The 'Good Old Days' that Never Existed: Revamping 401(k)s - Transcript

Tom Mullooly: Welcome to the Mullooly Asset Management podcast. This is episode number 229. I'm Tom Mullooly, and I'm here with my cohost Brendan Mullooly. And Brendan, you've got some information you want to share about 401(k)s you've been reading about.

Brendan Mullooly: Yeah. There was an article in the Wall Street Journal about a week or two ago. It was talking about, well, the title was The Case for Revamping 401(k)s, and discussed in the article was just the way that we incentivize people to use these accounts for retirement savings. The primary benefit that is pitched to people for making contributions to these accounts is that you can exclude your contributions from taxable income.

Tom Mullooly: I think a lot of people just miss that basic point. Like, hey, you know, if you max out your contributions, you're dropping your income, your taxable income by 18 grand if you're under 50. 24,500 if you're a 50 or over person maxing out your contributions. It's pretty good.

Brendan Mullooly: It's good, and that's what the article said. It's worked. It's worked okay. I mean, you could see, obviously, average and median balances in retirement accounts don't tell the whole story, but they're not great, you know? You see some people who manage to save a pretty good amount of money in these accounts. Other people, it doesn't really seem to be helping at all.

Tom Mullooly: Why is that?

Brendan Mullooly: I'm not sure. It's really just about savings habits. But, the idea this article is getting at was just talking about the exclusion of income as an incentive, and how it sounded good on paper, but it hasn't totally done it. It hasn't done enough to get people to do anything, obviously. So, just thinking about incentives, and how they may or may not always work. They sound good in theory. They don't really get people to do what you intend to do sometimes, or they have a completely different effect than what was intended.

Tom Mullooly: I think the bigger issue may be, and tell me if I'm wrong, but the bigger issue may be that people can't see that far into the future. So, there is no reward for them to have money taken out of their paycheck every pay period for a part of their life that's not going to happen for 15, or 20, or 30 years from now. And so, it's like, "Why should I do that when I have other things I want to do with the money? I want to pay down debt, or I want to go on vacation, or I have to pay my student loans." So, I don't think people can look that far ahead. Most people can't look that far ahead and say, "I really should be socking money away for retirement." We haven't created that much of an incentive, or painted an accurate picture for them, to show them how they're going to be eating dog food if they continue at the pace they're going.

Brendan Mullooly: Totally agree, and that that is the biggest hurdle. We try to create these incentives to get people to see these things, because left to their own devices, they don't. Not sure that the current incentive structure is working. This author suggested maybe something different, because over the next five years the government is going to give out basically a trillion dollars in incentives, meaning they're going to forego that much in taxable income by letting people exclude it. So rather than an exclusion, the author just throughout there, what if instead of an exclusion, we gave people a 25% credit, a tax credit, instead their contributions up to a certain amount, like 18,500? So, you would get four, $5,000, something in that ballpark. If you maxed out your account, you would get that in a tax credit because that's a little more valuable to people than just excluding 18 grand of income.

Tom Mullooly: Now we have to put whip cream on the ice cream?

Brendan Mullooly: If we want people to do it. I get that in a perfect world, people would just come to their senses and realize that if they don't save anything over the course of their career, that they're not going to have anything to live off of in retirement. But, I didn't think it was such a crazy idea. I thought it was interesting.

Tom Mullooly: I don't know. I hope they come up with something. I think one of the things that they implemented in the last 10 years is the auto-enrollment. Some firms have the ability to, as you get raises, you actually increase what you're contributing. That's great. And the numbers prove it. That more and more people are participating, and they're participating to a greater extent. More and more money's going into these plans. They're going to need it. I just don't know any other way to get people to take care of themselves. It's like exercise and dieting. It's, you have to take care of your future, your today's self, to be around for the future, and you're just screwing yourself if you're not putting some money away for retirement. I understand people, not everybody can do it. They don't make enough money, and their expenses are really high. I get it.

Brendan Mullooly: One of the biggest points in this article was that, and I don't know that a tax credit fixes this, but the exclusion of income as an incentive doesn't help the people who need the most incentive to do this. People who, I mean, 40% of people in this country probably pay no income taxes because that's the way the system is structured. They don't pay any income taxes, so who cares if they show less? "Oh, I can exclude 18,000 from my income?" That might be all they make this year. A lot of people outside of that 40%, like if you're making $50,000 a year, 60,000, it's not that much of an incentive to send money into a 401(k), because you're not getting a ton of taxes anyway, and it's not going to lower it by that much, when you do the math, to exclude whatever you can afford to put in there. If you make 50 and you can exclude 10, are you changing your tax bill that much at the end of the year by doing it?

