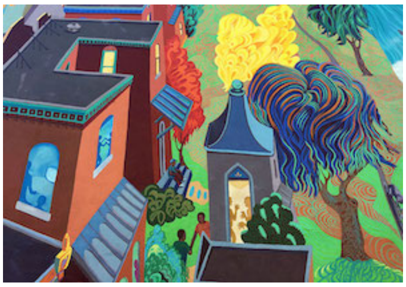
Will Fee-Only Advisors Warm to Annuities?

By Kerry Pechter *Fri, Oct 19, 2018*

At the National Association of Personal Financial Planners' meeting in Philadelphia this week, Wade Pfau of The American College and David Lau of DPL Financial Planners urged fee-only advisors to mix annuities and investments in retirement. (Painting of Philadelphia trolley stop by Paul Santoleri.)



The trouble with fee-only advisors—from an annuity marketer's viewpoint—is that they are master craftsmen. They dig annuities as much as Culinary Institute grads dig Swanson TV dinners. They do custom work. They're fiduciaries. As a rule, they don't buy packaged products.

When fee-only advisors attend annuity breakouts at conferences, they ask a lot of sharp-pencil questions. They're keen to learn how actuarial magicians pull doves out of top hats. They're sure they can do the same tricks at lower cost. In short, they're a tough audience.

But annuity promoters, aware that fee-only advisors and registered investment advisors (RIAs) represent a big, untapped market, feel hopeful. Another reason for optimism: Some fee-only advisors now admit that it might be *unfiduciary* not to consider annuities in retirement planning.

So it was that Wade Pfau, Ph.D., head of the doctoral program in retirement income at American College of Financial Services, and David Lau, creator of the new DPL Financial no-commission annuity platform, could be found preaching annuities to sizable audiences of fee-only advisors at the National Association of Personal Financial Planners conference in Philadelphia this week.

The Pfau philosophy

Wade Pfau

Pfau, as he often does, presented the case that there's no cheaper way for a retiree to deal with longevity risk—which he called the "overarching financial risk in retirement"—than to transfer that risk to a life insurance company by buying some form of life-contingent annuity.

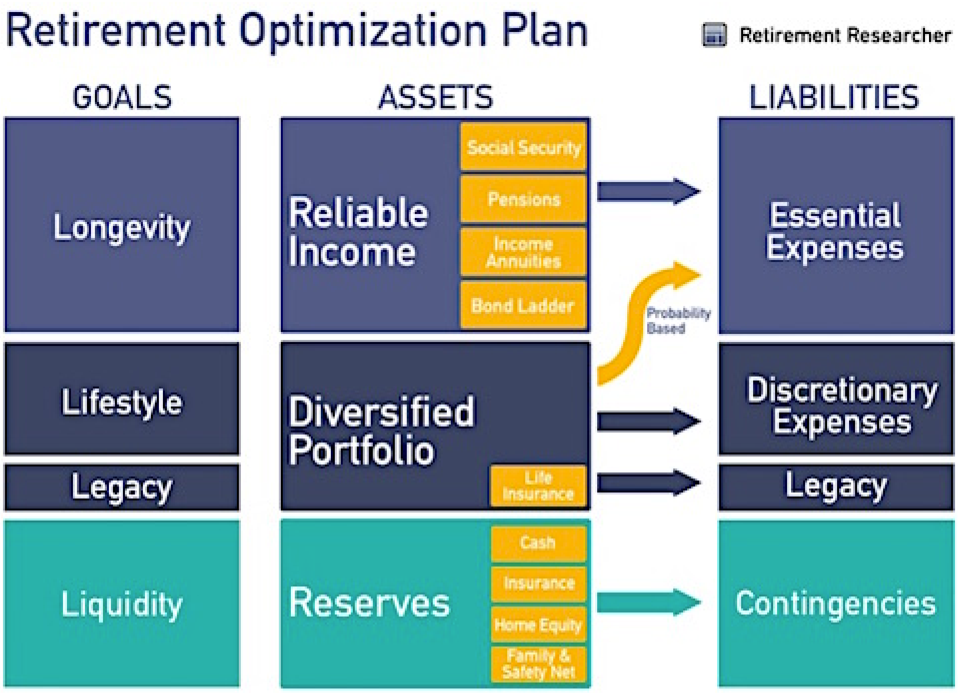
Indeed, it's almost QED that, if you're training to live to 100 by eating kale, drinking turmeric chai, taking Pilates classes and wintering in Arizona, it's almost a no-brainer to let an insurance company pay you an income based on the assumption that you'll only live to age 85 (the approximate average life expectancy for 65-year-olds).

