

Episode 250: Do Annuities Actually Improve Retirement Outcomes? What the Math Says

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Annuities, Buffer assets, Total return, Replacement rate, Cape ratio, Market timing, Bond yields, Asset allocation, Sequence risk, Insurance, Longevity risk, Retirement planning, Monte Carlo, Tax planning, Income protection

SPEAKERS

Wade Pfau, Briana Corbin, Alex Murguia

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. So I hear Alex promises the YouTube live details will be in the show notes. Then wondered aloud who exactly would be putting them there. Spoiler alert: it's me. Okay, actually, it's Liz. Thanks, Liz. Meanwhile, Wade and Alex tackle buffer assets, cape ratios, and the great annuity debate. Consider them noted.

Alex Murguia 01:06

Hey everyone, welcome to Retire with Style. I'm Alex, and I'm here with my good buddy Wade, and we're continuing our Q and A's from the live session that we had at this point, maybe a month ago, on YouTube, and we'll be doing another one shortly. So pay attention to it. How you doing, Wade?

Wade Pfau 01:26

Doing good, doing good. Yeah, looking forward to answering more questions.

Alex Murguia 01:30

All right. And so, what's new since the last time we spoke?

Wade Pfau 01:36

Not a whole lot. We we do still have coming up soon the the tax planning challenge. If you want to register, there's a link for that in the show notes. It's going to be november 2 to fourth, 12 p.m. Eastern time each day. So yeah, if if you want to do that end of year tax planning, thinking about Roth conversion opportunities and or capital gains harvesting opportunities, please do join us for the tax planning challenge. And yes, as you noted, we are thinking about also doing a

YouTube live again, though probably by the time this episode airs, we would have specifics. But at this stage, we do not have specifics for that.

Alex Murguia 02:11

But we'll put it in the show notes. How's that? I'll hold you to that.

Wade Pfau 02:15

Promise. What part of we will

Alex Murguia 02:17

do that? Maybe Brianna. We'll put it in the show notes, or Matteo, or someone else, but all right, okay. So let's hit the questions.

Wade Pfau 02:24

All right,

Alex Murguia 02:26

I am total return in Risa. So they came, they took the Risa and they came out as with a total return profile. I told my advisor I wanted to discuss putting liquid or near liquid assets aside to protect against a downturn, very casually he said that was not a total return approach. Can't it be

Wade Pfau 02:49

both? Okay, yeah, interesting question. We have policing of retirement income strategies. Is using a buffer asset a total returns approach? Really, I think the buffer asset works with any of the four retirement income styles, but probably it's going to be the total returns approach where it would add the most relevance. Because with any other retirement income style, you build in some sort of mechanism to help help manage short-term volatility through a reliable income contractually protected income source, and you're leaving yourself the most exposed with total returns. So, if there's anyone who's natural a natural candidate for a buffer asset, I would think it's the the total returns approach. And in terms of are you violating the spirit of total returns if you carve out some cash to sit on the sidelines and and use as a buffer asset. I don't think you necessarily are. And actually, really, the Harold Avinsky wrote about this back in the 1980s. He he talked about the five year mantra, which is probably excessive. But the idea you'd have five years of cash sitting on the sidelines, and the way he described it as it wasn't a violation of total returns investing, it was a risk management overlay to manage the spending need for a total return strategy. Your your other assets, you still invest with a total returns approach, but you have some cash on the sidelines as backup. If there, if should ever the need arise, you want to protect your portfolio during a market downturn. So, a risk management overlay to a total returns approach, and I I think that's a pretty reasonable way to think about

Alex Murguia 04:27

it. I will say one thing. I I agree with you, but I think there's a slight there's a potential here for slight misunderstanding, and you're using the term buffer assets, right? And the moment you take this question and you say, "I told my advisor I wanted to discuss putting liquid or new liquid assets to protect against a downturn, see that phrase can go many ways. You're answering it as like, "Oh, have money set aside for a rainy day. Something happens to my roof. Something." Happens health wise, and all of a sudden, I need, you know, things right, and so I have my

buffer assets. This could this could have been conflated with stock to bond allocation or like a bond ladder, you know, something like that. And maybe they're thinking about this is where the money from the portfolio is expected to come year after year, and in that case, I would say, yeah, maybe you know, I mean, maybe she was they were explaining it, and it was time segmentation type of explanation, and so that's where the advisor was like, no, that's not really total return. That's kind of time segmentation, because I I don't think people kept the nuance when you say buffer assets. What you what what that's really intended for not like oh time segmentation buffering no,