Tom Mullooly: Well, wait a minute. We can probably do this on the back of an envelope now, you know? If you're a single filer, you don't have an exemption anymore. You get a standard deduction which is going to be $12,000.

Brendan Mullooly: $12,000.

Tom Mullooly: You make $50,000, you put 10 grand into a 401(k), now your income is 40,000. Now you take the personal exemption. Now you're down to 28,000. What's the difference? I mean, it's going to be some difference between-

Brendan Mullooly: In terms of their tax bill due.

Tom Mullooly: ... what their tax. Right.

Brendan Mullooly: It might be like, I would imagine, not more than a thousand dollars or something. When you take that thousand and disperse it over their paycheck 26 times a year, or whatever it is, do they notice? Does it matter? Not really, probably.

Tom Mullooly: Maybe they should just tell people, "When you put money into 401(k)s, that they're going to get all the hot IPOs.

Brendan Mullooly: Right.

Tom Mullooly: Or they're going to get all the marijuana stocks.

Brendan Mullooly: Yeah.

Tom Mullooly: Or the bitcoin.

Brendan Mullooly: Right.

Tom Mullooly: Something that's going to really, you know?

Brendan Mullooly: It's a double edged sword, and I get your point. Something that makes it more exciting, like the exciting part about saving for your future. I guess, to some people if there is an exciting part, would be the investing. But, I think that's dangerous too, because then you're encouraging people to get excited about investing their 401(k) money, because I think a pretty decent rule of thumb is that if you're excited about putting money into an investment, that it's probably a terrible idea.

Tom Mullooly: Right. It's tough because you don't have, I was going to say you don't have 100% participation. You don't even have 80% participation. So, it's hard to revamp these plans because you don't know, even if they ripped up the way that these plans work and created tax credit, or some other incentive to do it, what's going to make people, human beings, say, "You know what? I'm going to start doing that." It's talking about changing behaviors. Hard to do. There's got to be some other way to do it. I mean, one discussion that we've had around the office is why is there a cap?

Why is it just 18,500 that you can put on? Why can't you, you know, if you have the ability to put more into a 401(k), we're not talking about a million dollars, but why can't you put 50,000 into it? If you make the money, why not? They ought to be able to say, "Hey, I'm going to take this next level contribution for 401(k)s. I know everybody gets this 18,500 threshold, but if I go to 50,000, I'll opt out of Social Security. Give my social security check to somebody else. Someone who really needs it."

Brendan Mullooly: Yeah. That there would have to be some kind of a balance, because I think the reason that there is a cap is because the people that it would serve, again, aren't the people that we're talking about here.

Tom Mullooly: Yeah.

Brendan Mullooly: The ones who these incentives would be aimed at. The people who really need to take control of their future the most.

Tom Mullooly: I just-

Brendan Mullooly: Who have no retirement savings.

Tom Mullooly: ... Have you ever thought what life would be like if we just didn't have 401(k)'s and IRAs? I mean, stop for a second. Everybody talks about the good old days when people had pensions, you know? At most, we saw this number just recently, it was something less than 50%. Like 46% of workers 50 years ago had pensions, so they weren't the good old days.

Brendan Mullooly: We're reminiscing about the good old days that never existed.

Tom Mullooly: That never existed.

Brendan Mullooly: Which do all of the time across all spectrums of life. The world was always better in our memories, and that's just, yeah.

Tom Mullooly: Holy crap. You look at what some of the wreckage that people go through when they have an emergency and they got to take money out of their 401(k) retirement plan before 59 and a half, because someone in their family is sick, and they've got doctor bills, and they are falling behind on their mortgage, and they're going to lose their house. Okay? This is serious. Why do we even have some of these retirement plans? Why can't people just save their own money?

I know it's a rhetorical question. We'll have to have another podcast. We'll have to get some cannabis products in here or something, and talk about bigger issues, but we talk about the golden days in the 50s and 60s when everybody worked for GE, and they had worked at the factory, and they had a pension, and they bought a house for $11,000 on Long Island. Everyone was happy. That's not true. That didn't happen. So, it happened to less than half of the people that were working during that period 50 and 60 years ago. So, we misremember things. I just wonder sometimes, is it all worth it? Doing all these crazy rules for IRAs and 401(k)s, and things like that.

