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BUSINESS Scott Burns Columns 2005

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7 sins of variable annuities

08:47 AM CDT on Tuesday, June 21, 2005

By SCOTT BURNS / The Dallas Morning News

The kids are gone. The last tuition bill has been paid. The mortgage is nearly paid off. The kitchen has been remodeled. Now that there are just two of you, you're equipped to cook for the National Guard.

You're making more money than ever before. You can save more money than ever before.

What's the catch?

The taxman thinks you are red meat.

If you are in this position – and millions of older baby boomers are – you might be tempted to put some of your money in a variable annuity.

Don't.

Here are seven reasons why variable annuities don't work for the vast majority of investors.

1. High expenses: While mutual fund expenses are declining, the insurance industry still thinks you're a patsy for fees. The 8,296 variable annuity sub-accounts launched before Jan. 1, 2000, have an average total expense of 2.14 percent a year, including 1.28 percent for insurance-related expenses. The 19,766 variable annuity sub-accounts launched since then have an average expense of 2.43 percent, including 1.41 percent for insurance-related expenses.

The expenses come out of your return. If you are hoping to earn 10 percent on your **DallasNews.com/Extra** investment, tax-deferred, fees averaging 2.34 percent – 23 percent of your return – are a powerful substitute for the taxman. In fact, taxes are deferred but higher.

Tilting against illusions (6/19/05)

Variable annuity watch

2. High taxes, Part A: In a variable annuity, you gain tax deferral at the expense of higher tax rates later. Withdrawals from variable annuities are taxed at ordinary income rates, which can be as high as 35 percent. If you invested in mutual funds and stocks outside of the variable annuity, you would pay dividend and capital gains taxes at 15 percent.

3. High taxes, Part B: In a variable annuity, income returns are withdrawn before principal. This means every dollar withdrawn is taxed at ordinary income rates.

Investments in mutual funds and stocks, on the other hand, allow you to realize principal as well as capital gains. If your investment doubles, for instance, every $1,000 of sale proceeds for a fund or stock will include $500 of nontaxable principal and $500 of capital gains taxable at 15 percent.

So you'll net $925 in after-tax cash for each $1,000 withdrawn. With the variable annuity, you'd net only $650 to $850 per $1,000 withdrawn until all earnings had been taken, assuming tax rates of 15 to 35 percent.

4. High taxes, Part C: If you die before spending the accumulated income in your variable annuity, the tax liability will go to your heirs. If you die before spending the accumulated capital gain in a mutual fund or stock, the unrealized capital gain disappears along with the tax liability. Some consider this tax benefit our only incentive to die.

5. Increased portfolio risk: High fees in variable annuities encourage excess risk. With fees running over 2 percent annually, it makes little sense to invest in a money market fund (gross yields under 3 percent) or a quality bond fund (gross yields 3 to 5 percent).

6. Lost flexibility: Because of their heavy-duty marketing expenses, variable annuities have punitive redemption fees that apply for as many as 10 years. Variable annuity investors tend to feel "locked-in" as a consequence.

7. High expenses and prospective returns: The 1980s and '90s were periods of high returns for both stocks and bonds. When 10-year Treasuries were yielding 8 percent, a 2 percent expense burden took "only" 25 percent of the yield.

Today, when 10-year Treasuries are yielding 4 percent, a 2 percent expense burden takes half the return.

Equity accounts in variable annuities face a similar problem. While equities were returning 15 percent, a 2 percent expense burden took only 13 percent of the return. If equities return a below-average 8 percent in the future, as some expect, a 2 percent expense burden will take 25 percent of the return.

Scott Burns answers questions of general interest in his Thursday columns. Write Scott Burns, The Dallas Morning News, P.O. Box 655237, Dallas, Texas 75265, or send an e-mail.

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