MOON CAPITAL MANAGEMENT

A Look at Variable Annuities

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Abstract

In 2018, investors purchased $92.9 billion of variable annuities, 65 percent of that within tax deferred accounts. Many of those investors were sold promises of safety, simplicity and tax benefits that (at best) were misunderstood and (at worst) were misrepresented. The exorbitant fees associated with annuities are well-known, but the pitfalls only begin there. Despite promises of favorable tax treatment, variable annuities can essentially convert tax-advantaged capital gains into ordinary income, while also depriving investors valuable estate tax planning benefits. Products with "guarantees" linked to the performance of equity indexes are needlessly complex and almost always structured in a way that actual investment returns fall far short of the index on which they are based. Surrender charges lasting the better part of a decade effectively keep investors' money locked up until the annual fees more than fund advisers' front-end commissions. The variable annuity industry is perennially one of the most common areas of reported adviser misconduct.

If there was any doubt that the variable annuity industry is designed to benefit advisers rather than clients, it was removed in 2014 when it appeared that advisers to IRAs and other tax deferred accounts were about to be legally required to act in their clients' best interests. The industry's own actions offered clear evidence that it believes variable annuities are generally not in investors' best interests.

Disdain for variable annuities is widespread among most of the investment industry, including many financial planners, money managers, registered investment advisers, journalists and even regulators – almost everyone except the people who sell them.

Tax promises and tax traps

"I think variable annuities were created for one reason only: to make the financial adviser selling you those variable annuities money."

- Suze Orman

Despite their reputation as tax-advantaged vehicles, variable annuities can turn tax-advantaged capital gains into higher-taxed ordinary income. Annuities also lose the benefit of one very common estate planning tax benefit: a step up in basis for inherited assets.

Investors are often swayed by the promises of tax deferral on their variable annuity investment – a promise that makes no sense when purchased in any type of retirement account. Gains within a retirement account are already tax-deferred, so the added expense of the insurance wrapper that magically creates tax deferral within an annuity is both redundant and worthless.

When owned within a tax-deferred account, the tax benefits of a variable annuity are redundant and unnecessary.

When purchased outside of a retirement plan – that is, with after-tax money – an annuity owner does not pay taxes on annual increases in his contract value; those gains accrue tax deferred. That sounds pretty attractive, assuming you can overlook the 2 percent to 3 percent in annual expenses you are paying within the annuity.

When owned outside of a tax-deferred account, variable annuities can turn capital gains into ordinary income.

However, that nifty tax deferral provides a nasty surprise when an annuity owner begins to finally withdraw money from his supposed tax-advantaged investment. All of the gains withdrawn from the annuity are taxed as ordinary income, even though the investments in the sub accounts are likely to have generated those investment earnings via capital gains. That is, while the investment sub-accounts generate capital gains, the magic of the annuity insurance wrapper causes withdrawals made from those gains to be taxed at higher, ordinary tax rates.

Loss of basis step-up

When an annuity owner dies, variable annuities are treated much differently than most other asset types.

Under current law, when someone bequeaths an asset, the recipient of the inheritance gets to establish a new cost basis in the asset – generally, the

value of the asset at the date of the owner's death. This "step up in basis" allows both the original owner and his heir to avoid paying taxes on all of the appreciation in the asset from the date of purchase until the owner's date of death. If you inherit some Apple stock that your grandmother purchased in 1980 for $22 a share, not only does she avoid paying capital gains taxes on her 900 percent gain, but so do you. Your cost basis becomes the value of the stock on her date of death (or 6 months following) allowing you to also avoid paying tax on 40 years' worth of gains.

Gains withdrawn from a variable annuity are taxed as ordinary income, even though the investments in the sub-accounts are likely to have generated those investment earnings via capital gains.

This step up in basis provision is available to almost every type of asset – but not an annuity.

