The Missing Sockdolager

By Editor Test *Wed, Jan 11, 2012*

An article appeared yesterday under the headline, "Variable-annuity guarantees disappoint over time." I think the jury is still out on that.

Yesterday, my friend and fellow journalist Bob Powell at *Marketwatch* published an interview with Ward Pfau, a retirement specialist whose articles I've cited in RIJ. "Variable-annuity guarantees disappoint over time," the headline read.

Perhaps you read the interview online. If you're in PR at one of the big VA issuers, perhaps your day was spoiled. Or perhaps you felt, when you finished reading, that the content didn't really make the headline stick.

A young Japan-based academic and CFA who has published papers in the *Journal of Financial Planning*, Pfau voiced criticisms that were both valid and familiar. Yes, insurance can be expensive. No, it's not for everybody.

But the story didn't contain the sockdolager I expected.*

On the contrary, the interviewee praised variable annuities with faint damns. At one point, he even seemed to make a persuasive case for variable annuities for the mass-affuent.

One sentence in particular stuck out: "If you have saved enough that you can meet your retirement spending goals with a low enough withdrawal rate (such as 2% or 3%), then you probably do not have any need to pay the rider fee for the GLWB," Pfau told Powell.

True. And by that formula, a household would need $1 million after taxes to generate a mere $30,000 a year in retirement. Not very many Americans are on track to retire with a nest egg of that size.

If Pfau meant that anyone with less than $1 million in savings and no pension should consider a variable annuity with a guaranteed lifetime withdrawal benefit, that's an endorsement, not a condemnation.

Pfau had other benign words for VAs. Asked to name the "pros" of variable annuities, he conceded that they "could help risk-averse retirees to sleep better at night and help them to stay the course with their asset allocation and not engage in panic selling after market declines. GLWBs could also be more helpful for retirees who have limited access to other guaranteed income sources, such as a corporate defined-benefit pension."

You could find identical language in a pro-VA story.

But, as I said above, Pfau pointed out valid VA weaknesses. "The guaranteed withdrawals are not inflation-adjusted and the fee structures can be quite complicated and expensive," he told Powell.

Point taken. To get inflation protection from a GLWB, your account value typically has to post new highs. When the contract owner is withdrawing 5% a year and the issuer is taking another 3% or more, the account value will have a hard time reaching new highs during the life of the contract, no matter how much risk the owner is allowed to take with his or her subaccounts.

In fairness to VAs, however, Pfau might also have mentioned the deferral bonuses that accompany many GLWBs, which can protect people from sequence-of-returns risk—the risk that ill-timed market losses will permanently hobble a retirement portfolio.

Whether people understand sequence risk or not, I'm convinced that they think this value proposition is compelling: Put in $100,000 today, and after 10 years you can pull out at least $10,000 for life, regardless of market performance.

Coincidentally, a friend of mine happened to call me the other night on exactly this topic.

He and his wife are considering a VA that offered such a deal. My friends are successful, fit, PhD-level, self-employed people in their mid-50s who are financially risk-averse. In today's market, they like the sound of a product that yields a 10% payout from age 65 to whenever. From that angle, fees don't look so important to them. (My friends are also considering a deferred income annuity; they don't especially need the liquidity of a VA.)

In the end, Pfau was on irreproachable ground when he told Powell, "You must really decide on a personal level whether you value that protection more than the fees you must pay for that protection." Many rational people do. Others, equally rational, do not. Go figure.

So, returning to the original question: Do variable-annuity guarantees disappoint over time? Call me in 20 years. I'll have a definitive answer.

**Sockdolager: Something that settles a matter; a decisive blow or answer; finisher.*