Episode 171: Unlocking the Secrets of Bond Laddering

Tue, Mar 25, 2025 1:33PM • 49:58

SUMMARY KEYWORDS
Retirement income, bond laddering, ETFs, Life X Funds, fixed income, retirement planning, income annuities, spending needs, inflation protection, Monte Carlo simulation, tax efficiency, bond maturities, financial planning, risk reduction, investment strategy.

SPEAKERS
Bob French, Nate Conrad, Alex Murguia, Briana Corbin, Wade Pfau

Bob French 00:00
The purpose of retire with style is to help you discover the retirement income plan that is right for you. The first step is to discover your retirement income personality. Start by going to risaprofile.com/style and sign up to take the industry's first financial personality tool for retirement planning.

Briana Corbin 00:41
Welcome back this week, it's all about giving bond ladders a glow up. Nate Conrad from lifex funds joined Wade and Alex to explain how ETFs can bring stability and strategy back to retirement income. Turns out ladders are cooler than they sound.

Alex Murguia 00:57
Hi everyone. Welcome to retire with style. I'm Alex and I'm here with Wade.

Wade Pfau 01:02
Hey everyone. And Alex and I are joined today by Nate Conrad from life X funds at Stone Ridge, and we're excited to talk about retirement income bond letters and in relation to the tool that lifex now has developed with with a suite of ETs. So Nate, welcome to the show.

Nate Conrad 01:18
Thank you for having me excited to be here today. Yeah,

Wade Pfau 01:22
yeah. And so for our audience, now, we know some some audience members may be familiar with life x, it has gone over, some gone through some changes over the years. It's now a suite of ETF funds no longer age based, like it was in the past, focused on the idea of retirement income, Bond letters, and so that's really going to be the topic of the conversation today, but we do want to make clear everyone listening understands. If you're familiar with life x from a couple years back, you want to take another look at it today. It's designed even, I think, up to 40 years of protected income. And that's one question I'd like to dive into deeper about how that works.

But yeah, that's going to be the conversation today, retirement income bond letters. And if you could just tell us a little bit about how you got to the point of developing a suite of retirement income focused products to help Americans as they get to retirement, and what's, what's special about especially the inflation protection and so forth.

Nate Conrad 02:18
Sure, happy to so, you know, I come from a background in bond trading, and you know, we'll see if I can make Wade blush a little bit here, when I started learning about the retirement income space, it was from reading Wade's paper about the efficient frontier for retirement income and learning about the way that income annuities can really reshape the way you think about a portfolio and create better outcomes for people in retirement, and for me and quite a few of my colleagues, including who everyone up to our CEO, Ross Stevens, we really fell in love with this idea of how can We drive better outcomes for people by improving the way fixed income plays a role in the portfolio. And you know, in your work, you did a lot talking about the way income annuities fit in. And from our perspective, that the challenge is just that most Americans haven't adopted that product as a solution, and so there's this incredible efficiency that you've documented academically in a better way to build portfolios. And we set out on this mission, you know, that we're now about seven years into of figuring out, how can we help more people get the benefits of this kind of an approach where you think about solving for spending needs and separately solving for growth, and build those two things together, and call it a bucketed approach that will ultimately drive better outcomes, both in terms of satisfying spending needs over the course of your life, as well as helping you achieve maybe a greater growth outcome or greater legacy outcome, in expectation, of course, with some degree of risk, when you're using investment products that have inherent risk. So that was really what set us off on the path,

Wade Pfau 04:07
okay? And yeah, I mean getting into things. I think a lot of listeners are familiar with bond funds, and this is technically a bond fund as well, but it's a bond ladder version of a bond fund, whereas most bond funds are like a constant duration bond portfolio. So could you talk a little bit about that? And when you're focused on funding a retirement liability, why you may want to think more about duration matching your liability with a retirement income ladder, rather than using a constant duration bond fund?

Nate Conrad 04:39
Sure, you know, maybe, maybe we'll get a chance here today to unpack it both, you know, from quantitative, you know, numerical perspective as well as you know, maybe from more of a human perspective, you know, when you just think about, you know, quite bluntly, the name fixed income. So we call it that for a reason, which is that people began accessing fixed income by buying bonds where you know the coupon and you know the amount of the principal, and you know when everything's supposed to be paid, and when you buy the bond, unless that issuer defaults, everything is totally fixed, and you know the income, and, you know, the cash flows, and when the mutual fund came along, and when the ETF came along, those provided a dramatically simpler way to access fixed income in a diversified manner, compared to you yourself going out and buying hundreds or 1000s of individual bond cusps if you wanted a big, diversified Bloomberg ag style portfolio. But when we packaged fixed income up the way we did as an industry, we really lost that virtue of totally fixed income, because when you buy a bond mutual fund or a bond ETF, the income varies year to year based on whatever the yield of the