Wade Pfau 05:45

so it could be a misunderstanding if they presented it differently to the advisor. But here it literally says

Alex Murguia 05:50

yeah yeah putting

Wade Pfau 05:51

liquid or near liquid assets aside to protect against a downturn. So that I know I know, but I know that to protect against

Alex Murguia 05:58

a downturn, I know you

Wade Pfau 06:00

you're putting a downturn maybe say that the advisor wasn't

Alex Murguia 06:03

wrong. I'm trying to kind of give him a yeah or giving that

Wade Pfau 06:06

out to the advisor. No time segmentation. You're not putting it aside. It's part of the retirement income strategy. You're earmarking it for upcoming expenses. Yeah, you're right. With the buffer asset concept, you are putting it aside, and it's just in the background. You don't really think of it as part of the portfolio, and you'll tap into it on a temporary basis to protect your portfolio at inopportune moments for

Alex Murguia 06:29

that. It's just whenever I see a downturn, I'm thinking, oh, protect from market volatility and buffer assets. I think, yeah, I guess you can protect from buffer market volatility, but it's more for protect from life kicking you in the butt, you know, with some unfortunate. It

Wade Pfau 06:42

sounds like you're thinking of an emergency fund, or that's not what a buffer asset is.

Alex Murguia 06:47

No, no, no, no. But you kind of, to me, I've always envisioned wanting to use it for that kind of stuff. But you're right; you can use it when the market goes down and just have it to draw.

Wade Pfau 06:57

Yeah, I would call that a reserve asset. That's your things not earmarked for spending that are available for spending. Yeah, yeah,

Alex Murguia 07:03

yeah. It's the spending part that I was that I was actually conflating. All right.

Wade Pfau 07:07

Yeah. So I a buffer asset for me is it's earmarked to your spending goal, your budget, your longevity and lifestyle expenses, but you're really just thinking it as something on the sidelines to help protect your portfolio from market volatility and the sequence of returns risk.

Alex Murguia 07:26

No, no, no, you're right. I was pigeonholing away too much. All right, next one episode suggestion. Here we go. What percent of what percentage of income should we really aim to replace in retirement, and is it different for singles versus couples? Why, Dr. Fowle recently mentioned take-home pay is roughly 80% of growth, but that may reflect married couples with kids. As a single person with no children, my take-home is only 54% after taxes. A 7% pension contribution, 1% one and a half percent healthcare, 5% to my 450 7b account, and point 3% to charity. So, am I really aiming to replace 54% or am I aiming, or am I missing something that makes the 80% the right target? My situation in six years, at my state's full retirement age, my pension will replace about 45% of my current pay. I plan to delay Social Security. I have 400,000 pre-tax, and I'm counting on my 450 7b to cover long-term care if needed. I'm feeling pressured to reach 80% that 80% number, and would love help sorting out how much more I actually need to save. Thanks for considering it. The only I would I would add, Wade, before you get going, is this is do a financial plan is is ultimately the answer here, the Q and do a financial plan. Right now we have the upcoming tax map tax planning challenge, but after that we will do a retirement income challenge, and that's what you need. I mean, 80% is just kind of the replacement rate that people use as a rule of thumb. But for your particular situation, do a plan. Wait.

Wade Pfau 09:17

Yeah, and this may have come up in one of the the YouTube live Q and A. I'm not a fan of the 80 replacement rate, and I'm pretty sure the context was I was saying, "Hey, yeah, you said everybody. But if you want me to say a number, there's a study that mentions an 80% replacement rate. So yeah, so I think this question came up in the context of in our YouTube live, someone had asked about replacement rates for retirement, and I'm I'm not a big fan of that 80% replacement rate. And I'm pretty sure I hedged it in in the context of, hey, there's not any one number. Everyone's going to have a different spending rate. If you really want to push me to say a number, there have been studies that indicate the average high. Household is going to replace about 80% of their pre-retirement income, but that's simply an average, and that's really the the end of the story. If this individual is determined that they're pretty comfortable living on 54% of their gross salary after all the taxes and everything, yet that that can be what they target for retirement. The only consideration is, do you want to spend more in those Google years? Like, is there are there certain things you've been dreaming to do, like the world trips and things, that will require some extra budgeting? But otherwise, yeah, if you've got a pretty good lifestyle already in place with a spending amount that's after tax 54% of your gross salary, you can plan your your longevity and lifestyle spending goals for retirement, reflecting about the

the same number. That it's just it may increase for inflation, but it's the same sort of spending number. And no, you should not feel pressured to have to spend more in retirement because the average household spends 80% of what you're comfortable spending, and if that's where you want to keep it, that's fine. Don't feel pressured to spend more than you want to by any means.

