Investing in Long-Term Bonds without Interest Rate Risk:

The No-Commission Annuity Solution for Improving After-Tax, After-Advisory Fee Bond Returns

Colva
Actuarial Services

Colva Actuarial Services - All Rights Reserved (2020)

Colva Actuarial Services

Table of Contents

04 Changing Advisory and Annuity Landscape

08 No-Commission Fixed and Indexed Annuities: Protecting high net worth client bond portfolios from interest rate risk—while deferring taxes until retirement

11 Bond Investing Overview

13 Fixed Annuity Overview

16 Indexed Annuity Overview

17 Benefits of Investing in Bond Funds through Tax-Deferred Annuities over Taxable Bond Strategies

23 Case Study: Optimizing After-Tax Bond Portfolio Returns For High Net Worth Clients

33 Conclusion

35 About the Authors

Colva Actuarial Services - All Rights Reserved (2020)

Most fiduciary financial advisors don't realize that fixed and indexed annuities are merely investments in long-term bonds without the interest rate risk. By utilizing annuities—in particular no-commission annuities— financial advisors can protect their clients' bond portfolios from market risk, interest rate risk, and sequence of return risk, all while deferring ordinary income taxation until retirement when the client is hopefully in a lower tax-bracket.

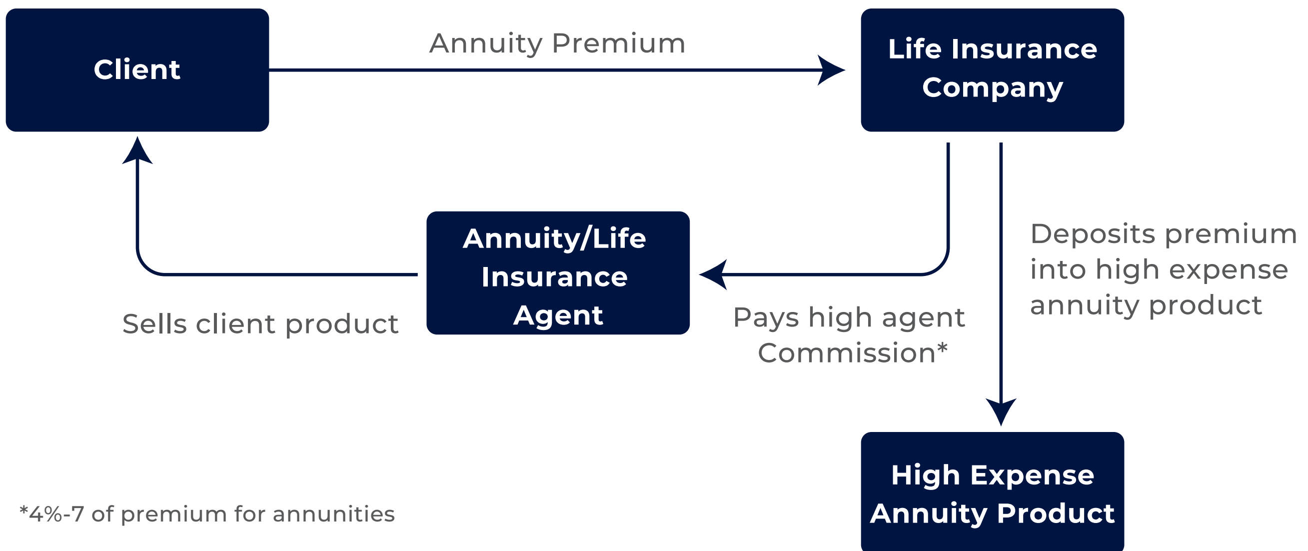
Furthermore, the financial advisor can charge the same AUM fee on the assets in the no-commission annuity that they charge on their taxable bond portfolios that they manage for the client with the added benefit of being able to charge the fee on a ***pre-tax*** *basis instead of on an* ***after-tax*** *basis which further improves the client's after-tax returns.*

In an age of fee-compression, low bond yields, and robo-advisors, clients are demanding that financial planners show them how they are better off using a financial advisor and paying his or her fee versus just doing asset allocation themselves. No-commission annuities are financial planning tools that allow fee-only, fiduciary financial advisors the ability to do just that.

Colva Actuarial Services - All Rights Reserved (2020)

Changing Advisory and Annuity Landscape

Annuities have had a bad reputation with fiduciary financial advisors for a long-time—and rightfully so. Historically annuities have been high commission/high expense products that ended up benefitting the agent who sold the product more than the client—who in most cases didn't fully understand the high expenses embedded in the investment they just made. Almost every financial advisor has had to get a client out of a bad annuity product at one point or another in their career.

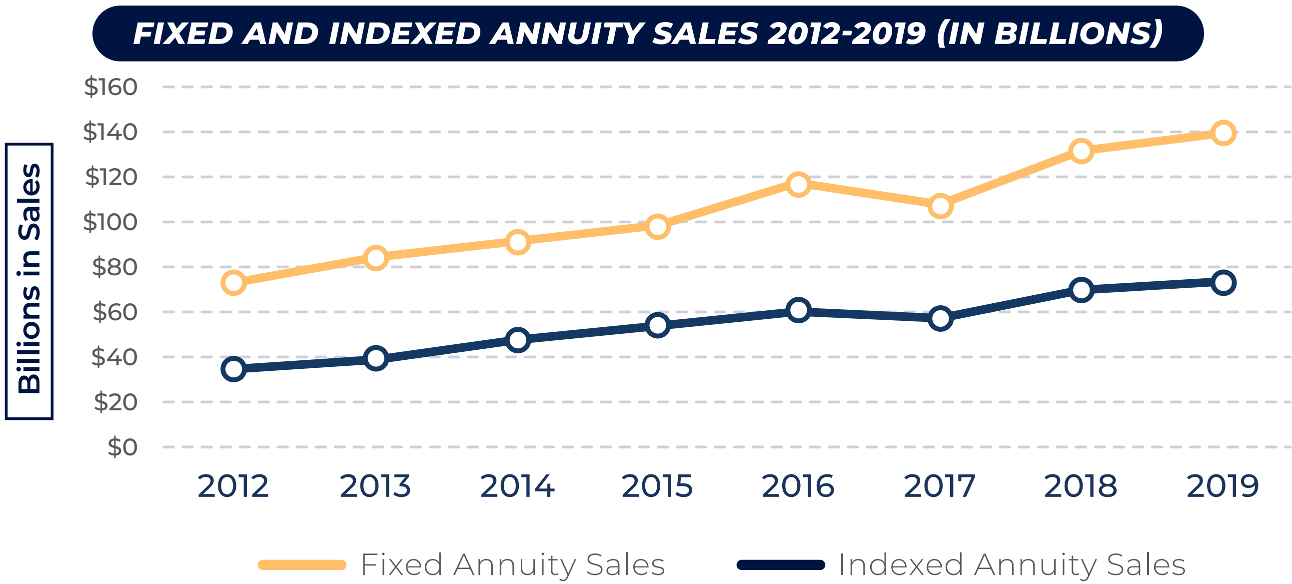


Historically the distribution of annuity and life insurance products centered around annuity and life insurance agents finding clients to sell the products to. In order to incentivize agents to generate sales, high agent commissions had to be paid to the agents. This forced actuaries at life insurance companies to impose high expenses and surrender charges into the annuity products that were ultimately purchased in order to recoup the upfront losses that were incurred as a result of the upfront commissions.

These high expense products left a bad legacy for fiduciary financial advisors who were often left trying to help clients get out of these bad annuity products that were sold to them years before.

For these reasons, fiduciary financial advisors often stayed away from recommending these products to their clients. But even though fiduciary financial advisors weren't recommending these products, client demand for these products have been extraordinarily high as clients have increasingly sought protection over the past few years from volatility in the equity markets and low yields in the bond markets.

Colva Actuarial Services - All Rights Reserved (2020)



Source: LIMRA

As clients have increasingly grown concerned about volatility in the equity markets and low yields in the bond markets they have overwhelmingly fled to fixed and indexed annuities which provide the downside protection and stability they are looking for. But since fiduciary advisors don't incorporate annuity solutions into their practice, clients continue to seek these products out from high-commissioned agents.

The end result here is that fiduciary advisors lose out on potential assets under management that are being invested elsewhere, and clients have to settle for getting a more expensive product from a high-commissioned agent as opposed to a better product from their fiduciary financial advisor.

