



## Preferred MOs

Allianz hastened the pace of change in the independent distribution channel by unveiling *Allianz Preferred*, a more exclusive “club” where members will have access to unique products and resources. The trade-offs are high annual dues (sales volume requirements), adhering to club rules (hiring suitability of officers and letting Allianz approve your marketing material) and agreeing not to belong to other clubs (no other distributor group). I believe this move is due in a large part to the creation of the *Annexus Group* and other annuity distribution groups. Reaction from marketing organizations has been swift and loud with many upset by this decision, but it was going to happen someday.

MOs primarily compete for agents by offering exclusive products or higher commissions, and since most MOs historically had access to the same products it means many tempted better agents to join them by offering to share the MO’s piece of the pie. Carriers try to forbid the paying of higher commissions to some agents by some MOs because it throws the marketing economics out of whack, but the only real recourse the carrier has is to cancel the MO’s contract which cuts into carrier sales. If the carrier offers true product exclusivity the MO has less incentive to offer a higher

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## Wall Street’s FIA Alternatives

The risk-reward proposition of an index annuity may be looked at from opposite ends. From a saver’s perspective it provides a no-market-risk to principal vehicle with a higher potential return than other no-market-risk to principal vehicles such as CDs. From an investor’s perspective it typically provides a lower potential return than an investment vehicle like mutual funds, but offers a no-market-risk to principal benefit that the investment vehicle can’t.

The first index annuities were promoted as a way to get stock market-like returns without market risk to principal; the transition to marketing them as a safe money place with greater interest potential occurred as early participation rates and caps fell, and registered reps became uninterested in index annuities. The rep that initially sold an index annuity with a 100% participation rate guaranteed for 5 years, or one that locked in interest gains each year subject to a 16% cap, quit selling them when the participation rate fell to 90% and the cap dropped to 14% because the ‘90s bull market would last forever.

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For those that say you can’t buy loyalty,  
Bill begs to differ.

## Wall Street's FIA Alternatives (continued from page 1)

During the millennium bear market a decade ago interest in index annuities resurfaced on Wall Street. However, the consensus in 2002 was to either wait until good times returned, or if you were a VA provider, to examine other ways to offer lower risk options, and I believe guaranteed withdrawal benefits were one of the outcomes.

The Crash of 2008 reminded Wall Street of the well publicized growth of index annuity sales, and the use of VA guaranteed withdrawal benefits, causing them to again look at the safer side of the street. The result has been the creation of a variety of investments designed to lessen the risk of investing. The following is a brief look at some of the more visible products.

### Index Certificates of Deposit

These CDs are FDIC insured and principal is returned upon reaching a typical maturity of 3 to 10 years. All of the early ones, and most of the current ones, use a term end point crediting structure where gains are not credited until the end of the multi-year period. Index CD sales were poor largely for the same reason that sales of term end point design index annuities declined, which is that consumers prefer annual reset methods that lock in gains. For emphasis, only \$300 million of the term-end-point designed Index Powered® CD was sold over 8 years, even though a hundred banks were marketing it.

Current credit methods include: *term end point* where final interest is a percentage of total equity or commodity index gain; *quarterly averaging* where the ending index value each quarter is noted, added together, and then divided by the number of quarters over multiple years to get an averaged end point to compute gain over the term; *quarterly cap forward* where several years of quarterly gains (up to a cap) and quarterly equity index or commodity losses (not subject to a cap) are added together; *summed individual cap gain/cap loss* takes the individual components of the index, adds together each gain up to 10% and

the index, adds together each gain up to 10% and each loss down to 20%, and then sums the component returns; and *inflation indexed* that credits the rate of inflation plus an additional yield, subject to a cap, on an annual basis. Commissions currently run 2%-3%. Key competitive points:

Taxes are owed on phantom growth – even though the interest is not usually paid out until maturity the bank must issue a Form 1099 each year showing the “might have” interest earned. Due to their design there could be a situation where the owner paid taxes on several years of phantom interest income only to have much lower actual interest paid out. I’m not sure how you would treat this on your tax return.

Liquidity is not guaranteed – some banks will redeem the CD before maturity, but no guarantees and the value is typically the market value. There may or may not be a secondary market.

