HELM
INVESTMENT MANAGEMENT

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# *A SHEEP IN WOLF'S CLOTHING*

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Variable annuities (annuity contracts based on underlying securities such as stocks) have long been pilloried for their high internal expenses, opaque and excessive commissions, staggering surrender charges and poor performance. Even so, annuity assets now total over $1 trillion and the latest hot stuff is the addition of a guaranteed living benefit (GLB). There are three types of GLBs: guaranteed minimum income, guaranteed minimum withdrawal and guaranteed minimum accumulation.

GLBs are sold as retirement distribution promises. Metlife for example, offers a GLB annuity called *AnnuiStar*™ that has a living benefit guarantee of 5% for life now or 7% for life if the annuitant is willing to wait 10 years before payments start. In addition, Metlife will, upon death, return the remaining principal plus any appreciation on the stock portfolio in the AnnuiStar variable annuity.

In return, a Metlife GLB annuity buyer must lock up money for more than ten years or face an 8% surrender charge. The buyer defers taxable income until annuity distributions begin, is guaranteed a lifetime 5% annual income and has a chance the underlying equities may grow. Seems like a good deal on the surface.

John Robinson, managing director of a wealth management firm in Hawaii, analyzed a similar GLB and published his findings in the May issue of the *Journal of Financial Planning*. He back tested a GLB holding the S&P 500, but subject to insurance company expenses, against an investment in an S&P 500 index fund for the period 1973 through 2006.

In other words, Robinson compared a $1 million investment in the S&P 500 index with a $1 million investment in the above GLB to see how the two investments would come out over the past 33 years. Each year, the hypothetical investor took out $50,000 from each investment. The GLB annuity, after annual 5% withdrawals, grew from $1 million to $5.1 million. The S&P 500 investment, after annual withdrawals, grew to $13.6 million. This is a whopping victory in favor of investing in a stock index vs. buying a GLB annuity with the same underlying equities. The difference is the annual drain of insurance company costs and fees. On the other hand, the above back test misses an important point. Buying and holding an S&P 500 index is an investment. Buying and holding a GLB is insurance. Investment risk within the annuity is transferred to the insurance company. Besides, the back test was the past. It is future uncertainty that drives insurance sales, including annuities.

The kind of investor that ought to consider a GLB annuity is one who is about to retire and whose chief concern is eventually running out of income. She knows a portfolio with a sizable equity allocation is more likely to produce income needed over the next few decades but can't stomach the risk and volatility. A guaranteed minimum income benefit and/or withdrawal benefit might be just the ticket to provide the confidence to allocate a portion of retirement funds to equities. But it's an expensive ticket.

We conclude that a portfolio of high grade bonds will have more flexibility and do as well or better than a GLB. A portfolio of both bonds and stocks should do much better. But investments, unlike GLBs, are not guaranteed by an insurance company. This is the trade off – a trade off that historically has paid off for insurance companies much more than for individual investors.

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