

Variable Annuities

In the past 10 years insurance companies have put a hard court press on trying to convince the consumer that variable annuities are the investor's answer to get around the contribution limitations that are imposed on IRA's and 401(K) retirement plans. On the surface variable annuities seem to be a good investment choice; however, when you begin to peel back the layers of most variable annuities what you discover are very expensive investment tools. To better understand the nature and the costs behind variable annuities, I feel it is important to point out why these investment vehicles might not be the appropriate vehicle for most consumers.

First, let's look at the basics. A variable annuity is basically a tax-deferred investment vehicle that comes with an insurance contract, usually designed to protect you from a loss in capital. This is why most variable annuities are marketed by insurance salesmen.

Because of the insurance wrapper, earnings inside the annuity grow tax-deferred, and the account isn't subject to the annual contribution limits placed on other tax-favored vehicles such as IRA's and 401(K)'s. Typically you can choose from a menu of mutual funds often described as subaccounts. Withdrawals made after age 59 1/2 are taxed as income. Earlier withdrawals are subject to income tax and a 10% penalty.

Variable annuities can be immediate or deferred. With a deferred annuity the account grows tax free until you begin taking distributions. Distributions can be annuitized (regular payments over a set period of time) or can be withdrawn as you see fit.

Up to this point in our discussion, variable annuities seem to offer a viable alternative to other tax-deferred investment vehicles, but, here is where the similarity ends .

Variable annuities are notorious for the fees they charge. The average annual expense on variable annuity subaccounts currently stands at 2.44% of assets compared to the average open-ended mutual fund of 1.32%, according to Morningstar. (Morningstar is a highly respected independent research company that evaluates investment vehicles). Unfortunately, variable annuity fees don't stop there. Many variable annuities pay a commission from the ongoing fees; the average contract fee being \$30 to \$35.

Another problem with most variable annuities is that your money is often locked up for several years—typically five. Trying to withdraw funds during this time will result in huge fines. These fees, do however, typically decrease as the years pass by. For example, you might be charged with a 6% surrender fee for a withdrawal during your first year of ownership. After seven years, however, that could be just 1%. The average maximum fee is a steep 5.94%, according to Morningstar.

One of the biggest selling features when you are presented a variable annuity is that the death benefit associated with the annuity guarantees that your account will hold a certain value should you die before the annuity payment begins. With basic accounts, this typically means that your beneficiary will at least

receive the total amount invested—even if the account has lost money. This would probably work fine if you purchased an annuity and died within a few months, however, in most cases, given the fact that stocks have returned an average of 12% annually from 1926 to 2007, the cost of this “safety insurance” greatly outweighs the benefit if you had invested the same amount in a basic mutual fund program.

In addition, gains in variable annuities are taxed at ordinary income tax rates. For most investors, that’s a lot higher than the 15% rate they now pay in their long-term mutual fund gains. According to one financial planner, a typical variable annuity investor would have to wait 15-20 years before a variable annuity would become more tax efficient than a mutual fund.

Finally, if you die with money remaining in your annuity, your beneficiary will inherit all the taxes that you have deferred. In a mutual fund your basis is “stepped up” at death and therefore, your beneficiary would owe no taxes on the gains, making a mutual fund a much more tax efficient estate planning vehicle.

I think that you can ascertain that I am no fan of the variable annuity as an efficient, cost effective investment vehicle for most investors. I personally believe that you would be better served and experience a much greater return on your investment by conservatively investing in a good mutual fund program offered by a stable mutual fund family with a solid record of performance over the years. I would personally recommend that you look at mutual funds that carry either a 4 or 5 star Morningstar rating over a minimum of 5 years that can be structured as either an IRA or a 401(K) before considering a variable annuity.

Till Next Time,

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