Turn 401(k)s into Bond Ladders

By Kerry Pechter *Wed, Mar 18, 2020*

Franklin Templeton SVP Drew Carrington says his firm's Defined Maturity Funds, which work like bond ladders, could provide retirement income for 401(k) participants, and could be paired with qualified longevity annuity contracts.

Bond ladders or certificate-of-deposit ladders are tried-and-true techniques for establishing predictable yearly income in retirement. But they currently have drawbacks. CD rates are too low, and bond ladders require large investments. Neither can be built by 401(k) plan participants prior to retirement.

One easy alternative is to use defined maturity funds (**DMFs**). These diversified bond funds combine the best features of a bond ladder and a bond fund, either as insulation from interest rate risk or as a safe stairway of annual income in retirement. Invesco and BlackRock offer them as exchange-traded funds (ETFs). **Fidelity** offers them as municipal bond funds.

Franklin Templeton distributes its defined maturity bond funds through retirement plans. The firm brought its first DMF to market in 2015, but it got little traction. The passage of the SECURE Act in December could change that by helping to reframe the 401(k) as a generator of retirement income.

“Prior to the passage of the SECURE Act, plan sponsors were broadly reluctant to embrace the income challenge,” said Drew Carrington, senior vice president and head of Institutional Defined Contribution at Franklin Templeton, in a recent interview with *RIJ*. “That was primarily because of the annuity selection liability issue.”

Carrington was referring to plan sponsors’ concerns that they could be sued if a life insurer who sold annuities to their participants later defaulted. “Decisions about products like ours, that have no insurance component, have also been held up [by those concerns],” he said.

Drew Carrington

"We're hoping that passage of the SECURE Act will drive renewed interest and spur action. We've seen a couple RFPs [requests for proposals] from plan sponsors. We hope that this may represent a turning point in the acceptance of retirement income options in 401(k) plans."

Franklin Templeton's institutional DMFs are liquid, actively managed diversified mutual funds containing a mix of investment-grade, non-callable bonds that all mature in the same year. There are no mortgage-backed securities or floating-rate bonds. They are structured so that plan participants who have retirement spending needs in 2021 might invest in a 2021 Fund, a 2022 Fund, etc. The current expense ratio is 32 basis points (0.32%) per year.

The DMFs are intended to fit the contribution and accumulation pattern of a 401(k) participant. "Every two weeks a person could purchase small slices of a fund. Other people might reach age 60 and decide to buy a five-year bond ladder all at once. Other people might say, 'I'll buy a new fund every year for five years,'" Carrington said. "You can go either way. The funds have liquidity and a daily price. The closer they get to maturity, the less volatile their value will be. If you sell the fund prior to maturity, there could be a market value decline. But barring a default the fund should mature at its par value," he added.

DMF ladders can be extended indefinitely, but Franklin Templeton envisions ladders of five years. "Our theory was that that's about as far out as most people have a sense of planning for. If you ask them what their income needs will be in a year, they can usually tell you. But if you ask them how much they'll be spending in 12 years, they don't know. So we created a five-year program, with one fixed maturing fund for each of the five years."

There’s a stereotype of rank-and-file retirement plan participants as largely disengaged from their retirement savings. Franklin Templeton also wondered if most people are too focused on yield and internal rates of return to appreciate the predictability of a ladder. “Some initial feedback from plan sponsors was that participants wouldn’t understand this, so we held focus groups,” Carrington told *RIJ*. “To ensure a broader swath of the US population, we made a point of conducting them in states such as Texas and Illinois instead of focusing on financial hubs like New York. The groups consisted of people over age 50 and currently participating in a 401(k) plan. Otherwise, they were as demographically diverse as possible.

“The interesting finding was that people immediately grasped that this was like a CD. They weren’t hung up on the yield component. They understood that you’d dedicate a portion of your savings today to the payment of certain expenses in the future. People thought of it as bucketing.

“We often heard people say, ‘I could set aside dollars to pay for a certain expense, like property taxes. Then I wouldn’t have to worry about that expense and I could spend my other money as I wish. One person asked, ‘Can I do this in different amounts each year?’

“As a general rule, the defined contribution industry tends to underestimate participants’ financial literacy. However, from our focus groups, we found that people intuitively grasped this product. I am now more inclined to think that participants close to retirement have a better sense of what they need than the industry gives them credit for.”

Franklin Templeton envisions participants using a bucketing strategy, where one income bucket consists of a DMF ladder and a later income bucket of a deferred annuity, or QLAC, or qualified longevity annuity contract. Created by the U.S. Treasury in 2014, QLACs allow Americans to buy late-life deferred income annuities with up to 25% of their tax-deferred savings (to a maximum of $135,000 for 2020) without violating the requirement to start taking distributions from tax-deferred accounts after reaching age 72.

The asset management firm asked retirement experts from The American College to run Monte Carlo simulations of the hypothetical performance of a Franklin Templeton DMF ladder, a portfolio of growth funds, and a MetLife QLAC during retirement to see if it outperformed the traditional 4% “safe withdrawal rule” established by William Bengen in 1994.

“We asked Michael Finke and Wade Pfau to answer the question, ‘If we think about risks like volatility and longevity risk in retirement, would a combination of a bond ladder, a QLAC and a growth portfolio outperform the 4% rule on those two metrics, and their answer was 'Yes,'" Carrington said.

"The research is compelling on that point. If your goal is wealth maximization on average and you care only about that, the answer is 'No.' Higher equity allocations create the potential for higher ending wealth. But they create a wider dispersion of outcomes in terms of income variability and longevity risk."

Carrington sees the potential to partner with an annuity issuer on products that combine DMFs and QLACs. "We're not officially co-marketing with an insurance company, but we are certainly open to joining into a conversation with others. That's why we did the joint project with MetLife and The American College," he told *RIJ*.

Carrington imagines the following scenario. "Most people will retire in their early 60s, draw down Social Security in their mid-60s and buy a QLAC that starts in their mid-80s. So we're looking at a 10- to 15-year window for these bond funds," he said.

"In that framing, if you make a back-of-the-envelope assumption that people can put up to 25% of their qualified savings into a QLAC, and put five percent into each year of your five-year bond ladder. That's a total of 50%. The other half of the portfolio is left to address income needs and inflation risk in the years [between the end of the bond ladder and the beginning of the QLAC income].

"HR departments tell us, my participants aren't asking for income products. But we say, there will be second order effects. Think about rearview cameras in cars. Nobody knew they wanted rearview cameras until they had them. Now they get in a car without one and say, 'Where's the rearview camera?'"