Marketing Appeal of Variable Annuities Compared to Mutual Funds

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When to Consider a Variable Annuity

- When other tax-deferred opportunities have been exhausted (401(k), 403(b), IRA, etc.).
- When the investment horizon is long.
- When product guarantees have a high value to contract owner.

Financial Writers

- Generally negative opinion of variable annuities.
  - Guarantees unlikely to pay off, so their cost reduces the expected returns.
  - Index funds are lower cost, are tax efficient and have a stepped up basis at death
  - Annuitization options are poor choices
  - Surrender Charges reduce liquidity

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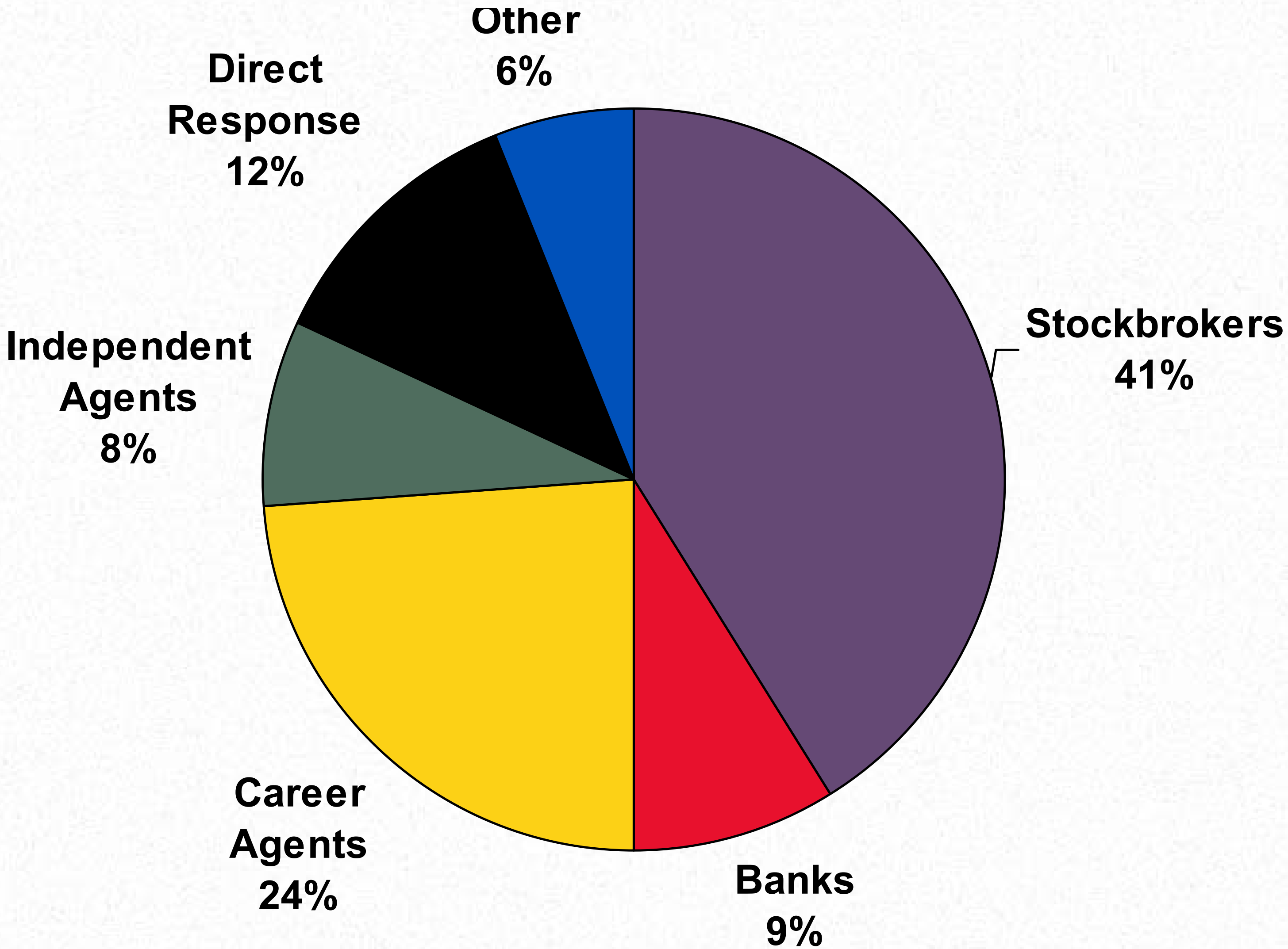
Distribution of Variable Annuities



Source: LIMRA International 2002

Taxation of Variable Annuities and Mutual Funds

- Mutual funds are taxed on gains and income passed through to investor plus any gains realized upon sale.
- Mutual fund long term gains and dividends are taxed at a reduced rate.
- Variable annuities are tax deferred until withdrawal is made. Withdrawals are taxed at ordinary income rate. 10% penalty on withdrawals prior to 59½.
- Variable immediate annuity payments taxed based on income in excess of an exclusion amount.

