How an Advisor Views CDAs

By Editor Test *Sun, Jul 15, 2012*

"Being able to tell [my older clients] they have a guarantee is huge," the fee-based advisor Kimberly Foss (pictured at left) told RIJAdvisor. "2008 was not fun and I don't want to go through that again."

Kimberly Foss, the president and founder of Empyrion Wealth Management in Roseville, Calif., talks about her "tweeners" as if she were caring for young teenagers at home. But she is referring to her 50- to 65-year-old clients who are facing retirement and suffer from a kind of post-traumatic risk disorder induced by the Great Financial Crisis.

To give them peace of mind, Foss is employing a contingent deferred annuity (CDA) called RetireOne from ARIA Retirement Solutions and Transamerica Advisors Life. "Being able to tell them they have a guarantee is huge," the fee-based planner told RIJ**Advisor**. "2008 was not fun and I don't want to go through that again."

CDAs offer fee-based advisors a way to put an income guarantee on the assets in a client's managed account or IRA without having to invest the assets in a variable annuity and move them to a tax-deferred separate account at a life insurance company. It's income protection specifically for the fee-based advisor distribution channel, where annuities have generally been unwelcome.

Like the guaranteed lifetime withdrawal benefits on variable annuities, CDAs assure clients that if they invest in certain funds and withdraw their money from the insured account at an approved rate in retirement—typically 5% a year—then they don't have to worry about outliving the money in the account. Withdrawals in excess of the limit can reduce the income base, and therefore reduce the annual income from the contract.

If the account goes to zero (because of withdrawals, fees, and/or poor market performance) while the policyholder is still alive, the CDA issuer will pay the policyholder 5% of the original assets (adjusted for special withdrawals or new premiums or gains) each year until the owner dies. For people who suffer extremely bad market performance in early retirement or who far outlive the average life expectancy, this type of protection could be very valuable.

Like a variable annuity with a lifetime income guarantee, a CDA can be particularly valuable for people like Foss's 'tweeners' who are in what Prudential Financial has famously named the "Retirement Red Zone"—the five to 10 years before and after the retirement date, when large distributions from a depressed account can lock in severe losses and ruin a retirement plan. The risk of such losses is commonly called sequence-of-returns risk.

Tax advantages

"Advisors can be somewhat more aggressive in investing, because they don't have to worry about sequence-of-return risk," ARIA CEO David Stone told RIJ**Advisor**. "The market could drop 30% to 40% and

the advisor doesn't care because they've got their high-water mark." Moreover, since the assets aren't tax-deferred, advisors can do tax-loss harvesting and take advantage of capital gains tax rates, which are lower than the income tax liability for most annuities.

The tax treatment of CDA income is still a bit in flux. A CDA prospective from the Phoenix Companies suggests that, according to private letter rulings that Phoenix received from the IRS, "the income tax treatment of the brokerage account assets is unaffected by the existence of the Insurance Certificate."

Ordinary income tax will apply only to income payments that come from the insurance company if and when the client's account reaches zero and the client is still alive. Even then, a Phoenix prospectus states, these payments will be treated "in part as non-taxable recovery" of the fees that the client paid for the CDA over the life of the contract. If that's true, then a person who pays $100,000 in fees on a $500,000 contract over 20 years would be able to exclude part of that $100,000 from the taxable portion of each annuity payment.

Foss views the CDA as a way of adding another source of guaranteed income to supplement her clients' Social Security income and any pensions or distributions from other investments that they have already have. She explains it to her clients as insurance on their income, just like health insurance or term life. As with term insurance, they can drop the wrapper if they feel they no longer need the guarantee.

There's no free lunch from this type of product. For a CDA that covers assets in a balanced fund and applies to one person, the fee is typically 1% per year. But a CDA that covers an all-equity fund and applies to a couple might cost as much as 390 basis points a year (as stipulated in the prospectus for a CDA that was recently filed by PHL Variable Insurance, a unit of the Phoenix Companies.)

Foss learned about ARIA's RetireOne in March and, after doing due diligence, now has five contracts in process. The policies cost her clients 1% each year, on top of Foss's own management fee and fees on the mutual funds and ETFs that ARIA designates as eligible for coverage. These include funds from Dimensional Fund Advisors, which Foss prefers, fVanguard, PIMCO, Schwab and Federated.

The fact that RetireOne is underwritten by Transamerica, and that Transamerica is owned by Aegon, the second-largest insurer in the world, reassures Foss that the protection will last, even if her clients live into their 80s or beyond. "If [Aegon] goes under, we're all in trouble," she said. While she hasn't used CDAs as a marketing tool yet, she plans to in upcoming webinars.

Things to watch out for

CDAs raise some of the same questions that variable annuity living benefits raise. By adding an insurance cost to a client's managed account, for instance, the product means that the investor is pressing down on the brakes and the gas at the same time. The 1% insurance fee is layered on top of the 1% to 1.5% advisory fee and investment management fees. There may also be a small fee levied by the advisory platform for offering the insurance.

Advisors should also be aware that CDAs don't allow them to attach a lifetime income guarantee to just any

funds their clients happen to own in a managed account. There are investment restrictions–though the permitted funds will typically be chosen from the advisory platform's existing fund lineup.

"That's the key to a CDA," said Eric Henderson of Nationwide, which has had a CDA since 2009. "You take the funds or the asset allocations that are already out there. We only protect a subset of them, but the advisor isn't investing in something totally new." Advisors also need to remember as well that, if they choose to guarantee an account with a high percentage of equities, the cost of the guarantee will be higher.

Another caveat: in at least one CDA, the asset-based advisory fee for the insured managed account comes out of a side fund. While the client is taking income from the CDA-protected accounted, another account is dropping in value, so that the client's real cash flow may be reduced. The fees must come from somewhere of course, but at least one advisor expressed discomfort with this arrangement last spring in the April 4, 2012 edition of RIJ.

One alternative to buying a CDA might be to increase the portfolio's bond allocation. Of course, in the current interest rate environment, an advisor might feel that it's cheaper to buy downside protection with a CDA for 1% than to sacrifice potential returns by adding ultra-low-yielding bonds to the portfolio.

Another alternative, especially if the client is certain that he or she wants to use the underlying assets for income, might be to suggest that the client buy a life annuity with a period certain. That's the cheapest way to buy income because it takes advantage of mortality risk pooling. Advisors should compare the price of CDAs with other kinds of annuities, as they might not always be the most economical strategy, said Curtis Cloke, the CEO of Thrive Income Solutions, whose software evaluates the costs and benefits of various retirement income solutions.

The CDA's biggest virtue, like that of a VA living benefit, is flexibility. It allows the investor to keep all options open. But both advisor and client need to remember that that flexibility comes at cost.

So far, few CDAs are available, pending resolution of some regulatory issues. Even fewer advisors know about and understand them. The few that were launched around 2008 fell victim to the market crash as insurers pulled back to core businesses. But most of the regulatory issues have been settled now.

"Nationwide has a product targeted at wirehouses, but the ARIA product is designed for the fee-only and fee-based market," said Tamiko Toland, managing director at *Annuity Insight*. "But the more that is available on the market, the more investors will ultimately have access to income guarantees."

"I do think it is a product of the future," said Ed O'Connor, managing director of Retirement Services at Morgan Stanley Smith Barney, which is expected to offer a Nationwide CDA in the near future. "A few years from now, there will be a greater supply and more clients will be using it both on the 401(k) and on individual side."

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