

# INVESTMENTS WITH AN INSURANCE "WRAPPER": BRILLIANT?

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Beer? In a bottle? Brilliant! Variable Annuities? Great idea?

In 2003, a well-known Irish beer company launched an ad campaign featuring two animated brewmasters declaring the invention of everything from bottled beer to six packs to sliced bread as "brilliant!" The campaign became a YouTube sensation.

Is putting an investment portfolio inside a variable annuity as brilliant as putting beer in a bottle? Probably not, but under certain circumstances it can be sensible. The challenge is that variable annuities generally come with expensive features that many people do not need. For most people, the expenses will easily outweigh the benefits. Nevertheless, the product does offer some benefits that are not available with traditional investments. For example, variable annuities

- provide a tax-deferred investment option to those without access to a qualified retirement account.
- allow you to tax-defer extra money if you've maxed out contributions to your existing retirement plans.
- may permit asset shielding (in some states, insurance products are protected from creditors and judgments).

To determine whether the possible advantages outweigh their cost and any potential tax complications, ask yourself the following questions:

Do you expect to:

1. Have a long investing ("accumulation") period?
2. Have a long income-receiving ("payout") period?
3. Deplete the bulk of your assets before death?
4. Pay income taxes at a lower rate in retirement?

If your answers to all these questions are "yes," read on. Otherwise you are probably better off investing directly in some mix of mutual funds, equity hedges (e.g., "LEAPs") and a fixed annuity, which is a product offering you a fixed stream of payments over time. Consider getting advice from an unbiased, well-informed financial

professional on how to proceed, although you should know that even financial professionals may find it challenging to compare and evaluate variable annuities.

## WHAT ARE THEY, ANYWAY?

In form, an annuity is an insurance product: You pay a fee, or premium, to an insurance company as consideration for some future payments. A **fixed annuity** offers you a stream of future payments (e.g., \$1,000 per month), often over the remainder of your life, in exchange for a premium. With a **variable annuity**, a portion of the money you contribute is placed in your choice of investment options, such as mutual funds, and is, therefore, subject to market risks. The amount of premium you pay and the money you receive over time depend, in whole or in part, on how those investments perform. Unfortunately, variable annuities and fixed annuities sound more similar than they really are.

## HOW ARE THEY REGULATED?

Variable annuities are currently regulated in the U.S. as insurance products by individual states' insurance commissions, although Congress periodically debates shifting responsibility to the U.S. Securities and Exchange Commission (SEC), which also regulates mutual funds. The financial professionals that sell variable annuities work under a variety of regulators and regulatory standards. Registered investment advisers (RIAs) and brokers are regulated directly by the SEC and by state securities regulators. Brokers are also subject to regulation by industry self-regulatory organizations, including the Financial Institution Regulatory Authority, better known as FINRA. Insurance agents and brokers are regulated by the insurance department of each state in which they are licensed. Financial planners are not separately regulated; their regulation depends on the services they provide.

## HOW DO VARIABLE ANNUITIES WORK?

These products typically offer tax-deferred earnings growth and can include other features, such as a death benefit, that will pay your beneficiary a guaranteed minimum amount regardless of account performance. During the **accumulation phase**, you choose to invest

the premiums you pay in a mix of investments. Your investments grow (or decline, depending upon asset performance) tax-free until you enter the **payout phase**, when the insurance company sends you periodic payments according to an agreed-upon schedule based on the performance of the investments.

## DO THE BENEFITS OUTWEIGH THE COSTS?

Investors in these contracts may be able to:

- make a tax-free switch to a fixed annuity after an accumulation phase,
- invest an unlimited amount of money in a tax-deferred environment with no annual capital gains liabilities,
- leave a designated inheritance,
- withdraw a guaranteed amount of money from the policy over time,
- avoid costly probate after the death of the annuity's owner, and
- gain protection in some states from creditors.

The benefits carry with them, however, some disadvantages:

- The additional cost of insurance (i.e., death benefit), guarantees and account fees will reduce investment returns.
- The contracts currently provide a tax deferral, but it is impossible to predict future tax law.
- Investors take on the credit risk of the insurer when they opt to annuitize their product, and state insurance funds may limit the amount and type of obligations they cover in the event of insurer insolvency.

- Withdrawals from variable annuities are subject to a ten percent tax penalty if you choose to take them before you reach age 59½ (similar to an IRA account).
- Several states, including California, subject contributions to variable annuities to premium tax, which can be as high as 3.5% (Nevada)<sup>2</sup>. Check with your state's insurance department for the current premium tax, if any.
- Only the most sophisticated individual investors will fully understand these contracts.

### INVESTMENT INSIGHT

Understand the motivations of your provider. The typically high sales charges of variable annuities may encourage a commission-based salesperson or insurance broker to use aggressive sales practices.

