

Frustration of a Variable Annuity Advocate

Moshe Milevsky proposes five
big ideas for industry reform

BY MOSHE A. MILEVSKY, PH.D.



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Frustrations of a Variable Annuity Advocate

Two and a half years ago, in the fine pages of this magazine, I described my road-to-Damascus like conversion from a variable annuity critic to gentle advocate. At that time I pointed out that VAs had evolved into retirement income pensions, in an era of declining corporate plans. They were no longer tax-sheltered mutual funds with a thin veneer of life insurance. They were risk management instruments for individuals.

However, in the same piece, I also expressed my growing concern that the prices associated with the new generation of riders — which now promised a generous lifetime of income — were in fact too low. And, while the conventional wisdom with all things VA-related was that these products were expensive and overpriced, my “stochastic” analysis indicated that quite the opposite was the case. The so-called mortality and expense fees were unreasonably low when compared to the cost of acquiring the economically equivalent “pension put options” in the open financial market.

And alas, as the last tumultuous year has illustrated, there was an apparent disconnect in the design of these products. They were never meant to live through a “black swan” or the Category 11 financial hurricane we have been living through. Ironically, the same annuity wholesalers who incessantly peppered financial advisors about their clients’ exposure to sequence-of-returns risk should have turned around and asked the risk management folks within their respective companies the exact same question.

So, as a result, we are now experiencing a reverse arms race of sorts. Insurance companies who aggressively competed with each other to offer more frequent step-ups or larger interest bonuses are now racing to decrease their risk exposure. Only time will tell if the new product equilibrium, with reduced features and higher fees, will also contain some residual benefits for the consumer. After all, the value proposition of the entire pie must be sliced into three equitable portions: the insurance company, the financial advisor and the client.

Missed Opportunity

In my mind, though, it is a great shame that the insurance industry has not taken advantage of these unprecedented dislocations, to make fundamental changes — as opposed to piecemeal clawbacks — to the entire annuity product line. What better time to declare to the actuaries, the wholesalers, the advisors and the world at large that entirely new

thinking is required in the retirement income and variable annuity space?

With that in mind, here are my suggestions for some structural changes to the “personal pension” business. I am not talking about miniscule changes to guaranteed interest rates, frequency of step-ups or nursing home waivers. Suspend your disbelief. I now offer five ideas for fundamental changes in product design, positioning and marketing. You can think of this as my wish-list of sorts, in increasing level of difficulty.

[1.] YOU ARE NOT ALONE:

Encourage Product Allocation by Design and not as an Afterthought

Here is the basic premise. Anyone approaching retirement without a defined benefit pension that provides the majority of their retirement income needs, should consider allocating wealth to an annuity product with some form of lifetime

income guarantee. Period. Yet, at the same time, even under the most optimistic assumptions regarding the product class, it is very hard to justify allocating more than two-thirds of a client’s liquid investable assets to annuities. In fact, even that might be an extreme, unless bequests and liquidity are a non-issue. So, why not accept this premise in the product design phase? Offer a combo package that already includes mutual funds, basic income annuities and VAs in one unified product. In other words, help financial advisors understand how the VA fits with all the other investments on their shelf in the construction phase. It shouldn’t be an afterthought.

The good news is that I am starting to see some insurance companies accept the retirement income “product allocation” philosophy by offering guidance that pre-assumes the existence of other asset and product categories.

The takeaway here is not that *some* people should have *all* of their money in the annuity, but rather that *all* individuals should have *some* quantum of income from the annuity. The question is: how much? And this is where the insurance industry must do a better job of explaining how their partial solution fits with the many other solutions in the market-

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place. This is the equivalent to the investment manager of a specialized gold fund acknowledging that the typical client should have around 5 percent in commodities, or the life insurance industry developing rules of thumb for how much term vs. whole life insurance a client needs. Right now VA products are being designed as one-stop shops for diversified asset allocation, IRA rollovers, etc., when they should really be part of a structured product allocation.

[2.] IF YOU CAN'T BEAT 'EM, JOIN 'EM:

Offer and Promote a Full Menu of Global and Passive Equity Fund Sub-Accounts

I obviously don't want to get ensnared in the often viscous "active versus passive" argument, nor do I want to debate here whether index funds outperform mutual funds. However, I do think it is important to acknowledge that a large segment of the investing public is growing increasingly skeptical of the value added by active management. The few managers who have been fortunate enough to beat the S&P 500 over a statistically meaningful time period can fail remarkably in subsequent years.

So I think that in order to attract a much larger universe of financial advisors and their clients, the insurance industry should cater to the possibility that widespread alpha is nearly impossible to achieve and hence not worth paying for. Ergo, offer guaranteed living income benefits (GLiBs) on S&P 500, Russell 3000 and MSCI index funds. Advertise them widely and market them aggressively. They might not compensate as well, but I reckon that the volume of new converts will help offset the reduced margins. To be clear, let me repeat. This is not just a question of offering one or two low-cost index funds as part of the infinite multitude of choices available within the sub-accounts. I am talking about a dedicated suite of index fund VAs with GLiBs. Yes, I know that some of the direct-to-consumer companies are trying this as we speak. But, as you know, these products need to be explained and the intermediary is critical to the sale.

