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Annuities: Beyond the Sales Pitch

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Overview

1. What are the types of annuities?

   Deferred: Fixed
   – traditional (non-indexed)
   – indexed (also called equity-indexed annuities)
   Variable

   Immediate (also called payout annuities or income annuities):

   Fixed (traditional, inflation-indexed, equity-indexed)
   Variable

2. What is the relationship between sales and commissions?

3. Which view of the annuity industry is more accurate?

   View #1: The annuity industry is in the business of producing valuable products that enhance financial security and peace of mind.

   View #2: The annuity industry is in the business of exploiting human foibles just to make a buck.

4. Should you buy the annuity now or should you wait?

   a. Will you be able to get a better deal later?
   b. Will you be able to get penalty-free access to your money if you need it?
   c. Are you counting on favorable tax laws that could change?
   d. Will next-generation products have new features that you might want?
   e. Will there be better research, disclosure and methods of analysis later?
   f. If you buy the annuity now, how will you determine if it is worth keeping in the future?

For more information:

– Glenn S. Daily and Laurence J. Kotlikoff, "Decision Making Under Uncertainty: A (Second) Wakeup Call for the Financial Planning Profession," 2006 (www.glenndaily.com)
– Jeffrey K. Dellinger, *The Handbook of Variable Income Annuities*, 2006
– Individual Finance and Insurance Decisions Centre (www.ifid.ca)
– National Association for Fixed Annuities (www.nafa.us)
– National Association for Variable Annuities (www.navanet.org)
– National Bureau of Economic Research (www.nber.org)
– Retirement Income Industry Association (www.riia-usa.org)
– Society of Actuaries (www.soa.org)
– TIAA-CREF Institute (www.tiaa-crefinstitute.org)

Deferred fixed annuities — Traditional (non-indexed)

5. What are the basic features?

   Premium limitations (minimum, maximum, single vs. flexible)
   Age limitations (purchase, annuitization)
   Interest rate (nonguaranteed, guaranteed, bonus)
   Guarantee period
   Surrender charge (premium vs. account value, issue-year vs. rolling, number of years, market value adjustment, free withdrawals, waiver)
   Guaranteed annuitization options
   Investor protections (not FDIC-insured, not a security)

6. Pricing: "There's no sales load, so all of your money goes to work for you immediately."

   Why this statement is misleading. See Ralph H. Gorter, "Credit Card Approach to Pricing," *Product Development News*, August 2000.

7. What are the uses?

   a. They are an alternative to certificates of deposit and other fixed-income investments.

      BUT are buyers adequately compensated for the risks of illiquidity?

      1. The risk that you will need your money for unexpected costs; e.g., medical expenses.

      2. The risk that you cannot rebalance your portfolio over time. See S. Browne, M. Milevsky and T. Salisbury, "The Liquidity Premium for Illiquid Annuities" (www.ifid.ca).

b. They let you defer taxes on investment income.

   BUT what is the relationship between the benefit and risk of tax deferral? Is it better to pay taxes over time rather than at the end? Will the tax rate be lower or higher in the future?

c. They let you make use of the cost basis of a life insurance policy that you no longer want. (What is the economic value of the tax shelter provided by the cost basis?)

d. They offer guaranteed annuitization options.

   BUT what is that feature worth? See Chi Chiu Chu and Yue Kuen Kwok, "Valuation of Guaranteed Annuity Options in Affine Term Structure Models," *International Journal of Theoretical and Applied Finance*, March 2007; Enrico Biffis and Pietro Millossovich, "The fair value of guaranteed annuity options," *Scandinavian Actuarial Journal*, 2006(1); Laura Ballotta and Steven Haberman, "The fair valuation problem of guaranteed annuity options: The stochastic mortality environment case,"*Insurance: Mathematics and Economics*, Vol. 38, Issue 1 (February 24, 2006); Mary Hardy, *Investment Guarantees: Modeling and Risk Management for Equity-Linked Life Insurance*, 2003; A.D. Wilkie, H.R. Waters and S. Yang, "Reserving, Pricing and Hedging for Policies with Guaranteed Annuity Options," *British Actuarial Journal*, Vol. 9, No. 2 (2003); and Moshe A. Milevsky and S. David Promislow, "Mortality Derivatives and the Option to Annuitize," *Insurance: Mathematics and Economics*, Vol. 29, Issue 3 (December 20, 2001).