Alex Murguia 11:12

Right.

Wade Pfau 11:15

Okay, I can ask this next question. It can be one for Alex. Can you share your thoughts on the current elevated CAPE ratios and how that might influence a soon-to-be or early years retiree strategy for their safe withdrawal rate?

Alex Murguia 11:32

Sure, a couple points though. You might want to define

Wade Pfau 11:36

the CAPE ratio as part of the answer.

Alex Murguia 11:43

Oh, the. What do you mean?

Wade Pfau 11:46

Well, just if someone's not familiar with the term CAPE ratio,

Alex Murguia 11:50

I got you. All right, all right, all right. It stands for it's.

Wade Pfau 11:55

Do you know?

Alex Murguia 11:56

It's an adjusted price to earnings ratio, significant adjusted year year price to earnings ratio. I usually I just have Shiller's name on it, so I don't even think of it like that. It came up with, you know, Shiller came up with it, and he's ultimately asking how expensive are stocks compared with you know earnings that companies have generated over a full economic cycle, and sort of usually it's like a 10-year cycle that that folks are looking at. So it's like the current stock market price plus the average real earnings over the past 10 years, and so it's one of these proxies for valuations that you start hearing about. All right, and so effectively, right now the ratio is in the 40s, low 40s, as of this one. What we looked at it right before, what 41 or something like that. Wait,

Wade Pfau 12:46

41.4, and the highest it's ever been was in very late, right at the end of 1999. It was about year, yeah,

Alex Murguia 12:52

yeah, yeah. So there's a couple things right now. Okay, it's 41.4. There's this AI craze. It was let's say 41, you know, right before you know during the internet during the last year or so of the internet bubble. So guess what? Let's get out right. And so right off the bat, I would not I would not look at this as a market time tool. I think Shelley would tell you the same thing. I know Finca is a huge fan of it, you know, but mostly from the standpoint of what are overall asset allocations that you're looking at for the next 10 to 15 years in terms of expected market returns. Now, does a cap ratio do a good job of kind of being able to forecast somewhat where what the stock returns are over the next 10 to 15 years, you know, within a range, yeah, does a reasonably good job within that standpoint. The same way that the best predictor of long-term bond returns are, you know, just look at the 10-year yield and and there you have just

Wade Pfau 13:54

a note on that point. Shiller published his first article on this in 1998, and at that point in the historical data, it did a really good job of predicting stock returns over the next 10 years, but to some extent, that's when the whole relationship broke down because since the mid 1990s, it's been overvalued in terms of being above its historical averages. That's that's how you're going to get very briefly during the 2008 financial crisis, but otherwise, yeah. And

Alex Murguia 14:21

once people see it, then it's known, and then it becomes you know more and more kind of accepted. I mean, Bob would always make a good point, you know, even about rising PE ratios, because you can take the cap ratio. Cape ratio is just like another valuation metric, so it's sort of more sensitive tool than you know generalized PE ratios and things like that. You know, you can argue, but it's not like they go from a PE absent a 911 crash or you know you know event or something like that. The PE of a market doesn't go from like 15 to 30. You know these wild moves up or you know downward. You know it's it's kind of over time. You know chits are being made and. The same thing is happening right now with the markets. Yeah, it's high, but it's not like surprisingly high from one day to the next. You know, everyone knew what it was yesterday. They more or less know what it's going to be tomorrow, and they're still here at the party. You know, kind of thing. So from that vantage point, I I do think it does signal, but there's a lot of false positives behind it that I wouldn't make it into an immediate market timing tool from that perspective. Now, a couple of differences since we brought up the whole 41 is at that time though in '01 the rates were significantly less than what they are now. So the rates for bonds and things like that. So if you're thinking about this, not from a market timing investment standpoint. If you're thinking about this, in my estimation, as an investor that's getting ready for retirement or in retirement, or you know, thinking about those things, then what I would look at would be sequence of returns risk, and you know, because that's important over the next, let's say, 10 to 15 years as you retire. You know, what am I going to get in the first swing of what what sort of batch of returns am I getting there? And you could make the case that yeah, the cape ratio is pointing to something that says you know what got us here won't get us there because the situation is somewhat different. But the the real good news is that right now? If you're thinking about it from a retirement income perspective, Wade, you said it the other day, but bonds are the the yields on bonds are quite healthy from the standpoint of being able to lock in sustainable rates in manners that you haven't before. And so, is it reasonable to have a healthier? Let me say, for lack of a better word, a healthier bond allocation right now than previously because of the elevated cape ratio compounded with the high yields that you could be getting from real, it seems you know good government instruments. I would say that that it becomes interesting. So, the danger of the the cape ratio being high from a sustainable

