What to Know About Variable Annuities

**WHAT IS A VARIABLE ANNUITY?**
Contracts with insurance companies through which the public invests in portfolios of securities on a tax deferred basis.

**HOW DO VARIABLE ANNUITIES WORK?**
Two phase investment product:

- **Pay-In Phase:** Investors pay premiums which are invested into different portfolios of stocks and bonds.
- **Pay-Out Phase:** At retirement, investors can elect to receive a lump sum or a fixed stream of lifetime payments.

**HOW IS MY FINANCIAL ADVISOR COMPENSATED?**
Financial advisors earn commissions of 6-12%. Compare to mutual funds which pay commissions of 1-3%.

- Insurance companies advance commissions to the financial advisor and recoup commissions through HIGH ANNUAL FEES and early SURRENDER CHARGES.
  - Annual fees equal 2.2 - 2.5% a year. Compare to mutual funds which charge 0.1 - 0.9% a year.
  - Severe early surrender charges are charged until the commission is fully recouped.

**HOW WILL MY FINANCIAL ADVISOR TRY TO SELL ME A VARIABLE ANNUITY?**
Financial advisors will justify high costs by emphasizing three selling points:

- **Tax Deferral:** Investment returns accumulate tax free and are not taxed until withdrawn. Investors should also consider:
  - Tax deferral can be obtained more cheaply through IRA’s or 401k’s.
  - Most investors will not hold a variable annuity long enough to benefit meaningfully from tax deferral.
  - Variable annuities are taxed at the higher ordinary income rate rather than at the lower capital gains or dividend rate.
  - Withdrawals before age 59 are subject to a 10% IRS penalty.
  - An investor’s heirs will not receive a stepped-up tax basis and will be taxed at a higher rate compared to other forms of inheritance.
• Guaranteed Minimum Death Benefit: Ensures that an investor’s heir receives the SHORTFALL between the value of variable annuity and the premiums paid.
  – The GMDB is NOT LIFE INSURANCE and is nearly worthless to the investor.
  – Portfolio diversification and extended holding periods make it highly unlikely that a shortfall will occur.

• Right to Annuitize: Investors can elect to receive a fixed stream of lifelong payments. However, only 2% are annuitized because:
  – Financial advisors persuade investors to switch into another variable annuity, triggering a new set of commissions.
  – Fixed payments are set at below market rates.