fund happened to be that year, and you never get your principal back until the day you sell, and you don't know what it's going to be worth if you're going to sell at a market price. And so for us, the observation was that as we packaged up this academic concept of diversification, which is so powerful, you know, in reducing risk, not eliminating it, but you know, really, really reducing it, we lost the true property of creating fixed income, whereas a true bond ladder, where you own a series of bond maturities, you know your coupon income, you know your principal income, and you can design Something that actually really aligns with your spending function. When you do that, the only risk you have is issue or default risk, if you're just holding those things to maturity and spending them, whereas we've created a new risk for people, which is market volatility based on the duration or the credit spread of what they own and having to sell at that volatile market price ends up, from my perspective, having a pretty stunningly negative impact on the safety of that spending plan that people create for themselves. And that's what you really see come out when you study these things in a Monte Carlo or in financial planning systems.

Wade Pfau 07:21
Yeah. I mean, I guess the way I think about that too, like with a bond fund in a total return investing environment, it's really just meant to reduce volatility, not because you're using it as fixed income, but because it has a lower standard deviation than maybe some of the other asset classes you're looking at. But that's more for an accumulation framework. It's we got to emphasize, we're talking about a liability here. You're trying to fund a retirement spending goal. And what does it mean to just have a less volatile, but still nonetheless, still volatile asset class, because it's not linked to your spending need, compared to to a bond ladder that has, as you said, coupon payments, as well as maturing face values that you've anticipated will fund the expenses as you go each now, actually in your with these funds each month in retirement, there's a distribution, not as it is usually with treasuries, where you're going to get two payments a year. Could you talk a little bit more about that as well, just how the actual design of life X works to provide that income

Alex Murguia 08:26
and and just to chime in here, when you do that, can you do that within the comparison, at least a little tidbit of a comparison? Because I'm thinking of folks listening in, thinking about, Wade, is that a bullet? Sort of share kind of thing, you know, that kind of just to touch upon that as well,

Nate Conrad 08:42
sure. So I think when most people think about a bond ladder, one of the typical approaches people create in a bond ladder, for simplicity, is they're really going out and buying something like one bond maturing every year for a horizon, maybe three years, five years. And so just for example, let's say you're building a five year bond ladder. You've got $100,000 and you buy $20,000 of a bond maturing in 2025, 20,000 in 2026, and you know, so on, you know, equal weight over five years. That's, I think, probably the most common shape of a bond ladder in the market today. And if you think about the experience you have owning that product, you have cash flows that are quite lumpy and spread out, because your principal is going to come back to you in annual chunks every time one of those bonds matures. And you're also getting this coupon income that actually decreases over time, assuming you're spending the money that comes out. Because in the first year, you have five bonds paying you coupons, and then the second year you have four and so on. So if you create a bond ladder that way, which I think is the most common format, it's very hard to live. Your life using that to plan spending, because you got to spend money all year long, and you have this uneven and lumpy thing. And if your

income is decreasing because of the way those coupons bleed off, most people, spending doesn't decrease over time. If anything, it increases with inflation. And so what we wanted to create in our product is both, you know, the the you know, call it like one ticker, easy way to access a bond ladder by wrapping it to an ETF, but also really adapt to the human way we live our lives, which is, we're spending money every day, and we got to pay our bills every month, and so what we created is a suite of ETFs that pay a distribution every single month. And behind the scenes, you have to do something a lot fancier in the way you shape the bond portfolio to be able to create smooth monthly income. But we do all that work behind the scenes in the ETF, so that as an ETF investor, you just get to collect that monthly distribution, and we offer a couple different flavors of those payouts. So we have, we have one set of ETF that targets what we call a level pay framework. So for instance, our lddr ticker is designed to go through the end of 2035 and to give you the exact same distribution per share every single month through 2035 and so if you wanted to try and target spending $1,000 or $10,000 a month, every month through 2035 it's very easy to figure out how to target that using lddr, we have a second version that's really meant for longer horizons that we describe as front loaded. So if you wanted to create a 30 year 40 year plan, what we do is we target a distribution of $10 per share in the early years and seven and a half dollars per share in the later years. And the thought process there is that for a lot of people, their spending needs are higher with they're in their 60s or in their 70s, and they're in a little bit better health, more travel and expenses of that nature, and then it tends to decline over time. And so that's about a 25% tilt towards the early years. And then we have another, another framework that is targeting a CPI linked payout style, where we're investing in tips instead of regular government bonds. And each year, the goal is to adjust that distribution based on inflation, which on average over time, you expect to be positive. And really, we think of that not as you're making money by getting a higher level of distributions, but rather, if you didn't get that, your real spending power would be decreasing. We're trying to provide you a real spending power over time

Wade Pfau 13:00
can and so those are like to just reiterate, 10 years, 15 years, and 20 years for the level, kind of level or inflation adjusted. And then I think it's 23 years through 40 years for the either level pay or inflation adjusted. But then with the 25% reduction for the final 20 years, right? An interesting point. So, like, whenever we've talked about tips ladders or Treasury ladders, 30 years has been the max. Could you talk a little bit about how you're able to go beyond the yield curve in that manner?