withdrawal rate is, I think, mitigated, you know, in a significant manner because the due to the where the yields are right now. And so, to that extent, is it a perfect wash in terms of that? No, probably not. But again, if you're a retiree, you know the you don't you know if you can make the case that okay maybe equity turns equity returns aren't going to be as healthy as they were during the last decade or so or since COVID, you know. But again, juxtapose that with the yields on bonds are quite attractive, so from a sustainable withdrawal rate, you can you can withdraw much more right now than you could five years ago from a balanced portfolio because of the strength of the of the yield curve right now. Wait, if

Briana Corbin 17:55

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Wade Pfau 18:19

Yeah, tips yields over 3% real could go a long way for you, but right. And I'm answering with the context of retirement income. Yeah, you don't want to use it as any kind of market timing because, like as we noted, this would have meant you'd have a lower allocation to stocks basically since the mid 1990s, and you would have missed out on a lot of return opportunities, but yeah, if you do want to think this, you might want to assume more conservative rates of return. The whole logic around what we do with like the funded ratio and everything, anyway, and yeah, in that regard, tips yields are quite attractive right now. That that could help support a higher withdrawal rate if you have a decent allocation to tips as well, no matter what the stock market ends up doing. But yeah, I mean, Shiller's cape ratio is high. Does that mean there's going to be a market downturn? Nobody knows. You would have been forecasting that to happen for a long time now, and hasn't happened yet. That's not to say it wouldn't happen in the future, but that's kind of the issue with Cape. It's concerning that it's so high, but there's not a lot of actionable information coming. I

Alex Murguia 19:27

just, I just wouldn't look. It's it's one of these things. The Cape is high, so I'm going to lower my safe withdrawal rate. I wouldn't think of it like that because your safe withdrawal rate is never going to be 8% anyways, or some crazy high number. It'll be let's just say four plus or minus, just to keep the conversation going. So that's actually good news in itself. I I would say okay, the cape is high, so let's just make sure the retirement plan isn't unnecessarily dependent on strong equity terms during the first decade. I think that's a better. Way of saying it, and we would make that recommendation regardless of where the cape ratio is right now. I think your

Wade Pfau 20:07

retirement income style-you're not comfortable relying on market returns. Well, you might be more concerned about cape, and that might speak more to well, yeah, let's lock in some reliable income that does not rely on on the stock market to do well, and that's

Alex Murguia 20:21

where you're actually quite fortunate right now because the rates that you're seeing right now

Wade Pfau 20:27

are high,

Alex Murguia 20:28

are quite high relative to what you've had the last I don't know seven years, right?

Wade Pfau 20:35

Yeah, tip yields they were negative for a while, and now they're well over like 3% That's a pretty strong real rate of return to lock in for retirement. So

Alex Murguia 20:43

even writers coming off of annuity, you know, I mean, there's there there's again to make your safe withdrawal rate to get that number. All I see it as you don't have to be that dependent on the stock market. So plan on not being that dependent on the stock market. There it is, way. That's my answer.

Wade Pfau 21:02

Fair enough.

Alex Murguia 21:05

All right. What else you got? All right. Just to get me going, did we do number three? Yes, we did. Yeah, that was. Yeah, we're at

Wade Pfau 21:15

number five now.

Alex Murguia 21:17

All right. In the recent episode, oh, this is another one. Okay, this blends well with the next one because it's

Wade Pfau 21:23

another rule of thumb

Alex Murguia 21:24

one. Yeah, yeah, yeah. This is a good one. In recent podcast episodes, you argue that annuities are not investments; they are insurance. But in earlier episodes, you have framed annuities or protection as an asset class, which kind of makes them sound like an investment. Could you explain a little more why it is wrong to think of an annuity as an investment while thinking of protection as an asset class is valid?

