# DON'T BE VICTIMIZED BY VARIABLE ANNUITIES

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Because of endless abuses, the nation's securities cops have proposed tightening the rules regulating annuity sales. But you can't expect the industry to clean up their act without a fight. The insurance lobby will keep this popular vehicle alive and breathing at all costs. The commissions that insurance agents and securities brokers receive for selling these vehicles are just to wonderful to resist. The commission received on the sale of a variable annuity is likened to the length of the surrender period. In other words, if the surrender period is 9 years (the average) the commission paid is approximately 9%. However, surrender periods can extend out to 15 years, and yes, the commission earned by the agent is between 13% and 15%!

You need to understand the moving parts of the variable annuity to protect yourself from purchasing this popular product when its unnecessary. A variable annuity is an "uninsured" securities/insurance product that provides investment options, much like mutual funds, for long term investors, who want an extra way to save for retirement. Further, these investment options (sub-accounts) are packaged within a variable annuity on a tax-deferred basis.

Variable annuities are strictly supplemental retirement investments. You should never buy one unless you can answer "yes" to these three questions"

1. Do you max out your 401-K or other workplace retirement plan every year?

2. Do you contribute the maximum each year to an Individual Retirement Account (IRA)?

3. If married, does your spouse take full advantage of items one and two, above?

A married couple in their 50's with his-and-her IRA's and 401-K's could theoretically put up to $39,000 into their retirement accounts this year without ever needing a variable annuity. And even then, tax efficient mutual funds would be a far better place for our financial over-achievers to accumulate their overflow of cash.

Variable annuities simply cost too much. Because annuities are primarily insurance products, their fees typically dwarf those charged by mutual funds. This is simple to understand when you realize there are two players involved instead of one.....the insurance company and the mutual fund company. According to Morningstar, the average variable annuity passes along expenses of 2.2 percent of the assets per year. This percentage probably won't mean much to you unless you realize how such a large fee can drain the momentum out or a portfolio. Lets suppose, for example, that you invested $3,000 a year in a typical variable annuity that generates a yearly 8 percent return before expenses. At the end of a 25-year period, your annuity would have grown to $168,012. But guess what happened if you had put that money into tax-efficient index mutual funds, charging as low as 0.2 percent in yearly expenses. You'd have every right to look smug. The index fund would be worth $230,172. That's a difference of $69,160!

Variable annuities can be taxing. Salesmen love to boast that you won't pay taxes on the money that's growing inside an annuity, because its "tax deferred". That's true, but its only half the story. You'll owe ordinary income taxes on every dollar of annuity withdrawals. This might not seem so bad until you appreciate what would happen if you had invested the same money in stocks or mutual funds in a plain old taxable account. These withdrawals would be taxed at long-term capital gains rates, which is only 15%. So lets say you're in a 35% ordinary income tax bracket and you've got a variable annuity. You'd pay $350 in taxes for every $1,000 you pull out. In contrast, if you'd kept this money in a taxable account, you'd pay no more than $150 for every $1.000 withdrawal. Extending this a bit, an investor cashing out a $100,000 annuity would pay $35,000 in taxes vs. $15,000 in a taxable account. So it is likely that investors buying variable annuities will actually end up paying more in taxes and having less after-tax wealth at retirement. In fact, the tax deferral feature of annuities actually *harms* investors who hold mostly equities in their sub-accounts. If these investors are not told that they are being tax-disadvantaged by this tax deferral feature, then their brokers are making material misrepresentations and omissions.

Further, the tax disadvantage won't die when you do. It can hurt your heirs. That's because your beneficiaries will be saddled with paying capital-gains tax on any profit your annuity generated. If your original $50,000 annuity grew to $75,000, your heirs would owe tax on the $25,000 profit. In contrast, if you had placed your money in taxable mutual funds, because of the step-up in basis, your kids would get that $25,000 tax free.

The death benefit of the variable annuity is always the sounding cry of those that believe wholeheartedly in this questionable product. This death benefit becomes their crutch when all other arguments fall. Here is one of the insurance industry's dirtiest secrets: The variable annuity's death benefit is often pointless or superfluous. It's the death benefit, however, that promoters love to stress to conservative investors. With a variable annuity, an insurer guarantees that heirs will receive at least the contributions made into the annuity, less any withdrawals, even if the account later drops in value. So, if you invest $100,000 in an annuity and the account is worth only $80,000 when you die, your heirs still receive $100,000. But remember that this variable annuity is supposed to be a long term investment. What is the likelihood of an annuity with diversified sub-accounts that you start in 2004 being worth less, 20 years later? And if you aren't willing to make that kind of lengthy time commitment, don't even think about a variable annuity. There is extensive scientific literature which values the guaranteed minimum death benefit (GMDB) based on the expected returns and variances of alternative sub-accounts and on actuarial estimates of remaining life expectancy. This literature establishes the value of the GMDB at only five or ten basis points per year. (the higher value of 10 basis points occurs when the GMDB guarantees to pay the net investment increased by a fixed percent per year with the guarantee capped at twice the value of the net investment). Therefore, while the GMDB is worth only 10 basis points or less, the