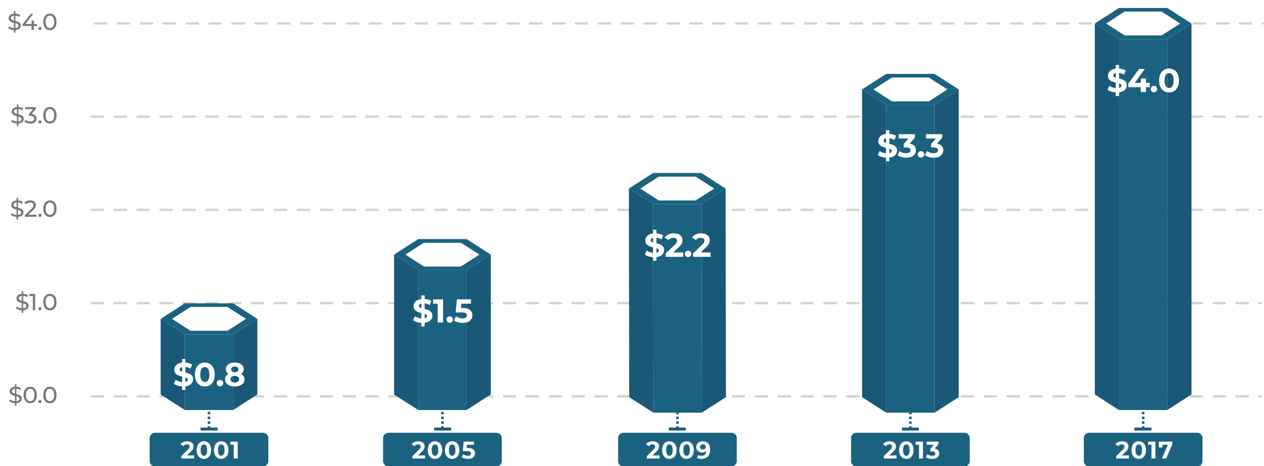
And here's the paradox with fiduciary advisors and annuities. Clients clearly want the protection that annuities provide. That's why people invested $200 billion into these products in 2018 alone with indexed annuity sales alone expected to grow by 40% by 2023.[1,2] But if fiduciary advisors aren't helping clients implement these products into clients' financial plans, guess who's more than happy to do so?

That's right—the high commissioned sales agent. And the high commissioned sales agent is going to sell the client a product that's significantly worse than what the fiduciary advisor would recommend (if he or she did recommend annuities in the first place). Not only is this the worst option for the client, it's also lost revenue for the financial advisor. Instead of the client investing their money prudently with their fiduciary financial advisor, they are investing these assets into high expense products. It's an opportunity cost loss for both the client AND the financial advisor who is losing out on assets under management.

Colva Actuarial Services - All Rights Reserved (2020)

Not only is this the worst option for the client, it's also lost revenue for the financial advisor. Instead of the client investing their money prudently with their fiduciary financial advisor, they are investing these assets into high expense products. It's an opportunity cost loss for both the client AND the financial advisor who is losing out on assets under management.

So what's the answer to this vicious cycle? The answer is for life insurance companies to design products without high commissionable expenses built in them which fiduciary fee-only advisors can use in their practice. This type of product provides maximum benefits to the clients who invest in it—and allows fee-only advisors the ability to charge an asset under management fee on the assets in the product. Furthermore, instead of a high commissioned agent being incentivized to sell clients products with high expenses, this type of product allows fee-only fiduciary advisors to utilize a product that clients clearly want in a way that most efficiently helps them meet their retirement goals.



Source: Tiburon Strategic Advisor analysis, June 2018

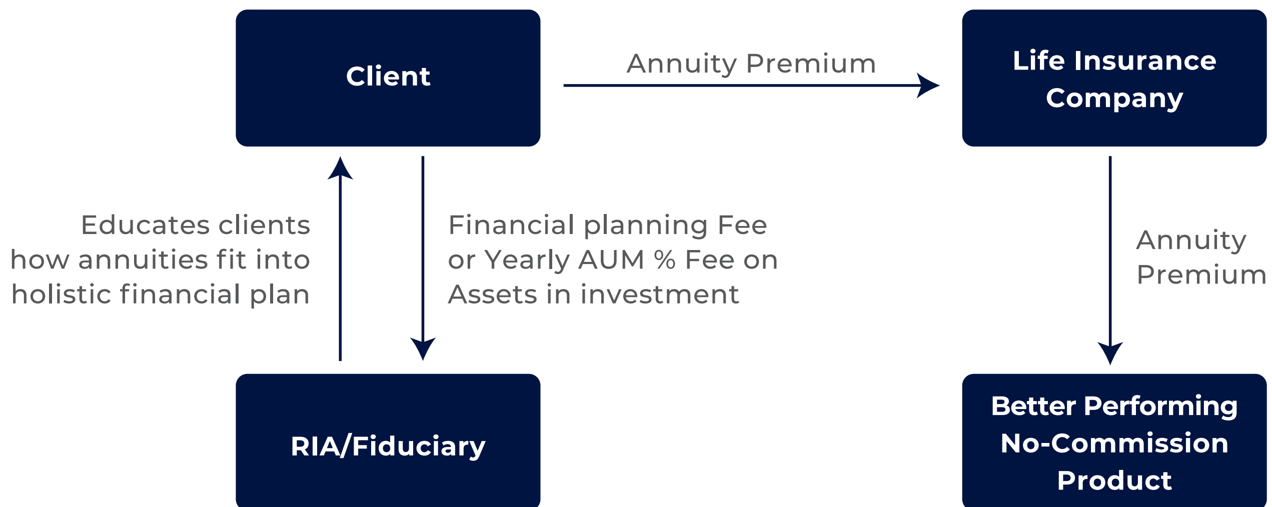
In an age of increasing fee-compression, clients are demanding that their financial advisors be fiduciaries first and foremost and provide advice and recommendations that are in their best interests. As a result, financial advisory firms are increasingly going fee-only and not taking commissions. These financial advisors realize that a better business model is to build up a large amount of assets under management and charge a fee based on the assets under management than to find new clients each year to sell products to and earn a commission.

Colva Actuarial Services - All Rights Reserved (2020)

The good news is that life insurance companies have already realized that this is the way of the future. Since the early 2000s an increasing number of financial advisors have gone the fee-only route and eschewed commissions completely. So while life insurance companies could previously rely on financial advisors who took commissions to sell the life insurance companies' products to their clients (while making a hefty commission on the transaction as well), the effectiveness of that distribution channel has slowly diminished as more and more advisors go the fee-only route. As a result, more and more life insurance companies are designing no-commission annuity products that can be used by these fiduciary fee-only advisors in their practice.

As an added tax-advantage to the client, the advisor is allowed to deduct their asset-under-management fee on a pre-tax basis from ***within*** the product the same way they would if they were managing a client's IRA account. This has a significant after-tax advantage over investing client assets in a taxable bond strategy and having the client pay the RIA with ***after-tax*** funds on these low-yielding assets.

NO-COMMISSION ANNUITY/RIA DISTRIBUTION STRUCTURE



As financial advisors go increasingly fee-only, life insurance companies have created better performing no-commission annuity products that can be marketed directly to RIAs. Instead of centering distribution on annuity agents, these products center distribution on the RIA itself. While there are no-commissions on these products, the RIAs can charge the same asset-under-management fee on the assets in the annuity vehicle (but on a tax-advantaged pre-tax basis) as they would on assets that the RIA manages outside the annuity vehicle. In exchange, the client gets a better performing annuity product that better fits their personalized financial plan as a result of the RIA acting as a fiduciary for the client.

Colva Actuarial Services - All Rights Reserved (2020)

No-Commission Fixed and Indexed Annuities: Protecting high net worth client bond portfolios from interest rate risk—while deferring taxes until retirement

Fiduciary fee-only advisors face a difficult task with asset allocation for high net-worth clients as they near retirement. The reason for this is that the traditional strategy for clients nearing retirement is to shift the asset allocation of their portfolios to a larger bond allocation to protect against losses in the portfolio. For high net-worth clients, this poses a number of notable disadvantages:

1. **Loss in Overall Return:** While shifting the portfolio allocation to a larger bond allocation lowers the overall downside volatility of the portfolio, it typically comes at the cost of overall return of the portfolio. Investing in lower yielding bonds instead of higher yielding equities reduces the overall return of the client's portfolio.

2. **Higher Percentage Loss to Taxes:** In addition to equity markets typically experiencing higher returns than their bond counterparts, long-term equity gains are also subject to a much lower capital gains tax rate. Bond funds, in contrast, typically distribute the majority of their gains each year and those gains are often subject to much higher ordinary income and short-term capital gain taxation. So whereas investing in equities may mean that a high net-worth client only pays 20% on their gains, changing that allocation to a bond fund may mean that the client pays 37% or more in taxes on their gains.

   So for high net worth clients, shifting the allocation from equities to bonds as they get closer to retirement often results in having lower gross gains **AND** losing a ***larger*** percentage of those reduced gains to taxes. This is a compound loss for clients who on top of these losses also have to pay their financial advisor their ~1% AUM fee which may leave them with very little net gain from undertaking this shift from equities to bonds.

So for high net worth clients, shifting the allocation from equities to bonds as they get closer to retirement often results in having lower gross gains AND losing a *larger* percentage of those reduced gains to taxes.

This is a compound loss for clients who on top of these losses also have to pay their financial advisor their ~1% AUM fee which may leave them with very little net gain from undertaking this shift from equities to bonds.

