All Upside and No Downside - Transcript

DISCLAIMER: Tom Mullooly is an investment advisor representative with Mullooly Asset Management. All opinions expressed by Tom and his podcast guests are solely their own opinions and do not necessarily reflect the opinions of Mullooly Asset Management. This podcast is for informational purposes only, and should not be relied upon as a basis for investment decisions. Clients of Mullooly Asset Management may maintain positions insecurities discussed in this podcast.

Tom Mullooly: Welcome back to the podcast. This is episode number St. Louis 314. So a couple of things that we wanted to cover today, a lot of them retirement plan-related. Two articles that I think we ought to focus on. The first one was an article in the Wall Street Journal about the mixed case for private equity in retirement plans.

Tim Mullooly: Yeah, I think both of the things we're going to talk about today fall under the, is it necessary umbrella. And this article in the Wall Street Journal about private equity in retirement plans is a perfect example of that. I don't know if it's necessary, and I think they said there's a mixed case, but the article seemed to make more cases against it. And I agree with all of those cases. There's just ... It just doesn't feel like there's a need for it. And I think it will confuse a lot of investors more than they need to be.

Tom Mullooly: One argument in the case for having private equity in retirement plans, is that the number of publicly traded companies has shrunk quite a bit over the last 20 years. More companies have found that it's a little better or more convenient for them to operate with a limited number of partners in terms of having private equity. Rather than go public and have to answer to shareholders every 90 days about their quarterly earnings in the past quarter, and what they see for the next quarter or quarters ahead.

Brendan: Yeah, I think the big argument for is that regular investors are somehow missing out because these companies aren't coming public or that their returns could be improved. But saying that private equity can do that, that's such a blanket thing because we think of private equity, there are a million different types of private equity funds, all sorts of different objectives. So we obviously think of all the wildly successful non-public companies that we could think of off the top of our heads. Companies that have later gone on to become public companies, but people couldn't get in at the ground floor unless they were an accredited investor or had connections somehow, or had enough money to invest in a private equity fund that had exposure to them. But to say just a blanket statement that it's going to give people a fair crack at investing in profitable stuff, we don't really know because you don't know what you're getting exposure to.

And people aren't really going to know anyway, because the way that they're describing doing this is by just injecting them into target date funds in retirement plans. I don't know. Again, another blanket category that you could make a ton of cases for or against that's become very widespread in the last decade let's call it.

Tom Mullooly: I don't want to get too far off the reservation, but when you talk about target date funds, there are different approaches. And you'll find that the mix from one family of target date funds to the next, their asset allocation can be pretty different.

Brendan: Their fees can be super different too just in terms of, because it's a fund of funds you're getting a pre-made portfolio. So yeah, depending on what they're using, that can be expensive, they can be cheap. The reason they've become so popular in general is because in the last decade, more and more retirement plans have okayed them being the default investment option. So when you get enrolled in your company 401k plan, instead of sticking the money into a stable value fund or cash basically, they put you into a target date fund based on your age, which I think is very useful for people because if they were just sending deferrals in to sit in cash, I think that's useless.

Tom Mullooly: And that's the way it was for decades.

Brendan: And a lot of people don't touch these things. And so rather than have the money just sitting in cash and then you find this out five years into it, because you were busy doing your job, at least you have generally appropriate investments. It doesn't mean it's tailored for your needs, for your situation or risk tolerance could definitely be improved upon customized, but it's certainly not the end of the world either.

I think it was a step in the right direction. But now as we've said, these things are all very different. And so some of them are going to have a little slice of private equity injected into them. And I don't know.

Tim Mullooly: Yeah. I think a lot of the cases against private equity in retirement plans is that there's a real lack of transparency. People won't necessarily understand what they're getting themselves into. Especially if it's kind of just shoved under the wrapper of a target date fund. They don't even know that they're paying or there's fees baked in with a private equity fund that are higher than usual. And these are private funds. They don't have a responsibility to report much of anything.

Tom Mullooly: But this is a seven, almost $8 trillion market. I think private equity wants to start tapping into.

Tim Mullooly: Yeah.

Tom Mullooly: There's a lot of ...