Nate Conrad 13:36
Sure, it's a it's a bit of a quantitative answer. So if you'll forgive me for being a little bit nerdy about it, you know the trick of the way we operate our funds that go beyond, let's say, 2055 which would be about as long as you could go if you're just buying the longest stated US government bond. When we start to look at 2060, or 2065 the key insight that underlies how we manage that is that there's really not much that we could learn in the world tomorrow that will impact interest rates in, let's say, 35 years in a way that's different than the way it'll impact the interest rate 25 years from today. And so when you when you look at that from a statistics perspective, what you would say is that the the you know, 25 year forward interest rate is extremely correlated, very nearly correlation one to the 35 year forward interest rate. And so the way we decompose the problem when we think about hedging that 35 year forward interest rate is that we proxy hedge it with something more in the 20 to 30 year range, where there are a lot of bonds to choose from, and we buy a quantity that is adjusted to reflect the duration risk and

the convexity risk that is inherent to those longer. Term bonds, and then over time, over the next decade, as the government comes to market with more bonds, we actively manage that portfolio through time to continue to replicate that risk as best as we can. And so it's not, you know, hedged to the 100.0 percentage point, but we think it's a pretty effective way to mitigate that risk and to create reliability all the way out to 40 years. Take all that work off of the you know, end investors, so that you can be 5560 years old and start thinking about planning, you know, out through the end of your financial planning horizon. And by wrapping into an ETF, it not only you know, takes away some of the work. But ETFs have these great features of the ability to do, you know, tax efficient in kind, create, redeem and other ways of minimizing both kind of the tax and the transaction costs associated with that rebalancing through time. So it's not quite as simple as a set it and forget it bond ladder, but because we wrap an ETF, you get a little bit more of that. Set it and forget it experience.

Bob French 16:07
Let's take a moment to let the audience know that this show is sponsored by retirement researcher. You can learn more about retirement researcher at retirement researcher.com and subscribe to our newsletter, where You'll receive weekly actionable information for your retirement planning benefit. Retirement researcher is an online community devoted to helping you create the retirement income plan geared towards your goals. Yeah,

Alex Murguia 16:31
and if, if somebody wanted to do beyond, you know, they get the 10 year or was, was a was there a lower what are the the lengths again on this

Nate Conrad 16:40
so we have as short as 2035 and as long as 2065 okay, so 40 different ETFs, so

Alex Murguia 16:47
someone could pick up the 2035 and then at 2035 there's no more. And so they would just get another one at that point if they wanted to contain your ladder, right? Yeah.

Nate Conrad 16:57
So lot of different ways people think about using them. You know, I think probably the most common way that we've seen in the market today is a lot of people, you know, really believe in this idea of long term investing. And you know, if you can stay in the stock market for at least a decade, sure you feel very confident that you're going to have a positive return. So the question is, how do you set yourself up as effectively as possible to stay invested for the long term, and covering your spending needs for that first decade with a bond ladder is a way of really letting you leave that investment portfolio, hopefully untouched for a decade plus to really pursue compounding, hopefully worry a little bit less about the ebbs and flows of the market, no,

Alex Murguia 17:43
but this is like a viable bridge if you bring in a financial planning component. You know, folks like to delay Social Security, correct? And so a lot of bridging, we got tons of questions with regards to bridging strategies, and this is almost a bond ladder in your pocket. Bridging bridging strategy here, if you will.

Nate Conrad 18:04

You know, I think there are a lot of people out there who like to use the quote that when you're in retirement, income is the outcome, right? Yeah. And, you know, the human thing is just all about like, where, where's the money coming from to spend every month? And it's all well and good to say that deferring Social Security is a good idea, but I still got to go pay my bills. So what should I do? No, I understand. And so just, you know, what's the purpose of bonds in the portfolio? Let's give them the purpose that matters most to people, which is, how am I going to spend money? And how am I going to think about generating that in a conservative approach? You know, I don't want to generate my spending money personally by relying on the price of the s, p, whereas I can buy a bond that's going to mature and it's US government. I feel pretty good about that.

Alex Murguia 18:51
Well, this, this touches upon the other saying you hear a lot where personal finance is more personal than finance, and so, you know, walk us through the behavior of stuff. Why? Why? Why do you think that's an added benefit to this whole thing?

