

Episode 247: Is the 4% Rule Still Relevant? What the Retirement Math Says

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4% rule, retirement planning, tax traps, Medicare, Social Security, QLACs, annuities, RMDs, inflation protection, asset allocation, AI impact, Roth conversion, TIPS ladder, early retirement, risk management

SPEAKERS

Wade Pfau, Alex Murguia, Briana Corbin

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. Welcome back for our next episode, where the 4% rule gets a reality check. Qlacs get their pros and cons, and nobody, including Wade, claims to know what AI will do to the market next.

Alex Murguia 00:53

Alrighty, next Wade. All right, let's get to some of these answered these live stream ones here. If a high earner working through 60s delays Medicare and Social Security to 70, what are the potential tax traps? Assume filing jointly and base income starts preferential stacking at 15% Excuse me, sorry. And N I I T applies. Thanks.

Wade Pfau 01:22

Okay, so you're delaying Social Security, so there's no Social Security torpedo tax trap. With Medicare, it's always your income applies two years later. So once you're getting to the point where you're going to be using Medicare in two years, the the Irma, the income related monthly adjustment amounts for Medicare premiums would start to apply and impact you two years later, but if you're still working and you're, it's one of those jobs that makes you eligible to not have Medicare serve as your primary payer starting at age 65. That's okay. So then the other tax traps, the big one is the whole preferential income stacking noted here, when your income starts to increase to the point where your preferential income, your long-term capital gains and qualified dividends start to get pushed from 0% into the the 15% bracket, that stacks on top of your ordinary income, and you might have been in the 12% Well, you would be in the 12% bracket or less at that point, 12% becomes 27% when you're also uniquely causing your long-term gains to get pushed from 0% to 15% and then the net investment income tax would apply to that as well. And now with this age 65 plus bonus deduction, \$6,000 per person age 65 and older, that phases out with income, so that's going to be another tax trap. That with when we're talking about this range of incomes, you're also going to see the the loss of that age 65 plus

bonus deduction. And if you were otherwise also itemizing, you may see phase outs of other deductions. Those would be the the main tax traps to be watching that for, and also if if you use the Affordable Care Act for health insurance, the loss of subsidies once you hit four, especially if you're below 400% of the federal poverty line, you want to be very careful about not going above 400% of the federal poverty line. But that's only if you're using the Affordable Care Act for health insurance, and if you're already over 400 of the federal poverty line, unavoidably, then you don't have to worry about that.

Alex Murguia 03:32

Okay. Here we go. Here we go. I would like to know your opinion. Oh, we kind of talked about a little bit, but we can touch base about a little bit more here. I would like to know your opinion on qualified longevity annuity contracts. We referred to them earlier as QLACs. Pros and cons.

Wade Pfau 03:54

So QLACs are SPAs, deferred income annuities. They're immediate annuities, but that defer payments until usually around age 80 or 85. You would get them in an IRA. That's the only place. And they're they're otherwise longevity insurance or deferred income annuities that start income at an advanced age. They were created to help manage the required minimum distribution problem around if I had to start RMDs in my early 70s, but I put all the money into a QLAC that didn't start paying by law by contract until later than the RMD start age, I would create a paradox for myself, and so QLACs were created, and and then therefore provide some tax benefit where you can delay required minimum distributions on the premium until it starts coming out as payments through the qualified longevity annuity contract. So, in terms of pros, you get that RMD benefit, which is an extra little bonus. It's a deferred income annuity that pays income late in life. So that's another pro. There's a lot of it. Mortality credits baked into that, just because the odds of living at those advanced ages are less. So you can see if if you're buying it at a young enough age, the payout rate could even be over 100. That would be probably if you're buying these in your 50s and delaying to age 85. And then another pro would just be some people use these as a way to approximate help for long-term care. Like if you're thinking, well, I don't know, probably the odds of needing long-term care support after age 85 or higher, so I'll buy a QLAC with the idea that that could help provide income for the long-term care. Long-term care expenses are tax-deductible. The QLAC is providing you ordinary income so that you're not going to waste the opportunity to itemize that long-term care expense as part of your deductible health expenses. So that's another advantage. Cons: so I think most people buy the QLACS with a cash refund provision if they don't make it to age 85, the premium becomes part of their estate that would go to their beneficiaries, but if you buy a life only Culac, I guess the con that you're thinking about is that's going to give you the highest payout rate, but then the premium would just be lost to the household if you didn't even live to the age where the payments begin. So that's a potential con. And then I usually argue, you don't need inflation protection inside of annuities, but you do have the the inflation problem with the QLAC. If this isn't going to start income until 20 years later, I know what the nominal value of that income would be, but I wouldn't know in advance what the inflation adjusted value of that income will be. So I think those are the basic pros and cons of QLAC. It's a good essay question. I feel like I'm taking a test.