e. They offer protection from creditors (varies by state). See Gideon Rothschild and Daniel S. Rubin, "Creditor Protection for Life Insurance and Annuities" (www.mosessinger.com/articles/files/creditprotec.htm)

8. How to be smart when playing against the insurance company

   a. Avoid products that have an initial guarantee period that is less than the surrender charge period ("trust me" products).

   b. Dial-a-commission products: Ask about similar annuities from the same company that pay a lower commission and have better features.

   c. Keep annuities that have an above-market guaranteed interest rate. Consider putting more money into them if possible. Check to see if the guaranteed annuitization options are "in the money."

For more information:

– Annuity Advantage (www.annuityadvantage.com)
– Beacon Research (www.annuitynexus.com)
– Comparative Annuity Reports (www.annuitycomparativedata.com)
– Fisher Annuity Index (www.mrannuity.com)

Deferred fixed annuities — Indexed

9. What are the basic features?

Premium and age limitations
Interest-crediting method (nonguaranteed, guaranteed, bonus)
Surrender charge (premium vs. account value, issue-year vs. rolling, number of years, market value adjustment, free withdrawals, waiver)
Guaranteed living benefits
Guaranteed annuitization options
Investor protections (not FDIC-insured, not a security)

10. What are the uses? **?**

For more information:

– Advantage Compendium (www.indexannuity.org)
– Annuity Advantage (www.annuityadvantage.com)
– Fisher Annuity Index (www.mrannuity.com)

– Craig McCann and Dengpan Luo, "An Overview of Equity-Indexed Annuities," Securities Litigation & Consulting Group, 2006 (www.slcg.com)
– Charles Jaffe, "Stupid Investment of the Week: Devilish details trip up equity-indexed annuities," *MarketWatch*, 10/7/2005 (www.marketwatch.com)
– Michael E. Edleson, with Jeffrey Cohn, "Equity-Linked Products: Having Your Cake and Eating It Too?," *Journal of Financial Planning*, January 1993 (www.fpanet.org)
– Michelle Edwards and Steve Swidler, "Do equity-linked certificates of deposit have equity-like returns?," *Financial Services Review*, Winter 2005 (www.rmi.gsu.edu/FSR/abstracts/Vol14/zux00405000305.pdf)
– Joan Warner, "EIAs: Behind the Hype," *Financial Planning*, October 2005 (www.financial-planning.com)
– "Equity-Indexed Annuities: A Complex Choice," 2005 (www.nasd.com)
– Marthe Lie, Snorre Lindset, and Arne-Christian Lund, "Is There a Need for an Industry Standard for Capital Guaranteed Products?" *Journal of Wealth Management*, Summer 2005
– W. Cris Lewis, "A Risk-Return Evaluation of an Indexed Annuity Investment," *Journal of Wealth Management*, Spring 2005
– William Reichenstein, "Insured Investment Products: The Reality Behind the Hype," *AAII Journal*, November 2004 (www.aaii.com)
– Gregory A. Kuhlemeyer, "The Equity Index Annuity: an examination of performance and regulatory concerns," *Financial Services Review*, 2000 (www.rmi.gsu.edu/FSR/abstracts/vol_9_4_2.htm)
– Moshe Arye Milevsky and Sharon Kim, "The Optimal Choice of Index-Linked GICs: Some Canadian Evidence," *Financial Services Review*, 1997 (www.rmi.gsu.edu/FSR/abstracts/vol_6_4.htm)

