

**P**op quiz: It looks and smells like the mutual fund business but comes in an insurance wrapper. And in the next ten years, it is expected to grow tenfold, to \$1 trillion. Give up? It's the variable-annuity trade. Insurance companies and mutual funds alike are grabbing at this brimming candy bowl.

Some \$118 billion of variable-annuity funds have been peddled already — many since 1990 (\$35 billion in 1993 alone). Players from Franklin Resources to Merrill Lynch have been scrambling to acquire or build variable-annuity assets. "Variable annuities will never be as big as mutual funds because there are no tax-exempt bond funds and [little demand for] money market funds in this market," says A. Michael Lipper, president of Lipper Analytical Services. But he predicts that by 2004 the business will be at least half as large as the mutual funds industry is now.

That's *without* counting all the cash funneled through variable annuities into guaranteed investment contracts, or those variable annuities sold by teachers' unions and others into the qualified market. Add in TIAA-CREF's \$124 billion in variable-annuity assets, and the market is more than \$240 billion. "The growth in variable annuities has been vastly understated because it has been misunderstood," contends Peter Bennett, who heads Equitable Life Assurance Society's variable-annuity business.

What's the attraction? Variable annuities are sort of limitless individual retirement accounts. Like IRAs, they guarantee investors tax-free accumulation of dividends and capital gains. And they can supplement other plans.

Most in the business attribute the swift rise in variables sales to demographics. "We are beginning to catch people in the baby boom," explains Joseph Buckley, vice president of retail annuity sales at John Hancock Financial Services. "As people age and get a sense of their own mortality, they also realize that they are going to spend one third of their lives in retirement and that they jolly well ought to save. About 37 percent of the savings for retirement has to be done on an individual's own initiative."

What the purveyors of variable annuities don't say quite so loudly is that the product provides rich benefits for them

# Variable annuities' reliable returns

*You'd think the point of these annuities was to provide the 'seller,' not the buyer, with a dependable income. Maybe it is.*

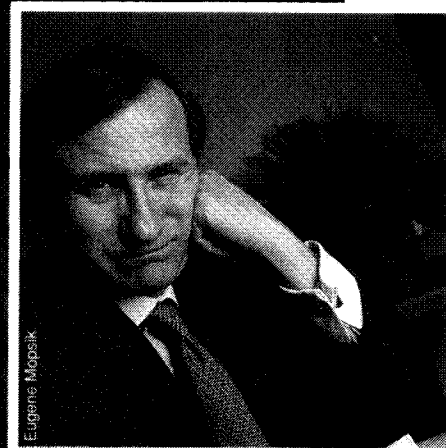
BY ALYSSA A. LAPPEN



Robert Frechette/JHFS

as well. Variable annuities are in fact *sold*, not bought. Perhaps 80 percent are purveyed through intermediaries, compared with 60 percent of mutual funds, says Paul Hondros, president of institutional sales at Fidelity Investments.

Insurance companies like being able to shift most of the risk they once assumed on annuities and GICs to the buyer, according to consultant Geoff Bobroff, who tracks the fund and annuity industries from Denver. On old-fashioned fixed-annuity products, insurers set a rate of return that they had to honor for the pre-



Eugene Mopsak

*Delaware Management's Wruble: "It's nice for the asset managers. The assets are quite sticky"*

*Hancock's Buckley: "We are beginning to catch people in the baby boom as [they] age and get a sense of their own mortality"*

determined term, whether the bond market rose or fell. High fees helped to offset the hazards. Nevertheless, few insurance companies are crying now that fixed annuities have been made passé by low interest rates: Gone are the risks of setting the promised returns too high, as Equitable did on its GICs in the mid-1980s.

Now the buyer decides what to invest in — and shoulders most of the market risk. Contracts typically offer at least five or six portfolio options, from a money market or corporate bond fund to an international stock or asset allocation

fund. Investors can switch freely among these funds without tax consequences. Aggressive investors get upside — and downside — potential. The sole risk covered by the insurance carrier: the “death benefit,” a guarantee that a buyer’s heirs will recoup all of the original principal.

The most powerful lure of the business for both fund families and insurers is that it represents an annuity for *them*. “Almost all variable annuities have asset-based charges,” points out Thomas Norton, a consultant on variable annuities at Towers Perrin’s Tillinghast division. Money managers collect annual advisory fees ranging from 25 basis points for indexed or money market funds to 125 basis points for aggressive overseas equity funds. This money rolls in whether markets are up or down.

“It’s nice for the asset managers,” croons Delaware Management Co. president Brian Wruble. “The assets are quite sticky.” In the pure fund business, he notes, the average investor attrition rate is about 1 percent per month. But variable-annuity buyers generally are in for the long term. Stephen Gibson, head of retail marketing at Putnam Investments agrees: “Many people will hold 13 or 14 years.”

Most contracts still carry five- or seven-year declining back-end loads to deter investors from leaving. But even after these “surrender” fees expire, losses on annuities are expected to be negligible. Asset managers have also benefited from less intense competition than in mutual funds. Some 1,160 variable-annuity investment choices are offered through contracts with roughly 80 insurance companies. That compares with more than 5,000 mutual funds.

