Christine Benz: Hi, and welcome to "The Long View. I'm Christine Benz, director of personal finance for Morningstar. I'll be conducting today's interview solo, as my colleague Jeff Ptak, who's my usual co-host, is traveling today.

We have two guests on the podcast today, both from Vanguard—Maria Bruno and Joel Dickson.

Maria is the head of U.S. Wealth Planning Research at Vanguard, leading a team responsible for conducting research and analysis on a wide range of retirement, wealth planning, and portfolio construction topics. She also contributes to the oversight of the investment philosophy, methodology, and strategies supporting Vanguard's advisory products and services. Maria is a certified financial planner and she's a fount of wisdom on many subjects, but especially retirement planning.

Joel Dickson, Ph.D., has worn many hats at Vanguard during his long career there. In his current position as Vanguard's Global Head of Advice Methodology, he oversees all investment methodology development for Vanguard's advice programs geared toward individual investors. Prior to assuming his current role, he was a senior ETF strategist within Vanguard's Investment Strategy Group, where he analyzed trends and developments in the exchange-traded fund market. He also served as head of Vanguard's Active Quantitative Equity Group.

Joel and Maria also host a monthly podcast that I'd highly recommend; it's called "The Planner and the Geek."

Joel and Maria, welcome to The Long View.

Joel Dickson: It's great to be here, Christine.

Maria Bruno: Thanks, Christine.

Benz: I want to start by talking about retirement, which is a topic that I think the three of us could sit here and geek out about for days. But let's start by talking about the accumulation period. Many of us know someone who is hurtling toward retirement and hasn't saved enough. When we look at the statistics at large, we see that a lot of people are undersaved for retirement. So, let's talk about that cohort. What are the key steps they can take as they try to improve their retirement preparedness?

Bruno: Christine, I'll start that. (One of us), I guess, is the Planner here. I mean, the key there really is to save and to understand not only how much to save, but into what types of accounts to save. So, I think there would be the importance of tax diversification in terms of being thoughtful, in terms of what types of accounts to direct contributions to maximize aftertax potential.

So, many of us who are in our working years have access to employer-sponsored plans, tax benefits go hand-in-hand with that. So, for many individuals, the key there is to make sure that you're maxing out these tax-advantaged accounts, taking advantage of company match where appropriate, and then, also being thoughtful in terms of supplementing those plans with tax-efficient investments within taxable accounts. So, it's the how much, but then also how do you actually direct those savings.

Benz: Would you prioritize the traditional tax-deferred vehicles over Roth accounts if someone's looking at their retirement kitty and seeing a fairly small balance and feeling like they're really playing catch-up? What's your advice on that front?

Bruno: I think it depends. Roth accounts offer lots of benefits in terms of tax-free growth and the ability for Roth IRAs, for instance, to avoid RMDs in retirement. So, there's some tax flexibility there down the road.

I think the thing there to think about would be--I'm a big proponent, and I think Joel will talk about this as well in terms of tax diversification --having both types of accounts. So, for instance, if you're thinking about someone who's saving in a 401(k), many plan sponsors offer a Roth deferral option. And you don't have to do all or nothing. You can direct your deferrals between those types of accounts. Employer-sponsored matches are directed towards traditional tax-deferred vehicles. So, that choice alone provides tax diversification.

For individuals who are saving the max, the Roth actually allows you to contribute more on an aftertax basis because those dollars have already been taxed, you're investing into the max and then that account grows tax-free.

Benz: So, the contribution limit is the same, but they are dollars that have already been taxed?

Bruno: Correct.

Dickson: Yeah. $6,000 after tax is actually a heck of a lot more in a tax-deferred or tax-advantaged vehicle than $6,000 pretax dollars. So, if you can afford that level of savings, it's actually a very large benefit. And one of the implications of that is that when we think about the rule of thumb between Traditional and Roth IRAs or 401(k)s in terms of making the decision of how to contribute and invest in those, the usual breakeven is A, Is your tax rate going to be higher in the future or lower in the future than it is today? And if it's higher, think Roth, if it's lower, think Traditional…

Benz: Which you're just kind of guessing about, right? If you are many years from retirement, that's really hard to make that assessment.

Dickson: Absolutely. And that was the point I was going to make, going back to you, say, Hey, low balances, should people think about the Traditional? It's such an idiosyncratic or individual sort of consideration from a planning standpoint, because there are plenty of people that have little wealth but have high income, for example. And so, even if you're a low balance, it might make sense to have a Traditional in that standpoint. Or potentially, again, if you can up the savings rate, to do Roth if you're going to now up your savings rate and do a max contribution just because on an aftertax basis, it's so much more in terms of aftertax value by making a max contribution. So, it really does come down to very individualized sort of circumstances.

Bruno: Although, I think to that I would add, for young investors, who are just starting out, who are presumably in a lower tax bracket than they would be later in their peak earning years, the benefit of the tax-free growth offered by the Roth over those long horizons far outweighs the tax deduction they'd get on the deferred contributions today.

Dickson: Yes and no. I mean, are you going to make withdrawals in your peak earning years? It's really when are you going to make the withdrawals, right?

Bruno: I say peak earning years because I think when you're in those stages and you are close to retirement, you are in your peak earning years and it becomes a little bit more complicated in terms of do I go Roth…

Dickson: Yes.