Pfau's claim to fame, in addition to having had Alan Blinder as a thesis advisor at Princeton, is that he has crunched the numbers on the "alpha" of life-contingent annuities so thoroughly over the past decade that even a Ken Fisher would be hard-pressed to refute them.

Although there is no orthodoxy when it comes to retirement income planning, Pfau explained that there are three main schools of thought. There is the time-segmentation method (whose merits are largely behavioral). There is also the Bengen safe withdrawal method (which lacks the certainty that retirees like).

Finally, there's the build-a-floor-and-go-for-upside method: Retirees should cover all their essential expenses with sources of income that are guaranteed for life (Social Security, pensions and annuities). They should divide the rest of their money between growth-oriented assets (for discretionary expenses or inflation-protection) and short-term reserves for emergencies.

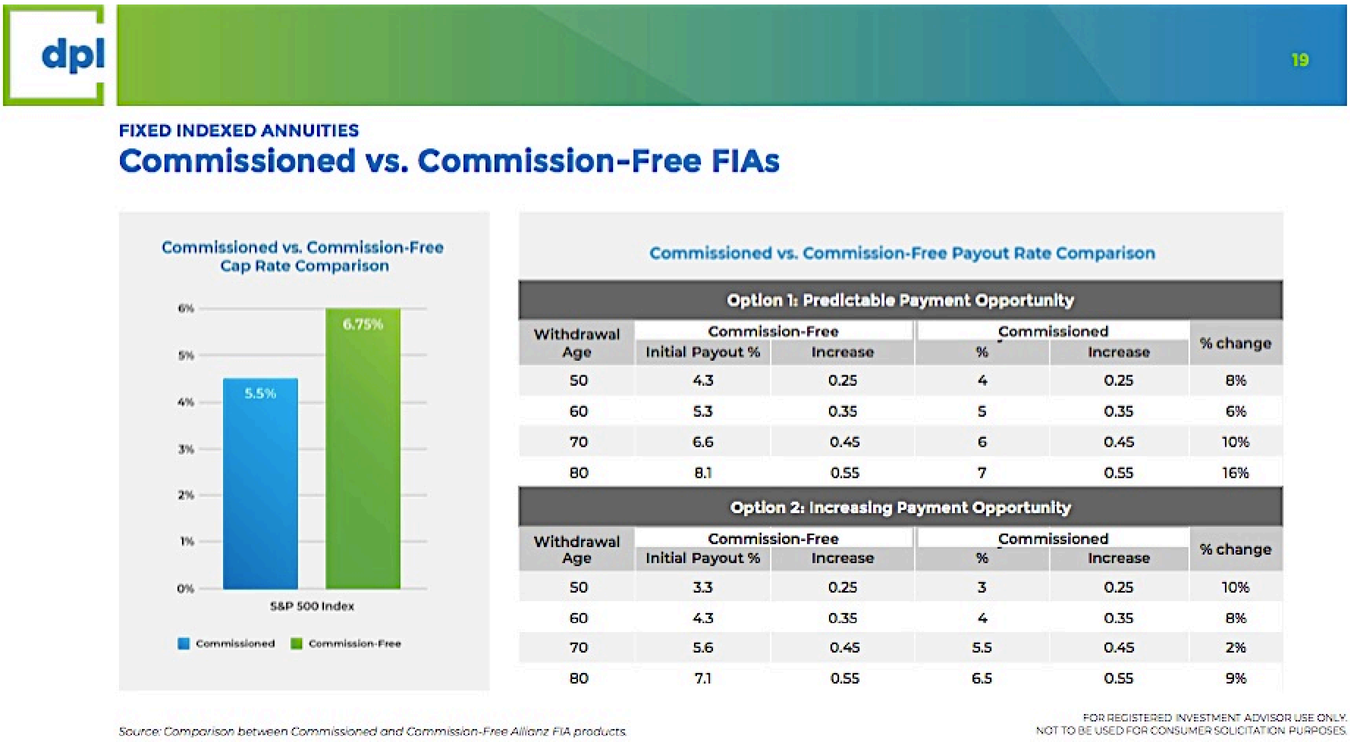
This approach is goal-based, and the goals will vary by client. See Pfau's presentation slide below. He's close to finishing a new book on the synergies between annuities and investments in retirement.



