

The Hidden Risks of Annuities

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Linscomb & Williams

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The Hidden Risks of Annuities

Dismal financial conditions, such as the 2008–09 bear market and the subsequent uncertain economic recovery, often create opportunities for clever marketing strategies designed to capitalize upon investor fears. It is common for the insurance industry and Wall Street investment banks to take advantage of such marketing opportunities. The following is a “pitch” many investors may be hearing:

Let's invest in an account where you have the upside opportunity of the stock market, but you can buy a 'seat belt' to save you from a market crash. If your investments do well, you get the benefit of market growth. If not, you get a minimum 6% return on investment.

The product being described is likely a variable annuity account (with guaranteed living benefits), one of many currently being offered in varying forms by a number of major insurance companies. Based on the sales pitch, it sounds terrific. Too good to be true? The answer is usually yes.

Not every variable annuity contract in the marketplace is a bad deal for the investor, however. There are some investor-friendly, straightforward low-load annuity products (typically offered through companies such as Fidelity, Schwab, T. Rowe Price and Vanguard) that deliver good value. However, the annuity contracts being heavily promoted in the current market are quite different. Members of the professional staff at Linscomb & Williams have provided expert witness testimony in variable annuity litigation, providing an excellent opportunity to fully dissect these contracts.

Below is a summary of some of the drawbacks likely to be excluded during such a sales presentation:

- These annuity contracts are burdened with extremely high annual costs. Without careful study of the prospectus, it is difficult to uncover and understand these costs. However, total contract expenses of 3.0% to more than 3.5% per year are not uncommon. Total expense loads in some contracts we have examined exceed 4.0% per annum. (Conventional mutual portfolios and low-load variable annuity portfolios typically have total expenses amounting to less than 1% per year.) Given long-term returns in the stock market of 9–10% per year (before expenses), any investment arrangement where an insurance company extracts in expenses the first 3–4% per year will be hard pressed to earn an average return for the client of more than 5–6% per year even if the market performs well.
- Once purchased, these contracts can be painful to liquidate if one experiences a change of mind about the merits. Most variable annuities have surrender penalties in the early years if the client decides to invest elsewhere. The penalties for early surrender can be as high as 8% of the amount withdrawn and can last up to seven years. These early withdrawal penalties are an economic necessity for the insurance company, which has often advanced selling commissions of as much as 5–10% of the front-end invested capital to the selling brokerage firm and representatives.

- The purported tax-deferral advantages of variable annuities are typically over-stated in most selling presentations. Often, because of overly simplistic assumptions made in comparative analyses, the benefit an investor can expect from tax deferral is inflated beyond what is likely under realistic assumptions about tax rates before and after retirement, tax categorization of actual returns, and timing of recognition of income and gains.
- The guaranteed minimum “return” of some amount (such as 6%) is not actually an investment return. Rather, it is typically a contract provision that allows you to withdraw this percentage from your account without payment of an early surrender penalty. The cash you are withdrawing would hopefully be covered by your investment earnings, but if necessary, it comes out of your original invested principal. The only “guarantee” is that if you reduce or exhaust your portfolio value, you can continue receiving the withdrawal rate in some form (guaranteed by the insurance company) or that your original investment amount can be applied to purchase a lifetime annuity contract from the insurance company so that you continue to receive some amount of money every month for as long as you live. The amount of this monthly income depends on your age and the insurance company’s guaranteed annuity conversion rates in the contract.
- Unfortunately, the guaranteed annuity conversion rates used in these contracts are typically uncompetitive. That is, if you were shopping annuity purchase rates among a number of companies, you might find rates almost twice as attractive as those in these contracts. In short, the annuity you can purchase with your “guaranteed account” is probably not one you would ever choose to buy if given the choice. The client availing himself of this guaranteed annuity purchase option often feels like the car buyer who has been grossly overcharged by a dealer who brags about the generous trade-in allowance. A raw deal is a raw deal.

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The High-Cost Burden

In her article, “The Worst Retirement Investment You Can Make”, Liz Pulliam Weston¹, personal finance writer and winner of the 2007 Clarion Award for Online Journalism wrote: “The typical annuity with just a death benefit costs 50% to 100% more in annual fees than comparable mutual funds. Life benefits can add 20% or more to that cost.”