Bruno: …or do I take advantage of the Traditional now potentially with the window of converting later when I'm in a lower bracket in retirement. So, I just think it's a little bit simpler when you're younger and accumulating.

Dickson: And that I think is really an important point. And Christine, I know, we'll probably talk about the decumulation phase here, too, but in many ways the accumulation phase is a lot easier. And what I mean by that is that the sort of typical rules of thumb that often get thrown out will likely get people largely to where they would want to be, or at least within the general vicinity. So, I mean, if you save 12% to 15% of your income, if you invest in a low-cost broadly diversified portfolio, if you maximize your tax-advantaged accounts, if you can control costs and taxes a little bit, and don't do something like self-inflicted wounds in terms of long-term benefits on either portfolio management or rolling over credit card debt and paying 20% interest rates and so forth. You do those basic things and you're pretty much going to be in relatively good shape…

Benz: Right.

Dickson: …come retirement. Decumulation can be very, very different, though.

Bruno: I think there's been a lot of advancements in terms of 401(k) plan design to make it easy. So, auto-enrollment, auto-escalation, defaulting into a balanced fund or a target-date fund. So, those types of defaults have really created a very good starting point for investors to create this disciplined investing. So, I would just add that.

Benz: So, the idea is, find a way to turbocharge your savings, take good advantage of the tax-sheltered vehicles that are on offer. And as Joel said, unless you're doing something really kooky elsewhere, chances are if you save enough, you'll probably be OK. But let's talk about people at the opposite extreme, and I'm sure that you encounter them, I certainly encounter them: supersavers, who have maxed out or are maxing out their 401(k)s, are making their maximum allowable contributions to their IRAs. What are some additional strategies that people should consider if they're still in accumulation mode and they want to try to add additional money into their investing pool?

Bruno: You know where Christine is leading us? You want to just talk about health savings accounts? Or … accounts? Christine?

Benz: Or aftertax 401(k)s might be an idea.

Dickson: Yeah. That's the thing. I do think there are a lot of opportunities, given--there's been a lot of complexity and incentives added into the tax code, for example, for certain things, whether it's health savings, retirement savings, so forth, we kind of want to incent certain behaviors through tax-code changes over time. But those incentives may also provide opportunities--what I refer to at times as *off-label uses* of different types of accounts. So, for example, a health savings account to provide at least on its face, a tax incentive, a better aftertax savings vehicle, if you will, to deal with healthcare costs can actually also be used potentially in a longer-term retirement savings by investing in a broadly diversified asset portfolio and just paying your health costs out-of-pocket and let it grow triple tax-free, if you will, in the HAS--you get the deduction, you get the deferral while it's in, and you don't get taxed on the way out, at least for qualified medical expenses--and use that in retirement to pay retirement health expenses without incurring additional taxable income, that might affect things like Medicare premiums, and so forth.

So, there's a lot of just all these different interactions, whether it's health savings, you mentioned aftertax 401(k)s, again, just is another way, backdoor Roth contributions in using the different vehicles in ways that maybe aren't the way that it was envisioned, but certainly are the way that it has been written into the incentive structure.

Benz: Well, let's talk about a couple of those that you mentioned, Joel. Let's start with the aftertax 401(k). Maria, maybe you can address how that works? How those are different? Sometimes people say, "Oh, that's just like a Roth 401(k) contribution, right?" So, let's start there and talk about how they're different and why you probably wouldn't want to touch the aftertax 401(k) until you've made your allowable contributions to either your Traditional 401(k) or your Roth 401(k).

Bruno: Yeah. I think I would start, Christine, by saying not everyone has the opportunity to do an aftertax contribution in their 401(k). So, first, the plan actually has to allow aftertax contributions. So, if that is a feature, then that is certainly another way to invest in a tax-deferred type of account. So, it allows you to save more in these tax-deferred type vehicles. So, certainly, if you have the opportunity to do that… I think I'm a fan of, first and foremost, making sure that you have the saving up to the company match, right. So, that's a no brainer. If you don't do that, you're leaving money on the table.

Going outside of the plan, potentially, in a Roth IRA, for instance, affords some flexibility in terms of using the benefit of a Roth IRA as potentially, as Joel would say, an off-label type of account to access those contributions-penalty- and income-tax-penalty-free if warranted, and then going back into the company plan. So, for those individuals that can have access to aftertax contributions, that allows you to save in these plans with higher limits.

Benz: So, it's like over $50,000 in total, right, in terms of your maximum total allowable contribution?

Bruno: Correct.

Dickson: Yeah. And even an extra $6,000 if you're above age 50, like some of us in this room. Yes, there's the added benefit there.

Bruno: Right. So...

Dickson: The catch-up contributions.

Bruno: …the catch-up contributions beginning at age 50.

Dickson: Exactly.

Benz: Which are available to all of these account types, right, not just the aftertax?

Bruno: Correct.

Dickson: Yeah. Well, the HSA catch-up starts at 55. And then, in an IRA, it would be $1,000 catch-up contribution as opposed to a $6,000 catch-up contribution.

Benz: Right. So, Joel, you mentioned the backdoor Roth IRA. Let's talk about what that is. I think that's probably a little more familiar than the aftertax 401(k). But let's just walk people through how that works. And also, I hope you can hit on some of the, sort of, traps to avoid in that space, because you do have to be careful.

