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Voiceover (00:00)

Welcome to The Breakthrough Advisor™ Podcast. In this podcast, we inspire advisors with ideas and pathways to break through barriers and build a thriving retirement income business. We will interview innovative technology developers, business leaders, and successful advisors, then help you organize and execute these ideas to move your business forward.

Jack Martin (00:34)

Hey folks, welcome to The Breakthrough Advisor™ podcast. My name is Jack Martin. I serve as the virtual CMO for InsurMark and lead advisor group, one of the top growth consultancy firms in the United States today focused on financial services and helping them grow organically in a 21st century way. So today we've got Wade Pfau, Dr. Wade Pfau joining us, whose expertise in annuities and retirement income

Most of you know, and so we wouldn't take this opportunity to catch up with him and see what's new on his radar. Wade, welcome to The Breakthrough Advisor™ podcast.

Wade Pfau (01:12)

Thanks, Jack. It's great to be back.

Jack Martin (01:15)

So I know you've been super busy, know, travels conferences, so on and so forth. With respect to annuities, what are you seeing, hearing, you know, in terms of innovation development out there? What should be on our advisors radar?

Wade Pfau (01:31)

sure. Yeah. mean, recently the work I've done in annuities has focused more on the different structured annuities out there, whether you've got the fixed index annuities, you've got the registered index linked annuities and all the different ways of structuring those returns and looking at a lot of new approaches, not just the traditional buffer annuity, but also something I've heard it called like a dual step up where even if you have a negative return down to the level of the buffer,

you get a fixed positive return in those scenarios. And so in the type of modeling I do, this has really interesting implications for an asset allocation for a portfolio. Even if you disregard the traditional idea, you use annuities for annuitization or for a lifetime income through a living benefit. Even if that's not a feature, if it's really used more as a tax -deferred accumulation tool, how different types of structured annuities can really have a positive impact when included

primarily as a fixed income alternative in an investment portfolio. You may even be able to lower the stock allocation a little bit, but really drawing from bonds using the structured returns of an annuity has that potential for a higher expected return and less volatility than you'd be getting with just using traditional fixed income bonds as part of the asset allocation.

Jack Martin (02:53)

from our asset allocation modern portfolio theory, just to kind of catch our audience up a little bit on the fundamental notion there that annuities are a replacement for bonds and income annuity can be absolutely a replacement for bonds from an asset allocation perspective when someone enters retirement. Do I have that about right?

Wade Pfau (03:15)

Yeah, yeah, with modern portfolio theory, of course, just diversification, using different asset classes, seeking the highest risk -adjusted returns, the idea of the efficient frontier that looks at all the different trade -offs between return and risk with the idea if you want a higher expected return, you accept more risk. But as you add more asset classes, the ability to extend that frontier. And when I first started looking at annuities, structured annuities, just

in that accumulation portfolio, I was a little skeptical at first just because I've always thought about using annuities for the lifetime income protections. And of course, any annuity contract you can annuitize if you wish. It's not done commonly. moving away from that sort of perspective to just how does that structured return offered through different types of annuities impact allocations with an accumulation mindset with trying to grow that pot of assets?

Well, even it doesn't necessarily impact the upside negatively when used as a bond replacement. But on the downside, getting that protection, we know bonds are risky. We saw in 2022, the double digit losses on different bond funds. Having that protection through the structured annuity can really help individuals in those, especially in those five to 10 years before retirement to help manage the downside risks so that they don't experience a significant loss.

with market volatility in those pivotal years before retiring.

Jack Martin (04:43)

So the concept there is swap out bonds for the annuities and keep the stock allocation the same, right?

Wade Pfau (04:52)

Mm -hmm. Yeah, at fundamental level. And you can vary that. mean, because you have more risk capacity with that protection, you could even increase the overall allocation of stocks. I don't usually include that point in the analysis. But yeah, you can keep the amount of stocks the same. There could even be some grounds to reduce the stock allocation slightly because the risk -adjusted returns on the annuities are so much stronger typically than bonds that you still get the growth potential to.

You don't need to be as aggressively invested on the stock side. But yeah, you have more flexibility when you include structured annuities into the allocation mix.

Jack Martin (05:30)

Well said, well said.

