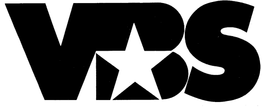

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VALUE BUILDING

From Paul A. Gomperz, CLU, ChFC

INVESTMENT OUTLOOK **October 2007**

VARIABLE ANNUITIES....... YES or NO???

Variable Annuities have aroused lots of discussion in both print and broadcast media over the years. Some writers hate them and some writers love them. Essentially, a Variable Annuity is a contract issued by a life insurance company where, instead of simply paying a stated interest rate on the money that is invested, the company offers a series of mutual fund type accounts called "Separate Accounts". On the most part, these accounts bear the name of and are managed by well known mutual fund companies. And so, when you invest your money into a variable annuity, you can select funds managed by companies you know such as *American Century, Dreyfus, Fidelity, Neuberger & Berman, Oppenheimer*, etc. You will see well known fund names such as *Main Street, Contrafund, Ultra, Income & Growth, Growth & Income, etc.* In fact, these accounts are managed by the same people who manage the real mutual fund bearing the same name using the same investment strategies. And so you have access to a whole bundle of fund investment opportunities from a variety of mutual fund managers within a single annuity contract.

So what's the dispute? Basically, there are two. One deals with income tax issues while the other deals with fees. When you own mutual funds, that portion of the gain attributable to Long Term Capital Gains is taxed at a lower rate than Ordinary income. Secondly, upon death, the cost basis of the mutual fund steps up to become the value as of the date of death (or nine months later) thereby eliminating all tax on gain between the purchase date and the valuation date. With Annuities, all gain paid out is Ordinary Income (there are no Capital Gain opportunities) and there is no step-up in value at death. If the money we are talking about is held in IRA or 401(k) rollover accounts, then the income tax payable on the flow of income from either an annuity or a mutual fund is the same. As for fees, while the mutual fund management fees inside variable annuities are usually reduced (because the funds have no marketing or administration costs when the fund is inside an annuity), the life insurance company puts an asset fee into the annuity that sits on top of the fund fee. That asset fee is normally between 1% and 1.65% per year. Net out the two fees, and the annuity will cost 0.75% to 1.25% more than a fund.

People purchase annuities for some very good reasons. Annuities grow tax deferred until income is taken out. A person in a high tax bracket now expecting to be in a lower bracket following retirement pays no tax until they begin withdrawing funds. Taxes on mutual fund gains are payable every year as they are declared. And with many better performing mutual funds actively trading their portfolios, much of the income they generate is ordinary income that is taxed at the highest rate. The money you would have paid for taxes on mutual fund gains remains available inside the annuity to create more growth. Variable Annuities will guarantee the amount invested will never be subjected to any market loss if the annuitant dies, and will lock in subsequent market gains. Annuities don't report any taxable income until funds are withdrawn. And then there is asset protection. Every state has an amount that a person can hold in annuities that is free from the claims of creditors. The best example is O.J. Simpson, who, it is reported, has paid very little to the Goldman Family because his assets were held mostly in annuities. Finally, for parents who are planning to fund their children's college education, assets held in annuities are considered retirement plans and do not get reported on the FAF Form that one fills out for financial aid. If a family holds their assets in Mutual Funds, the entire value, less certain deductions, counts as being available to pay for college. Assets held in annuities are not considered available.

The New Paradigm

But now comes an entirely new use of Variable Annuities that we covered in our April Newsletter when we discussed "The Have Your Cake and Eat It Strategy." Suddenly, Variable Annuities with lifetime income guarantees are becoming popular and preferred by persons who would never have considered a Variable Annuity in the past. How can that be? How is it possible that a financially astute person with hundreds of thousands or even millions of dollars in assets now prefers using a Variable Annuity over their traditional

investment models?
Let us first take a look at a traditional model. The first order of business was to create a flow of income that would never end. The second order of business was for that income to be ever growing so that the effects of inflation would be covered. The rule of thumb was that investments needed to be divided between Cash that produced some income and had no risk of going down in value, Bonds that produced a greater flow of income but had values that fluctuated, and a mix of diversified equity investments that produced some income, were held primarily for growth and whose value could fluctuate more widely. The cash plus income produced by the interest on the cash and bonds plus any dividends on the stocks covered current income. Future income and growth of income was based upon periodic pruning of the equity portfolio, which is the selling off of gains and placing the funds into the bond or cash accounts. A typical portfolio would have 10-15% in Cash, 30-40% in Bonds, and the rest in equities.

Over the past few years, we've seen many articles distributed by marketers of annuities and mutual funds quoting a study by Ibbotson Associates, a major actuarial firm. The study defined the risk that retired people were at for their money to run out within 25 or 30 years by comparing how the money was invested to the size of the annual draw. Basically, with draws of as little as 5% annually, the greatest risk for the money to run out was if the investment were concentrated in cash and bonds and the least risk of the money running out was if the money were concentrated in stocks. But there were no 100% safe harbors. Looking ahead those 25 to 30 years, there was a 100% probability that some risk remained that a person would run out of money no matter how conservatively they invested their assets.

The Life Income Guarantee Rider

But now the risk of running out of money has been eliminated. Variable annuities offer guarantees that the income their contracts promise will never end no matter what happens to the underlying investment portfolio. The most comprehensive article that I have seen on the subject recently appeared in the August 2007 issue of the FPA Journal (formerly the Journal of Financial Planning) published by the Financial Planners Association. The author, Ty A. Bernicke, CFP®, is a regular contributor to the magazine.

Bernicke acknowledges the anti-annuity bias felt by planners based on cost. He argues that the annuity's cost, which he estimates at 2.5%, is justified because it allows the investor to become more aggressive in their investments. They can do so because they have shifted the risk of their money running out to the insurance company. He points out those higher returns from moderate to aggressive investing more than cover the annuity's costs. He quotes studies that have front tested and back tested every 30-year period from 1926, when data first became available, to 2004. Overall, he writes, that the strategy utilizing annuity guarantees and more aggressive investing created an 18% higher average income and approximately 369% greater average inheritance. Now I would call that "Having Your Cake and Eating It."

Simply stated, if the retiree is currently investing money safely to assure that income lasts for life, they are not growing the money as well as it could be grown in a more aggressive environment. The costs of our annuities range from 1.9% to 2.25% with life income benefits included for the spouse. That cost shifts the risk of lifetime income to the insurance company. The underlying investment can then be professionally managed by the insurance company using strategies labeled "Aggressive", Moderate Aggressive", etc. The bottom line is that this approach will create more income and a greater inheritance than managing money in traditional ways.

If you question how insurance companies do this, remember they are in the business of taking on risk for a fee. There is a "Maximum Fee" to which they can go if the numbers don't work out as projected. Life insurance policies do the same thing. But even if they charge the highest fee permitted, your stream of income is still guaranteed. The only people at risk are the beneficiaries whose inheritance would be smaller if the economy collapses. But that same worst case basis has to affect people who manage their own retirement plan using a traditional model. Their income has to go down while the annuity plan guarantees a life income that can never decrease. Clearly it is the financial strength and claims paying ability of the insurance companies that stands behind these guarantees. If you are retired, or planning to retire, then call me to discuss this.

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