RETIREMENT INCOME INSTITUTE
Alliance for Lifetime Income

FEES VS COMMISSIONS WITH ANNUITIES

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Whereas compensation in the financial services industry varies significantly across financial advisors and products, it's often a one-time commission for annuities. A financial professional may collect 6% of the initial purchase price as compensation for the sale of a variable annuity, which is paid by insurer (versus a deduction from the premium). In contrast, investment advisers often levy an annual 1% fee on the balance of a retiree's investment portfolio.

At first glance, a financial professional's compensation via a 6% one-time commission from the insurer appears considerably higher than an annual ongoing 1% fee, which is why annuity critics often compare this one-time fee to the much lower ongoing fee applied to investment assets. However, this comparison is misleading. An ongoing fee deducted from client assets continues throughout retirement and, in present value terms, can be considerably higher than the up-front commission paid by the insurer from its general revenue on an annuity.

While management of an investment portfolio to provide annual income can require ongoing advising services, a financial product can also provide a lifetime income without the need for ongoing portfolio management. If the retiree's primary goal is to create income from retirement investments, it makes sense to compare the amount withdrawn from the portfolio to fund advisor compensation from asset fees and commissions to determine which model best supports this financial goal.

Let's assume a retiree has a choice between paying a lump sum fee at retirement for income guidance for the entire length of retirement or an on-going fee that is 1% of assets. It is possible to determine the equivalent initial commission (applied to the balance at retirement) that can result in the same income level and final balance level for a given set of assumptions.

For our analysis, we vary the assumed length of retirement (20, 30, or 40 years), the assumed nominal withdrawal amount ($5,000, $6,000, or $7,000 from a $100,000 initial balance), and the portfolio return (2% to 10%, in 2% increments). The average expected length of retirement for a 65-year-old male is 25 years, 26.4 years for 65-year-old women, and 30 years for a couple.

The exhibit on the following page illustrates the present value equivalent of a 1% annual asset fee applied to $25,000 of annual income and $30,000 of annual income at various portfolio return levels. For example, at a 5% initial withdrawal rate and a 6% portfolio return, a retired couple will pay 13.8% of the present value of their portfolio in fees to an advisor.

If the advisor encourages the retiree to withdraw a higher percentage of their wealth to fund income, the cost will be less because the higher income will reduce future wealth values.

Initial Commission to Generate Equivalent Income/Balance Assuming a 1% Annual Fee

Panel A: $5,000 Income					Panel B: $6,000 Income					Panel C: $7,000 Income				
		RETIREMENT PERIOD					RETIREMENT PERIOD					RETIREMENT PERIOD		
RETURN (%)		20	30	40	RETURN (%)		20	30	40	RETURN (%)		20	30	40
	2	10.2	10.3	10.3		2	8.7	8.7	8.7		2	7.6	7.6	7.6
	4	11.0	11.5	11.5		4	9.6	9.7	9.7		4	8.3	8.3	8.3
	6	11.7	13.8	14.7		6	10.4	11.3	10.3		6	9.1	9.2	9.2
	8	12.3	15.2	17.3		8	11.1	13.0	14.2		8	9.9	10.9	11.9
	10	12.7	16.4	19.3		10	11.7	14.4	16.5		10	10.6	12.5	13.8

Investment management and annuities require very different levels of management by financial advisors. An annuity is more of a "set it and forget it" approach to retirement income. The retiree simply withdraws the guaranteed minimum withdrawal benefit amount each year and the portfolio requires no ongoing maintenance. However, selling assets and withdrawing income from a portfolio on a periodic basis can require more active, ongoing advisor services.

The higher present value cost of an advised portfolio suggests that retirees will generally pay more of their retirement wealth in compensation, while bearing greater income risk from a managed investment portfolio than from product that provides protected lifetime income.

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