

Guaranteed Minimum Withdrawal Benefit Plans

Compendium of reports and comments

The TAMRIS Consultancy

October 2006 to July 2007

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Executive summary

The October 2006 report looked at the concept of the Guaranteed Minimum Withdrawal Benefit Plan and the Manulife product in particular.

At one level it concluded that the costs of the product combined with a lack of inflation protection invalidated it as a risk management tool. Investors were more likely to run out of money because of the high costs of the product than as a result of stock market and economic risks. The report also stated that there were simpler, lower cost alternatives to the Guaranteed Minimum Withdrawal product, alternatives that could better manage the risk of running out of money.

The report also concluded that the products invited moral hazard by favouring aggressive equity allocations (*there being little point in holding long term fixed interest allocations in a high cost environment*) at cyclically high valuations and, high withdrawal rates at high valuations (*5% withdrawal plus 3% MER plus other riders*) that naturally exposed an investor's long term financial security to a higher level of risk.

Investors would be better served with cheaper and more sensible structures as well as withdrawal policies that took account of market valuations and economic cycles. Many investors will live beyond the 20 year time frame and the GMWB product (*and indeed any solution with high charges and inappropriate structures*) increases the risk of running out of money for those looking to live beyond this time frame. In this respect they represent a risk to long term financial security that is not present in sensible lower cost structures.

The products were also considered to be restrictive and inflexible and inappropriate for clients with complex financial needs or even simple financial needs that were likely to change throughout the life of the policy.

The 2006 report looked at many of the fundamental and technical aspects of the GMWB product and should be referenced by anyone wishing to fully understand the nature of these products. The October 2006 report modeling was based on a 3% annual management expense ratio (the report was written before the launch of the product). Current Manulife Income Plus data shows an annual MER for a growth portfolio of some 3.4% (2.65% fund MER plus 0.75% GMWB rider). This would further increase the risks of the GMWB option illustrated in the October 2006 Report. Based on the information currently available, the Sun Life SunWise Elite Plus is the more expensive product.

The November report looked at the risk management characteristics of the GMWB relative to an index-linked GIC investment and the July 2007 update reviews the Sun Life SunWise Elite Plus product.

Since the launch of Manulife's product many advisors have started to offer GMWB products. The TAMRIS Consultancy is concerned that these products are being "sold" without full disclosure and that the regulatory regime is ignoring the substantial risks associated with the miss-selling of these products. The appeal of the product in the context of the marketing message must be high amongst those looking to retire or who are already in retirement and the opportunity to lock in investors for a 20 to 30 year term is a very strong sales incentive. Unfortunately the marketing message misrepresents the true nature of the product.

The final document included in this compendium is a product and product fundamentals educational document.

1 October 2006 Report - Introduction

“...you cannot make a decision about the present point in time without considering its impact on the future and the future’s impact on the present”.

There is a new breed of financial product out in the market place and it is called a Guaranteed Minimum Withdrawal Benefit plan. But it is more than just an ordinary product, to many it could become a “lifetime”. Buy it and you will most likely have to hold it for the next twenty to thirty years. At the end of it all there is **no guarantee** that you will have anything left to hold at all.

This report has been initiated by the introduction of Manulife’s Income Plus plan to the Canadian market place in October 2006, although the fundamentals of the analysis could well apply to other similar products expected to be introduced over the next few years.

This new product has “selling points”. It provides a “guaranteed return of your capital” over the lifetime of the plan if you are to immediately start taking an income (capital) from the plan. Over a twenty year period the plan guarantees to provide you with 5% of your initial capital back every year, irrespective of what stock markets do.

The product also appears to offer you a valuable guaranteed annual increase in your guaranteed minimum withdrawal if you purchase the product in the ten years prior to retirement or prior to your income need; for every year you defer taking an income you get a 5% increase on your guaranteed withdrawal benefit up to a maximum of 50%. If you purchase 10 years prior to your retirement need (which is the time frame the life companies want you to buy) you will get a 50% increase in the guaranteed minimum you can take at retirement. If you would be entitled to a guaranteed withdrawal of \$5,000 per \$100,000 invested, today, a 10 year deferral would entitle you a guarantee of \$7,500 on your investment, or so it would seem.

But all is not what it seems and the guarantees are somewhat illusory and couched in tomorrow’s money as opposed to today’s money.

It is also important to note that this product does not guarantee that your underlying capital will be worth anything at any point in time. All it does is protect the insurance company should the unimaginable happen and the high fees and charges have compounded the misery of a poor market environment and turned your savings into dust before the end of the policy period. In reality, the only time you are protected is when you have been impoverished. As this report will conclude, much of the value of the guarantee is eroded by a combination of inflation and the costs of the product.

Looking at an historical analysis of market returns, inflation and the impact of withdrawals and management expenses, we also find that a guarantee would only have been of benefit to an investor if this guarantee had been a real inflation protected guarantee – see section 3, Simulation of the Dynamics of a Guaranteed Minimum Withdrawal Plan.

To be blunt, over the withdrawal period you could achieve the same minimum guarantee and more, if you simply held the capital in “do it yourself” lower cost lower risk asset classes and would still have funds left over at the end of the period. The more relates to the fact that “Finsurance” products have hefty charges and the return on the plan investments would need to be higher than the lower risk alternative just to equal it in terms of security and eventual return of capital.

