Episode 74: Variable Annuities and their practical considerations.

00:00
Bob French
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00:49
Alex Murguia
Hey, everyone. Welcome to retire with style. I'm Alex, and I'm here with Wade Pfau, and we're talking today about variable annuities, part two. We think this is actually a very good episode from a practical standpoint. We laid a lot of definitional items in the previous episode just to begin to level set what's going on in a world of variable annuities. But what we want to do here is how can we help make you an informed consumer? What are the questions you want to be thinking about with regards to all those definitions that we laid out? What do you think, Wade? Do we go for that? Does that make sense?

01:30
Wade Pfau
Yeah. And I also realized right after we finished the previous episode when were giving the cliffhanger for today, we still need to talk about variable annuity fees. So that's part of the episode, too.

01:40
Alex Murguia
All right.

01:41
Wade Pfau
We want to not going to leave that aside. That's definitely something we'll dig in.

01:47

Alex Murguia
And a question that I then to do that. One of the things I mentioned in the last episode that you gave me a bit of the heisman on you said, we don't got time for that is managing risk. How does the insurance manage this risk for the income guarantee?

02:05
Wade Pfau
The scenario here is I'm investing in these sub accounts. I'm motivated to take as risky of positions as I can when I have a guaranteed lifetime withdrawal benefit, because I know that if I get hit by risk and I deplete the account, the insurance company is on the hook to continue those payments. So that is a significant risk the insurance company is taking. And so we're just framing, well, how do they go about managing that? Exactly.

02:33
Alex Murguia
And remember, to our listening audience, the sub accounts are ultimately mutual funds, right. That you get like a cafeteria option of things to pick and off you go.

02:47
Wade Pfau
Yes. And so you're motivated to invest as aggressively as you can because the living benefit, it's like a putt option on the stock market, which just means even if the stock market goes down or if the stock market goes down, you get paid for it. You continue to receive these distributions no matter what happens with the markets. It's not that you want the stock market to go down, but if it does go down, it's not going to disrupt your ability to meet the spending that you had earmarked as coming from this contract over a lifetime basis. Okay, so there's multiple ways that an insurance company can manage risks for the income guarantee. The first kind of a simple one to get the juices flowing. It's just they have a strong company culture, so they put a lot of effort into risk management, having good actuaries, managing their financial performance and so forth.

03:44
Wade Pfau
Thank you.

03:46
Alex Murguia
Insightful. Make sure that they're going concern.

03:50

Wade Pfau
Check. Make sure they're going concern. Yes.

03:56
Alex Murguia
What do they do, though? What do these going concerns do to sort of protect themselves a little bit?

04:02
Wade Pfau
Well, another thing they can do is just play around with the parameters. And we dug into that a lot last week that at the end of the day, it's how much guaranteed income does the contract provide? Well, they can start giving you the temperature and Celsius instead of Fahrenheit, as we talked about last week. Okay, let's give you a really high roll up rate and have you focus on that. But then we'll lower the withdrawal rate connected to it so that you don't get as much guaranteed income. So they just play around with the parameters to reduce the and I guess this is obvious, too. How do you manage the risk of an income guarantee? You guarantee less income. That's ultimately what this point is. But it's a lever they have to work with.

04:43
Alex Murguia
All right, what about the types of managers within the sub accounts? Now granted, we just did a whole thing on passive versus active, but I'm curious what you come up with.

04:58
Wade Pfau
So there's a universe of sub accounts. It's not like all 9000 mutual funds or anything. They're going to decide which financial service companies to work with as sub account providers and then choose funds from those companies. And they want high quality funds now. Right. We get into this active management type issue, but they don't want duds or they don't want really terrible managers as sub accounts because they want those accounts to perform well. Because the better the accounts perform, the less likely they're going to be on.

05:34
Alex Murguia
The hook to make their own on the hook.

05:36
Wade Pfau
Yeah. So they do put a lot of effort into choosing the sub account managers or choosing the companies that

they work with. And to the extent they can choose good managers who don't unnecessarily deplete, just perform poorly, then that's a benefit to the company, the insurance company, because if your money grows, they're happy because then they don't have to be on the hook to provide payments to you. So they want to choose good managers to help you have options that would let your money grow.

06:08
Alex Murguia
And even then, don't they limit what you can do within the sub accounts? Just to make sure you kind of said it earlier, but even more so, like cash and the like that you have set aside. You want to just talk about that.

06:20
Wade Pfau
A little bit, right? Yeah. I mentioned the point that technically, because you have this putt option on the stock market that you're okay. Even if the stock market goes down, you're incentivized to invest as aggressively as you can. Well, the more risk you take on, the more expensive it is to fund a guarantee on that. So they may limit how much risk you're allowed to take. That could be as simple as putting a cap on the amount of, like all their sub accounts they could classify as risky in the risky category or the not less risky category. And so the stocks and other things would be in the risky category. Bonds are more in the less risky category, but they could simply say, you're not allowed to have more than 70% of your assets in the funds we deem as being risky.