When someone other than a spouse inherits an annuity, the beneficiary's cost basis in the asset is the same as was the purchaser's. That is, any capital appreciation between the date of the annuity's purchase and date of the purchaser's death carries forward to the beneficiary.

This is doubly punitive to the beneficiary. Not only does losing the step-up in basis cause the beneficiary to inherit an unrealized capital gain, those capital gains will be eventually taxed as ordinary income when the beneficiary begins to withdraw money from the annuity. After possibly decades of paying exorbitant fees in order to enjoy "tax deferral," this tax trap is an especially cruel irony.

A beneficiary does not receive a step-up in basis when inheriting a variable annuity.

Costs and flexibility

Commissions on variable annuities typically range from 6 percent to 10 percent, explaining one reason these products are popular with salesmen. (We struggle to identify any additional reasons.) While the receipt of a sale commission is not evil, it is naïve to ignore the source of the commission: the investor. If a salesman receives a $7,000 payment for the

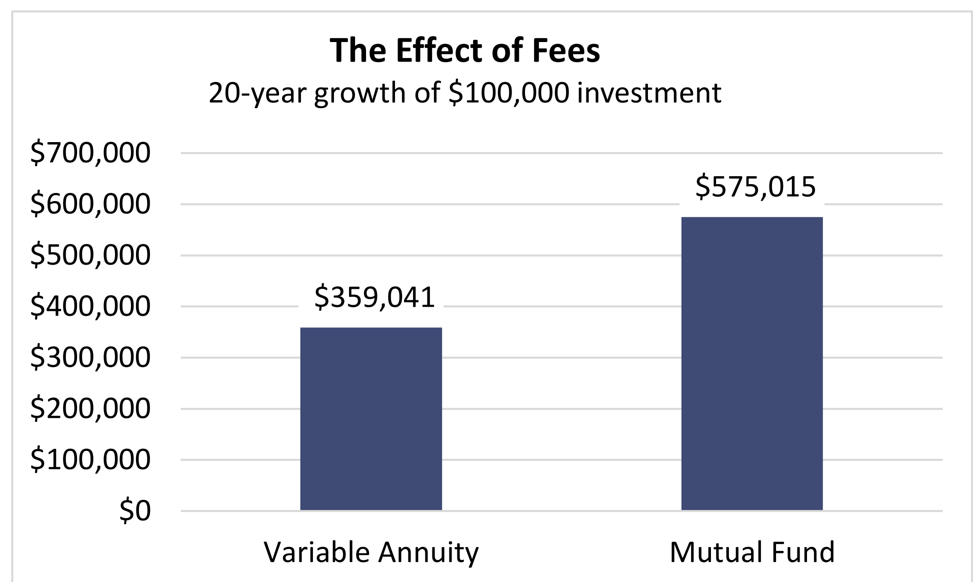
sale of a $100,000 annuity, it won't take long for the annuity company to earn back that commission if the annual expenses are 3 percent.

This assumes that an investor doesn't change his mind and wants to sell or liquidate a newly purchased annuity. To be protected against an investor surrendering his annuity before the company has earned enough to pay the broker's commission, variable annuities typically impose a surrender fee.

The average annual expense for a variable annuity is 3.4%, compared to 0.86% for the average large-cap stock mutual fund.

Surrender fees vary among insurance companies. An annuity surrender fee could be as much as 10 percent of the amount invested into the annuity within the first year it is effective. For each successive year of the contract, the surrender fee might drop by 1 percent. Thus, an investor might effectively have the option of no-penalty withdrawals 10 years after the contract was signed.

Fees can easily erode up to half of the underlying investment return of a variable annuity.



Assuming the underlying investments in a variable annuity and a mutual fund account each earn 10% annually, the average variable annuity fee reduces the 20-year return by almost $216,000.

