advising boomers

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Retro-Chic Annuities

Insurance companies are wondering if Boomers will give new life to these time-honored products.

By SUSAN WEINER

Whether you think Social Security is on the brink of collapse or perfect as is for generations to come, it's clear to everyone that Baby Boomers are going to have to spend more time and energy grappling with retirement planning than the generations that preceded them. This is a group that had the luxury, and responsibility, for taking care of their own sunset years, with a wide range of options: 401(k), IRA, Keoghs, SEPs, SIMPLEs. But

Boomers are also taking a new look at an old retirement favorite: the variable annuity. Often dumped on as too expensive and dismissed as products that are sold, never bought, it is nevertheless hard to dismiss them. They can still solve a lot of retirement problems.

Because of rising life expectancies,Boomers will live longer in retirement than earlier generations, says Bruce Ferris, senior vice president and director of sales and marketing of Hartford Life's investment products division. Already, there's a 50% chance that one member of a couple aged 65 today will live past age 92, he adds. That would mean 27 years in retirement. Boomers may live even longer.

Accordingly, many Boomers will need a steady, ongoing income that won't be exhausted by a long retirement. However, that is easier said than done. While Boomers' parents or grandparents could rely on Social Security and often a traditional defined-benefit pension, Boomers face greater uncertainty.

Debate rages about the long-term viability of Social Security. President Bush has discussed measures such as introducing private accounts, limiting benefits for wealthy retirees, and indexing benefits to prices rather than wages. It isn't clear how many of these proposals, if any, will survive Congressional debate. Social Security will survive in some form, but the Boomers feel uneasy about how much they'll benefit.

Also undermining retirement confidence is the ongoing shift from defined benefit to defined contribution retirement plans. As a result, "people are more responsible for providing their own income in retirement," says Mark Mackey, president and CEO of the National Association for Variable Annuities (www.navanet.org).

In fact, Social Security anxiety may actually be leading to a VA renaissance. The shift to DC plans also means that "Baby Boomers are more likely to use a variable annuity than their parents because they are more familiar with mutual funds and most have 401(k) plans," says Bedda D'Angelo of Fiscal Conditioning in Chapel Hill, N.C. And place the emphasis in VA on variable. Because of Boomers' experience with mutual funds, they are likely to opt for a variable annuity over a fixed annuity, she adds.

Of course, first comes the 401(k) plan. Even the most gung-ho variable annuity fans in the planning community generally advise that clients max out their 401(k) plans before they invest in a variable annuity, although some might buy a VA in a 401(k) for its insurance benefits. They praise VAs' ability to provide tax-deferred accumulation and participation in stock market appreciation while limiting the investor's downside.

Tax-deferred accumulation is a selling point for Boomers who have reached contribution limits for their 401(k), IRA or other qualified plans. For example, "when a client is in a high-income position with his company and cannot 'max out' his 401(k) contribution," says Ronald Oldano, senior financial advisor with American Express Financial Advisors in Tampa, Fla., "an annuity can help close the gap for his retirement savings needs." Brian Jones, vice president, Cooper, Jones & McLeland, Ltd. of Fairfax, Va., notes that the impetus for investing in a VA might come from a large cash inflow, such as from selling a business or cashing in stock options.

EQUITY-INDEXED annuities offer the ability to participate in a percentage of stock market gains, while limiting the investor's downside by promising that investors won't lose their principal. Plenty of investors were scared by the bear market of 2001 to 2003. "The guarantee helps them set aside their fears and invest in equities," says Hartford Life's Ferris.

Diversifying one's portfolio to include equities, rather than focusing only on less-volatile investments, is important. "The additional equity exposure is necessary for many Boomers who will be playing catch-up for the rest of their lives due to a lack of sufficient savings," says Loyd Stegent, director of financial planning at Cornelius, Stegent & Price, LLP in Houston, Texas.

NAVA's Mackey says that equity-indexed annuities proved their usefulness during the period 2001-

2003, when stock prices were depressed. During that period, variable annuity beneficiaries received payments totaling over $3 billion more than the value of those contracts at the time of death, according to Mackey."If not for the death benefit, people's families would have lost a lot of money," he says.

VAs appeal to another Boomer anxiety: People are increasingly concerned about outliving their assets, says Ferris. An adviser may be able to structure a portfolio without annuities that offers very little risk of outliving assets. However, there's no denying the psychological value of an annuity. For the nervous, the option to annuitize their variable annuity benefit can be valuable, though currently "only 2% of variable annuity holders take advantage of that option." They might also choose immediate annuities, which could be either variable annuities without the tax-deferred accumulation phase or fixed annuities. "Individuals are looking for packaged products that offer a safety net," says Shawn Jacobson, public relations director of the Financial Planning Association of Minnesota. Moreover, "Folks that want to make sure they will never outlive their income stream should at least consider an annuity," he adds.

Indeed, one of the few situations in which Bob Frey of Professional Financial Management in Bozeman,Mont.,may recommend VAs is for "the retiree that is taking more than prudent from a retirement portfolio and is exposed to longevity risk."