07:10
Alex Murguia
You know what I find fascinating with this? If you take a step back and the whole why not 100% in stocks? The sort of the tortoise people that say, just put it all in 100% in stocks and let it go, right. And then there's folks saying, no, you may not want to do that, et cetera, for the reasons. Right. But think about this. The insurance companies who are literally now on the hook to provide distributions for folks, they themselves realize the silliness of 100% in stocks or just have at it from a risk standpoint. This is almost like the manifestation of why you don't do 100% in stocks. I mean, they do the math better than anyone else in the world, and they've figured out magically, hey, you know what, we need to control how much risk people are taking with the underlying investments if we're going to guarantee distribution from it.

08:05
Alex Murguia
Right. You follow what I'm getting at?

08:07
Wade Pfau
Yeah, it's a great point. Yeah. They realize that it's not less risky for them if you're in 100% stocks.

08:14
Alex Murguia
Exactly. They're not telling you by leverage ETF.

08:21
Wade Pfau
No, yeah, that's the crux of the matter. And some companies may market providing more investment freedom, but that's the idea. You generally would have some sort of cap on your risky allocation. Whether it's 60%, whether it's 70%, that's one direction they can go. Another direction they can go is just the sub accounts are focused more on volatility controlled type fund offerings so that they're trying to keep the volatility of the yeah, but that's the same thing.

08:49
Alex Murguia
They're just cutting off tails.

08:52
Wade Pfau
And then another direction they can go, too, is require cash positions. So you've got all these sub account choices, but you may be required to keep at least 10% of it in cash, is an example of how that could work. Yeah, it's an effort to again, you're motivated to invest more aggressively. They're motivated to not have you invest more aggressively, although they want you to invest somewhat. I mean, there is like a balanced portfolio they do expect to grow. It's just the cost of providing a guarantee increases the more aggressively someone is investing the funds.

09:28
Alex Murguia
I mean, there is no safe withdrawal rate from a volatile investment unless you sort of make adjustments.

09:36
Wade Pfau
And there's one more issue there, too, that the insurance company is exposed to behavioral risk. So if you're a bad investor and you go 100% stocks and then the market crashes, and then you panic and sell your stocks, just like we know in a brokerage account, you may completely destroy your retirement. Well, in the context of a variable annuity, you may completely destroy the contract value, and therefore your behavioral mistake. They have to manage your behavioral mistakes. Or if you make bad decisions with your investment sub accounts, they're on the hook for providing that guaranteed payment. And so part of that is also they just want to do the best they can to avoid having you go from 100% stocks to all cash, because that's what humans tend to do sometimes. But that's an element of trying to manage as well.

10:31
Alex Murguia
Investors are the ID, and these guys are the super ego. And maybe you come up with the middle ground from a performance standpoint. So that's how they manage. Go on.

10:42
Wade Pfau
Well, there's one more. They can raise the fees that they charge. That's a good segue. That's a good segue into talking about variable annuity fees.

10:52
Alex Murguia
Yeah. And how do these fees work? And again, this goes back to I've said it since the beginning, there's bad everything. There are bad mutual funds, there's bad whatever you want. They're bad variable annuities, if you will. But I don't want it to be throw the baby out with the bathwater kind of thing. At the end of the day, you're paying for this insurance. And so I remember once, just as an aside and again, I think it happens to the uninitiated. You look at your statements and you look at some sort of expense ratio, and you compare it to a mutual fund. Expense ratio and the expense ratios of a variable annuity. Not knowing any better, you think, why would I pay three times as much for something like this to an advisor? That really and I can't stress enough, you'd be surprised how many advisors, after they take their basic CFP certification, no longer revisit this at all, and seven years later, they have no idea other.

11:58
Wade Pfau
Than what I don't think they're learning about variable annuities in the CFP program anyway. That's one of the motivations.

12:04
Alex Murguia
But that's when you're, like, enthusiastic about this stuff, you know what I mean? That's when you're enthusiastic about, oh, let me learn everything. You want to be like CFP of the Year or R-I-C-P person of the Year, you know what I mean? Not to take away from your curriculum, but you know what I'm getting at? After this sort of initial enthusiasm or certifications wane, you kind of go into your little cove of things. And so I think they miss this a lot. But what is the sort of the building blocks of variable annuity fees.

12:37
Wade Pfau
Yeah. So there's four potential types of fees. The first is the sub accounts have fund expenses and that's no different than any sort of mutual fund. But that's part of the analysis. Usually those fund expenses would be

pretty similar, whether it's the equivalent fund in a brokerage account or the equivalent fund from the same fund family that's created as a variable annuity sub account option. There could be the additional twelve B, one expense charge, that's more for the marketing, but that's an issue inside and outside variable annuities. But yeah, you've got the underlying fund expenses, number one. Number two, variable annuities will have a mortality and expense charge and that is going to be a percentage of the contract value. Just of course, the fund expenses are a percentage of the contract value. The mortality expense charge is also a percentage of the contract value.

