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The Vicissitudes of Variable Annuities

Skandia's "Guarantee"

Schiff's Insurance Observer recently returned from its summer vacation in Scandinavia. As we hiked through the pristine countryside during long, cool days, the subject of insurance was always at the forefront of our thoughts. Accordingly, it's fitting that this article deals with the vagaries of the variable-annuity business as practiced by a Swedish company. Over the last few months, our editorial associate, Isaac Schwartz, has been looking into Skandia Insurance Company and its U.S. subsidiary, American Skandia. Some of what we've learned follows.

"Let's sell variable annuities instead."

Mankind has been enriched by great innovations: the cotton gin, the airplane, the computer chip, and the Performance Advantage "guarantee" on American Skandia Life Assurance's variable annuities. The Performance Advantage promises a variable-annuity holder that if his annuity doesn't double in value by the end of 10 years, he'll receive a special benefit: either a 25-basis-point reduction in American Skandia's 140-basis-point annual fee or a 10% credit to the annuity's value. (In the latter option, the annuity becomes an immediate annuity and is paid out over seven years at an interest rate of about 3%.)

The Performance Advantage looks like an enticing feature. In reality, it may not be worth much of anything. American Skandia, in fact, considers it a free ride: if the annuity-holder's money doubles at the end of 10 years, American Skandia doesn't have to pay anything, and if the money doesn't double, the cost of the guarantee—according to American Skandia—is not what it appears to be. American Skandia says that the guarantee's benefit to American Skandia not only outweighs any cost, but that there is virtually no cost. Why an apparently valuable guarantee would have negligible cost to the guarantor is a matter worth examining.

Although the Performance Advantage is still available on some of American Skandia's variable annuities, of particular interest to us are the $9 billion of variable annuities sold between May 1999 and October 2000 that included the Performance Advantage guarantee. Because many of the mutual funds that these variable annuities were invested in have declined sharply, the guarantees on these annuities appear as if they could cost American Skandia a significant sum. American Skandia has not recorded the guarantees as liabilities, setting up reserves to cover future payments.

Since the mid-1990s, American Skandia, a subsidiary of Stockholm-based Skandia Insurance Company, Ltd. (Sweden's largest insurance company) has become one of the leading variable-annuity sellers. During the last five years, American Skandia has accounted for about 45% of Skandia's earnings.

Variable annuities are mutual funds in insurance clothing. Although they carry a small death benefit, they're essentially wrappers for "separate-account" assets that are invested primarily in stock mutual funds.

The annuity business is full of contradictions. Most annuity buyers aren't wealthy, and are therefore unable to take advantage of an annuity's most valuable feature—its tax deferral. Seventy-one percent of annuity buyers have annual household incomes below $75,000; 49% have household incomes below $50,000; 35% have household incomes below $40,000; and 10% have household incomes below $20,000. Like life insurance, annuities are sold, not bought.

Despite the fact that variable annuities tend to be high-cost products—many investors would be better off with a Vanguard index fund—the variable-annuity business flourished during the glory years of the great bull market that finally ended in 2000. According to *Best's Review*, annual variable-annuity sales grew from $7.2 billion in 1988 to $137.5 billion last year. About 60 insurance companies now offer 500 variable-annuity contracts with 15,000 different sub-account options.

American Skandia rode the crest of this wave: during the five years ending December 31, 1999 its variable-annuity assets increased 1,200%, to $29.4 billion. American Skandia hawked a number of the hottest New-Economy-valuation-doesn't-matter growth funds. It hit the wall during 2000, however, and by year-end its variable-annuity assets were only $29.7 billion—$300 million higher than the previous year. This appears to indicate a problem.

During 2000, American Skandia sold $7.1 billion of new variable annuities and experienced $2.1 billion of surrenders and withdrawals, bringing the *net* inflow of funds under management to $5 billion ($7.1 billion minus $2.1 billion). Since American Skandia's separate-account assets increased by only $300 million during 2000—despite a net inflow of $5 billion—we can calculate that the value of assets under management declined by $4.7 billion—a loss of about 15%.

Of course, not all of the 71 mutual funds available through American Skandia's variable annuities declined 15% last year. Some were up and some declined modestly. However, many of American Skandia's largest variable-annuity funds experienced horrendous losses.

At December 31, 2000, five of the mutual funds—JanCap Growth, Marsico Capital Growth, Janus Overseas Growth, Neuberger Berman MidCap Growth, and AIM International Equity—accounted for $8.5 billion of American Skandia's $30 billion of variable-annuity assets. These "go-go" funds turned in supercharged results in 1998 and 1999, and new money poured in. We believe that these high-flyers constituted a disproportionate amount of the $9 billion of variable annuities sold between May 1999 and October 2000 (the period in which *all* of American Skandia's variable annuities contained the Performance Advantage guarantee).

