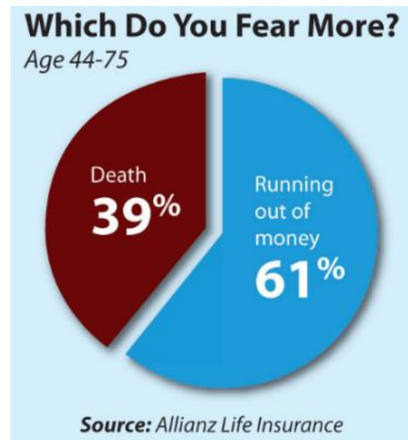
7 Reasons Why Variable Annuities are Horrible for a 403(b) or 457 Retirement Account.

Red Paper

Introduction



Let's face it, people aren't saving enough for retirement. Research also has proven that the biggest fear for people in or near retirement is running out of money. It's hard to believe that people fear running out of money more than death!

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

This Red Paper will explain the 7 reasons why a variable annuity is a horrible investment for a 403(b) or 457 retirement account. In fact, they are so bad for 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 investor's money in segregated asset accounts called "separate accounts" and then invest their money in underlying securities or mutual funds. These underlying investments are subject to market risks.

During the savings, or "accumulation" phase, the investments grow tax-free (really, tax-deferred). At retirement, investors 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 When the money is withdrawn, the investment gains are taxed as ordinary income (end of tax deferral period).

Variable annuities also provide a death benefit which guarantees that if the investor dies before retirement, their 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 the future annuity payments.

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

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

1. No Tax Benefit

A 403(b) or 457 retirement account is a vehicle for investors 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 an investor's retirement.

2. Charge High Fees

Variable annuities are expensive. According to a recent Investment Company Institute ("ICI") 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 the investor 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 the investments.

Many insurance companies claim that their variable annuity will guarantee a 5, 6, or even 7 percent return, and can return more if the market performs well. 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 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 an investor 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 investors would like for us to guarantee that they won't lose or outlive their money, give it to us and we'll pay it back to them over their lifetime but not pay them anything for the use of their 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 investors can enjoy the insurance benefit is by dying with an account balance that is less than their 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 their account would fall below the original investment. Investors end up paying more and more as their 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 in annuities sold every year are high commission variable annuities.

6. Severely Penalize the Investor if They Need Their 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 investors assets if they 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 their client's best interests and ensure fees are reasonable. How is a variable annuity best for their client if there are hefty fees if the Client needs their money for an emergency? The client is stuck if they have a variable annuity until the surrender charges are low or expire. This puts the client at risk if they need their money in a hurry.

7. No Risk Management to Avoid Market Downturns

As we mentioned previously, insurance companies that manage variable annuities typically invest the 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.

During the market downturn in 2008-2009, the S&P 500 lost approximately 50% of its value. When the market declines, investors need an investment manager that will make the necessary changes to minimize their 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.

Our Risk Management Approach

Managing risk in an investor's portfolio, as well as managing their expectations about risk, can be very challenging. When markets are up, investors want to know why they aren't doing better (which would require more risk than may be appropriate for their portfolio). Conversely, when markets are down, investors want to know why they're losing money (which would require less risk).

Our first step is to have investors answer a 5-minute online questionnaire that covers topics such as portfolio size, top financial goals, and what they're willing to risk for potential gains. Then we'll calculate their customized risk number between 1 and 99. This number pinpoints their exact comfort zone for downside risk and potential upside gain. The lower their score, the less risk they're willing to accept. The higher their score, the more risk they can handle. Once we know their risk number, we then create an investment portfolio that aligns perfectly with their risk tolerance and goals.

In addition, we can also use the tool to analyze the risk tolerance of an investor's portfolio. Together, we can run stress tests to see how their investments would fare if there were an interest rate spike or an

economic crisis. When it's all said and done, investors feel confident that their portfolio matches their personality and needs.

We strongly feel that it's important to quantify the amount of risk investors are taking and compare it to what they are comfortable with over the next six months. Click on the icon below to get a free portfolio risk analysis.

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