13:31
Wade Pfau
That covers the cost of business for the insurance company. If it's a commission paying annuity, that's meant to help recoup and cover the costs of paying the advisors commission. That's also helping to support some of the basic guarantees, such as any sort of basic death benefit and so forth, and also supporting the underlying annuitization tables that are part of any annuity contract. So you got the mortality and expense charges. The third option is the surrender charges, which is annuities are meant to be long term contracts. But if you want to get your money out in the early years in excess of the amount they allow you to take free of any surrender charge, you would face a surrender charge schedule. It could be something like 10% in year one, 9% in year two, 8% in year three, 1% in year ten, and then it goes away.

14:28
Wade Pfau
That would be one example of a surrender charge schedule. And to recoup, the commission was paid to the advisor and then if you kept it just for a couple of years, that's not enough time for the mortality expense charge to recoup that. So that's what the surrender charges are for.

14:43
Alex Murguia
This is, for me, this is interesting and I say this and let's have some context. Wade and I are managing principles of McClain Asset management. McLean Asset Management has largely been an assets under management firm. We do annuities and things like that. But for the most part we've been assets under management. We were fee only even a few years ago. And so I want to talk about this because this is where because you had mentioned commission, right? So in our business and our normal business, let's just say for argument's sake, I think it doesn't averages it's lower than that. But for the sake of this discussion, if you're managing assets and you're charging 1% a year and the relationships are long term, they're going to exceed effectively seven years, eight years, nine years, ten years, et cetera. Right? And so it's very easy to say, AHA, this surrender charge, I'm paying a commission for seven years.

15:40
Alex Murguia
Effectively you're almost front loading the advice over the course of a seven year over the seven plus year period. So if you really compare apples, if you're doing a true comparison, you want to know what the

lifetime value of the AUM bill was versus the lifetime value of the surrender charge. Now then there's more wrinkles in the sense of, well, but I'm providing ongoing financial advice, et cetera. So that's a fair point, but you want to be able to compare these in terms of what you're getting for that fee, if you will. Wade you want to maybe clear that up a little bit as well? I think it was clumsy when I was going through that.

16:20
Wade Pfau
No, yeah. And if you're a long term holder, you never pay any surrender charge. That's only if you want to get out of the contract early.

16:27
Alex Murguia
Yeah, I mean forgot to mention that part. Yeah, but you know what I'm trying to do here, I'm trying to kind of frame the whole fee thing in a correct way.

16:36
Wade Pfau
Right. And the advisor who sold the contract is paid the commission that the insurance company would gradually recoup through the mortality and expense charge. But they need you to be a long term holder of the contract for them to not lose money. So the surrender charge is their way to make up for that. If you decide to abandon the contract, which hopefully you're not going to generally do, you're going into these because they are meant to be long term contracts. But that's the issue there. And then the fourth potential charge is just for any optional benefits. If you have the guaranteed lifetime withdrawal benefit, if you have an optional death benefit writer those are not going to create any profits for the insurance company. The profit part is coming through the mortality and expense charges. The optional living benefit charges are simply used by the insurance company to buy the financial derivatives to help support the guarantee that they're on the hook to provide you.

17:35
Wade Pfau
So that's the way that's an additional and that may be there's different ways those work I mentioned before, these other charges are on the contract value with living benefits, the charge could be on the contract value charge could be on the benefit base, which would, if the benefit base is worth more, make that charge more expensive. Or it could be on some other type of hybrid between something in between the benefit based on the contract value. But again, those charges are simply meant to support the guarantees the contract provides. And then we've had David Lau on the show, DPL, we're friends with the kind of fee only annuities as well. And what those fee only annuities are doing is they strip the commissions out of the annuity, which allows the insurance company to reduce the mortality and expense charges because they don't have to pay the commission through that.

18:28
Wade Pfau
And it allows the company to potentially reduce or even eliminate surrender charges because they don't have to recoup that any commission, since it's a non commission annuity.

18:38
Alex Murguia
But it's not a but in the negative sense. But be clear, the advisor most likely has this now on their assets, and so they are charging an assets under management fee for this annuity within their overall cost. So they kind of shift a little bit as opposed to disappear. That's neither good nor bad. I'm just sort of pointing it out.

19:03
Wade Pfau
Yes. If you're paying the advisor and assets under management charge and they are managing the contract value of the variable annuity for you, that assets under management charge would apply to the contract value as well. That's completely separate of any involvement of the insurance company. It's not in that scenario, it's not a variable annuity fee, but it is a fee you pay by working with the advisor.

19:27
Bob French
Are you a financial professional looking to learn more about the Risa and Retirement Income best practices? Well, if you are, you should join our retirement income masterclass on Monday, August 28 and Tuesday, August 29. You can sign up@risapprofile.com advisors that's Riserprofile.com Advisors.

19:49
Wade Pfau
Okay.

19:50
Alex Murguia
And you want to talk a little bit about the ongoing feed drag and assets and required assets to meet the goal, right?

19:59
Wade Pfau
So that's like, how do you frame variable annuity fees? And so if you had a traditional kind of commission based variable annuity, you could have a three and a half percent total charge. It could be like a half a percent fund expense, maybe one and a quarter percent mortality and expense charge. Surrender charges

aren't applicable here, but we're now at 1.75%. I maybe didn't give these numbers high enough, but say another one and a half percent as the writer charge. Now that's getting us up to three and a quarter percent. So you're all in potentially paying three and a quarter percent as annual fee. And is that expensive? Well, one way to frame that. It's not so much the fee drag as how much assets do you need to feel comfortable with retirement. And if you can earmark less assets through the variable annuity because you're worried about outliving your money, and therefore you'd be using a really low, quote unquote, safe withdrawal rate with an investment portfolio, you might be able to meet your goal with less assets using the variable annuity.

