A NEW APPROACH TO TAX-ADVANTAGED INVESTING

The Benefits of Investment-Only Variable Annuities

By Mitchell H. Caplan, JD

High tax rates have been top of mind for advisors and their clients in recent years, particularly for high-income investors and the high-net-worth. The majority of advisors and their clients value tax deferral, but many are unaware of the full scope of its benefits. And to optimize client outcomes, a new generation of variable annuities is key.

The Power of Tax Deferral

Today's advisors must manage the dual challenge of rising taxes and ongoing volatility. To confront these complex market dynamics, 96 percent of financial advisors say tax deferral is important, and 94 percent report that their clients agree, according to a recent survey from Jefferson National. Further, 86 percent of advisors say they expect that tax deferral will be more important in the future, and 59 percent say they have increased their use of tax deferral over the past five years.

Tax deferral is a crucial component for optimizing client outcomes, but the survey reveals a lack of understanding around the full scope of its benefits. In fact, 59 percent of advisors say their clients have no knowledge about tax deferral beyond traditional 401(k) plans and individual retirement accounts (IRAs), which means that many clients are leaving opportunities on the table to maximize wealth through other tax-deferred vehicles. Moreover, only 19 percent of advisors are aware that tax deferral can generate additional alpha of 100 basis points (bps) or more depending on the assets within the portfolio.

For most clients, tax deferral can mean minimizing taxes today, saving for the future, and more. Tax deferral has the power to create "tax-alpha," maximize accumulation, generate more retirement income, and leave a legacy through a new generation of variable annuities.

The Tax-Efficient Frontier

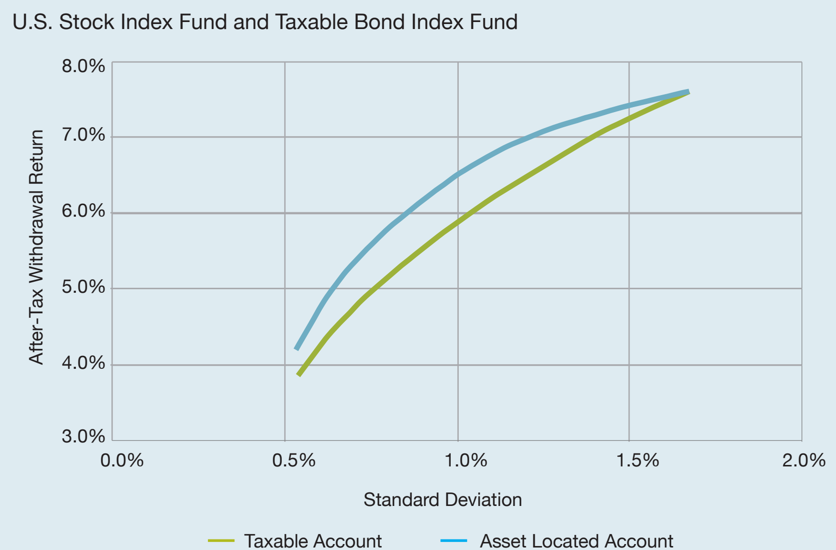
Every financial advisor is familiar with the concept of the efficient frontier and trying to attain the optimal balance of risk and reward. Achieving the efficient frontier is a driving force behind the investment choices that every advisor makes. Likewise, research has shown measurable benefits to achieving the tax-efficient frontier, where advisors use tax deferral to increase returns for clients, generating additional alpha of 100 bps or more without increasing risk.

The tax-efficient frontier is achieved through asset location, which typically is defined as optimizing portfolios by placing assets in the most tax-advantageous account type. Asset location begins with asset selection, which requires evaluating the tax characteristics of asset classes, turnover rates, clients' time horizons for their investments, and break-even points.

Figure 1 demonstrates how asset location can systematically improve returns, without increasing risk. It illustrates the expected rate of return at a given level of risk for an investor using a typical asset allocation strategy, compared to how the same investor would fare using an asset location strategy.

Start by evaluating the client's portfolio by asset class, risk, and tax characteristics. Identify the tax-efficient assets and

Figure 1: Two-Fund 10-Year Tax Efficient Frontier



Based on return data from the CRSP Mutual Fund database, calculated for the highest federal tax bracket. Average state taxes are also included. The 10-year returns are calculated for each 10-year period starting since the funds' inception in 1993 through 1998.

