Variable annuities: Beware of shrinking payouts

By Lisa Gibbs @Money August 6, 2013: 5:35 PM ET

Angling for more retirement income? Variable annuities are not as generous as they once were.

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Get a minimum income for life, no matter what. That compelling sales pitch has propelled investors to pour $1.5 trillion into variable annuities in the past decade.

Driving most of those sales was not the annuity itself, essentially a tax-deferred investment account; rather, buyers have been attracted by the "living benefit" rider, an optional feature ensuring that you can draw a base income from your investments regardless of how the markets perform or whether you drain your account.

Before the financial crisis, riders commonly guaranteed impressive returns of 8%-plus and annual withdrawals around 7%. So it was no wonder that over a period that included two bear markets Americans eagerly rushed into these insurance products, seeing them as the antidote to investment risk.

These days, however, the variable annuity and rider combination isn't looking like the panacea it once seemed to be.

Over the past 18 months, most of the insurers that sell these products have seriously scaled back guarantees offered on new contracts while hiking fees and restricting investment allocations on both new and existing policies.

Seven major firms, including AXA, John Hancock, and Prudential, have limited or prohibited additional investments in some of their older, more generous contracts. A few companies have even offered buyouts to customers willing to cancel the rider.

Meanwhile, the Securities and Exchange Commission is now looking into whether buyers were ever made fully aware of the potential for such changes.

What's going on? First, the financial crisis tanked customers' portfolios, putting insurers on the hook for billions in guarantees on pre-2008 contracts. Since then, years of low interest rates have left firms uncertain that they will be able to satisfy future payouts.

"A lot of companies got burned," says Moshe Milevsky, a finance professor at Toronto's York University. Besides rejiggering the terms on their contracts, many insurers have reduced the number of policies they sell; last year two big names -- Hartford and Sun Life -- dropped out of the business altogether.

If you have a VA (variable annuity) or were thinking of buying one, you're probably wondering where all this leaves you. For owners, the answer depends on your contract, your account value, and the changes to your terms.

For income shoppers, it ultimately comes down to what risks you can accept -- though there are cheaper, simpler, and more profitable ways to ensure that you won't outlive your money.

The sections that follow will help you make the right decision for you.

What the changes mean

While each insurer is tweaking its terms differently, there are a few common threads: limited investment freedom, tightened minimum-return and income guarantees, and higher fees.

The most common -- and arguably most impactful -- shift has been to cap owners' stock allocation. Through the VA itself, investors used to be able to choose from a large menu of mutual funds. You could go whole hog into stocks, if you so desired, knowing you had the rider's guarantees as a backstop.

Today most buyers who opt for a rider -- 88% do, says research firm LIMRA -- will see their stock stake capped at around 60%. You may also be required to use model portfolios or "managed-volatility" funds, which automatically shift assets from stocks to more conservative choices if your account value falls a certain percentage within a short time.

Such restrictions can have a huge impact on the value of the rider because of how the vehicle is structured.

First thing to know: While the actual money you've stashed in a VA-with-rider fluctuates with the value of your investments, a hypothetical account called a benefit base grows at a minimum "roll-up" rate each year -- say, 5% -- even if your real-life investments lose money. If your actual investments do better than this guaranteed return, the benefit base is increased, or "stepped up," to match them.

The rider also has a set schedule of guaranteed withdrawal rates based on the age you start collecting. Whenever you decide to start taking income, the percentage is applied to your benefit base to determine the amount. Then the money is drawn from your actual account.

You can generally tap the account for more, if needed, as well, though it will affect your future income. In the most popular kind of rider, known as the guaranteed minimum withdrawal benefit, the insurance kicks in once withdrawals drain the account, allowing you to continue receiving the same amount for as long as you live. (If you die before depleting the account, your heirs get what's left.)

Investment restrictions decrease the chances that your portfolio will suffer a major downturn, thus decreasing the chances the insurance will come into play at all. Also, the smaller your stock allocation, the less potential for step-ups. "If you're forced to have a balanced allocation, what's the point of buying protection?" asks Milevsky.

