



## What's Wrong With Variable Annuities

*Updated on September 10, 2007.*

**VARIABLE ANNUITIES** are sold more aggressively than fake Gucci handbags on the streets of New York City. Thanks in part to commissions of 5% or more, sales of variable annuities have soared over the past decade.

But popularity is no indicator of practicality. The truth is, annuities only make sense for a tiny fraction of the population. (See story<sup>1</sup>.) The rest of us should be buying plain old mutual funds. Of course, that's not easy to say to your dark-suited cousin who keeps taking you out for steak and Lafitte-Rothschild Bordeaux in hopes that you will sign on the dotted line. But, next time he invites you, you can bring along this article. Just make sure he pays the bill before you give it to him.

### The Basics

First, a primer. 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. Thanks to the insurance wrapper, earnings inside the annuity grow tax-deferred, and the account isn't subject to annual contribution limits like those on other tax-favored vehicles like IRAs and 401(k)s. Typically you can choose from a menu of mutual funds, which in the variable annuity world are known as "subaccounts." Withdrawals made after age 59 1/2 are taxed as income. Earlier withdrawals are subject to tax and a 10% penalty.

Variable annuities can be immediate or deferred. With a deferred annuity the account grows until you decide it's time to make withdrawals. And when that time comes (which should be after age 59 1/2, or you owe an early withdrawal penalty) you can either annuitize your payments (which will provide regular payments over a set amount of time) or you can withdraw money as you see fit.

### Fees, Fees and More Fees

Variable annuities are notorious for the fees they charge. Indeed, the average annual expense on variable annuity subaccounts currently stands at 2.37% of assets, according to Morningstar. (This figure includes fund expenses plus insurance expenses.) The average open-ended mutual fund (excluding municipals), on the other hand, charges just 1.33%. Unfortunately, variable annuity fees don't stop there. Many variable annuities also have loads on their subaccounts, surrender charges for selling within, say, seven years and an annual contract charge of about \$37.

### What Death Benefit?

The death benefit basically guarantees that your account will hold a certain value should you die before the annuity payments begin. With basic accounts, this typically means that your beneficiary will at least receive the total amount invested — even if the account has lost money. For an added fee, this figure can be periodically "stepped-up" or earn a small amount of interest. (If you opt not to annuitize, then the death benefit typically expires at a certain age, often around 75 years old.) Well, given the fact that stocks have returned an average of 12.1% annually (assuming dividends are reinvested) from 1926 to 2006, according to the Center for Research in Security Prices, over the long haul you need this insurance about as much as a duck needs a paddle to swim.

OK, investors who bought annuities and then died within the next two months probably got their money's worth. But, consider this: The death benefit was triggered in only 1% of all policies from 2002 to 2004, according to Limra International, an insurance-industry research group.

The price of this questionable feature: an annual 1.19%, according to Morningstar.

### Surrender Fees

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 typically decrease as the years tick by. For example, you might be charged a 7% surrender fee for a withdrawal during your first year of ownership. After seven years, however, that could be just 1%. The average fee is a steep 7.2%, according to Morningstar.

### Early Withdrawal Penalty

As with most retirement accounts, if you withdraw funds before age 59 1/2, you'll be hit with a 10% early withdrawal tax penalty.

### The Taxes

Gains in variable annuities are taxed at ordinary income tax rates, which go as high as 35%. For most investors, that's a whole lot higher than the maximum 15% rate they now pay on their long-term mutual fund gains and dividend income. And that tax difference can easily eat up the advantage of an annuity's tax-free compounding. "You're generally going to have to wait 15 to 20 years before these suckers become more tax efficient than a mutual fund," says CFP Dee Lee of Harvard, Mass.

Residents of some states may pay even more taxes on nonqualified variable annuity accounts. (That is, accounts that are not purchased within an IRS-approved retirement plan like a 401(k), 403(b) or IRA.) Some states also add a tax for variable annuities purchased within a qualified account.

### The World's Louisiest Estate-Planning Vehicle

There's no getting around the income tax due on annuities. In fact, if you die with money remaining in your annuity, your beneficiary will inherit all the taxes that you have deferred. Compare this to a mutual fund, whose basis is stepped-up at death. In that case, your beneficiary would owe no taxes on the gains. Both types of accounts — annuities and mutual funds — are liable for federal estate taxes on anything over the federal estate tax exemption (\$2 million for 2007-2008).

### Switch to a Low-Fee Variable Annuity

Now, if you've read all this and still want to buy an annuity, do yourself a favor and buy one with low costs and good investment options. These are available from mutual fund companies like Vanguard<sup>2</sup> (average total expenses, 0.57%, including mortality and expense risk charges) and T. Rowe Price<sup>3</sup> (average mutual fund expenses range from 0.35% to 1.05%, plus an additional 0.55% mortality and expense risk charge). Investors who already own run-of-the-mill high-priced annuities should consider a tax-free transfer — called a 1035 exchange — to a better quality, low-fee annuity. Just be sure to confirm that your surrender charges have expired before you make the switch.

*Updated on August 5, 2005.*

Links in this article:

<sup>1</sup><http://www.smartmoney.com/retirement/investing/index.cfm?story=buyannuities>

<sup>2</sup><http://www.vanguard.com>

<sup>3</sup><http://www.troweprice.com>

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