Alex Murguia 06:50

Well, I mean, look, we we all are, right? It the benefit is by asking these questions, everyone can kind of use our the community knowledge here. I mean, ultimately, we're a sample of one, and

we're answering the best we can. But I, I think everyone can kind of get their pieces of wisdom here, and and even QLAC, like the the other answers. Listen, for my own personal retirement income strategy, I'm definitely have QLACS, you know, and I'm I'm in my world, I'm mixing Culex and an HSA, you know, to to create some sort of super duper health bucket, if you will. What way?

Wade Pfau 07:32

Your long term care shield,

Alex Murguia 07:35

kind of right. I I think it pairs well with an HSA, a QLAC in that sense, in terms of just efficiency of of allocation,

Wade Pfau 07:45

yeah, the QLAC would help make sure that you can benefit from itemizing those health expenses. Whereas the HSA, that's not taxable income. So you're if that's all you had, if you didn't have any taxable income, you're you're wasting that opportunity to get a tax deduction.

Alex Murguia 08:01

So let's go here. We'll do one more of these live ones, and then we'll go back up to the stored ones. Can you comment on the 4% rule as a retirement guideline? Also, can you comment in investing asset allocate? Can you comment in investing asset allocation for the next five to 10 years in the era of AI.

Wade Pfau 08:24

So, with the the 4% rule as a retirement guideline, I don't think it's the worst thing in the world. But at the same time, it has a very prescribed set of assumptions attached to it that generally don't apply in real life. There's some reasons maybe 4% is too high. There's other reasons why it would be too low. But really, if you have any degree of flexibility for your spending, it's probably going to lean much more towards the the too low side. And now with tips yields being pretty high levels from a historical perspective, you could easily. Well, the 4% rule assumes a 30-year retirement. Right now, you can build a 30-year tip ladder to get inflation-adjusted income at pretty close to a 5% payout rate versus the 4% rule, which is assuming a diversified portfolio of approximately 50 to 75% stocks in retirement. We generally don't think the 4% rule is all that useful in real life because this is about having fixed distributions from your portfolio, and most people aren't going to have that. Whether it's you're delaying social security, so you need more now, but you're going to have less need less later on, whether it's tax bills, which are not gonna be constant, inflation-adjusted taxes are gonna be jumping all over the place every year. You may have those years. Sorry,

Alex Murguia 09:51

your general expenses aren't going to be the same. Your spending cycles are not going to be the same throughout your whole retirement age. Age,

Wade Pfau 09:57

right? Right. You might want to front-load expenses to enjoy the. Google years of retirement and anticipate spending less later on. There's a whole host of reasons why we use the funded ratio at when we're talking about like retire with style and we do our retirement income challenges.

We use the funded ratio where you project different expenses and you indicate what your assets are, including not just the investment portfolio, but other sources of income like social security and pensions and things, and then we model out: Can you sustain your goals? And the 4% rule is just a very limited, not particularly useful implementation of that.

Alex Murguia 10:37

Let me try to turn this question around. Okay, the way we're answering it, like, is the 4% rule a good financial planning tactic to use for portfolio withdrawals, right, et cetera? I think the answer is not really for a whole host of reasons that they're not really practical. Because remember, the 4% means just 4% of the portfolio the first year. If that's 50,000, then that's 50,000, and every year you spend the 50,000 plus or minus inflation. Period. So that's very robotic. So that's not practical from that standpoint. Now, let me ask you this question another way: If you have a pot of money and you're wondering how much more or less you can use from that money on a yearly basis to kind of live off of, you know, direction is a 4% a good number to just kind of see, like, oh, it's looking like I can spend around 50,000 a year. I obviously I need to drill down, but directionally, that's kind of the area code.

Wade Pfau 11:35

Yeah. So if you're so far from retirement and you're just trying to figure out how much do I need for retirement, the 4% rule just means you need 25 times whatever you want to spend, because then when you take 4% of that, you get to the the spending number. So yeah, you can use that as a way to just roughly check: Are you on track? But then I've written articles about how, you know, like if over a 40-year investing horizon, it's really going to be those last few years that determine whether or not you meet any sort of traditional wealth accumulation target. So even in that perspective, the 4% rule may not be all that helpful. I talk about the safe savings rates as a different way of thinking about all that. But

Alex Murguia 12:16

Wade is where you're getting there. Wade is effectively, if you're looking at it, you're in your 30s and you're looking at it thinking, "Oh, okay, I'm on track for this, or in your 40s, I'm on track for this. The reality is, is the impact of the returns, the you know, the last five years before you retire, will have a disproportionate effect, not because of sequence risk, but because of just compounding interest of assets.