Dickson: Sure. And absolutely. And actually, the aftertax 401(k) can, obviously, lead into an extension of the backdoor Roth of the, sometimes called, the *mega backdoor Roth strategy.*

Benz: So, let's connect those.

Dickson: You bet. Absolutely. So, when people talk about the backdoor Roth IRA, that's often coming into play for higher income investors because of the income limits that exist on direct Roth IRA contributions. And so, if your income--and it's different, whether you're single, head of household, married, in terms of your tax-filing status. But if your income limits exceed the Roth IRA, there may still be an opportunity to benefit from the tax diversification and approaches that Maria was talking about earlier, it's just that you kind of have to indirectly do a Roth IRA contribution by first contributing to an aftertax Traditional IRA, that is not a deductible contribution. And then people operationally will say, maybe you need to leave some time before you convert it to the Roth, or there's some debate about that. But ultimately, at some point, then taking that contribution that you made to an aftertax IRA and doing a conversion to the Roth IRA. And what that does is it gets it in a vehicle that now any future earnings--if it's in the Roth IRA--are not subject to taxation, assuming you meet the usual Roth IRA rules of at least with a conversion that it had been done at least five years ago when you take it out, you're over 59.5.

Whereas if it were left in the Traditional IRA, any dollar of earnings is ultimately taxed upon withdrawal at ordinary income tax rates typically. So, there's that potential benefit that arises.

Now, the pitfalls, as you mentioned, the big one being that you can't just designate the contribution that you made to the Traditional IRA and say, "I'm just going to contribute *that* amount, say $6,000, to a Roth IRA" and not have any additional tax because it hasn't been in that vehicle long enough to have any earnings on it. You have to incorporate all of your IRA dollars and any taxability of those dollars at the time you make the conversion. So, if you had, say, the $6,000, but you had $6,000 before of IRA and it was all otherwise subject to tax--if you were to withdraw it, then you can't withdraw $6,000 and say, "I owe no additional tax." Half of that amount, or $6,000 of the total $12,000, would actually be considered subject to income tax if you did a conversion.

So, that's a big pitfall that you kind of have to take into account in the assessment of whether it makes financial sense to do the Roth IRA.

Benz: So, it depends on the tax complexion of all of my IRAs, and it may be a little less attractive if, say, I have a very large rollover IRA in addition to this $6,000 that I'm contributing to the new IRA.

Dickson: Yeah, exactly. It's not just a tax-free, if you will, conversion at that point.

Benz: Before we leave this "off-label" topic, Joel, I was listening to your podcast on education savings, and you said that you have a 529 plan in your own name. So, let's talk about why that is? What your plan is? You have a Ph.D. already. So, are you planning additional education? What's going on there?

Dickson: So, yeah, this is--and I have to admit, this is one that I will get some pushback from some other folks in terms of my own tax planning on this one. But I'll give you what my thought process is. Again, another off-label usage, in that an education savings allows for--again, there are rules around it--but it allows for another form of tax-advantaged--or in this case tax-deferred, if it's not used for education purpose; tax-free after you make an aftertax contribution if it's used for education purposes--way to save. So, if I have some extra savings--one of the supersavers that you were mentioning Christine--and I've used up my 401(k), IRA-sort of contributions, then maybe an education savings vehicle could be another way to do it. Now, Maria is sitting here kind of smirking at me because…

Bruno: Because I practically hear this every day in the office.

Dickson: Yeah, exactly.

Bruno: Joel goes around the hallway talking about his 529 plan.

Dickson: Yeah. And honestly, Christine, I have no immediate plan of how I'm going to use it other than at some point, I will probably transfer that wealth, either to my kids, grandkids, or something along those lines. And it actually gets to a point that I know we wanted to talk about at some point, which is, how do you think about tax planning in the new tax environment that's been in place the last couple of years. And one of the big items that really is coming up with very large increases, for example, in the estate tax exemption amounts, is that by and large, there's more and more focus on minimizing income taxes during one's life than there is about avoiding estate taxes. And to me, the education savings in your own name is another one of those ways, even though you might have to worry about generation-skipping taxes at some point and you may have to worry about gift, overall taxable gift, even if it's to children and so forth. By and large, the vast, vast majority of people are not going to come up against those estate tax considerations. And so, it's a way to…

Benz: Because they're high--how high right now for the exclusion, the amount that is excluded?

Dickson: Yeah, basically, a little over $11 million for a single individual and $22 million for a household, if done properly.

Benz: So very rarefied net worth levels.

Dickson: Exactly. So, with that, the focus then ends up being a lot more on what do you do about income taxes while you're alive or investment taxes and I just sort of see an education savings account that provides tax deferral during an accumulation phase and with flexibility of being able to transfer those dollars to others down the road as another way to potentially minimize the tax burden. Or really the right way to think about it from my standpoint is maximizing the aftertax return of total investment portfolio.

Benz: So, Maria, how long can those dollars stay within the context of a 529? I know with traditional tax-deferred accounts, there are required minimum distributions. The IRS wants its cut at some point. How long can you take advantage of the tax benefits that come along with a 529? Joel mentioned grandkids. I don't believe he currently has any. So, how far into the future can you take these things?

