

5 REASONS

WHY ADVISORS MAY BE VIOLATING THEIR FIDUCIARY DUTY BY NOT OFFERING INDEXED ANNUITIES TO THEIR CLIENTS

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Fiduciary duty is defined as, “A legal obligation of one party to act in the best interest of another.” There is a lot of conversation today about who should or should not act as a fiduciary. And, while this conversation may apply to a broader audience as a result of recent DOL proposals, we will be focusing on those who currently must abide by this standard – Certified Financial Planners (CFPs), Registered Investment Advisors (RIAs), and Investment Advisor Representatives (IARs). For those in the securities industry, if you carry a series 65 or 66 registration, you also fall into this category

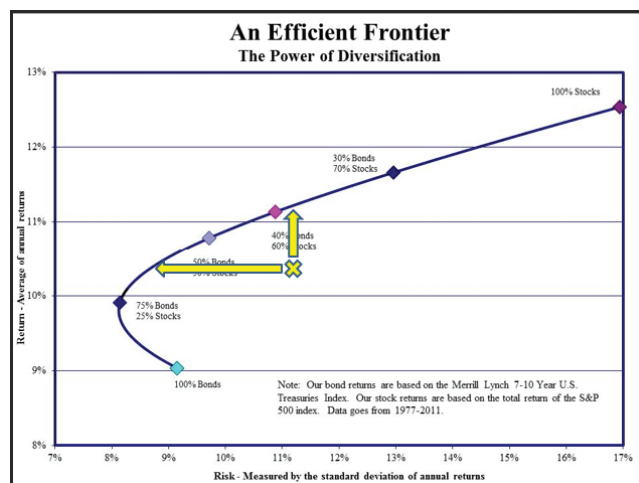
Unfortunately, when many advisors hear the term, indexed annuity, they cringe and use terms like complicated, expensive, illiquid and unsuitable. In many cases, these adjectives apply. But, today’s index annuity is about as far from those products sold 20 years ago as a modern Ferrari is from a horse and buggy. Disparaging an entire industry because of a few bad products would be like saying, “My dad owned a Ford that was a lemon. Therefore, I’ll never buy a car. I’ll continue to use my horse and buggy.”

Are there still poor products out there? Absolutely! But isn’t it the job and duty of the fiduciary to identify the best option for our client – without personal bias?

Let’s explore five ways you may be unknowingly violating your fiduciary duty.

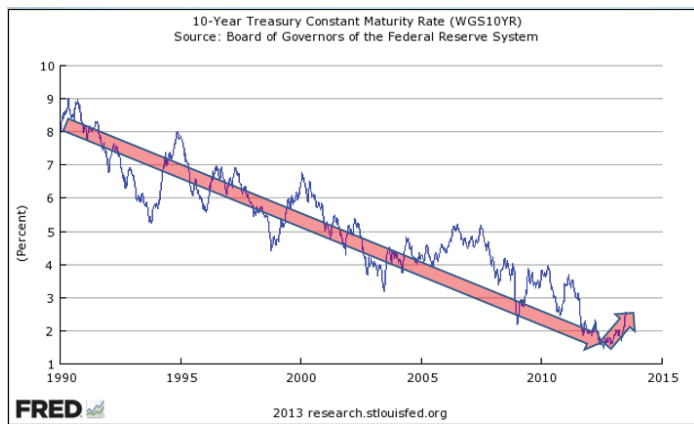
1. THE BETTER BOND

In 1990, Harry Markowitz won the Nobel Memorial Prize in Economic Sciences. He is most famous for his work often called Modern Portfolio Theory. In simplest terms, he postulated that for any investor, there is an ideal combination of assets (typically stocks and bonds) that will provide the maximum return with the minimum amount of risk. For example a conservative investor may have an ideal mix with 80% bonds and 20% stocks, while an aggressive investor may be best suited with 80% stocks and 20% bonds. This ideal combination is called the Efficient Frontier.



For the last 20 years, advisors have used modern portfolio theory to mitigate risk (often referred to as beta) in a portfolio. By blending a non-correlated asset like bonds into the portfolio, they could add an additional layer of return (or alpha) reducing risk. Using the Efficient Frontier to structure optimized portfolios has worked very well – but there is a storm brewing. The bond allocations in these portfolios are in trouble.

For the last 20 years, interest rates have steadily decreased. This rally in bonds has served to reinforce Markowitz’s theory, but that rally has ended. With the 10-year treasury floating at just above 2%, the potential for further decreases, while possible, is slim. And, even if rates decrease further, how far down can they go?



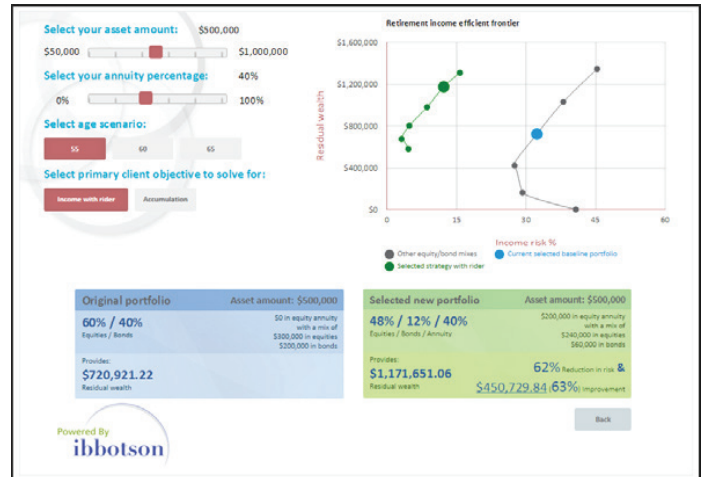
There are only two other options for these bond positions – a prolonged low interest rate environment or rising interest rates. Both of these scenarios will be bad for those using the efficient frontier but rising interest rates will wreak havoc on the traditional efficient portfolio. Due to the inverse relationship between bonds and interest rates, a mere 200 basis point increase in interest rates will cause a 15% reduction in value of a 10-year bond.

