

April 2010

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Individual ERM

Governments the world over claim to want to help their citizens save for retirement. Politicians will tell you that they would never do anything to hurt your chances of accomplishing this. Yet every few years the rules are changed. When I first started to seriously invest in the mid 1980s the IRA was still new, qualified money accumulated tax free and non-qualified money had dividends taxed at ordinary rates. I put dividend paying stocks in a qualified account and generally ignored dividends in my analysis, viewing them as a bonus.

When the Bush tax cuts were implemented in 2003 the playing field changed. Now 401(k)s were being offered in the workplace, and mine was slowly growing. Options for investing in these accounts quickly expanded from a stable value fund to include stocks and bonds. The capital gains and dividend tax rates were reduced, but I was happy because they were the same rate and did not differentiate between dividend paying and high growth companies. Bond payments and CDs continued to be taxed at ordinary income tax rates, and this always confused me. I was able to roll my 401(k) into an IRA account, which has freed me from the limited choices available from my employer. This released me from the lack of transparency in mutual funds to know exactly what I had at any given time. When I have the choice I put dividend paying stocks in the qualified account. Bonds would naturally be placed there too. 401(k)s are generally a good thing, but the limitations around what you can invest in are a problem. Most of the people choosing the options pay someone else to manage their own money. Why do they think they are qualified to pick for me? Their argument is that they outsource it to firms that do this all the time, but again these people do not have their own skin in the game and are encouraged to make the popular choices. During the dot-com boom they commonly placed these groups into tech heavy growth funds. No one gets fired for sinking with the Titanic. Only outliers get fired, but only outliers beat the market too.

Individuals should manage their funds holistically. In order to do this we need to open up the 401(k) market to take other types of assets. My personal marginal tax rate should not drive where I place assets. Liquidity should be the driver, keeping liquid assets in non-qualified accounts until you are old enough to access qualified accounts without penalty. The 401(k) dominates the savings of most families, yet this asset is held out separately from all others when managing it. There is no consideration of social security or defined benefit plans when calculating an asset allocation, nor consideration of tax consequences.

Politicians – please set up the rules and leave them alone. If I know what they are I can do what is best for me. If they change all the time I will incur a lot of transaction costs to become efficient. That should not have to happen.

Now there is discussion about raising the capital gains and dividend tax rates yet again. Even health care is taking a bite out of investment earnings. What kind of incentive is that? Work hard, save, and then we will tax all your earnings! Go ahead and buy that time share in Cabo, because if you do the prudent thing we will just take your money later. One of the primary drivers of the recent financial crisis was individual incentives. It appears we have not learned anything!

Was Malthus Right?

Thomas Malthus, soon after the American war for independence, theorized that population growth would one day outstrip man's ability to feed all those people. Many Malthusians have bought into this theory only to be amazed later at the growth in food production techniques. But was Malthus really just too narrow in his focus? Today we worry about climate change caused by carbon dioxide, ozone, methane, and other gasses released into the atmosphere. Could it be that there is a limit to how many people can be supported on the earth not because of food but because of planetary limitations on the environment?

Deferred annuities in an increasing interest rate environment

By Max J. Rudolph, FSA CFA MAAA
February 20, 2005

This was written back in 2005 and is reprinted here. I have put placeholders in for any specific data, but the paper could be used today to analyze a company's position.

Definitions

SPDA – single premium deferred annuity
RMBS – residential mortgage backed security
UDAC – unamortized deferred acquisition cost
FHLB – Federal Home Loan Bank
SPIA – single premium immediate annuity
SC – surrender charges

Current situation

This is a working position paper, designed to solicit opinions and make product managers aware of both the situation and the alternatives available.

With an existing in-force block of SPDAs sold through banks of over \$XX billion, YOUR COMPANY needs to understand what is likely to happen to the assets and liabilities as interest rates rise, as well as what options are available both today and in the future.

Currently, the assets backing the SPDA portfolio are made up of xx% RMBS, yy% private placement bonds, zz% commercial mortgages and aa% other asset classes. While other asset classes will have market value reduce as interest rates rise, the only asset class with large convexity risk is RMBS. When interest rates rise, individuals will be less likely to prepay their mortgages. This will extend their individual payment streams, which are then rolled up into RMBS assets. The market value of these assets moves quickly down when rates rise.

The liabilities are xx% completely beyond the surrender charge schedule, making this block especially vulnerable to interest rate increases. Combined with the bank distribution channel, that gets paid another commission to move the business; there is every reason to think this product line will have very sophisticated surrender schedules. Part of the block, yy%, has a X% minimum credited rate.

What can be done later

When interest rates rise, you have the option of either taking the pain immediately or spreading it out over time. Economically there is no difference – it is bad news! Most people think of the immediate pain; the UDAC release from the surrendered policies, the capital loss associated with the assets sold during a run on the bank. Each of these is muted somewhat by the offsetting tax impact. Here are some other solutions that don't require the large sell off in this specific portfolio's assets. Each assumes the block has suffered large surrenders. UDAC released due to future profits that are no longer there occurs in any case. If you choose to limit asset sales, or avoid sales of an asset with large convexity risk, the current year hit to Expected Gross Profits (EGP) can be minimized (really they are deferred since lower asset yields are maintained rather than purchasing new assets to back other lines in a higher interest environment). Here are some alternatives. Remember, this doesn't alter the economic impact of the surrenders.

- Have lines of credit available and untapped (FHLB is a similar alternative)
- Sell short term assets from total return portfolio first and then other portfolios
- Capital infusion from PARENT
- Roll over existing policies to current interest rates, with new surrender charges
- Sell new policies, using cash received to pay out surrenders (might be the default option for many companies – might have to credit nonsupportable rate)

What can be done today

- Set up the lines of credit/FHLB arrangement
- Surplus note to maintain capital position
- Move assets with convexity risk to short term bonds earning at least enough to cover credited rate of policies beyond surrender charge

- Conserve the policies to SPIA form
- Conserve the policies to 5/7 year guarantee
- Encourage policyholders to leave by emphasizing free partial withdrawals, lack of SCs where applicable and current low credited rate on annual data page

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