

Variable Annuities Part 3: Reaching the Break(ing) Point.

The core of a variable annuity is the sub-accounts, a portfolio of select mutual funds and cash management investments wrapped in an insurance contract

1. The identical funds are also available outside the VA where the universe of fund choices is exponentially greater including no load and low-cost index funds.
2. The VA offers a notional death benefit, but an actual term-life policy with a \$400,000 death benefit costs $\frac{1}{4}$ to $\frac{1}{2}$ of the mortality charges on a \$1 million policy depending on age, and the beneficiaries receive full policy payout upon on death regardless of portfolio performance.
3. Brokers typically receive 6% in commissions regardless of investment amount. Loaded mutual funds reduce overall commissions at “Breakpoints” for investments within a fund family on a sliding scale from 7% to 0%. No commissions are paid whatsoever on \$1 million investment and 2% on \$500,000. By contrast a \$1 million VA with the same portfolio will pay the broker, \$60,000 in commissions, a strong financial incentive to recommend a VA for sizeable investments and circumvent breakpoint discounts. NASD NTMs 02-85 and 03-47 discuss breakpoints and damages for breakpoint violations.
4. VAs have severe restrictions and limitations on distributions and impose substantial penalties and contingent deferred sales charges (CDSC). In Contrast to a VA, a mutual fund portfolio has no allocation restrictions, offers automatic withdrawal benefits, is fully liquid and not burdened with 3% excess costs to pay for notional insurance and benefits of dubious value.

All VAs guarantee a minimum return on the contract value, adjusted for surrenders, applicable solely towards the purchase of an Annuity paying out over ten years or more. Regardless of the rider terms, all guarantees if acted upon require annuitization and the forfeiture of the sub account and permanently fixes distributions, eliminates liquidity, and terminates all living and death benefits and guarantees. It also means a 20% immediate market loss.

I estimate that upwards of 90% of VA policy holders and their advisers never intend annuitization, and I have yet to see any Financial Plan ever to incorporate an annuitization strategy for the simple reason that the projected estate vanishes with the forfeiture of the sub-accounts and distributions become fixed. Furthermore, converting the investor’s sub-accounts into an annuity with a 10+ year growth rate of 2.5%/year yields a discounted present value adjusted for risk, market return, and liquidity that is substantially below the premium paid amounting to an immediate market loss of 20-40% depending on the annuity. J.G.Wentworth offered 80% for a 10-year annuity fixed annuity resulting in an immediate market loss 20% upon annuitization effectively offsetting any bonuses and guarantees.

The primary consideration for investors considering a Variable Annuity is whether the impact of VA fees and expenses on returns over the long-term are worth the additional annual expense and benefits. The first thing investors must understand is that they are buying an annuity and, with the exception of the notional death benefit and withdrawal riders, all guarantees and benefits apply only upon annuitization. If financial plans and projections forecast an estate, then annuitization is impossible.

In comparing VA returns to Index returns, I have analyzed three scenarios using 1) moderate growth, 8.15% avg return, 9.25% standard deviation, 2) SP 500 10.25% avg return, 12.05% Standard deviation, and 3) a stressed portfolio experiencing a 35% decline in year 3, raising Standard Deviation to 12.85% and lowering average return to 8.15%. The comparisons are staggering. Furthermore, I have illustrated the impact on shares of a hypothetical index with a .25% annual cost.

In every scenario, the index-only portfolio after 20 years exceeded the identical VA portfolio by a multiple of the original investment under identical withdrawals and market performance. Stressed portfolios never recover in a VA even after share value recovers fully; index portfolios do. The principal cause of this difference is depletion of shares caused by VA fees, expenses, and distributions funded through share liquidation. Furthermore, the analyses illustrate the significance of the sequence of returns on portfolios under distribution, particularly the long-term impact of modest early portfolio declines on long-term sustainability.

My experience is that Variable Annuities are most often sold on benefits and guarantees that the customer and adviser never intend to implement yet still pay an annual cost of 3%-4% that drains the portfolio and impairs returns. Sales projections that illustrate sustainability are commonly flawed and often fail to adjust for annual costs or volatility in projections based upon average portfolio growth. During the accumulation phase the account should still grow, but 90% of VA investors use withdrawal riders to generate distributions that results in surrenders, reduced benefits, and portfolio declines that lead to premature unsustainability.

The most onerous consequences occur to accounts under distribution. Yet, a significant inducement towards the purchase of a VA is the "tax-free"-penalty free withdrawals. Sub-accounts are expected to distribute 5%, plus 3.5% costs, and appreciate at market rate throughout life and leave an estate. Based upon the sequence of returns that may be possible but not likely in a VA, but it is a far greater probability in a properly indexed portfolio unburdened by VA expenses.

Considering that all the benefits of a VA can be obtained a la carte for a fraction of the annual expense, including a 300K term-life policy, it is hard to understand the popularity among financial planners, brokers, and advisers recommending VA purchase other than the 6% commissions and the distinct probability that VA investors over time will need to roll into a new annuity merely to preserve guarantees and increase penalty-free distributions and thereby generate new commissions in the future.

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