Tim Mullooly: There's a lot of upside I think for private equity to get into the retirement plans. I just don't know if there's a lot of upside the investors need to jump in on. I feel like there's the allure of, oh, it's private. It must be exclusive. I can't have access to it. It must be good. And then if that's allowed in their plans, people might think that they're getting in on something that is special or will help them outperform. And I don't know if that's the case, especially once you take the fees into account.

Brendan: Yeah. I was going to say that I don't think I've seen any evidence that would suggest that private versus non-private ... There's no definitive evidence that proves that it would be better for returns for people. That's nonsense if anybody says it would be. But one thing that we do know for a fact is indicative of future returns is high fee versus low fee.

Tim Mullooly: Yeah.

Brendan: And so if we're talking about something that on the whole is going to raise expenses for investors, which I would imagine this is going to, even if it's some cheaper version created by somebody like a Vanguard or a Fidelity maybe, it's not 2% and 20% of profits kind of fee. Maybe it's something lower than that. But if it's raising the fees that are baked into the 401K menu, I would imagine that, that's going to be a drag on returns moving forward. And that's not a good thing. We've been moving now for a while in the direction of lower fee 401K's making some progress. This would be a step backwards.

Tom Mullooly: There's actually been a lot of litigation over fees and 401K's.

Brendan: Yeah, and there should be.

Tom Mullooly: Yeah, I agree.

Brendan: Yeah.

Tom Mullooly: And so just to clarify something that Brendan just said, private equity space, venture capital space, hedge fund space typically operates on what they call a two and 20 basis. Do you want to just explain what that means a little bit?

Brendan: 2% management fee, regardless of what the fund does. And then 20% of profits above some sort of benchmark that they set versus 0.5% for a mutual fund.

Tim Mullooly: For a regular standard, plain vanilla index fund.

Brendan: That you're going to find in a 401k menu now.

Tim Mullooly: And they only gave one example of private equity returns versus non-private over the last decade. And it said that the private equity, the US private equity that they were measuring over the last decade had an annual return of almost 14 and a half percent.

Tim Mullooly: And then the total stock market index that they were measuring from ...

Tom Mullooly: This was the Wilshire, the Willshire 5000, right?

Tim Mullooly: It averaged about 13 and a half percent. So it was lagging the private equity funds by 1%. But then you bake in the fact that they're taking 2% for private equity and 20% for profits.

Brendan: I don't think that's a good measure anyway, because you can do the same thing for hedge funds and an index return of the universe of hedge funds or private equity is nonsense because we don't know which one you're getting.

Tim Mullooly: Right.

Brendan: So you're not getting an index of these returns. You're getting one of them.

Tim Mullooly: Yeah.

Brendan: And if one of them is going to make itself available to public investors, I just, I don't know. My guess is that you're getting the table scraps from the really good fund. So you're not getting exposure to the best private equity fund.

Tom Mullooly: I was just going to go there too. I really am skeptical that the offerings that are available in a large retirement plan are not going to be some juicy options.

Brendan: Your fund's getting the series D offering from a company. You're getting the fourth and fifth round of funding for a private company.

Tom Mullooly: Yeah, you're not an A level investor in Twitter or Uber or a company like that.

Tim Mullooly: So it said in the article that there's two, I forget. I didn't write down the names of the firms, but there's two private equity firms that have funds that are ready to be deployed into retirement plans. And neither of them report their returns. Great. So how do you even know if you're getting what you're paying for?

Brendan: You hit the nail on the head though before. I think this is more about these companies getting exposure to a big base of capital, as opposed to ... I just don't see what the upside is for the average investor here.

Tim Mullooly: For the investor, right.

Brendan: Especially if you're sneaking it into a target date fund, they're not even going to appreciate the fact that it's in there. It's just going to be snuck in there, and somebody else is going to be leeching more fees off of the fund that you're not even paying attention to because it's a default investment anyway.

Tim Mullooly: Is that small portion of the target date fund that's invested in private equity even going to move the needle that much for the investor to actually ...

Brendan: Are you going to be able to retire sooner because of that?

Tim Mullooly: Yeah, because there's a 15% private equity sleeve in your target date fund.

Brendan: No.

Tom Mullooly: Well, I also I think that they have to be cagey in how they get this into these plans. And burying it in a target date fund is probably the most clever way to do it.