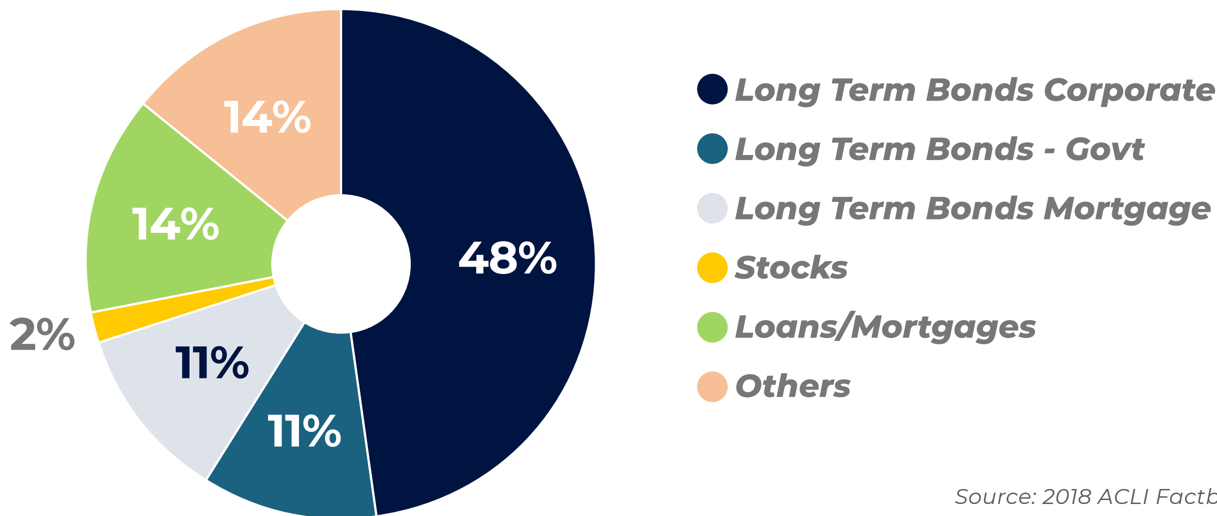
Colva Actuarial Services - All Rights Reserved (2020)

3. **Interest Rate Risk:** While bond funds do typically have lower volatility than equity investments, bond funds are still subject to losses if interest rates rise. Long-term bonds are the most sensitive to this interest rate loss. However, long-term bond funds also offer higher yields than their shorter term bond counterparts. In order to protect against large interest rate risk in long-term bond funds, financial advisors will typically change the portfolio allocation of their clients nearing retirement to a larger short-term bond allocation. This shift helps protect clients against volatility in the equity markets and large interest rate risk in the long-term bond market. Nevertheless, interest rate risk in both short-term and long-term bond funds subject clients to a loss of principal.

   And as most financial advisors are aware, loss of principal in the early stages of retirement as a client begins to make withdrawals poses a sequence of return risk that may make it difficult for the client to recover from in the later years of retirement.

Fixed and indexed annuities allow clients the ability to invest in long-term bonds without interest rate risk. So instead of allocating client retirement portfolios to long-term bonds subject to interest rate risk in order to chase after higher yields—or allocating to short-term bonds with low-yields in order to minimize interest rate risk—advisors can allocate part of their clients' bond portfolios to no-commission fixed and indexed annuities and get higher after-tax yields and/or lower volatility than if they were to invest in those bonds directly.

LIFE INSURANCE GENERAL ACCOUNT PORTFOLIO



Source: 2018 ACLI Factbook[2]

When a client invests in a fixed or indexed annuity, their investment is placed in the life insurance company's general account portfolio. As shown from the pie chart above, nearly 70% of the client's investment is placed in long-term investment grade bonds (Corporate, Government, Mortgage Bonds). So when clients invest in fixed and indexed annuities their underlying investment is placed in long-term investment grade bonds.

Colva Actuarial Services - All Rights Reserved (2020)

There are a number of advantages of investing in long-term bonds through an annuity versus investing directly into a taxable investment grade long-term bond portfolio:

1. The client receives the majority of the yield of the long-term bond portfolio while taking none of the interest rate risk.

2. The long-term bonds backing the client's investment are considered reserves and are both highly regulated by the government and secured from creditors. This means that even if the insurance company were to go bankrupt, these reserves would be bankruptcy protected. Furthermore, there are typically explicit state government guarantees that back these reserves to a certain amount.

3. The RIA can deduct its asset-under-management fee on a **pre-tax** basis from within the bond assets in the annuity the same way it would with client assets in an IRA whereas it is forced to deduct these fees on an **after-tax** basis from the bond assets in a taxable account. This is a significant tax-advantage for high net worth clients subject to high ordinary income taxation on their bond gains in a taxable account and phased out of qualified plans that would offer similar pre-tax deductions for advisory fees.

None of these protections can be found if a client chooses to invest in a long-term bond fund directly.

BENEFITS OF RIA CHARGING AUM FEE ON A PRE-TAX BASIS VS ON AN AFTER-TAX BASIS ON A LOW-YIELDING, TAX-INEFFICIENT ASSET

	Taxable Yield			Net Return (After-Taxes and Fees)			
	A	B	C = A - B	D	E = C * D	F	G = C - E - F
	Gross Yield	Pre-Tax AUM Fee	Taxable Yield	Tax Rate	Taxes Owed on Taxable Yield	After-Tax AUM Fee	Net Client Return (After taxes and fees)
RIA Charging After-Tax AUM Fee	2.0%	0.0%	2.0%	50.0%	1.0%	1.0%	**0.0%**
RIA Charging Pre-Tax AUM Fee	2.0%	1.0%	1.0%	50.0%	0.5%	0.0%	**0.5%**

The above table shows the benefits of an RIA charging their AUM fee on a pre-tax basis versus on an after-tax basis on a low-yielding, tax-inefficient asset. By charging their fee on a pre-tax basis, the RIA is able to reduce the taxable gain on the asset. This results in the client achieving an after-tax, after-advisory fee return that is 50 basis points higher than if the RIA were to charge their fee on an after-tax basis.

Colva Actuarial Services - All Rights Reserved (2020)

Bond Investing Overview

In order to do a comparison between the fixed annuity or indexed annuity and the underlying long-term bonds that the life insurance company invests in, we need to first look at the performance of the underlying long-term bonds and see how that compares to investing in the fixed annuity.

Let's assume that the life insurance company invests in a long-term bond account similar to the iShares Long-Term Corporate Bond ETF (IGLB)[3].

Here are the summary performance details of the iShares Long-Term Corporate Bond ETF as of 01/03/2020:

LONG-TERM BOND FUND CHARACTERISTICS AS OF 1/3/2020

Bond-Fund	Current Pre-Tax Yield-to-Maturity	Annual Standard Deviation (3yr)	Weighted Average Maturity (years)	Effective Duration
iShares Long-Term Corporate Bond ETF (IGLB)	3.61%	6.66%	22.88	14.06

Source: iShares[3]

We can see from the table above that the iShares Long-Term Corporate Bond ETF has a current yield of 3.61% but a large standard deviation of 6.66%. The large standard deviation is due to the heavy interest rate risk posed by investing in long-term bonds. This is readily seen by the long average maturity (22.88 years) and the high duration (14.06). The high duration of 14.06 means that if interest rates go up by 1%, the investor will immediately lose 14.06% of their investment in this long-term bond fund. This interest rate risk is an implicit surrender charge whenever clients invest in long-term bonds. This is a particularly noteworthy risk especially in the current low-yield environment in which interest rates are being purposely suppressed by the Federal Reserve in order to stimulate the economy. When this suppression is relieved, interest rates will rise causing an immediate loss to investors investing in bond-funds—particularly those investing in long-term bond funds.

Colva Actuarial Services - All Rights Reserved (2020)

It's for this reason that fiduciary advisors typically allocate client bond portfolios to bond funds with significantly lower duration. A standard bond benchmark is the U.S. Aggregate Bond Fund (AGG) . While this fund has a significantly lower duration, and hence is less sensitive to interest rate risk, it also has a significantly lower yield.

CURRENT LONG-TERM VS INTERMEDIATE-TERM BOND FUND CHARACTERISTICS AS OF 1/3/2020

Bond-Fund	Current Pre-Tax Yield-to-Maturity	Annual Standard Deviation (3yr)	Weighted Average Maturity (years)	Effective Duration
iShares Long-Term Corporate Bond ETF(IGLB)	3.61%	6.66%	22.88	14.06
iShares Core U.S. Aggregate Bond ETF (AGG)	2.29%	2.90%	7.92	5.64

Source: iShares[3,4],Annuity Rate Watch[5]

The AGG bond fund is a standard bond benchmark and is more reflective of the type of bond funds that an advisor would allocate the bond portion of a client's portfolio to. The AGG fund has a significantly lower effective duration and a lower volatility than the IGLB fund since it is less sensitive to interest rate movements than the IGLB fund.

In exchange for investing in a bond fund with lower sensitivity to interest rate movements than long-term bond funds, investors are also forced to accept a significantly lower yield.

As we'll see in the next section, the benefit of investing in fixed or indexed annuities over a shorter-term bond fund like the AGG is that investors can invest in long-term bonds and receive most of the yield of a long-term bond fund while taking none of the interest rate risk.

Colva Actuarial Services - All Rights Reserved (2020)

Fixed Annuity Overview

For those unfamiliar with a fixed annuity, let's do a quick breakdown of how it works.

A fixed annuity is a contract in which the client invests a lump-sum of capital with a life insurance company in exchange for a fixed rate of interest every year. The life insurance company invests this lump-sum into its general account portfolio which primarily invests in long-term bonds. The life insurance company then credits the client's account with the majority of the yield that this general account/long-term bond portfolio earns while protecting the client from interest rate risk. In exchange for protecting the client from interest rate risk that comes from investing in long-term bonds, the insurance company collects a spread between the rate that the long-term bonds in their portfolio are earning and the fixed annuity rate that they are crediting the clients' accounts.