Deferred variable annuities

11. What are the basic features?

    Premium and age limitations
    Loads (mortality & expense risk charge, administrative charge, subaccount expenses)
    Surrender charge (premium vs. account value, issue-year vs. rolling, number of years, free withdrawals, waiver)
    Subaccount options (fund selection, free transfers, automatic rebalancing)
    Guaranteed annuitization options
    Investor protections (regulated as both insurance and a security, but protections vary)

    Guaranteed death benefits:
    Guaranteed Minimum Death Benefit (GMDB) — return of premium, ratchet, roll-up
    Enhanced Earnings Death Benefit (EEDB) — x% of gains to offset income tax

    Guaranteed living benefits:
    Guaranteed Minimum Income Benefit (GMIB) — provides minimum income payments
    Guaranteed Minimum Accumulation Benefit (GMAB) — provides minimum account value at the end of a specified period
    Guaranteed Minimum Withdrawal Benefit (GMWB) — provides minimum withdrawal amounts over a specified period
    Hybrid guarantees — combinations of living benefits

12. Pricing: not consumer-friendly

    a. "No-load" design is inefficient and misleading. See Ralph H. Gorter, "Credit Card Approach to Pricing," *Product Development News*, August 2000.

    b. Most of the mortality & expense risk charge is for the recovery of commissions, but consumers are led to believe that it is for benefits provided by the annuity.

    c. Some of the investment management expenses may be kicked back to the insurer through revenue-sharing agreements, so the insurer's charges may be higher than they appear.

    d. Unlike A-share mutual funds, variable annuities have no commission breakpoints.

    e. Unlike B-share mutual funds (which convert to lower-cost A-shares after distribution costs have been recovered), some variable annuities have an ongoing load that never disappears, no matter how long you hold the annuity.

    f. The cost of guarantees may not be stated separately, and the pricing may not reflect risk.

13. What are the uses?

    a. They let you make use of the cost basis of a life insurance policy that you no longer want.

    b. They are an alternative to mutual funds for long-term asset accumulation.

       BUT what is the breakeven holding period?

       1. William Reichenstein, “Retirement Planning: Annuities and When They May Make Sense,” *AAII Journal*, July 2003 (www.aaii.com)

       2. www.finance.baylor.edu/reichenstein/research.htm

       3. Moshe Arye Milevsky and Kamphol Panyagometh, “Variable annuities versus mutual funds: a Monte-Carlo analysis of the options,” *Financial Services Review*, 2001 (www.rmi.gsu.edu/FSR/abstracts/Vol_10/V10-11.pdf)

    c. They offer protection from creditors (varies by state).

    d. They offer several types of guarantees.

       BUT are variable annuity guarantees a good deal? Seven questions to ask:

       1. How does the benefit work? (Benefit base, waiting period, restrictions, post-issue options)
       2. What does the benefit cost?
       3. What is the benefit worth?

          See Moshe A. Milevsky and Thomas S. Salisbury, “Financial valuation of guaranteed minimum withdrawal benefits,” *Insurance: Mathematics and Economics*, February 2006; Mary Hardy, *Investment Guarantees: Modeling and Risk Management for Equity-Linked Life Insurance*, 2003; and Moshe Milevsky and Steven E. Posner, “The Titanic Option: Valuation of the Guaranteed Minimum Death Benefit in Variable Annuities and Mutual Funds,” *Journal of Risk and Insurance*, March 2001.

       4. Does the benefit meet a real need in the context of a comprehensive financial plan?

          See Nancy Opiela, “Variable Annuities: Emerging from the Dark Side?”, *Journal of Financial Planning*, March 2007; Moshe A. Milevsky and Thomas S. Salisbury, “Asset Allocation and the Transition to Income: The Importance of Product Allocation in the Retirement Risk Zone,” September 2006 (www.ifid.ca); Moshe A. Milevsky with Anna Abaimova, “Applied Risk Management During Retirement,” 2005 (www.ifid.ca);