Weston goes on to point out that annuities are rarely touted as investment vehicles by fee-only financial advisers who are selecting investments for clients without the commission conflict:

“Some of most vociferous critics of variable annuities are those who spent some time in the brokerage firms or insurance companies that push them. Before he became a fee-only planner, Rob Pool of Portland, Ore., worked for a major brokerage firm, and the experience made him wary of the way annuities are sold. ‘They'd get recommended even if it wasn't in the client's best interest all the time,’ Pool said. ‘I can't say there's never a place for a variable annuity in a portfolio, but I haven't found it yet.’”

Linscomb & Williams recently prepared an historical simulation version of a Monte Carlo² financial model for a 58-year-old client to illustrate the effects of these cost differences on long-term outcomes. He desired to understand the difference in how he might fare over a 32-year period of retirement from age 58 to 90, with his starting investment of \$4 million. The two metrics he cared about: “How much cash do I get while I’m living, and how much is left when I die?”

For this particular client, the asset allocation policy was assumed to be 70% equity investments and 30% bonds and cash. Our analysis evaluated the outcome for the client in terms of annual cash income and ending value at life expectancy. We compared a popular version of the high-expense variable annuity contract (with a “guaranteed withdrawal benefit” feature) to an investment in a similarly allocated portfolio of a popular competitive low-load annuity offered by Vanguard without the excessive expenses.

We compared the two approaches in three historical periods: a bull market (starting 1975), moderate-return periods (starting 1951), and severe downturn (starting 1929). The results of the analysis are below. In the Good and Moderate environments, the client fares *significantly better* without purchasing all of the expensive insurance guarantees. Only in the Severe period (such as the Great Depression, where the stock market declined 75% in the first 39 months) is this not the case. Surprisingly, the advantage offered by these guarantees even in a severe economic downturn is what some would consider marginal.

Period	Wdrwls Over 32 Yrs High Cost Approach	Wdrwls Over 32 Yrs Low Cost Approach	Value Remaining Age 90 – High Cost	Value Remaining Age 90 – Low Cost
Good – start 1975	\$16,633,932	\$14,400,000	\$0	\$22,349,424
Moderate - start 1951	\$7,938,960	\$7,840,000	\$0	\$10,382,786
Severe - start 1929	\$6,428,000	\$4,950,000	\$0	\$0

Rich White, former editor of *Financial Planning Magazine* and author of several books, summarizes the cost/benefit trade-off associated with these guaranteed benefits this way: “Let's begin with a caveat, which is to disregard the sales hype often used to sell these riders. It goes like this: ‘When you add a seatbelt feature to your VA, you can participate in the stock market without risking your retirement security. If the market declines, rest assured that your GMWB (or GMIB) will rescue you from losses.’”

Such a claim can be misleading...the seat belt analogy is full of holes as only very specific situations will allow buyers to gain such a high level of protection. Because sales of living benefit riders are profitable for insurance companies and generate commissions for agents, consumers should try to dig deeper and learn the truth.”

The Surrender Charge Trap

All variable annuities which pay front-end commissions to selling brokers must levy a schedule of surrender charges against investors who decide to withdraw all or a significant portion of their invested capital within the first six to eight years (the surrender period). In most cases, a significant portion is likely to be defined as any amount exceeding about 6–10% of the original investment for each year during the surrender period.

Representatives selling these contracts may describe these charges as having a purpose of discouraging “short-term investment decisions”. In actuality, these charges are designed to reimburse the insurance company for the money paid to the selling agent at the commencement of the contract, since the insurance company intended to recover this cost in its management fees that would be assessed on the contract during the first five to ten years. If investors withdraw capital earlier, the insurance company loses those expected management fees that otherwise would have reimbursed this front-end commission cost.

The investor protection Web site³ managed by the U.S. Securities and Exchange Commission points this out in its education piece on variable annuities: “If you withdraw money from a variable annuity within a certain period after a purchase payment (typically within six to eight years, but sometimes as long as ten years), the insurance company usually will assess a “surrender” charge, which is a type of sales charge. This charge is used to pay your financial professional a commission for selling the variable annuity to you.”

A few variable annuities do not levy a surrender charge (contracts offered by no-load providers like Schwab, Fidelity, and Vanguard). These contracts do not pay the large front-end commissions to selling representatives. Hence, there is no economic need for the surrender charges in these contracts.

Most importantly, surrender charges limit the flexibility of investors compared to most every other type of marketable security. Changes in circumstances, tax position, or investment objectives can all create legitimate needs to alter one’s course and might suggest termination of a variable annuity contract within the first few years. If surrender charges are in place, they will impose what amounts to a “financial fine” on one’s decision to alter course.