Assume that an annuity purchaser allocates his assets equally between stocks and bonds. Over the long-term, such a broadly diversified portfolio might be expected to return 6.25 percent annually (this is the blended return assuming that the annual return on stocks is 10 percent and on bonds is 2.5 percent annually.) If the underlying investments within a variable annuity earn 6.25 percent, the average annual annuity fee of 3.4 percent erodes more than half of the annuity's average annual investment return. Even if an annuity owner selects all stock sub-accounts and earns an annual pre-fee return of 10 percent, the net investment return of the average annuity drops to only 6.6 percent.

Annuity contracts are intentionally over-complex. There is a reason for that – and it's not because insurance companies are trying to help you.

Complexity – why?

On the surface, variable annuities seem to be fairly straightforward and self-explanatory. Their sales materials explain very attractive features, with a precision that is simple, legally accurate - but almost always misleading. The materials always include footnotes warning an investor to carefully review the actual annuity contract, but unless you're a securities lawyer with a lot of time on your hands, trying to fully understand an annuity contract is likely overwhelming.

The complexity of these products creates opportunities for annuity companies to define terms in such a way that a reasonable person would be excused for misunderstanding how these products actually work. (A skeptic might suggest this is not an accident – that annuity companies depend on reasonable persons not understanding the details of these products. Include us in that group of skeptics.)

According to court documents, one company intentionally defined the terms of its indexed annuities so they would produce near-zero investment returns.

A salesman may tell you that when the stock market increases, his equity index-linked variable annuity is guaranteed to earn stock market returns, but when the stock market declines, your losses are capped at 5 percent. Or maybe he tells you that your losses are capped at zero. But all of that depends on the definitions of "stock market," "losses," "capped," "stock

market returns" and "guarantee." While those common phrases have very commonly accepted definitions in everyday usage, the definition of just a single term can easily depend on the definition of three or four additional terms, each of which is defined on a different page within a 92-page document.

"Annuities continue to get more complex, and the risks in selling them to senior investors remain substantial."

- Former FINRA Chairman Richard Ketchum

The following paragraph is an example. It's actually a very simple example. Don't be embarrassed if you need to read it a couple of times.

Complexity – a simple example

Index-linked variable annuities typically have something called an Index Return. Despite the obvious assumption, because of contract adjustments, an Index Return is not the same as the S&P 500 return, even if an annuity's marketing materials prominently feature phrases such as "S&P 500 based returns." Then there is a Participation Rate, or the percentage of the Index Return that is credited to the annuity Contract Value. The Cap Rate is the maximum annual investment increase in the Contract Value. And then there are expenses. There are always expenses.

Assume the total return of the S&P 500 is 20% in a year. The Index Return for the annuity is defined as an arithmetic average of the monthly change in the S&P 500, excluding dividends, producing an Index Return of 17.5%. If the annuity's Participation Rate is 90%, you might expect your Contract Value would be credited with a 15.75% return, or 90% of the 17.5% Index Return. But if the annuity also has a Cap Rate of 10%, the maximum investment return credited to the annuity in any year is limited to 10%. Once expenses of 2 or 3% are deducted, the owner of this equity index-linked annuity could earn as little as 7% in a year that the S&P 500 returns 20%.

To add further confusion, many annuity companies now create their own proprietary indexes to use with their annuity contracts. These non-standard, novel indexes always show outstanding hypothetical results,

which don’t always occur in real life. According to a January 2020 class action, annuity promoter, Security Benefits, intentionally defined the terms of its indexed annuity so that it would purposefully produce near-zero returns. One investor described in the suit earned exactly 0 percent in the same five-year period that Security Benefits’ sales material touted a five-year “index return” of nearly 39 percent.

> "Why are there so many problems with these things? Because the people who sell them don't understand what they are selling."
>
> -Michael Fein, president of CIC Wealth Management

These (and many other) interdependent, defined terms create a real-life complexity that makes understanding most variable annuities a nightmare. While the sales pitch is always simple, the actual performance of an annuity is never that straightforward.