Nate Conrad 19:06
So when you think about the experience of owning, you know, I think we'd use the phrase more like concentration bond fund. I think it's a good way to describe it. I think once you really look into the experience you you start to wonder, why? Why is that the default way people own bonds? Because, to me, it doesn't actually have very good

Alex Murguia 19:29
vestige of accumulation based in thinking exactly. It's fine if you're doing that, where the bond fund could be a balance for the portfolio. You're not looking for income. You just, you want the the you know, the dampening of the volatility, if you will. But it's different than retirement. Hence, exactly

Nate Conrad 19:45
so you know you buy, let's say an intermediate five to 10 year horizon, target duration bond fund interest rates go up 2% and that's what happened in roughly in. 2022 and at that type of a bond fund duration, you're probably talking about a markdown, you know, in price space of five to 10% Yeah. And for people who came into 2022 owning that sort of a fund, they came into the year with a yield on those funds about one and a half percent. And if you own something yielding one and a half percent, and then you take a 10% markdown, that is more than six years of that yield lost on paper. I think bond funds were

Alex Murguia 20:32
down on average, like 20% exactly

Nate Conrad 20:34
20 plus. You're sitting there saying, you know, I've wiped out a long, long time worth of earnings I'm sitting here underwater, and how am I going to claw back out of the hole? And it's a concentration bond fund, so it's not as if you can say, well, I'll just wait till it matures and get my money back. Yeah, you're in it, whereas if you owned a bond ladder, that was, let's say, a five year horizon, it's going to decrease on paper and market value, but as long as that issuer doesn't default, you're going to get the exact income and the exact principle that you thought when you were getting out. And so if you came into that with a held to maturity mindset, maybe

you don't even care at all that interest rates went up 2% so you have this terrible experience on the one hand, versus maybe not caring at all. On the other hand, that's if rates go up, rates go down, you just flip the whole thing on its head. If you own, you know, the the bond fund, now you have a price gain. Let's say it happened because, you know, the stock market crashed and interest rates fell. What you might want to be doing is saying, you know, I'm going to take some of my bond money and rebalance it into the stock market to balance out my portfolio. But now what that's saying is, you know, you have this low returning asset, it appreciated, and now it's time to pay a bunch of capital gains by selling that thing and writing a check to the government and creating leakage in your rebalancing. Or, you know, if you're trying to spend money the same thing, you got to sell it to get the principal out, versus if you own the bond ladder, you're probably saying to yourself, gee, I'm really glad I locked in interest rates when they were higher. Now I'm going to be collecting that same interest and principal that I wanted, even though rates have gone down. What

Alex Murguia 22:18
would happen if someone had to sell? Let's say the 2035 fund, and 2030 comes in and they get they have to liquidate. Are they subjected to the same slings and arrows of a normal bond fund?

Nate Conrad 22:28
Roughly the same? You know, price could be higher or lower. You'll have a capital gain or loss based on changes in bond prices. The one thing that's different, though, is it's not a concentration bond

Alex Murguia 22:40
fund. That's what I wanted to get in your answer. But in 2035 versus

Nate Conrad 22:44
today, the bonds it owns are going to be shorter dated. And so as it goes through time, you know, because those bonds are shorter and shorter dated, the price volatility gets smaller, and it kind of pulls to par, if you will. I got you. And so there should be relatively smaller capital gain or losses to be realized the closer you get to the end year, and when you think about the cash flow you're getting out of this thing, you know today, the the monthly distributions of that 2035 fund are a little over 11% distribution rate per year. And as you go through time, we're returning capital to you, and so the NAV is going to go down. And so when you fast forward five years, and we've returned capital for five years, that distribution rate is probably going to be a lot higher. And so you might actually not even have to sell it all, because the cash flow is just coming back to you so quickly as a percentage of the asset value, yeah,

Alex Murguia 23:46
especially if you're not using it as for income, you're just going to reinvest, to some extent. But I think this is the key here. There's a behavioral piece where, okay, there's some price stability, if you will, because you're taking everything, you're just waiting for things to mature, but I think also sure people can construct this. But talk about like the PETA factor here. You know, just that alone, just having everything in one wrapper, just makes a lot of sense from just an ease of of execution. What

Wade Pfau 24:18
was the factor there?

Alex Murguia 24:22
This is a really G podcast. So

Nate Conrad 24:29
when I've spoken to financial advisors who believe in the power of lottering, you know, there are those out there who believe so strongly in this that they go out and they build a bond ladder for, you know, a few or a lot or every single client, and they go out and buy every single Q sip. And one advisor told me that every single time he adds a new client, he spends about three hours building a spreadsheet and going out and buying all the different bonds and getting that in place. And that's a lot of work. Haven't you been an advisor once

Alex Murguia 24:59
tag? Actually work, really.

