

Variable Annuities: Emerging from the Dark Side?

by Nancy Opiela

Have your views on annuities changed? Time was when a majority of planners eschewed all annuities because of their high fees and inflexibility, not to mention the high commissions. The tide began to turn in the wake of the bursting of the technology bubble when planners warmed up to the possibility that immediate fixed annuities could be an important part of a retirement plan, particularly for shell-shocked technology investors fretting about a predictable retirement income stream. And today, although long relegated to the dark side, variable annuities are beginning to see the light of day in financial plans.

In fact, according to the National Association for Variable Annuities (NAVA), total premium flow for variable annuities, or total sales, for the first nine months of 2006 was \$116.9 billion, a 19.9 percent increase from the prior year's nine-month sales of \$97.5 billion. A 2006 study, *Prospects for Variable Annuities in the Retirement Income Market*, by Financial Research Corporation (FRC), suggests that advisors could add to that growth. According to the study, over the next decade, nearly half of advisors (46 percent) anticipate a slight increase in their use of variable annuities for income production, while another 18 percent predict a significant increase. Only 7 percent expect their use of variable annuities to decrease.

FRC's study also showed variable annuities were advisors' number two product choice to fund a client's rollover assets, behind mutual funds. Variable annuities were either the first or second choice of 55 percent of advisors, whereas 79 percent of advisors selected mutual funds as their first or second product choice.

Just what has sparked the reconsideration of variable annuities? First, there are the big-picture demographic trends such as longevity. Your clients could possibly spend longer in retirement than they did working, and many worry about running out of money. What's more, with pensions going the way of drive-in movies and the uncertain fate of the Social Security system, clients understand that they are increasingly responsible for constructing that all-important retirement foundation, a guaranteed amount of money to enable them to meet fixed expenses at a minimum level.

Accordingly, as the nation's 76 million baby boomers enter retirement, the focus in financial planners' offices is shifting appropriately from accumulation mode to distribution management. Rather than the hottest new investment, conversations center on reliable investment alternatives for rollover assets from 401(k)s and other employer retirement savings plans.

The Appeal of Guarantees

Perhaps more than demographic changes, however, changes to the variable annuities themselves are responsible for driving product growth. And those changes can be summed up in two words: living benefits. There's no question that the biggest change to variable annuity contracts in the last few years has been the widespread availability of living-benefit guarantees, whereby the insurance companies provide principal protection regardless of market performance. According to NAVA, more than 85 percent of all variable annuity contracts sold in the last year offer one or more living-benefit guarantees.

What are living-benefit guarantees? According to NAVA, a variable annuity is a "financial retirement product that combines tax-deferred savings with insurance benefits, including guaranteed lifetime income payments. It allows individuals to invest in a variety of underlying fixed, equity and other funds, and provides returns based on the performance of these funds. Living benefits build upon this foundation by providing specific income, withdrawal, and accumulation guarantees, further protecting individuals living in or planning for retirement against downside market risk."

The various forms of living benefits are

- Guaranteed minimum withdrawal benefit (GMWB)
- GMWB for life
- Guaranteed minimum income benefit (GMIB)
- Guaranteed minimum accumulation benefit (GMAB)

For example, a GMAB can guarantee that the account value of the annuity will be at least equal to the amount invested if held for a specified number of years (for example, ten years). (See the sidebar, "Variable Annuity Living Benefits," for explanations of each type of living benefit.)

The sales pitch for living benefits is that creating a "homemade" guarantee using alternative financial instruments would cost significantly more than the guarantee provided through the variable annuity. That is, NAVA reasons that the variable annuity cost is lower because insurance companies can take advantage of economies of scale and internal investment expertise not available to most investors.

It's no surprise that these guaranteed minimum benefits that also offer the potential for growth should the market soar appeal to the "have our cake and eat it, too" boomer generation, particularly those who lost big with the bursting of the technology bubble. There's a bonus for planners, too. The potential for growth provides something to discuss with clients and allows the planner to add value to the investment equation.

