

### **New-Wave Annuities**

From reduced-risk participation in the stock market to longevity insurance, planners have an expanding array of annuities to meet client needs.

By Donald Jay Korn

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Judging by the numbers, it's smooth sailing for variable annuities (VAs), and the seas are getting crowded with fleets of similar investment vessels. According to NAVA in Reston, Va., total "premium flow" (sales) of VAs hit almost \$117 billion in the first nine months of 2006, up nearly 20% over a year earlier. More impressive, "net flows" hit \$24.5 billion, a 66.4% jump. (Net flows are what's left after surrenders, withdrawals, exchanges and payouts.)

One reason for the rise is the four-year bull market, says Frank O'Connor, product manager for VARDS Products (formerly Variable Annuity Research and Data Service) at Morningstar, which compiles stats for NAVA. Investors are increasingly willing to put their money into stocks, and VAs offer the chance to do so while deferring tax. Soon, annuities sold in 1999 and 2000 will no longer be subject to surrender charges. "Investors are more likely to enter into exchanges, adding to total sales," he says.

### **LOVING LIVING BENEFITS**

Demographics are playing a role, too. More people are entering their retirement or pre-retirement years, so there's more interest in lifelong income. "Our VA sales were up sharply in 2006," says Kevin Hogan, senior vice president of insurance and annuity product marketing for LPL Financial Services in San Diego. "Defined benefit plans are dwindling, and VAs provide a strong alternative." So-called living benefits may replace disappearing pensions. "They're often structured to guarantee income for life," O'Connor says. Also, advisors may now be more comfortable with these features and can explain them to clients.

Current VA marketing efforts focus more on living benefits and less on tax deferral, and that may be why there are more VAs in qualified plans. The latest figures show more than 60% of total sales going into tax-deferred accounts. Some planners object to holding a tax-deferred annuity in a tax-deferred retirement plan, but the promise of guaranteed lifetime payments may justify this redundancy.

Planners interviewed barely mentioned tax deferral when explaining why they recommend VAs. The emphasis is on not outliving income. "No matter what other precautions you take, you still insure your home," says Tom Hamlin, a Raymond James Financial Services branch manager in Portland, Ore. "It's irresponsible not to insure equities, too."

As he sees it, clients need a healthy helping of equities to provide the returns needed over extended life expectancies. But the equities market is subject to so much uncertainty that the risks are substantial. Thus, it makes sense to pay for the protection of VA living benefits.

The cost of such protection needn't be exorbitant, contends Hamlin, who founded annuityfyi.com. "We look for the least expensive annuities for our clients," he says. "The ones we use actually cost less than managed money, when all the expenses are counted. I can make more with managed money, but annuities give my clients peace of mind."

Saul Simon, a planner in Edison, N.J., prefers VAs with "guaranteed minimum withdrawal benefits for life" (GMWBs). Clients can withdraw 5%, 6% or 7% of their investment each year, no matter how long they live. "They're protected against loss, but they still have upside potential if their investment accounts gain," he says. With a GMWB, investors don't have to annuitize their contracts to get the living benefit.

Anecdotally, GMWB features seem to be more popular than guaranteed minimum income benefits (GMIBs), which require annuitization," O'Connor says. GMWBs are gaining in popularity over GMIBs, says Scott Stolz, president of Raymond James' insurance and annuity general agency in St. Petersburg, Fla. "Now that GMWBs offer a lifetime income, more advisors no longer see the advantage of GMIBs. And GMWBs are easier to understand."

The appeal of GMWBs is simple, Stolz says. "No matter what the actual performance of the market, the client will someday be able to draw a lifetime income off a growing sum of money."

Such guarantees usually mean lower returns. Morningstar reports that VA subaccounts holding large-cap growth, value and blend stocks had average annualized returns of 2.8%, 6.8% and 4.7%, respectively, for the five years through November 2006. That's well below mutual fund returns in the same categories: 3.1%, 8.4% and 5.6%.

A similar tradeoff is offered by equity-indexed annuities (EIAs). These rode a rising tide in recent years, but sank a bit last year. For the first three quarters of 2006, EIA sales were estimated at \$19.4 billion, down 5% from the same period in 2005, according to Beacon Research in Evanston, Ill., which provides the AnnuityNexus database.

"Regulatory uncertainty played a role," says Judith Alexander, Beacon's director of sales and marketing. In particular, NASD Notice 05-50, released in mid-2005, addressed the responsibility of broker-dealers to supervise sales of EIAs. "Independent insurance producers who hold a securities license face difficult decisions on whether and how to sell indexed annuities," she says. "There are no such uncertainties with the sale of variable annuities, which offer a similar value proposition: upside potential with downside risk protection. Also, higher interest rates made bank CDs and market-value

adjustment annuities [bond-like fixed annuities] more attractive. Therefore, indexed annuity sales got squeezed on both sides of the risk/reward continuum."

Technically, EIAs are classed as fixed, not variable, annuities, which tend to attract conservative investors, so EIAs may give those investors slightly higher returns. "I use them as a component of clients' fixed-income portfolios," says Jim Kealing, a planner in Newhall, Calif. "Compared with bond funds, investors get tax deferral, no principal risk and a chance for better performance."