Many investors do not understand their marginal tax bracket, nor do they realize how few taxpayers are actually paying taxes at the highest marginal rate of 35%.

Tax Advantages or Tax Detriments?

A quick review of almost any of the variable annuity marketing Web sites will make clear that one of the most touted marketing advantages of a variable annuity is the tax-deferral treatment of accumulated investment earnings over time. Without going into detail, the basic premise is: avoid tax on your investment earnings during your working years (while your tax bracket is high) and recognize the accumulated taxable income during retirement when you draw out the funds (and your tax bracket is presumably lower).

Most analyses of the advantage of tax deferral are somewhat simplistic. They compare two alternative courses of action: investing in a variable annuity at one rate of interest on which taxes are not deducted versus investing in a fully taxable ordinary income (bank) type of account at the same rate of interest where taxes are removed at the highest marginal income tax rate. The comparison often makes its conclusion based on how much money has been accumulated at the point that retirement (and withdrawals) is commencing.

These simplistic analyses are deficient in a number of respects:

- The analysis often assumes that taxes during the working years are being paid at the highest marginal income tax rate (35% at the time of this writing). Many investors do not understand their marginal tax bracket, nor do they realize how few taxpayers are actually paying taxes at the highest marginal rate of 35%. For a married couple, taxable income (after subtracting all deductions and exemptions) must exceed \$350,000 before the taxpayer even begins paying tax at 35%. For obvious reasons, the advantages of deferring taxes through investment in a variable annuity will be overstated in an illustration if the actual investor is in one of the lower marginal tax brackets: 15%, 25% or 30%.
- Many analyses we have reviewed which analyze the financial advantages of tax deferral draw their conclusions based on how much is accumulated at the point retirement (and withdrawals) commence. For obvious reasons, this is like trying to determine the winner of a baseball game at the end of the 5th inning. During the drawdown phase, the alternative (after-tax) investment will draw down at a lower tax cost than the variable annuity (for which all accumulated income will draw down as fully taxable, ordinary income). For any analysis to be credible, it needs to be extended through the drawdown phase when all monies have been removed from both investments being compared.

- The most significant deficiency in the majority of the analyses of variable annuity tax deferral advantage is that no account is taken of how taxes are actually paid on a comparable non-variable annuity investment medium that would typically be used as a retirement accumulation and distribution vehicle. Most variable annuity investors are in fact choosing to allocate their capital among a number of investment fund options within the variable annuity contract. The most comparable strategy for investing outside the variable annuity would be an allocation of their investment capital among a number of mutual fund investment options of similar risk/return profile to those offered within the annuity contract. Investors in mutual fund portfolios are not reporting their investment gains every year as ordinary income fully subject to taxes. Instead, they typically realize their gains in three components: ordinary income (taxable in full as received), long-term capital gain (taxable at lower rates), and unrealized capital gain (not taxable until later when sold, i.e., deferred). Depending on the type of investment medium used, most of the accumulated return may fall under the third category which is tax-deferred. Moreover, as investment gains are drawn down later, much of the accumulated gain that has not yet been taxed will be taxed at preferred capital gains tax rates, not as ordinary income. We have seen no analysis on the popular Web sites of tax deferral advantages on annuities that take these real life tax realities into account.

Return ON Capital or Return OF Capital: Is the guaranteed return a “floor” or a “ceiling”?

The essential perception of most buyers of the Guaranteed Minimum Withdrawal Benefit variable annuity contracts is that there is some “floor” of annual investment return to protect them. This is a perception that is advantageous for the insurance providers to allow to be created even though it is a fiction.

- The “no worse than” return of 6% is not an investment return at all. Rather it is termed something such as a “guaranteed minimum withdrawal benefit” and is simply an amount that can be withdrawn from your account value each year with no penalty. If a client sticks with a plan of withdrawing no more than this percentage, his “guarantee” is that if his contract runs out of money, the insurance company will begin paying an annuity payment to him for his lifetime. Assuming he has been withdrawing each year, the continuing payments will be calculated typically in one of two ways. In some cases, the insurance company will simply guarantee that the client may continue making withdrawals as long as they live off the same annual amount that was being taken before the portfolio was exhausted. In other cases, the insurance company will provide the client with a life annuity. The amount of the annuity will be calculated using the insurance company’s guaranteed rates as though his original investment amount was being used to purchase the annuity. So why is this not a “guaranteed 6% return”? Let’s take each of the two methods in turn.
- The first catch: If you invest \$500,000 at age 55 and withdraw 6% per year (\$30,000) for 30 years until age 85, and then have nothing left, you have not received a 6% return. You have received a return of 4.31%. This is simple math, as part of what you received back over the 30 years was your original \$500,000 invested.



