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## Is a 'Two-Cylinder' VA Better Than a Single?

By Ryan Hinchey    Tue, Jul 6, 2010

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*Dual-account products offer the best of both worlds: low-cost tax-deferral with the option to move assets dynamically into a guaranteed lifetime payout vehicle over time.*

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The innovative “dual account” deferred variable annuity, which several insurers have recently brought to market in various forms over the past year, is a bit unusual. It combines two investment sleeves in one all-purpose tax-deferred accumulation/income product.

The first sleeve, like any plain vanilla variable annuity, holds mutual fund-like sub-accounts and has no living benefit riders attached to it. Policyholders can also transfer money to a *second* sleeve whose assets are held in a more limited selection of sub-accounts with the benefit of guaranteed lifetime income.

The contract owners thus have two accounts side by side: a low-fee investment account for growth and an account for guaranteed lifetime income. As their need for liquidity and growth declines during retirement, owners can gradually re-allocate assets from the first account to the second, building their future income stream layer by layer and reducing the overall risk of the portfolio.

So far, the two available versions of these products are the Personal Retirement Manager (PRM), issued by The Hartford, and Retirement Cornerstone from Axa Equitable. (Allianz Life has a dual account product, Retirement Pro, on file with the SEC.)

The “accumulation” sleeves are similar in all three products; it’s in the “income” sleeve that their differences emerge. The Hartford product provides an easy mechanism for building a ladder of deferred income annuities. Axa’s Retirement Cornerstone allows owners to transfer money in increments to a sleeve covered by a Guaranteed Minimum Income Benefit (GMIB), while Allianz Life offers a Guaranteed Lifetime Withdrawal Benefit (GLWB) on the assets.



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Hartford's Personal Retirement Manager offers deferred income annuities "on demand." When policyholders transfer money to the income sleeve for the first time, they commit to a seven-year window during which they are permitted to begin their lifetime income payout. Every time a transfer is made to the income sleeve, they lock in the prevailing payout rates for that chunk of money.

As with any income annuity, the insured's life expectancy and current interest rates determine the annual lifetime payout. Older age or higher interest rates generate a bigger annual payout for the insured. In essence, the advisor can use the PRM to build a ladder of deferred income annuities for his or her clients over time, thus diversifying the interest rate risk exposure of purchasing income annuities at a point in time.

Theoretically, a client should receive better payout rates by using this product than by purchasing a variable annuity and exchanging it for one or more deferred income annuities. After all, one set of distribution costs should be less than two.

Unfortunately these payout rates are a bit of a black box. To quote from the prospectus, "Payout rates are set at our sole discretion... there is no assurance as to future payout rates." Nothing assures an investor that he won't receive lower payout rates from The Hartford than what the income annuity market is offering. That's disturbing, especially when investors buy a B share contract and have to commit their money for eight years or pay a surrender charge.

Personally, I'd advise the issuer of such a contract to post the current and historical payout rates on its website and allow the general public to see how competitive the rates are. The same goes for GMIB issuers who seldom (if ever) include the guaranteed payout rates within their glossy product brochures. Best-in-breed insurers will differentiate themselves through transparency and disclosure, and what better means to do so than through their website?

PRM should come with a warning: "Invest in the stock market at your own risk." That's because it lacks any kind of equity guarantee. But if you believe that an income annuity offers the best value for those whose goal is to generate income, this new hybrid design will likely pique your interest.

Interestingly, this product's B-share has a premium-based distribution charge. This allows Hartford to recover acquisition costs over eight years regardless of market conditions. In year nine, the distribution fee disappears (although an M&E and account management fee remain), and the policyholders' fees drop for assets in the accumulation sleeve. The Hartford wrote off \$1 billion in DAC in the 2008 crisis. The new structure should help prevent that from happening again.

Axa's Retirement Cornerstone income sleeve resembles the company's popular Accumulator contract, but with a twist. Before contract owners annuitize the GMIB rider (which carries fees and investment restrictions), they can earn a deferral bonus or "roll-up" that increases the benefit base each year by the 10-year Treasury yield plus one percent. The policyholder can let the benefit base roll up in value or withdraw any or all of the roll-up (after a one-year wait).

The devil is in the details. The roll-up rate formula is attractively floored at 4%—but not so attractively

capped at 8%. Historic Treasury rates through 1962 show that such a ceiling would have been hit about 40% of the time. The rate for May was [5.25%](#), which by my calculation is roughly 60 bps more generous than their formula would dictate. The high rate is likely a teaser; they are free to lower the rate back down to the formula-based levels next year.

[For additional analysis of this product, see the [review](#) in Research magazine by Moshe Milevsky of York University in Toronto.]

Allianz Life's Retirement Pro has an income sleeve that is also linked to the 10-year Treasury, but swaps the GMIB for a GLWB. Traditionally, GLWB products calculate the guaranteed withdrawal rate from an age based table. Allianz's product differs by establishing the withdrawal rate based on the current 10-year treasury at the time of the first withdrawal. Prior to withdrawals, the income sleeve benefits from quarterly ratchets.

Unlike Axa's product, which automatically resets its rollup/withdrawal rate each year to current Treasury rates, Allianz locks in its withdrawal rate. There is limited opportunity to ratchet up the withdrawal amount if the right combination of market and interest rate growth plays out, however. Similar to Axa, money held in the Allianz income sleeve has additional fees and investment restrictions. Allianz keeps its withdrawal rate within 4% to 7%, an even tighter band than Axa's.

Axa's and Allianz's offerings both align product design features with market-based manufacturing costs. The wholesale cost to manufacture and hedge a guaranteed lifetime benefit is based on a number of volatile factors, one of which is interest rates. The 10-year Treasury isn't a perfect proxy for long-term rates, but anything more detailed would require a semester of advanced finance courses to understand.

From a risk management perspective, this technique will help these companies minimize losses in turbulent interest rate environments and help support their long-term guarantees. But it remains to be seen if these products may be too complicated and uncertain for consumers.

As an actuary, I welcome the introduction of the dual account products. They add control and flexibility for consumers. To echo a comment by Dr. Milevsky, they allow a good advisor to actively compare the contract's performance with their clients' evolving goals, and to make course adjustments as necessary.

This concept lends itself to life-cycle investing, in which people hold risky assets (like stocks) when they are young and gradually convert their portfolio to less risky assets as they near retirement. We've seen in recent years that annuities with an income guarantee can protect against sequence of return risk, so why not consider these dual account products (especially for non-qualified money) in that context?

For these products to gain traction, I believe, the accumulation sleeve must be effective in helping the client accumulate assets. This requires a large and diverse selection of funds, with low-fee options and minimal M&E and distribution fees. I would recommend reducing fees by scrapping any mandatory guaranteed death benefit in this sleeve.

If structured properly, dual account products offer the best of the accumulation and distribution worlds:

low-cost tax-deferral with the option to move assets dynamically into a guaranteed lifetime payout vehicle over time. It's a high-value proposition with potentially broad market appeal.

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