Crediting methods are usually very complicated – index annuities justly get accused for having some atrociously complicated and misleading crediting methods; some index CDs make these annuities look as simple as first grade arithmetic by comparison.

### Index-Linked Notes

Many types of interest bearing index-linked notes have been developed. Some are fixed, most are floating, and a few are fixed and floating. The notes may give you a percentage of the index gain over a period of years, or the gain may be computed more often and capped. The note may use a multiplier meaning the amount of index change is multiplied by a set number and then the multiplied return credited. The index link might be the S&P 500, Dow, the price of gold, inflation, a basket of currencies, or changes in the spread between the constant maturity rate (CMT) of 2 and 10 year Treasuries.



If the notes are held to maturity the principal value is returned, or maybe not. Some notes do agree to pay the principal amount upon maturity, others give you the market value, and still others offer a type of partial insurance where they'll return 100% of the principal if the loss isn't too bad. Depending upon the note some may be redeemed for the principal value on issue anniversaries, some may be redeemed early only if the issuer feels like it, and some may not be able to be redeemed at all. There may or may not be a secondary market. Key competitive points:

Taxes may be owed on phantom growth – depending on the structure of the note a Form 1099 could be issued though no interest or gain was paid out to the consumer.

Liquidity is not guaranteed – Some issuers will redeem the note before maturity, but no guarantees and the value is typically the market value. There may not be a secondary market.

There's no FDIC or Guaranty Fund – the note is backed by the financial strength of the issuer.

Even though the upside is typically capped the downside may not be – this applies more to devices such as *accelerated return notes* and not at all to most fixed and floating interest notes. The principal protection offered on some is if the closing value is down, say, 20% or less at maturity, then the issuer will give you back 100% of your principal. However, if the loss is greater the issuer will still only cover up to 20% of the loss. So, if the closing market value was 50% of the initial value you'd get the 50% market value plus 20% from the issuer for a total of 70%, meaning you're still down 30%.

### Step-Up Notes

With this low interest rate environment these are getting a bit of play. They promise to pay a fixed yield that increases after a predetermined period of time. For example, the note may pay 2.5% for the first five years and then increase the yield by 1% thereafter until maturity in 7 to 15 years.

Key competitive points:

Not insured or guaranteed – the issuer must be around at maturity

Issuer can pay off early – the ones I've seen are all callable with the issuer able to simply give you back your principal at their option.

Liquidity is not guaranteed – some issuers will redeem the note before maturity, but it is not guaranteed and the value is the market value, and there may not be a secondary market at all.

### Alternative Mutual Funds

In the first six months of 2011 Lipper says over 440 new mutual funds launched and many of these were alternative mutual funds. Since the "alternative" label can be used on just about anything, what I'm talking about funds that are designed to lose less in bear markets, although I don't think they would use that wording. Here are three approaches:

#### *Long/Short Equity*

This strategy uses long and short positions in common and preferred stocks. They actively look for stocks they think will go up and buy them (go long) and also look for stocks they think will go down that they don't own and sell them (short). This leveraged position is designed for capital gains; however, over the last 3 years the average fund in this segment lost 0.2%.

#### *Market Neutral Equity*

This strategy is designed to exploit equity market inefficiencies, which involves being simultaneously invested in long and short matched equity portfolios generally of the same size, usually in the same market and attempts to achieve capital appreciation. The average total return over the last 3 years for this market segment was 0.4%.

#### *Income Replacement Funds*

Possibly in reaction to GLWBs Fidelity began offering an Income Replacement Fund Series in 2007. These managed payout funds used the

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## Wall Street's FIA Alternatives (continued from page 3)

lifecycle stock/bond allocation approach and are designed to offer a level payout until the end of a future date you select. In 2008 Vanguard added payout funds to their mix. The income from these payout funds is not guaranteed.

In early 2009 Vanguard dropped their payouts by 16% and Fidelity cut some payouts 20% to 33%. However, things are looking up. For example, the current payout on the Fidelity Income Replacement 2042 Fund of 4.94% is supposed to be 5.01% next year.

Key competitive points:

Nothing is guaranteed – the consumer is fully exposed to both market risk and longevity risk.

The income replacement concept already failed – the whole idea is to provide an income payout that won't go down. In the crash of 2008 many payouts were cut.