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The 2003 Tax Act

- Reduced tax rates on dividends and long term capital gains.
- Reductions will sunset after 2008
- Variable annuity gains still taxed at the higher ordinary income rate.
- The impact is to reduce the attractiveness of variable annuities relative to mutual funds that distribute dividends and capital gains.

NAVA Study: Value of Lifetime Annuitization

- Prepared by PriceWaterhouseCoopers for the National Association for Variable Annuities and dated January 9, 2002.
- Compared annuitization of a variable annuity to systematic withdrawals from a mutual fund. The mutual fund withdrawals had a 95% percent chance of lasting for the remaining lifetime.
- Results showed that after-tax income from annuity exceeds mutual fund income in all cases tested.

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NAVA Study: Annuitization vs. Systematic Withdrawals After the 2003 Tax Act

- Prepared by PriceWaterhouseCoopers for the National Association for Variable Annuities and dated October 20, 2003
- Compares after tax performance of non-qualified annuities to that of mutual funds.
- Measures: Break-even holding periods and cumulative after tax distributions.
- Distribution options: Systematic withdrawals and annuitizations.
- Results show that variable annuities out-perform mutual funds with longer holding periods.
- Assumes expense rate for VA's exceed mutual funds by .17% based on industry data.

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How Do Non-Qualified Variable Annuities Compare to Mutual Funds

- **Case 1: Completely liquidating assets at retirement from both products.**
- **Case 2: Taking systematic withdrawals during retirement from both products.**
- **Case 3: Purchasing a immediate variable annuity (SPIVA) at retirement compared to mutual fund systematic withdrawals.**
- **Case 4: Annuitizing a VA at retirement compared to using mutual fund redemptions to purchase a Variable Immediate Annuity.**

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Case 1: Complete Liquidation of Assets at Retirement

- $100,000 invested in a mutual fund and a variable annuity at age 42.
- Lump sum distribution at age 62.
- Mutual fund expenses are assumed to be an average of 75bp annually.
- The sum of variable annuity mortality and expense charge and fund expense is assumed to be 150bp.
- Return over 20 years assumed to be 9%.

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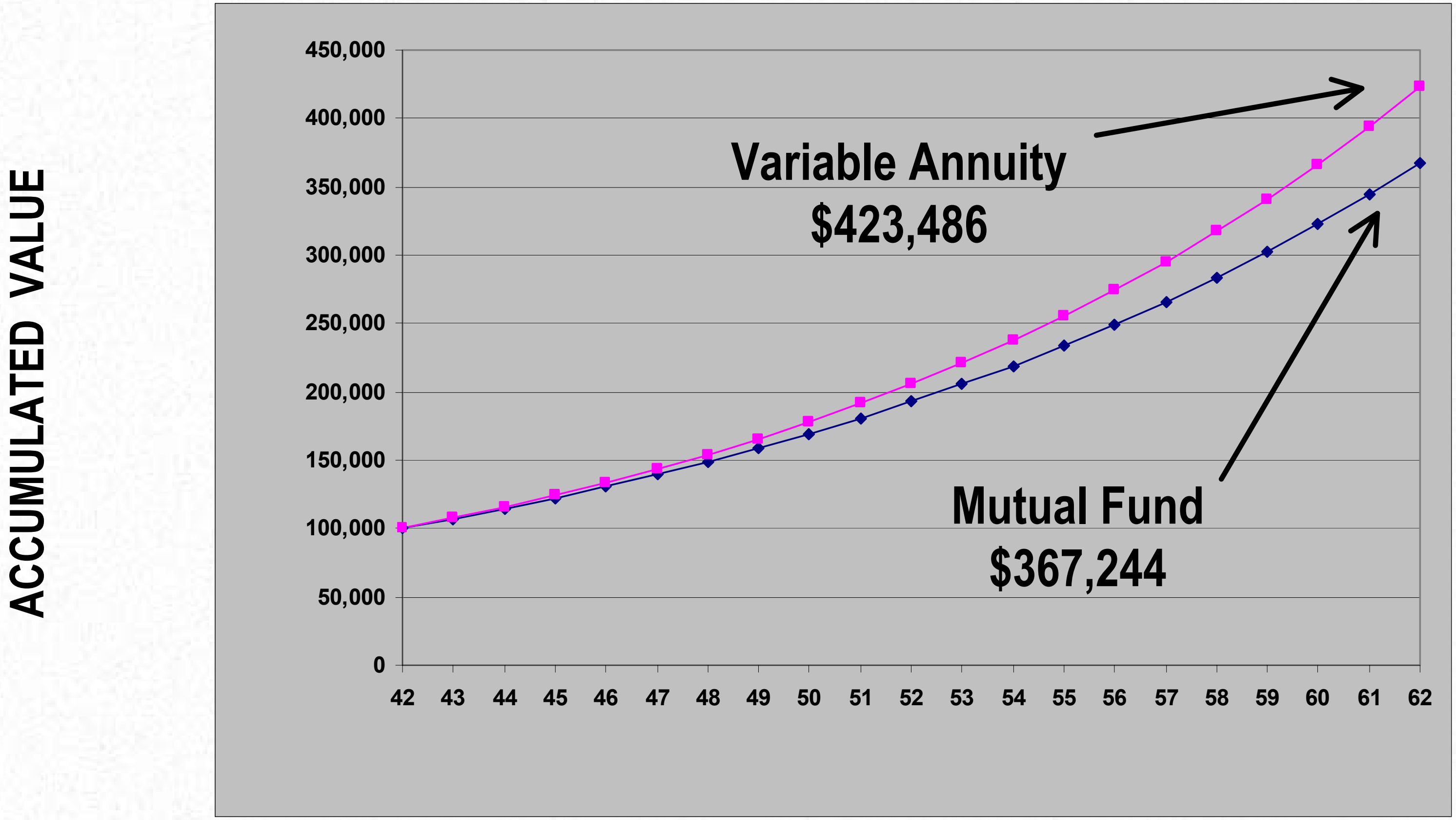
Taking a Lump Sum Withdrawal