Wade Pfau 12:40

Yeah, and like a lot of the online, just investment-based retirement planning things might use higher rates of return, like eight or 12% even. But just a 7% if you're assuming a fixed 7% rate of return, that means your wealth needs to double every year, every 10 years. I'm sorry, every 10 years, which means you're only halfway to your goal 10 years before retirement, or even less than halfway if you're thinking about how you're going to be adding more savings as well. So it's very hard to narrow in on a wealth accumulation goal as you if you're like 1015, 2030, years away from retirement. So yeah, roughly you could use something like the 4% rule to get a sense of if you're on track, but it starts falling apart as soon as you start to deal with any sort of real world volatility with market returns, as well as just what I started the answer with, which is the real world volatility of you have all these different income sources, all these different kinds of expenses, fluctuating taxes. It's very hard to have a retirement plan that works taking a fixed, constant inflation-adjusted amount from the investment portfolio.

Alex Murguia 13:52

Okay.

Wade Pfau 13:53

And the rest of that question, I'll just throw at you then, Alex. It's about the what are your thoughts on investing with the era of AI in the next five to 10 years.

Alex Murguia 14:03

Okay, so just to have it clean, since we're recording this, we'll probably snip all of these. Can you comment in investing asset allocation for the next five to 10 years in the era of AI? No, we cannot. I mean, I can barely tell you what's going to happen in the next five to 10 months in that in that era of AI in terms of progress, but that's the bad news. The good news is every day there are millions and millions of investors, you know, making their predictions of what's going to happen in the market in the age of AI, and those predictions, those forecasting, those those forecasts that millions of investors are making, are based on the probabilities of things that they think will happen. And so, in aggregate, they probably represent the best path of what is going to happen from an expectation standpoint. So, you know, to some extent, it's. Will everything turn out the way people expected from a probability standpoint? No, not at all. Will there be an overbuilding of I don't know data centers like we overbuilt fiber optics in early days of the internet telecom world? Most likely, it's what happens. And as that information comes in that things are being overbuilt or underbuilt or whatever. It'll get reflected in the prices, but you know, to the degree that's you know something was caught way off guard, there'll be huge spikes up or down. But to the degree that it's happening with known expectations every day coming in, little by little by little, it'll be what it will be, you know, from that standpoint. But do we know what's going to happen in the next five to 10 years in the era of AI asset allocation? I assume that means how that's going to affect the market. There are going to be no companies left, and you know there'll be a great depression. You know that kind of thing. That's kind of. We just don't think of the world that way, Wade.

Wade Pfau 16:09

Yeah, it's really. I think we've covered that. It's just we don't know what the future is going to bring. Full stop. So

Alex Murguia 16:18

there you go.

Briana Corbin 16:21

Are you getting close to, or are you in retirement? Well, investing during retirement is a little bit different than during your working years. Your investments are there to help you pay for retirement, and now is when they need to earn their keep. To make sure you're on the right track, download Retirement Researcher's eight tips to becoming a retirement income investor by heading over to retirementresearcher.com/8tips. Again, get your copy of Retirement Researcher's Eight Tips to Becoming a Retirement Income Investor by going to retirementresearcher.com/8tips. That's the number eight tips.

Wade Pfau 17:00

So the the next question coming in live here. So I'm considering doing an implan Roth. My wife will be starting a new job and making much more. We want to contribute the full 7500 to each