It is, there was literally an article I looked at either late yesterday or this morning that was talking about new research, our boomers and Gen Z, Gen X more at risk, you know, from a retirement income perspective than other generations. Okay. So, so there's been a little bit of this conversation about, know, do our, our, our pre -retirees and retirees facing retirement income problem or retirement income crisis. So what's your point of view?

What's the magnitude of the problem we're looking at there and you're from where you said?

Wade Pfau (06:09)

Well, I don't like the term crisis too much because that can really discourage people. you start saying that you're never going to have enough to retire, they may not even bother to try saving for retirement. They just assume they're going to either work forever or die before getting to retirement. It kind of can really create a negative perception about how to prepare for retirement. But certainly there's a problem. And we've seen this evolution, kind of the history of retirement.

People didn't retire going back to the agrarian era or the 19th century, early 20th century. People didn't have long retirements. They work until the last couple of years of their lives where then their family may take care of them. Then we transitioned to especially post World War II. People could enjoy potentially a 10 or 15 year retirement. And they had to find benefit pensions where they didn't, the employer was taking risk with respect to longevity.

and markets and people based on the length of their career and so forth. There was a formula that calculated the pension they'd get for the rest of their life. Then we had this transition to the defined contribution pension where there's no guidance and people are left on their own to decide how much to save. They're not required to contribute to their 401k plan, for instance, but when they do contribute, then they have to figure out an asset allocation.

And all the menu of options typically focuses on accumulation so that when they get to retirement, they don't necessarily know how much to spend from that portfolio. I've seen statistics that only about 10 % of DC plans at this point have some sort of guaranteed retirement income option included. So most people don't even have access to such an option if they wanted it. They're kind of left to their own devices and they have to manage longevity risk and they may not live 30 or 40 years in retirement.

They have to manage market volatility. They have to manage how much can I sustainably spend and figure out how to answer that. So it's definitely a problem. Now, I don't go all the way to calling it a crisis because at the end of the day, people can adapt and they may need to adapt to a lower standard of living than during their working years, but hopefully they still have social security and they still have something set aside that I think folks can manage. But the problem is

they may have to prepare for the possibility that their standard of living or the amount they can spend every year will decline after reaching retirement because they just don't have the savings and they don't have the tools or they're not able to look into the learning about the tools such as protected income sources that can help fund their retirements in a sustainable manner.

Jack Martin (08:51)

So you covered a lot there and that's an awesome summary of what's going on in the space. A couple of your colleagues have started talking about this concept called license to spend. And so as you were talking, I was thinking how, know, pre -retirement, you know, we're focused on modern portfolio theory. We get to post -retirement. Now we have a new set of risks, right? Longevity and sequence of returns.

And then we also have this bogey, which is the consumer's reaction to the uncertainty about longevity, right? So they tend to want to hunker down a little bit, even though they may have adequate resources. They may be able to, you know, from a modern portfolio theory, from a probabilistic, from a Monte Carlo perspective, you know, be able to come up with a plan that works for them. They may be able to adapt. We've learned that during pandemic, right? People adjust, they adapt. They can do all that, but still...

There's the psychological component that's really interesting about the security that people are feeling. So what does that factor in from your point of view?

Wade Pfau (10:00)

Yeah. And in the research I've done with this idea of retirement styles and looking at retirement risks and so forth, we find that traditional risk tolerance doesn't really relate to the concerns people have for retirement, which are, I'm, I'm, and this is where people risk aversion for retirement is really about, am I worried about outliving my money? am I worried about having extra resources to cover spending shots like healthcare, long -term care? And if I have high.

concerns about these types of issues, then I'm risk averse with relation to retirement. And that's where if I'm forced to spend from an investment pot, a pot of assets, I really don't feel comfortable because I'm worried about outliving my money. I'm worried about not having enough to cover a long -term care event. And so then I, I underspend there's been this idea of the retirement consumption puzzle, which is just as you were saying.

even with very conservative assumptions, it still seems like people who have assets are spending less than they could in retirement. And you mentioned the license to spend idea, David Blanchett, Michael Fincke have been writing about that. And the punchline of that was after doing the statistical analysis to control for all the different characteristics of individuals, having assets in the form of a guaranteed income stream versus an equivalent amount of assets in an investment portfolio.

help people spend twice as much from when it was in the form of an income stream than they would spend from the equivalent in an investment portfolio. So that's that idea of the license to spend, that when you have this protected lifetime income, you actually feel comfortable spending it. You don't feel this need to leave it all set aside because you have to manage these risks. You know that you'll continue to receive those payments, especially on the longevity side, even if you live to be 110.

you'll still continue to receive those payments through the risk pool. And so people do feel more comfortable spending that way.