Variable Annuity vs. Mutual Fund



Variable Annuity after-tax value at age 62: $297,986
Mutual Fund after-tax value at age 62: $356,346

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Case 2: Taking systematic withdrawals during retirement

- This analysis assumes a customer invests $100,000 in both a Mutual Fund and a Variable Annuity.
- Each fund is accumulated for a variable amount of years, and then systematic withdrawals are taken for 20 years.
- The amount of the systematic withdrawals for each product’s fund are determined so that the amount left in the fund is $0 after 20 years.
- The cross-over point is the minimum accumulation period needed so that the after-tax amount received from the Variable Annuity is greater than that received from the mutual fund.

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Cross - Over Points For Systematic Withdrawals

- **A customer invests $100,000 in a Variable Annuity mutual fund and $100,000 in the corresponding retail mutual fund and takes systematic withdrawals from both after accumulation period.**
- **The cross over point is the minimum accumulation period such that the total of after tax withdrawals over twenty years is greater for the variable annuity than for the mutual fund.**

	Assumed Return		Taxable Distributions	Fund Expenses & Annuity M&E Charges		
Fund	Accum.	Payout	DIV / STG / LTG / OI	Variable Annuity	Mutual Fund	Cross Over Year
Growth & Income	9%	S&P500	46/6/25/0	1.50%	1.00%	16
Aggressive Growth	10%	S&P500	22/8/33/0	1.75%	1.00%	22
S&P 500 Index	9.5%	S&P500	20/8/24/0	1.25%	.25%	32
High-Yield Bond	8%	Bond Index	0/3/4/93	1.50%	1.00%	1

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Case 3: Compare Systematic Withdrawals from a Mutual Fund to Variable Annuitization of a VA

- Assumes a male age 62 makes an investment of $2 million
- Annuity payments (variable annuitization option) for life with 20 years certain.
- Systematic withdrawals set to equal annuity payment amount until funds run out.
- Thirty year projection using 1974-2003 historical experience during payout period.

