INVESTING

Look Before You Leap: A Primer on Variable Annuities

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Sound Mind Investing

CBNMoney.com –Variable annuities (VAs) are mutual funds wrapped up in a tax-sheltered package. Unlike a fixed annuity, where you are essentially loaning money to the insurance company and, in return, agree upon a rate of return up front, the returns in a variable annuity aren't locked in ahead of time. They vary depending on how well the investments perform—that's why they're called "variable."

The VA has one major advantage over the fixed kind—you have control over the investments. Insurance companies typically offer a range of investment choices in their variable annuities, and let you decide how much money goes into each category. Your eventual return is affected by three things.

• Your allocation decisions. If you decide to put all your money into the stock market just before a major sell-off, you'll get off to a slow start. On the other hand, if you play it safe in the money market fund, you're giving up the reason for choosing a VA in the first place—greater profit potential.

• Investment fund performance. It could be that even though you make excellent allocation decisions, the funds offered by your particular insurer just don't perform well. Just like mutual funds, some VA funds finish in the top ranks year after year, whereas others are perennial also-rans. Check out the track records of the funds in the variable annuity being offered to you. How do they compare with other variable annuity funds over the same period?

• Fees, fees, and fees. There are three kinds of fees you have to pay with most VA products. First, there are the sales fees, usually disguised as "surrender charges." In the most common arrangement, there are no up-front sales charges; instead, the cost of commissions paid to the brokers and insurance agents is recovered by penalties paid if investors take their money out of the annuity in the first seven years.

Next come the "contract fees," which include annual administrative and insurance fees. Among their other purposes, these fees guarantee that your beneficiaries won't get back less than you put in, regardless of how poorly your investment choices perform. You can expect these fees to be between 1-2% per year. You pay these every year you own the annuity.

Finally there are the fees paid to the investment managers who make the portfolio decisions in the funds. These are similar to the management fees paid by shareholders of regular mutual funds and typically run about 1.0% per year. These also are ongoing. So, you can see how the overhead expenses cut into your returns by about 2-3% each and every year, even assuming you hold your annuity longer than seven years and avoid the surrender charges.

Another drawback is the loss of liquidity. Annuities are designed for retirement planning and are intended as long-term investments. Once you put your money into one, you're supposed to leave it there until at least age 59½. If you take it out sooner, you get hit with a 10% penalty from the government, just as with IRAs.

Are variable annuities worth the cost, red tape, and possible tax headaches down the road? Usually not.

Because of the high costs and the possible tax disadvantages, many financial planners recommend VAs only as a last resort after all the other options have been explored and exhausted. Their unique characteristics create a situation where it's difficult to decide which kinds of investments would be appropriate within a variable annuity.

On the one hand, if you invest in equities with growth potential, you're going to end up paying ordinary income tax rates on what would otherwise qualify for long-term capital gains tax treatment. On the other hand, if you put your VA money in fixed income investments, then the high fees become particularly burdensome. Do you really want to pay 2-3% a year or more just to invest in bonds (which have historically returned about 8% a year)? The same investment in a low-cost, no-load mutual fund (like those at Vanguard) would cost only about 0.3% per year.

When Variable Rate Annuities Make Sense

In my view, a VA is appropriate only if you can pass all eight of the following tests:

You're already making the full contribution to your IRA (whether tax-deductible or not).

You're already paying the maximum permitted into an employer-sponsored 401(k) plan.

You've got investment money you're willing to lock away for at least 18-20 years, which is the time needed to make up for the higher fees.

You're in one of the higher tax brackets now (28% and up) and have a reasonable expectation that your tax bracket will be lower after you retire.

You've set aside an amount of cash sufficient to cover major expenses and emergency needs so that you're sure you'll have no need to withdraw your money before age 59½.

You expect to make withdrawals in regular, systematic payments to supplement your other retirement income rather than withdraw your assets all at once.

You anticipate that your regular monthly withdrawals will exhaust the assets in your annuity in your lifetime. (Due to tax laws, an annuity is not a good vehicle for accumulating capital to leave to your heirs.)

You got a late start contributing to other retirement accounts and are using an annuity as a means for making up lost ground.

The SEC of the federal government offers its views of VAs on its website at www.sec.gov/investor/pubs/varannty.htm.