What Your Broker Doesn't Want You To Know About Variable Annuities

By Bill Broich

Disclaimer: In the early part of my career, I was licensed to sell variable annuities; I no longer maintain my securities license. The article below is gleaned from a wide array of information available to anyone; all you need to know is where to look. Be warned, I do not like variable annuities.

To be fair, this information isn't secret; it is fully disclosed in the prospectus provided to you by your broker when he talked to you about variable annuities. Gleaning the information can be more difficult.

This paper may help you understand **Variable Annuities** and to be able to ask the right question of your broker if you already own a variable annuity or are considering purchasing one.

All variable annuities have the same general design, but there can be many differences in features, benefits, fees and expenses.

Let me introduce you to the world of variable annuities....BB

One of the most fascinating segments of the investment world is variable annuities. I am fascinated not because of the product but because so many people can be convinced to buy a product so filthy rich in fees and expenses. I can't think of any other product available that has the fees structure of variable annuities. If there is a worse product, I would certainly like to see it.

When a broker talks to you about buying a variable annuity, he/she must provide you with a product prospectus. A prospectus will disclose all aspects of information about the variable annuity such as features, goals of the annuity, investment options, legal notices, fees and expenses. A prospectus will provide complete transparency of the product, all acts disclosed.

Definition of prospectus; *A formal legal document, which is required by and filed with the Securities and Exchange Commission, that provides details about an investment offering for sale to the public. A prospectus should contain the facts that an investor needs to make an informed investment decision.*

Transparency in any investment is critical and understanding the fine print is essential in making a final decision. A prospectus will provide everything about the investment in detail. Once you read a prospectus about a variable annuity ask yourself one simple question. Why would anyone buy a variable annuity?

A little background about annuities: In the annuity world there are two different classes of annuities, variable (securities) and fixed (insurance).

Another way to think of variable annuities is as opposite of fixed annuities. Fixed annuities are sold by insurance salespeople, licensed and regulated by their state of residence. Variable annuities are securities sold by licensed brokers and are regulated by the Security and Exchange Commission. The monitoring of the sales of these products is handled by the security watchdog, **FINRA**. (www.finra.org)

A nationally known financial expert, Jane Bryant Quinn (www.janebryantquinn.com) said it best in a past article in the ***Wall Street Journal***: *"I would like to take all variable annuities and smash them to smithereens."* And she is not the only high profile financial expert to make such strong claims. *"Experts see variable annuities for what they are, overpriced, high risk, expensive securities sold as safe and secure, I assure you they are not."*

Think of a variable annuity as a magic basket, a basket which holds your eggs. In actuality, the eggs are your investments. This basket can expand and contract as needed, it can hold different types of investments and it can also have handles placed on the basket. This magic basket's handles are called riders, riders to provide income, increase death benefits and other benefits. Inside the basket are your eggs, your investments. Your investment options can vary between stocks, bonds, real estate and numerous other choices. Plus in this magic basket, you can change your individual eggs (investments) as often as you wish.

The basket is not really magic and it does exist, it is called the annuity wrapper. The issuing company provides the basket and charges you a fee to maintain it. The fee is based on the overall value of your total investments and it can vary in cost from 1.25% to higher (or lower).

This expense is annual and ongoing. This fee is also called the mortality and expense fee. Mortality and expense risk charges, which the insurance company charges for the insurance to cover guaranteed death benefits and administration costs of the annuity. ,

The eggs in the basket are actually called sub accounts which operate just like a mutual fund. The sub accounts are separate and distinct; each sub account is managed by a company that also manages mirrored mutual funds. To be more direct, when you buy a sub account you are actually buying the mutual fund. Sub accounts are investments, investments in whatever the fund is designated to invest in, as an example it could be Foreign Bonds or Small Cap Growth Funds or US Treasuries, the options for investment are wide and varied. The number of sub accounts (investments) offered in a variable annuity is also wide and varied from a few choices to more than 300 based on the variable annuity. Sub accounts can be built into a portfolio in an attempt to reach an individual's goals.

The trouble with sub accounts? Fees and market risk.

A sub account is an investment, investments can go up or down, sub accounts carry market risk. The first part is the fees associated with the sub account, the fees are annual and based on the value of the sub account. The fees are also wide and varied and can range from .25% to 3% of the value of the sub account. In addition, the sub accounts are also subject to fees and expenses charged by the fund management when assets are bought and sold within the sub account.

So much has been written about variable annuities, both good and bad. Major financial publications such as the ***Wall Street Journal*** have railed against variable annuities. One article - *"Are Variable Annuities Safe"* - examines both sides of the argument. Here is the link: **http://www.wsj.com/articles/SB10001424052702303916904577376193314287640**

The fee problem is easy to explain when you know the actual workings of a variable annuity. It boils down to one simple fact: The funds in a variable annuity are not at the insurance company, the funds are actually invested away from the insurance company at the individual sub account. The insurance company has no ability to use the invested funds to make money other than to charge a fee.