By looking at historical results of no-commission annuities since they emerged in 2016 versus a long-term bond fund like the IGLB and the standard bond fund AGG benchmark, we can get a better understanding of the risk and return profiles of the no-commission fixed annuity versus comparable bond-funds that advisors might allocate client assets to.

Colva Actuarial Services - All Rights Reserved (2020)

HISTORICAL BOND RETURNS VS HISTORICAL NO-COMMISSION FIXED ANNUITY RETURNS

Year	iShares Long-Term Corporate Bond ETF (IGLB)	iShares U.S. Aggregate Bond ETF (AGG) Annual Return	No-Commission Fixed Annuity End of Year Fixed Rate (High band)
2014	17.09%	5.78%	
2015	-5.62%	0.53%	
2016	9.15%	2.54%	3.10%
2017	12.17%	3.73%	3.15%
2018	-7.00%	0.15%	3.75%
2019	23.49%	8.51%	3.20%
Compound Historical Annual Return (Geometric)	**7.62%**	**3.50%**	**3.30%**
Current Yield-to-Maturity (as of 1/3/2020)	**3.61%**	**2.29%**	**3.20%**
Annual Standard Deviation	**8.18%**	**3.28%**	**0.30%**
Sharpe Ratio (1.80%)	**0.78**	**0.53**	**4.95**
Sortino Ratio (1.80%)	**1.11**	**0.92**	**N/A**

Source: iShares[3,4],Annuity Rate Watch[5]

While long-term bond funds like the IGLB can have high returns when interest rates drop (like in 2019), the opposite happens when interest rates rise. For this reason, advisors typically allocate client bond funds to more intermediate funds like the AGG in spite of the low current yields.

No-commission annuities on the other hand, offer the ability to capture most of the current yield of long-term bond funds (3.20% vs 3.61%) while taking none of the interest rate risk and allowing investors the ability to defer taxes on the gains.

Therefore, when we look at risk metrics such as the annual standard deviation, the Sharpe Ratio and the Sortino Ratio, we see that the no-commission fixed annuity provides significantly lower volatility and more return relative to the risk. In fact, since the no-commission fixed annuity has never had returns below the reference rate of 1.80%, the Sortino Ratio can't be calculated on it.

As evidenced in the table above, long-term bond funds can have extremely high returns when the Federal Reserve drops interest rates (as they did in 2019) and long-term rates drop in response.

However, when interest rates rise those same long-term bond funds can have equally large losses. So, while long-term bonds can be extremely volatile, no-commission fixed annuities offer significantly lower standard deviations and a higher risk-adjusted return.

Colva Actuarial Services - All Rights Reserved (2020)

IMMEDIATE LOSS OF BOND PRICES AFTER 1% INCREASE IN RATES FROM 2% TO 3%

Bond Term (Years)	Immediate Loss of Market Value of Bond Prices on 1% Increase in Rates
10	-8.53%
20	-14.88%
30	-19.60%

The above table shows the loss in bond prices on a 10 year, 20 year, and 30 year term bond paying 2% annual coupons. While long-term bond funds absorb the largest loss in value upon a 1% increase in rates, even shorter term bonds are exposed to significant interest rate risk.

Colva Actuarial Services - All Rights Reserved (2020)

Indexed Annuity Overview

An indexed annuity is a contract in which the client invests a lump-sum of capital with a life insurance company in exchange for receiving part of the gains of an index when the index performs positively (while also being protected from losses when the index performs negatively). In other words, the investor in an indexed annuity receives the performance of a particular index subject to a cap on the gains and a floor on the losses (typically that floor is set to 0% so that the investor doesn't take any losses).

The life insurance company is able to provide this cap and floor arrangement by using a small portion of the client's lump-sum capital (approximately 3%-5%) to purchase/sell options on that particular index. They then invest the remainder of the lump-sum capital into the same long-term bonds that the fixed annuity investments are in.

Year	iShares Long-Term Corporate Bond ETF (IGLB)	S&P 500 Price Return Index (^GSPC) Annual Return	No-Commission S&P 500 Indexed Annuity End of Year Cap (High Band)	No-Commission S&P 500 Indexed Annuity Earned Rate (High Band)
2014	17.09%	11.39%		
2015	-5.62%	-0.73%		
2016	9.15%	9.54%	7.05%	7.05%
2017	12.17%	19.42%	6.80%	6.80%
2018	-7.00%	-6.24%	7.70%	0.00%
2019	23.49%	28.88%	6.45%	6.45%
Compound Historical Annual Return (Geometric)	**7.62%**	**9.75%**	**7.00%**	**5.03%**
Current Yield-to-Maturity/Cap (as of 1/3/2020)	**3.61%**		**6.45%**	
Annual Standard Deviation	**8.18%**	**11.39%**	**0.53%**	**3.39%**
Sharpe Ratio (1.80%)	**0.78**	**0.75**		**0.97**
Sortino Ratio (1.80%)	**1.11**	**1.00**		**1.08**

Source: iShares[3,4], Annuity Rate Watch[5]

Just like the fixed annuity, the caps on the no-commission fixed annuities have limited volatility in comparison to the underlying long-term bonds they are invested in. The volatility of the indexed annuity comes from the volatility of the underlying index. By accepting a higher level of volatility than the fixed annuity (but lower than that of long-term bonds), investors in the no-commission indexed annuity can achieve a higher rate of return than just investing in a no-commission fixed annuity.

Colva Actuarial Services - All Rights Reserved (2020)

Colva Actuarial Services

Benefits of Investing in Bond Funds through Tax-Deferred Annuities over Taxable Bond Strategies

Annuities offer a number of benefits to investors who would otherwise be investing their capital into short-term or long-term bond funds:

1. **Ability to invest in long-term bond funds without interest rate risk:** As we showed above, long-term bond funds have significantly higher yields than short-term bond funds. Annuities allow investors to capture most of the higher yield of these long-term bonds while taking none of the interest rate risk (meanwhile even short-term bond-funds are subject to interest rate risk).

2. **Ability to defer taxes on gains on an unlimited amount of contributions until retirement (when clients are potentially in a lower tax-bracket):** A significant problem with investing in bond funds is that typically a bond fund distributes its gains every year. These gains are typically taxed at ordinary income tax rates. For high-earning clients this means that a large portion of these gains will be eaten up by ordinary income taxation. So while an advisor might wish to allocate a larger portion of a client's portfolio to bonds instead of equities as a client nears retirement in order to avoid volatility, doing so means accepting a lower return on the client's portfolio as well as having a larger percentage of the gains be lost to taxes. This is a loss on both fronts for the client and offsets the reduced volatility that comes with investing in bonds over equities.

An annuity allows clients the ability to invest in long-term bonds and defer the taxes on these gains until after retirement. This is particularly advantageous for high-earning clients who would be typically phased out of contributing to qualified tax-deferred or tax-free retirement plans and can use annuities to defer taxes on an ***unlimited*** amount of assets without being subject to any kind of income limitations.

For those high earning clients who plan on lowering their tax bracket after retirement (via delaying withdrawals or moving to a tax with no state income tax) the advantage of using annuities to defer an unlimited amount of long-term bond gains until they are in a lower tax-bracket can result in significantly more after-tax income than if they were to just invest in those bond funds directly and pay the high ordinary income taxation each year on the gains.

Colva Actuarial Services - All Rights Reserved (2020)

Colva
Actuarial Services

Important considerations when using annuities for clients' tax-deferred bond strategy

While investing in bond funds through the use of tax-deferred annuities carries significant advantages over investing in bonds through a taxable account—particularly for high-earning clients—there are some drawbacks that should be noted:

1. **10% penalty on gains if withdrawals made before age 59.5:** As mentioned above, allocations made to an annuity are treated the same as if those allocations were made to a qualified plan. In exchange for the client receiving tax-deferred treatment on the gains in the annuity, if the client wishes to take out those gains prior to age 59.5 they are subject to the same 10% penalty that they would have to pay if they tried to withdraw their money from a qualified plan before age 59.5.

2. **Surrender charges for the first 5-7 years after 10% yearly withdrawal limit:** An annuity allows a client to take 10% of his or her total investment out each year without paying any surrender charge. Any withdrawal above that will be subject to a surrender charge that declines over the first 5-7 years. In general, the surrender charges for no-commission annuities are about 7% in the first year declining to about 3% in the 7th year. The reason why even no-commission annuities are forced to implement a surrender charge is because they are protecting the client from interest rate risk and essentially granting the client a put option on their investment. Without a surrender charge, clients would invest their money into an annuity when interest rates are low and when interest rates rise would immediately exercise their now in-the-money put option and exit the annuity—without absorbing any interest rate risk loss—and invest their money in newer, higher yielding bonds. This would leave the insurance company absorbing the upfront loss without enough time to earn the money back through the spread between what their general account is earning and what they are crediting their clients.