Many advisors, realizing this potential risk, have sought other non-correlating assets to take the place of all or a portion of their bond allocations. Real estate investment trusts (REITs) have been used by some advisors as an alternative to the bond position. Unfortunately, while adding bond-like yields, they also came with added risk and often, extreme illiquidity.

What if there was a strategy that could take the place of the traditional bond portfolio and provide better results for clients than bonds ever did? That strategy is available today!

Consider the illustration below prepared in conjunction with Ibbotson. By blending in this new asset class (an index annuity), an advisor can significantly reduce risk (beta)

while at the same time increasing return (alpha). Isn’t that what our clients are paying us to do?



Compared to a traditional bond, a modern index annuity can provide similar yields but, unlike bonds, offer a guarantee of principal. This guarantee contributes to a lower overall beta in the portfolio and often allows a higher allocation to stocks than the traditional bond allocation would.

These products have come a long way since their introduction over 20 years ago. As a result, their acceptance in the broker/dealer and RIA community has grown exponentially. The index annuity marketplace, which has hovered around \$30 billion in annual sales, is expected to exceed \$100 billion in the next few years.

Almost all of this growth is coming from the B/D and RIA marketplace. The most successful advisors in the country are realizing that an index annuity can be a valuable tool when designing an efficient portfolio.

Why the swing? Some of it is driven by demand for a bond alternative. Most of the shift has come as these products became less complicated and more broker/dealer friendly. In addition, the recent introduction of products from major-carriers with strong brand recognition has helped to accelerate this acceptance.

2. THE SAFE MONEY ALTERNATIVE

As our clients transition from accumulation to distribution, their investment objective tends to shift from, “Grow my money” to “Don’t lose my money.” Unfortunately, most of us are “genetically wired” to try to make money grow. This disconnect can be the source of frustrations and arbitrations. Like it or not, many of our senior clients just want to avoid market volatility completely. No matter how good

your advisory skills are, you can't asset allocate 100% of the risk out of a portfolio.

Our most conservative clients are looking for guarantees – guarantees we can't provide with stocks and bonds alone. An index annuity provides a 100% guarantee of principal.

3. INCOME FOR LIFE

As 76 million baby boomers transition from accumulation to distribution, we, as advisors, are faced with a dilemma: "How do we provide for an income need with an unknown time horizon and unknown inflation rate?"

An annuity is the only financial instrument that can guarantee a stream of income you can't outlive. 20 years ago this meant the "A" word (annuitization). With the introduction of income riders on annuity contracts, annuitization in most cases became a thing of the past. Income riders guarantee a series of withdrawals – for life – even if the annuity value is reduced to zero. These riders, just like index annuities, have matured greatly over time.

Income riders are available on both variable annuities and indexed annuities. However, they are much more efficient and less costly when attached to an index annuity. This is due to the fact that the company does not have to price the rider for potential negative returns.

In most cases, for under 100 basis points, a client can purchase this "longevity insurance" while still enjoying all the other benefits of the index annuity.

4. LIQUIDITY

One of the comments we often hear from advisors is, "I don't want to lock-up my client's money for the next 10 years." A fair comment, but on further examination, it may not carry much weight.

First, if you consider that an index annuity is being used for a portion of the client's portfolio, it is fair to assume that the remaining portion is in a fully liquid managed equity account – providing more than enough liquidity for all but the most extreme emergencies.

Second, although an annuity may have a 10-year contingent deferred sales charge (CDSC); it is by no means illiquid. Most annuities are 100% liquid for emergencies like death, nursing home, etc. They also provide a free withdrawal provision typically 7% to 10% per year without surrender charge. Most importantly, in most cases, they are 90% liquid day one. And, the liquidity percentage increases over time. When compared to the alternatives, this is quite an advantage. Compare this to a REIT, which may be totally illiquid for up to 10 years or more. Even a bond, which is theoretically fully liquid, may appear to have a surrender charge in a rising interest rate environment. If you own a 10-year bond and rates increase 200 basis points, that bond would trade at about a 15% discount (surrender charge). Obviously, you could hold the bond to maturity and redeem it for face value. The same is true for an annuity.

5. PRACTICE STABILITY

Arguably, one of the duties you owe your clients is to stay in business. It is obviously not in your clients' best interest if you fail to run your business wisely. Consider the points made in #1 above. By adding an index annuity to a client's portfolio, you reduce the risk while at the same time increasing the return. By adding index annuities to your practice, you arguably do the same thing.

Some of the better index annuities offer multiple commission options – for example, 7% to 8% up front or 1% up front with a 1% trail for life.

Mature practices, which have already transitioned to an AUM model, can use the trail commission option and add stability to their income. Since an index annuity cannot lose value, that portion of your book will provide continuous level or increasing income no matter what the market conditions. This may also make your practice more attractive to an eventual buyer.

For younger advisors or those beginning a transition to an AUM model, choosing the up front commission option allows them to build their AUM business on a portion of their collected assets while making reasonable income. The choice between commission options makes no difference to the client and can be made on a case-by-case basis.

In summary, incorporating index annuities for a portion of your clients' portfolios is a win-win. It increases return and reduces risk for your clients while at the same time adds stability and predictability to your practice.

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