The Variable Annuity as an Investment

The variable deferred annuity is typically sold as an investment*,* we examine it here as an investment, using as our framework a model used to describe the process of financial and estate planning. Then we will relate various characteristics of the variable annuity to three key aspects of the overall planning process, focusing on the extent to which these characteristics provide solutionsto the needsthat cause consumers to purchase financial instruments—investments—in the first place.

# The Model

The process of financial and estate planning may be described as a three-legged stool. The three legs are:

1. accumulation;

2. conservation; and

3. distribution.

From the standpoint of the planning process, each leg, or aspect, represents a need,or combination of needs,that must be satisfied if the plan is to be successful. From the standpoint of a deferred variable annuity, each aspect is reflected in one or more characteristics of the annuity that are designed to satisfy the need in question. We will examine each leg, first as a component of the planning process and, then, as a need for which certain features of the variable annuity were designed to provide a solution.

Leg One: Accumulation

The accumulation goal, as many investors perceive it, is to amass as much capital as possible, by achieving the highest investment returns possible, consistent with acceptable risk. While this may be a valid investmentobjective, it is not a good planning objective. Rather, one should aim for maximizing the probability of achieving one’s goals. Often, goals are expressed in the form of income*.* To satisfy these incomegoals, a tool designed specifically to create income may be more efficient than one designed to create a future lump sum that can then be tapped to create income. There is good evidence that a combinationof (1) instruments designed for pure wealth accumulation and (2) purely income instruments can produce higher probabilities of overall plan success than pure accumulation instruments by themselves.[[1]](#endnote-1) In so doing, a combination is actually addressing both the client’s accumulationgoal and his or her conservationgoal. That said, let’s stay focused on the accumulationgoal, and ask, “How can a variable annuity help the investor to achieve this goal?”

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The Variable Deferred Annuity as an AccumulationInstrument

The efficient accumulation of wealth is the object of all investment methodologies, including the widely used and popular Modern Portfolio Theory (MPT). This theory holds that, to achieve the highest returns possible, with the least amount of investment risk—or, viewed another way, to minimize the investment risk necessary to achieve a given portfolio rate of return—one should construct a diversifiedportfolio, composed of asset classes,that:

1. offers the opportunity, through a broadly diversified portfolio, to achieve the return necessary to achieve planning goals with the least amount of riskwhere risk is traditionally defined as volatility—usually measured by standard deviation*.*

2. reduces riskby constructing the portfolio efficiently from components that represent asset classes that are, to the extent possible, as weakly correlated—or even negatively correlated—as possible. This requires that the investment vehicle provide a sufficient variety of asset classes to allow construction of such a portfolio.

3. can be adjusted periodically. Many theorists believe that periodic rebalancingof the portfolio is essential, by selling those components that have outperformed expectations and buying those that have underperformed, so as to bring the proportions of the components back to the original optimum mix. How often such rebalancing should occur is a matter of considerable debate.

4. can be adjusted with as little expense(e.g., transaction costs, taxes, etc.)as possible.

How Does a Variable Annuity Allow the Investor to Build Such a Portfolio?

*1. A Broadly Diversified Portfolio.*

Early variable annuities offered only limited investment choices, often managed by the issuing insurance company. Today’s contracts typically provide the policy owner access to a wide variety of investment subaccounts,[[2]](#endnote-2) managed by several different independent money management firms, in addition to a fixed subaccount, which acts much like a fixed annuity, and for which separate management charges are not assessed. Some variable annuities offer thirty or more variable subaccounts from dozens of money managers. Generally, these subaccounts are actively managed and are sometimes said to be clones of mutual funds offered outside the annuity by the money manager. However, it is very important that the advisor understand that the term clone, in this connection, is misleading.

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For example, an annuity may contain a subaccount called Atropos Growth Opportunities, managed by, say, Olympia Capital Investments. Olympia may offer, outside the annuity, a mutual fund with the exact same name. But this does not mean that they are managed by the same individuals orthat they have precisely the same investment objectives or investment policies. Nor does it mean that the fees and expenses are the same. Even when the same individual manages both, and when the investment policies of both are essentially the same, that manager may employ different strategies in the annuity than for the mutual fund. Tax considerations alone might suggest the use of different strategies. Realized gains in a mutual fund must, by law, be distributed to shareholders of a mutual fund and are currently taxable even if reinvested.