The annual costs on these plans can be very high, with equity fund MERs of up 2.5% or more and the annual cost of the guarantee costing up to 0.75% per annum. Total annual management expenses excluding any initial and/or other fees are likely to be in the region of 3% or more for plans with high equity allocations, an important point given that these plans endorse high equity allocations. If you did decide that you needed access to more capital in any given year, your costs would of course be higher, how much higher is unclear without more detailed information on the charging structure. It is important to note that this document is made without full access to information on all charges and costs of the product and further analysis will be conducted once this is to hand.

Context provided by a source independent of the author is also useful. A Special Report (January 2006) from TD Bank looked at forecast returns for cash for the next 10 years at 4.4%, 5.6% for bonds and 7.3% for Canadian equities. Deduct 3% management expenses from the 7.3% equity return and we get a 4.3% forecast return on Canadian equities, lower than the forecast cash return. Obviously this is not a cast iron forecast, such things never are, but if the assumptions of economists at one of Canada's financial elite rule out a Guaranteed Minimum Withdrawal Benefit plan, then investors should proceed with extreme caution.

But just why are these products being recommended? Ostensibly because of the failure of defined benefit pension plans, the plans that once upon a time guaranteed to provide you the individual with a fixed income in retirement. These defined benefit plans failed because of the funding costs and the uncertainty of return needed to provide the guarantees. That these new financial insurance animals are meant to replace the old security lost, yet fail to acknowledge the risks that the old could not manage is not missed by the TAMRIS Consultancy.

The irony is that these defined benefit pension plans were some of the most efficiently run vehicles on the planet in terms of their costs. You could get annual management of the plans equity allocation for a 1/10th of the cost of a guaranteed minimum withdrawal plan, equivalent more or less to the annual management expense ratio of major market exchange traded funds.

So why are these new plans an efficient alternative to the old defined benefit pension funds? The answer is most likely that they are not. Ask yourself this question, would a pension fund have a better chance of meeting its liabilities with the heavy drag of the costs of these new products? The answer has got to be a resounding no; they would be in an even worse state than they are in now.

Perhaps we should look to the fact that these are intended to be 30 year investments, highly lucrative in terms of return for the financial institutions and with limited rational means of escape for the ordinary investor. Financial services companies earn their return on annual management fees and salesmen on the initial commission and the trailer. A 30 year time frame is a captive investor.

This product is billed as protecting the downside while at the same time allowing you to take advantage of the upside. What much of the following analysis will prove, is that that this product is more likely to increase loss to the downside and reduce returns to the upside while ignoring what is most important to any individual over their lifetime, greater certainty of real income.

So just why should an investor transfer their capital to an inflexible, high cost, long term investment vehicle that does not actually physically guarantee the value of their capital either during or at the end of the product and, that only vouchsafes to return the dollar value of the capital invested.

The only reason the TAMRIS Consultancy can see is that in a world of more flexible high cost financial solutions and self interested product recommendation that these plans, on the face of it, limit the damage and the costs by imposing a moratorium on all future transactions that initiate remuneration. But the solution is a world away from what the consumer should demand and the financial services industry could, should and is capable of delivering.

However, we must be careful not to throw the baby out with the bathwater and the subject that Milevsky and Salisbury have focussed on is one of extreme importance to all investors past, present and future. Investors have short and long term financial needs, an over emphasis on any one in terms of consumption and the asset allocation profile of a portfolio and, you will place one or the other at risk. The heart of the matter, as TAMRIS has pointed out for some 17 years now is "how do we manage the impact of periods of significant market and economic risk" on the ability of assets to meet short and long term financial needs.

The issue of risk is of significant importance in today's financial markets and it has little to do with day to day volatility. The last 30 years have been one the most profitable for investors in North American markets, coinciding at the start with very low valuations, high dividend yields, depressed economic activity and the latter part coinciding with historically low interest rates, low dividend yields, high valuations and

strong economic activity and corporate profitability. Indeed, the worst period for investors bar that which surrounded the depression and the 1929 crash was the 1970s. It is clear that returns and risks are greatest at peaks in market and economic cycles and if we are indeed at a peak today, then the parallels with the 1970s may be closer than many would like to think. At this point in time investors need sensible structures, sensible costs and sensible withdrawal demands on their assets; anything else could pose an extreme risk to the financial security of today's and tomorrow's retirees. It is precisely such peaks in economic and market relationships that the probabilistic limitations of Monte Carlo analysis will fail to capture.

The new "Guaranteed Minimum Withdrawal Benefits" product seems to be yet another attempt by the financial services industry to avoid the path of least resistance and to charge more for what could be done much more simply for less. And yes, there are basic fundamental common sense structures that can manage the same risks the product is "designed" to manage at much lower cost and much greater flexibility.

The rest of this report provides more detailed analysis of the weaknesses of the Guaranteed Minimum Withdrawal Benefit plan, an analysis of the impact of costs on the validity of such vehicles, a brief look at some of the assumptions of the Milevsky/Salisbury report and a short discussion of a viable low cost alternative structure.