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Part I of this article was published in the *Citrus County Chronicle,* December 2004

Variable Annuities: Buyer Beware (Part I)

John and Jane Doe (not their real names) recently came to our firm seeking investment advice. Three years earlier, on the advice of their "financial advisor," they had purchased a variable annuity into which they had placed the majority of their investment funds. The investments did not seem to be growing at the "guaranteed rate," and they were perplexed.

John and Jane had not kept the prospectus for the variable annuity product. However, we were able to secure it from the insurance company's web site. We reviewed this 350-page behemoth document and the 26 page annuity contract and riders in order that we could answer their questions.

"Why is the annuity not getting a minimum of 4% a year, as was promised," Jane inquired. We replied, "I'm afraid you misunderstood the nature of that guarantee. What the guarantee means is that, upon John's end of lifetime (for he was the annuitant), Jane as the beneficiary of the annuity would receive a minimum of the principal value plus an increase of 4% in value each year from the date of purchase, assuming no withdrawals. There is a basic death benefit to the policy which guarantees upon John's end of lifetime the value of the annuity will be at least equal to the amounts contributed less withdrawals. You chose an optional death benefit rider that increases the value at time of death by 4%, compounded annually."

Jane inquired, "You mean I have to wait until John dies to get this 4% guaranteed rate?"

We replied, "Unfortunately, yes. That's the way the vast majority of variable annuity contracts work. Be aware, however, that if the value of the annuity contract is greater than the guaranteed minimum, you've really received no benefit from this additional high-cost feature. Given that, over long periods of time, investments generally will outperform the guaranteed levels, annuities can be quite profitable for insurance companies."

John inquired, "How much does this annuity cost us? We didn't pay any commission when we bought it."

We explained, "There are three main costs of this annuity contract. The first is the basic death benefit (mortality and expense charges), which together with administrative fees costs you 1.25% per year. In addition, you chose several riders to the policy, including the 4% death benefit roll-up rider (0.30% per year), the guaranteed minimum income benefit (0.60% per year), and the charge for the 3% contract enhancement (0.42% for the first 7 years of the annuity contract). All of these fees add up to 2.57% per year. And then there's the annual costs of the mutual funds held in the sub-accounts in which you invest, which currently range from 0.60% to 1.20%. Mutual fund transaction costs and opportunity costs can also add to these expenses. In total, you are paying 3.2% to 4% a year, or even more, for all of the fees and costs associated with this contract."

John and Jane appeared stunned. They realized that paying such high costs was probably a big reason behind the poor performance of the mutual funds inside the annuity. They inquired, "Why did the broker sell us this annuity? He said it was a great deal!"

(We'll explore the "deal" of this annuity in our next article.)

Next Week: Variable Annuities: Buyer Beware (Part II). The Science of Investing column is written by Ron Rhoades, Mike Tringali and John Ceparano of the Joseph Financial Group. They may be reached at 746-4460 or www.josephpartners.com.

Variable Annuities: Buyer Beware (Part II)

(Note: Under heavy pressure from stockbrokers and insurance agents, the Citrus County Chronicle refused to publish this article, following the publication of Part I. Here, for the first time, is more truth about variable annuities - what many stockbrokers and insurance agents did not want you to know!)

Last week we examined John and Jane Doe's annuity contract, and looked at its high annual fees of 3.2% to 4% per year, and perhaps higher. John and Jane Doe inquired why the broker sold this annuity to them.

We replied, "If we look deep into this 350-page prospectus, we can find some answers. We see that the maximum surrender charge on this annuity contract is 8.5% initially. This is a good indication of what the brokerage fund received for selling this annuity. Additionally, annuity companies sometimes provide sales incentives to brokerage firms to sell the riders. A 12b-1 fee is also assessed inside the mutual funds, of 0.20% a year, and the annuity contract states that this fee may be utilized to further compensate the brokerage firm. Also, the prospectus says that trading within the mutual funds is often directed to the brokerage firms that sell the annuity, resulting in additional compensation to the brokerage firm. So, yes, we conclude that this annuity was a good deal - but only for the brokerage firm, and broker, who sold it. Certainly it's not a good deal for you."

Jane said, "How can we get out of this?"

We replied, "Unfortunately, if you were to get out now surrender fees totaling 9% apply after two years of the annuity contract. It will be an additional 5 years (7 years total) until surrender fees disappear. Since the brokerage firm was already paid for selling this annuity contract to you, these surrender fees are the way for the insurance company to recapture the sales commissions paid to brokers and agents, if they cannot extract them from you through the high annual expenses."

John bowed his head, stating: "I'm feeling a little sick to my stomach. At least this annuity provides some tax benefits."

We replied, "Unfortunately, this nonqualified annuity is actually tax inefficient. All gains that occur in the annuity are taxed as ordinary income upon withdrawal. The more favorable long-term capital gain treatment is not available. In addition, there is no stepped-up basis at time of death, which eliminates capital gains on mutual funds held in taxable accounts, but does not apply to annuities. The income tax deferral benefit told to you by your broker is offset by some really terrible tax treatments down the road."

Jane said, "Is there anything we can do?"

We replied, "Fortunately, you can withdraw 10% of the value of the annuity during each contract year, without a surrender fee. In addition, you can place the entire annuity contract in the insurance company's fixed account, which will earn 2% each year and without the imposition of all of those annual costs. We should also explore whether to allocate some of the annuity value to some of the lower-cost mutual funds inside the contract, but even then you'll see annual expenses of 2.8% or more. Whether to surrender the annuity contract now and pay the high surrender charges, or invest in the fixed account for the next five years, is a tough decision, and it will depend a lot upon your overall strategic asset allocation and needs. It also depends on whether a true death benefit exists now, and the age and health of the annuitant. We'll have to find out a lot more about you and your overall financial plan before we recommend any one or more of these options."

While John and Jane Doe were appreciative of our advice and insights, after they left we could not help but wonder how to stop such meetings, which occur all too frequently in our office, from occurring. If you still are considering the purchase of a variable annuity after all we've said, think twice, get objective advice from a third party before you buy it, and "buyer beware." We believe variable annuities are only suitable for less than 1% of our clients, and even then hardly ever for retirees. Perhaps the best advice we can give you is this - if someone wants to sell you a variable annuity, run the other way.

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