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tax-inefficient assets. Tax-efficient assets, such as index funds, funds with low turnover, and passively managed investments, generate long-term capital gains and dividends taxed at a maximum rate of 20 percent. Tax-inefficient assets, such as bond funds, real estate investment trusts (REITs), and many hedge-like funds, generate ordinary income or short-term capital gains taxed at a rate as high as 39.6 percent. Actively managed investments can suffer the biggest hit—short-term capital gains tax plus multiple transaction fees.

Figure 2: Optimal Asset Allocation

To further evaluate tax-efficiency we look at break-even points—the points in time when tax deferral will help assets yield better after-tax returns. Tax-efficient assets typically have longer break-even points and performance generally can be optimized when located in taxable vehicles, unless clients plan to hold these assets for several decades. Conversely, tax-inefficient assets can have break-even points of one year or less and almost always should be located in tax-deferred vehicles.

Figure 2 provides general guidelines for optimal asset location based on these break-even points.

A Tax-Advantaged Investing Solution

Once the tax-efficiency of assets has been evaluated, determine which assets should be located in taxable vehicles and which should be in tax-deferred vehicles. This will minimize the impact of taxes on accumulation, enhance portfolio performance, and maximize after-tax returns.

Placing tax-inefficient bonds and REITs in tax-deferred vehicles allows income to compound for years without paying taxes until assets are distributed. For clients close to or in retirement, and who typically allocate more bonds in their portfolios, this approach can be particularly beneficial. For advisors who use tactical management, liquid alternatives, and other high-turnover strategies to manage risk, a tax-deferred vehicle provides additional benefits. It allows them to reallocate as needed, capture more upside, minimize downside, cut costs, and compound gains for years. In this way, tax-deferred vehicles help advisors control how much clients pay in taxes and also when they pay taxes.

When using tax-deferred vehicles, it is first important to maximize contributions to qualified plans such as IRAs or 401(k) plans. However, high-net-worth individuals easily max-out the contribution limits of qualified plans ($17,500 in 2013 and 2014; $18,000 in 2015) and need additional vehicles and strategies to grow portfolios and minimize taxes. Once qualified accounts are maxed-out, one of the only available choices for more tax deferral is variable annuities.

A New Generation of Annuities

A great advantage of variable annuities (VAs)—one often overshadowed by the industry's focus on insurance guarantees—is the power of tax deferral. Studies such as Weiss (2008) show that tax deferral can generate additional tax-alpha of 100 bps or more, so the question is, why aren't variable annuities used more frequently for tax-advantaged investing? The answer is that most traditional VAs, with layers of asset-based fees for basic mortality and expense, income benefits, and other insurance guarantees, easily charge 300 bps or more—effectively wiping out the value of tax deferral.

To maximize the value of tax deferral, a VA must be low-cost. To this end, the industry is developing a new generation of investment-only variable annuities (IOVAs) designed as a low-cost tax-advantaged investing solution. IOVAs have low or no commissions and reduced asset-based or flat fees to help advisors generate more tax-alpha and help clients earn higher returns and build more long-term wealth.

Another key factor to generate more tax-alpha is access to a broad range of the right underlying funds. In the post-crash years, as asset classes have become increasingly correlated, it has become critical to have maximum choice to achieve maximum diversification. Likewise having the right mix of funds to implement more proactive risk controls can give clients confidence to maintain a more aggressive allocation to risky assets with greater growth potential, which is essential to keep pace with inflation and to maximize long-term performance.

This means moving beyond modern portfolio theory's traditional mix of fixed income and equities to enhanced modern portfolio theory. Most IOVAs include more noncorrelated asset classes, more hybrid investments, and more liquid alternative funds that employ strategies for managing volatility such as those favored by hedge funds and elite institutional investors. These risk-managed funds, with sophisticated actively managed strategies, can generate short-term capital gains and be highly tax-inefficient. Using them in a tax-deferred IOVA with lower fees captures gains in the short term so they can compound for the long term.

The Retirement Income Challenge

Investment-only variable annuities provide a new framework for the discussion every advisor is having with clients today, as they face the challenge of planning for retirements that could last 30 years or more.

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Over the next decade, boomers will turn 65 at the rate of 8,000 a day. Now that Americans are living longer, their number-one concern is whether they will outlive their assets. As the efficacy of Social Security comes into question, and the safety net erodes in an economic environment that remains unstable, the retirement income challenge is very real.

