Merriman FundAdvice

All about annuities

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Of all the products offered to investors, few are more controversial than variable annuities. The conventional wisdom is that variable annuities are sold, not bought. In other words, if there were no annuity salespeople, investors wouldn't buy them.

A quote from Forbes magazine typifies the low regard in which variable annuities are held. Tax deferral "is just about the only good thing you can say about these investment products," Forbes wrote under a headline that asked: "How gullible can investors get?"

We agree with much of Forbes' negative sentiment. But variable annuities can sometimes solve problems that other products just can't. In this article we'll tell you how to determine if you are a good candidate for an annuity.

First, let's review what annuities are, how they work and why they have so many critics.

THE BASICS OF ANNUITIES - *What annuities are*

An annuity is an insurance contract that lets investors set aside money that builds up without generating current tax liability. As a tool for retirement planning, an annuity has two phases: accumulation and withdrawal, which is known as annuitization.

In the accumulation stage, you give money to an insurance company either all at once or in a series of payments, and it earns a rate of return. That rate of return may be fixed in advance in what is called a fixed annuity. Or it may be dependent on investments, as in a variable annuity.

In the withdrawal stage, you receive regular payments, usually for the rest of your life. These payments may be guaranteed in advance, as in a fixed annuity, or may depend on investment performance, as in a variable annuity.

A fixed annuity is comparable to a bank certificate of deposit, with an interest rate guaranteed by the insurance company for a fixed period of time. The investor's return is known in advance. A variable annuity is essentially a mutual fund account wrapped inside a thin layer of insurance. The investor chooses from a variety of internal funds, known as subaccounts, the performance of which determines the return.

So, you might ask, what's wrong with deferring taxes on mutual funds? To which I answer: nothing much except high costs, low returns, high taxes, lack of liquidity and mandatory life insurance that can be extremely expensive.

Liquidity

Liquidity is the ability to get your money out of an investment in a timely manner without undue costs. Annuities, like bank certificates of deposit, impose early withdrawal penalties on investors who take their money out before a period of time agreed up front. A typical annuity has a surrender charge that declines year by year. For example, a seven-year surrender period may impose a 7 percent fee if you bail out in the first year, 6 percent during the second year, and so on until there is no penalty after seven years. The sooner you want your money back, the more you'll pay in fees.

Annuity costs

Although some variable annuities have no sales charge, most are load products. Sales commissions on annuities are not itemized for the investor. Typical commissions run from 5 to 5.5 percent of the money invested. And some heavily promoted "bonus" annuity contracts pay commissions up to 14 percent.

Like B-class shares of load funds, variable annuities pay sales commissions from expense charges that are levied over time. Total expenses are often more than 2.5 percent, considerably higher than those of the average no-load mutual fund – and 12 times as high as those of some no-load index funds.

Because expenses inevitably reduce the investment performance of annuities, it's important to know what they are. One charge is for managing the subaccount or subaccounts. The average charge is 0.8 percent a year, equivalent to a reasonably efficient mutual fund expense ratio. On top of that is an annual charge for insurance and operating expenses, averaging 1.1 percent. In addition, investors often must pay an annual contract fee of $30 to $50. And some annuities impose charges for each time you swap money between subaccounts.

Most investors pay little attention to annuity expenses, and some people may think that a no-load, no-surrender-charge variable annuity invested in a Standard & Poor's 500 Index fund is essentially the same as a mutual fund that tracks the index. Not quite!

The General Electric Savvy Investor variable annuity has a subaccount pegged to the S&P 500 Index with an annualized return of 16.2 percent in the five years from 1996 through 2000.

Compare that with the 18.4 percent annualized return of the Vanguard Tax-Managed Growth & Income Fund, which is a near-clone of the Standard & Poor's 500 Index. Since the underlying investments are nearly identical, the difference comes from the annuity's higher expenses.

It's a very significant difference. If at the start of 1966 you had invested $100,000 in the GE annuity pegged to the Standard & Poor's 500 Index, by the end of last year your account would have grown to $211,942. In the Vanguard tax-managed fund, the same $100,000 would have grown to $232,541, a difference of more than $20,000.

