



Letter to the Editor

January 3, 2012

The following is in response to our article, [Understanding Variable Annuities with GMWBs \(and the flaws in Ibbotson's analysis\)](#), which appeared on March 1:

Sir:

Your response to the Ibbotson study itself is flawed. You state, "First, Chen considered only one scenario – that where the investor lived to age 90, which has a probability of approximately 19%. His analysis, unlike ours, does not take into consideration mortality and the possibility that the investor might not live to age 90. Had he considered mortality, he would have replicated our analysis."

It is nonsensical to argue that not taking mortality into account is a flaw. One purchases an annuity precisely to eliminate the mortality risk. Your position is like the child who kills both his parents and then throws himself on the mercy of the court because he is an orphan. Put in your terms, would you advise your client not to buy homeowners' insurance because there was only a 19% chance of his house burning down by age 90?

I may be missing something here, but I have seen so many crackpot negative studies on variable annuities with living benefits that I could scream. Will somebody in the gear-head investment community admit that somebody, somewhere might like to have the peace of mind for the rest of his life that he will not run out of money?

If a client has seen all the data on risk and return, and then takes a decision to forego some hypothetical greater return in order to eliminate with reasonable certainty the risk that he will run out of money during his or a joint lifetime, then that is the end of the story.

Once a person has made up his mind, "shoulda, coulda, woulda" no longer apply, and there is no usefulness of further analytical gyrations.

As Benjamin Graham so authoritatively stated, "The essence of investment management is the management of risks, not the management of returns." Risk tolerance in the rational being is subjective, personal and final. It is, therefore, the independent variable in the investment equation.

Investment decision making requires a great deal of analysis, but it is only a tool to determine the trade-off between risk and return. When the investor establishes his risk tolerance, the investment decision follows. In most investment articles, the investment "winner" appears to be the dog; in reality, it is only the tail.



Regards,

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Editor's note: The consideration of a single mortality scenario was only one flaw we cited in the Ibbotson study. We also showed that the annuity we studied was inferior to a passive portfolio, once taxes and inflation were considered.

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