

THE “GUARANTEED” VARIABLE ANNUITY (Part 2)

Last month I explained in general terms how guaranteed variable annuities (GVA) operate and some of their positive and negative features. This month I want to expand on some of the challenges users of these products might face over the coming years and how it could especially impact those who use them with an “*I can’t lose*” belief.

Let’s first begin by reviewing the concept of trust. Most investors are familiar with a mutual fund which is a type of trust where multiple investors buy shares of ownership and a manager is paid a fee to make investment decisions for the money based on specific criteria. In essence the investor is putting their *trust* in the manager’s ability to earn returns for the investors benefit over time.

When investing money into an annuity you are also putting your *trust* into the insurance company and their financial management. Most investors rarely think of this aspect of the investment. What they know is that after the money is invested in the annuity they work with their financial advisor or insurance agent to make investment decisions with the money they invested in various mutual funds available within the annuity (in essence, *trusts* within a *trust*). But what they don’t recognize is how much *trust* they are inherently placing in the long-term, and hopefully successful, financial management of the insurance company.

A typical annuity investor is someone who does not want to bear the risk of running out of money during their lifetime so they choose to delegate that risk in exchange for a fee to someone else – in this case the insurance company. What the insurance company does is set aside some of the fee proceeds to pay current and future claims but use the remainder to invest and speculate in the hopes of earning returns for themselves. They expect that over time they will be able to pay out all claims for all annuitants (i.e. other investors in annuities making claims) through the fees they charge and the earnings they make on their investments.

Until recently the primary investment they used to offset future obligations were “safe” long-term U.S. Government and corporate bonds. In

addition they also used other “risky” investments such as stocks, commodities, and real estate. Historically the bonds could be counted on to provide annual returns in the 5%+ range. So if the insurance company assumes they need an 8% annual return to meet their future obligations this left the difference of 3%, or 37.5% of the needed return, to be achieved by using “risky” investments. A significant challenge to all investors is the current low interest rate environment. At the time of this writing the long-term U.S. Government bond yield is 2.9%. If the insurance company continues to assume they need an 8% annual return to meet their future obligations then 5%, or 62.5% of the needed return, must be generated from “risky” investments. So to think of it in another way *the insurance company is forced to take more risk to provide future benefits for the annuity investor at a time when the annuity investor wants to reduce their risk. And this is also occurring in an environment that has not necessarily reward risky investments.* And due to the likelihood of rising future interest rates and negative compounding (*more on this next month*) the insurance company could be hard pressed to pay out its future promised obligations.

Referring back to last month’s article for a minute I provided an example of an investor who made an initial “actual” investment of \$250,000 that turned into \$350,000 ten years later. Based on the guarantee from the insurance company they can begin drawing payments based on their “phantom” bucket value of \$500,000. BUT the actual cash payments come from the actual investment value in the investors investment account. So in this example, if the investor withdrew \$25,000 the first year (a 5% withdrawal), holding all else equal their actual cash bucket would be reduced from \$350,000 to \$325,000. ***It is imperative to comprehend that the only time the insurance company pays out a single dime is after you have exhausted your own money invested in the annuity.*** Only then will they begin making payments based on the “guarantee.” So referring back to my earlier comment in this article do you now see why it is imperative to be aware of the *trust* you are inherently placing in the long-term

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success of the financial investment decision making of the insurance company? Like all insurance you hope you never need it but it is likely those “guaranteed” payments may only come into play well into the future at a time when you no longer have the luxury of making other choices.

It is my objective to make sure all aspects of an investment product are comprehended before considering it for a solution for my clients. I hope these two articles provide you with a good foundation to assist you if you are considering investing in a GVA. A GVA can be a useful tool in your arsenal to plan for your future *but it is imperative you don't swing for the fences*. An investor in one of these products may find they need to rely on more of their actual investment account value in the future and less on the marketed guarantee.



Jeffrey D. LINK

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