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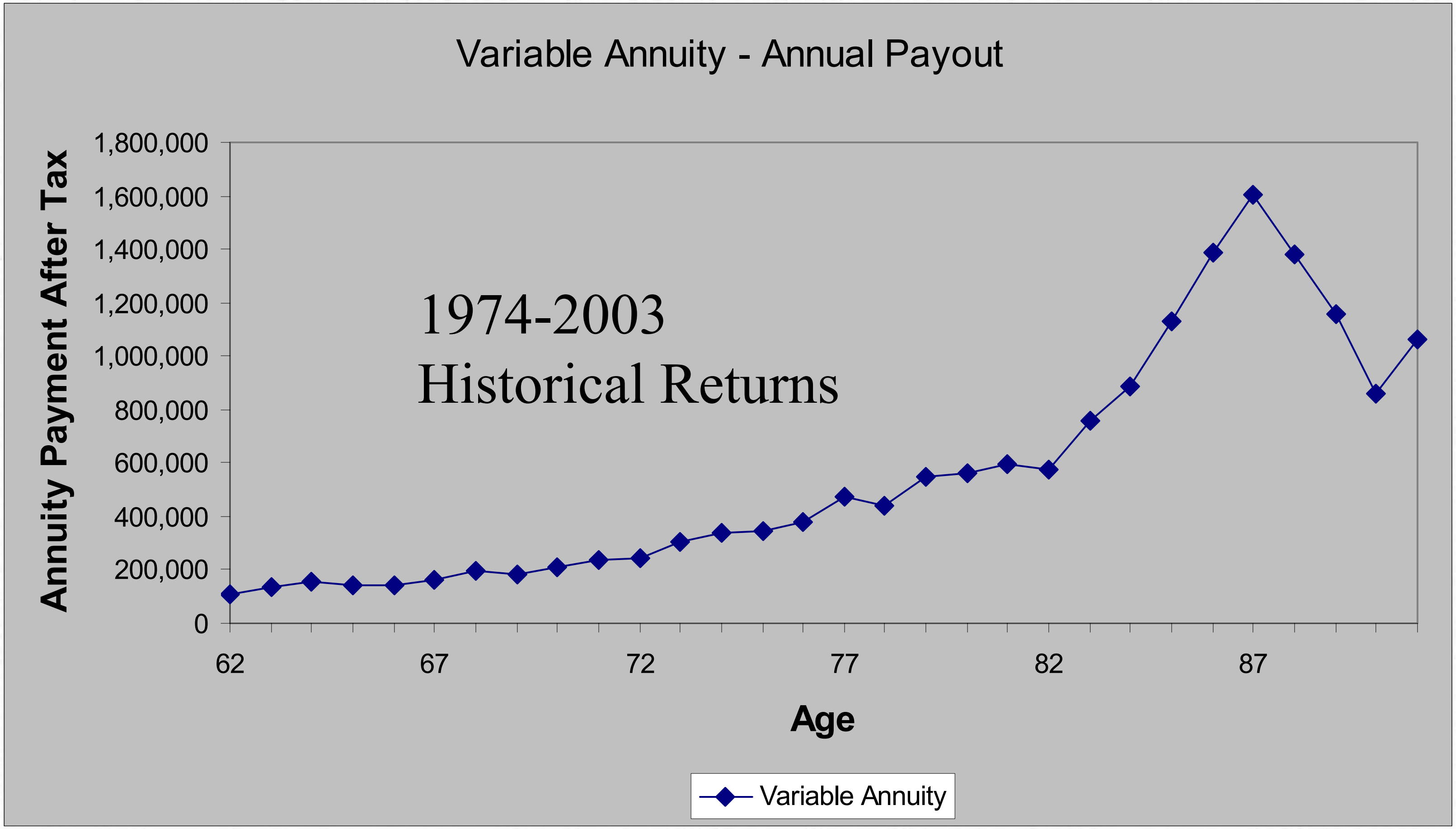
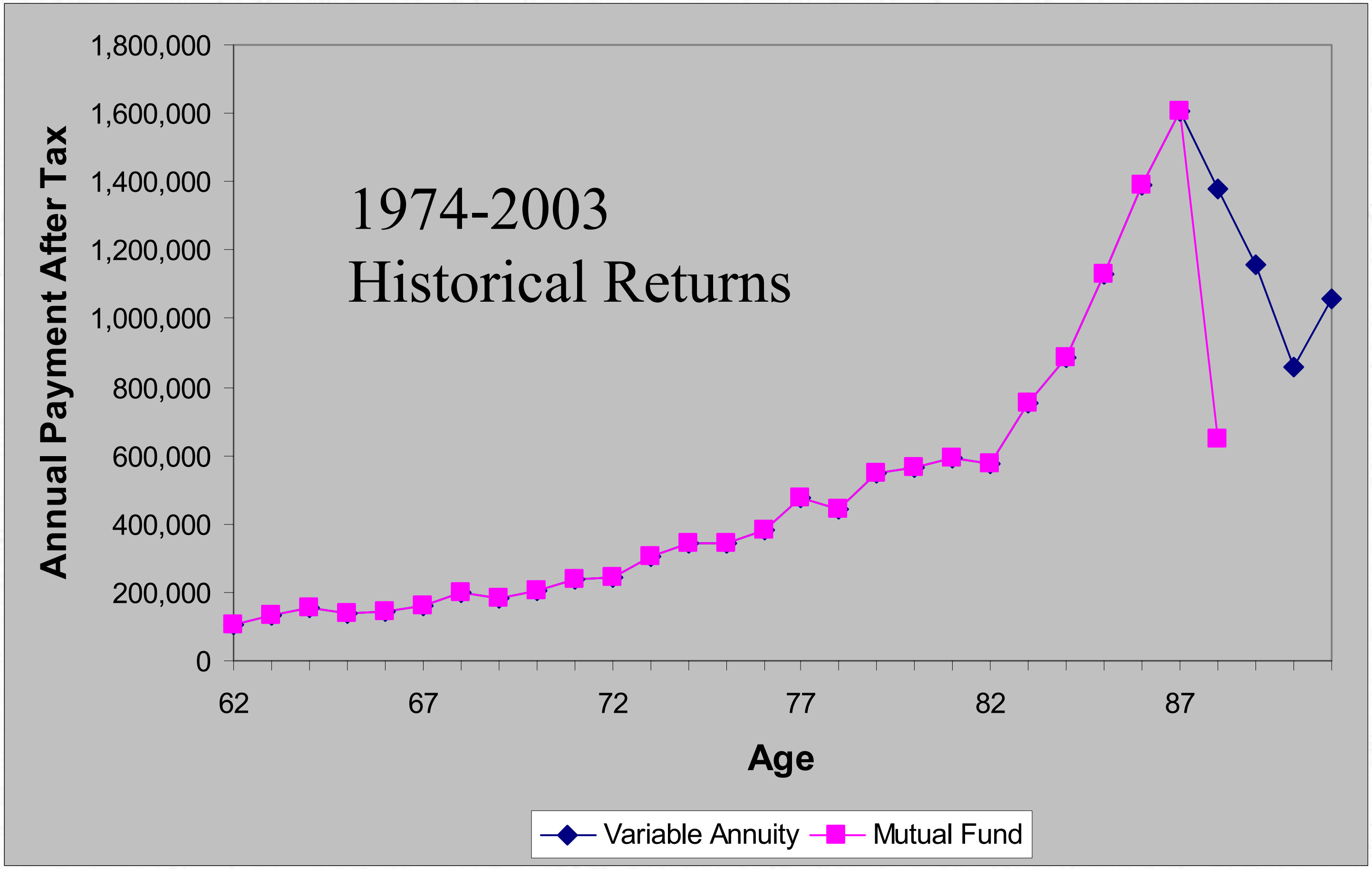
Creating Retirement Income By Annuitizing A Variable Annuity



