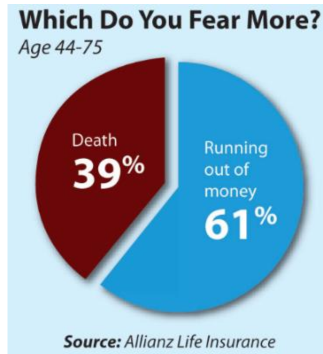
# 7 Reasons Why Variable Annuities are Horrible for your 403(b) or 457 Retirement Account.

Red Paper

## Introduction




Every day you read in the headlines that people aren't saving enough for retirement. Do you know that the biggest fear for people is running out of money? Can you believe that people fear running out of money more than death?

If you have been or are thinking about contributing to your 403(b) or 457 retirement plan, that's a great start and you should commend yourself. But saving is only part of what you need to do. The other part is to make sure you are contributing to the best possible investments available in the plan. Why trouble with being a diligent saver and contributing to your retirement plan only to have the investments work against you and not for you? Don't you want the best outcome for your hard-earned retirement?

This Red Paper will explain the 7 reasons why a variable annuity is a horrible investment for your 403(b) or 457 retirement account. In fact, they are so bad for your retirement that the SEC published their concerns and cautioned investors on variable annuities.

## What's a Variable Annuity?

Variable annuity products provide investment as well as insurance features. Insurance companies that sponsor variable annuities position your money in segregated asset accounts called "separate accounts" and then invest your money in underlying securities or mutual funds. These underlying investments are subject to market risks. During the savings, or "accumulation" phase, your investments grow tax-free (really, tax-deferred). At retirement, you can "annuitize" the accumulated funds to receive a stream of payments for a guaranteed period, such as 20 years, or until death. When the money is withdrawn, your investment gains are taxed as ordinary income (end of tax deferral period).

Variable annuities also provide a death benefit which guarantees that if you die before retirement your beneficiaries will receive the original investment or accumulated value, whichever is greater. An insurance policy covers the guaranteed death benefit plus the rates of return and expense ratios that will be used in calculating your future annuity payments.

## Why are Variable Annuities Horrible for Your 403(b) or 457 Retirement Account?

There are 7 reasons why variable annuities are a bad idea for your qualified 403(b) or 457 retirement account.

### 1. No Tax Benefit

Your 403(b) or 457 retirement account is a vehicle for you to invest tax-free (deferred) for retirement. Consequently, any tax benefit that variable annuities offer is completely worthless and provides no tax relief beyond what the plan does itself. Critics cite these worthless tax benefits as proof that variable annuity sellers are more interested in a sale than in making investment recommendations that are suitable for your retirement.

### 2. Charge High Fees

Variable annuities are expensive. According to a recent Investment Company Institute study conducted in 2017, the simple average expense ratio (includes investment management and transaction fees) of equity mutual funds was 1.28 percent in 2016. Variable annuities charge, on average, an additional 1.25 percent to 1.7 percent for the death benefit and administrative expenses on top of the mutual fund expenses. Consequently, the total cost of a variable annuity is in the range of 2.5 percent to 3 percent a year!

### 3. Lackluster Performance

There are two issues that negatively impact the performance of a variable annuity. Some insurance companies promote their own mutual funds or investment accounts in variable annuities. The mutual funds that they use tend to be mutual funds that are underperforming or don't have a lot of assets in them. So, they use these funds to create another income stream for the company. Good for the insurance company and bad for you since it often leads to lackluster investment performance. Additionally, with the total costs of variable annuities hovering in the 2.5 percent to 3 percent range per year, the added costs make it difficult to achieve a decent return on your investments.

Have you heard of an investment that will guarantee a 5, 6, or even 7 percent return, and can return more if the market performs well? Actually, these claims are very common in the variable annuity world. However, it is critical to realize that the guaranteed return is only half the story, and that the withdrawal rate attached to the annuity dramatically impacts the actual return achieved by the investment.

Moshe Milevsky, a professor of finance at the Schulich School of Business at York University in Toronto published an article in the August 2009 issue of the Journal of Annuity Analytics. In this article Dr. Milevsky calculated what the guaranteed accumulation rates in variable annuity

contracts are actually valued based on immediate annuity quotes obtained in March of 2009. The calculations are simple, and he took the market cost of providing the guaranteed annuity payments and figured out what rate was required to get to the lump sum from what was invested in the variable annuity originally. For example, if you purchased a variable annuity at age 55, with a guaranteed lifetime income benefit, with guaranteed growth of 5% during the accumulation phase, and that promised a 5% pay out factor for life beginning at age 65, the effective rate of return would have been 0.18%! Another way to look at the nature of this guarantee is that the insurance company is saying "if you would like for us to guarantee that you won't lose or outlive your money, give it to us and we'll pay it back to you over your lifetime but not pay you anything for the use of your money. No wonder insurance companies can afford to put their names atop such nice large buildings.

## 4. Death Benefit is Worthless

Although the insurance industry positions the death benefit as a way of protecting principal, this coverage is infrequently used and carries a high price tag. The only way you can enjoy the insurance benefit is by dying with an account balance that is less than your original contribution minus any withdrawals. The fact that US equities have historically grown by about 10 percent a year over the last 50 years makes it unlikely that your account would fall below the original investment. You actually end up paying more and more as your returns go up.

## 5. Handsomely Reward the Advisor

Those who sell variable annuities are handsomely rewarded for their efforts. Insurance companies pay commissions that range from 5 percent to 9 percent of invested assets. These commissions, plus the value of assets now held in retirement plans, help explain the aggressive marketing of variable annuities to qualified retirement plans. So, it's not surprising that over 75% of the $200+ billion annuities sold every year are high commission variable annuities.

## 6. Severely Penalize You if You Need Your Money

For insurance companies to recover the costs of selling a variable annuity and retain customers, they carry hefty surrender charges that will decline over time. A surrender charge is a fee assessed on your assets if you move money out of a variable annuity. The surrender charges are often 5 to 7 percent of assets in year one and decline one percent a year until they go away over the next 5 to 7 years.

Good financial advisors are supposed to act in your best interest and ensure fees are reasonable. How is a variable annuity best for you if there are hefty fees if you need your money for an emergency? You are probably stuck if you have a variable annuity until the surrender charges are low or expire. This puts you at risk if you need your money in a hurry.

## 7. No Risk Management to Avoid Market Downturns

As we mentioned previously, insurance companies that manage variable annuities typically invest your money in mutual funds under a set asset allocation. Additionally, they stay invested in those mutual funds and may rebalance to keep the asset allocation the same over time. So, the investments go up and down with the market.

You might remember the market downturn in 2008-2009, when the S&P 500 lost approximately 50% of its value. When the market declines, you need an investment manager that will make the necessary changes to minimize your exposure to the downturn. An active investment manager can sell stocks or mutual funds and hold cash or invest in non-correlated asset classes when they anticipate a downturn, thereby avoiding the worst of a bear market.

The best way to make money is to not lose it. Simply put, the larger the loss, the larger the gain must be to recover the loss. For example, a $100,000 account that loses $10,000 (a 10% loss) needs to return 11.1% to get back to $100,000, not 10%. If that same account loses $20,000 (a 20% loss) it needs a 25% return to break even, not 20%. Finally, if the account loses $50,000 (a 50% loss) it needs to return 100% to get back to $100,000.

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