Even the Securities and Exchange Commission (SEC) has warned about the complexity of these instruments. Norm Champ, director of the SEC’s Division of Investment Management, noted “it is a challenge to accurately describe the complex features of these variable annuity contracts.” Much of this complexity is unneeded – except that it allows an otherwise moderately straightforward contract to obfuscate expenses, definitions, terms and the likely outcome an investor will experience.

Fiduciary threat reveals problems

For decades, a recommendation to purchase an annuity has been specifically excluded from the legal definition of providing investment advice, relieving annuity salesmen from the obligation to register as investment advisers. This is significant, because Securities and Exchange Commission Registered Investment Advisers are legal fiduciaries and, as such, are required to make recommendations that are in their clients’ best interests. Non-adviser salesmen are not fiduciaries, so the products they recommend do not have to be in their clients’ best interests; they need only be suitable. This regulatory loophole protects the product salesman from liability when he recommends a product with a 5 percent fee when

he could have recommended an otherwise identical product that has only a 4 percent fee, or perhaps no fee at all.

Various regulatory bodies have debated the fiduciary vs. suitability standards ad nauseam, with the brokerage industry spending millions to lobby Congress and the SEC to continue an explicit salesman exemption from registering as a fiduciary adviser. That is, an adviser isn't really an investment adviser if he is selling a product; the SEC says that any advice a salesman might provide is simply "incidental to the sales process," thereby allowing the *non-adviser adviser* to place his interests above those of his customer.

"Brokers will stand up in front of a room and sell what they tell people are tax free, high income, you-can't-lose-your-money investments ... That's the shtick."

-Attorney Diane Nygaard

That appeared to be about to change in 2014, when then-President Obama directed the Department of Labor (DOL) to update its regulations, requiring all retirement advisers to put the interest of their clients above their own financial interests. "If you want to give financial advice, you've got to put your client's interests first," Obama explained. The new DOL rules would only apply to people providing service or offering advice to pools of money that fall under DOL jurisdiction. This would include 401(k)s and IRAs. The new regs would require that anyone selling products to retirement accounts must act in the account holder's best interest – not merely offer recommendations that were suitable.

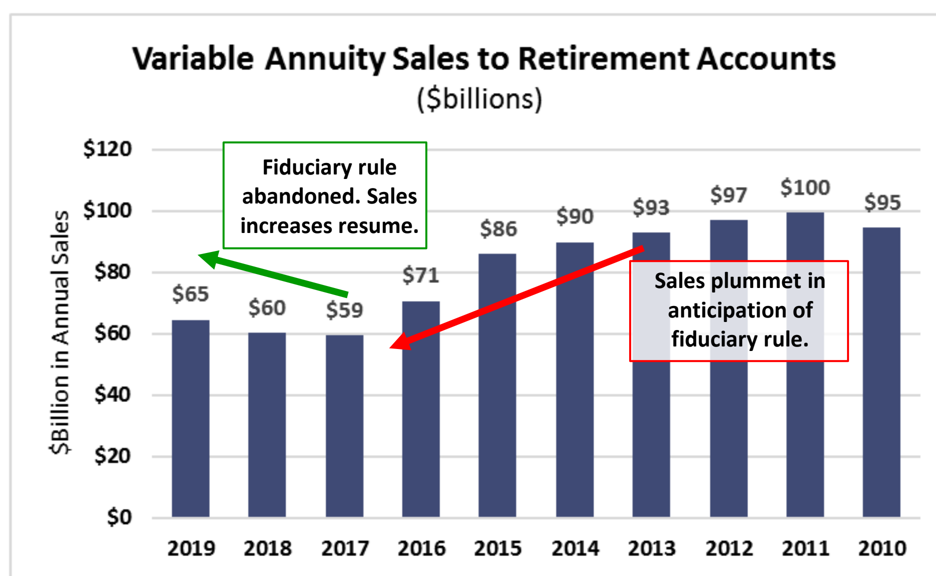
Despite the intense pressure from the U.S. Chamber of Commerce and almost every Wall Street firm, the DOL approved the new rules, setting an effective date of April 10, 2017.