Wade Pfau 21:52

Okay. Yeah, and and thank you for asking the question so nicely. This is actually seems like one of the more controversial topics we've had with very rigorous debates at the comment sections on YouTube, and one person was absolutely apocalyptic about this whole thing. So this is not a hill.

Alex Murguia 22:12

Me or you, because we both say this. So who is the culprit? Me or you?

Wade Pfau 22:16

No, no. Well, I'm the one who says that you should think of annuities. I said it too

Alex Murguia 22:20

like that. That's why I was like, "Who got busted? Yeah,

Wade Pfau 22:25

I think this was targeted at me. Although maybe you're guilty as well. I'm not sure, but it's not a hill I'm willing to die on. Like this is not. Yeah, and we mean

Alex Murguia 22:34

it in a different man. We kind of mean it tongue and cheeky kind of thing. But go on.

Wade Pfau 22:38

Well, well, the thing. So why do I say you should think of annuities as insurance and not as investments? Let's start there, and then we can add some more nuance and context. Because I, yeah, what this individual is asking is a fair point. So, annuities are insurance contracts, and I usually like to think about annuities for their lifetime income provisions. Now you don't. That's part of the answer about where we're going a different direction. Is you may not use them for lifetime income, so then it's a whole different ball game. But if you're using an annuity for lifetime income, it's insurance against outliving your assets, and it has this property. It has a rate of return, but you don't know what the return will be until you know how long you live. The longer you live, the more payments you'll get from the annuity, and the higher the internal rate of return on your premium. You get more cash flows out of it, more investment returns out of it. But then it's a return that's hedged to what you need. If you end up living a long time, you need more money to fund your retirement. The annuity gives you a higher return in those scenarios, if you don't live very long, you did not have as expensive a retirement to fund. The annuity would give you a lower return because you're getting less cash flows out of it, but you didn't need a higher return. So it's really giving you a return linked to what you need for your retirement. But as soon as you start talking about it that way, that's where I think people kind of they get into the mindset of, oh well, what if I don't live long enough to get a high return out of my annuity? Then that's where I like to put on the brakes and say, no, no, don't think about these returns. Just it's insurance against outliving your assets. Frame it as it is insurance. It's an insurance contract through an insurance company, but frame it that way to just think about is protecting against longevity risk. It's protecting against the risk of outliving your assets, and that's the case for why I say call it insurance rather than investments. Is it fair

Alex Murguia 24:34

to say it's an investment with insurance wrappers?

Wade Pfau 24:38

Well, that's okay. Then we have to get into the yeah the broader discussion is well. Then there's many types of annuities, and these days there's a lot of annuities you're not using for lifetime income. Okay, then you can call it an investment. I

Alex Murguia 24:52

well, I I didn't mean it to bring up something. I meant it more like yes, it has an expected return, but that expected return. Is always going to be muted to pay for the insurance benefit

that you get for it, and so when you compare the S and p5 100 to I don't know an annuity, and then just look at the return and say, well, that's higher than this. This is a crappy investment. That's not the case because you're not seeing the benefit that it you're not taking into consideration the benefit that it provided on the insurance side, which is the main reason you got the annuity to begin with, because it was just investment for investment. You you just would have bought and bought the S and p5 100.