   While there are no-commission annuities that come with no surrender charges, these annuities also force the clients to absorb any interest rate risk when they exit the annuity—which partly defeats the purpose of putting the client into the annuity in the first place. True to the old saying, there is no free lunch. Interest rate risk is an implicit surrender charge. Either the client is comfortable with interest rate risk and wants no surrender charge (in which case clients should just invest in the underlying bonds themselves), or they want protection from interest rate risk in exchange for paying a surrender charge if they exit early. In nearly all cases, investing in long-term bonds and taking the interest rate risk loss if interest rates rise will result in a greater loss than investing in long-term bonds through an annuity and paying only a surrender charge to exit the annuity under the same scenario.

Colva Actuarial Services - All Rights Reserved (2020)

IMPACT OF SELLING 2% COUPON RATE BOND AND IMMEDIATELY BUYING HIGHER 3% COUPON BOND

Bond Term (Years)	Immediate Loss of Market Value of Bond Prices on 1% Increase in Rates from 2% to 3%	Years of investing at the higher interest rate of 3% for the client to get back to the original 2% return
10	-8.53%	10
20	-14.88%	17
30	-19.60%	23

If interest rates on a 2% coupon bond rise by 1% to 3%, the original 2% coupon bond will experience an immediate loss in market value. Even if these 2% coupon bonds are immediately sold at market value (at a loss) and new 3% coupon bonds are purchased in their place to make the return back over time, it will take a number of years at the new coupon rate before the investor gets back to his or her 2% return that he or she purchased the original bond at.

As such, interest rate risk on long-term bonds poses a significantly longer and more severe surrender charge on the investor than the 7% to 3% declining surrender charge that an annuity—which invests in those same long-term bonds—poses.

Investing in a no-commission annuity therefore affords the investor the ability to achieve the majority of the higher yields afforded to long-term bonds without being exposed to significant implicit surrender charges via interest rate risk on these bonds.

3 Credited interest rates on fixed annuities and caps on indexed annuities can change

While the interest rate credited on fixed annuities and the caps on indexed annuities can change, the upside is that they can be increased for the client just as much as they can be decreased. As older bonds in the general account mature, new bonds will be bought at current yields. The interest earned on the general account going forward is merely a function of how the weighted yield on the new bonds being bought compare to the weighted yields on the old bonds that matured. Therefore, in a rising interest rate environment, the yield on the general account will slowly rise and so will the interest being credited to the client's account. The opposite is true in a declining interest rate environment. An important point to be noted here, is that volatility for clients in annuities will be significantly less than for clients investing in the underlying long-term bonds because the life insurance company is taking the full interest rate risk here (and the volatility in just the yield portion of the return is small in comparison to the volatility added by the interest rate movements bond funds face).

Colva Actuarial Services - All Rights Reserved (2020)

	iShares Long-Term Corporate Bond ETF (IGLB)	No-Commission Fixed Annuity End of Year Fixed Rate (High band)	No-Commission S&P 500 Indexed Annuity Earned Rate (High Band)
2016-2019 Annual Standard Deviation	8.08%	0.30%	3.39%

Source: iShares[3,4],Annuity Rate Watch[5]

Since no-commission fixed and indexed annuities emerged on the scene in 2016, the volatility of their returns have been significantly lower than the underlying long-term bonds that makeup the investment.

A similar story can be found with indexed annuities. In order for a life insurance company to provide a cap and floor on an index, they need to spend a portion of the client's invested capital each year on buying and selling options on that same index. The price of these options is dependent on the projected volatility of that index in that year. The more volatile that index is supposed to be in a given year, the more expensive the options. If the underlying index is volatile, the life insurance company can only afford options on strategies that give clients a lower part of the upside—i.e. lower caps on the indices. In the opposite environment where the volatility of the index is expected to be low, the cost of the options is cheaper and the life insurance company can afford to give the client higher caps on the indices. In both the no-commission fixed and indexed annuity, the volatility of these products has been significantly lower than the underlying long-term bonds.

No-commission annuities are what really shine here regardless of whether the client chooses a fixed annuity strategy or indexed strategy. Since the no-commission annuity is not paying a large upfront commission, they can afford to give clients either higher yields on the fixed account or higher caps on the indexed account. Furthermore, unlike some of their high-commissioned brethren, no-commission annuities don't have to employ questionable practices such as crediting a high yield in the first year and lowering it in the second year to trap clients in their products. While no-commission annuities are significant upgrades over their high commission counterparts, these better annuity products will still have to overcome the negative stigma that many fiduciary advisors have over using annuities due to bad client experience with some of the poor high-commissioned versions of these products.

Colva Actuarial Services - All Rights Reserved (2020)

	Fixed Annuity		Indexed Annuity	
	Commissionable Product	Non-Commissionable Product	Commissionable Product	Non-Commissionable Product
Current Yield/Cap	2.15%	3.20%	4.85%	6.45%

Source:,Annuity Rate Watch[5]

The above table looks at commissionable and non-commissionable fixed and indexed annuity products from the same carrier. In both cases, the no-commission product significantly outperforms its counterpart. By eliminating commissions, the insurance carrier can afford to offer clients better products.

4 Gains are taxed at ordinary income

Since annuities offer tax-deferred accumulation like other retirement plans, when the income is withdrawn and gains are realized these gains are all taxed at ordinary income (even if the investments were in equities)—just like a standard qualified retirement plan. It's also worth noting that the underlying investment in annuities are long-term bond funds which would be taxed at ordinary income even if the client invested in these assets outside of the tax-deferred annuity structure.

This ordinary income taxation issue is why advisors considering investing in a fixed or indexed annuity should do so by taking money out of the client's taxable bond portfolio and not from the client's taxable equity portfolio. The equity portfolio benefits from both higher yields and lower capital gains tax rates that are primarily tax-deferred to begin with, so taking money from a tax-deferred equity portfolio to put into a tax-deferred bond portfolio will have negative consequences all the way around.

The apples-to-apples comparison is to compare the client's taxable bond portfolio performance to the performance of a long-term bond portfolio within the tax-deferred/interest rate risk-protected annuity structure on an after-tax basis. A sample client portfolio will be modeled and shown on this basis in the following section.

Colva Actuarial Services - All Rights Reserved (2020)

5 Beneficiaries of annuities do not receive a step-up in basis at death

Much like other qualified retirement plans, annuities do not receive a step-up in basis when the assets in the annuity are passed on at death of the original owner. What this means is that when making withdrawals in retirement, the client wants to make sure to drawdown from the annuity first so that any unneeded income can be left in the taxable account and passed onto beneficiaries at death while benefitting from the step-up in basis provided to taxable account values.

6 Indexed annuity returns are based on the price return of the index and not the total return

A small point often neglected by clients and advisors when evaluating annuities is that they forget that the indexed annuity returns each year are indexed to the price return of the index and not the total return. So when doing financial modeling projections comparing investing the client's bond portfolio in taxable account versus an indexed annuity, it's important to make sure that the results of the price return are being used in the modeling.

Colva Actuarial Services - All Rights Reserved (2020)

Colva
Actuarial Services

Case Study: Optimizing After-Tax Bond Portfolio Returns For High Net Worth Clients

The best way to see the value of utilizing no-commission fixed and indexed annuities within a client's bond portfolio is to look at an actual case example. In the following case we'll look at a married couple, John and Sally, who are living in California, both age 52, with current joint annual income in excess of $500,000 a year. Due to their high income, and the fact that they live in a high income tax state, their marginal tax-rate is currently 48.1%. They have maxed out their tax-deferred retirement options and are currently trying to figure out how to best invest their bond portfolio given that they would be subject to high ordinary income tax on the gains. They want to work for another 10 years and then retire—possibly to a state with no income tax which would allow their marginal tax-rate to drop to 38.8%.

John and Sally, high net worth couple near retirement looking to optimize after-tax bond gains

- Both age 52
- >$500k annual income
- 48.1% marginal tax rate—contemplating moving to no-income tax state after retirement which would drop marginal tax rate to 38.8%.
- RIA charges 0.75% fee on after-tax basis

Financial advisors typically shift client assets to a heavier bond allocation as they near retirement. For high net worth individuals, this often results in both a loss of yield and increased taxes on the reduced gains.

By introducing tax-deferral strategies that protect clients' principal and increase after-tax yield, financial advisors can demonstrate added value to their clients' retirement goals.

Their fiduciary advisor, who charges a 0.75% asset-under-management fee, has advocated that they shift a larger portion of their assets into bonds and has suggested three options:

a. Tax-Free 10 year Municipal Bonds
b. Taxable Intermediate Term-Bonds (AGG)
c. Taxable Long-Term Bonds (IGLB)

While, taxable municipal bonds offer the couple the ability to avoid tax liability completely, the tax savings of municipal bonds don't make up for the loss of yield the clients would have obtained from just investing in taxable long-term bonds.

Colva Actuarial Services - All Rights Reserved (2020)

	10 Year Tax-Free A-rated Municipal Bond	Taxable Equivalent of 10 Year Tax-Free A- rated Municipal Bond	Taxable iShares Long-Term Corporate Bond ETF (IGLB)	Taxable iShares U.S. Aggregate Bond ETF (AGG) Annual Return
Current Pre-Tax, Pre-Advisory Fee Yield as of 1/3/2020	1.75%	3.37%	3.61%	2.29%

Source: FMSBonds[6],Annuity Rate Watch[5]

While municipal bonds offer tax-free yields, even at a 48.1% marginal tax rate the taxable equivalent yield for the municipal bond strategy only beats the AGG counterpart and falls short of the IGLB strategy. Choosing to invest in municipal bonds and hold them to maturity can protect against interest rate risk, but comes at a loss in yield for the client. Furthermore, if the client liquidates before maturity they would still be subject to interest rate risk.