Even before the new rules took effect, sales of variable annuities began to plummet – but only to IRAs and other account types under DOL jurisdiction. That is, as soon as it became apparent that the insurance industry would have to act in the best interests of its retirement plan clients, sales of variable annuities to those accounts began to drop, even

before the regulations ever took effect. From 2014 until the second quarter of 2018, variable annuity sales to retirement accounts declined 17 consecutive quarters.

Variable annuity sales to IRAs plummeted when the industry thought it would be required to act in clients' best interest.

What happened in the second quarter of 2018 that might have reversed this trend? The DOL announced it had changed its mind. It would not be implementing the fiduciary standard. Brokers were free to resume selling products to IRAs that months earlier, the entire industry tacitly admitted were not in customers' interests.



As soon as the DOL abandoned its best interest regulations, variable annuity sales to IRAs began increasing again.

How do we know that the annuity industry admitted that variable annuities are not investors' best interests? Wells Fargo provided a perfect example. In preparation for the DOL fiduciary requirement, Well Fargo Advisors implemented a new policy prohibiting its brokers from selling its most expensive products to retirement accounts but continued to allow their sale to non-retirement accounts. That is, Wells Fargo tacitly admitted that it

would act in its customers' best interests only when legally compelled to do so.

Ignoring the reversal in the regulatory environment, annuity industry executives had another explanation for the increase in annuity sales to retirement plans. Insured Retirement Institute CEO Wayne Chopus wants you to believe that consumers experienced a spontaneous epiphany of the virtue of annuities. "Annuity sales appear to be on the upswing, driven by consumer need and a growing awareness of the importance of allocating a portion of retirement savings to annuity products."

> Variable annuities are one of the investment industry's top products for customer complaints.
>
> - Carlo di Florio, former FINRA official

We're sure that it's just a coincidence that this growing consumer awareness just happened to coincide with the DOL's abandonment of the fiduciary requirement regulations.

Annuity friends in Washington

Annuity companies operate within an accommodating legislative and regulatory environment that routinely shifts further in favor of insurance companies – and to the detriment of individual investors. The DOL reversal on a fiduciary standard is just part of a long history of cozy relationships among regulators, legislators and the annuity industry. Congress has been a dependable, longstanding protector of the annuity industry, to the detriment of both small and large investors.

> The DOL reversal on a fiduciary requirement is part of a long history of cozy relationships among regulators, legislators and the annuity industry.

Technically, a variable annuity is an insurance product, not an investment security. The bulk of annuity purchasers' payments are allocated to sub-accounts that look very much like mutual funds. A small portion of those premiums, however, fund the purchase of smaller life insurance wrappers – thereby subjecting the entire variable annuity investment to regulation as an insurance policy, not an investment security.

This regulatory difference is significant. The SEC regulates the structure and sale of securities in a uniform manner at the federal level. Insurance products are generally regulated at the state level, where regulator competence varies widely and, in many states, is not especially sophisticated. For example, the current (February 2020) head of the Securities and Exchange Commission, Robert Jackson, came to the SEC from the NYU School of Law, following a long stint as the Director of Columbia Law School Corporate Law and Policy program. By comparison, immediately prior to being named head of the Tennessee Department of Commerce and Insurance, Hodgen Mainda, was vice president of community engagement for the Electric Power Board of Chattanooga.

By avoiding classification as "securities," annuity sales are regulated at the state level, where competence widely varies.

Following the financial meltdown of 2007-08, regulators appeared poised to make a small step in correcting this dangerous regulatory anomaly. In 2009, the SEC issued a rule that would have treated one type of variable annuity (index-linked annuities) as a security, requiring the same disclosures and other regulatory protections required of mutual funds. It was a small win for individual investors. It was also short-lived. Less than a year later, the Dodd-Frank Wall Street Reform and Consumer Protection Act explicitly reversed the SEC's attempt at federal regulation of indexed annuities, returning regulation of these types of variable annuities to 50 different state agencies.