Nate Conrad 25:03
And then just imagine that you want to make a change. You know, how many people do you know that have a bond letter that add to it or redeem from it because they want to rebalance their portfolio 100% you know, if you, if you think about a 10 year horizon, if you want to get cash every month for 10 years, 10 years times 12 months, that's 122 sips. So imagine, just for starters, placing 120 trades, and then imagining saying, you know, I think I just want to make like, a 5% change to the way to my portfolio. I'll just go place 120 trades to reduce IT pro rata, or to add for errata, I've never met anybody. No, it's their hand. It said they do that. You know, it's not practical.

Alex Murguia 25:46
And I'm even thinking the reporting, if you do quarterly reporting, a performance report, would just It would almost look like hieroglyphics at some point. And

Wade Pfau 25:54
in January, I did a workshop at the Retirement Research Academy about how to construct a bond ladder. And yes, it gets incredibly technical when there are coupon payments shortcuts, like there's this nice website, tips ladder.com that will tell you what to buy, but yeah, then you have to actually go out into the secondary market and buy a ton of individual bonds. So even with shortcuts, someone builds a spreadsheet for you to show you what you need. I mean,

Nate Conrad 26:22
yeah, I mean, in tips, you know, there's like a five year period where there just are no maturities. There's realities to it. You know, both the practical of, do you want to do that amount of work? Then there's, you know, what's the quality of the product you get? And it, is it the same thing that you would get here. There's a, there's a book that I love called atomic habits. The whole purpose of the book. How do you create and adopt and, you know, entrench habits? I just

Alex Murguia 26:49
want everyone to be 1% better, yeah.

Nate Conrad 26:53

How do you make things easy so that people actually do it? And when you look at, you know, how do we get to a place where people actually diversify and use the buy the market philosophy. We got there not because people said, well, let me just go buy 500 individual stocks. We got there because we have the index fund and a mutual fund or an ETF, and everybody does it that way, even if you could save a few basis points buying 500 stocks yourself.

Wade Pfau 27:20
So you're saying life X is kind of like to bond laddering as a index fund is to stock investing. That

Nate Conrad 27:26
would be, that would be a wonderful thing for people to think that one day. But I

Alex Murguia 27:30
mean it. But to be clear, you're talking about from a logistics standpoint, yeah, absolutely, it's it. You know, it makes life a lot easier. And when you do that, there's just less errors involved.

Bob French 27:41
Are you getting close to or are you in retirement? Well, investing during retirement is a little bit different than during your working years. Your investments are there to help you pay for retirement, and now is when they need to earn their keep to make sure you're on the right track. Download retirement researchers eight tips to becoming a retirement income investor by heading over to retirement. Researcher.com/eight tips. Again, get retirement. Researchers, eight tips becoming a retirement income investor by going to retirement. Researcher.com/eight tips. That's the number eight tips.

Wade Pfau 28:21
Another thing I think that's worth looking at. You shared with us a case study that you ran getting at this idea of we're back to concentration bond funds again. But if you you looked at running through basic financial planning software, investing over 20 years, investing over 20 years to fund spending for 20 years using an intermediate term government bond fund that we've had recent episodes about Monte Carlo. Up on this a 4.2% average rate of return with a 5% standard deviation. That was the assumptions driving the simulation, and how much you could spend with that versus if you know you're holding those bonds to maturity, and you know what the liability that your funding is, you've already talked about the potential for paper losses, but when you hold those bonds to maturity, you're not a professional bond trader. You're someone who's trying to have predictable income for your retirement. There's really not any standard deviation and and when you looked at that, what did you see in terms of those outcomes about potential spending from a pot of assets? So,

Nate Conrad 29:27
you know, this is one of those where, you know, you have a directional intuition, and you have no idea what the magnitude is. And I thought there was going to be something here, and I was pretty surprised by how big the effect was. So, you know, like you said, that the test we ran was Imagine, for simplicity, that you had a portfolio that is purely 100% you know, core government bond. You get your spending every month by collecting whatever the yield is and then selling to get principal. And the study, you know, using third party financial. Software said that you could safely spend about 5% of your starting principle every month for 20 years. And that path in the

Monte Carlo had about an 85% probability of success, 15% probability of failure. That was, you know, 4.2% return of bonds. Was the assumption that's pretty close to where interest rates are today in the government bond market, and a 5% volatility. Plug that in, you can spend about 5% of your portfolio every month, and the intuition we had was that you're taking a lot of risk there. There's a 5% volatility you're selling every month that should be injecting risk and hurting your ability to spend safely in this plan. And so we wanted to know, if you just built a bond ladder instead to create income every month for 20 years, what would that let you spend? And we used the same 4.2% rate. And just, did you know, time, value of money discounting of 20 years of spending, and we got a spending rate more like seven and a half percent instead of 5% and so no, for somebody who's, you know, got a million dollars in their nest egg, that's the difference between spending, You know, 50k versus 75k so pretty incredible difference. And it's not a statement that you're earning a higher return. Really, you should be earning an expectation, the same return you own, something returning 4.2% an expectation, either way, it's a story about risk reduction through holding to maturity and constraining the risks of your bond investing to be, you know, really a function of issue or default risk, and stripping out the volatility of selling at a market price. And so to us, that's the whole story of, you know, whenever in finance you find something that you believe gives you the same return with lower risk, you have to ask yourself, Why am I not doing that?

