn't make sense, so they they stop doing it. But there are plenty of annuities that have, if you will, a cost of living adjustment. And you know, what are your thoughts on that? You know, if someone's in that in that income protection, and they're worried about inflation, sure, a cost of living adjustment does

not match inflation point for point, but it really does rhyme really well, in in my opinion. But again, what do you think about that? Am I off or

Wade Pfau 14:21
yeah? So they're right. There's no CPI adjusted annuities anymore, but you can get cost of living adjustments. So running the numbers on that, I tend to think it's not necessary because those are just actuarial calculation adjustments. You get less income at the beginning because it's going to step up over time. It actually does backload longevity credits a little bit since you're really backloading the receipt of those payments to times when you have a lower probability to still be living. Right,

Alex Murguia 14:48
they give you less. They give you less at the beginning because they expect to give you more. So they they kind of they smooth it out by doing that, right? Backloading it then.

Wade Pfau 14:56
Yeah, and so that kind of gets back to my answer of. What I tend to see doing the simulations just put less money in it today, so that because you get a higher initial payout that's level and not going to get a cost of living adjustment, and that will make it easier for your investments outside of the annuity. Yeah, because if you pay less money, then you have more to. I got you. Okay, fair enough. Next question. I'm risk wrap and would still be inclined. Oh, sorry, I skipped one. What investments do you suggest to use for building a social security delay bridge or covering other short term income gaps? Well, your your basic options for this cash tips like a tips ladder, Treasury Inflation Protected Securities. If you want the inflation adjustments, a traditional bond ladder. If and you may not necessarily need those inflation adjustments if you're just talking about a few years short term. It's not going to be enough time for inflation to really pummel your those assets too much. But tips or traditional bonds, a period certain income annuity that doesn't pay for life; it just pays for a fixed period of time, and also reverse mortgages have been talked about in this context. Having that home equity conversion mortgage line of credit to tap into could provide a resource to support the delay of Social Security, because it's an important point. If you're delaying Social Security and you're already retired, you don't just you you're going to spend more of your assets in those early years, but you don't want to just use a higher withdrawal rate from the diversified portfolio. You really want to layer in a reliable income bridge to cover the missing Social Security benefits, so that you're not creating more sequence of returns risk for yourself, and in terms of which option do you pick at the what I just said the cash tips, traditional bonds in terms of a bond ladder, period certain annuity, or even a reverse mortgage. It's really just a matter of looking at the pricing of different options and see what's the most cost effective way of building that ladder at any particular time.

Alex Murguia 17:05
Mention taking no, you did. But everything as an investment, I was going to say a distribution from a portfolio, but that's what you're doing with the bond ladder. It technically is part of your portfolio, anyways.

Wade Pfau 17:15
You you and but you're carving it out so that you're not increasing sequence of returns risk. Like if I'm delaying Social Security, I don't want to. That may allow me to use a 3% withdrawal rate after age 70, but it might require just an 8% withdrawal rate now, and that would add more

sequence risk. So what you want to do is carve out of the portfolio a reliable income stream, matching the the social security benefit that you're not getting yet, and then you can get back down to a lower withdrawal rate on the diversified portfolio outside of that to help manage that sequence of returns risk in retirement.

Alex Murguia 17:55
Gotcha. Okay.

Briana Corbin 18:00
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Alex Murguia 18:24
Next question. I'm one second here. Let me just get the cursor right. I'm a risk wrap. I'm a risk wrapper. Now I'm a risk wrap and would still be inclined to use Aspia for essential expenses, leaving the assets for discretionary expenses in a portfolio benefiting from the market. Does this sound okay? Let me just start, and I'll let you. It sounds perfectly reasonable. I mean, listen, the RISA, the Retirement Income Style Awareness, it's meant as a starting point for where your preferences are, but this isn't a hard science. Yeah, there's a lot of numbers behind it, and we ran studies, you know, repeatedly, and they're they're very consistent about it. But still, this isn't like thermal dynamics where you have an input going in and there's the same output going out. You know that that kind of thing, and so it's it's perfectly fine if if you feel comfortable with that. There's I have no issues with it, you know, because every every strategy is is quite viable. So to the degree that you feel yourself being able to stick with it, that's really what's as important to me than that than the strategy in and of itself.