Wade Pfau 25:37

Yeah, and then on the on the investment side, think of the annuity more as a bond alternative rather than a stock alternative, and that's the whole. So, getting into protection as an asset class, which is a phrase I've used in some articles. Well, part of that you could say from a lifetime income perspective, the annuities working a lot better than bonds. So, the efficient frontier for retirement income is stocks and annuities instead of stocks and bonds, and that's kind of the protection as an asset class from the lifetime income. But the other angle on that too is just looking at on an after-tax basis because that's where taxable bonds every year you're paying taxes on interest, whereas non-qualified annuities give you the the tax deferral until you take distributions, so with tax deferral, there's a lot of like fixed annuities, whether it's a fixed index annuity or a multi-year guaranteed annuity, that can give you higher yields relative to bonds, especially on an after-tax basis. So that other element of protection as an asset class is thinking of this in in an investing framework, it still may be the case that it's like stocks and annuities instead of stocks and bonds, or at least annuities become an option in the fixed income part of the portfolio, where you're looking for which fixed income option is going to give me the best after tax return. So yeah, don't don't have the annuity compete against the stock market because that's not the point, and and I know that sometimes fixed index annuities the the marketing literature kind of goes in the wrong direction and makes it sound like you get the upside of the stock market without the risk, which is not true at all. You really have to think about it as is it going to do a better job than other bond options? Not is it going to do a better job than the stock market. So again, you're back to stocks and annuities instead of stocks and bonds. But yeah, with that whole kind of discussion, I guess yeah, you can think about it as an investment. I'm not going to argue against that. It's really more just about classifying what you want to call it. It's just I lean back to when used for lifetime income, I think it's helpful to think about it as insurance. If you are using it as an investment, then yeah, I think it's fine to to talk about it as an investment, and and that's a different use case than I'm usually just defaulting to, which is using the annuity for lifetime income.

Alex Murguia 28:00

Okay, my parting thoughts would be i I think this question arises because a lot of advisors sell annuities as investments, and a lot of RIAs, you know, that don't do annuities, sell investments, you know, against annuities as a better just outright return option when it's like a equity mutual fund and stuff like that, and so that's where we say quickly, hey, an annuity is not an investment, because when we say it, we we in our heads we're thinking when it's pitched against the stock market, some sort of stock market vehicle, if you will, and that's where that comparison is not the right one because this for the same reason you wouldn't compare a 10-year government bond to the S and p5 100 and say that's a crappy investment. It's just it serves different purposes, and I think the purposes of annuities is very different than an equity oriented investment. Now that being said, gun to my head, you say what's an asset class? You know, an asset class is is a is a you know collection of you know similarly styled vehicles, if you will, that have an expected investment return over the long term, right? That's why I don't think

collectibles, if you will, are an asset class, you know, from a portfolio doesn't really have an expected long term expected return, doesn't produce anything, doesn't do anything like that. Bonds do. There's a contract to give you a yield. Stock market does. Stocks do because they produce earnings and they give a derivative share of earnings to their holders, right? Or they reinvested into their company and the shares appreciate accordingly. Annuities do weight in the sense of it's a contract and there is an expected return over the long term within that. So, in that sense, yes, it's an asset class. You got us. Although you know, congratulations. No, I call

Wade Pfau 29:52

it. No, that's so. The question I just put asset class in quotes, and I usually put it in quotes too, like a fixed index annuity. It's so it's not purely an asset class because its returns are derived from the performance of the stock market index it's linked to, but it does have characteristics of an asset class in the sense that it's providing like if it's just an FIA with a cap, you're going to get returns between zero and the cap each year. Unlike bonds, you don't have the interest rate risk whether there could be a capital market loss if interest rates go up, so it's providing you a different kind of return experience, and that's where you can kind of think about it. Think about it as taking in the back door. Yeah, so it's like asset class in quotation marks rather than straight up. Yeah, asset class. I

Alex Murguia 30:39

just want to make sure that the person writing this doesn't think that I understand. Let me say, the person writing this understands that when we say it's not an investment, we mean it like not an investment comparable to like an equity only piece because it's just it's serving different function. It has different layers of cost that are related to its insurance component. That's all.

Wade Pfau 31:05

Okay, so yeah, this is not a hill I'm willing to die on. Yeah,

Alex Murguia 31:07

yeah, yeah. Do

Wade Pfau 31:08

you want to think about your annuities as investments? Yeah,

Alex Murguia 31:10

knock yourself out.

Wade Pfau 31:11

Knock yourself out.

Alex Murguia 31:12

You have talked about the benefit of annuities. When I try moving bonds to annuities in a Monte Carlo model, it lowers my odds of success. It also lowers my terminal value at every market scenario. I should mention my probability of success is high with or without an annuity, but this finding has made me question whether I should buy an annuity.

