Variable ANNUITY PROS & CONS

Surprising Truths Your Advisor Won't Tell You

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Introduction

"The truly educated man is that rare individual who can separate reality from illusion."
Unknown

Uncover the truth hiding behind the variable annuity salesman's hype so you can decide if it's an appropriate investment for you.

Variable annuities are complex and controversial investments.

Salespeople like to present variable annuities as having the growth potential of a mutual fund with the security of insurance, thus allowing you to invest in the stock market with a safety net. They might even use scare tactics to sell you by claiming variable annuities can protect you from seizure of assets in a lawsuit because it's insurance.

On the other side of the table are consumer advocates who argue that variable annuity fees are so steep it can take more than a decade to outperform more straightforward investments, the benefits are misrepresented, and the restrictive features and penalties aren't adequately understood. They offer studies that prove variable annuity purchases are rarely based on educated decisions but instead on salesmen's hype.

What follows is a primer on variable annuities so that you know how to ask the right questions and arm yourself with enough information to make an informed decision.

Your objective is to determine how variable annuities compare with competing investment alternatives and if they are the right product to achieve your financial goals. Examine the costs and benefits of the variable annuity being sold to you (variable annuities are rarely bought—they are sold) before risking your hard earned money.

Defining Variable Annuities—A Quick Overview

"What is the difference between unethical and ethical advertising? Unethical advertising uses falsehoods to deceive the public; ethical advertising uses truth to deceive the public."
Vilhjalmur Stefansson

Annuities come in two basic flavors—fixed or variable.

A fixed annuity provides a regular monthly check for the remainder of your life in exchange for a chunk of cash up front. With a fixed annuity, the earnings and payout are guaranteed by the insurance company. This is the traditional, conservative approach to annuitizing retirement income. But variable annuities are different.

A variable annuity is basically a mutual fund investment wrapped in the veneer of an insurance contract. You make payments during the accumulation phase that are deposited into investment subaccounts which fluctuate just like comparable mutual funds. When you begin the payout phase, you get your principal plus any gains or losses as a lump-sum payment or you can annuitize that same amount into a monthly payment stream.

As its name implies, the variable annuity's rate of return is not stable because it will vary with the performance of the underlying investment (subaccount). There are many different investment options for the subaccount similar to mutual funds with comparable risk/return profiles. The value of your investment will depend on the performance of the subaccount investment option you choose just as the value of an investment in mutual funds depends on the performance of the mutual fund.

What separates the variable annuity from a conventional mutual fund is the insurance wrapper and the high costs associated with it. Below are some of the more common characteristics of the insurance wrapper:

1. Tax deferred earnings.

2. Account is not subject to annual contribution limits like other tax deferred investments such as IRAs or 401Ks.

3. Guarantee against loss of capital (but usually only if you die).

4. Death benefit.

5. Annuity payout options offering periodic payments upon retirement.

6. Withdrawals before age 59½ are subject to a 10% penalty except under certain narrow circumstances and are taxed as ordinary income.

7. Withdrawals after age 59½ are taxed as ordinary income.

While some of these insurance characteristics may sound desirable (and others may not), the key issue to focus on is the sometimes steep fees associated with this insurance wrapper. Fees are one of the biggest complaints against variable annuities and may include the following:

1. Surrender charges if you withdraw money before a specified period.

2. Mortality and expense risk charges for the insurance risk (death benefit and guarantee against loss of principle).

3. Administrative fees for recordkeeping and other expenses.

4. Fund expenses for the investment subaccount.

5. Various additional charges for any other features that might be added such as stepped-up death benefits or minimum income guarantees.

If this is beginning to sound complex to you, then you are not alone. Variable annuities are some of the most complex investment choices available despite your salesman's attempt to over-simplify the issues.

And this complexity comes at a price. You pay for every benefit and service offered through additional fees. This is not a conspiracy theory—it's just basic business. No insurance company is going to offer a feature unless they can make a profit on it. That is how business works. Variable annuities are no exception—you pay for every feature.

And there are a lot of features to consider. In recent years there were over 3,000 different riders (insurance-speak for features) on more than 600 different variable annuity contracts. Even the experts can’t keep it all straight.

The question you must ask as a consumer is whether or not you really need the various features of a variable annuity, and if so, at what price? **(This question is key so pay special attention to it.)** Many features can be purchased in other ways at lower prices.

Below is a more detailed analysis of the features, benefits, and costs of variable annuities.

18 Questions to Consider Before Buying a Variable Annuity

"Never value the valueless. The trick is to know how to recognize it."
Sidney Madwed

The salesman peddling the variable annuity has a legal obligation to advise you as to whether or not his product is suitable for your investment needs. Consider the following questions before investing in a variable annuity.

1. How long before I can access my money?

2. What are the surrender charges and other penalties if I liquidate my variable annuity earlier than expected?

3. Is my investment objective sufficiently long-term to allow the tax deferral feature to overcome the higher costs? Show me the calculations and assumptions.

4. Will I have sufficient resources to cover other financial needs so that I won't have to access my variable annuity account before age 59½?

5. Will I have sufficient resources to cover other financial needs so that I won't have to access my variable annuity account before the surrender period ends?

6. Have I read and understood the prospectus?

7. Do I understand how this variable annuity works, why it costs more than conventional investments, and why the extra costs make sense for my personal situation? (A good exercise is to take the total expenses added together and subtract them from your safe withdrawal rate for a shocking wake-up call.)

What are the mortality and expense charges?

What are the underlying mutual fund management fees and total expenses?

What are the additional rider charges?

8. How exactly will the salesperson be compensated if I were to purchase this

variable annuity? What is the total dollar amount he will receive?

9. Have I shopped for competing variable annuities that would achieve the same tax deferral and investment objective but at a reduced price (e.g. Vanguard, TIAA-CREF, T Rowe Price, Fidelity, Jefferson National, etc.)?

10. Do I really need the features and benefits of this variable annuity or would it make better sense to seek out lower cost alternatives?

11. Can any features of the variable annuity, such as long-term care insurance, be purchased separately at a lower price?

12. Am I already maximizing the use of tax-deferred retirement plans such as 401Ks and IRAs?

13. Have I consulted with my tax adviser to make sure I understand all the tax implications of buying a variable annuity, how it will affect my tax picture in retirement, and how it will affect my estate upon death?

14. What are all the ways I could lose money with this investment?

15. Am I willing to take the risk that my account value could decline if the subaccount investment I choose performs poorly?

16. Have I itemized a list of every expense and fee associated with this variable annuity so I can see the total expense picture clearly?

17. How are the underlying mutual funds rated?

18. If buying the annuity because of an exchange, then add the following additional questions:

a. What are all the costs associated with this exchange?
b. How will the change in surrender period affect me?
c. Do I really need the features of the new variable annuity enough to justify the costs?
d. Is the new variable annuity really superior, or is the salesman just trying to create a commission?