

## How About 'Free-Based' Index Annuities?

By Kerry Pechter     Wed, Oct 4, 2017

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*If advisors choose not to sell fee-based FIAs because the remuneration is unattractive, then the fiduciary rule will have backfired.*

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Financial products aren't like other products. When you pay a premium for a four-piece Sage fly rod, you don't get only three sections of the rod. If you buy a cashmere overcoat at Bergdorf Goodman, and pay extra for the polite service, the prestige brand and the store's high-rent location, your overcoat isn't less warm or well-tailored.

But when you pay extra for a financial product, then you're getting a more or less flawed product. The amount you pay for distribution or service or advice effectively reduces its value to you. Financial products are unusual in this way.

Fee-based indexed annuities are a good example. These are indexed annuities that have no distribution costs—i.e., broker or agent commissions—baked into their crediting formulas. Fresh off the factory floor, so to speak, they have the potential, in up markets, to yield significantly more than commission-based indexed annuities.

Life insurers created these products in response to the DOL fiduciary rule. The rule made selling on commission to IRA clients more legally and administratively onerous, so many brokers and agents have migrated to a fee-based revenue model, where they earn a percentage of the assets they manage. The fee-based FIA lets them continue to sell FIAs within their new revenue if they choose.

But will they? Will brokers-turned advisors *keep* selling FIAs, even without the incentive of a commission? Will traditional fee-based advisors *start* selling them, now that they don't carry a commission? Will consumers demand them—or even learn that they're available?

More to the point, if fee-based advisors sell these new products, how will they bill clients for them? So far, it appears that advisors at some brokerages are planning to charge their usual managed account fee for the tax-deferred client money that's used to buy an FIA contract. I don't think that's appropriate, for these reasons:

- FIAs are guaranteed products. Investment management is really about managing the risks of securities, particularly stocks. That's where professional expertise comes in. FIAs are not securities, as the court decision on Rule 151A determined a few years ago. They aren't risky at the client level, so there's no risk management to charge for.
- FIAs are packaged products. The risk management techniques and the insurers bake the costs of those techniques into the crediting method, even before any distribution costs are tacked on. By the time the product reaches investors, the cost of "advice," in a sense, has already been deducted.

- FIAs are general account products. The assets live at the life insurer, not at the brokerage's custodian. Fee-based advisors don't charge a fee on other general account products, like single-premium immediate annuities—which is a major reason why they don't recommend them, even when they should—so why should they earn a fee on no-commission FIAs?

Instead, they should either charge a small one-time transactional fee on the sale or a much-reduced ongoing fee—as they might on a bond ladder or a fixed deferred annuity. If RIAs do try to charge the full rate, you can bet that some robo-RIA will undersell them. It certainly makes no sense to charge someone 10 times more for a \$500,000 FIA than for a \$50,000 FIA.

Brokerage executives counter that they deserve to make a living. A living, yes—but not a killing. If they truly are fiduciaries, their way of making a living shouldn't involve a zero-sum game with clients. Charging a full management fee on risky assets isn't necessarily a zero-sum game, but doing so on an FIA comes dangerously close. (If advisors aspire to be professionals, like doctors or lawyers, they should charge by the hour, as other professionals do. But that's another story.)

If fee-based advisors charge a managed account fee on FIA assets, then the financial industry will only have complied with the letter of the fiduciary rule. It won't have embraced the spirit of the rule, which was to help 401(k) and IRA savers maximize their retirement income. If they did that, and charged little or nothing, fee-based FIAs would practically sell themselves.