Wade Pfau 31:36

Okay, so this is not usually the finding I have when I'm looking at annuities with with plans with and without annuities, I usually find they would increase the probability of success. But let's I guess we have to walk through possible reasons why you might get a different result. One is what are the capital market assumptions of the planning software? If it's really optimistic about market returns, it is possible that the annuity cannot keep up with your optimistic market return assumptions inside the planning software, so that could reduce the probability of success. What's the planning age if you're only running the plan, say through age 85? That may be a not not enough time for the annuity to shine. I'm usually thinking people planning into their 90s, either 95 or even 100, and by then the annuity has a lot more opportunity to improve outcomes for the financial plan. So it may just be maybe optimistic return assumptions and only running through age 85 could be an explanation for this finding. I also think it's really important that you're allocating from bonds to the annuity. If you're selling stocks to purchase the annuity, that could lead to a lower probability of success and lower terminal wealth values. It's not usually a finding I see, but it'd be possible because I'm usually selling bonds to buy the annuity rather than selling stocks to buy the annuity. The other consideration is noting the probability of success is high with or without the annuity. Maybe we're not even talking about a material difference because every time you run Monte Carlo, you get slightly different results. If it was you got 97% without the annuity and 95% with the annuity, that might not even be an actual real difference. Maybe if you reran it again, you get 95% without the annuity, 97% with the annuity. So it's not clear if it's just a small difference that it's really a meaningful difference. And then don't forget the probability of success and the magnitude of shortfall idea. If you do run out of money, the annuity would still pay what it promises to meet part of the spending goal. So even if I usually would find the success rate increases as well, but even if the success rate drops slightly, maybe it's still worthwhile because when there is failure, it's not as significant because you still have that annuity income coming into the plan, and well, that would be the the main considerations I have. Again, I'm usually thinking, you know, reason. Well, the capital markets closer to like historical average numbers guiding the simulations with returns and volatility planning through age 95 or possibly 100, drawing from bonds to purchase the annuity, and in those kind of scenarios, usually I would find a partial annuity plan compared to investments only would lead to a higher probability of success, less shortfalls when failure does happen, and larger legacies as well. So, so this I what I've just outlined were reasons why you might possibly find a different conclusion.

Alex Murguia 34:54

I no, I I agree with that 100% I'm also just thinking. I'm not sure whether a positive Monte Carlo outcome or a somewhat muted Monte Carlo outcome is the reason that person should get an annuity or not. But rather, is that that is that embedded in that person's style? Because let's say this person was total return. You know, I'd be interested to know: Is why do you think you need an annuity? Is it because it's just another arrow that's floating around in the quiver, and hey, I should implement it, or is it the other way around? Is this person income protection, and it just has access to a Monte Carlo type of planning tool, isn't aware of a funded ratio, and doesn't see the benefits of what an annuity can add, you know, for a income protection person within a retirement income plan. Like I, that's where my mind went.

Wade Pfau 35:50

And one more related point that I just thought of-it's kind of related to the the stock market idea. But usually, I'm running cases where people have a more mixed asset allocation, so maybe 60% stocks, 40% bonds, so that they have room to purchase the annuity through the bond side.

If you're like 100% stocks in retirement, that means you're going to have to sell stocks to buy the annuity. And so, yeah, I could see how that might lead to lower legacy balances. It's to get the higher legacy balances. It really, it the whole idea is bonds are very inefficient for funding retirement expenses. It's we talked about this earlier. The efficient frontier for retirement income is stocks and annuities instead of stocks and bonds. So that's why I usually see those improved outcomes if you allocate from bonds to an annuity. But if you're if you are forced to allocate from stocks to the annuity, you might not see higher legacy balances for the plan.

Alex Murguia 36:45

Yeah, but yeah, the reason you would get an annuity is not for that to begin with. It's to get the income. Yeah, it's to make sure you have a steady stream of income and et cetera, et cetera.

Wade Pfau 36:56

So you're saying annuities are for insurance instead of as an investment.

Alex Murguia 37:00

Aha, aha! I'm not. I know nothing. That's gonna be used because that's gonna be used in every in every heat in every soundbite. But yeah, yeah, yeah, we're good. We're good.

Wade Pfau 37:16

All right.

Alex Murguia 37:17

Anything else?

Wade Pfau 37:18

No, that brings us to the conclusion. So we are getting closer now to our tax planning challenge starting november 2. Hope you'll join us for that. The link to register for that is in the show notes. And yeah, you should probably check the show notes as well for our next YouTube live session, which may or may not be quite soon related to when this episode appears.

Alex Murguia 37:39

Yep, we should have known that before we started this, but everyone let us know. All right, all right, everyone, thank you for joining.

Wade Pfau 37:48

Yep, thanks. Catch you next time on Retire with Style.

Alex Murguia 37:51

Bye.

Briana Corbin 37:53

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

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