Alex Murguia 32:03
I think there's one more piece there. This is intuitively that I don't think you can work it into the study. But Wade talks about this as well. Wade and I'm going but at it where, if you've earmarked your retirement income from this particular source, it gives you a lot more flexibility to do different things with the other portion of the investments that you'd never you don't have to kind of leave, just in case amount in that other part,

Wade Pfau 32:29
right, right? And that's important, like, if somebody is just kind of trying to follow through in their mind, how could you spend 50% more from the bond ladder than from a bond fund that has the same average rate of return? Well, the idea is the bond ladder would deplete to zero after the 20 years, the in 80 and in 85% of the simulations with the bond fund, there's still money left. I saw the report you shared like on average, about 20% of your initial balance is left after the 20 years. So it's not that you're assured you'd hit zero, but this is the whole question around in this case, there's not longevity risk, because we're talking about 20 years, but if I'm going to self manage market volatility, I'm forced to spend less to help ensure I don't run out of money. And so it's almost like, well, if I could spend 50% more from a bond letter, I can earmark less assets to the bond ladder that frees up other assets on the portfolio to be a source of true liquidity. That Can you talk a little bit about that as well? How? Yeah, you might have money left with that approach where you're spending less, but you're forced to allocate more assets to that spending goal, when those assets could have been freed up to do other things instead.

Nate Conrad 33:38
Yeah, no, exactly, you know, I think there's this, there's this idea that, for some people, is an, you know, an initial reaction of, how do I create safe spending power? And the idea is, I'm going to own bonds, and I'm not going to touch the principle. I'm just going to collect the coupons, I'm going to spend only the coupons, and I'm going to create safety by not touching that principle. And what we're talking about here is really the opposite idea. The idea is, no, let's spend the principle. And

Wade Pfau 34:10
Jane Austen world of exactly interest. I think there

Nate Conrad 34:14
are two huge unlocks in spending principle, even though it's not always intuitive until you really think about it. And the first is tax you know, obviously, consult your own tax advisor. I don't give tax advice here, but, you know, imagine you're doing this in a brokerage account. The coupon is the thing you pay tax on, maybe federal, maybe state, maybe Luke will, assuming we're not talking about Munis. The principal is what you can spend tax free, and so meeting your spending power with coupons is very expensive from a tax perspective, whereas getting your principal back is very efficient. So there's one unlock there, and the other unlock is that when you think about what's in your portfolio, bonds are typically going to be the lowest. Expected return asset, and so the amount of bonds that you need to own if you're going to spend the coupons, or if you're going to barely dip into the principal, you need to own a lot of bonds to do it that way. Whereas if you say, I'm going to spend down this slug of bonds over the next 10 years, 20 years, 30 years, whatever it is, if you plan to spend that all the way to zero. That lets you own less bonds. And if you own less of a lower expected return asset and more of a higher expected return asset, then an expectation What do you have a higher expected return portfolio, and you're going to be able to pursue compounding a bit more aggressively based on that sort of a change.

Alex Murguia 35:40
I mean, the only caveat there is just make sure the overall allocation is not doesn't creep up well beyond your wrist tolerance.

Nate Conrad 35:48
Exactly. You got to, you know, figure out for yourself or work with your advisor, like the

Alex Murguia 35:52
non the non laddered part of it. Sure it doesn't need to be earmarked for distributions with which to use your phrase as a huge unlock, but it still can't be like an abatross of emotional like of an emotional roller coaster where you know that part keeps you up at night, you know, because as you, as you are drawing down the ladder, you're technically less than fixed income,

Nate Conrad 36:14
correct? And as you said, personal finance is personal Yeah, that one right answer, you got to figure out the one that's right for you. But I think it's worth, you know, just to, like, think about the opposite argument. What does a target date fund do? A target date fund says you're getting older, we're going to dial down your equity risk, we're going to give you lower expected return portfolio, and we're going to take your long duration bonds and move them into short duration bonds. You know, probably different funds work differently. Think that's roughly the way the industry works. And to me, that is, we're giving you a lower expected return fund, and we're solving for a stable nav because you're going to get your money by selling every month, whereas, if you release this idea that you get your money by selling at the market value, you get it instead by decumulating bonds through maturities. I think you come to the opposite conclusion. You say, I want long enough duration bonds to lock in interest rates for the duration of my financial plan. To me, that's safer than owning really short duration bonds and a 95 year

old who has a very short remaining life expectancy shouldn't need very many bonds to fund expected spending needs. And a lot of those assets are actually probably meant to be legacy assets going to the next generation. In which case, why would the answer be that you should have 6070, 80% bonds when you might be able to fully cover a two standard deviation surprise and life expectancy with a pretty small allocation to bonds. So to me, some of the conventional glide paths are completely the opposite of what you should really do once you come to believe that laddering and maturing bonds is a better way to get money out. I think you actually start to consider flipping glide paths and going the opposite way. Sounds

Wade Pfau 38:07
like a rising equity glide path.

