Letters to the Editor – GMWBs and the Permanent Portfolio

April 5, 2011

The following is in response to our article, Understanding Variable Annuities with GMWBs, *which appeared on March 1.*

Dear Editor,

Thank you for the above article.

It was well written and I agree that most rational investors are better off with a passive well diversified 70%/30% equities/fixed-income portfolio.

As background, I am a fee-only advisor who is in his 16th year of practice. Along the way I have worked for a larger company, started an independent commission-based practice, and finally a fee-only RIA. So, I have sold annuities in the past and I have friends in the business who still do. Currently, the bulk of my practice is passively managed portfolios constructed of Dimensional funds and Vanguard funds.

The crux of the issue is what happens with investors in real-world situations.

The first flaw in almost all studies is that we assume that investors are rational and can handle the drawdowns of the market. I have come to realize over the years that my job for my clients is to keep them from shooting themselves in the foot. All too often clients make the worst decisions at the worst times, such as when those drawdowns occur. Unfortunately, a good portion of advisors do the same.

In the bear market of 2000-2002 I had a few clients in well diversified portfolios who wanted to go to cash. I explained to them that in all probability that would be a bad idea, but they insisted and I relented. After all, it is their money and I can only offer probabilities.

Of course, we know how that story ended. If they would have just stayed put they would have recovered. Most recently, in the bear market of 2008 I did not let my clients go to cash and the majority of them have more than recovered to the highs they had in 2007.

Let me go through a recent client situation. The value of this client's portfolio in 2007 at the peak was around $480,000. He was a new client and invested about $450,000 in the summer of 2007. I invested him in a 60-40 well diversified portfolio of DFA funds. He called me once a quarter for the last three years very scared about his portfolio and the overall economy. I had to constantly calm him down and reassure him he was doing the right thing. Needless to say, his account value recovered to about $479,000 at the end of February 2011. He was due for a client meeting.

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He came into my office and he was relieved that his account was approaching the highs of 2007. However, he wanted to now know how to protect what he had because he was retiring in six years and could not bear to go through another 2008. Ultimately, he decided to go with the Nationwide Destination variable annuity. I had to refer him to my father who is with an independent broker dealer because I cannot offer that product. However, I did look hard at it because I do care about this client.

With all the riders, M&E, and fund charges I assumed my *former* client would pay about 4% per year in fees. Currently, I was charging 1% and the average cost of the DFA funds and TD Ameritrade charges were around 50 basis points. So, all in he was paying around 1.5% (including trading costs at TD and fund expenses).

The one thing I did not see in the Nationwide product profiled in your study was the fact that most variable annuity providers step up the “protected benefit base” from 5% to 10% per year for 10 or 12 years. Because of this fact it is very hard to compare this product to a straight portfolio. But, I attempted to do so.

The income that my client would take off this rider was 5.25% (since he was taking the income after age 65). He would get a 10% simple increase per year on the benefit base until he takes withdrawals. So, after five years the benefit base would be $718,500 at a minimum (it could be more if the market value is higher than that). At that point he gets 5.25% of the $718,500, which is $37,721 per year for the rest of his life and the life of his spouse, who is one year younger than him.

But if he stuck with the 60/40 allocation in DFA funds he most likely would have been better off in the long run, although I could not guarantee this. Also, he was getting scared and would have most likely gone to a 40/60 equity-to-fixed income allocation. With the Nationwide annuity he actually moved up to the 70/30 equity-to-fixed income allocation because he felt secure that he knew his worst case income scenario. In a market decline he can sit tight because he has the peace of mind the annuity provides.

It is not always about math and probabilities, though. It is also about very emotional investors watching CNBC and getting very worried. You and I will tell them things will work out. We will tell them that if they cannot stomach the ups and downs to lower their equity portion of the portfolio. For this particular client it was not as black-and-white as a 70/30 passive portfolio versus a 70/30 portfolio within the Nationwide annuity. There is no way he would have gone with the 70/30 passive portfolio without some knowledge of his maximum downside risk. I would not have been surprised if he would have put most of the money into a CD at 2%.

For my money, I would go with the 60/40 DFA allocation. But, for a guy five years from retirement who is sick and tired of not knowing what is the worst case and not able to handle a 19% probability of running out of money an annuity might make sense.

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Thank you again for the article.

Sincerely,
Andrew Monsour
Monsour Advisory Services
Roanoke, VA

The following is in response to Geoff Considine's article, What Investors Should Fear in the Permanent Portfolio*, which appeared on March 22*.

Dear Editor:

Two quick points should be contemplated with regard to Considine's analysis. First, mutual funds are limited in the amount of gold (the commodity) as a holding and he should have used a 50/50 mix of the ETF GLD and one of the gold-mining ETFs or index returns. Too much physical gold in a portfolio potentially subjects the mutual fund to an IRS bad income test, which is very detrimental. Depending on its holdings in physical gold, PRPFX may have a bigger problem with regard to adjusting its allocation if gold should fall.

Second, the current price movement in gold is very different than previous price movements. Gold is moving because central banks are printing money and cannot pay for future liabilities. Gold is becoming a currency hedge. The $14 trillion dollar deficit supporting three wars and a congress with no incentive to enact deficit reduction policies may result in a much higher gold price in the future.

Although I agree with the author's primary point that the PRPFX is not the only suitable retirement strategy, the fund may require different levels of analysis before investors and advisors run head long into the fund. On the merits of its diversification , the fund was extremely well positioned for the past decade. The strategy will probably do as well as other strategies especially if GMO's forecast is correct.

Best Regards,

Peter J. Moran
Managing Partner
DundeeWealth US, LP
Berwyn, PA

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