However, financial planners, especially fee-only financial planners, find plenty to dislike about VAs. "The only reason to invest in a variable annuity is if you have a brother in the business and you want to give him the highest possible commission," says Frank Armstrong, president of Investor Solutions in Coconut Grove, Fla., though an article on his website does identify some narrowly defined situations in which he might use VAs.

"They are appropriate for almost nobody-because they are tax inefficient, difficult if not impossible to understand, have high costs and surrender charges which limit flexibility and provide poor liquidity, and have limited investment choices," says Warren McIntyre of VisionQuest Financial Planning in Troy,Mich.

He's not alone. High commissions, surrender fees and expenses are sticking points for many financial planners. Not only are expenses high, says Fiscal Conditioning's D'Angelo, but it's difficult to pin down exactly what they are. Planners dislike this lack of transparency, she adds.

But Mackey defends them, saying, "Commissions are a little higher because annuities are a very complex product." He reckons that the average VA commission runs around 6% vs. 4%-4.5% for mutual funds. For those who don't want advice, he notes, no-load VAs are an option. Indeed, no-load VAs from providers such as Vanguard are more favorably mentioned by financial planners." Shop around and you can find low priced VAs," says Jones of Cooper, Jones & McLeland.

On the expense front, an article in NAVA Outlook (May/June 2004) states that the average cost differential between mutual funds and VAs is just 0.863% and implies that is justified as "an additional charge for the valuable insurance features of a variable annuity." Counters Frey, "Most commission-based VAs are far higher, in the vicinity of 1.25-1.5%, a true consumer rip-off."

Advisors also cautioned that the upside to equity-indexed annuities is too limited. "You give up much of the potential upside because there are various mechanisms to cap what you earn, such as the participation rate whereby the contract holder only participates in a percentage of the growth in the index," says VisionQuest's McIntyre.

Some planners suggest strategies that mimic some-though not all- of equity-indexed annuity's advantages. Frey recommends tax-managed mutual funds once an investor has maxed out qualified plan contributions. "They offer the same tax deferral on the subsequent gains as a VA, no extra fees, far more favorable capital gains treatment on the ultimate gains, far more flexibility on withdrawals, and a step-up at death." Wall Street

Journal columnist Jonathan Clements recommends a combination of 10-year zero coupon Treasuries with call options on the S&P 500 or with a lowcost S&P 500 index fund.

Still, some financial planners agree that VA advantages justify the high expenses, especially for clients who suffered through the large-cap market decline. Again, the advantage may be psychological rather than economic.

"They were willing to accept a degree of uncertainty with the stock market while they were working, but do not want this uncertainty in retirement," says Jones of Cooper, Jones & McLeland, Ltd. of Fairfax, Va. Therefore, they are willing to accept a lower rate of return and higher fees in return for less investment anxiety and heartache." The added expense of a VA is worth it for their peace of mind. As for the issue of surrender fees, Mackey points out that some mutual funds charge contingent deferred sales charges and that savers will forfeit some interest if they cash a bank CD before its full term has run. For his part, Jones uses only VAs with no surrender fees. Jacobson says VAs should be sold only to investors who don't expect to tap their funds for at least seven to 10 years. That makes surrender fees a non-issue.

VAs are also criticized because they offer no step-up in cost basis at death, their gains are taxed as ordinary income rather than at the capital gains rate, and their insurance features may be superfluous for well-to-do retirees.

Part of the solution may be to use VAs in a way that offsets these disadvantages. "Annuities are generally an inefficient vehicle to pass wealth because they do not receive a step-up in basis like stocks, bonds and real estate," says Jacobson, a user of VAs. But that's not a concern for those who plan to annuitize and draw down the value of their VA during their lifetime.

TO MINIMIZE THE impact of gains taxed at ordinary- rather than capital gains-rates, Stegent allocates the bond and REIT portions of his client portfolios to the VA, keeping the equity portion in a taxable account. Similarly, since there's no step-up in cost basis, he allocates lowrisk, low-return assets to the VA and recommends that clients withdraw from their VA before their IRA.

The oldest Baby Boomers are just shy of 60, a fact that sales and marketing executives at insurance companies have noticed. And many feel optimistic about the future of VAs. "Our average issue age is 62.We haven't come into the sweet spot yet," said Ferris.

But others are skeptical that VAs will boom soon. Net sales of VAs peaked in 1997 says Lisa Plotnick, director of variable annuity research at Financial Research Corp. in Boston. Since then close to two-thirds of VA sales are coming from VA customers trading in their original VAs for replacements. Still, she notes, older Boomers are more likely than their younger Boomer colleagues to have a DB plan to ease their retirement income crunch. It may be today's 40-somethings who became nostalgic for the promised security of annuities, never mind the cost.

Susan Weiner, CFA, is a freelance writer in Newton, Mass., who specializes in investmentrelated topics.

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