Municipal bonds—like other individual bonds—can be bought and held to maturity as a means of avoiding interest rate risk. But the cost for avoiding interest rate risk through this strategy is liquidity. If interest rates rise and investors decide to sell their bonds before maturity, these investors will realize a significant loss.

No-commission annuities offer investors the ability to invest in higher yielding long-term bonds while deferring taxes until retirement—which allows for more compound interest as well as the potential for the client to be taxed at a lower marginal rate in retirement. Furthermore, the no-commission annuity allows the RIA to charge its AUM fee on a pre-tax basis which allows for greater after-tax returns. While no-commission annuities do face surrender charges if the client exits early, these surrender charges are significantly less than the interest rate loss that would be realized if interest rates on long-term bonds were to rise. Furthermore, every year an investor is allowed to withdraw 10% of the value in their annuity without having to pay any surrender charges (and without any interest rate risk loss if it's a non-MVA annuity). This allows more liquidity and protection than exiting a bond fund in a rising interest rate environment.

Colva Actuarial Services - All Rights Reserved (2020)

To understand the value-add of no-commission annuities, it's helpful to look at John and Sally's bond portfolio and model it assuming they invested their money in each of the following options: tax-free municipal bonds, taxable long-term bonds (IGLB), tax-deferred fixed annuity, and a tax-deferred indexed annuity. By doing that we can look at the after-tax returns and see which option provides the best return in the highest number of scenarios.

In order to model each of these three options, we first need to determine the modeling assumptions. We can do this based on a mixture of the current yields of these investment strategies as well as historical results.

Modeling Assumptions

	Mean Annual Return	Annual Standard Deviation	Floor	Cap
iShares Long-Term Corporate Bond ETF (IGLB)	3.61%	8.18%	N/A	N/A
10 Year Tax-Free A-rated Municipal Bond	1.75%	0%	N/A	N/A
No-Commission Fixed Annuity	3.20%	0.30%	1.40%	N/A
S&P 500 Price Return	8.00%	15.00%	N/A	6.45%

We can model the various investment strategies by utilizing current and historical results. Note that we assumed that client would buy and hold municipal bonds until the 10-year maturity period was reached so the annual standard deviation was assumed to be 0%.

Colva Actuarial Services - All Rights Reserved (2020)

10-Year After-Tax, After-Advisory Fee Bond Return Comparisons on 1000 Scenarios at 48.1% Marginal Tax Rate

Using the modeling assumptions above, we can then perform 1000 Monte Carlo simulations and look at the after-tax results. The following table shows the mean after-tax bond returns for the four bond investment strategies. Note that the IGLB and municipal-bond strategies assume the advisor's 0.75% AUM fee is taken out on an after-tax basis while the no-commission annuity assumes the advisor's 0.75% AUM fee is taken out on a pre-tax basis.

Bond Investment Strategy	Mean 10 Year After-Tax, After-Advisory Fee Bond Returns at 48.1% Tax-Rate (after RIA fee)
iShares Long-Term Corporate Bond ETF (IGLB)	**0.75%**
10 Year Tax-Free A-rated Municipal Bond	**0.99%**
No-Commission Fixed Annuity	**1.32%**
No-Commission Indexed Annuity	**1.78%**

Note that while the pre-tax annual return assumption of the long-term bond strategy was 41 basis points higher than the fixed annuity return assumption (3.61% vs 3.20%), on an after-tax and after RIA fee basis, the mean compound annual return of the long-term bond strategy is **57 basis points *lower*** than the mean after-tax and RIA fee fixed annuity return (0.75% vs 1.32%). The effect of high-tax rates on the taxable long-term bond strategy reduces the effect of compound interest growth while the ability to reduce taxable gains by charging a pre-tax fee allows for better after-tax growth of the fixed annuity for the client.

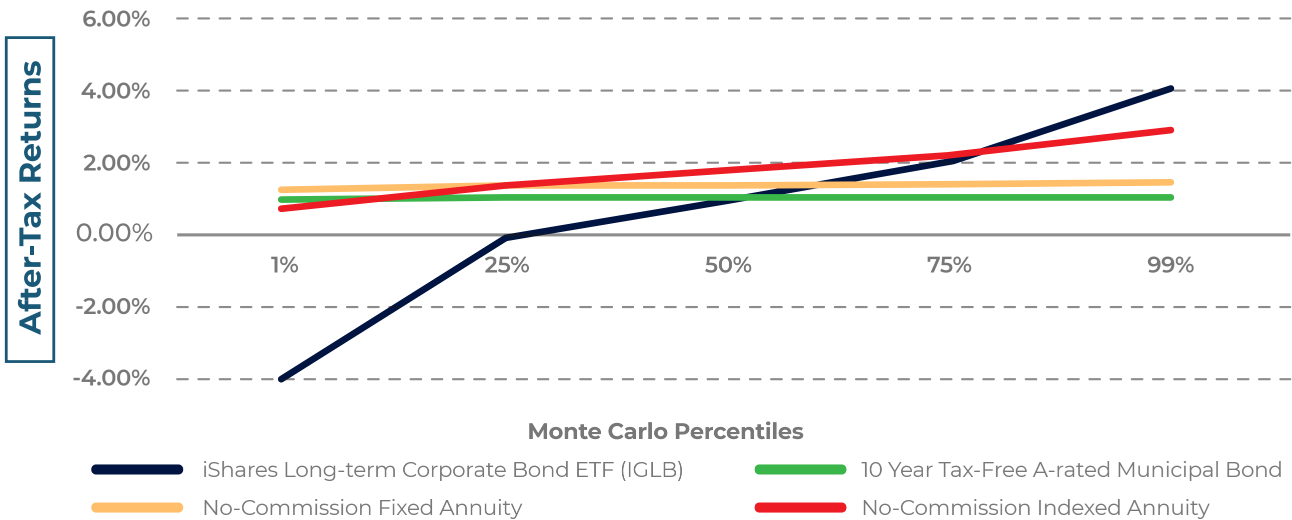
On an after-tax basis the indexed annuity beat both the long-term and the municipal bond strategy by **103 basis points** and **79 basis points** respectively.

As evidenced in the table above, even though the pre-tax mean annual return of the fixed annuity strategy was ***0.41% lower*** than the long-term bond strategy, on an after-tax basis the fixed annuity was ***0.57% higher*** than the long-term bond strategy. The effect of high-tax rates and having to pay advisory fees on an after-tax basis on the taxable long-term bond strategy severely limits the net after-tax benefit for the client while the benefit of being able to charge a pre-tax fee on the fixed annuity allows for it to outperform the higher yielding long-term bond strategy on an after-tax basis. The indexed annuity beat both the long-term and municipal bond strategies handily.

Looking at the mean after-tax results, however, doesn't give a full picture. In how many scenarios are the annuity strategies protecting the downside better than the other bond strategies? In how many scenarios are the annuity strategies giving up upside to the other bond strategies?

In order to answer those questions we need to look at our Monte Carlo results and the various percentile returns for each strategy and compare them to each other.

Colva Actuarial Services - All Rights Reserved (2020)



On an after-tax and after-advisory fee basis the fixed annuity beats the long-term bond strategy in **62%** of scenarios and the municipal bond strategy in **100%** of scenarios at the **48.1%** taxable rate

On an after-tax and after-advisory fee basis the indexed annuity beats the long-term bond strategy in **83%** of scenarios and the municipal bond strategy in **92%** of scenarios at the **48.1%** taxable rate.

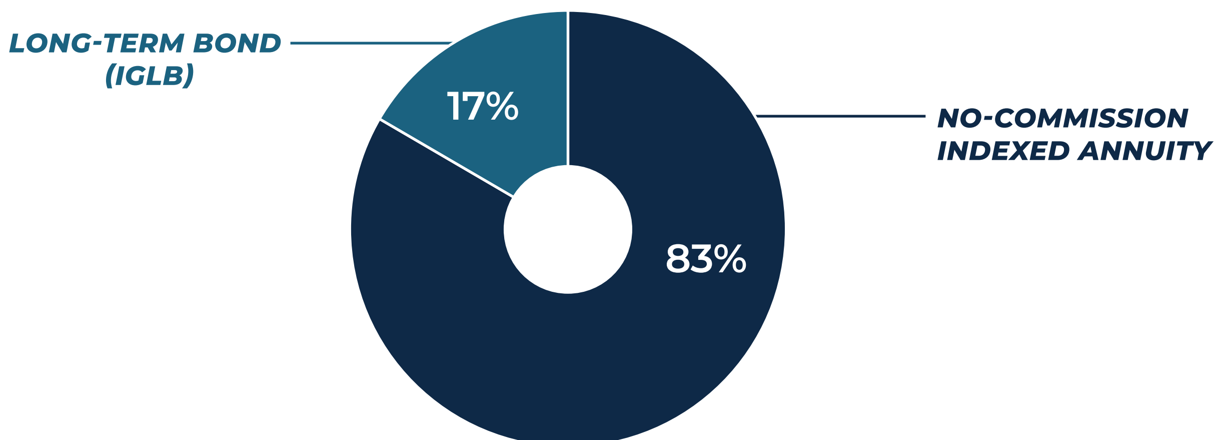
In the graph above we can clearly see the value of the fixed and indexed annuity. The low slope of the fixed annuity line reflects its low volatility in comparison to the highly volatile long-term bond strategy. This low volatility allows the fixed annuity to beat the long-term bond on an after-tax basis in **62%** of the scenarios while beating the municipal bond strategy in **100%** of the scenarios.

