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"The Devil is in the Details"

Michael Lewis's The Big Short recounts the birth, proliferation, and eventual collapse of the U.S. sub-prime mortgage industry. He explains how the market for mortgage-backed bonds, which had been created to make housing more affordable and to more efficiently match borrowers with willing lenders, gave way to an explosion of financial innovation that simply hid risk within a maze of unnecessary complexity. In one chapter, Lewis describes how a zero-down, interest-only negative-amortizing, adjustable-rate subprime mortgage allowed a California strawberry farmer making $14,000 a year to buy a $720,000 house. While it was known from the start that the borrower was likely to default upon the reset of his introductory interest rate, loans like these were wildly profitable for their originators. After collecting an up-front fee, the originator would bundled all of these subprime loans together, have the underlying risks covered up with AAA ratings by S&P and Moody's, and offload the risk onto unsuspecting investors.

At the heart of Lewis's book is an invaluable message consisting primarily of two points; incentives drive behavior and unnecessary complexity is often used to disguise risk, just as it did in the U.S. sub-prime mortgage market. The remainder of this article looks to tie these two concepts into today's world of personal wealth management, specifically as it pertains to the sales incentives and complexities that tend to exist in the world of annuities.

Given what has transpired in the financial markets over the past 10 years, investor demand for a way to earn a meaningful rate of return without taking on additional risk has increased substantially. This demand is driven by an aversion to uncertainty, or quite simply a genuine fear of going broke.

While this fear has permeated nearly every class of investor, its effects are understandably heightened amongst those who are already retired or are nearing retirement. Throw in the fact that life expectancies are continually edging higher and one can't help but notice the risk of outliving a limited pool of assets. This is commonly referred to as longevity risk. When there is so much talk about many investors facing their latter years, potentially without ample assets or income to support their needs, annuities are often mentioned as a potential solution.

Before going any further, it should be noted that annuities can help mitigate longevity risk. However, when contemplating the use of annuities, it is imperative to know and understand the incentives that are in place. More importantly, the financial incentives to sell an annuity often correlate closely to the complexity of the policy. While annuity sales incentives and the ability to hide risk within annuity contracts may not be as blatant as what transpired within the U.S. sub-prime mortgage market, fully understanding the details of any financial product is vital.

An annuity is a contract that is backed by an insurance company, where an investor (the annuitant) contributes an initial investment or premium in periodic installments or in a lump sum payment. In return, the annuitant receives an agreed upon stream of cash flows for a predetermined period of time. Income can be received for a fixed number of years, for the remainder of the annuitant's life, or for the remainder of multiple lives (i.e. a husband and wife). The stream of annuitized payments can commence immediately, or they may be deferred until a later date.

When annuity premiums are collected by the insurance company, they are invested in long-term bonds and other low-risk assets. In much the same way as they do with health insurance, the insurance company is able to hedge its risk by pooling the contracts of multiple annuitants. It is then able to cover the cost of those who live beyond their life expectancies with the profits made off of those who do not live as long. This model is not materially different from that of a casino, where the house may lose a few hands, but by the end of the night the odds (in this case the actuarial calculations) have nearly assured a collective profit.

The simplest way to hedge longevity risk with an annuity is through a fixed annuity contract. The purchase of a fixed annuity is very similar to buying a long-term bond. However, instead of receiving periodic interest payments followed by a lump-sum return of principal at maturity, annuity payments consist of a return on investment (i.e. interest) along with a systematic return of principal. The monthly cash flows associated with a fixed annuity will be higher than that of a comparable bond because a portion of the principal investment is returned every month in addition to the interest being earned. This leads some to believe that they are getting a higher return. However, keep in mind that there is no magic rate of riskless return being provided to the annuitant. The insurance company is able to invest in long-term bonds, provide the annuitant with an income stream, and still make a profit for themselves. For the insurance company to stay in business, the embedded return delivered on a fixed annuity contract must be lower than the return that they are earning on their own portfolio of bonds and other low risk investments.

