The Simple Guide to Variable Annuities

Bryan Anderson
AnnuityStraightTalk.com
(800) 438-5121

Variable Annuities (VAs) constitute 60% or more of annuity sales annually. This surprises me simply because most negative information about annuities in general is based on the structure of variable annuities. To me it doesn't make sense that 60% of people in or near retirement would want the associated complexity and cost. Be that as it may, learning about the distribution system for all insurance products will shed light on why VAs are so popular.

Online you will find various ads from people who "hate annuities" and even a quiz so someone can tell you whether a VA is the right choice. Both of these types of advertisements are nothing more than an attempt to get you to buy something else. That's not my goal because I believe you have it within yourself to make an informed decision. You may decide a VA is the right product and you may decide one of my alternatives is more to your liking. It's up to you.

In this report I'm going to show you:

1) The traditional purpose of variable annuities
2) All additional available features and associated costs
3) Introduce you to the reasons why variable annuities account for most sales
4) Is there an alternative?

When it's all said and done you should know enough to decide whether a VA is the right choice or if you'd rather take an alternate path toward security in retirement. While I do not sell variable annuities I have met several people over the years who have asked me to give a second opinion on their decision to purchase one. In many cases, so long as each person understood the benefits in return for the fees paid, I recommended they go ahead with the purchase.

For all intents and purposes, your satisfaction with a variable annuity will depend entirely on market performance. For the past decade VAs have done very well but for the decade before it wasn't pretty, to the extent that companies like Hartford nearly went bankrupt. For this reason, whether you use a variable annuity might depend on how you think the stock market will do in the coming years.

If your outlook is pessimistic then perhaps an alternative would better suit you. If you are ready to look at both sides then let's get started… happy reading!

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The Traditional Purpose of Variable Annuities

Unlike all other annuities, VAs give you the opportunity to invest in the stock market. Most contracts have a fixed rate option just like a money market fund, in addition to the typical opinions of both bond and mutual funds. Market risk and fluctuating account values should be expected in a variable annuity as you'd see with any brokerage account.

Way back when, the main use for variable annuities was to defer taxes on investments. Before qualified plans like IRAs, 401(k)s etc. became available, most people who saved outside pension plans did so with non-qualified, or after-tax funds. Being able to defer taxes until money was withdrawn was a major advantage over having taxable brokerage and savings accounts.

In the early 70s, traditional pension plans started to phase out for many private sector employees. In the place of pensions came the opportunity to start saving via employer sponsored retirement plans like 401(k), 403(b), 457 and various other forms of individual retirement accounts, or IRAs. All of these plans offered tax-deductible contributions in addition to tax deferral, so VAs lost some appeal because of it.

From that time forward, variable annuities worked well for only the highest earning individuals who could maximize contributions to retirement accounts and also have additional investment funds to squirrel away. Early in my career when I didn't know anything, my mentors told me that VAs were primarily meant for high-net worth individuals. Basically those who had extra money and the need to shelter money from a high tax bracket would benefit most from the product.

Specific timelines aside, insurance companies began to add additional benefits to VAs so the product would appeal to a wider swath of the population. Since most people now have the majority of assets in retirement accounts and don't need additional tax deferral, it is these added benefits that need to be analyzed to determine whether this is the product for you.

It's as simple as matching fees to the guaranteed benefits provided to see if a fee is worth paying. If you don't want the guarantee then don't pay the fee. If you don't want to pay the fee then you don't get any extra guarantees. Let's look at this more closely.

Additional Fees for Contract Guarantees

Since most people are looking for some type of protection from market volatility in retirement, the majority of variable annuities are sold with an additional guarantee. Below is a list of each type of fee you may find in a VA and the associated benefits that you get in return. Fees can be separated into two categories, mandatory and optional.

Mandatory:

- Mortality and Expense Charge (M&E)
  Every variable annuity, save for just a couple, comes with this fee that guarantees premiums paid as a death benefit, less withdrawals of course. It basically ensures the full initial premium is paid to heirs in the event of an untimely death. In basic form this makes VAs a good option for those who want market upside without risk of depleting a planned inheritance. Average M&E charge across this market is about 1.25%

- Mutual Fund Sub Account Fees
  Each bond or mutual fund has separate management fees deducted from the account value annually or quarterly. Fees on average range from .25% to more than 2.5% in some cases. You can expect the lower cost funds to be more conservative while the more expensive funds will be more aggressive and likely to provide higher returns.