Generating reliable retirement income has become challenging for advisors because each client's situation is unique, market dynamics have become more complex, and the landscape for variable annuities has evolved significantly. Beginning in the 1990s, the VA industry grew rapidly as products were offered with an expanding range of enriched insurance benefits and income guarantees. The appeal to investors was a compelling combination of downside protection, upside potential, and a guaranteed income stream in one product.

But since the financial crisis, historic low yields and ongoing volatility have made it increasingly challenging for insurers to manage risk, making these enriched income guarantees offered by traditional VAs more costly to provide and more expensive for consumers to purchase. Many companies have chosen to reprice and retool—raising fees, cutting benefits, and restricting allocations—and some have chosen to retreat from the industry altogether. In response, the industry has introduced the cost-conscious and tax-focused approach of IOVAs.

Table 1: Remaining Wealth or Shortfalls for a VA/GLWB and the Low-Cost IOVA with a 60/40 Asset Allocation and for Unguaranteed Low-Cost IOVA Replicating the VA/GLWB Payouts

Based on $100,000 Investment, 5,000 Monte Carlo Simulations, and Historical Market Averages

	LOW-COST IOVA	VA/GLWB
After 10 years accumulation and 20 years withdrawal		
Probability of Depletion	4.2%	32.9%
Median Ending Balance (real wealth)	$139,893	$29,718
Compared to initial deposit	40% more	70% less
After 20 years accumulation and 20 years withdrawal		
Probability of Depletion	5.9%	46.0%
Median Ending Balance (real wealth)	$250,376	$10,988
Compared to initial deposit	150% more	90% less
After 10 years accumulation and 30 years withdrawal		
Probability of Depletion	12.1%	58.0%
Median Ending Balance (real wealth)	$159,708	$0
Compared to initial deposit	60% more	Assets Depleted
After 20 years accumulation and 30 years withdrawal		
Probability of Depletion	11.4%	66.7%
Median Ending Balance (real wealth)	$295,331	$0
Compared to initial deposit	190% more	Assets Depleted

Source: Pfau (2014)

Greater Gamma through Tax Deferral

Just as tax-alpha allows an advisor to increase returns without increasing risk, beta can gauge the volatility of an investment compared with the market as a whole. Typically, gamma measures how fast the price of an option contract changes relative to the price of the underlying asset. Morningstar researchers Blanchett and Kaplan (2013) introduced a new approach to gamma to measure the added value of making better financial decisions to increase retirement income.

Blanchett and Kaplan (2013) state their approach to using gamma has been developed "to quantify the additional value that can be achieved by making more intelligent financial planning decisions." They add that gamma as a measure of more retirement income is created from five factors: (1) asset location and withdrawal sourcing; (2) total wealth asset allocation; (3) annuity allocation; (4) dynamic withdrawal strategy; and (5) liability-relative optimization.

All five factors are critical to creating more gamma and generating more retirement income. Leveraging tax deferral through asset location and withdrawal sourcing, however, is becoming increasingly important for advisors and clients, especially the high-income and high-net-worth. According to this research, the asset location component of gamma has real and measureable value. It adds tax-alpha to an overall portfolio and can add as much as 320 bps retirement income every year.

A New Approach to Retirement Income

Pfau (2014) determined when a guaranteed variable annuity is worth the cost of the additional protection it provides versus when a low-cost tax-deferred IOVA has the potential to provide greater wealth accumulation, generate greater retirement income, and offer greater legacy potential.

Pfau (2014) concludes that the primary advantage to the variable annuity is the power of tax deferral. Pfau (2014) also finds that just as the power of tax-deferred compounding can grow wealth, the drag of compounding fees can reduce wealth. In turn, low-cost IOVAs may have potential to provide more efficient ways for clients to generate income and obtain upside potential and downside protection.

Pfau (2014) uses a proprietary model that runs 5,000 Monte Carlo simulations using more than eight decades of market data to test a variety of investor scenarios to simulate how often a rider might be useful and what the true value of that rider would be. Table 1 illustrates an investor's outcomes when using a low-cost IOVA versus a guaranteed VA. It compares an investor's probability of asset depletion, their median ending balance, and the percentage of accumulated wealth or shortfalls, based on an initial investment of $100,000 using a range of common accumulation and withdrawal scenarios. The guaranteed VA is designed to provide income even if the account balance falls to zero, but its high asset-based fees are likely to erode returns

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on underlying assets and drive the balance to zero more quickly. Alternatively, in the majority of scenarios, the low-cost IOVA is likely to generate income comparable to the guaranteed VA. At the same time, in the majority of cases, the IOVA's lower costs reduce the risk of depleting wealth—and increase chances of accumulating more wealth—which may lead to more income and a larger ending balance.