Wade Pfau 19:40
Yeah, yeah, and so kind of, I guess the issue why the question was asked, we usually would label Espia as part of the income protection and risk wrap. The idea is you might look more at like a variable annuity with a living benefit to have more upside growth potential inside the annuity, but we do also talk about how risk wrap is more of. Behavioral version of income protection, yeah. Just like time segmentation is a behavioral version of total returns investing, and and the efficient frontier for retirement income, it's like SPAs and stocks, but that's the the behavioral element of that. A lot of times, people don't like SPAs because that's that irreversible commitment. Once you pay that premium, you you can't get access to the underlying funds. You you just get that monthly check for the rest of your life, and you've got that element. And then what that tells you is you can be quite aggressive outside of of the SBIA. But then when you look at your portfolio balance, it looks rather aggressive, and so not everyone's comfortable with SBA in stocks, and so I think that's really why we've seen since the 1990s the evolution of deferred variable annuities with lifetime income benefits that let you see the underlying contract value and invest it for growth. And if markets do well, have the opportunity for step ups for income. But yeah, there's no recent police that will say risk wrap people are not allowed to use a SPIA. They have to use a variable nudity. That's not the case at all. If you're comfortable building that reliable income floor with a SPIA, that that's perfectly okay. I

Speaker 1 21:16

agree. All right. Okay. Next question is: It seems I have different points on the RISA matrix for different purposes of the funds,

Alex Murguia 21:30
such as basic lifestyle, wants, desired inheritance, etc. I am safety first on basic lifestyle and mostly total total return on the others, well, this is a. Oh, sorry, I was going to go. There's a difference between essential and discretionary expenses, and the RISA kind of focuses on essential. But go on, wait.

Wade Pfau 21:52
Well, no, I mean this question comes up a lot, but this this is what income protection is. Yeah, if your total returns, your your total returns on the basics and total returns on the other. If you're income protection, you're safety first on the essentials, and your total you you build that first build a floor of reliable income and then invest on top of that for growth with the discretionary investment portfolio. So to say, I'm safety first for basic lifestyle and mostly total return for other expenses. That's what income protection is. The difference for total returns is your total returns for everything. With income protection, you first build a floor, safety first, reliable income floor for the basics, and then you invest a diversified portfolio, i.e. quote unquote, total returns for other more discretionary goals. So there's no contradiction. It's not you're not like I'm mixing styles. I'm income protection for some expenses and total returns for other expenses. No, like what you said, if you're safety first for essentials, that's income protection, and that still includes a role for the investment portfolio, which may look more total returns just for the diverse, the the discretionary piece.

Speaker 1 23:13
Okay. And more Wade, how's that? Hmm.

Alex Murguia 23:21
Do one more. How's that? One

Wade Pfau 23:22
more.

Alex Murguia 23:24
Okay. Even if a person leads towards safety first and commitment orientation for income, if a pension and social security for both spouses already match about 85% of total spending needs, maybe annuities are not necessary. Both the pension and social security are effectively an annuity. Do you agree? Wait, I'll let you answer it. I think you know where I stand with this as well.

Wade Pfau 23:49
Yeah, you actually preemptively answered this question. Yeah, yeah, yeah. Second one, but right the the visa tells you like what makes you comfortable, but then you you need a financial plan to see what kind of action is needed. That's we use the funded ratio in the retirement income challenges, and if because of your safety first and commitment orientation, you've kind of gone through life choosing a job that gave you a nice pension, having social security. If you get to retirement with Social Security and pensions covering your expenses, being safety first or being income protection doesn't mean you have to also buy an annuity on top of that. No, we

really look at the annuity to fill income gaps. If I don't have enough reliable income from Social Security from a pension, then I can look to a commercial annuity to potentially fill that gap. But if there's no gap to fill, you're good. Yeah, you don't need an. You already did in that particular case. You've already done it, right? You've already done what you're looking to do, and so you don't need to take further action at that point.

Alex Murguia 24:59
All right. That's a good number of nuggets for people to

Wade Pfau 25:05
yeah

Alex Murguia 25:05
digest with the week. What do you think?

Wade Pfau 25:07
Yeah, these questions are relatively straightforward to answer, so we even are stopping a little early. But

Speaker 2 25:13
hey,

Wade Pfau 25:13
no need to to drag on beyond the need.

Alex Murguia 25:18
Yeah, exactly. All right, everyone. Well, thank you for joining us on this week's episode of Retire with Style. We'll catch you next week, and hopefully, I well, hopefully there'll be good outcomes for for everyone. All

Speaker 1 25:31
right.

Wade Pfau 25:33
Well, welcome back, our national champion pickleball player.

Alex Murguia 25:36
Yes, yes. All right, thanks

Wade Pfau 25:38
everyone.

Alex Murguia 25:39
Bye, everyone.

Briana Corbin 25:41
Wade and Alex are both principals of McLean Asset Management and Retirement Researcher. Both are SEC registered investment advisors located in Tyson's Virginia. The opinions

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