Why Variable Annuities Are Just For a Few

Smoke and mirrors can't disguise the simple truth about variable annuities: Most investors can do better elsewhere.

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September 1, 2005

Okay, class, here's today's Marketing 101 challenge: How do you sell a product valued for its tax advantages after Congress changes the rules so its earnings may be taxed at rates nearly twice as high as those that hit competing investments? Tough, huh?

Yet that's exactly the position variable-annuity marketers found themselves in when Congress cut the tax rate on long-term capital gains to 15% (and 5% for the lowest brackets). That wasn't an assault on variable annuities. They still sport their tax advantages.

By putting an annuity wrapper around a group of mutual funds, insurance companies can offer a tax-favored environment. You can trade as much as you want inside the annuity without tax consequences, and annual earnings build up tax-free. But when money comes out, those earnings are taxed in your top tax bracket -- up to 35%. That's why cutting the rate on capital gains to 15% was such a body blow.

With characteristic resilience, the purveyors of annuities refused to throw in the towel. This investment has always been "sold probably more aggressively than any other financial product," says Jeff Lambert, a financial planner in Sacramento, Cal.

To fight back, insurance companies started adding and promoting features that have nothing to do with taxes.

- Some policies promise that one-year's gains can't be lost to a later market dip. If, for example, a $100,000 investment grew to $110,000 during the first year, $110,000 would become the minimum death benefit. Historically, the death benefit -- which is the hint of insurance that earns annuities their tax-advantaged status -- simply guaranteed that if you died with the plan in force, your heirs would get at least as much as you had invested, even if your investments declined in value.

- Some companies offer a death-benefit-type guarantee to the living, making up the difference if your balance drops below your investment after ten years.

- Many policies now let you access your money without a surrender charge if you enter a nursing home.

Whipped into a frenzy yet? That seems to be the goal of these sales sleights of hand. But such features fall short.

The death benefit, which usually costs more than $1,000 for a $100,000 account, isn't going to help you if the market tumbles while you're still alive. Companies that guarantee your principal while you are alive often charge another $1,000 a year on a $100,000 account. Yet the chances of your benefiting are almost nil. According to Ibbotson Associates, large-company stocks have had negative returns over a ten-year period only twice since 1926. (The worst period was from 1929 to 1938, when they lost an average of 0.89% annually).

Surrender-charge waivers won't protect you from the 10% tax penalty if you withdraw money before age 59½, and unless you buy the annuity after you retire, it's unlikely you'll enter a nursing home while the surrender period is in effect (often only seven years).

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