More recently, tucked in the 2020 spending package Congress approved in December 2019 was the Setting Every Community Up for Retirement Enhancement Act, giving rise to the laughingly inappropriate acronym SECURE Act. The act provides security for the insurance and annuity industry, not individuals. In the act, Congress not only provides protection for advisers who sell annuities to retirement plans, there are specific provisions that actually promote the use of annuities within those plans. That is, Congress specifically protects advisers who recommend and sell a

product that only three years ago, by its own actions, the annuity industry admitted were not in investors' interests.

Susan Neely was quick to respond. "We applaud House and Senate leadership for their determination to pass [the SECURE Act] … addressing critical needs of everyday Americans." Ms. Neely is the CEO of the American Council of Life Insurers, the country's largest annuity industry lobbying group. In a political environment in which there is essentially no bi-partisan agreement on anything, the SECURE Act passed the House by a vote of 417-3. Draw your own conclusions.

Conclusion

Despite their attractive marketing pitches, the details of the annuity industry and most variable annuities reveal a number of very specific problems that, when considered in total, create a very tiny appropriate target market for these products – if any at all.

J.D. Power found overall satisfaction for annuity providers was essentially equal to car salesmen, the airline industry and Comcast.

Variable annuities are illiquid, needlessly complex and punitively expensive. Although they are sold as tax-advantaged vehicles, when purchased with after-tax dollars they cause capital gains to eventually be taxed at the higher rates of ordinary income. And when purchased within a tax-deferred account (such as an IRA), an investor is needlessly paying higher expenses for a redundant tax deferral benefit.

Unlike almost every other type of asset, when someone inherits an annuity, he does not receive a step-up in cost basis. This eliminates one area of complete tax avoidance still available to investors: avoiding capital gains taxes at death.

The annuity industry has an extremely effective lobby in Washington. For legal purposes, variable annuities are not regulated as securities and the advisers who sell them are not are not regulated as investment advisers. Beginning in 2020, expect an annuity "sales pitch" to be included with your 401(k) annual report. The insurance industry succeeded in having this requirement codified by Congress in 2019.

The most effective argument against variable annuities comes from the people who sell them. When faced with the prospect of a legal requirement to act in the best interests of their retirement plan clients, annuity sales to retirement plans quickly declined. As soon as implementation of the requirement was cancelled, advisers immediately returned to selling variable annuities to retirement plans, despite tacitly admitting that the products were not in their clients' best interests.

About Moon Capital Management

Since 1995, Moon Capital Management has helped individuals, families and institutions meet their financial goals by providing a full range of investment management and planning services. Whether it's investing a single IRA, managing an endowment fund or providing comprehensive planning for a family's current and future financial needs, we help people achieve peace of mind through the effective investment of their assets.

> "Sound investing can make you very wealthy if you aren't in too big of a hurry. And it never makes you poor, which is better."
>
> - Benjamin Graham

We take our commitment to being fiduciaries at least one step further than most advisers: when we purchase shares of a stock for our clients, we purchase the same stock for ourselves - at the same time and at the same price. We eat our own cooking.

We sell no products and receive no commissions. We always use a third-party custodian for client accounts, providing an important check and balance on the safekeeping of our clients' assets.

Our value approach to research and investing had its genesis in the 1920s with the work of Benjamin Graham, co-author of the bible of fundamental investment research, "Security Analysis." Graham describes a successful investment as one "which upon thorough analysis promises safety of principal and an adequate return. Operations not meeting these requirements are speculative."

Like Graham, we always are concerned about having a margin of safety in every investment.

For more information about Moon Capital Management, visit www.mooncap.com, email us at info@mooncap.com or call us at (865) 546-1234.

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With special thanks to Grace Yagodich.

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