[3.] À LA CARTE BUFFET:

Completely Disentangle Living and Death Benefits

I know and appreciate the desire for life insurance and I certainly understand the need for longevity insurance. I

also accept the historical role of death benefits and its association with insurance contracts. The estate, bequest and legacy value is paramount for some. However, I question the need to offer any sort of life insurance in a retirement income and pension product for baby boomers who have very little interest in dying anything but broke; especially if its elimination will save the consumer an extra 50 or 100 basis points in fees. In fact, even if the unbundled saving is lower, I think that the absence of a death benefit (other than the account value itself) sends a powerful behavioral signal to the advisor and the client that this product is not about dying, but about living. I see too many sales pitches that are muddled and confusing. They go something like this. Buy this product and you will be assured a death benefit, a living benefit, tax savings, nursing home stuff, estate efficiency, etc. Simplification will bring more people into the tent.

[4.] SELL INSURANCE:

Offer Stand Alone Sequence-of>Returns Protection without Money Management

As it stands right now, investors and consumers who like the idea of protection and guarantees against adverse market conditions must purchase this insurance together with the money management services of the sub-account asset managers. So, if you want the privilege of withdrawing 5 percent of your \$1,000,000 nest egg for life, then you have to hand over your \$1,000,000 to the insurance company as well. But why must these two services be intertwined? Why not sell the longevity/market insurance separate from the money management? With some stretch of the imagination, this is akin to the difference between buying a whole life insurance policy, or a UL policy — where the insurance company invests your premiums — versus term life insurance in which pure protection is provided. Why not have the same with guaranteed living income benefits (GLiBs)? Note I am talking about something quite different from a single premium income annuity (SPIA).

The way I see it, this type of product would unfold and be developed in a two-step process. First, we would need a new index, perhaps called the S&P 500 *withdrawal* index that proxies for a declining retirement income portfolio. Then, an insurance company would offer deferred income annuities that start paying when the S&P 500 withdrawal

index hits a trigger value.

For example, the S&P 500 withdrawal index would be inaugurated in January 2010 at a value of \$1,000. Each month Standard & Poor's (hypothetically, of course) would add the total return of the S&P 500 stocks at the end of each month — like any other total return index — but would then subtract \$50/12 each month, to mimic the spending of retirement income. This spending number would be adjusted for inflation and would thus increase in nominal terms over time.

This is not the place to get into the minutiae of what I have coined the Ruin-Contingent Life Annuity (RCLA), but the idea is to protect a systematic withdrawal plan. Or, just think of being able to purchase a GLiB on your favorite managed portfolio or separate account, without having to move the funds, sell the investments or change the asset mix. It would be a true insurance overlay.

[5.] SPREAD IT AROUND:

Have a Consortium of Insurance Companies Syndicate the Guarantee

My final recommendation might be the most difficult to implement, yet is motivated by the single most vocal concern from consumers and clients today: Will the company be around to honor its guarantees in 20 or 30 years? The often heard question is usually followed by an (improper) reference to AIG, declining stock prices and increasing reserve requirements. The prudent advisor's response, explaining state guarantee associations, credit ratings and 150-year histories does little to alleviate irrational fears. You are playing defense from the get-go.

Think of the syndicated loan market. Large and rival banks — often archrivals — band together to spread the risk of making large loans by breaking them up into little pieces that are parceled out to members of the syndicate. If the lender runs into financial distress or defaults, all members of the syndicate share in the exposure. Financial institutions understand and manage credit risk (for the most part); why shouldn't consumers be allowed the same? It's time for a syndicated annuity market. This is not a mortgaged-back security or some newfangled credit default swap.

Mr. and Mrs. Consumer would buy a generic variable annuity from a syndicate of three to five highly rated insurance companies. A guaranteed minimum income stream would be

determined at the time of purchase. Each insurance company would agree to make a fraction of the payment, where the fraction is determined by the number of companies in the consortium. Alas, and this is the key part, if any one of the insurance companies defaulted or ran into financial distress, the other ones would step in to continue the remaining payments. The consumer is thus protected against default risk in a way that can never be achieved by one or two companies with an AAA rating.

An Opportunity To Fundamentally Retool

There it is: my wish list. In fact, I pledge here and now that the first financial entity that meets these five requests can use me as their poster boy for advertising, gratis. Take your time. I am 25 years from retirement.

On a more serious note, though, critical readers will notice that my wish list avoids compensation issues. Yes, it would have been easy for me to follow the crowd and drop some gratuitous comment about lowering overall fees, reducing surrender charges and slashing compensation. Alas, you don't need me to remind you that in a zero interest rate U.S. Treasury Bill environment every basis point counts. However, these are not product design issues. They are between (ethical) you and your (knowledgeable) client. They should not be legislated or mandated.

As I mentioned earlier, there are three participants in this relationship: the insurance company, the advisor and the client. Everyone has to eat right and everyone must be able to sleep tight. The risks and rewards should be allocated amongst these three parties. In the current environment, this is a shrinking — as opposed to zero — sum game. If the insurance company withdraws a feature to reduce its risk profile, it is reducing the value to the consumer even if the new level of prudence ultimately protects the end-user. This applies in the other direction as well. An insurance company that promises a 15 percent income-for-life-guarantee to a 65-year-old is useless. The company's mortality rate is higher than your client's.

So, with all of this in mind, I have decided to restart my dormant monthly column in *Research*, to both help advisors better understand many of the complex aspects of VAs, and to also advocate for some change in the industry. Feel free to comment, and stay tuned.

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