Nate Conrad 38:11
Feel like I heard that somewhere before, but

Wade Pfau 38:14
yeah, I think the math backs that concept at the very least, and the bond back to the behavioral sign, the bond laddering concept can make it much more palatable to actually implement something like that as well. Alex, I think you are planning out some questions. You have anything else? Well,

Alex Murguia 38:32
I just wanted to you mentioned at the beginning, and I think we've gotten this a lot in where people were like, What is this again? And then we had that, we came back and asked you, but I don't think we touched upon it. You had alluded to the payments as they come in. There's one that's steady, and there's one that's more variable, and you're trying to align it with financial planning studies that are out there. I think that's an interesting piece, because I know that we were we got a question that referenced the life X ETFs, and they said something like, well, they front load the income, and then later on, it's much less than something along those lines. You want to talk about how you know, how you think about income spending in that framework.

Nate Conrad 39:16
Sure, you know some of my thinking here is informed by David Blanchet work, I think he called it a spending smile, and came up with that, that metric, that it's about a 25% decrease in real spending terms. And so when you when you look at what we do, and you know, we call them our longevity, ETFs, where we do this front loading concept, it is that 25% change either in nominal distribution targets of $10 a share becomes 750 or it's in real terms, where it's $10 becomes 750 but with an inflation adjustment that's designed based on CPI and so you know the. I look at that, you know, if I'm trying to figure out how I create spending power for myself effectively when we return, you know, distributions of $10 versus 750 the way we do that incremental distribution of $10 is not that we're generating a higher return, it's just that we're doing more return of capital. We're giving you your own money back faster in those early years and a little bit slower in the later years. And so by accelerating that return of capital and giving that back to you at a faster rate early on, that's free from tax. So you're getting that money back tax efficiently. If you don't want it back, you can always reinvest it or go put it to work in your portfolio. So I think it doesn't hurt you in that respect, and you actually pay me less management fees because I'm billing an asset based fee, and I'm giving you back assets earlier. So I could tell you, it's not from a selfish perspective that we hand back the assets

Alex Murguia 41:04
you wanted you to kind of in known certain terms, say, Yeah, that's a feature, not a bug.

Nate Conrad 41:07
You know, absolutely, if people, if people want the flat payout path, you know, we have that too in our term ETF. But you know, for me, if I wanted to plan out 30 or 40 years, I would rather want it front loaded. And it's really the mindset we always bring to product design, is we build the product that we would want for ourselves. That's how we create alignment. This is the product I want my parents to own. And so that's the way we think about it, and we absolutely see that as a feature, not a bug. We want to help you get that tax free, spending power. It's an option, and if you don't want it, you reinvest it, you put the money back to work. But if we didn't distribute it, then you wouldn't have that option to spend it safely. You'd be back to having to sell if you wanted to get the extra money out

Alex Murguia 41:50
earlier. Also, they have the ability to work it as they want Wade any I'd like to ask you one more question, but I'll open it up to Wade, simply because who would have known 40 minutes talking about bond ladders. Wade, do you have anything before I ask a final one to Nate, yeah,

Wade Pfau 42:09
I think that point about the reduction in spending later, you're absolutely explaining that, right, and it's just an actuarial type calculation. The first time one of our listeners pointed that out to me. He thought it was more of a gotcha that spending is cut but but just to be clear, like if someone went to tips ladder.com I did check like before we recorded a 30 year tips ladder had a 4.5 4.54% pay rate, whereas the inflation adjusted life act CTF over 30 years is higher at 4.96 but just to make sure it doesn't confuse people, those aren't completely comparable calculations, because the final 20 years would have a reduction in spending. So just so that make sure everybody understands that. But no, absolutely,

Nate Conrad 42:52
yeah, don't. Don't let anybody be fooled. We're not returning more than any other tip letter, Bond letter. You know it's all we're doing is trying to create the return of government bonds. But government bonds,

Alex Murguia 43:03
but somebody's life cycle a little bit more. All right? And Nate, how can someone find out more about the offering?