21:02
Wade Pfau
And then at that point, who cares what the fee drag is? These are assets earmarked for my spending, and it's allowing me to meet that spending with less assets. And so that could make me feel more comfortable.

21:13
Alex Murguia
Is it easy to say, set another way? You have a million dollar portfolio and you want to retire, and you're going to take a sustainable withdrawal rate, and with that you're taking $38,000 a year or whatever, right? Or you don't have a million dollar portfolio and you get the same $38,000 a year through a variable annuity with less overall in assets. And so at the end of the day, to your point, what do you care? Because you're making $38,000 with less of an asset pool. It's all embedded in the fee. But so what you're doing with less money and you're getting that insurance component to it, is that a fair way.

21:53
Wade Pfau
Of kind of turning it around to that point too? You may have a higher fee percentage, but if you can apply that to a smaller asset base to fund your retirement, you're not necessarily paying more overall fees. At the end of the day, although that might be a stretch, it might still be more overall fees. But you are getting these protections that you have guaranteed lifetime income assured, no matter how long you live and no matter what happens with the financial markets during your retirement, subject to the claims paying guarantees of the insurance provider, which is a big disclaimer we should be clear about. Yeah.

22:33
Alex Murguia
But I get that. But still, you have to look at it for what the end game is. Not necessarily the it almost goes back to the first part that we ever said. The first thing out of our mouths is you need to compare apples to apples and just saying the feed drag and looking at 3.75 versus a mutual phone at, I don't know, 40 bips, it's just not the same thing.

22:59

Wade Pfau
They're doing different things. And the other piece of that is Moshe Molesky. We talked about how when you have these, you should invest more aggressively. Just mathematically, you've got this insurance that is allowing you to invest and to not be worried about what's happening in the markets. Moshe Moleski did have a study looking at big accounts with variable annuities with and without living benefits and found that people were generally increasing their stock allocations by five to 30 percentage points with the living benefit in place. Even more recently, David Blanchett had a study with the alliance for Lifetime Income showing how people are less likely to abandon their stock investments when they had protections in place. So there is a sense that people who have these guarantees are willing to invest more aggressively. And in doing that, well, if markets do okay, you're not necessarily sacrificing legacy because the risk premium from the stock market might more than compensate you for the fees that you're paying.

24:04
Wade Pfau
So that at the end of the day, even though you paid higher fees because you invested more aggressively, the legacy you provide net of fees or the value of your assets net of fees could be higher because the growth you achieved by feeling more comfortable. It's like with that Moshe Molesky scenario. Maybe if I didn't have the guarantee, I'd only feel comfortable with 40% stocks, but if that guarantee lets me feel comfortable with 60% stocks, that's that kind of scenario where that could more than compensate you for the higher fees that the guarantee provides.

24:38
Alex Murguia
Yeah. And assuming that the company comes through on the guarantee, et cetera, you're not paying a higher fee just for the investment sub accounts. You're paying a higher fee for those guarantees that come with it. Right, okay, Wade, that's a lot there. Let's say here, if you're now looking at these things, you're not looking at a variable annuity or someone's pitching you this or you're at a chicken dinner because you were like, yeah, let's do this as a goof, and you showed up and you start listening to folks. What questions should you start asking yourself to be an informed consumer? Let's say if you're we talked about the roll up rate last time, right. I would think, simply put, the trick there is, okay, at the very least, you want to know if the roll up rate is simple or compounded. Actually, I would say, as we're saying these in the podcast, we wrote down a bunch of these questions.

25:37
Alex Murguia
It'd be helpful to just think these through in terms of becoming an informed consumer. So there's a roll up rate. Why would we ask that? To figure out if it's simple or compounded.

25:50
Wade Pfau
Yeah. And also just so we can talk about the deferral stage before you turn on guaranteed income. Yeah, this

is what the guaranteed income will be, the risk management of the company. And also, just to be clear, there's so many levers in these contracts. So when we say that approach A is better than approach B, yes, but then if that's offset somewhere else, but yes, everything else being the same, when you look at the roll up rates, of course you want to know the value is it 4-5-6-7? But then is it simple or compounded? And all else being the same, a 7% compounded roll up rate is better than a 7% simple roll up rate because the compounded roll up rate is going to roll up on top of past roll ups. That's what compounding interest is all about. You get growth on growth rather than just growth on the initial value.

26:42
Alex Murguia
And to your point, this is where in isolation, yes, but you also have to consider what that is ultimately with a withdrawal rate, and this goes back to your fahrenheit and celsius comment before yeah.

26:55
Wade Pfau
And with a long enough deferral period, a 6% compounded roll up rate could easily grow the benefit base. More than a 7% simple roll up rate, for example.