Tim Mullooly: Especially because private equity funds aren't necessarily liquid investments.

Tom Mullooly: Right. So they have to put it in something like a target date fund that could be, that is more liquid.

So when you get retirees who are now in the phase where they need to take distributions or required minimum distributions, they probably have very, very little exposure to something like this. Their exposure, if they're in a target date or life cycle fund, it's going to be mostly bonds.

Brendan: But no, it's a good point because when you're talking about inflows and outflows, private equity isn't necessarily receptive to the idea of outflows. But if you've got people invested living off their money, they're going to be taking distributions and they need access to their capital, which is like the antithesis of private equity. But if you sneak it into a target date fund, it can suddenly be more liquid. But it can't be a standalone option, or it would be tougher to. We've seen a couple examples of I'm thinking of an insurance company in particular that runs a real estate version of this, which is kind of private equity-esque.

Tim Mullooly: Right.

Tom Mullooly: And you have a gated ability to access the capital and you just need to know that going in. And that's more complicated to run.

Brendan: Sure it is. You could only get back a certain percentage of your investment in the fund per calendar quarter or something like that. Or they can just straight up tell you, no, not now.

Tom Mullooly: I have this sneaking suspicion that private equity world may not enjoy ... Even though it sounds from the gist of the article in the Wall Street Journal, it sounds like they are really foaming at the mouth to get a piece of this almost $8 trillion 401K market. I don't think they're going to enjoy doing that because I think they're going to be open to more litigation over fees, more disclosure. They might as well just go public. They're going to find out, wow, this really isn't the party that we thought it was going to.

Brendan: Yeah. And just, I don't know ... Whenever I try to understand why something like this is happening, you just try to understand the reasons why it would occur. I can't find any of them. So I'm just trying to think along the lines of incentives. Somebody is obviously making a ton of money when this happens. And that's why it's going down. I don't see a clear cut benefit for the end user of these funds. So somebody is making a big profit off of this.

Tim Mullooly: It just seems like the article made the point. And I kind of agree with it too. This came on the heels of allowing certain types of annuities into retirement plans because they wanted to get exposure to the $8 trillion retirement plan pool. And now private equity wants to get in and they made the case that, that's going to open the door for hedge funds.

And it's just like all of these high fee, complicated kind of shady ... Not shady, but not transparent investments that just fall under the ... In my opinion, not necessary for retirement investors. They're all trying to break down the door and get in so they can all grab a piece of the pie.

Brendan: Right, so it gets easier and easier over time. They want to get in.

Tim Mullooly: Yeah, it just feels kind of sleazy to me. These people are planning for retirement. They don't need your two and 20 hedge fund and private equity funds in there taking some of their money.

Tom Mullooly: I think unless this all gets fleshed out a lot more than where we're at right now in the middle of 2020, I really believe that there's going to be questions moving forward with private equity in retirement plans and annuities about the fiduciary level of trust that's being administered by the plan trustees.

Brendan: Yeah. If these are allowed in the plan, it doesn't necessarily mean that the people who are overseeing them are going to say, yeah, let's do it.

Tom Mullooly: Right.

Brendan: Right? Because I think as you're alluding to, they're probably taking on some risk, even if it's been okayed by the regulatory authorities.

Tom Mullooly: Absolutely.

Brendan: It's like, eh yeah, that's nice. But I don't want to personally put my neck on the line for that because I don't feel like it's a great idea for the plan. So maybe the stamp of approval doesn't mean much moving forward. Maybe the people who are going to be the gatekeepers are doing a good job. But we've also seen that in the past, the revenue sharing nonsense and the whole 403B space. People will let a lot of pretty egregious stuff happen in these retirement plans. So I don't know.

Tim Mullooly: I think for me when comes down to it, it's like, okay, if you had to pick who is this benefiting more? The funds getting into the plans, or the investors investing in these funds? And I think it benefits the private equity funds more than it does the investor. So I don't think that it's right.

Tom Mullooly: Well, Tim, you teed up a perfect segue a moment ago for the second article with the annuities, and we ran right over it. Sorry about that.