I don't want to go off the deep end, but it's part of the reason why, when you guys finished playing Little League, I got involved at the commissioner level for our district. It was, "Okay. Some kid got hit in the on deck circle?> Okay. Everybody has to wear helmets." And then, someone got hit when someone was swinging a bat. "Okay. No bats in the on deck circle." Then it was, "You can't use this size bat." Then it was, you know, there was a rule for everything, and we just keep legislating more and more things. Let's make IRAs. Let's make Roth IRAs. Let's expand the 401(k)s. You're not going to change people's behavior. Just save money.

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Brendan Mullooly: Yeah, I think you've got to find that balance between having rules, and just not having any rules, because I don't think the opposite end of the spectrum works either, where you just leave everybody on their own, because we won't do that. If we don't try to incentivize, or maybe even force people to save for retirement through ... Forced meaning like social security, or pension, and incentivized meaning IRA, or 401(k), or whatever it may be. If we don't do any of that, the behavior doesn't change, or it gets worse because now there's no incentive at all, so now literally nobody is doing it instead of just most of the people.

Then what happens when people can't cover costs? Do we just let them die in the streets? Is that a thing? Because at some point we all feel responsible, and we have humanity, and we help other people, so if we're going to help them out anyway, then why not try to do something about it now and help them out?

Tom Mullooly: I don't want to go off the deep end, because I know that this is a business podcast, but that's actually where the church used to come in and help people when they were really in need. All of that's going away. Legislated away. Brendan, I know you wanted to talk about the bond apocalypse.

Brendan Mullooly: Yeah. Good post from John Rekenthaler this week at Morningstar.

Tom Mullooly: At Morningstar.

Brendan Mullooly: Right. He talked about how in 2010, the 10 year fell from 3.8% to 2.5%, and that's really when talks began to intensify about a potential bond bubble. Since then, we've seen the 10 year hover between 1 1/2%, and probably where it sits today, I think close to 3.1?

Tom Mullooly: Right.

Brendan Mullooly: Right? We added a single decimal. One tenth of 1% higher than three.

Tom Mullooly: Now, part of the reason why they were talking about this bond bubble was because the countries in the eurozone were still in a recession. They were taking a much longer time than the United States to come out. We came out of the recession in mid 2009, 2010. A lot of these countries were still having trouble. 2011 we saw the Greece problem. They started lowering rates, or continued to lower rates in the eurozone. Then they actually started talking about negative interest rates for the first time ever in the eurozone. So, even a 10 year at 1 1/2% seemed like a sexy deal because it was a positive yield, and that's why we saw a lot of money come rushing into these treasuries.

Brendan Mullooly: Yeah, right. We saw, after the recession, we saw calls for things like hyperinflation because of things like quantitative easing, and the lowering of interest rates. That never came to fruition. So John was basically saying, and I really loved the way that he put this, that even if bonds collapsed tomorrow, the statute of limitations has expired. Those people were wrong, and they were wrong for eight years. Along the way, not that this is a binary decision, because investors obviously, now in hindsight, since 2010, would have been pretty well served in the market too. But, most people put together some kind of a mix in their portfolio of stocks and bonds. The bond side would've been just fine when we were calling for doom and gloom. So 2010, this is the aggregate bond index. 2010, up 6%. 2011 up 7 1/2%. 2012 up 4%. In 2013 down 2%.

Tom Mullooly: Okay.

Brendan Mullooly: 2014-

Tom Mullooly: So all through these years they were looking for bonds to get destroyed?

Brendan Mullooly: ... yeah. I think a bubble implies great pain. Obviously, maybe a bond bubble is less than a stock bubble. But, calling something a bubble means people are going to lose their shirts in it.

Tom Mullooly: Right.

Brendan Mullooly: 2013, down 2%. 2014, up half a percent. 2015, up half a percent. 2016, up 2 1/2%. 2017, up 3 1/2%. This year so far, down what? Like one, 1 1/2%?

Tom Mullooly: About one and a half, right.

Brendan Mullooly: Right.

Tom Mullooly: Yeah.

Brendan Mullooly: Good article from John. One of the points that he made in there was that the quote/unquote, "Smart money," so people in our line of work, investment professionals, were the ones calling for the bond bubble, not mom and pop investors, because everyone likes to joke about the-

Tom Mullooly: They're the dumb money.

Brendan Mullooly: The dumb money, yeah. These dumb people who kept piling their money into bonds, and bond funds, over the course of the last eight years and did just fine, whereas we have professionals who maybe are getting too wrapped up in the details, or whatever narrative they're trying to spin, and clearly wrong.

Tom Mullooly: You know, in this period, this last eight or 10 years, I think the lesson really has been for investors, with yields at levels where you need a microscope to see them, they're so small, you're not really buying bonds for income, are you? You're really, I mean, you want to buy bonds and hold them in your account for some kind of bumper, or diversification.

