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INVESTING FOR RETIREMENT

Building a Cheaper Annuity

Companies try exchange-traded funds to trim the expenses of variable contracts

By LESLIE SCISM

A longstanding beef against variable annuities is their steep cost. A big plus of exchange-traded funds is their ultralow cost.

Journal Report

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Finally, momentum is growing to pair the two financial products in innovative ways, a trend consultants say is good for many people who are trying to save for retirement.

Variable annuities are a tax-advantaged form of investing in stock and bond funds. Sold by insurance companies, many come with downside protection: Should the funds tank, there is a guarantee of lifetime payments of a specified minimum amount.

The products won new converts in the wake of the financial-markets meltdown of 2008-09. But the annual cost—often topping 3.5% of the invested amount—turns many people off because it is a serious drag on investment returns.

That's where ETFs come in. They track benchmark indexes, providing exposure to stocks, bonds or commodities, often at rock-bottom prices.

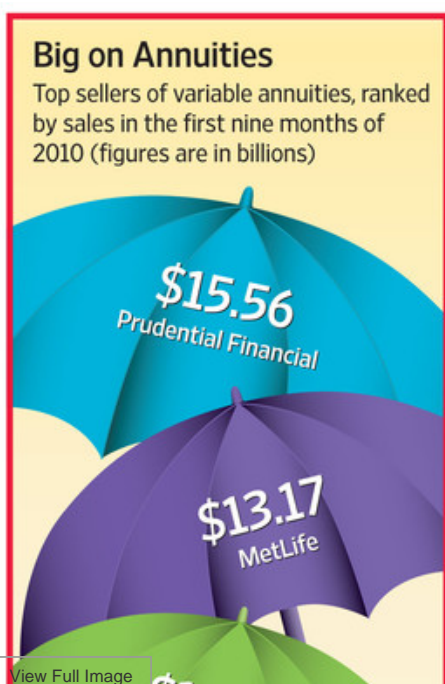
For complicated tax reasons, it isn't an easy thing to simply allow variable-annuity buyers to pick and choose among individual ETFs. For several years, a handful of insurers have offered ETFs as part of packaged asset-allocation portfolios, but those have remained relatively pricey offerings.

Now, the pace of innovation has picked up, and the savings being passed on to consumers are potentially greater—though financial advisers say the products still won't be cheap by many people's standards.

More-Efficient Hybrid?

Last month, units of Western & Southern Financial Group Inc. launched an ETF-focused variable annuity that "is really the leading edge of a whole series of products that feature ETFs," says Kenneth Mungan, leader of the financial risk-management practice at consulting firm Milliman Inc.

Western & Southern's variable annuity allows buyers to build a customized portfolio of ETFs from Vanguard Group and [BlackRock Inc.](#)'s iShares unit. The all-in cost, including the downside protection, typically will run 2.5% to 2.7% a year of the invested amount. That's cheaper than the first generation of



See the top sellers of variable annuities.

variable annuities with ETF-based asset-allocation portfolios. A popular one from MetLife Inc. has all-in fees of about 3.2%.

The Western & Southern product will be cheaper largely because of ultralow investment-management fees—0.09% to 0.5% of the amount in the ETFs. That compares with 0.83% for MetLife's best-selling ETF asset-allocation portfolio, which includes the cost of a sub-adviser strategizing about the underlying ETFs. Industrywide, the typical variable-annuity fund charges 0.91% a year in investment fees, according to Insured Retirement Institute, a trade group.

Mark Caner, president of W&S Financial Group Distributors, which markets the Western & Southern product, says variable annuities "often are viewed as gas guzzlers," so his team is pitching its new offering as "more efficient, a next-generation hybrid."

Elizabeth Forget, a MetLife senior executive, notes that her company's ETF-based offering wasn't aiming for a rock-bottom pricing structure but to meet demand from financial advisers for the index-tracking investment vehicles. MetLife says it continues "to look for new innovations in fund management and product."