Bruno: I think that's one of the unique features with 529 plans is that you have the flexibility to change beneficiaries. So, Joel right now can make himself the beneficiary of the account and then he can change the beneficiary to his children. So, there's a linear and there's some definitional requirements around who the beneficiaries can be, but you're talking siblings, kids, grandkids, and there's a lot of flexibility in these types of accounts. We get the question a lot with parents who may be worried. And worried is not necessarily the right word, but if the kids might get scholarships, and say, “What do I do with these monies?” Well, they can stay in these accounts for graduate school, but then also they could change the beneficiaries to *their* kids. So, there's a lot of flexibility with these types of accounts.

Dickson: And there's no required minimum distribution requirement on a 529 plan.

Bruno: No, there isn't. In the worst cases, if you need to tap those monies, it's almost--we talk about this--it's almost like a nondeductible, Traditional IRA. You're going to be taxed on the earnings, potentially a penalty.

Dickson: Yeah, if not used for education expenses and so forth.

Benz: So, I do want to talk about decumulation. We spent some time talking about people accumulating assets for retirement and other goals. Maria, you spend a lot of time on the decumulation topic, as do I. Let's talk about the biggest mistake that you see do-it-yourself investors make when it comes to decumulation, knowing that there are a lot of different situations, but what's one thing that you see a lot of investors stub their toe on?

Bruno: I think the one area where retirees trip themselves up is how much to spend, or what flexibility do I have in spending, right? So, a lot of individuals are leaving the workforce today with large deferred balances, and they have this burden of being thoughtful in terms of, well, "How do I meet my goals today?" but then also making sure that I'm protecting myself down the road around longevity risk and things like that. So, the risk typically is that I'm going to overspend today and then potentially put my later-stage retirement at risk. But that's also the flip side of that of underspending. So, I think the biggest area of concern for retirees is, "Well, how much can I spend?" So, we've got rules of thumb. We talk about this, Christine, as well to the 4% rule of thumb as a starting point. You know, it's a starting point.

Benz: And let's just talk about what that is, because I sometimes encounter people who think, "Oh, that means that I get to spend 4% of my balance year-in and year-out." That's not how it works, right?

Bruno: Well, there's different ways to think about a spending policy. One would be the traditional 4% spending rule that goes back to the mid-'90s by Bill Bengen when he started was really--what is the safe withdrawal for a balanced portfolio, say, for a 30-year time horizon, that would minimize the risk of outliving one's assets? And that came in about 4%. So, how that works is that, let's say, you have $1 million at retirement, 4% of that would be $40,000. And then you adjust that amount every year thereafter by inflation.

Dickson: Maria, who told you, you can play the geek doing math at real time?

Bruno: That's as far as I am going to go.

Dickson: OK.

Bruno: I learned from the best…

Dickson: We're doing a little role reversal here right now.

Bruno: The risk with that, Christine, as we know, is that it does not look at what the portfolio balance is. So, you've got potential market risk. So, if you are following this rule early in retirement and if there's a market downturn, what you think is 4% could actually be closer to 6%. So, that's one of the risks with that type of spending rule. And frankly, many retirees are not that prescriptive in terms of how they spend.

The other end of the spectrum would be a percent of portfolio, which would be what you just said, 4% of my balance each year, I would take that. What that exposes the retiree to is much fluctuation in spending levels on a year-to-year basis. So those are two common methods. Most retirees will probably fall in the middle, where they might have a rule of thumb, and then they adjust that in years where there may be a market downturn, they might cut back a bit. So, many of them, I think, will have flexibility to the best that they can.

Benz: Well, let's discuss that market downturn idea. Because that's top of mind for me--we're 10 years into this current equity market rally. And so, realistically, how do you counsel people who are just embarking on retirement. What traps should they be mindful of, because we know that that bad market environment coinciding with the beginning of retirement and too high spending can be a deadly combination?

Dickson: Well--and that was, in many ways, the genesis of the original 4% rule, which is, you know, in the, "worst-case scenario," what could you still sustain with pretty high degree of certainty over a long period of time. But Christine, I actually think about this problem--we get this discussion and where you're, obviously, leading here is on the so-called *sequence of return risk* and spending and so forth. I actually have a little bit of a different perspective, which is that there's really no such thing of sequence of return risk, what it really is longevity risk, in that, you only have a sequence of return risk problem for most people, if you're going to live to be 90 or 95. If you end up living to 75, or 80, or so forth, most portfolios, even if there's a downturn in the beginning, can still sustain, say, a typical 15-year type portfolio.

So, I often frame a lot of this in terms of the longevity piece. And in many ways, that's how the industry has framed this problem, I think, in some ways to the detriment at times of investors to Maria's point about the comfort to be able to spend, because of the uncertainty of whether it's healthcare costs and long-term care or how much it's – if something bad happens, do I have any buffer here? And the way we've done it is, we've modeled 30-year retirements for everyone in the household all the time with certainty. And that's just not the average or a median case. And so, we're in many ways telling people to, on average, oversave, underspend, and kind of guilting folks into thinking their retirement sufficiency is much, much worse than maybe it actually is--not saying we shouldn't be conservative and try to plan for the long term, but a lot of these issues tend to be issues only if you live too long, as it were.

Benz: But you touched on the reason why that we counsel people to strive or think about long retirement deaccumulation periods is that most people would rather spend less today than run the risk of running out later on. Right. If you ask me, that's what I would prefer that I would rather forgo some consumption today in exchange for maybe some peace of mind about not running out?