So why wouldn't somebody want to enter a fixed annuity if the monthly cash flows are anticipated to be higher than those of a comparable bond? The answer depends on a couple of factors. With an annuity, once the annuitant begins collecting payments, the contract becomes irrevocable and the annuitant's access to their original investment is forfeited. This can become a problem for those who run into unanticipated cash needs. Further, upon the death of the last surviving annuitant, an annuity has no transferable value to the annuitant's heirs. Lastly, the predetermined payout of a fixed annuity is a function of the annuitant's life expectancy and current interest rates. Therefore, when initiated in a low-interest rate environment, fixed annuities lock in a long-term rate of return that is consistent with current interest rates. This leaves the annuitant unduly exposed to the loss of purchasing power when interest rates increase. On the contrary, by using individual bonds, one can manage their incomes sensitivity to interest rate increases by keeping their maturities shorter.

Fixed annuities are fairly simple and can be an effective hedge against longevity risk for those who are not concerned about leaving assets for their beneficiaries or maintaining the ability to readily access their principal. However, complexity is often added to annuities in the form of an underlying investment account. This account offers tax-deferred growth and a source from which policy premiums are deducted prior to annuitization. Upon annuitization, the underlying investment account is forfeited in return for a stream of income. These products are referred to as variable annuities. Variable annuities are where the most abuse takes place in the form of heavy fees and overly-complex sales literature. Variable annuities are often sold for the tax-deferred growth of otherwise taxable assets. Many fail to realize that any tax-deferred gains earned within an annuity funded with after-tax dollars will eventually come out at the annuitant's top marginal tax rate, instead of being taxed at the more favorable long-term capital gains rate afforded to traditional taxable accounts. The claim of tax benefits become an all out lie for annuities that are purchased in retirement accounts, as IRA's are already afforded tax-deferred growth on their own.

For those that have been sold a variable annuity, it is likely the contract was held out as providing some sort of guaranteed benefit. With variable annuities, being able to discern what "guaranteed" means and how much that guarantee costs is dependent upon understanding every detail within the prospectus and contract and how your agent is being incentivized. In many cases this requires forgoing the colorful hypothetical charts of the annuity marketing materials and heading straight for the prospectus and contract. By dissecting these less visually appealing documents, which often consist of several hundred pages of fine-print phonebook-esque paper, one can start to piece together the complexity.

One of the main drawbacks of entering an annuity contract is the lack of flexibility. For instance, deferred sales charges, which are assessed in the event that the annuitant wishes to regain full control of the underlying investment account prior to annuitization, may start at 9% of the contract value and step down by 1% per year until reaching zero after 9 years. In most cases the cost of exit from an annuity contract can be very prohibitive.

Adding to the complexity of variable annuities are the endless list of options, commonly referred to as "riders" that are offered in return for higher premiums. These options can include, but are not limited to the following:

- Guaranteed death benefit riders, which offer payouts to designated beneficiaries if the annuitant dies prior to annuitization.

- Minimum guaranteed income base riders, which guarantee a stated rate of return on the base from which income will eventually be paid.

- Increased benefit payment options, which turn a fixed dollar income stream into one that steps up with inflation.

As the complexity ramps up, so do the underlying expenses, including the compensation that the sales agent will be receiving. Insurance companies don't often include additional options as a gift to the annuitant, but as a means to increase their profits.

As an example, the most recent contract that Sigma evaluated had a variable investment account that was shouldering an all-in cost of 3.15%. Of the total 3.15%, 2.15% was being charged on the initial policy amount, rather than the depressed market value of the underlying account. While the annuitant had the option of liquidating the contract and taking the proceeds, the effects of having the investment account saddled with fees of this magnitude in a weak market environment for 8 years left them no choice but to lock in an irrevocable stream of income.