Meanwhile, an approach even bolder than the Western & Southern one for holding down costs was filed in December for review by the Securities and Exchange Commission, according to Mr. Mungan.

If approved, this ETF-based offering would pass on savings from a redesign of the risk-management approach that many insurers use to offset the market exposure they face from offering guarantees, he says. Securities firm ValMark Advisers Inc. is the investment adviser, and Milliman is a sub-adviser for the portfolios.

Key Lesson

An estimated \$500 billion is in variable annuities sold in recent years with guarantees of lifetime income or withdrawals of a minimum amount.

The current round of innovation stems partly from lessons learned by insurers from the 2008-09 market turmoil.

With the steep slide in the markets, the guarantees of lifetime payments revealed shortcomings in their risk-management programs. One key lesson: Risk management works best when consumers' money is invested in index-based funds. It's easier for insurers to buy financial derivatives that are bets against the indexes; it's a tougher chore to hedge against a portfolio where a manager may be changing holdings daily.

The idea is that when the markets fall, the financial hedges gain in value. If they work perfectly, they offset the mounting liability of the guarantees.

Over the past two years, numerous insurers have pruned their fund lineups to remove the riskiest funds and increase the use of indexed strategies. ETF-based variable-annuity portfolios currently hold about \$3.6 billion in assets (most of it in MetLife offerings), up from \$620 million in 2007, according to Morningstar Inc.

So why not simply offer menus of ETFs from which investors can pick and choose? According to industry executives and lawyers, Internal Revenue Service rules require variable insurance products to follow certain diversification requirements to maintain tax-favored status; to permit variable-annuity buyers to select individual ETFs may result in the contracts not being sufficiently diversified.

Western & Southern solves this problem by restricting purchase of its variable annuity to people who can invest through an individual retirement account, where such investor choice is generally permitted. So the tax-deferred

treatment that the IRA enjoys applies to investment earnings within the variable annuity. The name of the product, in fact, is Variable Annuity for Roll Over Only Money, or Varoom.

Buyers can build their own portfolio from 18 Vanguard and iShares ETFs, plus a money-market fund, though some restrictions may apply. Varoom also offers model portfolios, of varying riskiness.

Investors who are 55 years old when they buy the annuity and its guarantee are eligible to withdraw 5.5% of a "benefit base" a year for life beginning at age 65, and 6.5% for life at age 70. This benefit base starts off as the initially invested sum and is increased each year that investment gains in the ETF accounts take the contract value to a new high; the base isn't reduced if there are investment losses. Withdrawal percentages increase under certain circumstances.

A Cheaper Hedge

The ValMark-Milliman approach still awaiting SEC approval is innovative in that it moves part of the financial-hedging program from the insurer's balance sheet into ETF portfolios. By taking that off the insurer's books, costs can be lowered for consumers, Mr. Mungan says. That's because the insurer doesn't have to raise prices to compensate for the punitive effect on reported earnings per share that sometimes results from holding financial hedges, under generally accepted accounting principles.

"The consumer is paying for the hedge asset no matter what," Mr. Mungan says. "But here, the consumer buys and owns the hedge asset at a cheaper price" through the ETF portfolio itself.

If approved by the SEC, the Valmark-Milliman portfolios could be offered by multiple insurance firms.

Stock-brokerage executives say the new approaches are promising but they aren't yet convinced they will be top sellers.

"Anything that pushes down the overall costs of the product is a good thing," says Scott Stolz, president of the insurance group at brokerage Raymond James Financial Inc. But he says the Western & Southern offering "doesn't have the most feature-rich" guarantee on the market and pays a slightly lower commission to advisers than some rival products, so winning business may prove tough.

Western & Southern says the annuity's design and low cost together make it favorable for both customers and advisers.

Ms. Scism is a news editor for The Wall Street Journal in New York. She can be reached at leslie.scism@wsj.com.

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