Consequently, advisors should avoid referring to these subaccounts as clones and, most certainly, shouldnever use the performance history of one when discussing the other. Moreover, the pricing of a variable annuity subaccount is different from the pricing of a mutual fund. Reinvested gains in a mutual fund purchase additional shares having, at the time of distribution, the same value as the original shares. By contrast, gains in a variable annuity subaccount do not purchase additional shares; instead, the value of the shares is adjusted to reflect those reinvested gains.

Similarly, though, most variable subaccounts are actively managed, as are most mutual funds. Recently, more and more variable annuities have added passively managed subaccounts designed to match the performance of an external index such as the S&P 500.

*2. An Efficient Portfolio.*

The availability of a wide variety of investment subaccounts, representing many asset classes, may allow the owner of today’s variable annuity to construct a portfolio that is not only diversifiedbut theoretically efficient. It is comprised of asset class components that are weakly, or even negatively, correlated, such that they do not perform in lockstep with one another. We say “may allow” because few, if any, variable annuity issuers provide the annuity owner, or his or her advisor, for that matter, with a tool to construct such an efficient portfolio. This construction is usually done by means of a technique known as Mean-Variance Optimization, and the software tool used to employ it is usually known as an optimizer. As of this writing, the authors know of no variable annuity issuer that provides either the client or the client’s advisor with an optimizer, either on a website or in illustration software.

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Of course, the client’s advisor may have access to such an optimizer, either incorporated in a financial planning software package or a standalone software package. However, even access to this tool will not suffice unless the advisor also knows some vitally important data about the subaccounts to be used to create the optimum portfolio. The required data includes:

* the expected meanreturn of the asset class;[[3]](#endnote-3)
* the expected volatilityof the asset class, as measured by its Standard Deviation (SD);
* the coefficient of correlationof the performance of every subaccount to be considered to the performance of every other subaccount to be considered; and
* the historical time periodto which these data refer.

Few, if any, variable annuity issuers provide all of this information. All provide historical return data, however, and an advisor who has access to an analysis tool such as Microsoft Excel®, expertise in using its statistical functions, and historical return data for all subaccounts to be considered for a common time period of significant duration (we suggest at least ten years) can derive the remaining data, which can then be plugged into an optimizer.[[4]](#endnote-4)

Realistically, though, few advisors will do this. First, because it requires statistical expertise that many advisors do not possess, and, second, because there is a much easier way to do the optimization—or, at least, there appearsto be.

Some advisors will choose specific investment subaccounts within the annuity to representasset classes (e.g., Olympia Giant Growth to represent large cap growth stocks) and create an optimized portfolio from those accounts, using optimizer software and the statistical data, such as Mean, SD, and coefficient of correlation, supplied with the software, representing the asset classes themselves.The subaccounts will, in this procedure, be acting as proxies for the asset classes.

Use of an optimizer program in this way is fairly common among advisors seeking to build optimized portfolios from actively managed mutual funds. Applying it to actively managed variable annuity subaccounts is not much different, and the results should be no less credible. The problem is the results will notbe credible—whether it is mutual funds or variable annuity subaccounts that are being optimized—if they are actively managed*.*

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The manager of an actively managed fund or variable annuity subaccount seeks to distinguishthe performance of the account from its peers, hopefully, by outperforming them. That is what sells the fund and that is what produces the manager’s bonus. If the benchmark for a fund is a particular index, the fund manager will seek to outperformthat index. But the whole idea of using a proxy for something is to obtain results as close as possible to the values that would be produced if that something were the thing used. The very idea of a proxy, a substitute—deliberately managed to produce results different from the object for which it is substituted—is self-contradictory.

Use of Mean-Variance Optimization (MVO) has its uses, but it is not nearly the ideal tool that many advisors suppose it to be when it’s used as just described. By definition, any fund or subaccount with a low R-Squared value,[[5]](#endnote-5) in relation to the asset class for which it is standing proxy, will not perform in accordance with the expectations for that asset class. The lower the R-Squared value, the greater the dissonance. The authors believe that MVO is a much more reliable and credible tool when the correlation between the asset classes chosen—to which the return, SD, and coefficients of correlation apply directly—and the proxies chosen to represent those asset classes is as close as possible. There is a fairly simple way to accomplish this objective: the proxies should be designed to mirror the asset classes they represent. If the asset class is, say, U.S. Small Cap Growth, as measured by the Russell 2000 Growth Index, then an excellent proxy would be an index fund or subaccount deliberately constructed to perform like that index.