Various riders may be advantageous to some annuitants, but determining their validity often requires a longer process than the mere suggestion of the sales agent. The complex descriptions and disclaimers associated with various riders can leave annuitants believing one thing, when the contract that they sign says something quite different.

Take for example a "minimum guaranteed income base" rider that was included in the aforementioned annuity. The annuitant was paying 0.75% of the original contract value amount per year so that their "income base" would be guaranteed to grow at 7% per year for 10 years. The annuitant was lead to believe in 10 years they could either annuitize the contract or elect to walk away with an investment account that had nearly doubled, risk-free. This ultimately fell under the description of too good to be true. The 7% guarantee only pertained to an intangible value that would be used to calculate an eventual stream of income if the policy holder decided to annuitize. Upon digging a bit further, the interest rate applied to this income base that had grown at 7% per year to arrive at the eventual annuity payout was so minimal, that the annuitant's actual return over the entire term of the contract would end up being nowhere near 7%. This is like promising someone who has been stuck in the desert a gallon of water, without telling them in too much detail that upon receiving the water they will only have access to a slow drip from a small hole in the bottom of the jug. Of course, in the case of the annuity, the annuitant could have known this in advance had they simply read the appropriate disclaimer in paragraph x on page z of the 200 page fine-print prospectus. In the end, the complex contract that they entered did not eliminate their investment risk, but rather, simply rearranged the deck chairs to make a guaranteed bond-like return appear to be something more substantial.

In the case of sub-prime mortgage lending, it was often the case that mortgage brokers were compensated not on whether a mortgage was the most appropriate for the borrower, but rather, on how much money that mortgage made for the underwriter. In the case of annuities, one should be similarly cautious. This is not to say that all variable annuities are overpriced or inappropriate, or that all insurance agents are simply looking to make the largest commission possible. The end consumer of any financial service or product, inclusive of the services that Sigma provides, ultimately needs to understand the incentives that are driving the recommendations, while realizing that unnecessary complexity is often used not to eliminate risk, but to cover it up.

At Sigma, we don't sell annuities as a part of our services and it is rare that we suggest the purchase of an annuity. However, we are often given the responsibility of reviewing annuity contracts for clients. No matter the unique details of the policy, Sigma's review and eventual advice is driven by a present value analysis. Present value represents the value in today's dollars of a future payment or series of future payments, discounted to reflect the time value of money and other factors such as investment risk. Through this analysis one is able to back out an implied rate of return based upon the cash flows being promised and the life expectancy of the annuitant. While the actual calculation is quite systematic, and simple in most respects, the process of discerning exactly what stream of income is due to the annuitant upon annuitization can be a meaningful test of patience.

Regardless of the situation, there is a simple way to determine whether or not a particular annuity is even worth taking a second look at. It has to do with whether or not the deal makes sense. A guaranteed return of 7% when a 10 year treasury bond is yielding 2.8% would probably qualify as not making sense. Either the return on investment is not 7%, or there is an undisclosed risk that is not being evaluated. Before signing a contract, the annuitant should know exactly what they are getting, how much they are paying, whether or not the same goals can be achieved with less complexity, and how much additional compensation the agent is receiving for each added layer of complexity. Only then can an informed decision be made.

At the end of the day, no annuity contract should be perceived as being able to offer above market returns with below market risk. Annuities are simply a means of transferring longevity risk from the annuitant to the insurance company. If something sounds too good to be true, dig deeper, read every word, and ask more questions. Chances are, if the person selling you the contract cannot explain every last detail concisely and in plain English, the sales literature is riddled with asterisks and disclaimers, the prospectus offers no meaningful amount of additional clarity, and the dotted line on which you sign says "no dollar amounts are guaranteed," it may be time to reconsider.

26261 Evergreen • Suite 455 • Southfield, MI 48076 • tel (248) 223-0122 • fax (248) 223-0144 • www.sigmainvestments.com