The difference becomes even greater when you consider the tax consequences. Assume you withdrew $40,000 out of each account this year. If you were in the 28 percent tax bracket, you'd pay taxes of $11,200 on the withdrawal from the annuity but only $4,560 on the withdrawal from your mutual fund. If you were in the 39.6 percent tax bracket, the taxes would be $15,840 on the annuity withdrawal and still only $4,560 on the mutual fund withdrawal. If you're wondering how that could happen, read on.

Tax breaks from annuities

Most people invest in annuities for one reason: to get a tax break. If you have already maxed out your IRA and 401(k) possibilities and have more money to put aside for the long term, the pitch goes, a variable annuity is like a gift from Congress. But when you examine the tax break carefully, you might decide this is a gift you'd just as soon pass up.

True, investors can put substantial sums into variable annuities and let them build up without paying taxes until the money is withdrawn. A variable annuity may seem like an unlimited nondeductible IRA. But it's very different.

Let's go back to the example above of $100,000 invested in the General Electric variable annuity and the tax-managed no-load mutual fund. To make things simple, let's ignore the annuity's lower performance and make the hypothetical facts slightly different, assuming each investment doubled in five years so it was worth $200,000.

When you make a $40,000 withdrawal from the taxable mutual fund, we will assume your basis in the fund remains $100,000. That means your average cost basis is 50 cents for every dollar you withdraw, which in turn means that $20,000 of the withdrawal is subject to tax. At long-term capital gains rates of 20 percent, your tax is $4,000, and you get to keep $36,000 of the withdrawal.

When you make a $40,000 withdrawal from the variable annuity, you may be shocked that the entire $40,000 will be taxed at ordinary income rates. If we assume you are in the 28 percent tax bracket, your tax bill will be $11,200, and you'll get to keep only $28,800 of your withdrawal. (If you are in the top tax bracket of 39.6 percent, you get to keep only $24,160.)

How could that happen? It turns out that Congress, which gave you the "gift" of tax deferral on your earnings, now wants to be paid back. Under federal tax laws, withdrawals from annuities are ineligible for favorable capital gains tax rates. Annuity owners must pay ordinary income tax rates on everything above their basis that comes out of a variable annuity.

Even worse, they must withdraw all profits from the account – and of course pay taxes on those profits – before taking out their original investments tax free.

It's true, of course, that the very last $100,000 you took out of the annuity would be free of income taxes. But by the time you can take your original investment out of an annuity, you will probably feel as if you've been taxed to the max.

Useless insurance

Most variable annuities include an insurance feature that guarantees your investment if you die while holding the contract. The cost of this insurance, formally called a "death benefit," is rarely disclosed explicitly. Instead, it's included in an annual fee for "mortality and expenses."

Every contract is different, but in all cases the insurance is quite limited. In most variable annuities, it guarantees that if you die while you own the contract, your heirs will receive at least as much money as you originally contributed.

That might be valuable if you bought an annuity just before a big market drop and then you died before it recovered. (And this suggests a deathbed strategy: If you unfortunately find yourself terminally ill with extra funds you want to leave to your heirs, buy an annuity and invest it as aggressively as you can. If your investments are successful, your heirs will get the benefit; if your investments flop, your heirs will not suffer the loss.)

According to Forbes, less than one-half of one percent of annuity contracts are terminated because of death or disability. And most of those contracts are worth at least as much as the original deposit. That means this "insurance" must pay off only a tiny, tiny fraction of the time. And in the few cases when the insurance does pay off, the amount that must be made up is rarely more than 20 percent of the whole original deposit.

Some contracts have a slightly more expensive insurance feature which insures that your heirs will collect the higher of your initial investment or the highest value of the account on any anniversary of the day the contract went into force. That might be valuable if you invested $20,000, the annuity grew to $30,000, then fell to $25,000. That means that if you died, your heirs would get at least $30,000.

But even with such a step-up clause, this insurance is a bad deal for annuity investors. The longer you keep an annuity, the less likely you are to need this insurance. If this insurance were rationally priced, the cost would decline sharply as the value of your annuity grew. But instead the opposite occurs, because your cost goes up with the value of your account. This has to be among the most profitable insurance that insurance companies sell.