Until a few years ago, index subaccounts were rarely offered in variable annuities. Recently, however, many contracts have added them, though usually only one or two broad, well-followed indices, such as the S&P 500. A few contracts also offer Exchange-Traded Fund (ETF) accounts, which are also designed to mirror various indices. The expense ratio of both types of accounts is generally much lower than that of their actively managed cousins, and one might wonder why, in light of the frequent criticism of variable annuities as being too expensive, we do not see more of them in the variable annuity marketplace. It’s possible that they are less profitable to the annuity issuer than actively managed accounts. It may also be that passively managed accounts are incompatible with the culture of many insurers, whose marketing usually highlights the investment managers available for their products. Whatever the reason, the debate between actively managed and passively managed still rages. Many commentators and a few scholars argue that active management can provide additional value, over and above the value expected from the asset class to which a fund is most closely related. For those who agree with this argument, a variable annuity offers a significant benefit that is often under-appreciated.

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As noted earlier, many variable annuities offer dozens of separate subaccounts managed by perhaps a dozen or more money management firms*.* Often, these managers are chosen by the insurance company because they represent a specific style expertise. Olympia Capital Investments, for example, may be a highly respected growth manager that is particularly adept and successful at managing client money using that style. By contrast, Asgard Asset Management may be well known and respected as a value manager. Another management firm may be highly successful at bond investing. By including all three firms in its stable of managers, an annuity offers the policyholder the opportunity to choose, not only those asset classes that comprise the most appropriate portfolio for his or her goals, but to select managers for each class that are unusually good at managing that particular kind of investment.

*3. Periodic Adjustment.*

Nearly all variable annuities allow the switching of money among the various subaccounts without cost.[[6]](#endnote-6) Moreover, such a transfer is not a taxable event for income tax purposes. This allows the annuity owner to adjusther portfolio to reflect changed objectives or time horizons, because a manager has consistently underperformed, or to rebalance the portfolio, to return the investment mix to original, or revised, percentage allocations. Most variable annuities offer the policy owner the opportunity to elect such re-balancing automatically, at various intervals; typically, annually, semi-annually, quarterly, or monthly, or when the existing percentage allocation of a holding varies from its target by at least a certain amount or percentage. Typically, there is no charge for this feature.

A related benefit allowed by many variable annuities is sometimes referred to as dollar cost averaging. This feature allows the contract owner with a lump sum to invest, who may be concerned about the risk of investing in the market at the wrong time (i.e., when share prices may be ready to fall), to deposit the lump sum into the fixedaccount of the annuity in an arrangement where a portion of this lump sum will be automatically transferred, each month, to variable subaccounts that she has selected, so that the entire sum will be transferred evenly across a certain time period, which is typically, six months or one year. Often, an annuity issuer will offer contract holders who elect this feature a higher-than-market interest rate on the funds remaining in the fixed account, which will, by operation of the feature, be entirely invested in the separate accounts at the end of the period.

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*4. Low Annual Cost.*

The owner of a modern variable annuity can construct a portfolio of many individual subaccounts, representing a wide variety of investment types and managed by a diverse stable of professional money managers with different styles and expertise. She can adjustthis portfolio periodically—in some contracts, as often as desired—at no costand with no tax consequence*,* and may elect to have adjustments made automatically, at no cost. These are powerful and attractive portfolio managementbenefits, rarely available to regular taxable accounts*,* which are all too often ignored when the variable annuity is considered as a wealth accumulation tool.

Leg Two: Conservation

The second leg of our three-legged stool model is wealth conservation.Here, the investor’s goal is to keep his accumulated assets as safe as possible from loss, including loss due to:

* poor investment performance;
* taxes;
* bankruptcy or other failure by the institution holding the investment; or
* attacks by creditors.

How can a variable annuity help the investor achieve this goal?

1. Protection from Loss from Poor Investment Performance.

Loss due to poor investment performance can adversely affect both the annuity owner during his or her life and the owner’s beneficiary, if the owner dies before the contract is surrendered or annuitized. Today’s variable annuities contain several risk management features that can help the annuity owner manage the risk of such losses.