Dickson: I don't know. I think there are a couple of schools of thought on that. And I think it gets to the difference between the supersavers and the not-so-supersavers that we were discussing a little bit earlier. The way to flip that around is the supersavers forgo consumption for saving down the road; the not-so-supersavers tend to consume most of everything today, tend to focus a little more on consumption. And the time in retirement when people typically can spend, especially on discretionary type items, is earlier in retirement. And we see that pattern time and time again, spending in real terms tends to decline for retirees, especially late in retirement, and it becomes a larger percentage of kind of home and healthcare costs relative to things like travel and food and so forth. So, I think there are--just like different types of investors, there are different types of savers and what they kind of view is interesting and important to them.

Benz: Yeah. I certainly encounter my fair share of retirees who seem to be underspending relative to what they tell me their portfolio balances are. Maria, one question I have for you is, You know I'm a proponent of the bucket approach, because I think it's, kind of, an intuitive way to think about asset allocation in retirement. But I want your candid opinion on what you really think about the strategy. Do you think it's helpful? Do you think that it's suboptimal because someone's carrying around a cash position? What's your take on the bucket strategy?

Bruno: I think it depends, Christine. When we think about total return investing here at Vanguard, for instance, it's making sure that you have short-term liquidity needs, and that can vary. Retirees might want to have a little bit more of a buffer, and maybe have a little bit more of a cash reserve, and then have the remainder of the portfolio balanced between stocks and bonds. The key within those markets, though, is to be diversified. And when you think about perhaps even a bucketing approach, say, on the bond side, if you're thinking about being diversified across the taxable bond market, for instance, you would have different types of bonds in terms of short-term, intermediate-term, long-term. So, inherently, you've got that diversification within that bond construction.

The one thing I would add is, there's an opportunity cost of not being invested. So, for those retirees who are very worried around short-term liquidity needs, and think they're playing it safe by not having money in the market, they may be overexposing themselves to the opportunity cost of not being fully invested. So, that comes with a little bit of a risk as well. I think it's probably two different ways to achieve probably the same thing in terms of a balanced diversified portfolio. And if a retiree feels, from a behavioral standpoint, that they may be better off by having a bucketed of type of approach, I think that's OK. At the end of the day, you still kind of get to the same end result; how you piece it together might be a little bit different.

Benz: So, the key point is not to have too much staked in the safe stuff in search of peace of mind that you need balance, and you need growth in case you are one of those retirees who ends up being retired for 30 years or more?

Bruno: Right. And I think retirees today are more comfortable with balanced allocations than maybe they were in the past. I think the key is to make sure that once you're entering a retirement, it's very prudent to have a balanced portfolio anywhere 40% to 60% equities, if not more. Some of the research that we've seen is that some of our retirees who invest in Vanguard, they don't de-risk throughout the retirement, they actually maintain those higher level of equity allocations. And that can lead to an interesting conversation in terms of why or what the trends might be there. Rebalancing is important. And certainly, if you're spending, then using the spending needs as a way to rebalance the portfolio is one way to get that as well. But I think we're seeing retirees who are much more comfortable being balanced into retirement and maintaining that balance.

Benz: Do you think many pre-retirees are a little bit complacent about equity risk? That they are coming into retirement with portfolios that are maybe what would have been appropriate 10 years earlier for them in their life cycle? Are you encountering that?

Bruno: Yeah, well, rebalancing is coming up a lot more, right, in terms of making sure that individuals are rebalancing, because we've been on, generally speaking, a very generous market upswing post 2008 crisis, you can't underscore the importance of having to rebalance, because knowingly or unknowingly retirees could be overexposed to equity risk. So, they want to make sure that they are properly balanced if we do get into, because we will at some point, we just don't know when, how extreme or how long any type of downturn may be.

Benz: So, if you are sourcing money for cash flows to meet your living expenses, it seems like maybe de-risking a little bit, peeling back on that equity exposure might be a good place to start?

Bruno: Could be, yes. Because if – for many of them that's the one area of the market that could be overweighed. So, you want to be mindful in terms of where to pair back and equities for many might be the first source.

Benz: So, people have a lot of leeway to control their tax burden in retirement, more than arguably they had while they were working and earning a salary. So, Joel, let's talk about that. Let's talk about withdrawal sequencing and other strategies to consider as you are looking at your total portfolio and trying to figure out, "Well, how do I keep my tax burden as low as it possibly can be from year to year?"

Dickson: Yeah. And I would reframe it a little bit, which is, again, it's not so much keep your tax burden as low as you can; it's what will maximize your aftertax consumption or wealth through different tax strategies. Because in periods, for example, when you might have really high health expenses that you can deduct from your income in a given year in retirement, that may be a year to take a Traditional IRA or a 401(k) withdrawal and add some taxable income because you are in now a pretty low tax bracket and smoothing out that tax liability over time and it also then gets you away from maybe a higher required minimum distributions in the future and so forth. Whereas in that scenario you probably would not want to withdraw from a Roth IRA or 401(k) proceeds, because even though you're not paying tax on it, the tax burden is so much lower in that year that you have the big medical deductions that you're probably better off saving the Roth withdrawals for when you have higher taxable income in other years.

