The Basics

The Worst Retirement Investment You Can Make

High fees, low flexibility and 'horrendous' tax treatment make variable annuities less attractive than ever, except to the people who sell them.

By Liz Pulliam Weston

By all rights, variable annuities should be dead by now.

A series of tax cuts seriously eroded this investment's main advantage of tax-deferred gains. The bear market dealt a body blow, and regulators have filed a series of enforcement actions against annuity sellers for unsuitable sales, lack of disclosure and churning.

Yet, variable annuities posted their second-highest sales ever in 2003:

- $124.6 billion in variable annuities were sold, up 11% from 2002 and not far from the 2000 peak of $128 billion.
- Assets in variable annuities are on track to match their mid-2000 peak of $1 trillion after falling to $797 billion in 2002.
- As of September, the amount of "new" dollars flowing into annuity contracts -- as opposed to exchanges or transfers from one contract to another -- was up more than 50% from a year earlier.

"The new money coming into the industry has really shot up," said Rick Carey, managing director of research for the VARDs Report, a Finetre Corp. publication that tracks variable annuity trends and produced the numbers above. "That is a very good indicator of the health of the industry."

But is it a good indicator of the financial health of the people who buy annuities? The revival in sales distresses variable-annuity opponents, who say the investment is rarely suitable for investors but is aggressively pushed by commission-driven salespeople.

"When you take the commissions out of the equation, the allure of a variable annuity disappears," said Miami fee-only financial planner Frank Armstrong, a former insurance agent and author of "The Informed Investor: A Hype-Free Guide to Constructing a Sound Financial Portfolio." "They cost a bundle," he added. "And the tax treatment (upon withdrawal) is horrendous."

A variable annuity, in case you're not familiar with the term, is an insurance contract that allows you to invest your premium in various mutual fund-like investments. Here are some key points:

- **Tax treatment.** Your gains in an annuity grow tax-deferred, but they are taxed as income when you withdraw the money. That contrasts with other investments such as stocks and mutual funds, which can qualify for lower capital gains treatments.

- **Penalties for early withdrawal.** Variable annuities are designed as retirement savings vehicles. So, you pay a 10% federal tax penalty if you withdraw money before age 59½. Insurance companies typically levy surrender charges of their own if you withdraw more than 10% of your balance in the first few years. Surrender charges usually start at 7% of your investment and decline to zero over the next six to eight years. They can range, however, up to 16% and last for as long as 15 years.

- **Death benefit.** Variable annuities typically come with a death benefit that ensures your heirs get back at least as much as you invested if you're unlucky enough to die while your investments are down. Your heirs will have other problems if you die owning an annuity, however. While most other investments get favorable tax treatment -- a so-called “step-up in basis” that eliminates or drastically reduces the taxes heirs must pay when they sell -- withdrawals from an annuity are taxed at regular income-tax rates.

- **Living benefits.** Death benefits aren't the only insurance feature you can get with a variable annuity. Increasingly, insurers are pushing so-called “living benefits” or “life benefits,” which guarantee that you can get back at least your original investment, usually compounded by a certain amount, when you withdraw the money in retirement. Investors stung by the bear market are greatly attracted to these guarantees, Carey said. That's helped fuel annuities' rise. Living benefits were available on 20 of the 25 top-selling variable-annuity contracts last year.

- **Costs.** The insurance features of an annuity aren't free, of course. The typical annuity with just a death benefit costs 50% to 100% more in annual fees than comparable mutual funds. Life benefits can add 20% or more to that cost.

Those extra expenses can seriously eat into your returns. Consider what would happen if you invested $5,000 a year in mutual funds with annual expenses of 1.5%, versus the same investment in an annuity with a 2.5% expense ratio. If the underlying investments returned 8% a year, after 30 years:

- Your variable annuity would be worth $362,177.
- Your mutual funds would be worth $431,874 -- a difference of nearly $70,000, or 14 years' worth of contributions.

The gap just widens if you consider the tax implications. In both scenarios, you won't have to pay tax on your original contributions when you withdraw the money. But the mutual fund gains would in most cases qualify for capital gains tax rates, which currently range from 5% to 15%, while the annuity's payments would be taxed at income tax rates -- currently 10% to 35%.

Are the life benefits worth it?

Meanwhile, the chances of your actually using the insurance benefits are slim. Although insurers took a hit during the extended bear market, when more variable-annuity portfolios dropped below the owners' original investments, relatively few people will die with their annuities worth less than what they paid. The living benefits typically come with a 10-year holding period, and there have been few 10-year periods where investors have actually lost money.

Insurers argue that the life benefits serve as “guard rails,” allowing investors to take more risk with the knowledge that their basic investment is protected. Many financial planners respond that a more appropriate response to risk is to construct a balanced, diversified portfolio with bonds and cash to cushion stock market swings.

“The appropriate way to handle the risk is to run it down to where you can sleep at night,” Armstrong said, “not to jack up your expenses and pay horrendous taxes on the other end.”

Of course, most variable annuities aren’t bought -- they’re sold. Only about 1% of variable annuities are purchased directly by consumers; the rest are sold through brokers, insurance agents and bank employees who are paid often-hefty commissions on their sales.

The math is lousy

“Nobody who’s in the fee-only (planning) business is going to recommend them,” said Armstrong. “Why do you think that is? You think we just have a blind spot that we can’t do the math?”

Some of most vociferous critics of variable annuities are those who, like Armstrong, spent some time in the brokerage firms or insurance companies that push them. Before he became a fee-only planner, Rob Pool of Portland, Ore. worked for a major brokerage firm and the experience made him wary of the way annuities are sold.

“They’d get recommended even if it wasn’t in the client’s best interest all the time,” Pool said. “I can’t say there’s never a place for a variable annuity in a portfolio, but I haven’t found it yet.”

The uses are very limited

Armstrong says he has -- but only in one scenario: a high-income client who is afraid of lawsuits and won’t consider a trust. Some states, like Florida, protect annuities from creditors’ claims.

Even that risk gets distorted in annuity sales pitches. As I wrote in “Beware an annuity salesman’s scare tactics,” the National Association of Securities Dealers recently accused several companies of exaggerating the risk of lawsuits to frighten elderly customers into buying high-cost, high-risk annuities to protect their assets.

Most people can get sufficient lawsuit protection by increasing the liability limits on their homeowners’ and auto insurance policies. For those who want more, “umbrella” or personal liability policies can offer coverage of $1 million and up.

If, after all this, you're still considering a variable annuity, you should take the following steps before you buy:

- Make sure you have maxed out all your other tax-deferred options -- 401(k)s, IRAs, Roth IRAs, etc. -- and want to save more for retirement. Even then, you first should consider all of the other methods of saving that I outline in "5 ways to be a tax-smart investor."

- Be certain you can leave the money alone for at least a decade and preferably two. It takes years for the tax benefit to outweigh variable annuities' added costs. Analyses by T. Rowe Price, a mutual fund company and annuity seller, found that the typical investor needs to hold a variable annuity for 10 to 20 years before paying the extra fees for an annuity to make sense.

- Understand the surrender charges, early withdrawal penalties and annual fees you'll be charged.

- Shop around and compare different annuities' features and costs. Vanguard, T. Rowe Price and TIAA-CREF all offer low-cost annuities.

- If you're interested in asset protection, consult an attorney who's experienced in this area of the law. Don't take a salesperson's word for how the creditor laws work in your state.

Liz Pulliam Weston's column appears every Monday and Thursday, exclusively on MSN Money. She also answers reader questions in the Your Money message board.