The living benefitsin modern variable annuity contracts provide the contract owner with four basic assurances:

1. a guarantee of a minimum future accumulation value, through the guaranteed minimum accumulation benefit;

2. a guarantee of a minimum income, through the guaranteed minimum income benefit;

3. a guarantee of no loss of principal through a guaranteed minimum withdrawal benefit; or

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4. a guarantee of a minimum income for life through a guaranteed lifetime withdrawal benefit.

Newer combination riders, incorporating elements of more than one of these benefits, provide these same assurances while offering greater flexibility.

The guaranteed death benefitin today’s variable annuity contracts assures the owner that her beneficiary will receive at least the amount originally invested, plus depending upon policy terms, a minimum rate of return on that investment or all or part of previously credited gains.

Both the living and death benefits are, of course, insurance features. They are, however, arguably relevant to a proper evaluation of the variable annuity-as-investment, for anyone whose overall financial planning goals include a desire for conserving his invested wealth.

2. Protection from Loss Due to Taxes.

One of the most-cited benefits of any deferred annuity, including a deferred variable annuity, is that undistributed gain is not subject to current income taxes. Indeed, tax deferralis often said to be the main attraction of deferred annuities. This, in the authors’ opinion, is unfortunate for two reasons.

First, this narrow focus ignores the many benefits offered by deferred annuities that have nothing to do with taxation. The investment aspects of a variable annuity just described may be sufficiently attractive to an investor to justify the annuity costs, irrespective of tax deferral*.* Moreover, an annuity is the only financial instrument that can guarantee its owner an income that he or she cannot outlive.

Second, the argument that tax deferral is the main benefit to be gained from owning a deferred annuity necessarily implies that anyone purchasing a deferred annuity inside an IRA or qualified plan foregoes that main benefit. It is certainly true that the holder of an IRA annuity does not get tax deferral, by reason of owning the annuity, because the IRA itself provides such deferral. However, there are other reasons why one might wish to fund an IRA, or qualified plan, with a deferred annuity.

All that being said, however, the tax deferral enjoyed by annuities is clearly a benefit. Dollars that would otherwise be lost to annual income tax are, in a deferred annuity, able to earn further gain. The miracle of compound interest, in which gain on an investment can, itself, earn yet more gain, is enhanced by yet another layer, producing

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what is sometimes called triple compounding. This is when: (1) the principal earns gain, (2) the after-tax gain earns gain, and (3) the gain that would otherwise be surrendered to pay tax can also earn further gain.

Notably, this tax-deferral value is increasingly valuable as tax rates on investments increase. Thus, the introduction of a new top twenty percent rate on long-term capital gains and qualified dividends under the American Taxpayer Relief Act of 2012 made using a variable annuity for tax deferral more appealing; the value is further enhanced for those subject to the “new” 3.8 percent Medicare surtax on net investment income under the Patient Protection and Affordable Care Act of 2010, along with the impact of the Pease limitation which phases out itemized deductions and the Personal Exemption Phaseout as income rises (which both function as a small additional surtax on income).

Of course, ­tax deferreddoes not mean tax-free!The untaxed gain will eventually be taxed, either to the living annuity holder or to the beneficiary. It will also be taxed as ordinary income. Whether the trade-offof tax deferral now, or a benefit, for ordinary income treatment later, which might be considered a costof that benefit, is attractive or problematic depends upon a number of variables. This includes assumptions as to tax rate, for both the annuity and the alternative, investment return rate, and, most importantly, how the money will eventually be distributed. Many annuity versus investment alternative comparisons are pure accumulation scenarios. They reckon the worth of each side of the comparison in terms of an after-tax future lump sum*.* In the authors’ opinion, such an analysis is inherently faulty. The benefits of a deferred annuity include guaranteed annuity payout factors—assurance that, regardless of future investment conditions or life expectancies, the annuity owner is assured of receiving at leasta specified income, every year—or more frequent payment interval—for each dollar that is annuitized. This benefit does come at a cost, which is part of the M&E charges of a variable annuity. Moreover, the annuity owner may elect to annuitize, using the greater of the current, nonguaranteedpayout factors or the payout factors guaranteed in the contract. While the latter have, historically, been less attractive and thus, rarely if ever used, they do represent minimum guarantees that might be of value in the future. In summary, the question of whether the benefit of *guaranteed* annuitization rates is worthits cost is certainly arguable. To the authors’ knowledge, there has rarely been a time when the guaranteed payout rates contained in an existing deferred annuity contract have been as attractive as payout rates available in Single Premium Immediate Annuity (SPIA) contracts.