Comparison: Creating Retirement Income Using a Variable Annuity and a Mutual Fund



Case 4: Comparing a Mutual Fund Plus a Variable Immediate Annuity at Retirement to a SPIVA

- A customer invests $100,000 in a variable annuity at age 42 and annuitizes at age 62.
- Alternatively, the customer invests $100,000 in the same mutual fund at age 42 and at age 62 uses the proceeds to purchase a SPIVA.
- The annuity is for life with 20 years certain.
- Return Assumption: Fixed 9% return during accumulation period and 1974-2003 historical experience during payout period.

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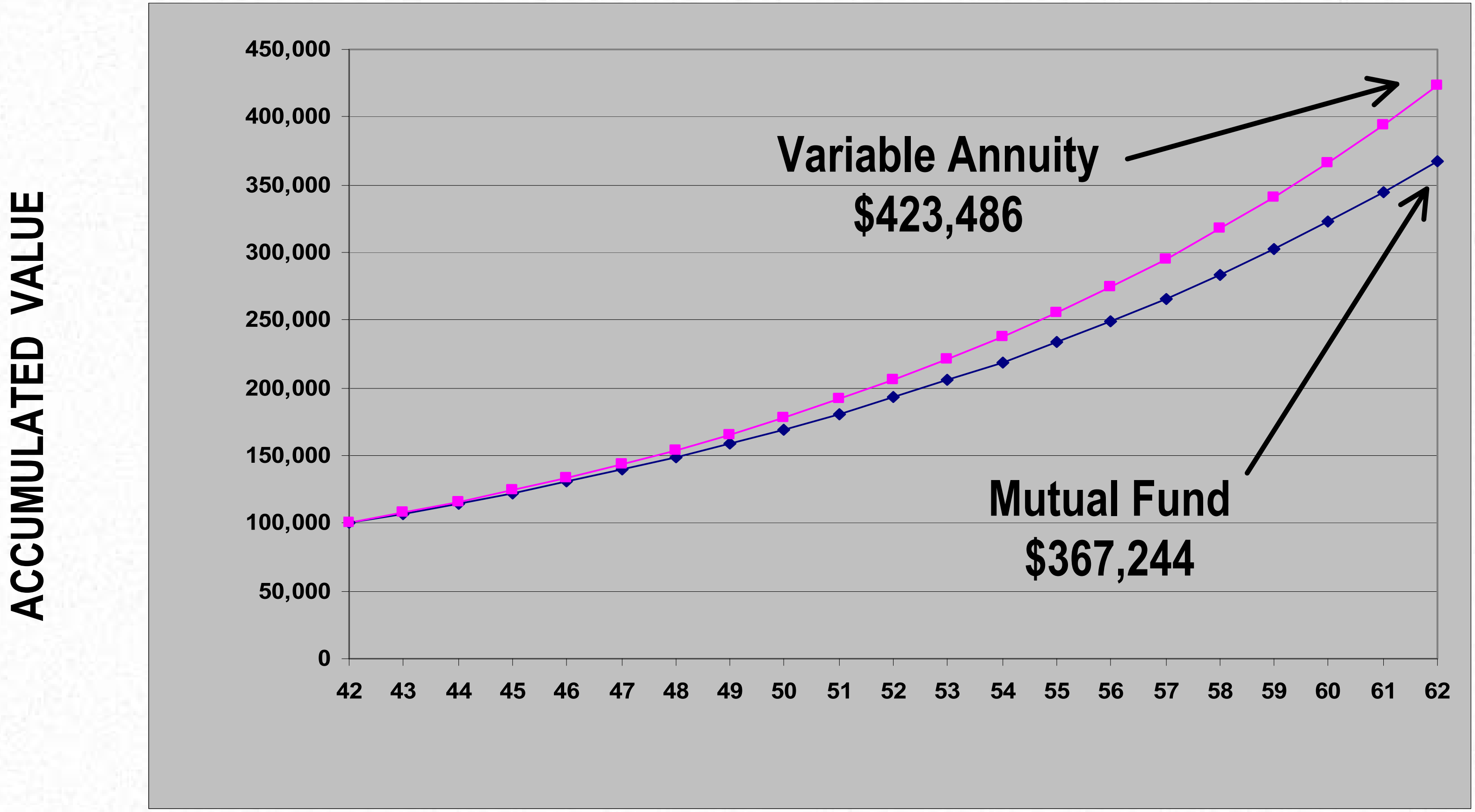
Accumulating Money For Retirement: The Benefit Of Tax Deferral