Marthe Lie, Snorre Lindset, and Arne-Christian Lund, "Is There a Need for an Industry Standard for Capital Guaranteed Products?" *Journal of Wealth Management*, Summer 2005; Moshe A. Milevsky and Anna Abaimova, "Variable Payout Annuities with Downside Protection: How to Replace the Lost Longevity Insurance in DC Plans," 2005 (www.ifid.ca); William Reichenstein, "Insured Investment Products: The Reality Behind the Hype," *AAII Journal*, November 2004 (www.aaii.com); and Zvi Bodie and Dwight B. Crane, "The Design and Production of New Retirement Savings Products," *Journal of Portfolio Management*, Winter 1999

5. Are better alternatives available?
6. What is the risk that the guarantee will not be honored?
7. Years after you buy it, will you be able to determine if you are still getting a good deal?

14. How to be smart when playing against the insurance company

a. Do not use qualified plan money to buy a variable annuity, unless you have decided that the guaranteed living benefits are worth the total costs. See www.insurancelaw.com/bib-qualified-annuities.htm.

b. Look at the costs, especially the asset-based charges (mortality & expense risk charge, administrative charge, living and death benefit charges and subaccount expenses).

c. Before exchanging one variable annuity for another, look at the value of all of the benefits provided by each contract. See Moshe A. Milevsky and Kamphol Panyagometh, "Exchanging Variable Annuities: An Optional Test for Suitability," *Journal of Financial Planning*, April 2004 (www.fpanet.org/journal/articles/2004_Issues/jfp0404-art7.cfm). Remember that a declining surrender charge has the same effect as a reduction in the asset-based charges.

d. If the annuity has a dollar-for-dollar GMDB that is "deep in the money," consider withdrawing almost all of the money and keeping the annuity for its life insurance value.

e. Look for ways to exploit mispricing of guarantees. (Example: the GMDB might be a good deal for a seriously ill client who wants to invest in volatile equity funds.) Make sure that you understand what benefits are provided at older ages.

For more information:

Morningstar Principia Variable Annuities/Life (www.morningstar.com)
www.nasd.com
www.sec.gov

Immediate fixed annuities

15. What are the basic features?

    Premium and age limitations (minimum, maximum)
    Annuity options (life only, period-certain, refund)
    Purchase price
    Liquidity features
    Investor protections (not FDIC-insured, not a security)

16. Pricing: longevity insurance is relatively cheap

    See Olivia S. Mitchell, James M. Poterba, Mark J. Warshawsky and Jeffrey R. Brown, "New Evidence on the Money's Worth of Individual Annuities," *American Economic Review*,
    December 1999.

17. What are the uses?

    a. They provide longevity insurance as part of a retirement plan.

       BUT how much of your money should you allocate to immediate annuities? When should you annuitize? Should you buy a life annuity or take systematic withdrawals?

       – Moshe A. Milevsky and Virginia R. Young, "Annuitization and asset allocation," Journal of Economic Dynamics & Control, 2007 (forthcoming)

       – Wolfram J. Horneff, Raimond Maurer, Olivia S. Mitchell and Michael Stamos, "Money in Motion: Dynamic Portfolio Choice in Retirement," Pension Research Council Working Paper No. 2007-7, February 2007

       – Jason S. Scott, John G. Watson and Wei-Yin Hu, "Efficient Annuitization with Delayed Payout Annuities," November 2006 (www.ssrn.com)

       – Moshe A. Milevsky, "Annuitization: If Not Now, When?", IFID Centre, July 10, 2006 (www.ifid.ca)

       – David F. Babbel and Craig B. Merrill, "Rational Decumulation," Wharton Financial Institutions Center Working Paper No. 06-14, July 2006

       – Gabriele Stabile, "Optimal Timing of the Annuity Purchase: Combined Stochastic Control and Optimal Stopping Problem," *International Journal of Theoretical and Applied Finance*, March 2006

       – Thomas Davidoff, Jeffrey R. Brown, and Peter A. Diamond, "Annuities and Individual Welfare," *American Economic Review*, December 2005

- Geoffrey Kingston and Susan Thorp, "Annuitization and asset allocation with HARA utility," *Journal of Pension Economics and Finance*, November 2005