### Do-It-Yourself FIA

This tried and failed choice says avoid index annuity “fees” and buy a bond, an option, and do it yourself. As I wrote earlier this year, following this advice over the last several years would have resulted in effective participation rates of less than 20%. Key competitive points:

The advice creates a term end point design – all of the articles I've read that suggest do-it-yourself create a term end point design that doesn't lock in gains for 5 years or longer, but well over 90% of consumers have consistently bought annual reset designs. The advice creates a solution that people won't use.

A consumer can't create a good annual reset – a consumer could buy a one year CD or Treasury and put the remaining money in a one year LEAP (Long Term Equity Anticipation) option but the costs are too high to make it competitive with an index annuity. Even with a million dollars the consumer is still paying retail markup wherein the insurance company is buying wholesale.

### Wall Street Alternatives Aren't

Wall Street's whole mindset is on managing risk and what these alternatives are generally designed to do is reduce the risk of investing. On the other hand, index annuities transfer risk away from the consumer and are designed to increase the return on savings. These are two different worlds. The good news for the index annuity world is Wall Street has not figured this out yet.

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## Preferred (continued from page 1)

commission to a star agent because the agent won't be able to do better elsewhere. Exclusivity avoids the problem because there is less incentive to do it, and the repercussions of losing exclusivity are felt more by the MO.

Another aspect of this is the carrier can exercise tighter compliance control over the MO. Allianz will require partner MOs to hire suitability officers – suitability officers are already working in the MOs Allianz owns – and have marketing materials reviewed and approved. This is a response to the NAIC suitability model act being adopted by the states and also a recognition that the potential carrier liability when bad MO and agent conduct occurs has ratcheted up in recent years.

It's not a question of whether the creation of distribution groups is good or bad, because it was inevitable. Last year I reported that more and more top agents were leaving large MOs to form their own “hero” MOs (where a top producer acts as a mentor to a limited number of agents). The creation of producer groups with high sales volume requirements means these small MOs will be unable to get top level contracts for some products, and may be unable to even get the annuity. These distribution groups should encourage more small MOs to align with larger ones. The new Allianz model creates opportunities for growth for both Allianz and its competitors. For every agent or MO that joins *Allianz Preferred* others will forswear them and do more with carriers that don't do groups.

## Annuity News & Trends

### ING Adds Strategy For Rising Interest Rate Scenario

A new crediting method for existing index annuities is to be unveiled this month. The *Interest Rate Benchmark* measures positive changes in the well known London Interbank Offered Rate LIBOR benchmark rate and applies a Multiplier. For example, if the interest rate benchmark number increased 1.5%, and the Multiplier was 4, the interest earned would be 6%. The Multiplier and Interest Rate Benchmark Cap are denominated in U.S. Dollars, guaranteed for one year, and may change annually. The strategy benefits from a rising interest rate environment and is a welcome addition to the methodologies offered.

### PHL Variable Insurance

launched the *CommandMark* FIA (11LIA) marketed by Legacy Marketing Group. The annuity has a 10 yr surrender schedule with MVA. In addition to a fixed account it offers pt-to-pt with cap for S&P 500 and Gold, and pt-to-pt with a multiplier strategy that calculates changes in the U.S. 10-Year Swap Rate and multiples positive movements up to a cap. The product also offers bonuses that vest over time.

### It's 1950 For New York Life

with their retro Guaranteed Future Income Annuity. The annuity collects single or multiple year premiums and pays out a future life income.

The deferral period can be as short as 2 years or as long as 40 years. The annuity income may be for joint lives and include inflation protection.

My 1950 reference is not intended to be snarky, but a recognition that annuities are returning to their true purpose which is to provide a safe and predictable income. I expect to see clones of New York Life's new deferred income annuity in the days to come.

### PHL Variable Insurance

filed on 31 May Annuity 10FIA (SERFF Tr Num: TPCI-127185644). The [annuity] has a 9 yr (9,8,7,6,5,4,3,2,1) surrender schedule with MVA, minimum guarantee of 1% on 90% and an 8% premium bonus that vests at 10%/year over 10 years. The contract offers a fixed account and seven index options including a 1 yr pt-to-pt less spread times p-rate up to cap, a 1 yr averaging option, a trigger method, a 1 yr monthly cap, and a Rainbow method Rainbow offering S&P 500, Russell 2000 & Euro Stoxx or S&P 500, Russell 2000 & FTSE.