Changes in guaranteed income further diminish the rider's value. Two years ago 70% of riders offered a 5% withdrawal rate. Now less than 50% do, says Morningstar.

A lower withdrawal rate means it takes longer for your account to run out and longer for the insurer to have to shell out its own money. Roll-up rates have drifted down too, from a typical 8% to around 5%, and some companies have found ways to further limit them (such as capping the number of years).

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Then there are the fees. The average toll for the popular minimum withdrawal benefit rose from just under 1% in 2009 to about 1.25% as of December, says Morningstar. Add to that the hefty costs of the base VA itself and expenses end up biting off 3.7%, on average, of the account value per year, according to the latest figures.

Over time that severely crimps your portfolio's ability to grow. Even after a bear market like the one in the 2000s, $100,000 in a mutual fund portfolio of 60% large-cap stocks and 40% intermediate-term bonds (assuming 0.75% in fees) would have grown to around $131,600 in 10 years. The same investment in today's average VA rider would be worth only $95,500.

Bottom line: These changes greatly reduce the payouts possible compared with past contracts. In a bull market, you're looking at thousands less in annual income.

The cutbacks give ammunition to the product's detractors, who have long argued that high fees eroded VAs' supposed benefits. "The upside potential on these is just a marketing fantasy," says Scott Witt, a Milwaukee-area actuary and fee-only insurance adviser.

Proponents counter that the products allow investors who remain scared stiff by the markets to feel comfortable with a bigger stash of stocks. VA riders "deliver peace of mind through guarantees of lifetime income, which can be especially valuable in an uncertain economic environment," says Whit Cornman, a spokesman for the American Council of Life Insurers.

But even some fans say that skimpier riders have made them less likely to recommend the products. "Today's benefits are so inferior," says Scott Stolz, president of the insurance group at financial advisory firm Raymond James.

What to do if you already have a VA-rider combo

Know what you're in for: Owners with contracts written before 2011 have been most vulnerable to term revisions. Thus far the most common changes have been to restrict stock allocation or force customers into more conservative options, to raise fees on the riders, and to limit additional contributions (guarantees haven't been touched for existing policyholders).

The fine print in the contracts generally allows your insurer to make these types of revisions, though the company will be required to inform you when terms are amended.

Haven't heard anything yet? You are not necessarily in the clear, says Stolz of Raymond James: "The longer interest rates stay low, or if there is a significant drop in the stock market, the more companies will feel a need to make changes."

Evaluate your guarantee. If you're being hit with a change, you have two choices: Accept the new terms and keep the contract, or cancel and find an alternative investment.

One way to make this decision is to look at the difference between your benefit base and the account value: If the former is at least 15% higher, you should probably keep the rider, says Wheaton, Ill., financial planner Robert O'Dell.

Calculating how much income you could take right now can also help you benchmark, says Stolz.

Start by multiplying your withdrawal rate by your benefit base; for example, 5.5% of a $500,000 benefit base is $27,500 a year. Next, compute what percentage of your actual account balance that income represents. On a balance of $435,000, $27,500 represents 6.3% -- much more than the 4% initial maximum that financial planners would recommend drawing from a portfolio to sustain a long retirement.

"It's an indicator of value," Stolz says, one that would probably outweigh the effect of any higher fee or investment change.

What if you're offered cash to drop the rider? Offers can be tempting (Hartford, for example, is dangling up to 20% of the benefit base for certain accounts). But as David Blanchett, Morningstar's head of retirement research, points out, "If the insurer wants to buy your policy, taking the cash probably isn't a very good deal for you."

You're likely to have a valuable guarantee that the company doesn't want to get stuck paying.

Keeping it? Start drawing now. An analysis published in February by York University's Milevsky concluded that most owners of older rider contracts should take income sooner rather than later. Essentially, he said, at age 65 and beyond, the income from taking payments now outweighs any increase you might achieve through step-ups in your account value down the road.

