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Technical Articles

## Insurance-Based Investment Products: Why Are People Talking More About Them Now?

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In a very short time, most financial planning challenges will be addressed at least in part with insurance-based investment products— most prominently, annuities. In particular, retirement plans based on accumulating wealth via a single personal portfolio, however well diversified, will soon seem quaint, and saving for college tuition in a manner that keeps all of the risk on the student's family will be viewed as not only unnecessary, but also a bit odd.

The rationale for this startling observation is a looming paradigm shift in the world of personal finance, now visible in articles springing up in the top financial journals—that is, the new response to the twin ideas that stocks are risky, even in the long run, and that the risks of preparing for long-term liabilities, in a world of perfect planning, would be shared.

In essence, to address the challenge of preparing for the future, our industry has up until now offered financial solutions based on products available at the time, and on a world view that diagnoses personal financial challenges as being fundamentally investment-based. We have been answering the question of how best to gather up money for a future obligation (such as college tuition or retirement income) with the basic advice: “Grow your portfolio.”

The obvious caveat in this new paradigm is that since the future is unknown, we don't really know how much the client needs to save, so we make a best guess of how much should be saved, and then we use portfolio diversification to optimize portfolio growth. If the resulting pot of money is far in excess of what is needed, the response to this result is an embarrassed, “Whoops, I'm sorry you saved so much when you could have been spending more all those years.” If the resulting pot of money is insufficient, the response is an embarrassed, “Whoops, I guess you'll have to save some more.” These solutions ultimately leave risk squarely on the customer.

Economists frame the challenge differently, and so (not surprisingly) they end up with different solutions. Economists view the challenge of preparing for future financial obligations as not just the investment challenge of how to grow a portfolio, but also as an insurance issue. They ask, “How can we get financial risk to the party most able and willing to bear risk, and remove risk from those who are unable or unwilling to bear risk?” and “What is the value to all parties when risks are shared?” Thus, economists consider not just the strategy of *save and diversify* but also such risk management techniques as *hedging and insuring*:

- *Hedging* means to sell the upside potential of an asset in return for downside price protection. The key to hedging strategies is to find a party whose risk preference is directly opposite to yours.
- *Insuring* means to pay a known price to protect against the possibility of a larger loss on some risky asset but to still keep the upside potential for the investment return on that asset.

Today, financial managers can strip apart almost any financial asset according to its risk components and sell each component to a different investor.

### Inflation-Protected Income for Life

Economists are combining hedging and insurance-based solutions with traditional investments to develop detailed models for the next generation of standard personal financial products. The core of the developing new solutions is an annuity offering lifetime, inflation-protected income. Meanwhile, financial planners share the widespread concern that the traditional diversified cash/bond/stock portfolio may not be adequate protection against the risks of increasing longevity, the shrinking equity premium and the uncertainty of stock performance even over the long term. The most common response so far, however, has been to focus on alternative equity investments such as hedge funds or direct investments in real estate or oil and gas.

There are cultural reasons for this propensity to keep looking for an investment-based solution. Planners in this generation believe in equity-based investment solutions, and they tend to measure themselves—and in large part to seek compensation—on the basis of investment performance. Plus, for many professionals in the planning industry, thinking positively about insurance-based investment products such as annuities is a new, startling and difficult idea.

Although annuities have existed for many years, they have frequently received bad press. Until just recently, the typical annuity was very high in price, commensurately mediocre in performance, and aggressively sold. Adding salt to the wound, annuities, at least as traditionally designed, still leave investment risk substantially on the investor. In this context, most advisors have an almost reflex aversion to insurance-based investment products. In contrast, leaders in the fields of economics and finance view financial products that combine insurance with investment characteristics as the cutting edge in personal finance.

As background, the earliest annuities were *fixed annuities*, which offer the promise of protection against the risk of outliving one's wealth. Insurance companies can offer this protection because they pool the risk associated with uncertain longevity across a large number of people. But with fixed annuities, there remains the risk that the fixed-income payments will not keep up with inflation. Because the level of a fixed annuity payment is highly dependent upon interest rates applicable at the time the contract is annuitized, everything else being equal, it's better to annuitize a fixed annuity at the peak of the interest rate cycle, or to use a fixed annuity only when funding a fixed-dollar obligation, or to purchase a series of fixed annuities over a long period of time and thus capture several different interest-rate environments and several different starting ages.

