

Unique challenges in handling existing VAs

When new clients bring previously purchased contracts to the table, advisers have options

By Ed McCarthy

Feb 23, 2014



Variable annuities' myriad contract-specific features, benefits and costs can be baffling, particularly for advisers who encounter them infrequently. But because net assets in these vehicles totaled about \$1.8 trillion at the end of the third quarter 2013, according to the Insured Retirement Institute and **Morningstar Inc.**, it's likely some of any adviser's prospects or clients own them.

For advisers inheriting variable annuities with new clients, what must they monitor to ensure the client maximizes contract returns? How should they choose from a VA's investment options and then integrate the contract's subaccounts into the client's overall portfolio?

Issuers' changes to contracts are another factor, as some companies are modifying their products to control their VA-business exposure or exit the business. In some cases, VA issuers have made buyout offers for part of their contracts' benefits; others have restricted contract owners' available investment options.

Consequently, managing existing VAs on a continuing basis can pose a unique challenge for advisers.

INTEGRATING VA, PORTFOLIO

On one level, managing a client's VA is similar to managing a portfolio of equities or mutual funds, said Mark Cortazzo, senior partner with Macro Consulting Group. Advisers should review contracts periodically to determine if any changes have been made to investment options or investment managers. Reviews are also warranted when clients reach contract trigger dates, such as age 65, and the contract provides a benefits increase.

Mr. Cortazzo says that one mistake to avoid is mechanically matching VA- and non-VA portfolio allocations. If the client's target allocation is 60% equities and 40% fixed income, for instance, the adviser should not necessarily duplicate that in the VA, he cautions. First, the combination of the bond portfolio's low yield and the VA's fees will "almost assuredly" result in a negative yield. Additionally, the presence of VA-contract guarantees can skew the investment decision toward a more aggressive allocation than that used in the non-VA assets.

"When you're constructing a portfolio that has an annuity as part of it, you have to look at that annuity differently because the risk-reward metrics on it aren't pure capital-markets risk-reward metrics," Mr. Cortazzo said. "They have an absolute floor; they have an absolute guarantee, not a relative protection. That needs to be looked at completely differently, and then you construct the rest of the portfolio around what you do to optimize that annuity contract."

RETIREMENT INCOME MODELING

Mike Henkel, head of Achaean Solutions with Achaean Financial Inc., agrees that VAs' inclusion of a lifetime income benefit and potential death benefit complicates the portfolio analytics. The products provide a percentage payout that the investor can't outlive, and that benefit can't be modeled in the traditional risk-reward "standard deviation kind of asset allocation framework," Mr. Henkel said.

He approaches the question of how much a client should hold in variable annuities by modeling and simulating a portfolio that combines a variable annuity and a systematic-withdrawal plan. Provided that he knows the general asset allocation inside the contract, Mr. Henkel runs Monte Carlo simulations that systematically vary the allocation combination between the variable annuity and the systematic-withdrawal plan.

Each simulation forecasts a given combination's probability of ruin (client runs out of money while still alive), expected shortfall (extra wealth needed at the start of retirement) and expected death benefit (remainder of client's investible portfolio at death). The adviser and client can then evaluate how each combination affects the client's goals, given the model's assumptions of withdrawal rates and risk levels.

"What an investor wants to see is, "what does it mean to me?" Mr. Henkel said.

MAKE ME AN OFFER

Some insurers recently have restricted their contracts' available investment options to more-conservative choices. Others have offered to buy out investors' living or death benefits.

Phil Rousseaux, president of Everest Wealth Management, experienced this latter change last year with three of his clients who owned Axa Equitable Life Insurance Co. variable annuities. In addition to waiving all surrender charges, Axa offered each VA contract a sufficiently large credit that returned the account's surrender value to close to its income value.

None of the clients were taking income from their variable annuities, and Mr. Rousseaux's analysis of the buyout offer showed that it was beneficial to move the funds to new contracts.

“Every one of them moved, and it made sense from an actuarial standpoint,” he said.

Mr. Rousseaux emphasized that each analysis is different, however.

Lately he has been advising most clients to keep their existing contracts because an older contract's income value is often much higher than its surrender value due to the high roll-ups.

“If the client is looking for guaranteed lifetime income, more times than not you've got to leave the contract where it is,” Mr. Rousseaux said.

Given variable annuities' complexity and the industry's changes, an adviser who infrequently sees the products risks providing suboptimal contract-management advice.

Mr. Cortazzo and his associates responded to this problem by developing an outsourced VA analytics and management service for registered investment advisers. This arrangement allows referring RIAs to draw on Macro Consulting's VA expertise.

The firms sign a non-compete agreement and the contract owner names Macro Consulting as the contract's representative, which allows the firm to earn future fees and revenue from the variable annuity.

This kind of arrangement can benefit all parties, Mr. Cortazzo said.

“The client doesn't pay any incremental fees, the RIA isn't paying any incremental fees and we're using the revenue that is getting paid to someone who, in many cases, isn't even involved in the relationship anymore, to offset the cost,” he said.

Ed McCarthy is a certified financial planner and freelance financial writer in Pascoag, R.I.