Mortality and Expense charged by the insurance company (M&E) is usually greater than one hundred basis points and is invariant to factors which affect mortality risk. The M&E charge is equivalent to the 12b-1 fees of 1.00% assessed in Class "B" mutual fund companies used to fund substantial upfront commissions paid to brokers who sell the investments. (See comparison of variable annuities to Class "B" mutual funds below).

This dubious insurance death benefit is costing people big dollars. Clearly, the insurance industry is charging 5 - 10 times the economic value of the guarantee. A study by researchers at York University in Canada and Goldman Sachs a few years age suggested that the insurance fee that's embedded in variable annuities is way out of proportion with what it's worth. A typical life insurance charge is 1.25% (although it can run as high as 1.60%) which would work out to a cost of $3,125.00 per year for a $250,000 annuity. Using the study's conclusions, a fair and normal death benefit charge for $250,000 of life insurance would be only $570.00 annually (20 years) for a male age 50 and $398.00 per year for a female the same age and term. Brokers sell variable annuities in part based on a claimed death benefit. This benefit is miniscule and so any such sales claims which are not tempered with realistic assessments of the true value of the death benefit are materially misleading.

But you can bail out. If you're trapped in a poorly performing variable annuity, look for the escape hatch. Its possible to transfer your money directly to another annuity company without triggering taxes through a vehicle called a 1035 tax-free exchange. You may, however, have to pay surrender charges. But beware of brokers and insurance agents eager to switch your cash from one annuity to another. Investors get transferred from one mediocre variable annuity to another many times because brokers receive those healthy commissions every time they persuade someone to switch.

Finally, run, that's right run, if anybody approaches you and offers a variable annuity in one of the following manners:

1. Put a variable annuity in your IRA. Remember, your IRA is already tax sheltered. The variable annuity's tax advantages are wasted within an IRA. A mutual fund is much more liquid and cost effective without any of the disadvantages stated above. If you need life insurance, pure term insurance is a much cheaper bet and can easily be paid for out of the cost savings of a mutual fund over the variable annuity, often at least 1.20%, annually (V/A - 2.20% v. M/F - 1.00%).

2. Take out a mortgage or equity loan on your residence to buy a variable annuity. Plenty of gullible people have done just that - which is one reason regulators are once again wagging their fingers at the dishonest salespeople who insist on peddling variable annuities to the unsuspecting.

3. You are solicited with a variable annuity that contains a bonus for you to come aboard and replace now, often to offset the surrender charge of an existing annuity. Don't be fooled! That bonus will cost you in terms of higher annual costs and/or a

lengthened surrender period. And of course, that increases the commissions paid to the broker who sells it to you.

4. You are approached by the aggressive salesperson that offers a "new" kind of variable annuity that contains a stepped-up death benefit or a guaranteed income benefit. That stepped-up death benefit is an additional rider and usually costs more than it's worth for a long term investment vehicle. The guaranteed income benefit is usually only available if you annuitize the insurance contract, i.e. surrender it to the insurance company in exchange for a stream of lifetime income payments. Historically, *about 2% of variable annuities are annuitized.* Losing control of your money is never a good idea and if that's the only way you can get a guaranteed income benefit, that's a bad idea! This is because by the time you need those income payments, you won't live long enough to use that portion of income that was guaranteed. Rather, buy a tax-efficient mutual mutual fund and take regular systematic withdrawals, while you keep the asset under your own "control" at all times.

5. Someone approaches you on the basis that the variable annuity is a "no load" product. While it is true that the insurance company "advances" the commission to the salesperson soliciting you, you pay dearly for that feature. If you cash in early, the insurance company is reimbursed by charging you a lengthy surrender charge of up to 9%. It declines each year, reducing their exposure because of the time value of money. If you hold and get out later, the insurance company is reimbursed for their commission advance by charging you an extra 1.25% (average) each year in expenses. Either way, you can be sure that they get it back and you face illiquidity and are charged exorbitantly for the "privilege" of owning this product, structured much like a tax-deferred Class "B" mutual fund in disguise. (See the chart below for a true comparison).