27:04
Alex Murguia
Yeah, okay, what other things within the roll up features they should be thinking about?

27:11
Wade Pfau
The big one would just be how long is the roll up rate applied? You can generally start purchasing living benefits in your mid 40s. But if you're 45 and you're thinking to retire at 65 and you're thinking, oh, I want to get that roll up rate for the next 20 years, well, read the fine print. The roll up rate may only be available for ten years and then there's no more roll ups after that. So just make sure you understand how long the roll up rate is applied.

27:37
Alex Murguia
So this is important with regards to your potential date when you're thinking about retiring, or if it's for longevity purposes when you're thinking about doing that. So this could be relevant actually, when you're in that stage of that whole bridging component to things in terms of step up frequencies, how frequently are step up opportunities provided? That would be something that would be interesting as well, because we talk about step ups, they're sort of path independent from roll ups, if you will.

28:10

Wade Pfau
Right. And this matters too, because the most common step up frequency would be annual. And then you're looking at contract anniversary dates. And we really didn't get into this specific point in detail, but if I bought the contract on April 3 and I have annual step up opportunity, we look at where the market is every year on April 3. If the market doubled during that year but then came back down so that on April 3 is back to where it started, I wouldn't get any step up. So all else being the same, more frequent step ups are better than less frequent step ups. And it could be quarterly, it could be monthly, it could be daily. A daily step up looks every day and it's still probably not intraday. So if the market was up at noon but was back down by closing time, you wouldn't get the intraday.

28:59
Alex Murguia
Could you imagine like an intraday opportunity?

29:03
Wade Pfau
But the more frequent the opportunity, the more likely you are to lock in a new high water mark.

29:10
Alex Murguia
The other piece is this is helpful to me, step up applies to the contract value. Roll ups are just roll ups, they're just going to increase. But whatever. Remember, roll ups, though, aren't investment rates of return as well. That's the other piece.

29:24
Wade Pfau
Nor you have step ups.

29:25
Alex Murguia
Yeah. No, I got you.

29:26
Wade Pfau
But they come from market returns, though.

29:29
Alex Murguia
Yeah, and to me, I just see it step ups relate to the contract value. Now, we said this earlier, but I think this

is because of the alliteration throws me off. It throws me off. So I can imagine everyone else do step ups stack on top of roll ups? Do step up stacks maybe define a little bit one more time since we're trying to put it together for folks, the stacking concept. And then do they stack on top of roll ups?

29:59
Wade Pfau
Okay, so stacking is better than not stacking. Not stacking means the roll ups are always applied to the initial benefit base, which is usually the initial premium put into the contract. So even if a step up got you to a new high water mark, the roll ups would continue to apply to the initial contract value or initial benefit base. And so you may get. A long time where your benefit base is flat because the roll ups are trying to work their way up to where that step up got you. Whereas stacking means if you got a new high water mark, you step up, the underlying contract value achieved a level higher than it ever was and higher than the benefit base was higher than any of the past roll ups got it to, then you reset the benefit base to that level. And if you stack roll ups now, the roll ups start applying to that new high watermark benefit base rather than continuing to apply to the initial benefit base at the start of the contract.

31:05
Alex Murguia
Okay, this question, just because I'm reading a question here and just want to make sure people understand the question, much less you go into just answering it. How frequently are step ups and roll ups vested into the benefit base?

31:27
Wade Pfau
The answer what are you trying to ask there? Yeah, annually it could be different than that. So this gets back to, well, what if I had daily step up opportunities? So what if my contract achieved a new high water mark one month later? I would then see my benefit base as being higher, but it wouldn't actually vest to be that higher benefit base until the end of the, until the next contract anniversary. And so that just gets into the scenario about if you want to turn on your lifetime income, the benefit base you see, may not actually vest until the next contract anniversary date. And so that's what the vesting is all about. It's only an issue if the step up and roll up opportunities have a different frequency than annual would generally be. The scenario just because I want people.

32:23
Alex Murguia
To be clear, can you describe benefit base and contract value real quick?

32:28
Wade Pfau
So the benefit base is the hypothetical value used that can be different from the underlying contract value,

the value of the underlying sub accounts, but the hypothetical benefit base that's used to calculate what the guaranteed income is. So I apply the withdrawal rate to the benefit base and if I got a big step up and later the contract value declined, the benefit base could be quite a lot higher than the contract value at any particular date. Well, when I turn on the lifetime income, I don't apply the withdrawal rate to the contract value. I apply the withdrawal rate to the hypothetical benefit base to see how much I'm allowed to distribute on a lifetime basis.

33:13
Alex Murguia
And someone listening. What purpose does the contract value serve at that point.

33:20
Wade Pfau
If it continues to grow? If the contract value is close to the benefit base, you can still so roll ups stop when you turn on lifetime income, but step ups continue generally. And I always have to say generally, because every contract is different generally step ups continue after you turn in lifetime income. It does just become more difficult over time to achieve step ups to a new high water mark. Because now it's not just net of fees, it's also net of the distributions you're taking. Okay, now we're really shifted into the distribution period. We're turning on the lifetime income.