Fixed annuities

Many investors choose fixed annuities instead of bonds, primarily for the tax deferral. You can find representative annuity rates on the Web at www.annuityscout.com. Rates are guaranteed by the insurance company for a period of years, sometimes including a higher rate for the first year. The longer guarantees generally have higher rates. For example, investors who want a 10-year guaranteed return could choose a contract from Lincoln Benefit Life that pays 7 percent for the first year and 6 percent for years two through 10. The same company offers a five-year guaranteed rate of 6.65 percent for the first year and 5.65 percent for years two through five. And of course an investor has no way of knowing what the rate will be when the guarantee period is over. On a one-year annuity, Lincoln Benefit Life offers a rate of 4 percent.

Investors willing to forego the guarantee can achieve higher returns with variable annuities. Last month, Vanguard's no-load variable annuities were paying 9.38 percent in the high-yield bond subaccount, 6.11 percent in the high-grade corporate bond subaccount and 5.96 percent in the short-term corporate bond subaccount. (Those rates compare with current taxable yields, quoted the same day, of 9.29 percent, 6.76 percent and 6.44 percent in the corresponding Vanguard mutual funds.)

The guarantee of a fixed annuity may be tempting. But it might not be worth giving up the higher yields available elsewhere. A fixed annuity is guaranteed by only one company. However, the bonds held in a variable annuity subaccount are backed by many issuing companies. Who do you trust more: one insurance company or 100 companies that issue bonds?

Retirement income from a fixed annuity

A fixed annuity can also guarantee a series of lifelong monthly payments in return for a lump sum, often when an investor retires. It works this way: In return for a one-time premium, an insurance company promises to pay you a set amount of money every month for the rest of your life.

In return, you give up whatever you paid as a premium. That initial investment is gone, and you can't get it back if you change your mind or your health suddenly turns bad and you realize you won't live long.

One variation of this plan spreads the annuity over the lives of two people, with payments continuing until the second one dies. You could buy an annuity with this feature to make sure the monthly payments would continue until both you and your spouse have died. To get that extra guarantee, you'll have to accept a smaller monthly payment.

Another common variation is to guarantee payments for some minimum number of years, or until your death, whichever comes later. Thus if you died two months after buying the annuity, your heirs could at least keep collecting payments for a minimum time.

If you are very worried that you might last longer than your money, the fixed annuity is a good way to "transfer" that risk from you to an insurance company. The insurance company has to take the risk that you might live to be very old. The company also takes the risk of earning enough income from your money to make the promised payments plus a profit. Therefore, the payment you get will be based on very conservative assumptions – and probably lower than what you could pay yourself if you invested the money on your own.

The biggest risk when you take a fixed annuity payout is inflation. Monthly income that seems quite adequate today is likely to be much less valuable in 15 to 20 years. Even at a modest rate of 3 percent, inflation can reduce the purchasing power of $1,000 to $859 in five years, to $737 in 10 years and to $633 in 15 years. After 20 years, that $1,000 buys only $544 of today's goods.

Those who signed up for fixed payouts in the early 1970s fared much worse after inflation that peaked at 13.3 percent in 1979 and 12.4 percent in 1980. Somebody who bought an annuity paying $1,000 at the start of 1970 saw its value erode to $706 after five years, to $460 after 10 years and to $326 after 15 years. By the end of 1989, that $1,000 monthly check would buy only $270 worth of goods and services in 1970 dollars. By the end of 1999, the figure had eroded to $200.

The tradeoff involved in a fixed annuity is a difficult one for many people to make, because it's a permanent decision. However, for some people, the assurance of a guaranteed monthly payment is extremely attractive.

We have more than 800 clients, and as far as I know none of them has chosen a fixed annuity payout. But if a client really wanted the security of a guaranteed fixed income to supplement Social Security, here's what I would suggest: Buy a large enough annuity to cover your basic costs of living, then invest the rest to grow and keep up with inflation.