6. Your under 59 1/2 and retire early or get laid off by your employer, and you transfer your 401-K into a Rollover IRA. The salesperson tells you all you have to do is buy a variable annuity and you can take systematic regular withdrawals from your IRA on a monthly basis without federal or state early withdrawal penalties. You see, the Internal Revenue Code generally provides that early withdrawals (if they are "substantially equal periodic payments") from an IRA prior to age 59 1/2 will avoid a 10% tax penalty (and the state penalty) if the early withdrawals are calculated under one of three formulas allowed by the Internal Revenue Service *IRC #72 (t) (2)(A)(iv): Notice 89-25, 1989-1 C.B. 662, Q&A 12.*

Most salespeople refer to this procedure as 72-T! Note the difference between a tax penalty and tax on withdrawals. While the penalties are eliminated, ordinary income tax on the IRA withdrawals are not. One of these three methods is known as the "annuitization method," which allows for computing the withdrawals by dividing the account balance by an annuity factor and using an interest rate "that does not exceed a reasonable interest rate on the date payments commence." *Notice 89-25, Q&A 12.* This method allows for the largest of the three methods of withdrawal and essentially the method will calculate substantially equal payments over the participant's life expectancy, taking into account a rate of return not to exceed a reasonable interest rate. The IRC requires that substantially equal payments must continue for a period of at least 5 years or until the participant attains the age of 59 1/2, whichever is longer. *IRC 72 (t)(4).* However, this warning appears in Tax Management Portfolios U.S. Income Series Compensation Planning series 355-5th; IRA's, Sep's and Simple's at III.D.2.b.3. "The use of the fixed amortization or fixed annuitization methods described above results in a fixed amount that must be distributed and may result in premature depletion of the taxpayer's account due to a decline in the market value of assets in the account."

**The big question is this! Did you need a variable annuity to accomplish these withdrawals without tax penalty! Not at all. You already had an IRA so a simple mutual fund would work perfectly at substantially less cost. Nothing in the tax code even mentions a variable annuity as a means of accomplishing this! Only the salesperson does. Further, to make it worse, many salespeople will stretch the limit of the "reasonable" withdrawal by making it so high that it could put your entire IRA into jeopardy. These practices represent both a material omission as well as a material misrepresentation which to my mind, become fraudulent acts in the securities industry.**

Finally, after all is said and done, the only real "guarantee" the variable annuity offers you, is one you have to die to get. One would be smart to usually avoid this unfortunate "uninsured" product at all costs. However, if you and your spouse have maxed out on your 401-K's and fully contributed to both IRA's and still need some tax deferral, explore variable annuities offered directly by firms such as Vanguard (M&E charge - 25 basis points or .25% annually), Charles Schwab, Fidelity (M&E charge - 75 basis points or .75% annually), T. Rowe Price (M&E charge - .55% or 55 basis points annually) and TIAA-CREF (M&E charge - 7 basis points annually) These companies try to keep the costs down to a more affordable level. Further, if you can't get insurance any other way due to health problems, and have maxed out as described above, then a low cost variable annuity may be appropriate. Further, look for some of the new variable annuities that use Exchange Traded Funds (ETF's) for the sub-accounts instead of mutual funds to dramatically lower management costs. Finally, always consider using a laddering strategy for annuity sales over $100,000. By combining different companies and different types of annuities i.e. fixed and index (principal is guaranteed in these products), this strategy can provide clients with the flexibility of both income distribution and asset accumulation (be sure the contract can be annuitized, free of surrender charges, after one year).

However, even with low cost variable annuities, one must compare the possibility of investment losses to a low cost mutual fund. The fact is, the possibility of investment loss endows the holder of the mutual fund with a *real tax option* to harvest those losses. The strategic investor can re-establish a similar position at a lower tax-basis, and deduct any current losses against comparable gains. *De facto*, this creates a tax refund, which supplements the return from the mutual fund. Indeed the recent market decline during the 2000-2001 period has generated much tax-loss selling activity. This type of strategy cannot be easily employed within a variable annuity. Since, despite the favorable ordinary income treatment on losses, which can be netted against ordinary interest gains, lapsing or selling, the variable annuity will most likely induce surrender charges on the order of 5-10%. How does the low cost mutual fund (with the real tax option) compare to the low cost variable annuity? It can take as long as 35 years for the investment in the variable annuity to outperform the investment in the mutual fund when the real tax option *is* utilized. If we compare the two after taxes, the investment horizon needed for the mean of after-tax wealth from the variable annuity to be greater than the mutual fund with the real tax option to be at least 14 years. Even with low-cost variable annuities, with insurance expenses lower than 10 basis points, it still takes 10 years for that variable annuity to outpace the results of a low cost mutual fund. What if we compare the two on a risk-adjusted basis? With the average cost variable annuity with 125 basis points of insurance expenses, the risk-adjusted break-even horizon can be as high as 30 years (the higher the standard deviation of the gross return, the longer the horizon needed for the variable annuity to outperform the mutual fund).

