LGC&D Wealth Management, LLC
Educated Investor Feature Articles: 2007, Vol. 1

Variable Annuities

Overview: Some variable annuities (VAs) are better than others; and if the investor already is holding a VA under some circumstances, awareness of options within the VA industry can lead to improvements in this component of his or her portfolio. Following is an overview of VAs, other options to consider prior to purchasing a VA and what to do with VAs already purchased.

Introduction

As we will discuss in more detail below, we would suggest that many variable annuities (VAs) do not provide adequate compensation for the costs involved, can be costly to surrender, and often might be prudently replaced by a low-cost, tax- and passively managed mutual fund. And yet, investors continue to purchase them in numbers that seem to defy logic. For example, according to a March 2006 article in the *Wall Street Journal*, overall sales in 2005 totaled more than $133 billion (including exchanges from one annuity to another).[1] This article discusses the advantages and disadvantages of the VA, other options to consider prior to purchase and what to do with VAs already purchased.

Variable Annuities: A Couple of Pros and a Lot of Cons

A VA is a mutual-fund-type account wrapped inside an insurance policy, which allows the investment earnings to be tax-deferred. The good news is that some are better than others. In an October 2004 *Wall Street Journal* article, columnist Jonathan Clements commented: “Just because most variable annuities are a bad bet doesn’t mean you should damn the entire category.”[2]

Thus, under some circumstances, awareness of options within the VA industry might enable an investor to improve upon a VA he or she is already holding. Unfortunately, tax deferral is almost the only advantage to this investment product. The negatives are more numerous:

- An insurance wrapper generally comes at a high price.
- Investment account expenses are also typically higher than usual.
- It is difficult to find passive, low-cost investment choices inside an annuity wrapper.
- VAs lack liquidity.
- The investor loses the potential for a step-up in basis that can occur when his or her estate is settled or when funds are donated to a charitable organization.
- The VA converts lower-taxed capital gains into higher-taxed ordinary income.

About the only legitimate remaining use for a VA is for creditor protection. Some states provide some degree of protection of VA assets from creditors. For example, physicians worried about malpractice suits might consider VAs as a valid investment. However, the laws are complex and vary from state to state. Therefore, before an investor purchases an annuity for this specific purpose, he or she should consult an attorney. If it does make sense to make the purchase, the investor should pay close attention to expenses.

Look Before You Leap

The bottom line is that the VA’s tax deferral advantage typically comes at a very high price. For example, according to a January 2006 *Wall Street Journal* article, “For retirees, particularly older retirees, deferred variable annuities can be a financial disaster, because they require a cash outlay late in life without the

guarantee of certain returns, and because early-withdrawal penalties could limit a retiree's ability to access cash in a pinch."[3]

In general, any significant benefits to be gained from wrapping an annuity around an equity portfolio disappeared with tax reforms passed in 2003. (Capital gains tax rates were reduced while leaving ordinary income tax rates at the same *higher* level).

Additionally, when fund families such as Vanguard and Dimensional Fund Advisors (DFA) introduced passively managed tax-managed mutual funds, any advantage a typical VA might have offered was further eroded. Tax-managed funds take one of the benefits of passive investing (tax efficiency) to an even higher level. These funds have practically eliminated any financial argument for purchasing a VA and using it as a vehicle for equity investing. (An exception could be for the real estate asset class. Because Real Estate Investment Trusts — REITs — are required to distribute virtually all of their income, real estate is a very tax-inefficient asset class. Of course, most investors don't need an annuity to hold a real estate component within their portfolio; they can accomplish the same thing inside an IRA or tax-deferred plan.)

Perceived Benefits

Let's take a quick look at the VA insurance "benefit" that is often touted as part of the sales pitch to prospective investors. The insurance typically guarantees that, when the investor dies, the value of his or her account will be at least as great as the money originally invested. But unless the investor receives a contract that steps up the insurance coverage over time, he or she is typically only insured for the starting value of the investment, even if the account has grown.

Many assume that, if the policyholder dies before annuitization begins, the heirs would receive at least the nominal value of the premiums paid. However, a 2001 article in the *Journal of Risk and Insurance* by Moshe A. Milevsky and Steven E. Posner on the value of this benefit found that, "A simple return-of-premium death benefit is worth between one and ten basis points, depending on gender, purchase age, and asset volatility. In contrast, the median Mortality and Expense risk charge for return-of-premium variable annuities is 115 basis points."[4]

And, according to the 2005 working paper "The Household Ownership of Variable Annuities" by Jeffrey R. Brown and James M. Poterba, "Only 5 percent of variable annuity contracts have insurance expenses under 75 basis points, whereas 12 percent charge more than 140 basis points."[5]

In a February 1998 *Forbes* article, author Carolyn T. Geer estimated that, "With the vast majority of annuities sold today, almost all of the money you are assessed for 'mortality and expenses' winds up in either the salesman's or the insurance company's pocket."[6] Even if the VA includes a periodic step-up in protection, the economic value of the insurance itself is negligible.

Fees and Expenses

In other words, as discussed above, VAs are expensive:

- Milevsky and Posner pointed out that, "The policyholder does not get an actual 'invoice' for management and insurance fees. Rather, the payments are charged to the account and implicitly reduce the amount of assets under management."[7]
- Surrender charges are common: Brown and Poterba commented that they typically decline to zero in the seventh year, but can take longer to do so. Milevsky and Posner estimated surrender charges of 1–7 percent for at least the first eight years.
- If the investor cashes out before reaching age 59 ½, an additional 10 percent tax penalty is assessed, except under narrow circumstances.

