Variable Annuity Outlook 2013: Tough Road Ahead

Move to RIA compensation model, new benefit focus just two of the issues to expect in 2013

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Sun Life Financial's announcement in mid-December that it will exit the annuity business is the latest company to do so in a growing trend. Hartford and Genworth have made similar announcements recently. Many companies that are forging ahead in the space are changing their focus from generous living benefits and guaranteed income features to instead offering alternative investments as a diversification tool.

The main culprit, experts say, is that many variable annuity products hedged their exposure incorrectly, something that wasn't revealed until the market crashed in 2008. As more and more annuity owners opted to initiate the guaranteed portion of the contract, something known as being "in the money," product distributors were unprepared, leading to solvency concerns for the industry as a whole.

Large and venerable insurance companies, some hundreds of years old, barely survived, and they aren't about to make the same mistake twice; hence the rush for the exit.

So does this dampen the outlook for the annuity industry in 2013? Not necessarily, says Mitch Caplan, who believes another reason is also fueling the trend—the move to fee-based.

"Competitors are exiting the business, and while they recognize the value in the fee-based model, as opposed to strictly commissioned-based, re-engineering their infrastructure is tough," Caplan, CEO of Louisville, Ky.-based Jefferson National Financial, explains. "Their infrastructure is very expensive, and if you don't use it to sell [the annuity product], then what do they sell? They're attempting to modify their existing structures, rather than building from the ground up."

Indeed, high-net-worth advisors, especially, have long been skeptical of annuities, in particular the way in which they were traditionally priced. But companies like Jefferson National now offer a pricing structure that fits with their business model, and more advisor are taking a fresh look at what annuities have to offer.

Jefferson was one of the first companies to develop a flat-fee variable annuity for the RIA space with its Monument Advisor product.

There are a number of other big picture trends, Caplan notes, among them “an extraordinary focus on rising tax rates.” “For variable annuities, it became an arms race around the benefits of tax deferral,” he says. “Because of the fees involved–usually 100 or 125 basis points–it was difficult for people to realize the benefits of tax deferral, which was largely eaten up in those fees.”

For the advisors Caplan has spoken with, asset location and well as asset selection are increasingly important. “What percentage of my clients’ assets are highly tax-inefficient, and should that portion therefore be placed in a tax-deferred account,” he adds. “As for the asset selection portion, what are the asset classes that are most intriguing? Those should be looked at.”

And of course, the fiduciary issue will return in 2013.

“It will become extremely current, especially with a new SEC head. The fiduciary issue will affect all products, of which annuities will be a part.” More than anything, Caplan concludes, advisors want any help with “managing through the volatility.”

“Advisors and clients are anxious, and they don’t know how to express their anxiety. It’s ‘what do I do?’ ”