CANNEX RESEARCH

Conversations with CANNEX Q&A: David Lau of DPL Financial Partners

Cannex's Tamiko Toland discussed the challenges of selling annuities to registered investment advisors (RIAs) with David Lau, Founder and CEO of DPL Financial Partners. David helped build the nation's first internet bank, TeleBank, but is better known within the annuity industry for his role as COO for Jefferson National. Over his decade there, he built a strategy and variable annuity product geared towards RIAs.

In 2018, he started DPL Financial Partners to bring fee-based annuities and insurance from a variety of insurers to RIAs. In that time, the firm has grown to serve over 10,000 advisors at more than 3,500 firms.

Q&A

How did David get from e-banking to distributing fee-based annuities?

TeleBank (now E*Trade Bank) is known as the first internet bank though it actually predated the internet. By relying on phone banking and ATMs, the bank had no physical footprint. "Eliminating bank branches in order to distribute and sell checking accounts and CDs has a material impact on the pricing and cost of the product," David explained.

This business model, which advertised direct to consumer and reduced costs, set the course of David's future endeavors. After selling TeleBank to E*Trade, he and co-founder David Smilow went in separate directions but reunited when Smilow was looking to focus on the annuity business at his new venture. At Jefferson National, David's objective was to figure out how to compete in the variable annuity market.

Starting with the premise that cost reduction is a valuable differentiator, the company leaned into a design that had no commissions and charged a flat fee rather than an asset-based fee. The flat fee reflects the fact that the operational cost to run the annuity is the same regardless how big the account is. The registered investment advisor (RIA) channel is the natural fit for this design.

"We thought, if you could go direct to consumer through advertising and do it efficiently, you provide much better products and that thesis has informed my career."

What was the key variable annuity innovation for Jefferson National?

For many years, insurers had targeted the RIA channel with lower-cost variable annuities (VAs). However, David noted that he studied the market and found that most RIAs managed assets through a custodian, many of them (at the time, 80%) through Schwab's custodial platform. His goal at Jefferson National was to offer a range of funds similar to the Schwab supermarket but with the added benefit of tax deferral.

As the company gained traction among RIAs, it turns out that most chose the Monument Advisor VA because of its cost structure first and foremost. Tax deferral ended up being a less attractive story. Nevertheless, the flat fee pricing is a benefit that others now offer.

"If [RIAs] are going to manage mutual funds and do it on Schwab, let's do the best we can to replicate that and basically say, for $20 a month, we're going to give you tax deferral, which is a really valuable thing."

How is the wholesaling process different for RIAs?

When the firm purchased Conseco's $2 billion annuity business, it also acquired its staff, including traditional annuity wholesalers. New to annuities, David initially tried to make the wholesaling model work, but soon discovered that it was a poor fit for RIAs. He decided to make a dramatic change, getting rid of all of the wholesaler in a move that "was considered pretty risky and controversial," even internally.

However, David said that it was quickly apparent that the traditional method to get appointments wasn't going to work at RIAs. Furthermore, his background was in marketing, particularly direct marketing. Therefore, he knew he could operate more efficiently and effectively to a large number of advisors, by relying on "a centralized model, marketing out to them with education and information and then giving them a resource to talk to when necessary."

"Not only is the traditional pricing problematic for this channel [RIAs], but the distribution model is problematic for this channel."

Was the administration platform the unsung hero at Jefferson National?

The only way Jefferson National was able to offer its innovative low-cost structure was by reducing costs in contract administration. The system relied on electronic filing and account management and was the basis for the first purely electronic annuity which had no option for paper delivery, the Annuity.com Direct Annuity. David was shocked to find his company was “way more efficient” than competitors with significantly more scale. It was the direct result of modern technology compared to their peers’ inefficient technology and heavy reliance on human capital.

In fact, the system was so efficient that the company considered marketing it to other insurers, but conversion from the old system would have been a key element of that service and that wasn’t a core part of Jefferson National’s business.