### Fee inflating

Returns on the insurers’ minimal risk are handsome — about 125 basis points a year on average, according to Tillinghast’s Norton. True, insurance fees on variables — known as mortality and expense ratios, or M&E — must both pass a tacit Securities and Exchange Commission review and be disclosed, as must asset-based administrative and distribution fees (average: 15 basis points).

Out of the fees, insurers also pay an average 5 percent commission to brokers and insurance dealers, about one percentage point more than the commission on mutual funds. Some companies also pay

## UP, UP AND AWAY

Barring interference from Uncle Sam, the assets of the top 20 variable-annuity advisers should triple again before long.

Adviser*	Assets** (\$ billions)	Assets† (\$ billions)
Prudential	\$4.3	\$12.0
Capital Research	2.6	9.6
IDS Life	2.5	7.8
Equitable	2.5	7.0
Aetna	4.0	6.9
Fidelity	0.7	6.9
Franklin	0.4	5.5
Hartford	1.1	5.4
Merrill Lynch	2.8	4.9
Putnam	0.5	4.3
John Hancock	1.6	3.6
Mass Financial	1.9	3.6
NASL Financial	0.8	3.0
Northwestern Mutual	1.4	2.7
Lincoln National	0.9	2.6
Metropolitan	0.4	2.5
Dean Witter	0.4	2.3
Mass Mutual	1.0	2.2
Valic	0.3	2.0
SunAmerica	0.9	1.8

\*Ranked using 9/30/93 assets.

\*\*Assets are at the fund level, excluding GICs, as of 12/31/90.

† Assets are at the fund level, excluding GICs, as of 12/31/93.

Source: Lipper Analytical Services.

20 or 25 basis points a year to brokers to retain investors. The annuities are admittedly a more complicated sell. But the average variable-annuity sale is about \$25,000, compared with just \$10,000 for mutual funds, says Lipper. And if buyers want to back out early, commissions and marketing overhead are covered by those back-end loads.

Insurers have enterprisingly figured out ways to enhance income. Trendsetters like Bankers Trust Co.’s Golden American and SunAmerica’s Anchor National Life Insurance Co. have hiked M&E fees by charging for add-ons, such as stepped-up benefits to guarantee an annual increase in principal for heirs.

Stiff commissions can take a heavy toll on profits for the first six years or so. “If you get 125 basis points, and you have a six-year surrender charge at the end, you’ve been spinning your wheels for six years,” says Jerry Golden, founder and former president of Golden American.

So Golden set up a manager-of-managers program at the company he founded in 1987 and later sold to Mutual Benefit. This features portfolios run by such glittering names as Martin Zweig, Felix Zulauf, J.M. Hartwell & Co. and Weiss Peck & Greer Investment Man-

agement. For supplying star quality, Golden collects an average 200 basis points for the first six years. That includes fees for the “step-up” death benefit: a guaranteed 7 percent annual increase in principal. Others charge M&E fees as high as 175 basis points a year, including 20 basis points for 6 percent or so annual increases in the death benefit.

“There’s been an onward march toward 2 percent at the annuity contract level,” notes consultant Bobroff. “Add in advisory fees, and there are annuity contracts out there that cost upwards of 3 or 4 percent per year.” American Skandia Life Assurance’s Advisors’ Choice line, for example, charges annual investment allocation, M&E and administrative fees of 2.9 percent *before* adding on fees for its money managers.

Some marketers see increasing danger in fee inflation. Asks one, “Do you want to have the highest fees in the business when [personal-finances writer] Jane Bryant Quinn is taking potshots at annuities because of the fees?” His firm sticks to total charges of about 220 basis points, he says, “putting us in the middle of the pack, which is safe.” Admits another annuity official: “Even at 2 percent per year, the annual fees add up. It could take about six years for one of these contracts to make any sense for the buyer. With higher fees, it will take longer. But I have to pay someone to sell, and they have to pay someone to sit on an 800 line.”

The business is especially lucrative for insurers and fund companies that provide the insurance “wrapper” and the money management, collecting fees for both. The biggest of these double-teamers is Equitable, with some \$14.8 billion in variable-annuity assets. It sold \$2.21 billion of annuities in 1993 alone. Equitable owes much of its success with variable annuities to the strong performance of its money management team.

John Hancock is also doing well. Hancock, too, both writes insurance for its variable-annuity contracts and manages the money. Although it did not start to really see demand for variable annuities until 1989, the insurer has boosted retail sales, from \$200 million in 1988 to \$1.2 billion in 1993. Like Equitable, Hancock is pushing hard in the qualified-pension and IRA arenas.

Equitable, because it double dips, making money on insurance as well as

money management, can afford to hold total fees to a maximum of 175 basis points a year for small institutional clients, 200 basis points for retail buyers. At the high end, moreover, fees include added bells and whistles like sophisticated asset allocation funds. Hancock's total fees tend to top out at a very modest 180 basis points, even for the most aggressive stock funds; for U.S. bond funds, fees are much lower. "We look at hurdle rates and hope for a return on surplus of about 12 to 15 percent," says vice president Buckley. "We want to run an efficient business where we are not gouging the customers."

