Variable Annuities – Part 1 of 5

Variable annuities with Guaranteed Minimum Withdrawal Benefits (GMWB) are making inroads to Canadian retirement planning. Here is a synopsis of facts about them based on market history.

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Variable Annuities (VA) with Guaranteed Minimum Withdrawal Benefits (GMWB) are very popular in the USA. They were first introduced by Hartford in 2002. In 2004, sales of all variable annuities (with or without GMWB) in the US reached $128 billion, of which 69% of all sales had the GMWB rider. The total assets in VA's were about $1.1 trillion at the end of 2004. In this series of articles, I will use VAG to refer to a variable annuity with guaranteed withdrawal benefits.

Last year, Manulife introduced VAG to Canada. Other insurance companies are following Manulife's lead. In this series of articles, I will try to demonstrate the benefits, pitfalls, the hype and the truth about VAG before you put your client's money and your practice at risk.

What is this product? The name variable annuity is a misnomer; it has little to do with an annuity. Think of it as a segregated fund. Your client's investment in a segregated fund is the "premium". Add to it the basic GMWB rider and you have a living benefit and a guarantee of return of your entire premium by means of annual withdrawals spread over 20 years. This is the worst-case situation. If markets do well, you may be able to have income for a longer period of time.

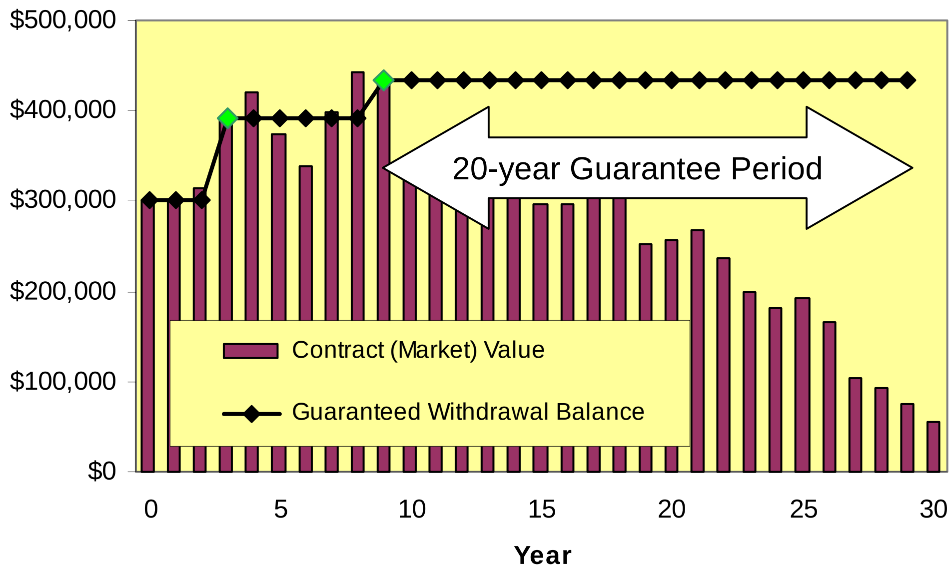
The segregated funds have a market value, which fluctuates just like a mutual fund. This is called the "Contract Value". In addition, there is another balance to track which is called the "Guaranteed Withdrawal Balance". Its value does not fluctuate with market conditions, but it is the base amount used to calculate the income that is paid out. The day you buy the VAG, both the contract value and the guaranteed withdrawal balance are same, i.e. your initial premium. Even if the contract value might go down to zero in adverse markets, annual payments continue for the life of the contract based on the guaranteed withdrawal balance. If a client buys a VAG with $100,000 at age 65, he is guaranteed to receive $5,000 each year throughout the contract period regardless of how his investments perform.

There are several important features and benefits of VAG:

- Step-up: If the portfolio does well and the contract value exceeds the guaranteed withdrawal balance, then it is reset higher, equal to the contract value. These resets are allowed at certain intervals. In Canada, -at the time of writing- insurance companies offer resets once every three years. In the US, most contracts allow annual reset. That means in the US, clients can take advantage of cyclical markets to reset. In Canada, they usually have to wait for long-term secular trends. In some cases this can make a big difference to the outcome. There is also a time limit or age limit for resets: Some companies allow resets for 30 years from the initial contract date; other companies allow resets until age 80. Read the fine print.

- Reset of Guarantee Period: When the guaranteed withdrawal balance is reset through a step-up, this also resets the guarantee period. If the guarantee is for 20 years, each time there is a reset, the clock on the portfolio life restarts for another 20 years.
- Guarantee Period: The guarantee period is the length of the guarantee after withdrawals start. The basic VAG's had originally a 20-year guarantee period. Currently, almost all contracts in the US have a guarantee period for life, with joint last to die available. In Canada, -at the time of writing- insurance companies offer only a 20-year guarantee period. If you sell a $100,000 VAG to a 65-year old female client, she is guaranteed to receive $5,000 each year until age 85. According to mortality tables, at age 85, she has a 50% chance of being alive. Yet, that is when the guarantee ends. You might think that resets might help extend the guarantee period. Don't count on it, they don't occur often.
- Bonus: If your client buys a VAG prior to needing the income, then insurance company may pay an annual bonus until withdrawals start. The bonus increases the guaranteed withdrawal balance by 5% each year, unless there is a reset that increases the balance by more than 5% in that year. The bonus is not added to the contract balance, just to the guaranteed withdrawal balance. In other words, the bonus cannot be cashed out, but it increases the annual income for the entire guarantee period. For example, if you sell a $100,000 VAG to a 55-year old client and he is planning to start withdrawing at age 65, his guaranteed withdrawal balance is increased to $150,000 by age 65, even if the investments stay flat or go down. There is usually a 10-year time limit on bonus accumulation.
- Death Benefit, Creditor-proofing: Usually, the same death benefit and creditor-proofing that applies to a segregated fund, applies to variable annuities as well.

Example: Bob, 65, is just retiring. He buys a VAG for $300,000. His contract allows him to reset once every 3 years until age 95. The guarantee period is 20 years. The asset mix is 80% SP/TSX index and 20% fixed income. The chart shows the contract value, guaranteed withdrawal balance and the resets over time, if he were to buy this contract in 1949. The green dots indicate where step-up resets occurred. The last step-up was in year 9, therefore it resets the guarantee period by 20 years. Even if the contract value goes to zero anytime after year 9, the GMWB rider ensures that 5% of the last guaranteed balance is paid each and every year until year 29.



This is an introduction to VAG. At this point, you need to be clear about one thing: In a mutual fund, we focus on the market value. In a VAG, we focus on two balances: the contract value (market value, including all deposits and withdrawals) and the guaranteed withdrawal balance, which determines the guaranteed withdrawal amount.

In Part 2, we'll go into more details.

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