33:56
Alex Murguia
Okay. Now we're distributing, right? And so income guarantee amount, what's a question someone's going to want to ask themselves when they're looking at the income guarantee amount. So someone's presenting them all these annuity levers and think about how this is not an easy thing, right? Because there were all these deferral period considerations right now, distribution period considerations, income, guaranteed amount, which should someone and even.

34:23
Wade Pfau
Before mentioning that, it's probably worth reminding everyone again that with a living benefit, we're not annuitizing the contract. Oh, yeah. So the guaranteed income amount is the amount that's defined as if I'm paying for that insurance, I'm allowed to take out this amount of money each year. And if I don't take out more than that, I will maintain my guarantee that should this act of spending this amount every year cause the underlying account to deplete, those payments will continue at the defined level in the contract. And so the guaranteed income amount is ignoring the step ups. You could get step ups to increase this even more. But if you don't get any step ups, it's that interaction of the roll up rates, four year deferral period, and then the withdrawal rate based on the age you start those distributions. So it's like that example where if you had a ten year deferral and 10% simple roll ups and a four and a half percent withdrawal rate, $100,000 premium would guarantee you at least $9,000 after ten years of deferral.

35:34
Wade Pfau
And it could be more if you got a step up along the way.

35:38
Bob French
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36:02
Alex Murguia
Okay, and how would you define, then, guaranteed withdrawal rates?

36:08
Wade Pfau
Yes, so the contract will have a schedule of guaranteed withdrawal rates that's not gender specific, but it is age specific. But it's usually not age by age. It's typically more in age bands. So just I'm completely making up numbers. But it could be, say, between the age, if you decide to turn on the lifetime income between the ages of 60 and 64, maybe you'll get a 5% payout rate. If you turn on the income between the ages of 65 and 69, maybe you'll get five and a half percent. Between 70 and 74, maybe five and a half percent, something like that. It's just an age based set of withdrawal rates where, depending on the age, you decide to turn on the guaranteed lifetime income not annuitize the contract, but just turn on the living benefit. It's going to tell you what percentage of the benefit base you're allowed to receive and that is based on the benefit base and that amount.

37:09
Wade Pfau
And now this is where there's so many caveats because all these contracts work differently. What I was describing just now was really these withdrawal rates are based on the age you turn on the payments, not the age that you open the contract. But there could be cases where those withdrawal rates are based on the age you open the contract, rather than the age you turn on the income.

37:34
Alex Murguia
Wade again for the uninitiated, if you wanted to turn off the income oh.

37:41
Wade Pfau
Yeah, could you turn you're not required to take out the guaranteed amount. You can leave it in there. That's where this would be the Moshe Molesky critique of you're paying for insurance, but you're not taking advantage of it. But yes, because you're not annuitizing the contract, you're not forced to receive that check in the mail. You could decide not to take out the full guaranteed amount. You could also take out more than the guaranteed amount. And then there would be some sort of provision about how that would reduce the subsequent guarantee.

38:15
Alex Murguia
That was my next question. What happens if you take out more? You're like, is it no more soup for you kind of scenario? Or it's like let's make a deal, if you will.

38:24
Wade Pfau
Right. It's going to be some sort of let's make a deal. Because it's liquid, you are allowed to take more than the guaranteed amount. It's just they'll recalculate what your subsequent guaranteed amount is and it would be lowered through some sort of provision that varies quite a bit from contract to contract. So make sure you understand the rules.

38:44
Alex Murguia
Sorry about that. How does it look for couples we've been talking about in the singular? How does this work in the plural?

38:51
Wade Pfau
So it could be for a single life or for a joint life, and typically it would be a couple that does that. There's two options. The most common, a lot of the guaranteed withdrawal rate schedules simply just if it's joint life, they reduce the payout by a half a percent. So if it would have been 5% for the single person, it'd be four and a half percent for a couple. If it would have been 6% for the single person, it'd be five and a half percent for the couple. There are some companies that actually offer the same payout rate for a couple as for a single, but they charge a higher writer fee for the couple. And that's just because they have to buy more protections. Because with a couple there's a greater chance that somebody lives longer.

39:36
Alex Murguia

Is it fair to say it's not that you're getting an advantage for doing it? Joint or single, it's going to be actuarially fairly priced.

39:44

Wade Pfau

Is that right? And that's a broader point to all of these levers we're talking about. At the end of the day, they're all going to work together in some manner that's based on actuarial science. So there's no way to really scam the insurance company because they have some really neat provision somewhere that's going to be offset somewhere else unless they're simply mispricing the contract.

40:08

Alex Murguia

That's why I said it because you're talking about they took it from the writer instead. There is no arbitrage. I mean the closest thing to the arbitrage is what you said in the last one. Sometimes in defined contribution plans they can't have gender based pricing so women can kind of make out a little better. But absent of that, it doesn't really matter, right? It's just what flexibility do you like?