DPL Financial Partners

In the other annuity-based presentation in Philadelphia this week, serial insurance entrepreneur David Lau (who co-created Jefferson National's low-cost investment-only variable annuity business for RIAs and sold it to Nationwide) gave a talk about indexed and variable annuities with lifetime income riders and, to a lesser degree, about income annuities.

Lau has created an Internet platform, DPL Financial, where RIAs and fee-only planners without insurance licenses can buy no-commission annuities from a variety of insurers, including Allianz, TIAA, Great American, AXA, Great-West Financial, Integrity, Security Benefit, and Colorado Bankers Life.



Option 1: Predictable Payment Opportunity					
Withdrawal Age	Commission-Free Initial Payout %	Commission-Free Increase	Commissioned %	Commissioned Increase	% change
50	4.3	0.25	4	0.25	8%
60	5.3	0.35	5	0.35	6%
70	6.6	0.45	6	0.45	10%
80	8.1	0.55	7	0.55	16%
Option 2: Increasing Payment Opportunity					
Withdrawal Age	Commission-Free Initial Payout %	Commission-Free Increase	Commissioned %	Commissioned Increase	% change
50	3.3	0.25	3	0.25	10%
60	4.3	0.35	4	0.35	8%
70	5.6	0.45	5.5	0.45	2%
80	7.1	0.55	6.5	0.55	9%

No-commission FIAs tend to have higher caps.

Only indirectly promoting his platform, Lau made the case for deferred annuities with lifetime income benefit riders. These products are hard to explain. It's not the underlying assets that are hard to explain: Indexed annuities are merely a cake of bonds or bond ladders with an icing of options on an equity index such as, most commonly, the S&P 500 Index.

David Lau

No, what's hard to explain is the income option. The income options on indexed annuities have drawn interest lately because they promise high annual payouts, relative to deferred income annuities (DIAs) or income options in variable annuities (VA), for retirees who buy their contracts ten years before they intend to take a monthly income from their accounts.

Part of the opacity stems from the fact that there are two layers of options in an indexed annuity with an income rider. There are the equity options in the underlying asset pool. Then there is the put option, which typically costs about 1% per year. When exercised, this allows the owner to convert an actuarially notional sum—the "benefit base"—to a stream of income that cannot be outlived. (The annual income is typically restricted to 5% or 6% of the benefit base.)

Under what circumstances might the owner exercise the income option? You would ordinarily do it if the market has done badly and the actual account value (liquid, accessible) is significantly lower than the benefit base. But the option doesn't give you direct access to the benefit base—it only gives you access to a guaranteed income equal to a percentage of the benefit base. The client still has access to the money in the account, although taking ad-lib withdrawals will reduce the annual income.

After the presentation, an advisor from Rye, NY, turned and said, "I think I'm starting to understand it." It all depends on whether the client, after six, seven or 10 years, exercises the option and takes the annual income.

There's the rub. The promised payouts on the product are high in part because quite a few contract owners pay for the option and never use it. Ergo, don't use this product unless you know you'll exercise the option, or unless you use the option for protection only during the 5-10 retirement "red zone" years. If the market doesn't crash during that time, you can stop paying for the option.

How does DPL get paid for providing its annuity platform? "RIAs pay a membership fee to join DPL. That's an expense for the firm essentially hiring us as an outside expert," said Heather Rosato, DPL Financial's chief marketing officer. "The carriers pay us an administration fee for the infrastructure we provide to distribute their products to RIAs (product education, licensing capabilities, broker-dealer, etc. That fee is baked into the product cost. Carriers can eliminate not only the commission but also their wholesaling and marketing costs. Our fee replaces those distribution costs and is 80-90% lower."

The new no-commission platforms mentioned above may not be an entirely new phenomenon. In the exhibition area of the conference, one of the booths was sponsored by **LLiS**. It bills itself as “The advisor’s insurance advisor.” The person manning the booth assured me that LLiS, whose CEO is Mark Maurer, has been offering commission-less annuities and other insurance products to RIAs and fee-only advisors for years. It seems that LLiS now has more competition.

Compensation dilemma

Some fee-only advisors are, not surprisingly, a bit confused about how to get paid for recommending a no-commission annuity to a client. In sidebar discussions at the conference, some of them confessed they would not feel right in buying, for instance, a no-commission annuity for a client and then charging the client a 1% management fee for the money in the annuity.

At the same time, some feel that it wouldn’t be ethical to deny their older clients the demonstrable insurance benefits of annuities just because such products don’t fit their business model. It’s a dilemma.