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One Faulty Investment

'I cannot imagine a situation where I'd recommend a variable annuity,' says the former chair of TIAA-CREF

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You rarely find me so deeply angry at a common investment product that I dream of blowing it to smithereens. Especially one that's sold by America's leading financial institutions, commands $393 billion in assets and sounds like a winner for retirees. But stand back, I'm going to light the fuse. My target: tax-deferred, **variable annuities**--a name that hints of probity, with a soupcon of tax savings on the side. What a laugh. It will cost you more in taxes and possibly risk your security, too. "I cannot imagine a personal financial situation where I'd recommend a VA as a good idea," says actuary John Biggs, former chair of TIAA-CREF pension funds. Before going forward, let me define the battlefield. I am not dissing tax-deductible retirement annuities that come with employer-sponsored plans. Nor "fixed annuities" that pay a set rate of interest. Nor "immediate annuities" that pay you a monthly income for life.

My quarry is the commercial tax- deferred annuity sold by stock brokers, insurance agents, banks and financial planners. Their market: older people--so they're lying in wait for boomers approaching retirement. Savers in their 70s and 80s could be roadkill, too (do you know where your parents' money is?). Here's how VAs work:
You put up a sum of money for a long-term investment in mutual funds. But instead of buying the funds directly, you buy through the annuity. Any investment growth (dividends, capital gains) accumulates tax deferred, to be taxed as ordinary income when you take the money out. Typically, you're penalized for withdrawals made during the first five to seven years, says the National Association for **Variable Annuities**, although modest sums may be taken free.
The VA usually comes with some guarantees--for example, that your investment will never be worth less than you put in. That especially appeals to retirees. But true long-term investments aren't likely to shrink, so the guarantees are vastly overvalued and overpriced, Biggs says. And you're still losing money steadily, compared with other investment options.

Start with the costs. You may think that you're paying no sales commission, because it's not visible. But the sales machine earns 5 percent to 8 percent. The broker's earnings are buried in the annual costs--contract costs, investment management, insurance guarantees, administration--typically about 2 percent a year. That's $1,000 on a $50,000 investment, and more as the investment grows. You'd be horrified if you saw what you were paying in dollars and cents, says attorney Ronald Uitz of Washington, D.C., who has sued annuity firms for misleading sales tactics.

I asked fee-only life-insurance adviser Glenn Daily, of New York City, to compare the purchase of mutual funds with buying the same funds inside a **variable annuity**. He assumed a $50,000 investment, earning 8 percent, for a buyer in the 30 percent tax bracket, with dividends and capital gains taxed at 15 percent.

Which worked better? (Drumroll, please.) The mutual funds, by a mile. Over more than 30 years, the fund investment outperformed the annuity both before and after tax. You also had access to your money, with no early-withdrawal penalties.

As for sales practices, you've got to hold your nose. The National Association of Securities Dealers brought more than 80 disciplinary actions against VA brokers over the past two years. Seniors are their particular prey, with 90-year-olds sometimes sold VAs whose withdrawal penalties last for 10 years or more.

To be fair, many brokers don't understand the product they're selling. But, still. A 90-year-old. In April the NASD proposed a special set of rules for policing VA sales practices. The question now is, can they pass? In a comment letter, the American Council of Life Insurers, a powerful lobby, ripped the proposals apart. (For more VA info, check the Investor Alerts at nasd.com.)

Once you've bought an annuity, you're potentially a sitting dupe. Within a few years your broker will probably suggest that you switch to another, "better" VA, in a tax-free exchange. If you bite, you'll pay another commission. You'll also have to hold the VA for many more years before you can touch your money penalty-free. In January the NASD brought an action against the Kansas-based broker Waddell &Reed for allegedly switching 6,700 customers to a new annuity that earned the broker higher fees. At least 1,400 folks were likely to lose money on the trade, according to the complaint, while W R earned $37 million in commissions. W R says its actions complied with all NASD regulations.

There's one little corner of the world where VAs might work, says annuity expert Moshe Milevsky of York University in Toronto. If you specifically intend to turn your VA into a future lifetime income, you might do well by buying now. But less than 1 percent of VA holders annuitize, which leaves the other 99 percent... where? Biggs says, darkly, that five years from now insurance execs will be marched, handcuffed, through courts to answer for the way they sell VAs today. It can't happen too soon.