Between January 1, 2000 and June 30, 2001, these five "growth" funds did the exact opposite of what they were supposed to do: they declined between 26% and 49%. JanCap Growth, for example, which at year-end 2000 accounted for half of the assets in these five funds, was down 32% in 2000 and down an additional 25% at June 30, 2001.

This tells us something about American Skandia's exposure under its Performance Advantage guarantees. Remember that for American Skandia's liability to disappear, a variable annuity must double in value by the end of its tenth year. That's a 7.2% compounded annual return. (For an American Skandia variable-annuity holder to earn a 7.2% annual return, however, his *gross* investment return must be about 9.6%. That's because American Skandia charges 140 basis points and the mutual fund manager charges about 100 basis points.)

A $10,000 variable-annuity investment in JanCap Growth on January 1, 2000 was worth about $5,100 on June 30, 2001. That $5,100 would have to quadruple in value in the next 8½ years—a whopping 17.4% compounded annual return (19.8% before management charges)—for American Skandia to avoid liability under its Performance Advantage guarantee. (Admittedly, we've chosen a fund that performed terribly during a particularly bad period; but then, so did many of American Skandia's variable-annuity holders.)

Although American Skandia's average variable-annuity account is invested in three funds, the odds are high that people who bought variable annuities between May 1999 and October 2000 have had bad results, even if they weren't in JanCap Growth. If we assume that a $10,000 variable annuity bought last year (which is now probably worth well below $10,000) grows to $15,000 rather than $20,000 in the next 8½ years, American Skandia would have a $1,500 liability for its Performance Advantage guarantee. (The present value of that liability is considerably lower.) If the $10,000 variable annuity grows to $20,000, there's no liability, because the annuity will have doubled in value. If the $10,000 grows to $19,999 (slightly less than a 9.6% gross compounded annual return), that would produce a liability of $1,999. If the $10,000 doesn't grow at all, the liability would be $1,000. (Ironically, the worse the variable annuity performs, the lower the liability for the Performance Advantage guarantee.)

Calculating the present value of American Skandia's potential liability for its Performance Advantage guarantees

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involves assumptions about interest rates, the future rates of return for scores of mutual funds, and the variable annuities' persistency. One also needs to know the amount of money in each fund and when that money was invested—information that's proprietary. Nonetheless, a back-of-the-envelope guess about the present value of American Skandia's potential liability indicates a figure in the neighborhood of $200 million to $250 million.

American Skandia, whose surplus is $343 million, says its liability is about $10 million to $13 million, and hasn't put up reserves to cover the cost of guarantees in the future. Indeed, it says that *if* its liability *were* large that it would ultimately make out even better. Here's the rationale: an annuity-holder who opts for the 10% Performance Advantage guarantee is getting a bad deal—he must accept a seven-year payout with an interest rate of about 3%. (That doesn't seem so bad to us.) Also, according to American Skandia, most people who buy their annuities don't want to annuitize (whether that will hold true for the future is unknown). Furthermore, American Skandia notes that on new variable annuities it would have to pay sales commissions and expenses (which run about 8%), whereas it won't have to incur these costs to hold onto assets if the Performance Advantage is triggered.

The alternative to the 10% Performance Advantage is the 25 basis-point reduction in American Skandia's 140 basis-point annual fee. American Skandia says that annuity-holders are more likely to choose this option, and that even with the reduced fees, the company would do better if the annuity remains in force than if it's surrendered. On $10 billion in assets, 25 basis points comes to $25 million per year.

Regarding the $200 million to $250 million estimated liability for American Skandia's Performance Advantage guarantees, one might say, "So what? It simply means that American Skandia's earnings were significantly overstated in 1999 and 2000."

Let's cast American Skandia's potential liability in a different light. Recall that American Skandia has accounted for about 45% of Skandia's earnings. If the quality of American Skandia's earnings is questionable, then so is Skandia's. And the quality of Skandia's earnings is important because Skandia's stock (52 kroner, Stockholm Stock Exchange: SDIA.ST) changes hands at about 20 times earnings, a multiple that's quite high for the insurance industry. [When we began researching this article, Skandia's stock was at about 100, down from 250 at its peak last year.] The stock market values Skandia's $271 million of reported earnings at $6 billion. In comparison, Nationwide Financial Services, which earned $450 million and has 4% of the domestic variable-annuity market (versus American Skandia's 3%), sells for 10 times earnings and has a market cap of $4.7 billion.

Comparing reported earnings at Nationwide and Skandia is comparing apples to oranges. Nationwide uses GAAP accounting, as do all U.S. public companies. Skandia, on the other hand, uses embedded-value accounting, the norm for European life insurance companies. (In the U.S., embedded-value accounting is known as "gain-on-sale.") "Embedded value" is the sum of shareholders' equity plus the present value of anticipated future surpluses of insurance contracts in force.