> *“Everybody focuses on the [variable annuity] product because the product was innovative, but it was really enabled by a low-cost structure on the back end.”*

How did David get from the tax deferral message at Jefferson National to positioning annuities for income at DPL?

Jefferson National's financial credit rating was too low to allow the company to launch any kind of guarantee or even a fixed account, David explained. The solution to that problem was a partnership with Phoenix to issue a version of Monument Advisor that did include a living benefit but leveraged Phoenix's higher rating. Unfortunately, Phoenix's rating fell (the insurer is now part of the Nassau Re group) in short order and they were never able to test the new offering.

Though Jefferson National remained committed to the tax deferral message on its investment-only VAs out of necessity, David saw the potential and the need to bring the full array of annuities to RIAs. Ironically, while some perceived the success of Monument Advisor as proof that this approach was the only way to reach RIAs, he commented, "it's actually not. It's just the only thing we could do."

Even though DPL started with a focus on investment-only VAs and term life, most of the products that its RIAs sell today have an income guarantee.

> *"It's actually about modernizing the cost structure, meaning eliminating commissions so it works within the RIA's business model. That's the key to the whole thing: then you can start figuring out all kinds of different products, but you have to build them in a way they can be used."*

How does David view fees versus commissions?

Commissions and fees both compensate the financial professional who is recommending an annuity, one from inside the product and the other (generally) from outside. Nevertheless, David has always held the view that commissions deteriorate the value of the product and “brings no benefit to the end consumer” whereas a fee supports an ongoing advice relationship.

The advice itself is valuable and the commission is simply compensation for a salesperson who may disappear while the higher internal cost to the annuity remains. By contrast, a RIA’s client may walk away the day after an annuity purchase and stop paying fees.

> *“The fee product is a better product we buy a lot, just like in the mutual fund world when you’re looking at the funds that are institutional share class as opposed to ones that have 12b-1 fees. The institutional share classes always have better-priced products.”*

How has the pandemic changed the perspective of RIAs?

Given that the Financial Crisis took place 13 years ago, David noted that many financial professionals have never experienced a down market. With the pandemic, the market rebounded so quickly that it reinforced the general principle that markets recover while not instilling any lessons about the potential effect of a downturn. (These observations mirror commentary about a similar phenomenon in investor attitudes in this Cannex-sponsored article.)

As a result, some may feel "emboldened relative to" annuities and not see the value in the protections they offer, David warned. "The market's not always going to go up," though the bull market of the last 13 years made it seem otherwise. He likened it to the internet bubble, when people thought they could simply manage their own assets. Before the bubble burst, you could "just throw a dart at the board and hit a dot-com company and make a fortune… until you didn't."

"It's almost like: 'What do we need protection for? The market always comes back, just like in the pandemic.'"

What has changed since Jefferson National first brought annuities to RIAs?

In 2004, RIAs only held about $500 million in assets and were more of a cottage industry populated by many individual practitioners and very few multi-office firms. They have grown to $6 trillion today, and now there are "mega" national firms where "the industry has moved from being asset managers to being financial planners" that focus on a financial plan that often uses insurance products, David explained.

At the same time, the transactional model at many wirehouses and broker/dealers is going out of style in favor of the fee-based model, in part under the pressure of SEC Regulation Best Interest. Even though they may not be serving as a fiduciary, the "historical points of differentiation for an RIA have basically gone away," in David's eyes.

This puts RIAs that fail to adopt insurance within their practices at a disadvantage and it deprives them of the ability to grow their businesses without having to find new clients. Adding on insurance products allows them to grow their "wallet share from existing clients" while staying within the existing business model. Also, without direct access to insurance, those who have already incorporated wealth management in their practices end up having to refer that business to another professional who can.

"If you're an RIA and you're not providing financial planning and wealth management, you're at a competitive disadvantage to pretty much everyone else in the market."

What misconceptions plague annuities among RIAs?

