

The Case for Variable Annuities / Guaranteed Drawdown

Billy Burrows – July 2008

What is a Variable Annuity?

Variable Annuities originate from the US where insurance companies offer a wide range of guarantees in order to differentiate themselves from mutual funds which are unable to offer insurance type benefits.

In the US, variable annuities are tax-deferred savings plans where there is no tax on investment gains but tax is payable on the income payments. At retirement investors choose between taking a lump sum payment (which is heavily taxed), or taking systematic withdrawals which is similar to our drawdown.

In a bid to stem falling sales when equity prices were volatile, many variable annuity companies started to introduce a range of guarantees including a “Guaranteed Lifetime Withdrawal Benefit” option.

Guaranteed Lifetime Withdrawal Benefit

This option provides a guaranteed lifetime income which is payable regardless of investment returns and some contracts have an investment “lock in”, whereby any gains are locked in.

In this way, investors can benefit from a guaranteed income for life without actually buying an annuity. In addition, if the fund increases in value, the level of income will increase, but if the fund value falls the income will remain at the level at the last lock in. On death, the funds can be paid as a lump sum to beneficiaries.

It is important to understand the nature of the guarantee. It is not a guarantee on a specific fund or index, it is a guarantee that applies to a portfolio of funds. Typically the investor will pick a pre-selected portfolio arranged by the insurance company and the guarantee will sit on top of that. The portfolios will be restricted to a certain proportion of equities, and this can be as high as 80%.

Dynamic Hedging

The insurance companies provide the guarantees through a process known as dynamic hedging. Sophisticated hedging techniques using a wide range of derivatives are used to ensure that the insurance companies can always meet their contractual guarantees. Importantly, the risk is put out into the capital markets where there is the capacity to take on the volumes of risk required.

Investors and their advisers are not expected to understand the “rocket science” behind dynamic hedging, but they should seek to understand the strength of the insurance company providing the guarantee, and the amount of any counter party risk.

Variable Annuities in the UK

In the UK the name Variable Annuity is being applied to pension drawdown policies (Unsecured Pension) that provide a guaranteed level of income or capital.

However the term Variable Annuity is misleading in the UK where annuities normally refer to guaranteed lifetime income policies. For this reason we prefer to use the term Guaranteed Drawdown.

There are now several products in the UK that can provide a guaranteed income from a pension drawdown plan and these include (see table for more details):

- Hartford - Guaranteed Retirement Income Plan (GRIP)
- Lincoln - i2Live
- MetLife - Retirement Portfolio
- Aegon- “Income for Life”

Company	Hartford -	Lincoln -	MetLife -	AEGON SE -
Product	Guaranteed Retirement Income Plan (GRIP)	i2Live	Retirement Portfolio	Income for Life
Overview	Drawdown (DD) with a guaranteed income and death benefit option	DD and variable annuity with option of an income guarantee and death benefits.	Personal pension with capital guarantee for accumulation phase and income guarantee for drawdown phase	An USP with a guaranteed level of income for life.
Income	Depends on age. At age 60, the single life guaranteed income is 5% of fund value	Investors can take up to 100% of the Maximum Supportable Income without affecting guarantee.	Depends on age but varies from 3.8% to 6.2% guaranteed for life	Dependent on amount invested and age when regular income taken
Guarantees	Each year investors lock into any growth up to 10%. Income and death benefits protected against fall in asset values	Guaranteed income is based on 75% of Maximum Supportable Income (MSI). Gains are locked in every 5 years.	Every 3 years, investors lock into any gains. This can increase capital value or income value depending on type of guarantee selected	Can lock in up to 100% of investment gains.
At age 75	Can continue with ASP or secure	Option to convert to Flexible Annuity	Capital guarantee will mature or	

	guaranteed income		income guarantee can continue beyond age 75	
--	-------------------	--	---	--

Advantages	Guaranteed income level reviewed each year. There is also a guaranteed death benefit.	Guaranteed income can increase at five year review. Flexibility to turn the guarantee on or off depending on circumstances.	Works for consolidation as well as income phase. No upside cap on lock in. Income can increase with each lock in.	Guaranteed income for life based on non-capped investment fund performance and options to take out Income for Life Annuity Income for Life ASP.
Disadvantages / Risks	Lock in restricted to 10%. No lock in after age 75	Income guarantee more complex	Lock ins apply every three years	More expensive than annuities or income drawdown.

Living Time has a plan called the “The Living Time Income Plan” and this is best described as a fixed annuity policy although it is written under Unsecured Pension rules

The rationale for Guaranteed Drawdown

The objective for many retirement age investors will be to arrange an income that has the following characteristics:

- Sustainable, in real terms
- For as long as they or their partner are alive
- Without taking undue risk
- With as much flexibility as possible.

Until now there has been no single retirement income product that has been able to meet these objectives. Level annuities fall short because they do not provide a sustainable income and there is no flexibility. Drawdown does not meet this requirement because it does not provide an income for life without undue risk.

A Guaranteed Drawdown plan meets these objectives. A sustainable income is achieved by investing in equities. Over the longer term equities provide an effective hedge against inflation. Income for life is guaranteed by the insurance company and the investment “lock in” means that investors do not take undue risk. Flexibility is obtained through the Unsecured Pension rules.

In short they provide the best of both worlds; secure income as well as flexibility and investment control.

Can investors really have their cake and eat it?

So if Guaranteed Drawdown plans provide annuity style income but with the flexibility of pension drawdown, what is the catch? There is no catch but there is a cost.

The cost of providing the lifetime income guarantee is taken by increasing the annual fund management charge. Charges differ from company to company but typically range from 0.75% per annum to 1.5% per annum.

Those against argue that the additional costs will drag down investment performance and make it difficult to achieve the returns required to provide future capital and income growth. They also point out that if the funds fall in the early years, the extra management charge is still payable so it will take longer for the funds to grow past the original sum invested, compared to a unprotected fund. They also argue that if the funds do well in the early years, the lock in will not kick in and so the investor will have paid for a guarantee that was not needed.

Those in favour argue that Guaranteed Drawdown plans are suitable for those retired investors who have the twin goals of continued equity investment and a guaranteed level of income. In response to the criticism of costs, they point out that UK style plans do not need to be expensive because they can be set up with similar costs to other drawdown plan and therefore the cost differential is only the cost of the guarantee. An extra 75 to 100 basis points for the benefit of a valuable guarantee may not seem excessive in relation to the guarantees provided.

It also important to note that a Guaranteed Drawdown plan can have up to 80% of the funds invested in equities, which is probably a higher equity exposure than for an unprotected drawdown fund.

Conclusion

One of the unresolved dilemmas for drawdown is that the older the client gets, the greater the returns required from drawdown in order to match the benefits from an annuity. However at that time of life older clients should be taking less risk not more. The greater returns are required to compensate for the absence of any mortality cross subsidy (mortality drag) and the increased cost of running a drawdown compared to an annuity.

Drawdown plans without guarantees transfer both investment risk and mortality drag to the client. The new guaranteed drawdown plans transfer both the investment risk and longevity risk to the insurance company but at a cost.

Is that cost justified? The jury is still out.