



**Variable Annuities:** *A Practical look at a practically awful product.*

– by John Augenblick

At one point or another, most of us have been pitched by a smooth-talking insurance salesperson singing the high praises of the eminently popular variable annuity. I'm sure that advantages such as tax deferred growth, a guaranteed death benefit, and the absence of contributions limits are touted as slam-dunk reasons so sign on the dotted line. However, consider what your well-groomed salesperson will likely not tell you in his quest for his sales commission. He'll neglect to mention that a variable annuity is perhaps the most fee-ridden of any modern investment vehicle and woefully inappropriate for the majority of investors.

### **The Basics**

To better understand why variable annuities are such poor investment vehicles it is important for us to understand the nature of the product. Essentially, a variable annuity is an investment that is contained within a life insurance product. The life insurance portion of the asset seeks to insure the risk of loss of capital via a guaranteed death benefit. The investor can choose from a limited field of "sub-accounts" which is an insurance industry term for the mutual funds that make up the investment portion of the annuity.

### **A Minefield of Fees**

Dooming the variable annuity (and the corresponding investor) to lousy investment performance are layers upon layers of fees. Ask your salesperson to explain all the details of all the underlying fees and watch the color drain from his face...then ask him about his 5% to 10% commission!

The first layer of fees, typically around 1.25%, pay for the mortality and expense charges which is industry jargon for the death benefit portion of the contract. To be sure, you will likely be paying this 1.25% long after your assets grow larger than the death benefit of your contract.

Next, the investor pays an average of 2.0% to cover the expenses of the mutual fund sub-accounts. This fee is particularly frustrating since a diversified portfolio of index funds outside an annuity contract can cost an investor less than 0.3% in annual expenses. Additional administrative fees, added feature fees, and sub-account transfer fees, are then piled on making the Variable Annuity an ultra-expensive lousy investment.

### **I Surrender**

I haven't yet mentioned that variable annuities feature a *surrender charge* which can cost the investor up to 7% of the value of the annuity if it is withdrawn in the first few years. As consumers, one would think that we would be naturally suspicious of an investment product that has a surrender charge – why should we be penalized when we discover that a product isn't right for us? An investment product that really adds value would never need a surrender charge to keep us from moving onto something more suitable. The mere mention of a surrender charge should serve as a red flag for any consumer that is not asleep at the wheel.

## **Bad for Loved Ones, Good for Uncle Sam**

Admittedly, variable annuities do grow in a tax-deferred status. But let's not kid ourselves—those taxes will eventually come due and Uncle Sam will claim his piece. Annuity distributions are taxed at normal income tax rates (as high as 35% for some of you), compared to only 15% for long-term capital gains and qualified dividends. Worse yet, if you were to die with money in your annuity, your loved ones will inherit a hefty bill for all the taxes that you have deferred. Compare this to stock or mutual fund gains, which enjoy a cost basis step-up provision in your estate, passing along zero taxes to your beneficiaries.

## **Human Nature and Economics**

I think all of us understand that insurance companies collect significantly more in fees than they payout in death benefits to annuity investors. Undoubtedly, some of us purchase variable annuities and absorb all those fees simply to capture piece of mind. I just think piece of mind doesn't have to cost so much. Instead of listening to insurance sales pitches we should spend our time and effort investing responsibly to grow our assets to levels that surpass any guaranteed death benefit. For me—*that* is piece of mind.

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