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Nonetheless, in some cases it may still be appealing to utilize a variable annuity for pure tax deferral alone (versus a comparable pure accumulation scenario without the annuity). This is especially true in scenarios where not all the investments that might be held inside of a variable annuity for tax deferral were going to be eligible for (long-term) capital gains treatment anyway, such that creating ordinary income may not be adverse. For instance, more actively traded investment strategies, or in general investments that have greater turnover, have limited value to being held in a taxable account and may benefit more from tax-deferred compounding. In addition, many types of “alternative” asset class investments that have appealing risk/return and diversification characteristics can be relatively tax-inefficient and/or generate mostly or entirely ordinary income. Thus, in some cases using a variable annuity to shelter investments for tax-deferred compounding growth is simply a matter of absorbing the cost of the annuity and its guarantees in exchange for tax-deferral on investments that are already high-return, ordinary income, and tax-inefficient. In this context, the variable annuity essentially becomes an “asset location” vehicle, which can be used to create tax-deferred growth for those who do not already have sufficient tax-preferenced accounts to shelter high-return tax-inefficient investments, especially if the annuity contract can be held at a reasonably low cost.

Purchasing a Deferred Annuity vs. Accumulating in Existing Investments, then Purchasing a SPIA

The holder of any nonannuity investment wishing to convert his accumulated wealth to a guaranteed income stream could elect to purchase a SPIA. However, the success of this scenario, as compared to investing in a deferred annuity at the outset, depends upon two assumptions:

1. that the payout rates in SPIA contracts will always be more attractive than those guaranteed in today’s deferred contracts;

2. that the after-taxvalue of the accumulated wealth—invested in the alternative being considered—will, when invested in the SPIA, produce a greater income than the annuitized deferred annuity.

 If the alternative investment contains any as-yet-untaxed capital gains, the tax on that gain must be paid on the surrender of the investment. By contrast, the entire future value of the deferred annuity, including all untaxed gain, could be available to purchase the same SPIA, if the deferred annuity is exchanged for the SPIA in a tax-free exchange under Code section 1035.[[7]](#endnote-7) Or the deferred annuity could be annuitized using the then-current payout factors available for holders of that contract, if they are more attractive than those of every SPIA the investor might

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consider. While that situation has not occurred in the past, it might well occur in the future, if average longevity increases. A comparison of a variable annuity versus an investment alternative that addresses which alternative is better, purely in terms of an after-tax future lump-sum, does not consider the potential advantages of an exchange of such annuities. Moreover, it does not allow for even the possibility that the guaranteed payout factors in the deferred annuity might be more attractive than future SPIA rates. Whatever one believes, as to the latter possibility, it should be taken into account. Any comparison that ignores a benefit that is contractually guaranteed by one alternative but is absent in the other is hopelessly flawed, unless one is prepared to decree that benefit to be utterly worthless—now, and at every time in the future.

3. Protection from Loss Due to Bankruptcy or Other Failure of the Institution Holding the Investment.

All investors are, or should be, concerned with the extent to which they may lose money as a result of the bankruptcy, or other failure, of the institution holding that money. Investors in annuities should be aware that the cash value in their contracts is not insured by the FDIC. Fixed annuities are backed by the general assets of the issuing insurer and are subject to the creditors of that insurer*.* The situation with variable annuities is somewhat different. The investments in the variable subaccountsare not held by the insurer, are notprotected from loss other than by operation of any living benefits elected by the annuity owner, and are not subject to the insurer’s general creditors. However, the contractual guarantees—including annuity payout factors, guaranteed minimum death benefits, and guaranteed living benefits—are, like the cash value of a fixed annuity, backed only by the financial resources of the issuing insurer.The advisor recommending—or even discussing—an annuity with a client should exercise special care to ensure that the client understands these limitations. That said, most alternative investments are not guaranteed against loss due to bankruptcy or insolvency, as many holders of stock and bond issues can attest. We mention the issue only because annuities are sometimes marketed by depository institutions whose regular accounts are insured, and because of frequently cited regulatory concerns that the inapplicability of such insurance to annuities sold by those institutions—or by advisors not connected with such institutions—is not well understood by consumers.