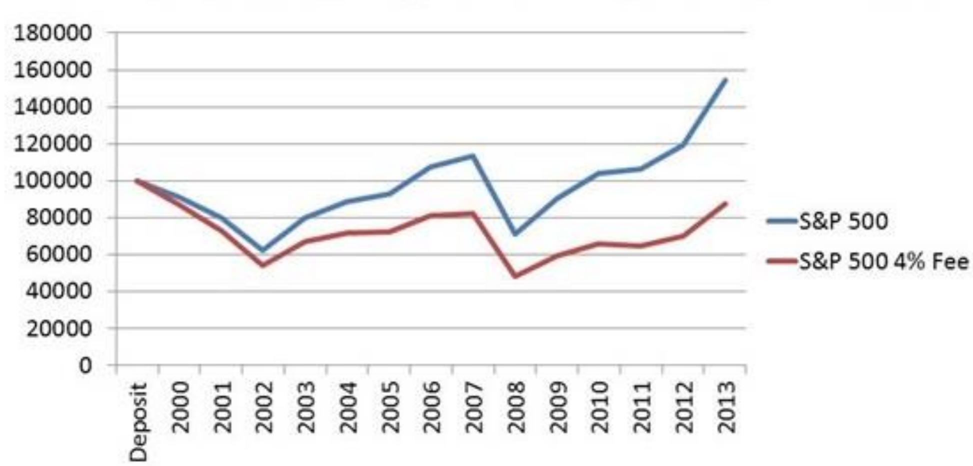
According to the national leader of reporting financial fees, *Morningstar*, the average fee for variable annuities is 3.61% and this would not include and handles on the basket (riders). The 3.61% is for the basket and the sub accounts. Riders added to the variable annuity would be another fee and expense on top of the basic expenses.

The Motley Fool writes about fees and expenses in variable annuities: http://www.fool.com/retirement/annuities/annuities02.htm

Riders added to variable annuities can provide a myriad of benefits, increased death benefits, income guaranteed, long term care and much more. Unless you know for certain your plans for the eventual use of a variable annuity, adding riders that charge fees can really add up in the expense column.

Have a look at what a **4% expense fee** can mean to long term accumulation, using the historical S&P Stock Index.

Fees Can Greatly Impact Results: 4% per Year Fee



Does a 4% fee sound too high? The truth is simple, 4% is nearly the national average of an annual fee for a variable annuity, some rider fees could push the overall cost even higher.

Once you have decided to buy your "basket" and added your sub account investments, you will be faced with the "rider" options. While there is nothing wrong with adding riders you are sure you will use, adding those riders with a "possibility" of their use can be another expense subtracted from your account value.

Fees for riders such as extended death benefits and guaranteed income benefits can vary wildly based on the product you selected and your age. An average cost can add .50% to 1.00% in additional fees when an income rider is selected. The simple cost of the rider needs to be accurately accounted for and compared to any desired result. The actual expense can be devastating to any account growth.

A popular rider is the guaranteed death benefit rider which assures the beneficiary of the variable annuity will receive a fixed and guaranteed amount at the death of the annuitant. What is often overlooked is just exactly how this benefit is calculated. If the variable annuity has a guaranteed death benefit of $100,000 (example) and the actual cash value of the variable annuity is $75,000 then the amount actually covered by the death benefit rider is $25,000. The $100,000 is paid in a lump sum but in reality, $75,000 was the actual value of the cash in the contract.

Fees for a death benefit enhancement rider can be high, always ask and compare before selecting this rider.

The **Security and Exchange Commission** (SEC) has additional information about variable annuities:

What You Should Know at: http://www.sec.gov/investor/pubs/varannty.htm

Questions to ask your broker about variable annuities.

- What is the purpose of the variable annuity? What do you want it to accomplish?
- If you add a rider to the annuity, is it something you actually plan to use?
- Are you investing in the variable annuity through an IRA? Why?
- What might happen to your retirement income should your account value decrease?
- Do you understand the features of the variable annuity and the costs associated?
- Do you understand the surrender penalties when considering a long term commitment?
- Are there features of a rider attached to a variable annuity, such as increased death benefit, providing a benefit that may be less expensive if purchased separately?
- If you are exchanging one annuity for another one, are you using the IRS 1035 rules for a tax free exchange?

Information is the key to success, the more you learn, the more options for success. Annuities can be the perfect vehicle for use as a retirement vehicle, make sure your choices of product make sense for your goals.

FINRA provides more information for you at the links below

The following resources provide additional information about variable annuities, their risks and benefits, exchanging or replacing annuities, and whether this type of investment is the right choice for you.

- FINRA Investor Alert: Variable Annuities: Beyond the Hard Sell
- FINRA Investor Alert: Should You Exchange Your Variable Annuity?
- FINRA Investor Alert: Should You Exchange Your Life Insurance Policy?

Numerous videos exist on a wide array of topics at www.annuity.com/videos

Like all important decisions, take your time and make sure your decision matches your income and investment goal and your personal horizon time period. It is important to consult advisors who are licensed and authorized to provide advice. Everyone's personal situation is different; no one plan will ever fit all situations. I also advise that you obtain more than one opinion before making any final decision.