The Right VA is Key

Advisors surveyed say they believe that tax deferral is important, and many believe its importance will increase. Clients who are not capitalizing on low-cost tax-deferred vehicles and the proper location of assets are missing a number of important opportunities now—and in the future.

Most clients have a general idea about tax deferral, but many are unfamiliar with details around the implementation of various tax-advantaged investing strategies. To help clients understand, it's important to communicate concretely about tax-efficiency and asset location in terms of real outcomes at a practical level—whether to minimize taxes, grow a portfolio, or generate more income.

Tax deferral can allow high-income and high-net-worth clients to manage their tax bills. For investors heavily allocated to fixed-income, alternatives, or tactically managed portfolios, tax deferral can help to optimize performance by generating additional tax-alpha of 100 bps or more, year over year. Tax deferral can maximize accumulation of retirement savings, helping to generate more retirement income that can last a lifetime or help leave a larger legacy.

In this challenging environment of rising taxes and volatile markets, clients will demand a more holistic approach to financial advice. Tax-deferral strategies will become more important. The need for asset location and tax-optimization will grow, and tax-efficiency will become a new standard for managing portfolios and planning for retirement. When taking this new approach to tax-advantaged investing, the right kind of low-cost IOVA is key.

BEST PRACTICES FOR LEVERAGING LOW-COST IOVAS

Variable annuities can be used as tax-deferred vehicles. However, traditional variable annuities have been criticized for layers of asset-based insurance fees that drive up costs and drive down performance. Research shows that the advantage to the variable annuity structure is the power of tax deferral—but it must be low-cost. Just as the power of tax-deferred compounding can grow wealth, its corollary is that the drag of compounding fees can reduce wealth. A new generation of low-cost IOVAs can provide a low-cost tax-advantaged investing solution to accumulate more wealth and generate more income.

Max Out Qualified Plans

When considering IOVAs, it first is important to maximize contributions to qualified plans such as IRAs or 401(k)s. The 2014 contribution limit to employer-based 401(k) plans is $17,500 ($23,000 age 50 or older). The 2014 tax-deductible contribution into an IRA is up to $5,500 ($6,500 age 50 or older). Your high-net-worth clients can easily max out these low contribution limits—and can benefit from additional tax-deferred vehicles.

Peel Back Insurance Fees

IOVAs are designed to be low-cost, but fees are still involved. Keep the following in mind:

Mortality and expense (M&E): Most annuities assess M&E charges. The industry average is 135 bps per year according to Morningstar. Many low-cost IOVAs charge substantially less, from 30–85 bps. This is still an asset-based fee. So the greater the investment, the higher the costs of this M&E. For a $100,000 VA, the client may pay $850 in M&E per year; for a $1-million VA, the client may pay as much as $8,500 every year. For higher-balance accounts a flat-fee IOVA may be the lowest cost.

Administration fee: Many IOVAs, even the low-cost variety, charge an annual asset-based administration fee of 10–25 basis points. For the $100,000 VA, that could add as much as $250 per year; for a $1-million VA, it could add as much as $2,500 every year. Look for IOVAs with no additional administration fees.

Insurance guarantees: Many annuities, even the low-cost variety, may offer optional insurance guarantees to provide enhanced death benefits or future income streams. The industry average for an income guarantee is 125 bps, according to the 2013 Insured Retirement Institute Fact Book. For clients seeking more upside potential, look for IOVAs with no additional insurance guarantees.

Commissions: For registered investment advisors and fee-based advisors who seek to maintain a fiduciary standard and eliminate the possibility of any conflict of interest, look for no-load IOVAs.

Surrender fees: Any VA that pays commissions to an advisor will charge a surrender fee to keep the client locked-in until the company can recoup its commission. These surrender fees can range from 3 percent to 7 percent. For flexibility and liquidity, choose an IOVA with no commission and no surrender fee.

Find the Most Funds

Instead of complex insurance guarantees, low-cost IOVAs offer a broad range of investment options including all asset classes and style boxes. To maximize diversification and manage volatility, look for more noncorrelated asset classes, hybrid investments, and liquid alternative funds that employ strategies like those favored by hedge funds and elite institutional investors. In addition, look for unlimited transactions and no transaction fees.

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