SIGMA
INVESTMENT MANAGEMENT COMPANY

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Duty to Clients Is *Not* Variable

We recently watched a 1936 movie, *Lloyds of London*, starring Tyrone Power. The context for this thrilling drama was the history of insurance. No, really. It helped substantially that the Power character's best friend was Horatio Nelson. You have to admire the writers for the chutzpah or faith to believe they could create a box-office bonanza from the subject matter, Admiral Nelson notwithstanding.

Speaking of chutzpah, the so-called financial "services" industry has not covered itself in glory over the past few years. In large part, this is because vast segments of the industry do not provide services, only products, and many of the products created are both shoddy and complicated. Many insurance companies are among the worst offenders in this practice, and the product called the variable annuity is among the worst of the lot.

Insurance companies will tell you there are three valuable features of variable annuities. First, the annuity gives the purchaser the ability to switch investments within the annuity among different mutual fund-like options. Second, the money invested within the annuity grows tax-deferred until the purchaser withdraws the money in retirement, like with an IRA. Third, the insurance feature of the product guarantees the purchaser's heirs a minimum value if the purchaser dies – often the original amount invested.

Whatever investment options the purchaser may have in an annuity, though, are fewer than the number of investment options available outside of the annuity. Why limit yourself? You almost always could invest with the same investment manager outside the annuity via a much less-expensive mutual fund. The tax-deferred nature of the annuity is pointless for purchasers who have not maxed out other, superior tax-deferred investing options, such as 401(k) plans and IRAs, options that do not have the same disabilities as variable annuities. In many cases, the salesperson puts the variable annuity inside the purchaser's IRA or 401(k), also making the deferral worthless.

Of the supposed advantages of the product, then, only the insurance feature remains. Whatever its attractiveness, the insurance certainly is not free. First, to obtain it, the purchaser cannot withdraw their money from the annuity before retirement without a tax penalty. Second, the annuity products typically have substantial embedded surrender fees for a number of years, restricting the purchaser's ability even to switch to a competing annuity. Third, and most egregious in our view, the amount you pay for the insurance is a percentage of the value of your account, but the true worth of the insurance to you varies inversely with the account value.

> ***"But when to mischief mortals bend their will, How soon they find fit instruments of ill!"***
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> -- *The Rape of the Lock,* Alexander Pope

Assume you buy a $100,000 variable annuity that guarantees the purchase price if you die. The administrative, mortality and expense charge for the insurance might be two percent annually, or $2,000. If the stock market goes up substantially and your account value doubles to $200,000, you are now paying $4,000, but the insurance protection is still only for $100,000. The account value would have to fall by more than half for the insurance to kick in if you kick off. You are paying *twice* as much for insurance that is only *half* as beneficial to you as when you bought it. In what other area of human endeavor does the cost of something increase as your need for it declines?

We believe you know everything you need to know about variable annuities once we tell you we have *never* had a prospect come in our door and say that, after careful research and due consideration, they have decided that they want to buy a variable annuity as part of their investment portfolio. Ever. What *does* happen all the time is that a prospect dumps a bunch of variable annuity statements on our conference room table and tells us that they have no idea what it is or why they bought it, other than the person who sold it to them was nice. Sometimes, they believe they bought a mutual fund, not an expensive, hard-to-get-out-of insurance product. We cannot say with metaphysical certitude that in no event could a variable annuity be suitable for an investor. We can assure you, though, that in our observation, variable annuities are never bought, only sold. The next time you are tempted to buy a complicated investment product because of a nice salesperson, buy the nice person a set of snow tires instead. We are sure they will appreciate the gift, and you are likely to come out way ahead in your portfolio.

If we owned a time machine, we would love to go back to attend the studio pitch for *Lloyds of London.* What could the producers possibly have said to convince Twentieth Century Fox to go forward with the first and only movie of the insurer-as-hero genre? Perhaps it could have been a not-so-subtle reminder of who was financing the studio back then. We would also use our time machine to be present at the creation of the variable annuity, to see who in their right mind could imagine it appropriate to charge customers more for something the less they need it.

As his navy sailed into glory at Trafalgar, Admiral Horatio Nelson famously sent the flag signal "England expects that every man will do his duty." We at Sigma expect those in the financial "services" industry to do their fiduciary duty, to respect both clients and ethical obligations. Until they do, they will continue to have the bad reputation they now richly deserve.