TRENT CAPITAL MANAGEMENT, INC.

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The High Cost Of Security

In nervous times, variable annuities with income guarantees make for catchy sales pitches—but mediocre investments.

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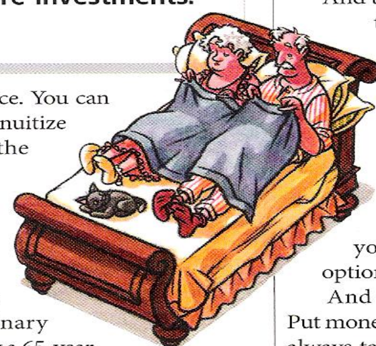
LOOKING FOR GUARANTEED RETIREMENT income? The insurance industry has a product for you. Like robins after the rain, annuity underwriters come out in force after a market spill. Flavor of the moment: annuities that can grow (somewhat) in the next bull market yet have the protection of a minimum payout. Vendors include MassMutual, MetLife, ING and Axa Equitable.

The guaranteed-minimum-income benefit is an add-on to a variable annuity, which itself is a bundle of mutual funds with a bit of life insurance wrapped around it. The purpose of the insurance is to confer tax deferral on the funds, which it does by virtue of an ancient (if hard to justify) rule that earnings inside the policy aren't taxed until they come out. To turn mutual funds into a tax-deferred annuity, the insurer adds a "death benefit" that lets your heirs get out at least what you put in.

Example: You invest $100,000 in an annuity, hoping it will grow to $200,000 before you retire. Alas, a market crash takes your account to $91,000, and the next day you get run over by a train. Your heirs get $100,000, the extra $9,000 being life insurance of a sort.

The new twist is being pitched as helping you, not your heirs. The guaranteed-minimum-income benefit promises to base variable annuity payouts on the assumption that accounts grow 5% to 6% a year, compounded, even if the underlying investments fare far worse.

Say you put $100,000 into the annuity at age 50 and invest in a mix of stocks and bonds. Whatever happens to that portfolio, you have an imaginary account growing 6% a year to $226,090 at age 65. At that point you have a choice. You can withdraw or annuitize the money in the portfolio, or you can turn the imaginary account into a lifetime annuity. At MassMutual the imaginary account will buy a 65-year-old male a payout of $11,910 a year for life.



"The latest generation of variable annuities with [guaranteed income] riders can guarantee everybody actuarially and legally that they will never run out of income before they run out of breath," gushes Joseph E. Godfrey III, a managing director at Cowan Financial Group, which sells MassMutual products.

Sounds pretty good. You get a shot at the terrific returns that stocks might deliver over the next 15 years, while resting comfortably on a 6% minimum return—which happens to be a whole lot more than you can earn these days on 15-year Treasurys.

It will not surprise you that there are several gotchas built into this product. The biggest is that MassMutual's lifetime annuity payout of $11,910 represents a meager 5.3% annual return. That includes both principal and interest and assumes a life expectancy of 20 years. If a 65-year-old male takes $226,090 to Vanguard he can do better—$20,044 a year for life.

There's a more subtle actuarial effect at work as well. A 50-year-old who buys mutual funds now with the intention of buying a lifetime annuity in 2023 gets to look at the hole card that life deals him before placing his bets. If he gets cancer at 64, he doesn't buy the annuity; he just lives off the funds for a while and leaves what's left to his grandchildren. The buyer of the guaranteed-minimum annuity does not have that option—at least not with the $226,090 in the imaginary account. If he declines the $11,910 annual payout in favor of a lump sum, the sum he gets is what his portfolio has in fact earned.

And that brings us to the other catch in the insurance product. The portfolio must be (at MassMutual) partly invested in bonds, and it is subject to annual fees in the vicinity of 2.7%. Those fees cover fund management, overhead and the actuarial cost of the death benefit (the $100,000 minimum if you die young) and the $11,090 annuity option.

And what if you change your mind? Put money into a no-load fund and you can always tap the money. With an insurance policy you're going to get nicked for an early surrender fee in the first seven years.

Jeffrey Voudrie, a fee-only financial adviser at Legacy Planning Group in Johnson City, Tenn., is skeptical of the guaranteed-minimum annuity policies. "The hefty expense for that peace of mind only gives you a false sense of security," he says.

What should you buy instead? A mix of stocks and fixed-income investments, with a hefty dose of the latter (like government-guaranteed bank CDs) if you are a worrier. Wait until you retire, then buy an immediate annuity. You're likely to get the best quote from a vendor of no-load funds like Vanguard, USAA or TIAA-CREF. And if your health is poor, you don't have to buy the annuity at all.

One more thing you should know about annuities is that, despite the allure of deferral, their tax attributes are not great for someone investing in the stock market. They convert long-term capital gains into ordinary income taxed at maximum rates. Outside an insurance policy the gains on your growth stocks will probably be taxed at no more than 20%, even under an Obama Administration. And if you are sitting on tax-loss carryforwards (who isn't?), you won't even pay that 20%. F