Tim Mullooly: No, I was going to say even with what I just said, I don't think it's right. And Christine Benz wrote an article about if annuities are right for you. Annuities seemed to be a hot topic among advisors and people in the industry on whether or not they're actually valuable for clients or the merit that they have. But she walked through a few questions that people should ask themselves to determine if an annuity is actually right for you, because there are a couple of cases where it does make sense for people. They're not all bad.

Brendan: This was a good framework because again, like private equity or hedge funds to just say, annuities bad or annuities good is nonsense because it's such a broad space. There are specific kinds that I care for and don't care for. I kind of tend to fall along the same lines as Christine Benz here with the opinions. One of the things we're talking about here is, are these things that growth vehicle? In my opinion, no, not ...

Tom Mullooly: And all of our opinions, no chance.

Brendan: Yeah. Not a growth vehicle. She kind of just ran through a couple of things here. So, that being one of them. I think that in most cases, the type of returns you're going to get from an annuity type vehicle with all the riders and fees that are baked in, you're not going to get stock returns. You'll probably get something more similar to bond returns. So as a growth vehicle, not the best. And especially not the best if you're investing in an annuity, having forgone the opportunity to put money into other tax deferred areas in the first place. Because another reason would be, hey, I need to defer some taxes. I make a ton of money. I don't want to pay taxes on my growth along the way.

What else can I do? I max out my retirement plan at work. I can or cannot send money to an IRA. What else is there? So you could arrive at an annuity. I would argue depending on the need to access your money over a period of time, that comes into the question. But you could run a portfolio that just doesn't have a lot of turnover and you keep it a lot simpler than going with the annuity wrapper for tax deferral. You could just run a tax managed brokerage account instead.

Tom Mullooly: There's so much to unpack when we start talking about annuities. I think inside retirement plans, annuities make sense for some cases.

Brendan: Well specify what kind of annuity you're talking about.

Tom Mullooly: Okay, so I'm talking about ...

Tim Mullooly: And their plan for retirement. Not within their retirement account.

Tom Mullooly: Right.

Brendan: Right.

Tom Mullooly: So I'm talking about an immediate annuity, not a deferred annuity. Here's how we can take your lump sum of money and turn it into a stream, an even stream of money, not going to be impacted by the markets whatsoever for the rest of your life. And maybe over yours and someone else's life.

Brendan: Works like a pension or social security.

Tom Mullooly: Works great.

Brendan: Maybe you want to do it with a portion of your money.

Tom Mullooly: That's right.

Brendan: So that you know, hey, I've got social security that throws off X. I'm going to buy this annuity that's going to throw off Y. And then the rest I'm going to make up from the investments that remain liquid outside of those things.

Tim Mullooly: Yeah.

Tom Mullooly: These annuities, they're good for some people, but do we need to see billions and billions of dollars going into these products every year? Probably not. It just doesn't make economic sense for a lot of people who are buying them, especially inside retirement plans. And they're buying them with the idea that they've been sold as a growth vehicle.

Brendan: Well, so one of the other things that I have a big problem with ... So the box we've just checked there is, if you need a steady income and you want to make sure you don't outlive it, you can make a deal with an insurance company to get income stream. Like you just said, over a lifetime or joint lifetime. Check. You can do that with an annuity. That says nothing about growth or anything like that. I think a lot of people get talked into buying these things because the promise is that you don't have to deal with market volatility. That you can somehow grow your money without being subject to any volatility in the stock market, which is total bull crap.

Tim Mullooly: Upside, no downside.

Tom Mullooly: That's false, just an outright lie.

Tim Mullooly: Right.

Brendan: The important distinction that I would make is that you're not going to get stock market growth. You will pay dearly for not dealing with the volatility. If you don't want to have volatility and you want to sign up for a deal so that you have a capped downside, you're also going to have a capped upside. And the insurance company usually has the rights to change the rules along the way. So as I said earlier, what you end up getting is something in the realm of returns you might have earned in a bond index fund over time.

Tim Mullooly: Right.

Brendan: So if you're doing this with all of your money and you need stock like returns to meet or obtain goals in the future, you need to deal with the stock market volatility you get there. I'm sorry to tell you that, there is no way around it no matter what anybody trying to sell you a bill of goods has to say.

Tom Mullooly: So, it's amazing to see when you step back and see that you're going to earn bond-like returns ...

Brendan: And have no access to your money.

