



The great annuity rip-off

DO YOU WANT PROOF POSITIVE that investors are irrational? Here it is: Sales of variable annuities went up 16% last year, to \$85 billion.

A variable annuity is a mutual fund-type account wrapped in a thin veneer of insurance that renders the investment earnings tax-deferred.

The tax deferral is just about the only good thing you can say about these investment products. Almost everything else about them is bad: the high -- sometimes outlandishly high -- costs, the lack of liquidity, the fact that the annuity converts low-taxed capital gains into high-taxed ordinary income. That tax deferral comes at a very high price.

The last of those three drawbacks just became bigger. The 1997 tax law cut capital gains tax rates while leaving ordinary income tax rates high. So the benefit of wrapping an annuity around your stock portfolio has just about vanished.

That tax change should have stopped annuity sales cold. The salespeople who push these things should have moved on to products more suitable for their clients, like plain old mutual funds. Shares of the leading variable annuity vendors -- such as Hartford Life, Nationwide Financial Services and SunAmerica -- should have collapsed.

None of these things has happened. Their shares are up 30% and more over the last year. What on earth is going on?

Its the old story: Annuities are sold, not bought. And a good salesman can get a lot of mileage out of the apparent tax advantages of a tax-deferred annuity. This investment product, he will tell you, is like an IRA, except that there is no \$2,000 limit on contributions. You can put in \$1 million if you want. Leave the money in as long as you want. It compounds tax-deferred.

The statement is true, up to a point. But unlike a deductible IRA or a 401(k), which is bought with pretax dollars from your paycheck, a deferred annuity gives you no tax deduction when you buy it.

Nor is an annuity anything like one of those new Roth IRAs. The Roth IRA is tax-exempt (if you meet certain criteria). An annuity is merely tax-deferred -- meaning that you have to reckon with the tax collector someday on your earnings.

In a typical transaction a stockbroker (or financial planner or insurance salesman) persuades you to salt away, say, \$20,000 in an annuity policy that is a mutual fund in all but name. Indeed, the portfolio choices for your account will often be clones of popular mutual funds (like Fidelity Contrafund). Your choice of portfolios is usually wide: stocks, bonds, money markets, foreign securities.

But with an annuity theres an extra layer of fees. In addition to the investment fee on the portfolio theres a "mortality and expense risk" charge, typically 1% or more a year. This covers the cost of the "insurance" you are getting.

Insurance? Its there, a pale imitation of life insurance. The insurance guarantees that when you die, the value of your account will be at least as great as the money you originally put in -- unless you get a contract that steps up the insurance coverage over time, all you are insured for is the starting value. If the account has indeed grown, you still get only the value of the account, no more, no less; the insurance pays nothing. To collect on the insurance, that is, you have to pick a rotten investment -- and then drop dead before the investment recovers. Is that what you had in mind? We doubt it.

What is the actuarial value of that life insurance? (See box, p.109.) It is safe to say that with the vast majority of annuities sold today, almost all the money you are assessed for "mortality and expenses" winds up in either the

salesmans or the insurance companys pocket.

Assuming you dont die, the account accumulates. Say it grows to \$32,000 and you decide to cash out. The \$12,000 increase in value is taxed as ordinary income, at federal rates of up to 41% (taking into account a surcharge that relates to itemized deductions) plus state and local levies; for a New York City taxpayer that can add up to higher than 50%. Thats true even if much of the gain is from stock price appreciation. If those same stocks were held in a mutual fund the price appreciation would be taxed at about half those rates, assuming the fund shares are held for at least 18 months.

Annuities are costly to own. Expenses -- portfolio management fees, plus that "mortality" charge -- average a hefty 2.1% a year. Thats half again what it costs to own the average mutual fund, and ten times what it costs to own the Vanguard Index 500 fund. Surrender charges are common, starting out typically at 7% if you cash out in the first year and declining to 0% in the seventh year. Also, if you cash out before you reach 59 1/2, you have to pay a tax penalty, except under certain narrow circumstances.

There are a handful of exceptions to the rule that annuities are costly. The College Retirement Equities Fund sells very low-cost annuities, but only to schoolteachers and professors in the TIAA-CREF pension system. Vanguard, T. Rowe Price and Jack White sell annuities with no surrender fees and low annual expenses -- but they dont sell very many.

The rest of the business pretty much belongs to people who live on commissions: insurance agents, stockbrokers and commission-paid financial planners. They get a payout of up to 7%, which they share with their firm. Where else can they pocket that kind of money? Not in load mutual funds, where the average commission is something like 4%.

Certainly not in stocks or bonds, where commissions are facing stiff competition. "The salesman has a new hammer, and everybody starts looking like a nail," says Charles Haines, a fee-only financial planner in Birmingham, Ala.

If the terms are so terrible, then why do people buy the salesmans pitch? Because they are mesmerized by the words "tax deferral." Does this sound familiar? A generation ago a different crop of investors was mesmerized by the words "tax shelter" -- and ended up with worthless railcar leases and cattle farms.

But just what is this tax deferral worth? Get out a pencil and do some arithmetic. Say youve got \$20,000 to salt away for retirement in 20 years and you want to put it in stocks. If you own the Vanguard Index 500 fund, most of your return takes the form of unrealized appreciation in the funds shares. You will get income dividends of only 1.5% a year, which will create a tax burden equal to maybe 0.7% of assets annually.