CLASS "B" MUTUAL FUND v VARIABLE ANNUITY

(A COMPARISON)

| | Class "B" Mutual Fund | Tax-Deferred Variable Annuity |
|---|---|---|
| **SIMILARITIES** | | |
| Multiple Investment Choices | Yes | Yes |
| Prospectus to be given at time of sale | Yes | Yes |
| Diversification (Cash/Stocks/Bonds) | Multiple Funds per family | Multiple Sub-Accts. per sponsor |
| Maintain as Accumulation Vehicle | Yes | Yes |
| Breakpoints Available | No | No |
| Systematic Withdrawal | | |
| Available or (IRC 72-T) | Yes | Yes |
| Front-End Load Pd. by Customer | No | No |
| Comm. Pd. by Sponsor (Gen'lly = to Surr. Pd). | Yes (4 – 6%) | Yes (6 – 10%+) |

| | | |
|---|---|---|
| Surrender Chg./Early Withdrawal | Yes | Yes (10% Free) |
| Higher Mgmt. Exp. Than "A" Shs. **+Mortality Exp.** | Yes **(+1.00 – 1.75%)** | Yes **(+1.50 – 2.25%)** |
| Pays 12b-1 fees/Annual Trails | Yes | Yes |
| Mortality and Expense Charge | Yes, 1.00% in the form of a 12b-1 fee/yr. | Yes, Average 1.25%/yr. |
| **DIFFERENCES** | | |
| Surrender Period | 5 - 8 Yrs. | 6 -15 Yrs. |
| Taxable Distributions (Payout) | Yes (Long-Term Cap. Gain) | Not Currently – (Ordinary Income upon withdrawal) |
| Converts to "A" Shs. after Surrender Period | Yes (6-8 yrs.) | No |
| 1st Year Cust. Bonus Avail. (Add'l Cost and Longer Surr. Pd .) | No | Yes |
| Principal & Inc.Guar. (Annuitize + Inc. Cost and Longer Surr. Pd.) | No | Yes |
| Life Ins. Guarantee Benefit Avail. (Greater of Mkt. Val. or Basis) | No | Yes |
| Customer can Annuitize (Surr. For Stream of Income Payments) | No | Yes |

Securities regulators in Massachusetts are questioning fifteen financial firms, including some of the largest brokerage firms, regarding the suitability of variable annuities for clients age 75 and older. These individuals are known as super seniors. Other regulators also have placed a spotlight on the sale of variable annuities. A joint report that the SEC and the NASD issued in 2004 highlighted numerous abuses, such as excessive switching of policies, failure to disclose material facts and unsuitable sales.

But the Massachusetts inquiry is notable because of its bright-line test - sales to anyone age 75 or older. Massachusetts Secretary of State Galvin has identified "unethical or dishonest conduct" for "systematically targeting" senior citizens, particularly as their CD's mature. Galvin correctly has said, "This is a form of elder abuse if I ever saw it. "Variable annuities are uninsured (no guarantee of principal), bear market risk, carry high fees and impose surrender charges as high as 7% for early withdrawals".

The investigation is "snowballing", and now includes large brokerage firms such as Morgan Stanley, UBS, Merrill Lynch, Wachovia Securities and American Express. Banking firms include Citizens Financial Group, Sovereign Bancorp and FleetBoston Financial Corp., now owned by Bank of America Corp.

Then, the underbelly of variable annuity sales again was exposed, this time by Waddell & Reed's $16 million fine for wrongfully switching its customers' variable annuities. Quite simply, Waddell & Reed placed its financial interests ahead of its customers' well-being when, in 2001 and 2002, it switched about 5000 customers out of their United Investors Life Insurance contracts and into Nationwide Insurance Company contracts. Why?

Nationwide Insurance Company had agreed to pay Waddell & Reed fees in a fee-sharing agreement that would benefit the company's brokers and its bottom line. As Mary Schapiro of the NASD stated, "What was most troubling about the case is what a concerted effort and aggressive campaign it was on the part of the company. There was little regard given to whether this was good for investors."

Despite proclaiming its innocence months ago and promising a vigorous defense, Waddell & Reed now has agreed to pay as much as $11 million in restitution to customers. The firm also will pay a $5 million fine to the NASD and a $2 million fine to state regulators. The variable annuity switches cost Waddell's customers almost $10 million in surrender charges (fees paid to exit a variable annuity early). Thankfully, the NASD also sent a message to executives. Waddell & Reed's former president, Robert Hecher, was suspended for six months and fined $150,000. Waddell's former national sales manager (now senior vice president for public affairs), Robert Williams received the same sanction.