- Geoffrey Kingston and Susan Thorp, "Annuitization and asset allocation with HARA utility," *Journal of Pension Economics and Finance*, November 2005

- Ivica Dus, Raimond Maurer, and Olivia S. Mitchell, "Betting on Death and Capital Markets in Retirement: A Shortfall Risk Analysis of Life Annuities versus Phased Withdrawal Plans," *Financial Services Review*, Fall 2005 (http://www.rmi.gsu.edu/FSR/abstracts/Vol14/zux00305000169.pdf)

- Hato Schmeiser and Thomas Post, "Life Annuity Insurance Versus Self-Annuitization: An Analysis From the Perspective of the Family," *Risk Management and Insurance Review*, Fall 2005

- Paul D. Kaplan, "Asset Allocation with Annuities for Retirement Income Management," 2005 (www.ifid.ca/Conference_Material/2005_Kaplan_paper.pdf)

- Moshe A. Milevsky with Anna Abaimova, "Applied Risk Management During Retirement," IFID Centre, 2005 (www.ifid.ca)

- Moshe A. Milevsky, "The Implied Longevity Yield: A Note on Developing an Index for Life Annuities," *Journal of Risk and Insurance*, June 2005 (www.ifid.ca)

- Moshe A. Milevsky and Virginia R. Young, "The Timing of Annuitization: Investment Dominance and Mortality Risk," IFID Centre, 2005 (www.ifid.ca)

- Moshe A. Milevsky, Kristen S. Moore and Virginia R. Young. "Optimal Asset Allocation and Ruin-Minimization Annuitization Strategies," IFID Centre, 2004 (www.ifid.ca)

- Peng Chen and Moshe A. Milevsky, "Merging Asset Allocation and Longevity Insurance: An Optimal Perspective on Payout Annuities," *Journal of Financial Planning*, June 2003 (www.fpanet.org)

b. They can be used to pay premiums on life insurance policies.

c. They let you make use of the cost basis of a life insurance policy that you no longer want.

18. How to be smart when playing against the insurance company

    a. Think carefully about the when-to-annuitize decision.

    b. For large purchases, use more than one company to reduce risk. Construct an "efficient frontier" showing the trade-off between annuity payments and financial strength.

    c. Consider spreading the purchase over time, to avoid locking up a low interest rate for life with a large portion of your money.

    d. If you are not in good health, ask about impaired-risk annuities that provide a higher monthly income based on medical underwriting.

For more information:

www.immediateannuities.com

Immediate variable annuities

19. What are the basic features?

    Premium and age limitations (minimum, maximum)
    Annuity options (life only, period-certain, refund)
    Assumed investment return (benchmark rate of return)
    Purchase price
    Loads (mortality & expense risk charge, administrative charge, subaccount expenses)
    Subaccount options (fund selection, free transfers, automatic rebalancing)
    Liquidity features
    Guaranteed benefits
    Investor protections (regulated as both insurance and a security, but protections vary)

20. What are the uses?

    Same as for immediate fixed annuities.

21. How to be smart when playing against the insurance company

    a. Think carefully about the when-to-annuitize decision.

    b. Think carefully about whether you will be happy with the insurer's selected funds for the rest of your life.

c. Make sure that you understand the relationship between the monthly annuity payments and the assumed investment return.

d. For large purchases, use more than one company for diversification.

For more information:

– Jeffrey K. Dellinger, *The Handbook of Variable Income Annuities*, 2006

– National Association for Variable Annuities, "Immediate Variable Annuities," www.navanet.org/res/immediateVA.pdf

– Moshe A. Milevsky and Anna Abaimova, "Variable Payout Annuities with Downside Protection: How to Replace the Lost Longevity Insurance in DC Plans," IFID Centre Research Paper, October 12, 2005 (www.ifid.ca)

– Glenn S. Daily, "The attractions and pitfalls of variable immediate annuities," *AAII Journal*, February 1994