Roth, as well as convert up to the top of the 22% bracket from my five 457 plan. Also, we're about 10 to 12 years away from retirement. Thanks. Okay, so on the Roth side, you just have to make sure your incomes. You, if your income exceeds certain thresholds, you can't make Roth contributions. That's where that whole discussion around backdoor Roth contributions comes into play, where you can contribute to an IRA and then, and it would be non-deductible because you're probably also over the income limits to be deductible. But then in a few days, do a Roth conversion. And if your IRA was otherwise empty, that can work without a hitch. But if you did have funds in your IRAs, then you run into that pro rata rule where you have to draw proportionally, and so that the backdoor Roth may not work because a lot of that would be taxable. Although if you're doing Roth conversions anyway, maybe that can work out fine. And then with the 457 plan, you'll just have to check every plan has different rules. I don't know if you mean going from the 457 to a Roth IRA or doing in-plan, doing a conversion from the traditional version of the 457 into the Roth version of the 457. A lot of times, it may not really be possible to take any money out of the plan in that manner while you're working there. But if you can do it inside the plan, that might work out okay for you. But yeah, otherwise, and don't necessarily-it's not the top of the 22% bracket that you want to target necessarily. It's if you want to manage a 22% effective marginal tax rate, and you have to pay. Watch out for other kind of things in the tax code. Although Social Security is probably not a problem for you, Irma, I suppose, is not a problem. Probably getting health insurance through the wife's job, I would suppose, so that the Affordable Care Act subsidies would not be an issue. But you might still want to watch out for the stack. We we already talked about this: the preferential income stacking, where when you start to push gains or qualified dividends from the 0% bracket into the 15% bracket, that adds on top of the tax rate you're paying. And with the 22% bracket, you might be running into the net investment income tax at some point. So, just managing a 22% effective marginal tax rate doesn't necessarily mean filling the 22% tax bracket. So, just be cognizant of that as well.

Alex Murguia 19:59

Okay. Here's a question that we had here listed. It's a good one. It's a meaty one as well. Okay, so this is from Zach, and I'd love to hear you expand on this framework in a possible forced early retirement Scenario. So, the bullet, the the headline for this one is long horizons and annuity efficiency for a retiree in their late 40s needing to fund a 45 plus year retirement annuity payout rates lack meaningful mortality credits. Does a tip bond ladder become the primary safety first bridge tool to to age 70, or are there other risk pooling tools you consider?

Wade Pfau 20:52

Okay, and yeah, this is a long question. Maybe we should take these chunk by chunk here. Okay, so yeah, payout rates on annuities are not going to be very high in your 40s. It's not that they don't have meaningful mortality credits. It's just they're getting amortized over a much longer time horizon because not many people are dying yet in their 50s and 60s. It's really in the mid 70s where mortality rates start to pick up, and that's where if you wait until those ages, you start seeing those payout rates grow to a more significant degree, but if your income protection, having the annuity in your late 40s or early 50s can still work out, it's just naturally going to be more expensive because you do have a very long time horizon ahead of you, and yeah, building a tips ladder would be a way to help build in that inflation protection in those years. But but ultimately, one of the characteristics of income protection is you like stable, reliable income. Whereas total returns tends to be more flexible. About if markets do well, I'll spend more. If markets do well, I'll spend less. I think it's really hard to retire at such a young age and not have

some flexibility with spending. But like you almost have to have a degree of a total returns to to at least be comfortable with the idea. My spending may fluctuate over time based on how my portfolio is doing. Just because, as this question is noting, you need a lot of savings to have a an inflation adjusted, protected, reliable lifetime income stream starting in your late 40s that could potentially last for the the next 50 to 60 years. So, well, caveat emptor just to be aware of the you're right. It could be costly, and there may not really be any way around that for the first part of the question.

Alex Murguia 22:47

Okay, so then the next headline is high baseline expenses and capital requirements. Fully funding a 20 plus year essential spending floor with tips can require a huge percentage of a portfolio. How do you advise early retirees on balancing a fully guaranteed floor against leaving enough capital in equities to combat long-term inflation and health costs?

Wade Pfau 23:11

Yeah, yeah. So this is really just continuing with what I was saying before, right? You but you can't put all your money into the floor. You do need it's first build a floor and then exposed to upside. So if it takes everything you have to build a floor, there's a misalignment with the retirement planning. There, it's folks can retire young, like the the fire community financial independence retire early, but to have that not be overly expensive. It really requires that flexibility, so that you don't feel like you need to have a full, fully reliable, guaranteed inflation-adjusted income floor to last for the rest of your life. You can have that, but that's the point. It's just very expensive. You're not able to put all your money or all your assets into that because you do need some discretionary funds as well to help manage the inflation risk and other costs that may pick up later in life. And so, if you can't build the floor that you're comfortable with and leave enough outside of that for the discretionary diversified portfolio piece, it may ultimately mean ultimately mean you're not yet at the place where you can really comfortably retire. If you can be flexible with spending, that would make it easier to comfortably retire and and not have everything built into a protected, reliable, inflation-adjusted lifetime income floor.

Alex Murguia 24:43

Okay, and then the last part is transition timing. What is a safety first approach for someone experiencing career uncertainty, such as tech industry disruption, who may need to retire unexpectedly in one to five years? I should structure short-term liquidity, parentheses cash and short-term tips, in a taxable account without prematurely locking up capital.