What's the Broad Appeal?

In 1998, Geer described how investment company T. Rowe Price sent its potential customers a software program meant to assess whether VAs were suitable investments for them. By including characteristics

such as an investor's age, income and tax bracket, the program concluded that for many of those potential buyers, a simple mutual fund would be a more optimal choice.

Since the only substantial benefit of a VA is its tax deferral feature, there is virtually no reason to hold an annuity inside another tax deferral vehicle such as an IRA. Yet, many VAs are sold that way. The *Wall Street Journal* cautioned investors: "Regardless of the fees and other terms, investors should keep in mind that deferred variable annuities are best suited for those planning to work 15 to 20 more years before they'll need the money."[8]

If the terms of VAs are so unfavorable, why do so many people buy them? Many prospective investors are led astray by strong sales pitches that focus on the tax deferral benefit of VAs. Fortunately, tax deferral can typically come much cheaper and more efficiently through low-cost, tax-efficient mutual funds that are both passively and tax managed.

Brown and Poterba compared the expense differential of variable annuities and mutual funds. They found that, "Even with a horizon of 40 years, under the [2003] new tax rates, variable annuities provide a higher net of tax return only if the expense differential is under 25 basis points."[9] And that analysis did not consider that holding equities inside of a VA causes the loss of other tax benefits, including the loss of the potential for a step-up in basis for the estate of the investor, the inability to harvest losses, the inability to donate appreciated shares to charity and the loss of possible foreign tax credit.

Geer also pointed out another advantage that tax-managed mutual funds have over tax-favored annuities. With mutual funds, investors can escape the "capital-gain tax altogether by either giving the fund shares to charity or leaving them in [their] estate. No such option is available to an annuity holder. Transfer or bequeath an annuity to anyone but your spouse and you trigger recognition of the full appreciation as income."[10]

Tread Carefully

Given that Brown and Poterba estimated that, at the end of 2004, total assets invested in VAs exceeded $1 trillion, there should be numerous opportunities to lower expenses and/or improve investment returns. Investors who currently hold a high-cost annuity might benefit by investigating low-cost, no-surrender-charge annuities. If the VA's applicable surrender charge period is over, or even nearly over, the decision to make the tax-free Section 1035 exchange is easy. Unfortunately, associated surrender charges often prevent investors from being able to cost effectively implement a 1035 exchange. An investor's investment advisor or accountant can help calculate this relatively straightforward cost analysis.

At least one exception to the VA high-cost rule would be AEGON (which provides access to DFA funds). AEGON can work with VA holders who are seeking to escape from their current high costs and poor investment choices, using a Section 1035 tax-free exchange.

Investors should be aware that sales pitches for "bonus" annuities are likely aimed more at generating new commissions for the salesperson, than at reducing expenses for an investor who is imprisoned in a high-cost product. Annuity holders with a few years left in their surrender charge period might be approached with the following "typical" story:

> I understand that you are unhappy with your current VA because of your investment choices' poor performance and you have a three percent surrender charge left. We are going to "help" by giving you an upfront "bonus" of 3 percent to cover the surrender charge. It will not cost you anything to switch.

Unfortunately, the only "bonus" is to the salesperson. The new sale starts the surrender period all over again. And, with new VA products, the surrender period is often even longer and more expensive than on the original annuity. The surrender charge could extend to as many as 10 years, with an even higher prepayment penalty than that of the original VA. The annuity holder would now be locked into another high cost (or even higher cost) product for a much longer time.

How to Proceed

For investors who already hold VAs, we would suggest that they take the following steps: 1) investigate whether VAs are appropriate within their portfolio and 2) determine whether their existing VAs have reasonable costs and appropriate investment choices. If the VA is inappropriate, then consider making a 1035 exchange.

Much of the evidence from academic studies on VAs has suggested that, in general, the costs of VAs far exceed potential benefits. With all the caveats discussed in this article, we agree with Jonathan Clements when he said that variable annuities are "usually a horrible investment."

[1] Jeff D. Opdyke, Variable-Annuity Inflows Dropped 49% Last Year. *Wall Street Journal*, March 9, 2006.
[2] Jonathan Clements, Defending a Much-Maligned Investment: When Variable Annuities Make Sense. *Wall Street Journal*, October 20, 2004.
[3] Diya Gullapalli, Financial Makeover. *Wall Street Journal*, January 16, 2006.
[4] Moshe A. Milevsky and Steven E. Posner, The Titanic Option: Valuation of the Guaranteed Minimum Death Benefit in Variable Annuities and Mutual Funds. *Journal of Risk and Insurance*, March 2001.
[5] Jeffrey R. Brown and James M. Poterba, Household Ownership of Variable Annuities. Working Paper, National Bureau of Economic Research, October 2005.
[6] Carolyn T. Geer, The Great Annuity Rip-Off. *Forbes*, February 9, 1998.
[7] Moshe A. Milevsky and Steven E. Posner.
[8] Diya Gullapalli.
[9] Jeffrey R. Brown and James M. Poterba.
[10] Carolyn T. Geer.

This material is derived from sources believed to be reliable, but its accuracy and the opinions based thereon are not guaranteed. The content of this publication is for general information only and is not intended to serve as specific financial, accounting or tax advice. To be distributed only by a Registered Investment Advisor firm. Copyright © BAM Advisor Services LLC, 2006.