PACIFIC LIFE | ADVISORY

Big Opportunities Often Begin as Quiet Revolutions

What every financial services firm should know about new business possibilities afforded by recent private letter rulings.

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Not everyone sees the revolution before it hits the tipping point. Even when a new product overcomes prior obstacles, solves important problems, and provides a competitive edge, widespread adoption isn't always instant—which is why the early adopter is often the one who catches the market share.

It's my opinion that fee-based advisors and the financial services firms who see the value of using fee-friendly[1] annuities—now allowed by recent IRS private letter rulings[2]—will lead the field. They could gain a significant competitive advantage over those that aren't willing to change or are dismissing these retirement savings vehicles altogether.

For an example of the opportunity at stake, let's revisit the history of mutual funds.

Only a generation ago, many financial professionals disliked mutual funds—much like many dislike annuities today. They seldom used packaged products or outsourced portfolio management and could rarely be convinced to do otherwise. In 1998, the total global net assets of mutual funds registered in the United States amounted to approximately $5.53 trillion.[3] Fast forward to today, and that thinking is a distant memory and seems impossible. Financial professionals have overwhelmingly turned to professional management afforded by funds, which garnered $27 trillion in U.S. investor assets in 2021![3] Mutual funds are now mainstream investments and form the core of individual retirement accounts. I believe a similar phenomenon is poised to happen in the annuity space.

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[1]Fee-friendly refers to the ability to bill directly on a client's annuity contract without creating a taxable event or reducing benefits.
[2]IRS.gov, "CC:FIP:B04-PLR-101288-19," November 15, 2019
[3]Statista Research Department. "Total net assets of US-registered mutual funds worldwide from 1998 to 2021." *Financial Instruments & Investments*. Statista, June 28, 2022.

IRS private letter rulings (PLRs) created one of the biggest innovations to hit the advisory industry in recent years.

The inability to bill and directly extract an advisory fee from the client's annuity without creating a taxable event or reducing benefits has been one of the top reasons Registered Investment Advisor firms (RIAs) cite for not considering annuities, which can be important vehicles for retirement planning. And honestly, I get it. That was a big obstacle. But now, all that has changed—and it's about time.

In 2019, the IRS has granted eight annuity providers (including Pacific Life) a favorable private letter ruling allowing fee-based advisors to withdraw their advisory fees directly from a nonqualified annuity contract without creating a taxable event or reducing benefits for the client, assuming the fee is no more than 1.5% of the annuity's cash value for the calendar year.

So, if fee-based advisors choose to work with one of those annuity providers, they can now manage the advisory annuity within the context of the total portfolio. They can also assess and extract the pro-rata share of their advisory fee directly from the annuity, just as they would with most other assets in a client's portfolio.

You may ask, "Why haven't I heard about this?"

And to that I say, "Right?" It's a big deal.

Even though this important change can positively impact financial advisors' businesses and potentially clients' financial plans, there has been little publicity around the ruling. And truly, that's a shame.

RIAs, the financial advisors who work for them, and their clients may have missed out on critical opportunities these past few years by not considering annuities more broadly—especially during a volatile market coupled with the uncertainty of economic conditions.

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That's why I am on a mission to get the word out that offering fee-friendly advisory annuities can be a client-centric business-building opportunity for fee-based advisors. Keep in mind, my goal isn't to convince commission-based financial professionals to stop offering commission-based products. It is only to raise awareness among fee-based advisors who have evolved their business models to provide advice as a service and, as a result, have mistakenly believed annuities don't fit in their practice.

This couldn't be farther from the truth. Modern fee-friendly advisory annuities can offer some clients new possibilities to pursue their financial goals compared to their non-fee-friendly counter parts, yet many RIAs prevent their financial advisors from using these viable products.

This is the industry's "Catch 22."

Currently, there are financial services firms that either don't allow advisory annuities on their platforms or restrict their financial advisors' ability to bill clients on the asset. This is largely because prior products were not designed to allow fee-based advisors to pull their fees directly from the annuity. Consequently, many annuity carriers have not designed fee-friendly versions, because firms have not allowed these types of annuities on their platforms. It's an odd, circular issue.