40:35

Wade Pfau

Right? And what are you most comfortable with? Companies will market different things that one company might market. They have daily step up opportunities. Now, actuarily speaking, that's not necessarily better than annual step up opportunities because again, they'll change some other lever somewhere else to reduce the advantage on some other feature. But if that resonates with you might go that way. Another company might market that. They have unlimited investment freedom so you could be 100% stocks but probably they're going to have a lower payout rate associated with that. So you've got some flexibility to go with the story that resonates with you. It's just each company is trying to offer some different story as a way to market their particular approach to building the product. We didn't really mention this at all, but another feature you might see is the withdrawal rate could lower when you deplete the contract value.

41:36

Wade Pfau

So it may be the company could offer 5% flat for life is one option. Another option would be no, you can actually take out 7% while money still remains in the contract. But if you do that, the contract will reset to offer you 3% after you deplete the contract value. So that could be another just example of a lever you have to play with and that might be really bad. Why would you want the income to deplete after the contract value runs out? But in terms of the sequence of returns risk, it's always the partial annuity strategy. That much higher payout rate early on helps to protect your other investments so that they're better prepared to provide the difference when that contract value depletes.

42:17

Alex Murguia
You said something and I want to ask a question and I'm trying to see, and forgive me if I'm not getting it right, I'm just trying to constantly put myself in a consumer listening to this for the first time and I'm thinking how did I feel listening to this for the first time? And what you just said made me think, oh, the contract value is depleted and I get 3%. Is that what the annuitization is?

42:39
Wade Pfau
Yeah. With that settlement phase where now the insurance company is on the hook to start paying you out of their pockets. Well, in this scenario I just created, you were allowed to take 7% of the benefit base each year. But when the contract value depletes and this is not a surprise, you were told this, but the settlement phase is going to give you 3% of the benefit base, and that's an option you may have had. Another option may have been you're allowed to take 5% a year, but then in the settlement phase, you're allowed to continue taking five. You would receive 5% of the benefit base on that ongoing basis.

43:17
Alex Murguia
And again, you may say to yourself, well, why wouldn't I do that? Well, because you're going to be paying for that. You're paying for that extra two percentage points in some other sort of lever, if you will, but that may give you more security. Impact of non lifetime withdrawals?

43:35
Wade Pfau
Yes. Even when you're in the deferral phase and you want to take out a distribution, you can clarify that you don't want to turn on your lifetime income, you just want to take a distribution. And that's what we talked about. Every contract is different, but they're going to do something to then lower the benefit base if you do that. And conversely, even when you're taking the lifetime distributions, you could decide to take more than the lifetime distribution. You can do so. It's just they will recalculate the benefit base accordingly and reduce it so that you would have less subsequent guaranteed income. But that's the same logic of a brokerage account. You can spend as much as you want, but if you spend more, you're just going to reduce the chance of being able to spend in the future. It's the same idea. It's just made more explicit with the variable annuity.

44:32
Wade Pfau
You can spend as much as you want, but if you're going to spend more than the guarantee you're paying for, you're just going to get a reduced guarantee for the future.

44:40
Alex Murguia

Wade, you can spend as much as you want as long as it's zero. Yeah. Okay, just as we're winding here, we talked about the questions from a deferral period. That has to do with just the interplay between the roll up rate, the step up rate, the stacking vesting, contract value, et cetera, distribution. We just went through those questions income, guaranteed amount, the withdrawal rates, et cetera. The risk management approach. We mentioned it. But just I can knock these out, Wade, real quick in the interest of time, and then you could take us home with the other one. But again, risk management. What you want to find out here is what's your maximum allocation to risky assets? What's the maximum allowed? Remember, this goes back to actually they're trying to price the risk accordingly, and in doing so, they can't control you if they just give you carpalanche.

45:32
Alex Murguia
So they want to sort of provide guardrails on what you're allowed to do simply because it allows them with their estimates. It allows them with their pricing on estimates a little bit better. And that's done with. What's the allowed allocation on risky assets? What are the fund choices that you're allowed to have? Are there any requirements about using volatility controlled funds holdings in cash? We've mentioned this earlier. And then ultimately, what's the credit rating that the insurance company has earned simply from a stability standpoint? And so from a risk management question, those are the questions you kind of want to understand as you go into this as well, Wade. Do you want to go into the risk management approach with regards to fees?

46:21
Wade Pfau
Yeah. So as a review of what were talking about on the fee side, you want to understand the fees that you're paying, including variable annuity, sub account and sub account fees. So you have the underlying expenses on the sub accounts you choose. You have the mortality and expense charge for the annuity contract. You want to understand what those are and generally those would be applied to the contract value, but you want to just make sure that is the case, that they're not applying them to the benefit base. Would you mind some other metric?

46:51
Alex Murguia
Because it's a new term again for the uninitiated, and you said it. But just mortality and expense charges, those.

46:59
Wade Pfau
Entail, that's a percentage fee. That's the one where the insurance company is making its money.

47:07

Alex Murguia
That's why I'm asking again.

47:10
Wade Pfau
So the investment sub account charges, the variable annuity is picking fund managers to provide those funds. Those fees go to the fund manager. The mortality and expense charge is the percentage fee that's going to the insurance company to cover their costs of doing business and to cover the guarantees. That the basic guarantees that are being provided as part of the contract. Not any living benefits, just basic return of contract value, death benefit and so forth. And then if you have an optional writer for guaranteed lifetime withdrawal benefits or an optional death benefit or some other type of optional living benefit, there's a fee for that and that's going to be used to purchase the financial derivatives to support the guarantee. The insurance company is not making money off of their writer fees.