So, it's a complicated array of tax considerations and especially interactions that come up in decumulation and that's why I said earlier that I think the decumulation problem is a lot harder than the accumulation problem. And the rules of thumb just don't work as well, and a lot of these approaches have interaction effect. So, for example, how much taxable income you have can trigger different levels of Medicare premiums or different levels of Social Security taxation. So, how you think about all of those effects can really change for just even different spending levels. Maria had mentioned earlier about how spending levels are a key lever in retirement and the same investor with different spending levels, say, as a percent of the portfolio in a given year, might have very different withdrawal strategies that arise. We sort of think about the typical rule of thumb as for somebody who is going to spend all of their income or expect to spend all of their wealth in retirement--that scenario that I often refer to as: Your plan is to bounce the cheque at the funeral.

In that situation, the general rule of thumb would be, take money out of the taxable account first and then think about your tax-advantaged accounts and depending on some tax considerations, whether it's Traditional or Roth at that point will kind of depend. But as soon as you add up a bequest motive that you want to leave a certain amount to heirs, all of a sudden that rule of thumb withdrawal order can flip on its head, because a Traditional IRA may not be a particularly good asset to pass through an estate if you have choice of different types of accounts to do that in terms of maximizing the aftertax kind of bequest for your heirs. So, it really does get customized and personalized very, very quickly.

Benz: Right. The taxable account may be the better account for your heirs to inherit from you.

Dickson: Right. Because of step-up in basis and so forth, yeah.

Benz: Right. Maria, you have talked about something that you've called the *retirement sweet spot* in terms of there being some tax-planning opportunities there. So, can you expand on that? What do you mean by that, and what years or what life stage are we talking about?

Bruno: Yeah. So, with that, Christine, it's really--you're planning for RMDs, required minimum distributions, from tax-deferred accounts before they begin, when they are required at age 70.5. So, I know you get this question a lot in terms of, "How do I manage with RMDs?" The fact of the matter is, your options are relatively limited once you've reached that required age of taking distributions, the money has to come out of the accounts. You may have some flexibility in terms of a charitable distribution. But beyond that, the money has to come out and is fully taxed for most. So, the key there is to think about these years that are leading up to age 70.5 to see if there's opportunities to accelerate some taxable income, whether it's taking distributions from Traditional IRAs or potentially even doing series of partial conversions leading up to that. And what that does is it helps reduce those deferred balances, which then inherently reduce RMDs as well and the tax hit that comes with that later.

So, it's interesting because it does fly in the face of what we've done with the financial planning through the years, which was always defer, defer, defer. Here, you're actually proactively looking at strategies that could accelerate income taxes, but to do that taking advantage of relatively lower tax rates. So, for individuals who maybe retiring in their 60s, they may defer Social Security, so their taxable income maybe a good amount lower than it would be at age 70.5. So, it may be a good idea to accelerate some taxable income to either meet spending needs or to create tax diversification for later.

Dickson: And Maria, you had done some research a while ago. What was the figure? It was something about 25% or so of the investors that we looked at didn't really need their required minimum distribution when it came out?

Bruno: Right. So, we did a study a few years back looking at Vanguard shareholders who were taking required minimum distributions. And what we found was that about 20% seemed to be reinvesting those proceeds into taxable accounts. So, we get this question a lot in terms of, "Do I need to spend the money?" Well, you need to take the money from the account.

Benz: Right.

Bruno: You can reinvest the net proceeds in a taxable or nonretirement account. So, it leads us to think, to what Joel has mentioned is, that people either may not be spending or maybe they have different types of motives with their monies. So, the key there would be to invest those proceeds in a tax-efficient type of investment within nonretirement accounts.

Dickson: But that's where we've heard about the *tax bomb scenario* of required minimum distributions and then if you are not spending it, you are having to pay the tax, then you are just putting it into a portfolio. Whereas to Maria's point exactly, you may have found that you would have been better off doing partial Roth IRA conversions all the way along up until age 70.5 and now you don't have that same tax bomb coming in when you didn't--you weren't going to need the money anyway.

Benz: Let's just talk about asset classes. So, once you get pass the big three--so maybe you've got an U.S. total market index, an international equity index, and some sort of a core bond fund--what other asset classes should be on the table?

Bruno: Well, I think, when you think about the core asset classes--stocks, bonds--and have diversification within that, Christine...so, make sure you have exposure, because when you think about the global markets, the global economies, we're split about 50% U.S., 50% non-U.S. So, if as an individual you are making a conscientious decision to have, what we call, a *home bias* and invest exclusively in domestic equities, for instance, or domestic bonds, you are pretty much missing out on potentially half of the economy, the global economy. So, you want to be mindful in terms of making sure you have exposure across the asset classes, but then also be diversified within those asset classes.

We get the question a lot in terms of, "Hey, should we be invested in sector type stock funds or REITs or things like that?" If you are investing in broad market indices, you do have exposure to the different types of sectors. So, you want to be mindful that if you're making a conscientious decision to invest above and beyond that you may be exposing yourself to some unique risks and you want to be thoughtful about that as well.

Benz: So, if you have a total market index, you have a little bit of REIT exposure there, that's kind of what you're saying?

Bruno: Correct.

Benz: So, take a look at those sub-asset-class exposures?

Bruno: Correct.

Benz: How about you, Joel? In terms of asset classes that you think are most overrated or maybe downright unnecessary in investor portfolios, can you name a few that you think aren't as especially additive?

