

## **When Is a Variable Annuity Right for a Retirement Account?**

By Mary Ann Golin, CFP®, CFPC

Today, it is important to understand how annuities got to be such an important part of retirement planning. Annuities offer many different investment options and even more withdrawal options. They are complicated and sometimes costly to the unknowing investor. Although this article will not discuss the abuses which have been and are going on or the myriad nuances each insurance company builds into their investments, it will show the possibility of using an annuity in a retirement account and the drawbacks related to doing so.

The Great Depression of the 30's was the reason the government instituted the Social Security System. Before Social Security, little retirement funding was available to the average worker, other than what he or she could put aside during their working years. In the early 1900's annuities were ways to self fund or for employers to fund retirement accounts. One of the earliest of these plans was TIAA-CREF: **T**eachers **I**nsurance **A**nnuity **A**ssociation – **C**ollege **R**etirement **E**quity **F**und. TIAA-CREF is not the subject of this article but due to their early role in using annuities in retirement accounts, it is the model which many other companies have used to capture this business.

TIAA-CREF is synonymous with teachers' retirement plans thanks to Andrew Carnegie who, in 1918 established the first teachers pension plan. TIAA-CREF is a multi billion dollar company today which offers annuities primarily for teachers' retirement plans all across the country. The company was originally incorporated in New York as a life insurance company and only bought bonds as the underlying investment for the retirement plans it offered. It was designed to provide safety and security. The annuities offered in the plans would typically have a lifetime payment guarantee, the earnings wouldn't be taxable while inside a life insurance product, and in many instances, there would be a lump sum balance left for beneficiaries. Unfortunately, when the retiree wanted to access the assets for living expenses, there were and are penalties imposed for early withdrawal or limitation on withdrawal amounts which makes them illiquid. Withdrawal complexities are not in the scope of this article.

TIAA-CREF created the first variable annuity which was offered July 1, 1952. Their experts analyzed common stock performance from 1880 to 1950 and found that only investing in bonds wasn't as prudent as originally thought. Stock performance during that 70 years showed that if there had been a balanced portfolio of stocks AND bonds, the accounts would have performed much better. This balanced portfolio strategy is still in the headlines today as the government tries to come up with a way to save Social Security and it is the strategy of choice for most Financial Planners.

Does the TIAA-CREF plan mean that annuities are always best for retirement Accounts? Not necessarily. Over the last century and particularly in the last 25 years, annuities have evolved into something very different from the investments available in 1918.

Today, virtually every insurance company that offers annuities has a variable investment option which has its own set of guarantees, withdrawal features, and other characteristics which set it apart from every other such annuity. Variable annuities are just what the name implies: their value is variable depending on the performance of the underlying investments. Typically, a well known mutual fund manager or private money manager directs the buying and selling of the portfolio assets. For this service, the managers receive a management fee. This fee usually comes out of the performance of the fund. Then there is the mortality fee which also typically comes out of the performance of the fund. This means that the same portfolio held outside of an annuity would have better performance. Mortality fees pay for guarantees in the contract. Finally there are administrative fees that are typically charged separately and are subtracted from the account value.

There is another argument against using annuities in a retirement account that relates to the tax deferred status of retirement accounts. Annuity assets are tax deferred because they are part of a contract with an insurance company. Why would a person want to have tax deferred investments in a tax deferred account? The only rational reason would be some sort of guarantee. Some experts speculate that broker payout is the reason.

Because annuities pay death benefits to beneficiaries, annuities are often sold as a vehicle to provide for beneficiaries. But isn't a retirement account for the benefit of the retiree? This is another major stumbling block to positioning annuities in retirement accounts. If one is looking to provide for beneficiaries, it is better to do this with after tax money in a life insurance policy.

In the spiraling inflation of the 1980's, many fixed annuities were available. Unlike variable annuities, fixed contracts were offered with a specific rate for a specified time and a minimum rate of return. These were very much a CD alternative for the conservative investor who wanted the guarantee of positive account growth and was willing to leave the money invested for the time it took to get past the early withdrawal penalties. These fixed rate annuities have proven valuable recently due to the low interest rate environment of today and the minimums that are still being paid.

It is a balanced strategy that works best. For the low net worth client, perhaps a part of their retirement account could be invested in the less expensive but guaranteed fixed annuity to give that client the assurance such an investment offers. In this case, the rest of the account earmarked for growth should be invested in low cost mutual funds or individual stocks. For the middle level net worth client, there might be a place for limited exposure to a variable annuity, always keeping a balance with fixed income and liquidity in mind. In this case, the fixed income component would be well served with high quality bonds. The high net worth client shouldn't have more than 20% in annuities of any kind. There are always exceptions that prove the rule, however.

The "irrational exuberance" of the 90's should make everyone stop and think about all of the features of any investment, especially one that is complicated and has the possibility of becoming illiquid. Variable annuities in retirement accounts? There might be a small place for them but only after careful evaluation of the costs, guarantees, and potential for loss of capital at a time when loss cannot be tolerated.

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