A Very Popular Annuity Sales Presentation – What Do You Think of It?

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Imagine that you and your spouse are fifty year-olds, and in the summer of 2010 hear about the following retirement product. This annuity offers a guaranteed 8% on your money for the next 10 <u>or more</u> years, and then will annuitize your accumulated balance in annual payments for as long as either of you live, annually paying you 5% of the total your money was guaranteed to grow into over the deferral period. The insurer also, as a special bonus, if you act before the promotion ends, will immediately give you an additional 10% bonus on your funds on the first day.

So, if you give the insurer $100K, you will immediately see an account balance of $110K that will grow tax-deferred over, let's say, 15 years at the guaranteed 8% compounding into $348,939, which will then be annuitized into a lifetime annuity as long as either you or your spouse are alive of $17,447 (5% of $349K) annual payment, which will only upon pay-out be taxed based on the "type of dollars" that you had invested. (That is, if the invested dollars are from ordinary funds, a Regular IRA, or a Roth IRA, your pay-outs could, respectively, be partially-taxed under regular annuity tax laws, fully-taxed, or all tax-free.) Sounds pretty attractive, doesn't it?) Several insurers, such as Allianz, Aviva, ING, North American, Prudential, and many others have been doing a lot of business with this retirement annuity. Certainly after the last few years during which the Dow Jones Index has ricocheted from 13,000 to 7,000 to 10,000, money market rates have averaged about 1%, and municipal bond rates are under 4% - this retirement annuity looks like it provides both great security and a currently seemingly-cosmic <u>guaranteed</u> yield.

An agent, for example, might ask, 'Is there any other investment today that guarantees you 8% for fifteen years?' And remind you that if you can act quickly, it is even better than that with the immediate 10% bonus. 'And rest assured,' the agent might continue, 'if for any reason both you and your spouse die before having received a total of several years of annuity payments equal to your accumulated balance, then the insurer will make a final substantial payment,' and

provide details about such. The agent will also definitely mention the insurer's A or A+ ratings and other factors to allay any possible concerns or questions about the insurer's financial strength.   'For a healthy 50 year old couple, like you two, looking for a safe and yet attractive retirement vehicle this certainly sounds good, doesn't it?' Sales manuals and instructors, of course, teach such language, and agents know that after asking such a trial closing question to be quiet and to wait for the consumer's response.

The Big Question

Assuming the couple lives another 30 or 35 years, **what do you think the couple's rate of return (ROR) will be on this product?** Paul, a 52 year old, Phi Betta Kappa from an Ivy League school where he majored in economics and computer science certainly found this annuity attractive. His wife, Mary, a year younger and an economics major as well, was valedictorian of her class at their alma mater. Both have worked extensively in business, now living and working in Oregon, and currently managing a 7 figure retirement nest-egg. They would not qualify as anyone's idea of dummies.

Paul in fact had naturally asked his agent this very question. His agent, who is very professionally-dressed, spoken, and mannered, and who was using a computer spreadsheet to present this concept, had explained that the annual rate of return is calculated by recalling that Paul's $100K had grown into a total of $349K that was paid out, which is a gain of $249K, or in percentages a 249% increase over 35 years. Paul's agent stated that the annual rate of return was 7.1% (249%/35 years), which he reminded again could be tax-free or otherwise depending upon the "type of dollars" with which it is funded.

Paul's wife, Mary, who hadn't been able to attend the meeting with their agent, also found the 7% quoted return very attractive, in fact, almost too attractive, so she calculated an average rate of return by multiplying all the quoted annual rates. She used the guaranteed annual rate of return of 8% for 15 years, included the guaranteed first year 10% bonus (if they acted promptly while it was still being offered), and the guaranteed 5% pay-out rate over 20 years. So consequently**,** Mary calculated the annuity was guaranteeing approximately a

6.5% annual return. It still seemed very attractive, especially since it was all guaranteed. So they called me, to ask my opinion.

When I explained that the annual rate of return over this chosen 35 year period would be 5.43%, Paul and Mary were both quite surprised. They thought they had properly understood the annuity. Paul explicitly recalled their agent's calculation. Mary also trusted her own financial skills and arithmetic. How could this actual rate of return be so much lower than what their agent, who on his web site touts "his sophisticated mathematical and financial knowledge," had explained, or that Mary, no dummy herself, had calculated? After all, this annuity's returns are entirely guaranteed[i]; this retirement product isn't like a typical mutual fund or other investment where future performance is uncertain.