In embedded-value accounting, the *present value* of *future revenue* from an annuity is booked *at the time of sale*. Unlike GAAP, earnings are based on estimated fees that will be received over, say, a decade, minus corresponding expenses. (A variable-annuity company's revenues consist primarily of asset-management fees and mortality fees.) This method can increase reported earnings during periods of growth—1995 to 1999, for example—since fees that won't be received for years are booked in the initial year.

A difference between GAAP and embedded value is that in GAAP, acquisition costs are amortized over a number of years, the theory being that expenses are matched to income. (Income, of course, should come in over a number of years.) In embedded value, income is recognized upfront, and so are expenses.

The calculation of embedded-value earnings for a rapidly growing variable-annuity company is particularly imprecise because the variables can have huge swings and are inherently unknowable. Furthermore, because the history of variable annuities is relatively brief, there is less historical information from which one can extrapolate future results than there is in traditional life insurance.

For example, American Skandia's assets under management may not grow as rapidly as expected. If that happens, the future fee revenue (the 1.4% of assets under management) will be lower than initially projected. Since many expenses are fixed, a change in revenue due to a decline in assets under management dramatically reduces profitability. American Skandia's 10-K notes that "a 10% decline in assets under management as of December 31, 2000 would reduce annual fee-related income by $54 million." Last year, American Skandia's revenues were $572 million and its operating earnings for were $96 million. All things being equal, a 10% decline in assets under management would reduce operating earnings by about 50%.

When a company grows rapidly, as American Skandia has, it often generates negative cash flow from operations. That's because upfront sales costs can run about 8% for variable annuities. These acquisition costs are (presumably) recouped over time from the annual fees charged to the variable-annuity holder, and from a fee if the annuity is surrendered early. (According to American Skandia, about half of its annuity-holders surrender their annuities within seven years, making them ineligible for the Performance Advantage guarantee.)

If an insurance company incurs 8% upfront costs to attract assets, it can, at least in theory, best recoup that money if it retains the assets for a long time and if the assets appreciate, thereby creating greater management fees.

Since American Skandia's average persistency is about seven years (it's actually too early to state this with precision), that raises an issue about the *value* of the company's earnings. To make an analogy, investing in American Skandia—and Skandia—is akin to investing in an oil well in which half the oil will be depleted in seven years, and the cash flow from the well will be used to drill more wells—which will also run out of half their oil in seven

Correction: The last issue of *Schiff's* was labeled Volume 13, Number 17. That was not correct; it was actually Volume 13, Number 16. This issue, therefore, is labeled Volume 13, Number 17a. Unless we really screw up, our next issue will be Volume 13, Number 18.

years. In such a case, does it make sense for an investor place a 20 p/e ratio on earnings that, to a good extent, are the result of a wasting asset?

We'll continue our analogy. If the price of oil appreciates, the value of the oil wells becomes greater, because the future stream of earnings will be greater. Similarly, a variable-annuity company whose assets under management grow in value (as a result of appreciation) benefits from increased future cash flows. The process works in reverse, too. If the price of oil declines—or assets under management decline—future cash flows should also decline. Right now, Skandia is in the decline phase. Sales have slowed, assets under management are down, upfront sales costs will be more difficult to recoup, and liability from the Performance Advantage guarantees seems a certainty.

In the glory days of the New Economy and the new-valuation metrics, if you told Skandia that something was likely to go wrong, it's unlikely that they would have believed you.

In a future article we'll further examine American Skandia, in particular the clever financing method it has used to fund its acquisition costs and to increase surplus.

Letter to the Editor

September 18, 2001

David Graifman, an insurance analyst at Keefe, Bruyette and Woods, and a subscriber to *Schiff's Insurance Observer*, was killed in the World Trade Center disaster. Earlier in his career, he had been a ratings analyst at Standard & Poors, covering the insurance industry.

He was an honest, decent, hard-working fellow with a great sense of humor, and was well-liked by many in the insurance business.

He was also a close friend of mine and introduced me to *Schiff's* several years ago. He thought I would enjoy it even though it had nothing to do with my own industry or work. He was right, and I eventually became a subscriber myself.

David thought *Schiff's* was one of the most interesting and amusing publications out there. Once, he told me he was always looking for less to read, not more, and I asked how *Schiff's* fit into that. He said he didn't *need* to read *Schiff's*, but chose to read it because he enjoyed it—the same reason he took time to read *The Onion*.

If you wouldn't mind, I know he'd have been honored—or certainly amused—to be mentioned in your pages.

Keep up the good work.

Robert M.S. Matson
Creative Director
The Innovation Works, Inc.