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BEWARE THE GREAT GMWB SCHEME

William Solomon / May 17, 2011

Guaranteed Minimum Withdrawal Benefits (GMWBs) can look good on the surface — income for life! Your clients will never outlive their money, guaranteed — no matter what happens to their investments or how long they live. That's quite a promise. And the illustration that accompanies the sales pitch convinces them that total financial ruin is just around the corner.

But if you look beyond the fear mongering perpetrated by the Canadian insurance industry (and at least one of the major chartered banks), you'll discover the implied promise is expensive, and, in many instances, of little value.

What's the guarantee?

It's important to understand the nature of the guarantee included in the current GMWB offerings. For an annual fee, which ranges from 0.4% to almost 1% (depending on the company and asset class being insured), the insurance company will guarantee a fixed annual percentage payout, usually around 4.5% to 5% of the initial investment, depending on the age at which payments commence.

This fee would be in addition to the base fee of the underlying investment, which itself could be 2.25% to 3% per annum.

This annual payout may increase, but will never decrease, regardless of future investment returns on the underlying assets or your client's longevity. Sounds great, until you analyze the guarantee, how it's structured and the magnitude of the premium your client must pay.

No funds will be received from the insurance company until the investment account is completely exhausted, which may be many years in the future — if at all.

For example, if investment returns exceed 5% per annum (i.e. sufficient to cover the annual payout), no insurance payment will be made to the client. In fact, returns can be as low as 0% per annum, and if the policyholder dies before the end of the twentieth year, no insurance is provided either (5% x 20 years). Until the fund is reduced to zero, the fund is still able to pay all the annual payments. However, the client must pay the premium every year as long as the plan is in force.

The guarantee in the GMWB applies to two mutually exclusive contingent events: investment rate of return and life expectancy.

Only when rates of return are low (something less than 3% per annum) and life expectancy is long (over 25 years after age 65) does the guarantee have any value to the purchaser. In all other instances — higher rates of return or shorter lifetime of the annuitant — the guarantee is of no value whatsoever. With higher rates of return, the investments generate sufficient income to meet the annual payout requirements. Persons with shorter lifetimes will die before the fund is exhausted.

It should be noted that life expectancy for males and females at age 65 is 18 and 21 years, respectively. As mentioned earlier, even an annual return of 0% every year for 20 years wouldn't require an insurance payout should death occur before age 85.

Realistic returns

Furthermore, since 1960, when data was first collected, there has never been a 10-year period when rates of return on balanced pension funds have been below 5% per annum. That includes the most recent 10 years, ending December 31, 2010. In fact, there has never been a five-year time period that experienced negative returns.
Should the rates of return shown in the charts accompanying Mr. Callahan's article (see below) come to fruition, there is likely to be a much more serious problem: the survival of the insurance company that issued the GMWB.

AGE	ANNUAL RETURN
50	Initial Investment
51	-7%
52	+3%
53	-19%
54	-4%
55	+9%
56	-31%
57	-6%
58	+5%

Could any insurance company survive a 10-year period with an annual compound rate of return of -7%, as indicated in the illustration? Assets would lose 50% of their value in less than 10 years. Unless the government bails them out, many Canadian insurance companies would go the way of Confederation Life under this investment scenario.

The illustration included rates of return that have no basis in historical fact. Yet people often make investment decisions based on such illustrations. Each year, the Canadian Institute of Actuaries compiles the "Report on Canadian Economic Statistics," which covers data back to 1924. The report includes data on the rate of return of Canadian pension plans, with data from 1960. This data is used as a proxy for the rate of return that might have been earned by balanced mutual funds. The lowest median rate of return earned by Canadian pension funds occurred two years ago in 2008 when a rate of return of -15.9% was recorded. The previous low return was in 1974, when the median balanced fund earned a rate of return of -12.7%. The only instance of two consecutive negative years was in 1973 and 1974, when a return of -2.1% preceded the -12.7% loss in 1974.

It is, in my opinion, disingenuous and misleading to show investment scenarios of the sort included in Mr. Callahan's article. The chart "GMWBs revisited" provides a more plausible illustration. It begins with a negative return in the first year followed with a strong recovery, then an assumed rate of return (net) of 5% per annum for the next six years, then finally a 4% return until the fund is exhausted — when the annuitant is age 101.

AGE	ANNUAL	FUND, END OF	AMOUNT
65		$400,000	$20,000
66	-15%	320,000	20,000
67	+16	351,200	20,000
68	5	348,760	20,000
69	5	346,198	20,000
70	5	343,508	20,000
71	5	340,680	20,000
72	5	337,714	20,000
73	5	337,714	20,000
74 and on	4	334,600	20,000

In much of the marketing material used by insurance companies, illustrations are shown that are based on highly improbable events and returns. While anything is possible in the financial markets, the scenarios put forward in the marketing material are remote at best. For this reason, I believe GMWBs prey on the ignorance and fears of retirees.

The Bank of Montreal has also recently entered this market with a product that pays out 6% of the initial invested amount after a 10-year deferral period. Bank of Montreal guarantees this level of payment for life. For the first 15 years, payments are deemed to be a return of capital, and are received by the annuitant tax-free. Following the first 25 years (10-year deferral period and 15-year payout), all payments would be fully taxable.

Besides being an illiquid investment for 25 years, the product comes with an annual management fee of 2.75%, which is almost 2.0% higher than many similar mutual funds that don't offer a guarantee. The insurance industry has recently taken exception to a bank offering this product, claiming it to be an annuity, which is its exclusive domain.

So, what now?

What are the options available to retirees who are looking for a guaranteed or reliable source of income? The traditional annuity products are still available from the same insurance companies, but at today's historically low rates, they may not be an attractive choice.

Alternatively, many financial advisors recommend a high-income fund that consists of fixed-income securities — both government and corporate — as well as dividend-paying equities, income trusts and preferred shares.

The return from this type of investment, from both income and capital appreciation, is usually targeted to be about 5% to 6% per annum, or about the same as the payout from the GMWB, but without the guarantee. This type of financial product would also be available at a lower cost than those associated with GMWB products.

Limited data suggests people who purchase funds subject to a GMWB are less inclined to sell their holdings when returns are poor. This is in contrast with investors who are unwilling to hold on to their investments when markets are in decline. To that extent, the benefit is worthwhile, since it keeps people invested through market downturns.

For security-conscious individuals, GMWBs provide a means of obtaining lifetime income at a modest level with complete certainty — albeit at an expensive price. The added fee that's paid for the GMWB reduces the return to the investor and increases the likelihood that his or her return objectives won't be met.

My misgivings with GMWBs revolve around the high fee that's charged for the underlying guarantee, and the fact that it's a
fundamentally flawed product that exploits the fears of retirees by using misleading advertising illustrations. I would put GMWBs in the same class as other ill-conceived insurance products, like product insurance (the insurance they try to sell you when you buy an electronic gadget), accidental death and dismemberment insurance and critical illness insurance. Quite frankly, I recommend taking a pass on all these.

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