In comparison to the municipal bond strategy, the fixed annuity strategy beats it handily and offers more liquidity. Trying to exit a municipal bond early will subject the investor to interest rate risk. In order to avoid this, the investor has to hold the municipal bond for the entire term of the bond. However, with a no-commission annuity the investor can take out up to 10% each year free from surrender charges and interest rate risk (if a non-MVA annuity is purchased).

The no-commission indexed annuity has even better results due to its ability to capture a part of the upside when the index performs well. As such, the indexed annuity beats the long-term bond strategy on an after-tax and after-advisory fee basis in **83%** of the scenarios while beating the municipal bond strategy in **92%** of the scenarios.

Colva Actuarial Services - All Rights Reserved (2020)

PERCENT OF SCENARIOS WITH HIGHER 10 YEAR AFTER-TAX AND AFTER-ADVISORY FEE RETURN



LONG-TERM BOND STRATEGY (IGLB) NO-COMMISSION INDEXED ANNUITY

On an after-tax and after-advisory fee basis, the indexed annuity outperformed the long-term bond strategy (IGLB) in 83% of scenarios.

It's important to note that these results were modeled assuming future interest rates will follow a normal distribution. In other words, like most financial planning software, the results were modeled assuming that an increase in interest rates over the long-term was equally likely as a decrease in interest rates over the long-term in comparison to current yields. With interest rates currently near historic lows, a more appropriate assumption would be that interest rates rise and revert to long-term means over the long-term. As demonstrated in the previous section, if interest rates do rise, long-term bond funds like the IGLB will experience significant upfront losses that will take years to recover from. In such a scenario, no-commission fixed and indexed annuities will drastically outperform long-term bond funds to a greater extent than what has been modeled here.

IF INTEREST RATES DO RISE, LONG-TERM BOND FUNDS LIKE THE IGLB WILL EXPERIENCE SIGNIFICANT UPFRONT LOSSES THAT WILL TAKE YEARS TO RECOVER FROM. IN SUCH A SCENARIO, NO-COMMISSION FIXED AND INDEXED ANNUITIES WILL DRASTICALLY OUTPERFORM LONG-TERM BOND FUNDS TO A GREATER EXTENT THAN WHAT HAS BEEN MODELED HERE

Colva Actuarial Services - All Rights Reserved (2020)

10-Year After-Tax and After-Advisory Fee Bond Return Comparisons on 1000 Scenarios if Marginal Tax Rate Drops to 38.8% in Retirement

As discussed at the beginning of this whitepaper, one of the problems for high net worth clients wishing to shift their portfolio allocation to a larger bond percentage is that they are often phased out or limited in contributing to tax-deferred plans that would allow them to defer high ordinary income taxes on bond gains until retirement when they can potentially lower their tax bracket by either taking less income annually or by moving to a state with no state income tax.

In order to show the value of the tax-deferred benefit of fixed and indexed annuities, it's important to show the after-tax returns assuming the client is able to reduce their marginal tax-rate in retirement. The following table shows the mean after-tax returns if the client invests in taxable bond strategies versus a tax-deferred no-commission annuity strategy in which the clients move out of California and therefore reduce their marginal tax rate by the 9.3% state income tax they were paying on their bond gains.

MEAN AFTER-TAX AND AFTER-ADVISORY FEE BOND RETURNS IF CLIENT IS ABLE TO DECREASE MARGINAL TAX-RATE TO 38.8% IN RETIREMENT

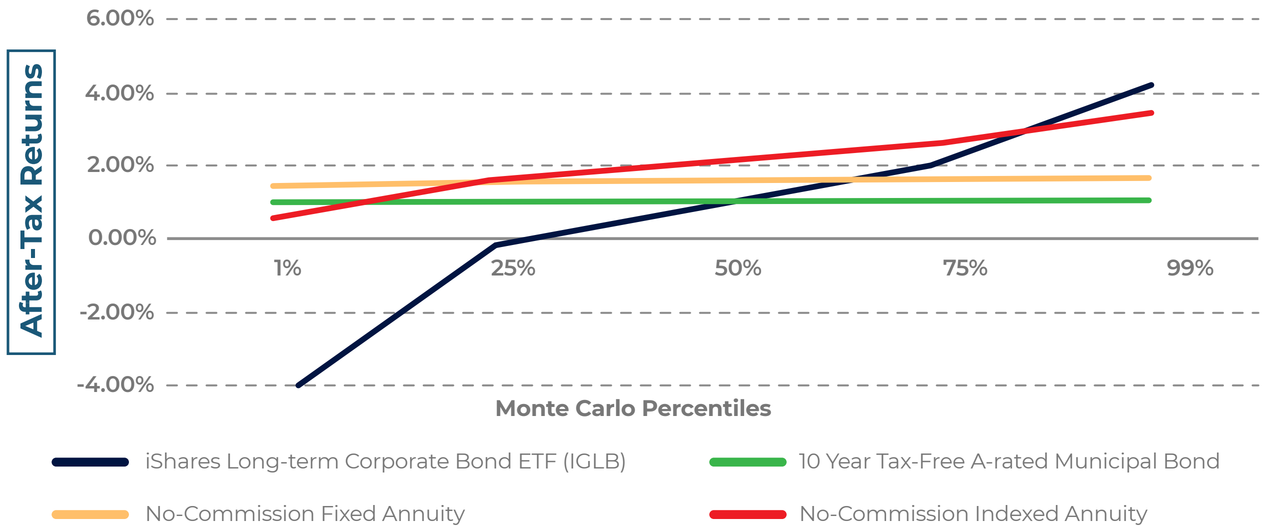
Bond Investment Strategy	Mean 10 Year After-Tax, After-Advisory Fee Bond Returns if Marginal Tax-Rate Drops to 38.8% In Retirement
iShares Long-Term Corporate Bond ETF (IGLB)	**0.75%**
10 Year Tax-Free AAA-rated Municipal Bond	**0.99%**
No-Commission Fixed Annuity	**1.55%**
No-Commission Indexed Annuity	**2.09%**

While the long-term bond strategy requires the client to pay taxes on bond gains at their current marginal tax-rate of 48.1%, the no-commission annuities allow the client to defer taxes on these gains until after retirement in which case their marginal tax-rate could be significantly lower. By waiting to pay taxes on these gains until the client is in a lower tax-bracket, the after-tax and after-advisory fee returns of the no-commission annuities are significantly higher than their taxable long-term bond counterparts.

As evidenced by the table above, deferring taxes until retirement when the client is in a lower marginal tax bracket allows for the client to maximize the value of the no-commission annuities. This can be further demonstrated by looking at the Monte Carlo percentile breakdowns below.

Colva Actuarial Services - All Rights Reserved (2020)

AFTER-TAX AND AFTER-ADVISORY FEE RETURNS OF INVESTMENT STRATEGIES IF CLIENT DROPS MARGINAL TAX-RATE TO 38.8% IN RETIREMENT BY MONTE CARLO PERCENTILE



The tax-deferred benefit of annuities in combination with a drop in marginal tax-rate in retirement allows the no-commission annuity strategy to significantly outperform its bond counterparts. On an after-tax basis the fixed annuity beats the long-term bond strategy in **67%** of scenarios and the municipal bond strategy in **100%** of scenarios at the 38.8% taxable rate

On an after-tax basis the indexed annuity beats the long-term bond strategy in **93%** of scenarios and the municipal bond strategy in **96%** of scenarios at the 38.8% taxable rate.

Sensitivity Testing

A common concern for investors in annuities is that the fixed annuity crediting rate or the indexed annuity cap could drop. As such, it's important to sensitivity test these assumptions. The two questions that should be asked here are:

1. If the spread between the long-term bond yield and the fixed annuity yield is increased, how will that affect the after-tax and after-advisory fee return comparison?

2. How much can the cap on indexed annuities be decreased such that the mean after-tax and after-advisory fee returns on indexed annuities and long-term bonds are equal?

Colva Actuarial Services - All Rights Reserved (2020)

AFTER-TAX AND AFTER-ADVISORY FEE RETURNS AFTER DROPPING FIXED ANNUITY YIELD FROM 3.2% TO 2.1% AT 48.1% MARGINAL TAX RATE

		Current Assumption	Sensitivity Test Assumption
Pre-Tax Returns	iShares Long-Term Corporate Bond ETF (IGLB) Pre-Tax Annual Return	3.61%	3.61%
	No-Commission Fixed Annuity Pre-Tax Annual Return	3.20%	2.1%
After-Tax, After-Fee Returns	iShares Long-Term Corporate Bond ETF (IGLB) 10 Year Mean After-Tax and After-Fee Annual Return	0.75%	0.75%
	No-Commission Fixed Annuity 10 Year Mean After-Tax and After-Fee Annual Return	1.32%	***0.75%***

In our current assumption the pre-tax and pre-advisory fee fixed annuity yield of 3.2% was 41 basis points lower than the current 3.61% pre-tax and pre-advisory fee yield on the long-term bond strategy. This led to the mean after-tax and after-advisory fee compound annual return of the long-term bond strategy being **57 basis points** lower than mean after-tax and after-advisory fee compound annual return of the fixed annuity strategy. Since the fixed annuity offers significantly better after-tax and after-advisory fee results, the pre-tax yield of the annuity can be drastically lowered from its current pre-tax yield while still beating the long-term bond strategy on an after-tax and after-advisory fee basis.