Load vs. no-load

A few years ago, in an effort to make variable annuities more attractive to investors who could benefit from them, some investment companies established "no-load" variable annuities. They are sold directly to investors, without any commissioned salespeople. These products have low annual expenses and no surrender charges, so they erase some of the disadvantages of this product.

Among the sellers of no-load annuities are Janus, T. Rowe Price, Schwab, Scudder, Vanguard and USAA. However, investors haven't exactly stampeded to buy no-load variable annuities. Without salespeople to push them, these products have mostly been ignored.

"Bonus" annuities

Variable annuities are so lucrative that insurance companies have added a new wrinkle: "bonus" annuities that promise immediate extra deposits. But insurance companies are among the most conservative institutions in America, and you can bet they haven't started giving away free money.

Bonus annuities are designed to persuade people to transfer assets from existing annuities into new ones in what is known as a 1035 exchange. That's named after a section of the tax code that lets investors move money from one annuity to another without paying taxes. To make switching attractive, insurance companies offer to immediately credit the new account with 3 to 10 percent of the amount transferred. But there's a catch – actually several. "There is no free lunch," said Tina Baughman, president of AnnuityScout.com, an online annuity sales site that encourages the purchase of low-load and no-load annuities.

"Refinancing" an annuity isn't nearly as beneficial as refinancing a mortgage. First, when you cash out of an existing annuity, you must pay an early withdrawal penalty unless you've held the annuity long enough, possibly up to 10 years, to get past the surrender-charge period; about half of all investors who buy bonus annuities wind up paying this charge. Second, bonus annuities usually have higher annual expenses than the annuities being replaced. Third, the surrender period on the bonus annuity is longer, often 10 years, than the one on the old annuity. Fourth, naturally, the surrender period starts all over with the new annuity.

Finally, if you buy a bonus annuity, you may have to give back the bonus payment if for any reason you cash out the annuity before the end of the new surrender period. The details are spelled out in the contract itself.

Salespeople sometimes tell prospects that because the bonus deposit is bigger than the surrender charge on an existing annuity, this bonus represents an instant profit. But they rarely help people figure out that the new contracts will nibble away relentlessly at that "profit" in the form of higher expenses.

Forbes cites a case in which a retired couple transferred $1 million from an existing annuity and paid an early surrender charge of $25,200 (4 percent of the initial investment). They received an "instant bonus" of $50,000 on their new annuity. The new annuity charged 1.7 percent annually, compared with 1.25 percent on the old one. On a balance of $1 million, that means the insurance company would have taken back an extra $4,500 a year for as long as the couple owned the new annuity, with a higher amount every year as the account size grew.

If the annuity policy appreciated at 8 percent a year, those extra expenses would "take back" the entire $50,000 bonus in the first eight years of the policy. After 10 years, this couple would have paid a total of about $68,800 in extra expenses, a high price for that "free" $50,000.

But in this case, that didn't happen. In the first year of the new annuity, the husband was unexpectedly diagnosed with terminal cancer and needed to withdraw the money. The new annuity imposed an early surrender penalty that cost the couple $80,000.

Under the terms of a bit of fine print in the annuity contract that the couple probably never noticed, the insurance company also required reimbursement for the entire $50,000 "bonus." That bonus turned out to be only a fantasy. But the surrender charges totaling $105,200 on the two annuities were very real.

Bells and whistles

Insurance companies have added a few new features they hope will make annuities more attractive. Long-term care riders pay for part of the costs of nursing care in addition to regular monthly income. The riders essentially add some very expensive and often quite limited insurance benefits. Living income benefits guarantee to continue at least some portion, for example 80 percent, of your regular monthly payment even if your investment subaccounts fall severely in value. But this provision costs extra, reducing your regular payment every month for the rest of your life.