David said DPL surveys have revealed tremendous gaps in fundamental understanding of annuities. He's also seen it come up in conversations where RIAs often describe an annuity as "some kind of Frankenstein-like product that is the combination of all the bad things about different kinds of annuities."

Lack of liquidity is one issue that comes up often, and David connected that to ignorance about the availability of income riders that guarantee income without locking up assets. He admitted "it's stunning" how many claim that they're very knowledgeable about annuities yet aren't aware of these riders. "They only think about annuitization."

"It drives me nuts when people have extremely strong opinions built upon bad information."

How do RIAs need to catch up to changes in the economic environment?

It comes as no surprise that RIAs are even further behind other financial professionals in recognizing the importance of protection for their clients, but the client need will pull the industry in that direction. "The importance of annuities and secure income is felt more immediately by the consumer, secondarily by the advisor who has been doing things a certain way for so long it takes them a little time to catch up to the lag of what the realities are," David reasoned.

Multiple factors have changed over the past 15 years that should give all financial professionals cause to reconsider how to plan for and generate income in retirement. For one thing, interest rates have hit historic lows, even ignoring the additional dip early in the pandemic. A traditional safe approach to rely on interest from bonds now generates such poor returns that income gets very low or the investor runs a much higher risk of depleting principal.

Of all factors, low interest rates drove the most change in retirement planning strategy, according to results from the Protected Retirement Income and Planning study that Cannex conducted in partnership with the Alliance for Lifetime Income. RIAs were half as likely (11%, compared with 23% overall) to have changed their retirement planning approach at least moderately during 2020. Among those who did, interest rates was the most common reason (68% of those who adjusted their strategy).

Also, people are living longer at the same time that another key source of guaranteed income in retirement, the pension, is on the decline outside the public sector. People may need to rely on their savings to create income over a 30-year period, which "is probably a third of their life," David emphasized. These are important shifts that all financial professionals, not just RIAs, need to adjust to.

"[RIAs have] never been able to use protection products, so they have to sell against protection products and they are asset managers that believe in their ability to manage risk through diversification of assets and being really great asset managers."

What is David's biggest pet peeve about annuities?

Complexity is the biggest, "but not in the way that a lot of people think about it." David said he believes these products get a bad rap even though they are not necessarily that complex. The calculation of a mutual fund return is "a hell of a lot more complicated" than an annuity, especially when considering the simpler style of contracts and guarantees.

For example, David favors a VA with an accumulation benefit or other downside protection to use for tax-deferred accumulation and then make a decision on how to convert that to income "later in a client's life when they're ready for income." A fixed annuity or fixed indexed annuity also serves that purpose well, he added.

In other words, David said he believes that guarantee designs that are complex fail to bring value to the client and "are unnecessary" while annuities at their core "fundamentally are good products." In his opinion, the industry needs to get out of its own way to help bring simple and useful annuities to the market.

"It's the complexity and ultimately building products to be sold and not used."

What does David miss about the industry's past?

David said he is nostalgic for the days when RIAs were more of a cottage industry led by entrepreneurial individuals who were "characters" and risk takers. As an entrepreneur himself, he felt a connection with the older generation of RIAs and appreciated their willingness to dive into a business model that wasn't established yet.

Today's RIAs behave more like businesses and with that comes professionalism that has both "good and bad" elements to it.

"You're starting to miss some of those characters and it's getting to be more corporate."

What changes does David look forward to in the future?

David anticipates the time when education of advisors about the challenges of retirement and how to solve them makes a dent in the number who operate their practices with that focus. One challenge is that fact that accumulation and wealth building are “a sexier story” even if it’s been commoditized and is easy to accomplish through inexpensive index funds and rebalancing.

“That’s basically the prudent academically driven advice,” David explained, “But retirement is super complicated.” Part of providing advice through retirement is not just risk management but understanding the mental and psychological needs of the client.

> *“I really look forward to when there are more advisors who are focused on retirement and are expert on retirement and are not simply taking accumulation strategies and trying to apply them to retirement because it doesn’t work any more.”*