FISCHER
INVESTMENT STRATEGIES

Variable Annuities

Overview: Following is an overview of variable annuities (VAs), including other options to consider prior to purchasing one and what to do with a VA you already own.

Introduction

In many cases, VAs do not provide adequate compensation for the costs involved, can be costly to surrender and might be prudently replaced by a low-cost, tax- and passively managed mutual fund. If a guaranteed income stream for life is the goal, a single premium immediate annuity, known as a SPIA, might be an option to consider.

Even with these choices, investors continue to purchase VAs in numbers that seem to defy logic. In 2011, overall sales totaled more than $153 billion.[1]

A Couple of Pros and a Lot of Cons

A VA holds mutual-fund sub-accounts wrapped inside an insurance policy, which allows the investment earnings to be tax deferred. Many now come with guarantees of growth and income under certain circumstances. The U.S. Securities and Exchange Commission recommends that before purchasing VAs, individuals should learn as much as possible about the benefits they provide, the charges they carry and how they are structured.[2]

High Costs

- The insurance wrapper and associated guarantees generally come at a high price.
- VAs lack liquidity due to surrender charges in the first years, often up to eight years.

Less Transparent Costs

- The VA converts capital gains (typically lower rates) into ordinary income (typically higher rates).
- Guarantees are widely misunderstood by the owner of the annuity and sometimes even by the person selling it. These complicated rules can limit the benefit to the owner holding the annuity and the beneficiary who could inherit the annuity.
- The owner loses the potential for a step-up in basis from which stocks or mutual funds would benefit when his or her estate is settled.
- It is difficult to find passively invested, low-cost options inside an annuity wrapper.
- Investment account expenses in a VA are typically higher than their mutual fund counterparts.

More on Fees and Expenses

- An article by Moshe Milevsky and Steven Posner in the *Journal of Risk and Insurance* pointed out that, "The policyholder does not get an actual 'invoice' for management and insurance fees. Rather, the payments are charged to the account and implicitly reduce the amount of assets under management."[3]
- The same article noted surrender charges of 1–7 percent for the first five to eight years for the annuities examined during that period.[4]
- If an annuity owner cashes out before reaching age 59 ½, an additional 10 percent tax penalty is assessed, except under limited circumstances.

Perceived Benefits

The bottom line is that VAs with income guarantees that seem too good to be true are probably just that. According to *Money* magazine, "Anything above the standard roll-up of 5 percent and withdrawal rate of 5 percent for singles or 4.5 percent for couples comes with a higher cost or specific conditions. One might get a higher rate now but no guaranteed growth after 10 years."[5]

Furthermore, the rate of guaranteed income (4.5 percent to 5 percent using the example above) is partially a return of premium and partially growth. It is not a number that should be compared to growth in an investment portfolio, or bond yields, which measure only growth. In fact, studies show that when the return of premium is stripped out of the guaranteed values, the remaining growth is often comparable to current fixed income rates.

Annuity holders should be aware that sales pitches for "bonus" annuities are likely aimed more at generating new commissions for the salesperson than at reducing expenses for an investor who is in a high-cost product. Annuity holders with a few years left in their surrender charge period might be approached with the following story:

> I understand that you are unhappy with your current VA because of your investment choices' poor performance and you have a 3 percent surrender charge left. We are going to help by giving you an upfront bonus of 3 percent to cover the surrender charge. It will not cost you anything to switch.

Unfortunately, the greatest bonus in this scenario is to the salesperson. The new sale starts the surrender period all over again. The annuity holder would now be locked into another high-cost product for an even longer time.

What Is the Broad Appeal?

If the terms of VAs are so unfavorable, why do so many people buy them? People want to quell their fears about market drops by purchasing an investment-like product that provides a guarantee. Unfortunately, like so many things that seem too good to be true, the perceived value often outweighs the actual benefit.

Many prospective annuity holders are led astray by strong sales pitches that focus on the guarantees of VAs without clearly outlining the limits, exceptions and sacrifices. A guaranteed income stream can typically be attained more efficiently and cost effectively using a strategy of investing in a bond ladder and then a straightforward, low-cost annuity, such as a SPIA.

Should a Liquidation Be Considered?

If the VA's applicable surrender charge period is over, or if the annual fees exceed the current surrender charge, the decision to liquidate the product may be worth considering. An individual's investment advisor or accountant can help calculate this relatively straightforward cost analysis, but an advisor must also take into account the current value of any guaranteed aspects of the annuity.

Section 1035 Exchanges

Individuals who currently hold a high-cost annuity might benefit by investigating low-cost, no-surrender-charge annuities if they would like to defer the tax bill on any taxable gain in the annuity they currently own. Such a transaction can be done using the tax-free Section 1035 exchange, which allows one to move money from one annuity to another without triggering a tax bill.

AEGON offers an option for a low-cost, no-surrender-charge annuity and provides access to the Dimensional Fund Advisors family of funds. AEGON can work with VA holders who are seeking to escape from their current high costs.

How to Proceed

Individuals who already hold VAs can take the following steps: 1) investigate whether VAs are appropriate within their portfolio and 2) determine whether their existing VAs have reasonable costs and appropriate investment choices. If the VA is inappropriate, then consider liquidating the product or making a 1035 exchange. If the value of the income guarantee is so great relative to the account value that the annuity should be kept, consider choosing the most aggressive investment choices available.

[1] John McCarthy, **Sales Increase as Annuity Industry Consolidation Continues.** *Morningstar,* 2012.

[2] **Variable Annuities: What You Should Know.** *U.S. Securities and Exchange Commission*, April 18, 2011.

[3] Moshe A. Milevsky and Steven E. Posner, **The Titanic Option: Valuation of the Guaranteed Minimum Death Benefit in Variable Annuities and Mutual Funds**. *Journal of Risk and Insurance*, March 2001.

[4] Ibid.

[5] Lisa Gibbs, **Variable Annuities: Buyer Beware.** *Money,* January 23, 2012.

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