Yet there's no doubt that these new guarantees complicate the analysis of the variable annuity products. In fact, the FRC study illuminated the irony that although much of the future growth in variable annuities is expected to be advisor driven, 57 percent of advisors said they are not currently selling variable annuities because they find the living benefits riders too complicated for clients to understand—in no small part because of concerns about whether such products are "overpriced."

Complicated Analysis

How are planners analyzing variable annuities and presenting them to clients?

With the need for a reliable income stream established, Helen Salazar-Realini, CLU, CFP®, of Raymond James Financial Services in Coral Gables, Florida, begins her variable annuity presentations by noting that the guarantees variable annuities offer compare favorably with the fixed immediate annuity. She explains, "With the variable annuity, not only do clients not have to annuitize, but there is some potential for upside gain. Clients respond well to products where, if their account earns nothing for the entire time they have it, they are guaranteed 7 percent for 14.5 years."

Salazar-Realini agrees that the analysis is complicated because, apart from the straight math involved in breaking down the product's cost, there's an all-important benefit that is impossible to put a price on: peace of mind.

John L. Olsen, CLU, ChFC, AEP, of Olsen Financial Group in Kirkwood, Missouri, agrees that planners' cost analyses must factor in the very human benefit of the client being able to sleep at night. "In real life, apart from the mathematical analysis, that's where the rubber meets the road," he says. "Annuities are all about guaranteeing income to manage risk."

Just as important to factoring in the value of a good night's sleep, Olsen says it's important to consider the benefit that the variable annuity's guarantee may enable the client to take on greater risk elsewhere in the portfolio. "With assurance that there's a floor that their retirement income won't fall below, many risk-averse investors may agree to direct more of their assets into equities where there is potential to earn greater returns than the CDs they might currently favor," he explains.

Olsen continues, "Let's say you have a client whose CDs are just not going to produce the income he needs, but he is terrified of taking on more risk and running out of money. Guaranteed living benefits provide a floor that's there in the event that all other investments fail. If we can guarantee this stream of income for a certain number of years, in the light of that certainty, he may be more willing put the rest of his money into investment vehicles like equities that will enable him to profit if the market performs well."

Olsen notes, too, that this strategy may be particularly effective for risk-averse baby boomers who have not prepared adequately for retirement and likely could not build their nest eggs fast enough through more conservative investments.

Shifting from ROI Mindset

That notion brings Olsen to his primary point about variable annuities: that they should be presented and evaluated as a risk management tool, not an investment product. "The argument that annuitizing a contract is a sucker bet, because you're locking in a low interest rate in this environment, misses the point," he says. The decision to annuitize isn't an *investment* decision, but a decision to *manage risk*.

"A variable annuity is a tool to manage the risk of not having a guaranteed income. This is something that is very easy to miss, especially for those of us who manage money and operate through a return-on-investment lens. We're used to looking at a product and asking, What is the return on capital? With annuities, you are not buying a return on investment. In fact, return on capital can never be calculated unless you can tell me when you are going to die. With annuities, you are buying guaranteed income—and that very simple fact seems to evade a lot of folks."

As boomers switch from accumulation mode, where return on investment is everything, to retirement and income distribution, where not outliving one's assets is the chief worry, Olsen says planners will have to switch gears from investment to risk management. "Many planners are still embedded in the return-on-investment mentality, but we're all going to be ripped away from that to address the one big risk nobody wants to mention: What are the chances that my account balance will fall to zero before my blood pressure does?" he says. "If I want to avoid running out of money, the only solution is something that guarantees I won't run out, something tied to my duration—and that's an annuity."

Olsen, who handles a lot of estate planning, also notes that annuities can have an interesting behavioral impact on clients, "allowing them to do some things they would not have done in the absence of a guaranteed income stream."

He explains, "There are people out there with millions of dollars who will not make annual exclusion gifts to their children or grandchildren because they worry about running out of money themselves. It may sound silly, but it's a real concern. A fascinating thing happens if you can help the client build a floor with laddered bonds or an annuity. Suddenly, it might not be such a bad idea to give some money away so they can watch the kids enjoy the gift."