That said, in all fifty states, as well as Puerto Rico and the District of Columbia, there are guarantee fundsto reimburse owners of annuity and life insurance contracts from losses resulting from insurer insolvency. The coverage provisions and limits of these funds vary by state. Information on this topic is available at: www.annuityadvantage.com/stateguarantee.htm.

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4. Protection from Loss to Judgment Creditors.

A serious concern for many investors is the extent to which their assets may be attached by judgment creditors. Many advisors are unaware of the special protections afforded annuities by the laws of many states. Unfortunately, the extent to which annuity cash values receive creditor protection and the limitations on such protection vary widely, and simple answers are—in this context—more than usually dangerous. Two sources of insightful information on this subject are the websites of the law firm of Donlevy-Rosen & Rosen (protectyou.com) and *Quatloos!,* the marvelously informative and surprisingly humorous self-described “Cyber Museum of Scams & Frauds” devoted to estate planning and tax protestor and creditor protection scams (http://quatloosia.blogspot.com).

Leg Three: Distribution

The third leg of the planning stool is distribution.Here, there are typically two goals involved:

1. during the investor’s lifetime, to create income—in the amounts required—from accumulated capital;

2. at the investor’s death, to ensure that the wealth passes, as efficiently as possible, to those intended.

How can a variable annuity help our investor to realize these goals?

Income

Annuities are particularly useful in meeting a goal of required income because income is what annuities are all about. Their effectiveness as accumulation instruments notwithstanding, annuities were originally developed for one purpose—to produce income. When the desire is for an income that will, in any and all events, last as long as the life of the recipient—however long that might be—an annuity is arguably the perfect instrument because it is the only instrument that is guaranteed to do so. Furthermore, all annuities can do so.

What a variable annuity can do in this regard, that no other financial instrument can, is produce an income stream that (1) is guaranteed to last for the lifetime of the annuitant, assuming a life annuity payout option is elected, and (2) will fluctuate in amount—that is, the amount of each payment will vary—reflecting the performance of the underlying investments. This is the so-called variable annuity payout option in a variable deferred annuity contract and the basic structure of a variable immediate annuity.

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Why is such a variable payout desirable? Well, initially it should be admitted that for some investors, it is not. Some investors will desire a guarantee—that annuity payments will never change. For those individuals, a fixed annuity payout is indeed more appropriate. This option is available in variable deferred annuity contracts, just as it is in their fixed cousins. On the other hand, however, many investors are concerned with the impact of inflation on their retirement income. They know that, whatever the nominal value of their income, it is the purchasing powerthat buys groceries.

But is a payout arrangement where the amount of each payment varies, not with the cost of living, but with the performance of the annuity investments, truly the best way to keep pace with inflation? If keeping pace with inflation is the sole objective, probably not. After all, the investments could suffer a loss—resulting in a decrease in the amount of the annuity payment—at the same time that inflation is increasing, further eroding the purchasing value of each dollar of that payment. A better solution would be a life annuity where the amount of each annual payment is adjusted in accordance with some index of inflation, such as the Consumer Price Index. Unfortunately, very few insurance companies offer such a contract. A few insurers offer fixed annuities where the amount of each year’s payment will be increased by a specified percentage, typically, one percent to three percent; at the time of this writing the authors know of no company offering an annual adjustment of more than five percent. For the inflation fearful, a guaranteed increase of a few percentage points each year is better than nothing, but it is probably not what they would prefer. Of course, the initial payment of the increasing annuity will be lower than that of the level one. The greater the guaranteed annual increase, the greater this difference will be.

For those individuals, the choice, at the present time, comes down to purchasing a truly inflation-indexed annuity from an insurer that offers one that may not contain all the features the investor wants, or electing a variable payout in the hope that the performance of the annuity investments chosen will enable annuity payments to rise with, or even beyond, the rate of inflation. The authors hope that more insurers will choose to offer genuinely inflation-indexed annuities, both as immediate contracts and as payout options in deferred ones.

