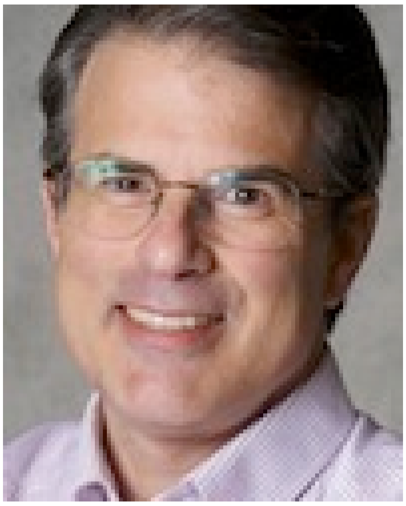
Ibbotson Taken to Task over Indexed Annuities

By Kerry Pechter *Thu, Jan 31, 2019*

Michael Edesess and Bob Huebscher have challenged Roger Ibbotson's favorable analysis of fixed indexed annuities on at least two grounds. It was another battle in the endless war between the insurance and investment mind-sets.



If you read the January 28 edition of Advisor Perspectives (AP), you know that Michael Edesess and Bob Huebscher published a kind of takedown of Roger Ibbotson's year-ago endorsement of fixed indexed annuities. In a March 2018 white **paper**, Ibbotson portrayed FIA as a generally prudent financial instrument. Historically, he calculated, an FIA would have yielded about half a percent more per year than long-term government bonds (5.8% vs. 5.3%).

This week's AP **response** was titled, "A Close Look at Ibbotson's Research on FIAs." Edesess, a mathematician, economist and author, and Huebscher, AP's publisher, make it a bit personal. They "reasonably assume" that Ibbotson, whose Zebra Capital firm does business with Annexus, the FIA design firm, was "financially incented to present a favorable view of FIAs."

Ibbotson

Edesess and Huebscher proceed to examine a 12-year, two-year point-to-point Athene FIA and conclude that an adept advisor could safely outperform it "by purchasing, every two years, a high-quality two-year corporate bond and a two-year SPY at-the-money call option—a call on the SPDR ETF, which tracks the S&P 500." No doubt.

FIAs have always attracted controversy. When I first heard of equity-indexed annuities, as they were still called in the early 2000s, they epitomized the “wild west” of the financial world. Bob MacDonald, who helped create that reputation by using irresistible commissions, island vacations and other incentives to fire up independent insurance agents, was still CEO of Allianz Life of North America, the top seller of indexed annuities. MacDonald, an unabashed huckster, wrote a lively book called ***Cheat to Win*** (Paradon, 2005).

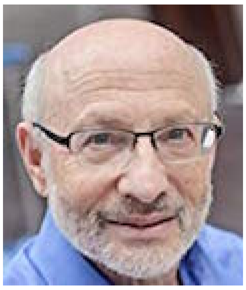
A favorable environment nourished the growth of then-EIAs. As interest rates bottomed out (under Greenspan) after the dot-com bust, edgy investors were jones-ing for yield, and indexed annuities could offer 100% principal protection and potentially higher gains than certificates of deposit if the S&P 500 Index rose.

Few people understood EIAs, though the basic design is not complicated. Most of the premium goes into the insurer’s general fund and a fraction of it is applied to the purchase of options on an equity index. Data collected by the top EIA analyst at the time, Jack Marrion, suggested that they could return an average of between 3% and 4% a year with no risk of loss.

At that time, before the 2008 financial crisis, indexed annuities were on the cusp of a 10-year odyssey involving not one but two cycles of execration and redemption. The first cycle peaked in 2007 when the EIA industry frustrated an SEC attempt to regulate them as securities. The second cycle peaked when Donald Trump ended the Department of Labor’s crusade to hold variable and indexed annuity transactions to a sales-chilling level of ongoing scrutiny.

The EIA, renamed a “fixed indexed annuity” or FIA after the SEC affair, has by now cemented its grip as the top-selling annuity product. It is sold not just by independent insurance agents but in channels, such as the broker-dealer channel, where it was once shunned. More and more insurers are building them. Champions of the product have been vindicated by rising sales.

The product had achieved enough respectability by early 2018 that the venerable Roger Ibbotson, founder of Ibbotson Associates and emeritus professor of Yale, published his white paper endorsing the concept. As endorsements go, it was not much more emphatic than the American Dental Association’s famous inscription on tubes of Crest toothpaste. But there it was.



Edesess

I won't comment on Roger Ibbotson's motives; I wasn't in his shoes. Regarding the Edesess-Huebscher article, it's no surprise that they found a securities market solution better than the FIA they selected. (They picked a high-value target: an FIA with an egregious 12-year surrender period. They might have analyzed one of the new no-commission FIAs, or the value of an FIA guaranteed income rider.)

An investment solution will beat an insurance solution every day of the week and twice on Sunday—*unless* the insurable event occurs. And, in a world of average outcomes, those events never occur. Guarantees are an expense, not an asset (though agents might characterize FIAs as assets).

Personally, I'm not susceptible to the charms of FIAs, which, as far as I can tell, behave with the reassuring predictability of a knuckleball. But I can see how, during periods of low interest rates and market uncertainty, they can be an attractive substitute for CDs, bonds or cash. They can also serve as a hedge against sequence risk for near-retirees, and as a source of guaranteed income. Important from a marketing perspective, FIAs give salesmen the magical "you're safe either way" mantra that liberates indecisive people to sign irrevocable contracts.

No one should be shocked that insurers build them and distributors sell them. They're cheaper (in terms of capital) to produce than variable annuities, while gathering similar lump-sum premia. For producers, they require only a state insurance license to sell and they pay handsome commissions. They generate enough profit to attract private equity companies. Have they been mis-sold? That's why the Bush SEC and Obama DOL went gunning for them.

When we see heated clashes over FIAs, what we're witnessing, in one sense, is a manifestation of the Mars/Venus conflict between the insurance and investment worldviews. The two are fundamentally different. The tailwind of insurance product sales is fear; greed is the tailwind of investment product sales. Insurers sell guarantees; investment companies sell risk. Insurance has actuaries; investing has quants.

To refine the point, let me share something that an insurance man I know, who sells indexed annuities, told me recently. This adage was significant to him. And he wasn't the first insurance man to tell me this. Listen closely.

"*The best product is the one the client will buy*," he said. Think about that for a moment. The first time I heard it, I didn't know how to respond. What did it mean? Was it a self-serving tautology? Was it a reference to "liberating indecisive people to act"? I'm not sure. But consider it a litmus test. If you sell investment advice, that motto will probably baffle you. If you sell insurance products, those may be words you live by.