- The second catch: Assume you invest \$500,000 at 55 and withdraw \$30,000 per year for a number of years until the money is gone. Then the insurance company offers you a lifetime annuity purchased with \$500,000. This sounds good. Here is the real catch. The annuity conversion rates for calculating this guaranteed annuity benefit in the contract are very uncompetitive—in some cases about one-half of what one would find available in the open market if going out to purchase a new annuity. Some examples from products offered today:

Conversion Age	Purchase Amount	Company	Guaranteed Annuity	Open Market Annuity*
77 (M)	\$504,532	ABC	\$32,290	\$62,616
85 (M)	\$753,128	ABC	\$62,811	\$129,612
77 / 75	\$1,402,552	XYZ	\$84,153	\$129,228

* Estimate from www.immediateannuities.com

- In reality, at the end of the day, an investor’s true return will depend almost entirely upon the investment market environment over the years the contract is owned. Historical simulations illustrate that because of the very high expenses, in all but extreme bull market environments (ex: 1975-1999), returns on a balanced investment allocation (60% stocks and 40% bonds) are likely to be 3.5% to 6.0% per annum.
- L&W prepared an analysis for a client who was considering one of the contracts being marketed heavily today. In 55 historical simulations of every 25-year historical period from 1928 through 1983, there were only 3 times (out of 55) a contract of this nature out-performed the identical investment portfolio structured within a contractual arrangement with reasonable investment expenses (a no-load, low expense variable annuity).

Conclusion

Our research suggests that in order to overcome the extremely high expenses associated with Variable Annuity contracts, one must have the good fortune to invest precisely at a market bottom preceding a long bull market (a period such as 1/1/1975 to 12/31/1999). In such a period, it may indeed be possible to earn a 10% compounded return after deducting the costs of the guarantees. We should note, however, that investing in competitively priced financial offerings during the same period would have resulted in significantly higher returns than 10% per annum, and more in the range of 13-14%. Nonetheless, in virtually every other similar-length period, one’s net return after expenses is likely to be at or below the guaranteed return of 5% or 6% described as the “floor”. Six percent is definitely not the floor, and more likely represents the ceiling. Our recommendation to someone who is approached with such a product would be to thoroughly read the contract and to fully understand the terms set forth before signing it. One would be wise to closely examine any language in the contract covering annual costs, surrender penalties, tax-deferral advantages and any guaranteed “returns”.

Helpful Web Sites / Articles

www.annuityfyi.com

www.ehow.com/variable-annuity

www.seniormarketadvisor.com

Variable Annuities – What You Should Know

<http://www.sec.gov/investor/pubs/varannty.htm>

How to Research Variable Annuity Expenses

http://www.ehow.com/how_4806197_research-variable-annuity-expenses.html

Variable Annuities? Don't bother

<http://articles.moneycentral.msn.com/RetirementandWills> (Type "Variable Annuities" in the search box.)

Footnotes

¹Liz Pulliam Weston is a columnist for *MSN Money* and author of the question-and-answer column *Money Talk*, which appears regularly in national newspapers. She appears weekly on CNBC's *Power Lunch* and regularly on other television programs, including NBC's *Early Today*, to discuss credit and other personal finance issues. She was part of the *Los Angeles Times* reporting team that earned a Pulitzer Prize for its coverage of alcoholism amongst Alaska natives. Pulliam Weston is a graduate of the certified financial planner training program at University of California, Irvine.

²Named after the city in Monaco where the primary attractions are casinos offering games of chance, the Monte Carlo method of financial analysis uses random variables to approximate the probability of certain outcomes by running multiple trial runs, or *simulations*. Running multiple trials allows analysts to define all potential outcomes of an investment and to create a probability distribution, or *risk assessment*, for that investment. By comparing results against risk tolerances, investment managers can then determine how to proceed with certain investments.

³The investor protection Web site managed by the US Securities & Exchange Commission can be found at: <http://investor.gov>. To read the article cited on variable annuities, go to: <http://investor.gov/variable-annuity-charges>.



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