Tom Mullooly: And have no access to your money. But to get those kind of returns and to see how detailed some of these contracts get with gee, should I lock in the 8% cap upside on the NASDAQ? Who cares?

Brendan: The rules are set up to benefit the insurance company so that they can turn a profit. This isn't a charity for them.

Tom Mullooly: Right.

Brendan: So they make these rules. And then you have to read a book that looks like the Hobbit, or like one of the Lord of the Rings books. It's like 4000 pages with tiny print. You have to read the rules, and all of them are different. And none of them are good for you.

Tim Mullooly: I think the annuity that Tom described and that you described that is appropriate for people is very simple. You described it in 30 seconds and it was very clear. As you get more and more complex down that line into the equity indexed annuities, variable annuities, all these different things with all these different rules, to me it just becomes more and more unnecessary. So that's where I kind of draw the line in terms of which annuities are actually useful and which ones are sold as useful and end up being not as useful as they were made out to be.

Brendan: The insurance companies ... Basically we're talking about ...

Tim Mullooly: Because the annuities do exactly what they're designed to do. It's not like they don't work. They work exactly as they're designed. It's just people don't understand how they're designed. Or they're not explained in a clear manner when they buy it.

Tom Mullooly: It's unfortunate because we have to oftentimes explain to people who are three years into an annuity, four years into an annuity, an annuity they bought somewhere else ...

Brendan: A deferred annuity usually that's supposed to be a growth kind of investment.

Tom Mullooly: Right.

Brendan: Right.

Tom Mullooly: And now they can't even get a phone call back from the person that sold it to them, or that person's moved on. And they can't get any answers to this. And we're the ones that kind of have to pick up the pieces and explain this to folks. So, okay, this is what actually happened. And this is what is going to happen. Your prison term will end in five more years when the surrender charge ends.

Tim Mullooly: Here's what you actually bought.

Tom Mullooly: With a tax bill.

Tim Mullooly: For me too, in terms of liquidity, for people if they need that money at all within the next three, four or five years like this, and any type of annuity with a surrender charge is absolutely inappropriate and they should run away. If liquidity is a big concern for you, most annuities are probably not something you should be looking at.

Brendan: Usually people haven't considered the idea of if it's a deferred annuity that's supposed to grow for them, they're not sure because the point is so long into the future. They're not sure if they even would want to annuitize at the end of the growth period, whether we're talking variable or equity index annuities here.

Tom Mullooly: Right.

Brendan: So if they don't know that and the growth in the annuity sub-accounts, or whatever we're talking about here is based on them annuitizing at the end, giving up that pool of money and then collecting an income, a lot of them, they bought it because they thought it was market upside with limited downside kind of product. And what they're finding out is that is only true if they play by the rules for longer than the surrender period. And then they also want to turn over all of their money to the insurance company to collect it in a monthly income. They can't take out lump sums. They can't take out different amounts if they want to do something different one year versus another year.

They've basically taken those investment dollars and they've turned it into a pension, a future pension payment.

Tom Mullooly: Which may or may not be what they had in mind.

Brendan: Right. Assuming that they annuitize.

Tom Mullooly: Yeah.

Tim Mullooly: I think if you don't plan or if you buy an annuity, you should 100% annuitize it at some point.

Tim Mullooly: And if you don't ...

Tom Mullooly: Yeah, if you don't then why did you buy it?

Tim Mullooly: Why did you get into this thing?

Tom Mullooly: Right.

Brendan: Yeah.

Tim Mullooly: And that kind of speaks to what you just said. Some people don't even know if they want to annuitize it at the end of the line.

Brendan: You've got people in their thirties, forties, fifties who have 10, 15 years minimum before they would think about collecting money. So to them, the idea of having to know whether or not ... Because you need to decide now, am I going to turn this into an income stream in the future? And if you're not, then you have to consider why you're in it, like what you're saying.

Tom Mullooly: A lot to unpack as I said earlier. These types of topics raise a lot of questions. So if you've got questions or you know someone that owns an annuity, they're not really sure how this thing works, definitely share the link to this podcast with them, or have them call us. And we'd be happy to walk them through what their money's tied up in. That's going to wrap up the St. Louis episode, episode 314. Thanks again for tuning in. And we will catch up with you in Syracuse, 315.