Brendan Mullooly: Yeah. It's funny that you say that, because another good posts from Morningstar over the last couple of weeks, I agree with your point by the way, is from Ben Johnson. He talks about the different kinds of bonds, and how some of them are better diversifiers than others. So you're talking about low yields on bonds. We've seen that over the last eight years, but some bonds yield more than others. You might think all bonds are equal here. Conventional wisdom says stocks and bonds, they're not perfectly correlated. It's two asset classes that people like to pair together for reasons of diversification, but it depends is the answer, because depending on what kind of bonds you put in your portfolio, they may or may not act as the buffer that you described when stocks are taking a downturn.

Tom Mullooly: Well, I think a good example of that would probably be probably, probably, be high-yield bonds.

Brendan Mullooly: Right.

Tom Mullooly: You know, these junk bonds, these are corporate bonds that are issued with some pretty higher than average rates. In our experience, we found that they tend to move like stocks.

Brendan Mullooly: It's tough because I'm sure there have been, will be in the future, people out there who want to be in something like bonds because they have heard that they are less risky than stocks, which is generally true, but then at the same time will look at bonds and say, "Ah. This one yields more than that one. Why don't I put my money here?" If they don't really know what they're doing, that may not be the strategy they want to go with, because they're going to get, not stock-like volatility, but not super far off either. That's kind of what Ben looks at in this article. He looks at correlations between the Russell 3000 Index and different types of bonds. Meaning he wants to see how well they move in line with one another.

Tom Mullooly: Okay.

Brendan Mullooly: High-yield bonds, a perfect correlation is when something is one. One is the way that they score a perfect correlation, meaning they move exactly in step with one another. High-yield bonds are .73 correlated to the Russell 3000 Index, which is a broad spectrum of IS stocks across mid caps and small caps and large caps. So, you're not really getting anything there. You could find another equity piece. You could find international stocks are probably .73 correlated to US stocks

Tom Mullooly: Basically, what you're saying is you're going to get about the same kind of risk that comes with it, with the returns that you're getting?

Brendan Mullooly: Yeah. So, to speak to that, during 2008, 2009, the biggest draw down on the Russell 3000 reached 51% during that time period. High-yield bonds were down 33%, right? So, you're not getting much there.

Tom Mullooly: You still got whacked.

Brendan Mullooly: Yeah. Whereas, these correlations too, they're not exactly static, as Ben alludes to. Even things like treasuries, at their worst, during 2008, 2009, were off. But they were off 4%.

Tom Mullooly: Right.

Brendan Mullooly: And they finished up the year of 2008 up, and depending on where you were, out the spectrum of the duration of the bond portfolio. You could have been up, as much as I think long term bonds in 2008 were up, 15, 20%. But the biggest risks for bonds are basically the credit risk, which is what we're speaking about, which is how likely are these bond issuers to pay back the money that they've been loaned? Which is, essentially, you're a loaner when you own bonds. How likely are they to pay you back? More likely being things like treasuries from the US government, and less likely being bonds issued by companies that are suspect with crummy looking balance sheets, or a-

Tom Mullooly: And every 90 days they're reporting earnings, and you kind of get a trend from there.

Brendan Mullooly: ... Yeah. Or duration risk, meaning how long are you loaning the money for? What Ben has seen a lately, with inflows at least, has been that people are looking for high quality bonds, and they're taking little or no duration risk.

Tom Mullooly: We're also seeing the same kind of things. A fractured market, so to speak, with municipals, because now some municipalities are more riskier than others.

Brendan Mullooly: Right.

Tom Mullooly: State of New Jersey. A good example. It used to be these turnpike bonds used to be Triple A rated. Fantastic. Now State of New Jersey bonds are all getting marked down. State of Illinois, same thing. So you've got to be really selective when you're making investment decisions on municipals, on corporates, really anywhere.

Brendan Mullooly: You want to know the exposure you're getting. So obviously, if you're buying an individual bond, do your homework on whatever the corporation or municipality is. If you put money into a bond mutual fund, or an ETF, look at the exposures. See what kind of credit ratings the portfolio has overall, and how much in each category. The duration of the portfolio is going to have a big impact in terms of if interest rates continue rising, things with longer duration are going to be affected more than ones with shorter duration.

Tom Mullooly: Good stuff. As a friend of the firm would say, "Fascinating." All right, that's going to do it for episode 229. Thanks for tuning in and we will catch you on the next episode.