But, as you'll discover further along in this article, there also may be self-serving reasons many annuity carriers have not created fee-friendly annuities. That's a teaser—but to understand it better, first, let's look at the history of advisory fees.

Let's explore how advisory fees were handled in the past.

Prior to the IRS PLRs, there were three ways a fee-based advisor could handle the billing of their fee on an annuity:

1. Manage the annuity for free
2. Require a higher separate cash balance ("side car") for billing
3. Apply a higher fee on other non-annuity assets in a client's portfolio

Number one is a non-starter, and number two is only a good idea if markets are unfavorable because, in that scenario, holding more cash may be better than being invested. But particularly when investing a client's portfolio for potential growth, this creates a literal "cash drag." So, that leaves number three, which tends to be the typical way the fee on the annuity is billed. But, as you'll see below, it can get complicated.

If fee-friendly advisory annuities are so great, why don't all annuity carriers offer them?

It's important for RIAs to understand why an annuity carrier might not offer a modern, cost-conscious, fee-friendly advisory annuity even though IRS PLR interpretation now allows it. Referring to number three in the paragraph above, if a fee-based advisor pulls their fee for managing the annuity from one of a client's non-annuity assets and not from the annuity contract itself, the annuity carrier gets to keep more of those assets under their management. And that's good for the annuity carrier, right? So, not offering fee-friendly annuities can be a benefit to their bottom line.

In addition, when a fee-based advisor pulls their fee from another investment asset to cover the fee for managing the annuity, it can make the annuity performance appear to be doing better than the other asset—which is great for the annuity carrier, as well. However, billing this way can create transparency issues for fiduciaries. It also can make for awkward conversations, as they must explain to their clients why their billing necessitates excess cash drag and/or reduces the net returns amount of other assets in the portfolio.

Many fee-based advisors don't want to have that conversation. So, they often choose not to offer annuities in the first place. But, as it's a fiduciary duty to consider all products that could be in the best interest of a client, this can create a dilemma. Depending on the client's circumstance and financial goals, an annuity could be a strategic addition to the client's overall portfolio.

That's why it's important to choose a forward-thinking annuity carrier who seeks to create products with fully transparent billing processes and embraces the many advisory annuity innovations that have occurred over the past few years.

A renaissance in advisory annuity design is taking place.

It's only fair to note that, in addition to fee structure, there have been many challenges for financial services firms and fee-based advisors when it comes to incorporating annuities into their clients' plans. Product designs, pricing, technology structure, and integrations have all presented challenges that seemed difficult to overcome. And they were—until now. Over the past few years, a wave of innovations has made these viable products easier to use. Most notably, you can now find providers that offer annuities with:

- Fee-friendly billing.
- Cost conscious, institutionally-priced investment options.
- Transparent product structures.
- Seamless technology integrations.
- Easy-access concierge programs with licensed individuals who remove the "hassle-factor" of writing annuity contracts.

There are annuity providers working to make it all easier. So, now is the time for fee-based advisors and financial services firms to take a second look at the special features of advisory annuities and the opportunities they may provide to both their business and their clients.

The future holds new possibilities for firms, financial advisors, and clients.

Now that many of the reasons for the resistance to using annuities have been eliminated, here is an important fact to help support the consideration of adding fee-friendly advisory annuities to your firm's platform or to your clients' portfolios:

DALBAR's 2022 Quantitative Analysis of Investor Behavior Report found that the average variable annuity equity subaccount investor traded less than the average equity mutual fund investor and earned consistently more as a result.[1]

Variable annuity subaccount investors were more inclined to avoid negative behaviors and, as such, earned higher returns than their mutual fund investor counterparts.

Clearly, a lucrative opportunity exists for forward-thinking financial services firms and fee-based advisors who will step up and lead the movement happening in the industry. By adding fee-friendly advisory annuities to their business models, they offer clients a true, full range of options to help them reach their financial goals.

It's time to take a renewed look at incorporating fee-based, fee-friendly annuities and participate in the growth of the advisory business model within the financial services industry.

[1]"2022 QAIB Report: Variable Annuities." DALBAR, Inc., September 2022.