The above table shows that the pre-tax and pre-advisory fee yield of the fixed annuity could be decreased by **110 basis points** to 2.1% and it would still provide equivalent after-tax and after-advisory fee results as the taxable long-term bond strategy.

The above table shows that in order for the fixed annuity strategy to no longer out-perform the long-term bond strategy, the crediting rate on the fixed annuity would have to drop by 110 basis points to 2.1% while the yield on the long-term bond strategy stays constant. In other words, there is a lot of room for the carrier to decrease the yield on the fixed annuity and have it still out-perform the long-term bond strategy on an after-tax and after-advisory fee basis.

It’s important to note that any increase or decrease in the no-commission fixed annuity credited rate will be a direct result of long-term bond interest rates moving up or down. So the spread between the two is unlikely to dramatically shift. As shown in previous sections, the no-commission fixed annuity rate has not been very volatile from year to year.

We can take a similar approach when looking at the indexed annuity by reducing the current cap on the index.

Colva Actuarial Services - All Rights Reserved (2020)

AFTER-TAX AND AFTER-ADVISORY FEE RETURNS AFTER DROPPING INDEXED ANNUITY CAP FROM 6.45% TO 3.25% AT 48.1% MARGINAL TAX RATE

		Current Assumption	Sensitivity Test Assumption
Pre-Tax Returns	iShares Long-Term Corporate Bond ETF (IGLB) Pre-Tax Annual Return	3.61%	3.61%
	No-Commission Indexed Annuity 10 Year Mean Pre-Tax Annual Return	Cap: 6.45% 8.00%	Cap: 3.25% 8.00%
After-Tax, After-Fee Returns	iShares Long-Term Corporate Bond ETF (IGLB) 10 Year Mean After-Tax and After-Fee Annual Return	0.75%	0.75%
	No-Commission Indexed Annuity 10 Year Mean After-Tax and After-Fee Annual Return	Cap: 6.45% 1.78%	Cap: 3.25% *0.75%*

In our current assumption the indexed annuity cap is **6.45%**. This leads it to outperforming the long-term bond strategy by **103 basis points** on an after-tax and after-advisory fee basis.

In order for the long-term bond strategy to start outperforming the indexed annuity solution on an after-tax and after-advisory fee basis, the cap on the indexed annuity would have to **drop below 3.25%**.

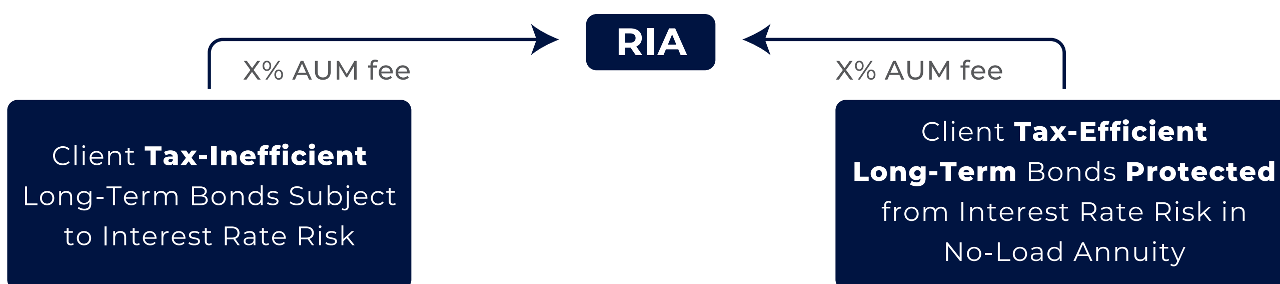
As the above table shows, the cap on the indexed annuity would have to drop from 6.45% to 3.25% for the after-tax and after-advisory fee returns of the long-term bond strategy to surpass that of the no-commission indexed annuity.

Colva Actuarial Services - All Rights Reserved (2020)

Conclusion

No-commission fixed and indexed annuities can offer tremendous value to clients and their fiduciary advisors, particularly for those advisors managing taxable bond portfolios for clients who are subject to high ordinary income taxes.

For clients, no-commission annuities offer the ability to reduce the volatility of their long-term bond investments portfolio and increase their after-tax returns. Even clients who prefer intermediate term bond funds can achieve both higher after-tax yields and reduced volatility by utilizing the right combination of no-commission fixed and indexed annuities as opposed to investing in intermediate term bonds.



No-load annuities provide RIAs the ability to invest client bond funds in long-term investment grade bonds while taking none of the interest rate risk. For high net worth clients, this can provide higher after-tax returns and more downside protection than investing in these bonds directly while still earning the RIA the same AUM fee that they would make if these assets were invested in tax-inefficient bonds directly.

For fiduciary advisors, these no-commission products allow advisors the ability to shift assets from tax-inefficient strategies to tax-efficient strategies while still earning their same AUM percentage fee on the assets (while taking their fee on a pre-tax basis that is better for the client). It's a win for the client, and a win for the advisor. In an age of fee-compression, clients are demanding more value from their advisors. Simply allocating high net worth client bond portfolios to low-yielding municipal bonds that are still subject to interest rate risk for the duration of their holding period, is not going to cut it anymore. If you're a high net worth client, would you be satisfied with an advisor allocating your bond portfolio to 1.8% yielding municipal bond and then paying the advisor his or her 1% fee on those assets for simply moving your assets to a low-yielding/liquidity constrained asset? The 0.8% net yield the client gets after paying the advisor's fees won't even keep up with inflation.

Colva Actuarial Services - All Rights Reserved (2020)

Allocating client bond portfolios to municipal bonds or even long-term bonds are simply asset allocations. In an age of fee-compression, low bond yields, and robo-advisors, clients are demanding that advisors prove their financial planning worth and the value they are providing to clients on an after-advisory fee basis. Otherwise, the client could just allocate the funds to low-yielding bond mutual funds on their own. No-commission annuities on the other hand, are more than just asset allocation; they are a financial planning tool. They help protect clients' assets in retirement. While no-commission annuities have a long way to go in order to be as operationally and technologically efficient as investing in taxable bonds, no-commission annuities offer fiduciary advisors the ability to show how no-commission annuities can both protect client downside and increase after-tax and after-advisory fee yields in retirement in a way that taxable bond investments in a low-yielding environment cannot. This is what clients want from their financial advisor—fiduciary financial planning solutions. By explaining to clients how these no-commission annuities can increase their chances of a successful retirement, the fiduciary advisor is demonstrating added value over his or her competitors who are simply allocating client bond portfolios to highly taxable funds.

To learn more about how to implement No-Commission Annuities into your clients' portfolios, visit www.colvaservices.com or contact us at (800) 561-4028 or support@colvaservices.com.

Colva Actuarial Services - All Rights Reserved (2020)

About the Authors

RAJIV REBELLO FSA, CERA

Rajiv Rebello, FSA, CERA is the Principal and Chief Actuary of Colva Actuarial Services (www.colvaservices.com). Rajiv works with fiduciary RIAs to help them implement fiduciary life insurance, annuity, and alternative investment solutions into their current practice in order to help increase clients' after-tax returns and reduce volatility in their clients' portfolios. By helping to establishing a fiduciary insurance practice within fiduciary RIA practices, these RIAs no longer have to refer clients to outside parties who would take assets away from the RIA and invest them in non-fiduciary and often high-commission life insurance solutions. Rajiv can be reached at rajiv.rebello@colvaservices.com

NOLASKO ABREU

Nolasko Abreu is an Actuarial Director at Colva. He works directly with RIAs to help model their clients' current bond portfolios and compare them to no-commission annuity, alternative asset, and life insurance strategies to show clients how reduced volatility and increased after-tax, after-advisory yields can benefit them in retirement. Nolasko also helps show clients how to maximize tax-free returns in no-commission/low-commission life insurance products by minimizing expenses and premium payments. Nolasko can be reached at nolasko.abreu@colvaservices.com

[1] LIMRA. Available at: https://www.investmentnews.com/article/20190405/FREE/190409952/indexed-annuity-sales-projected-to-grow-nearly-40-by-2023

[2] 2019 ACLI Factbook. Available at: https://www.acli.com/-/media/ACLI/Files/Fact-Books-Public/2019FLifeInsurersFactBook.ashx?la=en

[3] iShares IGLB Index. Available at: https://www.ishares.com/us/products/239423/ishares-10-year-credit-bond-etf

[4] IShares AGG Index. Available at: https://www.ishares.com/us/products/239458/ishares-core-total-us-bond-market-etf

[5] Annuity Rate Watch. Available at: https://annuityratewatch.com/

[6] FMS Bonds. Available at: https://www.fmsbonds.com/market-yields/

Colva Actuarial Services - All Rights Reserved (2020)