VA fund value to be annuitized: $423,486

After-tax value of mutual fund used to purchase SPIVA: $356,345

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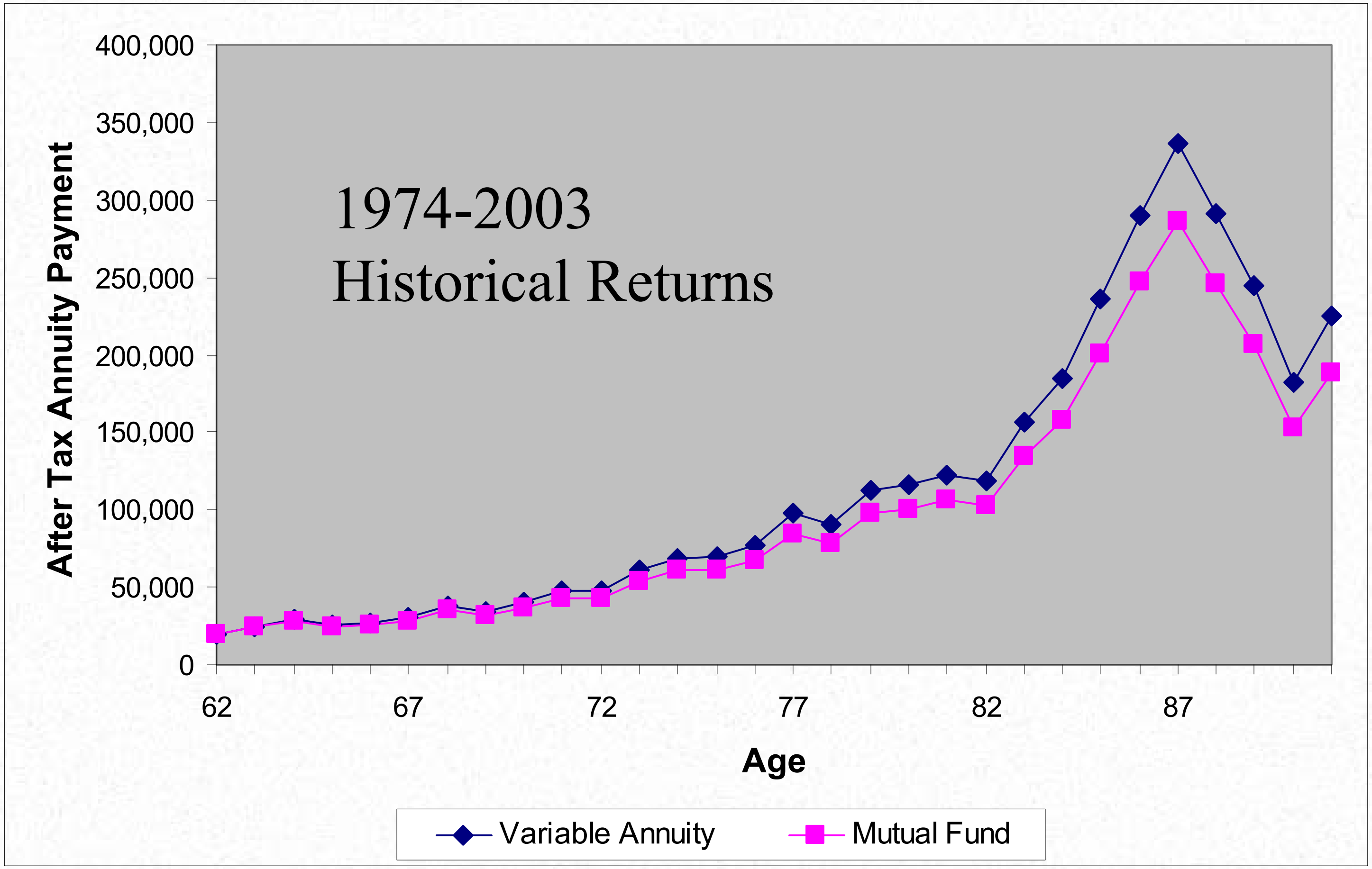
After Tax Annuity Payments After Accumulating Money In A Variable Annuity Or Mutual Fund