The scenario described above is one in which the investor’s goal is for an income that is guaranteed both to last a lifetime—or for the lifetime of investor and someone else—and to keep pace withinflation. But what if the goal is to outperform inflation? Many consumers, and probably all advisors, know that lifestyles are not carved in stone. Some retirees wish to do better every year—in real dollar terms. For these individuals, an inflation-indexed payout may not be so attractive. If they believe that a properly designed portfolio, which probably consists mostly of equities, is more likely than not to

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outperform inflation, a variable payout may make more sense. In any event, the guarantee that the income, whether level or varying with investment performance or inflation rate, cannot be outlived is a powerful benefit. But annuity payout factorsare not the only mechanism by which a variable annuity can generate income for the investor. Living benefits can do so as well. The Guaranteed Minimum Income Benefit (GMIB) guarantees a minimum income based on a guaranteed benefit base that is unaffected by any investment losses within the annuity. The cost of this benefit is, however, not only the contractual charge assessed, but also the fact that the GMIB income stream usually requires annuitization using payout factors less attractive than those available to contract holders not electing this benefit.

The guaranteed partial withdrawal benefit also provides a guarantee of a minimum income, but it is really a guarantee of principal irrespective of adverse investment performance, provided that principal—or benefit base, if higher—is accessed via withdrawals not exceeding a certain limit each year.

Passing Wealth to Those Intended

Annuity proceeds are paid to the contract owner’s designated beneficiary*.* They generally pass outside of probate, avoiding the potential cost and time delays that may be associated with that process. In addition, annuity proceeds usually enjoy special creditor protection—the level of protection varying with state law.

Furthermore, special restrictive beneficiary designations offered by some carriers can allow the contract owner to limit the beneficiary’s access to proceeds, by either requiring a fixed systematic withdrawal schedule or imposing limits on the amount that the insurer will release each year.[[8]](#endnote-8)

The variable annuity, viewed strictly as an investment, is a remarkably potent vehicle. While many proponents and critics see it purely as an accumulation device, it offers benefits designed to address the needs implicit in all three legs of the financial and estate planning stool.

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1. Two of the best demonstrations of this conclusion are in “Making Retirement Distributions Last a Lifetime,” by Ameriks, Veres, and Warshawsky, *Journal of Financial Planning*, Dec. 2001, and “Merging Asset Allocation and Longevity Insurance: An Optimal Perspective On Payout Annuities,” by Chen and Milevsky, *Journal of Financial Planning*, June 2003. [↑](#endnote-ref-1)
2. These variable subaccounts are sometimes referred to as separate accounts. [↑](#endnote-ref-2)
3. For purposes of projecting possible future values, the arithmetic mean is generally considered to be a better factor than the geometric mean. Published historical performance figures generally report the geometric mean, which is always equal or lower—often, significantly lower—than the arithmetic mean. [↑](#endnote-ref-3)
4. As noted earlier, most historical returns information, when including mean return, use the geometric mean—as that is the best measure of average performance in historical data. If that geometric mean is used as an input in an optimizer software program that expects the user to supply an arithmetic mean—a better measure of the average when forecasting future values—the results will be theoretically inaccurate. [↑](#endnote-ref-4)
5. R-Squared (R2) is a measure of the extent to which change in one variable can be explained by changes in another, the model. It is often said to be a measure of goodness of fit. [↑](#endnote-ref-5)
6. Many contracts limit the number of transfers that may be made without cost per year. A few allow switching as often as daily. [↑](#endnote-ref-6)
7. Deferred annuities are commonly exchanged for SPIAs when the annuity owner decides to annuitize and the current payout factors in the deferred annuity are less attractive than those available from a SPIA. Because this practice is so common, the authors suggest that the often-cited statistic that “only about 2 percent of deferred annuities are ever annuitized” is probably misleading—perhaps very misleading. Any deferred annuity exchanged for a SPIA would be considered as not annuitized, although the result of the Section 1035 exchange produces that result. [↑](#endnote-ref-7)
8. Such options are particularly appealing for deferred annuity owners that do not necessarily want to deal with the cost and hassle of using a trust to accomplish the same goals. In addition, the use of an individual beneficiary, albeit with restrictions, may be more income-tax-favorable that naming a trust as a beneficiary. [↑](#endnote-ref-8)