"The sooner you run down the VA and get the account to ruin, the quicker you start living off the insurance company's dime and stop paying insurance fees," his report says.

That said, if the percentage you can withdraw goes up with age and you're close to a break point -- you're 69, say, and the percentage goes from 5% to 5.5% at 70 -- wait until then.

Ditching it? Minimize your costs. Early on, variable-annuity owners are hit with a charge on the way out the door. These "surrender fees" usually decline over five to seven years -- say, from 8% the first year down to 2% in the seventh. Wait to cancel until the percentage owed falls below the annual expenses you're paying so as to avoid losing a lot of your investment value.

Also, be aware that if you own the VA outside an IRA, canceling could trigger a big tax liability: You'll owe ordinary income taxes on investment gains.

You can avoid those by exchanging the annuity for another in what's called a 1035 exchange, says financial planner O'Dell. See the next section for alternative products that can secure your income. Just make sure to get 1035 forms from the insurer.

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What to do if you're shopping for income

Take stock of your stock anxiety. Even before the changes in rider terms, "there were cheaper ways of guaranteeing income," says insurance adviser Witt.

Still, the product can make sense for certain people -- in particular, those so fearful of another 2008 that they're taking much less risk than they should. For such individuals, a VA-rider combo presents a shot at growth, notes Miami financial planner Bruce Cacho-Negrete.

To overcome the fees, though, you need to be mostly in stocks, he adds: "If you can't get at least 80% exposure, it's harder to make the case for these." (Right now only one insurer, Jackson National, lets you go in that deep.)

Invest conservatively now, annuitize later ... Got a stronger stomach? You'll have potential for more income if you stash your money in a conservative, low-fee mutual fund portfolio until you need income, then purchase an immediate annuity at that time.

With this type of annuity, you hand over a lump sum to the insurer and start getting paid immediately. Unlike the VA, the amount you invest is the insurer's to keep even if you die the next day. But payouts are higher, since insurers can transfer premiums of those who die early to those who live longer.

Currently, a 65-year-old man investing $100,000 could get $6,800 a year. The size of the check depends on your age and interest rates at the time of purchase, though -- good reasons to wait to buy. (Find quotes at ImmediateAnnuities.com.)

Last September, Wade Pfau, a researcher at the American College of Financial Services, analyzed various income strategies for a 65-year-old couple, including immediate annuities, a VA-rider combo, stocks, and bonds.

His conclusion: A mix of stocks and immediate annuities provided the best balance of guaranteed income and flexibility to draw from savings for lifestyle needs or to cover emergencies. The exact percentages of each, he says, depend on your preference for meeting a spending goal, vs. having leftover wealth. But, Pfau adds, "50% stocks/50% annuity could be a pretty good mix."

...Or nail down later income now. An alternative strategy would be to buy a deferred-income annuity, similar to an immediate annuity except that it allows you to lock in future income. You buy now and delay paychecks anywhere from 13 months to 45 years. A 65-year-old man with $100,000 can buy $16,520 a year starting at age 75; if he waits until 85 to start collecting, he'll get $62,950.

The reason for the gaping difference: the increased likelihood he will die between 75 and 85 and the insurer will pocket the money. (Shop for these, too, at ImmediateAnnuities.com, but be aware that a deferred annuity is different from a deferred-income annuity.)

On the upside, this method cuts out investment risk in the period before you need income. Downside: You lose the potential for market rallies that would boost your portfolio and interest rate hikes that would make the contract more productive.

The most effective way to use a deferred-income annuity is to buy one with a slim slice of your portfolio and push the income way into the future, says Pfau. The goal: to ensure you'll have some income in your later years if your portfolio runs dry. You'll pay much less for that security than you would for a variable annuity. ■

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Retirement Solutions
RICK ALFORD, CRP
5700 Granite Parkway, Ste. 200
Plano, TX 75024
972-731-2539
rick@rick-alford.com
rick-alford.com