Dickson: Well, I actually think in many ways the portfolio-construction and asset-class question comes into one of, What can you access at reasonably low cost without taking sort of undue or uncompensated risk? So, diversification is a key, cost and the potential erosion of returns in terms of accessing that, and then also kind of just your own behavior from a reactionary standpoint. I actually have a little bit of a--I'll actually give a little bit of a contrary sort of view on portfolio construction, which is …

…I agree completely with Maria's point: You need to think about the diversification and the diversification broadly. I mean, if you work in the technology industry and a big part of your compensation and even maybe your investment portfolio is tied to technology, you might want to think about how to minimize that risk exposure in your portfolio. And one of the ways that this comes up is company stock in employer plans. And overexposure to company stock, while it's not nearly as large as it used to be, you can still observe it in a number of different client portfolios with this idea that, "Well, I know my employer, I trust my employer" and it comes into play--and we've seen it in survey data--that they will think that the risk of their employer stock is actually sometimes even less than that of a diversified broad market equity fund when in fact the average stock is probably 3-4 times more volatile than a diversified fund. And so, you have human capital risk at the same time as you have investment risk if you have a concentrated security, especially if it's in an industry where the company that you are also employed with.

But my sort of contrary view is that as long as you're relatively diversified, you have low costs, and you've got these exposures pretty well maintained, the difference in portfolio construction--and people love getting into these portfolio-construction discussions about factors and core and explore or three-fund portfolios, broad market, market capitalization and so forth… At the end of the day, if you have a fairly well low-cost broadly diversified portfolio, differences in that is not going to be the differences between in retirement you eating filet mignon or fish sticks. These are kind of small little differences that on the margin can make a little bit of difference, but you need to make sure the other things are in play first. So we talked about it earlier: Are you saving enough? Are you insured against the things that really can derail retirement income and efficacy, like loss of income or disability, or the fact that you have to leave the workforce to take care of a relative? All of those types of issues we find are more of the big derailers than getting portfolio construction exactly right or wrong. This is one where you can be close enough and as long as you just stick to it and maintain it, you'll probably be all right.

Benz: Maria, there seems to be widespread agreement that investment returns could be modest or at least muted over the next decade versus what they've been over the past decade. Do you agree and what kinds of adjustments does that call for it at the portfolio level?

Bruno: Yeah, it's a good question, Christine. When you think about it, we don't know. We can look at current market conditions and look at where we are with interest rates and what our economic forecasts can be. I think looking at a 10-year horizon as a starting point. It can be a good start. I think, not to overplay the diversification conversation, but just to make sure you've got the right asset allocation and diversification within that. And just be careful in terms of making decisions based upon what could potentially happen. So, at Vanguard, we've got our core investment philosophy, which is to focus on the things that you can control, and that being first and foremost making sure you've got the right allocation but then also diversification within that.

And I think making decisions based upon what you think could happen is very dangerous, because essentially that's market-timing, right? You might get it right once or twice, but to get that right consistently--research has shown that it's a wasted effort and it comes with cost as well. So, I think investors really need to be prudent in what they think about what the future returns can be. So, to make projections and to do simulations based upon double-digit returns on balanced portfolio can be risky. So, you want to make sure that you've got prudent inputs into the financial-planning process to make sure that you are well-balanced there. That may mean that you may need to look at other things in terms of whether it's being thoughtful around savings or spending--those types of things that come together with it.

Benz: Joel, you focus on ETFs in your current position. Let's talk about the ETF space. I'd like to get your take on how ETFs are generally being used by investors. Are they using them for the better or are they using them as betting devices, and that pun comes courtesy of my colleague Ben Johnson who loves puns.

Dickson: Well, actually, he stole that from a paper that we wrote about six years ago "ETFs for the better or bettor." And what we showed, at least among a group of Vanguard clients--now there may be a self-selection element there; there is some evidence that Vanguard clients even on our brokerage side tend to be a little bit more buy-and-hold than the average investor--but we found while there was a little bit of additional trading in the ETFs among our investors--and we controlled for a number of different things--a lot of that additional trading could actually be explained not by the fact that it was ETF or fund but that it was by the characteristics of the investors. That is, investors that were more likely to trade chose the ETF. And so, what we basically saw was those that log on to their accounts and check their balances every day, those that in this case were retired and male. That combination was much more likely to trade whether it was a mutual fund that they held or an ETF and it just so happens that that demographic was more highly represented in our ETF population relative to our mutual fund population.

So, about roughly half, just a little less than half of the additional trading that we could observe, we could immediately tie back to the demographic or investing characteristics of those investors and not to the vehicle itself, if you will. So, we weren't seeing necessarily, quote, “bad behavior” in terms of the trading usage of it. I would say, though, that the way that the ETF landscape has grown, I kind of describe it as competitive and crowded and I don't mean crowded in necessarily a negative way, certainly there are lot of ETFs and it can get confusing and daunting for somebody trying to sort through all of them just like it can with all of the different mutual fund choices. But it's been competitive and crowded in a way that ultimately, I believe, has been pretty good for consumers. At least the cost of the investment portfolio has dropped tremendously. Even if you look at Morningstar's own data on asset-weighted costs, there has been a significant decline in expenses in the mutual fund/ETF world over the course of the last decade, and the ultimate beneficiary of that is the end consumer. And so, that's been a very good thing, in my mind, at least over the course of that period.

Benz: So, have the benefits of ETFs versus traditional index funds been a little bit oversold, I would say? Do you think the public is overestimating the benefit that accrues to them through an ETF versus just a plain-vanilla traditional index fund?