Jack Martin (12:00)

So I think it's easier for folks like us that live in that on a daily basis to say, I feel more comfortable with it. But it's kind of a bit of a complex conversation, right? I mean, this isn't a new concept. mean, this whole mortality credits thing, know, in tontines, you know, starts in London, you know, centuries ago, right? And so it's been in the discussion flow, if you will, but it seems like

it might be such a complex subject that, unless you're willing to really push the fear, uncertainty, doubt buttons in conversations with consumers, it's hard to get that across. mean, what do you see? What do you think?

Wade Pfau (12:48)

Right. Well, in the U S there's still this perception that due to some past abuses and things that annuities are just treated as a bad word. And it's, you have to overcome that sort of hurdle to be able to have these conversations. I, I remember back in the years I was living into Japan and someone there asked me like, why in English are there these two different words, annuity and pension? I thought they mean the same thing. Why do you have two words in English or what's the difference?

And it's like, yeah, I mean, the idea of annuity is it's supposed to be a pension. And I guess the difference is just we went down this path in the US of creating tax advantages for annuities and then having them start to be treated as a tax deferral tool rather than the original purpose of providing a guaranteed stream of payments, either over a lifetime or just for a fixed period. We moved away from that and that added complications and

And that's why we now have these two different words. But if we could get back to this idea that annuities are meant to be pensions and they can allow people in defined contribution plans to have a defined benefit pension based still on their savings that they have, but at least they know they have this protected lifetime income source that they can achieve through that asset base. I think that would help get us back on the right path of being able to talk about annuities for their original purpose to provide a guaranteed stream of payments.

Jack Martin (14:14)

So I want to come back to this conversation with consumers about retirement income per second, but something you just said makes me want to take a little bit of a detour. And so the detour is to speak to those in the audience who might be listening saying, I'm skeptical about this concept of lifetime income, protected income. So as a financial advisor, you're an economist, a CFA, you're not an insurance guy. So what would you say to that wealth manager?

about where lifetime income should fit in the way he thinks about portfolios for his retiring clients.

Wade Pfau (14:52)

Yeah, when I see the criticism or the concern about annuities, it's usually two topics. One is this idea of you just can't trust the insurance company and it's going to go out of business or it's not, you're relying on them to make payments for the next 30 years, but you really can't rely on anyone to be around for the next 30 years to support those promises. That's one of the issues. The other one is just this inflation idea that annuities don't provide inflation protection and therefore they're.

They're essentially useless in the mindset of anyone who kind of feels that way. And I think reasonable responses can be made with regard to both of those concerns. It's this idea of not getting what's promised through the annuity. Of course, it's always a potential risk, but I think it does get overstated quite a bit because if you look back at US history, there's very few cases where people were not made whole on their annuity payments.

a handful and I think it gets overstated because they talk about like during the financial crisis in 2008, some of the troubles insurance companies had, but that didn't extend to the walled off assets that were supporting the annuities. Even if those companies had gone out of business, the annuities would have still been protected. So I think those concerns can get overstated, but they have to be acknowledged. Yes, nothing is a hundred percent safe. And if there's a widespread

bond default in the United States government doesn't pay its promises on bonds, that would definitely cause trouble for insurance companies. But this really, you have to get into a pretty catastrophic scenario where insurance companies are not going to be able to meet their obligations. that's where you just go ahead.

Jack Martin (16:39)

And what about, no, that's extremely well positioned. And what about the insurance question? I mean, the inflation question.

Wade Pfau (16:48)

Well, the inflation question is there I think it's always framed whenever a skeptical advisor starts thinking about annuities, it's an all or nothing thing. It's either you put 100 % of your money in the annuity or you don't put anything into the annuity. And the answer to that is no, that's not how it works. An annuity strategy is always a partial annuity strategy. Part of the funds go into the annuity, part are left into the investment portfolio. And in that regard,

The annuity is not the source of inflation protection, but what it does, it becomes the workhorse for income. In those early years, even if it's not giving you the inflation adjustments, it's covering a disproportionate amount of spending in the early years because for anyone who has a conservative spending strategies, they want a high probability that the plan would work. The payout rate on the annuity would be higher than the overall withdrawal rate. They would feel comfortable using if they were going to self -manage longevity risk.

