Variable Annuity Life Insurance: NOT!

Variable Annuities are Insurance Products and as such must include an insurance component, a policy with a death benefit initially pegged to the value of the contribution, the "contract value". On average, VAs charge 1.35% +of the contract value each year to pay for the insurance benefit. Consistent with life policies the charge is called a "mortality" expense. On a $1 million VA, the mortality expense is $13,500/year. This fee will increase if the portfolio appreciates under riders in most VA policies called Step-up. So, if the portfolio appreciates to $1.2 million, a paid rider allows the investor to <u>permanently</u> "step up" the notional[1] (theoretical) insurance benefit raising the mortality expense to $16,200/yr. on $1.2 million of portfolio value. Another VA's riders allow investors to "ratchet" up the notional insurance benefit annually to match portfolio appreciation by increasing mortality charges .5% to $1.85% or $18,500/year.

Assume the investor dies after 10 years having paid $135,000 in mortality expense over that time. Disregarding fee impact, growth and step-up, if the investor died during a severe recession and his portfolio declined to $700,000, the heirs would elect the $1 million insurance proceeds but must surrender the $700,000 portfolio bringing the total cost to the investor/heirs to $835,000 for $1 million payout, a net benefit of $165,000 after ten years. If death occurs after 12 years, there is virtually no net benefit at all as total mortality expenses will exceed the net policy benefit. Furthermore, an insurance payout terminates all living benefits and guarantees on return and growth, all of which are conditioned solely upon electing an annuity payout over a minimum of 10 years at 2%/year.

But what is the investor paying $13,500/yr. for? The net insurance benefit here is the difference between the surrendered portfolio at death, $700k, and the $1 million notional death benefit or $300,000 (minus premiums paid). Had the portfolio declined only10% to $900,000, the net benefit would drop to $100,000 (minus premiums paid). By comparison, a $300,000 term policy on a 50-year-old male is less than $3,000/year and offers fixed protection at savings of $105,000. His heirs get to keep the portfolio in addition to policy proceeds that increase the estate by $300,000 regardless of performance.

If at death the VA portfolio has appreciated the heirs would inherit the portfolio but there are no insurance proceeds at all, not even a refund of premiums! So even after 10 years and $135,000-$185,000 in mortality expense and with death occurring there is no policy payout whatsoever if the portfolio is at parity with or exceeds the insurance contract amount. The irony for many investors is that as markets rise, many must pay for a rider to step up the notional insurance benefit for additional premium simply to preserve the net benefit and "protect profit". If VA investors do not "step up", the portfolio value will likely exceed the contract value permanently over time, making the mortality expense more of a surcharge

[1]The insurance benefit is "notional" or theoretical. The actual insurance benefit is calculated by subtracting the surrendered portfolio's value from the notional death benefit upon death. On contract date the net benefit is zero not $1 million. VA sponsors restrict risky investments, require income allocations, and offer balanced investment choices. The probability of a Portfolio ever going to zero from market activity is nil and net benefits are typically a small fraction of the notional insurance benefit in situations even when the investor dies during market recession.

than insurance premium. Of course, had the investor bought the $300,000 term policy referenced above, the estate would have saved $105,000 in mortality expense and would have received the $300,000 policy proceeds at death in addition to the portfolio.

VA insurance is in fact a unique and prohibitively expensive form of Portfolio Insurance[2] disguised and sold as Life insurance. It primarily protects the VA sponsor by requiring full surrender of the portfolio sub-accounts, a windfall premium, in the event the policy has to pay out. Portfolio Insurance is normally a short-term hedge against market reversals. It is never a long-term solution due to high costs that impair returns. Mortality expenses are lifelong and ever increasing.

Two things are deeply troubling about all this, 1) VAs are routinely sold and promoted as providing a “Death Benefit”, especially to those unable to qualify for a life policy, when in fact they are only selling questionable and expensive notional “portfolio insurance”, and 2) why are the mortality expenses not refunded when upon death there is no policy payout as with normal whole life or term policies? So, who would knowingly pay for a life insurance policy that was unlikely to ever pay proceeds when death occurs? Variable Annuity owners!

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[2] Portfolio Insurance is a strategy using derivatives that is employed sparingly by professional portfolio managers to hedge short term risk. It has been widely criticized for its cost and value on a long-term basis.