Inflation Cushion

By Kerry Pechter *Tue, Sep 15, 2009*

PIMCO envisions a trillion-dollar retail and institutional market for its new TIPS-based 'Real Income' managed payout funds.


Thomas Streiff

How can fund companies and 401(k) service providers satisfy participants' need for an income-generating exit strategy but still keep as much money as possible from walking out the door? For many in the securities industry, that's the $64,000 question.

So far two solutions have hit the market: the in-plan variable annuity with a guaranteed lifetime withdrawal benefit, such as Prudential's, and managed payout balanced funds of the kind that Vanguard and Fidelity created.

Now comes PIMCO, the West Coast bond giant and unit of Allianz SE, with a new spin on the managed payout concept: Treasury Inflation-Protected Securities mutual funds that pay an inflation-protected monthly income over either a 10-year or a 20-year period.

PIMCO says that its Real Income 2019 and Real Income 2029 Funds, which are "1940 Act" mutual funds that post a daily share value, are comparable to period-certain income annuities, only fully liquid. The funds are just now beginning to be rolled out to individual investors via brokers. Plan participants will hear about them later.

"The products will be distributed initially through the large broker dealers, which includes the four remaining wirehouses and the large independent broker dealers, as well as the banks," said Tom Streiff, a PIMCO executive vice president who until recently worked in retirement products at UBS. "In addition to that we'll market to 401(k) plan sponsors."


Thomas Streiff

Streiff expects the funds to suit people who leave their employer after age 59½ and who want to turn part of their savings into immediate income. The employee could leave his or her job but stay in the plan and receive checks from the recordkeeper.

That would appeal to institutional money managers who fear losing assets to a rollover IRA at a competing custodian. “Lots of plan recordkeepers are now saying, ‘We don’t want this money to walk away anymore. We would like that money to stay in the plan,’” Streiff told RIJ.

“We haven’t built the institutional product yet,” he added. “We expect the early adopters to be the retail platforms and we’ve been talking to them and they’re ready to go. But the institutional market could dwarf the retail market in short order. We haven’t built a collective trust yet but that’s not hard to do.”

“If we sell to half of the people who need income but don’t buy annuities, we’ll get $2 trillion,” Streiff said.

How they work

The funds offer a target monthly payout consisting of coupon interest, inflation-adjusted principal, and an inflation premium until depleted at their maturity date. Streiff estimated the annual payouts from a $100,000 investment to start at about $11,200 for the 2019 fund and about $6,200 for the 2029 fund.

By comparison, a person who invests $100,000 in an inflation-adjusted 10-year period certain immediate annuity from Vanguard would receive about $10,500 a year to start, according to the firm’s online calculator. A non-inflation-adjusted ten-year payout annuity would pay a flat $11,700 or so.

As for expenses, that depends on the share class, and ranges from 39 basis points for institutions like Charles Schwab to 49 basis points for “P-share” customers like Bank of America/Merrill Lynch or 79 basis points for “D-shares,” apparently intended for smaller advisory firms or individual advisors. Intermediaries can apply their own layer of fees, however, and that could range from zero for some fee-only advisors to a one percent management fee for others to a front-end load in the case of registered reps.


Gang Hu

According to one advisor, who heard it from his PIMCO wholesaler, the wirehouses will charge a front-end load of 3.75%, 3.25%, 2.25% and 1.75% for investments of under $100,000, $100,000 to $249,999, and $250,000 to $499,999, and $500,000 to $999,999, respectively. Investments of $1 million or more will have no load.

Converting a TIPS fund into a managed payout fund required a lot of financial engineering, Streiff said. “[Real Income] looks simple from a distance, and we want it to look straightforward to the investor. But the reason why this hasn’t been done before is because it’s complicated. It’s because of how TIPS themselves work.

"We have to take the lumpy, awkward structure of TIPS—there are five years in which no TIPS mature, TIPS dividends are paid out only twice a year, and the inflation accruals are monthly—and turn it into a predictable cash flow for the investor. That's the challenge," he added.

"We have built a proprietary algorithm that fills the holes in the TIPS curve. You can do that with inflation swaps or derivatives, but we chose not to use any of those. We're creating a synthetic TIP using actual TIPS in other parts of the curve. It's possible that no one else will do this. You have to be a major player in the TIPS market," Streiff said.

The funds are managed by PIMCO senior vice president Gang Hu, who formerly worked at Deutsche Bank and has an undergraduate degree from Tsinghua University in Beijing.

The funds don't protect investors from longevity risk, but PIMCO suggests that investors add longevity protection by buying a deferred, life-contingent income annuity—also called an ALDA, or advanced life deferred annuity—that could provide monthly income when the TIPS income stops.

For those unfamiliar with TIPS: they pay a real yield, currently about 1.9% for a 2019 maturity, and each year the value of the underlying bond grows by the CPI rate. For example, if you invested $1,000 in a new 10-year TIPS with a 2% coupon and inflation the following year is 3%, the principal would rise in value to $1,030 and the interest payment for that year would be $20.60.

(To read experts' comments on the new PIMCO payout funds, see "Early Reviews of PIMCO's Payout Funds."