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Annuitization After Accumulating Money In A Variable Annuity Or Mutual Fund

	Variable Annuity Annuitized	Mutual Fund Proceeds Annuitized
Accumulated value at age 62	$423,486	$367,244
Amount available to annuitize	$423,486	$356,345
First annuity payment pre-tax	$25,032	$21,064
First annuity payment after tax	$19,200	$19,016
Difference between first after tax payment	$184	
Difference between year 20 after tax payment	$16,542	
Difference between year 25 after tax payment	$43,180	
Difference between year 30 after tax payment	$35,590	

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Summary of Results

Case	Results
Liquidation after 20 year accumulation period	The Mutual Fund has a higher after tax withdrawal
Accumulate and take systematic withdrawals over 20 years	If accumulation period is from "x" years or longer VA has a higher 20 year sum of after tax payments
Annuitization of a variable annuity and systematic withdrawals from a mutual fund	Mutual Fund runs out while annuity payments continue for life
Annuitization of a variable annuity and a mutual fund	The Variable Annuity has a higher 20 year sum of after tax payments

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Common Assumptions for Comparisons

- **Investment Return**
  - **Fixed return for accumulation period from 8-10% based on fund, historical indices for payout projection period for the number of projection years leading up to 2003.**
- **Fund and Annuity Expenses**
  - **.75% for standalone mutual fund and 1.5% for the VA for analyses.**
  - **For crossover analyses fund specific expenses are used.**
- **Taxes**
  - **Combined federal and state tax is 27.5%** on ordinary income and 20.0%** on dividends and long term capital gains before and after retirement, except for the lump sum liquidation which was taxed at 35%.**
  - **For analyses using average expenses 27% of fund return paid as dividends, 6% as short-term capital gains, 21% as long term capital gains and 20% as ordinary income***. For crossover analyses average fund category distributions were used***.**

** Assumes contract holder is in 23% federal marginal tax bracket (based on PWC survey) , state tax rate is 5.84% and capital gains tax rate is 15%.

Key Factors and Their Impact on the Favorability of a Variable Annuity or a Mutual Fund

Factor	Favors:
Higher Rate of return	VA
Longer Accumulation Period	VA
Higher State income tax rate	VA
Higher Mutual Fund exchange rate	VA
Higher Tax bracket at retirement	Mutual Fund
Higher Difference between VA and Mutual Fund fees	Mutual Fund
Higher Mutual Fund long-term gains and dividends	Mutual Fund

Conclusions

- Variable annuities can outperform mutual funds on an after tax basis in several different situations:
  - Accumulation horizon is long and systematic withdrawals will be taken.
  - Desired investments generate relatively small dividends and long term gains (e.g. bond funds).
  - Funds that will be used to purchase payout annuity (annuitization)
  - Available minimum guarantees provide additional utility to contract holder.
  - Relatively low fund fees on variable annuity funds.

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Marketing Appeal of Variable Annuity Guarantees

- Value of these features not considered in the previous analysis.
- Guaranteed Minimum Death and Living Benefits (GMDB’s and VAGLB’s).
- Creates an additional benefit that does not have a direct counterpart in mutual fund investments.
- Appeals to investors that want market participation yet have some degree of risk aversion.

Variable Annuity Guarantees

- These benefits provide various forms of protection against market drops.
- Guaranteed Minimum Death Benefit (GMDB)
  – provides additional death benefit protection in the case of market underperformance
- Guaranteed Living Benefits (VAGLB)
  – Guaranteed Minimum Withdrawal Benefit (GMWB)
  – Guaranteed Minimum Income Benefit (GMIB)
  – Guaranteed Minimum Accumulation Benefit (GMAB)

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Guaranteed Minimum Death Benefit (GMDB)

- Different variations of this benefit provide different levels of protection against death in a down market environment.
  - **Return of Premium Guarantee**. The most basic level of protection. This is provided in the base contract sold by many companies.
  - **Reset**. The benefit is reset based on the fund value as of a periodic reset date.
  - **Ratchet**. This ratchets up the death benefit to the highest fund value over several periodic anniversaries.
  - **Roll-up**. Provides a death benefit equal to the premiums accumulated at a specified interest rate
- Many companies provide a maximum of different combinations of these variations.

Guaranteed Living Benefits (VAGLB)

- Guaranteed Minimum Withdrawal Benefit (GMWB)
  - Provides a return of investment guarantee if systematic withdrawals are taken. The maximum annual withdrawal for this benefit is typically 7% of the initial investment. The additional cost for this benefit ranges from 35-50 basis points.
- Guaranteed Minimum Income Benefit (GMIB)
  - Provides a guaranteed annuitization income benefit. This benefit is based on a minimum accumulation value applied to a conservative fixed annuitization price.
- Guaranteed Minimum Accumulation Benefit (GMAB)
  - Provides a guaranteed return of investment or additional return on the funds over a specified period.