With uncharacteristically little fanfare, Fidelity Investments sold \$1.3 billion of variable annuities last year through its insurance arm. "We do very little advertising," says Richard Jameison, president of the firm's life insurance arm. "We have only 400 representatives nationally, and we probably have the highest number of sales per rep." One stimulus to sales is low fees — just 175 basis points for the most aggressive fund.

Fidelity also sells variable-annuity funds through more than 20 independent insurance companies. The firm took in a total of \$2.8 billion in variable-annuity business last year, raising its annuities under management to more than \$5 billion.

#### **PR disaster**

Variable annuities had their origins in fixed annuities and variable life insurance. Hancock has been in the annuity business since the 19th century and Equitable since about 1900. The latest craze began with the success of these two as well as Jerry Golden's Monarch Life Insurance Co., which sold \$4 billion of variable-life contracts in the five years after its founding in 1979. The contracts were popular with consumers, largely because of their triple tax benefit: deferral on all gains and interest as well as tax-free access to the funds through loans — on top of the tax-free life benefit to heirs.

With an eye to duplicating the instant success of variable life, such firms as Mass Financial Services and Dreyfus Corp. took their existing funds to insurers like Nationwide Financial Services to have them marketed in additional variable-annuity packages. They quickly sold \$2 billion worth.

But the Internal Revenue Service

## **“Some marketers see increasing danger in fee inflation.”**

took a dim view of the mechanism that allowed one class of well-educated investors to reap tax-deferrals not available to others. In 1981 the IRS ruled that fund companies could not sell existing funds this way. Then Congress gave the industry a reprieve, allowing variable annuities in separate accounts. The result was that funds had to either roll variable annuity assets into separate accounts, or fixed annuities, or let buyers redeem their shares without penalty. "It was a public relations disaster," says Golden.

The business didn't stay down for long, however. In 1986 Congress began to phase out deductible life insurance policy loans. Two years later it put the kibosh on single-premium life policies that gave immediate loan access to tax-protected funds. Then came the failures of First Capital, Executive Life, Baldwin United and Mutual Benefit: All hurt investors in fixed annuities. Variable annuities, however, seemed safe because of the IRS's separate-accounts rule. "The only good news out of Mutual Benefit and First Capital," says Golden, "was that they successfully tested the idea that separate variable accounts were sacred."

In 1992 the taxman poked his sharp pencil into the industry again. Former president George Bush proposed a plan to limit tax deferral on variable annuities. All contracts would have to be annuitized, and those who died soon after buying a contract would have to forfeit some or all of their principal. The industry fought off the assault, but it left an emotional scar. The Treasury Department's insatiable need for new tax revenues could prompt the IRS to try its tax gambit again if variable annuities grow too big.

A more immediate concern for the industry is that competition is on the rise. Although the number of insurance companies wrapping variable investment offerings may not grow by much, 69 so-called subaccount fund offerings came to market last year alone. One new driver of the mar-

ket: banks, which offer variable annuities to mutual fund customers.

Another potential problem for high-fee purveyors could be the players that are already pushing back the industry's fee and load boundaries. Vanguard Group has been selling no-load variable annuities (with insurance from Capital Holding) since 1991, for

total fees ranging from only 84 to 106 basis points a year. Vanguard has not marketed its low-cost variable-annuity program much, except to IRA investors and those invested in tax-free bond funds. Even so, the fund family has raised some \$770 million in three years. "Most of the cost for insurance in the average variable annuity is to pay for sales agents," says Jeremy Duffield, who heads the Vanguard program. "But we don't have sales agents. We spend about one tenth of what our competitors do, and yet we have \$30 million coming in every month."

#### **Growth segment**

Scudder, Stevens & Clark has been actively selling its direct-marketed Horizon line of low-fee, no-load variable annuities since 1988, yet has brought in only \$200 million. Insists David Watts, president of Scudder's variable-life investment fund, "We are growing steadily and consistently." He notes that he has also sold a respectable \$520 million of variable annuities through traditional variable contracts with nine other plans.

The no-load variable field is now heating up. Charles Schwab & Co. plans to offer a no-load insurance wrapper from Trends America for the fund families enrolled in its OneSource program that have variable-annuity investments. Similarly, Fleet/Norstar Investment Advisors has introduced a no-load variable annuity registered in all 50 states that it is selling directly to its customers in six states. And Janus Capital Corp. has come out with a six-portfolio family of variable annuities. "Several others are in various stages of developing no-load, direct-market variable annuities," says Bobroff.

"We are on the verge of a huge new growth segment in the market," the Denver consultant continues. And why not? Direct marketers spend only \$200 to \$500 to attract a customer — cheap given the average size of a variable-annuity account. Traditional insurance and fund companies may just have to rethink their rather lavish fees. ■