RECOMMENDATIONS

Fixed payout annuities are fairly straightforward contracts, as described above, that guarantee a monthly payment for life. If your health is uncertain or bad, a fixed annuity is probably not a good deal; but if you expect to live a very long life, an annuity may eventually *give you “more than your money’s worth” from the insurance company. But before you buy an annuity, consider whether you can afford to take the responsibility yourself of investing money to provide income. Any financial planner can help you figure out the underlying assumptions behind a fixed annuity: how long the payments may last and what interest rate is necessary to generate them.*

Last month we inquired at AnnuityScout.com (888-741-9844) and were told that a 65-year-old male who invested $100,000 could get a guaranteed monthly payment of $848 for life. We were told the same male buyer could get a contract that guaranteed to pay $776 per month for 20 years, to either the buyer or his survivors, and then all payments would stop.

That tells us that the insurance company expects the average 65-year-old male to live less than 20 years, hence the higher monthly payout without a guaranteed period. It also let us figure out that, based on these rates, the buyer could accomplish the same thing, 20 years of fixed payments of $776, by achieving a compound rate of return of 7.09 percent.

If you can earn more than that, you will be better off doing it yourself instead of turning the chore over to an insurance company. For instance, if you earned 8 percent interest on $100,000, you could make that $776 payment and have $32,553 left after 20 years. Earn 9 percent and your balance after 20 years would be $78,748; if you earned 10 percent, you’d have $138,627 left. You can be sure the insurance company will invest your money at a higher rate of return than 7.09 percent, and these figures might suggest the insurance company’s potential gross profits after making the agreed-upon payments.

Because the purchase of a fixed annuity is a permanent decision that cannot be reversed, it is always wise to consult with a professional advisor (not an insurance salesperson) before buying one.

Variable annuities are more complex. To determine whether a variable annuity is worth considering, ask yourself the following questions;

1. Am I already contributing the maximum possible to my IRA and 401(k) accounts?

2. Am I very sure I won’t need the money I’m considering investing until I’m at least 59.5 years old?

3. Am I prepared to lock up this money for at least 10 years?

4. Am I considering buying a no-load annuity contract (meaning no salesperson is involved)?

5. Am I certain that my tax rate will be lower when I retire than it is now?

6. Do I prefer to actively manage my investments by switching from one fund to another instead of simply buying and holding?

If you can answer yes to all those questions, then a variable annuity may be for you.

If a salesperson suggests you purchase a variable annuity inside an IRA, that's a clear sign this salesperson is not looking out for your best interests. The main justification for the higher expenses of a variable annuity, as compared with a mutual fund, is the tax deferral of annuity earnings. But an IRA already includes tax deferral, and the higher expenses of an annuity amount to paying extra for something you already have. ***In my view, it should be illegal to put a variable annuity inside an IRA.***

Here's a blanket recommendation that I am quite comfortable with: If you are a buy-and-hold investor, don't use annuities. Instead, use no-load index funds in a taxable account so you can get the benefit of long-term capital gains tax rates. We especially recommend tax-managed index funds like those offered by Vanguard and Dimensional Fund Advisors.

If you use market timing and plan to withdraw most or all of the money in your annuity while you are alive, an annuity may be to your benefit. In a taxable account, market timing typically subjects much of your money to taxation at ordinary income tax rates. That reduces your after-tax return substantially. But in a variable annuity, your gains can build up in a tax-deferred environment, and you'll almost certainly end up with more money.

If you use market timing and you plan to leave the annuity to your heirs, it's hard to know in advance whether your heirs will get more from a taxable account or from a variable annuity. That depends on several factors that are impossible to know many years in advance, including the size of your estate, the future income tax rate of your beneficiary, and what proportion of your estate the annuity makes up.

Most likely, you'll do your heirs a favor by keeping the money in a taxable account. As an estate planning attorney in Seattle told us, "Annuities may be great when you are alive, but they are terrible for your heirs." It's not hard to see why. The entire value of the annuity is subject to estate taxes. And whoever inherits it must pay tax, at ordinary income rates, on everything above the buyer's original investment. The end result could be that the majority of the value of the annuity at the buyer's death is eaten up by taxes.

Perhaps my most important recommendation is this: Before you buy any annuity, fixed or variable, read the entire contract until you understand it. If necessary, pay a financial advisor who does not sell products and who isn't involved in the proposed transaction to help you interpret it. Buy only after you understand the entire deal.

If you do that, you'll maximize the chance that any annuity you buy will work for you, not against you.