The Case for Fee-Agnostic Analysis of Annuities

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In a "fiduciary-aware" world, fees have become a critical data point in considering the suitability of any investment. For annuities, which have long been criticized for excessive fees and sales charges, this shift has been seen as anything from a challenge to a death knell. One consistent message we have heard from regulators and distributors alike is that the insured benefits of annuities are crucial for making the case for an annuity sale within a tax-deferred environment. Even in the retail world, where "bare bones" variable annuities are making a comeback, these benefits are useful for many clients that don't have enough guaranteed sources of income for retirement.

Living and death benefits are certainly valuable, but they come at a cost. Yet again, the conversation quickly circles back to one that focuses on fees.

A Challenge to the Primacy of Fees

However, I challenge the conventional wisdom that fees must drive the conversation around product sales and exchanges. Indeed, an approach that looks elsewhere can ultimately serve the client better than blind devotion to fees as the arbiter of value. The real question that we need to ask in any transaction is: What is the true economic value this product provides to this client?

Using economic value as a starting point for assessing the suitability of a product for a client, we can do a more effective job of matching solutions to client need. After all, an economic value analysis does not ignore fees; instead, it incorporates them into its calculations. The end result reflects the total value, including the effect of fees deducted during the life of the product.

One product may have lower fees than another but also provide less benefit to the client. If the aim is, for example, to generate maximum potential income, then the fees as a lone metric are irrelevant and even distracting. Living benefits represent the mother lode of complexity, containing an array of features that affect real life performance. It is impossible to untangle the relative value of benefits for individual clients in more than a generalized sense.

Even in cases where we understand the broader dynamics of a rider, it is hard to know the inflection point where the numbers shift. For example, many offer a deferral bonus and increase the guaranteed withdrawal percentage when income starts later. However, putting off the start of withdrawals also reduces the total number of years where a client is able to withdraw money, so even in the face of bonuses and withdrawal percentage increases, it may be worth less to a client who defers income a little too long.

In these situations, there is no back-of-the-napkin estimate that is either practical or acceptable for compliance purposes. However, there is a role for a genuine calculus of the economic value, applied consistently across product types and including factors such as underlying contract fees and all facets of the operation of both death and living benefits. This type of calculation creates a benchmark that allows comparison across products fairly and for the express purpose of understanding the performance of the benefits themselves.

A New Framework for Benefit Analysis

The basic framework for assessing annuity benefits has never revolved around this sort of precise understanding of benefit valuation. With that information in hand, it would be possible to pivot the conversation away from the fees as a monolithic data point in the evaluation of products. The problem with relying on fees is that this method does not sufficiently take into account what it is that the fees are actually buying.

Economic value does not replace other considerations of suitability of a contract and elements of product design can inform a purchase decision, from investment options to guarantee structure. For example, a higher early withdrawal rate with a lower lifetime guarantee may suit one client situation better than the opposite.

Unused, a Benefit Becomes a Stale Option

It is important to make one thing clear: a benefit has no economic value if it is never exercised. If a client pays for something and never uses it, those fees amount to an expired option. In similar fashion, liquidity is the ability to turn an asset into cash, another factor that investors need to figure out whether they need. This is not to say that the ability to turn on income is worth nothing to a given investor, even if it is never used. However, there is no economic value if that switch is not activated.

In the context of analyzing living benefits, the assumptions around utilization drive the calculations. Age, gender, and election of single or joint life are all important. By the same token, the initiation of income is a key metric in assessing how much the benefit is worth for a specific client scenario.

This is worth mentioning not simply because it is a fact but, more importantly, because it is an excellent example of how value-driven analysis can alter the conversations around these products in the first place. A side effect of pivoting the analysis of annuity purchases from fees to client value is a fresh set of eyes—or at least a new set of glasses. •

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Tamiko Toland is Head of Annuity Research for Toronto-based CANNEX. Her focus is the U.S. annuity market, where CANNEX recently launched CANNEX VA Analysis℠ and CANNEX FIA Analysis℠, innovative annuity benchmarking tools. She is responsible for product development and strategy as well as thought leadership on the annuity space. She has more than 15 years of experience tracking trends and key issues on retirement income, synthesizing commentary and analysis for broad audiences and specific clients. She is known for her dynamic presentations with a unique perspective on the industry and the forces that are shaping it.