The annuity also offers three 5 year pt-to-pt options that average the last six months (PHL tries to be clever by calling averaging a "soft landing" approach which would only be true if the index was down at the end of the period). The [indexes] are S&P 500, S&P 500 plus DJIA plus FTSE, S&P 500 plus DJIA plus Euro Stoxx.

Although these are the indices mentioned, PHL had preserved flexibility by saying they could offer one or more of the following indices at a future date: Nikkei 225, iShares Barclays Aggregate Bond Fund, Barclays Capital U.S. Aggregate Bond Index, Hang Seng, S&P 400, iShares MSCI Hong Kong Index Fund, NYSE Arca Hong Kong 30.

The annuity riders include a GLWB and enhanced death benefit with a cost of 0.60% (maximum 3%).

### Interstate Compact to 41

Oregon has become the 41st member of the Interstate Insurance Product Regulation Commission joining the springtime Alabama and Nevada initiatives.

### FINRA Case #2007011393902

NFP Securities, Inc. was censured and fined \$50,000. The firm approved (and didn't keep a copy of) advertising materials a rep used in his retail equity-indexed annuity (EIA) business conducted at workshops for senior citizens that contained false, exaggerated, unwarranted or misleading statements. The firm did not supervise the representative's workshops, in that it did not require him to produce a copy of the script for the workshops and did not attend any of the live workshops to confirm that the contents of the workshops complied with NASD rules and that only firm-approved materials were being used.

## Annuities Are Not Illiquid

Annuity naysayers complain that deferred annuities are illiquid, but that's not what they mean, because the statement "annuities are illiquid" is always connected to a comment on annuity surrender charges. However, paying a fee to get liquid and illiquidity are not the same thing.

In most cases if I sell a share of stock I will incur a cost – a fee or commission – to get the cash value of that stock. Since there is a cost to get my money does that mean that stocks are illiquid? If the response is that stocks are liquid because paying a commission to sell the stock does not make them illiquid then the same logic applies to an annuity wherein paying a surrender charge also permits the annuityowner to receive their cash value.

To get the cash value from many securities, certificates of deposit and deferred annuities the owner will incur a cost, but that doesn't mean these are illiquid. It simply means that liquidity needs to be thought of as a financial expense, just like the paying of taxes on interest or gains, management fees or lost opportunity costs. When you look at liquidity from a cost viewpoint, it allows one to do a more rational comparison as to whether it is worth the cost. Here's what I mean:

As I write this there is a multiple year guaranteed annuity (MYGA) available paying 2.9% for 5 years. My credit union money market account pays 0.75%. The annuity surrender charge begins at 9% and drops 1% each year before ending after year five. The money market has no penalty. What this means is if I put \$100,000 into each and surrendered them in a month that liquidity cost of the annuity is \$9,000 more than the liquidity cost of the money market.

After 3 years the cost to cash in the annuity is down to \$6,537. However, because the annuity yield is 2.9% the annuity account value is \$108,955 while the money market value – assuming rates don't change – is \$102,267. After applying the surrender charge the annuity produces a check-in-hand of \$102,418. Even though the annuity "cost to get liquid" is \$6,537, due to the higher yield the annuity produces \$151 more in pocket (\$102,418 - \$102,267) after 3 years.

The surrender charge is always higher with the annuity, but when you look at what really counts – what winds up in the consumer's wallet – the 5-year annuity beats the money market after only 3 years. Although the annuity has a 5 year penalty the "liquidity cost" of buying the annuity turns into a gain after 3 years if the alternative was the money market account. Indeed, by the end of the third year the no surrender penalty money market incurs the liquidity cost because the consumer would realize more cash-in-hand with the annuity.

Since liquidity is now framed as a cost it can be analyzed in that context...