Capital gains payouts on the Vanguard fund have been extremely modest.

When you cash out, the accumulated gain in fund shares is taxed at low capital gains rates.

Now look at the Prudential Discovery Select stock index account. Sure enough, this will spare you the 0.7% tax bill. But at what cost! The annuitys total expenses run 1.8% of assets annually. That is 1.6 percentage points above the cost of the Vanguard fund, more than wiping out your current tax savings.

If this were the end of the matter, the annuity mightnt be too bad.

But now look at what happens when you cash out. Lets assume an average annual return of about 7%; the account quadruples in 20 years, to \$80,000. In the ordinary Vanguard index fund you would have a long-term capital gain of a bit less than \$60,000 (less, because your reinvested dividends get counted in your purchase price). On that you would owe federal tax of \$12,000. At Prudential the whole gain is ordinary income.

Youd owe something close to \$24,000.

The taxable mutual fund has another advantage over the supposedly tax-favored annuity. You could escape the \$12,000 capital-gain tax altogether by either giving the fund shares to charity or leaving them in your estate. No such option is available to an annuity holder.

Transfer or bequeath an annuity to anyone but your spouse and you trigger recognition of the full appreciation as income.

Any prospective customer who takes the time to understand annuities runs away screaming. A recent report by consulting firm Cerulli Associates puts the matter as delicately as it can: "Information about variable annuity purchases reveals that they do not appear to be based on educated decisions."

Consider the experience no-load fund giant T.Rowe Price had when it sent potential customers software to help them determine whether variable annuities were right for them. The program factored in the investors age, income, tax bracket and investment horizon -- and it regularly told potential buyers that they would be better off in a plain old fund. An educated consumer, as it turned out, was not a good prospect for annuities.

If folks really knew what they were buying, how could you explain the \$21 billion of annuities sold in 1996 that went into IRAs? IRAs, already tax-sheltered, benefit not a whit from the annuities deferral feature.

A case can be made for buying one particular kind of variable annuity inside an IRA. This is the kind that converts a lump sum into a monthly payout that lasts only as long as you do; what you are paying for is not a tax shelter, which is already there, but rather an assurance that you wont outlive your capital. But of that \$21 billion worth of IRAannuities sold in 1996, only 1% were these monthly payout contracts.

"This is one of the biggest disgraces in the entire securities industry," fumes investment adviser Joseph Ludwig of Tandem Financial Services, in Canton, Mass. One of the victims: Ludwigs own son-in-law, Barry Joseph. Before marrying, Joseph bought a Metropolitan Life annuity inside his IRA. "I honestly thought I bought a mutual fund," says Joseph. "The salesman never mentioned the word annuity to me."

After Congress lowered the tax rate on capital gains, the annuity industry commissioned a study by Price Waterhouse on the implications. A stunning specimen of spin, the study concluded that the new tax rates would have a negligible impact on the number of years it takes for the benefits of tax deferral to overcome the higher costs of variable annuities relative to mutual funds.

But Patrick Reinkemeyer, editor of Morningstars variable annuity report, says Price Waterhouse made some dubious base assumptions. Among them: that variable annuity investors will be taxed at the rock-bottom 15% federal income tax rate when they withdraw their money in retirement, and that the investments will earn 13.6% per year, the average for mutual funds from 1987 to 1996.

Richard Toolson, an accounting professor at Washington State University, has done his own calculation of break-even points. For someone in the 36% income tax bracket who has to choose between a low- turnover index fund and an annuity portfolio earning the same pretax return, it would take more than 40 years for the annuity to earn back even a low 0.5% mortality charge. Yes, the salesman is right when he says that "annuitizing" your investment when you retire (taking monthly payouts over a long period) keeps the taxman at bay a while longer.

Still, 40 years is a long time.

And a 0.5% fee is not easy to find. The average mortality charge in the annuity industry is 1.3%; with that kind of fee, says Toolson, the annuity buyer never comes out ahead, even if his tax bracket has gone way down by the time he cashes in the annuity. Toolson didnt even figure in the freebie that owners of stocks or fund shares get when they donate or bequeath the property.

Not counting academics lucky enough to be eligible for CREF, is there anybody who in his right mind should even consider owning an annuity?

Glenn Daily, a fee-only insurance consultant in New York City, offers a few examples.

Case one: Someone who owns an underwater cash value life insurance policy. Say you have poured \$100,000 into a universal life policy and it now has a cash value of \$85,000. Insurance policy losses are almost never tax-deductible, but if you transfer the \$85,000 to an annuity, the first \$15,000 of profit you make on the annuity is tax-free.

Case two: a retiree who has just barely enough money to live on and needs one of those monthly payout annuities.

Case three: potential targets of lawsuits. Three-quarters of the states, among them New York, Washington, Florida and Texas, protect assets in variable annuities from creditors, to one degree or another.

Doctors worried about malpractice suits, for example, might do well to stash some money in variable annuities.

If you fall into one of these three categories, look for a no-load annuity (see table, p. 108) and don't pay a penny more than you have to in expenses. What if you've bought a high-cost annuity already and regret it? Cut your losses. Wait until the surrender charge period is over and then roll your account into a no-load, low-expense annuity via a tax-free "Section 1035" exchange.

Sidebars[The performance game](#)[What is this insurance worth?](#)[Imprisoned](#)

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