Nate Conrad 43:12
So we have, we have a website, lifex funds.com, and, you know, particularly given we have so many different ETFs and different ways to create a spending plan. Highly encourage you to go on there, go to the our funds page, and that's where you can see what all the options are. And there are some tools there that enable you to think about if you're targeting a certain amount of monthly or annual spending power, if you have a certain amount of money you want to put to work, and help you think about what that can represent in these different types of spending paths and try and tailor something that feels right to you. So feel free to check it out on the site,

and if you want to get in touch with us, there's some information on there to help you reach out, either by email or by phone to get to get help figuring it out.

Wade Pfau 43:55
Excellent. In the show notes, we can add a link to the life X funds website for for listeners to get more information as well. While we're talking about things, we'll put in the short notes. I do need to also mention I'll be at the Dallas money show on April 6. The event is April 4 through six. It's in Grapevine, Texas, right by the grapevine Mills Mall, where I like to go to their round one with my youngest son to do the crane machines. We become real big on winning prizes from crane machines, so it's excited. That's right next door there, but we'll put a link to that. If anyone in the Dallas area wanted to go to the Dallas money show, wait. You

Alex Murguia 44:31
got time for that? And you don't have time for pickleball,

Wade Pfau 44:35
crane machines is very

Alex Murguia 44:38
your hand dexterity with a paddle. You forgot the question? We got one more question.

Wade Pfau 44:44
No, I didn't forget a question. Actually, it was the newest comment on the YouTube page, but aligned perfectly with the discussion. So I thought, wow, there's some synergies here. But and Nate, I'll ask you to answer. The question as well. GC Burkett says, now here to the question that he's asking. So if your funded ratio, and we've had a bunch of recent episodes about that, so just your ratio of assets to liabilities, if your funded ratio is over 100% should you invest more conservatively? So this means, effectively, if you have enough assets to meet all your liabilities to fund your retirement successfully, so that you now have surplus wealth beyond that, should you invest more conservatively?

Nate Conrad 45:32
Should I go first Wade Sure absolutely your

Alex Murguia 45:35
response is recorded? I

Nate Conrad 45:40
guess I'm probably supposed to start by disclaiming that it'll provide financial advice. I'll just tell you what I would do in that situation. You know, when I I like to think about kind of bucketing and goals based investing frameworks, and the way I think about that is, if I'm funded above one, I'm going to use a bond ladder type solution using my funding equals one to completely cover the spending needs that I have, and everything above that is where I get to go to work and take that and try and grow that in something more and invest more aggressively. Because even if all that goes to zero, if I've used a really conservative strategy to cover all my funding needs, I'm okay, and so I'm creating a bucket that is my spending bucket. I'm covering that with a government bond later. I'm not getting creative. I'm not doing corporates or something like that, a boring and basic government bond ladder for my funding needs, and then everything

else I want to go actually be quite aggressive in the way I deploy the rest and try and turn that into something where I can really make an impact in giving that away to the causes or to the people that I care about. But, you know, again, putting my own personal life view on it, I'm not going to wait to give that away, to do so through my will. I'm going to be pretty thoughtful about when and how am I going to give that away? And for me, you know, when my when my daughter is old enough to have a kid, I'm giving her a night nurse, I'm helping with tuition, that kind of thing.

Wade Pfau 47:06
Yeah, there you go. Yeah, yeah. I think that's a great answer. It's probably the GC was, was thinking like the the old, if you've already won the game, should you stop playing and but yeah, just to follow through with that idea, you should be the most conservative when you're underfunded because you don't have the ability to take that risk. And I thought this question matched perfectly today with that conversation we had about the Monte Carlo, where, if you can earmark portion of your assets to get that 100% funded status fully covered, anything above that is gravy, exactly like you were saying, Nate, and so it's it's more your invest conservatively when you're underfunded, once you get over funded, you don't invest everything aggressively, exactly like you're saying. You can lock in your goals. Stop playing the game to make sure your lifestyle is covered. But it's that surplus wealth over 100% funded that you now have some wiggle room with, and you have the risk capacity to, if you're you don't have to invest it more aggressively, but you're certainly justified doing so if, if you'd like to, yeah,

Alex Murguia 48:11
Wade, am I going to see any of that surplus wealth in your will to me? No, no. That was great. And folks may be wondering, you know, we, you know, we think highly of Nate and the gang at Life x, and we thought, You know what? This is a story that should be told and and there it is. Thank you for being on the show. Nate. Really appreciate it.

Wade Pfau 48:35
Thank you wade, thank you, Alex. Yeah, thanks everyone for listening. We'll catch you next time on retire with style.

Bob French 48:42
Wade and Alex are both principals of McLean Asset Management and retirement researcher. Both are SEC registered investment advisors located in Tysons, Virginia. The opinions expressed in this program are for general informational and educational purposes only, and are not intended to provide specific advice or recommendations for any individual or on any specific securities to determine which investments may be appropriate for you, consult your financial advisor. All investing comes with risk, including Risk of Loss past performance does not guarantee future results. You