So the annuity provides a disproportionate amount of spending. It allows the investments to be left alone and to have more opportunity to grow. It reduces sequence of returns risk for the investment portfolio because the distributions are lower early on. Now the portfolio is gonna have to cover the inflation, but it has a better opportunity to do that because of the lower distribution pressure in the early retirement years. And I've done a lot of simulations around that.

And so it's not that the annuity provides the inflation protection, but the annuity makes it easier for the other non -annuity assets to provide the inflation protection. And that's really the conclusion I've come to, that this idea that you can't consider an annuity because it won't have inflation protection. I think that's a really naive or simplified way to look at it.

Jack Martin (18:35)

Very well said. the circle back to a comment we made earlier. So this license to spend thing, one of the benefits of the protective income is it allows the consumer to invest more aggressively because their needs are being met by the income, which kind of supports the same thing you were just talking about, right? As an advisor. So I'm looking at that, you know, where I might in a normal retiree portfolio flip to a 60 40 kind of allocation.

because of the protected income stream, I might be able to look at a 65, 70, 30 kind of a split, right?

Wade Pfau (19:11)

Yeah, when you have that protected lifetime income, you have more risk capacity because your lifestyle is less vulnerable to a market downturn because you'll still have that protected income. Therefore, if you're comfortable with it, you can invest more aggressively with the rest. And that speaks to if the whole issue. So if you're very anti -annuity, you probably are pretty confident about the stock market. So of course there's risk with the stock market.

Jack Martin (19:21)

Gotcha.

Wade Pfau (19:38)

But usually investment managers believe their stocks will be able to outperform inflation, that you'll have growth and excessive inflation. And so that's where the annuity makes it easier for the stocks to do their job and to provide that growth and excessive inflation to be able to support the inflation need.

Jack Martin (19:56)

So this little bit of a conversation we've just been having about where annuities fit from an advisor perspective, in my mind, really highlights the challenges that we have as advisors in communicating the benefits of annuities to consumers. So what are you seeing? What are you hearing? Where's the innovation happening in helping us have conversations with our clients and with our prospects?

that don't totally nerd out on Monte Carlo and probabilistic simulations and that sort of thing. so where do you see the innovation today in that conversation flow?

Wade Pfau (20:33)

Well, for what I'm working to contribute to that whole conversation, it's work that I did with Alex Marghiia where we developed this idea of retirement income styles, just acknowledging there are different viable approaches to building a retirement strategy. We're agnostic, as you mentioned earlier, I don't work in the insurance world. My background is more on the investment side. So I think insurance can add a lot of value on a mathematical basis to a retirement income plan, but I've...

been around long enough to see there are plenty of folks that can never consider an annuity. They do like the investment -based approach. But for consumers out there who aren't steeped into these debates and who might run across them if they start researching retirement income and see some of the online discussions taking place about investments versus insurance for retirement income, it's hard to sort throughout that. And so with the idea of the retirement income style awareness assessment,

We try to provide a starting point for people to understand their personal psychology characteristics, preferences with regard to how they want to source their retirement income. If they come out as a total return investor, they're comfortable relying on the idea that stocks will outperform bonds and that you can rely on market growth to fund your retirement and you want to maximize flexibility for your assets. Well, we find about a third of the population leans that way.

But if you're instead, and that's where most of the consumer media is focused, it's the investment management is most closely linked to pre -retirement wealth accumulation. But we find there's plenty of people who instead, even if they're comfortable with the idea of stocks for the long run, that stocks will outperform, when it comes to their retirement, they only get one chance to have a successful retirement and they...

don't want to have to rely on market growth to fund their basic expenses and retirement. They really prefer some sort of contractual guarantee to be behind the assets funding their basic expenses. And they're comfortable committing to something to solve their lifetime need, take it off their to -do list, not have to worry about it. And so people who are then income protection, when they see the report based on the way they answered the questions, it will have statements that align with that.

that I value having a stream of reliable income, even if it did mean not maximizing growth potential for my assets. I don't want to take market risk with the assets meant to cover my basic expenses and retirement. I'm comfortable committing to something even if it means having less flexibility for those assets, because I know that will help to support the lifetime goal. And so when the advisor is then able to walk through, and this is again, people that total return report.

there's not going to be that role for annuities, but people whose report is income protection. You express preferences that align with what in the United States is available through commercial annuity products. I know there's a lot of misconceptions out there about them, but let's look at whether something like this might fit your preferences for your plan. And then not even that, but now another kind of issue with annuities is they've gotten so complicated. There's so many different types and the living benefits and then.

or using a variable annuity with a living benefit or a fixed index annuity with a living benefit. But it can also help sort through some of that to find what's an appropriate starting point so that we can narrow the discussion to a particular type of annuity that aligns best with the characteristics and preferences that the individual exhibited when they took the assessment.

