

The TAMRIS Consultancy

Variable Annuities + GMWBs A Review of Sequence of Return Arguments

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1 A review of “sequence of returns” arguments

This report looks at the modelling of sequence of return risk within the context of Variable Annuities with GMWB riders and alternative lower and higher cost portfolio structures.

The modelling concludes, based on the sequence of returns data used, that sequence of returns risk is not a risk to the ability of a lower cost, well structured and managed portfolio to meet financial withdrawals over time with sequence of return data sets used by product providers.

Indeed, the high costs and naïve systematic withdrawals of VAs + GMWBs specifically expose them to such risk. The report supports an argument that VAs + GMWBs are only competitive when we look at simple naïve high cost withdrawal strategies.¹

While a VA + GMWB provides a lifetime guaranteed income withdrawal - this is only once a portfolio is fully depleted - and takes away the risk of running out of capital, *investors who use such products assume other risks*: these risks include reduced certainty of income and capital security, a higher level of inflationary risk and reduced flexibility to adjust the relationship between asset allocation and financial needs over time².

If these products are to be safely sold, the risk assessment and product sales process will need to include a fair assessment of the exchange of risks and returns that are taking place. The ability to do so will be influenced by the degree of impartiality that an advisor has with respect to the sale and the range of portfolio options an advisor is able to provide; advisors that rely on this product as their main lifecycle wealth management tool will be unlikely to provide their clients with the necessary perspective and investors would do best to look to advisors who have strong structured investment processes that cater to a wide range of risk aversions.

As for those who provide these products, the naïve systematic withdrawal policy followed and the high cost equity allocations allowed for, increase the costs of insuring the product and the risks to the provider of having to meet the income guarantee at a future point in time.

2 Life cycle wealth management

Lifecycle wealth management is about the management of assets to meet financial needs over time while managing the risks to the ability of those assets to meet those needs.

While this means optimising the balance of the portfolio between short and long term assets to meet short and long term financial needs, it also means selecting a withdrawal rate (that may also necessarily vary over time), that can be safely maintained through periods of significant market and economic risk, and a structure capable of providing the necessary income and capital security to meet financial needs during risk events³.

Managing short and long term needs also means protecting the purchasing power of planned income and capital withdrawals, which, means that income and capital withdrawals today need to be set at a level capable of providing inflation protection over time. This is contrary to GMWBs, which, because of their high costs and limited structural flexibility, risk setting withdrawals at too high an initial level and of limiting the potential for long term inflationary increases.

A structure that can manage risk and return, while providing the necessary flexibility to meet the changing demands of individuals as they move from pre to post retirement and within retirement to stages of advanced capital depletion is critical.

¹ Where an advisor will construct a portfolio of MER mutual or segregated funds or other securities/products and follows a systematic withdrawal policy which does not differentiate between bonds or equities during rising and falling markets.

² Obviously, if these risks have not been communicated at the point of sale, the true nature of the product's risk and return profile over time has not been communicated and hence the contractual relationship underpinning the transaction is compromised.

³ This can only be achieved by complex integrated asset and liability modelling.

Managing short term risks to financial security does not mean exposing a portfolio to risk by blindly taking a fixed withdrawal (as with a VA + GMWB), nor should it constrain the ability of a portfolio to provide the long term returns necessary to meet future financial security (as with a VA + GMWB).