48:03
Alex Murguia
So you're essentially saying the sub account fees and these writer fees to purchase whatever leaps or whatever in the open market, those are pass throughs for the most part, right?

48:14
Wade Pfau
And we didn't mention this before specifically either. But you can see if you look at a variable annuity company, they may have multiple options available. And so what you'll see is the more robust the guarantee, the higher the writer fee. And so you don't necessarily just want the lowest rider fee. Maybe the writer fee is 0.8%, but then the guarantee rate is four and a half percent. But if you're willing to pay I'm just making up numbers right now. If you're willing to pay at a 1.2% fee, maybe you get a 5% payout rate guaranteed. Maybe if you're willing to pay a 1.6% fee, you get a five and a half percent guaranteed withdrawal rate. So it's not just a matter of finding the lowest fee on the writer because again, this is an actuarial game. The more robust the guarantee, the higher the writer charge.

49:06
Wade Pfau
And you just want to understand what that is, how it works, what is applied to it, maybe applied to the benefit base or maybe applied to the contract value.

49:13
Alex Murguia
I mean, the question you have to ask yourself here to me when you're talking about these rider fees, and that is if you had the money yourself and you wanted to go in the open market and buy leaps and the contracts to do so, could you get a better rate than the insurance company? And that's not even considering

the pooling, the mortality pooling benefit and all that. That's not even considering that. Most likely the answer is going to be no, frankly, simply because of how they work on the institutional side.

49:47
Wade Pfau
Yeah, and that point is a little bit of a teaser when we later talk about fixed index annuities where someone will say, oh, you could just create your own fixed index annuity, and yes, maybe, but you don't get that institutional pricing and so forth. But to try to recreate your own guaranteed lifetime withdrawal benefit, that's a whole nother world of complication that you need an entire team of actuaries to have figured out a household is not going to be able to replicate. And that's not even with the brisk pooling feature as well.

50:19
Alex Murguia
Even if we read your book yeah.

50:21
Wade Pfau
Even if you read my book, you're not going to be ready to go price your own glwds, unfortunately. Maybe if you read some of Moshe Molevsky's books, he is the Calculus of Retirement Income. That is really a book about calculus, and that's what you need for pricing some of this my book doesn't have any calculus. Okay, then. Fee adjustments. Does the insurance company have any capacity to change the fees? And that's generally the answer is yes. So right now the writer fee may be 1%, but when you read the fine print, the insurance company reserves the right to increase it to up to one and a half percent. Now, they generally aren't doing that to trick you, but if financial derivatives become more expensive, they may have to pay more to support the guarantee in the future, and they reserve the right to increase the fee accordingly.

51:14
Wade Pfau
And then also surrender charges. You want to make sure you understand what that surrender charge schedule looks like and how that works. In the event that you did need to take a distribution early on, and that distribution exceeds the amount you're allowed to. Take out before the surrender charge is applied so that at the end of the day, that's variable annuities, I think we had a pretty good discussion. Every company is offering different features and so forth, so what we talked about isn't universal, but I hope it's sufficient to really help the listeners understand how these work and gives them the ability to start looking at the features of any particular contract. And they may have to change the terms. They may not see the term benefit base. It may be called income base. They may not see contract value. It might be called account value.

52:03
Wade Pfau

But once you make that basic translation that you actually understand what you're reading about, that's my hope with these episodes.

52:12
Alex Murguia
No. 100% I think folks, especially in podcasts, maybe shy away from providing the level of detail we did today simply because it's like, oh, it's going to be boring, or whatnot? I don't know what to say sometimes. You're dealing with a lot of money. You spent 30, 40 years building up this base. You need to know there's no way around it, right? You just need to sit down and listen in. I think we've been accomplishing that so far, so I think it's a great way.

52:46
Wade Pfau
Yeah. If you're thinking to put $200,000 into a contract, you want to make sure you understand how that contract works. And it can be complicated, but it's not insurmountable. It is possible to understand how these contracts work. It's not impossible to understand. And hopefully there you go. The listeners have I think that's a.

53:08
Alex Murguia
Slogan for a retiree with style. It's not impossible to understand. You missed your calling, man. All right. And with that, I think that's a wrap. Right? Wade.

53:23
Wade Pfau
Yeah, let's call a wrap on the variable annuity conversation.

53:27
Alex Murguia
All right. And what's the follow?

53:30
Wade Pfau
Well, it's either going to be fixed, indexed, annuities, or it's going to be something completely different. We still need to figure that out.

53:37
Alex Murguia
Right. We'll see how we find some point in the future.

53:41
Wade Pfau
We're going to continue with other types of annuities as well. Just don't know if it'll be next week or not quite yet.

53:47
Alex Murguia
All right, everyone, thank you for this installment of Retire With Style. Thank you for spending the afternoon, evening or morning with us. We really appreciate it. More to follow. Bye now.

54:01
Wade Pfau
Take care, everyone.

54:03
Bob French
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