- Is the cost likely to be incurred? – a cost not incurred is not a cost.
- Are there tax savings from annuity tax deferral (or from the penalty itself) that might offset part of the cost? – although the dollar benefits of tax deferral are more apparent as time passes and yields increase, the mental relief from knowing you won't get a Form 1099 next year on the interest compounding inside the annuity may be a benefit. Also, a surrender charge that eats into principal might be taken as an itemized miscellaneous deduction on the annuityowner's Form 1040<sup>1</sup>.
- Is the possible maximum annuity liquidity cost of \$9,100 offset by the fact that it effectively drops to \$0 in 3 years, and results in \$11,559 more interest in 5 years (\$115,366 vs \$103,807 cash value)?

Viewed in this cost/benefit manner the emotional words of "illiquidity" and "surrender charges" are removed and the decision can be made looking at the financial considerations.



Liquidity costs are always comparisons, so the nature of the cost/benefits change as the alternatives change. If instead of a MYGA the decision was between the money market and an index annuity with a 10 year surrender schedule that began at 12%, you would still consider the odds of getting hit with a \$12,000 liquidity cost for an early surrender, and the effects of tax deferral over time, but now the decision would focus more on the heightened return potential of the annuity versus the money market.

If the choice was the index annuity or a 5-year CD with a 2% rate the decision elements are similar, but the initial liquidity cost difference would now be 10% (12% penalty for the annuity minus the 2% surrender penalty for the CD). If the other choice was a mutual fund the decision element would now be between a known maximum liquidity cost of 12% for the annuity (assuming no market value adjustment) and an unknown liquidity cost for the fund that ranges from zero to 100%. Now the fund has the greater potential liquidity cost and the question would be does the return potential of the mutual fund offset the greater certainty of the index annuity.

This does not mean you should say that a deferred annuity is liquid because “readily convertible into cash” is a definition open to interpretation, but you can say that a deferred annuity is not illiquid since the cash value is available upon paying a liquidity cost. And many financial instruments charge a liquidity cost of one type of another.

1. Marrion & Olsen. 2011. *Index Annuities: A Suitable Approach*. p. 205

Index Annuity Cost	Alternative	Why Choose The Index Annuity
<i>Surrender Charge</i>	MYGA	Higher Potential Returns
	CDs	Tax deferral, higher potential returns
	Bonds	Tax deferral, higher potential returns, principal value protected from interest rate risk, compounding of interest earned.
	Mutual Funds	Tax Deferral contrasted with securities taxes, principal and realized returns protected from market risk, lower liquidity cost hazard

## Life Expectancy

Age	A.D. 225	A.D. 2007
0	30	78
20	27	59
25	25	54
30	22	49
35	20	45
40	19	40
45	14	35
50	9	31
55	7	27
60	5	23

Life expectancies of today are based on analyzing the death patterns of millions. Domitius Ulpianus of Rome created a life expectancy chart that was mostly guesswork, but did reflect the observations of his time. Unfortunately, Ulpianus did not enjoy his full life expectancy as he was murdered at age 58 by his soldiers after cutting back on their job benefits.

Source: Kopf, Edwin William. 1927. *The Early History Of The Annuity*. The Table Of Ulpian, A.D. 225

Source: U.S. National Center for Health Statistics. Table 105. *Expectation of Life and Expected Deaths, by Race, Sex, and Age: 2007*

## Returns (Year Ending 31 July)

### Range of 1st Year Index Annuity S&P 500 Linked Returns

Annual Point-to-Point	3.00% - 8.45%	S&P 500	17.31%
Trigger Method	4.05% - 5.60%	Dow Jones Industrial Average	16.03%
Monthly or Daily Average	3.00% - 10.27%	Russell 2000	22.45%
Monthly Cap Gain-Not Loss	0% - 9.00%	Nasdaq	22.25%
Fixed Account	1.45% - 4.45%	One Year Certificate of Deposit	0.67%

Data Source: Advantage Compendium, bankrate.com No index sponsors or endorses any index product

## Range Of 1st Year Real World Index Annuity Returns

This chart shows the range of actual first year index annuity returns for 12 month periods ending at the end of each month for the first half of 2011. The results include almost every index annuity on the market in the first half of 2010.

Looking at January, the worst annual pt-to-pt annuity (blue) returned 3%, the best 12.4% for the year, and all of the other annual pt-to-pt product returns were in between. Monthly cap (green) returns ranged from 0% to 9.8% depending on the product. Top averaging returns were generally uncapped.

Range of Returns By Crediting Method