A spreadsheet showing **the correct calculation** is attached as this article's last page; it uses the financial formula for the internal rate of return on a stream of payments/investments and receipts/returns. **The agent's mistake** is that it fails to take into account the compounding of money over time; it is simplistic, incorrect, and misleading.   As those who know the financial "Rule of 72" [ii] know, if a sum of money doubles over 10 years, then its average annual rate of return is not the 100% gain divided by the 10 years, it is 7.2% . **Mary's mistake arises** from a little more complicated problem. Her approach fails to take into account the fact that when one annuitizes a lump-sum, as is done when the payments begin, she exchanges the lump-sum for a stream of payments guaranteed for her and/or Paul's lifetime. Specifically, her simplistic approach of mathematically averaging the annual rates of return fails to take this fact into account; a fact properly reflected in the changing, longevity/duration dependent RORs shown on the last page. **Paul's mistake arises** from his misplaced trust in their agent, an otherwise very affable guy who has the manner and trappings of professional success, yet apparently lacks the necessary competence and/or ethics.

Public Policy Considerations (next page)

Public Policy Considerations

It would seem that anyone <u>genuinely</u> <u>and</u> <u>seriously</u> interested in public policy issues pertaining to consumer financial products ought to be very interested in above real-world examples of misrepresentation and misconception. Insurers will no doubt quickly point-out that the annuity contract, of course, does not contain any misrepresentations. Some insurers' counsels might therefore claim that they and their colleagues have done a very fine, and irreproachable job.

Insurance regulations, however, define any and all communications with the public or individuals as advertisements. These laws further require that, "Advertisements shall be truthful and not misleading in fact or in implication. The format and content of an advertisement of a life insurance policy or annuity contract shall be sufficiently complete and clear so that it is neither misleading nor deceptive, **nor has the capacity or tendency to mislead or deceive.** [emphasis added]"

What does this regulatory language mean? Does one need to be an attorney to understand it? I don't think so. How could the annuity sales presentation that Paul and Mary received have been "sufficiently complete and clear" and "without a tendency to mislead" such that these two Ivy League Phi Betta Kappas so misunderstood the product? According to this laymen's reading of the above regulatory language, intentionality to mislead is not required to have this regulation been violated. Certainly, Paul and Mary's agent's presentation undeniably "had a capacity or tendency to mislead," because it misled. A few of the obvious questions arising from this real-world experience are:

1) How could the agent have miscalculated and misrepresented the annual rate of return? B) What does that indicate about his sales training? C) What does this indicate about his use of an XL spreadsheet, and yet his or his insurer's failure to employ its capabilities to correctly calculate this product's performance statistic, ROR, of such critical importance?

2) What does it indicate that these two smart consumers could so misunderstand this product and the agent's sales presentation? B) Specifically, what does their misunderstanding indicate about the adequacy of the sales materials if they could so misunderstand or miscalculate the rate of return by 1%?

3) What do the misrepresentation, misunderstanding, and misconception of this retirement product's most important characteristic, its ROR, indicate, about the insurer's sales compliance standards? B) Should insurer sales materials be tested on groups of consumers to make sure that the information presented is properly understood? Or not likely to be misunderstood?

4) What do the misrepresentation, misunderstanding and misconception of this widely-sold retirement product indicate about regulatory practices and enforcement? B) What "surveillance" of real-world sales practices do regulators perform? And how haven't they caught this widespread and blatantly problematic practice? C) What compensation is owed duped purchasers who were explicitly told by their agent an inaccurate ROR? D) What financial competence standard should regulators have to demonstrate to qualify as financial product regulators? After all, we have seen what the SEC, FINRA, the Federal Reserve, and other regulatory agencies have "accomplished" during the Madoff, mutual fund market-timing scandals, and the mortgage market meltdown when these agencies were led and staffed primarily with attorneys or generalists or consumer advocate types who, as those recent events have shown, were without sufficient genuine financial expertise or real world selling/marketplace experience to have been effective.

Final Thoughts

The above retirement annuity is a relatively simple and straightforward financial product. And yet, we see that its typical sales presentation is inherently

flawed. It could well be successfully argued that the typical sales presentations of this guaranteed[iii] annuity <u>are</u> <u>intentionally</u> <u>deceptive</u>. Certainly, they are designed to either explicitly mislead consumers (with their emphasis on the currently unobtainable 8% annual return, and 10% first year bonus and their agent's faulty calculations), or implicitly prey upon consumers' ordinary misconceptions. **This is not a good situation**. It is not merely that consumers do not obtain what they thought they had bought (which is pretty bad), it is also that society as a whole has excessive resources ,i.e., agents' and consumers' time, engaged in, respectively, selling and evaluating such products that would otherwise not be engaged in if the product were properly disclosed. This conclusion is irrefutable. And the total societal costs of such financial crimes are enormous and extensive.

That conclusion is irrefutable even without delving into the question of inadequate disclosure of agent sales compensation. In the above case, curious readers may be interested to know: Paul was informed by his agent that any commission he might earn (that the agent might earn as a result of Paul buying the annuity) "would <u>not</u> be paid out of your principal or earnings."