Typically, EIAs offer a modest minimum return along with a percentage of a stock market index. "They can work well for risk-averse people who like principal guarantees," says Kealing. "With a good EIA, you'll probably wind up with a higher return than from a bank CD or a straight fixed annuity. I look for a high-quality insurer, and then I look at the crediting method because that can make the difference." EIAs vary in how they set the minimum return and participation in the index returns.

In contrast, Jeff Winn, director of retirement and estate planning at International Assets Advisory in Orlando, Fla., treats EIAs as a hybrid of equities and fixed income. The end return is driven by the stock market, but clients are guaranteed at least a certain return if they hold on for a period. They may be well-suited for clients who want a lump sum at the end of the term, he says.

"Historically, EIAs have returned 70% to 85% of the underlying index," Winn says. "In the past 10 years, EIAs outperformed the S&P 500. They offer some equity participation to clients who otherwise would not hold stocks."

Both EIAs and VAs are deferred annuities. Should clients eventually annuitize the contracts, converting them into immediate annuities? Not necessarily. "Only once in 30 years have I advised a client to annuitize," says Phil Cook, a planner in Torrance, Calif. "Clients are locked into a payment stream, with little flexibility."

Similarly, a few advisors avoid immediate annuities. "The cost of the guarantee and other expenses decreases the income potential dramatically," says John Gay, who heads Frisco Financial Planning in Frisco, Texas. He might advocate an immediate annuity for a trustee who must distribute an inheritance and provide a specific income for a financially irresponsible beneficiary--or for an ultra-conservative investor who would otherwise eschew stocks.

Nonetheless, sales of immediate fixed annuities are up 10%, to \$4.4 billion for the first three quarters of 2006, from the same period in 2005, according to LIMRA. Immediate variable annuity sales were up 38%, to \$285 million.

At Genworth Financial in Richmond, Va., Tim Layton says immediate annuity sales are up partly because "we added a commutation feature in late 2005 that offers investors a chance to get money back in a lump sum." That might reassure clients who are reluctant to forego a hunk of change for relatively modest periodic payments. Genworth

plans to launch an immediate variable annuity in early 2007. "Advisors were interested in guaranteed minimum returns," Layton says. "So our immediate VA will have three floors--investors will pay more for higher floors." Genworth has been seeing increased annuitization of deferred annuities as well. "The customer base is growing older," Layton says. "Locking in a lifetime income stream may seem like a good idea." Most Genworth IAs have lifetime payouts. Clients can get a period-certain annuity or a contract that will make some ongoing payments to heirs in case the annuitant dies during that period.

## THE RIGHT EXCHANGE

With such a breadth of products available, it's likely that some clients will be holding inappropriate annuities or contracts that lack newer features. If so, there's an escape clause in Section 1035 of the tax code, which permits clients to exchange one annuity for another without triggering the deferred income tax.

"Some new clients own VAs with high costs," says **Brent Kessel**, president of Abacus Wealth Partners in Pacific Palisades, Calif. "We have advised them to exchange for lower-cost annuities from companies such as Vanguard and Peoples Benefit Life [a subsidiary of Aegon]." Typically the annuity has mortality and expense (M&E) charges and mutual fund subaccount expense ratios well over 1%. "Even clients with 4%-5% surrender charges on old annuities may be better off with new ones," he says. "They earn back the surrender charge, and the rest is gravy."

Judith Maurer, founder of Low Load Insurance Services in Tampa, Fla, analyzes annuities for financial planners. She recently did a report for a client with a VA with M&E charges of 1.65% and high fund charges. "It had one year left in the surrender period, but the expenses were so high that the client would have been better off switching to a no-load annuity from Ameritas and paying the surrender charge."

Tax-free exchanges needn't be annuity-for-annuity. People who no longer want or need a life insurance policy and don't want to pay the premiums can exchange it for an annuity, which may not require more premiums and which may generate an income stream.

Kim Dignum, executive vice president of Frost Investment Services in Fort Worth, Texas, reports life-insurance-for-annuity swaps. "I've worked with people who formerly had insurance provided by an employer but who became responsible for paying the premiums," she says. "They could switch to a deferred annuity if they were younger, or to an immediate annuity if they needed cash flow."

For any type of tax-deferred annuity exchange, Dignum advises finding the contract value and the surrender charge to see if a swap is worthwhile. Clients should keep a record of their basis in the old annuity to hold down the income tax when money is taken out.

Clients can also sell an annuity to a structured settlement firm like J.G. Wentworth in Bryn Mawr, Pa., as long as it's not held in a tax-deferred retirement account. Any gain is taxable but it still might be better than an exchange or a surrender, says Michael Vaughan, managing director of the annuity purchase program. "You have to compare the net amounts a client would receive."

Last year, Wentworth bought a deferred annuity from a client who had held it for just over six years. She had invested \$75,000, received a 10% upfront bonus and had a current account value of \$106,000. "She wanted to reallocate assets and pay some medical bills." But the contract had to be annuitized for at least five years to get the full account value. The cash surrender value was under \$80,000. Wentworth paid nearly \$95,000 in cash. Even after paying tax on a gain of almost \$20,000, the client was ahead of where she would have been with a surrender.

*Senior Editor Donald Jay Korn has been writing about investments and tax and estate planning for Financial Planning since 1985.*

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