Dickson: So, the short answer, yes, I would agree with that, Christine. The somewhat longer answer is: The whole industry of investments in many ways is about making mountains out of molehills when there are, ultimately, small differences and you try to blow them up for differentiation. Whether it's, you know, "Hey, we expect this to have difference in performance for this reason, or that reason," or, in the case of ETF versus fund, oftentimes what you hear about are the differences between the ETF and the traditional mutual fund structure and what you don't hear is that, well, if you were to do a DNA analysis, it's more like two different humans than it is humans and--I don't know--clams in terms of comparisons. That is, these are really, really close in terms of the structure. In the investment vehicle, they are both commingled, publicly available, generally low cost, and in a wrapper vehicles to obtain an investment exposure. And the fact that there are a little bit of differences in terms of internationalization versus externalization of costs or perceived tax benefits that get sometimes accrued to the ETF, but that in fact are the same rules that mutual funds can follow because the taxation system is exactly the same for ETFs and funds, it's just how it's used in the structure maybe a little bit more optimized in the ETF for certain elements. Those things tend to get lost and get blown up as, oh, this is just completely a better mousetrap when in fact 98% of the DNA is the same.

Benz: You've both been involved in developing of Vanguard's advice methodology for the personal advisor services. I'd like to talk about that service, which has been growing by leaps and bounds. Can you talk about what kind of advice the service encompasses? So, I guess, an example would be if I come to the service and ask my advisor if I should buy a long-term care insurance. Will they help me with things like that? Will they help me figure out if I should pay off my mortgage or let it ride? What sorts of questions will they help me tackle?

Bruno: Yeah, Christine, I think that's one of the benefits of having a hybrid type of advisor service where you actually have a certified financial planner actually working with an individual throughout the process. So, first and foremost, I think the most important part of the financial planning process is the goal discovery: Understanding what it is that you are trying to achieve and then what are the means to help achieve that. So, that encompasses investment planning, portfolio construction, how do you put the puzzle pieces together when you build the investment portfolio. But then probably even more importantly would be, How do you make the decisions in terms of how to save? Some of the things that we talked about today: how to drawdown, for people who are approaching retirement, what are the things to think about. Healthcare is at probably the top of the retirees' mindset in terms of helping understand what healthcare costs are, recurring healthcare costs, long-term care, those types of things, when to take Social Security. So, those are things that through the planning process we can help and either provide guidance to our clients or actually give them advice within the planning process as well.

Benz: So, in terms of the fees, how are those fees levied? If I have assets that I hold outside of Vanguard, does that fee get levied on all of my assets? How does that work?

Dickson: Well, so the short answer, Christine, is that the fees would be over those assets that we advise.

Benz: OK.

Bruno: That Vanguard manages…

Dickson: That Vanguard manages in the advice wrap or service that we provide to the client. So, there are certain assets that maybe we would account for in terms of projecting your financial success of meeting your goals, but that we may not be advising.

Bruno: And that maybe a 401(k), for instance, that you might have another investment provider where we can't manage those assets, for instance, but they are brought into the process. But the individual investor then would be responsible for making decisions within the construct of the overall financial plan.

Benz: Jeff and I recently talked to Michael Kitces, and he firmly believes that the next wave in financial planning will be very niche-oriented. So, the example that he uses would be a planner who specializes in helping doctors sell their practices. Do you see Vanguard having a role in such an environment where you've got ultra-specialized advice being offered under this personal advisor services umbrella?

Dickson: So, there are lots of ways. I would actually say that one of the things that Kitces also says in that context is that there will probably be a shakeout in the industry between those that provide mass affluent and yet still customized advice versus the differentiation of smaller advisors that maybe don't have the same scale and ability to deliver at a low cost the kind of broad-based advice where the niche-oriented comes into play as a differentiator. We certainly see our efforts at Vanguard in more of the mass customization, technology-enabled, broad-based investment, and financial planning advice for millions of investors over time, where we can bring the technology to bear and the scale, much like on the product side in the mutual fund world, where we can bring the cost of advice down through that automation and approach because a lot of what's done from an advice standpoint is very rules-based and being able to get the efficiencies, onboarding, data gathering, some optimization around advice methodology. But with that benefit where a client feels it's appropriate and relevant to have an advisor there to be able to also work through that, that technology-enabled advisor being a broad-based approach is kind of the way that we have been going and continue to see our role going forward.

Benz: Like I said at the outset of this conversation, I think that the three of us could talk about these subjects all day long and may be all night, too. But we'll have to leave it there. Joel and Maria, I want to thank you both so much for being here today.

Bruno: Thanks, Christine. Thanks for having us.

Dickson: Thank you, Christine.

Bruno: And give our best to Jeff as well.

Benz: I will. Thanks so much. Talk to you soon.

Bruno: All right. Thanks.

Dickson: Yeah. Bye-bye.

Benz: Thanks for joining us on The Long View. If you liked what you heard, please subscribe to and rate The Long View from Morningstar on iTunes, Google Play, Spotify, or wherever you get your podcasts. You can follow us on Twitter at Christine_Benz and at syouth1, which is S-Y-O-U-T-H and the number one. Finally, we'd love to get your feedback. If you have a comment or a guest idea, please email us at thelongview@morningstar.com. Until next time, thanks for joining us.