End Notes:

i It is true that these annuity products are guaranteed. But such guarantees are provided by the insurer itself, and hence are really dependent upon the insurer's future financial performance. Life insurers' financial performances can be and have been significantly misunderstood, as **all should recall the major financial collapses of: Baldwin United, Equitable, Executive Life, General American, Mutual Benefit, etc**. In contrast to bank failures and in contrast with the public's perception of insurer failures, consumers of failed insurers have often been seriously financially harmed as regulatory actions to "protect all the policyholders" typically have involved "locking-in" policyholders to years of inadequate returns in order to preserve the myth that the policy's purported guarantees have been preserved.

ii The financial **"Rule of 72"** is an excellent way to quickly and very accurately estimate the average annual rate of return (ROR) when one knows that a sum of money has doubled in value over a period of years. The formula is: 72 divided by the number of years required to double equals the average ROR. For instance, if your $1000 investment becomes worth $2000 in 4 years, your average ROR was 18%. Alternatively, if someone tells you that your investment will grow 12% a years, then it will double in 6 years (72/12 =6). This is a useful little rule to know; but keep mind that when something has increased 8 fold over 40 years, that such represents three (3) doublings (from 1 to 2, 2 to 4 and then 4 to 8). Also be careful to not simplistically apply the "Rule of 72" to situations where there are multiple payments and receipts. In the article's example, it usefulness has been cited not because it was directly applied, but because it is a rule that many people know and therefore was a way to highlight the agent's

mistake. No doubt, of course, if or when there is litigation on the above type of annuity sales misrepresentation, insurers' corporate counsels will probably endeavor to say that consumers weren't mislead by the agents' statements that the annuity was offering a 7.1% return over 35 years because of consumers' knowledge of the rule of 72, and therefore would have recognized the agent's error and not been tricked like Paul. Some insurance corporate counsels' work, I am very sad and sorry to have to report, indicates that they have the conscience of **Madoff.**

iii The guarantees of this article's retirement annuity have not been explicitly studied, so no opinion is herein offered regarding whether or not there are some contractual provisions that would modify or constrain the above described annuity's values if the insurer failed. It can be a very interesting separate study to examine what rate or return an insurer must actually earn given all of its actual costs to be able to provide its "guaranteed" returns. There is a very fine line between "guarantees" that are very attractive and "guarantees" that are too good to be true. Unfortunately, many routinely mistake the latter for the former; recall Equitable's 1980s Guaranteed Investment Contracts (GICs) that virtually forced this insurer into **its second failure** in the 20th century when it had to be rescued by AXA, the big European insurer, in the early 1990s. Now this insurer, AXA-Equitable, rides around most amusingly in a convertible car on TV as the **800 lb Gorilla**. May we all come back from the dead to such blissful experiences!

$100,000 Retirement Annuity Shown to Paul and Mary by their agent

Paul and Mary are ages 52 and 50, with excellent longevity prospects

	Years	Annuity Value, purportedly at year-ends	Annual pay-outs	Rate of Returns (ROR)
	1	118,800	assume made at	
Annuity Values	2	128,304	beginning of year	
reflect an 8%	3	138,568	which maximizes	
guaranteed	4	149,654	calculated RORs	
annual growth	5	161,626		
with	6	174,556	Note: This table summarizes only the	
a possible	7	188,521	primarily information presented	
extra 10%	8	203,602	to Paul and Mary by their agent.	
first year bonus	9	219,891	Their agent did mention other	
if consumers	10	237,482	important facts about the product,	
act "quickly"	11	256,480	i.e, possible surrender charges,	
before it	12	276,999	etc. so no one should assume that	
expires	13	299,159	the omission of such from this article	
	14	323,091	was an add'l agent mistake.	
	15	348,939		
	16		17,447	
	17	Pay outs equal	17,447	
	18	5% of "Value"	17,447	
	19	at end of	17,447	
	20	chosen deferral	17,447	
	21	period, in this case	17,447	
	22	15 years	17,447	
	23		17,447	
	24	Pay-outs continue	17,447	
	25	as long as either	17,447	
	26	Paul or Mary is alive	17,447	
	27		17,447	**3.71%**
	28	There is a minimum	17,447	**4.03%**
	29	guaranteed pay-out	17,447	**4.31%**
	30	to allay concerns	17,447	**4.56%**
	31	about the possibility	17,447	**4.78%**
	32	of both dying early	17,447	**4.97%**
	33	during the pay-out	17,447	**5.14%**
	34	phase.	17,447	**5.29%**
	35		**17,447**	**5.43%**
	40		17,447	**5.94%**
	45		17,447	**6.25%**
	50		17,447	**6.45%**

End Notes: Repeated

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