While Olsen concedes that it's arguable that, in isolation, guaranteed living benefits may be "overpriced," he argues that determining the true value requires looking at the big picture and asking how the variable annuity helps the client manage the rest of his or her portfolio. "If you can guarantee an income so that a client goes from a CD mindset to putting 70 percent of his assets into equities, then the return he earns from that decision has to be a lot more than the 60 extra basis points he pays to get that income guarantee," Olsen says. "People look at annuities in a vacuum and miss the point that creating a guaranteed income stream may permit changes in the portfolio that produce less risk so that the client is less fearful. Our evaluation shouldn't center on the question of whether the return on the annuity fits with our pre-conceived notion of what's right."

Although living benefits have prompted planners to re-examine variable annuities, Olsen says if the variable annuities are evaluated through a return-on-investment lens, the discussion will stop there because the cost is too high for the return.

Too Little Information

Glenn S. Daily, a New York-based, fee-only insurance consultant, understands the appeal of variable annuities with guaranteed living benefits, noting, "They purport to offer a win-win situation: you get high returns if your investments perform well, while limiting your risk of loss if they don't." But what frustrates Daily in his product analyses is the lack of complete information.

Daily explains, "Buyers have no chance of making an informed decision because one piece of information is currently not disclosed: the 'money's worth' of the guarantee, or the ratio of the economic value of the benefit to its cost. A money's-worth calculation would help consumers identify products that offer a better value."

Daily says regulations to require this information are under consideration for principal-protected products in Denmark and Norway, and disclosure may eventually improve in the United States.

Also noting the fact that economists are beginning to publish more research about the appropriate role of financial guarantees, Daily believes it is premature for investors to buy a variable annuity with living benefits. "It is possible that these products will become a useful tool for personal financial planning in the future, but we are now at the stage where buyers are volunteering to be guinea pigs, with no assurance that they are being adequately compensated for their participation in this experiment," he says.

Wait

Daily's advice to consumers is simple: wait. "It is expensive to get out if you decide that you made a mistake," he says. "You could be looking at a three-year surrender charge that starts at 6 percent and although this is a relatively low charge among agent-sold variable annuities, it is still a factor to consider in making a purchase decision."

What's more, Daily says new products are being developed. "Annuity companies are competing to come up with innovative product features, including combinations of guarantees. As the market matures, a few companies may decide to offer products that pay lower commissions and provide better consumer value," he notes.

Daily stresses that it is unlikely that a client will be missing out on a really good deal by waiting. "The cost might increase in the future, due to higher reserving requirements and better pricing methodologies. However, that could be offset by lower commissions and competition," he explains.

If clients do choose a variable annuity with living benefits after factoring in the value of peace of mind and overall portfolio benefits, Daily has three words of advice for planners: read, read, read. He explains, "These contracts are complicated. If consumers have a complaint, the insurance companies' comeback will be that all prospective buyers are advised to read the prospectus, the contract, and the riders, and they will argue that these lengthy documents adequately disclose the costs, benefits, and risks of the contract."

Furthermore, Daily notes that the Securities Litigation Uniform Standards Act of 1998 limits class actions related to variable annuities, so buyers may have trouble finding an attorney who will take their case for a contingent fee. "Litigating an individual case can cost at least \$25,000, and there is no guarantee that even a good case will be successful," he says.

Be Rational

Having long objected to variable annuities for all but very active traders because annuities convert capital gains to ordinary income, Peter Katt, CFP®, LIC, of Katt & Company in Kalamazoo, Michigan, has a larger issue with the new living-benefits guarantees.

Katt explains, "The product is presented as heads you win, tails you break even. However, for clients who are invested in CDs due to fear, that's a moral hazard. These people are going to over-subscribe to equities because of their belief that they can't get harmed. They don't understand that guaranteed doesn't mean guaranteed. The guarantee is only as good as the amount of reserving that the insurance company is doing to protect those guarantees."

Continues Katt, "These new living-benefits guarantees are a lot more dangerous than guaranteeing death benefits—and that caused two insurance companies to run into the arms of a savior."