Jack Martin (24:12)

So folks, if you haven't been exposed to the Risa platform, it's fantastic. It does a great job. I think of it as kind of a diagnostic tool to start, right? It is a great guide for a conversation, a great structure to have that conversation. I feel...

As I go through that, it's a little bit like visiting my doctor for my annual exam, right? I got to run through this battery of tests and he comes back and he kind of puts all the pieces together and says, hey, here's the deal. And so that's kind of what it feels like, right?

Wade Pfau (24:48)

Well, maybe in our original research version, you might have that sense. But we've kind of streamlined things that if you only want to know the basic RISA style, it's a five minute, 12 question assessment. I don't think we've gotten that feedback that people feel like they're going through the forms. And they have to fill out the doctor's office.

Jack Martin (25:06)

Well, OK. OK, maybe maybe that's extreme. I apologize. So so help us understand then. So we it still is a diagnostic, right? What we're trying to do is figure out what. Gotcha. Gotcha. And so once we get that, then that's the starting point you're saying for us to because it's going to give us insight as to the type of annuity as well as whether it's whether they're inclined to do annuities or not, right?

Wade Pfau (25:19)

or like a personality profile, but for retirement income.

Right. And then of course you do the financial planning and identify whether or not there's an income gap. Because sometimes income protection folks, they kind of naturally went into a career that provided income protection. it may be lower, like they're not commission paid on commission, but they're, they're working for a government position or a teaching position with good job protection and also maybe still a defined benefit pension so that they already have enough guaranteed income. They may not need a commercial annuity.

But you have that conversation.

Jack Martin (26:05)

Maybe they're vice presidential nominee and they don't have any investments, they just have guaranteed income. So.

Wade Pfau (26:11)

Hehehehe

have the pension, so they won't need an annuity. But at least when you do the financial planning, the RISA, retirement income style awareness, informs if there's an income gap to be filled, how would that individual feel most comfortable filling the gap? Are they fine with a total return investing approach? Would they really value a fixed annuity, a variable annuity, or even if they have more of that bucketing style?

Maybe they want some sort of bond ladder or just a deferred fixed annuity or something not with lifetime income provisions to fill those short -term buckets for safety.

Jack Martin (26:52)

While the times flown by this been a great conversation. So any any parting gifts for the audience? You know from the world of Wade Pfau about income annuities and the like.

Wade Pfau (27:06)

Just the, yeah, they add value. so whatever we can help to spread that message to the broader public, understand, mean, social security is an income annuity. It's a particularly attractive one because it provides inflation protection, which does help to also alleviate the concern about commercial annuities, not having inflation protection. At least you get that through social security and survivor benefits. And so people love social security and...

There's no reason not to love income annuities for the same sort of reasons. So helping people understand that that similarity I think is really key looking forward.

Jack Martin (27:43)

So I think a lot of our audience has heard you speak in the past. So let's go beyond the Dr. Pfau, the presenter. So what are a couple of things that you do when you're not researching and presenting about retirement income and annuities that might surprise people? What are the things you're doing when you're not being Dr. Wade Pfau, you're just being Wade?

Wade Pfau (28:05)

Well, I still have three kids, so they keep me busy with their various activities and things. This summer, I had some opportunities to travel around, spend some time in Japan, spend some time in Iowa, kind of two contrasting locations with my mother, that sort of thing. But yeah, was time with family.

Jack Martin (28:24)

Awesome. Hey, folks, this has been Dr. Wade Pfau on The Breakthrough Advisor™ podcast. I want to thank you all for taking time out of your busy schedules to join us. Check us out wherever your podcasts, wherever you can join your podcast. Please like, share, comment, subscribe. And until next time, we look forward to seeing you on The Breakthrough Advisor™ podcast. Thanks, folks, and have a great day.

Voiceover (28:59)

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