Wade Pfau 25:10

Yeah, so this is a tough one too because right, definitely a risk, a retirement risk is kind of forced early retirement, but the techniques to manage forced early retirement risk are not comfortable. It's like you have to oversave because you never maybe you're planning to work for another 10 years, but it's like, but if I need to be ready to retire in one year, just in case I lose my job, that may be an insurmountable amount of savings. But yeah, certainly building, I guess, to work in the direction of helping to manage this risk. I think what's being proposed here is fine. You know, just making sure you have some liquid, accessible funds in taxable accounts so that you don't have to worry about the 10% penalty because it's in a retirement account that you can't tap until 59 and a half, unless you have some qualifying exception and so forth. I think that sounds reasonable. And the other idea of it is just saving as much as you can now to be ready to deal with the risk that you suddenly are unable to work in several years. There's really not much else

beyond that to be thinking about for the most part, other than keeping your skills up to date to be able to pivot to continue to work in in some other role. Should you lose the job and find it hard to find a new position in your current field,

Alex Murguia 26:40

I wonder if this question was driven by AI fears, which is kind of the the previous question was about what's the effect on the economy if you know in the age of AI. I kind of like everything's connected. All right, since we're here, let's just continue with one more saved one here. Tax planning question: Which Roth conversion strategy is generally better for a 60-year-old? 15-year full conversion, ages 60 to 75, convert all assets into a Roth in equal amounts over 15 years within that 12% bracket. 10-year conversion. 65 to 70. Yeah,

Wade Pfau 27:24

Alex, there's so much in this question to this is a hard question. Maybe this is a good question. We're going to be doing that tax map calculator challenge in November. This is going to be hard to really read this one in advance, and there's so many moving parts. I was just reading them

Alex Murguia 27:43

cold because they've been coming in. So okay,

Wade Pfau 27:45

yeah, it's like how narrow should I make my Roth conversion window? This is probably something that would work better if we could be having some visuals to go along with

Alex Murguia 27:57

it. Let's go to the next one. Could you provide an overview of annuity safety and risk. Specifically, are annuities 100% risk-free, and what strategies exist to mitigate risk beyond the state guarantee funds? Additionally, how resilient are these safety nets if multiple large insurers fail simultaneously?

Wade Pfau 28:15

Yeah, this is the kind of how risky are annuities. So they're certainly not 100% risk-free. Nothing you can really argue that nothing's 100% risk-free. So shouldn't go that far. They they have contractual protections, but you know the insurance company can fail. So the the question writer is noting there are state guarantee funds that work differently in each state, but that can help protect policyholders up to limits. And but then the question continues: like, how resilient are those safety nets if multiple large insurers were to fail simultaneously? They may not be able to manage large, multiple large insurers failing simultaneously. But you have to think about like insurance companies are mostly holding fixed income portfolios, so for multiple insurers to fail simultaneously, we're almost talking about a scenario where so much of this is government bonds. It's like multiple, well, maybe heavily weighted in U.S. government debt, but governments are not paying their debt obligations, which is just we're talking about a massive catastrophic economic scenario at that point. Yeah, an annuity may not be able to survive that, but really, there's no financial plan investments. So the stock market would be completely decimated in these kinds of scenarios, there's not really a lot of financial risk management you can do to prepare for the kind of economic situation that would cause multiple large insurers to fail simultaneously. Now, historically, there's very few cases where annuity annuity holders were not made whole on their promise. Payments-it's only happened a couple of times historically,

and a lot of those were more connected to smaller, small companies. But generally, the large kind of mutual companies that have been around for 150 years-they're generally more stable, and they've stepped in to help with when smaller companies have gotten into trouble, so you can really only find a handful of cases in U.S. history where annuity holders have not been made whole on the the promised payments. That's not to say it could never happen in the future. And yeah, you can develop these scenarios. It could be a problem if multiple large insurers fail simultaneously. You may not be made whole on your promised annuity payments. It's how much weight to put into that. It's tough to say because your investment portfolio is not really going to survive that kind of scenario either. So I, it's just I guess the risk management here is making sure you keep up with having a garden, you know the the classic self sufficiency, because the economic system is not going to

Alex Murguia 31:07

aquaponics way aquaponics

Wade Pfau 31:10

the multiple large insurers failing is not just going to happen in isolation. This would be part of a massive catastrophic economic event.

Alex Murguia 31:21

Yeah, it goes back to the AI question, though. Really,

Wade Pfau 31:24

it does in a way.

Briana Corbin 31:28

And that's a wrap on this part of the conversation. Wade and Alex will pick right back up next episode, so make sure you're subscribed so you can catch the rest next time. 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 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.