Optional:

- Guaranteed Lifetime Income
  This is the most common additional option on variable annuities. This guarantees a minimum level of lifetime income will be paid regardless of account performance. If the market corrects and your account value drops, the income is guaranteed no matter what and if the market outperforms you may see increasing income as well. Fees range from roughly 1% to 2% depending on the amount of guaranteed increases for the deferral years. For instance you can pay 1% to use only your basis plus market growth to increase guaranteed income or you can pay close to 2% to get a guaranteed 6% or more income increase to your lifetime income for each year of deferral. It's kinda like social security.

- Guaranteed Death Benefit
  M&E provides a base level death benefit of premiums paid but withdrawals reduce the basis for that. If you add an extra death benefit then income withdrawals don't reduce the death benefit. Yes, you can take lifetime income and guarantee that your heirs will receive your initial investment. Another use for the additional death benefit also includes the ability to pass the highest account value on as a death benefit. If you own the contract and the value doubles, the death benefit locks in at each new high now matter what happens on the day you die.

Putting All the Fees Together:

I'm going to put all the fees together using a legitimate average to show you just how high it can all go. In terms of the benefit provided it makes mathematical sense but the sticker shock creates an emotional response. That's why I say if you don't want to pay the fee then don't elect the benefit.

> M&E- Industry average 1.25%
> Sub Account Fees- Middle of the road average 1.5%
> Guaranteed Lifetime Income- Reasonable average 1.25%
> Additional Death Benefit- Let's call it 1%

This comes to a total of 5% for all the bells and whistles, which could be higher or lower than this depending on company, contract and the amount of benefit guaranteed by each additional option. It is high and fees are the #1 reason other professionals tell you not to use them. But you have to put it into perspective. Imagine walking into any investment advisor's office and saying, I want to invest in the stock market and get 4% income for the rest of my life and a guarantee that no matter how long I live, the income continues and my family inherits every penny that I invested at the beginning. What will he or she say? How much would they charge for that?

Aside from them laughing you out of the office they'll refuse to come up with a cost for that level of guaranteed protection. Or, they could be smart enough to realize it, in which case they'll just show you a variable annuity. There may be a better way to do it with lower costs but the average investment advisor doesn't have it. Insuring against market risk is very expensive.

Why Are So Many Variable Annuities Sold?

Sales volume of any type of annuity is directly related to the distribution structure of each product. Put simply, it depends on the advisor who is selling them and the wholesaler who is trying to convince advisors to sell them.

In the case of variable annuities, all of them are distributed by banks and broker/dealers because it takes a licensed securities representative to be able to sell them. Places like Wells Fargo, Bank of America, Edward Jones, Merrill Lynch and Fidelity are just a small sample of the companies that broker variable annuities. That these companies manage a majority share of investment assets nationwide is no coincidence. Much of the annuity sales volume contributes to but doesn't displace assets that the company manages.

Most advisors can legally go out and get any product they want, whether fixed or variable, but in many cases the brokerage company limits licensed advisors to a specific list of approved products. If you are working with one of these advisors then you'll never know if you were truly shown all reasonable options.

On top of this, many advisors don't want to lose management assets either because that's where they make their money. Selling away to a fixed insurance product reduces said advisor's fee-based business. At worst it is the highest level of hypocrisy for both company and agent, while at best it's the right product for you and it doesn't matter. That, however, all depends on what you need

Is There a Better Option?

It all depends on what you want. It's hard for many to accept total fees of 4% or more but it's appropriate for the amount of guarantee provided with insurance against the stock market. I'm not telling you to like it, just trying to explain why it is reasonable. I certainly don't think this product is the best answer for 60% of people who buy annuities. But my goal is not to tell you why VAs are good or bad. For some they work well but for others there are far better options.

While I was getting ready to write this I looked up contract specs for the #1 selling annuity in the country in 2020. Just the basic spec sheet is 40 pages long. There are around 60 fund options, five different guaranteed income options and four different types of additional death benefit. The darn thing is about 12 different annuities in one and it gave me a freaking headache working through it.

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There certainly more simple choices you can make and many that come with little to no fees. Blended the right way in a retirement portfolio it's quite possible you'll get equal benefit with much lower cost and less risk. Just like variable annuities, those strategies aren't for everyone. Retirement decisions are among some of the most important you'll make in your life so for peace of mind, take your time!

Annuity Straight Talk has been doing this for a long time and I doubt you'll find many other people who will recommend a product that he doesn't sell himself. However, that's exactly what I've done since the beginning. Check out my site for more guidance. I've got a newsletter that answer almost any retirement question you have and a podcast for those who want to see the video or have the information delivered verbally.

If you'd like a second opinion, I or my associates would be happy to give you some unbiased advice. Feel free to call or make an appointment.

All my best,

Bryan Anderson
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Make an appointment here.