Katt argues that investors over-subscribing to the market will create a bubble that at some point will burst. "The market will come down harder and faster than all these hedge formulas can handle, and all of a sudden we'll have companies that are exposed because they guaranteed a 5 percent return on money invested and the market's down 60 percent," he says. "Insurance companies do not print money. They can go bankrupt, and when they do, their guarantees go out the window. Heads I win, tails I break even is a compelling pitch to consumers, but what's going to happen if a couple of these companies tip over and the guarantees are gone?"

Accordingly, Katt advises planners to resist the emotional product pitches and evaluate variable annuities in the same rational manner they would analyze other products. "Insurance agents play on emotions because they don't understand the math behind their products," Katt says. "There's a rigorouslyness involved when you use your mind as opposed to using your personality—it's the difference between a bowler as an athlete and someone in an Ironman competition."

John Olsen, too, suggests that planners need to help clients avoid the "oversimplification and generalities that cloud the debate over annuities." He explains, "The current debate about if and when annuities are appropriate is cluttered with assumptions and preconceptions. The polemic on both sides often obscures more than it reveals and makes it difficult for objective advisors to judge when an annuity is or is not suitable for a client."

Helen Salazar-Realini concludes, "We all have our little prejudices and strategies we feel comfortable with based on what's worked for us and what we've seen work for others. Naturally, planners don't always all agree, and whether or not to use annuities is a particularly divisive topic. However, if we respectfully listen to each other, and learn from each other, that can only help us to do what's best for our clients."

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Sidebar

Types of Variable Annuity Living Benefits

Following are the most popular types of variable annuity living benefits:

Guaranteed minimum withdrawal benefit (GMWB). Guarantees that a fixed percentage—generally 5 to 7 percent—of the annuity premiums can be withdrawn annually for a specified period of time until the entire amount of paid premiums has been withdrawn, regardless of market performance.

Example: Susan purchases a \$100,000 variable annuity, with a guaranteed minimum withdrawal benefit of seven percent. Even if the market value of her annuity contract has declined to \$65,000, for example, the GMWB guarantees that Susan can withdraw \$7,000 (7 percent of \$100,000) per year, until she has received the entire \$100,000.

Guaranteed minimum withdrawal benefit for life. An increasingly popular living benefit that guarantees an income payment for life. A fixed percentage—typically 4 to 5 percent—of the annuity premiums can be withdrawn annually for as long as the annuitant lives. These payments continue even after the initial investment amount has been paid out, and regardless of the actual account value.

Example: Joe buys a \$100,000 variable annuity, with a guaranteed minimum withdrawal benefit for life of 5 percent. He will receive \$5,000 a year for as long as he lives, even beyond the 20 years it would take to recoup the principal amount, and even if the account value drops due to poor investment performance.

Guaranteed minimum income benefit (GMIB). Guarantees that when a contract is annuitized—that is, converted into retirement income payments—the income payments will be based on the greater of the actual contract value or a minimum payout base, which typically is equal to the amount invested credited with a competitive rate of interest (five percent is common). If the contract value grows, monthly income payments may be higher, but never lower, than the guaranteed minimum amount.¹

Example: Bill invests \$100,000 in a variable annuity and selects the guaranteed minimum income benefit, guaranteeing 5 percent annual growth. He makes no withdrawals or transfers. At year 12, as a result of stock market losses, the variable annuity is valued at only \$85,000. However, by selecting the GMIB, Bill would have at least \$179,585 to annuitize.

Guaranteed minimum accumulation benefit (GMAB). Guarantees that the variable annuity contract value will be at least equal to a certain minimum amount—typically the premium amount—after a specified number of years, regardless of actual performance. Many GMABs guarantee the return of premium after a ten-year period.

Example: Mary buys a \$100,000 variable annuity with the guaranteed minimum accumulation benefit. She holds the annuity for ten years, and makes no withdrawals. By this time, the stock market has declined, and the market value of the funds in her variable annuity sub-accounts is only \$73,000. However, with the GMAB feature, Mary is guaranteed that her contract is still valued at \$100,000.

1. Annuity options and tables are typically limited to those specified in the annuity contract, and may differ from those available if the GMIB is not elected.

Source: National Association for Variable Annuities.