## THERE'S NO SUCH THING AS A FREE LUNCH.

The costs of variable annuities vary extensively and every penny you pay in fees is a penny that won't benefit from compound returns. In the U.S., providers such as TIAA-CREF and Vanguard specialize in low-cost products, while others such as Fidelity, Schwab, and T. Rowe Price have some low-cost options in their repertoire.

Variable insurance products are often more expensive than traditional investment vehicles, and the costs vary widely among providers. To demonstrate this, we surveyed seven variable annuity providers. Our survey was conducted in New York. Bear in mind, the products and options we show here may not be available in your state, and the pricing will differ among states and change over time. Expenses can be significantly higher than those listed here. The chart below shows the results of our survey and lays out some of the costs typically found in the "expenses" section of your prospectus.

Charge Type	What this is	Price Range <sup>3</sup>
Distribution Charge	A charge (a percentage of total contract value) that compensates the insurer for expenses incurred in selling the product to you.	0.00 – 0.35% annually
Mortality Charge	Annual charge for the death benefit. Charge is a percent of total contract value and based in part on the health of the annuitant.	0.20 – 1.70% annually
Portfolio Operating Expenses	Annual charges for trading, advising, and managing your investments. Charge is a percent of your investments allocated to each fund, equivalent to expenses for a mutual fund.	0.09 – 1.80% annually
Administrative Fees	Charges for record-keeping and other administrative expenses. Charge is a percent of your total contract value.	0.10 – 0.35% annually
Surrender Charges	A penalty paid if money is withdrawn from the contract in deviation from the agreed-upon schedule. Charge is a percent of the withdrawal and is in addition to any tax penalties for early withdrawal.	0.00 – 9.00% of withdrawal
Transaction Fees	A charge assessed for transferring between investment options. Some contracts offer a limited number of free transactions. Charge is per transaction.	\$10.00 – \$25.00 per transaction

Although insurance companies must disclose all charges and fees associated with a product, they may present them differently. Some companies use different names for similar benefit and expense categories and, in some cases, include more than one line item in an expense category. For example, Vanguard currently includes the mortality charge as a portion of portfolio operating expenses.

The list above is not meant to be comprehensive; make sure you read the prospectus carefully to understand the full range of fees you will pay. These instruments are as complicated—and potentially expensive—as any investment an individual investor is likely to encounter.

On top of the standard features, there are various insurance options available at an additional cost. Note, however, that some of the most economical policies offer few additional features.

Investors should look beyond the label on the feature to understand its specific terms. A death benefit is a good example; the cost will depend on the amount of the benefit you elect. Other features may be more difficult to compare among policies, as more than one important fact will vary. Some typical features are described in the chart below.

## LOOK BEFORE YOU LEAP.

Another important consideration is the financial strength of the insurance company underwriting, or providing, the annuity (an

especially important issue if you choose to convert to a fixed annuity). If you're dealing with company representatives, ask them for the ratings of the carrier. If they don't provide them (which is not a good sign), you can do some homework on your own. A.M. Best, Fitch Ratings, Moody's Investors Service, and Standard & Poor's make their basic ratings available without charge on their respective websites (registration required).

But ratings aren't everything. Recent history provides examples of well-rated (even triple-A) insurance companies going under or having to seek emergency financial support. If you're thinking about adding a variable annuity to your investment portfolio, consult your adviser about the range of uncertainties associated with insurance products.

For more information on investing or to find a CFA charterholder who advises on individual or family wealth management, please visit [trustcfa.org](http://trustcfa.org).

<sup>1</sup> This material is from the forthcoming book *The New Wealth Management: The Financial Advisor's Guide to Managing and Investing Client Assets* by Harold R. Evensky, Stephen M. Horan, CFA, and Thomas R. Robinson, CFA (part of the CFA Institute Investment Series).

<sup>2</sup> All figures in this article may change over time.

<sup>3</sup> Based on our May 2010 survey of providers including AXA, MetLife, New York Life, Prudential, Schwab, TIAA-CREF, and Vanguard for products offered in New York.

Feature	What this is
Death Benefit Provision	At the annuitant's death, the insurer contracts to pay the greater of the contract's current cash value or other agreed-upon value.
Guaranteed Minimum Income Benefit (GMIB)	Guarantees that the investor will receive a specified minimum level of periodic income, regardless of investment performance.
Guaranteed Minimum Withdrawal Benefit (GMWB)	Ensures that the investor receives a periodic stream of payments up to the principal amount invested if the account loses value because of investment performance. This feature could have little or no value if the investor dies before receiving payments equal to the amount invested.
Guaranteed Account Value	Guarantees that the account's value will be greater than or equal to a contracted amount at a specific date.

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