



Letters to the Editor and a Final Thought on VAs with GMWBs

March 8, 2011

The letters below are in response to Robert Huebscher's article, [Understanding Variable Annuities with GMWBs](#), and to Peng Chen's response, [The Real Flaws – A response to 'Understanding Variable Annuities with GMWBs'](#), which were published last week. We provide a final thought at the end.

Dear Editor:

Neither of these articles really addressed the core issue when advising a client who is considering such a product. That is the emotional one presented by the client. Only pure annuity salespeople dwell on the issues raised by the authors. Client emotions override cost, return and the ultimate results of an investment.

Marcus R. Michles
Capital Guardian LLC
Winter Park, FL

Dear Editor:

I found Robert Huebscher's article interesting and it confirmed many of my beliefs, especially about buying variable annuities that require a portion of the portfolio to be invested in fixed income. However, I do firmly believe that certain variable annuities riders can be appropriate as a portion (20% or less) of a properly constructed portfolio.

We often tell our clients that a basic tenet of risk management is that they should insure against low-frequency/high-severity events because *those* are the events that can devastate their lifestyle. Examples of such events include hurricanes, earthquakes, death at a young age, and a severe equity market downturn during early retirement. If a client is looking to insure against the latter, a variable annuity with a GMWB invested 100% in equities can be a valuable tool.

Bruce Cacho-Negrete, CFP®
The Starner Group
Raymond James & Associates
Miami, FL



Dear Editor:

Your article on this subject was awesome.

Henry Schwarzberg JD, CIMA®, AIF®, CRPS®

Dear Editor:

Mr. Huebscher made some good points. The retirement question is an excellent example of when you should and should not insure. The loss of income during retirement is a low-frequency, high-severity event, like the risk that your house will burn to the ground. Even risk takers insure against that potential loss. The reason is simple; you insure your house because even though there is little likelihood that it will burn to the ground, you could not handle the expense of a new one.

Likewise, you will either run out of money in retirement, or you won't. If you do have to eat dog food in the dark for 15 years, it is small comfort that you had an 85% chance of not running out of money. You only get to cast the dice once. A person who has only one shot at retirement wants to have the law of large numbers on his side.

Kimble Johnson

Dear Editor:

Once again you nailed it!

To paraphrase one of my heroes, John Bogle, " It is hard to embrace the truth when one is paid a high price to ignore it."

Keep up the good work and thank you for the constant flow of thoughtful commentary.

Best,

Brian Murphy
Pathways Financial Partners
Tucson, AZ



Dear Editor:

The article on variable annuity with guaranteed withdrawals answered all my questions. It was thorough, clear and informative.

Mary Dean
Dean Consulting & Associates
San Diego, CA

Dear Editor:

Please moderate your tone. This is a vital dialogue and deserves better.

My own reactions to the discussion are these:

1. Not only does the Peng study have the advantage of illustrating age to 90, Huebscher does a disservice by emphasizing likely death prior to that. The very purpose of the product is to safeguard against longer-than-expected mortality. To complain about an age-90 mortality assumption is akin to complaining about a term insurance premium that never results in a death claim. Since the retiree running out of money is the worst possible financial outcome imaginable, I would have preferred illustrating *later* rather than *earlier* mortality. It is the "long tail" event of living well into ones 90s or beyond that represents the retirement income challenge; to disregard that is to treat retirement income investing as one would accumulation investing, nothing more than total return minus fees.
2. The choice of the Nationwide product as an illustration is a poor one, in my view, and skews the study. Several carriers offer more attractive products.

Terry R. Altman CLU CFP(r)
Altman Financial LLC
Bloomfield Hills, MI

Dear Editor:

Morningstar is in danger of losing its objectivity. It's one thing to have an analysis shop and another one entirely to have a money management shop. Is that much different than the wirehouses? What's worse, one of their units takes money from a vendor to fund research. Is that any different than a drug company funding drug-related research? They know the outcome before beginning. That is polemic, not research.

Before buying any annuity, I'd favor buying a life insurance company's bonds. Assuming



that the company is unlevered, I should do better.

I can diversify business risk by buying a life insurance industry ETF. Now there's a concept.

Will I do any of these things for my clients? Probably not.

You did everyone a service by analyzing the Ibbotson study. That said, I am not sure that Monte Carlo presents a totally accurate picture, either.

Jim Pursley
Gaia Capital Management
Forest Grove, OR

Dear Editor:

That was a good article by Robert Huebscher. The one issue I can't get around, which he points out, is the mandate requiring 30% of the portfolio to be invested in bond funds. With internal expenses exceeding 3%, it will be difficult for that bucket to break even, putting all the pressure on the other 70% of the portfolio to generate ample returns to pay out that 5%, or more. I would be much more receptive to the product if investors were permitted to invest 100% in equities, which will never happen.

Anonymous

A Final Thought

Chen's analysis focuses on the advantage of the VA+GMWB over bonds in a retirement portfolio. The bonds in his portfolio have a projected return of 4.36% but are assessed a 200bp fee, for a net return of 2.36%. The VA+GMWB has a median IRR of 4.13% over the 30-year period he considered. The 200bp in fees imposed on the bonds drive the return advantage of the VA+GMWB.

But are 200bp a reasonable fee? Not if the bond portfolio consisted of a single bond.

You can buy an AA-rated state-issued GO municipal 30-year bond today yielding 4.94%. That is 6.59% on a taxable-equivalent basis (conservatively using a 25% tax bracket). That bond has at least as good credit as Nationwide and provides the same undiversified exposure as the VA+GMWB.

An advisor could charge 100 basis points, and the nominal payments from the coupons alone on this bond would be in the 51st percentile of VA+GMWB returns. An advisor might



charge a more reasonable 50 basis points, and then the payments would be in the 41st percentile. Or the advisor could simply tell the client to go buy the bond on his/her own, since there is no management associated with it. In this case, the return is in the 34th percentile.

The muni bond provides no inflation protection. But, as our study demonstrated, the VA+GMWB provides only very modest potential for growth in the payout amount.

Of course, with a muni bond the client gets the principal in 30 years.

Robert Huebscher

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