*Variable annuities* were introduced in the early 1950s in response to the notion that stocks tend to preserve purchasing power better than fixed investments. Variable annuities allow investors to allocate premium payments to a variety of investments, including especially stocks. The first variable annuity offered by an insurance company was the TIAA/CREF 403(b) annuity, established in the early 1950s and now, according to TIAA/CREF, the largest mutual fund in the world. The first published description of the rationale and mechanics for a variable annuity contract is a 1952 *Harvard Business Review* article titled "A Better Pension Program." Today, there are further developments in the annuity markets, for example, the *equity-indexed annuities*, a hybrid that offers a fixed stream of income with some upside potential related to movements in the equity markets.

Internal Revenue Service rules are also a driving force in the design of annuity contracts. The IRS has recently indicated an easing in how annuities can be distributed to heirs. Previously, IRS rules forced heirs to receive accelerated annuity payments, (thus paying high ordinary income taxes). With modern contracts, clients can arrange to have an annuity contract act like a stretch IRA for their heirs and can restrict or ease access by heirs to lump-sum distributions from the contract in addition to mandatory withdrawals. This recent change in the tax climate has made the decision of whether to annuitize even more complicated, since annuitization before the owner's death reduces the possibilities for stretching out payments for heirs.

Despite all of these exciting advances, however, fixed annuities do not offer inflation protection, and variable annuities involve investment risk.

But the annuity market may be about to change. Professors Merton and Bodie describe the new paradigm in the January/February 2003 issue of the *Financial Analysts Journal*. They propose that in retirement, your *escalating annuity* would pay a minimum benefit linked to the cost of living, with the possibility that payments would increase, but not decrease, with the performance of the stock market. In other words, the insurance company would hedge inflation risk with inflation-protected bonds such as Treasury Inflation Protection Securities and provide upside potential via a series of call options on broad stock-market indexes. Not a bad pension plan! It would nicely address the need to keep up with inflation and also offer upside (but no downside) potential and so address what economists call the human propensity for "habit formation"—a wonderful economic term for the fact that most people don't want to ever experience a decrease in their standard of living. It would also allow individuals to avoid needless under-spending during retirement.

*Bundled annuities* would combine two products (for example, the escalating life annuity just described with long-term care insurance) and so pool the risk of longevity across a large group of people without making individual investors choose how much to invest in long-term care insurance versus an annuity. For pre-

retirement, economists propose investment vehicles that would protect individuals from large swings in the value of their homes or against saving too little or too much for college tuition, or from being in a particular occupation.

There are specific theoretical reasons for the particular design of these products. Economists assume that most consumers, given limited lifetime resources, are trying to smooth their consumption over an uncertain lifetime to an optimal level, and that part of meeting this long-term goal is to assign risk to the correct party.

Research reveals that one reason annuities have been so expensive is because there is a self-selection process at work: Healthy people tend to buy annuities, and people expecting health problems tend to buy long-term care insurance. Insurance companies have correctly adjusted premiums to reflect this "adverse selection" process, making individual products look expensive from the point of view of someone in the general population. Bundled products are meant to address this adverse selection problem.

Recent research efforts indicate that the typical consumer would forgo about 20 percent of discretionary wealth in order to gain access to a lifetime annuity (with some exceptions, including the very poor, the very wealthy and people already living over their income). Plus, with sufficiently large pools of insured people, the cost of bundled products could be less than the purchase of the component products. Getting sufficiently large pools of insured people is essential for appropriate pricing, and this fact is expected to shape domestic policy debates. For example, many economists support self-direction of Social Security accounts but usually also propose that we follow the lead of Great Britain by requiring annuitization at retirement. (Great Britain is also a model for the United States since inflation-proofed annuities are already routinely available in that market, as they are also in Australia and Israel.)

In light of these developments, it is prudent to take a fresh look at how you are funding your clients' long-term liabilities, including, for example, both retirement income and college expenses. Be ready to consider an upcoming generation of insurance-based investment products, available either for individual purchase or through employer-sponsored retirement plans. Look for the possibility of inflation-proofed income. Expand your notion of diversification away from the traditional framework of cash/bonds/stocks, to include a consideration of how much of a client's wealth to annuitize and how much to keep in the traditional portfolio. Consider Social Security and other public policy debates in light of the fact that we'd all be better off if inflation-proofed annuitization were more easily available.

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