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Living Benefits Provided by Top Annuity Writers					
Company	2003 VA Sales ($B)	Market Share	Living Benefits Offered		
			GMWB	GMAB	GMIB
Top Annuity Writers					
Hartford	11.7	13%	✓	-	-
TIAA-CREF	9.6	10%	-	-	-
Equitable	8.1	9%	-	✓	✓
MetLife	7.3	8%	-	-	✓
AIG/Sun America	5.9	6%	-	-	✓
Pacific Life	4.6	5%	✓	✓	✓
ING	4.3	5%	✓	✓	✓
Prudential	3.8	4%	✓	✓	✓
Nationwide	3.5	4%	-	✓	-
AEGON	3.2	4%	✓	✓	✓
Top Ten Total	62.1	67%			
Other Annuity Writers					
Lincoln National	2.8	3%	✓	-	-
Phoenix	0.6	1%	-	-	✓
John Hancock	0.3	<1%	-	-	✓

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Source: Morgan Stanley

Guarantee Challenges

- Explaining guarantees to prospective or current contract holders. Potential for miscommunication.
- Requires highly skilled and specialized sales and service staff to understand guarantees.
- Creates extra risk and administrative burden for issuing company.

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Other VA Features

- A Fixed fund option
- Dollar Cost Averaging
- Automatic Asset Allocation
- Death Benefit Tax Riders
- Long Term Care Riders

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VA Fund Selection

- Low expenses
- Large selection of funds
- Diversified selection of funds
- Name brand or fund manager name recognition
- Expense reimbursement arrangement

Incorporating Variable Annuities into the Retirement Planning Process

- Educating financial planners and sales force about when a Variable Annuity is a favorable investment.
- Educating financial professionals and the public about the benefits of annuitization, in particular the benefits of variable payouts.

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Suitability – NAIC "Senior Protection in Annuity Transactions Model Regulation"

- Two main requirements

1. There must be "reasonable grounds" to believe that a recommendation for an annuity purchase to a "senior consumer" is suitable.
2. There must be adequate supervision of annuity recommendations to ensure compliance with the regulation.

- Provides that compliance with NASD suitability rules satisfies requirements for variable annuity recommendations.

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Proposed NASD Rules for Variable Annuity Sales - Suitability

- In recommending a deferred variable annuity transaction, a registered representative would be required to determine that:
  - the customer has been informed of the unique features of the variable annuity;
  - the customer has a long-term investment objective, and
  - the deferred variable annuity as a whole, and its underlying sub accounts, are suitable for the customer, particularly with regard to risk and liquidity.
- The registered representative would be required to document these determinations.

Proposed NASD Rules for Variable Annuity Sales – Prospectus & Disclosure

- Must provide prospectus and "plain English" risk disclosure document highlighting:
  - Liquidity issues
  - Sales Charges
  - Fees
  - Federal Tax Treatment
  - Premium Taxes
  - Market Risk

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Proposed NASD Rules for Variable Annuity Sales – Review, Supervision and Training

- Registered Principal would be required to review all transactions for suitability.
- Registered Principal must review and approve suitability document and replacement/exchange document
- Firms must maintain specific, written supervisory rules
- Develop and document specific training policies.

SEC and NASD Joint Report

- Weak and strong practices noted by examiners in several areas:

1. Suitability, Sales Practices and Conflict of Interest
2. Supervision
3. Disclosure
4. Books and Records
5. Training

- Several Enforcement Cases Ongoing.

Ongoing Developments

- Portman-Cardin III
  - Initiative before Congress that would allow a $2,000 annual exclusion from a lifetime stream of annuity payments from qualified retirement plans (including IRA's).
  - Incentive to reduce longevity risk
  - Help reduce the risk of elderly poverty
- The American Council of Life Insurers (ACLI), Committee of Annuity Insurers and National Association for Variable Annuities (NAVA) formed a coalition (Americans for Secure Retirement).
  - focus on legislation to make a tax incentive for life contingent income payments from individual annuity contracts.

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Ongoing Developments (cont'd)

- Lifetime Savings Accounts and Retirement Savings Accounts (LSA's/RSA's) – Creates tax free/tax deferred accounts for personal savings with higher limits than current IRA's.
- Guaranteed benefits capital charges and reserves – could increase charges for guaranteed benefits, especially if no company hedging program.
- SEC: New and Proposed Rules
  - New SEC disclosure rules for market timing risks
  - Would require written compliance procedures and disclosure of compensation.
  - 2% fee to be charged for trading funds within 5 days of purchase to address market timing abuse.
  - Get rid of 12b-1 fees.

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Summary

- VA’s can outperform mutual funds in certain instances.
- VA Guarantees play a big part in today's market.
- Regulation is increasing at the state and federal level.

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